

THE Little
Engine
THAT Hasn't



THE POOR PERFORMANCE
OF EMPLOYER TAX CREDITS
FOR CHILD CARE

The National Women's Law Center is a non-profit organization that has been working since 1972 to advance and protect women's legal rights. The Center focuses on major policy areas of importance to women and their families, including employment, education, health and reproductive rights, and family economic security. Christina Smith FitzPatrick is a Senior Policy Analyst at the Center. Nancy Duff Campbell is Co-President of the Center.

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Nancy Duff Campbell

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I. INTRODUCTION AND SUMMARY

A. The Child Care Problem and Efforts to Address It

Across the United States today, there is an acute shortage of high-quality, affordable child care. Women with children have entered the paid labor force in unprecedented numbers—including women who are the sole source of support for their families, women living in poverty who are required to work under the rules of the new welfare system, and many other women whose contribution to their families' earnings is necessary to make ends meet.¹ But these women and their families have found, too often, that their communities do not offer child care options that provide a healthy, educational experience for their children, or, indeed, any good child care options that fit within their budget.

A variety of federal, state and local programs and funding streams provide public support for child care. Although the total public investment in child care is difficult to quantify, as is the total need of American families for child care, the available evidence suggests that child care programs are underfunded and fall far short of reaching all who need help. For example, the Child Care and Development Block Grant (CCDBG), which provides federal funds for child care subsidies, reaches only one in seven eligible low- and moderate-income children,² and Head Start serves only about three in five eligible low-income preschool-age children.³

B. "I Think I Can"—The Popularity of Employer Tax Credits for Child Care

One approach to address the child care needs of America's families has become popular with state policy makers: tax credits for employers that provide some form of child care assistance to their employees. These credits permit an employer to offset part of its child care expenditures against its state tax liability.⁴ In effect, the credits result in the government's sharing the costs of providing child care benefits with employers. The credits are generally structured as a given percentage of eligible expenses, often with a limit placed on the amount that can be claimed. They vary, from state to state, in terms of their size (the portion of child care expenses that are offset by the credit, as determined by the credit rate and any limits placed on the amount that can be claimed), their scope (the types of expenses that can serve as the basis for the credit), and their reach (the types of employers who can take advantage of the credit). Thus, for example, Mississippi offers a credit equal to 50 percent of costs, applicable to all types of expenditures related to child care assistance provided to employees and available to all for-profit employers, while New Mexico's credit is equal to 30 percent of costs, applicable to expendi-

¹ Just over 72 percent of American women with children under age 18 — almost 79 percent of women with children ages six to 17, 65 percent of women with children under age six, and 57 percent of women with infants (under age one) — are in the paid labor force. See Bureau of Labor Statistics, U.S. Dep't of Labor, *Employment Characteristics of Families in 1999-2000*, Current Population Survey Table 5 (2001), available at <http://www.bls.gov/news.release/famee.t05.htm>.

² Calculations by the Children's Defense Fund, using data on the number of children served from U.S. Dep't of Health and Human Services, FY 2003 Budget in Brief, February 2002, and data on the number of children eligible from the Office of the Assistant Secretary for Planning and Evaluation, U.S. Dep't of Health and Human Services, as presented by Julie B. Isaacs at the State Administrators Meeting in Washington, DC, August 13, 2001.

³ Children's Defense Fund, *The State of Children in America's Union: A 2002 Action Guide to Leave No Child Behind* vii (2002).

⁴ Although this report focuses on employer tax credits for child care, in some states the credits permit an employer to offset part of its adult dependent care expenses as well. See *infra* note 5.

tures for operating an on-site facility or subsidizing employees' child care expenses in an outside facility and available only to corporate tax filers.

Over half the states—28 in all—have enacted one or another form of employer tax credit for child care,⁵ and the momentum for enactment of these measures seems to have accelerated. In 1983, only four states had such credits.⁶ By 1989, at least 13 states had such credits.⁷ In the past five years, 11 states have enacted new credits or expanded existing ones.⁸ And the federal government recently enacted, effective in tax year 2002, a credit against federal income tax for the same purpose.⁹

The policy makers who have led the charge for enactment of these measures clearly have had the best intentions and the highest hopes. One governor, on signing into law a tax credit for employers who offer on-site child care centers for their employees, noted the importance of child care to working families and said he expected the provision to lure more employers into offering convenient child care for their employees.¹⁰ Legislators in another state claimed that the tax credits they enacted would create an incentive for employers to help their employees with child care.¹¹ A state senator in a state that enacted a new credit in 2000 said it would take the pressure off parents searching for affordable, quality care.¹² Co-sponsors of a bill in another state said they expected the legislation to help workers and thereby lead to increased productivity and higher worker morale.¹³ The leading sponsors of the new federal tax credit stated their belief that this measure would provide an incentive for businesses to assist in providing child care for their workers, and thereby increase the supply of child care for working families.¹⁴

C. This Little Engine Hasn't Performed Well

Is the wave of enthusiasm for employer tax credits for child care justified? This report takes a hard look at the existing data on employer tax credits for child care, assesses the effect these credits have had so far, and analyzes the reasons for the impact—or, more accurately, lack of impact—they have had.¹⁵

⁵ The following states have enacted employer tax credits for child care: Arizona, Arkansas, California, Colorado, Connecticut, Florida, Georgia, Illinois, Kansas, Maine, Maryland, Michigan, Mississippi, Montana, Nebraska, Nevada, New Jersey, New Mexico, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, Tennessee, Texas, Virginia and Wisconsin. The Michigan credit was repealed in 1993. The Arizona credit was repealed in 1994. The Wisconsin credit was repealed in 1997. For statutory citation to these credits, see Appendix A. The following states expressly include adult dependent care expenditures in their employer tax credits: Arizona, Illinois, Mississippi, Montana, Ohio, Oregon, Rhode Island and Wisconsin.

⁶ The four states with employer tax credits for child care in 1983 were Connecticut, Michigan, New Mexico and Ohio.

⁷ The 13 states with employer tax credits for child care in 1989 were California, Connecticut, Kansas, Maine, Maryland, Mississippi, Montana, New Mexico, Ohio, Oregon, Pennsylvania, Rhode Island and South Carolina.

⁸ The 11 states that have enacted new credits or expanded existing ones in the period 1998–2002 are Colorado, Florida, Georgia, Maine, Maryland, Montana, Nebraska, New Jersey, Oklahoma, Pennsylvania and Texas.

⁹ See Economic Growth and Tax Relief Reconciliation Act of 2001, § 205, 26 U.S.C. § 45F (2001).

¹⁰ See Kathy Pruitt, *Barnes Signs Tax Credit for Firms that Offer Day Care*, Atlanta Journal and Constitution, March 31, 1999, at A1.

¹¹ See Marcia Heroux Pounds, *Companies Gain Incentives to Help with Child Care*, Ft. Lauderdale Sun-Sentinel, May 15, 1998, at 3D.

¹² See Robin Tysver, *Child-Care Bill Moves Forward - Measure Criticized as Corporate Welfare Advances With 31 Votes*, Omaha World-Herald, April 7, 2000, at 13.

¹³ See John Moritz, *Bill Would Give Tax Breaks for Day Care, Employers Who Provide Access Would Get Credit*, Fort Worth Star-Telegram, May 5, 1999, at 1.

¹⁴ See 147 Cong. Rec. S8252-54 (daily ed. July 26, 2001) (statement of Sen. Grassley); 147 Cong. Rec. S3351-53 (daily ed. April 3, 2001) (statement of Sen. Kohl).

¹⁵ The effectiveness of employer tax credits in expanding the availability of child care has not been examined since 1989, when only 13 states had such credits, and only four states could provide data on state expenditures and the number of claimants for their credits. See Child Care Action Campaign, *Employer Tax Credits for Child Care: Asset or Liability?* (1989).

Despite the optimism of the backers of these measures, the results of this analysis are not promising. This report examines the 20 state tax credits for which data are available.¹⁶ In 16 of these states, *five or fewer corporations claimed the credit*, out of tens of thousands of corporations that filed state tax returns.¹⁷ In five of these 16 states, *not one corporation claimed the credit*.¹⁸ Even in the few states with higher numbers of claimants (e.g., as many as 164 in California, 21 in Oregon, 20 in Connecticut), the numbers represent only a tiny fraction of the state's total number of corporate filers. In terms of the amount of money states have expended through the credits, both total and per claimant, the picture is equally bleak. In 13 of the 18 states in which these data are available,¹⁹ the state spent less than \$150,000 in forgone corporate tax revenue, statewide, in the year studied.²⁰ Only four states spent more than \$20,000 per claimant.²¹

¹⁶ Data are available for the employer tax credits in the following 20 states: Arizona, Arkansas, California, Connecticut, Florida, Georgia, Illinois, Kansas, Maine, Maryland, Mississippi, Montana, New Mexico, Ohio, Oklahoma, Oregon, Rhode Island, South Carolina, Tennessee and Virginia.

For each state the report uses the information for the most recent year for which data are available. Doing so raises two potential problems. First, comparisons are made among data from different years. With the exception of the Arizona credit, which was last available in 1994, the year of the data ranges from the late 1990s to fiscal year 2001. Second, the data for a particular year might not be representative of a state's experience, being either unusually low or high. (For example, utilization in the first few years of a credit's enactment may be lower than in subsequent years since businesses could take several years to learn about and respond to the credit. Utilization of a credit may be unusually high in a given year if more employers than usual incur one-time expenses such as the construction of a new facility.) Concern about these potential problems is mitigated, however, since the utilization of these credits within each state over the last 3-5 years has been fairly consistent. (The exception is Georgia which expended an unusually large amount in 1998.) Concern may still remain about depressed utilization during the early years of a credit. In 16 of the 20 states examined in this report, the data are for at least the fourth year of the credit. The data for Florida and Oklahoma are for the first year of the credit; for Ohio, the second year; and for Virginia, the third year. The report indicates when the data are for the early years of a credit.

Data are not available for nine state credits. Three states (Nebraska, New Jersey and Texas) have enacted credits so recently that data are not yet available. Five states (Colorado, Michigan, Nevada, Pennsylvania and Wisconsin) could not provide utilization data about their employer tax credits that was disaggregated from data on their other tax provisions. Ohio, in addition to its employer tax credit for child care, also has an enterprise zone credit (which includes child care as an eligible investment) for which utilization data are not available.

Five states (Connecticut, Georgia, Maine, Montana and Oklahoma) have enacted newer versions of their employer tax credits than the ones described in this report. Data for these current tax provisions are not available. Because of this absence of data, the report relies on data for the older versions of the credits in these five states. The utilization of the newer versions of the credits could be different than it was for the older versions: the new Connecticut credit is substantially weaker than the old version; the new Georgia credit is significantly stronger than the old version; the new Maine credit adds an incentive for employers to support quality child care; the new Montana credit is somewhat stronger than the old version; and the new Oklahoma credit is less restrictive in some respects and more restrictive in others. With the possible exception of Georgia (see *infra* note 32 for a discussion of the new Georgia credit), however, information about the utilization of these new credits should not affect the conclusions of this report, as the discussion that follows will make clear.

¹⁷ The 16 states with five or fewer claimants are Arizona, Arkansas, Florida, Georgia, Illinois, Kansas, Maine, Maryland, Mississippi, Montana, New Mexico, Oklahoma, Rhode Island, South Carolina, Tennessee and Virginia.

This analysis is based on corporate tax returns only. Although ideally an analysis of these credits would include information about non-corporate claimants, this report does not analyze data from personal income tax returns because only ten states—Arizona, Arkansas, California, Maryland, Montana, New Mexico, Oklahoma, Rhode Island, South Carolina and Virginia—were able to provide information about the utilization of the credits through the personal income tax. In addition, these data are difficult to interpret because it is not possible to determine how many employers are represented by the number of personal income tax claimants. For example, if a law firm qualifies for an employer tax credit for child care, each of the partners in the firm would be able to claim a portion of the credit on his or her personal income tax return. Thus, multiple personal income tax claimants could represent only one employer.

Nine of the states with five or fewer corporate claimants were also able to report data from personal income tax returns. Of these states, four had more than five claimants if filers claiming the credit through the personal income tax are considered. Counting both corporate and personal income tax claimants in these states, Arizona had fewer than 15 claimants total, Maryland had fewer than six, Montana had nine and New Mexico had fewer than 12.

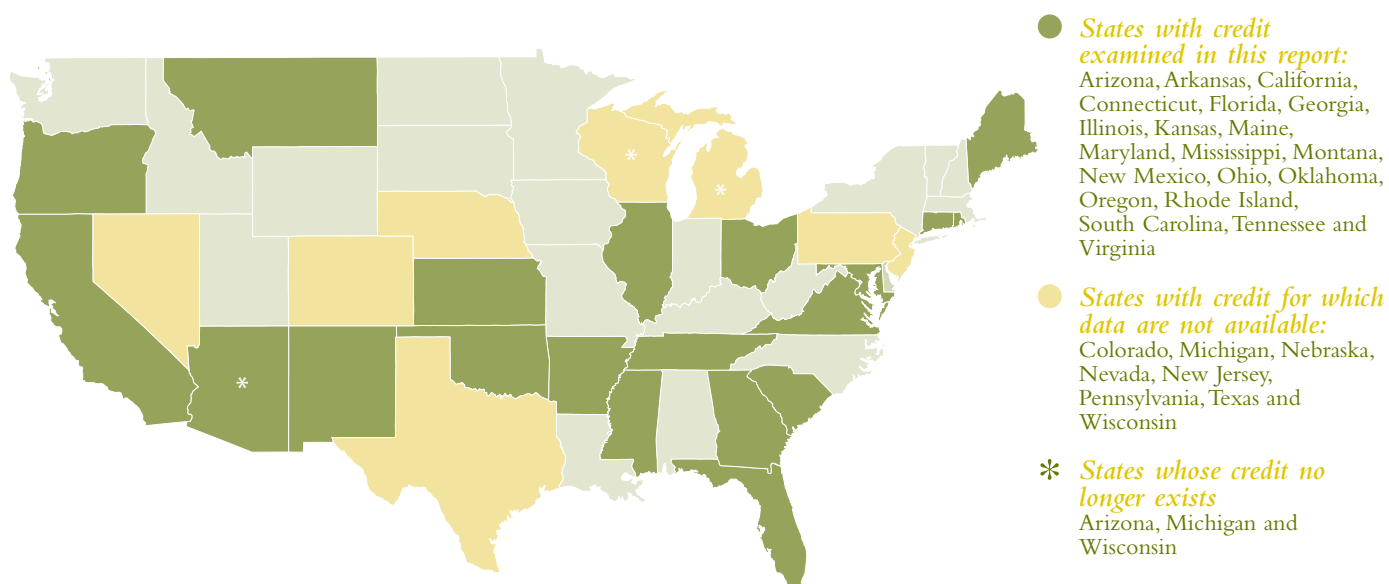
¹⁸ Arkansas, Oklahoma, South Carolina, Tennessee and Virginia had no claimants. If personal income tax claimants are considered, only South Carolina had more claimants—three total. It is not possible to determine from the number of personal income tax claimants how many employers are represented. See *supra* note 17.

¹⁹ The 18 states with expenditure data are Arizona, Arkansas, California, Connecticut, Florida, Georgia, Kansas, Maryland, Mississippi, Montana, New Mexico, Ohio, Oklahoma, Oregon, Rhode Island, South Carolina, Tennessee and Virginia. The two states that provide information about the number of filers claiming the credits but do not provide information about expenditures are Illinois and Maine.

²⁰ The 13 states that spent less than \$150,000 in foregone corporate tax revenue are Arizona, Arkansas, Kansas, Maryland, Mississippi, Montana, New Mexico, Ohio, Oklahoma, Rhode Island, South Carolina, Tennessee and Virginia.

²¹ The four states that spent more than \$20,000 per claimant are Connecticut, Florida, Georgia and Oregon.

Clearly, for the many employers who are not taking advantage of available child care tax credits, the credits are not serving as an incentive to provide child care assistance to their employees—one of the express goals of the sponsors of these measures. Moreover, although some of the small number of employers who *are* taking advantage of these credits may be providing child care assistance to their employees that they would not previously have provided, at least some of these employers are receiving a tax benefit for assistance they would have provided even in the absence of a credit. It appears, in short, that these tax credits are not serving their intended purposes very well. Unlike the famous “little engine that could,” this engine of change is nowhere near the top of the hill.



D. Reasons for the State Credits' Poor Performance

It is difficult to assess fully the factors that account for the low utilization of employer tax credits for child care since there is little variation among the states: all the state credits, regardless of their characteristics, have had very low utilization, particularly when compared to the total number of corporate tax filers. However, some of the states have had more claimants than others. The report analyzes several possible explanations for the low utilization of these credits and draws conclusions from the variations that exist in the data, when possible.²²

1. Design and Implementation Theories

Weakness of the credits

One theory is that the credits are not strong enough (as measured by the combined effect of their size, scope and reach) relative to the cost of providing child care assistance to act as an incentive for employers to change their policies. The weakest credits do show the lowest utilization, but most of the strongest credits also have produced few if any claimants.

Lack of accurate information

It is also possible that employers are ill-informed about the credits, in that they are not aware of the credits' existence or misunderstand what is required to claim them. Anecdotal information suggests that lack of awareness about the credits among employers may be a problem. Better

²² This report relies on descriptive analysis. Further work on this topic could explore whether a regression analysis would shed more light on the factors that influence utilization of the credits. However, the relatively small sample size, the comparatively large number of explanatory variables, the small amount of variation in the utilization of the credits and the lack of data for several of the explanatory variables pose some difficulties for a regression analysis.

marketing may help increase awareness and, as a result, utilization; two of the three states that have worked with community groups to distribute materials specifically about the credits have had more success than other states in attracting claimants. In contrast, although some employers may not fully investigate the credits because they misunderstand the requirements for claiming them or the effect of claiming the credits on otherwise allowable tax deductions, the states' actual reporting requirements and limitations on claiming deductions have not affected utilization.

