A Model To Avoid: Arizona’s Tuition Tax Credit Law.

Pathak, Arohi; Holmes, Dwight; Mincberg, Elliot; Neas, Ralph G.

People for the American Way, Washington, DC.

2001-09-00

10p.; Produced by the People for the American Way Foundation.


Opinion Papers (120)

Accountability; Disadvantaged Youth; Educational Vouchers; Elementary Secondary Education; Extracurricular Activities; Poverty; Private Schools; Public Schools; State Legislation; *Tax Credits; *Tuition

In 1997, Arizona enacted a tuition tax credit law. Supporters consider this law a model for improving public education. Opponents believe it is a model for seriously undermining public education, particularly public schools serving poor children. The two types of tax credits Arizona offers are a private tuition tax credit and tax credit for public school extracurricular activities. Over 3 years, the Arizona policy has largely subsidized education for middle- and upper-income families, while lower-income families have not benefited. Opponents argue that this law diverts significant resources away from programs that could otherwise support and strengthen public education for poor and disadvantaged students. There are few regulations governing the operation of school tuition organizations (STOs). State officials demand little accountability from STOs and do not require them to provide scholarships based on financial need or previous inability to attend private school. Evidence shows that a large majority of STOs provide tuition payments primarily to religious schools, often specific schools that reflect the religious views of the affiliates of the STOs. Arizona taxpayer dollars going to public schools or private STOs under the tax credit law are not donations, as supporters call them. While a state can earmark funds based on the needs of public schools and students, Arizona's tuition tax credit interferes with this ability, effectively reallocating funds in a patently inequitable manner that hinders school improvement and reinforces economic divisions. (SM)
A Model to Avoid:
Arizona's Tuition Tax Credit Law
Over the past 11 months, the school voucher movement has suffered one major political setback after another. Last November, Michigan and California became the latest states in which voters decisively defeated voucher initiatives. This spring, the Wisconsin Legislature refused to support a proposal to significantly expand the Milwaukee voucher plan—the nation’s longest-running, publicly funded voucher program. In Congress, vouchers fared no better as both the administration’s voucher proposals and various voucher amendments were rejected.

In the face of these defeats and a new national poll showing record-high support for public schools, voucher proponents are seriously rethinking their strategy. Many of them are now embracing and endorsing a different tactic: tax credits for private school tuition.

Andy LeFevre, who directs the education task force for the ultra-conservative American Legislative Exchange Council, has praised tuition tax credits as a viable policy alternative. Tuition tax credits, LeFevre said, “are looked at in a little more favorable light in states than vouchers ... the end goal is the same as a voucher; it’s just a different way to come about it.”

For years, a group of pro-voucher legislators in Arizona tried, without success, to pass a state law that used vouchers to divert public tax dollars to private schools. Then, in 1997, the state enacted a tuition tax credit law—prompting the bill’s author, Trent Franks, to ask: “Why do we need vouchers at this point?” The pro-voucher Cato Institute has added its voice to this chorus, recently lauding the Arizona tax credit law as a model for improving public education in the United States. Yet, nothing could be further from the truth.

The available evidence shows that the Arizona law is a model for seriously undermining public education, particularly the public schools that serve poor children. Over a three-year period, the Arizona scheme has cost more than $55 million, money that has gone largely to subsidize education for middle- and upper-income families, both in private and public schools. By contrast, low-income families who pay fewer taxes do not benefit from the tax credit. In fact, the tax credit depletes state funds, making less money available for needed improvements in public schools that serve low-income and disadvantaged students. In addition, while the public and policymakers are calling for much more accountability of public schools, there is virtually no accountability—and evidence suggesting financial abuse—for Arizona’s tax credit scheme.

The 1997 Arizona law provides a dollar-for-dollar, state income-tax credit up to specified amounts for two types of expenditures—one for donations made to private scholarship organizations, and one for donations to support extracurricular activities of public schools. Most other states do not have tuition tax credit laws, although efforts to promote them are under way across the country. As People For the American Way Foundation’s (PFAWF) research demonstrates, both aspects of the Arizona tax credit law divert significant resources away from programs that could otherwise support and strengthen public education for poor and disadvantaged students.
Arizona’s private tuition tax credit

The first type of tax credit available under the Arizona law allows taxpayers to claim a credit against state income taxes for contributions up to $500 ($625 if filing jointly) to eligible “School Tuition Organizations” (STO).6 These STOs, in turn, provide scholarships to students, paying for all or part of their tuition at religious and other private schools. The legislation stipulates that taxpayers claiming this credit cannot earmark their donations to benefit their own dependents. It also states that STOs are to spend at least 90 percent of their revenue on scholarships, and to provide scholarships to students in more than one school.7

