FIXING THE CHILD CARE CREDIT: HIDDEN POLICIES LEAD TO REGRESSIVE POLICIES*

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Over the last fifteen years, federal child care assistance has more than doubled. The cost of federal child care assistance rose from $1 billion in 1972 to about $6.2 billion in 1987. Accounting for inflation, these figures represent a real increase of 127%. By 1989, expenditures will approach $8 billion, representing an additional 24% increase in just two years.[1]

Poor and low-income families, however, have not benefited from this increased government spending. Federal child care assistance to poor and low-income families also increased during the 1970's and 1980's, but not nearly as rapidly. Between 1972 and 1987, spending on these programs rose from about $800 million to about $2.7 billion, which is only a 29% increase after inflation.[2]

The federal government should do a better job in meeting the child care and child development needs of disadvantaged children. Low-income children are now served primarily by the Head Start and Social Services Block Grant programs. The Head Start program is one of the few broadly popular remnants from the War on Poverty. But its orientation is badly out-of-date. The program should be improved and modernized to reflect contemporary conditions, and it should be expanded to serve poor children for a longer period of their lives.

To pay for this expansion of Head Start, the Child and Dependent Care Tax Credit[3] should be capped and the resultant savings redirected to a revitalized Head Start program. The first part of this Article reviews current federal child care expenditures. Part II proposes capping the Child and Dependant Care

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[1] D. BESHAROV & P. TRAMONTOZZI, THE COSTS OF FEDERAL CHILD CARE ASSISTANCE 1 21 table 1 (Am. Enterprise Inst., Apr. 20, 1988).

[2] *Id.*

[3] I.R.C. § 21 (West Supp. 1988).

Tax Credit so that low-income families become the main beneficiaries of federal child care assistance.

I. Programs for Poor and Low-income Families

A. *Child Care and Early Education*

A number of federal programs are devoted exclusively to child care, early education, or related services, at an annual cost of about $1.9 billion. The largest of these programs is Head Start, which spends $1.1 billion per year on local preschool programs for low-income children.[4] The Child Care Food Program[5] ($551 million)[6] and the Special Milk Program[7] ($4 million)[8] provide milk, food, and money to child care providers for an estimated 1.1 million low-income children daily.[9] The Department of Education also supports preschool programs for handicapped children by providing states with approximately $178 million in grants under the Special Education and Rehabilitative Services program.[10]

Another $11 million in federal expenditures provides less direct support for child care programs. Under the Dependent Care Planning and Development Program, the Department of Health and Human Services (HHS) makes grants totaling up to $5 million per year to the states for child care services before and after school, and for the development of local child care information and referral services.[11]

Through the Child Development Associate Scholarship Program, HHS gives up to $1 million in grants to the states.[12] This

[4] Office of Mgmt. & Budget, Budget of the United States Government: Appendix, Fiscal Year 1989, at I-K36 (1988) [hereinafter Budget Appendix, FY 1989].

[5] 42 U.S.C. § 1766 (1982).

[6] Budget Appendix, FY 1989, *supra* note 4, at I-E81.

[7] 42 U.S.C. § 1772 (Supp. IV 1986).

[8] U.S. Dep't of Labor, Child Care: A Workforce Issue 22 (1988) [hereinafter A Workforce Issue].

[9] These figures are for fiscal year 1986. S. Stephan & S. Schillmoeller, Child Day Care: Selected Federal Programs 20–21 (Library of Congress, Cong. Research Serv., Apr. 7, 1987).

[10] Budget Appendix, FY 1989, *supra* note 4, at I-18.

[11] *Id.* at I-K36.

