

A CATALOG OF TAX-BASED APPROACHES FOR FINANCING CHILD CARE
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I. INTRODUCTION

Despite the continuing efforts of child care advocates to expand the availability of high-quality, affordable child care for all who need it, public investments in child care, at both the state and federal levels, remain woefully inadequate. Faced with this persistent problem – exacerbated now by an economic downturn and budget shortfalls at all levels of government – child care advocates have much to gain by exploring new and creative means of supplementing their traditional strategies for securing resources for child care.

To this end, the National Women's Law Center initiated a series of meetings over the past two years with policy experts from various fields to discuss tax-based approaches for financing child care. The working group convened by the Center included child care experts as well as experts in tax law, community development, low-income housing and other fields. Participants in these discussions agreed that, as child care advocates search for new tools to increase funding for child care, a variety of tax-based methods can and should supplement more traditional direct spending. A wide array of tax-based strategies were considered, including several mechanisms that are already used to help finance child care and could be expanded, as well as methods that exist in other fields but could be adapted to the child care context. Most of the mechanisms examined focus primarily on increasing the supply or the affordability of child care, but many of them also affect quality, indirectly if not directly. This paper, which grew out of the working group's meetings and represents a record of its ideas, explains each of the approaches discussed and identifies some advantages and disadvantages of each model. The Center is interested in exploring with advocates and policy makers in the states and at the federal level ways in which any of these approaches might be implemented in a particular jurisdiction.

A central premise of this work is the recognition that tax-based approaches offer some distinct advantages over direct spending programs. Unlike direct spending programs, which are typically dependent on annual appropriations from the legislature and thus inevitably require intensive advocacy efforts in which different interest groups are pitted against one another in a scramble for scarce budget dollars, tax provisions avoid the vagaries of these appropriations battles. In effect, tax provisions act as entitlements in that, in most cases, all who qualify for tax benefits will automatically receive them. In addition, although tax cuts – including new or expanded tax deductions or credits – decrease government revenues, they may be possible even when a state has placed limits on direct expenditures, and elected officials often find tax cuts politically appealing even at times of severe budget constraints.

At the same time, tax strategies have their own limitations, and should not supplant spending strategies: both are important, and child care advocates are best served by exploring various combinations of the two. When advocates have an array of options to promote, they can tailor their recommendations to particular goals and specific political environments, and have alternative proposals to offer as appropriate opportunities arise.

A variety of different tax-based approaches to child care are described below. What they generally have in common is that they increase the amount of money available for child care. They do so by providing a tax benefit that acts as an incentive for a private contribution or investment, by increasing the resources available for parents with child care expenses, or by generating new revenue for child care.

The first category of measures included in this paper consists of supply-oriented strategies – that is, tax measures designed to increase the supply of child care by creating incentives for private sector contributions to or investments in child care. These include tax strategies to direct and increase private charitable donations to child care, to increase private investment in child care, and to secure debt financing for child care. The most promising supply-oriented strategies are ones that would bring new money into the system (particularly from financial institutions and other private investors); encourage the pooling of resources; generate funds that would be available to both for-profit and non-profit providers; accommodate both large and small investments; build on existing mechanisms; leverage sufficient private investment to justify the public expenditure; and do not impose substantial costs or administrative burdens on either child care providers or investors.

The second category consists of demand- or consumer-oriented strategies aimed at increasing the demand for child care by augmenting the resources people have to pay for child care. These include individual income tax credits such as federal and state dependent care tax credits, individual savings accounts with tax benefits, and tax-financed social insurance models. The most promising of these approaches are those that provide assistance to families with children, particularly low-income families, by increasing family resources available to pay for child care and potentially allowing parents to purchase higher-quality care, and that are easy to access.

The third category of mechanisms is a little different. Instead of creating tax benefits for investors in child care or for parents with child care expenses, these mechanisms raise money for child care directly through the tax system. The money raised can then be used for any of the strategies already identified, and others as well. Examples include generating revenues from new tax checkoffs, excise taxes, sales taxes, and local property taxes, and using these revenues to fund either tax benefits that in turn can bring private money into the child care system or direct grants to parents or child care providers.

Because many of the approaches discussed in this paper consist of tax deductions or tax credits, a few words on the nature of these tax benefits – and their limitations in assisting low-

income families – are in order. Both deductions and credits are a means of lowering the taxes of qualifying taxpayers, but deductions do so by decreasing the amount of income that is subject to taxation while credits do so by directly reducing the amount of taxes owed. The following examples illustrate the difference:

- **DEDUCTION:** Assume a corporation with \$500,000 in taxable income and a marginal tax rate of 10 percent qualifies for a \$25,000 tax deduction. Without the deduction the business would owe \$50,000 in taxes ($\$500,000 \times 10\%$). The deduction reduces the business's taxable income to \$475,000 ($\$500,000 - \$25,000$). With the deduction the business would owe \$47,500 in taxes ($\$475,000 \times 10\%$), for a tax benefit of \$2,500 ($\$50,000 - \$47,500$).
- **CREDIT:** Now consider the same corporation (\$500,000 in taxable income and a marginal tax rate of 10 percent), but instead of qualifying for a deduction the business is eligible for a tax credit of \$25,000. Without the credit, it would owe \$50,000 in taxes. With the credit it would owe only \$25,000 ($\$50,000 - \$25,000$). This credit thus provides a tax benefit worth \$25,000. With a credit and a deduction *of the same size*, the credit will be worth more than the deduction. However, a credit is not inherently more valuable than a deduction, since both the size and design of each can be altered to make one more valuable than the other.

It is critical to understand that both deductions and credits can be of limited value to those with low incomes. At the federal level and in many states, families with incomes below the poverty level do not owe any taxes. For these families, neither reducing the amount of their income subject to taxation through a deduction nor reducing the amount of taxes they owe through a credit will yield a benefit. Similarly, some low-income families who owe minimal taxes cannot take full advantage of a tax deduction or credit, because they do not have enough taxable income or tax liability against which to claim the full amount of the deduction or credit. For example, an individual with \$1,000 in tax liability who qualifies for a credit of \$3,000 would receive only \$1,000 from the credit – one-third of what he or she is theoretically entitled to receive. Refundable credits, however, can address this limitation. With a refundable credit, taxpayers receive the full value of the tax credit, regardless of the size of their tax liability. In the previous example, \$1,000 would offset the individual's tax liability, and the remaining \$2,000 would be refunded to the taxpayer in the form of a check.

Another noteworthy feature of deductions is that in a progressive income tax system they tend to be more valuable to those with high income than to those with low income. The value of a deduction depends on the taxpayer's tax rate: the higher the tax rate, the greater the value of the deduction. Since high-income taxpayers tend to face higher tax rates than low-income taxpayers, deductions will generally be more valuable to those with high income.

In addition to analyzing various tax-based approaches for financing child care, the working group identified a few lessons to guide the promotion of these mechanisms. First and

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foremost, of course, is the fact that different mechanisms are appropriate for different goals – advocates therefore should identify their goals for a tax-based strategy and choose the mechanism to pursue accordingly. In addition:

- Before promoting a tax-based strategy to legislators, advocates should do some research and marketing to determine if support for such a tax strategy exists. For example, if a credit is directed toward employers, talk to employers to investigate whether they would be likely to claim the credit. Potential beneficiaries of the provision can serve as valuable partners during the advocacy phase.
- Tax benefits that are enacted should be actively marketed to ensure they will be successful; merely including a reference to a credit or deduction on the tax forms may not be enough to alert potential claimants.
- Beware of legislators substituting spending on a child care tax mechanism for spending on other child care programs. Tax strategies should be utilized in addition to, not instead of, direct spending programs.

This paper does not describe in detail each of the various proposals that it covers, but it is followed by an appendix containing descriptions of all of the programs in the order that they are discussed in the text. Programs described in the appendix are italicized in the text below.

II. DISCUSSION

A. Supply-Oriented Tax Strategies to Increase the Development and Provision of Child Care

The approaches defined as supply-oriented consist of tax incentives for contributions to or investments in child care, which are justified by their proponents on the grounds that the market does not sufficiently encourage such investment. The mechanisms considered fall into three categories: contribution tax credits and deductions, investment tax credits, and tax-subsidized debt financing, a range that recognizes that the needs and relative strengths of developers, owners and operators of child care facilities are sufficiently heterogeneous to justify pursuing as wide a range of strategies and levels of investment as possible.

1. Contribution Tax Deductions and Credits

Tax deductions and credits for contributions are designed to attract grants and donations of various amounts from individuals and businesses. Securing a tax credit or deduction for contributions reduces the actual loss that a donor bears in making a gift by compensating the donor for some amount of the gift with tax benefits. In this way, donors can be encouraged to give more than they may otherwise have intended to give. Credits and deductions for contributions tend to carry very low or no risk to donors because the tax benefit is available for simply making an eligible grant or gift and the donors are not held accountable for how the

money is used. For example, taxpayers who itemize their deductions are allowed to deduct from their federal taxable income the value of contributions made to charitable organizations.

Contribution tax deductions or credits could be established specifically for donations made to eligible child care. For example, *Colorado's contribution tax credit for child care* is a state tax provision under which an individual or corporation making a monetary contribution to promote child care in the state is eligible for a tax credit. In 1998 Colorado expended over \$700,000 through an earlier, smaller version of this credit, implying at least \$2.8 million in contributions. In 1999, Maine adopted a similar credit, "the quality child care investment credit," effective for tax year 2001.

Credits and deductions for contributions present certain advantages to both donors and child care providers. They can be relatively simple for donors to take advantage of, especially for donors who already itemize their deductions. Because of their relative simplicity, the transaction costs are limited for both donors and recipients. If donors give more than they otherwise would as a result of the tax benefit they receive through the deduction or credit, then the mechanism will have generated new money for child care. In addition, child care providers can use donated funds for a wide range of activities, including to increase teacher salaries and otherwise improve child care quality, unless they are specifically earmarked by the donor. Finally, these mechanisms require little administrative work on the part of child care providers, although some administrative effort is needed to cultivate a long-term relationship with donors that will encourage them to give on a regular basis.

