

Fiscal Analysis of Arizona's Corporate Tax Credit Scholarship Program

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Executive Summary

This analysis finds that the Arizona corporate tuition tax credit scholarship program could save the State of Arizona's General Fund an estimated \$57.2 million over the next five years, an average of \$11.4 million annually.

The analysis updates a 2005 report by the Joint Legislative Budget Committee (JLBC) that looked at the fiscal impact of a similar proposed program and reflects the program as actually passed in 2006. In its 2005 analysis, the JLBC determined that each student who transfers from a public school to a private school would save the state General Fund \$5,000. The program achieves a savings because students who transfer to private schools do so with scholarships that are less than the average per-student state base funding for Arizona public schools.

Additionally, the JLBC concluded that the corporate tuition tax credit scholarship program "potentially could reduce School Facilities Board (SFB) costs for new school construction and building renewal."

Description

On June 21, 2006, Arizona adopted a corporate tax credit scholarship program that allows businesses to claim income tax credits for contributions to school tuition organizations (STO).¹ Businesses may claim the income tax credit from June 30, 2006 through June 30, 2011, and they may receive a credit against their income taxes for contributions made during the taxable year to a school tuition organization (STO) that awards scholarships to eligible children. To be eligible for a corporate tax credit scholarship, children must come from families whose annual income does not exceed 185 percent of the income level required to qualify for the federal free or reduced lunch program, and either:

1. "Attended a governmental primary or secondary school as full-time students...for at least the first one hundred days of the prior fiscal year and transferred from governmental primary or secondary school to a qualified school.
2. Enroll in a qualified [nongovernmental] school in a kindergarten program.
3. Received an educational scholarship or tuition grant if the children continue to attend a qualified school in a subsequent year."²

In fiscal year 2007, aggregate tax credits cannot exceed \$10 million. Each year thereafter, the aggregate tax credit cap is increased by 20 percent, reaching \$20.7 million in fiscal year 2011.

Methodology

The Joint Legislative Budget Committee (JLBC) prepared a fiscal analysis of a corporate tuition tax credit scholarship program proposed in 2005 that was not adopted. The 2005 program had the same student eligibility requirements. Under that proposal, the amount of tax credits would have been capped at \$10 million for calendar year 2006 and would have increased \$5 million annually until reaching a total statewide maximum cap of \$55 million in calendar year 2015 and each year thereafter.³ This analysis of the corporate tuition tax credit scholarship program actually passed in 2006 draws upon the assumptions

used in the JLBC 2005 fiscal analysis, updated to reflect adopted tax credit donations caps, scholarship amounts, and student enrollment figures.

Overview of Estimated Fiscal Impact

As the JLBC analysis notes in its 2005 fiscal analysis, the corporate tuition tax credit scholarship program would have two possible areas of fiscal impact. The new tax credit would reduce up-front state revenue, but the new scholarships “would reduce the state’s K-12 costs if students attend private schools rather than public schools.” Two factors in particular make it impossible to know the precise fiscal impact of the scholarship program. Those factors, along with the assumptions for this analysis, are described below.

The Number of Corporate Donations

As noted in the 2005 JLBC analysis, it is not possible to predict the level of annual corporate donations because they depend on the decisions of individual business, and the amount of Arizona corporate income tax collections changes annually. Over the past decade, annual corporate income tax collections have averaged \$656 million, ranging from a low of \$505 million in fiscal year 1996 to a high of \$883 million in fiscal year 2006.⁴ The JLBC assumes that in the first year of the corporate tuition tax credit scholarship program tax credits would amount to \$5 million in its 2005 analysis. This analysis uses the Arizona Department of Revenue (DOR) assumption that corporate donations under the program adopted in 2006 will be \$10 million, which represents 1.13 percent of fiscal year 2006 corporate income tax collections.⁵ The current DOR assumption closely resembles the experience of a similar corporate tuition tax credit program in Pennsylvania. The Pennsylvania program capped corporate income tax contributions at \$20 million in its first year and received \$19 million in corporate income tax pledges, which represented 1.2 percent of the state’s total corporate income tax collections for that year.