[12] *Id.*

money pays for scholarships to needy candidates for the child development associate credential.[13]

B. *Welfare and Job Training—Child Care Expenses*

The various federal welfare and job training programs are another major source of direct and indirect funding for child care services. The two major federal welfare programs—Aid to Families with Dependent Children (AFDC)[14] and Food Stamps[15]—subsidize child care indirectly by allowing recipients to deduct child care expenses from their income when determining eligibility. These policies, which are designed to encourage work and self-sufficiency, cost the federal government an estimated $94 million in 1987.[16]

Similar child care deductions are also allowed under two federal housing assistance programs: the Public and Indian Housing Program, and the Section VIII Housing Program, which provides rent vouchers to make private housing affordable for low-income families. Both programs deduct child care expenses from family income when determining the participants' rent copayment. For 1988, an estimated 210,000 families with 480,000 children are expected to deduct child care expenses, at a cost of $18 million.[17]

The Work Incentive Program (WIN)[18] seeks to reduce welfare dependency by providing money to states to help AFDC recipients find and retain jobs. States are required to provide child care services to WIN participants who need them. In 1987, these services cost the federal government an estimated $12.6 million.[19]

As part of its overall strategy for training economically disadvantaged individuals and dislocated workers, the federal government provides money to states for child care services and subsidies within broad-based employment programs. Local programs funded under the Job Training Partnership Act (JTPA)[20]

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[13] S. Stephan & S. Schillmoeller, *supra* note 9, at 25.
[14] 42 U.S.C. § 601 (1982).
[15] 7 U.S.C. § 2011 (1982).
[16] D. Besharov & P. Tramontozzi, *supra* note 1, at 8 n.24.
[17] A Workforce Issue, *supra* note 8, at 42.
[18] 42 U.S.C. § 630 (1982).
[19] D. Besharov & P. Tramontozzi, *supra* note 1, at 9–10 n.26.
[20] 29 U.S.C. § 1501 (1982).

spend over $9 million for child care supportive services and subsidies.[21]

C. *Student Financial Aid—Child Care Expenses*

A number of federal financial aid programs for students base the size of individual grants upon the cost of school attendance. Beginning in 1988, this cost may include reasonable child care expenses.[22] Data on the costs of this new child care provision are not available for most of these programs, but estimates provided by the Department of Labor indicate that child care will add an estimated $65 million to total expenditures for the Pell Grants program,[23] which provides grants for low-income students.[24]

D. *Social Services and Community Development Funding*

In addition to the programs described above, a portion of an additional $6 billion in social services, child welfare grants, and community development grants[25] is available for child care services. Unfortunately, the structure of these block grants to the states makes it difficult to determine with any degree of certainty precisely how much money is involved.

Consider the largest of these programs—the Social Services Block Grants (Title XX).[26] In 1987, over $2.7 billion[27] was given to the states to provide a full range of social services—at the states' discretion. There are no requirements as to how the states should apportion the money. To enhance states' flexibility further, there are also no detailed record-keeping requirements on how these funds are used or whom they benefit. Thus, little

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[21] A WORKFORCE ISSUE, *supra* note 8, at 44–47.

[22] *See id.* at 27, 29.

[23] 20 U.S.C. § 1070(a) (1982).

[24] A WORKFORCE ISSUE, *supra* note 8, at 27.

[25] Programs include Social Services Block Grants, Community Development Block Grants, Community Services Block Grants, and the Area Economic and Resource Development Program. Child welfare grant programs include Child Welfare Services, the Child Welfare Training Program, Indian Child Welfare Grants, and Child Welfare Research and Demonstration Projects. For a description of child care-related activities, see S. STEPHAN & S. SCHILLMOELLER, *supra* note 9, at 6–26. For budget information, see BUDGET APPENDIX, FY 1989, *supra* note 4, at I-K35 to -K37, I-M22.

[26] 42 U.S.C. § 1397 (1982).

[27] BUDGET APPENDIX, FY 1989, *supra* note 4, at I-K36.

data exist on how much Title XX money is spent by the states on child care.[28]

The Department of Labor estimates that in 1988 $660 million (24%) of Title XX spending supported child care.[29] However, based on a recent survey of state child care spending, HHS estimated that combined state and federal Title XX spending on child care totals $1.1 billion per year.[30] Thus, assuming a standard two-thirds federal share, total federal spending could be as high as $726 million per year, or about 27% of total Title XX spending.

