


 Abstract

A hidden tax preference arises when religiously affiliated schools are financed by tax-deductible charitable contributions in lieu of tuition. This article explores the implicit contracts between parents and schools and examines potential free-rider problems. Revised estimates of the fiscal costs of a federal tuition tax credit are presented as well. Finally, the article shows how the existence of this preference makes the case for a federal tuition tax credit relatively stronger.

HIDDEN TAX PREFERENCES AND THE REAL COSTS OF TUITION TAX CREDITS

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In 1983, there were 5.7 million students in private primary and secondary schools, with 4.6 million of this total enrolled in religiously affiliated schools. All donations and gifts to any private, nonprofit educational organization are tax deductible. This tax preference is available to both secular and parochial schools (Toma, 1981). Tuition, however, is a payment for a benefit received and is not tax deductible. Likewise, charitable contributions to church, synagogue, and other religious organizations are allowable deductions unless benefit is received from the contribution. Thus, a "contribution" for tuition at a parochial school is not legally deductible. However, if the school is considered a ministry of the church and if enrollment of one's children in school is not dependent upon a contribution, then designated gifts or contributions to the educational ministry of a church are allowable deductions.

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A hidden tax preference arises when religiously affiliated schools are financed by tax deductible, charitable contributions instead of tuition. That is to say, instead of paying nondeductible tuition, the parents, as it were, drop a check in the collection plate. The possibility of donations in lieu of tuition has been suggested before, and there is empirical evidence consistent with the existence of this phenomenon (Frey, 1983). The purpose of the current article is to analyze some implications of this hidden tax preference. First, the article explores the implicit contract between parents and school necessary if the school is tuition free and examines possible free rider problems. Building on the work of West (1985), we then revise estimates of the fiscal costs of a federal tuition tax credit in light of this hidden preference. Finally, the article shows how the existence of this hidden tax preference makes the case for a federal tuition tax credit relatively stronger.

IMPLICIT CONTRACTS AND THE FREE-RIDER PROBLEM

It would be best to start with an example in order to better understand how a school can be tuition free and not succumb to a free-rider problem. This example is generalized from particular cases. Suppose a local church establishes a tuition-free school that is financed from the general fund of the church as well as from designated gifts. The pastor, or maybe the education minister, may ask the congregation for donations to this ministry, noting the average cost per student as well as the fact that not all parents of students enrolled in the church's school can afford to make contributions. This average cost figure can also be emphasized during a meeting for parents of prospective students. Anyone making a free-will donation toward the school would have an allowable charitable deduction even if the donor happened to have a child enrolled in the church school and even if the contribution was equal to the average cost figure cited.

The presentation of the financial ramifications of the church

school can be made in such a way that parents realize that they are entering into an implicit contract when they enroll their children. That is to say, if they have the means they are obligated to financially support the school. They may contribute more, or others without children enrolled may also contribute. After all, it is not unusual to find people volunteering time or money to schools, whether the schools are public or private, secular or parochial (Clotfelter, 1985).

One possible difficulty with such "free" religiously affiliated schools would be enforcement of the implicit contract. Voluntary contributions may result in a free-rider problem. It should be remembered that parents may have internal moral limitations that make them less susceptible to the free-rider problem than the rational economic man who inhabits many theories. At least as far back as Adam Smith and David Hume, economists have noted ethical considerations affecting behavior.¹ Although unaccounted for in traditional economic theory, a sense of obligation or commitment can cause people to behave in ways not consistent with their own self-interests or utility maximization (Sen, 1977). Moreover, an extremely cynical view of human nature is just as unrealistic as an overly romantic view (Buchanan, 1986).²

Parochial school administrators may be able to structure requirements so that there is a self-selection process that eliminates students whose parents are more likely to succumb to the temptations of free-riding. For example, one church in northern New York allows only its members to enroll their children in its school. Another requires that the parents be "saved" or "born again" as well as members of a church where they are submitted to the spiritual authority of its pastor. Members of other churches also must have the support of their pastor, even to the extent that their church must bear the financial burden of their children's costs. While these are legitimate requirements given the special nature of the education received and would be in force regardless of the tax consequences, these requirements do tend to screen out parents who would be most likely to free-ride.³

Some churches may need to resort to subtle forms of social

pressure to induce "voluntary" donations. Other churches have allowed their schools' parents that are their members merely to drop their tuition payments into the collection plate. Although strictly illegal, such nonallowable charitable deductions on income tax returns would be very hard to detect even if the returns were audited. Of course, the probability of being audited is itself generally quite remote.

