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Tax Credits to Help Low-Income Families Pay for Child Care

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In recent years, federal–state funding for direct subsidy programs has been cut while tax assistance for child care has expanded.

When Congress enacted welfare reform, it expected more people, particularly single mothers, to enter the labor force and exit welfare (Weil 2002). These new low-income workers face enormous challenges. Key among them is how to pay for decent child care.

Within the broad area of child care tax and subsidy policy, this brief focuses on tax policies that can help low-income families pay for child care. First, it analyzes recent changes to the Child and Dependent Care Tax Credit (CDCTC), the main child care–focused instrument in the tax code, to determine whether these changes reached more low-income families. Second, it offers two options for increasing the credit's value to low-income families: (1) making the credit refundable so low-income families with no tax liability can receive it; and (2) increasing the credit rate. Third, it considers expanding the Earned Income Tax Credit (EITC) and the Child Tax Credit (CTC) as an alternative way to help low-income families with children.[1]

Subsidizing Child Care in Theory and Practice

Child care is expensive, and high-quality care may be beyond the reach of many lower-income families. In 1998, average annual child care costs per family ranged from $3,000 to $13,000, depending on region, type of care, and age of children (Schulman 2000)—and the cost of high-quality care can be steep. Although the cost of care does not appear to affect employment significantly, it does affect the child care arrangement chosen (Ribar 1995). Low-income working parents may be forced by high child care costs to rely on unsafe or inadequate child care arrangements, to the detriment of their children.

Poor-quality child care can result in young children missing opportunities essential to the development of healthy intellectual and social capabilities (Carnegie Corporation of New York 1994). And although money cannot guarantee high-quality child care, many aspects of good care, such as high teacher-to-student ratios, are expensive (Giannarelli, Adelman, and Schmidt 2003). As a result, subsidizing child care may be necessary to protect children in lower-income families and may contribute to economic mobility.

Although tax and direct subsidy programs can help offset some of these costs, many low-income families receive little or no benefit. The tax subsidies only help those with income tax liability, but most poor families don't pay income tax. Direct subsidies are better targeted, but funding limits prevent most eligible households from receiving assistance.

In recent years, federal–state funding for direct subsidy programs has been cut while tax assistance has expanded. Faced with budget shortfalls, more than half the states that subsidize child care for poor families reduced those subsidies between 2001 and 2003 (GAO 2003) following large increases in the late 1990s (Edie 2005). The long-term situation is even bleaker as states wrestle with ballooning costs for health care and education. On the positive side, the 2001 Economic Growth and Tax

Relief Reconciliation Act (EGTRRA) expanded the CDCTC. Effective in 2003, the expansion allowed families to count more child care expenses toward the credit and increased the credit rate for families with incomes below $43,000.[2] EGTRRA also expanded the refundable EITC for most married couples and the CTC. Though not earmarked specifically for child care, unlike the CDCTC, these credits can benefit families even when they do not owe income tax.[3]

Subsidizing child care through the tax system instead of the transfer system has several advantages, but also significant drawbacks. Tax subsidies can be very effective because most low-income working households already file income tax returns to claim tax refunds and the EITC (Holtzblatt and McCubbin 2004). In addition, given that tax programs are expanding and transfer programs directed at child care are stagnating or contracting (Edie 2005), tax assistance appears more politically feasible at this time. But many low-income households are cash constrained. For them, a tax credit may come too late to help pay for quality child care. Tax returns are filed months, and sometimes a year or more, after expenses are incurred.

Similarly, subsidizing child care through direct cash assistance has advantages and drawbacks. First, it can directly reduce the cost of child care when the expenses are incurred. Second, the agency administering a child care grant or voucher can monitor the quality of the care to help ensure the best interests of the child are served. But, fewer eligible people may use a direct assistance program than a tax credit because of welfare stigma or because the application and recertification processes are difficult for working families to handle. For example, welfare office hours typically coincide with normal working hours, and low-income people often lack the flexibility to take time off from their jobs to wait in line for benefits (Adams, Snyder, and Sandfort 2002).