Uncertainty Still another possibility is that employers are declining to take advantage of these credits due to uncertainty about their ability to claim them. For example, a credit can be repealed at any time, which may discourage employers from establishing a relatively expensive benefit like child care assistance if their decision is based largely on the existence of the tax credit. Sunset provisions confirm that some credits are time-limited, and dollar limits on the total amount a state may expend through a credit add an additional element of uncertainty, but neither of these design features has had an effect on utilization.

These factors could be addressed by changing the design and implementation of the credits, for example, by making the credits stronger or engaging in outreach to employers to ensure they are accurately informed about the availability of the credits. But with the possible exception of better marketing efforts, none of these strategies has affected the utilization of these credits.

2. Fundamental Limitations of a Tax Approach

There are serious questions about the extent to which tax credits can ever effectively persuade employers to provide child care assistance to their employees.

Lack of state tax liability An important limitation on the ability of tax credits to act as an incentive is that many employers have very little state tax liability, or none at all, against which to apply a credit. In addition to the non-profit organizations and government agencies not subject to taxation, on average, 57 percent of state corporate filers have no tax liability and 93 percent of state corporate filers do not have sufficient tax liability to take advantage of the full amount of the credit for which they are eligible.²³

Other motivations The ability of a tax credit to influence employers is also limited because employers are motivated by factors other than tax advantage in making the decision to provide child care assistance, such as concerns about liability issues or about providing a benefit that only a subset of employees can use. If employers decide that child care is not a benefit they would like to offer based on factors such as these, a tax credit will have little influence.

3. Other Concerns

There are other concerns about the credits, such as their ability to promote the quality and affordability of care.

Quality and affordability Employer tax credits for child care are not well suited to effectively address the quality or affordability of care. The credits generally do not have requirements about the quality of care that must be provided, the degree to which the care must be affordable for low-income families, or the fees that may be charged to parents. Making the credits more restrictive to address these concerns is likely to be incompatible with the goal of increasing their utilization, since imposing such requirements would likely decrease the number of employers who are eligible for the credits.

²³ National Women's Law Center calculations based on corporate tax liability or taxable income data provided by the following states, in the most recent year for which data are available: Arizona, Arkansas, California, Connecticut, Florida, Georgia, Illinois, Kansas, Maine, Maryland, Mississippi, Ohio, Oklahoma, Oregon, South Carolina and Virginia. The other states analyzed in this report did not respond to requests for this information.

4. Unfortunate Consequences

The failure of these credits to act as an incentive for businesses to make new investments in child care for their employees produces two unfortunate consequences.

Windfall effect If tax credits are not effective in encouraging additional employers to provide child care assistance, the employers who claim them receive a tax benefit for child care assistance they would have provided even in the absence of a credit. The credits are not effective in increasing the supply of care and the tax assistance provided is a windfall to those who receive it.

Crowding out effect If tax credits do not live up to the expectations that policy makers have for them, as legislative bodies consider them, especially during times of budget shortfalls and scarce public dollars, the budget allocation that is set aside can crowd out funding for other approaches to child care that are urgently needed and proven to be effective, like subsidies to help low-income families meet their child care needs. When the credits are not widely utilized, the money allocated for them is left unspent but is unavailable for other programs.

E. The Federal Credit and Other Alternatives

The new federal credit has many similarities to the state credits and could suffer from many of the same problems that have plagued the state credits. For example, the credit is not particularly strong, and no money has been allocated to market it. The federal credit may attract more claimants, however, since it will be easier logistically, especially for multi-state employers, to take advantage of a federal credit than one or more state credits, since employers generally have more federal than state tax liability to offset, and since the combination of the federal and state credits can provide a more significant financial incentive for more employers to provide child care assistance to their employees. However, the ability of the credits to act as an incentive will be limited by many employers' lack of tax liability, whether state, federal, or both.

In the end, alternative models for encouraging private-sector investment in child care may prove more effective than employer tax credits. Colorado, Florida and Oregon have developed models to encourage a wider range of private investment in child care than credits that limit their benefits to employers who provide child care assistance to their employees. But a more thorough investigation of these alternative mechanisms once more data are available is needed before the efficacy of these strategies can be assessed and compared to the performance of employer tax credits for child care.

F. This Report: Methodology and Structure

This study is based on original research. After conducting a literature review, the authors collected and reviewed every state employer tax credit statute. The authors then contacted the department of revenue in each state offering such a credit for utilization data: the number of filers claiming the credit in that state and the amount of money the state expended through it. This research yielded 20 states with utilization data that, unless otherwise noted, were the basis for this study.²⁴ In addition, the authors conducted over 50 interviews with national and state-level child care experts, tax policy specialists and employers to test theories regarding why the credits have not been better utilized, to find any relevant additional research or data sources, and to learn more about the history of and experience with the credits at the state level. Among those interviewed were representatives of 10 employers, who provided valuable insight into how businesses view the credits.

²⁴ See *supra* notes 16 - 22 and accompanying text for a list of these states and discussion of the limitations on the data available.

A Note on Tax Benefits Not Analyzed in This Report

There are several types of tax benefits at the state and federal levels that employers incurring child care expenses may claim to reduce their tax liability, some of which may be substantial, that are not examined in this report. For example, both employers and employees may receive federal (and often state) tax benefits for child care assistance provided through a Dependent Care Assistance Program (DCAP), as described in Section 129 of the federal Internal Revenue Code. An employee need not pay income tax, an employer need not pay unemployment taxes, and neither an employer nor an employee need pay Social Security and Medicare taxes (also known as “payroll taxes”) on up to \$5,000 in benefits offered through a DCAP.

Employers may also deduct from their federal taxable income as “ordinary and necessary” business expenses under Section 162 of the Internal Revenue Code the cost of providing child care assistance to their employees.²⁵ In addition, an employer that donates money to a nonprofit organization providing care to its employees, and that receives no direct economic benefit from this donation, may be eligible for a charitable deduction under Section 170 of the Internal Revenue Code and many state codes.

Moreover, this study examines only tax credits against state income, franchise, use or privilege taxes and does not include local-level initiatives. For instance, Maryland permits Prince George’s County and Baltimore City to extend property tax credits to property owners providing child care for employees;²⁶ Massachusetts provides that for the purpose of local property taxes, any portion of a business property operated as a child care facility will be subject to the same tax rates as residential property;²⁷ and North Dakota allows localities to exempt from property tax property used to provide early childhood services.²⁸

Although, ideally, an evaluation of the incentive effect produced by these credits would include a comparison of the number of employers claiming the credit in each state with the number of employers offering child care assistance and the amount of child care assistance provided both before and after implementation of the credits, no data exist that would allow such an analysis.²⁹ The utilization data are thus used as a rough proxy for gauging the incentive effect.

This report is organized as follows. Section II describes the employer tax credits for child care that have been adopted at the state level; discusses variations in their size (amount of child care expenses that can be claimed as a credit), scope (nature of the expenses eligible for the credit),

²⁵ In addition, some states allow for favorable tax treatment of such expenses. For example, Arizona allows employers to accelerate the amortization of the costs of establishing a child care facility. See Ariz. Rev. Stat. § 43-1130(B) (2001).

²⁶ See Md. Code Ann., Tax-Prop. § 9-318; Md. Code Ann., Tax-Prop. § 9-214 (2001).

²⁷ See Mass. Gen. Laws ch. 59, § 3F (2002).

²⁸ See N.D. Cent. Code § 57-02-08 (2002).

²⁹ Some national surveys concerning employer-provided benefits exist. The Bureau of Labor Statistics conducts the National Compensation Survey each year, which provides information about the provision of certain benefits provided by employers to employees. See, e.g., Bureau of Labor Statistics, U.S. Dep’t of Labor, National Compensation Survey—Benefits (2001), available at <http://www.bls.gov/ncs/ebs> (only national-level data are available, and the information is presented as a percentage of employees who receive a benefit such as child care, not the percentage of employers who offer it). Some non-governmental organizations such as the Conference Board, Families and Work Institute and Burud & Associates have conducted employer surveys regarding the provision of benefits such as child care, but they do not provide state-level data, nor do they provide data on all employers regardless of size. See, e.g., Susan Otterbourg, The Conference Board, *A Business Guide to Support Employee and Family Involvement in Education* (Jan. 1998); Ellen Gallinsky & James T. Bond, Families and Work Institute, *The 1998 Business Work-Life Study: A Sourcebook* (1998); Burud & Associates, *National Trend Study of Work-Site Child Care* (Nov. 1998).

reach (eligibility to claim the credit), and overall strength (combined effect of size, scope and reach); and presents data showing the number of employers claiming the credits in each state and the amount of money expended by each state on the credits. Section III analyzes the possible reasons for the low utilization of the credits, and assesses how well the credits address other child care goals as well as other concerns about them. Section IV examines the new federal tax credit and analyzes whether it is likely to produce different results than the state credits. Section V describes some alternative models for encouraging private investment in child care.

Several appendices accompany the report. Appendix A lists the statutory citations and effective dates for the state employer tax credits for child care. Appendix B presents a table summarizing the features of the state employer tax credits for child care analyzed in the report. Appendix C lists the state agencies that provided the state tax data used in the report. Appendix D lists the individuals who were interviewed for the report.

II. STATE EMPLOYER TAX CREDITS FOR CHILD CARE: WHAT THEY ARE AND HOW WELL THEY ARE UTILIZED

Although employer tax credits for child care have gained popularity and have been enacted in one form or another in over half the states, their utilization has been surprisingly low. In 16 of 20 states examined, five or fewer corporations claimed the credit, out of tens of thousands of corporations that filed state tax returns in those states.³⁰ In five of these 16 states, not one corporation claimed the credit.³¹

This section will first describe the credits that exist at the state level and the variations among them. It will then describe the utilization of the credits, including the extent of state expenditures on the credits and the private spending leveraged by the credits.

A. How State Employer Tax Credits for Child Care Are Structured

Employer tax credits for child care permit an employer to offset part of its child care expenditures against its tax liability, thus in effect dividing the costs of providing child care benefits between the employer and the state. The credits are generally structured as a given percentage of eligible expenses, usually with a limit placed on the amount that can be claimed by an individual employer and sometimes with a limit on the amount that can be claimed by all employers.

The credits vary in the following dimensions, all of which determine their overall strength:

- *size*, which refers to the portion of the employer's child care expenses that may be offset by the credit (such as 50 percent of expenses, up to \$100,000);
- *scope*, which refers to the types of expenses that can serve as the basis for the credit (such as the costs of operating an on-site child care facility) as well as any limitations on the employees or communities that may benefit from the child care subsidized through the credit (such as limiting the credit to benefits provided to former public assistance recipients); and
- *reach*, which refers to the types of employers that can benefit from the credit (such as businesses organized as corporations).

A credit generous in all three of these dimensions is strong; conversely, restrictions in any of these dimensions weaken a credit and can sometimes offset generosity in other dimensions.

The following discussion highlights the most salient variations in the structure of state employer tax credits for child care. A table summarizing the provisions of each credit appears in Appendix B.

1. Size

State credits offer widely varying amounts of tax relief to employers. The amount of tax relief is affected by the percentage of expenses an employer can claim as a credit, limits placed on the amount that an employer can claim, and the interaction between the employer's federal and state tax liability.

³⁰ See *supra* note 17.

³¹ See *supra* note 18.

The credit rates offered by the states analyzed in this report vary considerably. Some credits cover only a small percentage of employer costs. For instance, the state with the lowest percentage—Arkansas—offers a credit equal to 3.9 percent of eligible costs. Illinois' credit is equal to five percent of such costs. Other credits cover a much larger percentage of costs. The states with the highest percentage—Arizona, Connecticut, Florida, Georgia, Kansas, Mississippi, Ohio, Oregon and South Carolina—cover 50 percent of eligible costs.³²

Most of the states examined cap their credits at a maximum amount per employer,³³ while others cap their credits at a maximum amount per employee or child served,³⁴ and still others cap them at a certain portion of the employer's total tax liability.³⁵ Sometimes, a combination of caps is used.³⁶ Four states restrict the total amount the state may expend through the credit in any given year.³⁷ A few states do not cap their credits at all.³⁸

Both the credit rates and the limits can result in a credit's covering only a small percentage of an employer's costs. The effect of credit rates is straightforward: lower rates will result in employers receiving a lower percentage of their costs through the credits than will higher rates. The effect of credit limits is more complicated. Employers pursuing relatively small, less costly projects will for the most part be unaffected by limits placed on the amount an employer can receive through a credit. But the limits can produce a substantial effect on the percentage of costs employers with large expenses can recuperate through the credits, particularly when the limits are placed on the total amount that an employer may claim rather than on the amount an employer may claim per employee served.

Any time an employer's expenses qualify it for a credit that exceeds the limit placed on the total amount an employer can claim, the percentage of expenses recovered by the employer will be smaller than that implied by the credit rate. Consider, for example, a state with a credit equal to 50 percent of eligible expenses, with a limit of \$50,000 per employer. An employer with \$100,000 in eligible expenses will receive a credit of \$50,000, which is 50 percent of expenses. Compare this example to that of an employer that has \$400,000 in eligible expenses. Fifty percent of that amount is \$200,000 but, because this amount exceeds the \$50,000 limit, the employer will still only be able to claim \$50,000. As a result, the actual credit received by this employer is only 12.5 percent of its total expenses, which is a quarter of the nominal rate of 50 percent.

³² The new Georgia credit, effective in 2000 but not a part of this study because utilization data are not yet available, is larger: it equals 75 percent of some eligible costs and 100 percent (10 percent per year over ten years) of others. Two states have relatively small credits that could be said to have credit rates higher than 50 percent. Florida offers a credit equal to 50 percent of some eligible expenses and \$50 per month per child served for others—the latter part of the credit could be described as equaling 100 percent of those expenses, with a limit of \$50 per child served. Similarly, Maryland provides a credit that reimburses employers for their first \$600 of eligible expenses per employee, which could equal more than 50 percent of eligible expenses.

³³ The states that cap their credits for some or all expenses at a maximum amount per employer are Arizona, Arkansas, California, Connecticut, Florida, Kansas, Maine, New Mexico, Ohio, Oregon, Rhode Island, South Carolina, Tennessee and Virginia.

³⁴ The states that cap their credits for some or all expenses at a maximum amount per employee or child served are California, Florida, Maine, Maryland, Montana, Ohio, Oregon and South Carolina.

³⁵ The states that cap their credits for some or all expenses at a certain portion of the employer's tax liability are Georgia, Rhode Island and South Carolina.

³⁶ California, Ohio, Maine and South Carolina have per capita limits on some types of expenses and total limits on others. Oregon's credit for start-up and construction costs equals 50 percent of such costs, up to the lesser of \$100,000 or \$2,500 per employee.

³⁷ Florida and Connecticut cap the total amount of credits that may be claimed in the state in any tax year at \$2 million per year, and Kansas caps that amount at \$3 million per year. In Virginia, the total credits claimed may not exceed \$100,000 in any fiscal year.

³⁸ In three states, the total value of the tax credit available to employers is unlimited: Illinois, Mississippi and Oklahoma. In three other states, part of the credit is unlimited: Arkansas (operating expenses only), Connecticut (subsidies and voucher expenses only) and Oregon (resource and referral expenses only).

The larger the expense, the more pronounced the effect of limits on the percentage of expenses that can be recovered through the credit will be. Constructing a new child care facility is very costly. Interviews with commercial child care facility developers, loan funds that finance child care facility construction, and child care advocates suggest that building or thoroughly retrofitting a child care facility can cost between \$1 million and \$3 million.³⁹ When compared to the high cost of a large project like this, credit limits, which range from \$5,000 to \$100,000, are quite low.⁴⁰ Most limits fall between \$25,000 and \$50,000, and could therefore cover only one to five percent of these construction costs.

Some credits have limits on the amount claimed *per employee*, rather than on the total amount claimed. These per-employee limits can allow some employers with large expenses to recover more costs than they would under the total-amount limits. For instance, in one of the above examples an employer had \$400,000 in eligible child care expenses and was eligible for a 50 percent credit; because of the credit's total-amount limit of \$50,000, however, the employer actually recuperated far less than 50 percent of its expenses. Suppose instead that the credit had a limit of \$2,000 per employee, and that the employer's assistance reached 100 employees. The \$400,000 expended thus translates into \$4,000 of spending per employee; the credit calculation of 50 percent (\$2,000 per employee) does not exceed the limit. As a result, the employer would recover a full 50 percent of its expenses.

Per capita limits can also reduce the percentage of expenses that an employer can recuperate through the credit, however. This situation will occur any time the per capita limit results in a lower credit than the amount the employer could receive based solely on the credit rate. In the above example, any per capita credit limit below \$2,000 per employee will result in the employer's recuperating less than the 50 percent of expenses implied by the credit rate. Caps on the amount an employer may claim per employee or child served range from \$50 (Florida) to \$3,000 (South Carolina), with most under \$1,000.⁴¹

Finally, another factor that affects the amount of the credit for employers is the interaction between state and federal tax liability. A state credit will decrease an employer's state tax liability. However, if an employer lowers its state tax liability by claiming a credit, its federal tax liability will be higher than it would have been if the employer had not claimed the state credit. This situation arises because state taxes are deducted from income in the calculation of federal taxable income. When state tax liability decreases, the amount deducted from income decreases, resulting in higher federal taxable income and tax liability than if the credit had not been claimed. Despite this interaction, an employer's combined federal and state tax liability will be lower as a result of claiming a credit than it otherwise would have been.⁴² But, after taking into consideration the interaction between federal and state tax liability, the net value of the credit will be lower than its face value. (See box on following page.)

³⁹ According to these experts, these costs range between \$100 and \$300 per square foot of facility space (although they can vary considerably based on such factors as the type of facility, its location and its size), and industry standards call for around 100 square feet of space per child. Constructing a one-hundred-child facility, then, will cost an employer between \$1 million and \$3 million, plus additional costs such as those for playground facilities, classroom and office furnishings, and architects. The construction costs in rural areas such as North Carolina are at the low end of the range given, while the costs in urban areas such as San Francisco are at the high end of the range. Telephone conversations with representatives, detailed in Appendix D, of the following groups: two nationwide commercial developers (Bright Horizons and ARAMARK); a nationwide loan fund (the Enterprise Foundation); several regional loan funds (the Child Care Facilities Fund in San Francisco, the Child Care Capital Investment Fund in Boston, Self-Help in North Carolina, the New Jersey Community Loan Fund and the Illinois Facilities Fund); and Alliance for Early Childhood Finance.