II. A Regressive Tax Break

The largest federal child care program is the Child and Dependent Care Tax Credit.[31] Because it is so poorly targeted and allows for so much abuse, approximately half its benefits provide an unjustified tax break for upper-income families. Targeting the credit to low- and moderate-income families would make available nearly $1 billion a year, money that could be used to help the families who need it most.

Tax benefits under the credit will reach an estimated $4 billion in 1988, with approximately 9.6 million families claiming an average credit of $419.[32] A shocking proportion of these credits goes to middle- and upper-income families. In 1985, nearly half went to families with incomes above the median; less than 1% went to families with adjusted gross incomes below $10,000, and only 13% to families with adjusted gross incomes below

[28] Ultimately, the extent to which states pay for child care through Title XX (or any other federal block grant) is not terribly relevant. A state has a certain amount of money with which to pay for social services, with funds coming from federal, state, and local sources. How a state chooses to allocate this money (and from what sources it funds particular activities) does not change the *total* amount of funds available for social services.

Like all money, Title XX funds are fungible; if a state chooses to spend all of its federal money on child care, that does not necessarily mean that it is spending more money on child care than other states. It does mean that the state would have to "charge off" all other social services to state and local sources—essentially an accounting decision.

[29] A Workforce Issue, *supra* note 8, at 31.

[30] Personal communication from William Prosser, Assistant Secretary for Planning and Evaluation, Dep't of Health & Human Services (Feb. 17, 1988).

[31] I.R.C. § 21 (West Supp. 1988).

[32] House Comm. on Ways & Means, Background Material and Data on Programs Within the Jurisdiction of the Committee on Ways and Means: 1988 Edition 615 table 12 [hereinafter Ways & Means].

$15,000.[33] So few lower-income families can benefit from the credit that less than half of all mothers in the labor force claim it.[34]

The credit's distributional defects are steadily worsening, while its cost increases by $500 million a year. A recent Urban Institute study found that because of recent tax law changes, for 1988, families with incomes under $12,000 will receive half the benefits they did in 1985, while those with incomes over $32,000 will receive 50% more.[35]

A similar situation exists with the relatively unknown Employer-provided Child or Dependent Care Services Tax Credit,[36] which allows taxpayers to establish $5000 tax shelters for child care expenses. Until last year when taxpayers were precluded from claiming both credits, higher income families (the ones with enough expenses to claim and enough income to shelter) received what amounts to a second credit worth as much as $2000. The cost of this additional credit was $30 million in 1987.[37] Before this change, costs were estimated to rise to $150 million in 1989, and to $1 billion by 1993.[38]

Moreover, there is widespread cheating under the credit. Special IRS audits reveal that two out of five taxpayers inflate their child care expenses, for a cumulative total of 28% of all claims. This is the same rate of overclaiming as for travel and entertainment expenses.[39] Approximately $4.5 billion in such phan-

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[33] *See* STATISTICS OF INCOME DIVISION, INTERNAL REVENUE SERVICE, INDIVIDUAL INCOME TAX RETURNS 1985, at 81 table 3.3 (1988) [hereinafter TAX RETURNS].

[34] Robins, *Federal Support for Child Care: Current Policies and a New Proposed System*, FOCUS, Summer 1988, at 6.

[35] *See Distributional Effects of Alternative Child Care Proposals, Hearings Before the Subcomm. on Pub. Assistance and Unemployment Compensation of the House Comm. on Ways & Means*, 100th Cong., 2d Sess. 3 (1988) (unofficial transcript) (statement of Roberta Ott Barnes, Senior Research Associate, Urban Inst.) According to the study, about 3% of the credit's benefits in 1988 will go to families in the bottom 30% of the income distribution, while almost half will go to families in the top 30%. The top 10% of families will receive 14% of the benefits.

[36] I.R.C. § 129 (West Supp. 1988).

