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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 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 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 and the deduction for contributions to charitable organizations, including schools and scholarship-granting organizations) would be a way 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 have further argued 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 have argued 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.

Legislation was introduced in recent Congresses to provide nonrefundable and refundable credits for families' K-12 education expenses. The latter approach would allow eligible families with school-age children to receive a tax benefit even if its value exceeded their income tax liability — the difference being provided to the family via a tax refund. Bills also have been introduced to offer nonrefundable credits to those who make contributions to school tuition organizations (STOs), which in turn use the funds to award K-12 education scholarships.

A tax credit available to families incurring K-12 education expenses, or a credit dedicated to funding STOs, potentially would provide families with an incentive to send their children to private schools, including those who might have done so anyway. In order to target the tax benefit to families who might otherwise not have been able to exercise school choice, some bills have included an income ceiling for claimants or restricted the credit to families with children assigned to failing public schools. While such bills likely would encourage school choice because tuition would be among the many qualified education expenses, they also could make K-12 education in general more affordable for families by broadly defining qualified expenses to include such things as computer hardware and software, academic tutoring, and educational supplies.

This report will be updated as warranted.

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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 to the 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 K-12 education is optimal and have called for a range of reforms, including policies that seek to equalize available resources across schools and local educational agencies (LEAs), policies that provide additional funding for the education of more costly to educate students, and market-oriented policies that would encourage parents to select the school they deem most appropriate for their children, with funding to fully or partially offset the costs of tuition and fees provided through vouchers or reimbursed through the tax system.

In the past decade, Congress increasingly has turned to the tax code to provide subsidies beyond traditional grants and loans to persons attending public and private postsecondary institutions. In 2001, after several failed attempts, the 107th Congress extended one of these higher education tax benefits — Coverdell Education Savings Accounts — to apply to qualified elementary and secondary education expenses (i.e., tuition at religious and secular private schools and certain costs associated with enrollment in public schools). Several bills have been introduced since then that would support school choice through the creation of direct or indirect tax subsidies for families' expenses associated with enrolling their children in private or public schools.

This report focuses on proposals offered to amend the federal income tax code to subsidize the expenses of families with children enrolled in the K-12 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, it reviews existing federal tax provisions that could help families pay for the cost of their children's K-12 schooling.[1] The report then analyzes the kind of proposals that have been introduced to expand existing federal tax benefits or to authorize new ones for families incurring 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 currently assists families who opt to send their children to private schools through favorable tax treatment of scholarships, among other provisions in the Internal Revenue Code (IRC), which are discussed later in this report. The federal government also supports public school choice nationwide 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

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[1] The report excludes the exemption of private schools from taxation and the individual income tax deductions of state/local income, sales, and property taxes; and of home mortgage interest that subsidize families who choose to reside in desirable school districts or 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 Florida, Ohio, Utah, and Milwaukee, Wisconsin. (Recently, however, the Florida Supreme Court ruled that Florida's Opportunity Scholarship Program is in violation of the Florida Constitution. The program will cease operating at the end of the 2005-2006 school year.) 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.

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.

Federal funding to support the enrollment of students in nonpublic schools currently is provided through two targeted programs. In the District of Columbia, school choice is supported through a federally funded voucher program — the DC School Choice Incentive Act — under which scholarships of up to $7,500 per year are awarded to students for attendance at private schools located within the District of Columbia.[4] Also, during the 2005-2006 school year, federal funding is being provided under the Temporary Emergency Impact Aid for Displaced Students Program to help offset the costs of educating elementary and secondary students who were displaced by Hurricanes Katrina and Rita, irrespective of whether the students are enrolled in public or nonpublic schools. The program is a temporary emergency aid program in which up to $6,000 in funding is made available to schools on a per-student basis. (Up to $7,500 is available for students with disabilities.) Under the program, the Secretary of Education makes grants to SEAs, which in turn award funds to LEAs and Bureau of Indian Affairs (BIA)-funded schools on a per-student basis. To provide for the education of students enrolled in nonpublic schools, LEAs must deposit funds into student accounts and nonpublic schools must waive or reimburse a student's tuition to access funds.[5]

