Long Term Fiscal Impact Analysis of Legislative Bill (LB) 295

(105th Nebraska Legislature, 2nd Session)

March 2018   —   William Scheideler

INTRODUCTION

LB 295/AM1418 initially provides up to $2,000,000 per year in tax credits for qualified donations to organizations that provide scholarships to attend private elementary and secondary schools. The $2,000,000 cap will increase annually by the federal urban consumer price index, and may increase another 20% per year if a year's tax credits exceed 95% of the annual cap. The potential maximum annual tax credit is capped at $10,000,000. This analysis shall determine the potential for savings in state expenditures for public education due to enrollment migration from public schools to private schools as a result of LB 295.

RELEVANT PARAMETERS OF LEGISLATION

1. $2,000,000 annual maximum cumulative tax credit.
2. 2% annual increase of maximum tax credit due to Consumer Price Index for Urban Consumers (estimated average future rates).
3. 20% annual increase of maximum tax credit if at least 95% of current year maximum is reached.
4. Each donor's tax credit is 100% of the qualified donation.
5. Scholarship eligibility limited to:
   a. Family income up to 370% of federal poverty level. This is two times the eligible level for the Reduced School Lunch program, which is 185% of the poverty level.
   b. Students not previously enrolled in private school, except for:
      i. Students enrolled in private 8th grade, and/or
      ii. Siblings of a student who is otherwise eligible.
      iii. Children who received a scholarship in a prior year.

OBJECTIVES

1. Identify *Fiscal Break-Even* point, which shall be the year, if it exists, at which the annual expected reduction in state expenditures equals the annual expected loss in state revenues.

2. Identify *Fiscal Hold-Harmless* point, which shall be the year, if it exists, at which the total cumulative reduction in state expenditures equals the total cumulative loss in state revenues.

GENERAL ASSUMPTIONS FOR ANALYSIS

1. Tax-creditable donations will be converted to student financial aid one year after receipt by a qualified scholarship granting organization (SGO), which coincides with the year such corresponding tax credits would be assessed and applied against state revenue. While a year delay in all scholarships is not certain, a single year cohort is needed for a reliable estimate of the impact on a static single-year model of state aid to schools. At the onset of program implementation, it is likely that there will be a slow pace of engagement by SGOs, the Nebraska Department of Revenue, and the families with regard to applying for, approving, and administering tax credit scholarships. Furthermore, only scholarships approved by the first half of a year would likely accommodate the matriculation process of most schools. Approvals during the second half of the year would be reserved for a subsequent calendar year.

2. The time-lag of revenue collected with respect to calendar year versus state fiscal year is inconsequential, and the calendar year is ignored in favor of the state fiscal year that ends in that calendar year (e.g., Calendar Year 2019 = State Fiscal Year 2018-19).

3. Allowable administrative costs for scholarship organizations will be maximized every year (*reduces total possible financial aid available*).[1]

4. Available financial aid will be fully expended as scholarships every year. That is, SGOs will award as scholarships—after deducting administrative costs—all funds received from private donations that qualify for a tax credit in LB 295.[2]

5. Each scholarship will be awarded entirely on the basis of financial need, as determined by a recipient's family income.[3] Income distribution percentages for each school district were computed from U.S. Census Bureau data, which provides estimates of the school-age population (i.e., ages 6-17) residing in each school-district, by four levels of income relative to the poverty level that would be eligible for scholarships under LB 295.[4] For these scenarios, scholarship award amounts are determined for each public school district based on the percentage of student population at each of these four income levels, as follows:

    a.   0 - 100% of poverty = 100% of tuition and fees.
    b. 101 - 185% of poverty = 55% of tuition and fees.
    c. 186 - 300% of poverty = 33% of tuition and fees.
    d. 301 - 370% of poverty = LB 295 maximum level. This percentage is not accurately measurable because Census Bureau poverty data is not reported at the school district level for 370% of poverty. 301 - 400% will be used instead.
    e. 301 - 400% of poverty = 25% of tuition and fees.

6. Each of the four levels of average scholarship amounts will be the minimum amount assumed necessary to motivate the parents of eligible students at the corresponding income level to enroll their child in a private school.

7. Public-to-private student migration. 93% of scholarship recipients will have been enrolled in public school in the preceding school year, or in the case of kindergarten, will have been expected to enroll initially in public kindergarten if not for a first-year scholarship. Because LB 295 allows existing private pre-K and 8th grade students to qualify for a scholarship (to enroll in private kindergarten or 9th grade), approximately 7% of scholarship-eligible students are likely to have enrolled in private school without the scholarship. This percentage reflects the exclusion of the Nebraska Department of Education's statewide count of private kindergarten and 9th grade enrollment, but limited to those students estimated to meet the income limits. LB 295 scholarships are also available to private school students if they are siblings of a student who is otherwise eligible. The likelihood of this situation occurring statewide is assumed to be low at the onset and would diminish every year to nearly zero impact by the 13th year; so this analysis did not attempt to estimate the number of such students.[5,6]

8. Student migration may occur only from school districts for which a private school alternative is available nearby. *Nearby* shall mean that an approved private school is located in the same county as a public school district.

9. Potential student migration from any public school district is first weighted by the proportion of its eligible scholarship recipients to total *nearby* private school current enrollment. Districts are then further weighted for school choice. *School choice* refers to the number of providers and/or the diversity of social affiliation (e.g. Catholic, Lutheran, secular, etc.) that is represented among *nearby* private schools.

10. As of school year 2017-18, statewide private school enrollment is approximately 34,000.[4] Average enrollment at existing private schools is approximately 60% of capacity, meaning private institutions statewide could absorb up to approximately 13,600 students (40% of capacity) from public schools without additional investment in real property. This estimate is based on self-reported student capacity by private schools comprising over 75% of enrollment statewide.

BASIS FOR DETERMINATION OF STATE SAVINGS

LB 295 could cause a reduction in annual state expenditures only if implementation of the new law were to cause a reduction in the computation of state-funded aid to public schools. This would normally occur if public student enrollment were to decline, depending on the relative distribution of that decline among public school districts.

Student population is a key component of Nebraska's primary public school funding formula, the Tax Equity and Educational Opportunities Support Act (TEEOSA). A change to the current distribution of public school enrollment across all 245 public school districts can change both the aggregate total of TEEOSA aid awarded and the distribution of that aid among districts.[7]

This fiscal impact analysis utilizes a district-level model of TEEOSA, which computes school aid in accordance with the official TEEOSA formula, as codified in the Nebraska Revised Statutes, and further interpreted in practice by the Nebraska Department of Education. The amounts for each component and interdependent sub-calculation of the model have been reconciled to the FY 2017-18 TEEOSA aid certification published by the Nebraska Department of Education in May 2017.

First, it must be acknowledged that a uniformly applied migration assumption for scholarship students from most 245 school districts would result in little or no change in the total amount of TEEOSA aid awarded, and therefore no reduction in state expenditures. Thus, state savings are contingent upon student migration occurring disproportionately among public school districts. This is not merely an assumption, as it is necessary to exclude school districts altogether which are not geographically located near a private school. It also follows that migration would be lower in areas with existing-but-inadequate private school options, and migration would be higher in areas with more school options. Perceptions of school quality may also have significant impact as parents consider and evaluate the standardized test scores, class size, and general reputation of a school, but these factors were not evaluated in this analysis.