To help enact the law, tax credit supporters argued that it would expand educational opportunities for those who could not otherwise afford private school.8 However, the law does not require STOs to provide any scholarships to students based on financial need or previous inability to attend a private school. Furthermore, although parents are precluded from designating their own dependents as beneficiaries of their “donation,” they are able to designate other specific individuals. As a result, as the Arizona Republic reported, some parents are writing $500 checks for their friends’ children, who, in turn, are reciprocating. Under this loophole, 96 percent of the more than $361,000 donated to the Arizona Scholarship Fund—the seventh-largest STO in 1999—was earmarked for students who were already enrolled in private schools.9 Trent Franks, a former state legislator who conceived of Arizona’s tax credit approach, openly admits that this is how many parents are using the law.10

Other evidence confirms that the tax credit program primarily benefits those who can already afford to send their children to religious and other private schools. As of the year 2000, at least 25 of the 35 STOs that reported data provided tuition payments primarily to religious schools, usually specific schools that reflect the religious views or affiliations of these STOs.11 A telephone survey conducted by PFAWF recently found that many STOs give priority to students already enrolled in religious schools that reflect the organization’s religious mission or goals. In the survey, 19 of the 21 STOs responding indicated that their practice was to serve students already enrolled in private or religious schools; public school students are considered for scholarships only if money is left over after these existing private school students have been provided for.12 As a result, those who gain from this tax law provision are generally those who have already had their children in private schools.

ASU study offers clues to law’s real beneficiaries

A study by Glen Wilson of Arizona State University concluded that scholarship amounts primarily averaged below $500. Since low-income students would generally need larger scholarships to pay the high costs of private school tuition, this study strongly suggests that the Arizona tax credit functions more as a middle- and upper-class subsidy than it does as a vehicle for increasing access for low-income students. For example, in 1998, 85.3 percent of all scholarships granted averaged below $500, 8.6 percent averaged between $500 and $1,000, and less than 7 percent averaged above $1,000.13

Precise information on who benefits from the program is difficult to find. For example, even if a low-income student were able to obtain an STO scholarship sufficient to cover the cost of private school tuition, other factors—such as transportation to and from campus, application fees, and admission tests—could hamper the student’s ability to attend private or religious schools. The
precise role these or other obstacles could play is unknown because the state collects very little
information from STOs and also because private schools are largely unregulated by state officials.
Yet, for a news story last year, the Arizona Republic interviewed a spokeswoman for Arizona’s
governor who readily admitted, in the newspaper’s words, that “it is mostly middle-income families
whose kids already are in private schools who are taking advantage of the program, not the poor kids
supporters claimed it would help.”14

An absence of accountability

There are few regulations governing the operation of STOs, and even these rules can be
circumvented. For example, the law stipulates that scholarship organizations may not designate
all their scholarship money to one particular school. Yet, the Chabad Lubavitch Orthodox Jewish
Synagogue Scholarship Fund provides scholarships only for students attending the Phoenix
Preparatory High School. Fund officials argue that since boys and girls are taught separately in
the orthodox Jewish tradition, scholarships are actually benefiting two different institutions,
despite the fact that students of both sexes are housed in the same building.15

Even while the Arizona tax credit diverts millions of state tax dollars to private and religious
schools, state officials demand little accountability from STOs. STOs don’t have to provide any
information on the quality of the education provided through state-subsidized dollars and don’t
have to be certified by the Arizona Department of Revenue or have their records audited.16
PFAWF research has also found that STOs provide the state with donation information—such as
the name, address and social security number of the donor, donation amount, scholarship amount
and length, student beneficiary, and school beneficiary—only when the donor chooses to make it
available. STOs are not required to follow up with donors to obtain this missing information.17

This may explain why more parents have claimed tax credits on contributions made to
scholarship organizations than these organizations report. For example, in its report on 1998 tax
credits, the Arizona Department of Revenue could verify only 53.8 percent—a bare majority—of
the 6,400-plus tax-credit claims against STO-provided donor lists.18 And, while the Department
of Revenue acknowledges this growing problem, the laxity in reporting requirements has yet to
be rectified. In other words, there is no specific oversight authority or any enhanced ability of
state officials to investigate suspected tax fraud.19 Last year, the Department’s chief economist
warned that she saw “lots of possibilities for abuse.”20

In the meantime, opponents of the tuition tax credit scheme have rightfully raised serious
concerns about the loss of tax dollars for Arizona public schools. Since 1998, more than
$33 million in taxpayer dollars has been diverted from the state treasury to fund religious and
private schools under this program, even while some of Arizona’s urban public schools have
been unable to fund important kindergarten enrichment and after-school tutoring programs for
students.21

Arizona’s tax credit for public-school extracurricular activities

The second type of tax credit allows Arizona taxpayers to claim a smaller credit of up to $200
($250 if filing jointly) for expenses toward extracurricular activities at public schools. Parents
can claim the credit for contributions made toward their children’s expenses such as band
uniforms, equipment or uniforms for varsity athletics, field trips, math and tutoring programs and
scientific laboratory materials. Credits can be claimed by any eligible taxpayer—the provision could enable public schools to receive donations from non-parents as well.

