PRIVATE SCHOOLS AND THE PUBLIC GOOD

Policy Alternatives for the Eighties

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10. Credits v. Subsidies: Comment on the California Tuition Tax Credit Proposal

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The National Taxpayers Union has recently sponsored an unusual educational tax limitation scheme. The proposal was circulated unsuccessfully for signatures in the form of a constitutional initiative. The California state income tax was its principal target. The proposed reform would have reduced the tax liability of corporations and individuals by awarding a tax credit for specified expenditures for elementary, secondary and higher education. Under the NTU proposal the taxpayer would qualify for the proposed credit by paying the tuition and/or "incidental expenses" of a person attending a private school or the "incidental expenses" of a person attending a public school. The individual or corporation could claim tax credit for as many--and whichever--students he or it chose. The total credit gained by all contributing taxpayers for any one pupil could not exceed $1200. Corporations could use the credit to eliminate up to half of their income tax liability to the state. Individuals could use the credit to eliminate their entire income tax liability to the state.

The Taxpayers' device has a number of unique features which are interesting for their own sake. Moreover, it provides a useful window on the relative advantages of tuition tax credits and direct educational subsidies to families, sometimes called vouchers or scholarships. Plans of the latter sort would provide families not liking their assigned public school a voucher or scholarship to be used to pay for educational costs at qualifying elementary or secondary schools of their choice both public and private. Both voucher and tax credit advocates have captured public attention of late with their talk about choice and competition. But as we will see, the intended beneficiaries of the plans differ significantly. We are unenthusiastic about the educational tax credit plans we have seen proposed--and we are especially cool to the NTU scheme. In this essay we explain why.

TAX CREDITS PROVIDE SMALLER BENEFITS TO FAMILIES THAN DO VOUCHERS.

Consider first a voucher plan that would make available to par-

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ticipating families a scholarship worth, on average, about 90 percent of what is spent on children in public schools. Such a plan has been proposed for California. In California in 1980 the average scholarship would be worth more than $2000. Now compare tax credits. In practice, such proposals presuppose far lower benefits. Recent federal proposals by Senators Moynihan and Packwood envisioned tax credits worth less than $500 per child. Plans enacted in a few states and struck down by the courts (a matter to which we will return) have provided benefits of under $200 per child. Even the NTU proposal under consideration here, while seeming to call for a substantially larger benefit--superficially, up to $1200 per child--is on its face, considerably less valuable to families than the proposed scholarship would be.

Moreover, a state income tax credit plan such as the NTU's inevitably will provide less adequate funding for schools of choice than will the California scholarship. If for no other reason, the entire pool of state personal and corporate income tax is far smaller than the total now spent on public schools; this total is potentially available for scholarship plans, if all families participate and are given scholarships worth something near to current public spending levels.

In addition, even for the rich, the $1200 figure is misleadingly high. Those whose state income taxes are lowered by a credit will have less to deduct for federal income tax purposes. Thus, for those who itemize federal tax deductions, part of the benefit from the state credit must be sent to the federal treasury. Ironically, the tax cutters' proposal becomes a form of inverse revenue sharing helping out Uncle Sam.

Consider, for example, a California family with $40,000 of yearly income and two school-age children. Today this fairly well-to-do family pays a maximum state income tax of about $2400; it will probably pay considerably less because of itemized deductions for mortgage interest, property taxes and the like. The NTU initiative would permit such a family, by spending $1200 or more on the education of each child, to wipe out all its state taxes.

However, because of the interrelation of state and federal tax laws noted above, the net cash benefit to the family would not be $2400. The family in our example will probably be in the 35 to 40 percent marginal tax rate bracket for federal tax purposes. On the normal assumption that it itemizes deductions for federal purposes, its real benefit from the NTU plan would be only about $1500, not $2400. The difference, $900, would be redirected from California to the federal Treasury.

A scholarship, by contrast, is worth its full face value to both family and school. Thus, credits generally would have to be larger than subsidies in order to deliver the same dollar benefit. Given the current level and structure of state income tax plans, however, this cannot happen. In short, people pay too little state income tax to produce this effect. This brings us to the next general point.

WHILE SCHOLARSHIPS PROVIDE EQUAL BENEFITS TO ALL, TAX CREDITS ARE HIGHLY REGRESSIVE.

We have shown above that the hypothetical well-to-do California family may benefit as much as $1500 from the NTU tax credit initiative. Now consider the outcome of the credit for other families. One with $20,000 of income in 1980 will owe roughly $440 in state income taxes (and often less if it is a homeowner family which itemizes deductions). This sum minus any increase in federal income taxes caused by the state credit—perhaps $90—represents its maximum savings under the initiative. The effect is that the state would pay only $350 to $440 toward the education of the children in the $20,000 family as compared to $1500 toward the education of the children of the $40,000 family. This is plainly regressive.