TEEOSA Components

Formula Students. This number represents a public school district's enrollment for purposes of calculating TEEOSA aid. The Nebraska Department of Education derives it from actual student counts. *Formula students* dictate *basic funding arrays*, which combine schools' spending to determine average spending. Higher spending schools are adjusted down to the average and may receive less TEEOSA aid as a result. Any loss in *formula students* due to public-to-private migration could change a public school district's relative position in its *array* or change the school composition of the *array*, as well as decrease the averages computed by the *array*. Such an effect would typically result in less TEEOSA aid one year after the loss of students, and it would be permanent (annualized against all future calculations of aid).

Poverty Allowance. TEEOSA allows schools to exempt certain expenditures for poverty from the calculation in their *basic funding arrays*. Essentially, an allowance may make it appear that a school district spends less than its *array* peers do, which can result in more TEEOSA aid. Public-to-private migration of at least two income levels assumed in this analysis (100% and 185% of poverty) would reduce the *poverty allowance*, thereby reducing its relative benefit in basic funding arrays. Depending on the distribution of those reductions within each *array*, this would generally result in lower TEEOSA aid one year after the loss of poverty students, and it would be permanent (annualized against all future calculations of aid).

Student Growth Adjustment. School districts that are growing in enrollment may qualify for an additional amount of TEEOSA Aid on a more-or-less pro-rated basis. This *adjustment* has no impact on *basic funding arrays*. Public-to-private migration in otherwise growing districts would reduce their *adjustment* one year later. However, since annualized tax credits only funds annual scholarships for the same students, the loss of students from public schools would be only one-time. Therefore, TEEOSA aid would be reduced by this component only in that first year of impact.

Needs Stabilization. At some higher amount of public-to-private migration, some public school districts might qualify for this *adjustment*, which holds harmless any school district for which TEEOSA computes to need less funds than it did the year before. This is generally rare under current law because TEEOSA inflates its initial calculation of school spending by 5%. However, if a school district's needs were reduced based on lost enrollment, it could qualify for *needs stabilization*, which would increase TEEOSA State Aid. However, statewide, *needs stabilization* would not greatly offset the decrease in TEEOSA Aid caused by reduced enrollment.

Averaging Adjustment. In general, public schools with enrollment (as defined by TEEOSA "Formula Students") of 900 or greater may receive additional state aid per student if their per-student spending is lower than the average for all other schools over 900 students. At some higher amount of public-to-private migration, some public school districts could fall below 900 students, which would disqualify them for this potential aid increase, but more significantly, remove their per-student spending from the peer average. Usually, smaller schools have higher per-student spending, so a loss of smaller schools would result in lower average per-student spending and lower Averaging Adjustment aid for all remaining schools. This analysis has determined that the Averaging Adjustment could decrease sharply if public-to-private migration were to surpass 4,000 students. At this point, it is likely that at least one school district would drop below 900 students.

FINDINGS

Scenario 1 — Average Tuition Method

Based on the individual data collection of the 2017-18 tuition and fee rates of 85% of private enrollment in Nebraska, the statewide average (kindergarten through 12th grade combined) is approximately $4,725 per year.[8] Based on 90% of private enrollment, the Omaha metro area's average annual tuition and fees are approximately $5,450 per student.

Unlike the measurement for public schools, tuition rates do not indicate the actual cost of educating a student, which for many private institutions, is subsidized in aggregate by other private means and not passed on to any student. However, LB 295's eligibility requirements largely prevent the possibility of private schools using the new tax creditable donations to supplant existing private donations because those original donations would still be necessary to provide financial aid to existing private students.[9]

This analysis compares the fiscal impact (TEEOSA spending reductions vs. tax credits) based on the maximum number of students that might transfer from public to private school if they are provided with enough financial aid at their income level to afford tuition and fees. It is assumed that higher average tuition and fees will result in fewer scholarships awarded.

For this scenario, the annual tax credit amount of ($1 less than) $1,900,000 was selected because that amount <u>prevents</u> an automatic annual 20% increase in tax credits available, as provided for in LB 295. This ceiling is used merely to isolate the fiscal impact due solely to a single cohort of potential migration against a static model for state aid to public schools (that is, the same students would need to exhaust the same amount of donations every year. This scenario also does not account for LB 295's automatic CPI inflation or change in family income). For the purpose of this scenario, allowing for growth in annual tax credits for any reason could otherwise generate additional migration and skew the results for a single cohort.

Therefore, setting the maximum annual tax credit (loss to state revenue) at $1,899,999, a 100% rate of tax credit to donation would require $1,899,999 in annual donations. Deducting 10% for SGO administrative fees would leave $1,710,000 for scholarships. These funds would be distributed to eligible students in accordance with each public school district's percentages of enrollment across the four measured income levels and at scholarship amounts made proportionate to those income levels, as explained in this report's GENERAL ASSUMPTIONS.

Maximum scholarships were evaluated at four values for comparison:
   $5,450—average tuition of the Omaha metro area, where most student migration would occur.
   $4,725—average tuition statewide.
   $4,245—analysis-constructed amount, representing the maximum tuition cost needed to achieve the point of *Fiscal Hold-Harmless,* <u>and for all future years.</u>
   $4,530—another analysis-constructed amount, representing a maximum tuition that might achieve *Fiscal Hold-Harmless* within 10 years before a cumulative state loss would occur.

Regardless of tuition rate, student migration would generate no TEEOSA Savings in Year 1 of the tax credit because enrollment changes in one year do not impact TEEOSA aid payments until one year later. However, a large one-time TEEOSA savings would occur in Year 2 because of the reduction to *Student Growth Adjustment*. Finally, by Year 3, an annualized, consistent TEEOSA savings would occur that may or may not be greater than the annual tax credit.

The results of the four tuition rates (maximum scholarships) are compared in Table 1 and Chart 1.

TABLE 1. STATE FISCAL IMPACT OF $1.9 MILLION TAX CREDIT
(with four assumptions for average tuition)

REVENUE LOSS: TAX CREDIT ($)	AVERAGE STUDENT TUITION/FEES ($)	STUDENT MIGRATION	CUMULATIVE NET GAIN/(LOSS) [Years 1-2]	CUMULATIVE STATE NET GAIN/(LOSS) [Years 1-3]	ANNUAL STATE NET GAIN/(LOSS) [after Year 3]	FISCAL BREAK EVEN	FISCAL HOLD HARMLESS*
1,899,999	4,245	778	1,567,288	1,567,860	571	2 years	3 years
1,899,999	4,530	729	1,318,439	1,156,711	(161,728)	2 years	10 years
1,899,999	4,725	698	1,051,219	765,510	(285,709)	2 years	5 years
1,899,999	5,450	606	322,607	(284,104)	(606,711)	2 years	2 years

* *Fiscal Hold-Harmless* at 3 years presumes permanency if tax credit were held flat. Any other point of *Fiscal Hold Harmless* presumes fiscal losses in subsequent years.

