



Return on Education

A Series of Briefs about K-12 Funding Issues

Private School Tax Credits Divert Public Dollars for Private Benefits

Arizona's tax credits to support private schools diverted more than \$100 million from the state budget in 2013—funding that could otherwise be used to fuel public schools. That amount will increase because the tax credits are designed to grow substantially every year, further diminishing funds available for public education and other priorities. Tax credits claimed for private schools have grown far faster than state revenues or the state economy, yet they lack the basic accountability and control that state budgets have.

Reforms are needed to make these credits more accountable, to control their growth, and to focus funds exclusively on scholarships for students who couldn't afford private schools without financial help.

There are four different private school tax credits available—two for households and two for businesses. To get the tax credits, Arizonans donate to a “school tuition organization” that administers scholarships to students enrolled in private schools. The families and businesses then subtract dollar for dollar the amount of the donation from the state income taxes they owe. As the credits were created and expanded, supporters have argued that they make private schools an option for students in low income families who can't afford the tuition without scholarships. In practice however, private school enrollment has not increased since the tax credits were

established in the late 1990s, while public school enrollment has grown. And many of the scholarships are given to students with high family incomes. In other words, the evidence shows that the credits have significantly reduced state revenue in order to subsidize private school tuition for families who would have chosen private schools without the scholarship funding.

How Tuition Tax Credits Came to Be

In the mid 1990s, Arizona had a vigorous debate over using state tax dollars to support a variety of options for parents to educate their children. Arizona's Constitution prohibits public funding of vouchers for private and religious schools. As an alternative, legislators created a tax credit system allowing money to flow directly from taxpayers to Student Tuition Organizations with taxpayers receiving a dollar-for-dollar reduction in their state income tax. A lawsuit in 1998, *Kotterman v. Killian*, challenged this system on grounds that it enabled the state to do indirectly what it could not do directly. The Arizona Supreme Court allowed the arrangement to stand, saying that the benefits from donations to STOs accrue primarily to students and their families, not to private schools or religious institutions. The court also ruled that since no money actually reaches the state treasury, tax credits are not actually public funds. A later attempt to create a direct voucher program giving state money directly to parents was declared unconstitutional in 2009 in the *Cain v. Horne* decision.