Relying on contributions has limitations, however. With a credit or deduction that is limited to charitable giving, the donation by definition must be made to a charity, therefore excluding for-profit care. Even a broader credit or deduction for contributions relies in large part on the charitable intent of the donor. If only small donations are generated, the additional funds may not be enough on their own to allow a child care provider to rely on them in any substantial way. For example, in 1998 the Colorado contribution credit attracted about 1,300 taxpayers and expended about \$700,000. If this sum were spread equally among the claimants it would represent about \$2,000 in contributions per claimant. Even if each claimant gave \$2,000 to only one entity, the amount contributed is unlikely to be sufficient to lead to large-scale improvements.

One existing mechanism that has the potential to act as a method for pooling charitable donations is the *charitable gift fund*, a type of donor-advised fund established by some investment firms. Several individual and/or corporate donors can contribute cash, securities, mutual funds, or other assets to the fund and take a tax deduction for the full amount of the donation at the time it is made. The donor can then recommend that the fund's trustees make contributions to particular tax-qualified charities over a period of time. Existing charitable gift funds have not generally been structured in a way that encourages contributions to a fund for a particular purpose – such as child care – but could be. Similarly, a contribution tax credit could allow donations to a state fund as another way of pooling small donations into a larger fund designated for child care. A non-tax-based strategy that has been used in the child care context to

accomplish the same goal is Florida's Child Care Executive Partnership program under which the state matches contributions to community child care purchasing pools that are, in turn, used to provide child-care subsidies to low-income families.

2. Investment Tax Credits

Some states have established tax credits that provide a partial reimbursement for expenses incurred for activities in which the legislature wants to encourage investment. Thus, as with contribution credits, some charitable intent or other reason for making the investment is necessary since the tax credit alone will not make the investor whole. For example, the investor may expect the investment to generate a return on its own, but not one sufficiently large to justify the investment in the absence of the tax credit. The following are examples of these types of credits:

- *Employer tax credits for child care* allow employers who provide child care assistance to their employees or communities to receive income tax credits based on a variety of expenses, including start-up costs, operating costs, or the cost of subsidies given to parents to pay for child care. Half the states have such credits and the Economic Growth and Tax Relief Reconciliation Act of 2001 includes a new federal employer tax credit for child care. (A forthcoming National Women's Law Center report, *The Little Engine That Hasn't: The Poor Performance of Employer Tax Credits for Child Care*, provides a detailed analysis of these credits.)
- *California's farmworker housing tax credit* allows taxpayers to offset the costs of building and rehabilitating farmworker housing. A similar credit could be established for building and rehabilitating child care facilities.
- *Maine's Employment Tax Increment Financing* allows for-profit employers who create a certain number of jobs that meet a range of economic development criteria, including certain wage levels and benefits, to qualify for a credit equal to a portion of the state income withholding taxes paid on behalf of qualified employees. A tax increment program could be structured to encourage employers to offer child care assistance to their employees or to encourage child care providers to pay higher wages and provide benefits to their employees.
- Proposals pending in California and the U.S. Congress would offer *tax credits or exemptions for elementary and secondary school teachers* to encourage them to remain in teaching or achieve higher board certification. These proposals could be expanded to include child care providers and early childhood educators.

These kinds of mechanisms have the potential to generate more money for child care if they encourage investors to invest more than they otherwise would invest. However, research by

the National Women's Law Center concerning the effects of the existing state employer tax credits for child care suggests that, at least in their current form, the employer tax credits have not been successful in encouraging a substantial number of businesses to provide child care assistance. Of the 20 credits for which data are available, 16 had five or fewer corporate claimants and in at least five states not one corporation claimed the credit.

Other investment credits have been developed to encourage investment in low-income communities or in projects that benefit low-income individuals. Some of these credits operate like the credits above or like contribution credits in that they only reimburse a portion of the investment made. But the amount of funds available for the tax credits is usually limited, requiring interested donors to apply and compete for the credits, which are designed to encourage investment in communities that have difficulties attracting non-profits or businesses.

- *A Neighborhood Assistance Program Tax Credit* is authorized under some state laws to provide tax assistance to businesses that invest (e.g., by providing cash, materials, staff) in community non-profit organizations that provide neighborhood assistance, job training, education, crime prevention or other community services in low-income neighborhoods. Investments in organizations providing child care are eligible for these credits.
- The *Community Development Corporation (CDC) Tax Credit* was authorized until 1998 as a pilot program administered by the U.S. Department of Housing and Urban Development (HUD) to promote employment and business opportunities in low-income areas. HUD awarded federal tax credits to competitively selected, tax-exempt CDCs, which then found an investor willing to provide a grant or make a loan to the CDC, available for ten years, in exchange for a tax credit. Investments in child care qualified for the credit.
- The *New Markets Tax Credit* is authorized under federal law for investments in projects that serve low-income communities, including contributions to community development banks, venture capital funds, or investment funds created to promote economic development in disadvantaged areas. Investments in child care qualify for the credit.

In addition to these credits, which provide only a partial reimbursement for investments, a significant federal credit has been developed to provide a return on funds invested. The *low-income housing tax credit (LIHTC)* provides investors with a return on their investment in low-income housing projects by offering them federal tax credits spread over ten years based on the depreciable cost attributable to the low-income units of the project. This credit carries some amount of risk for investors because the tax benefit is not entirely available at the time that the investment is made; rather, it is spread out over time and often subject to recapture rules if the project funded by the investment does not meet certain performance measures. The LIHTC is the model for an investment tax credit for child care recently adopted in Oregon that is described

below. In addition, U.S. Representative Nancy Johnson has introduced legislation to expand the low-income housing tax credit to include child care facilities in low-income housing developments (*Johnson Amendment to LIHTC*).

Oregon's Corporate Child Care Tax Credit, a five-year pilot program, is designed to encourage taxpayers to invest in child care. Modeled after the LIHTC, the program authorizes the Child Care Division of the Oregon Employment Department to allocate up to \$500,000 in tax credit certificates each year to taxpayers that make contributions to the Child Care Division or another selected community agency for the purpose of promoting child care. Like the LIHTC, the tax credit certificates will provide individuals and businesses with a financial return on their investment. Investors will apply for the credits stating how much they are willing to contribute in exchange for a tax credit. For example, an investor could decide that she will pay \$750 for \$1,000 in tax credits. Therefore, the amount available for child care will be less than the \$500,000 allocated for the credits, but promoters expect that the difference between the value of the contributions and the value of the credits will diminish over time as investors compete for the credits. The money generated will be pooled at the state level, allocated to non-profit community agencies in the state's five regions, and subsequently distributed to child care providers through an application process. The program, through its criteria for selecting providers, such as restrictions on the fees a provider may charge to parents and requirements about the training of child care workers, seeks to strategically allocate tax credit certificates to encourage child care investment in low-income communities and to make child care more affordable and of higher quality for low- and moderate-income families. The Oregon credit thus attempts to address not only the supply but also the quality and affordability of child care.

An investment credit such as the LIHTC or the Oregon credit offers several advantages to the child care community. Promoting child care as an investment rather than a charity is in and of itself desirable. Since such a credit provides a return on the investment, it is likely to be able to attract a larger pool of potential investors and to generate a larger infusion of capital than a contribution credit could. The pooling of funds generated through the Oregon credit into a statewide pool allows for large grants to be made to child care providers, regardless of the size of individual contributions, and for requirements about the affordability and quality of child care to be imposed on participating providers. The LIHTC has been structured to require multi-year commitments from investors. Requiring similar commitments for investors in child care could guarantee long-term funding and also encourage long-term relationships between investors in child care and providers that are mutually beneficial. For a credit to translate into higher quality care and lower costs for parents, criteria would need to be adopted for projects claiming the credit, as has been done in the low-income housing context and in Oregon, such as restrictions on fees charged to parents.

However, an investment credit such as the LIHTC presents certain disadvantages as well. Most importantly, it is complex, in terms of both the structures that must be in place to minimize investor risk and the systems necessary to comply with reporting requirements. For example, in the context of the LIHTC, a syndicator market has developed to bundle projects together and

allow investors to invest in this aggregation, thereby minimizing risk. A significant amount of paperwork is required to document that the funds are being properly used. The Oregon credit eliminates much of this complexity since the state, rather than the investor, is responsible for how contributions are used.

Another disadvantage of this type of approach is the significant cost to the government of providing tax benefits that would result in a sufficient return on investment. The LIHTC, for example, fully funds much of this country's low-income housing. A very powerful credit for child care would be very costly, especially in comparison to the private money leveraged, and could compete directly with other government appropriations for child care. The Oregon legislature set aside \$500,000 for each of the five years of the pilot program. Promoters hope these credits will generate at least \$250,000 in contributions the first year, and that this figure will rise as investors learn about the credit certificates and compete for them. This substantial cost to the state in comparison to the amount of money generated for child care raises the question of whether a direct spending program – providing \$500,000 for child care – would be preferable to this tax credit approach.

Finally, an investment credit such as the LIHTC or Oregon credit requires some marketing to attract potential investors who may not understand the value of the investment credit and therefore may not be interested in it. Marketing this type of credit to potential investors would most successfully be done by intermediaries who have considerable knowledge about tax policy in general and the investment credit in particular, the needs of the field that requires investment, and the needs of potential investors. Child care providers currently do not have the capacity to market effectively an investment credit because they have limited familiarity with tax policy and the investment community and because they have limited staff resources to expend on this type of work. Oregon plans to select an intermediary to administer and facilitate the relation between the state, investors and child care providers. Regardless of who markets an investment credit, the need to educate and attract potential investors presents a transaction cost. In Oregon, the administrative costs of the program are subtracted from the amounts contributed, reducing the amounts available for child care providers.

3. Tax-Subsidized Debt Financing

With debt financing, funds for a project are borrowed from investors and must be repaid. In the child care context, debt financing is most appropriate for the construction and rehabilitation of child care facilities since sufficient funds generally are not available up front to pay for the project but the facility can serve as collateral for the loan. Developers may receive debt financing either through private loans or through bond issues, which can be subsidized by the government through the tax system. For any kind of debt financing, a stable income stream must be available in order to make the required periodic repayments.