CHART 1. CUMULATIVE TEEOSA SAVINGS VS CUMULATIVE REVENUE LOSS
ANNUAL $1.9 MILLION TAX CREDIT
(with four assumptions for average tuition)
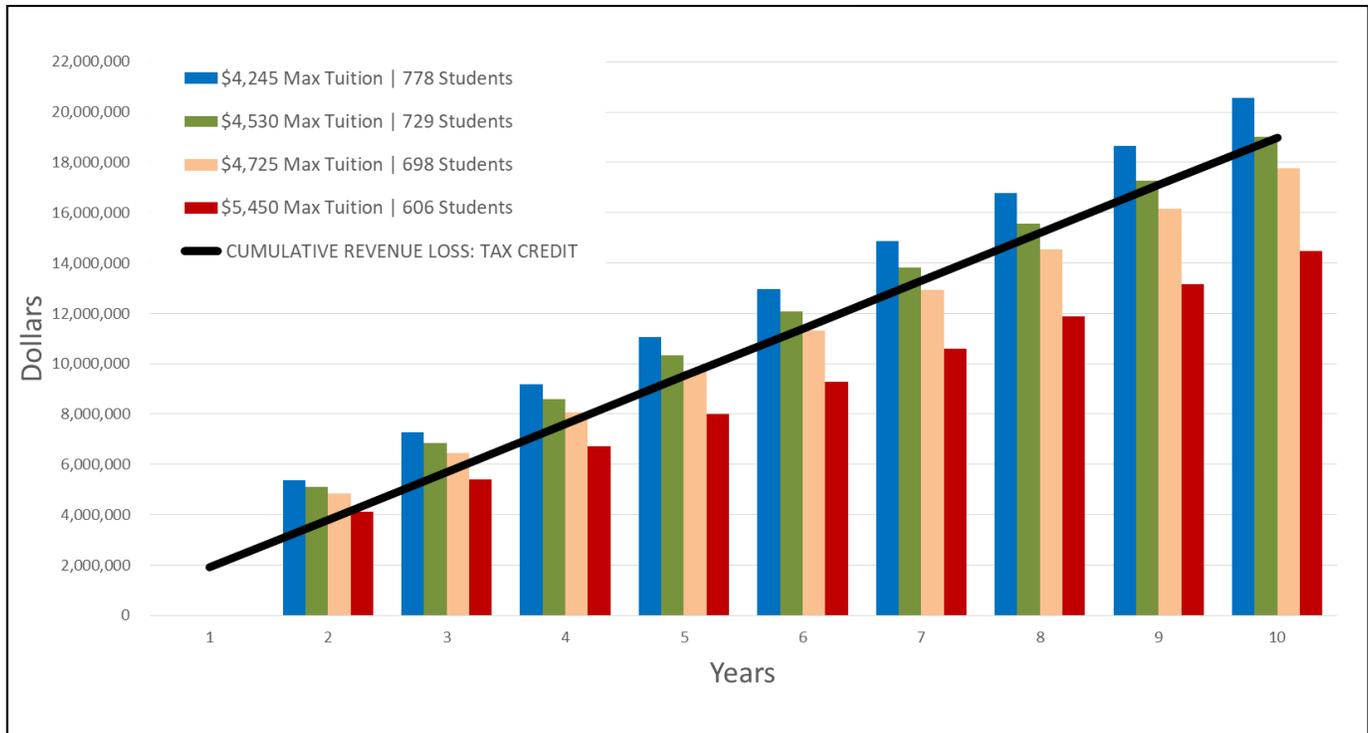
These data show that approximately 778 students would need to migrate in order for annual TEEOSA savings to offset perpetually the annual $1.9 million tax credit. This analysis estimates that the average maximum tuition could be no more than $4,245 in order to achieve 778 students. However, this is below the actual state average tuition, and therefore is less likely to occur, which means that a perpetual $1.9 million tax credit is not likely to achieve a permanent *Fiscal Hold-Harmless*. Instead, at the more likely statewide average tuition of $4,725, the state could achieve net savings every year until the point of *Fiscal Hold-Harmless* at about the sixth year. At that point, annual losses would overtake initial savings, resulting in cumulative losses every year thereafter. If applying the Omaha metro average tuition of $5,450, then the state likely would achieve *Fiscal Hold-Harmless* only in Year 2; that is, it would experience a net loss every year thereafter. Finally, at the arbitrary tuition of $4,530, initial state savings would extend *Fiscal Hold-Harmless* until the 10th year of tax credits, but after that point, cumulative savings would be exhausted by annual losses.

Summarized and restated:

Fiscal Break-Even would likely occur in two years if:

. . . tax credits are limited to $1.9 million per year, and
. . . statewide average tuition rate ($4,725) is the basis for scholarship levels.

Fiscal Hold-Harmless would likely occur after five to six years, after which the state would experience annual losses of about $300,000 per year.
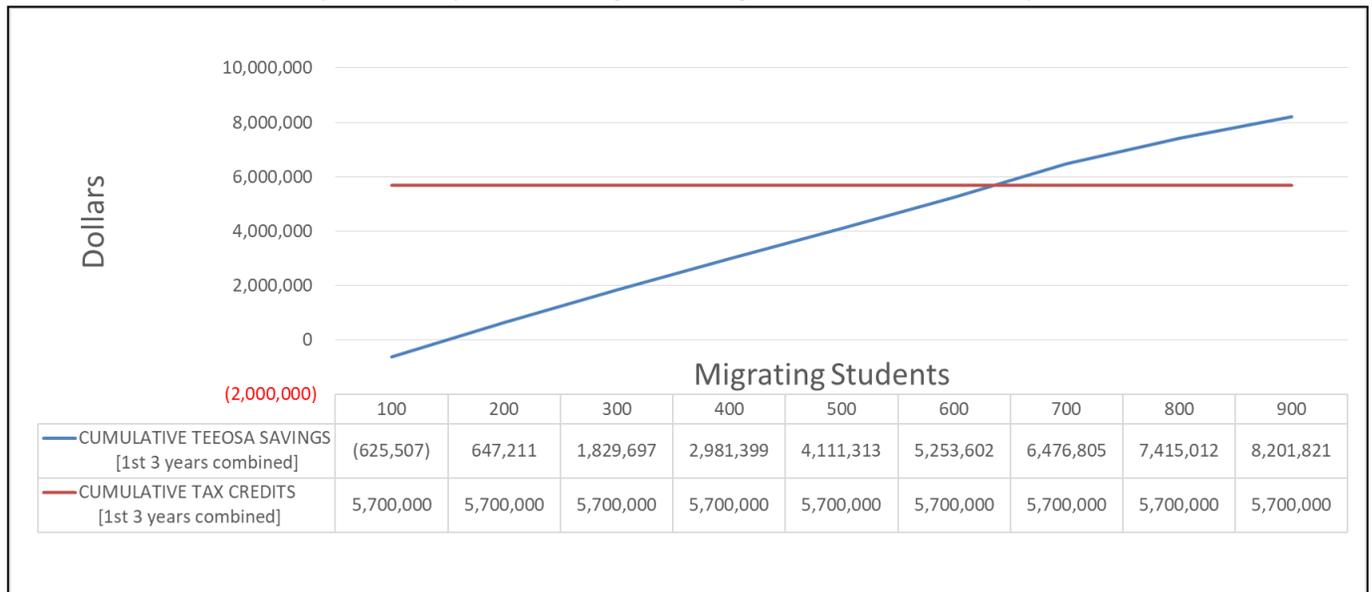
In order to make *Fiscal Hold-Harmless* permanent, either annual tax credits would need to increase, or average tuition rate would need to decrease, or a combination of both.

Scenario 2 — Isolated Migration Method

This scenario recognizes that TEEOSA aid is independently impacted by the loss of public school students, so analysis of the tuition rate / scholarship amount is not necessary to estimate the migration necessary to reduce TEEOSA aid and offset tax credits. Table 2 and Chart 2 compare the cumulative TEEOSA savings over the first three years that might be obtained from a one-time migration of students in increments of 100. The net savings are compared with respect to lost revenue from $1.9 million in tax credits, the same threshold as in Scenario 1. Also, the three-year period is evaluated because spending reductions are stabilized in the third year. Year 1 creates no spending reductions, and Year 2 provides a one-time spike in spending reductions.

