

Tax Incentives for Education: An Assessment

R. Kavita Rao
Senior Fellow

National Institute of Public Finance and Policy
18/2, Satsang Vihar Marg, New Delhi 110067

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1. Introduction

Tax treatment of educational institutions and other charitable or non-profit organizations has always been a somewhat contentious issue in tax policy. Exemption provided to these institutions is considered a mechanism by which to encourage economic activity in these fields, there are two kinds of arguments raised against such an exemption. First, exemption for some service providers in an activity where other similar but non-exempt service providers might exist undermines the viability of the latter. Institutions setup with a profit motive will be dis-incentivised. Second, the provisions of the income tax act do not provide limits on the pricing mechanism. In other words, institutions which charge a significant fee too could avail of the benefits of these provisions. This tends to violate generally acceptable notions of charity.

Indian Income Tax too follows fairly common international practices of providing exemptions to such institutions provided they are organized as a charitable trust or as a non-profit organization. This study attempts to identify the implications of the provisions of the income tax act in relation to the education sector in India and attempt to quantify the impact of these policies on the exchequer. It should be mentioned here that the data available on private expenditure on education and/or on the potential income generated in this sector is very poor. While enrolment figures are generally available for recognized institutions of school and higher education, no information is available on the fees charged by these institutions. Any estimate on the quantum of impact of these provisions would therefore be based on proxies and assumptions.

The study is organized as follows: the following section outlines the provisions of the Income Tax Act with respect to education. Some implications of these provisions are discussed in section 3. Section 4 provides some estimates of the fiscal impact of these provisions, while section 5 provides a discussion of the alternative policy instruments.

2. Treatment in Income Tax:

The Income Tax Act provides two kinds of incentives for the education sector – first, those available to people enrolling into the education system and second, those available to institutions providing these services. For individuals availing the services provided by the educational institutions, there are two kinds of deductions available; one, deductions towards the tuition fees paid and two, deductions of the interest payment on any education loans taken. Both these deductions are limited in terms of the extent of benefit. For the former, the deduction was available for a maximum of two children. (section 80C subsection 2(vii)). For the latter, while the entire interest payment can be deducted from the income, for purposes of taxes, this deduction was available only for 7 years from the year in which the interest payment on the loan begins. This scheme was extended to cover spouse and children of the tax payer in 2008. (Section 80E)

The first provision was clubbed along with all other savings instruments, with a cap of Rs one lakh overall, for all the instruments put together. This limits the extent of benefits that individuals might avail from this provision, given that there are alternative competing instruments to choose from. To the extent, they get credit for any expenses incurred, households can be spared the effort to identify and invest in other savings instruments, for the purposes of tax saving alone. Since there is a substitution among instruments, it is to be expected that the extent of benefit would be limited, especially since the beneficiary needs to be tax paying individual. These provisions do not confer any benefits to individuals, who have low income or have access to tax free incomes. The provisions of the second provision however are more interesting, since this provision provides benefits over and above other benefits of the tax law. By potentially expanding the income earning capacity of the individuals, the

There is no separate treatment of institutions in the activity of education in the Income Tax Act. However, the provisions under the sections dealing with income from property for charities (section 11) and those dealing with trusts (section 12) do allow for the creation of institutions to provide educational services, without a liability of income

tax on incomes generated through fees or ancillary activities. Section 11, in the definition of a charitable purpose includes relief of the poor, education, medical relief and the advancement of any other object of general public utility. While there is a provision limiting the possibility of charging a fee or cess in the case of “any other object of general public utility”, the same does not hold for the other three categories of charitable purpose.¹ Thus, in the case of an educational institution, setup as a trust with a charitable purposes, it is allowed to charge fees for the service provided. The Income tax act however, does limit the use that the resources mobilized can be put to. Eighty five percent of the total receipts from such fees as well as from income from property held by the trust needs to be used in the current fiscal year towards the provision of the chosen charitable activity. Only fifteen percent of the receipts can be accumulated in specified instruments. The act however does provide for accumulation in excess of the stated 15 percent, provided, it is for a clearly specified purpose and is not for more than a period of ten years. The other set of provisions that allow such institutions to be created and sustained without the liability of income tax are set out in section 10 (23c), which allows a not-for-profit university or educational institution to receive funds without the liability of income tax, provided the funds are used for the stated purposes of the institutions. In this case as well, accumulation of more than 15 percent of income is permissible only for limited period of time.