The point becomes more vivid as we move down the income scale. Families with income of $10,000 and under would receive virtually no benefit from the NTU initiative. Hence, when others exercise their choice to attend private schools with the financial support of the state, these families will not have that option. Put simply, tax credits provide no increase of choice to any family that pays no state taxes. The only way for credits to begin to be equivalent to vouchers is to make them "refundable"—that is, to subsidize families whose tax liability is too low to need the credit. Politically, this is unlikely. Tax credit plans tend to be promoted by groups whose purpose is to let taxpayers control the use of their own taxes and not to redirect those dollars to empower lower income families. Moreover, even tax credit advocates would agree that making the credit refundable would transmute their idea into a kind of complex voucher plan. In sum, since tax credits principally benefit high income families and very low income families not at all, if the objective is educational opportunity for children and autonomy for families, tax credits are a poor second choice.

THE EXTENSION OF THE TAX CREDIT TO INCLUDE EDUCATIONAL EXPENDITURES MADE BY TAXPAYERS WITHOUT CHILDREN LACKS A RATIONALE AND WILL HAVE NEGATIVE CONSEQUENCES.

Unlike typical tax credit plans, the NTU scheme does not restrict the credit to those spending on their own children. We find this puzzling. What is the point of helping corporations and nonparents avoid state income taxes by spending on the children of strangers? Why is the corporation or individual given power to decide which child and which school is worthy? Do higher income persons and corporate boards of directors have the best judgment about where the children of blue collar workers should study? No one so argues.

If the point of the initiative were to shift authority for assignment away from the public school bureaucracy, that power surely should be given to the family, as it is in any voucher plan. It should not be bestowed upon some person or corporation with little or no relationship to the child. But this is precisely what the tax credit initiative does. One is tempted to infer that the proposal is designed merely to cripple the state income tax, and that schools are incidental to its purpose.

In any event, the children who would actually benefit from stranger-choices would in many cases be children of middle and upper-middle income families. Where these have more than one child and have exhausted their own tax liability, they nevertheless could benefit from someone else's tax credit. It would be quite natural for friends to assist one another; and friends will generally be of the same social class. Corporations will institutionalize this practice by setting up special tuition fringe benefit programs for their executives.

The "stranger" tax credit provision creates yet another perverse incentive, for the opportunity for private bargaining would not be neglected. Jones pays Smith $600 in exchange for Smith's paying $1200 in tuition for Jones' son. Everyone is ahead except the state treasury and public morality. Such fraud could not be policed.

If the argument for giving tax credits to corporations and nonparents is that this would stimulate private donations to educational institutions, it must be remembered that this incentive currently exists in both the state and federal tax codes for those wanting to make an unrestricted gift to a tax exempt school. Thus, today, government already "pays" for half or more of any charitable gift made to a school by most corporations and well-to-do individuals. To be sure, this incentive might be enhanced—indeed made nearly irresistible—by converting today's charitable tax deductions into tax credits. However, we think the tradition of having government reimburse part, but not all, of one's educational gift is a wise one to preserve. Painless charity is meaningless. Moreover, if government attaches extra tax benefits to gifts for education, this will surely divert gifts away from churches, hospitals and other charities. That seems highly undesirable.

Conversely, it is not clear that the tax credit initiative will actually stimulate greater educational giving. This is because, in order to obtain the tax credit, a donor's funds have to be identified with an individual child. This earmarking, while insuring that the proposed credit is obtained, will probably destroy the charitable tax deductibility of the payment. If so, the tax advantage of the credit is eroded. Table 1 sets out the financial implications of the case of X, an individual or corporation, whose income today is $50,000 and who, we will assume, is in the 50 percent federal tax bracket and the 10 percent state tax bracket (which is roughly the case, if he is a California resident).

TABLE 1

	Consequences of Unrestricted $1000 Charitable Gift	Consequences of Earmarked $1000 Gift Under NTU Initiative
Tax Changes:		
State Taxable Income	-1000	No Change
State Tax Change	- 100	-1000
Federal Taxable Income (Assuming Itemizing)		
From Charitable Gifts	-1000	No Change
From Lower State Taxes	+ 100	+1000
Net Fed. Taxable Income	- 900	+1000
Federal Tax Change	- 450	+ 500
Net Tax Change (State and Fed.)	- 550	- 500
Revenue Flows:		
To School	+1000	+1000
From/To Federal Govt.	- 450	+ 500
From State Govt.	- 100	-1000
From Individual	- 450	- 500