Government assistance to developers in securing debt financing is justified by its proponents because of two imperfections in the market. First, in some circumstances developers

of a child care project may be unable to secure a loan from conventional lending sources because the lenders consider the project's slim profit margins and unreliable income stream to render it too risky for such financing. Second, even if lenders are willing to issue a loan for a child care project, the interest rate offered may be prohibitively high, deterring developers from taking out loans to finance the costs of constructing child care facilities or of other child-care-related projects.

Among the following examples of debt financing subsidies, the first currently exists at the state level. The other two are currently available at the federal level. While none identifies child care as a qualifying use of the funds, modifications could be made to existing programs or the models could be adapted for use for child care. Non-tax-based strategies that have been used in the child care context (for example, in California) to accomplish the same goal as these mechanisms (that is, reducing the cost of borrowing for qualifying projects) include loan guarantee funds, in which the government guarantees private sector loans, and government loan funds.

- *Tax credits for forgone interest* allow financial institutions that make below-market-rate loans for qualifying projects to claim a tax credit.
- *Tax-exempt bonds* provide bondholders with interest payments not subject to federal income tax. Since the investors do not have to pay federal income tax on the interest received from the bonds, the issuer may be able to offer a lower interest rate than otherwise would be required to attract investors.
- *Interest-free bonds* issued by the state give bondholders a federal tax credit instead of interest payments from the state government. Since interest payments are not required, this mechanism makes debt financing less expensive for the bond issuer.

There is some concern that child care providers do not have a sufficiently stable or adequate income stream to engage in any activities which would require them to incur new expenses (e.g., as would be the case if they were to take out a loan or if they were required to pay back investors). In addition, to the extent that investors and lenders require an equity interest in order for them to become involved with financing child care, other mechanisms will be needed to fund child care improvements that are not related to construction and rehabilitation of facilities and thus in which there is not the potential for securing such an interest.

B. Consumer-Oriented Tax Strategies to Increase Resources Available to Families for Child Care

This section outlines tax mechanisms aimed directly at increasing resources for child care consumers as opposed to providers or developers. Here, the strategies cover the following areas: tax credits and deductions that benefit families with child care expenses; tax strategies that

encourage family savings and that could be expanded to include saving for child care; tax strategies that currently help families finance higher education and could be modified to assist families with child care expenses; and tax strategies to finance a social insurance program to help pay for child care.

1. Tax Strategies to Help Families Directly with Expenses

Tax-based mechanisms currently exist to provide assistance to families. Some are available specifically for child care expenses, while others place no restrictions on how the money can be used.

The federal and most state *child and dependent care tax provisions* offer tax relief to families with child care expenses at a range of income levels but are often designed to provide more assistance to those with lower incomes. Under these provisions, taxpayers can deduct or receive a portion of their employment-related child care expenses as a credit on their federal and sometimes state income tax returns. The maximum federal dependent care tax credit (DCTC) amount ranges from \$960 to \$1,440 (increasing to \$2,100 in tax year 2003, under changes made by the Economic Growth and Tax Relief Reconciliation Act of 2001). One significant problem with the federal DCTC and many of the state credits is that they are not refundable. That is, taxpayers whose credit amounts exceed their tax liability will not receive the excess in the form of a refund. Since few poor families have income tax liability, these families do not receive any benefit from a non-refundable credit. Ten states have refundable child care tax credits.

The tax benefits available through federal *dependent care assistance programs* (DCAPs) allow employees to exclude from taxable income child or dependent care benefits provided by their employers. DCAPs may not discriminate in favor of highly compensated employees, but when they take the form of salary reduction plans, as most do, they are more valuable to higher-income than lower-income taxpayers because their tax benefits are achieved by lowering the amount of income subject to tax, which yields larger benefits for those with higher marginal tax rates. Moreover, to take advantage of these tax benefits, an individual must work for an employer who has agreed to establish a DCAP.

Two refundable federal tax credits provide financial assistance to families that can be used for any purpose, including child care. The federal *child tax credit* (CTC), and parallel credits in some states, are available to families with children. Under changes made by the Economic Growth and Tax Relief Reconciliation Act of 2001, the federal CTC will increase from \$500 per child to \$1,000 per child by tax year 2010 and will begin to be partially refundable for families with earnings above \$10,000 in tax year 2001. The federal *earned income tax credit* (EITC), and parallel credits in some states, are available to low-income families with children and earnings. In 2001, families with earnings up to \$32,121 are eligible for the EITC, whose maximum benefit is \$4,008. Improvements to the EITC in the Economic Recovery and Tax Relief Reconciliation Act of 2001 help reduce the “marriage penalty” in the EITC and simplify the rules for claiming the credit.

A few states have *stay-at-home parent tax credits* to help parents stay at home or take family leave to care for a child. Such mechanisms can be complementary to the tax benefits that DCTCs provide parents in the paid labor force and are similar to CTCs in that the money can be used for any type of expense.

Advocates have made the argument that child care should be viewed as the first stage of the education continuum, and that therefore financing strategies should be available for child care expenses that are similar to those that are available for higher education expenses. Policymakers use a combination of *individual tax credits and deductions for higher education*. For example, New York state recently created a tax deduction of up to \$10,000 of higher education tuition. At the federal level, the Hope and lifetime learning credits assist low- and moderate-income taxpayers to offset partially the costs of higher education.

All of these tax mechanisms for providing financial assistance for child care have some advantages. First, as part of federal and state tax codes, they are entitlements – all who qualify for the credits will receive them. Second, parents may use the increased subsidy or increased income – which can be quite substantial when considering the combined effect of the federal credit with state credits or deductions – to defray the cost of care and, potentially, to purchase higher-quality care. A few states directly encourage parents to choose high-quality care by making the amount of the DCTC available dependent upon the quality of the care for which it is claimed. Third, the credits could also increase demand for care, encouraging child care providers to open new child care facilities. Fourth, these mechanisms are relatively easy to claim.

A few limitations of these mechanisms are worth noting. They provide little or no assistance to poor and low-income families unless they are refundable. For the most part, these methods also do not leverage new *private* funding for child care but rather help defray expenses families already incur. Finally, these mechanisms do not directly affect the supply or quality of care, although they could do so indirectly.

Oregon's Corporate Child Care Tax Credit noted above in connection with its supply-oriented features – in that it, like the Low Income Housing Tax Credit, serves as an incentive for new child care investments – can help families with their child care expenses by restricting the fees that participating providers may charge to low-income parents.

2. Tax Strategies to Encourage Family Savings to Pay for Child Care

Tax-preferred savings accounts have been used to encourage families to save for a variety of purposes: retirement, purchasing a home, starting a business, and financing higher education. Generally, participants are allowed to deduct contributions to such accounts from their taxable income, thereby reducing their tax liability and increasing their disposable income. When the money is withdrawn, it is taxed. (In a variation on this model, the contributions are made from after-tax income and then withdrawals are not taxed.) If money is withdrawn for a purpose other than the one specified, penalties are assessed.

The most well-known model is the *Individual Retirement Account (IRA)*, which, at the federal level, allows individuals to save for retirement. A similar tax-preferred account could be established to allow savings for child care, or early withdrawals from established IRAs could be permitted penalty-free to meet child care expenses. One variation on such a model already exists at the federal level. *Education IRAs* are tax-deferred trust or custodial accounts specifically for higher education expenses. Participants can deduct contributions to such accounts from their taxable income; the funds accrued are taxed upon withdrawal but are otherwise penalty-free if used to pay higher education expenses.

While strategies to encourage savings could be used to help parents pay for child care, this model presents a special challenge since most people have children relatively early in their work lives and therefore would not have saved very much in these accounts by the time they would need to draw on the savings to pay for child care. Pairing savings accounts with a loan program so that families could borrow against their savings to pay for child care and then repay the loan later might allow families to spread their child care spending over time. Such a model has been proposed in the higher education context. *Children's savings accounts* are retirement savings accounts that have been proposed to operate like traditional IRAs except borrowing from the account temporarily is permitted for the costs of a child's higher education without incurring any tax penalty.

Another problem with the savings approach is that this strategy is of limited value for low-income families who do not have disposable income. A savings account coupled with a loan program is beneficial for middle- and upper-income families, who have a greater ability to save than low-income families, but direct government subsidies are a better way to help low-income families with child care expenses. One way to increase the value of tax-preferred savings accounts for low-income families would be to provide government, or require private institutional, seed and/or matching money for the accounts. This is also a way to encourage private financing of child care that is largely missing now. For example, *individual development accounts (IDAs)*, available in some states, are restricted, interest-bearing savings accounts for low-income individuals whose individual deposits are matched or partially matched by the government in the form of tax deductions or credits. The structure of these tax mechanisms varies. Most allow account holders to deduct their contributions from taxable income, while a few provide tax credits to private organizations that provide matching funds for these accounts. Another, similar program for encouraging savings was President Clinton's *Universal Savings Accounts* proposal, which would have created voluntary retirement-savings vehicles subsidized by federal tax credits. IDAs could be established specifically to encourage savings for child care, or child care expenses could be designated as an acceptable use of the funds accumulated in IDAs established for other purposes.

Policy makers will need to address several other design issues if this mechanism is used for child care. First, for any significant amount of savings to have accumulated to pay for child care expenses, individuals would have to begin saving before they had children. Second, since not everyone who opens a savings account to pay for child care will end up with child care

expenses, alternative uses for the funds will need to be identified. Third, to avoid the problems of large administrative fees reducing the value of the accounts and of people losing their savings due to poor investments, restrictions may be needed on the types of investments that can be made with the funds in these accounts.

3. Tax-Financed Social Insurance Models

Social Security and unemployment insurance are examples of tax-financed, government-sponsored social insurance programs. They are near-universal programs to insure against risks faced by workers in the paid labor force. Workers and employers contribute to Social Security through payroll taxes, and employers pay unemployment insurance taxes. Although nearly all workers and employers pay into these programs, not every worker will need to draw funds from the program to the same extent. By spreading out the cost of these benefits over the entire working population, the cost to any one contributor is relatively small, while the payment to those who benefit from the programs is relatively large. In some instances the programs benefit not only the worker but also the worker's spouse, divorced spouse, children and survivors.

