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Federal Tax Benefits for Families' K-12 Education Expenses in the Context of School Choice

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Summary

Some believe that comprehensive reform of elementary and secondary (K-12) schools and districts is needed to improve the quality of education being provided to the nation's children. Proponents of reform have called for, among other things, policies to encourage parents to select the public or private schools they deem most appropriate for their children, with federal assistance provided through school vouchers or K-12 education tax subsidies. For some, the authorization of tax benefits for K-12 education expenses beyond those already included in the federal tax code (e.g., Coverdell Education Savings Accounts (ESAs) and the deduction for charitable contributions to scholarship-granting organizations) would be means of expanding school choice while minimizing some of the concerns that have inhibited the expansion of vouchers (e.g., church-state entanglement and regulation of private schools). Some proponents further argue that a new K-12 education tax benefit would be more effective than previously tried school reforms at providing students with better educational opportunities and at reducing existing inequities. Some opponents of expanded K-12 education tax benefits and of unregulated school choice argue that if enacted, such policies might undermine the current state of public education and might exacerbate existing inequities in the quality of education available to children of different segments of society.

The 108th Congress potentially will see bills introduced to provide families with new tax subsidies for the expenses they incur in enrolling their children in private and/or public schools. In the 107th Congress, several proposals were offered to provide additional assistance through the tax code to families who incur K-12 education expenses for their children. Among these, only the expansion of Coverdell ESAs (previously designated Education Individual Retirement Accounts) was enacted into law, allowing distributions to be used for K-12 education expenses. Other proposals would have authorized new tax credits or deductions for K-12 education expenses. Several of these proposals would have made the tax credit refundable, allowing eligible families with school-age children to receive the credit even if it exceeded their regular tax liability — the difference being provided to the family via a tax refund.

A tax credit or deduction available to families incurring K-12 education expenses, or a credit dedicated to funding scholarship-granting organizations, potentially would provide families with an incentive to send their children to private schools, including those who might have done so anyway. To target the tax benefit to families who otherwise likely would not have been able to exercise school choice, some proposals have been designed, either explicitly or implicitly, to establish an income ceiling for claimants. Other proposals are targeted, for example, to families with children assigned to failing public schools. While such bills likely would encourage school choice, as tuition would be one of many qualified education expenses, they also could make K-12 education in general more affordable for families with school-age children (e.g., by broadly defining qualified expenses to include school fees, computer hardware and software, academic tutoring, and educational supplies).

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Federal Tax Benefits for Families' K-12 Education Expenses in the Context of School Choice

The primary benefit afforded by federal, state, and local governments to families with children attending elementary or secondary school is a free education which, with few exceptions in modern times, has been an education provided at a public school. Through the latter half of the 20th century and into the 21st, the quality of the education being provided our nation's children from kindergarten through 12th grade (K-12) has been a high-priority issue of public policy. Much of the policy debate has centered on proposals to remedy some of the many disparities evident across regions and locales and between students of different backgrounds in the resources provided for K-12 education and the resultant outcomes. Some have questioned whether the current system of publicly funded elementary and secondary education is optimal and have called for reforms ranging from policies that seek to equalize available resources across schools and local educational agencies (LEAs); to those that provide additional funding for the education of more costly to educate students; to market-oriented policies that would encourage parents to select the school they deem most appropriate for their children, with funding provided through vouchers or reimbursed through tax subsidies.

At the same time, the Congress increasingly has turned to the tax code to provide subsidies beyond traditional student grants and loans to persons attending public or private postsecondary institutions. And in 2001, after several failed attempts, the 107th Congress extended one of the higher education tax benefits (i.e., Coverdell Education Savings Accounts) to include certain costs families incur when sending their children to private secular and religious as well as public K-12 schools. The 108th Congress likely will consider bills to support school choice through the creation of tax subsidies for families expenses associated with enrolling their children in private or public schools.

This report focuses on proposals that were considered by the 107th Congress to amend the federal tax code to subsidize the expenses of families with children enrolled in the elementary or secondary school of their choice. It begins with a discussion of K-12 education reform efforts to provide a context for the proposed tax subsidies. Next, we review existing federal tax provisions that could help families pay for the cost of their children's K-12 schooling.[1] Then, we analyze proposals

[1] The report excludes the exemption of private schools from taxation and the individual income tax deductions of state/local income and property taxes and of home mortgage interest that subsidize families who choose to reside in desirable school districts or (continued...)

before the 107th Congress that would have expanded existing or authorized new federal tax benefits for families with K-12 education expenses.

Background on K-12 Education Reform Efforts

Over the past several decades, a wide array of elementary and secondary education reform efforts have been proposed, with many of them having been implemented, either nationwide or within selected states. Efforts at reform have included court-ordered school desegregation plans, federally funded education programs aimed at serving disadvantaged children in distressed communities, the restructuring of state education finance systems, and various forms of school choice. Recently, policymakers have focused their attention on a number of school choice proposals as one means of effecting K-12 education reform.[2]

While many school choice reform proposals have garnered broad-based support, and several have been enacted and implemented by various states or the federal government, others have languished amid controversy. Public school choice reforms that have been implemented successfully in a majority of the states include open enrollment policies (either intradistrict or interdistrict), magnet schools, and charter schools. Only a few states have adopted policies supportive of private or comprehensive school choice, such as tuition vouchers and tax subsidies.[3] The federal government supports public school choice through a number of programs authorized under the Elementary and Secondary Education Act (ESEA), as amended by the No Child Left Behind Act (NCLBA, P.L. 107-110). These include components of the Title I-A program, which funds educational services for the disadvantaged; the following Title V programs: Charter Schools, Innovative Programs, Voluntary Public School Choice, and Magnet Schools; and the requirement that states ensure that public school choice is made available to students attending persistently dangerous schools or who have been a victim of a violent crime on school property. The federal government also provides support for families opting to send their children to private schools through its tax treatment of scholarships, among other things, as discussed below.

Attempts to authorize vouchers for private school tuition through federal legislation have faltered, however. During the first session of the 107th Congress, as reauthorization of the ESEA was debated, Members of both the House and the Senate

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[1] (...continued)
attendance areas, which often have higher property values and hence, greater amounts of deductible taxes or home mortgage interest.

[2] For a more in-depth review of school choice issues, see CRS Issue Brief IB98035, *School Choice: Current Legislation*, by David P. Smole.

[3] Currently, publicly funded school choice programs using vouchers operate in Milwaukee, Wisconsin; Cleveland, Ohio; and the state of Florida. (Voucher programs also have operated in the states of Maine and Vermont for many years in areas without public schools.) The states of Arizona, Florida, Illinois, Iowa, Minnesota, and Pennsylvania currently support school choice through some form of tax subsidy to individuals or corporations.

attempted to incorporate the authorization of school vouchers into their respective versions of H.R. 1. While voucher proposals were debated on the floors of the House and Senate, none of the amendments proposed were adopted by either chamber.

When the 107th Congress passed the NCLBA to reauthorize the ESEA, it authorized funding for supplemental educational services.[4] Children from low-income families who attend schools that fail for 3 consecutive years to make adequate yearly progress in student proficiency on state academic assessments must be offered the opportunity to receive supplemental educational services, funded under Title I-A. According to the statute, parents of eligible children may select an approved provider of supplemental educational services. This may be a public, private nonprofit, or for-profit entity. Religiously affiliated organizations may provide supplemental educational services; however, all instruction must be secular, neutral, and nonideological. Approved providers are compensated by the LEA for the services they provide.

Among the issues that make choice-based education reforms controversial are the locus of control over education policy decisions, and the separation of church and state. Many people are suspicious of school choice proposals that would limit LEAs' or state educational agencies' (SEAs') autonomy over education governance issues, such as the establishment of curriculum requirements and criteria for enrollment, including the boundaries of attendance areas; the authorizing or chartering of schools; and the control of locally generated revenue. Others are concerned about the possibility of states and localities either being permitted or required to allow the use of public funds to pay for the cost of a student's attendance at a private for-profit or religiously affiliated school. Still others are concerned about the potential for increased government oversight of private schools and home schools.

While church-state entanglement issues are complex and have comprised much of the debate over public funding of private school choice, the Supreme Court added a degree of clarity to this debate in its ruling on *Zelman v. Simmons-Harris*. In *Zelman*, the court ruled that the Constitution allows publicly funded school vouchers to be used to support the attendance of children at religiously affiliated schools in instances where parents have the opportunity to select from options that also include public and private secular schools.[5] The ruling permits rather than requires public funding of religiously affiliated schools, such as through vouchers. Despite the court's ruling, all but three state constitutions contain either "Blaine Amendments"

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[4] Supplemental educational services are educational activities provided outside of normal school hours that are designed to augment or enhance the educational services provided during regular periods of instruction. For additional information on supplemental educational services, see CRS Report RL31329, *Supplemental Educational Services for Children from Low-income Families*, by David P. Smole.

