

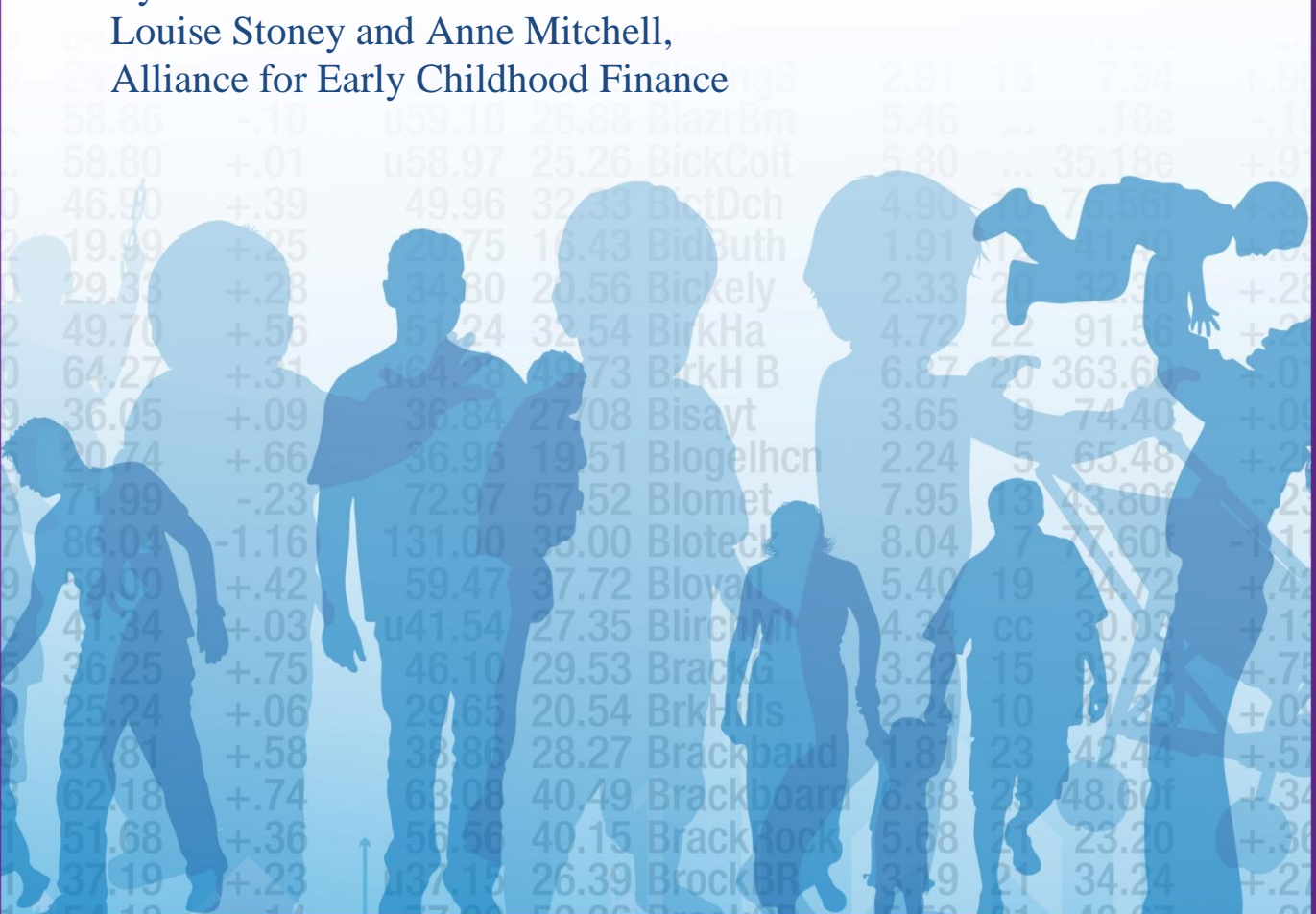


Issue Paper #2



# Using Tax Credits to Promote High Quality Early Care and Education Services

By  
Louise Stoney and Anne Mitchell,  
Alliance for Early Childhood Finance



We are grateful to Gene Steuerle, PhD of the Urban Institute; Geoff Nagle, PhD of Tulane University; and Mark H. Greenberg, J.D. of the Center for American Progress for reviewing earlier drafts. Their comments enriched and improved this paper. The views expressed are those of the authors and not necessarily those of the reviewers, the authors' organizations, or The Pew Charitable Trusts.

**The Partnership for America's Economic Success** was created by a group of business leaders, economists, advocates, and a dozen funders in order to document the economic impacts to the nation of proven investments in children from before birth to age five. Funders include the Buffet Early Childhood Fund; Robert Dugger; George Gund Foundation; Horace Hagedorn Foundation; Paul Tudor Jones; Ohio Children's Foundation; Peppercorn Foundation; The Pew Charitable Trusts; PNC Financial Services Group, Inc.; Scholastic, Inc.; The Schott Foundation for Public Education; and Anonymous. The Partnership is managed by The Pew Charitable Trusts.

1025 F Street, NW, Suite 900 Washington, DC 20004  
(202) 552-2000 [www.PartnershipforSuccess.org](http://www.PartnershipforSuccess.org)

*Release Date: November 20, 2007*

## **Contents**

Introduction	4
Background	7
Types of Tax Credits	11
Lessons Learned	18
Conclusion	23
References	24
Appendix A	29

## Introduction

America's long-term economic success depends on ensuring that children – the next generation of citizens – succeed in school and life (Heckman & Masterov, 2004). Advances in neuroscience underscore that young children learn from the earliest moments of life, and that learning is especially rapid in their first five years. The accumulated evidence from evaluations of high quality early education programs tells us children in those programs advance in intellectual, social and emotional competence in the short term, do better academically (in both reading and math) and socially in school, and generally live more productive lives as adults than children who have no preschool education or who have poor early educational experiences (Shore, 1997; Shonkoff & Phillips, 2000; Brown & Scott-Little, 2003; Rolnick & Grunewald, 2003; Lynch, 2004; Gilliam & Zigler, 2004; Barnett & Ackerman, 2006).

Research suggests that many kinds of programs for young children have the potential to provide good early education, i.e., to promote social, emotional, intellectual, and physical development and learning (NICHD Early Child Care Research Network 2005; Marshall et al. 2003, Kontos, et al. 1995). However, many young children do not have opportunities to experience good early childhood education (ECE) for two key reasons. First, many of the early care and education programs and services available to families do not meet accepted standards of quality (Vandell & Wolfe, 2002; Helburn & Bergmann, 2002.) Second, the cost of high-quality early care and education exceeds the price most families are willing or able to pay (Pearce, 2006; Helburn & Bergmann, 2002).

### Early Care and Education is a Market-Based Service

ECE is essentially a market-driven service: providers offer services for a price; consumers choose among those services and pay the price. Most early care and education services are delivered by the private sector – in for-profit, nonprofit and faith-based center-based programs as well as thousands of home-based businesses. By and large, the only public agencies providing early care and education are public schools that primarily offer part-day classes for preschoolers; these classrooms represent a small fraction – probably less than 6% – of total ECE services.<sup>1</sup>

ECE is essentially a market-driven system: providers offer services for a price; consumers choose among those services and pay the price.

Current estimates suggest that the private sector early care and education industry includes over 300,000 regulated establishments – 120,000 centers and 214,000 home-based businesses – that serve nearly 10 million children every day (Center for the Child Care Workforce, 2002; National Association for Regulatory Administration and the National Child Care Information and Technical Assistance Center, 2006). Most of these businesses

---

<sup>1</sup> The National Institute for Early Education Research reports that in 2006 state pre-kindergarten programs served 942,766 children and a third of these children were served outside the public schools. Assuming the ECE industry serves 10 million children the 628,510 enrolled in school-based pre-K represent slightly more than 6% of the total.

-- since the majority are home-based -- are proprietary (U.S. Census, 2002; Casper and O'Connell, 1998) and the center-based ones are generally quite small. The average child care center has the capacity to serve fewer than 70 children and more than 80% of all early care and education businesses employ 20 or fewer workers.<sup>2</sup>

Early care and education is a special market sector because it serves both public and private needs (Warner et al, 2004). As a private good, it enables parents to work. As a public good, it prepares children for school, enhances the productivity of our educational system, and helps strengthen our future workforce. But the public good aspect of ECE services is vulnerable to market forces, which are focused on short-term factors such as price and convenience, rather than the long-term benefits of quality early education. And children, the primary beneficiaries of ECE, have no consumer voice in the child care marketplace. All of these factors work at cross purposes with what is needed to support the long-term health of our economy—high-quality ECE services (Stoney, Mitchell and Warner, 2006).

Current expenditures for early care and education services can be grouped into three broad categories – the family contribution, government assistance (including all tax and expenditure-based subsidies from federal, state and local governments), and private sector support (including employers and philanthropy). While current data on the percent in each category are not available, a study conducted in 1995 revealed that the largest share of early care and education revenues, about 60%, is contributed by consumers, about 39% is government assistance and less than 1% comes from the private sector (Mitchell, Stoney and Dichter, 2001).<sup>3</sup> Efforts to update these numbers suggest that, over the past decade, the percentage of revenues derived from family contributions has declined slightly, the percentage derived from government contributions has risen slightly (mainly as a result of welfare reform and expansion of state-funded pre-kindergarten) and private philanthropic contributions have also increased. Still, family contributions are by far the largest ECE revenue source. A reasonable estimate of the total annual expenditure by consumers is \$46 billion based on information from the US Census Bureau (Stoney, Mitchell and Warner, 2006). By comparison, current state expenditures for pre-kindergarten -- which is the fastest growing ECE public revenue source -- total about \$3 billion nationally.