⁴⁰ See *supra* note 33 for a list of states that cap their credits for some or all expenses at a maximum amount per employer. According to an examination of the relevant tax forms, none of the state provisions requires the amortization of construction expenses over a period of years. Instead these costs can be expensed in the year they occur.

⁴¹ See *supra* note 34 for the list of states with limits on the amount an employer can receive per employee or child served.

⁴² The interaction described here is unaffected by the new federal credit described in Section IV.

Interaction Between State and Federal Tax Liability

The following table presents an example of the effect a state employer tax credit for child care expenses would have on both the state and federal tax liability of a hypothetical company. This employer has \$500,000 in taxable income, and owes \$25,000 in state taxes before taking into consideration the tax credit for child care. With a state tax credit of \$15,000 for its spending on child care, the company's state tax liability would be reduced to \$10,000. The credit would result in a \$15,000 savings in the company's state taxes. However, this reduction in state tax liability causes an increase in federal tax liability because state taxes paid are deductible from federal taxable income. If the company does not take the state credit, it can deduct its \$25,000 in state taxes paid from its federal taxable income. If the company does take the credit, its state tax liability will be only \$10,000 and therefore it can only deduct that amount from its federal taxable income. Since its federal taxable income is higher if it takes the credit, this company's federal tax liability is \$5,100 *higher* than it otherwise would be if it takes the state credit. The company is still better off taking the credit than not taking the credit, however: its total tax liability is \$9,900 lower than it otherwise would be if it takes the credit. After taking into consideration the interaction between federal and state tax liability, the net value of the credit is \$9,900, only 66 percent of the face value of \$15,000. (These calculations assume a federal marginal tax rate of 34 percent, one that is in the middle of the range of corporate marginal tax rates. Using a higher rate would result in a smaller net value of the state credit, while using a lower rate would result in a higher net value.)

Effect of a State Tax Credit on Total Tax Liability for a Hypothetical Company

	Without state credit	With state credit	Change in tax liability due to credit
State taxable income	\$500,000	\$500,000	
State income tax, pre-credit (5% flat tax rate)	\$25,000	\$25,000	
Employer credit for child care	0	\$15,000	
State income tax liability, post-credit	\$25,000	\$10,000	-\$15,000
Federal taxable income, before deduction for state taxes	\$500,000	\$500,000	
Federal taxable income, after deduction for state taxes	\$475,000	\$490,000	
Federal tax liability	\$161,500	\$166,600	+\$5,100
Total tax liability (state + federal)	\$186,500	\$176,600	-\$9,900

2. Scope

The kinds of expenses covered by state employer tax credits for child care can be divided into five categories:

- the costs of *start-up and construction* for a child care facility for employees;
- the costs of *operating* an employer-run child care facility;
- the costs of *purchasing* employees' child care through payments to a third-party child care provider;
- the costs of providing *direct subsidies and vouchers* to employees; and
- the costs of providing *resource and referral services*.

Table 1 shows how many of the 20 credits cover each type of expense. Start-up and construction costs are the most frequently covered, with 18 states allowing employers to claim a credit based on such expenses. Operating expenses are also covered by most of the state credits. Over half of the states cover the costs of purchasing care from a third party and the costs of providing direct subsidies and vouchers to employees. Relatively few states cover the costs of resource and referral services.

TABLE 1:

Number of states covering each category of expense for the 20 states examined⁴³

Start-up and construction costs ⁴⁴	18
Costs of operating an employee child care center ⁴⁵	16
Costs of purchasing child care for employees from a third-party provider ⁴⁶	14
Costs of providing direct subsidies and vouchers to employees ⁴⁷	14
Costs of providing resource and referral services ⁴⁸	8

Only three of the 20 state credits are restricted to one of these five categories: Tennessee and Virginia allow employers to take a credit only for start-up and construction expenses, while Georgia allows employers to take a credit only for operating expenses. Most of the state credits

⁴³ This list includes the credits in the following 20 states with utilization data available: Arizona, Arkansas, California, Connecticut, Florida, Georgia, Illinois, Kansas, Maine, Maryland, Mississippi, Montana, New Mexico, Ohio, Oklahoma, Oregon, Rhode Island, South Carolina, Tennessee and Virginia. See *supra* note 16.

⁴⁴ The states expressly offering a credit for the employer's costs in constructing and establishing a child care facility for employees or offering a broad credit for child care expenses that would appear to include such costs are Arizona, Arkansas, California, Connecticut, Florida, Illinois, Kansas, Maine, Maryland, Mississippi, Montana, Ohio, Oklahoma, Oregon, Rhode Island, South Carolina, Tennessee and Virginia.

⁴⁵ The states expressly offering a credit for the employer's costs in operating a child care facility for employees or offering a broad credit for child care expenses that appears to include such costs are Arizona, Arkansas, California, Florida, Georgia, Illinois, Kansas, Maine, Maryland, Mississippi, Montana, New Mexico, Oklahoma, Oregon, Rhode Island and South Carolina.

⁴⁶ The states expressly offering a credit for the employer's costs in contracting with or providing direct payments to a third-party provider or offering a broad credit that appears to cover such costs are Arizona, California, Florida, Kansas, Maine, Maryland, Mississippi, Montana, New Mexico, Ohio, Oklahoma, Oregon, Rhode Island and South Carolina.

⁴⁷ The states expressly offering a credit for the employer's costs in providing vouchers or reimbursement directly to employees or offering a broad credit that appears to cover such costs are Arizona, California, Connecticut, Kansas, Maine, Maryland, Mississippi, Montana, New Mexico, Ohio, Oklahoma, Oregon, Rhode Island and South Carolina.

⁴⁸ The states expressly offering a credit for the employer's costs in providing child care resource and referral services or offering a broad credit that appears to cover such costs are Arizona, California, Kansas, Maine, Mississippi, Montana, Oklahoma and Oregon.

cover expenses from two or more of these categories, and at least eight states provide a credit for start-up and construction, operating, purchasing, subsidizing and resource and referral costs.⁴⁹

Some states further narrow the scope of expenses eligible for the credit by covering only care provided to certain employees or in certain communities. One of the 20 states, Maryland, has such a provision. The Maryland credit specifies that only child care spending on specific types of employees, namely state residents who are former recipients of cash assistance under the federal-state Temporary Assistance for Needy Families (TANF) program or the state Family Investment Program or who have disabilities, can qualify for the credit.

3. Reach

The 20 state credits vary in the types of employers that can potentially take advantage of them. None of the state credits is available to all employers and the credits in all the states exclude some types of employers, such as government agencies, from claiming them.⁵⁰

Maryland is the state with the widest reach: all for-profit businesses and non-profit organizations may claim its credit. Illinois is the most restrictive: only manufacturers may claim its credit. The other states can be divided into two categories: those whose credit is available to a wide range of for-profit employers (e.g., whether organized as for-profit corporations or as partnerships, limited liability companies, or other non-corporate forms) and those whose credit is available only to a subset of for-profit employers (e.g., only those employers subject to a particular state's corporate income tax). Most states fall into the former category.⁵¹

Little information is available about what percentage of employers are organized in each of the different forms, and therefore what proportion of employers are excluded under each of these state limitations. But the exclusion of government agencies and non-profit organizations means that on average 25 percent of workers are employed by organizations that cannot take advantage of the credits because they are not subject to tax.⁵²

4. Strength

Consideration of size, scope and reach together is important for understanding the strength and potential benefit offered by any single credit. The following examples demonstrate how restrictiveness in one dimension can have the effect of neutralizing apparent generosity in another:

- A credit that is broad in scope (for example, covering any child care expenses an employer might incur) but small in size (for example, equal to only 20 percent of those expenses up to \$5,000) offers little actual benefit to employers.
- A credit that is large in size (for example, equal to 50 percent of expenses) but narrow in scope (for example, limited to expenses incurred in constructing an on-site child care center)

⁴⁹ The states expressly offering a credit for all five categories of expenditures or offering a broad credit that appears to cover such costs are Arizona, California, Kansas, Maine, Mississippi, Montana, Oklahoma and Oregon.

⁵⁰ In addition, businesses with no tax liability are generally unable to take advantage of the credits. See discussion *infra* pp. 31-33.

⁵¹ Arizona, California, Connecticut, Georgia, Kansas, Mississippi, Montana, Oklahoma, Oregon, South Carolina and Virginia make their credits available to a wide range of for-profit employers. Arkansas, Florida, Nevada, New Mexico, Ohio, Rhode Island and Tennessee make their credits available only to particular subsets of for-profit employers.

⁵² National Women's Law Center calculations based on data for 1997. According to the Bureau of Labor Statistics there were 122.7 million employees on non-farm payrolls and 19.6 million government employees. See Bureau of Labor Statistics, U.S. Dep't of Labor, Tables from Employment and Earnings—Establishment Data: Historical Employment, B-1: Employees on non-farm payrolls by major industry, 1950 to date, available at <http://www.bls.gov/ces/home.htm#ee>. Since the Bureau of Labor Statistics does not provide information about the number of people working for non-profit organizations, that information was obtained from a different source, Independent Sector. According to Independent Sector there were 10.6 million non-profit employees. See Independent Sector, *The New Nonprofit Almanac in Brief: Facts and Figures on the Independent Sector 2001* 8 (2001), available at <http://www.independentsector.org/PDFs/inbrief.pdf>. The 25 percent figure was calculated by adding together the number of government and non-profit employees and dividing by the total number of employees on non-farm payrolls.

is beneficial to employers who are constructing such a center, but is completely unavailable to employers offering other forms of child care assistance, as well as to employers that have already constructed on-site centers and are currently shouldering operating costs.

- A credit that is large in size but narrow in reach (for example, available only to for-profit businesses organized as corporations) affects fewer employers than one that is available to all for-profit employers regardless of how they are organized.
- A credit that is wide in reach (for example, available to all for-profit and non-profit employers) but narrow in size and scope (for example, limited to a few hundred dollars per employee, and only applicable to assistance provided to former recipients of public assistance) provides little real benefit even to the relatively few employers with qualifying expenses.

The strength of the 20 state credits varies considerably. For example, Arkansas has a relatively weak credit, limited to \$5,000 of the first-year operating costs of an employer-operated child care facility and 3.9 percent of the salaries of child care providers engaged exclusively in providing child care in that facility. Not only does this credit cover only a small fraction of the expenses an employer is likely to incur in providing child care to employees, but it is available only to employers operating their own facilities. An employer-operated child care facility will often be the most expensive and labor-intensive method of assisting employees with child care, and by so limiting its credit, Arkansas (like the other four states that limit their credits to construction and/or operating expenses for employer-operated facilities—Georgia, Illinois, Tennessee and Virginia) offers no assistance to the much larger universe of employers that might be offering more modest—or just different—child care benefits to employees, or might be willing and able to offer such benefits.

Mississippi, on the other hand, provides a relatively strong credit. It allows employers to claim a credit equal to 50 percent of their expenses for the construction and operation of their own child care facilities, for contracting with third parties to provide care, and for any expenses undertaken “to increase the quality, availability, and affordability of dependent care in the community used by employees” (which includes subsidies and resource and referral expenses), with no dollar limit on the total credit that can be claimed.⁵³ Because it covers half of an employer’s expenses without limitation, it has the potential to offer large tax benefits to employers, and because it covers a wide variety of expenses, it is available to a relatively broad range of employers, including those that might not be willing to open their own child care facility but might contract with an existing child care facility to make care available to employees or provide resource and referral services to employees.

Tables 2a and 2b give further details about the weakest and the strongest state employer tax credits for child care. The weakest credits have very low limits, combine low credit rates or low limits with a narrow range of expenses covered, or combine low limits with low credit rates. The strongest credits permit employers with a wide variety of qualifying expenses to claim credits equal to 50 percent of expenses and either do not cap the amount that may be claimed as a credit or establish a relatively generous cap. Appendix B contains a table summarizing the components of the 20 state credits examined in this report.

It might be expected that the stronger the tax credit, the greater the incentive for employers to provide child care assistance to their employees, since a stronger credit means more employers will be able to offset more of their child care expenses against their tax liability, and thereby reduce the cost to them of providing this assistance. The next section presents the utilization data available for these credits. A subsequent section examines whether a credit’s utilization is related to its strength.

⁵³ Miss. Code Ann. §57-73-23 (2000).

Weakest State Tax Credits for Employer-Provided Child Care for the 20 States

State	Start-up/ Construction Costs	Operating Costs	Purchasing Costs	Costs of Subsidies and Vouchers	Resource and Referral Costs	Limits on Size of Credits
Arkansas	\$5,000 credit (regardless of costs) for first year employer provides a child care facility	3.9% of the annual salary of employees engaged exclusively in providing child care in employer-provided facility				\$5,000 for start-up/construction costs
Illinois	5%, limited to businesses primarily engaged in manufacturing	5%, limited to businesses primarily engaged in manufacturing				
Maine ^a	20%	20%	20%	20%	20%	lesser of \$5,000 total or \$100 per enrolled child
Tennessee	25%					\$25,000 per facility; \$100,000 total
Virginia	25%					\$25,000; total state amount expended on credits for all employers limited to \$100,000

^a This credit was amended in 2000, effective in 2001. The amended version is not analyzed in this report because no data are available.

Strongest State Tax Credits for Employer-Provided Child Care for the 20 States

State	Start-up/ Construction Costs	Operating Costs	Purchasing Costs	Costs of Subsidies and Vouchers	Resource and Referral Costs	Limits on Size of Credits
Mississippi	50%	50%	50%	50%	50%	
Ohio	50% in the first year		50%	50%		\$100,000 for start-up/construction costs; \$750 per child for purchasing and subsidy and voucher costs
Oregon	50% allotted over ten years	50%	50%	50%	50%	\$2,500 per employee for start-up/construction costs, limited to \$100,000 total; \$2,500 per employee for operating, purchasing, and subsidy and voucher costs
South Carolina	50%	50%	50%	50%		\$100,000 for start-up/construction and purchasing costs; \$3,000 per participating employee for operating costs and subsidies; total cannot exceed 50% of tax liability

B. Utilization of State Employer Tax Credits for Child Care

The impact of state employer tax credits for child care is related to how widely and to what degree the credits have been used. If utilization is high it means that many employers are providing child care assistance to their employees. But even then it is not clear whether the employers claiming the credit were motivated by the credit's enactment or by some other factors, and no data are available to permit a direct evaluation of the impact of the credits on employers' decisions to offer child care assistance. If utilization is low, however, it necessarily means that few employers are being motivated by the credits to begin to provide or increase child care assistance to their employees, an express goal of the sponsors of the credits.

This section will examine three types of utilization data:

- the number of filers claiming the credits;
- the amount expended through the credits, both total and per claimant; and
- the amount of private spending leveraged by the credits, both total and per claimant.

Table 3 sets out the available information, state by state, on the utilization of the credits by corporate filers and the cost to the state of providing these credits.⁵⁴

TABLE 3:

Utilization of State Employer Tax Credits for Child Care by Corporate Filers for the 20 States

	Number of corporate filers claiming credit	Number of corporate filers ^a	Tax expenditure through corporate tax returns	Tax Year (unless otherwise indicated)
Arizona ^b	5	49,529	\$6,839	1994
Arkansas	0	31,326	\$0	2000
California (A) ^c	126	481,036	\$681,000	1999
California (B) ^c	38	481,036	\$258,000	1999
Connecticut ^d	20	51,053	\$504,864	1997
Florida	4	259,028	\$186,800	1999
Georgia ^d	5	126,685	\$575,497	1999
Illinois	<5	130,739	^e	1999
Kansas	5	35,000	\$35,200	2000
Maine ^d	<5	15,000	^e	1999
Maryland	<3	82,014	\$400	1999
Mississippi	2	60,547	\$8,039	FY2001
Montana ^d	3	15,000	\$11,444	FY2000
New Mexico	2	30,000	<\$100,000	1999
Ohio	8	104,738	\$132,500	2000
Oklahoma ^d	0	38,000	\$0	1999
Oregon	21	37,500	\$697,000	1999
Rhode Island	2	30,000	\$31,000	2000
South Carolina	0	73,069	\$0	FY2000
Tennessee	0	120,000	\$0	2000
Virginia	0	77,000	\$0	1999

^a Data refer to the returns of C-corporations.

^b Credit has been repealed, effective tax year 1995.

^c California has two credits. (A) refers to its credit for the costs of purchasing care from a third-party provider, and (B) refers to its credit for start-up and construction and resource and referral costs.

^d Credit has been replaced by a new credit for which data are not available. Connecticut's new credit became effective in tax year 1998; Georgia's in tax year 2000; Maine's and Montana's in tax year 2001; and Oklahoma's in tax year 2002.

^e Information unavailable.

⁵⁴ This analysis is based on corporate tax returns only. See *supra* note 17.

1. Number of Employers Claiming the Credits

Overall, few employers have claimed the credit in any of the 20 states for which utilization data are available. Of these 20 states, 16 had five or fewer claimants.⁵⁵ Of those 16, five had no claimants at all.⁵⁶

Only one state stands out in terms of number of claimants. California had as many as 164 corporate claimants, more than any other state.⁵⁷ The difference between the number of claimants in California and the number in other states is substantial. Oregon had the next largest number of claimants (21), followed by Connecticut (20). But when analyzing this information, it is important to remember the size of California relative to other states. For example, taken as a proportion of all corporate filers, California had no more claimants than either Connecticut or Oregon. In no state was the number of claimants more than a tiny fraction of its corporate filers.