Given the popularity of these social insurance programs, it has been suggested that such a model could be used to help families pay for child care expenses. However, there are several reasons that a government-sponsored social insurance program to fund child care is not likely to be a good model to pursue. It seems unlikely that it would gain political acceptance when even government-sponsored health insurance (beyond Medicare) cannot secure support. In addition, a child care social insurance program funded by increasing the payroll tax could have a regressive impact. A progressive benefit structure could ameliorate the regressivity of the tax, but there is a limit to how progressive the benefits could be while still maintaining support for the system. Finally, there are existing proposals to use temporary disability insurance and unemployment insurance funds to pay for family and medical leave, and it is important to avoid undercutting those efforts by pressing for a similar proposal for child care.

C. Mechanisms for Directly Raising Child Care Funds Through the Tax System

There are several examples of state-based, direct tax strategies that are or could be used to generate revenues for child care directly through the tax system. Several states allow tax filers to make donations to various causes, including children's programs, on their income tax forms. The donations reduce the size of any tax refund the donor would otherwise receive, or increase the size of the donor's tax liability. Colorado has such a voluntary income tax checkoff for child care, financing a fund that is dedicated to improving the quality of care in the state.

Some states impose excise taxes on tobacco products, using the proceeds to fund children's programs. California voters passed Proposition 10, authorizing a cigarette tax to support early childhood development programs, and Indiana at one time supported school-age child care with a cigarette tax. Other examples of direct tax strategies include the following:

NATIONAL WOMEN'S LAW CENTER, WASHINGTON, D.C., NOVEMBER 2001

- Sales taxes are assessed based on the price paid for tangible goods. A few local governments dedicate a portion of local sales tax revenues to child care. In 1990, voters in Aspen, Colorado enacted a provision to raise the local sales tax and dedicate the increase to affordable housing and child care. Three categories of child care services are supported through the sales tax: 1) child care resource and referral services, 2) grants to nonprofit centers for capital improvements and subsidies for infant/toddler programs, and 3) child care tuition assistance for low-income working families.
- Local property taxes are levied on the value of residential and commercial land and buildings. Funds for child care may be generated through property taxes in several ways: 1) communities may decide to increase property taxes and earmark the increase for child care (Seattle, Washington followed this model, raising property taxes to support a variety of children's services); 2) communities may decide to earmark a percentage of existing local property tax dollars for children's services (San Francisco did this); or 3) property taxes may be levied by "special taxing districts" for children's programs. These districts are legal entities separate from general-purpose local governments such as cities, towns, and counties and are fiscally and administratively independent of local government. (Florida authorizes any county government in the state to create a children's services district. These district boards may raise revenue through taxation, if through a referendum voters authorize the board to collect property tax. The revenue collected must be dedicated to "juvenile welfare services," and child care is one such service.)

With this type of approach, states need to determine how to allocate the money generated. For example, they could use the money to fund one of the initiatives described in this memo. Or significant grants could be given directly to providers for making specific improvements aimed at increasing quality and affordability or to families to subsidize the cost of care.

III. CONCLUSION

No single strategy will achieve the goals of making high-quality child care accessible and affordable to all. Rather, several strategies, at both the state and federal levels, must be pursued simultaneously. Particularly since some of these mechanisms are new, it is important to test many promising ideas to see which ones should be pursued more broadly.

Contribution credits and debt financing strategies have the potential to increase the amount of money available for improving child care quality, affordability and availability. However, more work needs to be done to determine how contribution credits should be structured in order to be most effective at attracting donations, and how such contributions could

be bundled together to give providers and/or families the significant infusion of resources often required to be meaningful. The apparent success of the Colorado contribution credit suggests that further investigation of this credit may be warranted to determine if it should be used as a model by other states. Maine's new, similar credit may provide additional information that will help to evaluate this model.

Investment tax credits and direct taxation strategies seem to be the best mechanisms for generating significant amounts of money for large-scale or relatively expensive projects, although as described earlier, investment tax credits have significant disadvantages that may make them a poor choice for financing child care. The experience with the newly enacted Oregon Corporate Child Care Tax Credit may provide a workable model. Debt financing strategies also may be useful in the child care context to subsidize loans through the tax system.

To improve parents' ability to pay for care, the strategies directed specifically at parents are important. For these tax mechanisms to be most effective they must be large enough to make a real difference in parents' ability to pay for care and they must be refundable in order to benefit the lowest-income families. Policymakers may want to consider adding incentives for parents to select high-quality care, as two states have already done.

For more information, please do not hesitate to contact National Women's Law Center Policy Analyst Christina Smith FitzPatrick, at 202-588-5180 or cfitzpatrick@nwlc.org.

APPENDIX TO CHILD CARE FINANCING SUMMARY MEMO
Descriptions of Tax-Based Financing Strategies

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APPENDIX TO CHILD CARE FINANCING SUMMARY MEMO
Descriptions of Tax-Based Financing Strategies

This appendix accompanies a November 2001 memo analyzing a variety of strategies for increasing financing for child care with the ultimate goal of improving quality, affordability, and availability. The appendix provides a description of each of the programs or mechanisms mentioned in the text of the memo, in the order mentioned.

I. Supply-Oriented Tax Strategies to Increase the Development and Provision of Child Care

A. Contribution Tax Deductions and Credits

- 1. Contribution Tax Deduction or Credit:** At both the federal and state levels tax benefits are provided to individuals and corporations who make contributions to tax-qualified charities. Such mechanisms could be structured to allow contributions to organizations other than tax-qualified charities to be eligible.

Deductions lower tax liability by reducing taxable income. The value of the deduction depends on the marginal tax rate. For example, a corporation might have \$500,000 in taxable income, \$25,000 in contributions, and a marginal tax rate of ten percent. Without the deduction for contributions, the business would owe \$50,000 in taxes (\$500,000 x 10%). The deduction for contributions reduces the business's taxable income to \$475,000 (\$500,000 - \$25,000). Therefore with the deduction the business would owe \$47,500 in taxes (\$475,000 x 10%), for a savings of \$2,500.

For those with taxable income, a deduction at the federal level is worth between 15 and 39.6 percent of the amount deducted.

While a deduction reduces *taxable income*, and indirectly tax liability, a credit directly reduces *tax liability*. For instance, consider the corporation with \$500,000 in taxable income, \$25,000 in contributions, and a marginal tax rate of ten percent. This business would owe \$50,000 in taxes before applying any credits. If this business were eligible for a tax credit equal to 20 percent of its contributions, it could reduce its tax liability by \$5,000 (\$25,000 x 0.20). Instead of owing \$50,000, the business would therefore owe only \$45,000 in taxes.

A tax credit for contributions will be more valuable to a taxpayer than a deduction for the same contributions if the credit rate (20 percent in the

above example) is larger than the taxpayer's marginal tax rate (10 percent in the above example).

Existing charitable contribution tax deductions and credits may be claimed for contributions to charities, which in many instances would include non-profit child care providers. Contribution deductions or credits could also be created expressly for child care (see Colorado's Contribution Tax Credit for Child Care, below).

2. **Colorado's Contribution Tax Credit for Child Care:** Colorado's child care contribution credit is available to any individual or corporation that makes a monetary contribution to promote child care in Colorado. Among other eligible donations, contributions to any child care provider (whether incorporated or not incorporated as a non-profit or for-profit corporation) qualify for the credit if the contribution is made for the acquisition or improvement of facilities, equipment, or services, including the improvement of staff salaries, staff training, or the quality of child care. The credit is equal to 50% of the value of the contribution, and is capped at \$100,000. According to the Colorado Department of Revenue, "One of the prime goals of this tax credit is to encourage employers to contribute to child care for their employees."¹ The credit is not available to a taxpayer who receives something of value in exchange for the contribution, but this restriction does not prevent a company from contributing to a child care center and claiming a credit based on that donation if the employees of the company receive a benefit in the form of discounted child care.

The most recent year for which information regarding uptake of the Colorado child care contribution credit is available is 1998. At that time, the credit was more restricted in size and scope, equal to only 25% of a contribution, up to \$100,000, and only available for donations that promoted child care in an enterprise zone. This smaller, more restricted credit was nevertheless claimed by about 1,300 taxpayers that year, resulting in a state expenditure of more than \$700,000. The state's per-claimant expenditure for the credit was relatively small, averaging about \$500 per claimant in 1998, implying average child care spending of \$2,000

¹ Taxpayer Service Division, Colorado Department of Revenue, *FYI Income 35: Child Care Contribution Credit 1* (March 1999).

per taxpayer.² The data must be disaggregated by type of filer (i.e., corporate vs. individual) in order to be analyzed more completely.

3. **Tax-Deductible Charitable Gift Fund:** Some investment companies have created a mechanism to make charitable giving easier. For example, the donor-advised funds offered by Fidelity, Vanguard, and the National Philanthropic Trust allow donors to obtain a tax deduction for a significant financial contribution immediately while making decisions about the charities that should receive the funds over a period of several years.

With a charitable gift fund, a donor makes an irrevocable contribution to establish an account within the donor-advised fund. Usually the donation is in the form of cash, securities, or mutual funds, but the Trust allows for the donation of paintings, buildings and other similar investments. At the time of the contribution, the donor can deduct from taxable income the full amount as a contribution and, in the case of appreciated securities, does not have to pay capital gains taxes. The donor can then recommend organizations to receive donations from the account. The board of trustees of the fund retains final approval of all donations, and ensures that only §501(c)(3) public charities receive funds and that the contribution does not result in self-dealing. Both individuals and corporations can establish such accounts. The Vanguard and Fidelity funds include a general fund to which donors can contribute if they would like the grant decisions to be made entirely by the trustees.