Unlike other U.S. educational institutions such as colleges or private schools, most ECE businesses rely solely on tuition revenue. The average child care center generates 87% of its revenue from parent tuition, while the average institution of higher education generates only 35% from tuition and fees (Mitchell, Stoney & Dichter, 2001). Public support (child care subsidy) is mainly in the form of fees paid on behalf of children in low-income eligible families and typically paid only when an eligible child is in attendance. While

---

<sup>2</sup> The industry has a paid workforce of 2.3 million, with slightly more than half (52%) working in regulated firms. Paid jobs in the child care services industry sector, which includes both child care and preschool, are projected to grow 38 percent over the 2004–2014 period, compared with the 14 percent employment growth projected for all industries combined (Bureau of Labor Statistics, 2006).

<sup>3</sup> These data should not be interpreted to mean that 60% of every dollar spent on ECE comes from consumers, but rather that 60% of overall revenues in the ECE system are derived from user fees. On average, low-income families receive a higher percentage of government subsidy and therefore contribute a lower percentage of fee income than do families with higher incomes.

there are a few third-party sources that provide direct operating support – such as Head Start grants, state pre-kindergarten initiatives, or employer grants – these sources represent a relatively small percentage of total ECE expenditures in the US.<sup>4</sup> Thus, to remain economically viable, early care and education programs must set fees high enough to cover costs, maintain full enrollment, and collect fees (or publicly funded vouchers in lieu of fees) in full and on time. This makes programs especially vulnerable to market conditions.

Economists at Cornell University (Warner et al., 2004; Warner, 2006) have described early care and education as an "underdeveloped market" for several reasons, which include:

*Lack of effective demand from consumers for high quality services.* Child care is expensive. The average price for full-time services in a center for a preschooler is more than public college tuition in all states (NACCRRA, 2007). Yet families have years to save for college expenses and are often at the peak of their earning potential when children enter college; ECE costs, on the other hand, must be paid when parents are young and typically have limited savings and wages.

*Low profitability because labor expenses are high due to high staff/child ratios and small classes necessary for high-quality services.* Labor costs constitute the majority of expenses in early childhood programs (60-80%).

*Few economies of scale.* Early care and education is largely composed of very small businesses, reducing opportunities for cost savings that are possible on a larger scale.

*Insufficient product differentiation.* It is extremely difficult both for consumers to get objective information on the quality of ECE services and for programs that offer high-quality services to distinguish themselves in the market.

Carefully crafted market-based finance and policy strategies that reach a broad range of families and ECE providers can help address some of the market challenges noted above. The Quality Rating and Improvement Systems (QRIS) that are operating in 14 states and being developed in many more are one example. A QRIS is an organized way to assess, improve and communicate the quality of early care and education programs that families might consider for their children. An intervention like QRIS can affect early care and education markets in several ways. First, it creates an industry-wide standard for *quality assurance*. Second, it offers a framework for *supply side interventions* e.g. supports for program improvement, technical assistance to programs, professional development for personnel, and financial incentives for providers to seek and maintain higher quality. Third, it offers a framework for *demand side interventions* e.g. easy to understand publicly available ratings that show the relative quality of different programs and financial incentives for consumers to choose higher quality.

---

<sup>4</sup> Head Start was funded at \$6.7 billion for FY 2007; state-funded pre-kindergarten was \$3 billion for 2005-06. Together they represent almost \$10 billion annually.



This paper explores the feasibility of using another market intervention: tax credits, linked to quality/accountability measures like a QRIS, to help promote, and perhaps partially finance, higher quality early care and education services. Tax credits and deductions in other fields will be examined, with an eye to identifying tax policies that offer lessons for ECE. While the principles described in this paper apply to both federal and state tax policy, most of the examples we use are state tax credits – simply because that is where most policy innovation has occurred. States play a key role in policy and finance. While much attention is focused on federal taxes, state taxes have been growing steadily since World War II and now represent about one-third of total tax receipts (Steuerle, 2004).

This paper explores the feasibility of using a market intervention--tax credits, linked to quality and accountability measures like a QRIS--to help promote and finance higher quality early care and education services.

This paper focuses on one, market-based financing strategy: tax credits. The authors' primary interest is in exploring the extent to which tax credits can help encourage the use of high-quality ECE. These credits may also help to offset the cost of ECE and, in that respect, are part of the overall ECE financing system. However, the reader should not mistake our focus to imply that tax credits alone are a sufficient financial support for early care and education. They are not. The Alliance for Early Childhood Finance has written extensively about a broad approach to ECE policy and finance, one that includes a range of public and private investments in institutions, infrastructure, practitioners and families. The Alliance approach is structured around five key principles: 1) systemic reform; 2) universal access; 3) improved quality, with clear performance indicators to measure accountability; 4) respect for the social and economic value of children and the families who raise them; and 5) increased public investments and leadership to secure these investments (Stoney, Mitchell and Warner, 2006). To demonstrate that it is entirely possible to craft and finance an ECE system that embodies these principles, the Alliance has developed a concrete proposal and national policy agenda, which is available at [www.earlychildhoodfinance.org](http://www.earlychildhoodfinance.org).

## Background

Using the tax system to promote high quality ECE and partially finance early care and education might appear to be an unusual approach. Yet there are several reasons to consider it. These include the following:

### Saliency

Tax policy essentially defines American values and touches nearly every American. Taxes influence how citizens consume, work, save and invest. Policymakers often turn to the tax code when they seek to fundamentally change the economy or society's behavior (Steuerle,

Lessons from other fields suggest that to be effective, tax policy must be designed to augment and coordinate with – but not replace – existing direct subsidies. Tax credits alone are not likely to produce the results we desire for children.

2004). Even if a tax provision does not result in immediate or significant financial gains for consumers or producers, the action of creating a tax benefit increases the visibility of a product or practice and validates its value. By itself, this raises interest in the product and helps to reduce skepticism about new ideas or technologies (Brown et al, 2002). Thus, policy that embeds the development and use of high-quality early care and education into our tax code sends a powerful message: ensuring that children have access to high-quality early learning matters. Early care and education advocates have long agreed that public engagement is a key part of the agenda. Embedding ECE policy in the tax code is a potentially powerful way to engage the public.

## **Stability**

If our goal is to ensure that all children in America have access to high-quality early care and education, stable and consistent policy and funding that reinforces that value is needed. Currently, most public funding for early care and education services is found on the expenditure side of the budget. These expenditures must be re-appropriated each year, and funding limits typically prevent most eligible families from receiving assistance. Significant amounts of time, energy (and sometimes money) are spent on advocacy campaigns to ensure that these funds are included in state and federal budgets. It is almost always a tough fight; families and early care and education businesses are never confident that the government funding they receive will continue. Tax policy offers increased stability. Tax credits and deductions are available to all eligible families and typically remain in effect unless they are repealed. In some states a two-thirds majority vote is required to repeal a tax policy.

## **Equity**

How resources are distributed in an economy is a complex issue in tax policy. Horizontal equity, the principle that those with equal ability to pay should pay equal taxes, is almost universally accepted. Vertical equity (progressivity) is the principle that those who are more capable of contributing should contribute more and those with greater needs should receive more. In reality, taxpayers with little or no resources cannot be expected to pay an equal share of costs; thus, tax policy can be used to help redistribute resources. Individual equity refers to the principle that individuals should benefit from their own labor and savings and is often used to justify greater choice among a range of options. For example, higher education tax credits, which may be used at any school, are often viewed as improving individual equity since they provide greater choice for the same or similar benefits (Steuerle, 2004.) Based on these definitions, well-crafted ECE tax credits that are refundable, broadly available, and linked to quality measures could help to promote equitable choices.

## **Efficiency**

Expending public funds directly for early care and education typically requires a fairly sophisticated administrative infrastructure in federal, state and local government. While this infrastructure can play a role in ensuring quality and accountability as well as collecting data for accountability and planning, it is also costly. Each time a new initiative



or funding stream is added by government, a system for administering these funds must be developed (e.g. a request for proposals or allocation formula must be developed, staff assigned to negotiate/monitor contracts or establish rates and process reimbursement, and so forth). In the ideal world, this administration would be streamlined and all funds would flow through a common infrastructure. In the real world, multiple bureaucracies and funding structures are all too often the norm.

Allocating funds via the tax system affords the opportunity to use an already existing infrastructure to administer resources. Indeed, the Internal Revenue Service (IRS) is uniquely qualified to administer a universal, income-related, market-based benefit such as ECE financial incentives. The IRS currently maintains wage data, and does so for families at all income levels. Even low-income working families that do not owe income taxes file returns to claim the Earned Income Tax Credit (Burman et al, 2005.) And unlike a direct assistance program administered by the Department of Social Services, a tax benefit administered by the IRS has no 'welfare stigma' nor does it require completion of an often lengthy and complex application form or interview with a caseworker (that may conflict with hours of work.) Adams, Snyder and Sandfort (2002) have documented that these barriers often prevent eligible families from applying for or receiving the child care benefits to which they are entitled.