[5] For more information, see CRS Report RS21254, *Education Vouchers: An Overview of the Supreme Court's Decision in Zelman v. Simmons-Harris*, by Christopher A. Jennings; and CRS Report RL30165, *Education Vouchers: Constitutional Issues and Cases*, by David M. Ackerman.

and/or "compelled support clauses" that generally prohibit the provision of public funds to religiously affiliated institutions, such as schools.[6]

Debate thus remains over the desirability and feasibility of expanding private school choice programs, including those that might involve religiously affiliated schools. Supporters of public funding for religious schools continue to offer arguments that mirror those espoused by proponents of providing public funding to private schools in general. These include the prospect of such schools being more effective than public schools,[7] the idea that competition between public and private schools in attracting students might make both types of schools better, and the idea that parents who send their children to private schools should not have to pay both taxes to support public education and the cost of their own children's private school education. They also note that public funding for religiously affiliated schools has been upheld under the U.S. Constitution. Some opponents still object to allowing public funds to be directed to religiously affiliated schools and are loathe to support such policies. Others who support religiously affiliated schools often object to the prospect of government funding out of concern that too many strings might be attached. For instance, the government might attempt to regulate such things as hiring practices, criteria for enrollment, and curriculum requirements.

Some believe that the authorization of additional tax subsidies for elementary and secondary education expenses would avoid some of the issues that have inhibited the expansion of school vouchers and that the new tax benefits would prove more effective than previously tried school reforms at providing better educational opportunities for the nation's school children. Others oppose further expansion of K-12 education tax subsidies out of concern that they could work against current education reforms.

The 108th Congress likely will consider bills to provide new or expanded tax benefits to assist families with the K-12 education expenses and to support school choice. Such proposals might be patterned after bills introduced in prior Congresses. We now turn to a review of existing tax benefits available to families to meet their K-12 education expenses. This is followed by a review of bills introduced during the 107th Congress that would have created new tax benefits for families incurring K-12 education expenses.

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[6] Komer, Richard and Clint Bolick. *School Choice: The Next Step: The State Constitutional Challenge*. Institute for Justice, July 1, 2002. According to the Institute for Justice, 36 state constitutions contain Blaine Amendments, with most adopted during the latter half of the 19th century. They were designed primarily to prohibit state aid to Catholic schools. Constitutions of 29 states contain compelled support clauses, which forbid the practice common during colonial times of the government collecting money to support churches. State constitutions differ in how strictly they limit public funding of religiously affiliated schools.

[7] According to a research summary by the U.S. Department of Education, National Center for Education Statistics (Private Schools: A Brief Portrait, by Martha Naomi Alt and Katharin Peter in *The Condition of Education 2002*), students attending private schools outperform those attending public schools based on a number of indicators. (Hereafter cited as Alt and Peter, *Private Schools: A Brief Portrait*.)

Federal Tax Benefits that Help Families Pay K-12 Education Expenses

The federal tax code currently has a few provisions that may help families pay for their children's elementary, secondary, or postsecondary school expenses. The following discussion focuses on elements of these tax benefits that apply both to K-12 and postsecondary school attendance or only to K-12 school attendance.

Scholarships and Tuition Reduction

Scholarships. Amounts paid to assist students in the pursuit of their studies are tax free to the students and their families if the awards are used toward tuition and fees required for enrollment in the educational institutions or toward fees, books, supplies, and equipment required for courses at the institutions. Grants that specify their use for other educational expenses (e.g., room and board) or that prohibit their use for tuition or course-related expenses are taxable. Educational institutions at which scholarships are used must maintain a regular teaching staff and curriculum as well as a regularly enrolled student body that attends classes where the school carries out its educational activities.

According to the Thomas B. Fordham Foundation, there were about 100 privately funded scholarship programs that reportedly enabled between 75,000 and 100,000 low-income children to attend private K-12 schools in 2001. Typically, the scholarships go to elementary or secondary school students in families with incomes below specified levels who live in certain geographic areas. The programs generally provide partial tuition assistance. Recipient families often are selected through lotteries or on a first-come, first-served basis.[8]

The Children's Scholarship Fund (CSF) is the largest source of private school scholarships offered on a nationwide basis to low-income families.[9] The 34,000 children who are recipients of CSF scholarships attend approximately 7,000 private schools in 49 states.[10] Families were chosen through a random drawing, and if selected, all their eligible children (i.e., entering kindergarten through eighth grades) were entitled to scholarships at the schools of their choice. In fall 2001, the CSF announced that there would be a second round of 14,000 scholarships available to families in 18 locations. The scholarships could total $80 million, or about one-half the amount awarded in the first round.

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[8] Finn Jr., Chester E., and Kelly Amis. *Making It Count: A Guide to High-Impact Education Philanthropy*. Thomas B. Fordham Foundation, September 2001; and Ladner, Dr. Matthew. Just Doing It 5. *Children First America*, July 21, 2001.

[9] The income criteria are based on the national poverty level and guidelines for the federal school lunch program. For a family of two, for example, the income eligibility criteria was $29,295; for a family of four, $44,415. For more information, see [http://www.scholarshipfund.org/index.asp].

[10] [http://www.scholarshipfund.org/index.asp]

Proponents of school choice sometimes use the terms scholarships and vouchers interchangeably as they both are intended to help families pay for their children's education costs. Others make a distinction between the two based on the funding source, with vouchers financed through government appropriation of funds and scholarships through private resources.

Tuition Reduction. Educational institutions may reduce the tuition of dependent children of current employees or of former employees who retired or left due to disability, and the benefit is not taxable to the child or employee.[11] The tuition reduction can occur at a school other than where the employee works, but the subsidy must be remitted by that school rather than employee's school (e.g., school A provides reduced tuition to the 9 year old son of a secretary employed at school B).

Information on the prevalence of tuition reductions offered by private K-12 schools is very scanty. The U.S. Department of Education, in its Schools and Staffing Survey, collects data on the share of private schools, by affiliation, that allow a reduction in tuition. However, schools could provide discounts for reasons other than a student being a dependent of a school employee (e.g., based on a family's financial need or its enrollment of multiple children at the same institution).

Charitable Contributions

Individual taxpayers who itemize their deductions (i.e., who do not take the standard deduction) may claim a deduction for charitable contributions made to qualified tax-exempt organizations, including a political subdivision of a state (e.g., public schools, which generally are organized into LEAs) and non-profit groups that are religious, charitable, scientific, literary, or educational in purpose. These are commonly known as "Section 501(c)(3) organizations," after their place in the federal tax code, and include organizations that provide scholarships for K-12 education as mentioned above. Donations to nonprofit educational organizations are not deductible if they substitute for tuition or other enrollment fees.

Deductions for charitable contributions cannot exceed 50% of a taxpayer's adjusted gross income (AGI). Excess contributions may be carried forward for 5 years. The total of certain itemized deductions, including the deduction for charitable giving, is limited if the taxpayer's AGI is above a threshold that is adjusted for inflation each year. Consequently, high-income taxpayers may be unable to claim the full amount of their deduction for charitable contributions.

Corporations also may make tax-deductible contributions to qualified organizations. The deduction is limited to 10% of taxable income.[12] Excess contributions may be carried forward for 5 years.

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[11] A dependent child is a son, stepson, daughter, or stepdaughter of an employee or former employee who is claimed as a dependent or whose parents are deceased.

[12] The rule for S-corporations is different since they are not taxable entities.

According to the American Association of Fund Raising Counsel, the largest category to receive charitable donations in 2001 was religion (38.2%).[13] The next largest category lagged far behind: education, 15.0%.[14]

Coverdell Education Savings Accounts (ESAs)

Coverdell ESAs are trusts or custodial accounts that initially were dedicated to paying only the qualified higher education expenses of designated beneficiaries. In the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16), Congress expanded the savings account's purpose to allow distributions to be used for certain expenses incurred after December 31, 2001 in connection with attending public or private elementary and secondary schools (either secular or religiously affiliated). The authorization of Coverdell ESAs to cover K-12 education expenses will lapse after December 31, 2010, unless the Congress extends it.

The Basic Provisions. Anyone below specified income levels may make nondeductible contributions to the ESAs of a beneficiary who is under age 18, provided that total contributions per child do not exceed $2,000 annually.[15] Taxpayers may make deposits to ESAs if their modified AGI is below $110,000 for single filers and below $220,000 for married filers.[16] The annual contribution limit, which is not indexed for inflation, phases out for single filers with incomes of more than $95,000 but less than $110,000; for married filers, with incomes of more than $190,000 but less than $220,000. However, corporations, tax-exempt organizations (e.g., a foundation, charity, or union), or lower income individuals could contribute to accounts of children in families whose incomes fall in the phase-out range. Children's assets (perhaps obtained through gifts) could be deposited in ESAs of which they are the beneficiaries, for example.