[37] OFFICE OF MGMT. & BUDGET, BUDGET OF THE UNITED STATES GOVERNMENT: SPECIAL ANALYSES. FISCAL YEAR 1989, at G-43 (1988) [hereinafter BUDGET SPECIAL ANALYSES, FY 1989]. Other estimates are much higher. For instance, for fiscal year 1986 the Joint Committee on Taxation estimated a revenue loss of $110 million. S. STEPHAN & S. SCHILLMOELLER, *supra* note 9, at 13. However, for the same year, OMB placed it at $40 million. OFFICE OF MGMT. & BUDGET, BUDGET OF THE UNITED STATES GOVERNMENT: SPECIAL ANALYSES. FISCAL YEAR 1988, at G-44 (1987).

[38] BUDGET SPECIAL ANALYSES, FY 1989, *supra* note 37, at G-43.

[39] C.E. STEUERLE, WHO SHOULD PAY FOR COLLECTING TAXES? 42 table 4-1 (Am. Enterprise Inst., 1986).

tom child care expenses are claimed, for an annual revenue loss to the Treasury of about $1.3 billion.[40]

A. *Fix the Credit?*

Over the years, Congress has tried to make the credit less regressive. In 1976, the credit was changed to a credit from a deduction, in an attempt to make it as valuable to lower-income families as it is to families with higher incomes.[41] Then, in 1981, the credit was changed from a flat 20% of expenditures for all families to a proportionally higher credit for low-income taxpayers: 30% for incomes under $10,000 and 20% for incomes above $28,000, with a sliding scale in between.[42] Eligible expenses are limited to $2400 for one dependent and $4800 for two or more dependents.

Unfortunately, such provisions are insufficient to counter the realities of child care economics. First, to benefit from a nonrefundable tax credit, one must owe taxes. Lower-income families, by definition, often do not. This is why many observers have suggested making the credit refundable, as President Bush's child care proposal would do.

Second, families that can claim the credit (families where the mother works outside the home) tend to earn more than families in which the mother stays at home. Two-earner families, for example, had a median income of $40,422 in 1987, 52% higher than the median income of "traditional" two-parent/one-earner families, $26,652.[43]

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[40] In 1985, the latest year for which figures are available, taxpayers received about $3.1 billion in credits. TAX RETURNS, *supra* note 33, at 81 table 3.3. Assuming an average credit of 20% of child care expenditures, which is the minimum available (the average is probably somewhat higher), taxpayers claimed that they spent about $16 billion on child care expenses. A 28% rate of overclaiming on this amount would total $4.5 billion (28% of total expenses claimed). Again, assuming an average credit of 20%, the revenue loss would be approximately $900 million. These are 1985 numbers; with the use of the credit having increased an estimated 46% since 1985, we can project revenue losses due to cheating at $1.3 billion in 1989. BUDGET SPECIAL ANALYSES, FY 1989, *supra* note 37, at G-43.

[41] Tax Reform Act of 1976, Pub. L. No. 94-455, § 504(a), 90 Stat. 1563–66. For a brief legislative history of the Child and Dependent Care Tax Credit, see WAYS & MEANS, *supra* note 32, at 613.

[42] Economic Recovery Act of 1981 (ERTA), Pub. L. No. 97-34, § 124(a), 95 Stat. 197–99.

[43] BUREAU OF THE CENSUS, U.S. DEP'T OF COM., CURRENT POPULATION REP., SERIES P-60, No. 161, MONEY INCOME AND POVERTY STATUS IN THE UNITED STATES: 1987, at 12 table 12 (Aug. 1988).