However, the IRS does not have the capacity to track or verify program quality--a drawback if our goal is to ensure that financial incentives are linked to effective programs. However, states are rapidly developing new industry-wide systems and infrastructure to support ECE program quality, ensure accountability and maintain data. The Quality Rating and Improvement Systems noted earlier are one example. ECE practitioner registries, that include information on the training and educational qualifications attained by early care and education teachers and staff, are another example. These systems could be linked, through automation, to tax claims. Automated links would not only simplify administration but also offer clear incentives for government to establish and maintain an industry-wide infrastructure that effectively measures quality in all ECE settings.

### **Flexibility**

There are many ways that families care for and educate their children. As noted earlier, the early care and education market is diverse and families choose from a wide array of center- and home-based services. Administering funds via the tax system not only allows families to choose the services that best meet their needs but, if strategically linked to quality standards, offers an economic incentive to select high-quality services. High-quality early care and education services are expensive. Since third party funding is scarce, most high-quality ECE programs must pass these increased costs on to consumers through higher fees.

A 'merit good' is a product or service that has benefits beyond its direct purchaser. Generally these are benefits to society as a whole. High quality ECE is a merit good because it prepares children to succeed in school and life, enhances the productivity of our current work force, and contributes directly to growth in jobs and income.

Structuring ECE tax credits so that they provide larger tax benefits for higher quality services recognizes this price difference. In other words, carefully crafted tax credits could function as a market-based strategy to reinforce a merit good. The "green" tax credits that have been established by many states – to encourage consumers to purchase and/or install energy-efficient appliances or equipment – are an example of this approach and will be discussed in more detail later in this paper.

### **Caution: Tax Credits Have Serious Limitations**

Despite the strengths noted above, tax strategies have many limitations. Tax policy is often complex, and can require a fair amount of sophistication to understand and use. Effective tax strategies generally require an industry infrastructure and/or marketing capacity that is currently not present in early care and education. Without carefully crafted limitations, tax credits will provide greater benefits to higher income families. And tax credits often generate only small sums. These barriers can be overcome, but they must be carefully considered and addressed. To this end, there are clearly some circumstances in which a tax credit strategy might not be appropriate.

#### *Cash Flow Limitations*

Tax credits are based on the assumption that the tax payer spends money to achieve the desired goal and then claims a credit to reimburse those expenses. That said, cash flow is an essential ingredient. No matter how generous the tax credit, if recipients of the credit -- a family, an early childhood teacher or an ECE business -- do not have the required up-front funding, they will be unable to benefit from the credit. In some cases it may be possible to resolve this problem through advance payment, loans or other strategies to improve cash flow. But in many cases direct government expenditures is simply a more appropriate approach. For example, without access to a government subsidized program and/or a child care voucher -- at least as the primary form of subsidy -- low-income families are unlikely to use high-quality early care and education. And some families -- such as those with health or mental health problems, a history of child abuse or drug problems -- need targeted supports and/or counseling in order to make appropriate child care decisions.

#### *Refundability*

Tax credits will not benefit low-income families, who often owe little or no income taxes, unless the credit is refundable. Currently the federal Child and Dependent Care Tax Credit is not refundable; most benefits accrue to higher-income families. This is a serious barrier and one that needs to be addressed (see page 12 for suggested revisions to the federal CDCTC.) Nine states have made their state child care tax credits fully or partially refundable.

## Outreach and Tax Assistance

Effectively implementing tax credits that are linked to quality measures will require targeted outreach. Families, as well as ECE practitioners and programs, need to understand the tax benefits and how to apply for them. And many families and ECE businesses will need assistance in completing and filing tax returns in order to take advantage of the credits.

## Infrastructure

Effectively linking a child care tax credit to quality measures will require an infrastructure that allows the tax department to readily identify eligible taxpayers and track compliance with quality standards. It is entirely possible to adapt existing infrastructure -- such as ECE professional development registries and quality rating systems -- to achieve this end. But the task requires careful thought.

In sum, there are compelling reasons to strategically include tax credits as one element in the package of financial support for families and the early care and education industry. If combined with government subsidy for low-income families and direct supports for early childhood programs, tax credits can help provide an additional market incentive for higher quality ECE. Tax credits alone will not produce the results we desire for young children. They are one potential strategy for ECE finance, but should not be the only one. Lessons from other fields suggest that to be effective, tax policy must be designed to augment and help to coordinate – but not replace – existing direct subsidies.

## Types of Tax Credits

This paper is based on a review of state and federal tax policies that target early care and education as well as tax policy that has been used in other fields such as energy, housing, business investment, research and development. Ideally tax policy is deemed effective when it has been evaluated to determine that it is producing the desired effects on behavior or outcomes or other results. While most of these policies have not been evaluated they nevertheless offer some helpful lessons to the field of early care and education.<sup>5</sup> We will focus on four types of tax credits, including those for: consumption,

### Tax Credits vs. Tax Deductions

In general, a *tax credit* is more valuable to a taxpayer than a *tax deduction* of the same amount. A tax credit reduces the taxes paid, dollar-for-dollar. A tax deduction lowers taxable income. For example, for a taxpayer in the 35-percent tax bracket, the value of a \$100 tax deduction is 35 percent (\$35). But the value of the same amount as a tax credit is 100 percent (\$100). Further, a deduction is worth more to a taxpayer in a higher tax bracket than to one in a lower tax bracket. And a credit isn't worth anything to a taxpayer who owes no tax unless the credit is *refundable*.

<sup>5</sup> Note: the purpose of this inquiry was to identify tax policies that have the potential to affect consumer and practitioner behavior and/or offer innovative ways to administer public dollars. Indeed, some of the tax policies identified by the

business investment, charitable contributions, and job development. Each of these strategies will be discussed in more detail below.

## Consumer Tax Credits

A consumer tax credit is a direct reduction in the tax liability of an individual who purchases (consumes) a particular product or service. Consumer tax credits can function as a market-based strategy to reinforce a merit good – an approach that has been used to promote renewable energy technologies such as solar, wind, biomass, geothermal, and hydropower. Most small-scale renewable energy technologies, although they make an important contribution to the environment, are still substantially more expensive on a dollars-per-watt basis than conventional sources. To help address this market inequity, the federal government, along with many states, has created tax credits and other incentive programs for renewable energy. These credits are not new – some date back to the 1970s and early 1980s – and some were quite generous. In the past, combined tax credits of 50 percent or more were available for solar energy technologies. Currently thirteen states<sup>6</sup> offer consumer tax incentives for renewable energy. Credits range from 10% to 35% of equipment and installation costs. Maximum incentive amounts range from \$1,000 to \$10,500 for residential systems. Most tax credits must be claimed in the first year of production, allowing for any remaining credit to be carried over to the subsequent five, and in a few cases, ten years (Gouchoe et al, 2002).

Energy credits offer helpful lessons to the field of early care and education because they are designed to achieve similar ends; they are a flexible, market-based strategy to reinforce a merit good. Research and evaluation of these policies suggests that well-crafted credits can help level the market playing field.

Consumer tax credits are also used in early care and education, although they are subject to income caps and rarely linked to quality measures. The federal tax code, as well as 23 states, currently includes a credit for tax filers with employment-related child and dependent care expenses.<sup>7</sup> The federal child and dependent care tax credit (CDCTC) applies to care and education provided in any legal setting,<sup>8</sup> regardless of program quality.

A *'refundable'* tax credit is one that is available to a taxpayer who owes no taxes. For example, a taxpayer who is eligible for a *tax credit* worth \$500 and who owes only \$100 in taxes can only claim \$100 of the credit. If the same tax credit were *refundable*, the taxpayer could claim the full \$500.

---

authors meet these criteria but may also support programs or activities that have not been evaluated or proven to effective. A basic assumption of this paper, however, is that ECE *program quality* will be measured by, and linked to, a QRIS or other research-based accountability tool. That said, an innovative or effective strategy for *administering funds* still offers promise.

<sup>6</sup> These states include: Alabama, Arkansas, California, Hawaii, Iowa, Maryland, Massachusetts, Montana, New York, North Carolina, North Dakota, Rhode Island and Vermont. Most credits cover solar and wind technologies; a few consider biomass and hydro as eligible technologies. For more information, go to <http://www.nrel.gov/docs/fy02osti/32819.pdf>.

<sup>7</sup> A more in-depth discussion, as well as detailed information on each state benefit, is available from the National Women's Law Center, at <http://www.nwlc.org/details.cfm?id=2698&section=tax>.

<sup>8</sup> Tax filers are required to include the social security number, or employer ID, of the child care provider when claiming the expense.

Size of the credit varies. Low-income families (gross incomes below \$15,000) may claim up to 35% of what is spent and those with higher incomes (over \$43,000) may claim up to 20%. Allowable expenses are limited to \$3,000 for one child and \$6,000 for two or more. Theoretically, low-income families with more than one child can receive a maximum credit of \$2,100 – but only if they actually spend \$6,000 on child care. Since it is highly unlikely that anyone making \$15,000 a year could spend \$6,000 on child care, the maximum credit is purely hypothetical. In fact, a single parent earning \$15,000 and spending \$1,200 on child care would get a whopping \$86 (the total tax she owes). And given that the current federal CDCTC is not refundable, many potentially eligible families are unlikely to benefit from the credit at all since they probably do not owe any taxes. Higher income families – who are likely to spend more than \$6,000 per year on child care – get a lower percentage credit because of the expense caps yet a higher dollar amount because they owe more taxes. In reality, the average federal CDCTC claim is currently about \$500. Families with adjusted gross incomes below \$20,000 receive about \$275 annually and families with adjusted gross incomes over \$500,000 receive about \$530 annually (Mitchell & Stoney, 2006; Burman, Maag and Rohaly, 2005).