Tax credit proponents argue that this provision of the law helps public schools by enabling them to offer extracurricular activities that they otherwise would not be able to afford. However, an examination of this aspect of the Arizona law demonstrates that, in practice, the neediest public schools receive only a minimal benefit. An analysis by the Arizona Republic reveals that public schools with the greatest needs receive the least from tax credit donations. For example, Nadaburg Elementary—a public school in one of the state’s wealthier districts—was able to collect as much as $333 per student through tax credits. In contrast, Glendale Elementary, located in a predominantly poor area, was able to collect only $4 per student during this same period. The analysis did find a few exceptions where schools in low-income areas benefited from donations made by nearby retirement communities, but the overall finding was clear: public schools in wealthier communities have benefited disproportionately.

Similarly, the study conducted by Arizona State University’s Glen Wilson found that in 1998, among a sample of 929 public schools, the schools in the poorest areas and with the lowest test scores received the least money from tax credit donations. The study reported that public schools in the poorest communities received fewer than 4,100 donations amounting to approximately $2,900 per school. Conversely, public schools in the wealthiest areas of the state received more than 29,000 donations averaging approximately $13,000 per school. By allowing taxpayers to direct where their dollars go, the Arizona tax credit law actually exacerbates existing gaps in the quality of programs between low-income schools and schools that serve wealthier communities.

In fact, most of the tax credits are used by middle- and upper-class families as a subsidy for their own children’s extracurricular expenses—expenses they would have incurred anyway. Since the tax credit is a delayed reimbursement, only families who earn enough to owe state taxes, and who can afford the up-front expenses, can utilize the credit. In other words, there is no way for poorer families to take advantage. As a result, there is little expansion of opportunities for low-income students to participate in extracurricular activities, since these activities rely heavily on a family’s ability to pay.

Both overall statistics and individual examples support this conclusion. According to the Arizona Department of Revenue, in 1998 more than 75 percent of tax credit claimants had an income surpassing $50,000, including more than 50 percent with incomes above $75,000. In contrast, less than a quarter of the claims were made by taxpayers earning between $20,000-$50,000. And a mere 2 percent of tax-credit claims were made by families earning $20,000 or less.

**Subsidies for trips to Catalina Island**

School officials report that wealthier Arizona parents have used the tax credit to help send their children on band field trips to Vancouver and New York, or to send other students to cheerleading camp. Former Superintendent of Public Instruction Lisa Graham Keegan used the tax credit to recoup $200 of the $300 she paid for her son’s trip to Catalina Island, off the coast of southern California—but less fortunate students stayed at home. Meanwhile, the state’s ability to bolster educational programs at public schools is clearly undermined due to the loss of
millions through the tax credit. In 1998, the state lost $8.9 million just through extracurricular-activity tax credits. This figure soared to $14.7 million in 1999.\textsuperscript{31}

While supporters argued that the law would provide a fresh stream of money for public schools, very little of the money credited as “donations” for public schools actually represents new funding. In practice, parents are obtaining receipts from school officials for expenses that they have traditionally paid each year (e.g., purchasing a band instrument or athletic equipment). Relatively few taxpayers are writing open-ended checks that public schools are free to use for new programs that enhance students’ academic or cultural experiences.

For example, Scottsdale’s Desert Canyon Middle School collected $150,242 in “donations” in one year, but 98 percent of that amount paid for pre-existing school activities that parents had traditionally funded.\textsuperscript{32} Similarly, Paradise Unified Valley School District received $770,000 in tax credit donations in 1999, but only $183,000 truly represented new money to the schools. The remaining $587,000 was claimed as credits by parents for their children’s extracurricular activities, which included the district’s annual trip to Catalina Island Marine Institute where students study oceanography and scuba diving.\textsuperscript{33}

The schools are basically reduced to issuing receipts so parents can claim their credit—and must spend inordinate amounts of resources to do so. According to Paradise Valley’s assistant superintendent for business services, James DiCello, of the $183,000 received by the district, more than half was spent on overtime for secretaries—who stayed late to write receipts for parents claiming the credit—and for other related costs.\textsuperscript{34}

