EducationNext

How to Fund Education Savings Accounts with Tax Credits

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In recent years, policymakers across the nation have shown great interest in education savings accounts (ESAs). Last year alone, three states adopted new ESA policies, Arizona expanded student eligibility for its ESA, and several other states considered ESA legislation.

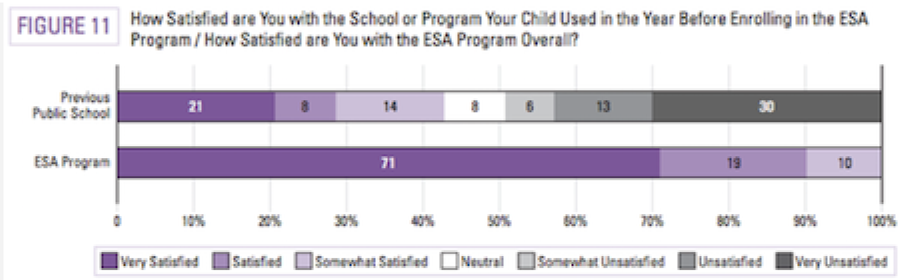
Whereas traditional voucher programs empower families to choose among numerous private schools, ESAs give parents the flexibility to customize their child's education. Under existing ESAs, the state deposits funds into private, restricted-use bank accounts that parents of eligible students can use for a wide variety of educational purposes, including private school tuition, tutoring, textbooks, online courses, educational therapies, and more.

In a new Cato Institute report, Jonathan Butcher of the Goldwater Institute and I draw from the experiences of three states to explore how to fund ESAs through tax-credit-eligible private donations, similar to scholarship tax credit (STC) policies in 16 states. This funding model should be attractive to policymakers in states where constitutional provisions, such as Blaine amendments, may prohibit publicly funding private education. As Clint Bolick of the Goldwater Institute details in the report, publicly funded educational choice programs have a mixed record in court, but STC laws have a perfect record of withstanding constitutional challenges.

Differing Models for Educational Choice: Arizona, Florida, and New Hampshire

In 2011, Arizona became the first state to enact an ESA law. Although eligibility was originally limited to students with special needs, Arizona lawmakers subsequently expanded eligibility to include adopted children, children of active-duty military personnel, students living on Native American reservations, and students assigned to a district school with a D or F rating, as well as siblings of eligible students. Arizona ESA families use restricted-use debit cards to make qualifying educational purchases, and then submit receipts to the state department of education for review before the state makes its next quarterly deposit.

Arizona parents report high levels of satisfaction with their ESAs. A survey of ESA parents in the first year of the program found that fewer than half of respondents had been satisfied with their child's previous public school, but the ESA parents unanimously expressed satisfaction with the education their children received through the ESA.



Source: Friedman Foundation survey.

Three years later, Florida became the second state to enact an ESA law. Florida's Personal Learning Scholarship Accounts are similar to Arizona's ESAs but also differ in some key respects, including student eligibility, funding, and management. Arizona's accounts include multiple categories of children, while in Florida, only certain categories of students with special needs are eligible.

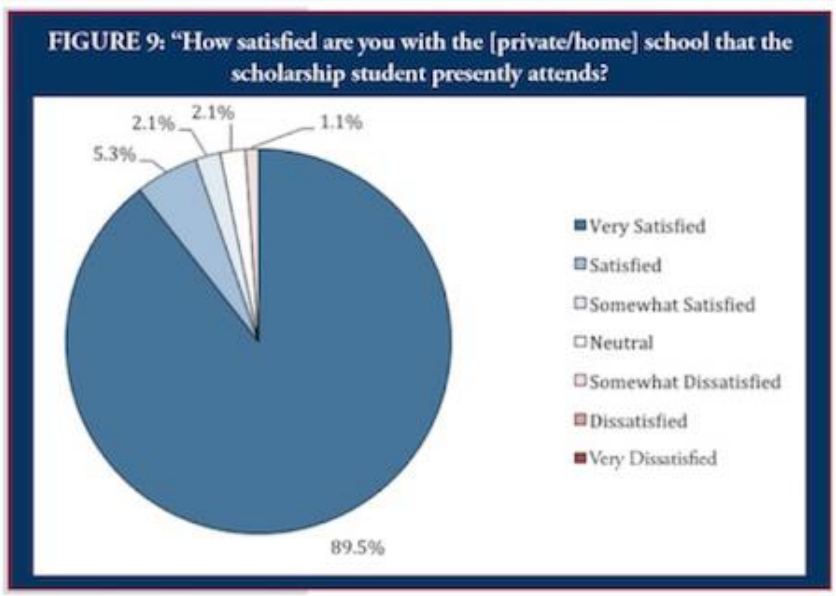
The critical distinctions between Arizona's ESAs and Florida's accounts are that the former is funded through the state funding formula with the state department of education administering the program. In Florida, the state funds ESAs through separate annual appropriations and private school scholarship organizations are responsible for the accounts' implementation.

