NYLS Journal of Human Rights

Volume 16
Issue 1 *SYMPOSIUM: WOMEN, EQUITY AND FEDERAL TAX POLICY: OPEN QUESTIONS*

Article 16

1999

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Dr. Alison P. Hagy

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DR. HAGY: Before I begin my comments I want to say that I am on leave from the Census Bureau, so in my comments today I am wearing my Duke University "hat." As such, my comments should not be construed as the opinion of the United States Census Bureau.

The Child and Dependent Care Tax Credit (CDCTC) is the largest federal government program in the United States aimed at helping families with child care. It is estimated to have cost the federal government $2.8 billion in forgone tax revenues in fiscal year 1998. There is an alternative tax relief program, the Dependent Care Assistance Plan (DCAP), that is estimated to have cost the federal government $890 million in forgone tax revenues in fiscal year 1998. President Clinton, in his budget just submitted to Congress, has proposed a generous expansion of the CDCTC along with additional tax credits for employer-provided child care and/or employer-provided child care resource and referral services.

WHAT IS THE MOTIVATION FOR THIS LEVEL OF GOVERNMENT INVOLVEMENT IN THE CHILD CARE MARKET?

From an economist's perspective, the rationales for government intervention fall into two broad categories: equity and efficiency. In the first case, the government might be motivated by a desire to ensure that access to a particular service or commodity is not conditioned on income. Examples with which we are familiar are food, housing and health care. That is, the government might desire that some minimally acceptable standard of child care be affordable to all families. In the second case, there may be market imperfections that open the door for government intervention. In particular, in the child care market there may be what are called positive externalities. That is, there may be benefits that extend to individuals beyond the child, or even beyond the parents, to society at large. Another common example of where there may be positive externalities is in primary and secondary education. So, to the extent that there are positive externalities in the child care market, parents may choose to purchase a level of child care quality that is lower than what would be considered socially optimal.

There may also be what are called informational asymmetries in the child care market, where parents have a difficult time judging the quality of the care they are purchasing for their child. For these reasons as well, parents may purchase a level of child care quality that is below what is socially desirable, in fact, even below what they would desire for their own child, in the absence of any external benefits to society. Finally, an often-cited goal of government intervention in the child care market is to induce low-income parents to work, so that they may gain work experience that may lead, ultimately, to self-sufficiency. These are several ways the economist would rationalize government intervention in the child care market.

HOW MIGHT THE GOVERNMENT INTERVENE IN THE CHILD CARE MARKET?

There are several ways in which the government may intervene in the child care market. Government subsidies to child care can make child care more affordable to low-income families, thus addressing the government's equity concerns. Government subsidies also have the potential to induce parents to purchase higher quality care, resolving society's desire for a higher level of quality care than parents would choose to purchase on their own. There are subsidies to encourage the provision of information to parents about the quality of care available that may address informational asymmetries inherent in the market. Finally, child care subsidies may influence labor force participation and parent's hours-of-work decisions. Specifically, tax relief for child care that is tied to labor force participation, such as the CDCTC, increases the effective wage rate of the recipient, usually the mother. Thus, tax relief is likely to influence the mother's labor force participation decision as well as her decision regarding how many hours to work.

The government may (and does) intervene in the child care market in other ways, for example, by regulating the child care market. States and localities regulate the quality of care by regulating certain quality-related attributes of care. For example, there are regulations regarding the number of staff to children in the child care arrangement, the size of the group in which the children are cared for, and whether or not the provider has specialized training in early education and care. Regulations, in and of themselves, can provide information to parents simply by reducing the uncertainties inherent in choosing a child care arrangement.

I will not talk further today about government regulation or other interventions in the child care market intended to reduce informational asymmetries. Instead, I will focus on government subsidies to child care and, specifically, those subsidies that operate through the tax code. To what extent does tax relief for child care address the government's stated concern for equity? Do government subsidies, in fact, induce parents to purchase higher quality care? Do government subsidies for child care induce low-income parents to work? These are important questions. The existence of market imperfections, such as positive externalities or informational asymmetries do not, in and of themselves, provide a sufficient rationale for government intervention. Government policy, in this case tax relief for child care, should produce more benefits for society than what it costs the taxpayer. Let me give you a brief history of the tax relief for child care in the United States.