Resources in the funds could be pooled and directed toward child care in two ways. First, the trustees could designate tax-qualified child care as one of the grant-making priorities of a general fund. Second, a donor could establish an account with the intention of making contributions to child care. The donor could market the existence of the fund and attract contributions from other donors interested in supporting tax-qualified child care. The donor who established the fund could retain control over grant recommendations. In either case, the power of a donation is increased because it is pooled with other funds, allowing larger grants to be made. The money could be directed to state child care funds or other intermediaries for allocation or grants could be made directly to tax-qualified child care providers.

² The actual average taxpayer expenditure may have been higher since some taxpayers may have been prevented by the \$100,000 credit cap from claiming the full credit to which they would have otherwise been entitled.

B. Investment Tax Credits

- 1. Employer Tax Credit for Child Care:** Tax credits for employers who offer child care assistance to their employees currently exist in 25 states. These tax credits take a wide variety of forms, both in terms of the types of expenses that are eligible for the credit and the size of the credit offered. While a few states offer credits only for start-up expenses, others offer credits for the costs of operating an employer-sponsored child care center, the costs of subsidies given to parents to offset their child care expenses, and the costs of resource and referral services. Some states offer employers a credit equal to a percentage of eligible expenses, sometimes with a cap on the total amount of the credit that can be claimed. The size of the credits structured in this way ranges from 3-5 percent in Maine to 100 percent (spread over 10 years) in Georgia. Other states restrict the credits to a certain dollar amount per employee or per child served. For example, Florida offers a credit equal to \$50 per month per child served in an employer-operated child care facility. For those state credits that have had claimants, the most recent available data show that the average value of the employer tax credits for child care ranged from a few thousand dollars for each corporate claimant in several states to about \$150,000 for each corporate claimant in Oregon. A \$150,000 credit in Oregon represents expenditures of at least \$300,000 for child care.

Separate research by the National Women's Law Center concerning the effects of the existing state employer tax credits for child care suggests that, at least in their current form, the employer tax credits have not been successful in encouraging a substantial number of businesses to provide child care assistance. Of the 20 credits for which data are available, 16 had five or fewer corporate claimants.

The Economic Growth and Tax Relief Reconciliation Act of 2001 creates a federal employer tax credit for certain child care expenses beginning in 2002. Employers can receive a credit of 25 percent of their spending on the construction or rehabilitation of a child care facility or on contracts with a third-party child care facility to provide child care services to employees. In addition, employers can receive a credit of 10 percent of their spending on resource and referral services for employees. The total credit cannot exceed \$150,000 annually.

- 2. California's Farmworker Housing Tax Credit:** California has established a credit to offset the costs of building and rehabilitating farmworker housing. Investors can claim a credit equal to 50 percent of eligible costs, which include finance and construction costs, excavation costs, installation costs and permit costs, but do not include land and costs

financed by grants and below-market financing. Since the amount of money available for this credit is limited, the taxpayer must apply to obtain the credit. The housing must be operated for thirty years pursuant to the requirements set forth in the Farmworker Housing Assistance Program. There are recapture provisions if these conditions are not met.

A similar credit could be enacted for the construction of child care facilities. Investors could claim a credit equal to a percentage of their expenses. In exchange, the state could require that owners of the facility limit the amount of rent charged to the child care provider. Or, if the investors both owned and operated the child care facility, the state could require that a certain percentage of the child care slots be reserved for low-income families and that the fees charged to these families be limited as well.

3. **Maine's Employment Tax Increment Financing:** Maine has established Employment Tax Increment Financing as an economic development strategy. Under this program, for-profit employers can qualify for a payment equal to a portion of the state income withholding taxes paid on behalf of qualified employees for ten years if they create at least 15 new full-time jobs within two years that meet the following criteria: the wages offered in the new jobs exceed the area's average per capita income and the workers in the new positions are offered health and retirement benefits. A tax increment program could be structured to encourage child care providers to pay higher wages and provide benefits to their employees. In addition, tax increment programs could be designed to include child care assistance as one of the benefits an employer must offer to employees to be eligible for the tax benefit. In tax year 2000, six businesses used Maine's employment tax increment financing program.
4. **Tax Credit or Exemption for Elementary and Secondary School Teachers:** There are currently a few proposals pending in Congress and in California to offer elementary and secondary school teachers special tax treatment. Among the proposals that are pending in Congress is a \$5,000 refundable federal income tax credit for school teachers who have achieved national board certification. A similar proposal could be created to benefit child care providers. Such a credit would supplement provider wages and would create an incentive for providers to stay in the child care field. In addition to rewarding child care providers, a refundable provider credit would also benefit families who have children in child care, since the refundable credit could discourage high turnover rates in the child care field and thereby lead to higher quality child care. In California, the governor has proposed to make certified school teachers exempt from paying state income taxes. The purpose of this proposal is to encourage

school teachers, who earn modest salaries, to remain in the teaching field. Such a proposal could be extended to child care providers, who, on average, earn considerably less than school teachers.

5. **Neighborhood Assistance Program Tax Credit:** Neighborhood Assistance Programs (NAPs) are authorized under state law to provide tax credits to businesses that make contributions to community-based non-profit organizations serving low-income communities. The first NAP was enacted in Pennsylvania in 1968. Similar programs are currently offered in 12 states (PA, CT, DE, FL, IL, IN, KS, MD, MO, NE, VA, WV), and are being proposed in 5 additional states (CA, NJ, NY, OR, RI). In 1991 NAPs generated over \$63 million in private sector money for non-profit organizations and cost \$33 million in foregone state revenue.

To qualify for a tax credit under a NAP a business must make a contribution (cash, materials, staff) to a community non-profit organization that provides neighborhood assistance, job training, education, community services, or crime prevention. The services provided by the non-profit organization must primarily benefit low-income households as defined by a given state's NAP. Depending on the particular features of the NAP in a given state, a non-profit organization may use the private contributions to acquire, rehabilitate, expand, or improve buildings or land, or to meet operating expenses.

The tax credit amount that a contributing business receives varies from state to state, but the amount is currently as high as 70 percent of the total contribution made by a business. The tax credit amount offered by a NAP does not reflect the full amount of tax assistance that a business may receive by making a contribution, since it does not include the amount of tax assistance that a business would receive if it also claimed the federal charitable gift deduction on its federal income tax return. The tax credit becomes available to a business in the year in which it makes its contribution to a non-profit organization. Any tax credit amount that a business is unable to use in the first year in which the credit becomes available can typically be carried forward for a limited number of years.

Usually there is a cap on the total amount of tax credits that may be claimed by all businesses through a NAP in a given year. In order to receive one of these limited tax credits, businesses seeking a NAP credit must file an application.

In general, the language governing NAPs is broad enough to include child care as an allowable use of funds. In Pennsylvania, for example, child care is specifically marketed as an acceptable use of funds, as long as the child

care includes an educational component. NAPs could be effective in raising new private investments in child care, including money to be used for operating expenses. However, the competitive nature of applying for NAP credits may disadvantage smaller child care providers that lack the ability to market themselves successfully as an attractive and significant NAP project.

6. **Community Development Corporation Tax Credit:** The community development corporation (CDC) tax credit was a pilot program administered by the U.S. Department of Housing and Urban Development (HUD) between 1993 and 1998. To qualify for the program, a CDC needed to be a 501(c)(3) tax-exempt charity and its primary purpose had to include promoting employment and business opportunities in a low-income area. HUD awarded \$2 million in federal tax credits to a competitively selected CDC. The CDC was then responsible for finding an individual or corporation that was interested in providing a grant or loan to the CDC in exchange for the tax credits. A CDC then had to use capital generated from the tax credits to create employment and business opportunities for residents of low-income communities.

Further, individuals or corporations who gave grants, provided loans or made investments in a selected CDC were required to ensure that their contribution would be available to the CDC for ten years. In exchange, the contributing individual or corporation could claim for ten years a credit equal to 5 percent of the overall amount provided. The cumulative worth of the CDC credit was 50 percent of the total amount provided. If the contributing individual or corporation made a grant rather than a loan to the CDC, then the contributor could claim both the federal charitable gift deduction and the CDC credit, increasing the value of the tax assistance received by the contributor. If the CDC proved unable to provide services successfully to its target population, there was no recapture of the credit.

The pilot program was moderately successful. HUD initially selected 20 CDCs and awarded each \$2 million in credits. Each CDC could potentially raise an additional \$2 million in private investment for a total contribution to the CDC of \$4 million. Between 1993 and 1998, the CDC credits raised \$20 million in private investment, or one-quarter of the total amount that the CDCs could raise. A few CDCs were able to market their entire \$2 million in credits successfully, but several had difficulty doing so. The Local Initiatives Support Corporation (LISC) offered investment partnerships similar to the partnerships LISC has created to attract low-income housing financing that takes advantage of the low-income housing tax credit (see Low Income Housing Tax Credit, below).

It is also important to note that most contributions to CDCs came from banks. These banks may not have been responding solely to the CDC credits, but may have also been responding to the Community Reinvestment Act, which requires banks to demonstrate equitable lending, service and investment practices. It is difficult to know how much of the investment in CDCs was due to the CDC credit alone.

The language establishing the CDC tax credit program was broad enough to include child care as an acceptable use of the funds. A new credit structured like the CDC credit could be especially effective for child care if some priority could be given to awarding credits to CDCs that propose to create or expand affordable, quality child care in their community. Information on whether any of the CDCs awarded credits during this pilot phase used any of the funds generated to promote child care is not readily available.

7. **New Markets Tax Credit:** The New Markets Initiative, part of the omnibus fiscal year 2001 federal appropriations legislation enacted in 2000, is designed to facilitate economic development in disadvantaged urban and rural areas. The key elements of the initiative include the creation of the New Markets Tax Credit, New Markets Venture Capital (NMVC) Firms, strengthened and expanded empowerment zones (EZs), and new tax incentives for investment in “Renewal Communities.” The New Markets Tax Credit will provide incentives for equity investment for business growth in low- and moderate-income rural and urban communities. The credit, worth over 30 percent of the amount invested (in present value terms), is available to taxpayers who invest in a wide range of privately managed community development investment funds, such as community development banks, venture capital funds, and new investment companies, that finance businesses in low- and moderate-income communities.