CHART 2. SPENDING REDUCTIONS VS TAX CREDITS ON $1.9 MILLION TAX CREDIT
(isolated by student migration regardless of tuition cost)

	100	200	300	400	500	600	700	800	900
CUMULATIVE TEEOSA SAVINGS [1st 3 years combined]	(625,507)	647,211	1,829,697	2,981,399	4,111,313	5,253,602	6,476,805	7,415,012	8,201,821
CUMULATIVE TAX CREDITS [1st 3 years combined]	5,700,000	5,700,000	5,700,000	5,700,000	5,700,000	5,700,000	5,700,000	5,700,000	5,700,000

The results predict that for a $1.9 million annual state investment in tax credits, about 650 students would need to transfer from public to private schools in order to reach the point of *Fiscal Hold-Harmless* by the third year, but fiscal losses would occur every year thereafter. Remember from Scenario 1, it was determined that migration of about 778 students would be necessary in order to reach *Fiscal Hold-Harmless,* but it would also be sustained in all subsequent years. Still, Scenario 2 should be relevant to policymakers when comparing LB 295 goals with Nebraska's biennial budget process. In other words, at $1.9 million, migration of 650 students is likely the minimum necessary to achieve no fiscal impact to the state cumulatively over three years, which is the shortest period useful for this analysis.

Scenario 3 — 22% Annual Growth Method

This scenario analyzes a trend of possible student migration and TEEOSA savings in conjunction with total tax credits that increase by 22% annually (estimated CPI 2.0% annual growth plus 20% allowable growth if 95% of the prior year's maximum is reached). In order to evaluate the trend of 22% increases through LB 295's starting point of 1,900,000, the amount $857,658 was chosen as a notional initial maximum tax credit. Average tuition and fees for each year are set to increase by the estimate 2%, passing through the $1.9 million level of tax credits at the current statewide average tuition rate of $4,725. Assuming that both poverty thresholds and tuition rates would increase at the same rate of inflation as the automatic inflation in tax credits, the factors should cancel out any impact on the corresponding increase in student migration.

Table/Chart 3a show, for each annual tax credit increment, the estimated student migration and the correlating stabilized annual net gain/loss to the state after any initial savings for Years 1 and 2 (see Scenario 1). The gains/losses are based on a static application of the tax credit in each row, that is, it assumes each tax credit level would not change from year to year. Note that this is not a likely outcome LB 295; instead, these tax credit levels would more likely be the result of annual 22% increases, and each annual fiscal impact would then be partly dependent on the years preceding it. Such a likely progression is shown later in Table/Chart 3b. Alternatively, Table/Chart 3a show the isolated fiscal impact of merely setting the tax credit level lower or higher.[10]

Table/Chart 3a shows increases in the expected two-year spike in state savings as the annual tax credit approaches about $2.3 million. Then it begins to decline. Yet, the Year 3 savings (which are the stabilized expected annual savings for all subsequent years), behaves as expected throughout and grows steadily as the annual tax credit maximum is incrementally raised. This inconsistent track for Year 2 is caused by the diminishing impact of the TEEOSA component, *Student Growth Adjustment*, on Year 2. As student migration grows, it surpasses the all expected student population growth in a school district. Essentially then, savings from *Student Growth Adjustment* has a limit, but the annual tax credit can be increased.

TABLE 3a. FISCAL IMPACT OF TAX CREDIT INCREASES, YEAR 3 AND AFTER

REVENUE LOSS (TAX CREDIT) IN 22% INCREMENTS ($)	AVERAGE MAX STUDENT TUITION/FEES	STUDENT MIGRATION	STATE NET GAIN/(LOSS) [YRS 1-2 COMBINED] ($)	AVERAGE ANNUAL NET GAIN/(LOSS) [YEAR 3 & AFTER] ($)
857,658	4,365	314	28,162	(598,311)
1,046,343	4,452	384	151,381	(605,456)
1,276,539	4,542	468	438,245	(484,392)
1,557,377	4,632	572	747,975	(376,239)
1,900,000	4,725	698	1,051,217	(285,710)
2,318,000	4,820	853	1,065,087	(138,301)
2,827,960	4,916	1,041	788,501	19,074
3,450,111	5,014	1,270	314,095	91,608
4,209,136	5,114	1,550	(118,001)	327,699
5,135,146	5,217	1,892	(776,211)	488,729
6,264,878	5,321	2,309	(1,432,921)	815,457
7,643,151	5,428	2,818	(2,245,674)	1,213,074
9,324,644	5,536	3,440	(3,185,626)	1,741,603
11,376065	5,647	4,196	(3,289,792)	3,441,647
13,878,800	5,760	5,121	(4,709,579)	4,213,960
16,932,136	5,875	6,250	(6,327,997)	5,282,326

In Table 3a, a positive state fiscal impact in Year 3 indicates that permanent *Fiscal Hold-Harmless* would be achieved at that tax credit level by Year 3 or soon thereafter. It may not occur precisely by Year 3 because as tax credit levels increase, the first two years eventually show a net loss, which would delay *Fiscal Break-Even* and *Fiscal Hold-Harmless* until subsequent annual savings caught up. Scenario 1 revealed that a perpetual aggregate tax credit level of $1.9 million and statewide average tuition rate of $4,725 could not achieve permanent *Fiscal Hold-Harmless*. This is confirmed in Table 3a. However, Table 3a shows that <u>an initial, static tax credit level in the range of $2.8 - $3.5 million would most likely result in permanent *__Fiscal Hold-Harmless__* by no later than Year 3.</u> (This range would shift downward somewhat if average tuition rates were held static at the current estimate of $4,725. But see Endnote 10.)