Not all churches will be able to utilize this hidden tax preference and be tuition free because of problems with monitoring and enforcing their implicit contracts. For example, the memberships of larger denominational churches may not have a sufficiently high level of commitment necessary to overcome free-rider problems. It would also be particularly difficult for some Catholic schools, especially high schools, to be tuition free. In urban areas these schools are under more centralized administration and there is not a school for every local church. Here the free-rider problem may be more severe, since a failure to pay burdens the church at large. Members may have a reduced sense of commitment to the archdiocese relative to the local parish church. Monitoring problems also increase, since the local priest has less incentive to snoop into his parishioner's giving records when the benefit goes to other administrators.⁴

The use of implicit contracts would be more likely in the smaller church/school situations where there is no separation between local church administration and school administration. Smaller churches, especially fundamentalist churches, may not only have a stronger sense of commitment among their members but also have stronger incentives to be tuition free. Moreover, it should not be inferred that tax avoidance is even the primary reason for being tuition free. Some legal counsel discourages the charging of tuition since many churches claim that their schools are ministries of the churches and thus are not subject to state regulation. Charging a fee for this ministry while not for others may make it easier for the state to claim that the school is distinctly different from the other activities of the church and therefore subject to regulation. Tax avoidance may be an unintended consequence.

Use of voluntary donations to finance parochial schools is likely to increase. Membership in fundamentalist churches is growing rapidly, and these churches are more likely to be interested in a Christian alternative to public schools that is free of state interference. Private non-Catholic school enrollments have been increasing at a phenomenal rate. In 1965 about nine out of every ten private school students were in Catholic schools, while in 1983 this number had fallen to less than six out of ten (NCES, 1985). However, these figures seriously understate non-Catholic private school enrollment, since it has been estimated that only 72% of non-Catholic private schools are surveyed by NCES. It is precisely the small fundamentalist schools that are most likely to be missed in such surveys. There are now nearly twice as many non-Catholic as Catholic private schools. Between 1965 and 1983, Roman Catholic school enrollment declined by 46%, while non-Catholic private school enrollment increased by 212% (Cooper et al., 1984).

REVISED COST ESTIMATES

E. G. West (1985) recently provided estimates showing that if 1.0% to 1.4% of the current public school enrollment switched to private schools, a federal tuition tax credit of \$300 would save more in government expenditures than it would cost in lost tax revenues. The basic reason for this is that pupils leaving public schools would reduce direct expenditures for public education far more than the tax revenue lost from the tuition tax credits. This difference may be great enough to more than offset the tax credits going to parents of students already in private schools. Given the expected magnitude of the number of students switching from public to private schools (Gemello and Osman, 1983), the tuition tax credit may actually reduce the total of all government budget deficits in the United States.

West calculated a revenue "break-even" transfer of students switching from public to private schools induced by a tuition tax credit without taking into account the hidden tax preference

discussed above. Given the average value of the tuition tax credit (t), the number of students already attending private schools (s_{pr}) the average cost of public schools (c), and the number of students switching to private schools (Δs), West balanced the tax expenditures to those already with children in private schools with the public expenditure reduction of those switching to private education:

$$ts_{pr} = \Delta s(c - t) \quad [1]$$

Solving for the "break-even" number of students gives

$$\Delta s = (ts_{pr})/(c - t) \quad [2]$$

West estimated that the "break-even" number of students switching (Δs) would have to be 0.9% to 1.4% of current public school enrollment. This is well under the expected change induced by a tuition tax credit.