In sum, if the choice comes down to making an unrestricted gift and getting the charitabale deduction or making a restricted gift and getting the credit, for our hypothetical taxpayer the following points can be made: (1) In neither case is the gift free to the individual; it will cost about the same—one half—in each case. Thus, there is no increased stimulus to give; (2) The consequences to the school are relatively worse if the donor takes the credit, for the gift is restricted and not unrestricted; (3) Of course, some will prefer, at the same cost to them, to be able to earmark the gift for a particular child. As a result the social consequences are very likely to be worse. Tax-exempt schools can usually be counted on to use their donations for scholarships for the needy or for all pupils; restricted gifts will more often go to children of the middle class. Moreover, under the NTU initiative, funds will flow to schools that are not tax-exempt, and this may well be a social loss; (4) The intergovernmental impact of the tax credit route is far worse. Instead of the federal government losing $450 and the state $100, as happens with the charitable gift, the restricted gift costs the state $1000 and brings in a $500 windfall to the federal treasury. This is hardly a contribution to "local control."

Now it is true that the picture changes somewhat as we focus

on less wealthy donors and small businesses. But again, if one's idea is to let individuals give to charity some of what they now pay into the state treasury, the NTU device is hardly the ideal. Instead let us have an initiative that does just that. Imagine, for example, a measure that allowed persons to direct 50 percent of their state income taxes (up to $500) to tax-exempt charities of their choice. As noted above, we would prefer a provision that also required taxpayers to contribute something out of their own pockets and not just out of their taxes; but we would surely prefer this hypothetical proposal to the NTU initiative. And, of course, we would prefer a family educational subsidy to any of these tax schemes. Scholarship or voucher plans, by empowering families, avoid all these pitfalls, while leaving in place the general tax incentive to private charitable giving.

THE EXTENSION OF THE TAX CREDIT TO COVER "INCIDENTAL" EXPENSES OF PUBLIC EDUCATION IS ILL-CONCEIVED AND LEGALLY RISKY.

What are the "incidental expenses" for which the credit may be taken under the NTU initiative? Would they include the cost of transportation, the cost of lodging if the child lives at a boarding school, the cost of lunch for school children generally, the cost of after-school tutors? None of this is made clear by the initiative, and this lack of clarity is crucial. If "incidental expenses" includes the provision of a car to a Beverly Hills sophomore, one can see how useful it will be to some income groups. Let us suppose, however, that the term is limited to such things as school supplies, musical instruments, fees for field trips and other similar school activities. Even so, the result is highly unfortunate. Rich families will get these things free by way of the credit, while welfare families will pay cash. The poor will not only pay more; they alone will pay anything.

This bizarre provision, of course, was not designed for that purpose. Its intent was to give the appearance that public school users are included in the system. It was thought that this might bring the initiative within the possible exception to the Establishment Clause barrier suggested by Justices Powell and Burger in the 1973 "aid to parochial school" cases. The Justices reserved judgment about "general" systems—i.e., those designed to help families using all kinds of schools, public as well as private. However, the "incidental expense" provision is such a transparent device it is likely to have the opposite of its intended effect. It gives the entire enterprise an aroma of deceit—worse, of amateur deceit. Presently we will speak further of the federal Constitution.

THE EXTENSION OF THE TAX CREDIT INITIATIVE TO HIGHER EDUCATION IS UNWISE AND INEFFECTUAL.

There is, of course, much to be said for the reform of educational finance at the postsecondary level. Presently, however, it is far fairer and more rational than the financing of schools. California higher education has a mature and balanced system of financing which can adapt to different tuition levels for the different kinds of state higher education systems; it thus provides reasonably tailored subsidies for the varying needs of student. There also exists an elaborate system of federal loans and scholarships (through the Basic Educational Opportunity Grant program) as well as some state scholarships for private education.

The tax credit proposed would cause serious dislocations of this system. If the payoff were sufficient, perhaps these dislocations would be justified. It appears, however, that very little, if any, thought was given to the effects upon higher education in the drafting of the NTU initiative. That was not the real interest of the sponsors. Again, it is merely a device to avoid the Supreme Court's interpretations of the Establishment Clause. In our judgment the effort is vain. It will be a very simple matter for the Justices to sever their treatment of higher education from the rest of the proposal.

TAX CREDITS AND VOUCHERS ARE NOT DISTINGUISHABLE IN THE DEGREE OF STATE REGULATION INVOLVED.

Tax credits often are advertised as simpler to administer and less of an encroachment on the freedom of private schools. It is said the in the case of tax credits, only the taxpayer has to deal with the government; the school gets its money without bureaucratic hassle. Vouchers by contrast are said to draw the school inevitably into the government net.