2. State Expenditures Through the Credits

The cost of child care credits in forgone tax revenue gives an indication of how substantial an investment in child care states are making through these credits. As with many budget items, the amount of expenditures is related to the size of the state: states with more employers are likely to have more claimants and are likely to spend more through the credit. It is therefore helpful to examine both total and per-claimant state spending on the credits. Doing so will allow for a comparison among states regarding the average amount of assistance provided to individual employers through the credits. Table 4 presents information about total state expenditures, per-claimant state expenditures and total and per-claimant private spending leveraged by this state spending, for the 18 states with both expenditure and utilization data. This table presents information from corporate tax returns. Some states also allow the credit to be claimed on personal income tax returns. When expenditures through both corporate and personal income tax returns are considered, states spend about \$5.75 million per year on these credits.⁵⁸

Most states expended relatively little through these credits. For the 18 states with expenditure information available, total corporate expenditures ranged from a low of \$0 in five states to a high of \$939,000 in California.⁵⁹ Thirteen of these states spent less than \$150,000 in forgone corporate tax revenue through their employer tax credits for child care.⁶⁰ Those states that had the most employers claiming the credits (California, Connecticut and Oregon) also reported among the highest total state expenditures for these credits: as might be expected, when more employers claim a credit, the credit usually becomes more expensive for a state to provide.⁶¹

⁵⁵ See *supra* note 17.

⁵⁶ See *supra* note 18.

⁵⁷ California reports data for its two credits separately, but does not report whether there is any overlap in claimants of the two types of credits. Adding together the number of claimants for each part of the California credit could therefore result in double counting some corporations. Part A of the credit had 126 claimants, while Part B had 38. Therefore, at least 126 corporations claimed the credit, but the number could be as high as 164.

⁵⁸ National Women's Law Center calculations based on data for the most recent year for which data are available in each state. See *supra* notes 16 and 17.

⁵⁹ The number of states with corporate expenditure data (18) is less than the number of states with claimant data (20) because Illinois and Maine each reported that they had fewer than five claimants but did not report the amount expended through the credit. Of the ten states that were also able to provide data concerning the amount expended on the credit through the personal income tax, see *supra* note 17, the total expenditures through both the corporate and personal income tax returns were substantially greater than the expenditures through the corporate returns alone in only three states: California spent \$2.8 million total, Maryland spent \$96,008 total and South Carolina spent \$14,732 total.

⁶⁰ The thirteen states with less than \$150,000 in forgone revenue are Arizona, Arkansas, Kansas, Maryland, Mississippi, Montana, New Mexico, Ohio, Oklahoma, Rhode Island, South Carolina, Tennessee and Virginia.

⁶¹ Georgia, however, did not have many claimants, but had significant expenditures: \$575,497 in 1999.

TABLE 4:

State Corporate Tax Expenditures, Total and Per-Claimant, and Private Spending, Total and Per-Claimant, for the 18 States with Both Expenditure and Utilization Data

	Total state expenditure through corporate tax returns	State expenditure per claimant ^a	Minimum total private investment ^b	Minimum private investment per claimant ^c
Arizona	\$6,839	\$1,368	\$13,678 - \$22,797	\$2,736 - \$4,559
Arkansas	\$0	\$0	\$0	\$0
California (A) ^d	\$681,000	\$5,405	\$2,270,000	\$18,016
California (B) ^d	\$258,000	\$6,789	\$860,000	\$22,632
Connecticut	\$504,864	\$25,243	\$1,009,728 - \$1,262,160	\$50,486 - \$63,108
Florida	\$186,800	\$46,700	\$373,600	\$93,400
Georgia	\$575,497	\$115,099	\$1,150,994	\$230,199
Kansas	\$35,200	\$7,040	\$70,400 - \$117,333	\$14,080 - \$23,467
Maryland	\$400	e	e	e
Mississippi	\$8,039	\$4,020	\$16,078	\$8,039
Montana	\$11,444	\$3,815	\$57,220	\$19,073
New Mexico	<\$100,000	e	e	e
Ohio	\$132,500	\$16,563	\$265,000	\$33,125
Oklahoma	\$0	\$0	\$0	\$0
Oregon	\$697,000	\$33,190	\$1,394,000	\$66,381
Rhode Island	\$31,000	\$15,500	\$103,333	\$51,667
South Carolina	\$0	\$0	\$0	\$0
Tennessee	\$0	\$0	\$0	\$0
Virginia	\$0	\$0	\$0	\$0

^a State expenditure per claimant is calculated by dividing total state corporate expenditures by the number of claimants.

^b Minimum total private investment is calculated by dividing the state expenditure on corporate claimants by the state's credit rate. For the states with different credit rates for different types of expenses, a range is given.

^c Minimum private investment per claimant is calculated by dividing the state corporate expenditure per claimant by the state's credit rate. For the states with different credit rates for different types of expenses, a range is given.

^d California has two credits. (A) refers to its credit for the costs of purchasing care from a third-party provider, and (B) refers to its credit for start-up and construction and resource and referral costs.

^e It was not possible to calculate these figures due to incomplete information.

Looking at expenditures per claimant, rather than total expenditures, sheds light on what total state expenditures actually mean for individual employers claiming the credit. For example, the California credits, which appear large by other measures, look relatively small by this one: the credits averaged about \$6,000 per claimant. With the exception of one state, the average per-claimant spending through these credits is relatively small: only Georgia expended more than \$100,000 per employer claiming the credit. Among the rest of the states, all but three, Connecticut, Florida and Oregon, expended \$20,000 or less per claimant. State spending per claimant may be kept relatively low in some states because of limits on the amount that can be claimed by an individual employer. However, only in Florida have per-claimant expenditures approached their credit limits,⁶² so these limits cannot account for the low spending per claimant found in most states.

3. Private Spending Leveraged by the Credits

Using the state expenditures and the state credit rates, it is possible to determine how much private money has been leveraged by the credits. For example, Georgia's credit leveraged over \$1.15 million in private spending on child care from \$575,000 in state expenditures (\$575,000

⁶² Florida limits the amount any one employer can claim to \$50,000 and had an average state expenditure per claimant of \$46,700.

in state expenditures \div 50% credit rate = \$1,150,000). The amount of private corporate spending leveraged by these credits ranges from \$0 in five states to \$3.1 million in California.⁶³ Comparing the total amount of private spending leveraged by the credits is inappropriate, however, because doing so does not account for the states' differences in size. Instead, examining the amount of private spending leveraged *per claimant* is more useful.

In states without limits on the amount of the credit, the actual amount of private spending leveraged per claimant can be determined. For example, Oklahoma's credit equals 20 percent of eligible expenses with no limit. If the state expended on average \$20,000 per claimant, this would imply that on average each claimant had \$100,000 in eligible expenses (\$20,000 in state expenditures \div 20% credit rate = \$100,000). If, however, there is a limit on the amount of credit that can be claimed, it is possible only to determine the minimum average amount of private spending leveraged. For example, the Virginia credit equals 25 percent of eligible expenses and is limited to \$25,000. If the average state expenditure per claimant were \$25,000, this would imply average spending of at least \$100,000 by each claimant (\$25,000 in state expenditures \div 25% credit rate = \$100,000). Because of the limit, higher spending would not yield a higher average state expenditure.

With the exception of Georgia, the private spending on child care per claimant in the 16 states for which it is possible to determine this information was quite low.⁶⁴ In Georgia, employers claiming the credit spent on average at least \$230,000 on eligible child care expenses. There is a significant drop to the next highest spending level: Florida claimants spent on average at least \$90,000, Oregon claimants spent on average at least \$66,000, and claimants in Connecticut and Rhode Island spent on average at least \$50,000. Four states had private spending in the \$15,000 to \$35,000 range.⁶⁵ The minimum average employer investment in states whose credits had claimants was lowest in Arizona, which had employer spending of less than \$5,000.⁶⁶ In the five states without claimants it was, of course, \$0. Again, the low levels of private spending in most states are not the result of the credits' limits since in only one state have claimants' average expenditures even approached the limit.

In summary, the available state utilization data suggest, in general, that low numbers of employers claim child care tax credits, that the states spend relatively little through these credits, and that private spending by the companies claiming the credits is relatively low. It seems clear, then, that the credits have not succeeded in motivating large numbers of employers to begin offering child care assistance. The next section will explore possible reasons for the poor performance of these credits.

⁶³ When expenditures through the personal income tax are also considered, *see supra* note 17, the total private spending is substantially greater than the private spending of corporate claimants in only two states: California claimants spent at least \$9.3 million total and South Carolina claimants spent at least \$14,732 total.

⁶⁴ It was possible to determine this information for Arizona, Arkansas, California, Connecticut, Florida, Georgia, Kansas, Mississippi, Montana, Ohio, Oklahoma, Oregon, Rhode Island, South Carolina, Tennessee and Virginia. It was not possible to determine this information for Illinois, Maine, Maryland and New Mexico.

⁶⁵ California, Kansas, Montana and Ohio had private spending in this range.

⁶⁶ In Arizona, the average private spending was \$2,736 per claimant. Arizona places a limit of \$15,000 on the credit claimed for construction expenses and a limit of \$5,000 on the credit claimed for other allowable expenses. Given the credit rate of 50 percent for construction expenses and 30 percent for other eligible expenses, depending on the type of expenses incurred employers could spend between \$10,000 and \$17,000 before hitting the credit's limit.

III. EVALUATION OF STATE EMPLOYER TAX CREDITS FOR CHILD CARE

As shown in the previous section, employer tax credits for child care have not been very effective as measured by their utilization, which suggests that they have not expanded the supply of child care. Some possible reasons for this poor performance are discussed below. In theory, some of the factors that may lead to low utilization could be addressed by changing the design and implementation of the credits, but close analysis reveals that doing so may not make a difference. Indeed, there are fundamental limitations of a tax credit approach. Moreover, in addition to the failure to increase the supply of child care, employer tax credits are not well suited to effectively address the quality or affordability of care. Finally, a serious and unfortunate consequence of the disappointing performance of these credits is that the budget allocations for them—which are based on expectations for their utilization that are not borne out—can crowd out funding for other approaches to child care that are urgently needed and proven to be effective, such as subsidies to help low-income families meet their child care needs.

A. The Design and Implementation of the Credits May Be Flawed

Three plausible explanations that relate to a credit's design or the way in which it has been implemented have been identified for the low utilization of these credits: a credit may be too weak to induce employers to offer child care assistance to their employees; employers may not be aware of a credit, or, if they are aware of it, may misunderstand what is necessary to claim it; and uncertainty about the continuing availability of a credit may discourage employers from making long-term investments in child care based on the existence of the credit.

1. The Credits May Be Too Weak

According to several representatives of employers and others with experience interacting with employers on child care issues, a possible explanation for the low utilization of the tax credits is that they are simply too weak. If the credits are too small relative to the cost of providing child care, they will not act as a sufficient incentive to persuade employers to provide child care assistance to their employees. For especially weak credits, even employers who provide such assistance may determine that the credit does not provide enough reward to justify the administrative burden of claiming it.⁶⁷

If this explanation for low utilization were accurate, the data would show that weak credits have very low utilization and that stronger credits attract more claimants than weaker ones. The data available, however, do not support this contention.

All of the weak credits have attracted few claimants. In each of the states highlighted in Table 2a as having relatively weak credits (Arkansas, Illinois, Maine, Tennessee and Virginia), fewer than five corporate filers claimed the state's credit in the most recent tax year for which information is available. Not a single corporation claimed the credits offered by Arkansas, Tennessee or Virginia.

⁶⁷ See *infra* pp. 28–29 for a discussion of administrative burden.

While some of the stronger credits have attracted more claimants than some of the weaker ones, not all have done so, and none has attracted a significant number of claimants. Of the four states with the strongest credits, highlighted in Table 2b (Mississippi, Ohio, Oregon and South Carolina), the credit of only one has had relatively more success than the others, and even it had a small number of claimants: 21 corporate filers claimed the Oregon credit. The Mississippi, Ohio and South Carolina credits had few if any claimants: Mississippi had two, Ohio had eight and South Carolina had none.⁶⁸ Two of the mid-level credits attracted more claimants than most of the others. The Connecticut credit had 20 claimants and the California credits attracted up to 164 claimants. The other mid-level credits, however, attracted no more than five claimants.

Thus, no weak credit has been successful at attracting claimants, but many of the stronger credits have been similarly unsuccessful. And credits that are mid-level in strength have attracted more claimants than all but one of the other credits. To analyze this seeming disparity in result it is useful to examine the component parts of the “strength” factor. As discussed earlier, the overall strength of a credit depends on its size (the portion of expenses that are offset by a credit, which is usually determined by both the credit rate and the limit placed on the amount that can be claimed), its scope (the types of expenses that can serve as the basis for a credit), and its reach (the types of employers who can take advantage of a credit).

a. Size

The most straightforward determinant of size is a credit's rate: the smaller the credit rate, the less powerful the incentive. As expected, the utilization of credits with the lowest rates—25 percent or less—was extremely low. However, the data do not suggest that wide utilization occurs with higher credit rates. California with a credit rate of 30 percent, Oregon with a credit rate of 50 percent and Connecticut with credit rates of 40 percent and 50 percent, depending on the type of expense, had the most claimants, but still not a substantial number. And of the other seven states with credit rates of 50 percent and for which data are available, all had fewer than nine claimants and most had no more than five.⁶⁹

Another factor influencing the size of a credit is the limit placed on the amount that can be claimed by employers. Credits with low limits might be expected to attract few claimants, and unlimited credits and those with high limits might be expected to have higher utilization than credits with low limits. This theory is not supported by the data. Credits with the lowest limits—such as Arizona, Arkansas, Maine, Maryland, Tennessee and Virginia—had few claimants.⁷⁰ But those with no limits on the amount that employers can claim also had few claimants,⁷¹ and Oregon, with 21 claimants, is the only state with a relatively high limit that had more than eight claimants.⁷²

⁶⁸ If personal income tax claimants are considered, South Carolina had three claimants total. The low utilization of the Ohio credit may result from its newness: the data are for the second year of the credit. See *supra* notes 16 and 17.

⁶⁹ The other states with credit rates of 50 percent for some or all portions of their credit and utilization data available are Arizona, Florida, Georgia, Kansas, Mississippi, Ohio and South Carolina.

⁷⁰ These states' credit limits range from \$600 per employee in Maryland to \$25,000 per facility in Tennessee.

⁷¹ Illinois, Mississippi and Oklahoma place no limits on their credits: Illinois had fewer than five claimants; Mississippi had two and Oklahoma had none.

⁷² Oregon limits its credit to the lesser of \$100,000 or \$2,500 per employee for start-up and construction costs and \$2,500 per employee for operating, purchasing, and subsidy and voucher costs. It places no limit on resource and referral costs. The other states with relatively high limits are Georgia (50 percent of tax liability), Ohio (\$100,000 for start-up and construction costs and \$750 per child for purchasing costs and subsidy and voucher costs), and South Carolina (\$100,000 for start-up and construction costs, \$3,000 per participating employee for operating and subsidy and voucher costs, with a total that may not exceed 50 percent of tax liability).

The results might be different for a significantly larger credit. The new Georgia credit effective for tax year 2000, for which data are not yet available, will help to test whether a very large credit with a relatively high limit (100 percent of construction costs over ten years and 75 percent of operating expenses, with each part of the credit limited to 50 percent of tax liability) will significantly increase the number of Georgia employers claiming the credit.⁷³

Substantially increasing the size of a credit may, however, raise a concern for policy makers: at some point a credit could be so large that it would no longer leverage much private spending. With a 50 percent credit, every dollar of government spending is matched by at least one dollar of private spending. With a higher credit rate, each government dollar is matched by less than a dollar of private money, leaving the government to bear the majority of the cost of child care assistance. Especially since such government subsidies only benefit participating businesses and their employees, at some point policy makers need to consider whether direct spending on publicly funded child care programs is a more efficient use of scarce resources.⁷⁴

b. Scope

Credits covering only a narrow range of expenses could be expected to have low utilization and broader credits could be expected to have higher utilization than narrower ones. The data confirm that narrow credits (e.g., those limited to costs associated with an on-site center or those targeted to specific populations) have had few claimants. No state with a narrow credit had more than five claimants. All but one of the five states with no claimants have narrow credits: two have credits limited to construction expenses (Tennessee, Virginia), one covers only construction and operating expenses (Arkansas), and one covers only the expenses of providing child care to former welfare recipients or employees with disabilities (Maryland). Broader scope, however, has generally not resulted in higher utilization. Eight states' credits cover the full range of costs an employer could incur to provide child care assistance to its employees. Of these eight, only California and Oregon had more than five claimants.⁷⁵ And South Carolina, which has a relatively broad credit, had no claimants.⁷⁶ Although narrow credits have uniformly been unsuccessful, credits with a broader scope have generally not had higher utilization.

c. Reach

Another factor that could explain the low utilization of the credits is that many employers cannot take advantage of them. In most of the states examined in this report, employers not subject to taxation (for example, government agencies and non-profit employers) may not claim the credit.⁷⁷ Some states allow only businesses organized as corporations to claim the credit.⁷⁸ If more employers were able to take advantage of the credits, there might be more claimants.

⁷³ *But see infra* note 102 and accompanying text.

⁷⁴ Under the new Georgia credit, employers may in fact recuperate more in tax benefits than they spent on child care. *See infra* note 90 and accompanying text.

⁷⁵ Arizona and Kansas each had five claimants, Maine had fewer than five claimants, Montana had three claimants, Mississippi had two claimants and Oklahoma had no claimants. California had as many as 164 claimants and Oregon had 21 claimants.

⁷⁶ If personal income tax claimants are considered, South Carolina had three claimants total. It is not possible to determine from the personal income tax data for South Carolina how many employers are represented. *See supra* note 17.

⁷⁷ The exception is Maryland, which allows non-profit organizations to claim the credit. *See discussion infra* pp. 32-33 for mechanisms states could employ to allow non-profit organizations to benefit from these credits.

⁷⁸ For-profit employers without income tax liability in all states but Kansas also cannot claim the credits, *see discussion infra* pp. 31-33.

Evaluating the effect reach has on utilization is difficult. The one state that allows non-profit employers to claim the credit—Maryland—has had very few claimants, although the narrow scope and small size of the credit could help to explain this result.⁷⁹ And the states that allow businesses other than corporations to claim the credit do not provide sufficient data to evaluate the effect of this factor on utilization.⁸⁰

This analysis suggests that there is no clear relationship between credit strength and utilization. Although the weak credits have attracted few if any claimants, the stronger credits generally have not had higher utilization.

2. Employers May Be Ill-Informed About the Credits

Another possible reason for the low utilization of the credits is that employers are ill-informed about them. They may not know that the credits exist or understand what is required to claim them.