3. Implications of the Provisions

The provisions of the Act discussed above can be viewed as mechanism to create capacity in the provision of educational services in India as well as in the utilization of such provisions created. In other words, the first set of provisions, implicitly realize that limited role of government in providing services in the field of education. Given the rising costs of education in the non-government institutions, these provisions attempt to cushion the impact of accessing these services. This is reiterated in the 6th Pay Commission recommendation as well, where government employees are provided a reimbursement of the tuition fee paid for upto two children.

¹ This provision would be applicable from April 2009.

On the other hand, the provisions directed towards the service providers allows for an expansion in the capacity of the service providers. It is however often felt that there is a significant degree of misuse of these provisions. Most tax reform committees in the country have therefore attempted to grapple with this issue and identify mechanisms to limit the misuse. Shome Committee Report for the Tenth Five Year Plan was one such effort. The identified misuse in provisions is related to the applicability of the commonly understood notion of charity to the institutions which avail benefits under the Income Tax Act as charities. Institutions which charge high fees for services rendered, potentially with limited access to most sections of the society attract the attention in such discussions. In the UK, some of these concerns are sought to be addressed by formulating some principles of public benefit within the Charities Act 2006. These are

Principle 1: There must be an identifiable benefit or benefits

- 1a It must be clear what the benefits are
- 1b The benefits must be related to the aims
- 1c Benefits must be balanced against any detriment or harm

Principle 2: Benefit must be to the public, or section of the public

- 2a The beneficiaries must be appropriate to the aims
- 2b Where benefit is to a section of the public, the opportunity to benefit must not be unreasonably restricted:
 - by geographical or other restrictions; or
 - by ability to pay any fees charged
- 2c People in poverty must not be excluded from the opportunity to benefit
- 2d Any private benefits must be incidental

The Charity Commission of UK provides detailed guidelines on the mechanism of assessing the “public benefit” for different kinds of charitable institutions. This provides one mechanism for regulating such institutions, if that be the intention or purpose. For the United States, some of the discipline is brought in by distinguishing between a public charity and a private charity, where the latter only receives funds from a limited number of people. Once an organization is granted the status of a public charity, a significant number of its documents and communication with the IRS is available in the public domain, allowing for a cross-check. For educational institutions, the laws require the

institutions to be racially non-discriminatory in terms of admission, appointment of staff and access to scholarships and loans.

In addition to the above, international experience suggests that educational institutions often are provided the benefit of exemption from income tax in many countries in order to encourage people to donate and sustain these institutions thereby reducing the demand on government to be the sole provider of educational services in the country. In the UK for instance, these exemptions come through provisions similar to the Indian case, where education is considered a charitable purpose. In addition, in UK, donations to a charity too can be made free of taxes. In other words, the donor and the charity can claim back any taxes paid on the donation – the charity is entitled to claim the basic rate equivalent while the donor can claim the rest, if the donor is from a higher tax slab.² It would appear that donations can be made more attractive through such provisions. In the United States of America too, provided a charity is listed as a qualifying organisation to receive donations, such donations can be exempt for the donor as well. In both these countries, there are limitations on the benefits that the donor can receive from the charities. In the UK there is a prescribed ceiling depending on the amount of donation received, while in the US, the cost of the benefit received needs to be deducted from the total donation made, for claiming an exemption for the donation. These provisions extend to donation of properties to charities as well.

Such a provision however does not exist for all charities in India. There are only a limited number of charities or trusts, donations to which can be completely deducted from the income for purposes of computing taxable income. For a number of other institutions, deduction of upto 50 percent of the size of donation is provided with an overall limit of 10 percent of the total income of the donor. It has been argued in India that this is one of the principle reasons why people in India do not donate to these institutions in a big way. (See Raja Chelliah, “Taxation of Charitable Trusts”, Economic and Political Weekly of December 29, 2001 — January 4, 2002 and Amaresh Bagchi and Bulbul Sen, “Of Archaic IT laws and Charity”

² See http://www.hmrc.gov.uk/charities/gift_aid/basics.htm

<http://www.rediff.com/money/2007/feb/16spec.htm>) These papers suggest that charitable and non-profit institutions do play an important role in the delivery of social services in the country. While there might be reason to seek better regulation of these institutions, the incentives provided through the exemptions should be retained so as to protect the viability of these institutions.

There is however an alternative perspective on this subject as well. Since charities often compete with other non-exempt organizations in the provisions of services in a given field, exemptions provided to the former often undermine the viability of the latter. In other words, institutions guided by the profit motive cannot make a foray into this arena if there is a predominance of the non-profit institutions. It should be recognized that while these institutions do provide services, probably at a price lower than the institutions guided by the profit motive, limitations on their ability to utilize the resources could be counter-productive as well. For instance, the limitation of allowing accumulation of only upto 15 percent of the total income of the institution does not allow the institution to manage its resources inter-temporally.