The United States Income Tax Code has had special provisions for child care expenses since 1954. Initially, work-related child care expenses by low-income families were deductible from the tax base. In 1971, Congress expanded deductibility to cover a broader range of income groups. The Tax Reform Act of 1976 replaced the deductibility of expenses with a flat 20 percent credit for work-related child care expenses. The Economic Recovery Tax Act of 1981 (ERTA) modified the credit by introducing the current declining credit rate. ERTA also introduced Dependent Care Assistance Plans (DCAPs) which are employer-provided benefits that effectively give some taxpayers the choice between claiming the CDCTC and deducting child care expenses from their taxable income. Subsequent tax reforms have made minor changes to the tax relief provisions, but they are substantially the same as enacted in 1981.

I will give just a brief description of the two tax relief programs. They are similar in certain respects. The common features include: only the expenses for children under the age of 13 qualify; both parents, or the single parent, must work or be enrolled in school; child care expenses must be work-related; and, eligible expenses are limited to the earned income of the parent with the least income. The programs differ in the amount of eligible expenses, the value of the reduction in taxes and in their administration. For the CDCTC, qualified expenses are limited to \$2,400 for families with one child under age 13 and \$4,800 for families with more than one child under age 13. For families with adjusted gross incomes (AGI) below \$10,000, the credit is 30 percent of qualified expenses. The rate of the credit falls until AGI reaches \$28,000. For families with AGI above \$28,000, the credit rate is 20 percent. Importantly, the credit is nonrefundable so that the total credit is limited to the family's tax liability.

In contrast, DCAPs are flexible spending accounts in which employees can reduce their pre-tax income and use the reduction to pay for child care expenses. Total family contributions to DCAPs are limited to \$5,000. Since DCAP contributions lower taxable income, the DCAP's value roughly equals the family's marginal tax rate multiplied by the DCAP contribution. It should be noted that a dollar of child care expenses cannot be subsidized through both the CDCTC and the DCAP. Each dollar contributed to a DCAP lowers the maximum expense qualifying for the CDCTC by a dollar. Whether a family benefits more from a DCAP or from the CDCTC depends on its credit rate and its marginal tax rate. Since higher income families have lower credit rates (because of the declining credit rate) and higher marginal tax rates, they are likely to find it advantageous to use a DCAP, if they have access to it, rather than the CDCTC.

WHAT DOES CURRENT RESEARCH TELL US ABOUT THE DISTRIBUTIONAL CONSEQUENCES OF TAX RELIEF FOR CHILD CARE?

In other words, does tax relief for child care satisfy the government's desire to achieve equity? In research with Professor Bill Gentry of Columbia University, I have studied exactly this question.[5] Our primary data source is the National Child Care Survey (NCCS), which surveys families with at least one child under age 13 and thus isolates a cohort of families with children of eligible ages for tax relief. The NCCS also includes information that is not available from previously analyzed tax return data. For example, it has information on access and participation in DCAPS, so when I talk about the distributional consequences of tax relief I am also including the DCAP program which is, as I said before, more likely to benefit higher income families.

Our results suggest that a broad cross-section of Americans benefit from tax relief for child care. However, tax relief does not reach the bottom 10 percent of the income distribution, primarily because the CDCTC is nonrefundable. Despite this regressivity at low income levels, we find that above the bottom quintile of the income distribution tax relief is progressive; that is, the effective subsidy rate steadily declines with income. We attribute this progressivity to a combination of progressive features of the tax rules, for example, the declining credit rate. Among families that receive tax relief for child care expenses, the tax benefits average about 1.24 percent of family income. While our results on the progressivity of tax relief indicate that this percentage varies systematically across income groups, tax relief is really too small to influence the income distribution dramatically.

I am hesitant to judge the government's tax policy toward child care expenses in isolation from the remainder of its efforts to help families with child care. There are numerous other programs, including the Child Care and Development Block Grant, that are better targeted toward helping the low-income population. However, as the largest federal government program helping families with child care, the CDCTC does not help those most in need.