During the 107th Congress's deliberations over reauthorization of the ESEA, the House and Senate considered numerous proposals to expand federal support of parental choice and access to privately provided educational services. Proposals were made to do so through school vouchers and tax subsidies. Although voucher proposals were debated on the floors of the House and Senate, none of the amendments proposed were adopted by either chamber. The NCLBA did, however, authorize supplemental educational services.[6] Supplemental educational services, as provided for in the ESEA, are tutoring and other academic activities that are beyond instruction provided during the regular school day and are designed to increase students' achievement on state academic assessments and their proficiency in meeting state academic achievement standards. The ESEA requires LEAs to offer supplemental educational services to low-income students who attend Title I-A schools that have not made adequate yearly progress (AYP) for three or more

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[4] For additional information on the issues faced during consideration of the DC Parental Choice Incentive Act, see CRS Report RL32019, *Proposals to Establish a Scholarship or Voucher Program in the District of Columbia: Policy Issues and Analysis*, by David P. Smole. The program was enacted as part of the Consolidated Appropriations Act, 2004 (P.L. 108-199).

[5] For additional information on the Temporary Emergency Impact Aid for Displaced Students Program, see CRS Report RL33236, *Education-Related Hurricane Relief: Legislative Action*, by Rebecca R. Skinner et al. The program was enacted as part of the Department of Defense, Emergency Supplemental Appropriations to Address Hurricanes in the Gulf of Mexico, and Pandemic Influenza Act, 2006 (P.L. 109-148).

[6] For additional information on supplemental educational services, see CRS Report RL31329, *Supplemental Educational Services for Children from Low-income Families Under ESEA Title I-A*, by David P. Smole.

cumulative years, as part of a series of requirements in support of school improvement. Supplemental educational services are significant in that they offer parents the opportunity to select a public or private entity to provide publicly funded educational services to their children.

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 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.[7] 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" and/or "compelled support clauses" that generally prohibit the provision of public funds to religiously affiliated institutions such as schools.[8]

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

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[7] For additional information, see CRS Report RL30165, *Education Vouchers: Constitutional Issues and Cases*, by Angie Welborn, and CRS Report RS21254, *Education Vouchers: An Overview of the Supreme Court's Decision in Zelman v. Simmons-Harris*, by Christopher A. Jennings.

[8] Richard Komer 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.

effective than public schools,[9] 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 K-12 education expenses would avoid some of the issues that have inhibited the expansion of school vouchers and that such 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.

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 students and their families if the awards are used toward tuition and fees required for enrollment in an educational institution, 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.

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[9] For example, recently released data from the National Assessment of Education Progress (NAEP) show that 4th, 8th, and 12th grade students in private schools had higher average scores in reading, mathematics, science, and writing than their counterparts in public schools. However, these data do not necessarily indicate that private schools are more effective in educating students than public schools. (U.S. Department of Education, National Center for Education Statistics, *Student Achievement in Private Schools: Results From NAEP 2000 — 2005*, NCES 2006-459, 2005, at [http://nces.ed.gov/nationsreportcard/pdf/studies/2006459.pdf], visited Jan. 26, 2006.)

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 and secondary school students in families with incomes below specified levels who live in certain geographic areas. The programs generally provide partial tuition assistance. Families typically are selected either through lotteries or on a first-come, first-served basis.[10] The Children's Scholarship Fund (CSF) is the largest source of private school scholarships offered on a nationwide basis to low-income families.[11]

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 sometimes make a distinction between the two based on the funding source, with vouchers being associated with public funding and scholarships being associated with private funding.

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.[12] 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 the employee's school (e.g., school A provides reduced tuition to the nine year old son of a secretary employed at school B).

Information on the prevalence of tuition reductions offered by private K-12 schools is scant and difficult to interpret. The U.S. Department of Education collects data on the share of private schools, by affiliation, that allow a reduction in tuition in its Schools and Staffing Survey (SASS). However, schools reporting tuition reductions could be providing 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

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

[11] Additional information on the Children's Scholarship Program is available at [http://www.scholarshipfund.org/index.asp], visited Jan. 27, 2006.

[12] 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.

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, however.

Deductions for charitable contributions cannot exceed 50% of a taxpayer's adjusted gross income (AGI). Excess contributions may be carried forward for five 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.[13] Excess contributions may be carried forward for five years.