Arizona's Four Private School Tax Credits

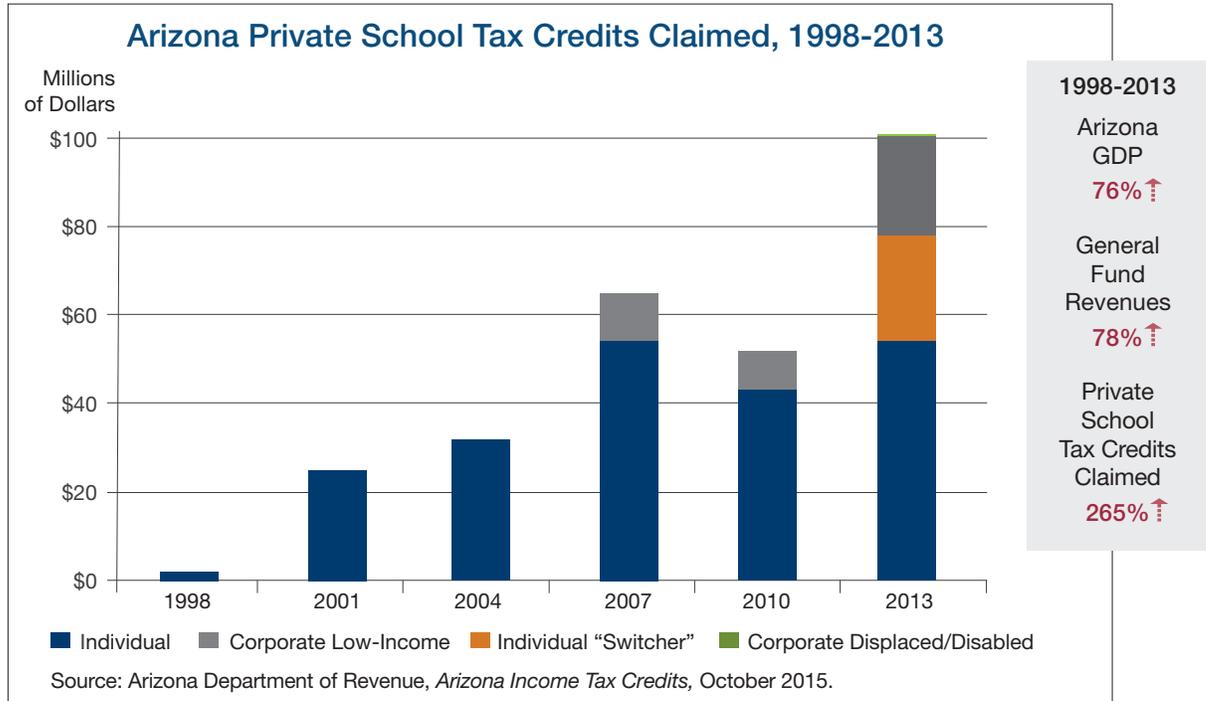
Credit	2016 Limit	Yearly Increase	Scholarship Amount	Requirements	Amount Claimed
Original Individual (A.R.S. §43-1089)	\$535 Single \$1,070 Married	Inflation (avg. 1-2%)	Scholarship available up to the amount of tuition	<ul style="list-style-type: none"> STOs “shall consider” economic need when awarding scholarships, but no specific criteria exist. 	\$56.8 million (2014)
Individual Public School “Switcher” (A.R.S. §43-1089.03)	\$532 Single \$1,064 Married	Inflation (avg. 1-2%)	Scholarship available up to the amount of tuition	<ul style="list-style-type: none"> An individual must first make the maximum donation to an STO under the original credit. Scholarship limited to students who attended a public school for the first 90 days of the previous school year, Kindergartners enrolling in school for the first time, children of an active duty member of the military, or continuing students. 	\$27.0 million (2014)
Corporate Low-Income* (A.R.S. §§43-1183, 20-224.06)	\$51.6 million Aggregate Cap for all businesses statewide	20% annually	\$5,100 K-8 \$6,400 9-12 Increases by \$100 annually	<ul style="list-style-type: none"> Designated for “low income” students. “Low income” defined as 1.85 times the income level required to qualify for reduced price lunch, which is actually more than three times the federal poverty level, or over \$81,000 annually for a family of four. Must meet the same requirements as public school switchers above. 	\$22.5 million (2013) \$4.1 million carried forward
Corporate Displaced/Disabled* A.R. S. §§43-1184, 20-224.07	\$5 million Aggregate Cap for all businesses statewide	None	90% of what a school district would receive for the student or actual tuition, whichever is less.	<ul style="list-style-type: none"> Awarded to students who have a disability requiring special education services or other educational accommodations, or students who were previously foster children and have been adopted. 	\$368,577 (2013) \$136.018 carried forward

* Insurance companies do not pay corporate income tax, but can claim a credit against premium tax that counts against the aggregate cap.