Evaluating the CDCTC

The largest tax program directed specifically toward child care costs is the Child and Dependent Care Tax Credit, worth about $2.8 billion in FY 2006 (OMB 2005). The CDCTC is a nonrefundable tax credit that offsets up to 35 percent of working parents' child care costs, up to $3,000 for one child and $6,000 for two or more children.[4] The credit rate declines with income; most families receive a 20 percent credit.

Although tax credits generally are more valuable to lower-income families than exclusions or deductions, unless the credits are refundable they are of little use to very low income families. Refundability means that when the amount of the credit exceeds tax liability, the difference is refunded to the family. Because the CDCTC is nonrefundable, it provides no benefit to families that do not owe income tax. In 2005, among single parents with two children, only those with earnings above $23,700 can benefit from the credit. In theory, families with two children could receive a maximum credit of $2,100 (35 percent of $6,000), but in practice, few receive such a large credit. For higher-income households (those with adjusted gross income [AGI] above $43,000), the maximum credit is $1,200 for a family with two or more children and $600 for one with a single child.[5]

Because neither the maximum expenses eligible for the credit nor the phaseout thresholds are indexed for inflation, the real value of the credit declines over time, especially for lower-income households. Middle-income families may also benefit less from the CDCTC in the future. Increasingly, middle-income families are subject to the alternative minimum tax (AMT). A temporary provision allows taxpayers to continue to use the CDCTC even if they are subject to the AMT, but the provision is scheduled to expire after 2005. If it is not extended, growing numbers of middle-class families will not be able to use the credit over time (Burman, Gale, and Rohaly 2003).

Improving the CDCTC

Two changes would make the CDCTC more useful to low-income families: making it refundable and increasing the maximum credit rate. If the CDCTC were refundable, eligible families could receive the full credit even if they had no tax liability. Given refundability, a higher credit rate would offset more of low-income families' child care costs.

Another important consideration for reforming the CDCTC would be to index the credit (both the amount of the credit and the incomes over which it applies) for inflation—the norm since the early 1980s for many income tax provisions.[6] Without indexing, the maximum credit will shrink in value over time, and fewer families will be eligible for higher credit rates.

Making the CDCTC Refundable

Making the CDCTC refundable would benefit low-income families. Under current law, we project 6.4 million families will receive the nonrefundable credit in 2005. We estimate that about 1.5 million more could receive a refundable credit in 2005.[7]

Under this option, the average credit would rise by $100 compared with current law, to $629. Almost all the benefit would accrue to families with incomes below $40,000; most higher-income families already receive the full CDCTC under current law (figure 1).

Approximately 550,000 people with incomes below $10,000 would receive an average credit of $704 if the credit were refundable; nobody in that income range benefits under cur-

rent law. This refund could help struggling low-income families substantially. Families with incomes between $10,000 and $20,000 that pay for child care would receive the largest average benefit ($911), since they pay more for care than the lowest income group and qualify for higher credit rates than the higher income groups.

Although the benefits of the refundable CDCTC can be substantial for families that receive it, only a small proportion of households benefits. In total, only 4.2 percent of all families benefit from the CDCTC under current law. If it were refundable, 5.4 percent of all families would benefit from the credit. Almost all the change in beneficiaries between the two options is realized in the lowest income classes. Under current law, no families with income below $10,000 benefit from the credit, compared with 2.8 percent of families in this income class when the credit becomes refundable. Similarly, the proportion of beneficiaries in the $10,000–$20,000 income class rises from 0.2 to 3.7 percent when the credit is refundable.