Earnings on contributions generally grow on a tax-deferred basis. The deferral confers greater benefits on more affluent families because of their higher marginal tax rates. If, for example, two families pay $2,000 annually into an investment for 15 years that earns 6% per annum, the balance would have increased to $46,552 if

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[13] AAFRC Trust for Philanthropy. *Giving USA 2002*. (Hereafter cited as AAFRC, *Giving USA 2002*.)

[14] The education sector includes all levels of educational institutions; libraries; tutoring programs; scholarship funds; vocational and technical schools; and parent, teacher, student, and alumni associations.

[15] Deposits may be made to the ESAs of special needs beneficiaries regardless of their age. Special needs beneficiaries include persons who, due to physical, mental, or emotional condition including learning disabilities, require a longer period for the completion of their education.

[16] For purposes of determining whether an individual is eligible for the Coverdell ESA and other tax benefits mentioned in this report unless otherwise indicated, modified AGI is the taxpayer's adjusted gross income plus the exclusions for foreign earned income and foreign housing costs and the exclusion of income of residents of Guam, American Samoa, the Northern Mariana Islands, and Puerto Rico.

earnings accumulated tax-free about the time their children begin secondary school.[17] If the families instead had to pay federal income tax on the earnings each year, the family in the 30% federal tax bracket would have amassed $40,648; the family in the 10% federal bracket, $44,479. Thus, the tax deferral in this example is worth considerably more in additional interest to the higher than to the lower income family. (If states follow the federal law, the tax deferral benefit is even greater.)

When funds are disbursed from the accounts, those applied toward qualified expenses are not subject to federal income tax. Earnings withdrawn for other purposes count as taxable income to the beneficiary with some exceptions (see "Tax Consequences of Transferring Funds" below). Nonqualified distributions that exceed qualified expenses also are subject to a 10% penalty unless they are made due to the beneficiary's death or disability or made due to receipt of a nontaxable scholarship or educational allowance.

Qualified elementary, secondary and postsecondary expenses include tuition, fees, books, supplies and equipment. Costs incurred by special needs beneficiaries for special needs services are included as well. Qualified expenses for beneficiaries attending or enrolled in a public K-12 school or private secular or nonsecular K-12 school also include academic tutoring; computer software, hardware, or services such as internet access if used by the beneficiary and the beneficiary's family during the years in which the beneficiary is in school;[18] and room and board, uniforms, transportation, and supplementary items or services (e.g., extended day programs) that are required or provided by the school.

A school is defined as any institution that provides elementary or secondary education as determined by state law. Although expenses associated with homeschooling are not explicitly mentioned, some states consider homeschools to be private schools (e.g., Alabama, California, Delaware, Illinois, Indiana, Kansas, Kentucky, Louisiana, Michigan, Nebraska, North Carolina, Tennessee, and Texas).[19]

Tax Consequences of Transferring Funds. An amount withdrawn from one ESA in a 12-month period and rolled over to another ESA on behalf of the same beneficiary or certain of their family members is not taxable.[20] Rollovers are useful

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[17] The preferential tax treatment accorded ESAs was worth $5,904 in additional interest to the family with a 30% marginal tax rate and $2,073 in additional interest to the family with a 10% marginal tax rate. (The calculation assumes that the entire $2,000 contribution is deposited into the ESA at the end of each year starting in the year the child is born through the year the child reaches age 14.)

[18] Expenses for computer software designed for sports, games, or hobbies are not covered unless it is mainly educational in nature.

[19] Colorado, Florida, Maine, Virginia, West Virginia, and Utah consider groups of homeschools to be private schools but individual homeschools in these states are not deemed private schools, according to the Home School Legal Defense Association.

[20] One rollover is allowed per ESA during the 12-month period ending on the date of the payment or withdrawal. Family members are the original beneficiary's spouse; children, grandchildren, and stepchildren; brothers, sisters, stepbrothers, stepsisters; parents, (continued...)

for a number of other reasons. By making a same-beneficiary rollover, the type of investment can be changed. In addition, amounts transferred between accounts are excluded from the ESA's annual contribution limit. The transfer of account funds to a younger family member extends the period during which deposits can be made and tax-deferred earnings can accumulate. Thus, while the original beneficiary's account balance might be too low to offset much private school tuition, room and board, etc., the transferred funds could immediately bolster the account balance and thereby be of greater use to other family members (e.g., the original beneficiary's younger sibling).

Balances remaining in ESAs when beneficiaries reach age 30 or die, whichever is earlier, generally must be distributed and the earnings included in the beneficiary's or the estate's income.[21] If, however, account balances of beneficiaries under age 30 are rolled into accounts of other family members or if account balances are transferred to other family members upon the original beneficiaries' death, there are no tax consequences.

Rather than transferring funds between ESAs of the same beneficiary or to other family members, the beneficiary of an ESA may be changed. The particular trust or custodial account must permit this action to be taken. As in the case of rollovers, the new beneficiary must be a member of the original beneficiary's family.

Interaction with Qualified Tuition Plans (QTPs). Starting after December 31, 2001, contributions can be made to an ESA and to a QTP on behalf of the same beneficiary. (A QTP allows contributions to grow tax-deferred and funds to be withdrawn tax-free if used to pay qualified higher education expenses.)[22] Thus, funds may now accumulate simultaneously in an ESA and a QTP, with a family perhaps using the former for K-12 expenses and the latter for higher education expenses. If funds from an ESA are used to pay K-12 expenses and the beneficiary goes to college, any balance remaining in the account could be used toward the beneficiary's higher education expenses or transferred to the beneficiary's QTP.

Some have suggested that, rather than drawing upon a college-bound student's ESA to pay K-12 expenses, the account should be allowed to continue to grow. About the time a child starts elementary school, for example, a $2,000 contribution made each year for 6 years to an ESA that earned 6% per year would have grown to just $13,951, with the great majority of the balance accounted for by contributions. The preferential tax treatment accorded ESAs would produce only $210 in additional interest for a family in the 10% tax bracket and only $618 in additional interest for

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[20] (...continued)
stepparents, and grandparents; aunts and uncles; nieces and nephews; sons-in-law, daughters-in-law, fathers-in-law, mothers-in-law, brothers-in-law, and sisters-in-law; spouses of the aforementioned individuals; and first cousins of the original beneficiary.

[21] The age limit does not apply to special needs beneficiaries.

[22] For more information, see CRS Report RL31214, *Saving for College Through Qualified Tuition (Section 529) Programs*, by Linda Levine.

a family in the 30% tax bracket.[23] Thus, the expansion of the tax deferral to saving for K-12 expenses generally and elementary school expenses particularly appears to be of limited immediate value to families.

Observations. Because the preferential tax treatment of ESAs is worth more to higher income families, they may be more likely to establish them than lower income families. Higher income families also may be more likely to set up ESAs because they have a greater propensity to save than lower income families. The $220,000 income ceiling on contributions by joint tax filers suggests that affluent families would not be subsidized; however, as previously noted, others may contribute the full $2,000 annually to the ESAs of dependent children in families whose income is in the phase-out range. In contrast, the tax provision is of no benefit to families with such low incomes that they (a) are unable to save or (b) do not pay tax on savings because their incomes are completely offset by the standard deduction and personal/dependent exemptions. It thus appears that expansion of ESAs to elementary and secondary school expenses will be of more assistance to higher than to lower income families.

Although the tax-deferred savings accounts will enable families to accumulate more money for K-12 education expenses than they otherwise would have, the amount of the tax benefit is probably too small to affect a family's decision about whether to send their children to public or private school. The influence of the ESA on a family's choice of school will be even less significant if the account is drawn upon for elementary school expenses and if less than the maximum is contributed each year. In terms of school choice, then, the main outcome of extending the ESA to pay for K-12 education expenses may be to slightly subsidize higher income families who might have sent their children to private school anyway.

Review of Proposals for K-12 Education Tax Subsidies — 107th Congress

Several tax proposals were offered during the 107th Congress to further help families offset some of the costs associated with enrolling their children in the elementary or secondary school of their choice. Most of the proposals called for a tax credit, which would directly reduce an individual's income tax liability. These, and a bill to provide a tax deduction,[24] are reviewed below.

Many of the proposals were for refundable tax credits. In general, a refundable credit is not limited by the taxpayer's regular tax liability; the taxpayer may receive

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[23] With the tax-free treatment, interest would have grown to $1,951. If a family with a 10% marginal tax rate instead had to pay tax annually on the investment, the interest would have totaled $1,741; a family with a 30% marginal tax rate, $1,333. (The calculation assumes that the entire $2,000 contribution is deposited into the ESA at the end of each year starting in the year the child is born through the year the child reaches age 5.)

