



 TAX CREDITS  
FOR EARLY  CARE  
AND EDUCATION:  
Funding  Strategy  
in a New Economy 

By Susan Blank and Louise Stoney

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**A**N EXTENSIVE BODY OF research makes it clear that high-quality early care and education (ECE) not only benefits individual families but is a major public good.<sup>1</sup> By preparing young children at a critical stage in their development to succeed in school and in life, high-quality ECE can make an important contribution to America's long-term economic health.<sup>2</sup> But the cost of high-quality ECE exceeds the price that most families are willing or able to pay for it, and the public financing system for ECE remains relatively haphazard and fragile. Especially with today's enormous pressure on states to curtail spending, the need to find ways to put high-quality ECE within the reach of more families has been thrown into sharp relief. This issue brief examines one ECE financing strategy that thus far has not received the attention it deserves—the use of tax credits to raise the quality of services and to make high-quality ECE more available to low-income and working-poor families.

#### WHAT ARE TAX CREDITS?

Tax credits are direct dollar-for-dollar reductions in the tax liabilities owed by taxpayers.<sup>3</sup> These credits differ from tax *deductions* or *exemptions*, which reduce taxable income. Some tax credits are refundable—meaning that when taxpayers complete their tax returns, they submit a claim and receive a check for the amount of the credit, just as if it had been a tax refund.

Tax credits can reduce different kinds of tax liability (for example, income, franchise, sales, payroll, and property tax) and can reward different kinds of behaviors. Thus ECE tax credits can be offered not only to families who pay for ECE for their children but to ECE providers who operate small businesses as well as to businesses and individuals who donate money to support socially valuable ECE services. While not as visible as the more familiar subsidies that make care more affordable, ECE tax credits have been adopted by a growing number of states.

#### WHY USE TAX CREDITS TO HELP FINANCE ECE?

To help answer this question, this section starts by focusing

on the advantages of using any tax mechanism to support ECE and next considers the particular advantages of tax credits vs. tax deductions.

ECE financing strategies that rely on tax credits have several important assets. Tax-credit strategies are:

- ▶ **Part of familiar systems.** A tax-credit strategy is administered by an existing, almost universally used bureaucracy—either the IRS or state tax-collection agencies. In contrast, most direct-funding mechanisms used to support ECE services require additional dollars to administer and monitor new initiatives. Moreover, ECE tax credits fit the operating style of many businesses, which routinely take advantage of tax incentives.
- ▶ **Non-stigmatizing.** Americans who avoid using government financial assistance offered through a subsidy or service will more readily use a tax credit for a similar purpose.<sup>4</sup>
- ▶ **Relatively stable and uncontroversial.** Unlike the typical government funding of social programs, credits need not be renewed annually and thus in some cases they can provide a more secure funding base than an appropriation for a social program or policy. Sometimes framed as tax cuts, credits can on occasion be used to fund expenditures that otherwise would be stalled by opposition to paying for them by raising taxes.
- ▶ **Conducive to the use of nontraditional ECE funding streams.** Tax credits allow states to tap into funding sources that are different than the education and welfare-to-work dollars that are most often used to support ECE services. For example, the proposal for the Louisiana package of ECE tax credits—which is described later in this issue brief—was made as part of the Governor's budget for economic development.

To hone in on the relative merits of tax credits vs. deductions:

- ▶ **Tax credits are more equitable than deductions.** Because the U.S. and most states graduate their income tax rates, a deduction is worth less to someone in a lower than a higher tax bracket. In contrast, the value of a tax credit does not vary by income. And generally a credit is more beneficial to a taxpayer than a tax deduction of the same amount. For example, for a taxpayer in the 35-percent tax bracket, the value of a \$100 tax *deduction* is \$35 while the value of a \$100 tax *credit* is \$100. Furthermore if the *credit* is refundable, people who do not owe the full amount of the credit in taxes can benefit as much as other taxpayers.