Increasing the Maximum Credit Rate and Phasing Out the Credit Faster

Along with making the CDCTC refundable, low-income families would benefit from increasing the maximum credit rate from 35 to 50 percent. The current credit rate declines by 1 percentage point for each additional $2,000 of AGI, starting at $15,000 until it reaches 20 percent at an AGI of $43,000. We phase out the credit at a rate of 1 percentage point for each additional $1,000 of AGI between $30,000 and $60,000. This proposal is similar to one the Clinton administration made in 2000. The faster phaseout means that some taxpayers with AGI over $30,000 could lose up to $60 of tax credits for every $1,000 of additional income earned.[8] But, since the phaseout does not start until a higher income level, the faster phaseout spares everyone with incomes under $30,000 from the implicit surtax. Since those households tend to face high effective marginal tax rates from the phaseout of the EITC (and, in some cases, eligibility for transfer programs such as food stamps), this schedule might be preferable in the context of the whole tax and transfer system.

Figure 1 shows the average credit families at various income classes would receive if the credit rate were increased. The maximum credit would increase from $2,100 to $3,000 for families with at least two children. On average, families that claimed the credit would receive a credit of $866. Those in the lowest income class would receive an average credit of $1,006. Again, families with incomes between $10,000 and $20,000 would receive the greatest average benefit—$1,314.

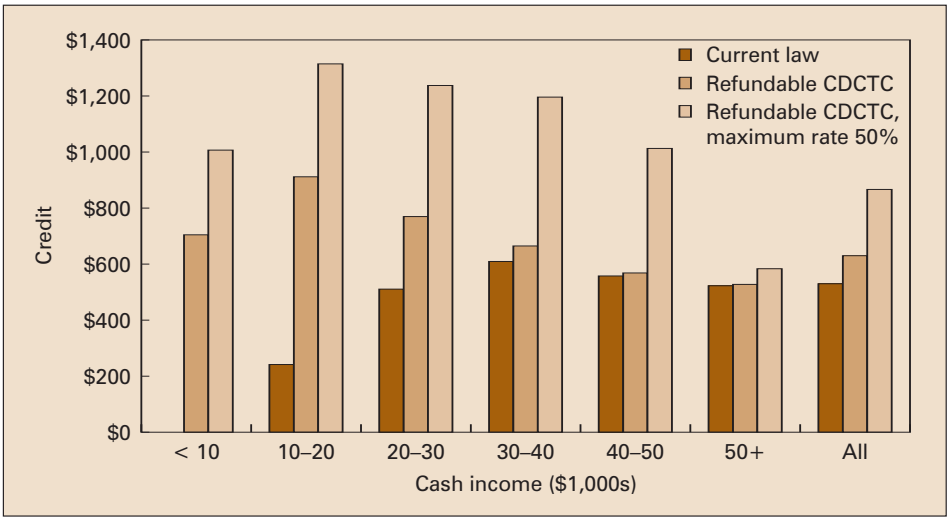
Reforming Other Refundable Tax Credits

Another approach to helping low-income households meet their child care needs would be to increase their income through expanding either the refundable EITC or the partially refundable CTC. An advantage of this approach is that it is neutral toward how working families meet their child care needs. It does not require creation of a new refundable tax credit to help low-income households, and it is highly targeted. The main disadvantage is that the EITC has been under assault lately from those who complain it is prone to high error rates and is tantamount to welfare run through the tax system. For this reason, significant EITC expansions (and expansions in other refundable credits) may be politically infeasible. In addition, this option offers no direct incentive to pay for better child care.

Expanding and Simplifying the Child Tax Credit

Currently, households are allowed to claim a partially refundable child tax credit for each qualifying child under age 17. The CTC equals $1,000 per child and starts to phase out when AGI exceeds $110,000 for married couples and $75,000 for single heads of household. Low-income house-

FIGURE 1. Average Tax Credit for Families Claiming Credit Under Various CDCTC Options, 2005