This is a simple misunderstanding. Tax credits can be less intrusive than subsidies to families; or they can be more intrusive. It all depends upon the conditions attached to the claiming of the credit by the taxpayer and how these conditions compare to those which limit redemption of the voucher by the school. Imagine, for example, a tax credit available only for those whose children are enrolled in racially integrated, secular, private schools that do not charge over $2000 and which must be approved by the state superintendent of public instruction. This plan plainly would involve the bureaucracy with participating schools and would force some schools to alter their basic structure in order to participate. By contrast a particular voucher scheme might involve no regulation of schools at all—direct or indirect. Schools could cash the vouchers as simply, or even more simply, than supermarkets redeem food stamps. The supposed abstract advantage of either credits or vouchers in this respect is imaginary.

In practice one must evaluate the specific regulations required by the particular proposal. Both our proposal and the NTU initiative would protect participating private schools from further regulation in the areas of curriculum, hiring and facilities. Ours would, however, impose three important additional controls on schools. They could not charge tuition in excess of the voucher amount; they would have to take all applicants—with excess demand resolved by lot; and they would have to provide public information about themselves. Not all voucher proposals contain all these rules, or any of them. We prefer them because they give the consumer control over the entry process. This furthers the objective of providing poor families, uninformed families and families with unpopular children the same opportunity as others. The school market would become truly open to all. A 1981 version of our proposal takes a somewhat different approach to the "equal access" issue. It requires voucher schools to set aside 25 percent of their places for children of low-income families and to charge those families no more than the voucher amount. The California tax credit proposal, by contrast, would encourage the rich, the talented, and other elites to use exclusive schools to buy isolation from others for their children. Which set of values you have is a personal matter, but the issues are too important to resolve solely on whether more or less regulation is required. We too have a strong bias against regulation—except where it is necessary to maintain the very freedom of the family's choice.

There is, by the way, a good reason for the anti-bureaucratic policy maker to prefer a voucher system to a tax credit. The voucher device opens a vast opportunity for deregulation of the public sector. Credits, by themselves, do not. Public voucher schools that would operate in the same deregulated fashion as their private competitors are readily imaginable. We have made just such a proposal.* For credits to achieve the same result, the idea of tuition in American public schools would have to be accepted. That is not readily imaginable, nor is it currently permissible under many state contitutions.

THE TAX CREDIT INITIATIVE IS PROBABLY NOT CONSTITUTIONAL TO THE EXTENT THAT IT ALLOWS CREDITS FOR EDUCATIONAL EXPENSES AT RELIGIOUS SCHOOLS.

Inasmuch as the U.S. Supreme Court has already held one private school tax credit plan unconstitutional (in the Nyquist case), to escape the same result new proposals must be different in ways that will matter to the Court. The strategy of the drafters of the NTU initiative is to expand the class of beneficiaries by extending the benefits of the plan to non-parents and to users of both higher

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*Editor's Note: See Appendix to chapter nine above.

education and the public schools. We believe that this technique would fail to sanitize the proposal. As we have said, the extension to higher education can easily be severed. As for elementary and secondary schools the Court will see, just as in Nyquist, that the initiative promises no change in California's existing dual educational structure--public schools on the one hand and private, mostly religious schools, on the other. Therefore, the "primary effect," as in Nyquist, will be seen to be the aiding of religious schools and their users. The side effect of benefitting non-poor public school families and some non-parents will be just that--a side effect.

Perhaps the Court could be talked into severing religious school users from the NTU plan. The result of that, however, is a benefit limited to secular private schools, causing many religious schools to perish from the new competition. By contrast many constitutional scholars predict that a properly drawn voucher system will survive scrutiny with religious schools included. While people may differ on the desirability of these outcomes, they are plainly different in important respects.

The necessary and sufficient conditions of including religious schools lie in the extension of real choice to all elementary and secondary school families. This requires that a plan promise the creation of large numbers of new private non-religious schools and/or new public schools of choice. And it requires that working class and poor families be given the leverage, through choice, to make their existing public schools more responsive to their wishes. Only then is any benefit to religious schools and their users likely to be seen as an incidental, rather than the primary effect. While none of the tax credit initiatives have promised any of these changes, properly designed scholarship systems which aid all schools and children promise all of them; and that is why the constitutional outlook for the two is very different.

The differing constitutional prospects, in the end, reflect the differing educational aims of the plans. Tax credits really aspire to provide tax relief to current private school users. Vouchers aim to extend choice to all.

CONCLUSION

The artificiality of schemes like the credit proposal discussed here should now be transparent. As relief for the taxpayer it is weak tea. As aid to education it would be effective on behalf of the few percent of children enrolled in secular private schools. Its structure betrays its genesis. It was developed as a political device to exploit both dissatisfaction with public education and the taxpayers' revolt. In the end, it is to be recommended only to those who seek to sidetrack efforts at basic reform of our educational system and its financing.