If employers do not know about the credits, the credits cannot act as an incentive for them to provide child care assistance to their employees, and even employers who are currently eligible may not claim the credits. No data exist about whether employers know about the credits. But many, though not all, of the individuals interviewed for this study—including business representatives and individuals who work closely with them—thought that many employers do not know about them.

Individuals interviewed for this report suggested some reasons that employers may in fact be ignorant of the credits. First, finding out about the various credits available and determining whether or not the employer would be eligible requires a commitment of resources that not all employers have made. Given limited time and resources, employers may investigate only credits likely to be more lucrative or may investigate credits only in states in which they have a significant tax liability. Second, especially in larger businesses, there may not be adequate communication between human resources staff who are responsible for investigating and administering benefits such as child care and accountants and legal staff who are responsible for investigating and maximizing tax benefits. Individuals familiar with this communication problem reported that establishing systems to improve the information flow is a sizable task that many corporations have not undertaken. The result is that the relationship between the two sets of benefits is often not known or explored. Even when employers are offering child care assistance, they may be unaware that they can claim a tax credit for that assistance.

It may seem unlikely that an employer would not know about a tax credit for which it is eligible, particularly given the prevalence of tax accountants and attorneys who are paid to help minimize tax liability. But even some of the state tax officials interviewed for this report demonstrated a lack of awareness of the credits: in some states the officials did not know what documentation was required to claim the credit; who, if anyone, was marketing the credit; or, in one case, that the credit even existed.

⁷⁹ In fact, in several other cases it is impossible to distinguish among the effects of size, scope and reach. For example, it is possible that narrow scope could help to explain the low utilization of the credits in Arkansas, Illinois, Tennessee and Virginia, but it is difficult to isolate that factor from the effects of size. The Arkansas credit is limited to \$5,000 for construction expenses for an employer-provided facility and 3.9 percent of the salaries of child care providers in the facility; the Illinois credit is limited to five percent of construction and operating expenses for manufacturers; the Tennessee credit is limited to \$25,000 per facility for construction costs; and the Virginia credit is limited to \$25,000 total for construction costs.

⁸⁰ See *supra* note 17.

The states analyzed in this report have taken a variety of approaches to informing employers about the existence of their credits. Two states—Rhode Island and Tennessee—expressly provide a line for their child care credit on the tax forms. The other states have a general line-item for tax credits, and claimants must refer to the instructions or to other forms to find out which credits are included on that line. Neither the Rhode Island nor the Tennessee credit has had greater utilization than the credits of the states that do not have their own line on the tax forms, however. Some states highlight the credit in the front of the instruction book in its first year. Others include a description of the credit in their economic development materials and on their economic development web sites.⁸¹ A few states distribute other materials specifically related to the credit.⁸² For example, Oregon worked with a coalition of child care advocates to produce an *Employer Tool Kit* that includes a description of its credit, and both California and Mississippi designed brochures describing their credits that are distributed by child care resource and referral organizations. The Oregon and California credits have attracted more claimants than others, but the Mississippi credit has had few claimants. This suggests there may be some value in developing specific materials and working with community groups to market the credit.

Even if employers know that a credit exists, they may not pay attention to it if they misunderstand the requirements for claiming it. No data exist about employers' level of understanding of these credits. Several state-level observers reported that employers had complained to them about the cumbersome nature of the reporting requirements and cautioned that any new record-keeping and reporting requirements impose a burden on employers since they must adapt their information systems and collect new data. Other observers assumed that it must be difficult to claim the credits, though they did not have first-hand experience, suggesting that this perception may be pervasive. If employers assume the credits are overly burdensome, they may not bother even to find out more about the credits.

If employers have a clear understanding of the nature of the credits' reporting requirements, one could expect to find a relationship between the burden of reporting requirements and the utilization of the credits. A review of state tax forms suggests that about two-thirds of the 20 states have record-keeping and reporting requirements that are substantial, but the remaining third have requirements that are quite modest. Six states require employers to submit an application to be eligible for the credits.⁸³ Another seven require detailed information to be enclosed with the employer's tax return, such as explanations of expenditures, providers' licensing numbers or addresses, and the names of the dependents served through the child care expenditures.⁸⁴ In contrast, four states require only that employers report their total qualifying expenditures and/or the amount of the credit on their tax returns.⁸⁵ One state—Montana—requires only basic information about the employees receiving assistance in addition to the expenditure data. Two states further require only basic information about the providers supported through the credit.⁸⁶

⁸¹ Arkansas, Connecticut, Kansas, Maryland, Mississippi, Montana, New Mexico, Oregon, Rhode Island, Tennessee and Virginia include information about the credit on their economic development web sites. Of those, however, only Arkansas, Kansas, Maryland, Oregon, Rhode Island and Virginia provide substantive information and the information on the Montana, Maryland and Mississippi web sites was difficult to locate.

⁸² California, Mississippi and Oregon have developed materials such as brochures specifically about the child care credit. Georgia and South Carolina include information about economic development incentives, including these credits, on their Department of Revenue web sites.

⁸³ Arkansas, Connecticut, Florida, Maryland, Mississippi and Virginia require businesses to apply for the credits.

⁸⁴ The states requiring detailed explanations of expenditures are Arizona, Georgia, Kansas, Rhode Island and Tennessee, and all of these except Tennessee also require other detailed information. California requires the names of the dependents served. Oregon requires other types of detailed information.

⁸⁵ Illinois, Maine, Ohio and Oklahoma require only this basic information.

⁸⁶ The states requiring only information about employees and the child care providers supported through the expenditures are New Mexico and South Carolina.

States with few requirements and those with more substantial ones have had few claimants, and the three states with the largest number of claimants have substantial requirements. It thus appears that the extent of the states' reporting requirements has had no effect on utilization.

Finally, employers may mistakenly believe they must choose between taking a business deduction or claiming a child care credit for their spending on child care, and that taking a deduction is more advantageous to them. In most of the 20 states the former assumption is wrong because businesses are not required to choose between taking a deduction or a credit. And in all the states the total tax benefit of taking the credit is always larger than taking only the deduction.⁸⁷ But these misperceptions could discourage employers from investigating the credits.

If employers in fact understand the relationship between the credits and otherwise allowable deductions, states that require businesses to choose between claiming a deduction and a credit for their child care expenses might be expected to attract fewer claimants for their credits, and states that allow businesses to claim a full deduction and credit might be expected to have higher utilization of their credits than others. In only one state, Mississippi, must employers choose between taking a deduction and a credit,⁸⁸ and in that state utilization is low. In four states, employers must reduce the amount they deduct by the size of the credit.⁸⁹ California and Oregon, the two states with the highest utilization, are among this group. Fifteen states allow employers to claim both a deduction and a credit for the same expenses.⁹⁰ In all but one of these states utilization of the credit is nonetheless low.⁹¹ Utilization does not therefore seem to be related to state policy on this issue.

In sum, lack of awareness about the credits may help to explain their low utilization. For the most part states have done little to address this problem. Two of the three states that have worked with community groups to distribute materials specifically about the credits have attracted more claimants than the others, suggesting that better marketing may help to increase utilization. Concerns about burdensome reporting requirements and the effect on otherwise

⁸⁷ Claiming the credit instead of a deduction will be advantageous to an employer as long as the credit rate is larger than the business's marginal tax rate. In the 20 states examined in this report the credit rates are larger than the marginal corporate tax rates.

The following example illustrates the difference in value between claiming a deduction and a credit for child care expenses. Consider a company with \$100,000 in child care expenses and a marginal tax rate of five percent that can claim a child care credit equal to 30 percent of expenses. The credit would be worth \$30,000, subtracted directly from the company's tax liability. If the company were allowed to deduct the full \$100,000 from its taxable income, it would receive a tax benefit from this deduction of \$5,000 (5% x \$100,000). (The value of a deduction—that is, the amount by which tax liability is reduced—equals the amount deducted multiplied by the marginal tax rate.) This company's total tax benefit would be \$35,000.

If the company were required to reduce the amount deducted from taxable income by the size of the credit, the company would be able to deduct \$70,000 (\$100,000 - \$30,000) from its taxable income. The deduction would then be worth \$3,500 (5% x \$70,000) instead of \$5,000. This company's total tax benefit would be \$33,500.

If the employer were required to forego deducting these expenses from taxable income in order to claim the credit, it would receive only the \$30,000 benefit from the credit and none of the benefit from the deduction.

⁸⁸ Mississippi provides that if an employer claims its child care credit, no deduction will be allowed for the expenses that serve as the basis for the credit.

⁸⁹ California, Maryland, Montana and Oregon require claimants to reduce the amount they could otherwise claim as a deduction by the size of the credit.

⁹⁰ The employer tax credit statutes for the following states contain no express prohibition against claiming both the child care credit and the standard business expense deduction for the same expenses: Arizona, Arkansas, Connecticut, Florida, Georgia, Kansas, Illinois, Nebraska, New Mexico, Ohio, Oklahoma, Rhode Island, South Carolina, Tennessee and Virginia. However, Oklahoma provides that employers may not claim the credit for expenses for which an *employee* takes a deduction, credit or exemption.

Under the Georgia credit first available in 2000, for which utilization data are not yet available, employers can recuperate more than 100 percent of their investment in the construction of a child care facility when the combined value of the state deduction for these expenses and the credit is considered.

⁹¹ Connecticut allows employers to claim both a deduction and a credit for the same expenses and has had a relatively high number of claimants—20.

allowable deductions may discourage employers from even fully investigating the credits. But the states' actual reporting requirements and policies on the relationship between the credit and deductions seem to have had little or no effect on utilization.

3. Uncertainty About the Availability of the Credits May Discourage Employers from Making Investments in Child Care Based on Them

A child care tax credit is not likely to be an important factor in an employer's decision to offer child care assistance if the employer believes the credit may not be available in future years. Similarly, if an employer is unsure of its ability to claim the credit in the current year, the employer may not be moved by the existence of the credit to invest in child care.

Because a credit may be repealed at any time, an employer may be wary of establishing a relatively expensive benefit such as child care assistance if its decision is based mainly on the existence of a tax credit.⁹² If the credit is repealed, the employer would no longer have the financial incentive to continue offering child care, but discontinuing the benefit could generate significant ill-will among employees.

Sunset provisions specify that a credit will expire at a designated point in time. Credits with sunset provisions might be expected to have fewer claimants and lower utilization than credits without such provisions. Five of the state credits examined in this report have sunset provisions.⁹³ Four of these five states have indeed had few claimants.⁹⁴ But the fifth state, California, had the most claimants of any state (at least 126), though its sunset provision also has the longest expiration date.⁹⁵ Moreover, many of the states without sunset provisions also have had few claimants and only one of the states with no claimants has a sunset provision.⁹⁶

Four states add a dimension of uncertainty about the credits' current availability: they each have placed a limit on the total amount that the state can expend through the credit each year.⁹⁷ In Connecticut, Florida and Virginia, businesses must apply for the credits, and in Florida and Virginia, the credits are allocated on a first-come, first-served basis (Kansas also allocates the credits on a first-come, first-served basis, but has no application process). Connecticut gives preference to applicants whose child care assistance serves low-income employees. Credits in these states could be expected to have fewer claimants than credits in other states since employers could not be sure they will receive a credit. With the exception of Connecticut, no more than five corporations claimed the credits in these states. But many states without such limits also have had very low utilization. Moreover, in none of the states with these kinds of credit limits has the total amount claimed in any year come close to the credit limit, suggesting that the limit has had little effect on utilization.

In short, some general uncertainty about these credits may deter employer investment in child care based on them. But uncertainty in the form of either sunset provisions or limits on the total amount the state may expend does not seem to have had an effect on utilization.

⁹² This may be especially true if an employer is uncertain about its year-to-year tax liability.

⁹³ The Arizona, California, Florida, Ohio and Oklahoma credits have sunset provisions or otherwise expire on set dates.

⁹⁴ Arizona had five corporate claimants; Florida, four; Ohio, eight; and Oklahoma, none. As previously noted, in two of these states—Florida and Oklahoma—the data are for the first year of the credit.

⁹⁵ The credits in these states were effective for the following periods of time: Arizona, five years; California, 15 years; Florida, 10 years; Ohio, five years; and Oklahoma, five years.

⁹⁶ The Arkansas, Oklahoma, South Carolina, Tennessee and Virginia credits had no claimants; of these credits, only Oklahoma's has a sunset provision.

⁹⁷ Connecticut, Florida, Kansas and Virginia place limits on the total annual amount that can be expended by the state through the credit.

Steps could be taken to improve the design and implementation of the credits. The credits could be strengthened. Employers could be better educated about the credits. Uncertainties about the credits' availability now and in the future could be reduced in part (though statutes can always be repealed). But with the possible exception of better marketing efforts, none of these features has had any real effect on the utilization of these credits.

B. Tax Credits May Not Be Able to Motivate Employers to Offer Child Care Assistance

Design and implementation features may not be the primary reasons for the credits' low utilization. Rather, tax credits may be an ineffective way to affect employer decisions to provide child care assistance to employees because a large proportion of employers have no tax liability or because considerations other than tax advantages weigh more heavily in employers' decisions to provide child care assistance.

1. Many Employers Have Little or No State Tax Liability to Offset with the Credits

Because the value of the credits is the amount of tax liability they offset, the pool of employers who can potentially take advantage of the credits is limited to those with state tax liability, and only those employers with liability above a credit's limit can make full use of the credit. These limitations exclude two groups of employers from the credits' influence: employers that are not subject to taxation such as government agencies and non-profit organizations, and businesses with little or no tax liability. Employers in these groups who offer child care assistance to their employees would not be able to take advantage of the credits.

As previously discussed, although information is not available about the number of employers affected by the exclusion of government agencies and non-profit organizations from the credits, the proportion of employees working for such entities is substantial.⁹⁸ Government agencies and non-profit organizations employed 25 percent of all workers in 1997.⁹⁹

Information about the tax liability or taxable income of corporate filers is available in 17 of the 20 states examined.¹⁰⁰ A large proportion of corporations in these states have very little or no tax liability either because they operate at a loss or because they claim deductions and credits that eliminate most or all of their tax liability. On average, 57 percent of corporations filing returns in these states had no tax liability against which to claim a credit in the most recent year for which data are available,¹⁰¹ ranging from a low of 23 percent in Tennessee to a high of 80 percent in South Carolina.¹⁰² While a substantial number of corporations are excluded from the benefit of these credits because they have no tax liability, this factor alone cannot account for the credits' low utilization. On average, about 43,000 corporations in every state, and at least 6,000 corporate filers in every state, have tax liability and could therefore take advantage

⁹⁸ See *supra* note 52 and accompanying text.

⁹⁹ See *supra* note 52 and accompanying text.

¹⁰⁰ The following states provided information about the tax liability of corporations: Arizona, Arkansas, California, Connecticut, Florida, Georgia, Illinois, Kansas, Maine, Maryland, Mississippi, Ohio, Oklahoma, Oregon, South Carolina, Tennessee and Virginia. Montana, New Mexico and Rhode Island did not respond to requests for such information. The data are from the mid- to late-1990s, dependent on the most recent year available from each state.

¹⁰¹ National Women's Law Center calculations using data provided by 17 states. See *id.* If the state has a corporate minimum tax, the number of filers paying this minimum amount is included in the number of filers with no tax liability against which to apply a credit.

¹⁰² *Id.* In Georgia, 74 percent of corporate filers had no tax liability in 1999, the most recent year for which data are available. *Id.* Because the pool of employers eligible to claim the credit in Georgia is smaller than in most states, the success of the Georgia credit effective in tax year 2000, for which utilization data are not yet available, may be limited, despite its significant strength. See discussion *supra* p. 26.

of the credits if they incurred the necessary expenses.¹⁰³ A significant number of employers in each state, then, have some tax liability against which to claim the credits.

However, even employers that owe taxes may not be motivated by the credits if their tax liability is not sufficient for them to claim the full credit for which they are eligible. One way to get an indication of the proportion of employers with sufficient liability to claim the full amount of the credit for which they are eligible is to examine the states with limits on the amount that can be claimed. Employers need to have tax liability of at least the amount of the limit to take full advantage of the credit. Twelve of the 17 states for which corporate tax liability information is available place dollar limits on the amount of the credit that any employer may claim.¹⁰⁴ With one exception, no more than seven percent (3,500, on average) of corporations in these states have tax liability exceeding the credit limit.¹⁰⁵ While 3,500 is a small fraction of the total number of corporations in a state, it is still a relatively large number, particularly compared to the number of employers claiming the credits in each state thus far. Therefore the absence of sufficient tax liability alone cannot account for the low utilization of the credits. But lack of tax liability significantly limits the pool of employers able to take advantage of the credits—when 93 percent of corporations in a state cannot take full advantage of a credit, the overall incentive effect will be small.

Most of the states examined, however, have structured their credits in such a way that a number of these little-to-no tax liability employers should be able to take greater advantage of them, thus expanding the pool of potentially eligible employers and possibly increasing the utilization of the credits. These states recognize that some corporations may not have tax liability in a particular year because of an unusual circumstance, but owed taxes in previous years, or will owe taxes in future years. Their credits include provisions that allow corporations to apply the tax credit to past or future years' tax liability if they do not owe enough taxes in the current tax year to take full advantage of the credit for which they are eligible—so-called “carry-back” and “carry-forward” provisions.¹⁰⁶

Credits without such provisions could be expected to attract fewer claimants and those with such provisions could be expected to have higher utilization. Arizona, Georgia, Kansas and Maine—the four states without carry-back and carry-forward provisions—have indeed had low utilization.¹⁰⁷ And the three states with the highest utilization—California, Connecticut and Oregon—all have carry-back or carry-forward provisions. However, the other 13 of the 16 states with such provisions have had low utilization.¹⁰⁸ Thus, carry-back and carry-forward provisions do not seem to have affected utilization in any significant way.¹⁰⁹

¹⁰³ See *supra* note 101. The inclusion of California substantially increases the average number of corporations with tax liability for all the states. Without California, on average 28,000 corporations in each state have tax liability. *Id.*

¹⁰⁴ Arizona, Arkansas, California, Connecticut, Florida, Kansas, Maine, Ohio, Oregon, South Carolina, Tennessee and Virginia place dollar limits on the amount of the credit that any one employer may claim. The limits range from \$5,000 in Arizona, Arkansas and Maine to \$100,000 in Ohio, Oregon and South Carolina.