Of course, any financing strategy has disadvantages. One common criticism of using tax credits to support ECE—that the credits create a cash-flow problem for low-income families and care providers who cannot wait to be reimbursed—may be overstated. This is in part because cash flow is a major concern only in the first tax year but not for recurring credits. Moreover, designers of ECE tax credits can adapt mechanisms used in other tax credit systems to alleviate the cash-flow problem—for example, practices like the Mortgage Credit Certificates that can be issued to federal taxpayers.<sup>5</sup> Besides the cash-flow concern, other key objections to using tax credits to support ECE are that any new credit adds to the complexity of an already unwieldy tax system and that as credits proliferate, government will find it increasingly hard to monitor their use to prevent fraud and error. There is also a concern about the size of tax credits: If credits are to function as incentives, they must be large enough to influence behavior. Interestingly, most of the existing child care tax

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credits that encourage employers to subsidize child care for their workers go unused,<sup>6</sup> very likely because the credits are too small to appeal to these employers who often owe little or no state tax.

Even strong proponents of ECE tax credits do not view them as a panacea for the unaffordability of high-quality ECE in the U.S. But because it is reasonable to conclude that the many advantages of credits outweigh their drawbacks and because it is important to capitalize on as many approaches as possible to strengthen current ECE financing systems, credits should be considered in any mix of strategies that are under consideration for improving the quality of ECE and making high-quality ECE more affordable.

### Maximizing the Potential of the Credits: Linking to Quality-Improvement Efforts, Focusing on States, Making Credits Refundable

#### LINKING TO QUALITY IMPROVEMENT EFFORTS

A growing number of states have established Quality Rating and Improvement Systems (QRISs) to assess, improve, and communicate the level of quality in ECE programs. Designed as easy-to-understand structures, most QRISs use symbols, typically stars, to assign ratings to programs. The most effective

QRISs offer financial incentives linked to quality; as the star level increases, so does the level and scope of financial incentives. As will be illustrated by the profile of the Louisiana School Readiness Tax Credits later in this issue brief, combining an ECE tax credit with a QRIS or other similar initiative adds to the power of the credit to promote the use of high-quality care.

#### FOCUSING ON STATES

Although federal tax credits are apt to make a much greater dollar difference to taxpayers than state credits, there are reasons why states are the preferred starting points for enacting ECE tax credits. One reason has to do with the locus of authority for ECE services: Most federal ECE spending is administered by state governments, and most ECE system-building efforts such as QRIS initiatives are led by state entities. Also states can be used as laboratories, allowing for learning from diverse state approaches before any efforts are made to design a nationwide federal tax credit.

#### REFUNDABILITY

A significant number of the families, child care workers, and businesses cannot take advantage of tax credits unless the credits are refundable. To understand why, it is first important to recognize that many U.S. taxpayers—47 percent of all individual taxpayers in 2009<sup>7</sup>—owe no federal income tax. And typically taxpayers without these federal obligations also owe no taxes to their states. Thus, nonrefundable tax credits will seldom be an incentive to low-income families to take advantage of high-quality ECE. (Strikingly, in 2009 a family of four with two children under age 17 earning up to \$50,000, which is well above the poverty level, owed no taxes.)<sup>8</sup> Similarly, non-refundable ECE tax credits will have no value to most ECE workers, who typically earn very little. Finally, in most states only publicly held companies pay corporate income taxes, and thus nonrefundable credits have little or no appeal to the many privately held companies that are typically not taxed at the corporate level. Notwithstanding the strong case for making credits refundable, in the event that it is impossible to do so, the next best option is to design the system so that taxpayers can apply some or all of their credits to taxes owed in future years.

The following short profiles of ECE tax credit systems in four states around the country offer a window into how this financing strategy has been translated into operations.