Many states link their child care tax provisions to some or all of the provisions of the federal CDCTC. However, quite a few states have significantly improved upon the federal CDCTC in two ways: by making the credit refundable (in other words, families receive the financial benefit even if it exceeds the amount of taxes they owe) and by linking the credit to program quality. Thirteen states<sup>9</sup> have credits that are either fully or partially refundable. Three states – Maine, Vermont and Arkansas – have made higher tax credits available to families who use higher quality child care. Maine doubles the credit (from 21.5% to 43% of the federal CDCTC) for taxpayers who use an early childhood program that has a Quality Certificate.<sup>10</sup> Vermont allows a higher credit (from 24% to 50%) if the program meets national accreditation or credential standards.<sup>11</sup>

In addition to making the CDCTC refundable so that it has value to low-income families and linking it to program quality so that children benefit, two other changes would increase its effectiveness. These are raising the expense limits to match the actual price of child care and indexing those limits for inflation so their value does not erode over time.

Louisiana recently enacted a package of school readiness tax credits that are designed to encourage the use of higher quality early care and education services. The package includes an increased, refundable tax credit for families with a child under six enrolled in an early care and education program that participates in the state's quality rating system. Maximum credits for one child would range from \$263 for a child enrolled in a two star program to \$1,050 for a child enrolled in a five-star program. The tax credit package also

---

<sup>9</sup> In nine states— California, Colorado, Hawaii, Iowa, Minnesota, New Mexico, New York, Oregon, and Vermont — the credit is fully refundable. In four states — Arkansas, Louisiana, Maine, and Nebraska — the credits are partially refundable (Campbell et al, 2006).

<sup>10</sup> For more information on Maine's tax credit, and quality certificates, go to <http://www.maine.gov/dhhs/occhs/taxcredits.htm>.

<sup>11</sup> Campbell et al, 2006, p 48. For additional information on Vermont's tax credit go to <http://www.state.vt.us/tax/creditslowincome.shtml>.



includes incentives for programs and businesses to participate in the quality rating system and for ECE teachers to attain higher levels of education and training. See Appendix A for more information on Louisiana's new law.

### **Business Investment Tax Credits**

A business investment tax credit is a direct reduction in the tax liability of a sole proprietor or corporation to offset cost of investing in the business. The federal tax code currently allows businesses to exclude all (or a portion of) business-related expenses such as labor costs, office expenses, equipment used in a trade or business, and so forth. Thus, for all intents and purposes, most business investments are already tax-deductible. However, some business expenses are afforded higher value – in the form of a tax credit.

Federal and state governments have used targeted tax credits to stimulate business growth and investments in jobs and new facilities as well as in research and development. Over 30 states and the federal government have established research and development tax credits. About 27 states have established business tax credits for investments in facilities, equipment or new technology. At least 16 states have created credits for job creation, typically in industries such as manufacturing and high technology. In most cases job creation credits require employers to pay wages above the county or state average wage and/or provide employee benefits such as health insurance. Most business investment tax credits are designed to be claimed in the year expenditures were made, but typically allow for any remaining credit to be carried forward (Outlaw, 2004.) Evaluation of these credits has been mixed, with most studies suggesting that the credits were only moderately successful in encouraging new or additional investments (Sohn & Knaap, 2005, Dumagan, J. June, 1995, Edwards, 1993.)

Several states, including Maine, Oklahoma and Florida, have enacted targeted tax credits (or tax exemptions) for early care and education businesses. While research on the effectiveness of these credits has not been conducted, they have proven to be popular with policymakers and the industry.<sup>12</sup> These policies are helpful examples of how ECE business tax credits might be structured. The Maine Quality Child Care Improvement Tax Credit was established in 1999 to assist providers as they make investments that improve the quality of care offered in their centers or homes. Taxpayers (a family child care provider or a child care center owner who operates as a sole proprietor) who have expended at least \$10,000 in one year may receive a \$1,000 tax credit each year for 10 years for a total \$10,000 credit at the end of the 10-year period. A corporation, financial institution, partnership, LLC, S-corporation, estate or trust that spends up to \$30,000 may receive a tax credit of 30% of the expense. In neither case can the credit reduce the tax otherwise due below zero (i.e., it is not a refundable credit); however, any unused portion of the credit may be carried over to the following year or years until exhausted (State of Maine, 2007).

---

<sup>12</sup> ECE leaders in Maine, for example, report that participation rates in practitioner training and ECE program quality improvement initiatives jumped significantly following passage of the quality child care tax credit. Similarly, the child care directors association in Oklahoma believes that the state quality child care tax credit is a significant incentive to see three-star status.



Oklahoma has a tax credit for child care businesses that incur expenses to comply with standards of national accreditation systems recognized by the State. The credit equals 20% of eligible expenses and any unused portion may be carried forward for up to four years. Florida has established a sales tax exemption for educational materials and property tax exemption equivalent to that of a nonprofit educational institution for ECE businesses that achieve one of several accreditations recognized by the state in the Gold Seal subsidy reimbursement program. To receive the sales tax exemption, ECE businesses must offer health insurance (Florida Department of Children and Families, n.d.).

As noted earlier, the Louisiana legislature recently enacted a school readiness tax credit package that includes targeted credits for ECE businesses. The refundable tax credits are linked to the provider's star quality rating and the number of low-income children they serve. Proposed benefits range from \$750 per low-income child enrolled in a 2-star program up to \$1,500 per low-income child enrolled in a 5-star program. Because the credit is refundable, non-profit providers may also participate.

### **Contribution and Community Investment Tax Credits**

A contribution tax credit reduces the tax liability of an individual or business that makes a contribution to, or investment in, another business. These tax credits are typically used to raise revenue for non-profit entities and/or businesses that produce a merit good. Other fields – such as housing and community development – have effectively used this approach to generate capital in low-income communities. Several examples follow.

The federal Low-Income Housing Tax Credit (LIHTC) was established in 1986 to provide incentives for private sector production of low-income housing. The LIHTC acts as a capital subsidy, allowing investors to obtain a competitive return on their investments while allowing rents to be set below the cost of developing or maintaining the property. In the first 15 years of the program over \$50 billion in tax credits has been committed to develop about 1.2 million housing units (Malpezzi & Vandell, 2002). The LIHTC allows taxpayers (businesses and individuals) who invest in low-income housing to receive a dollar for dollar credit against federal tax owed over a ten year period. The LIHTC is administered at the state level. Each state is permitted to allocate a certain amount of tax credits each year, based on its population. Intermediaries 'sell' the tax credits to investors and act as a bridge between investors and projects. Developers who receive tax credit proceeds must comply with guidelines intended to ensure that the housing is rented, at affordable prices, to low-and moderate-income families and is well-managed. Several states have created state tax benefits that 'piggy back' on the federal credit and make it even more attractive to investors (Malpezzi and Vandell, 2002; Stoney, 1998).

In 2000, Congress established the New Markets Tax Credit (NMTC) to generate investment capital for revitalization of economically distressed communities. Investors (including individuals, financial institutions and other corporations) who make qualified equity investments in designated Community Development Entities (CDEs) are eligible for the credits. CDEs act as the conduit between investors and development projects in distressed communities. Investors receive a total return of 39%, claimed over a 7 year period. In the first three years the investor receives a 5% credit on their investment; in the

final four years the value of the credit is 6% annually. CDE investments cannot be redeemed prior to the conclusion of the seven-year period. The NMTC is not refundable (that is, taxpayers cannot receive payments for tax credits that exceed their total tax liability) however taxpayers can sell their investment, along with the right to claim any remaining tax credits, to another investor. As of January, 2007, the NMTC has attracted nearly \$5.3 billion in investment. Spurred by these funds, CDE investment in low-income communities grew from about \$140 million in 2003 to \$2.2 billion in 2005. Most CDE investment has been in the form of loans – to businesses seeking to build or rehabilitate commercial real estate, purchase fixed assets or for working capital. Other uses include construction or operation of cultural arts centers and charter schools. A recent GAO study found that 64% of NMTC investors reported that they increased investments in low-income communities because of the credit (GAO, 2007).

Nine states<sup>13</sup> have established Neighborhood Assistance Programs (NAPs) that offer tax credits to taxpayers (businesses and individuals) that make contributions (cash, materials, staff) to community-based non-profit organizations that provide neighborhood assistance, job training, education, crime prevention or other services in low-income communities (Outlaw, 2004). Depending on the state, a non-profit organization may use NAP contributions to purchase or rehabilitate facilities or to meet operating expenses. Tax credit amounts range from 40% to 70%, depending on the state, and can typically be carried forward for a limited number of years. Contributors may receive additional benefits if they claim the federal deduction for charitable contributions. In most states, NAP authority is broad enough to include early care and education as an allowable use of funds and in some cases, such as Connecticut, child care services are specifically mentioned as an allowable investment. The biggest barrier to use of these credits by early care and education programs is the competitive nature of applying for NAP credits. Most states set a cap on the total amount of NAP tax credits that may be claimed in a given year. Nonprofit businesses seeking a NAP credit must file an application and must be able to market themselves successfully as an attractive NAP project. Current information on the effectiveness of these programs is not available, however in 1991, NAPs generated over \$63 million in private sector funding and cost \$33 million in forgone state revenue (NWLC, 2001).