CHART 3a. STABILIZED ANNUAL FISCAL IMPACT VS TAX CREDIT LEVEL
("stabilized" means Year 3 and each year after will have similar savings)
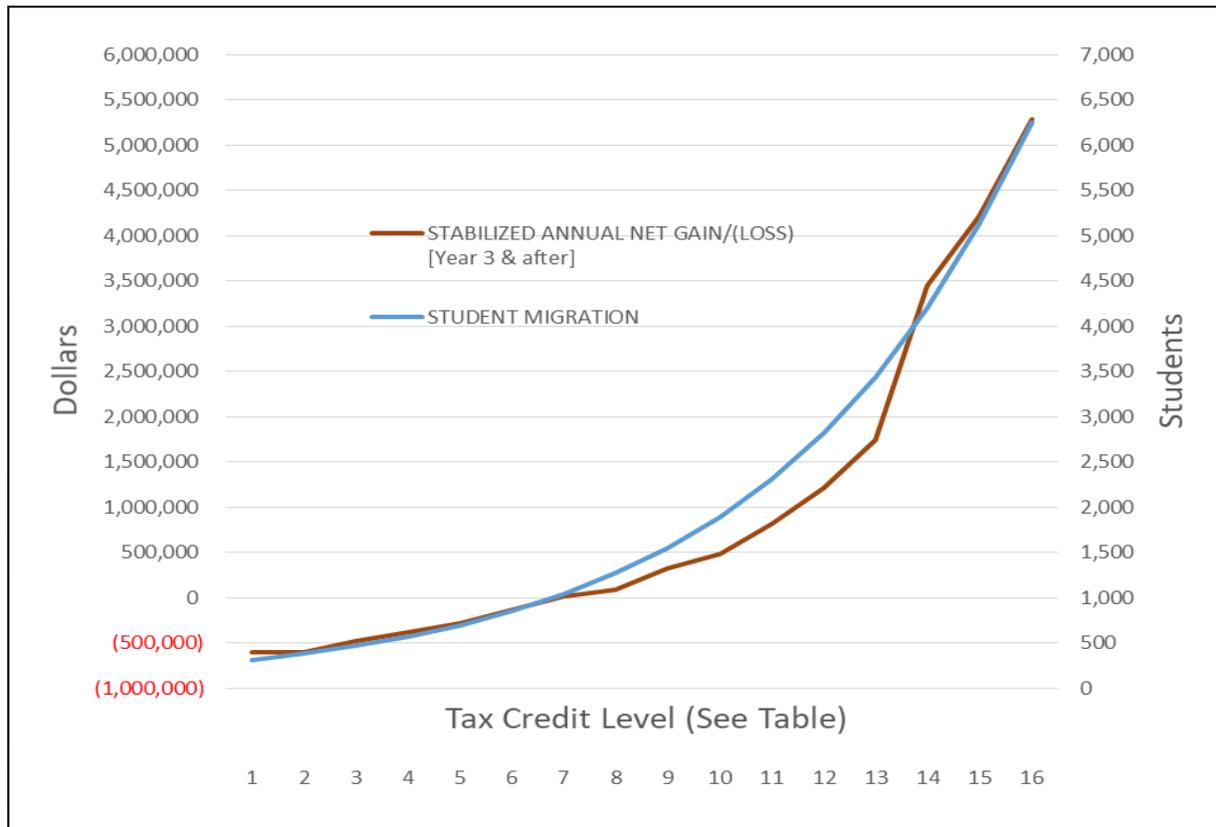

Table/Chart 3b evaluate these fiscal gains/losses cumulatively; assuming one year would trigger a 22% increase and so on. This analysis complicates the calculation of *Fiscal Break-Even* and *Fiscal Hold-Harmless* because the cohort of scholarship students would increase each year, merging the annual impact of the cohort from the previous year with the impact of the increased cohort in the next year. Table 3b shows that—using this analysis' starting point of $1.9 million, **Fiscal Break-Even** and **Fiscal Hold-Harmless** would be realized in Year 2 and Year 3, respectively, as expected. However, both those benchmarks would be lost by Year 4 and delayed again until about Year 11 and Year 12, respectively. The trend also predicts permanent **Fiscal Hold-Harmless** by Year 13.

This phenomenon occurs because annual student increases would generate no TEEOSA savings for their first year, but would include the 2nd-year surge of only the previous year's added students, and would include the stabilized annual savings from all earlier years' students. This *overlap-delay effect* would actually cause annual state losses by Year 3, but those losses would more or less steadily decline until about Year 10, when annual fiscal impact approaches zero. Then by Year 11—when student migration were to exceed about 5,000—there would likely be a large increase in TEEOSA savings, due to what appears to be a significant drop in the TEEOSA component, *Averaging Adjustment*.

TABLE 3b. FISCAL IMPACT WITH 22% ANNUAL INCREASE TO TAX CREDITS

YEAR	REVENUE LOSS: TAX CREDIT ($)	AVERAGE STUDENT TUITION/FEES ($)	STUDENT MIGRATION	TEEOSA SAVINGS ($)	ANNUAL NET STATE GAIN/LOSS ($)	CUMULATIVE STATE GAIN/LOSS ($)
1	1,900,000	4,725	698	0	(1,900,000)	(1,900,000)
2	2,318,000	4,820	853	4,851,217	2,533,217	633,217
3	2,827,960	4,916	1,041	2,464,159	(363,801)	269,416
4	3,450,111	5,014	1,270	2,923,033	(527,078)	(257,661)
5	4,209,136	5,114	1,550	3,616,930	(592,206)	(849,868)
6	5,135,146	5,217	1,892	4,627,672	(507,473)	(1,357,341)
7	6,264,878	5,321	2,309	5,730,644	(534,234)	(1,891,574)
8	7,643,151	5,428	2,818	7,226,629	(416,522)	(2,308,096)
9	9,324,644	5,536	3,440	9,024,127	(300,516)	(2,608,612)
10	11,376,065	5,647	4,196	11,279,259	(96,807)	(2,705,419)
11	13,878,800	5,760	5,121	15,064,923	1,186,124	(1,519,296)
12	16,932,136	5,875	6,250	18,403,394	1,471,258	(48,037)

CHART 3b. FISCAL IMPACT WITH 22% ANNUAL INCREASE TO TAX CREDITS
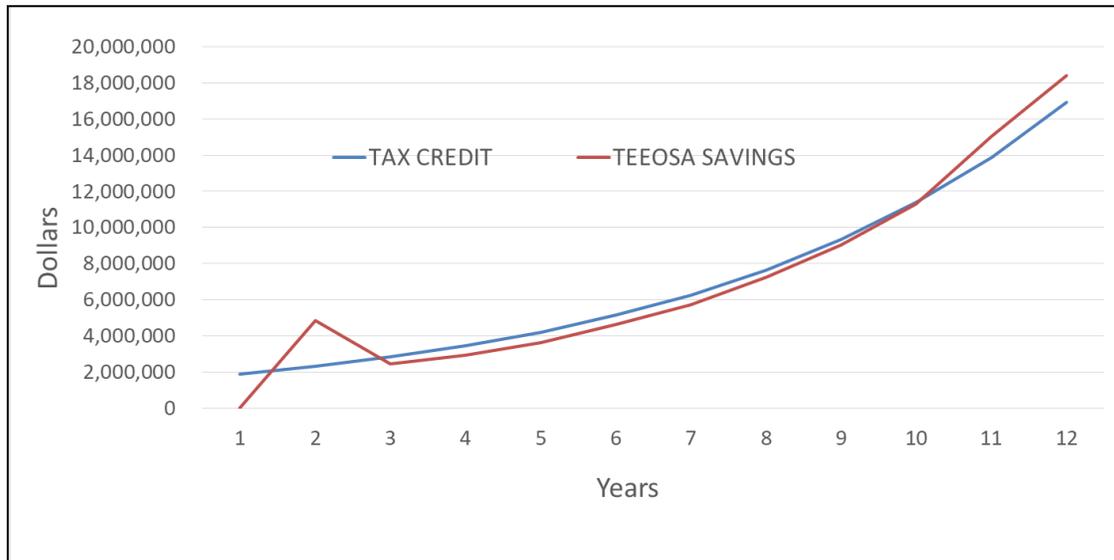
The results of Scenario 3 confirm that a static, annual tax credit between $2.8 million and $3.5 million is the target needed to achieve permanent *Fiscal Hold-Harmless*. However, Scenario 3 is ultimately a growth model, and $2.8 million represents the tax credit limit for only one year among several (see Table 3a). Due to the *overlap-delay effect* (see Table 3b), TEEOSA savings would increase with corresponding annual tax credit increases, but each year's TEEOSA savings (spending reductions) would be spread out across three years, while applied against each year's full tax credit. <u>Still, TEEOSA savings would eventually outpace corresponding annual tax credit increases, resulting in another *Fiscal Break-Even* in about 11 years and at about 5,000 students, and achieve permanent *Fiscal Hold-Harmless* about one to two years later.</u>

Scenario 4 — Reduce Income Eligibility

As stated earlier, LB 295 would allow students to apply for scholarships if their household income is at or below two times the maximum income allowed for participation in the federal free/reduced lunch program. Federal guidelines currently set this level at 185% of the "poverty level" as computed each year by the U.S. Census Bureau, so LB 295 would allow income up to 370% of poverty. The Census Bureau does not estimate the population of children at this level; the closest is 400%. This analysis uses the Census data at 400% as equivalent to the 370% required by LB 295.