¹⁰⁵ National Women's Law Center calculations based on data provided by 11 states: Arizona, Arkansas, California, Connecticut, Florida, Kansas, Maine, Ohio, Oregon, South Carolina and Virginia. (Tennessee did not provide adequate corporate tax liability information to be included.) The exception to the seven percent figure, Arkansas, places a limit of \$5,000 on the credit employers may claim for construction expenses. Eighteen percent of corporate filers in Arkansas have tax liability in excess of \$5,000. *Id.* The inclusion of California substantially increases the average number of corporations with tax liability exceeding the state's credit limit. Without California, on average 1,700 corporations in each state with a credit limit have tax liability exceeding the limit. *Id.*

¹⁰⁶ Arkansas, California, Connecticut, Florida, Illinois, Maryland, Mississippi, Montana, New Mexico, Ohio, Oklahoma, Oregon, Rhode Island, South Carolina, Tennessee and Virginia have carry-back or carry-forward provisions. Arizona, Georgia, Kansas and Maine do not have such provisions.

¹⁰⁷ Georgia, however, has expended a relatively large amount through its credit.

¹⁰⁸ Arkansas, Florida, Illinois, Maryland, Mississippi, Montana, New Mexico, Ohio, Oklahoma, Rhode Island, South Carolina, Tennessee and Virginia have carry-back or carry-forward provisions but low utilization.

¹⁰⁹ For employers who do not have tax liability in *any* year, carry-back and carry-forward provisions will, of course, not be effective.

Another option for making the credits available to corporations with insufficient tax liability is to make the credits refundable. If a credit is refundable and a corporation's tax credit exceeds its tax liability, it receives the difference in the form of a refund. One state—Kansas—has made its credit refundable, yet the utilization of its credit has been low.

Two other mechanisms could make the credits available not only to corporations with insufficient tax liability but also to non-profit organizations. States could allow employers to claim a credit against the state taxes they are required to withhold from their employees' wages. Maryland's credit has such a provision. The utilization of the Maryland credit has been quite low, however, although most likely because it is so weak. In addition, the credits could be marketable, meaning that employers who qualify for the credits but do not have sufficient tax liability to claim them could sell them to corporations that could make use of them. None of the states has adopted this approach.

The lack of tax liability among many employers significantly limits the ability of these credits to act as an incentive. More states could adopt such mechanisms as carry-back and carry-forward provisions or refundability, but the evidence does not suggest that these mechanisms increase utilization.

2. Other Considerations May Outweigh Tax Advantages in Employers' Decisions About the Provision of Child Care Assistance

Serious questions have been raised about the extent to which it is possible for tax credits to influence employer behavior. Treasury Secretary Paul O'Neill, for example, has asserted that business tax measures have limited ability to have such influence. During his confirmation hearing he stated, "As a businessman I never made an investment decision based on the tax code. If you give money away I will take it, but good business people don't do things because of inducements."¹¹⁰

The entire idea of offering a financial incentive in the form of a credit is based on the assumption that an employer's decision about whether to provide child care is largely driven by the ability to secure a tax advantage. But many other factors play a role in the decision. If employers are convinced that providing child care assistance to their employees makes good business sense—because of improved recruitment, retention and performance of their workers, or for other reasons—they will provide the assistance even in the absence of a credit. At the same time, employers who are reluctant to offer child care assistance may be motivated by other considerations. Employers interviewed for this report outlined some of these considerations. Some employers believe that it is inequitable to offer a benefit that serves only some employees (those with child care needs) or that because of the demographics of their workforce, few employees would use a child care benefit. Others prefer to make their offices "family-friendly" in other ways, such as by offering flex-time and telecommuting. Some employers think that the risk of legal liability associated with providing child care assistance of any form makes providing such assistance untenable. Other concerns may also be present. For example, employers may view child care as an inappropriate area for employer involvement, or worry they may offend employees who view child care as an individual responsibility. Others may be unwilling to commit resources and personnel to the task of learning about and administering an entirely new benefit. If an employer has decided that child care is not a benefit that it would like to extend to its employees based on some or all of these factors, then a tax credit is likely to have little influence on that employer.

¹¹⁰ Mortimer Caplin, *Now is the Time to Reform the Tax Code*, The Wall Street Journal, February 7, 2001, at A26 (quoting Treasury Secretary Paul O'Neill).

Tax credits may have limited ability to influence the behavior of employers because such a large percentage lack sufficient tax liability to take advantage of the credits and because other factors concerning the provision of child care assistance may be more important to employer decisions than tax advantages. These limitations, and the relative failure of mechanisms states have used to address them, suggest that the low utilization of the credits results from a fundamental problem with a tax incentive strategy, not with design and implementation features within the states' control.

C. Tax Credits Are Not Well Suited to Address the Quality or Affordability of Care

The evidence suggests that employer tax credits have not been effective in expanding the supply of child care, and it may be that tax strategies cannot be successful in this regard. They suffer from another defect as well: the credits are not well suited to address the quality or affordability of care.

Increasing quality and affordability are important goals of child care policy. High-quality child care has been shown to contribute to children's healthy development and education,¹¹¹ and to allow parents to be more successful in the labor force.¹¹² Yet most care in the United States today is not of high quality; it often fails to provide developmentally appropriate activities, and in the most egregious cases, endangers children's health and safety.¹¹³ Furthermore, for many families, paying for child care can be prohibitively expensive, though it is often a necessary prerequisite of entering the paid workforce, retaining employment and obtaining better jobs. For families that do obtain child care, the associated costs can be their second greatest expense¹¹⁴ and can consume over 20 percent of their income.¹¹⁵ It is important, then, that not only the supply but also the quality and affordability of child care be improved.

Rarely do employer tax credits for child care address child care quality. Only two of the state credits examined in this report include provisions to encourage the child care assistance provided by employers to be of high quality, beyond requiring that the child care financed through the credit meet licensing and certification requirements. Arkansas requires accreditation by the state Department of Education. Oklahoma requires that the child care subsidized by the tax credit be accredited by a national organization.

Some of the credits support child care assistance—such as vouchers—that directly lower parents' child care costs. But most have no mechanism to ensure that the government subsidy provided for other forms of child care assistance, such as the construction of a child care facility, will result in lower costs to parents. Of the states analyzed in this report, only two seek to make child care more affordable for families who have the most difficulty paying for the care they need. Maryland structures its credit to encourage employers to give child care assistance to

¹¹¹ See Ellen Peisner-Feinberg et al., *The Children of the Cost, Quality, and Outcomes Study Go to School, Executive Summary* (1999); National Institute of Child Health and Human Development Early Child Care Research Network, *The Relation of Child Care to Cognitive and Language Development*, 71:4 *Child Development* 960 (2000).

¹¹² See Deborah Lowe Vandell & Barbara Wolfe, U.S. Dep't of Health and Human Services, *Child Care Quality: Does it Matter and Does it Need to Be Improved?* 35-37 (2000).

¹¹³ See S.W. Helburn et al., *Cost, Quality, and Child Outcomes in Child Care Centers, Public Report 1*, 26-29 (2d ed. 1995).

¹¹⁴ See Bureau of the Census, U.S. Dep't of Commerce, *Statistical Abstract of the United States: 2000* Table 731 (2001), available at <http://www.census.gov/prod/2001pubs/statab/sec14.pdf>.

¹¹⁵ According to Census Bureau data, in 1997 families spent on average between five and 23 percent of their income on child care, depending on income level. Lower-income families spend a higher fraction of their income on child care than higher-income families do. See Bureau of the Census, U.S. Dep't of Commerce, *Current Population Reports No. P70-86, Who's Minding the Kids? Child Care Arrangements: Spring 1997* Table 8 (July 2002), available at <http://www.census.gov/prod/2002pubs/p70-86.pdf>.

low-income employees. The Maryland credit applies only to child care expenditures on state residents who are former recipients of cash assistance under the federal-state Temporary Assistance for Needy Families (TANF) program or the state Family Investment Program, or who have disabilities. Connecticut, which requires businesses to submit an application to receive its credit, gives priority to employers whose programs target low-income employees.

Credits could be structured to have strict requirements for quality, to give priority or greater assistance to low-wage employees, or to require employers to address the differential ability of parents to pay for child care. However, placing more restrictions on the credits might make fewer employers eligible for the credits and therefore reduce their ability to increase the supply of child care.¹¹⁶ Utilization could be further depressed because employers are reluctant to ask questions of their employees about the quality of care provided to their children or their family income. Also, the process of determining which employees could receive assistance might prove so cumbersome administratively that employers would decide that offering child care assistance is not worth their while. For example, an effective income-targeting requirement would require an employer to consider an employee's family income rather than only the employee's wages so that assistance is not wrongly provided to a low-wage employee married to a high-wage individual. For all these reasons, the credits may not be well suited to address the quality or affordability of child care.

D. Ineffective Credits Can Create a Windfall for Some Employers and Crowd Out Other Vital Spending

In general, if tax credits are an ineffective catalyst for change, employers receive a tax benefit for child care assistance they would have provided even in the absence of a credit. The credit is not effective in increasing the supply of care and the tax assistance provided is a windfall to those who receive it.¹¹⁷ In addition, an ineffective but over-funded credit can crowd out funding for other urgent child care needs.

The latter concern is very real. The spending projections for the state employer tax credits have sometimes been quite large and often have reflected considerable overestimates of the revenue that would be expended through the credit. In three of the 20 states examined, information is available about both the initial cost estimates made and the amount actually expended. Florida, Maryland and Montana each predicted over \$2 million in annual expenditures through the credit. These estimates were substantially off the mark: actual expenditures were \$187,000 in Florida, \$400 in Maryland and \$11,000 in Montana.¹¹⁸ Actual utilization data are not available for four other states that provided initial cost estimates: Maine, Nebraska, New Jersey and Texas. With the exception of Maine, each state predicted over \$1 million in annual expendi-

¹¹⁶ For example, the Oklahoma credit, which requires national accreditation, had no claimants. Only three percent of child care centers in Oklahoma are nationally accredited. Francyne Wharton, Philadelphia Citizens for Children and Youth, NAEYC Accredited Centers Compared to Regulated Centers, June 26, 2001 (unpublished table, on file with National Women's Law Center). Three of the four credits with requirements regarding quality or affordability (Arkansas, Maryland and Oklahoma) had few if any claimants, suggesting that such requirements may indeed depress utilization. However, other states without such requirements have also had low utilization. Other factors, such as the small size or narrow scope of these credits, could also contribute to their low utilization. Because so few credits have quality or income-targeting requirements, it is difficult to assess the effect these requirements have on utilization.

¹¹⁷ Although lessons from economic development tax incentives restricted to new investments are beyond the scope of this study, the success or failure of these efforts might provide guidance on whether this type of tax credit can have the intended effect of increasing the supply of care.

¹¹⁸ These figures refer to spending through the corporate income tax. Maryland and Montana also allow the credit to be claimed through the personal income tax and provide data about these claims. The cost estimates are still off the mark when total expenditures are considered. Maryland spent \$96,000 and Montana spent \$36,000 when both corporate and personal income tax expenditures are considered.

tures and Texas predicted about \$5 million annually.¹¹⁹ Given the utilization experience in other states, it seems likely that these are overly optimistic estimates.

Such overestimates are problematic in that the projected expenditures allocated to these credits become unavailable for other spending goals, including spending to otherwise increase the supply of care or meet other urgent child care needs such as improving affordability and quality of care. In other words, the slice of the spending pie that is allocated to employer tax credits—even if it is never consumed because employers are not claiming the credits—is unavailable for other needy programs and policies. This is particularly unfortunate in a time of budget shortfalls and scarce public dollars.

The analysis in this section suggests that although it may be possible to improve the design and implementation of the credits (e.g., by strengthening marketing efforts), it is not clear that doing so will result in higher utilization. Fundamental limitations of a tax incentive approach may be more relevant to the performance of these credits: a large portion of employers lack sufficient tax liability to take full advantage of and therefore be influenced by these credits, and factors other than tax advantage may play important roles in employers' decisions regarding the provision of child care assistance. Other concerns about these credits include their difficulty in addressing such issues as quality and affordability. Unless and until they are utilized to a far greater degree, they will continue to crowd out resources for other, more effective forms of child care assistance.

¹¹⁹ When the Maine credit was established in 1998, the legislature predicted \$37,000 in annual expenditures.

IV. IMPLICATIONS OF THE NEW FEDERAL CREDIT

In June 2001, as part of the Economic Growth and Tax Relief Reconciliation Act (EGTRRA), Congress enacted into law the first federal employer tax credit for child care.¹²⁰ Beginning in tax year 2002, EGTRRA gives employers a 25 percent credit for the costs of acquiring, constructing, rehabilitating, or expanding a child care facility, the costs of operating a child care facility, or the costs of contracting with a third-party child care provider; in addition, it gives employers a 10 percent credit for the costs of providing resource and referral services to employees. The total credit has an annual limit of \$150,000 in tax assistance per employer.

Many of the problems with state-level credits discussed in the previous section may apply to the federal credit, resulting in similarly low utilization. It is possible, however, that some of the unique properties of a federal-level credit will render it more successful than its state-level counterparts. In addition, the combined value of the federal and state credits may provide a larger financial incentive for more employers to provide child care assistance to their employees than either credit does acting alone.

A. Comparison of the State and Federal Credits

The federal credit, like many of its state-level counterparts, is not particularly strong, with limitations in size, scope and reach. The credit rate of 25 percent for most expenses is no bigger than the rate of most state credits and the rate of 10 percent for the costs of resource and referral services is smaller than most state credit rates. In addition, the federal credit, like most state credits, limits the amount of tax assistance that any employer can claim—although the \$150,000 limit is higher than most existing state credit limits. As discussed in earlier sections, placing limits on the amount that can be claimed diminishes the ability of the credit to act as an incentive, because when an employer's expenses would result in a higher credit than is allowed by the limit, the percentage of its expenses reimbursed by the credit is lower than the stated credit rate. With respect to the credit's scope, it covers a broad range of expenses, but not the full array covered by some states. In terms of reach, the federal credit is available to all for-profit employers with federal tax liability but excludes government agencies and non-profit organizations.

The federal credit is vulnerable to some of the other deficiencies of the state credits as well. Poor marketing and a lack of understanding of the credit could depress its utilization. Employers may be uncertain about the future availability of the credit both since it can be repealed at any time and since it contains a sunset provision.¹²¹ In addition, the federal credit may not be able to motivate employers any more than the state credits if businesses generally do not make decisions based on tax credits and if other factors play a significant role in employer decisions regarding child care assistance. And, like most state credits, the federal credit does not directly address the affordability of care, nor does it ensure that the child care provided is of high quality.

Most importantly, as at the state level, a substantial portion of federal corporate filers will be unable to take advantage of the credit because they lack sufficient tax liability. In 1997, the most recent year for which data are available, 60 percent of corporate filers owed no federal

¹²⁰ See *supra* note 9.

¹²¹ The federal credit became effective in tax year 2002 and will expire after tax year 2010. This nine-year period places the federal credit in the middle range of the state credits with sunset provisions. See *supra* note 95.

income tax.¹²² Less than two percent owed at least \$150,000 in federal income taxes, the amount of liability required to take full advantage of the federal credit.¹²³ While only a tiny fraction of corporations could take full advantage of the federal credit, the absolute number of corporations with this level of tax liability is still rather substantial: 40,810 owed at least \$150,000 in income taxes. Thus, as with the situation in the states, there is the potential for a relatively large number of corporations to claim the credit, but the credit's ability to act as an incentive is hampered by its exclusion of corporations lacking sufficient tax liability.¹²⁴

As a result, the federal credit could produce the same "crowding out" effect as state credits, by consuming a budget allocation that ends up unused but is nonetheless unavailable for spending on other important child care policies. The U.S. Congress's Joint Committee on Taxation estimates that in its first year, the new federal credit will cost \$48 million,¹²⁵ several times larger than all current spending on state tax credits combined. It remains to be seen whether the credit will be utilized to a degree that supports these projections, though the experience with state credits certainly raises some questions about whether it will. If the credit is not heavily utilized in a particular year, its budget allocation will not be spent and could have been better used to fund other critical child care priorities. The Child Care and Development Block Grant, for example, which is the largest federal direct spending program for child care, is currently funded at a level that enables it to serve only one in seven eligible children;¹²⁶ an increase in its funding could have a direct impact on the number of children it serves.

These similarities between the federal and state credits suggest that the federal credit may have no more success than the state credits have had. But it is possible that the federal credit will be better utilized than the state credits for two reasons. First, more employers are likely to have federal tax liability than state tax liability against which to apply a credit, and their federal tax liability is likely to be larger than their state tax liability. Second, employers are likely to find it easier to take advantage of a federal credit than one or more state credits.

The federal government collects much more in corporate taxes than state governments do. In 1999, the most recent year for which data are available, state corporate income taxes generated \$30.8 billion dollars for the states,¹²⁷ while the federal corporate income tax generated \$216.3 billion.¹²⁸ This disparity means either that more corporations pay federal taxes than state taxes, that federal tax liability is higher than state tax liability for many corporations, or that both are true.¹²⁹

¹²² National Women's Law Center calculations based on data provided in an August 29, 2001 telephone conversation with staff of the Internal Revenue Service and Internal Revenue Service, U.S. Dep't of Treasury, 1997, *Corporation Income Tax Returns Table 22: Number of Returns and Selected Tax Items, by Size of Total Income Tax After Credits (2000)*, available at <http://www.irs.gov/taxstats/display/0,,i1%3D40%26genericId%3D16841,00.html> (choose 97coalcr.exe).

¹²³ See *id.*

¹²⁴ The federal credit has a provision allowing both carry-backs and carry-forwards, which may ameliorate this effect for some employers.

¹²⁵ See Joint Committee on Taxation, 107th Cong., *Estimated Budget Effects of the Conference Agreement for H.R. 1836, Fiscal Years 2001-2011* (Comm. Print JCS-51-01, 2001). In each subsequent year the credit is projected to result in expenditures of more than \$100 million.

¹²⁶ See *supra* note 2.