There are also differences in how parents access and use the ESA funds. Rather than using Arizona-style debit cards, Florida ESA families first request approval for qualifying educational expenses via a website. Typically, parents spend their own money to make approved purchases and apply for a reimbursement from the scholarship organization for their expenses. For some larger purchases, like private school tuition, the scholarship organizations can pay the school directly from the child's ESA.

New Hampshire's scholarship tax credit law offers a third model of educational choice that is both privately managed and privately funded. Enacted in 2012, the Granite State's STC was the first to allow scholarship organizations to assist homeschoolers. NH's STC offers corporations tax credits worth 85 percent of their contributions to nonprofit scholarship organizations that aid low- and middle-income families. However, unlike with ESAs, tax-credit scholarship recipients in New Hampshire can choose *either* to use the funds to cover private school tuition *or* for qualifying homeschooling expenses, such as curricula, textbooks, online courses, or tutoring.

As in Florida, NH scholarship recipients who are homeschooling must use their own funds to make purchases and then submit receipts for reimbursement. However, what was initially the state's sole scholarship organization, the Network for Educational Opportunity (now an affiliate of the Children's Scholarship Fund), would sometimes make exceptions in cases of particular financial hardship. Kate Baker, the then-director of NEO (now CSF-NH), called such exceptions "high-risk prospects" because of the potential consequences from the state department of revenue if the scholarship recipients failed to return the required receipts. Fortunately, the scholarship organization has so far achieved a 100 percent rate of receipt submissions.

Similar to Arizona's ESA, the program was popular among parents. In a survey of tax-credit scholarship recipients in the first year, 97 percent expressed satisfaction with their chosen private school or homeschool.



Source: Show-Me Institute report.

Policymakers who want to expand educational choice in their states should seek to combine the advantages of each approach. Below, we offer some suggestions for designing tax-credit ESAs.

Designing Tax-Credit Education Savings Accounts

A tax-credit ESA would combine aspects of the three approaches discussed above. Donors would receive tax credits in return for contributions to nonprofit scholarship organizations that would set up, fund, and oversee the accounts.

The scholarship organizations could serve several functions beyond merely collecting donations and issuing ESAs. For example, they could act as information clearinghouses to help families make informed decisions about their children's education. They could even provide an extra layer of accountability by rating education providers or providing ESA families with a platform to do so.

ESA Eligibility

The ultimate promise of educational choice is that every child should have access to the education that best meets his or her needs. However, for various reasons, some states limited their ESA eligibility to students with special needs. ESAs serve these students particularly well because they give parents greater access to a wide variety of services and therapies in and outside of the classroom. Where funds are limited, it makes sense to target those populations that are most in need. Nevertheless, students from all walks of life can benefit from a greater ability to tailor their education to their particular needs. Ideally, all students should be eligible for an education savings account.

Qualifying Purchases

Once approved, families could then use the ESAs to purchase qualifying educational products and services, such as:

- Tuition or fees at a qualified school or an eligible postsecondary institution
- Textbooks
- Educational therapies or services from a licensed or accredited practitioner or provider
- Tutoring or teaching services
- Curricula and related materials
- Tuition or fees for an online learning program
- Fees for a nationally standardized norm-referenced achievement test, an advanced placement examination, or any exams related to college or university admission
- Contributions to a college savings account
- Services provided by a public school, including individual classes and extracurricular programs
- Any fees for the management of the ESA

In addition, some states allow families to use ESA funds for some consumable materials, such as pens and paper, or for hardware used for educational purposes, such as computers or tablets. Other states disallow these categories of purchases. This is an area where policymakers must weigh the needs of low-income families against the potential for abuse. If given the prerogative to do so, the scholarship organizations can play an important role in striking the right balance.

Tax Credits and Funding

Sufficient funding is necessary for the success of the program, so policymakers should allow the widest possible base of financial support and make contributing as easy as possible. Where possible, both individual and corporate taxpayers should be eligible to receive tax credits for their contributions to the ESA-granting organizations. Moreover, in order to maximize the number of students who will be able to benefit from an ESA, the state should offer dollar-for-dollar tax credits in return for these contributions.

Spending ESA Funds

Policymakers should see to maximize the ease of using the ESA while ensuring that the ESAs funds are only used for their intended purposes. Both the reimbursement model and the debit card model are effective ways of minimizing the potential for abuse, but the former generally requires beneficiaries to pay out of pocket first. That can be difficult for many low-income families. Policymakers may also want to explore other options to maximize flexibility while minimizing the risk of fraud. For example, Nevada is contracting with BenefitWallet, a subsidiary of Xerox that specializes in flexible spending accounts, to provide families with a way to use their ESAs via a website or smart-phone app.

Conclusion

Education savings accounts empower families to customize their children's education. Since every child is different, these accounts allow families to find learning experiences for their children that are as unique as each child. They are an improvement on traditional school-choice programs because they enhance the freedom of parents to purchase a wide variety of educational products and services and save for educational expenses in future years, including college. In states where courts have narrowly interpreted their state constitution's Blaine amendment, funding ESAs through tax credits is a constitutionally sound method of providing every child with the chance at an excellent education.

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