According to the American Association of Fund Raising Counsel, the largest category to receive charitable donations generally is religion (35.5% in 2004).[14] The next largest category, which lags far behind, is education (13.6% in 2004).[15]

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 K-12 schools (either secular or religiously affiliated). The authorization of ESAs to cover K-12 education expenses will lapse after December 31, 2010, unless extended by the Congress.

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.[16] Taxpayers may make deposits to ESAs if their modified AGI is below $110,000 for single filers and below $220,000 for married filers. 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; and for married filers, with incomes of more than $190,000 but less than $220,000. However, corporations, tax-exempt

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

[14] Giving USA Foundation, *Giving USA 2005*.

[15] 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.

[16] 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.

organizations (e.g., a foundation, charity, or union), or lower income individuals could contribute the maximum amount to accounts of children in families whose incomes fall within 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 earnings accumulated tax-free, by 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 28% federal tax bracket would have amassed $41,013; while the family in the 15% tax bracket would have amassed $43,483. Thus, the tax deferral in this example is worth noticeably more in additional earnings to the family in the higher tax bracket than it is to the family in the lower tax bracket. (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 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 K-12 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.,

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[17] The preferential tax treatment accorded ESAs was worth $5,539 in additional earnings to the family with a 28% marginal tax rate and $3,069 in additional earnings to the family with a 15% 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.

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 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

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[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, 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.

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 six 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 $313 in additional interest for a family in the 15% tax bracket and only $578 in additional interest for a family in the 25% 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 do lower income families. The $220,000 income ceiling on contributions by joint tax filers suggests that very 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 K-12 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

Several tax proposals have been offered in recent Congresses to further help families offset some of the costs associated with enrolling their children in the K-12

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[23] With tax-free treatment, the investment would have grown by $1,951. If a family with a 15% marginal tax rate instead had to pay tax annually on the investment, the gain would have totaled $1,638; for a family with a 28% tax rate, $1,373. (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.)

school of their choice. Some bills would have created a nonrefundable tax credit and others, a refundable tax credit. In general, a refundable credit is not limited by the taxpayer's regular tax liability; the taxpayer may receive the full value of the credit for a given income even if it exceeds his/her liability.[24] 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 generally limited by the taxpayer's regular tax liability. 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.[25]

Proposals to Amend Existing Tax Benefits

Mirroring the Coverdell ESA's legislative history, some bills would extend already existing tax benefits to K-12 education expenses. The provisions that would be expanded are the Hope Scholarship Credit and the Higher Education Deducation.

The Hope Scholarship Credit currently applies to the qualified tuition and related higher education expenses of each eligible student in the taxpayer's family.[26] 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 two years of undergraduate education, and the credit can only be claimed for the first two years of postsecondary school. Eligibility to claim the credit is phased out for individuals with modified AGIs in 2005 between $43,000 and $53,000 (between $87,000 and $107,000 for joint filers).

Legislation has been introduced to expand the Hope Credit's definition of qualified tuition and related expenses to include K-12 school expenses as defined for ESAs. It also would make explicit that homeschools are to be considered schools for purposes of the credit. Additionally, it would define qualified K-12 education expenses to include contributions or gifts to the school (other than the homeschool) that the taxpayer's dependent attends.

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[24] 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.

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

[26] For information on the Hope Scholarship Credit see CRS Report RL31129, *Higher Education Tax Credits and Deduction: An Overview of the Benefits and Their Relationship to Traditional Student Aid*, by Adam Stoll and Linda Levine. (Hereafter cited as CRS Report RL31129, *Higher Education Tax Credits and Deduction*.)

Similarly, another proposal would build on the Higher Education Deduction, which is the above-the-line deduction for college tuition and fees.[27] An above-the-line deduction may be taken by taxpayers whether or not they itemize deductions. This approach would allow 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 are defined as those of ESAs, except that the K-12 deduction would exclude room and board and would explicitly include expenses incurred in connection with enrollment or attendance at a homeschool as determined under state law.