¹²⁷ See Bureau of the Census, U.S. Dep't of Commerce, *State Government Finances: 1999* (July 2001), available at <http://www.census.gov/govs/state/99statess.xls>.

¹²⁸ See Internal Revenue Service, U.S. Dep't of Treasury, *2000 Internal Revenue Service Data Book*, Publication 55B, Table 7: Internal Revenue Gross Collections, by Type of Tax, Fiscal Years 1971-2000, available at <http://www.irs.gov/pub/irs-soi/00db07co.xls>.

¹²⁹ What is known is that federal marginal tax rates are higher than state marginal tax rates. Corporations face a marginal tax rate of between 15 and 39 percent at the federal level, See Internal Revenue Service, U.S. Dep't of Treasury, *2001 Instructions for Forms 1120 and 1120-A, Tax Rate Schedule 17*, available at http://www.irs.gov/pub/irs-pdf/i1120_ay.pdf, while marginal tax rates for corporations in the states range from one percent in Alaska and Arkansas to 12 percent in Iowa, See Federation of Tax Administrators, *Range of State Corporate Income Tax Rates*, available at http://www.taxadmin.org/fta/rate/corp_inc.html.

In addition, it may be easier logistically, especially for multi-state employers, to take advantage of a federal credit than one or more state credits. For example, given that many employers owe more in federal than in state taxes, they may pay more attention to opportunities to minimize their federal tax liability. Also, it is easier for a corporation to report aggregate child care expenses than it is to break down the figures by state and it is easier to learn one set of federal criteria and requirements than it is to keep track of varying state requirements. Without a federal-level credit, a multi-state company may be willing to offer assistance only in those states that offer a credit. Perhaps wishing to avoid disparities in employee benefits based on geographic location, it may not offer child care assistance at all. With a federal-level credit, the company may have more of a financial incentive to develop a company-wide child care benefit that spans more than one state in which it operates.

B. Value of the Federal and State Credits Considered Together

The combination of the new federal credit and existing state credits will increase the percentage of child care expenses a company in a state with a credit can recuperate and could therefore result in more claimants at both the federal and state levels. Table 5 presents information about what percentage of eligible expenses four hypothetical corporations, each with a different level of spending on construction of a child care facility, could expect to recover under two sample state credits, the federal credit and the combination of the state and federal credits, depending on their level of spending.

TABLE 5:

Percent of Eligible Child Care Expenses Covered by Two State Credits, the Federal Credit and the Combined Federal and State Credits

Credit	Eligible child care expenses			
	Company A \$100,000	Company B \$250,000	Company C \$500,000	Company D \$1,000,000
Mississippi (50%, no limit)	33%	33%	33%	33%
Rhode Island (30%, \$30,000 limit)	20%	8%	4%	2%
Federal (25%, \$150,000 limit)	25%	25%	25%	15%
Total, Mississippi + Federal	58%	58%	58%	48%
Total, Rhode Island + Federal	45%	33%	29%	17%

Calculations assume a federal marginal tax rate of 34 percent, one that is in the middle of the range of corporate marginal tax rates. The percentage of child care expenses covered by the Mississippi and Rhode Island credits takes into account the increase in federal tax liability that occurs as a result of claiming the state tax credit. *See supra* p. 14. Using a higher marginal tax rate would result in the net value of the state credits (once the effect on federal taxes is considered) being lower than appears in this table. Using a lower marginal tax rate would result in the net value of the state credits being higher.

If these employers were to claim only the Mississippi credit of 50 percent of eligible expenses, which has no limitation on the amount that can be claimed, they would each recuperate one-third of their eligible expenses, no matter the amount of spending. (They would receive less than 50 percent of their expenses through the credit because of the interaction between state and federal tax liability.¹³⁰) Mississippi has a relatively generous credit; Rhode Island's credit is more typical of the amount available under existing state credits: 30 percent of eligible expenses, up to a limit of \$30,000. The combination of the Rhode Island credit's limitation on the total amount that an employer can claim and the interaction between federal and state tax liability diminishes the value of that state's credit. Employers who spend \$250,000 on eligible child care expenses would recuperate only eight percent of their expenses and employers who spend \$1 million would recuperate only two percent by claiming the Rhode Island credit.

¹³⁰ *See discussion supra* p. 14.

If these employers were to claim only the federal credit equal to 25 percent of construction, operating and contracting expenses, with a limit of \$150,000, those with less than \$600,000 of eligible expenses would recuperate 25 percent of eligible expenses. As the amount of eligible expenses increases over \$600,000, the percentage of expenses the federal credit would offset declines. With expenses of \$1 million, employers would recuperate only 15 percent of expenses by claiming the federal credit.

The combined effects of a federal and state credit would be greater than the effect of either considered alone. The combination of the Mississippi credit with the federal credit would cover up to 58 percent of eligible expenses, but due to the limit of the federal credit, the percentage of eligible expenses covered declines as expenses increase. With \$1 million in expenses, the combined Mississippi and federal credits would cover 48 percent of expenses.

The Rhode Island credit combined with the federal credit would cover as much as 45 percent of expenses if an employer had \$100,000 in eligible child care spending. The percentage of eligible expenses covered declines as expenses increase. With \$1 million in expenses, the state and federal credits would cover only 17 percent of expenses.

These examples suggest that the combined value of the federal and state credits will provide employers with a larger offset of their expenses than claiming either the state credit or the federal credit alone. The combined value of the credits may provide an incentive for more employers to provide child care assistance, possibly resulting in increased utilization of both the federal and state credits.¹³¹ In some instances, however, the increase will be modest and may therefore have little effect. And, of course, employers in the states without credits will only be able to claim the federal credit. Finally, the ability of these credits to act as an incentive, alone or in concert, is hindered by the fact that many employers, including the majority of corporate filers, have insufficient state or federal tax liability (or both) to take full advantage of the credits.

As the federal and state credits acting together begin to offset a significant portion of eligible expenses, the question is raised, as it was with the state credits, whether the credits are leveraging sufficient private investment to justify the expenditure of government funds. If the credits in combination come close to offsetting all of the employer's expenses, the government is effectively paying for the child care assistance provided by the employer.¹³² It may then be more efficient to provide government funding directly to providers, parents, resource and referral agencies or others to increase the supply—and potentially the affordability and quality—of child care.

A full evaluation of the new federal credit will have to await the collection of data about its utilization. Since the federal credit is substantially similar to the existing state credits, many of the concerns raised about the state credits will be the same for the federal credit and it is possible that the federal credit will be no more effective than the state credits. However, the federal credit could be more attractive to employers than the state credits alone since federal tax liability is higher than state liability for many employers and since it will be logistically easier for employers to claim the federal credit than multiple state credits. In addition, the combined

¹³¹ Also, as employers learn of the federal credit, they may be prompted to explore similar options at the state level, thereby potentially increasing utilization of the state credits.

¹³² If a state credit were large enough, the combined value of the existing federal credit and allowable federal deductions with the state credit and allowable state deductions could actually exceed the value of an employer's investment in child care assistance. *Cf. supra* note 90. For simplicity's sake and to isolate the effect of the tax credits, this report considers only the value of the tax credits without considering the value of allowable deductions.

value of the federal and state credits could be much higher than the value of either by itself. While the combination could create more of an incentive for employers to provide child care assistance and claim the credits, this incentive will be limited by many employers' lack of tax liability, whether state, federal, or both. The potential for the combination of the federal and state credits to offset a large portion of an employer's child care expenses also raises the question whether the substantial amount of government expenditures on the credits might be more effectively and efficiently spent on direct government funding of child care.

V. ALTERNATIVE MODELS FOR ENCOURAGING PRIVATE INVESTMENT IN CHILD CARE

A few states have developed models for encouraging private investment in child care that may be more effective than employer tax credits.¹³³ Colorado provides a tax credit to any taxpayers making qualifying contributions to child care. Florida has a similar non-tax-based mechanism: a program in which qualifying contributions to child care are matched dollar for dollar by the state. In 2001 Oregon enacted a unique credit for taxpayers making a contribution to child care in the state: investors receive a dollar in tax benefits for every dollar they contribute. A preliminary review of the limited utilization data available suggests that these mechanisms may be promising alternatives to employer tax credits. However, a more thorough analysis will be needed to answer questions raised by these approaches as well.

A. Colorado's Contribution Credit

Colorado has a child care contribution credit available to any individual or corporation that makes a monetary contribution to promote child care in Colorado. Among other eligible donations, a contribution to a child care provider (whether incorporated, as either a non-profit or for-profit corporation, or not incorporated) qualifies for the credit if the contribution is made for the acquisition or improvement of child care facilities, equipment or services, including the improvement of staff salaries, staff training or quality of child care. The credit is equal to 50 percent of the contribution, and is limited to \$100,000. The credit is not available to donors who receive 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. 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."¹³⁴ Some form of this credit has been available since 1989.

Data on the utilization of the current version of Colorado's credit are not available. Data are available for a similar credit that is more restricted in size and scope, equal to only 25 percent of donations that promote child care in an enterprise zone, up to \$100,000.¹³⁵ This smaller, more restricted credit was nevertheless claimed by about 1,300 taxpayers in 1998, resulting in a state expenditure of more than \$700,000. Colorado'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 per donor.¹³⁶

A drawback to this type of credit is that individual donations spread among many child care providers are unlikely to produce enough revenue to permit significant improvements in the child care system. Even if each Colorado claimant gave \$2,000 to only one entity, unless many

¹³³ For statutory citations to the provisions discussed in this section, see Appendix A.

¹³⁴ Taxpayer Service Division, Colorado Dep't of Revenue, *FYI Income 35: Child Care Contribution Credit 1* (March 1999).

¹³⁵ See Colo. Rev. Stat. Ann. § 39-30-103.5(1)(a)(II) (2001).

¹³⁶ The actual average donor 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.

claimants contributed to the same entity the amounts contributed are unlikely to be sufficient to lead to large-scale improvements.¹³⁷

B. Florida's Child Care Executive Partnership Program

In 1996 Florida established the Child Care Executive Partnership (CCEP) program to encourage investment in child care for low-income working families. This investment must be in the form of contributions to the CCEP, which can be earmarked specifically for an employer's own low-income families or distributed more generally to other low-income families. The program defines "low-income" as families earning below 200 percent of the poverty line. For every dollar an employer, foundation or local government provides, the state will match it using funds from the federal Child Care and Development Block Grant, subject to a limit set each year by the state.

In fiscal year 2001, nearly 100 businesses participated in the CCEP.¹³⁸ Contributions of \$4.5 million by these businesses were matched by \$4.5 million in government money, yielding a \$9 million fund for child care assistance.¹³⁹

C. Oregon's Corporate Child Care Tax Credit

In 2001 the Oregon legislature authorized a five-year pilot program, effective for tax year 2002, to encourage private investment in child care. 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. Investors can purchase the credits at face value: a one dollar contribution buys a one dollar tax credit.

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 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 certain, as yet undetermined, percentage of each family's income. The funds used to market these credits to investors and administer the program will come out of the money raised for child care.

¹³⁷ In 1999, Maine adopted a "quality child care investment credit," effective for tax year 2001, which at first blush appears similar to the Colorado contribution credit. The statutory language permits any "investor" to claim a credit against taxes equal to a percentage of the investment in "quality child care." Although this language seems broad, the Maine Revenue Services issued a "Guidance on Child Care Investment Credit" that has defined "investor" as a "taxpayer operating a child care facility." Accordingly, the only individuals or entities that may claim the credit are those that operate a child care facility. See Me. Rev. Stat. Ann. tit. 36, § 5219-Q (2000). Utilization data are not yet available for the Maine credit.

¹³⁸ See e-mail communications with Phyllis Kalifeh, President, Florida Children's Forum, (June 24, 2002) (on file with National Women's Law Center). About 10 non-profit and public entities, representing the United Way, local Children's Services Councils, and city and county government agencies, also participated. *Id.*

¹³⁹ See *id.* In addition, \$10.5 million was contributed by the United Way, local Children's Services Councils, and city and county government agencies and matched with \$10.5 million in government money. *Id.* All together, \$15 million in Child Care Executive Partnership contributions was matched by \$15 million in government money, yielding a \$30 million fund for child care assistance. *Id.*

Proponents of this credit intended for it to model the federal low-income housing tax credit (LIHTC)¹⁴⁰ by giving investors a financial return on the investments they make in child care.¹⁴¹ However, because the Oregon Attorney General interpreted the statute to prevent the credits from being sold for less than face value, further legislative action will be necessary for the program to be implemented as intended.¹⁴² In the proposed amended version, the return would occur by allowing investors to receive more in tax credits than they contribute to child care.¹⁴³ Investors would bid for the credits, with the \$500,000 allocated to those with the highest bids.¹⁴⁴

D. Comparison of These Mechanisms to Employer Tax Credits for Child Care

These mechanisms offer some advantages over employer tax credits. For example, the reach of these programs is much broader. Employer tax credits for child care are generally available only to a limited pool of potential claimants, namely, for-profit businesses with tax liability who provide child care assistance to their employees. In contrast, the mechanisms in Colorado and Oregon are available to any taxpayer, and the Florida program is available to all employers, local governments and foundations. In addition, since the Florida program is a matching program instead of a credit, its benefits are available even to those with no tax liability. All these mechanisms, then, have a broader reach than employer tax credits for child care and therefore could be expected to be more effective at attracting contributors.

Another advantage of these mechanisms over employer tax credits for child care is that they require less on the part of claimants. Participants in these alternative programs need do nothing more than make a qualifying contribution. In contrast, businesses claiming employer tax credits for child care must commit to administering a child care benefit for their employees, which could require a multi-year investment and commitment. Because of this difference, the alternative mechanisms may not need to be as strong as employer tax credits to be effective. Thus, although with the exception of the new Oregon credit none of these mechanisms is appreciably stronger than several of the employer tax credits, these alternative mechanisms may have more success than employer tax credits in attracting claimants.

Finally, one advantage of the Florida and Oregon programs, which the Colorado credit could incorporate, is the pooling of resources at the state or regional level. This aggregation of contributions allows these states to have more control over how the assistance is distributed. Florida and Oregon have both chosen to use this control to direct assistance to low-income families. States could also decide to use the fund to support the development of high-quality care, which Oregon has done to some extent.

Some of the same problems facing employer tax credits for child care could hamper these alternative programs, however. For example, these mechanisms will not be successful if potential claimants are not informed of their availability. In addition, these mechanisms are similar to employer tax credits in that they are based on the assumption that providing a tax incentive is enough to affect decisions regarding the provision of child care assistance. To the extent that

¹⁴⁰ 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. See I.R.C. § 42 (2001).

¹⁴¹ Telephone interviews with Rebecca Shine, Shine Consulting and formerly of The Enterprise Foundation, May and June 2002.

¹⁴² *Id.*

¹⁴³ *Id.*

¹⁴⁴ *Id.*

other factors are more important than tax advantage, these mechanisms may find no more success. The “crowding out” concern applies here too: if these programs prove less successful than legislators anticipate, they could consume budget allocations that would have been better spent on other child care investments. Finally, the Oregon credit in particular raises the question of whether a direct spending program would be a more efficient way to address child care: in Oregon, the state will pay 100 percent—and if amended as intended would pay even more—of any new child care spending generated through this program, leveraging no private investment.

Utilization data are available for the Florida program and a credit similar to the Colorado credit, but not yet for the Oregon credit. The information available suggests that the Florida program and the Colorado credit may be more successful at attracting participants and leveraging private spending than the state employer tax credits. The Florida program and the Colorado credit resulted in \$4.5 million and \$2.8 million in private spending, respectively, considerably more than the amount leveraged by most of the state employer tax credits for child care.¹⁴⁵ However, without more detailed utilization information from both these programs and the state employer tax credits, it is impossible to perform a direct comparison and reach firm conclusions about the relative efficacy of these approaches.

Although sufficient data are not currently available to permit a thorough evaluation of these models, it will be important to monitor their progress to determine if their ways of encouraging private investment in child care are preferable to the ways in which employer tax credits have attempted to encourage such investment.

¹⁴⁵ See *supra* Table 4, which estimates private spending by corporate claimants. When expenditures through both corporate and personal income tax returns are considered, the estimate for one state demonstrates more private spending than the Florida and Colorado programs: California leveraged a total of \$9.3 million in private spending.

VI. CONCLUSION: THE LITTLE ENGINE THAT HASN'T

Although tax credits for employers that offer child care assistance to their employees have become increasingly popular with policy makers and have been enacted in over half the states, they are not proving effective in practice. Available data on the utilization of the state credits show that few employers are taking advantage of them, which suggests that they are not having a significant impact on the supply of child care. It is unclear whether the new federal credit will be any more effective.

Several of the design and implementation features of the state credits could be improved in an attempt to increase the ability of these credits to influence employers and thereby increase the supply of child care. The credits could be strengthened. Employers could be better educated about the credits. Uncertainties about the ability to claim the credits could be reduced by modifying caps on state expenditures or by eliminating sunset provisions, although statutes can always be repealed. But, with the possible exception of improved marketing efforts, none of these features has affected the utilization of these credits.

A significant problem facing tax-based strategies is the lack of state tax liability among a substantial proportion of employers. In addition, the ability of tax credits to influence the behavior of employers may be limited due to the greater influence of factors other than tax advantage. Tax credits may be ill-suited to address such issues as quality and affordability of child care, and overly large tax credits may result in the government spending leveraging little if any private investment in child care. In the end, the resources allocated for these credits may go unused, reducing the amount of money available for other, more effective forms of child care assistance.

Since the federal credit is substantially similar to existing state credits, many of the concerns raised about the state credits are similar for the federal credit and the federal credit may have no more success than the state credits have had. However, the federal credit could be more attractive to employers than the state credits since federal tax liability is higher for many employers and since it will be logistically easier, especially for multi-state employers, to claim the federal credit than multiple state credits. In addition, the combined value of the federal and state credits could be high enough to attract more claimants than the state credits alone. However, the ability of these credits to act as an incentive, alone or in concert, is hindered by the fact that many employers, including the majority of corporate filers, lack either state or federal tax liability (or both) and therefore cannot take full advantage of the credits. If at some point the combination of the two credits gives employers as much as or more in tax benefits than they invest in child care, the government is effectively paying for the child care assistance. It may then be more efficient to provide government funding directly to providers, parents, resource and referral agencies or others to increase the supply—and potentially the affordability and quality—of child care.