This income threshold creates a precise trigger in the legislation for adjusting predicted student migration, which then predicts TEESOA state aid savings, and of course, the fiscal offset to the lost revenue from tax credits. Based on the results of this analysis, it is safe to assume that <u>raising the household income limit would generate more student migration and more savings per dollar of tax credit; and lowering the income limit would generate less savings.</u> Table 4a shows the predicted impact of changing income thresholds on student migration, if no other component of LB 295 were changed. Also, in order to focus on the impact of this single factor, tuition is set flat at the estimated statewide average of $4,725. The tax credit is limited to the (one dollar less than) $1.9 million annual tax credit to remain comparable to the other results of this analysis.

TABLE 4a. STATE FISCAL IMPACT OF CHANGING INCOME ELIGIBILITY
(assuming $1,899,999 million tax credit, and $4,725 average tuition)

MAXIMUM HOUSEHOLD INCOME (% of Poverty)	STUDENT MIGRATION	CUMULATIVE NET GAIN/(LOSS) [Years 1-2]	CUMULATIVE STATE NET GAIN/(LOSS) [Years 1-3]	ANNUAL STATE NET GAIN/(LOSS) [after Year 3]	FISCAL BREAK EVEN	FISCAL HOLD HARMLESS*
No limit	999	2,449,759	3,225,926	776,167	2 years	3 years
500	917	2,126,813	2,600,653	473,840	2 years	3 years
370 (400)	698	1,051,219	765,510	(285,709)	2 years	5 years
185	476	(182,574)	(673,276)	(490,702)	2 years	None
100	362	(1,492,363)	(2,519,321)	(1,026,959)	2 years	None

* *Fiscal Hold-Harmless* at 3 years presumes permanency if tax credit were held flat. Any other point of *Fiscal Hold-Harmless* presumes fiscal losses in subsequent years.

It should be noted that *raising* the income limit would likely produce diminishing returns on the number of students that might migrate. This is because the relative *needs-based* scholarship amount will be lower for these higher-income students, and at some point, the award will not be high enough to incentivize migration. This analysis has already assumed that a 25%-of-tuition award would incentivize migration by a student with household income at the LB 295 maximum—twice the level of Free/Reduced Lunch. This is not a certainty. Therefore, raising the income limit further could produce diminishing returns, which Table 4a does not indicate. However, this cannot be evaluated without historical data, which could only be available after LB 295 was implemented for at least one year.

Notwithstanding the concerns about raising the income level above two times Free/Reduced Lunch, lowering the income limit would necessarily reduce migration because scholarship awards would be higher and therefore fewer. Table 4b shows the approximate tax credit total that would be needed to achieve **Fiscal Break-Even** by Year 2, and **Fiscal Hold-Harmless** by Year 3 and every year thereafter.

TABLE 4b. TAX CREDIT NEEDED FOR LOWERED INCOME ELIGIBILITY

(assuming $4,725 average tuition; values are approximated)

MAXIMUM HOUSEHOLD INCOME (% of Poverty)	REVENUE LOSS: TAX CREDIT ($)	STUDENT MIGRATION	ANNUAL STATE NET GAIN/(LOSS) [after Year 3] ($)	FISCAL BREAK EVEN	FISCAL HOLD HARMLESS*
370 (400)	**2,800,000**	1,000	0	2 years	3 years
185	**4,200,000**	1,500	0	2 years	3 years
100	**5,100,000**	1,900	0	2 years	3 years

* *Fiscal Hold-Harmless* at 3 years presumes permanency if tax credit were held flat.

Scenario 5 — Reduce Individual Tax Credit Percentage

Several states have implemented a tax credit scholarship program similar to LB 295. Some authorize less than a dollar-for-dollar (100%) tax credit against the donation to a scholarship granting organization (SGO). The concern is whether a lower tax credit incentive might discourage donations to the point that fewer scholarship funds are raised. It is likely that fewer and fewer taxpayers would choose to participate in any tax savings program as the tax incentive decreased, but it may or may not be true that there would still be enough willing participants at any given tax credit percentage to reach the program goal anyway. For LB 295/AM 1418, the *goal* is $2 million in scholarships; but LB 295 caps the tax credit, not the donation. So, if the tax credit percentage per donation were reduced by law, then corresponding donations would have to increase to attain the same total of aggregate tax credits. Therefore, if donor participation decreased due to lack of incentive, thereby causing aggregate tax credits to decrease, then the resulting funding for scholarships might also decrease, might remain about

the same, or might possibly increase. Such hypothetical possibilities would need to be evaluated with historical evidence of diminished taxpayer participation.

This analysis evaluated Iowa's tax credit scholarship program. Of all the state programs, Iowa most closely compares to Nebraska for the following reasons:

1. Similar household income distribution across total population.[11]
2. Similar percentage of private-to-public enrollment.[12]
3. Geographic proximity is more predictive of cultural compatibility, i.e., propensity for charitable giving.

Because of their demographic and socio-economic comparability, Iowa's tax credit participation over the past 10 years should be a good indicator of how Nebraska's participation might be. Iowa has allowed a 65% tax credit for scholarship donations since its program's inception in 2006. During this time, its maximum aggregate annual tax credit has grown from $2,500,000 to $12,000,000, corresponding to maximum scholarship funding of about $3,850,000 to 18,500,000 (at Iowa's 65% rate of tax credit per scholarship donation). Iowa has reached or almost reached its aggregate cap every year. If the tax credit had been 100%, there almost certainly would have been 100% participation, but the maximum scholarship funding would only have been $2,500,000 to $12,000,000. Therefore, a general conclusion can be drawn that a 65% tax credit in Iowa may have nominally reduced donations in some years, not at all in other years, but that <u>all years have resulted in more scholarship funding (and more student migration) than if the tax credit had been 100%.</u>

Because of the general lack of comparability among states, there is no other reliable historical data to estimate for Nebraska the potential impact of a lower tax credit than Iowa's 65%.[13,14]

It is likely that Iowa would reach a ceiling in donations as it continued to increase its annual aggregate tax credit cap. A population has a finite amount of discretionary wealth, so at some point those funds would be exhausted, regardless of the tax credit percentage. However, Iowa's current $12,000,000 tax credit cap does not appear to be near this point of exhaustion. Nebraska has approximately 60% of Iowa's population, and because of the two states' demographic similarities, Nebraska should have a relatively equal proportion of discretionary wealth. But because Iowa's point of diminishing returns has not yet been discovered, all that could be surmised from this is that, at a 65% individual tax credit, Nebraska might not reach donation exhaustion if the aggregate tax credit cap were set proportionally to about $7,200,000.