[24] As a deduction reduces the amount of income against which tax is imposed, its value (i.e., how much it lowers income tax liability) depends on a taxpayer's marginal tax rate.

the full value of the credit for a given income even if it exceeds his/her liability.[25] For example, if a family had a regular tax liability of $1,000 and a $1,400 refundable credit, the credit would eliminate the liability and the Internal Revenue Service (IRS) would send the taxpayer a check for the remaining $400. In contrast, a nonrefundable credit is limited by the taxpayer's regular tax liability.[26] Thus, if a family had a regular tax liability of $1,000 and a single nonrefundable credit of $1,400, the credit would eliminate the liability but the taxpayer would not receive the outstanding balance. If the taxpayer had several nonrefundable credits, the regular tax liability limitation would apply to all of them taken together.[27]

Proposals to Amend Existing Tax Benefits

Mirroring the Coverdell ESA's legislative history, some of the bills introduced during the 107th Congress would have extended already existing tax benefits to elementary and secondary education expenses. H.R. 5193 would have amended the higher education tax deduction; H.R. 253, the Dependent Care Tax Credit (DCTC); and H.R. 2410, the Hope Scholarship Credit.

Above-the-Line Tax Deduction. Taxpayers currently can take an above-the-line deduction (i.e., a deduction available both to persons who claim the standard deduction and to those who itemize their deductions) for tuition and related higher education expenses. For 2002 and 2003, individuals with modified AGIs of up to $65,000 ($130,000 for joint filers) may deduct a maximum of $3,000 per return in higher education expenses; for 2004 and 2005, the maximum allowable deduction rises to $4,000.[28] Individuals with modified AGIs that exceed $65,000 but are below $80,000 ($130,000 and $160,000, respectively, for joint filers) may deduct up to $2,000 per return for 2004 and 2005. The provision is effective through December 31, 2005.[29]

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[25] Regular tax liability is determined by multiplying taxable income by the appropriate tax rate. Taxable income is derived by subtracting above-the-line deductions (or adjustments) to determine adjusted gross income and then subtracting from adjusted gross income the greater of the standard or itemized deductions and personal/dependency exemptions.

[26] Technically, nonrefundable personal tax credits are limited to the excess of the regular tax liability over the tentative minimum tax. In 2002, the minimum tax limitation would not have applied to married-couple joint filer families with gross incomes under $49,000 or to single-parent families with gross incomes under $35,750.

[27] Unused portions of certain nonrefundable personal credits may be carried forward to subsequent years.

[28] For purposes of the higher education deduction, modified AGI is the taxpayer's adjusted gross income plus the foreign earned income and foreign housing cost exclusion and the exclusion of income of residents of Guam, American Samoa, the Northern Mariana Islands, and Puerto Rico. Taxable social security benefits, the exclusion of interest from savings bonds used to pay qualified higher education expenses, the exclusion for employer-provided adoption assistance, the deductions for retirement savings and for student loan interest payments, and the disallowance of passive activity losses are taken into account in calculating AGI for eligibility purposes.

[29] For more information on the higher education deduction, see CRS Report RL31129,
(continued...)

H.R. 5193, the Back to School Tax Relief Act of 2002 (approved by the Committee on Ways and Means on September 5, 2002), would have added a separate above-the-line deduction for elementary and secondary education expenses to the deduction for higher education expenses without otherwise amending its terms. The bill would have allowed individuals with modified AGIs not exceeding $20,000 ($40,000 if filing jointly) to deduct qualified K-12 expenses of up to $3,000 per return. Qualified expenses were defined the same as those of Coverdell ESAs (see page 7 of this report), except that the K-12 deduction would have excluded room and board and explicitly would have included expenses incurred in connection with enrollment or attendance at a homeschool as determined under state law.

Credits. Families with employment-related expenses incurred for the care of a dependent child under age 13, among others, can now claim the nonrefundable DCTC. Qualifying expenses normally are limited to the earned income of the parent or, in the case of married couples, of the lesser-earning spouse. Covered expenses can include the education costs only for children attending preschool and only if they are incidental to and cannot be separated from the cost of caring. For 2002, the stated maximum DCTC is 30% of qualifying expenses up to $2,400 for one child (i.e., $720) and up to $4,800 for two or more children (i.e., $1,440). The subsidy rate is gradually reduced for taxpayers with AGIs that exceed $10,000 until it reaches 20% for taxpayers with incomes over $28,000. Taxpayers whose entire tax liability is eliminated by their standard deduction and their personal/dependent exemptions do not benefit from the credit. In 2002, a single parent with one child having income up to $12,900 and a married couple with two children having income up to $19,850 would have had no tax liability due to these factors.[30] Beginning in 2003, taxpayers are able to claim a credit equal to 35% of qualifying expenses up to a ceiling of $3,000 for one child (or $1,050) and $6,000 for two or more children (or $2,100). The stated subsidy rate of 35% gradually decreases for taxpayers with AGIs above $15,000 until it reaches 20%.

H.R. 253 would have modified employment-related expenses to include the cost of educational activities provided while children are being cared for, as well as the cost of transporting them to the place where care is provided in certain instances. It would have increased the credit to 40% of up to $3,600 of qualified expenses for taxpayers with one child and $6,000 for taxpayers with two or more children. Also, for taxpayers with AGIs that exceeded $50,000, the rate of the subsidy would have been decreased, down to 10%. Thus, families with incomes of up to $50,000 would

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[29] (...continued)
Higher Education Tax Credits and Deduction: An Overview of the Benefits and Their Relationship to Traditional Student Aid, by Adam Stoll and James B. Stedman. (Hereafter cited as CRS Report RL31129, *Higher Education Tax Credits and Deduction*.)

[30] If the income of a single parent with one child were at least $18,900 but not over $20,000, the largest credit she could claim would be $600 (i.e., $2,400 x 25% subsidy rate). With an income of $18,900, her regular tax liability would be $600 — ($18,900-$12,900) x 10% — which would be completely offset by the credit. With less income, the tax liability would be lower and so would the credit. With income over $20,000, the actual subsidy rate would be less than 25%. The largest credit the family could technically claim is $960 ($4,800 x 20% subsidy rate) if their income were at least $29,400.

have been able to claim a credit of up to $1,440 for the educational expenses of one child and up to $2,400 for two or more children. Families with AGIs of $110,000 or more would have been able to claim a credit of $360 for one child and $600 for two children.[31]

The Hope Scholarship Credit currently applies to the qualified tuition and related higher education expenses of each eligible student in the taxpayer's family.[32] The nonrefundable credit may be claimed for 100% of the first $1,000 of qualified expenses and for 50% of the next $1,000 (indexed for inflation). Eligible students are defined as those enrolled, on at least a half-time basis, in a higher education program leading to a degree, certificate, or credential. Eligible students cannot have completed their first 2 years of undergraduate education, and the credit can only be claimed for the first 2 years of postsecondary school. Eligibility to claim the credit is phased out for individuals with modified AGIs between $40,000 and $50,000 (between $80,000 and $100,000 for joint filers).

H.R. 2410 would have expanded the definition of qualified tuition and related expenses to include elementary and secondary school expenses as defined for Coverdell ESAs (see page 8 of this report). It also would have made explicit that homeschools were to be considered schools for purposes of the credit. Additionally, it would have defined qualified K-12 education expenses to include contributions or gifts to a public or private school, other than a homeschool, that the taxpayer's dependent attends. The bill, however, would have modified neither the definition of eligible student nor the limitations on the credit as described above.

Proposals for New Tax Credits

H.R. 257, the Education Empowerment Tax Credit Act, would have authorized a refundable credit of up to $1,000 for qualified K-12 education expenses for each qualifying child. Allowable expenses would have included tuition and fees, books, academic tutoring, special needs services, computers and computer equipment (including software and services), and educational supplies connected with the enrollment of a qualifying child at a public or private elementary or secondary school (including religiously affiliated schools and homeschools). Fees for nonacademic activities and sports would have been excluded.

H.R. 316, the Children's Education Tax Credit Act, would have allowed an individual to claim a refundable credit of up to $1,500 for qualified K-12 education expenses for each qualifying child. Allowable expenses would have included tuition and fees, tutoring, books, supplies, computer equipment (including related software

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[31] The bill also would have expanded the Dependent Care Assistance Program (DCAP) to cover educational expenses of children under age 13. The program currently allows employees to exclude from gross income up to $5,000 annually in employer dependent care assistance (e.g., child care services) when determining their income tax liability. For more information, see CRS Report RL30081, *Child Care Subsidies: Federal Grants and Tax Benefits for Working Families*, by Thomas Gabe, Bob Lyke, and Karen Spar.

[32] For information on the Hope Scholarship Credit, see CRS Report RL31129, *Higher Education Tax Credits and Deduction*.

and services) and other required equipment connected with the enrollment of a qualifying child at a public or private elementary or secondary school (including religiously affiliated schools and homeschools). Expenses for meals and lodging would have been excluded from allowable expenses, as would tuition and fees for homeschooling. The bill would have limited eligibility to individuals with dependent children who received or were eligible to receive free or reduced-price meals under the Richard B. Russell National School Lunch Act or the Child Nutrition Act of 1996.[33]

H.R. 3685, the Education, Achievement, and Opportunity Act, would have authorized a refundable credit of up to $2,500 for qualified elementary school educational expenses, and up to $3,500 for secondary school educational expenses, for each qualifying child attending a public or private school (including religiously affiliated schools and homeschools). Educational expenses would have included tuition and fees; computers, educational software, computer support services, and books required for instruction; academic tutoring; special needs services; transportation fees; and academic testing services. Fees for nonacademic activities and uniforms would not have been treated as allowable expenses. Homeschooling expenses would only have been covered if the qualifying student was administered the academic assessments otherwise required of students attending the nearest public school. The value of the credit would have been phased out for single filers whose modified AGIs exceeded $75,000 ($150,000 in the case of joint filers).