Two states – Oregon and Colorado – have established contribution tax credits specifically for the early care and education industry. Research and experience suggests that both of these efforts have generated increased revenue for ECE (Fitzpatrick and Campbell, 2003; Olsen, 2006). Oregon's pilot Child Care Contribution Tax Credit, which was established in 2003, allows investors to purchase state tax credit certificates worth .75 for every \$1 contributed. In addition, investors may claim the contribution as a charitable deduction. Proceeds from the credits are placed into a pooled fund, which supports several community-based demonstration projects. Each demonstration project includes three elements: a wage initiative to enhance provider compensation; subsidies to ensure that low-income families do not spend more than 10% of their income on child care; and quality enhancements that include staff for training, technical assistance, classroom

---

<sup>13</sup> These include: Connecticut, Delaware, Indiana, Louisiana, Maryland, Missouri, Nebraska, Pennsylvania and West Virginia.

observation and equipment. At present, \$500,000 in tax credits is available each year, which generates annual contributions worth about \$667,000. The Oregon Child Care Division, which is responsible for administering the credit program, originally contracted with a syndicator to help sell the credits. However, they have found that this is no longer necessary. The credits are so easy to sell that the Division is able to quickly distribute all available credits by simply notifying the state's leading accountants and tax preparers. Most credits are purchased by individual taxpayers who are subject to the federal Alternative Minimum Tax. For these taxpayers the credits are a way to simultaneously lower their taxes and make an important charitable contribution (Olsen, 2006).

Colorado allows taxpayers that make a monetary contribution of up to \$100,000 per year to "promote child care in the State" to claim an income tax credit of 50 percent of the total contribution. The credit is not refundable (e.g. cannot exceed the tax liability) but may be carried forward for up to 5 years. The contribution may be made to a wide range of child care facilities, programs or services but cannot be made by someone who has a financial interest in the organization (Colorado Department of Revenue, 2007).

Twenty-eight states and the federal government have also enacted tax credits for employers that provide some form of child care assistance to their employees. The credits range from 20% to 50% of expenditures. In 2002, the National Women's Law Center assessed the effect of these credits in 20 states and found little or no impact. In 16 of these states, five or fewer corporations claimed the credit. In 5 of the 16 states, no corporation claimed the credit. Weakness of the credits and lack of promotion, coupled with minimal corporate state tax liability, were cited as primary reasons for such limited impact. The research team suggested that broader investment and contributions tax credits – such as those in Colorado and Oregon (described above) were far more effective in generating funds for early care and education (Fitzpatrick & Campbell, 2002).

### **Occupational Tax Credits**

There are various benefits that fall into the category of occupational tax credits. Sometimes tax credits are established to encourage businesses to employ particular individuals (such as former welfare recipients) or to open an office or plant and/or employ individuals who reside in a particular low-income area (such as an empowerment zone.) Some occupational tax credits accrue to the employees, that is, taxpayers who work in a targeted industry are eligible for special tax breaks.

This paper will focus on the latter approach – tax credits that accrue to the employees of a targeted industry. A number of tax credit proposals for teachers have been introduced in state legislatures (including Maryland, Louisiana and Georgia) as well as in Congress.<sup>14</sup> California has enacted two credits for educators. The first is a state income tax credit of \$250 to \$1,500 per year for any credentialed California teacher in active service who has at least four years' teaching experience. The size of the credit is based on years of teaching experience. California also allows cities and counties to use mortgage revenue bonds or

---

<sup>14</sup> In FY2003 a federal teacher tax deduction was enacted as part of the economic stimulus bill. This law allows teachers to deduct \$250 for out-of-pocket expenditures related to classroom instruction.

tax credits to support the Extra Credit Teacher Home Purchase Program. The initiative is structured as a mortgage credit certificate program. Participating teachers and principals who are first-time homebuyers and agree to serve for a minimum of five years in a low-performing school can reduce their tax liability by taking 15 percent of their annual mortgage interest payments as a dollar-for-dollar federal income tax credit (Prince, 2002).

Two states – Louisiana and New York – have developed tax credit proposals for early care and education teachers and staff. In 2003, advocates in New York drafted a proposal to convert their (former) child care wage subsidy initiative into a tax credit. The legislation would have established a refundable tax credit, provided directly to ECE practitioners, based on various levels of educational attainment. A credit of \$2,000 was proposed for those with the highest credentials with lesser credits of \$1,500, \$1,000 and \$750 based on identified educationally-related criteria. By linking proof of education or training to a web-based, statewide practitioner registry, and using the tax system to distribute funds, advocates argued that the credits would reach more practitioners and would also be cost effective to administer. The proposal generated significant discussion and support, but was opposed by NYS AFL-CIO and therefore did not go forward.<sup>15</sup> The school readiness tax credit package that was recently enacted in Louisiana (see Appendix A) also includes a refundable tax credit for early care and education teachers, linked to their educational attainment. Practitioners who have attained level 4 on the state’s ECE career lattice are eligible for an annual credit of \$3,000, and lesser credits of \$2,500, \$2,000 and \$1,500 are available for practitioners at levels 1 through 3. The credits will be adjusted annually based on the Consumer Price Index.

## Lessons Learned

Most early care and education tax credits are relatively new and few have been comprehensively evaluated, thus it is difficult to discuss their effectiveness. However, some of the tax credit initiatives used in other fields have undergone evaluation. This research indicates that some tax credits have produced results while others failed to have any impact. Lessons learned from this research suggest that effectively using tax policy as a market-based strategy to reinforce a merit good appears to rest on the factors described below.

### Cost & Stability

Research on 'green' tax credits indicates that the credit must be large enough to encourage consumers to purchase a higher-priced product but not so large that a sharp increase in demand overwhelms a fledgling industry infrastructure causing supply and quality problems. Abruptly eliminating the incentive can have equally devastating consequences. Solar tax credits suffered from both of these problems—a large initial credit and then abrupt elimination (Clement et al, 2005; Prentice and Hamre, 2004; Gouchoe et al, 2002).

---

<sup>15</sup> The AFL-CIO argued that the tax credit would usurp part of the collective bargaining process.

Determining the right size of an incentive is important. Maryland offers title and tax rebates of \$125-\$2,000 for the purchase of hybrid and electric cars, which is similar to the size of the factory rebates auto companies use to affect customer choices. Since auto companies have a compelling interest in product sales they spend considerable resources to determine effective rebate levels – research that is beyond the means of most states. By building on research from the auto industry, however, the state was able to select an effective credit level (Brown et al, 2002).

Research on self-sufficiency standards could help determine the appropriate level of an ECE consumer tax credit. Self-sufficiency data might be used to determine how much a family is able to pay and then linked to incentives large enough to make quality ECE desirable and more affordable. Standards established for a Quality Rating and Improvement System could be used as a guide for industry tax credits. The cost of delivering ECE services at each quality level could be estimated. These data could then be compared with market prices and available subsidy to determine the revenues needed to raise quality. A tax incentive could be crafted to help fill this gap.

### **Quality Assurance**

To have a real impact on consumer behavior, tax benefits must be linked to a product or service that produces the desired results. The best way to achieve this is through industry-wide standards that are focused on raising the bar above what is commonly available in the market. Experience from federal energy tax credits is a case in point.

The federal Energy Tax Act of 1978 included a 15% tax credit up to a maximum of \$300 for residential conservation and renewable energy investments made between April 1977 and December 1985. The credit covered insulation, storm windows and doors, weather-stripping and furnace modifications – standard energy efficiency measures at that time. During that period, about 30 million claims were made, resulting in nearly \$5 billion in lost federal revenues. Later evaluation of the credit indicated that it had little impact on consumer behavior. Most eligible households did not claim a tax credit and 88% of those who claimed the credit reported that they would have made the improvement even if the credit had not been available. Because almost any product was eligible, there is no assurance that these improvements actually saved significant amounts of energy. In contrast, Oregon offers a green buildings incentive program, called Sustainable Buildings, which is linked to the national Leadership in Energy and Environmental Design (LEED) standard ratings. The credit is structured as graduated levels based on dollars per square foot according to the LEED silver, gold and platinum certification criteria (Brown et al, 2002).

The need for quality assurance is underscored by California's experience with solar tax credits. In the early 1980s California offered generous state tax credits which, when coupled with federal credits available at the time, fostered the building of thousands of poorly designed solar hot water systems and early wind turbines. The credits lacked quality control mechanisms, as well as technology and energy objectives. Since that time,

California has switched to production tax credits that are designed to ensure that projects deliver the estimated energy savings (Brown et al, 2002).

There are a number of possible quality control mechanisms for the ECE industry. Using existing quality standards with evidentiary links to good results for children is one approach. Currently, federal tax benefits for ECE are delivered via the Child and Dependent Care Tax Credit (CDCTC) which has no features to encourage taxpayers to choose quality (the merit good aspect of ECE). Federal, state and local ECE tax credits could be structured to reinforce industry-wide and research-based quality standards, such as those used to establish a state Quality Rating and Improvement System or national early childhood program accreditation.

### **Market Differentiation**

Public incentives like tax credits can help create the ‘market pull’ that drives new consumer options (Brown et al, 2002). But there must be an easy way for consumers and intermediaries to identify which products meet quality standards and which don’t. Another important element in Oregon’s Sustainable Buildings incentive is the decision to link its credit to national LEED Certification rather than writing its own regulations. The LEED silver, gold and platinum designation is easy to understand, well-documented, and familiar to most architects and engineers in the state. "By itself, the state's action increases the visibility of the technology or practice and validates it with the state's credibility. Greater market share launches a virtuous circle: as market share increases, more market actors salespeople, specifiers, installers, etc. become vested in the technology or practice..." (Brown et al, 2002. p. iii).