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[5] *See* William M. Gentry & Alison P. Hagy, *The Distributional Effects of the Tax Treatment of Child Care Expenses*, *in* EMPIRICAL FOUNDATIONS OF HOUSEHOLD TAXATION (Martin Feldstein & James M. Poterba eds., 1996).

WHAT DOES CURRENT RESEARCH TELL US ABOUT THE ABILITY OF CHILD CARE SUBSIDIES TO INDUCE PARENTS TO PURCHASE HIGHER QUALITY CARE?

I have looked at this question with Professor David Blau of the University of North Carolina at Chapel Hill.[6] Again, we use data from the NCCS as well as data from the complementary Profile of Child Care Settings Study. We find that parents, in fact, appear to view quality and quantity of care as substitutes for one another. That is, a decrease in the price per hour of care leads to an increase in the demand for hours of care, as we might expect, but it also leads to a decrease in the demand for quality-related attributes of care, including staff-to-child ratio, group size and provider training. So, we find that, basically, there is a quantity/quality trade-off here. Now, parents may, in fact, be willing to pay for higher quality care. They may just perceive quality differently from developmental psychologists, specifically in ways that are much more difficult to measure than the often-cited structural attributes of staff-to-child ratio, group size and provider training. There has been very little work done investigating the demand for quality in child care. Clearly, more work should be done before definitive conclusions are drawn; however, at this juncture there is no evidence that child care subsidies induce parents to purchase higher quality care. In addition to the work that I have done with David Blau on this topic, I have looked at subsidies that are tied to the purchase of higher quality care, as measured by staff-to-child ratio.[7] For example, do these tied subsidies induce parents to purchase higher quality care? Again, I find the answer is no.

DO CHILD CARE SUBSIDIES INDUCE LOW-INCOME PARENTS TO WORK?

The available evidence suggests that child care subsidies do increase the mother's probability of working. A 10 percent reduction

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[6] *See* David M. Blau & Alison P. Hagy, *The Demand for Quality in Child Care*, 106 J. POL. ECON. 104 (1998).

[7] *See* Alison P. Hagy, *The Demand for Child Care Quality: An Hedonic Price Theory Approach*, 33 J. HUM. RESOURCES 683 (1998).

in the price of child care increases the probability a married mother will work by 2 to 8 percent. There is less evidence that child care subsidies increase hours of work, conditional on the mother already working.[8]

WHAT ARE THE CURRENT PROPOSALS FOR EXPANDING TAX RELIEF FOR CHILD CARE?

President Clinton has proposed expanding the CDCTC. In particular, the credit rate would be increased to 50 percent for taxpayers with AGI of $30,000 or less. For taxpayers with AGI above $30,000, the credit rate would fall until AGI equaled $59,000. Then, for taxpayers with AGI above $59,000, the credit rate would be 20 percent. The proposal would also extend up to $250 of additional credit (or $500 for two or more qualifying dependents) to taxpayers with a qualifying dependent under the age of one. This additional credit would be available regardless of whether the taxpayer actually incurred any out-of-pocket child care expenses. In other words, this latter provision would provide tax relief for stay-at-home moms. There are additional employer tax credits for the provision of child care services to their employees, as well as for the provision of child care resource and referral services.

ARE THESE PROPOSALS LIKELY TO IMPROVE UPON THE CURRENT SYSTEM OF TAX RELIEF FOR CHILD CARE?

Expanding the current CDCTC is unlikely to improve the distributional consequences of tax relief for child care. Under the current proposal, the CDCTC would remain nonrefundable and, as a result, would remain inaccessible to those households at the bottom end of the income distribution. The proposal to provide tax relief for stay-at-home moms who have a child under the age of one could be considered a proposal to improve the quality of care, if one believes

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[8] *See* COUNCIL OF ECONOMIC ADVISORS, THE ECONOMICS OF CHILD CARE (1997).

parental care is the best form of care for infants.