#### Tax Credits in Four States

##### LOUISIANA

To date, Louisiana's system of ECE tax credits, known as the School Readiness Tax Credits (SRTC), is the country's most innovative and far-reaching state effort to use tax credits to promote high-quality ECE services. SRTC aims to meet two needs associated with implementing

a successful QRIS—first, the need to provide financial incentives to encourage providers to participate in the QRIS and help them offset the cost of attaining higher star levels, and second, the need to bring the QRIS to the attention of the sizeable numbers of parents who do not use the star ratings to guide their decision-making about which providers to choose. Enacted in 2007, SRTC legislation created four separate, refundable tax credits, with each credit tied to the state’s QRIS, which is known as Quality Start. Under the legislation:

- ▶ **Families** with a child under six years old who is enrolled in a child care program that has a Quality Star rating of at least two stars are eligible for a tax credit, and that credit increases in value with higher ratings. For example, a family with one child who attends a child care center with a two-star rating is eligible for a credit of \$788; that same family qualifies for a \$1,575 credit if the child is cared for in a center with a five-star rating. The credit is refundable for families with annual incomes below \$25,000.
- ▶ **Child care providers** that participate in Quality Start are eligible to receive a refundable tax credit based on the number of stars they earn and on the number of children in the subsidized Child Care Assistance Program or in foster care whom they serve. The value of the credit, which is available to nonprofit as well as for-profit providers, ranges from \$750 to \$1,500 per child. Funds from the tax credit are in addition to—not in lieu of—child care subsidy reimbursements.
- ▶ **Child care teachers and directors** are eligible for a refundable tax credit if they teach in a center that participates in Quality Start. The value of the credit, which ranges from \$1,500 to \$3,000, is based on the level of education the individual has attained.
- ▶ **Businesses** that provide financial support to centers that participate in Quality Start are eligible for a credit with its value based on the star rating of the center. Businesses may also receive a tax credit for donations up to \$5,000 made to child care resource and referral agencies.

Because the credits are refundable, teachers in Quality Start centers who earn low wages (and therefore pay little or no tax) can still benefit. Thus, in an industry where low pay can be an obstacle to quality—in part because poor salaries contribute to high levels of staff turnover—these teachers receive what is in effect a wage subsidy in the form of a tax refund. Similarly, refundable credits function as annual grants for child care centers, many of which have tight budgets that make it hard to maintain and improve

the quality of their services.

Figures from the state Department of Revenue suggest that SRTC has given a significant boost to Louisiana’s child care industry. In 2009 SRTC added over \$5 million in state general funds to the state’s resources for ECE services. A 2008 survey found that 55 percent of the providers who were either participating in Quality Start or planning to do so expected to take advantage of SRTC by serving more children who received child care subsidies and/or were in foster care.<sup>9</sup> These are groups of children whom providers of high-quality ECE cannot always afford to serve but who are particularly likely to benefit from the ECE experience. In 2010, when the state budget deficit threatened Louisiana’s ability to draw down its full federal child care allocation, funding from the SRTC contributed to the state match. As a result, even though many other services were subject to budget cuts, child care subsidies were not reduced and the state has continued to draw down its full allotment of child-care federal matching funds.

#### COLORADO

From 2004 through December 2010, Colorado taxpayers could claim income tax credits for making monetary contributions to promote child care in the state. Colorado’s Child Care Contribution Credit (CCCC) permits a tax benefit of up to 50 percent of the total contribution up to a maximum credit of \$100,000 annually (but not more than the taxpayer’s Colorado income tax liability).<sup>10</sup> Donations qualify for the credit if they are made to licensed child care providers (centers and homes), as well as to other licensed child-serving programs (such as foster care homes) and other child-serving programs that register with the State Department of Revenue—for example, child care resource and referral agencies. For-profit entities may receive donations that qualify for the credit as long as the funds are directly used for the acquisition or improvement of facilities, equipment, or services, including the improvement of staff salaries, staff training, or the quality of child care.