S. 488, the Education Opportunity Tax Credit Act, would have allowed an individual to claim a refundable credit of up to $1,000 per qualifying dependent enrolled full-time in a K-12 school up to a maximum of $2,000. Allowable expenses would have included mentoring and computer technology or equipment, including Internet access and related services. The term school was defined as any public, charter, private, religious, or homeschool that offered an elementary or secondary education as determined by state law.

S. 1414, the Parent and Teacher Achievement Act of 2001, would have authorized a nonrefundable credit of up to $1,000 for qualified K-12 education expenses for each qualifying student. Allowable expenses would have been the same as those for Coverdell ESAs (see page 8 of this report). Qualifying students would have included the taxpayer's dependent children, as well as the descendants of a taxpayer's children (i.e., grandchildren), among others.[34] While the maximum

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[33] Children from families with incomes below 130% of the inflation-indexed federal poverty guidelines are eligible for free lunch subsidies (e.g., for the 2001-2002 school year, $19,019 for a family of three, and $22,945 for a family of four). Children from families with incomes between 130% and 185% of the federal poverty guidelines are eligible for reduced-price lunch subsidies (e.g., between $19,019 and $27,066 for a family of three, and between $22,945 and $32,653 for a family of four). For more information, see CRS Report 98-25, *Child Nutrition Programs: Background and Funding*, by Joe Richardson.

[34] In addition to taxpayers' children, stepchildren, and grandchildren, they would have been able to claim the credit for the following relatives: spouses; brothers, sisters, stepbrothers, and stepsisters; parents, stepparents, and grandparents; aunts and uncles; nieces and (continued...)

allowable credit per qualifying child was $1,000, only $500 would have been allowed for tuition expenses. The credit would not have had a income cap limiting the eligibility to claim it. A separate provision in the bill was designed to assist low-income families send their children to a school of their choice. It will be discussed later in the report.

In its FY2003 budget request, the Administration proposed authorization of a refundable tax credit of 50% of the first $5,000 of qualifying educational expenses (i.e., up to $2,500) per child[35] for certain costs associated with attendance at different schools for children assigned to public schools that fail to make adequate yearly progress (AYP) on state assessments.[36] Allowable expenses associated with students attending a qualifying school appeared to have been the same as for Coverdell ESAs (see page 8 of this report), but would have excluded tuition and fees for attending any public school within the same LEA as a student's assigned local school. A qualifying school would have been any public school (other than the local school), including a public charter school, that made AYP during the prior year, a private (including religiously affiliated) K-12 school, or a homeschool. A qualifying student would have been one who attended, at the close of the prior school year, a public elementary or secondary school identified as failing to make adequate yearly progress for that year according to the terms of the ESEA, as amended by P.L. 107-110. In addition, a student newly assigned to a school identified as failing to make adequate yearly progress for the prior school year would have been considered a qualifying student. Such students generally would have been able to continue as qualifying students from year to year, even if their local school ceased to be identified as failing, until such time as they would be assigned to a different school that had made adequate yearly progress (e.g., being newly assigned to a successful high school).

Analysis of Proposals for K-12 Education Tax Subsidies as They Relate to School Choice — 107th Congress

Those who would use the federal tax code to give more families the opportunity to exercise school choice face several interrelated issues. First, they might want to design the tax benefit to enable families who would not otherwise have done so to send their children to public school alternatives. As previously noted, a concern about the education savings approach embodied in the Coverdell ESA is that families with limited resources have to use much of their current earnings for consumption

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[34] (...continued)
nephews; and sons-in-law, daughters-in-law, fathers-in-law, mothers-in-law, brothers-in-law, and sisters-in-law.

[35] A qualifying child would have been defined as a taxpayer's son, daughter, stepson, stepdaughter, sibling, stepsibling (or descendant of such individuals), or foster child, who shared the same principal residence as the taxpayer for more than half of the tax year.

[36] For additional information on AYP, see CRS Report RL31487, *Education for the Disadvantaged: Overview of ESEA Title I-A Amendments Under the No Child Left Behind Act*, by Wayne Riddle.

rather than putting aside money for their children's future education. Second, the value of the subsidy would need to be large enough to make private schools truly affordable for families on tight budgets but not so large that the provision's cost to taxpayers is prohibitive. And third, the question arises as to whether creating a new tax benefit to encourage school choice activates the same concerns that have hampered other initiatives to authorize a federally funded voucher program.

Equity, Windfalls, and the Affordability of Private Schools

Equity. An above-the-line deduction, such as was proposed in H.R. 5193, could be taken both by persons claiming the standard deduction (who tend to be lower income) and those claiming itemized deductions. However, taxpayers without income tax liabilities could not claim the deduction, and among those taxpayers with liabilities, the deduction's value would differ based on the individual's tax bracket. For example, a single parent with two children having income in 2002 of $15,900 or less could not take an above-the-line deduction for K-12 education expenses because her tax liability would be eliminated by the head-of-household standard deduction ($6,900) and personal/dependent exemptions ($3,000 x 3 = $9,000). Similarly, the tax liability of a married couple with two children having income of $19,850 or less would be fully offset by their standard deduction of $7,850 and personal/dependent exemptions of $12,000. The largest deduction under H.R. 5193 that single-parent families with two children could have taken in 2002 would have been $300 for taxpayers with AGIs from $18,900 up to $20,000, all of whom have a 10% marginal tax rate. Alternatively, the maximum tax savings afforded by H.R. 5193 among married-couple taxpayers with two children would have been $450 for taxpayers with AGIs from $34,900 up to $40,000, all of whom would have had a 15% marginal tax rate.[37]

In contrast, a refundable tax credit would take the incidence of income tax liability out of the equation in determining which families may claim the benefit. All families with qualified K-12 expenses would be entitled to claim the full amount of the credit regardless of how much or how little income tax they owe the government. The government would forgo revenue from families whose tax liabilities equal or exceed qualified elementary or secondary school expenses. It would draw upon the U.S. treasury to pay families the amount by which their eligible education expenses exceeds their income tax liabilities. The refundability feature thus provides low-income families the same opportunity as other families to make use of an elementary and secondary education credit.

A nonrefundable credit, like a deduction, might not be of much help to low-income families because one must have an income tax liability against which to apply eligible expenses. As a nonrefundable credit could enable all taxpayers — regardless of their marginal tax rates — to get the same tax savings from the same amount of qualified expenses, it might be considered more equitable than a deduction. The

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[37] Between 2002 and 2005, when H.R. 5193's K-12 education deduction would expire, the value of the deduction would have decreased for some taxpayers because the personal/dependent exemptions and standard deduction is adjusted for inflation while the maximum of $3,000 in qualified K-12 expenses remains the same.

overall limitation on nonrefundable credits in the tax code could reduce the usefulness of a nonrefundable K-12 education credit for those families with small tax bills and large "competing" credits, however. If the total of such nonrefundable credits as the DCTC and higher education credits meets or exceeds a family's income tax liability, the family would be unable to make use of a K-12 education credit. (An above-the-line K-12 education deduction also could eliminate or reduce tax liability against which to apply existing nonrefundable credits.)

The only bill described previously that would have authorized a new nonrefundable credit for elementary and secondary school expenses also contained a tax provision intended to help low-income families send their children to a school of their choice. S. 1414 would have provided a nonrefundable income tax credit equal to 75% of the charitable contributions made to school tuition organizations (STOs) by individuals (capped at $500 for single filers and $1,000 for joint filers) and corporations (capped at $100,000). These entities, in turn, would have awarded tax-free scholarships to K-12 students eligible for the federal free or reduced-price school lunch program.[38]

Arizona's private school tax credit program often has been referred to in the debate over whether to adopt a K-12 education tax benefit at the national level. Arizona taxpayers are eligible to receive a nonrefundable credit against state income taxes for contributions made to STOs that are operated as Section 501(c)(3) organizations (see page 6 of this report). The STOs, in turn, award scholarships to eligible children to assist them in attending private schools. According to two studies, many STOs in the state appear to focus their scholarship awards on students already enrolled in private schools.[39] This finding has prompted some to suggest that families who may not be in greatest need of government assistance to send their children to private schools are benefitting from the taxpayer-financed tuition grants, and that this could be related to the program's design. Although Arizona's STOs are not required to award scholarships based on financial need, it does appear that

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[38] Among the other bills that would have provided nonrefundable credits to those who make charitable contributions to STOs, the credit contained in H.R. 1681 appears to be the same as in S. 1414. H.R. 1029/S. 462's credit to fund STOs could not exceed $250 in the case of a single filer and $500 in the case of a joint filer. H.R. 370 would have set a higher ceiling, namely, $3,000. H.R. 1029/S. 462 and H.R. 370 would not have limited the family income of K-12 students to whom the STOs could give grants. H.R. 5192 similarly would not have limited the family income of students to whom "education investment organizations" award tax-free scholarships that may be used for the same expenses as Coverdell ESAs. The bill would have given a credit equal to 50% of the charitable contributions made to these organizations or to public, private, and religious schools (capped at $250 for individual filers, $500 for joint filers, and $50,000 for corporate filers). H.R. 5192 also would have modified Coverdell ESAs to explicitly cover homeschool expenses.