Industry-wide standards for early care and education programs and practitioners – such as QRIS, national accreditation, and career lattices – are already available in many states and are currently used to reinforce market differentiation. Linking tax credits to these measures will help to further this goal.

### **Public Education**

Educating the public about the policy goal in general is a critical first step in using tax policy to help shift behavior. Consumers, practitioners and intermediaries need to fully understand the credits and quality assurance system as well as the key role that early education plays in life-long success. Experience from energy credits suggests that consumers tend to be strongly motivated by non-economic factors – they want to do the right thing for the environment. Case studies of energy tax credits in New York, Oregon and North Carolina found that the tax credit was not the primary motivating factor influencing purchasing decisions but often helped to “seal the deal.” In some cases, customers were unaware of the credit when they first contacted a dealer, but reported that the credit played a significant role in their final decision (Gouchoe et al, 2002). Similarly, promoting early care and education through the tax system could be an effective strategy to educate consumers and reward them for making better choices for their children.



## **Administrative Simplicity**

Effective tax credits are simple to understand and have minimal paperwork. One reason that Oregon's Residential Energy Tax Credit program<sup>16</sup> has been successful is that it is easy to use. Oregon does not have a sales tax so the credit is income-tax based. However, credit applications are available at the point of purchase. Upon purchase, the vendor fills out the state tax credit form and attaches it to the customer's receipt for them to fill out and mail to the Department of Revenue. When the application is approved the customer is sent a voucher to attach to their state income tax return. Oregon is currently in the process of completely automating the system so the application can be directly submitted to the State at the store where the product was purchased rather than by mail (Brown et al, 2002). Using existing administrative infrastructure is efficient. As described earlier, many states are building automated systems to track the training and education of ECE teachers as well as the quality rating of ECE programs. These systems could be linked to tax records, and used to streamline administration of ECE tax credits.

## **Infrastructure**

Technology to easily identify eligible providers and track compliance, as well as an industry-wide system of training and technical assistance designed to ensure that enough high-quality services are available to consumers, are essential elements of an effective tax credit. Evaluation of renewable energy incentives has shown that “a weak infrastructure, including a shortage of qualified installers and inadequately trained building inspectors” diminished effectiveness of the incentives (Gouchoe et al, 2002). The ECE industry has begun to build, and invest in, an industry-wide infrastructure that can provide supports to ECE programs and practitioners. This infrastructure includes statewide career development systems that provide and/or track training and education of teachers and staff in early childhood programs, QRIS monitoring (to track compliance) and QRIS technical assistance (to ensure that the industry includes a sufficient supply of high-quality programs). Additionally, the National Association for the Education of Young Children – the leading national accrediting body – has strengthened the infrastructure of its accreditation system.

## **Strong Industry Support**

Effective tax benefits are widely marketed by the industry they seek to engage. Industry and utility company support of energy-efficiency tax credits was instrumental in their effectiveness. Stakeholders interviewed for an evaluation of Oregon's energy credits noted that communication and partnerships with equipment vendors and installers, utilities, and engineering and architectural firms played an important role in the program's success (Gouchoe et al, 2002). Maryland retailers echoed this sentiment, and reported that star-energy tax incentives do not sell products on their own but are effective when combined with the retailers' ability to explain the benefits of energy efficiency, and the tax credit, to the customer (Brown et al, 2002).

---

<sup>16</sup> The program offers tax credits for products such as solar water heaters, geothermal heat pumps, star-energy appliances, alternative fuel vehicles and compressed natural gas fueling stations.

Effectively using tax credits to promote high-quality early care and education will require strategic engagement of ECE industry leaders. ECE programs, practitioners and intermediary organizations (such as Child Care Resource and Referral Agencies and professional associations) will need to fully understand the tax credits: how they impact the industry, how to apply for them, and how to use them as a marketing tool. Outreach materials and targeted education campaigns aimed at consumers as well as ECE providers, will be needed.

ECE tax credits must be seen as a complement to -- not in lieu of -- current federal, state and local child care subsidies as well as the direct supports available through Head Start and preschool programs.

### **Complementary Financial Incentives**

Tax credits cannot stand alone; they must be embedded in a package of policies designed to stimulate the market to develop the programs and supports needed to sustain quality over time. Experience with energy tax credits underscores this point: a single financial incentive by itself cannot ensure significant market penetration of renewable energy technologies (Gouchoe et al, 2002). In ECE, tax credits must be seen as a *complement to* current federal, state and local child care subsidies as well as the direct supports available through Head Start and preschool programs.

### **A Strategy for Consumers Who Do Not Owe Taxes**

Tax credits have little or no value for many low-income families who typically do not owe taxes and may not even file tax forms. Making tax credits refundable is a partial solution. Yet even those who do file tax returns may not benefit from the credit since it requires them to spend their own money upfront to purchase services and then claim the expense when filing taxes. Unlike the Earned Income Tax Credit which is based on earnings rather than spending, the CDCTC is based on specific child care expenditures that must meet certain requirements and be predictable. Advancing the CDCTC is possible but risky: what if child care payments change or stop during the year and the credit that can be claimed is less than the advances already received? One way to address this might be for the employer to allow the advance payments to be transferred directly to the taxpayer's child care provider rather than included in the employee's paycheck. This is similar to the way an automatic payroll deduction is sent to a savings account.

### **A Strategy for Businesses That do Not Owe Taxes**

Like renewable energy products and services, early care and education is essentially a market-driven system. Many ECE service providers, however, have no tax liability or are non-profit. Effectively engaging these providers is key to success. Experience with energy-efficient tax credits suggests that engaging the non-profit sector is not only possible but productive. Oregon offers a unique solution in their energy tax credit package – a “pass-through” option whereby non-taxed organizations may purchase energy-efficient systems and transfer the credit to a third party (such as a large commercial or industrial company in the community or an energy services company) in exchange for the net present value of the

tax credit (Oregon Department of Energy, 2006). Making a comparable grant or other type of cash incentive available to non-profit organizations is another approach. The Louisiana School Readiness Tax Credit law makes the provider tax credit refundable, and therefore available to non-profit entities and for-profit entities that owe no taxes. Another option is to offer incentives, either via tax credits or direct appropriations, for middle-market actors. In the case of star-energy products these actors are the manufacturers and marketers. In the case of early care and education they would be entities that offer training and technical assistance to child care programs and their staff so that they are able to meet the higher standards.

### **Adequate Time**

It takes several years for marketing channels, intermediaries, providers and consumers in the state to become familiar with the credits and how to effectively use the incentive. Research suggests that, to be effective and reach wide-scale use, tax credits are at least a five-year and often a ten-year effort (Brown et al, 2002). Thus, ECE tax credits should not be viewed as a quick fix. Effective implementation will require a long-term commitment that includes developing industry-wide standards, outreach and infrastructure.

## **Conclusion**

Tax credits have been used by many states and the federal government to increase the use of products and services that have a merit good aspect and to encourage development of and investment in emerging technologies and programs. Even if a tax credit does not result in immediate or significant financial gains for consumers or producers, the action of creating a tax benefit can increase the visibility and validate the use of a particular product or service. The salience, stability, equity, efficiency and flexibility of tax strategies offer unique reasons why carefully crafted tax credits – linked to quality measures such as a state Quality Rating and Improvement System – could be a useful strategy for early care and education. Clearly tax credits cannot stand alone. Tax benefits on their own would be an insufficient funding source for early care and education. However, when combined with other direct investments from government, employers, consumers and the private sector, tax credits offer a promising, market-based incentive for high quality early care and education services.

## References

- Barnett, W. S., & Ackerman, D. J. 2006. Costs, Benefits, and the Long-Term Effects of Preschool Programs, *Community Development: The Journal of the Community Development Society*, 37 (2).
- Brown, E., Quinlan, P., Sachs, H. and Williams, D. 2002. *Tax Credits for Energy Efficiency and Green Buildings: Opportunities for State Action*. Washington, DC: American Council for an Energy-Efficient Economy. [www.aceee.org](http://www.aceee.org)
- Bureau of Labor Statistics, U.S. Department of Labor (n.d.). *Career Guide to Industries, 2006-07 Edition*, Child Day Care Services, on the Internet. Retrieved on April 9, 2007 from <http://www.bls.gov/oco/cg/cgs032.htm>.
- Burman, Maag and Rohaly, 2005. *Tax Subsidies to Help Low-Income Families Pay for Child Care*. Washington, DC: Urban-Brookings Tax Policy Center. <http://www.taxpolicycenter.org/publications/template.cfm?PubID=311199>
- Casper, L. and O'Connell, M. 1998. *State Estimates of Organized Child Care Facilities*. Washington, DC: Population Division. U.S. Bureau of the Census. Working Paper No. 21. <http://www.census.gov/population/www/documentation/twps0021/twps0021fr.html>
- Center for the Child Care Workforce 2002. *Estimating the Size and Components of the U.S. Child Care Workforce and Caregiving Population: Key Findings from the Child Care Workforce Estimate: Preliminary Report: Executive Summary*. Washington, DC: Center for the Child Care Workforce. Retrieved on April 9, 2007 from <http://www.aft.org/ccw/index.html>.
- Clement, D., Lehman, M., Hamrin, J. and Wiser, R. 2005. *International Tax Incentives for Renewable Energy: Lessons from Public Policy*. San Francisco, CA: Center for Resource Solutions.
- Colorado Department of Revenue, Taxpayer Service Division. *Child Care Contribution Credit*. Retrieved on March, 30, 2007 from <http://www.revenue.state.co.us/fyi/html/income35.html>.
- Cost, Quality and Child Outcomes Study Team. 1995. *Cost, Quality and Child Outcomes in Child Care Centers*. Denver: University of Colorado.
- Dumagan, J. 1995. *Re-examining the Cost-Effectiveness of the Research and Experimentation Tax Credit*. Office of Business and Industrial Analysis Office of Policy Development Economics and Statistics Administration. U.S. Department of Commerce.