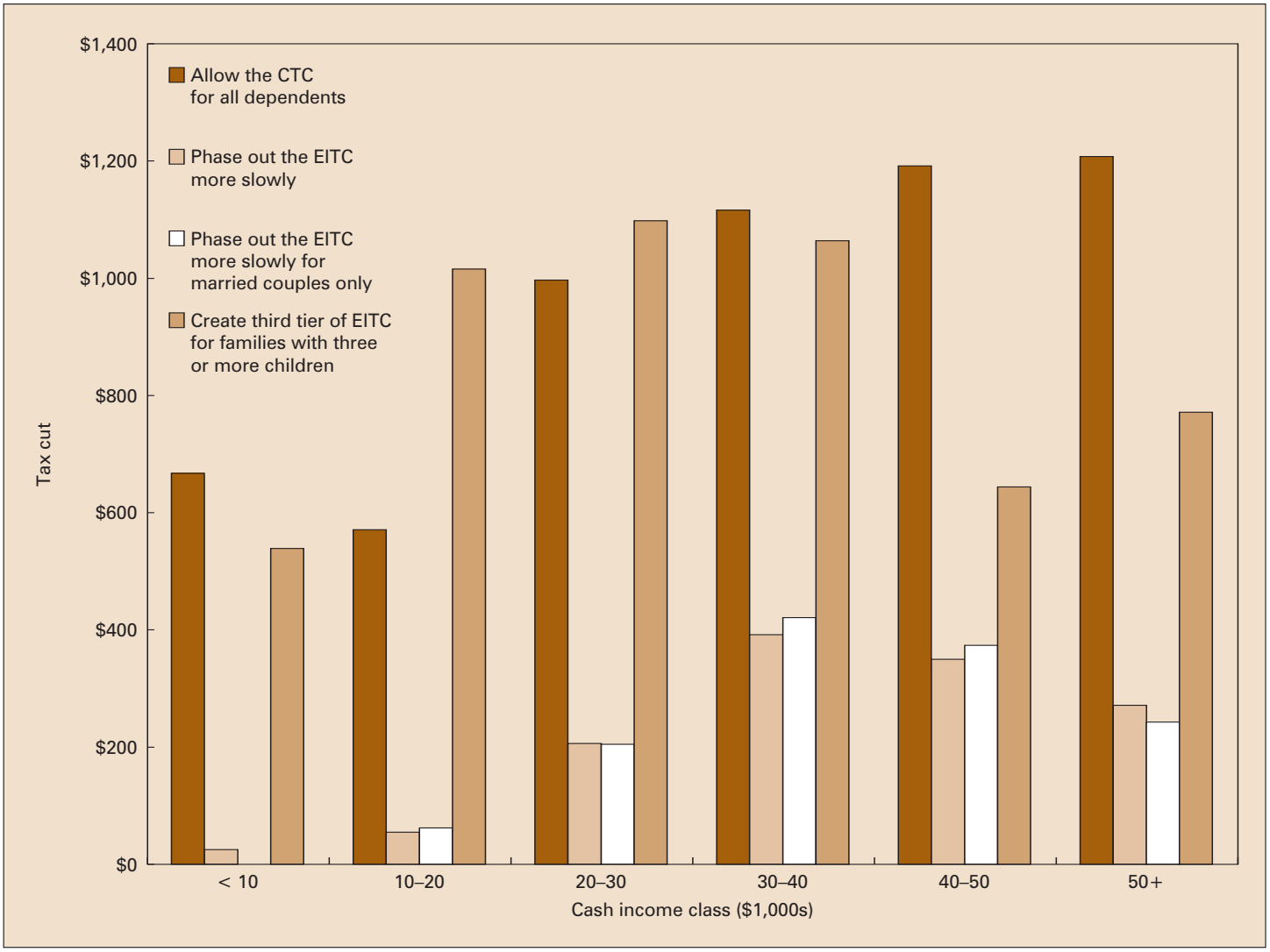
Source: Urban–Brookings Tax Policy Center Microsimulation Model (version 0305-2).
Note: For additional information see Burman, Maag, and Rohaly (2005).

holds may claim a refundable CTC of up to 15 percent of earnings in excess of $11,000 in 2005.[9] Thus, a household with earnings of $12,000 may claim a refund of up to $150 (15 percent of $1,000) if it contains at least one qualifying child. If EGTRRA is not extended, the CTC will return to $500 per child after 2010 and the new refundability rules will expire.[10]