Proposals to Authorize New Tax Benefits

Credits for Families that Incur K-12 Education Expenses. A third bill would authorize 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[28] attending an elementary or secondary school, as defined under the Elementary and Secondary Education Act, or any private, parochial, or religious school organized to provide elementary and/or secondary education. Educational expenses would include tuition and fees; computers, educational software, computer support services, and books required for instruction; academic tutoring; special needs services; fees charged for transportation provided by private schools; and academic testing services. Qualified expenses would be reduced by any payments toward them made from an ESA. Fees for nonacademic purposes (e.g., uniforms) and nonacademic after-school activities would not be treated as qualified expenses. The value of the credit would phase out for single filers whose modified AGIs exceeded $75,000 ($150,000 in the case of joint filers).

In its FY2003 and FY2004 budget requests, the Administration also included 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 for certain costs associated with attendance at schools of choice for children assigned to public schools that have not made adequate yearly progress (AYP).[29] Similar legislation was introduced to allow an individual to claim a refundable credit of 50% of the first $5,000 (i.e., up to $2,500) per dependent enrolled in a private school or another public K-12 school because a child otherwise would have been assigned to a public school identified for improvement under ESEA Title I-A. Eligible schools would have included any

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[27] For tax year 2005, individuals with modified AGIs of up to $65,000 ($130,000 for joint filers) can deduct a maximum of $4,000 per return in higher education expenses. Higher income individuals with modified AGIs that exceed $65,000 but are below $80,000 ($130,000 and $160,000, respectively, for joint filers) can deduct up to $2,000 per return for 2005. This temporary provision expired on Dec. 31, 2005. For more information see CRS Report RL31129, *Higher Education Tax Credits and Deduction*.

[28] A qualifying child would be defined as a taxpayer's son, daughter, stepson, stepdaughter, or a descendant of any such individual; and a sibling, stepsibling (or a descendant of such individual), or an eligible foster child who the taxpayer cares for as the taxpayer's own child.

[29] For additional information on AYP see CRS Report RL32495, *Adequate Yearly Progress (AYP): Implementation of the No Child Left Behind Act*, by Wayne C. Riddle.

public, private, parochial, religious, or homeschool that offered an elementary or secondary education. Qualified expenses would have included tuition and fees, transportation, books, supplies, computer equipment (including software and services), and other required equipment. Meals and lodging were specifically excluded. For homeschools that met the requirements of state law, qualified expenses would have included the cost of tutoring, books, supplies, computer equipment (including software and services), and other equipment directly employed in furnishing such education. Qualified expenses would have been reduced by any tax-free scholarship received.

Another approach would allow an individual to claim a *nonrefundable* credit of up to $3,000 for qualified education expenses per dependent enrolled in a qualified K-12 educational institution (i.e., any private, parochial, religious, or homeschool). The maximum value of the credit would be adjusted annually for inflation. Qualified expenses would include the cost of attendance within the meaning of Section 472 of the Higher Education Act of 1965 (20 U.S.C. 1087ll), including tuition and fees, books, supplies, transportation, and a personal computer. The bill would not make eligibility for the credit contingent on family income.

Credits for Contributions to K-12 Scholarship Organizations. The exact form of proposals to allow *nonrefundable* credits to taxpayers who make contributions to organizations that award scholarships to K-12 students has differed from one Congress to the next. Some bills have been more generous than others in the amount of the credit that could be claimed. Some would allow corporations, in addition to individuals, to claim the credit. Many proposals have specified that the groups awarding grants (variously called school tuition organizations, scholarship granting organizations, and educational investment organizations) must operate as Section 501(c)(3) organizations, which were discussed earlier in this report's section on charitable contributions. Typically, the bills have not limited scholarship eligibility to K-12 students based upon family income.[30] Some would allow the organizations to make grants not only to students, but also to public and private schools (including, in some instances, homeschools). While some proposals have maintained the existing definition of tax-free scholarships, others would extend use of the awards to some or all ESA-qualified expenses. (See the earlier discussion in this report on scholarships and ESAs). One bill would authorize a federal tax credit of up to $100 for single filers ($200 for joint filers) for contributions to education investment organizations made by taxpayers in states that authorize the minimum state scholarship tax credit specified in the legislation. Under this proposal, taxpayers would be prohibited from requiring that their contributions benefit a particular child. In addition, state school tuition organizations (STOs) would have to operate as Section 501(c)(3) organizations.