[39] Lips, Carrie, and Jennifer Jacoby. *The Arizona Scholarship Tax Credit: Giving Parents Choices, Saving Taxpayers Money*. Cato Institute, Policy Analysis No. 414, September 17, 2001. (Hereafter cited as Lips and Jacoby, *The Arizona Scholarship Tax Credit*.); and Wilson, Glen Y. *The Equity Impact of Arizona's Education Tax Credit Program: A Review of the First Three Years (1998-2000)*. Education Policy Studies Laboratory, Research Report, March 2002.

> [m]ost [Arizona] scholarship organizations use financial need as the primary criterion for allocating scholarships to eligible students. Therefore, most scholarships are given to students currently enrolled in affiliated private schools who are either at risk of having to leave the private school or whose families are making significant sacrifices in order to send them to private school. In this sense, some scholarship organizations serve as a kind of financial aid office for the private schools, assisting students in serious financial need.[40]

And, while taxpayers who claim the credit cannot designate that their contributions to STOs be used for their own dependents, they may recommend that their contribution be designated for another child (e.g., an individual might recommend the child of a neighbor for a scholarship, or grandparents might recommend their grandchild, if not a dependent). According to the Arizona Department of Revenue, STOs can forward a check to a qualifying school "with the stipulation that the funds are to be used only for a specific student."[41] There have been claims that families have attempted to game the system by making contributions on each other's behalf and recommending one another's children for scholarships. However, this practice would appear to be inconsistent with Section 501(c)(3) of the IRC, which precludes qualified organizations from conferring a benefit upon a particular individual.[42]

S. 1414 potentially would have been more targeted toward low-income students attending public schools, if students currently attending public schools are more likely than private school students to be eligible for free or reduced-price school meals.[43] In contrast to the Arizona program, where scholarships are limited to tuition, S. 1414 (and the other bills that would authorize a credit for contributions) would have allowed the tax-exempt scholarships to cover the cost of books, supplies, and other course-related equipment as well as tuition and fees.

Targeting Tax Benefits to Certain Families. Depending upon its design, a K-12 education tax benefit could be made available to all families that incur qualified expenses or primarily to those families who would otherwise have had difficulty sending or keeping their children in the schools of their choice. Some of the proposals would have limited "windfalls" (i.e., subsidizing individuals for actions they would have undertaken anyway) by targeting the tax benefit based on family income directly, on the eligibility of children for a particular government program, or on the enrollment of children in certain public schools.

Uniquely, the Administration would have focused eligibility on families whose children, in the previous year, attended a school that failed to make AYP on state academic assessments and who would be assigned to the same or another failing school for the current academic year. The credit thus would have been available only

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[40] Lips and Jacoby, *The Arizona Scholarship Tax Credit*.

[41] State of Arizona Department of Revenue, Pub. 707, p. 10.

[42] According to federal regulation, an organization is not operated solely for charitable purposes if it benefits private interests such as designated persons or the organization's founder or his/her family members. This is referred to as the "inurement of benefit" test.

[43] The subject of how well eligibility in the school lunch program approximates the low-income student population is addressed on this page in connection with H.R. 316.

to those families whose children were not being afforded a quality public education, as judged according to government standards. Some view this targeting mechanism as a proxy for income based on the assumption that few higher income families will be eligible for the credit because they would be unlikely to have children in public schools that fall below minimally acceptable standards. Others believe, in contrast, that implementation of the recently enacted ESEA accountability requirements will result in large numbers of schools being identified as failing; if true, the Administration's proposal might have had a broader focus than relatively low-income families.

To target the tax benefit on families that would encounter financial difficulties if they were to send their children to private schools, H.R. 316's credit could have been used only by families whose children received or were eligible to receive free or reduced-price school meals. As described in more detail in footnote 33, these are families with incomes below $27,066 for a family of three and below $32,653 for a family of four in the 2001-2002 school year. The U.S. Department of Agriculture (USDA) estimates that some 15.5 million children received free or reduced-price lunches in FY2001. LEAs certify more children as eligible for the program than actually participate, however. The USDA estimates that some 19.7 million children were approved as eligible for free or reduced-price lunches in FY2001.[44] While the larger number could represent the pool of children that would have been eligible for H.R. 316's credit (and S. 1414's scholarship program), the method used to determine eligibility might affect the size of the population. Under current school lunch program rules, families are certified eligible based on their self-declaration of total annual cash income; only a very small sample is chosen for verification. Recent USDA reviews strongly suggest that the number of children certified eligible under the self-declaration approach is substantially higher than estimates of family income derived from the Current Population Survey — 27% higher in 1999.[45] Thus, if eligibility for the credit were determined by comparing the program's family income limits with income reported in tax filings, fewer children than certified by LEAs could be eligible for the credit.

Of the proposals that included an income criterion directly, most had much higher ceilings than under the free and reduced-price school lunch program. The proposal to amend the DCTC (H.R. 253) would have allowed the full credit for families with AGIs of $50,000 or less. The value of the credit would have been reduced, but not eliminated, for higher income families. The proposal to amend the

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[44] An unduplicated count of children eligible for free or reduced-price meals under all the programs covered in the Richard B. Russell National School Lunch Act and the Child Nutrition Act is not available. They cover lunches and breakfasts served in schools and in residential child care institutions through the School Lunch and School Breakfast programs, in addition to meals served in after-school settings as well as in day care centers and family day care homes.

[45] Frost, Alberta. Office of Analysis, Nutrition, and Evaluation, Food and Nutrition Service, U.S. Department of Agriculture. *Free and Reduced Price Certification: An Update*. A presentation delivered at the American School Food Service Association's Legislative Action Conference, March 2002. Available at [http://www.fns.usda.gov/cnd/lunch/F&RP/AFLAC_03-02.pdf].

Hope Scholarship Credit (H.R. 2410) would have allowed families with modified AGIs of $40,000 or less ($80,000 or less when filing jointly) to claim the full credit. The amount of the credit would have decreased until a family's income reached $50,000 ($100,000 when filing jointly), at which point it could no longer be claimed. Under H.R. 3685, the value of the credit would not have been reduced until a family's modified AGI reached $75,000 ($150,000 when filing jointly). Families with incomes of up to $124,000 ($199,000 when filing jointly) would have been able to claim a partial elementary school credit, and those with incomes up to $144,000 ($219,000 when filing jointly) would have been able to claim a partial secondary school credit. The tax deduction proposed in H.R. 5193 would have been available to taxpayers with more moderate incomes, namely, a modified AGI of up to $20,000 ($40,000 for joint filers); there was no proposed phase-out of the benefit over a given income range.

The Affordability of Private Schools. As discussed earlier, allowable expenses for which a K-12 education credit or deduction could be claimed are broadly defined in the 107th Congress proposals to include costs in addition to tuition. If a tax benefit were claimed for the costs of sending a child to a school of choice, however, the greatest expense to a family likely would be tuition. The limited data that are available on private school education expenses suggest that, in many instances, tuition alone would exceed the maximum amounts of the proposed tax deduction and credits, which are between $1,000 and $3,500 per child. Similarly, if the average scholarship of $1,049 that CSF reportedly awarded to students beginning in the 1999-2000 school year can be taken as a guide for grants funded through a newly authorized credit for charitable contributions to STOs, then tuition alone would also exceed the typical amount of a scholarship.[46]

The most recent data from the National Center for Education Statistics (NCES) indicates that in school year 1993-1994, private elementary school tuition ranged between $1,572 and $3,773 for elementary school, and between $3,699 and $10,488 for secondary school, depending on school type. (See **Table 1**.) More recent data reported by the National Catholic Education Association (NCEA) indicates that the average tuition charged by Catholic elementary schools in school year 2001-2002 was $2,178 and that median freshman tuition at secondary schools was $4,289.[47] The National Association of Independent Schools (NAIS) reported that for coeducational schools (excluding 7-day boarding schools), median K-8 tuition exceeded $10,000 and median tuition in 9th and 12th grades was $14,000 for school year 2001-2002.[48]

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[46] Families typically paid another $1,315 resulting in average tuition of $2,364, as reported by Marjorie Coeyman in: Vouchers Stay Visible. *Christian Science Monitor*, September 11, 2001. Note: The average scholarship awarded by STOs in Arizona for the 2000-2001 school year was $856, or about 28% of average private school tuition in the state in that year, according to Lips and Jacoby, *The Arizona Scholarship Tax Credit*.