A fuller evaluation of the new federal credit will have to await the collection of data about its utilization. The experience with state employer tax credits for child care should also continue to be monitored. Additional data are needed to analyze fully the impact of the credits. At the very least, each state, and now the federal government as well, should collect and make available data on the utilization of and expenditures on the credits. In addition, information about the

number of employers providing child care assistance in each state and the type of care provided would be valuable in evaluating the effect of the credits on the supply of care. Future research on this topic should build from this descriptive analysis by determining whether a regression analysis and a longitudinal analysis could shed more light on the factors affecting the utilization of these credits. Periodic state and federal evaluations to assess whether the credits are having their intended effect would also be valuable.

As discussions progress about establishing new credits or revising existing ones, the limitations of employer tax credits for child care need to be recognized and understood. If policy makers decide to proceed with these credits, they should use reasonable cost estimates so as not to unnecessarily crowd out spending on other programs, ensure that the credits leverage a sufficient amount of private investment, and set aside resources to inform employers about the credit and the requirements for claiming it.

Finally, the financing strategies adopted by Colorado, Florida and Oregon may be promising alternatives to employer tax credits for child care. For example, the pooling of resources, as in the Florida and Oregon programs, may allow for large-scale projects and the targeting of assistance to improve quality as well as to support families most in need. The limited data available for a few of these strategies suggest that they may have the potential to attract greater interest than employer tax credits. But a more thorough investigation of these alternative mechanisms once more data are available is needed before the efficacy of these mechanisms can be assessed and compared to the performance of employer tax credits for child care.

APPENDIX A

Statutory Citations

I. Statutory Citations for the 20 State Employer Tax Credits Analyzed in this Report^a

Arizona	Ariz. Rev. Stat. §§ 43-1075, 43-1163 (2001) (effective tax years 1991-1994).
Arkansas	Ark. Code Ann. §§ 26-51-507, 26-51-508, 26-52-516, 26-53-132 (2001) (effective beginning tax year 1995).
California	Cal. Rev. & Tax Code §§ 17052.17.5, 17052.18 (2002) (effective beginning tax year 1995); Cal. Rev. & Tax Code §§ 17052.17, 23617 (2002) (effective beginning tax year 1998).
Connecticut	Conn. Gen. Stat. §§ 17b-740, 17b-741 (1997) (effective tax years 1990-1997); current version codified at Conn. Gen. Stat. §§ 17b-740, 17b-741 (2001).
Florida	Fla. Stat. §§ 220.19, 624.5107 (2001) (effective beginning tax year 1999).
Georgia	Ga. Code Ann. § 48-7-40.6 (1998) (effective tax years 1994-1999); current version codified at Ga. Code Ann. § 48-7-40.6 (2001).
Illinois	35 Ill. Comp. Stat. 5/210 (2001) (effective beginning tax year 1995).
Kansas	Kan. Stat. Ann. § 79-32,190 (2001) (effective beginning tax year 1989).
Maine	Me. Rev. Stat. Ann. tit. 36, §§ 2524, 5217 (1999) (effective tax years 1988-2000); current version codified at Me. Rev. Stat. Ann. tit. 36, §§ 2524, 5217 (2001).
Maryland	Md. Ann. Code art. 88A, § 54 (2001) (effective beginning tax year 1995); Md. Code Ann., Ins. §§ 6-105.1, 6-115 (2001) (effective beginning tax year 1995); Md. Code Ann., Educ. § 21-309 (2001) (effective beginning tax year 1995); Md. Code Ann., Tax-Gen. §§ 10-704.3, 8-213, 8-410, 8-216, 8-413 (2001) (effective beginning tax year 1995).
Mississippi	Miss. Code Ann. § 57-73-23 (2001) (effective beginning tax year 1991).
Montana	Mont. Code Ann. §§ 15-31-131, 15-30-186 (1999) (effective tax years 1990-2000); current version codified at Mont. Code Ann. §§ 15-31-131, 15-30-186 (2001).
New Mexico	N.M. Stat. Ann. § 7-2A-14 (2001) (effective beginning tax year 1983).

^a Five states (Connecticut, Georgia, Maine, Montana and Oklahoma) have enacted newer versions of their employer tax credits than the ones analyzed in this report. Data for these current tax provisions are not available. Because of this absence of data, the report relies on data for the older versions of the credits in these five states. For these states, the citations to the versions of the credits analyzed in this report are listed first, followed by the citations to the current versions of the credits.

Ohio	Ohio Rev. Code Ann. §§ 5733.36, 5733.37, 5733.38, 5747.34, 5747.35, 5747.36 (2002) (effective beginning tax year 1999); Ohio Rev. Code Ann. §§ 5747.34, 5747.35, 5747.36 (2002) (effective beginning tax year 1997).
Oklahoma	Okla. Stat. tit. 68, § 2357.26 (2002) (effective tax years 1999-2001); current version codified at 2001 Okla. Sess. Laws 1256.
Oregon	Or. Rev. Stat. §§ 315.204, 315.208 (2001) (effective beginning tax year 1988).
Rhode Island	R.I. Gen. Laws § 42-12-23 (2001) (effective beginning tax year 1988).
South Carolina	S.C. Code Ann. § 12-6-3440 (2001), originally codified at S.C. Code Ann. § 12-7-1260 (1989) (effective beginning tax year 1989).
Tennessee	Tenn. Code Ann. §§ 67-4-808, 67-4-908 (2001) (effective beginning tax year 1994).
Virginia	Va. Code Ann. § 58.1-439.4 (2002) (effective beginning tax year 1997).

II. Statutory Citations for Employer Tax Credits for Which Utilization Data Are Not Available

Colorado	Colo. Rev. Stat. § 39-22-517 (2001) (effective beginning tax year 1992); Colo. Rev. Stat. § 39-22-521 (2001) (effective beginning tax year 1997).
Michigan	Mich. Comp. Laws § 208.39a (1991) (effective tax years 1981 and 1982).
Nebraska	Neb. Rev. Stat. § 77-27, 222 (2002) (effective beginning tax year 2003).
Nevada	Nev. Rev. Stat. § 364A.140 (2001) (effective beginning tax year 2001).
New Jersey	1999 N.J. Laws 102; 1999 N.J. Laws 108 (effective tax years 1999-2001).
Ohio	Ohio Rev. Code Ann. § 5709.65 (2002) (effective beginning tax year 1981).
Pennsylvania	Pa. Stat. Ann. tit. 62, § 491 (2002) (effective beginning tax year 1982).
Texas	Tex. Tax Code Ann. §§ 171.701 - 171.707 (2002) (effective beginning tax year 2002).
Wisconsin	Wis. Stat. Ann. § 71.07(2dd) (1999) (effective tax years 1995-1997).

III. Statutory Citations for Alternative Models for Encouraging Private Investment in Child Care

Colorado	Colo. Rev. Stat. Ann. § 39-22-121 (2001) (effective beginning tax year 2000).
Florida	Fla. Stat. Ann. § 409.178 (1999) (effective beginning tax year 1996).
Oregon	2001 Or. Laws Ch. 674 (H.B. 2676) (effective beginning tax year 2002).

APPENDIX B

Summary of the Provisions of the 20 Employer Tax Credits for Child Care Analyzed in this Report

State	Start-up/ Construction Costs	Operating Costs	Purchasing Costs	Costs of Subsidies and Vouchers	Resource and Referral Costs	Costs for Care for Particular Employees	Limits on Size of Credits
Arizona ^a	50%	30%	30%	30%	30%		\$15,000 for start-up/ construction costs; \$5,000 for other costs; total not to exceed \$15,000
Arkansas	\$5,000 credit (regardless of costs) for first year employer provides a child care facility	3.9% of the annual salary of employees engaged exclusively in providing child care in employer- provided facility					\$5,000 for start-up/ construction costs
California	30%	30%	30%	30%	30%		\$50,000 for start-up/ construction costs and resource and referral costs; \$360 per child for operating costs, purchasing costs, and subsidy and voucher costs
Connecticut ^b	40%			50%			\$20,000 for start-up/ construction costs; preference given to employers whose programs target low-income employees; total state amount expended on credits for all employers limited to \$2 million
Florida	50%	\$50 per month per child served	50%				\$50,000; total state amount expended on credits for all employers limited to \$2 million
Georgia ^c		50%					50% of tax liability
Illinois	5%, limited to businesses primarily engaged in manufacturing	5%, limited to businesses primarily engaged in manufacturing					

^a This credit was repealed effective tax year 1995.

^b This credit was repealed effective tax year 1998 and was replaced by a new credit not analyzed in this report because no data are available.

^c This credit was amended in 1999, effective in 2000. The amended version is not analyzed in this report because no data are available.

Summary of the Provisions of the 20 Employer Tax Credits for Child Care Analyzed in this Report, continued

State	Start-up/ Construction Costs	Operating Costs	Purchasing Costs	Costs of Subsidies and Vouchers	Resource and Referral Costs	Costs for Care for Particular Employees	Limits on Size of Credits
Kansas	50% in first year of facility's operation	50% in first year of facility's operation; 30% after the first year of facility's operation	30%	30%	30%		\$45,000 for start-up/construction costs and operating costs in the first year; \$30,000 for operating costs (after first year), purchasing costs, subsidy and voucher costs, and resource and referral costs; total state amount expended on credits for all employers limited to \$3 million; refundable
Maine ^d	20%	20%	20%	20%	20%		lesser of \$5,000 total or \$100 per enrolled child
Maryland						100% of child care expenses for employees with disabilities or former recipients of TANF or the state Family Investment Program during the first two years of employment	up to \$600 per employee during first year of employment, \$500 during second year
Mississippi ^e	50%	50%	50%	50%	50%		
Montana ^f	20%	20%	20%	20%	20%		\$1,250 per employee
New Mexico		30%	30%	30%			\$30,000
Ohio	50% in the first year		50%	50%			\$100,000 for start-up/construction costs; \$750 per child for purchasing and subsidy and voucher costs
Oklahoma ^g	20% of expenditures to provide nationally accredited care	20% of expenditures to provide nationally accredited care	20% of expenditures to provide nationally accredited care	20% of expenditures to provide nationally accredited care	20% of expenditures to provide nationally accredited care		No credit allowed for expenses for which an employee takes a deduction, credit or exemption

^d This credit was amended in 2000, effective in 2001. The amended version is not analyzed in this report because no data are available.

^e Employers may also claim the credit for any expenses which increase the quality, availability and affordability of care in the community used by employees during the employee's work hours.

^f This credit was amended in 2000, effective in 2001. The amended version is not analyzed in this report because no data are available.

^g This credit was amended in 2002, effective in 2002. The amended version is not analyzed in this report because no data are available.

Summary of the Provisions of the 20 Employer Tax Credits for Child Care Analyzed in this Report, continued

State	Start-up/ Construction Costs	Operating Costs	Purchasing Costs	Costs of Subsidies and Vouchers	Resource and Referral Costs	Costs for Care for Particular Employees	Limits on Size of Credits
Oregon	50% allotted over ten years	50%	50%	50%	50%		\$2,500 per employee for start-up/ construction costs, limited to \$100,000 total; \$2,500 per employee for operating, purchasing, and subsidy and voucher costs
Rhode Island	30%	30%	30%	30%			\$30,000, but credit cannot reduce tax liability below \$250
South Carolina	50%	50%	50%	50%			\$100,000 for start-up/ construction and purchasing costs; \$3,000 per participating employee for operating costs and subsidies; total cannot exceed 50% of tax liability
Tennessee	25%						\$25,000 per facility; \$100,000 total
Virginia	25%						\$25,000; total state amount expended on credits for all employers limited to \$100,000

APPENDIX C

State Agency Personnel Who Provided the State Tax Data Collected for this Report

Arizona:

Elaine Smith
Office of Economic Research
Department of Revenue

Arkansas:

Joe C. Ellis
Corporation Income Tax Section
Department of Finance & Administration

California:

Dawn Poxon
Receiving Section
Franchise Tax Board

George Ramsey
Statistical Research Section
Franchise Tax Board

Colorado:

Janet Archebeck
Office of Tax Analysis
Department of Revenue

Connecticut:

Michael Galliher
Research Unit
Department of Revenue Services

Florida:

Holger Ciupalo
Office of Research and Analysis
Department of Revenue

Christian Weiss
Office of Research and Analysis
Department of Revenue

Georgia:

Anthony Jackson
Income Tax Division
Department of Revenue

Ed Manny
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Department of Revenue

Illinois:

Debbie Best
Communications Office
Department of Revenue

Phil Mannheim
Research Division
Department of Revenue

Kansas:

Kathleen Smith
Office of Policy and Research
Department of Revenue

Maine:

Debra Bartlett
Income Tax Division
Revenue Services

Deb Castle
Income Tax Division
Revenue Services

Maryland:

Carol Novella
Board of Revenue Estimates
Comptroller's Office

Mississippi:

Ben Bishoff
Revenue Office
Tax Commission

Montana:

Shona McHugh
Compliance, Valuation and Resolution
Department of Revenue

Nebraska:

Jim Bogatz
Legal Services
Department of Revenue

Dave Dearmont
Research Division
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Pamela Forster
*Eastern Housing
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 Division of Taxation*

Richard Kaluzny
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Allen Maury
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Amy Brown
*Research Section
 Department of Revenue*

Greg Kramer
*Research Section
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 Department of Revenue*

Kathleen Ross
*Bureau of Research
 Department of Revenue*

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 Comptroller's Office*

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Judith Curtis Waldron
*Office of Fiscal Research
 Department of Taxation*

APPENDIX D

Individuals Interviewed for this Report

Kim Allred

AmGen

Craig Anderson

Security Benefit Group

Sheila Bair

Richard Behan

Marriott International, Inc.

Amanda Blagman

New Jersey Community Loan Fund

Helen Blank

Children's Defense Fund

Judy David Bloomfield

One Small Step

Victoria Bok

Child Care Capital Investment Fund

Terry Bond

Families and Work Institute

Richard Brandon

Human Services Policy Center, University of Washington

Roger Brown

Bright Horizons Family Solutions

David Brunori

State Tax Notes

Sandra Burud

Drucker School of Management and School of Education, Claremont Graduate University

Duncan Chaplin

Urban Institute

Abby Cohen

Child care law and policy consultant

Jonathan Dotson

Bright Horizons Family Solutions

Sharon Deich

The Finance Project

Leadell Ediger

Kansas Association of Child Care Resource and Referral Agencies

Carol Eickert

AFL-CIO

Peter Esteve

Abbott Laboratories

Michael Ettlinger

Citizens for Tax Justice (now at Economic Policy Institute)

Elizabeth Evans

Illinois Facilities Fund

Patricia Fields

Lucent Technologies (now at P&P Planning Professionals)

Dana Friedman

Bright Horizons Family Solutions

Amy Gillman

Local Initiatives Support Corporation

Stacie Goffin

National Association for the Education of Young Children

Karen Gorton

Metro Child Care Resource and Referral

Cathy Grace

Lee County Families First (now at Early Childhood Institute, Mississippi State University)

Gassia Gujral*Exalt Work-Life Programs, Bank of America***Sandra Hackley***Interfaith Community Services***Janet Hansen***Committee for Economic Development***Donna Hefner***Florida Children's Forum***September Jarrett***Child Care Facilities Fund of Low Income
Housing Fund***Clifford Johnson***Institute for Youth, Education and Families,
National League of Cities***Gil Johnson***Policy Management Assistance Corporation
(now at Computer Sciences Corporation)***Christine Johnson-Staub***Associated Early Care and Education, Inc.***Dale Johnson***Abbott Laboratories***Phyllis Kalifeh***Florida Children's Forum***Donna Klein***Marriott International, Inc.***Nancy Kolben***Child Care, Inc.***Dave Lissy***Bright Horizons Family Solutions***Joan Lombardi***The Children's Project***Patricia Magnuson***The Enterprise Foundation***Elizabeth McNichol***Center on Budget and Policy Priorities***Linda Mills***Mills Consulting Group, Inc.***Anne Mitchell***Early Childhood Policy Research***Mary Nemmers***Oregon Child Care Resource and Referral
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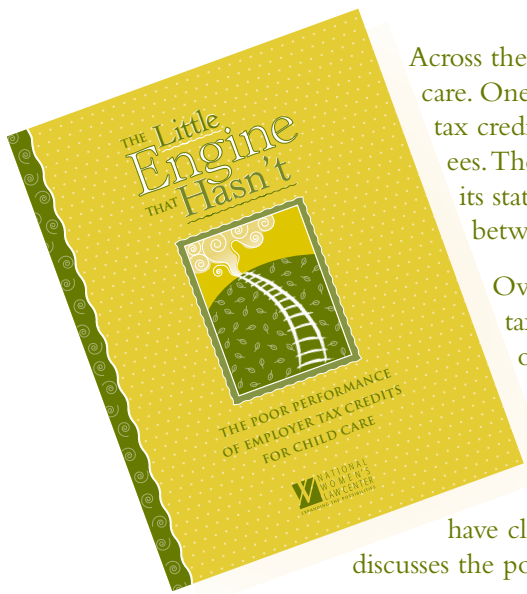
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The Little Engine That Hasn't: The Poor Performance of Employer Tax Credits for Child Care



Across the United States today, there is an acute shortage of high-quality, affordable child care. One approach to addressing these needs has become popular with state policy makers: tax credits for employers that provide some form of child care assistance to their employees. These credits permit an employer to offset part of its child care expenditures against its state tax liability, thus in effect splitting the costs of providing child care benefits between the employer and the state.

Over half the states and the federal government have enacted some form of employer tax credit for child care. The policy makers who have led the charge for enactment of these measures clearly have had the best intentions and the highest hopes, but is this wave of enthusiasm for employer tax credits for child care justified? Using available data about the utilization of the credits and interviews with child care advocates, tax experts and employers across the country, this report takes a hard look at employer tax credits for child care. The report finds that few employers have claimed these credits, assesses why these credits have had such a limited impact and discusses the policy implications. It is an invaluable resource for policy makers and advocates alike.

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