4. Estimating the Size of Incentives Provided

Incentives to the Individuals

As discussed earlier, the incentives provided to the individuals are of two kinds: a deduction of the tuition fee from income in the estimation of taxable income and a deduction of interest on loans taken for purposes of higher education purposes. Since the former is clubbed with a number of other instruments, it is not clear whether the addition of this clause provides any additional incremental benefit to the individual. Hence, for the purposes of this exercise, this form of incentive is excluded from the assessment of the quantum of benefit provided to the beneficiaries. Turning to the second category of benefits, while information in the public domain does not cover all potential lending institutions, there is some information on public sector banks. In these banks, the outstanding education loans are Rs 26925 crore, as on March 2009. With an interest rate of 10 percent, the interest payable would be Rs 2764.6 crore. Assuming that 60 percent

of the loans would be taken by people in the 30 percent tax bracket, and the balance by individuals in the 20 per cent tax bracket, the benefit provided by this provision would be Rs 2692.5 crore*(.6*.3+.4*.2), which is about Rs 700 crore. Including the loans extended by the private sector banks and potentially by the non-bank financial institutions, could raise the figure to at least Rs 800 crore. It should be mentioned that these loans are for higher education alone.

Incentives to the institutions

Any effort to estimate the impact of the exemptions provided to institutions in the field of education is rendered rather difficult in the face of limited data available. There are no information sources to ascertain the flow of funds in the form of tuition fees to these institutions. Further, there are no readily useable estimates of the cost of setting up and running such institutions. All efforts at arriving at such estimates therefore have to be based on interpreting from the limited data available, on the basis of assumptions, the potential income earned in this sector. Given the fact that resources from the charitable institutions cannot be transferred out of the institution by way of “dividends”, and there are limitations on the amount of resources a charity can accumulate in any given year, the estimation of surplus in these cases would be rather “notional”, and needs to be viewed as such. In order to arrive at a reasonably reliable number, an attempt has been made to derive the number from alternative assumptions. These are discussed below. Since there are larger number of students in the schools and there is somewhat more information available on the same, the discussion focuses on these institutions to begin with.

1. A study quoted in the press by ASSOCHAM suggests levels of expenditure per capita on tuition fees at Rs 35000 per year.³ The survey estimates that close to 3 crore children study in such private schools. While the cost of school education in the private sector is not easily available, it is common for schools to have an average class size of about 25 students or more. Assuming a lower class size of 10 should therefore allow for all the other support staff and cost of facilities provided to the students. Further assuming that cost per

³ “Rising School Expenses vis a vis Dilemma of Young Parents”, Assocham
<http://timesofindia.indiatimes.com/india/School-expenses-rise-by-160-in-8-years/articleshow/3178191.cms>

teacher is Rs 25000 per month, i.e., Rs 3 lakh per year, the above figures generate a surplus of Rs 15000 crore.⁴ At the present corporate rate of 30 percent, this amounts to Rs a benefit to the tune of Rs 4500 crore.

Alternatively, if one takes the Kendriya Vidyalayas as the benchmark, the cost per child in these schools is Rs 10245 in 2008-09. Assuming that the cost of education of a child in a private school is Rs 25000 in place of the above, to take care of the infrastructure costs, the net income per child would be Rs 10000 amounting to Rs 30000 crore for all the above students put together. In other words, the tax incentive amounts to Rs 9000 crore, if this alternative approach is adopted.⁵

2. The National Sample Survey for the year 2004-05 estimates that the total number of students in private unaided institutions in both schools and in institutions of higher education is 40639900, with 19225200 in the urban areas and 21414800 in the rural areas. These are the institutions which potentially benefit from the exemptions considered in this study. Of these the enrolment in schools is estimated to be 364 lakh. Given that the unaided schools would attempt to generate and sustain investment without assistance from the government, it is assumed that there is some surplus from fees beyond the costs of running the institution. If one assumes that the surplus for rural areas is about Rs 5000 per student in schools and that from urban areas is Rs 10000 per student, the surplus generated would be about Rs 27000 crore. Even with lower margins of Rs 3000 per student in the rural areas and Rs 6000 per student in the urban areas, the surplus amounts to Rs 16400 crore. This corresponds to an incentive of Rs 8100 crore by the first set of assumptions and Rs 5520 crore as per the second set of assumptions.