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[30] Those bills that would make scholarship eligibility contingent on income limit scholarship receipt to students eligible for the federal free or reduced-priced meals under the under the Richard B. Russell National School Lunch Act. For more information on that act see CRS Report RL31577, *Child Nutrition and WIC Programs: Background and Funding*, by Joe Richardson; and U.S. Department of Agriculture, Food & Nutrition Service, *Nutrition Program Facts, National School Lunch Program*, Sept. 2005, at [http://www.fns.usda.gov/cnd/lunch/AboutLunch/NSLPFactSheet.pdf], visited Jan. 26, 2006.

Analysis of Proposals for Tax Subsidies To Expand School Choice

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 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. 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 K-12 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 a K-12 education credit.

A nonrefundable credit 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.[31] The 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 (e.g., the Hope Scholarship and Lifetime Learning credits) meets or exceeds a family's income tax liability, the family would be unable to make use of a K-12 education credit.[32]

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[31] A deduction reduces the amount of income against which tax is imposed, and therefore, its value (i.e., how much it lowers income tax liability) depends on a taxpayer's marginal tax rate. As in the case of a nonrefundable credit, taxpayers without income tax liabilities could not claim a deduction (either above-the-line or itemized). Among those taxpayers with liabilities, generally the higher the individual's marginal tax rate (i.e., the higher their AGI), the larger the tax savings conferred by a deduction.

[32] An above-the-line K-12 education deduction also could eliminate or reduce tax liability against which to apply existing nonrefundable credits.

The other bills that offer nonrefundable credits for contributions to STOs or education investment organizations would confer tax benefits on individuals who make contributions benefitting other people's children. In some instances, a portion of the scholarship funds would target children in low-income families. A recent proposal would specifically prohibit contributors from designating the beneficiaries of scholarships funded by their contributions, leaving that responsibility to the Section 501(c)(3) organizations that operate the scholarship programs.[33]

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 enrolling their children in the schools of their choice. Some of the proposals for tax benefits would limit "windfalls" (i.e., subsidizing individuals for actions they would have undertaken anyway) by limiting eligibility

- to individuals with incomes below a specified amount,
- to individuals with children otherwise eligible for particular means-tested government programs, or
- to individuals with children currently or recently enrolled in certain types of public schools.

To target the tax benefit on families that would encounter financial difficulties if they were to send their children to private schools, some proposals would limit eligibility to claim the benefit (or to receive scholarships funded by the benefit) to families with incomes below a threshold amount or whose children receive or are eligible to receive free or reduced-price school meals. The income limits for eligibility to receive free or reduced-price meals generally are lower than the income limits contained in many tax credit proposals that directly include an income criterion.

One proposal, for example, would have focused eligibility on families whose children, in the previous year, attended a Title I-A school that has been identified for improvement under ESEA Title I-A, and who would be assigned to the same or another school so identified for the current academic year. The credit thus would have been available only to those families whose children were assigned to schools not meeting specific educational accountability requirements. 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 may be less likely than poorer families to have children in Title I-A schools — especially those that fail to meet ESEA Title I-A accountability requirements. Others suggest that as implementation of the ESEA Title I-A accountability requirements proceeds, increasing numbers of Title I-A schools will be identified for improvement, and such a tax credit proposal could have a somewhat broader focus than relatively low-income families.

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[33] 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 and/or family members. This is referred to as the "inurement of benefit" test.

The Affordability of Private Schools. As discussed earlier, qualified expenses for which families could claim a K-12 education credit generally have been broadly defined to include costs in addition to tuition. Still, if a tax benefit were to be claimed for the costs of sending a child to a school of choice, the greatest expense to a family likely would be tuition. Data on private school tuition suggest that, in many instances, tuition alone would exceed the maximum amounts of many proposed K-12 education tax credits, which often have been for between $2,500 and $3,500 per child. Also, if the average reported CSF scholarship of $1,246 were to be viewed as indicative of the value of scholarships that initially might be funded through a credit for charitable contributions to STOs, then such a scholarship might fall short of typical private school tuition.[34] (However, the value of scholarships awarded by STOs cannot be estimated from the amount contributed because STOs presumably would have the flexibility to balance the value of scholarships against the number granted.)