Problems associated with the extracurricular activity tax credit also can be seen in the lax reporting mechanisms that are in place. With schools having little incentive to report accurate data to state officials, the Department of Revenue has found serious discrepancies between the donations reported by schools and taxpayer contributions. The Department of Revenue was only able to verify about 61% of the reported data.\textsuperscript{35} Due to the complexity in collecting data from various parties, the Department of Revenue decided to rely on just one set of data for the future—donations made toward the extracurricular activities at public schools.\textsuperscript{36}

**Conclusion**

Arizona taxpayer dollars going to public schools or private STOs under the tax credit law are not, in fact, “donations” as supporters generally call them. While a state can earmark funds based on the needs of a public school and its students, Arizona’s tuition tax credit interferes with this ability—effectively reallocating funds in a patently inequitable manner that hinders school improvement and reinforces economic divisions.\textsuperscript{37} In essence, by diverting public money to private tuition organizations which then allocate funds, the tax credit functions as a de facto voucher system with very little accountability. This may explain why one newspaper noted that the architect of the tax credit law and his allies consider the private tuition tax credit provision to be “the next best thing to vouchers.”\textsuperscript{38} Using state tax dollars in this manner serves to exacerbate, rather than ameliorate, inequities in educational resources. Similarly, the tax credit for public school extracurricular expenses serves largely to benefit middle-class and wealthy parents by subsidizing their children’s extracurricular activities, while offering little benefit to low-income families.
Proponents are touting the Arizona tax credit law as a model for expanding educational opportunities. Indeed, the state’s tax credit scheme does serve as a model—for what other states should avoid.

### Arizona’s Tuition Tax Credit Numbers at a Glance

<table>
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<tr>
<th>Year</th>
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<th>Extracurricular Activity Tax Credits</th>
<th>Total Tax Credits</th>
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<tr>
<td>1998</td>
<td>$1.8 million (15 STOs)</td>
<td>$8.9 million</td>
<td>$10.7 million</td>
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<tr>
<td>1999</td>
<td>$13.7 million (31 STOs)</td>
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<tr>
<td>2000</td>
<td>$17.5 million (35 STOs)</td>
<td>Data not available</td>
<td>More than $17.5 million(^{39})</td>
</tr>
<tr>
<td>Total</td>
<td>$33 million</td>
<td>More than $23.6 million(^{40})</td>
<td>More than $56.5 million(^{41})</td>
</tr>
</tbody>
</table>

*SOURCE:* Private School Tuition Organization Tax Credits Reported by School Tuition Organization, Calendar Year 1998 through 2000, Arizona Department of Revenue; Public School Extracurricular Activity Credit Reported by Schools and Taxpayers, 1998 and 1999, Arizona Department of Revenue. (Note: Some totals are listed as “more than” a specific amount because the state has not yet released data on extracurricular activity tax credits for the year 2000.)
ENDNOTES

1 Lowell C. Rose and Alec M. Gallup, “The 33d Annual Phi Delta Kappa/Gallup Poll of the Public’s Attitudes Toward the Public Schools,” September 2001. (For the first time in the poll’s history, a majority of respondents gave their local public schools a grade of A or B.)


5 Data based on donations made to private STOs from 1998-2000 and donations made to public schools from 1998 to 1999 only; data for public school donations made in 2000 is not currently available; Arizona Department of Revenue. Available figures on the cost of the Arizona tax credit program are provided in the chart at the end of this report.

6 School Tuition Organizations are defined as charitable organizations exempt from federal income tax as specified in the 501 (C)(3) of the IRS code; organizations allocate at least 90% of annual revenue toward educational scholarships or tuition grants to students, allowing them to attend any qualified school they are admitted to. A.R.S. § 43-1089. Available at: http://www.azleg.state.us/ars/43/01089.htm.

7 A.R.S. § 43-1089. Available at: http://www.azleg.state.us/ars/43/01089.htm.

8 Glen Y. Wilson, “Effects on Funding Equity of the Arizona Tax Credit Law,” Education Policy Analysis Archives, August 1, 2000.


10 ibid.


12 Survey data collected from telephone interviews with officials at STOs, September 7 and 10, 2001.


15 ibid.


17 ibid.


20 ibid.

21 Arizona Department of Revenue, School Tax Credit Information; Arizona Department of Revenue, STO data from 1998 and 1999.


25 Glen Y. Wilson, “Effects on Funding Equity of the Arizona Tax Credit Law,” Education Policy Analysis Archives, August 1, 2000, pp. 3-5.


27 ibid.

28 Data based on federal adjusted gross income; “Arizona’s Individual Income Tax Credits For Schools: Final Report of 1998 Credits,” Arizona Department of Revenue, Office of Economic Research and Analysis, October
Acknowledgments:
Arohi Pathak, Research Assistant
Dwight Holmes, Education Policy Manager
Elliot Mincberg, Vice President & Director of Education Policy
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