[47] Catholic school tuition in 2001-2002 taken from the executive summary of the annual statistical report on Catholic elementary and secondary schools, which is available at [http://www.ncea.org/newinfo/catholicschooldata/annualreport.asp]. Note: The data reported as means and medians are not directly comparable.

[48] National Association of Independent Schools. Resources and Statistics, National Tables,

(continued...)

With the addition of other education expenses commonly associated with private school attendance (e.g., uniforms and transportation), even a tax benefit of as high as $3,500 in many instances would fall short of a family's total annual cost. A partial subsidy of K-12 education expenses could, however, be sufficient for families on the margin of private school affordability to decide to transfer their children from public schools or to retain their children in private schools. In addition, some believe that having families pay a portion of private school costs might have the advantageous effect of increasing parents' involvement in their children's education.[49]

The prospect of partial coverage of education costs might not only limit a tax benefit's utility to lower income families, but also likely would affect the type of schools families select. As described above and shown in **Table 1**, religiously affiliated schools generally charge lower tuition than other private schools. Religiously affiliated schools often are able to do so because many of the operating and facilities costs are subsidized by charitable contributions, and because some staff may work for comparatively low wages out of a devotion to serve the faith or may have a portion of their salaries paid by the church rather than by the school. For example, the NCEA report indicated that average parochial school tuition represented only 59.6% of actual per-pupil costs of $3,505 at elementary schools in school year 2001-2002, while median freshmen secondary school tuition represented 78% of per-pupil costs of $5,571. Other private schools also subsidize tuition with funds provided from endowments. Nonetheless, the typically lower tuition of religiously affiliated schools might make them more attractive to families compared to either nonsectarian private schools or out-of-boundary public schools, which also usually charge comparatively high tuition.

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[48] (...continued)
Table 3: Tuition by Student Type, 2001-2002, available at [http://www.nais.org/]. (Hereafter cited as NAIS, *Resources and Statistics*.)

[49] Under the Cleveland Scholarship and Tutoring Program, parents must pay the difference between the scholarship amount and school tuition (which is capped at $2,500). Parents' contributions can be made in cash or in-kind contributions.

Table 1. The Average Cost of Tuition at Private Schools in the 1993-1994 School Year

Category of school	Elementary school	Secondary school
Catholic	$1,572	$3,699
Other religious	$2,213	$4,795
Nonsectarian	$3,773	$10,488

Source: U.S. Department of Education. National Center for Education Statistics. *Schools and Staffing Survey: 1993-94*.

While some of the proposals made during the 107th Congress for tax credits would have called for reimbursing families for their educational expenses on a dollar-for-dollar basis up to a specified limit, others would have called for offsetting a share of expenses incurred. Under the Administration's proposal, for example, a family would have needed to incur $5,000 in expenses in order to claim the maximum amount of $2,500 per child. Similarly, H.R. 253's expansion of the DCTC would have required a family with income of $50,000 or less pay $3,600 in expenses in order to later claim the maximum credit of $1,440 per child. Given the requirement that families absorb a large share of education costs, proposals of this design likely would benefit families with higher incomes who have a greater ability to make substantial up front expenditures more so than lower income families.

The Cost to the Federal Government

The Administration's proposal and H.R. 5193 are the only proposals for K-12 education tax benefits for which budget effects have thus far been developed. For qualified expenses incurred beginning with the 2002-2003 school year and extending through the 2006-2007 school year, the Joint Committee on Taxation (JCT) estimated that the President's proposal would have cost $295 million through FY2007 in the form of revenue forgone and refunds.[50] In contrast, the Treasury Department estimated that the credit could have receipt and outlay effects of $3.5 billion over the same period.[51] The marked difference in these estimates principally is due to their different assumptions about the credit's take-up rate (i.e., the proportion of families with eligible students that will claim the credit). About 95 cents of every dollar the Treasury Department estimated the credit would have cost the government was expected to be in refunds to families with little or no income tax liability, which reflects the expectation that a substantial share of low-income families will be financially able to pay up to $5,000 in qualified expenses in order to later get back up to $2,500. The JCT appeared less persuaded that very many families with children in failing schools possess the financial resources that would

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[50] Joint Committee on Taxation. *Estimated Budget Effects of the Revenue Provisions in the President's Fiscal Year 2003 Budget Proposal*. JCX-17-02. March 15, 2002.

[51] Department of the Treasury. *General Explanations of the Administration's Fiscal Year 2003 Revenue Proposals*.

have enabled them to incur educational expenses for which they would only be partially reimbursed sometime later. At least in part because of this design feature, the JCT expected far fewer families would have utilized the Administration's proposed K-12 education credit.

The other proposals would not have conditioned eligibility for a K-12 education deduction or credit on the school that a child initially attended. That is to say, families with children in public and private schools (including, in some cases, homeschools) also could have been eligible for a tax benefit if they purchased computers or employed the services of academic tutors, among other things. The sheer number of eligible families could have resulted in a much larger tax expenditure on the part of the government: about 26.5 million taxable individual returns were filed for 1999 with exemptions for children living at home and AGIs of under $200,000 (about the highest income level for eligible families in the aforementioned bills).[52] The large eligible population (e.g., about 7.4 million taxable individual returns have exemptions for children living at home and AGIs of under $40,000), in combination with a fairly high take-up rate and the broad definition of qualified expenses contained in H.R. 5193, could well have contributed to the JCT's revenue estimate for the bill of $4.9 billion from FY2003 through FY2007 for expenses incurred beginning on January 1, 2003 and extending through December 31, 2005.[53]

The bills that would not have conditioned eligibility for a K-12 education benefit on the type of K-12 school attended could nonetheless have encouraged school choice because their definitions of qualified expenses included tuition. The bills' very broad definitions also could have made a K-12 education more affordable for families with children between about 5 and 18 years old. In addition, they could have promoted greater educational equity among those families whose children are enrolled in public schools. For example, as a result of the credit or deduction, more low-income families of public school students might have been able to afford a computer for their children to use at home. However, the availability of a tax credit or deduction with many types of qualified expenses beyond tuition might have prompted some higher income families to buy a faster computer with more memory, a larger monitor, and better speakers than their children actually need for educational purposes. This unintended behavior, and the heightened cost to government that would accompany it, could have been greater in the case of a credit or deduction than in the case of the Coverdell ESA, where people are largely spending the money they contributed to the savings vehicle.

A new elementary and secondary education tax benefit could well have imposed costs that extended beyond the federal budget. It might have placed an added burden

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[52] File 99IN23AR.XLS available by searching [http://www.irs.gov]. Note: These IRS data overstate the number of eligible families because they include, in addition to families with children attending K-12 schools or being homeschooled, children who had not yet entered kindergarten as well as children who no longer attended K-12 school and were living at home (e.g., while attending postsecondary school and/or while working).

[53] Joint Committee on Taxation. *Estimated Revenue Effects of H.R. 5193, the "Back To School Tax Relief Act of 2002."* JCX-80-02. July 24, 2002.

on the IRS, including the drafting of new or amended tax forms and the issuance of regulations. The design in some bills could have been more onerous than others if administered properly. For example, the Administration's proposal would have limited use of the credit to students in failing schools. Presumably, the IRS would have had to verify that schools fit the definition to ensure that only legitimate claims were paid. Similarly, H.R. 316 and S. 1414 would have targeted students eligible for free and reduced-price school meals. Here, the IRS might have had to determine for itself from the income figures on families' tax returns whether their children were eligible for the program or required that LEAs provide families with documentation of their children's eligibility for inclusion with their tax forms. (Not all LEAs currently provide documentation.)

A K-12 education credit or deduction also could impose costs on eligible families. To the extent the above-described proposals defined terms differently from their current definition in the Internal Revenue Code, it could have caused confusion among tax filers. Overlapping definitions of qualified expenses between the Coverdell ESA and a new K-12 education tax benefit also could have made it difficult for families to decide when to use funds from their accounts and when to claim a credit. The complexity of tax filing could increase, as well, due to the typical requirement that the use of tax subsidies be coordinated.[54] In addition, recordkeeping burdens would increase as taxpayers would have to substantiate qualified expenses. Under those bills that covered tutoring, for example, parents who wanted to claim a tax benefit might switch from employing an older full-time student to employing someone more able to provide them with whatever documentation the IRS requires. Depending on the particular bill, families could encounter other costs (e.g., under the President's proposal, parents would need to "monitor new local schools to know whether the qualifying student could attend such school as a result of passing into a higher grade").[55]

Thorny Voucher Issues Revisited

A tax benefit for elementary and secondary school expenses is viewed by its proponents as a way to avoid some of the controversies associated with vouchers, including federal funding and regulation of private sectarian and nonsectarian schools. Whether a tax credit has these advantages over a voucher could depend upon whether it is refundable or nonrefundable. From an economic perspective, both a refundable credit and a voucher redistribute public funds — either through tax expenditures or appropriations — to low-income families. Thus, some assert that the federal government could use the issuance of refund checks drawn on revenue collected from all taxpayers as justification for expanding its oversight of elementary and secondary education to private schools. The government might, for example, take steps to ensure that low-income and minority children are afforded adequate access to private schools. It also might impose on private schools accountability

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[54] For example, the Administration's K-12 education credit could not be claimed for the same expenses paid with distributions from an ESA and H.R. 316 would require that qualified expenses be reduced by the amount of any tax-free scholarships.