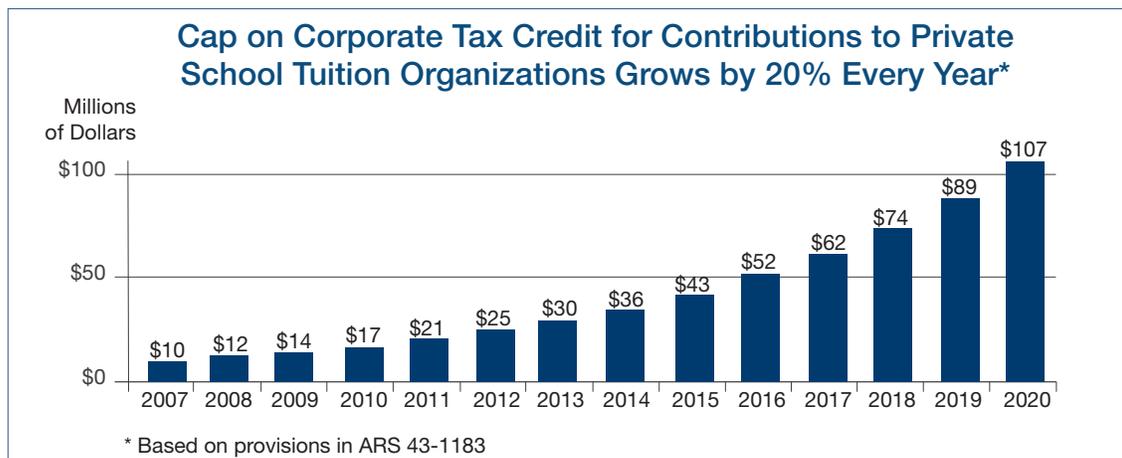


Private School Tax Credits on High Speed Acceleration

Since creation of the original private school tax credit for individual taxpayers in 1998, the state legislature has added three additional tax credits and expanded access to the credits. The total dollars claimed has grown to over \$100 million in fiscal year 2013—the most recent year with complete data available. Private school tax credits claimed grew far faster than state revenues or the state economy.



Individual tax credits can skyrocket without warning or control if more taxpayers make qualified donations. The so-called “low income” corporate tax credit is subject to an aggregate limit that automatically increases by 20% each year. In 2007, the first year of the program, the cap was \$10 million. In the current state budget year it is \$51.6 million. By 2020, the cap will exceed \$100 million.



Scholarships Leave Out Low Income Students

Support for private school tax credits over the years by state lawmakers and advocates has often been based on the argument that the scholarships funded through the credits would help low income students gain access to private schools. And it is clearly true that scholarships have benefitted some students from low income families.

But the credits were never designed to provide more opportunities for students from families struggling to make ends meet. The laws creating the individual private school tax credits have *no income requirements at all for scholarship recipients*. And the so-called “corporate low-income tax credit” allows scholarships for students with family incomes up to \$81,000 a year (for a family of four). For the two individual tax credits, fewer than 4 in 10 scholarship dollars in the 2014 state fiscal year went to children in families with incomes below 1.85 times the federal poverty level—\$44,000 for a family of four. Even combining these scholarships with the “low income” corporate tax credit, more than \$1 of every \$5 in scholarships granted went to students with high family incomes—far above the state median of \$55,300 for families with children.

For Every \$100 in Scholarships Awarded Through Individual Tax Credits, Only \$39.62 Benefitted Low Income Students



\$39.62
to low income
students

\$30.23
to middle income
students

\$30.15
to high income
students

For the original individual tax credit, 8 Student Tuition Organizations awarded more than half their scholarship funding to students with incomes above \$80,601 for a family of 4—more than \$25,000 **above** Arizona’s median income for families with children.

Note: Data represents scholarships granted in 2014.

Low income = Less than 185% of the federal poverty level (\$44,123 for a family of 4).

Middle income = 185%-342.25% of the federal poverty level (\$44,123-\$81,627 for a family of 4).

High income = Above 342.25% of the federal poverty level (\$81,627 for a family of 4).

Source: Private School Tuition Organization Income Tax Credits in Arizona, Arizona Department of Revenue, September 2015.

Scholarships granted through corporate tax credits were not reported to the Department of Revenue by student income level.

One Scholarship Leaves Low Income Families Facing Big Hurdles for Tuition

The average yearly private school tuition in the United States is \$8,549, according to the National Center for Education Statistics at the U.S. Department of Education. As the table below shows, no category of scholarship under Arizona’s tax credit system came close to covering this average cost in the 2014 state fiscal year. Students are permitted to seek scholarships from multiple STOs, but the state does not keep track of how many students get more than one scholarship. The data shows that an average scholarship from a single STO would cover only a fraction of tuition, leaving a big gap for low income parents to finance.

Type of Tax Credit/ Scholarship	Value of Scholarships Awarded	Number of Scholarships	Average Scholarship Amount	Percent of Average Tuition Covered
Individual	\$50,708,016	27,362	\$1,853.23	22%
“Switcher”	\$18,136,839	13,548	\$1,338.71	16%
Corporate Low Income	\$24,519,525	13,118	\$1,869.15	22%
Corporate Disabled	\$1,622,020	349	\$4,647.62	54%

Source: Private School Tuition Organization Income Tax Credits in Arizona, Arizona Department of Revenue, September 2015.