The description of the New Markets Tax Credit seems to be broad enough to include child care as an acceptable use of funds. Increased investments in community development banks, for example, would increase the amount of funding available to make loans for projects that promote economic development, including child care. To ensure that child care is one of the investments prompted by this program, it could be promoted as an important use of these funds.

8. **Low-Income Housing Tax Credit:** The LIHTC facilitates the development of low-income housing by giving investors a return on their investment in low-income housing projects: they receive tax credits spread over ten years based on the depreciable cost attributable to the low-income

units of the project and are allowed to deduct passive activity losses over this period. Generally, investors are organized into partnerships, with a one percent general partner who is usually a nonprofit developer, and 99 percent limited partners who can use the tax benefits of the project to offset their tax liability. The partnership agreement dictates how the tax benefits of the project will be allocated and also determines what will happen to the property at the end of the compliance period (the 15-year period during which the owners of the development must operate the project consistent with all the stipulated restrictions about allocating units for low-income households and charging appropriate rents). The partnership agreement may specify that after the compliance period, ownership of the property will be transferred to the general partner at no cost to the general partner. In this case, the limited partners' return would derive solely from the reduction in tax liability afforded by the LIHTC. A syndicator can form an investment-limited partnership, which becomes a limited partner in a variety of partnerships. These investors pool their contributions and spread them over many projects, thereby reducing their risk.

In effect, the LIHTC operates like a loan from the private sector to the federal government. Private investors make a loan at the beginning of the project, and the loan repayments come in the form of reduced tax liability. The LIHTC has generated a significant infusion of funds into the creation of low-income housing. The federal tax expenditure on this credit is estimated to be \$3.5 billion in 1999.

Investors benefitting from the LIHTC currently receive about an eight percent return on their investment. This return has declined over time since the credit was made permanent and as competition for the credits has increased.

A tax credit for the development of low-income child care facilities could be modeled on the LIHTC. Private investors would be given a tax credit over ten years for their initial investment in the construction or renovation of facilities. Restrictions would be placed on the percentage of the facility's child care slots that must be reserved for low-income families and on the fees that could be charged to these families.

9. **Oregon's Corporate Child Care Tax Credit:** In 2001 the Oregon legislature authorized a five-year pilot program to encourage business investment in child care. Modeled after the LIHTC, the program authorizes the Child Care Division of the Oregon Employment Department to allocate up to \$500,000 in tax credit certificates each year to taxpayers that make contributions to the Child Care Division or another

selected community agency for the purpose of promoting child care. Like the LIHTC, the tax credit certificates will provide individuals and businesses with a financial return on their investment. Investors will apply for the credits stating how much they are willing to contribute in exchange for a tax credit. For example, an investor could decide that she will pay \$750 for \$1,000 in tax credits. Therefore, the amount available for child care will be less than the \$500,000 allocated for the credits, but promoters expect that the difference between the value of the contributions and the value of the credits will diminish over time as investors compete for the credits. Oregon plans to select an intermediary to administer and facilitate the relationship between the state, investors and child care providers. The administrative cost of running the program at the state and regional levels will be subtracted from the contributions made and available for distribution to child care providers.

The money generated will be pooled at the state level, allocated to non-profit community agencies in the state's five regions, and subsequently distributed to child care providers through an application process. The program, through its criteria for selecting providers seeks to strategically allocate tax credit certificates to encourage child care investment in low income communities and to strengthen the viability and continuity of child care providers while making child care more affordable for low- and moderate-income families. For example, to receive funds a child care center must demonstrate that at least 25 percent of the families served have incomes that are 80 percent or less of the median income for the region, that its employees have adequate training and will attend required training established by the state's Child Care Division, and that it will limit fees charged to low-income families to a percentage of each family's income. The percentage will be established by the Child Care Division.

10. **Johnson Amendment to LIHTC:** During the 106th Congress, Rep. Nancy Johnson (R- CT) proposed several amendments to the LIHTC, one of which is related to child care. Currently, day care centers and other Community Service Facilities located in a project qualifying for the LIHTC can only count in the eligible basis of the property if the centers exclusively serve project tenants. The Johnson amendment would have eliminated the restriction on non-tenant usage and would allow these centers to count in the eligible basis of the project if they are designed to serve primarily people whose income is 60% or less of area median income. This credit was intended to encourage the inclusion of child care centers and other similar facilities in LIHTC projects.

C. Tax-Subsidized Debt Financing

1. **Tax Credit for Forgone Interest:** Some states have provided tax credits to financial institutions who make below-market-rate loans for qualifying projects. A tax credit could be created specifically for loans made for the construction or renovation of child care facilities, or for other child care projects.

Oregon offers a credit to financial institutions making loans for the development of low-income housing. The credit equals 100 percent of the difference between the actual finance charge assessed in a year and the finance charge that would have been assessed for a nonsubsidized loan, but the credit is limited to four percent of the average unpaid balance on the loan. Oregon expended \$4.2 million through this credit during the 1997-99 biennium.

California offers a credit to financial institutions making loans for the rehabilitation or construction of qualified farmworker housing. The credit equals 50 percent of the difference between the amount of interest income that would have been collected if the loan rate had been one point above prime and the actual amount of interest due for the term of the loan. This credit has attracted very little interest from lenders.

2. **Tax-exempt Bond:** The federal income tax code allows “exempt facilities bonds” to be issued. Bondholders are not required to pay federal income tax on the interest received from these bonds. Currently, certain residential rental projects can qualify for this type of bond financing. Rental projects are eligible if either 20 percent or more of the units are reserved for those with incomes of 50 percent or less of area median income; or if 40 percent or more of the units are reserved for those with incomes of 60 percent or less of area median income. The interest rate offered on the bonds reflect the risks associated with the project. Since the investors do not have to pay federal income tax on the interest received from the bonds, the issuer may be able to offer a lower interest rate than otherwise would be required to attract investors.

There have been proposals to include school facilities in the list of projects eligible for exempt facilities bonds. Qualifying child care facilities could also be added.

3. **Interest-free Bond:** The U.S. Department of Education administers a program that allows states to issue bonds on which they do not have to pay interest: qualified zone academy bonds (QZABs). Instead of receiving interest payments from the state government issuing the bond, bondholders

receive a federal tax credit. QZABs are available to schools that have established a partnership with a business and are located in an Empowerment Zone or Enterprise Community and can be used to rehabilitate public school facilities, purchase equipment, develop course materials, or train teachers. In addition, the business partner must pledge contributions having a present value of at least 10 percent of the gross proceeds of the QZAB. In this way, the government investment leverages new private sector funds. The program could be expanded to include similar child care expenditures.

11. Consumer-Oriented Tax Strategies to Increase Resources Available to Families for Child Care

1. Tax Strategies to Help Families Directly with Expenses

1. Child and Dependent Care Tax Provisions

- a. *Federal Child and Dependent Care Tax Credit (DCTC):*** The federal DCTC is available to families with employment-related child care expenses for children under 13 and is equal to a percentage of eligible child care expenses. A wide range of child care qualifies for the credit, including that provided by child care centers, nursery schools, family child care homes, nannies, relatives (as long as they are nondependents over the age of 18), and day camps (but not overnight camps). In the current DCTC, eligible expenses are limited to \$2,400 for one child and \$4,800 for two or more children. The expense limits were set in 1981 and reflected average prices for care at that time.

The credit declines as income rises, diminishing from 30% of qualified expenses for those with incomes of \$10,000 or below to 20% for those with incomes above \$28,000. It is not indexed for inflation.

The maximum credit of \$720 for families with one child, or \$1,440 for families with two or more children, is available to families with incomes below \$10,000. In practice, however, virtually none of these families is able to claim the maximum credit because families with incomes this low generally have no tax liability. The maximum credit for families with incomes over \$28,000 is \$480 for families with one child and \$960 for families with two or more children.

The Economic Growth and Tax Relief Reconciliation Act of 2001 improved the DCTC by increasing the expense limits, increasing the percentage of qualifying expenses that may be taken as a credit, and increasing the adjusted gross income levels at which the percentages of qualifying expenses can be claimed. The expense limits will increase to \$3,000 for families with one child or dependent and \$6,000 for families with two or more children or dependents. The maximum credit rate and the income level associated with this rate will rise to 35% of qualifying expenses for those with incomes of \$15,000 or below, and the credit rate will decline more slowly. As a result, those with incomes above \$43,000 will receive the minimum credit rate of 20% of qualifying expenses. These changes will be effective beginning in tax year 2003 and will increase the maximum credit amounts to \$1,050 for families with one child or dependent and \$2,100 for families with two or more children or dependents.

Because the credit is available to all families for almost all types of child care, it appeals to a wide constituency, and as part of the tax code, it is an entitlement for those families who qualify for its benefits. In addition, tax provisions have historically been stable funding mechanisms because they have not been subject to the debates of regular reauthorization or annual appropriations. The DCTC has several important shortcomings, though. Because the credit is not refundable, families owing little or no federal tax cannot take full advantage of it. In addition, relative to the current average price of child care, the amount of benefit a family receives through the tax credit is small, even with the 2001 improvements described above. Moreover, because the credit is not indexed, the benefits it provides have diminished and will continue to diminish over time, although the 2001 changes have temporarily ameliorated this problem for some families. The credit also does not provide greater benefits to families who use higher quality care, and the value of the DCTC is probably too small to affect consumer choices in the direction of purchasing higher-cost or better-quality child care. NWLC and other child care advocates recommend making the DCTC refundable; increasing the eligible expense limits to reflect the current average cost of care and indexing the limits for inflation; and adjusting the sliding income scale so that more low-income families can gain the full benefits of the DCTC and indexing this income scale to inflation.

- b. *State Child and Dependent Care Tax Credit or Deduction:***
Twenty-six states and the District of Columbia provide some sort

of state tax relief for child care expenses, whether in the form of credits or deductions. All but a handful of states link their child care tax provisions to the federal DCTC in some manner, most commonly by calculating the state credit as a percentage of the allowable federal credit. The best state tax plans offer refundable credits on a sliding scale that benefit low-income families the most. Ten states have refundable credits.