In 2004, Congress passed legislation that made the definition of a child more uniform. Before 2004, the same child could be deemed eligible for some tax benefits but not others. The law retained different age limits among the various provisions. As a simplification to the tax code, we examine making the definition of a child for the CTC consistent with that of a dependent. Effectively, this raises the age limit from 16 to 18, or 23 for full-time students.[11]

Figure 2 shows the average tax cut for families at various income levels if eligibility for the CTC were extended to all dependents. Over 7 percent of all households would benefit from this change, with the greatest share of tax benefits concentrated among families with incomes above $50,000. Relatively few low-income families would benefit. Only 0.2 percent of those with incomes below $10,000 and 2.6 percent of those with incomes between $10,000 and $20,000 would benefit from the change, compared with 12.7 percent of families with incomes between $50,000 and $100,000 and 13.9 percent of families with incomes between $100,000 and $200,000. On average, those who benefit in the lowest two income categories would receive an average tax cut of $670 and $570, respectively, while those with higher incomes would receive an average tax cut of at least $1,000.

FIGURE 2. Reforming the Child Tax Credit and Earned Income Tax Credit: Average Tax Cut for Families Receiving Tax Cut (2005$)



Source: Urban–Brookings Tax Policy Center Microsimulation Model (version 0305-2).
Note: For additional information see Burman, Maag, and Rohaly (2005).

Modifying the Earned Income Tax Credit

The EITC provides a much more targeted vehicle for increasing aid to low-income families. The EITC is the largest cash assistance program for low-income families.[12] It provides up to $4,400 a year (in 2005) for working families with two or more children, and smaller amounts for families with fewer children. For families with tax liability less than their EITC, the excess is rebated to them in the form of a tax refund.

The EITC has three ranges. In the phase-in range, the credit increases with earned income until reaching the maximum credit. Then, over a fixed range of earnings (the "plateau"), recipients receive the maximum credit. At higher earning levels, the credit phases out as earnings increase until it is eliminated. In 2005, the credit phased out for single parents with two children once their earnings reached $35,263. Married couples with two children could receive the EITC until their combined earnings reached $37,263.

The EITC phaseout may discourage work among secondary earners (Ellwood 2000). One way to lessen that disincentive would be to phase out the EITC over a larger range of income.[13] By extending the point where the EITC phases out by 10 percent, families in the phaseout portion of the EITC will receive a slightly larger credit, and families with incomes within 10 percent of the current maximum income will receive a small EITC. Families with incomes between $20,000 and $40,000 are the most likely to receive a tax cut (about 27 percent, compared with 10 percent overall), but their average tax change is modest. Among all families receiving a tax cut from this option, the average cut is $220. Those with incomes between $30,000 and $40,000 receive the largest average cut—$390.

Because secondary earners are more sensitive to high phaseout rates, we also examine expanding the EITC phaseout for married couples only. Fewer families benefit from this change, only 3.2 percent overall, and the benefits received are roughly equivalent to those in the previous option.

A final option for reforming the EITC—and the one most targeted to costs associated with raising children—would create a third tier of the EITC for families with three or more children. The option would increase the credit rate for three or more children—currently 40 percent—by 25 percent, the approximate difference in the poverty threshold between a single-parent household with two children and a similar household with three children. The phase-in rate thus becomes 50 percent. The income range over which the credit phases in is the same as for a two-child family under current law—$0 to $11,000 in 2005—and the credit begins to phase out at the same income levels as under current law and at the same 21.06 percent rate that applies to families with two or more children. Since the maximum credit is larger, the credit applies over a larger range of income.

Although the tax benefits of expanding the EITC to families with three or more children are substantial, less than 5 percent of households in any income class would receive a tax cut. Qualifying tax filers with incomes between $20,000 and $40,000 would receive an average tax cut of over $1,000 (figure 2). Almost 25 percent of the benefits would accrue to families with incomes between $10,000 and $20,000, and 5 percent would go to those with incomes under $10,000.