[55] Joint Committee on Taxation. *Description of Revenue Provisions Contained in the President's Fiscal Year 2003 Budget Proposal*. JCS-3-02. March 18, 2002. p. 35.

requirements similar to those recently required of all public schools under the ESEA and of private school students served under Title I-A.

Proponents of a nonrefundable K-12 education tax credit argue that it should be regarded as taxpayers retaining their own money. Because no claim is made "on someone else's wallet," it allegedly would not provide the government an opportunity for further regulation of elementary and secondary education.[56] A similar logic often is applied to nonrefundable credits and church-state separation: because a nonrefundable credit allows taxpayers to keep some of their own income, the money does not enter the public coffer, and thus, does not reflect government support of religion.[57] Others do not support this interpretation of tax expenditures.

The Impact on Public and Private K-12 Education

Some contend that authorization of a K-12 education tax benefit would foster competition among schools to attract student and their families, leading to improved school quality for private and public schools alike and greater equity in access to private schools for students of different socioeconomic backgrounds. However, not everyone shares the notion that competition would positively affect overall school quality. Some also are concerned that a K-12 education tax benefit, especially one that would not cover the full cost of tuition and expenses, might keep private schools beyond the reach of lower income students.

Market-Oriented Competition. It is argued that providing families with a tax benefit that allows them to enroll their children in the school of their choice will stimulate competition among public and private schools that will lead to improvement in overall quality.[58] For example, schools that prove attractive to parents because they offer a higher quality education per dollar of spending would be expected to draw students away from less productive schools. As a result, either lower achieving schools would close their doors, replaced by the more efficient schools, or they would succeed by increasing their productivity and maintaining their student bodies. Either way, the reasoning goes, school choice could improve the quality of K-12 education for all students whether enrolled in public or private schools.[59]

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[56] Reed, Lawrence W. *A New Direction for Education Reform. Mackinac Center for Public Policy*. 2001. Available at [http://www.mackinac.org/].

[57] *Educational Tax Credits: Issues and Arguments*. Available at [http://SchoolChoices.org/roo/taxcredits.htm].

[58] For a review of a range of studies investigating the effects of competition between schools on educational outcomes, see: Belfield, Clive R., and Henry M. Levin. *The Effects of Competition on Educational Outcomes: A Review of US Evidence*. National Center for the Study of Privatization in Education, March 2002, available at [http://www.ncspe.org]. The authors find that the research in this field points to a consistent link between competition and positive educational outcomes. They note, however, that the effects of competition are modest and that between one-third and two-thirds of the studies reviewed lacked statistical significance.

[59] Hoxby, Caroline M. *School Choice and School Productivity (or Could School Choice be*

(continued...)

To a degree, competition and choice already exist in the elementary and secondary education marketplace. Some metropolitan areas are served by multiple school districts, and private schools exist along side regular public schools. Wealthier families and those who place a premium on education thus can determine which are the best schools for their children and send them there, either by residing in the attendance area of the selected public school or by paying tuition to enroll their children in a private school. Those with fewer financial resources are less likely to be able to locate in a district with high-quality public schools or to send their children to alternatives to regular public schools. Some proponents of market-based reforms believe that providing a new tax benefit for educational expenses will create a more level playing field among families.

Others dispute the idea that market competition would lead to more equitable K-12 education markets.[60] Some assert that a tax credit or deduction that is not well-targeted, for instance on low-income families, could induce additional middle and upper income families to enroll their children in private schools; this, in turn, could shut out lower income students' access to the available spaces (especially if the tax benefit does not cover educational expenses in full). Children from low-income families thus would be relegated to public schools or the least desirable private schools, unaccompanied by middle and higher income classmates. With relatively more children from middle and upper income families attending non-public schools, those who hold this viewpoint argue, support for the funding of public schools could waver and the quality of public education could deteriorate (especially in areas with a high proportion of low-income children). While critics of a new tax benefit thus believe it would exacerbate rather than ameliorate inequities in the quality of education available to children of different segments of society, others suggest that education markets operating under a voucher program could lead to decreased residential segregation, and ultimately, to increased equity.[61]

Not only do students compete for schools, but schools also compete for students. At present, nonpublic schools may selectively admit students, giving preference, for example, to those who score well on admissions exams, whose siblings currently are enrolled in the schools, or who are members of a particular religious denomination. Many private schools do not offer costly programs that serve special needs students, nor are they required to. Private schools also can dismiss students for unruly behavior more easily than can public schools. Different types of schools vary in their admissions policies. Member schools of the NAIS, for example, currently accept

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[59] (...continued)
a Tide that Lifts All Boats?). National Bureau of Economic Research Working Paper 8873. April 2002.

[60] For an analysis of market competition based on school vouchers, see: Whitte, John F. *The Market Approach to Education: An Analysis of America's First Voucher Program*. Princeton, NJ, Princeton University Press. 2000.

[61] Nechyba, Thomas J. *Public School Finance in a General Equilibrium Tiebout World: Equalization Programs, Peer Effects and Private School Vouchers*. National Bureau of Economic Research Working Paper 5642. June 1996.

approximately 46.5% of all applicants.[62] Conversely, nearly all Catholic schools are open admissions, though many are oversubscribed. A small number of public schools admit students on a competitive basis.

The increased competition that a new tax benefit could foster might, according to some observers, lead to sorting among schools based on the characteristics of the students they serve. If it were more efficient for schools to tailor their academic programs to a fairly homogeneous student body (e.g., with like abilities or interests), they might limit the programs offered, with different schools targeting different students. For example, some schools might offer International Baccalaureate and Advanced Placement Programs, while others might focus on basic skills or vocational programs. Private schools might opt to admit the easiest to educate students (i.e., skim) and defer to public schools the obligation to serve those who are more costly or difficult to educate (e.g., disadvantaged students, students with disabilities, and students with behavioral problems). Others suggest, however, that private schools would accept diverse student bodies out of service to the community.

Some of these potential market effects likely would vary according to the characteristics of the new K-12 education tax benefit. For example, if a credit or deduction were large enough to cover nearly all the costs of attending a private school and if eligibility were limited to low-income students, certain effects described above might be less acute (e.g., pricing out of the market those with the least ability to pay). The impact of competition could be further mollified by limiting eligible schools to those that do not discriminate among students in admissions and by requiring that students be admitted on the basis of a lottery when schools are oversubscribed. While the imposition of additional statutory limitations on the eligibility of families might buffer some of the potential negative consequences of market competition, it also might impede some of its anticipated benefits.[63]

Supply and Demand Effects. As noted earlier, a new K-12 education tax benefit would allow families to apply a portion of their income toward educational expenses that they otherwise would have applied toward taxes. Consequently, the demand for private school education could increase in the short-run and produce an increase in the supply of private school education in the long-run. Private schools could accommodate the immediate demand shock fairly easily in areas with excess capacity, as happened with the voucher programs in Cleveland and Milwaukee. In those areas in which the initial spike in demand surpasses the currently available supply, families potentially could face waiting lists.

Sustained demand for private school education eventually could be expected to lead to the opening of more private schools.[64] Tuition in new private schools might

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[62] NAIS, Resources and Statistics, Table 25: Admissions Ratios & Percentages, 2000-2001.

[63] See, for example: Murnane, Richard J. The Uncertain Consequences of Tuition Tax Credits: An Analysis of Student Achievement and Economic Incentives (p. 210-222) in James, Thomas and Henry M. Levin (eds). *Public Dollars for Private Schools: The Case of Tuition Tax Credits*. Philadelphia, PA, Temple University Press. 1983.

[64] Based on limited evidence, the supply of private schooling may not be very responsive (continued...)

be somewhat higher than currently charged because, as previously noted, many private schools use charitable contributions and endowments to set tuition substantially below the cost of the education they provide.[65] If more private schools opened, however, they could dilute these funds and consequently raise tuition to some degree.

[64] (...continued)
to changes in demand. For more information see: Belfield, Clive R. *Tuition Tax Credits: What Do We Know So Far?*, National Center for the Study of Privatization in Education. September 2001.

[65] See discussion on page 21 of this report.