This analysis assumes a one year delay in the fiscal impact of corporate tuition tax credit scholarship program with regard to both the loss of up-front corporate tax collections to the state and the savings from public school transfers. This assumption rests on the DOR’s standard scoring of a tax credit’s fiscal impact, which assumes the fiscal impact will begin in April following the first year of implementation, or April 2007.⁶ This assumption is also based on the fact that school districts receive Basic State Aid funding according to their prior year, not current year, average daily membership (ADM) counts. Thus, as the JLBC explains, “It is possible that savings from Basic State Aid may not be immediately achieved in the year that a public school student transfers to a private school. The bill does not prohibit school districts from including transferred pupils in their ADM counts after they transferred.”⁷

“Natural Transfers”

In its analysis, JLBC concluded that each student who transfers from a public school to a private school will save the state General Fund about \$5,000 in fiscal year 2007, increasing by 2.5 percent annually. The corporate tuition tax credit scholarship program is limited to public school children from families whose annual income does not exceed 185 percent of the income level required to qualify for the federal free or reduced lunch program. According to the JLBC, approximately 47 percent of all Arizona public school students, about 487,000, currently qualify for the federal free and reduced price school lunch program.

Kindergarteners are also eligible for corporate tuition tax credit scholarships if they come from families meeting the annual income requirements. They are the only possible source of “natural transfers,” students who would attend a private school with or without the corporate tuition tax credit scholarship program because they may be enrolled in either a public or a qualified private school. The JLBC estimates that 96 percent of students enrolling in kindergarten would not enroll in private school apart from the corporate tax credit scholarship program, about 76,200 students. That means only 3,200 students could be

potential “natural transfers” enrolling in private kindergarten, or 0.66 percent of all students who qualify for the federal free and reduced price school lunch program. Given this small likelihood, this analysis assumes eligible students using corporate tuition tax credit scholarships are not “natural transfers.”

Cost-Neutral Estimate

As with the JLBC fiscal analysis of the 2005 proposed corporate tuition tax credit scholarship program, this analysis first estimates how many public school students would have to transfer to private schools in order for the adopted 2006 scholarship program to be cost-neutral. It uses the JLBC per-pupil state General Fund savings of \$5,000 for fiscal year 2007, which the JLBC projected to increase 2.5 percent annually. As summarized in Table 1, between 2,000 and 3,800 students would have to use corporate tuition tax credit scholarships from fiscal years 2007 to 2011 for the program to be cost-neutral. Those figures represent approximately 0.2 percent of current Arizona public school enrollment and 5 percent of private school enrollment.

Table 1: Number of Participating Students Needed for the Corporate Tuition Scholarship Program to Be Cost-Neutral, Fiscal Years 2007-2011

Fiscal Year	JLBC Per-Pupil General Fund Savings	Corporate Donations Cap	# Students Needed to be Cost-Neutral
2007	\$5,000	\$10,000,000	2,000
2008	\$5,125	\$12,000,000	2,341
2009	\$5,253	\$14,400,000	2,741
2010	\$5,384	\$17,280,000	3,209
2011	\$5,519	\$20,736,000	3,757

Sources: Author’s calculations based on JLBC fiscal analysis of SB 2378; and SB 1404.

Those annual student participation rates appear likely based on participation in the current individual tuition tax credit program, which awarded an average of nearly 15,000 scholarships annually from 1998 to 2005. Research also indicates that there is unmet demand among low-income families for tax credit scholarships. A 2003 survey found that the waiting list for scholarship students at Arizona School Choice Trust, one of 55 STOs statewide, reported having 2,000 low-income children on its waiting list. The median household income of wait-list families was less than \$30,000, about 30 percent below the state average, and 70 percent of those children had been waiting for scholarships for three or more years.⁸

However, participation rates in the first year of newly-adopted scholarship programs are typically lower than subsequent years, since it takes time for families to learn about them. First-year participation rates can also be low if a new scholarship program faces a legal challenge, as the Arizona individual tuition tax credit scholarship program did when it was adopted. As the DOR notes in its 2006 annual individual tuition tax credit report, “Activity in 1998 was artificially low due to a court case challenging the constitutionality of the credit based on separation of church and state. The credit was determined to be constitutional.”⁹ Once the program was ruled constitutional, participation increased dramatically in one year, from 128 scholarships awarded in 1998 to 3,365 scholarships awarded in 1999. In 2000, the number of scholarships awarded increased sharply again to 15,081, and increased steadily each year thereafter up to 22,522 scholarships awarded in 2005.