Third, upper-income mothers are more likely to use child care centers, which are more expensive than family-based care and thus allow more expenses to be claimed. College-educated (and thus wealthier) mothers are twice as likely to use child care centers and preschools as are mothers without a high school education.[44] Conversely, about 60% of the families with incomes under $15,000 use unpaid relatives for child care.[45]

Finally, until 1988, the credit was available for children up to age fifteen. As children reach that age, most low-income families are relying on friends, relatives, or free community services, or the children are home on their own. Middle- and upper-income families, though, continue to use the credit (to help pay for day camp in the summer and for such after-school activities as dance classes and gymnastics). Because there are so many families with older children and because so many mothers work only part-time, the average size of the credit is low. Even families with incomes above $40,000 only claim about $400.[46]

B. *Cap the Credit*

Although upper-income families spend more money on child care, lower-income families spend a higher *percentage* of their incomes on child care for younger children. Families earning under $20,000, for example, spend about 8% of their income on child care, while families earning over $50,000 spend less than 3%.[47] This is a 267% difference, over five times greater than the 50% higher allowance the credit now grants to lower-income families.

Government policy can and should do much more to support all mothers in the labor force—and their children. However, it is ludicrous to think that a $400 credit affects the child care decisions of upper-income families.

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[44] BUREAU OF THE CENSUS, U.S. DEP'T OF COM., CURRENT POPULATION REP., SERIES P-70, No. 9, WHO'S MINDING THE KIDS? CHILD CARE ARRANGEMENTS: WINTER 1984–1985, at 17 table 4 Part B (May 1987).

[45] WAYS & MEANS, *supra* note 32, at 586.

[46] TAX RETURNS, *supra* note 33, at 81 table 3.3.

[47] L. Brush, Usage of Different Kinds of Child Care: An Analysis of the SIPP Data Base 42 (Oct. 14, 1988) (unpublished paper prepared for William Prosser, Social Services Policy Div., Assistant Secretary for Planning and Evaluation, U.S. Dep't of Health and Human Services) (on file at the HARV. J. ON LEGIS.). According to the study, families with incomes over $70,000 spend only 11% more on child care than do families with incomes under $10,000.

The credit should be capped so that upper-income families do not get an unfair tax break. In fact, the credit should be re-capped. In 1954, when the credit was first established as a deduction, elegibility was capped at $21,556 (1987 dollars). In 1971, the cap was raised to $50,000, with a phase out for higher incomes, and, in 1975, to $73,908 (1987 dollars). Only in 1976, when it was made a credit, was the cap totally removed.[48]

Perhaps it made sense to remove the cap when marginal tax rates were high. However, now that upper-income families have been granted dramatic tax relief, there is little reason to continue this tax break. This is not just an abstract issue of social justice. Although the average benefit for families with incomes above $40,000 is a relatively modest $400, there are nearly two million such families. Capping elegibility for the credit at incomes between $45,000 and $55,000 would generate about $1 billion that could be directed to families who genuinely need help in paying for child care.[49]

Theoretically, the credit could be made more equitable by raising the percentage of child care expenses that is reimbursable from 30% to 60%, for example. However, because more money would be at stake, this would only encourage more cheating, which is now concentrated among families earning between $25,000 and $50,000.[50] Raising the amount reimbursable would also aggravate the tax code's bias against stay-at-home mothers who sacrifice their own careers to care for their children or, as is often the case, for an elderly or sick relative.

The savings from a cap should not be used to start a new federal child care program with greater appeal to the middle class. It would be more efficient—and it would be better social policy—to use the funds to revitalize and expand Head Start, a program that combines elements of child development and child care for families of greatest need.

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[48] Unadjusted figures are: for 1954, $5,100; for 1971, $18,000; and for 1975, $35,000. For a brief legislative history, see WAYS & MEANS, *supra* note 32, at 613.

[49] In 1985, taxpayers with incomes above $40,000 took an estimated $750 million in child care credits. TAX RETURNS, *supra* note 33, at 81 table 3.3. Assuming 46% growth at these income levels, a rate equal to the overall growth of credit use (BUDGET SPECIAL ANALYSES, FY 1989, *supra* note 37, at G-43), revenue losses would exceed $1 billion in 1989.

[50] Estimate based on Taxpayer Compliance Measurement Program data, provided by the Office of the Assistant Commissioner (Planning, Finance and Research), Internal Revenue Serv. (June 1988).