Among private schools, Catholic schools often have comparatively lower tuition levels. Data for the 2004-2005 school year show that the average tuition at a Catholic elementary school was $2,432 and at a Catholic high school, $5,870.[35] Other private schools, particularly independent private schools, typically have much higher tuition levels. Tuition data for independent day schools show that for the 2004-2005 school year, median tuition for grades 1 and 3 was $12,783; for grades 6 and 8, $14,475; and for grades 9 and 12, $16,025.[36] With the addition of other education expenses commonly associated with private school attendance (e.g., fees for uniforms, transportation, and other purposes), even a tax benefit of as high as $3,500 in many instances would fall short of a family's total annual cost. However, subsidizing a portion of K-12 education expenses could be sufficient for families on the margin of affording a private school education to decide to transfer their children from public to private schools or to retain their children in private schools. Also, 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.[37]

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

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[34] According to CSF, the typical family contribution above the scholarship amount is $1,607, resulting in average tuition of $2,853. (Children's Scholarship Fund , *About CSF, Facts*, at [http://www.scholarshipfund.org/index.asp], viewed Jan. 27, 2006.)

[35] National Catholic Educational Association, *Annual Report on Catholic Elementary and Secondary Schools — United States Catholic Elementary and Secondary School Statistics 2004-2005*, at [http://www.ncea.org/newinfo/catholicschooldata/annualreport.asp#tuition], viewed Jan. 27, 2006.

[36] National Association of Independent Schools, *Independent School Facts for All NAIS Members Schools*, Nov. 2004, at [http://www.nais.org/files/PDFs/NAISmembers2005Reviewed1.pdf], viewed Jan. 27, 2006.

[37] For example, under the Cleveland Scholarship and Tutoring Program, the voucher covers either 90% or 75% of tuition, up to $3,450, depending on family income. Parents must pay the difference between the scholarship amount and actual school tuition; and this payment may be made either in cash or in the form of in-kind contributions.

schools families select. Catholic and other religiously affiliated schools generally charge lower tuition than other private schools. Religiously affiliated schools often are able to do so because many of their operating and facilities costs are subsidized by charitable contributions and because some staff may work for comparatively lower 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 National Catholic Educational Association (NCEA) reports that average Catholic school tuition represented only 61% of actual per-pupil costs of $3,998 at elementary schools in school year 2004-2005, whereas average freshmen secondary school tuition represented 82% of per-pupil costs of $7,200.[38] Other private schools also subsidize tuition with funds provided from endowments, although typically to a lesser extent than Catholic schools. For example, in 2004-2005, median tuition at independent day schools represented 92% of total expenses.[39] Nonetheless, the typically lower tuition of religiously affiliated schools might make them more attractive to families, compared with either nonsectarian private schools or out-of-boundary public schools, which also usually charge comparatively high tuition.

While some of the proposals for K-12 education tax credits have called for reimbursing families for their educational expenses on a dollar-for-dollar basis up to a specified limit, others call for offsetting a share of expenses incurred. Under some proposals, for example, a family would need to have incurred $5,000 in expenses to claim the maximum benefit of $2,500 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 is the only K-12 education tax benefit for which budget effects have been developed. For qualified expenses incurred beginning with the 2003-2004 school year and extending through the 2007-2008 school year, the Treasury Department estimated that the credit could have receipt and outlay effects of $3.3 billion over the same period.[40] Joint Committee on Taxation (JCT) estimated that the President's proposal would cost $372 million through FY2008 in the form of revenue forgone and refunds.[41] The marked difference in these estimates principally is due to their different assumptions about the credit's take-up rate (i.e.,

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[38] National Catholic Educational Association, *Annual Report on Catholic Elementary and Secondary Schools — United States Catholic Elementary and Secondary School Statistics 2004-2005*, at [http://www.ncea.org/newinfo/catholicschooldata/annualreport.asp#tuition], viewed Jan. 27, 2006.

[39] National Association of Independent Schools, *Independent School Facts for All NAIS Members Schools*, Nov. 2004, at [http://www.nais.org/files/PDFs/NAISmembers2005Reviewed1.pdf], viewed Jan. 27, 2006.