Generally, state tax provisions allow claims for the same range of child care services as the federal credit. Maine and Arkansas are the only states that structure their credits to provide greater benefits to parents who use higher quality child care. Beginning in tax year 2001, Maine will double its credit from 25 percent of the federal DCTC to 50 percent for taxpayers who use “quality child care.”³ Arkansas’s credit is refundable when expenses are undertaken to enroll three- to five-year-old children in accredited, center-based child care.

In recent years, as separate analysis by the National Women’s Law Center has shown, state legislatures have been active in improving child care tax credits. States’ most typical method of improving their child care tax credits has been increasing the percentage of the federal credit that may be taken against state income tax liability, but within that basic pattern, several variations have occurred. Maximum credit amounts range from a low of \$25 in Louisiana to a high of \$1,584 in New York.

2. **Tax-Preferred Dependent Care Assistance Program (DCAP):** The federal Internal Revenue Code allows employers who have established a written, qualified dependent care assistance program (DCAP) to exclude child or dependent care benefits provided to their employees, in an amount up to \$5,000 per employee, from federal income, FICA and unemployment taxes. (In most states, these benefits are not subject to state income taxes either.)

The benefits may take several forms, including cash, a voucher, or free or subsidized care in an employer’s or other child care facility. Most

³ “Quality child care” is defined as care provided at a child care site that is licensed and accredited, utilizes recognized quality indicators for child care services approved by the Maine Department of Human Services, Office of Head Start and Child Care, and includes provisions for parent and client input, a review of the provider’s policies and procedures, a review of the provider’s program records, and an on-site program review.

commonly, however, a DCAP is established as a salary reduction plan, whereby employees are permitted to set aside up to \$5,000 from their annual pre-tax salaries for child or dependent care expenses. Specifically, the employee's pay is reduced by the amount the employee designates (sometimes subject to an employer limitation), and this amount is returned to the employee in the form of reimbursement for child or dependent care expenses. The value to the employee is that he or she does not have to pay income or FICA taxes on the amount of the salary reduction. The value to the employer is that it does not have to pay FICA or unemployment taxes on this amount. If the employee does not use the full amount of the salary reduction for child or dependent care expenses, however, he or she loses the right to the money, so care must be taken in designating the amount of the salary reduction. The employer must also ensure that neither this nor any other form of DCAP discriminates in favor of highly compensated employees.

The tax benefits provided by a DCAP generally are worth more to higher-income than lower-income employees since the former are usually in higher tax brackets. Therefore, if an employer offers only a pure salary reduction plan, the DCAP will be more beneficial to higher-income employees. The value of excluding some income from taxation will be worth 39.6% of the amount excluded for someone in the highest federal tax bracket and only 15% of the amount excluded for someone in the lowest federal tax bracket. If, however, the employer itself contributes to the DCAP (for example, by matching amounts reduced from an employee's salary or by providing child care vouchers), these contributions will be as beneficial to lower-income as higher-income employees, or—depending on the way the DCAP is structured—could be even more beneficial to lower-income employees.

3. **Child Tax Credit:** The Economic Growth and Tax Relief Reconciliation Act of 2001 increased the existing federal child tax credit (CTC) and expanded the partial refundability of the credit. Before these changes, the federal income tax code offered a \$500 tax credit for each dependent child that a tax filer could claim. The child tax credit is available in addition to the EITC and the personal exemptions that can be claimed for dependent children. All families, except for those with very high incomes, are eligible for the credit. Because this credit is targeted to families with children, the tax savings that the credit offers could be used to offset child care expenses.

The 2001 tax law expands the CTC by increasing the credit to \$600 per child in 2001 and eventually doubling the credit to \$1,000 per child by 2010, and replaces the partial refundability formula that exists in current

law with a new formula that allows many more working, low-income families to receive the benefit of the CTC. Under the tax bill, families that have little or no federal income tax liability may be eligible for a partial refund of their CTC, regardless of the family's size.

To determine the amount of the CTC families will receive as a refund, if any, they must first determine their tax liability. If their tax liability is greater than the amount of their CTC, they use the CTC to reduce their tax liability. If their tax liability is less than their CTC, they use the CTC to eliminate their liability. If any amount of their CTC remains unused, they may claim as a refund the lesser of that amount or an amount determined under the new formula. In 2001-2004 the formula is 10% of earnings above \$10,000, a threshold that is adjusted for inflation each year beginning in 2002. In 2005-2010, the formula is 15% of earnings above that year's inflation-adjusted threshold. The total CTC received – the amount used to offset tax liability plus the amount received as a CTC refund – may not exceed the amount of the CTC for that year.

Three states have established child tax credits in addition to their dependent exemptions. The Colorado credit is \$300 per child aged 5 or under for families with \$64,000 or less in federal adjusted gross income who qualify for and claim the federal DCTC or CTC. The North Carolina credit is \$60 per child claimed as a dependent for married couples with less than \$100,000 and heads of household with less than \$80,000 in federal adjusted gross income. The Ohio credit is \$20 for each individual for whom the personal or dependent exemption is claimed.

4. **Earned Income Tax Credit:** The federal Earned Income Tax Credit (EITC) is a refundable tax credit targeted to low-income working families. Families who qualify for the EITC tend to have low or no federal income tax liability because their incomes are so low. Since the EITC is refundable and these families owe very little or no federal income taxes, most families who qualify for the EITC receive the credit in the form of a refund. In effect, the EITC serves as an income supplement for the families who receive it. Families may use this money to meet any of their expenses, including child care.

A special feature of the EITC is that it is available to families in advance of filing their federal income taxes. Low-income workers may choose to receive the amount of the EITC for which they qualify in their paychecks from their employers throughout the year.

Although working childless adults are eligible for the EITC, working families with children are eligible for a greater EITC amount than childless

adults, and are eligible for the EITC at higher incomes than childless adults. In 2001, families with one child will be eligible for the EITC until their incomes reach \$28,281. The maximum credit for such a family is \$2,428. (For families with two or more children, the maximum income level for eligibility is \$32,121 and the maximum credit is \$4,008.) Consequently, most of the benefit that the EITC offers is received by working families with children. Because working low-income families who have children are in dire need of affordable child care, the EITC can provide many of the families who receive it an additional resource for meeting their child care expenses. This is particularly true for families who choose to receive the EITC in their paychecks throughout the year.

The Economic Growth and Tax Relief Reconciliation Act of 2001 included some simplifications to the EITC and a provision to mitigate the marriage penalty faced by low-income couples. The new marriage penalty provision will increase the EITC benefits for some married couples and increase the number of married couples eligible for the EITC. Under current law, the value of the EITC begins to decline for couples with children and incomes above \$13,090, until it is completely phased out for families with \$28,281 in income and one child (\$32,121 in income for families with two or more children). Beginning in tax year 2002, the income at which the value of the EITC will begin to decline for married couples and the income at which married couples become ineligible to receive the EITC will increase gradually. By tax year 2008, the increase will reach its maximum of \$3,000. If this change were fully implemented now, married couples with children would not see the value of the EITC begin to decline until they had \$16,090 in income, and they would not become ineligible for the credit until they had \$31,281 in income and one child (\$35,121 in income for couples with two or more children).

In addition to the federal EITC, seventeen states offer their own EITCs. Fifteen of these states calculate the state EITC as a percentage of the federal EITC; one state relies upon federal EITC eligibility rules but creates a slightly different state EITC structure; and one state has an EITC that differs from the federal credit in important respects, but still provides the bulk of its benefits to low-income families with children.

5. **Stay-at-Home Parent Credit:** A few states provide tax assistance to parents caring for their young children at home. For example, Utah provides a \$100 nonrefundable tax credit to an income-eligible family that provides full-time, parental care to an infant less than a year old. Proposals to extend some of the benefits of the federal DCTC to parents staying at home with young children have been made in Congress and by the Clinton Administration.

6. **Individual Tax Credit for Higher Education:** Two nonrefundable federal tax credits are available to offset partially higher-education costs: the Hope credit and the lifetime learning credit. These credits are based on the amount of tuition and fees paid to a postsecondary institution for the taxpayer, the taxpayer's spouse, or the taxpayer's dependent.

For taxpayers with modified AGI below \$40,000, the Hope credit is equal to 100 percent of the first \$1,000 paid in tuition and fees annually plus 50 percent of the next \$1,000 in tuition and fees paid annually for each eligible student. A student is eligible if he or she has not completed the first two years of postsecondary education; is enrolled in a program that leads to a degree, certificate, or other recognized educational credential; is taking at least half of the normal full-time workload for his or her course of study; and has never been convicted for possessing a controlled substance.

For taxpayers with modified AGI less than \$40,000, the lifetime learning credit is equal to 20 percent of the first \$5,000 (\$10,000 after 2002) of qualified tuition and related expenses paid for all students annually by the taxpayer. Unlike the Hope credit, the lifetime learning credit may be claimed even if the student is not attending school full-time or has already completed the first two years of postsecondary education.

The Hope and lifetime learning credits are available if the expenses are paid with the proceeds of a loan, but are not available for expenses paid with tax-free funds (such as scholarships excludable from income). These credits are phased out according to a sliding scale for taxpayers with modified AGI between \$40,000 and \$50,000. Only one credit may be claimed for each student in any one tax year. Neither credit may be claimed if a taxpayer has taken a tax-free withdrawal from an Education IRA in that tax year.

New York has established a refundable tax credit for a small portion of higher education tuition costs. When fully implemented in 2004, if tuition expenses are less than \$5,000 the taxpayer will be able to claim a credit equal to the lesser of the amount of tuition or \$200. If expenses are \$5,000 or more, a taxpayer may claim a credit equal to 4 percent of tuition up to \$10,000 (for a maximum credit of \$400).

In the child care context, child care tax credits play a similar role in offsetting a portion of a family's child care expenses. Only three states, however, permit families to offset as much as 100 percent of their expenses, as the Hope credit does, even though child care expenses can be

greater than higher education expenses. Potentially, these higher education credits could be expanded to include the costs of early childhood education as an eligible expense as well.