Accountability Gaps

More than half of private school tax credit donations contributed since 1998 have gone to four STOs: Catholic Education Arizona, Arizona Christian School Tuition Organization, Arizona’s Catholic Tuition Support Organization, and Institute for Better Education. State law also allows STOs in Arizona to retain 10% of their proceeds for administration. For each of the four largest STOs listed above, those allowed expenses topped \$430,000 in 2014.

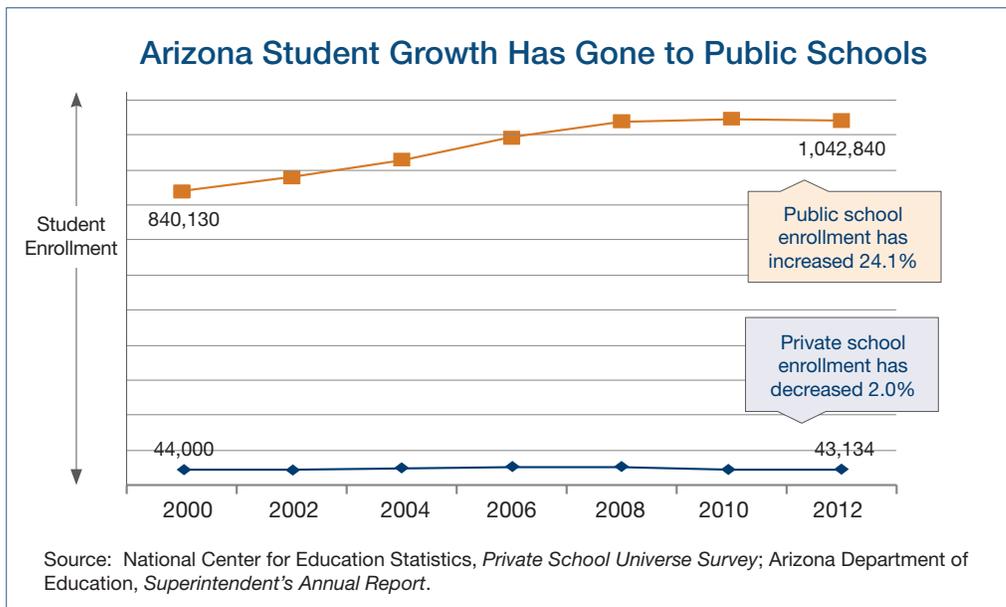
Private school tax credits lack the normal controls that exist in the spending side of the state budget. State agency budgets have to be voted on every year or every two years and spending cannot go above the appropriated amount. But tax credits operate on autopilot without needing periodic legislative approval. The amount of credits claimed cannot be predicted in advance nor cut back during the year if it goes above available funds.