With respect to the proposed employer tax credit for the provision of child care services to their employees, economic theory suggests that it does not matter whether the subsidy is literally handed to the consumer or to the provider as to who actually receives the benefit of the subsidy. Empirical evidence suggests that the supply of child care is quite responsive to increases in demand. For example, the demand for paid child care has more than doubled in the past 20 years, yet the real price of child care has not changed over the same time period. As a consequence, a subsidy that is literally handed to providers will simply be passed on to consumers, lowering their price of child care. Thus, we have no reason to expect that employer subsidies will have different effects than the employee subsidies we already have.

Finally, the proposed employer tax credit for the provision of child care resource and referral services represents a new approach to improving the quality of child care purchased in the market. This approach assumes parents purchase lower quality care than would be socially desirable due to informational asymmetries rather than due to the existence of positive externalities. The assumption is that access to more information through these resource and referral services would enable parents to make better decisions about quality. This would be true if employers can better identify quality than can parents; if this is true then, of course, this latter approach has promise.

PROF. THOMAS: I am interested, Alison, in what you said about cost. You said that in the past 20 years the real cost of child care does not appear to have increased?

DR. HAGY: Right.

PROF. THOMAS: To what could we attribute that? Is that an effect of the ceiling on tax credits for child care?

DR. HAGY: No, the supply of child care services is, as economists would say, highly elastic, so that as the demand increases the supply increases to satisfy the demand. As such, the price is not driven up.

PROF. THOMAS: Some of us who have had the opportunity to test that in the marketplace might not agree with that supply and demand theory. There seems to be a supply problem there.

Another question I have had about some of the data in this area is the reliability of the pricing information, for example, that found in the National Child Care Survey. A few years ago there was concern that it was hard to get reliable information about what child care workers were paid. Do you have any news about that?

DR. HAGY: Well, I would say that most of the research in the past has relied on what parents say they pay for child care as opposed to what providers say they are paid for child care, and there is a real difference between the two. Economists believe that you can rely more on what providers say they are paid. When you ask parents how much they pay for child care, it involves the quality they choose, for example. So, you want to define a price per hour of constant-quality care. You define such a price with information that is provided by suppliers because they give you a whole lot more information about the quality of care, and about the attributes of the arrangement, than you can collect from the parents. So, we think by using the complementary Profile of Child Care Settings Study (where we get information about prices from the providers) we can have a better measure of price than we can get when we ask the parents.

THE AUDIENCE: I have two questions. In New York City, of course, the child care market is probably a little different than it is in a lot of other communities. There is a lot of subsidized care here, there is a lot of off-the-books care here and there is a tremendous amount of family care here. I am wondering how you capture that type of informal care that is so important in areas where there are a lot of lower income workers?

DR. HAGY: In terms of when we ask households, we get information from them about their child care, whether it is a center-based arrangement, a family day care arrangement or a more informal arrangement, relatives or someone coming into their home. It is much more difficult to collect information on the informal market from providers, so the provider information that we have is only on center-based providers and regulated family day care providers. You are absolutely right; there is a real lack of information from the providers on unregulated care. We do not know who is providing the child care; we can not go talk to them. In fact, it has been estimated that about 90 percent of the family day care market is unregulated. It is not because these people are providing care illegally, but just because legal requirements do not require them to be licensed. Your question is a really important one, but one to which we do not have a lot of answers and where the data is lacking. When I am looking for price information for the informal provider, I have to go back to what most studies have done and use the prices that parents give us.

THE AUDIENCE: Since we have been talking so much about price and I have paid for child care for the past 10 years, I would like to know what the standard is per month for child care. I feel that this $2,400 deductible has gone unchanged as long as I have been buying child care. It seems to be a joke because paying $70.00 per month for quality care per child seems to be very unrealistic.

DR. HAGY: Right. Well, when I said the price has not gone up I mean the real price, not the price in nominal dollars. You are absolutely right; they have not indexed the level of qualifying expenses for inflation — I left that out of my talk in the interest of time — but they are also proposing to index the level of eligible expenses for inflation.