- Edwards, C.1993. *The Research and Experimentation Tax Credit* Washington, D.C: the Tax Foundation. <http://www.taxfoundation.org/publications/show/591.html>
- Fitzpatrick, C. and Campbell, N. 2002. *The Little Engine That Hasn't: The Poor Performance of Employer Tax Credits for Child Care*. Washington, DC: National Women's Law Center.
- Florida Department of Children and Families (n.d.). *Gold Seal Quality Care Tax Exemptions*. Retrieved on April 13, 2007 from <http://www.dcf.state.fl.us/childcare/goldseal.shtml#LinkTE>.
- Gouchoe, S, Everette, V, Haynes, R. 2002. *Case Studies on the Effectiveness of State Financial Incentives for Renewable Energy*. National Renewable Energy Laboratory. NREL/SR-620-32819. Golden: CO. <http://www.nrel.gov/docs/fy02osti/32819.pdf>
- Government Accountability Office 2007. *Tax Policy: New Markets Tax Credit Appears to Increase Investment by Investors in Low-Income Communities, but Opportunities Exist to Better Monitor Compliance* (GAO-07-296).
- Heckman, J.L., & D. Masterov. 2004. *The productivity argument for investing in young children*. Working Paper No. 5, Invest in Kids Working Group, October 2004.
- Howes, C. 1983. Caregiver behavior in center and family day care. *Journal of Applied Developmental Psychology*, 4: 99–107.
- Kontos, S., Howes, C., Shinn, M, Galinsky, E. 1995. *Quality in Family Child Care and Relative Care*. New York: Teachers College Press, Columbia University.
- Maine Revenue Services for Tax Professionals. 2001. *Maine Tax Alert: Individual Income Tax Legislative Summary* Volume 11, No. 2. <http://www.maine.gov/revenue>
- Maine State Legislature. Statutes and Session Laws. *Quality child care investment credit*. Retrieved on March, 30, 2007 from <http://janus.state.me.us/legis/statutes/36/title36sec5219-Q.html>.
- Malpezzi, S. and Vandell K. 2002. "Does the Low-Income Housing Tax Credit Increase the Supply of Housing?" Center for Urban Land Economics Research, School of Business, University of Wisconsin-Madison. <http://www.bus.wisc.edu/realestate/pdf/pdf/LIHTC%20Note%20Malpezzi%20Vandell%20as%20of%20October%2011%202002.pdf>
- Marshall, Nancy L., Cindy L. Creps, Nancy R. Burstein, Kevin E. Cahill, Wendy Wagner Robeson, Sue Y. Wang, Nancy Keefe, Jennifer Schimmenti, Frederic B. Glantz. 2003. *Massachusetts Family Child Care Today: A Report on the Findings from the Massachusetts Cost and Quality Study*. Wellesley Centers for Women and Abt

- Associates, Inc. Retrieved April 9, 2007 from <http://www.wcwonline.org/earlycare/FamilyChildCare2004.pdf>.
- Mitchell, A. and Stoney, L. 2006. *Can We Use Tax Strategies to Help Finance Early Care and Education?* Alliance for Early Childhood Finance. Issue brief for conference call. <http://www.earlychildhoodfinance.org/What%27sNew/AgendaPage.htm>
- Mitchell, A., Stoney, L., & Dichter, H. 2001. *Financing Child Care in the United States: An Expanded Catalog of Current Strategies 2000 Edition*, Kansas City: The Ewing and Marion Kauffman Foundation.
- National Association of Child Care Resource and Referral Association 2007. *Most Recent Child Care Data by State (with national comparison)*. Retrieved on April 9, 2007 from <http://www.naccrra.org/randd/map.php>.
- National Association for Regulatory Administration and the National Child Care Information and Technical Assistance Center, 2006. *The 2005 Child Care Licensing Study*. Retrieved April 9, 2007 from <http://www.nara.affiniscap.com/displaycommon.cfm?an=1&subarticlenbr=104>.
- National Institute of Child Health and Human Development Early Child Care Research Network, National Institute of Child Health and Human Development (Eds). 2005. [\*Child Care and Child Development: Results from the NICHD Study of Early Child Care and Youth Development\*](#). New York: Guilford Publications.
- National Institute for Early Education Research, 2006. *The State of Preschool 2006*. Rutgers, NJ: The State University of New Jersey.
- National Women's Law Center. 2001. *A Catalog of Tax-Based Approaches for Financing Child Care*. <http://www.nwlc.org/display.cfm?section=childcare>
- New York State Legislature. *Occupational Tax Credit* (A7946/ S 3774.) Introduced Monday, April 14, 2003.
- Olsen, T. Administrator, Oregon Child Care Division. Personal communication. November, 2006.
- Oregon Department of Energy. 2006. *Administrative Rules: Business Energy Tax Credit* OAR 330-90-0105 to 330-90-0150. Salem: OR. <http://www.google.com/search?hl=en&ie=ISO-8859-1&q=Oregon+Business+Energy+Tax+Credit&btnG=Google+Search>
- Oregon Employment Department, Child Care Division. *Child Care Contribution Tax Credit*. Retrieved on March 30, 2007 from <http://www.oregon.gov/EMPLOY/CCD/taxcontribution.shtml>.



- Outlaw, E. TaxCreditResearch.com. (Searchable Database of State Tax Credits.) Last updated, 2004. <http://www.taxcreditresearch.com/secure/list.cfm>
- Pearce, Diana. 2006. *Self-Sufficiency Standard for Pennsylvania (5<sup>th</sup> edition)*. Holmes, PA: PathwaysPA. Retrieved April 9, 2007 from [http://pathwayspa.org/policy/FINAL\\_PA-2006\\_full%20report5-15-06.pdf](http://pathwayspa.org/policy/FINAL_PA-2006_full%20report5-15-06.pdf).
- Prentice, C. and Hamre, A. 2004. *Vermont Homeowner Renewable Energy Incentives: Towards and Effective Incentive Strategy*. Middlebury, VT: Environmental Studies.
- Prince, C. 2002. *Higher Pay in Hard-to-Staff Schools: The Case for Financial Incentives*. Arlington, VA: American Association of School Administrators. <http://www.aasa.org/publications/content.cfm?ItemNumber=2215>
- Shine, R. 2002. *The Oregon Child Care Investment Tax Credit: A New Financing Approach for Child Care*. Columbia, MD: The Enterprise Foundation. <http://www.practitionerresources.org/cache/documents/626/62696.doc>.
- Shonkoff, J., & Phillips, D. 2000. *From Neurons to Neighborhoods: The Science of Early Child Development*. Washington, D.C.: National Academy Press.
- Shore, R. 1997. *Rethinking the Brain*. New York: Families and Work Institute.
- Sohn, J. and Knaap, G. 2005. *Does the Job Creation Tax Credit Program in Maryland Help Concentrate Employment Growth?* Economic Development Quarterly, Vol. 19, No. 4, 313-326 (2005) DOI: 10.1177/0891242405278183. <http://edq.sagepub.com/cgi/content/abstract/19/4/313>
- State of Maine, Department of Health and Human Services, Office of Child Care and Head Start. *Child Care Tax Credits*. Retrieved on March 30, 2007 from <http://www.maine.gov/dhhs/occhs/taxcredits.htm>.
- Steuerle, G. 2004. *Contemporary U.S. Tax Policy*. Washington, D.C.: The Urban Institute Press.
- Stoney, L. 1998. *Looking into New Mirrors: Lessons for Early Childhood Finance and System-Building*, Boston, MA: Horizon's Initiative.
- Stoney, L., Mitchell, A. and Warner, M. E. 2006. "Smarter Reform: Moving Beyond Single-Program Solutions to an Early Care and Education System" *COMMUNITY DEVELOPMENT: Journal of the Community Development Society*, Vol. 37, No. 2, Summer 2006.
- Warner, M. E. Adriance, N. Barai, J. Halla., B. Markeson, T. Morrissey, & W. Soref. 2004. *Economic Development Strategies to Promote Quality Child Care*, Ithaca, NY: Cornell University Department of City and Regional Planning.

Warner, M.E. ed. 2006. "Articulating the Economic Importance of Child Care," Special Issue of *Community Development: Journal of the Community Development Society* 37(2).

Warner, M. E. 2006. "Putting Child Care in the Regional Economy: Empirical and Conceptual Challenges and Economic Development Prospects," *Community Development: Journal of the Community Development Society* 37 (2): 7-22.