It is often said that only 16% of Head Start eligible children are enrolled in the program.[51] This, however, is a misleading statistic, since it includes both three- and five-year-olds, the former being on the young side for Head Start as presently constituted and the latter able to attend kindergarten, which is now available in every state. In fact, approximately 40% of eligible children already spend at least one year in Head Start. About $1 billion could guarantee one year of Head Start for every eligible child.[52]

C. *Middle-Class Politics*

Although child care received little attention between 1972 and 1987, as this Article describes federal subsidies more than doubled in this period. Simultaneously, a sharp reversal in the beneficiaries of federal child care assistance has occurred. In 1972, nearly 80% of federal expenditures benefited low-income families; now, only about half do. The nature, extent, and targeting of assistance have now moved to the forefront of public debate.

Unfortunately, the major bills before the 100th Congress—Senator Christopher Dodd's (D-Conn.) "Act for Better Child Care Services" ("ABC")[53] and Senator Orrin Hatch's (R-Utah) Child Care Services Improvement Act[54]—would have gone far in ratifying the trend toward greater middle-class subsidies. The ABC bill, for example, would have provided support to families earning up to 115% of the median income.[55] Nationally, that would be about $34,000, but ABC set eligibility by state median incomes, so that many states would have considerably higher caps: for example, $39,530 in Illinois, $41,656 in California, and $44,941 in Massachusetts.[56] Moreover, the bill did not guarantee low-income families a minimum percentage of appropriated funds; it merely required that state plans "give priority for ser-

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[51] CHILDREN'S DEFENSE FUND, A CHILDREN'S DEFENSE BUDGET: FY 1989: AN ANALYSIS OF OUR NATION'S INVESTMENT IN CHILDREN 194 (1988).

[52] Personal communication from Clennie Murphy, Associate Deputy Director, Head Start, U.S. Dep't of Health & Human Services (June 10, 1988).

[53] S. 1885, 100th Cong., 1st Sess., 133 CONG. REC. S16,555 (daily ed. Nov. 19, 1987).

[54] S. 2084, 100th Cong., 2d Sess., 134 CONG. REC. S1,423 (daily ed. Feb. 25, 1988).

[55] S. 1885, *supra* note 53, at § 18.

[56] Henderson, *Federal Day-care Bills: 'You have to start somewhere'*, Christian Sci. Monitor, Jan. 21, 1988, at 23, col. 1.

vices to children with the lowest family incomes."[57] The Hatch bill had no income cap.

Perhaps child care should be universal—available to *all* families, regardless of their income—like public schools. But that is a long-run issue, as is the proper role of the federal government in establishing such a system, which would call for an enormous increase in public spending. In today's world of Gramm-Rudman-Hollings limits, it is simply wrong to funnel scarce federal dollars (in increasing amounts and proportions) to middle-class families who need them less. Priority should be given to families with the greatest need. An expansion of Head Start, for example, could do more for poor and low-income families than any federal child care bill now on the horizon.

Capping the credit, though, might face fierce opposition. More than a million upper-income families would lose a tax break. Also, women's groups strongly support the credit. Thus, politicians seem loath to take away one of the last tax breaks left by the reformers in 1986. In June 1988, for example, when the Senate Finance Committee sought to raise additional revenues to pay for welfare reform by phasing out the credit at the highest income levels,[58] Senator Bill Bradley (D-N.J.) successfully blocked the effort, calling it "insulting to working women."[59] Few male politicians want to face that charge.

For upper-income families, for whom the average credit is only $400, the credit's importance is mainly symbolic. While symbols can be important, in a time of scarce government resources, help should be focused on families that need dollars, not symbols. The credit should be a symbol of our support for working mothers who need financial assistance, not of our inability to achieve a progressive tax code.

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[57] S. 1885, *supra* note 53, at § 7(11)(B)(i).

[58] The proposal would have capped the credit elegibility at between $70,000 and $97,500, which would have generated about $200 million to help pay for welfare reform.

[59] Senator Bill Bradley, Press Release of June 16, 1988, *Bradley Amendment Saves Tax Credit for Child Care* (on file at the HARV. J. ON LEGIS.).