⁴ It is often argued that the pure cost of education in private institutions is lower than that in government schools, since the teachers and staff in the former are paid market wages which tend to be considerably lower than the government wages. The present assumption therefore would not be an underestimate of the expenses on employing teachers and the overhead costs.

⁵ These figures are derived from the figures provided in the following websites: <http://kvsangathan.nic.in/enroll-cat.htm>, <http://kvsangathan.nic.in/budget.htm>

Table: Estimates of Surpluses for Private Unaided Institutions

	rural	Urban	total
NSS data (2004-05)			
Enrolment in private unaided institutions (Lakh)	192.25	214.15	406.40
In School education (lakh)	179	185	364
surplus per child (Rs per year)	5000	10000	
total surplus (Rs crore)	8965	18469	27434
surplus per student (Rs per year)	3000	6000	
total surplus (Rs crore)	5379	11081	16461
In higher education			
Graduate	767804	1652464	2420268
diploma not equivalent to graduate	386356	832300	1218656
diploma equivalent to graduate	140624	460954	601578
total (lakh)	12.95	29.46	42.41
surplus per student (Rs per year)	10000.00	10000.00	
total surplus (Rs crore)	1294.78	2945.72	4240.50
7th All India School Education Survey (2002-03)			
In Private Unaided schools	13238280	20285540	33523820
Unrecognized	5506778	2499254	8006032
surplus per child (Rs per year)	3000	6000	
Surplus private unaided schools	3971	12171	16143
Total Surplus (Rs crore)	5624	13671	19294

Source: computed using NSS Report 517 and 7th All India School Education Survey

- An alternative estimate can be arrived at by using the numbers from the Seventh All India Educational Survey of 2002-03. This survey records a figure of 33523820 as enrolment in private unaided schools, and 8006032 in unrecognized schools.⁶ Of the students enrolled in the private unaided schools, 13238280 are from rural areas and the rest from urban areas. Even assuming lower margins per student of Rs 3000 in the rural areas and Rs 6000 in the urban areas, the total surplus in these schools amounts to Rs 16143 crore. If figures for the unrecognized schools too are added to this base on the same assumptions as above, the total amounts to Rs 19294 crore. It is

⁶ See <http://gov.ua.nic.in/NScheduleData/main3.aspx?flag=13>

important to point out that these figures refer to the year 2002-03. Studies on the education sector in India often suggest that the share of private unaided schools in India has been consistently rising over time.⁷ Even the current shares of private unaided schools in India are maintained, the number of students would increase over the years, suggesting a higher figure for the size of surplus free of taxes. The corresponding tax incentive would be Rs 5788 crore.

4. Turning to higher education, using the same NSS data, the enrolment of students in private unaided institutions is to the tune of 42 lakh. Assuming an average margin of Rs 10000 per student per year – the margins can be substantially higher in management institutions and in technical institutions – the total surplus is Rs 4200 crore. Some studies argue that the estimates of NSS in terms of higher education are underestimates. If these arguments are valid, the actual estimates would be correspondingly higher.

Taking the figures from the NSS reports to be an acceptable first approximation, the total surplus accruing to the unaided institutions would amount to Rs 20600 crore even with conservative assumptions. At the present tax rate of 30 percent, this implies a tax incentive to the tune of Rs 6200 crore.

5. Some Conclusions

Given the limitations in expanding the scope of government intervention in the field of education, it has increasingly come to be accepted that the private sector is here to stay. The provisions of the Income Tax Act provide a mechanism for such institutions to derive a tax exempt status, albeit with some restrictions. It is now an important question, where these institutions should be offered any tax benefits and if yes, should the benefits be provided only within these broad parameters and restrictions or should they be

⁷ Kingdon, Geeta Gandhi (2007): “Progress of School Education in India”, Global Poverty Research Group, Working Paper series 071, Economic and Social Research Council, Oxford University, <http://www.gprg.org/pubs/workingpapers/pdfs/gprg-wps-071.pdf>

expanded to cover all educational institutions? For some clarity on this front, it is important to ask whether the exemption accorded to these institutions is for furthering the cause of education or for furthering the cause of charities in the country.

Whatever be the answer to the above question, there are two important changes in the regime called for on the following lines– first, since these institutions are deriving some public benefit, should the benefits provided by them be accessible to public at large? Can a more precise definition of “charitable purpose” be invoked to ensure that the benefits do not exclude some segments of the population by design. Second, since these institutions are expected to provide public benefit, should information on these institutions be made accessible to the public to allow for greater public scrutiny? Reforms on these lines can protect institutions which do provide public good and limit the scope of others which are perceived to be misusing the system.