THE AUDIENCE: I have a question concerning the paradigm that you are using in light of the rationale that you would only seek state intervention to correct the market. Given your findings on progressivity, could you actually rethink tax subsidies or state expenditures? I think about the tax system or the tax subsidies as, actually, a tool of redistribution, not as an intervention of the market. Perhaps, given the findings, women in marriages are bearing child care expenses. As such, perhaps the tax system acts as redistribution to working women.

DR. HAGY: I suppose you could think of it as a way of reducing the marriage penalty to a certain degree. My only question is why is it tied to the purchase of child care? If you want to redistribute income, just redistribute income. Don't distort people's decisions about whether to purchase child care and what type of child care to purchase.

THE AUDIENCE: My point is that it would be redistribution to working women and I am not talking about working women with children who pay for child care, but redistribution through the system to families with children; the marriage bonus issue. But, if you would like redistribution to a specific category of women with children, I think that's a good thing — using child care subsidies as a redistributive tool, not just as a tool for intervening in the market for child care.

DR. HAGY: There are two reasons why you might intervene in the child care market: to try to correct any sort of market imperfection, and to try to achieve better equity. If you are most concerned about the lowest income groups, you are not going to achieve equity with the tax credit because the lowest income groups do not have a tax liability and the tax credit is nonrefundable.

PROF. THOMAS: I will end this part of the program with another piece of tax history. The nonrefundable child care credit for working parents has some curious features. By its terms, it offers a maximum credit of $1,440 to working parents who spend $4,800 on care for two or more children.[9] But the maximum credit has probably never available to anybody. This becomes apparent if we go back and look at the tax rates and personal exemptions and standard deductions that have also been applicable. There is an income ceiling for the maximum credit; to be eligible for it, the working parent or working couple's adjusted gross income cannot exceed $10,000. Even in 1982 when it was put into effect, no qualified family configuration with adjusted gross income below $10,000 would have owed enough federal income tax to make full use of the statutory maximum.[10]

Indeed, today, no working parents who are within the income limits for the maximum credit get any benefit from the child care credit at all. This is because after giving effect to the standard deduction and personal exemptions, no married joint filing couple or head of household with adjusted gross income of $10,000 or less has any regular federal income tax liability.[11] One does not even have to

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[9] *See* I.R.C. § 21(a)(2) (1999).

[10] A dual worker married couple with $10,000 of adjusted gross income who filed a joint return and had the necessary two dependent children, in 1982 would have had tax liability of only $312. Because the child credit is nonrefundable, its value is limited by the amount of tax otherwise due. A sole worker parent with two children and $10,000 of adjusted gross income filing as head of household in 1982 would have had a tax liability of $570, still $870 short of the theoretical maximum. For 1982, ERTA set the personal exemption at $1,000 and the zero bracket amount, which had the same effect as the standard deduction in current law, for married joint filers at $3,400 and for heads of household at $2,300. See GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT OF 1981 PREPARED BY THE STAFF OF THE JOINT COMMITTEE ON TAXATION, Dec. 31, 1981, and Public Law 97-34, for 1982 rates, deductions and zero bracket amounts.

[11] For 1999, a married couple that files a joint return and has two children

reach the question of whether parents with adjusted gross income at the $10,000 level would typically be in the position to spend the $4,800 for child care for two children, which is the child care expenditure level at which the theoretical maximum credit of $1,440 occurs.

DR. HAGY: Right. Those at the low end are much less likely to purchase child care at all.

PROF. THOMAS: Yes, I agree. When we examine it and try to apply it, the child care tax credit emerges as a provision that promises more than it can deliver to low income working parents.

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does not begin to have either taxable income or tax liability until adjusted income exceeds $18,200, the total of the standard deduction ($7,200) and the four personal exemptions of $2,750 each. Similarly, an unmarried working parent with two dependent children in the home would not owe federal income tax until his or her adjusted gross income exceeded $14,600, representing the total of the standard deduction for heads of household is $6,350 and three personal exemptions. See I.R.C. §§ 1 (a) & (b), 63(c) and 151 (1999); and Rev. Proc. 98-61, 1998-52 IRB 18, for inflation adjustments for 1999.