Suppose some schools that were financed by donations charge tuition so that parents can take advantage of the increased subsidy available with the tuition tax credit. Tuition tax credits increase the total tax expenditures to these existing private school students only by the difference between the value of the tax credit and the tax savings derived from deductible donations. For the analysis here it does not matter whether or not these deductions are legal. If the average value of the existing tax preference for donations is t^* then the net benefit of a tuition tax credit (t_n) to such an existing private school parent is ($t_n = t - t^*$) if $t^* < t$, otherwise $t_n = 0$. Substituting t_n into (2) gives

$$\Delta s = s_{pr}(t - t^*)/(c - t) \quad [3]$$

West's estimates assumed, using 1983 data, that t equaled \$200 to \$300 and c equaled \$3,075. Private school enrollment (s_{pr}) was 5.7 million in 1983. Similar estimates can be made for equation (3) if t^* is known. The average value of the "donation" would be equal to the product of the fraction of private school parents that

TABLE 1
Breakeven Transfer of Students

	As a Percentage of Enrollments in		
	Public Schools*	Private Schools*	Reduction
f = 0	0.9 - 1.4%	6.9 - 10.8%	0
f = 20%	0.7 - 1.2%	5.5 - 9.3%	14 - 21%
f = 40%	0.5 - 1.0%	4.0 - 7.7%	28 - 43%
f = 60%	0.3 - 0.8%	2.5 - 6.1%	43 - 65%

*Figures assume an average tuition tax credit of \$200 and \$300, respectively. Based upon public school enrollment of 45.04m and private school enrollment of 5.7m.

were deducting donations (f), the average marginal tax rate (r) and the average donation in lieu of tuition (d). That is,

$$t^* = frd \quad [4]$$

While "d" can be estimated by the median tuition in 1983 (\$981, using West's assumptions) and the marginal tax rate by an average tax bracket of 22%,⁵ the fraction of students whose parents avail themselves of this credit is completely unknown. Based on a very unscientific and small sample of parochial schools, personal conversations, as well as the statistics concerning the growth of fundamentalist churches and private school enrollments, it is safe to assume that variable f is substantial and growing.

The estimates of the impact of this hidden tax preference on the "break-even" transfer of students can be seen in Table 1. Since f (the fraction of private school students who were financed by voluntary contributions) is unknown, estimates of the break-even transfer are given for various values of f. Estimates are given in ranges, with the lower end assuming that the average tuition tax credit is \$200, while the upper end assumes the average credit is \$300. If only 20% of private students are currently financed with tax deductible contributions, the number of students needed to switch to private schools in order to make tax credits revenue neutral is only 0.7% to 1.2% of public school enrollments. This is a significant reduction, 14% to 22% lower than West's original

estimates. Of course this reduction increases if a higher percentage of students are financed with deductible contributions.⁶

Many schools, as mentioned before, are financed by voluntary donations for reasons other than tax avoidance. These schools may decide to remain tuition free even with the existence of a tuition tax credit. If this is the case, the reduction in the real costs of tuition tax credits are even greater. The calculations implicitly assume that tuition would be charged if the parent's tax savings were greater.

CONCLUDING REMARKS

The current tax system contains a hidden tax preference for private education. Namely, deductible charitable contributions in lieu of tuition may be used to finance religiously affiliated schools. While the degree to which this tax preference is used is unknown, it may well be significant, since 80% of private school enrollments are in religiously affiliated schools and the memberships of fundamentalist churches are growing rapidly. The existence of this preference has important implications concerning both the positive and normative economics of a tuition tax credit.

Preoccupation with the current budget crisis will not be with us forever. A tuition tax credit will be proposed again, and when it is, the analysis of this article should have important impacts on the expected federal revenue loss. For example, if the tax credit increases private school enrollment by 10%, the federal revenue loss would be about 80% to 90% lower if only 20% of current private enrollments are receiving this hidden tax preference.⁷ West has already shown how a federal tuition tax credit would actually reduce combined budget deficits of all governments in the United States. However, his estimate of the requisite "break-even" number of students needed to switch to private schools falls by 14% to 22% if only one out of five students in private schools is financed by voluntary donations.