There is a fundamental difference between Iowa's tax credit program and Nebraska's proposed program. Nebraska's LB 295/AM1418 sets limits for individual tax credits, ranging from $5,000 for individual taxpayers, up to $150,000 for corporations. These limits are allowed to increase at the same annual rate as the aggregate annual tax credit cap (CPI-inflation plus a potential 20%). Iowa has no such official limits. However, there still would be the limit imposed naturally, that is, an individual's total

state income tax liability. Indeed, this appears to have limited donations by high-income Iowans (> $1 million in annual income), whose average annual tax credit was only $18,500 during the first five years of Iowa's program.[15] Still, placing formal limits on donations and creating categories of donors may prevent the formation of a natural maximum donation and instead require more donors to participate than would otherwise be necessary. This would be more likely early in the implementation of LB 295, when individual taxpayer limits are set at $5,000 - $10,000. A 65% tax credit may have less appeal under such circumstances, and donations could decrease as a result. Unfortunately, only experimentation by implementation could determine the outcome of the combination of these variables. No state offers historical data with these exact circumstances to extrapolate an estimate. However, under Iowa's one set of circumstances—65% tax credit with an average individual tax credit maximum of about $18,500—the analysis shows that donations reached or almost reached the aggregate tax credit cap every year; and scholarship donations were higher than if the tax credit were 100% of the donation.

Table 5 shows how reducing the individual tax credit percentage might affect scholarship donations, student migration, and net loss/savings to the state after TEEOSA spending reductions offset the tax credit. This table merely shows the relative impact if and only if lowering the tax credit does not reduce total donations. As stated earlier, some in-practice experimentation by the state would be necessary to determine the level of tax credit percentage, if any, at which donations might decline instead of increase.

TABLE 5. POTENTIAL FISCAL IMPACT OF CHANGING TAX CREDIT PERCENTAGE
(assuming no diminished donor participation—tax credits reach $1,899,999 at any rate)

TAX CREDIT ON DONATIONS*	DONATIONS GENERATING FULL TAX CREDIT	STUDENT MIGRATION	CUMULATIVE STATE NET GAIN/(LOSS) [Years 1-3] ($)	AVERAGE ANNUAL NET GAIN/(LOSS) [after Year 3] ($)	FISCAL BREAK EVEN	FISCAL HOLD HARMLESS**
100%	1,899,999	698	765,510	(285,709)	2 years	5 years
95%	1,999,999	736	1,172,507	(147,544)	2 years	10 years
90%	2,111,110	780	1,579,507	2,081	2 years	3 years
85%	2,235,293	834	2,036,507	156,640	2 years	3 years
80%	2,374,999	891	2,473,507	381,093	2 years	3 years
75%	2,533,332	953	3,050,507	638,596	2 years	3 years
70%	2,714,284	1,021	3,527,507	922,124	2 years	3 years
65%	2,923,075	1,091	3,994,507	1,270,238	2 years	3 years

* Benchmarks for this analysis. 100% shows the estimated result if LB 295/AM1418 is enacted, as drafted. 65% shows the estimated result if relying on Iowa's historical success.
** *Fiscal Hold-Harmless* at 3 years presumes permanency if tax credit were held flat. Any other point of *Fiscal Hold-Harmless* presumes fiscal losses in subsequent years.

SUMMARY

LB 295 would provide tax credits to encourage investment in private education via the funding of student scholarships. This would necessarily reduce state revenue by the amount of the tax credits. However, scholarships would result in the migration of students from public schools to private schools. The purpose of this analysis is to examine the impact of student migration levels, explore the impact on public school districts where the migration might be concentrated, and determine the impact on state expenditures for school aid if significant enrollment shifts are realized. The results rely on several assumptions, but the three most significant are:

1. Weighting potential migration from each public school district by:
    a. Geographic proximity to private schools.
    b. Ratio of capacity of private to population of eligible students.
    c. Diversity of school choice.

2. Identifying an average cost of tuition to determine a range of possible scholarship awardees and corresponding decrease in public school enrollment.

3. Requiring that scholarships will be entirely need-based, i.e. proportionate to family income, and that partial scholarships will be enough to persuade private enrollment for students with family income above the threshold for full tuition reimbursement.[9]

Here is a review of the five scenarios in this analysis:

- State tax credits cannot necessarily be offset by state TEEOSA spending reductions at every level of tax credit. The prevailing average rate of tuition determines how much annual tax credit would be necessary to generate enough scholarships to affect TEEOSA sufficiently.

- *Fiscal Break-Even.* A 100% tax credit per donation, combined with a tax credit total of $1,899,999 million—the highest amount that would not trigger a 20% increase—would likely result in TEEOSA savings that completely offset tax credits by the second year of implementation. The first year would always be a 100% fiscal loss because TEEOSA state aid would not be affected until the second year. TEEOSA spending reductions would be exceptionally large in the second year because of a one-time reduction in the TEEOSA component, *Student Growth Adjustment*. This large one-time reduction would diminish to an overall stabilized annual reduction in the third year, but the second year would be large enough to exceed the first two years of tax credits combined.

- *Fiscal Hold-Harmless.* Also under static conditions, approximately $2.8 - $3.5 million is the range of annual tax credit needed to generate TEEOSA savings that would completely offset the annual tax credit, in perpetuity, by no later than Year 3. Lower annual tax credits could generate a temporary period of *Fiscal Hold-Harmless*, after which there would be annual losses. Higher annual tax credits could experience a delay to *Fiscal Hold-Harmless*, but which subsequently would be permanent.

- **Biennial Budget Benchmark = 650 students.** Three years is the shortest term by which to measure meaningfully the fiscal impact of LB 295. This is primarily because there is a time delay of one year from the time tax credits reduce state revenues to the time that student migration reduces state spending via TEEOSA state aid. The benchmark of 650 students was derived (based on current enrollment and fiscal data) in recognition of the political constraints of the state's biennial budget process. This represents the number of students that would need to migrate to private schools in order to generate enough TEEOSA savings over three years to equal the combined three years of tax credits (at $1,900,000 per year). As LB 295/AM 1418 is currently drafted, "650" is attainable because the statewide average private tuition rate / maximum scholarship of $4,725 should produce about 700 students. Therefore, 650 students would result in *Fiscal Break-Even* in two years and *Fiscal Hold-Harmless* the following year. However, there would likely be fiscal losses in all subsequent years.

- **Overlap-Delay Effect.** This phenomenon would occur if the maximum tax credits were increased from one year to the next. Every year would add a new, small cohort of students that would not generate much TEEOSA savings compared to the corresponding increase in tax credit. For several years, much of the increasing TEEOSA savings would lag one year behind the corresponding increased tax credits, but apparently at a diminishing rate. So eventually, the gap would be eliminated, and the cumulative fiscal losses over several years would eventually be completely offset. The TEEOSA component, *Averaging Adjustment*, would likely cause an acceleration of this offset, which this analysis estimates could occur as early as the 11th year of continuous 22% tax credit increases (the maximum allowed by LB 295).

- **Lowering the income eligibility** for scholarship awards would increase the amount of each scholarship on the basis of financial need. This would decrease the number of scholarships awarded, the number of migrating students, and the savings from TEEOSA state aid. Raising income eligibility would do the opposite. However, if income eligibility were lowered, it could still be possible for the state to reach permanent *Fiscal Hold-Harmless* within three years if the initial aggregate tax credit cap were raised well above the $2 million currently proposed in LB 295.