Warner, M.E. and Zhilin Liu 2006. "The Importance of Child Care in Economic Development: A Comparative Analysis of Regional Economic Linkage," *Economic Development Quarterly* 20(1):97-103.  
<http://government.cce.cornell.edu/doc/pdf/Warner%20Liu%20EDQ%202006.pdf>

# Appendix A.



## LEGISLATIVE FISCAL OFFICE

### Fiscal Note

Fiscal Note On: **SB 361** SLS 07RS 1325  
 Bill Text Version: **REENGROSSED**  
 Opp. Chamb. Action:  
 Proposed Amd.:  
 Sub. Bill For.: **SB 189** **REVISED**

<b>Date:</b> June 20, 2007	5:02 PM	<b>Author:</b> DUPLESSIS
<b>Dept./Agy.:</b> Social Services		<b>Analyst:</b> Myra Lowe
<b>Subject:</b> Child Care Tax Credits		

TAX/TAXATION RE -\$7,100,000 GF RV See Note Page 1 of 2

Grants school readiness tax credits to individuals for child care expenses of children five and under, to child care providers, to child care directors and staff, and to businesses providing assistance for child care. (See Act)  
Proposed law provides a refundable tax credit against an individual's income tax for child care expenses of children 5 and under. This credit is in addition to the credit provided for such expenses in R.S. 47:297.4 and is based upon the "quality rating" of the child care center which the child attends. Proposed law provides a refundable tax credit against any individual or corporation income tax or corporation franchise tax for child care providers based on the number of children who participate in the Child Care Assistance Program, who are in centers or facilities operated by the child care provider, multiplied by an amount which is based on the quality rating of the child care center or facility. Proposed law provides a refundable tax credit against individual income tax for eligible child care directors and child care staff based on academic qualifications or attainment of certain levels in the LA Pathways Child Care Administrator or Classroom Certificates. Proposed law provides for a refundable credit against any income tax or corporation franchise tax for business-provided child care based on percentages of eligible child care expenses and depends on the quality rating of the child care expenses of the

EXPENDITURES	2007-08	2008-09	2009-10	2010-11	2011-12	5-YEAR TOTAL
State Gen. Fd.	\$0	\$357,000	\$356,000	\$367,000	\$382,000	\$1,462,000
Agy. Self-Gen.	\$0	\$0	\$0	\$0	\$0	\$0
Ded./Other	\$0	\$0	\$0	\$0	\$0	\$0
Federal Funds	\$0	\$0	\$0	\$0	\$0	\$0
Local Funds	\$0	\$0	\$0	\$0	\$0	\$0
<b>Annual Total</b>	<b>\$0</b>	<b>\$357,000</b>	<b>\$356,000</b>	<b>\$367,000</b>	<b>\$382,000</b>	<b>\$1,462,000</b>

REVENUES	2007-08	2008-09	2009-10	2010-11	2011-12	5-YEAR TOTAL
State Gen. Fd.	\$0	(\$7,100,000)	(\$10,600,000)	(\$24,700,000)	(\$25,800,000)	(\$68,200,000)
Agy. Self-Gen.	\$0	\$0	\$0	\$0	\$0	\$0
Ded./Other	\$0	\$0	\$0	\$0	\$0	\$0
Federal Funds	\$0	\$0	\$0	\$0	\$0	\$0
Local Funds	\$0	\$0	\$0	\$0	\$0	\$0
<b>Annual Total</b>	<b>\$0</b>	<b>(\$7,100,000)</b>	<b>(\$10,600,000)</b>	<b>(\$24,700,000)</b>	<b>(\$25,800,000)</b>	<b>(\$68,200,000)</b>

#### EXPENDITURE EXPLANATION

The Department of Revenue estimates the need for as many as 7 additional positions (\$257,000; nine months in FY08 with annualization and 4% growth per year) plus one-time expenses of \$100,000 for computer system modifications. These positions will be needed to ensure that the various types of affected taxpayers are properly claiming these various credits. The Department of Social Services must establish criteria and systems to determine eligibility for these tax credits. The Department anticipates no material impact on expenditures. However, material costs do seem likely.

#### REVENUE EXPLANATION

The discussion below provides some illustrative guidance as to the potential costs of the various tax credits proposed by this bill. Based on the various assumptions made, the resulting potential total **tax credit revenue losses are \$7.1 million in FY09, \$10.6 million in FY10, \$24.7 million in FY11, and \$25.8 million in FY12.**

The fiscal note estimates originally assumed at an immediate 50% participation rate and are described below. However, such an immediate jump to that level of participation does not seem likely. The proponents have provided additional information from programs in three other states that suggests a ramp-up of participation in this program over four years. The phase-in schedule resulting from that information seemed reasonable and has been incorporated into the estimates below in an additional statement appended onto the discussion of each credit component of the bill, and summed for the overall fiscal estimate of the bill. **That phase-in schedule is 13% participation in year 1, 20% year 2, 48% year 3, and 50% year 4.** All other original assumptions have been retained.

#### **Child Care Expense Tax Credit**

This is a refundable tax credit which is based on a percentage of child care expenses provided for in R.S. 47:297.4. This percentage is based on the quality rating of the child care center or facility. The quality rating ranges from 1 star to 5 stars. The maximum credit an individual can claim for one child would be \$263 for a two star center; \$525 for a three star center; \$787 for a four star center; and \$1,050 for a five star center. The credit caps out at \$2,100 regardless of the number of children claimed for child care expense. According to the Department of Revenue, for the tax year 2004, the child expense tax credit provided for in existing law cost the State \$6.7 million for 80,675 tax returns. Assuming that 50% of these returns included children who be attending a child care center that chose to participate in the Quality Rating System and using an average tax credit of \$83 ( $\$6,700,000/80,675$ ), the decrease to State General Fund revenue would be \$3,348,013 ( $40,338 \times \$83$ ) for FY 08-09. It is anticipated that the cost for future fiscal years will be greater since individuals who qualify for this tax credit would have an incentive to place their children in centers that participated in the Quality Rating System and to choose the centers that had the higher ratings. **The phase-in schedule of participation results in the following revenue losses: FY09 \$871,000, FY10 \$1.339 million, FY11 \$3.214 million, and FY12 \$3.348 million.**

#### **Continued Purpose**

related child care center or facility or the child care center or facility the child attends. Proposed law provides for the credits to be applicable the later of Jan. 1, 2008 for the income tax or 2009 for the franchise tax or the calendar year that rules for the Quality Rating System are promulgated and franchise years after rules are promulgated. These tax year dates imply that the first fiscal year that can experience material revenue losses is fiscal year 2008 - 2009.

#### **Continued Revenue Explanation**

##### **Child Care Provider Tax Credit**

This is a refundable tax credit which is based on the number of children who attend a child care center and participate in the Child Care Assistance Program administered by DSS. The legislation stipulates the amount of the credit based on the quality rating of the child care center. A five star center can receive \$1,500 per eligible child; a four center star can receive \$1,250 per eligible child; a three star center can receive \$1,000 per eligible child; and a two star center can receive \$750 per eligible child. According to DSS, there are approximately 29,000 children, under age 5, who are served through the Child Care Assistance Program. Assuming that 50% of these children attended a child care center that on average had a 3 star rating, the estimated decrease to State General Fund revenue in FY 08-09 would be \$14,500,000 ( $14,500 \times \$1,000$ ). It is anticipated that the cost for future fiscal years will be greater because child care providers, that have higher star ratings, would have more of an incentive to provide care for those children who are from low income families. **The phase-in schedule of participation results in the following revenue losses: FY09 \$3.770 million, FY10 \$5.800 million, FY11 \$13.920 million, and FY12 \$14.500 million.**

##### **Child Care Directors and Staff Tax Credit**

This is a refundable tax credit for eligible child care directors and staff who meet the qualification requirements defined in this measure for each level (1-4). The credits will be adjusted annually by the percentage increase in the Consumer Price Index (CPI). The legislation stipulates that a director or staff can receive \$3,000 for Level 4, \$2,500 for Level 3, \$2,000 for Level 2, and \$1,500 for Level 1. According to a publication entitled "Investing in the Child Care Industry" issued in 2005, there were 9,873 child care employees (includes Licensed Child Care and Head Start/Early Head Start). Assuming 50% of these employees were in child care centers that chose to participate in the Quality Rating System and assuming that each employee would be eligible for Level 1, the estimated decrease to State General Fund for FY 08-09 would be \$7,405,500 ( $4,937 \times \$1,500$ ). It is anticipated that this cost will increase in future fiscal years since the credits will be adjusted annually based on the CPI. It is also anticipated that this tax incentive would encourage more child centers to participate in the Quality Rating System and that higher levels of certification will be obtained, thus also increasing the cost. **The phase-in schedule of participation results in the following revenue losses: FY09 \$1.925 million, FY10 \$2.963 million, FY11 \$7.109 million, and FY12 \$7.406 million.**

##### **Business-Provided Child Care Tax Credit**

This is a refundable tax credit for "eligible" business child care expenses for the child care center or facility based on the following expenses: 1) construction, renovation, expansion, major repairs, equipment purchases, maintenance, and operation; 2) payments made to an eligible child care center or facility for child care services, not to exceed \$5,000 per year; and 3) purchases of child care slots at eligible child care centers or facilities, not to exceed \$50,000 per year. The credit is based on a percentage of the eligible expenses which depends on the quality rating of the child care center or facility to which the expenses are related or the child attends. The percentage ranges from 5% for a two star center to 20% for a five star center. The total credit cannot exceed \$50,000. This legislation also provides for a refundable tax credit for the payment by a business for fees and grants to child care resource and referral services not to exceed \$5,000 per year.

If at least \$5 million dollars were infused into the child care industry by various businesses during the first year of implementing the Quality Rating System and the eligible child centers or facilities had on average a three star rating, the estimated decrease to State General Fund for FY 08-09 would be **\$500,000** ( $\$5,000,000 \times 10\%$ ). It is anticipated that this cost will increase in future fiscal years as more businesses take advantage of this tax credit. **No phase-in schedule was applied to this component of the bill, with the full tax credit loss amount assumed from the first effective year.**