The current tax preference also raises questions involving

horizontal and vertical equity. Undoubtedly this preference is horizontally inequitable, since it treats the parents of children in private schools differently depending upon their religious preferences. In all likelihood the benefits of the current tax preference go disproportionately to higher income groups due to the progressive rate structure of the federal income tax, and this impacts vertical equity. A tuition tax credit is more equitable, since all parents of private school children are treated alike. The credit's tax subsidy is dependent upon neither religious preferences nor income levels.

There is a need for further research in order to estimate the extent to which this hidden tax preference is being utilized. Estimates of the actual use of donations in lieu of tuition not only affect forecasts of federal revenue loss but also help in evaluating improvements in horizontal and vertical equity obtainable with a tuition tax credit. Data collection is complicated because a large fraction of the schools likely to be tuition free are currently not being surveyed, and their very existence is hard to ascertain (Cooper et al., 1984).

One important conclusion from the analysis of this article is that the case for a federal tuition tax credit is relatively stronger because of the existence of the hidden tax preference. This is due in part to the reduced cost estimates of a tax credit. The tax credit may also help redress certain horizontal and vertical inequities of the current tax preference for religiously affiliated private schools. Finally, the opponents of tuition tax credits, including the National Educational Association, the National PTA, National School Boards Association, Americans United for the Separation of Church and State, Public Education and Religious Liberty and People for the American Way, claim that such public aid for private education would subsidize religious education. However, as has been noted above, the current tax system already contains tax preferences that subsidize only religiously affiliated schools. In fact, fundamentalist Christian schools are most likely benefited. This "born-again" bias may be particularly galling to some of the above groups. A tuition tax credit would extend the subsidy to all parents with children in private schools, not just those with preferences for religiously affiliated schools.

NOTES

1. In the last paragraphs of the conclusion of *An Inquiry Concerning the Principles of Morals* (1751), Hume clearly describes what we now call a free-rider problem, referring to the free rider as "a sensible knave" and arguing that morals can overcome self-interest. He goes on to write, as if anticipating the possible criticisms of rational egoists, "I must confess that if a man thinks this reasoning much requires an answer, it will be difficult to find any which to him appears satisfactory and convincing." Smith basically agreed with Hume, but in *The Theory of Moral Sentiments* (VI.ii.1.1 and 2) he held that the effectiveness of ethical considerations modifying self-interested behavior decreases as "social distance" between people increases.

2. Noting the failure of rational egoism and the free-rider problem to explain a great deal of cooperative human behavior that is observed, Dennis Mueller (1986) has suggested that social scientists use the insights of behavioral psychology and adopt adaptive egoism as a fundamental behavioral postulate.

3. It should not be concluded that these people are less likely to free ride due to some perceived incentive effect. They are not contributing in order to gain or maintain their salvation. To be saved or born again basically refers to an individual making a personal decision to accept Jesus Christ as his or her savior. Such an individual is saved by grace or by faith in Jesus Christ alone. Their reluctance to free ride may be viewed as a response to, or as a consequence of, their assured salvation. See John 3:1-18; Romans 10:9-10; Ephesians 2:8-9.

4. It should not be inferred that all Catholic school parents will be unable to take advantage of the hidden tax credit. For example, a Catholic church in a certain midwestern state allows its members to drop into the collection plate tuition checks made out to the church. It is left to their individual consciences whether to take this payment as a charitable deduction. Needless to say, this may not be the only church doing this.

5. This is based on an average marginal tax rate of 18% on federal returns and a typical state tax rate of 4%. These rates were added since most state returns allow deductions for charitable contributions (Musgrave and Musgrave, 1984: 379). Frey (1983) assumed a tax rate of 35%. This would reduce the federal revenue loss even more.

6. There are numerous possible criticisms of these estimates. Many have already been addressed by West (1985). However, the estimates are merely intended to be suggestive of the possible magnitudes. Any further refinement in these estimates is rather pointless until the utilization and incidence of the hidden tax preference can be better ascertained.

7. This assumes that deductible charitable contributions reduce the average value of the tuition tax credit to those with children already in private schools by 14% to 22%.

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