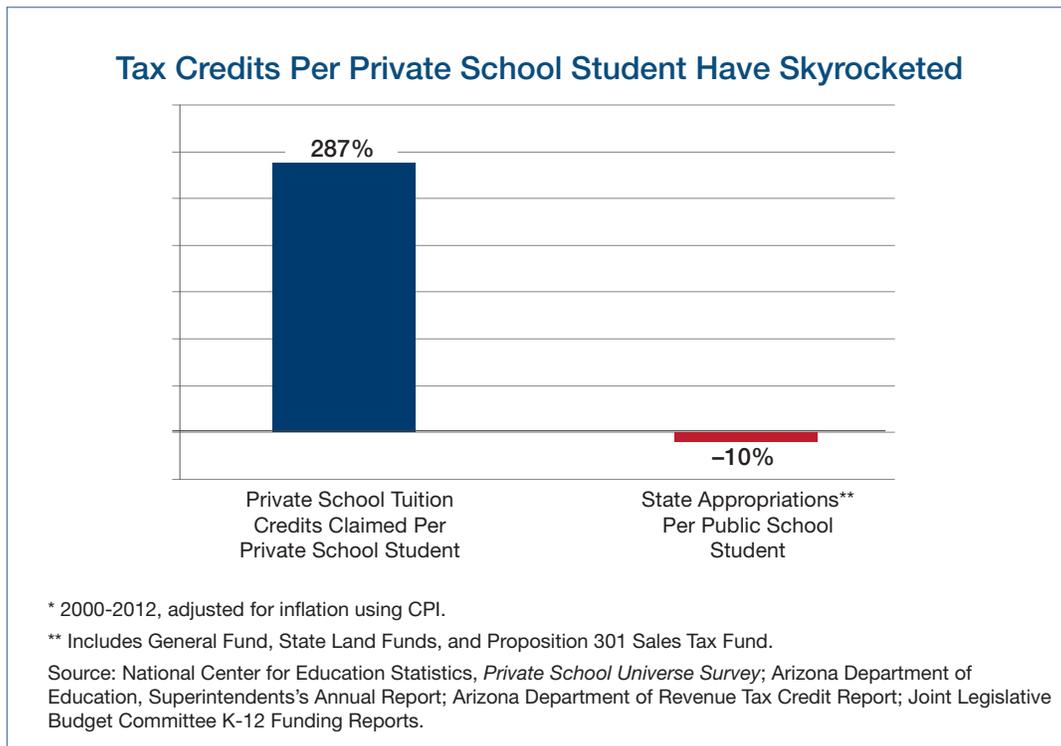
According to Arizona law, a donation to an STO cannot be designated for the donor’s own children, nor can it be made contingent on the recommended student receiving a scholarship. However the law does allow an individual donor to recommend a specific student to receive a scholarship. In fact, some STOs market the tax credit by encouraging parents to get friends and family members to donate and to recommend their students. The recommendation process distances the scholarships from the goal of supporting students in low income families. Recommendations promote scholarships for students who would be attending private school anyway and can now enjoy lower tuition—at the expense of other state priorities. The student recommendations are akin to giving taxpayers the authority to recommend which mile of highway should be paved next by the Department of Transportation or which stretch of highway should get extra patrols from the Department of Public Safety or which child should qualify for Medicaid health coverage.

*“The Engle Family needs a favor!
Will you help?
You can get a DOLLAR FOR DOLLAR
TAX CREDIT and help our family to
continue to provide our children the
opportunity to be in a private school.”*

Sample message
suggested for parents to use in
soliciting tax credit donations
and student recommendations
from friends and family members,
Arizona Tuition Connection website.

Proponents of private school tax credits argue that the cost to the state’s general fund is lower than it appears. Most state funding to public schools is based on student count. If students switch from public schools and attend private schools instead, the state is no longer responsible to support them through the school funding formula. But it is clear this “switching” has not shaped the statewide trends. Enrollment in private schools statewide has remained virtually flat since the private school tax credits were created, while public school enrollment has risen. Private school enrollment has dropped from 5% of total school enrollment to 4% of total school enrollment from 2000 to 2012.





Legislative Reforms for Improved Private School Tax Credits

Private school tax credits, the Student Tuition Organizations, and the scholarships should be reformed to be more accountable and targeted to educational opportunities for students in low income families. Steps to reform can include:

- **Limit STO Administrative Expenses to 5% of Donated Funds.** This will target more resources directly on student education.
- **Cap Growth In “Low Income” Corporate Tax Credits at this year’s level.** Under current law, the aggregate limit on this single tax credit will exceed \$100 million annually in four years. Nothing else in the state budget is allowed to grow on autopilot by 20% annually.
- **Focus all scholarships on students in low income families.** Requiring all scholarships to be limited to students whose families earn less than 1.85 times the federal poverty level (\$44,900 for a family of four) will match the scholarships to the original goals of the tax credits.
- **Remove the Ability to Recommend Specific Students.** The current design of the tax credits encourages family members and friends to divert their state tax dollars to help pay the private school tuition of someone they know, subsidizing families who could already afford private school tuition and directing state tax policy to the private benefit of specific people.



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