[40] Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2004 Revenue Proposals*.

[41] Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions in the President's Fiscal Year 2004 Budget Proposal*, JCX-15-03, Mar. 4, 2003.

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 cost the government is 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 appears less persuaded that very many families with children in failing schools possess the financial resources that would enable them to incur educational expenses for which they would only be partially reimbursed sometime later.

The other proposals would condition eligibility for a K-12 education 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 would 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 result in a much larger tax expenditure on the part of the government.

The bills that would not have conditioned eligibility for a K-12 education credit on the type of K-12 school attended could nonetheless encourage school choice because their definitions of qualified expenses include 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 promote greater educational equity among those families whose children are enrolled in public schools. For example, as a result of the tax benefit, more low-income families of public school students might be able to afford a computer for their children to use at home. However, the availability of a tax benefit with many types of qualified expenses beyond tuition might prompt 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 be 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 K-12 education tax benefit could well impose costs that extend beyond the federal budget. It might place an added burden on the IRS, including the drafting of new or amended tax forms and the issuance of regulations. The design in some bills could be more onerous than others if administered properly. For example, the Administration's proposal would limit use of the credit to students in failing schools. Presumably, the IRS would have to verify that schools fit the definition to ensure that only legitimate claims were paid. Similarly, some proposals would target students eligible for free and reduced-price school meals for scholarships. Here, the educational investment organizations and the IRS might have to determine for themselves from the income figures on families' tax returns whether their children are eligible for the tax-free scholarships or require that LEAs provide families with documentation of their children's eligibility for submission to STOs and inclusion with their tax forms. (Not all LEAs currently provide documentation.)

A K-12 education tax benefit also could impose costs on eligible families. To the extent the above-described proposals define terms differently from their current definition in the IRC, it could cause confusion among tax filers. Overlapping definitions of qualified expenses between the ESA and a new K-12 education tax benefit also could make 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 (i.e., no double benefit). In addition, recordkeeping burdens would increase as taxpayers would have to substantiate qualified expenses. Under those bills that cover tutoring, for example, parents who want 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.[42]

Voucher Issues Revisited

A tax benefit for K-12 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 might 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 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.[43] 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.[44] 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

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[42] Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2004 Budget Proposal*, JCS-7-03, Mar. 2003.

[43] Lawrence W. Reed, *A New Direction for Education Reform*, Mackinac Center for Public Policy, July 2, 2001, [http://www.mackinac.org/article.aspx?ID=3541], viewed Jan. 27, 2006.

[44] School Choices.org, *Educational Tax Credits: Issues and Arguments*, at [http://www.schoolchoices.org/roo/taxcredits.htm], viewed Jan. 27, 2006.

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.[45] 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.[46]

To a degree, competition and choice already exist in the K-12 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.[47] 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

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[45] For a review of a range of studies investigating the effects of competition between schools on educational outcomes, see Clive R. Belfield 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, Mar. 2002, at [http://www.ncspe.org/publications_files/688_OP35V2.pdf], visited Jan. 26, 2006. 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.

[46] Caroline M. Hoxby, *School Choice and School Productivity (or Could School Choice be a Tide that Lifts All Boats?)*, National Bureau of Economic Research Working Paper 8873, Apr. 2002, at [http://www.nber.org/papers/8873], visited Jan. 26, 2006.

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

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.[48]

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 approximately 53% of all applicants.[49] 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

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[48] Thomas J. Nechyba, *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, at [http://www.nber.org/papers/W5642], visited Jan. 27, 2006.

[49] National Association of Independent Schools, *Independent School Facts for All NAIS Members Schools*, Nov. 2004, at [http://www.nais.org/files/PDFs/NAISmembers 2005Reviewed1.pdf], viewed Jan. 27, 2006.

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.[50]

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.[51] Tuition in new private schools might 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. If more private schools opened, however, they could dilute these funds and consequently raise tuition to some degree.

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

[51] Based on limited evidence, the supply of private schooling may not be very responsive to changes in demand. For more information see Clive R. Belfield, *Tuition Tax Credits: What Do We Know So Far?*, National Center for the Study of Privatization in Education, Sept. 2001.