7. **Individual Tax Deduction for Higher Education:** The state of New York has recently created a deduction from state taxable income for higher education tuition that is the first of its kind. When fully implemented in 2004, taxpayers, regardless of income, will be able to deduct annually up to \$10,000 of tuition expenses (not counting expenses paid for with scholarships or financial aid) for the education of the taxpayer, the taxpayer's spouse, or the taxpayer's dependent at any institution of higher education, not including graduate school. The value of a deduction depends on the taxpayer's marginal rate. Since the marginal tax rates in New York range from 4% to 6.85%, the maximum value of the deduction ranges from \$400 to \$685.

The federal tax code offers some small deductions based on higher education expenses. For qualified taxpayers, interest paid on student loans may be deducted during the first 60 months that interest payments are required. The deduction is available even to taxpayers who do not itemize. In 1999, the maximum student loan interest deduction was \$1,500. This increases to \$2,000 in the year 2000 and \$2,500 for 2001 and later years. The deduction is phased out for taxpayers with modified AGI above \$40,000 and is not available to taxpayers with modified AGI of \$55,000 or above.

A taxpayer with a modified AGI of less than \$68,100 may also deduct all or part of the interest received on the redemption of savings bonds if the taxpayer pays qualified education expenses during the same years. Qualified education expenses include contributions to an Education IRA.

In the child care context, child care deductions play a similar role in offsetting a portion of a family's child care expenses. No state, however, permits families to deduct as much as \$10,000 in child care expenses, even though child care expenses can exceed those of higher education. (New York recognizes this by providing a child care credit whose value is greater than its higher education deduction – providing a maximum benefit of \$1,584 for child care expenses versus \$685 for higher education expenses – but most states' child care credits or deductions are worth less than New York's deduction for higher education expenses.) Deductions for higher education expenses could be expanded to include early childhood education. In addition, deductions could be allowed for the interest paid on loans taken to pay for child care expenses.

B. Tax Strategies to Encourage Savings to Pay for Child Care

- 1. Tax-Preferred Individual Retirement Account (IRA):** The federal Internal Revenue Code gives a tax preference to two kinds of accounts designed to help individuals save for retirement. In the traditional IRA, individuals with taxable compensation can make tax-free contributions to a retirement savings account. (However, if the owner of the IRA participates in an employer's qualified retirement plan, the amount of IRA contributions that will be tax-free declines to zero between \$33,000 and \$43,000 of adjusted gross income (AGI) for single filers and between \$53,000 and \$63,000 of AGI for joint filers. These income limits will gradually increase until in 2007 the range will be \$50,000 - \$60,000 for single filers and \$80,000 - \$100,000 for joint filers.) Annual individual contributions are limited to total taxable compensation or \$2,000 per individual. (Under the Economic Recovery and Tax Relief Reconciliation Act of 2001 this limit will begin to increase in 2002 until it reaches \$5,000 per individual in 2008.) Taxes on the contributions are deferred on the principal and interest until withdrawn. In a Roth IRA, contributions made are not tax deductible, but amounts deposited in the account grow tax-free and are not taxed at withdrawal. Only joint filers with incomes below \$160,000 and single filers with incomes below \$110,000 may contribute to a Roth IRA. The money in both types of IRAs cannot be withdrawn without incurring a 10% penalty before the account holder reaches age 59½ except under specified circumstances. For example, penalty-free withdrawals may be made from traditional IRAs or Roth IRAs for qualified higher education expenses or for a first-time home purchase. Child care could be added as a basis for a penalty-free withdrawal.
- 2. Tax-Preferred Education IRA:** Established under the federal Internal Revenue Code, an Education IRA is a trust or custodial account created only for the purpose of paying the qualified higher education expenses of the designated beneficiary of the account. Eligible individuals may contribute up to \$500 cash each year to an Education IRA for a child under age 18. Contributions made to an Education IRA are not tax deductible, but amounts deposited in the account grow tax-free. If, in any given year, withdrawals from the account do not exceed the child's qualified higher education expenses (including tuition and fees, room and board, and the costs of books, supplies, and equipment) no tax need be paid on the withdrawals. Individuals eligible to contribute to Education IRAs are those with modified AGIs of less than \$110,000 (\$160,000 for a joint return), and those eligible to contribute the full \$500 a year are those with modified AGIs less than \$95,000 (\$150,000 for a joint return). (Beginning in 2002, the \$500 limit on annual contributions will increase to \$2,000, the funds in the account may be used for elementary and secondary education

expenses as well as for the costs of higher education, and the income limits will be higher.) The purpose of these accounts could be expanded to include the payment of early childhood education and child care expenses.

3. **Tax-Subsidized Children's Savings Account (CSA):** Variations of children's savings accounts for education have been repeatedly proposed in Congress, though have never become law. The KIDSAVE proposal, sponsored by Senators Lieberman and Kerry in 1995, would have allowed parents eligible for a child tax credit to put the tax credit proceeds into an IRA for their children. Taxes would be deferred on the principal and interest until withdrawn, like a traditional IRA, but unlike a traditional IRA, the child could borrow from the fund temporarily in the form of a ten-year loan for the costs of higher education without incurring any tax penalty. Otherwise, the assets could not be withdrawn from the IRA until the beneficiary reached age 59 ½. Other CSA proposals have included a government contribution component, sometimes through refundable tax credits. A proposal introduced by Rep. Houghton (R-NY) in 1997 would establish a Children's Retirement Account (CRA) for every child under six; the U.S. Treasury would directly deposit \$1,000 into the CRA every year until the child reached the age of six. Account-holders would be permitted to borrow from these retirement accounts to finance higher education or a first-time home purchase. Former Senator Kerrey suggested the establishment of an "investment account" for every child born in the United States with the \$500 child tax credit (made fully refundable) deposited into the child's investment account for the first five years of life. Individuals could be allowed to borrow from such funds to pay child care expenses.
4. **Individual Development Account (IDA):** Generally speaking, an IDA is an interest-bearing savings account for low-income individuals that is restricted to three uses: (1) buying a first home; (2) receiving post-secondary education or training; or (3) starting a business. Child care could be added as a permissible use. Deposits made to the accounts generally do not count as income for the purposes of determining eligibility and benefit levels for public assistance programs. Some states provide matching funds for deposits made to the accounts, while others have established tax credits to encourage individuals and businesses to provide matching funds. These matching funds help low-income individuals to build assets more quickly over time. Currently, small-scale IDA programs have been authorized by various federal laws (for instance, the Personal Responsibility and Work Opportunity Act of 1996 (PRWORA) permitted states to include IDAs in welfare reform plans and welfare-to-work programs, while the Assets for Independence Act

provided competitive grants to non-profit IDA programs) and are being implemented in a variety of forms in some states.

During the 106th Congress, the leading bipartisan proposal to expand the availability of IDAs was the Savings for Working Families Act sponsored by Senators Lieberman and Santorum and Representatives Pitts and Stenholm, which would provide tax credits to financial institutions that annually match up to \$500 of deposits made by a low-income individual into an IDA and to private investors contributing to non-profits that run matching IDA programs.

5. **Tax-Subsidized Universal Savings Account (USA):** The Clinton Administration proposed this retirement savings vehicle in 1999. The proposed USAs would be voluntary individual retirement savings accounts subsidized by federal tax credits, available to low-income individuals and individuals without employer-provided retirement plans, and designed to encourage and supplement retirement savings. Any eligible individual could open a USA. Individuals with an adjusted gross income (AGI) of under \$20,000 would receive an automatic annual \$300 government contribution to their USA in the form of a refundable tax credit, whether or not they themselves made any contributions to the account, and would receive a dollar-for-dollar match in the form of a refundable tax credit deposited directly into the USA for every dollar deposited into the account. Individuals with an AGI between \$20,000 and \$40,000 would be eligible for smaller benefits, and individuals with an income above \$40,000 would receive no automatic government contributions and the smallest match. Total contributions to the USA, including the tax credits, would be capped at \$1,000 per year.

USA earnings would grow tax-free until retirement. Upon retirement, fifteen percent of each withdrawal of a USA would be excluded from taxes, in order to approximate a tax-free return of an individual's own after-tax contribution.

C. Tax-Financed Social Insurance Models

1. **Tax-Funded Social Security and Unemployment Insurance** are two examples of government-sponsored social insurance programs. They are nearly universal programs that insure against risks faced by all workers. The Social Security system protects against the risk of the dramatic loss in family income that can occur as a result of disability, retirement or death. Unemployment Insurance protects against the income loss that can occur from being involuntarily terminated from one's job without cause. Given the popularity of these social insurance programs, it has been suggested

that such a model could be used to help families pay for child care expenses. An insurance model is also attractive because it enables its participants to share the cost and risk: although everyone pays into the system, not everyone directly benefits from it, meaning that beneficiaries can receive more than they contribute to the system.

Both Social Security and Unemployment Insurance are financed through payroll taxes. In the case of Social Security, the tax is divided equally between employees and employers. For Unemployment Insurance, only employers pay the tax. This form of financing has been criticized for being regressive (i.e., low-income workers pay a larger percentage of their income in these taxes than do high-income workers). Some of this regressivity could be eliminated by making the benefit structure quite progressive, by making tax rates increase with income or by making all wage and salary income subject to taxation (currently, there is a limit on how much income is subject to the Social Security and Unemployment Insurance taxes). But the payroll tax is fundamentally regressive in a different way: since only income from wages and salaries is taxed, high-income people, who are more likely to have income from non-wage sources such as investments, will pay a smaller fraction of their total income towards these social insurance programs than do lower-income people, who are less likely to have income from sources other than wages and salaries.

Creating a social insurance program to fund child care expenses would require an increase in the payroll tax or a tax on employers. Whereas proposals have been made to allow states to fund paid parental leave out of the existing Unemployment Insurance funds, paying for child care would be significantly more expensive and therefore might require a new funding stream. Adding an additional payroll tax and structuring it so that it would be less regressive than existing payroll taxes would be politically difficult. Given that payroll taxes are already the highest taxes paid by many low-income workers, increasing those taxes may also be undesirable.

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