Distributional and Revenue Effects of the Reforms

Table 1 compares the different options according to the distribution of the tax benefits by income and the revenue cost. The revenue cost estimates assume a baseline in which the relevant expiring provisions—those allowing the use of personal credits against the AMT, and the EGTRRA expansions of the EITC and CTC—are extended; that is, they represent the incremental cost of further expansions, not the cost of extending current law parameters.[14] Against that baseline, Option 5 (expanding the EITC phaseout range for married couples only) is the least costly. The revenue cost is low ($12.9 billion) because most EITC returns are filed by single heads of household, not married couples. If head-of-household returns were included (Option 4), the cost would increase to $38.5 billion. Adding a higher credit for larger families would cost about $27.6 billion.

The most costly option—$113 billion over 10 years—is Option 3 (expanding the age limits for the CTC). That option would substantially expand the pool of children eligible for the credit. Making the CDCTC refundable and indexing its parameters for inflation (Option 1) would cost $24.2 billion over the budget period; increasing the maximum credit rate to 50 percent would cost about $43.1 billion.

The options also vary in their target effectiveness. Option 1 is targeted at low-income households. About three-quarters of the benefits of the change would accrue to those earning less than $20,000. Only about 2 percent would go to those with incomes over $50,000. If the maximum credit rate were increased to 50 percent (Option 2), more middle-income households would benefit since credit rates would be higher for those with AGI up to $60,000.[15] Nonetheless, Option 2 provides the largest average tax cut ($41) for people with incomes below $20,000. As noted earlier, for the 3.3 percent of households that benefit from the provision, the credit is quite significant, averaging almost $1,200.

TABLE 1. Distributional and Revenue Effect of Options

	Distribution by Cash Income Class, 2005[a]									Ten-year revenue loss ($billions)[b]
	$0–20k			$20k–50k			$50k+			
	% with tax cut	Average tax cut ($)	% of cut	% with tax cut	Average tax cut ($)	% of cut	% with tax cut	Average tax cut ($)	% of cut	
1: Refundable CDCTC[c]	3.3	28	74.9	1.3	11	22.6	0.1	1	2.1	24.2
2: Option 1 + 50% max rate[c]	3.3	41	51.5	4.6	30	40.9	2.0	11	12.6	43.1
3: Conform CTC age limits[d]	1.6	14	3.4	7.2	84	32.2	12.0	156	64.2	113.0
4: Expand EITC phaseout[e]	9.1	6	5.8	22.6	73	92.6	0.3	1	1.6	38.5
5: Option 4 for MFJ only[f]	1.0	1	2.0	8.6	32	95.5	0.2	1	2.3	12.9
6: EITC third tier[g]	2.1	22	29.5	4.2	43	68.8	0.1	1	1.6	27.6

Source: Urban–Brookings Tax Policy Center Microsimulation Model (version 0305-2).
[a] Calendar year. Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis. Tax units with negative cash income are excluded from the lowest income class but are included in the totals. For a description of cash income, see http://www.taxpolicycenter.org/TaxModel/income.cfm.
[b] Fiscal year revenue loss for 2005–15. The baseline includes extending certain expiring provisions. The costs of the extended provisions are $14.1 billion to extend the use of personal credits against the AMT in options 1 and 2, $134.2 billion to extend CTC provisions in Option 3, and $7.7 billion to extend the EITC provisions in options 4–6.
[c] Includes indexing CDCTC parameters after 2005.
[d] Qualifying children for the CTC are all those eligible under current law (extended) plus any dependent children not currently eligible.
[e] The option would reduce the EITC phasedown rates so the credit phases out at a 10 percent higher income level than under current law. The phaseout rates would be 6.05, 13.34, and 17.87 percent for no children, one child, and two or more children, respectively.
[f] This option would apply the slower phaseout rates specified in Option 4 only to married couples filing joint returns.
[g] The phase-in rate for three or more children would be 50 percent; the other parameters would be the same as for two or more children under current law.

All the EITC options would provide the largest benefits to families with incomes between $20,000 and $50,000. Among those options, only Option 6 (creating a higher credit for families with three or more children) provides significant assistance to those with very low incomes. Option 3 is the least targeted option. It would provide the smallest share of benefits to those with very low incomes, and almost two-thirds of the benefits would go to those with incomes over $50,000.