- Based on Iowa's experience, a **lower individual tax credit percentage** could generate higher donations, more scholarships, more student migration, and more TEEOSA savings than could a higher individual tax credit percentage. The concern is whether a lower tax credit might dissuade potential donors, thereby reducing donations below what they would have been at the higher tax credit rate. Iowa's 10-year history shows full or almost full tax credit utilization (maximum eligible donations) at a 65% individual tax credit. Iowa's socio-economic indicators are comparable to Nebraska's, making Iowa's experience a useful example. However, Iowa has no individual caps on its tax credit, although donors are constructively limited by their state income tax liability. Iowa's average tax credit for taxpayers earning over $1 million was about $18,500 (a natural limit). In contrast, LB 295/AM 1418 creates donor categories and assigns a range of donor caps. The donor caps are allowed to increase with inflation and with the state's aggregate cap increases (if they occur). Initially these donor caps may

inhibit donations from wealthy individual taxpayers and require more donors across more donor categories to make up the difference. Yet, in later years, the donor caps may automatically increase to the point where donors would not likely be constrained below the limit of their annual tax liability (natural maximum).

CONCLUSION

Finally, it must be stressed that this analysis measures only the fiscal impact of potential student migration for given amounts of tax credits and tuition rates, all based on a very specific and static set of data and assumptions. In reality, one cannot isolate the following variables: actual donations, number of scholarship awards, number of students willing to transfer from any one school district, average tuition rates, Consumer Price Index, as well as the numerous fiscal variables that impact the TEEOSA school aid formula. This analysis should be viewed primarily as a trend simulation. At a certain level of annual tax credits, state government spending on public schools will necessarily decrease due to student migration; and at an amount that fully offsets the tax credit. It is not possible to know in advance the exact tax credit level necessary to generate an equal or greater offset in reduced state spending, but the analysis generally confirms <u>state spending should decrease at a faster rate than the corresponding annual increase in tax credits.</u> This still presents the challenge to set an initial tax credit sufficiently high enough. This analysis predicts $2.8 - $3.5 million would be ideal, but the amount could be somewhat higher or lower, depending on the afore-mentioned variables.

ABOUT THE AUTHOR

Nebraska School Finance Strategies, Inc. offers economic consulting services in the field of public education finance, with special emphasis on the analysis of the Tax Equity and Educational Opportunities Support Act (TEEOSA), Nebraska's primary formula for distributing financial aid to kindergarten through twelfth grade public schools. State spending for all public education (early childhood through post-secondary) annually equals almost half of the state's general fund budget, and TEEOSA comprises almost half of all public education spending.

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ENDNOTES

[1] Pursuant to LB 295, AM1418 §10, scholarship-granting organization administrative fees are limited to 10% of total tax-credit eligible donations.

[2] Any funds not immediately converted to scholarships would result in fewer scholarships in any given year and shift calculated increases in private school enrollment to subsequent years. This would skew the results calculated in this analysis, which are dependent on scenarios created by the listed assumptions.

[3] LB 295, AM1418, Section 4 (1) (e) requires scholarship amounts to be based on a recipient's financial need. This verbiage is vague and could be measured differently by SGOs, but still it is customary for SGOs to scale awards proportionately. This analysis assumes the method for all SGOs would be to prorate scholarships on the basis of family income relative to the federal poverty level.

[4] SOURCE: U.S. Census Bureau, *Table* B17024, American Community Survey 5-Year Estimates A*ge by Ratio of Income to Poverty Level in the Past 12 Months* - 2012-2016; and Free/Reduced Lunch authority—82 FR 17182, pp 17182-17185.

[5] SOURCE: Nebraska Department of Education, Data Research and Evaluation, 2017-2018 Nebraska County Membership by Grade. (www.education.ne.gov/dataservices/TXT/CountyMembershipByGrade_20172018_Export.txt).

[6] To prevent overestimation of TEEOSA savings, it is assumed that all private kindergarten and ninth grade students at or below 400% of poverty would receive an LB 295 scholarship. This would reduce potential public-to-private migration by approximately 6.9%, which would nominally limit the reductions in state aid expenditures. LB 295 also allows siblings of scholarship students to qualify for their own scholarships, and these siblings could already be private school enrollees. Such students could further reduce potential public-to-private migration, but the existence of these family combinations is impossible to evaluate, so although some negating impact is likely, it is assumed to be nominal and therefore not accounted for in this analysis. However, even if such scholarships were numerous in the first year of LB 295, the phenomenon would diminish every year—families that were grandfathered by LB 295 would be replaced by families with only first-time students—until nearly no scholarship recipients were originally private school students.

[7] SOURCE: Tax Equity and Educational Opportunities Support Act (TEEOSA), Nebraska Revised Statutes 79-1001 through 79-1033.

[8] A 2015 analysis of tuition yielded a statewide average of approximately $6,000, and an Omaha metro average of $7,200. Data quality analysis since then revealed that this estimate was based in part on inconsistent data—some schools reported "institution cost per student" instead of tuition rates. This inflated the 2015 statewide tuition estimate considerably. However, higher estimated tuition would result in fewer scholarships and fewer migrations, so the overestimated tuition in 2015 actually resulted in underestimating the state savings in public school spending. The current statewide and Omaha-metro estimates of $4,725 and $5,450, respectively, represent a more consistent school-by-school comparison of actual tuition rates.

[9] Some schools do not publish a base tuition rate, so their 2017-18 numbers instead represent "average tuition paid." This after-the-fact construct of tuition could shift with every student gained/lost. For example, a private school next year could charge all LB 295 scholarship students substantially more than this year's "average tuition paid" by existing students. If that were to occur regularly, then the tuition basis for this analysis—$4,725—could be compromised. LB 295 / AM 1418 attempts to mitigate this kind of risk by limiting tuition rates to no more than an institution's actual cost, and by requiring SGOs to submit annual financial audits. Moreover, many new students would likely take advantage of formal, qualified tuition discounts offered by several schools; so $4,725 is likely higher than the average maximum scholarship that actually would be needed. This is likely true even with the risk of tuition inflation by schools with unpublished rates. As such, $4,725 should provide an adequate buffer against inconsistent scholarship awards; so the estimated tuition rate in this analysis should be relied upon as conservatively high, and the corresponding student migration as conservatively low.

[10] Table/Chart 3a does not completely isolate for tax credit amounts because instead of affixing a flat maximum tuition rate, a 2% increase in tuition is assigned to each 22% tax credit increase. This is done primarily because Table 3b requires an incremental increase of tuition, and it uses the same data sets as Table/Chart 3a to remain consistent in Scenario 5. Whereas, holding the tuition rate flat would not have changed the trend relationship shown on Table/Chart 3a, but rather the data points along the trend line, and therefore it would have offered little analytical benefit for this scenario at the expense of being inconsistent with the data used for Table/Chart 3b.

[11] SOURCE: U.S. Census Bureau, *Table* B19001, American Community Survey 5-Year Estimates. *Household Income in the Past Twelve Months* - 2012-2016

[12] SOURCE: U.S. Census Bureau, *Table* B14003, American Community Survey 5-Year Estimates. *School Enrollment by Type of School.*

[13] Iowa Code 2017, Chapter 42, §422.11S.

[14] Kansas has similar socio-economic indicators and a 70% tax credit, but Kansas' tax credit program restricts eligibility to underperforming public school students. Its implementation is therefore not representative of statewide and regional demand for school choice, so it is likely that fewer donations (due to fewer interested donors by region) are generated as a result of Kansas' restrictions on scholarship eligibility.

[15] SOURCE: "Iowa's School Tuition Organization Tax Credit Tax Credits Program Evaluation Study." Published 12/1/2012, By Angela Gullickson. Tax Research and Program Analysis Section, Iowa Department of Revenue.