Thus, significantly fewer potential donors and scholarship students may participate in the program until they are certain that it will continue, possibly resulting in an initial cost to the state General Fund. However, based on participation rates in the individual tuition tax credit program, it is likely that any initial costs will be offset by savings in subsequent years.

Estimated Scholarship Savings

Under the current scholarship program, in fiscal year 2007 maximum scholarship amounts cannot exceed \$4,200 for K-8 students and \$5,500 for high school students. Each year maximum scholarship amounts increase \$100, up to \$4,600 for K-8 students and \$5,900 for high school students in fiscal year 2011. Based on annual reports compiled by the DOR of scholarship awards under the individual tuition tax credit program, the JLBC explains that STOs “currently try to maximize the number of pupils receiving scholarships and typically require parents to pay at least a portion of their child’s tuition costs.”¹⁰ Arizona private school tuition averages \$3,700 for elementary students and \$5,500 for high school students.¹¹ According to the 2006 annual DOR individual tuition tax credit report, the average scholarship was worth \$1,370 in 2005, which represents a 2.7 percent increase over the 2004 average scholarship amount.

However, the individual tuition tax credit scholarship program is not means-tested and may be used by students currently attending private schools regardless of family income. The corporate tuition tax credit scholarship program is designed for public school students from low-income families who would not otherwise be able to attend private schools. Average STO scholarship amounts will therefore likely be higher under the corporate tuition tax credit program than the individual tuition tax credit program. The estimate summarized in Table 2 calculates savings using an adjusted average scholarship amount that is twice the average individual tuition tax credit amount, \$2,814 for fiscal 2007, and increasing annually by 2.7 percent through fiscal year 2011.

Table 2: Estimated Annual General Fund Savings Based, Fiscal Years 2007-2011

Fiscal Year	JLBC Per-Pupil General Fund Savings	Corporate Donations Cap	# Students Needed to be Cost-Neutral	Average Scholarship Amount	# Participating Students	# Students Above Cost-Neutral Level	Total General Fund Savings
2007	\$5,000	\$10,000,000	2,000	\$2,814	3,554	1,554	\$7,770,000
2008	\$5,125	\$12,000,000	2,341	\$2,890	4,152	1,811	\$9,281,375
2009	\$5,253	\$14,400,000	2,741	\$2,968	4,852	2,111	\$11,089,083
2010	\$5,384	\$17,280,000	3,209	\$3,048	5,669	2,460	\$13,244,640
2011	\$5,519	\$20,736,000	3,757	\$3,130	6,625	2,868	\$15,828,492

Sources: Author’s calculations based on JLBC fiscal analysis of SB 2378; SB 1404; and DOR annual individual tuition tax credit reports.

As illustrated in Table 2, once annual participation levels exceed approximately 2,000 to 3,800 students, every student who transfers to a private school using a corporate tuition tax credit scholarship over the next five years generates a state General Fund savings ranging up to approximately \$5,500. Based on participation in the individual tuition tax credit scholarship program, it is likely that participation in the corporate tuition tax credit scholarship program will exceed those cost-neutral levels. Assuming full participation given the scholarship amounts and donation caps, the corporate tuition tax credit scholarship program could save an average of \$11.4 million annually, ranging from \$7.8 million to \$15.8 million in state General Fund savings each year.