Conclusion

Although EGTRRA increased the value of the CDCTC on paper, the actual benefit eluded most low-income people. First, because the credit is not refundable, low-income families that do not owe income taxes cannot benefit from it, regardless of the credit rate. Second, low-income families are unlikely to have sufficiently high child care expenses to take advantage of the increased limit on qualifying expenses. Higher-income families, however, did benefit from the higher expense limit. Although a few families benefited from the increased rates, most will continue to receive a CDCTC worth 20 percent of qualifying expenses.

Making the CDCTC refundable would provide a substantial amount of assistance to low-income families. Indexing the CDCTC for inflation will guarantee that the real benefits provided do not erode over time. But because the credit would likely be received in a lump sum upon filing a tax return, it is unclear whether this will actually affect people's child care choices. This is true regardless of whether the current maximum credit rate of 35 percent is retained or the alternative maximum credit rate of 50 percent is adopted.

Two refundable credits—the CTC and the EITC—also help working families with children. Simplifying the CTC to make the definition of a qualifying child consistent with that of a dependent could benefit many families, but aid would not be targeted to low-income families. Reforming the EITC provides more targeted benefits, but like the CTC reform, benefits are not tied directly to the costs associated with child care.

Extending the phaseout of the EITC could reduce the disincentive to work inherent in the EITC. Because secondary earners appear more responsive to such disincentives, a more targeted option would extend the phaseout only for married couples.

Alternatively, larger families could be helped by adding a third tier of the EITC for families with three or more children. This option is less expensive, but would not benefit most low-income families.

Notes

1. For more information, see Burman, Maag, and Rohaly (2005).

2. The federal income tax system also subsidizes child care through flexible spending accounts. These accounts allow parents to exclude up to $5,000 of qualified expenses for child care from their taxable earnings. These accounts typically benefit

higher-income families that face higher marginal tax rates. EGTRRA did not change the treatment of these accounts.

3. As discussed later, the CTC is only partially refundable, which limits its benefit for families with very low incomes.

4. EGTRRA increased the maximum credit rate and the amount of expenses eligible for credit, starting in 2003. See Burman, Maag, and Rohaly (2002) for a discussion of the EGTRRA changes.

5. In addition, 27 states provide income tax credits or deductions for child care. See Donahue and Campbell (2002).

6. Indexing the credit for inflation is explored in more detail in Burman et al. (2005).

7. The estimate assumes that the more valuable credit does not induce more families to pay for care (or purchase more expensive care). The actual response (both take-up rate for the credit and the cost of the credit increases) could be higher if people change their behavior.

8. The credit phases out at a rate of 1 percentage point per $1,000 of AGI. One percent of the maximum child care expenses allowed ($6,000 for two or more children) is $60.

9. The threshold is indexed for inflation.

10. A refundable child tax credit for certain families with three or more children predates EGTRRA and will continue past 2010. However, most low-income families receive a larger benefit from the EGTRRA provisions (Burman et al. 2002).

11. The credit would also continue to be available in the limited cases where nondependent children are eligible under current law.

12. Preliminary estimates of the 2002 nonadministrative costs of the EITC total $38.7 billion (IRS 2004); the combined expenditure of state and federal funds on cash assistance in Temporary Assistance for Needy Families totaled $14.6 billion (HHS 2002).

13. The phaseout is tantamount to a surtax in the phaseout income range. Expanding the phaseout range by 10 percent reduces the surtax rate by about 9 percent. (The surtax equals the maximum credit divided by the amount of income in the phaseout range. Increasing the phaseout range by 10 percent increases the denominator of this calculation by 10 percent. In consequence, the new surtax rate equals 1/1.1 times the original surtax. 1/1.1 = 0.91.)

14. Burman et al. (2005) break out the costs of extending the expiring provisions.

15. Some people have cash incomes greater than their AGI, because cash income includes nontaxable items such as pensions.

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