The JLBC also notes the corporate tuition tax credit scholarship program could save on new building and construction costs. Precise annual savings cannot be estimated because new school construction is approved through a multi-year process that is not immediately affected by the scholarship program, and only growing districts with projected space deficiencies qualify for new school construction funding. The proportion of students transferring from such districts because of the scholarship program is also impossible to predict. Nevertheless, the JLBC analysis concludes that the corporate tuition tax credit scholarship program “potentially could reduce School Facilities Board (SFB) costs for new school

construction and building renewal..., which could help offset the cost of tax credits under the bill. New school construction costs would decrease if the SFB approved fewer new schools because of reduced enrollment growth... This would reduce SFB building renewal costs as well because fewer school buildings would require funding under that formula.” Estimates based on existing private school capacity, which require no major construction or plant renovations, also show there are approximately 26,000 available private school seats in Arizona.¹²

About the Author

Vicki Murray, Ph.D., is an independent education policy analyst based in Paradise Valley, Ariz. She received her Ph.D. and master’s degree in politics from the University of Dallas, where she was an Earhart Foundation Fellow.

Endnotes

¹ A school tuition organization is defined as “a charitable organization in this state that both: (a) Is exempt from federal taxation under section 501(c) (3) of the internal revenue code and that allocates ninety per cent of its annual revenue for educational scholarships or tuition grants to children to allow them to attend any qualified school of their parents' choice. (b) Provides educational scholarships or tuition grants to students without limiting availability to only students of one school.” See SB 1404; cf. A.R.S. 43-1183, “Credit for contributions to school tuition organization; definitions,”

<http://www.azleg.state.az.us/FormatDocument.asp?inDoc=/ars/43/01183.htm&Title=43&DocType=ARS>.

² SB 1404. The Joint Legislative Budget Committee (JLBC) notes that language in the bill could be interpreted as allowing 185 percent of 185 percent of the limit required to qualify a child for reduced priced lunches. For fiscal year 2006-2007, that limit is \$37,000 and 185 percent of that amount is \$68,450. Free and reduced lunch income limit figure is based on the U.S. Department of Agriculture, Food and Nutrition Service, “National School Lunch Program,” <http://www.fns.usda.gov/cnd/lunch/AboutLunch/NSLPFactSheet.pdf>; and the JLBC fiscal analysis of SB 2378 sponsored by Sen. Dean Martin and HB 1176 sponsored by Rep. Steven Yarbrough prepared by Steve Schimpp on February 8, 2005. The bills and Schimpp’s fiscal analyses are identical.

³ In 2005, identical corporate tuition tax credit scholarship bills were introduced in the Arizona House of Representatives and the Senate. Sen. Dean Martin sponsored SB 2378, and Rep. Steven Yarbrough sponsored HB 1176. The JLBC fiscal analyses of both bills are identical and were prepared by Steve Schimpp on February 8, 2005.

⁴ Arizona Department of Revenue (DOR) annual reports and the “June 2006 Tax Facts” summary.

⁵ According to Karen Jacobs of the DOR in response to a telephone query from author on September 21, 2006.

⁶ According to the JLBC, “Corporations make estimated tax payments throughout the year. These estimated payments generally are then applied to the corporation’s total tax liability when the corporation files its tax return, generally in April of the following year. For example, TY 2006 estimated payments generally would be incorporated into the April 2007 tax filing.” Thus corporations would adjust their 2006 estimated payments downward by \$10 million for their STO contributions. JLBC adds, “When determining the fiscal impact of tax credits, DOR typically does not make this ‘estimated payment’ adjustment. Instead, they usually assume that the fiscal impact of a tax credit will begin in April following the first full year of implementation.” See JLBC fiscal analysis of SB 2378, p. 2.

⁷ JLBC fiscal analysis of SB 2378, p. 3.

⁸ Dan Lips, “The Impact of Tuition Scholarships on Low-Income Families: A Survey of Arizona School Choice Trust Parents,” Goldwater Institute Policy Report #187, December 11, 2003.

⁹ DOR, “2006 Individual Tuition Tax Credit” annual report, p. 3, n. 3, referring to *Kotterman v. Killian*; cf. Clint Bolick, “School Vouchers: Constitutionally Permissible in Arizona,” Goldwater Institute Policy Brief, March 8, 2004.

¹⁰ JLBC fiscal analysis of SB 2378, p. 2.

¹¹ Vicki Murray and Ross Groen, “Survey of Arizona Private Schools: Tuition, Testing and Curricula,” Goldwater Institute Policy Report #199, January 5, 2005.

¹² Murray and Groen, “Survey of Arizona Private Schools,” 2005.