According to a study sponsored by two state entities, the estimated value of contributions made using the CCCC in 2009 was \$22.8 million, with these contributions supporting an additional \$1.2 million in federal matching dollars.<sup>11</sup> The study concluded that, “for every dollar that the state invests in the child care industry via the CCCC, \$4.65 is added to the Colorado economy through private contributions, federal matching dollars, and the multiplier effects of the spending.”<sup>12</sup>

In 2010, Colorado enacted legislation that suspends all state tax credits if the state Gross Domestic Product (GDP) drops by more than 6 percent, and because the GDP did drop by that amount, CCCC, along with all Colorado state tax credits, was suspended. More recent legislation eliminates the 6 percent trigger in 2013, regardless of the status of the GDP. In that year the credit will be restored in phases—50 percent of the credit





will be available in 2013, 75 percent in 2014, and the full credit for 2015-19. If a donation is made in tax years 2011, 2012, 2013 or 2014 and the tax credit is wholly or partly unavailable for that year, the taxpayer can carry forward however much of the credit that remains to a year when CCCC becomes available.

#### OREGON

The Oregon child care contributions credit, established in 2003, is designed to encourage taxpayers—both individuals and companies—to donate to projects that improve the quality of the state’s ECE system. Taxpayers make contributions to the state’s Child Care Fund and receive tax credit certificates, which are worth 75 cents for every dollar spent. The actual tax benefits of the credits, however, typically result in tax savings that exceed the size of the contribution—largely because the contribution can be deducted from liability for state taxes, because it also counts as a charitable contribution for federal tax purposes,

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and because it often helps taxpayers avoid the federal Alternative Minimum Tax.

Proceeds from the credits are placed into a pooled fund, which supports several community-based projects. Current projects focus on Education Awards for child care providers and improvements to child care facilities. Previously funds were used to support demonstration projects focused on enhancing compensation for providers, strengthening subsidies for low-income families, and improving the quality of care.

At present \$500,000 in tax credits, generating annual contributions worth about \$667,000, is available each year.

#### PENNSYLVANIA

In 2001 Pennsylvania enacted the Educational Improvement Tax Credit, which enables businesses in the state to receive credits if they donate to organizations that register with the state as Pre-Kindergarten Scholarship Organizations (PKSOs)—entities that are authorized to distribute the donations as scholarships to families who need subsidies for prekindergarten services. The tax credits to businesses that make the donations are equal to 100 percent of the

first \$10,000 contributed and up to 90 percent of the remaining amount contributed up to a maximum credit of \$100,000 annually.

PKSOs must be nonprofit organizations and must use at least 80 percent of the annual tax credit donations for scholarships, with the rest to be used for administering their scholarship programs. Families qualify for PKSO scholarships if their household incomes do not exceed income levels tied to family size—for example, \$70,000 for a family of three. The PKSOs include child development programs, United Way agencies, community foundations, and other intermediary organizations.

While there is no requirement or incentive for PKSOs to target scholarships to ECE programs that are part of the state’s QRIS, there is no prohibition against doing so. Some United Ways have been able to use the credit to finance their local initiatives to promote the QRIS among child care centers.

In an effort to ensure that community-based early childhood programs took advantage of the tax credit, in 2009 the Women’s Community Revitalization Project conducted outreach and training sessions on the credit. Possibly in part because this work heightened the visibility of the PKSO funds, many early childhood programs applied for them and all available credits were exhausted. Currently state legislation is pending to increase the program by \$25 million, bringing the program total to \$100 million per year.<sup>13</sup>

#### ATTRIBUTES OF A SUCCESSFUL ECE TAX CREDIT SYSTEM

The experiences of the four states suggest that a **SMART** ECE state tax credit strategy should be:

**SYSTEM-BUILDING:** *The strategy should be integrated with and advance the state’s larger ECE system-building approach.* For a number of reasons, Louisiana’s SRTC package of four different tax-credit mechanisms is an excellent example of the system-building approach: Notably the credits build on the existing child care subsidy system, they encourage the use of the ECE services rated by the state’s QRIS, and they provide extra incentives to serve low-income children. They also encourage families to use, and businesses to invest in, star-rated programs.

**MOTIVATING POLITICALLY:** *The strategy should have a brand and message that promote bipartisan support and that take advantage of the state’s current political environment.* Linking ECE tax credits to quality standards and using QRISs and other similar initiatives designed to improve the quality of care as a branding and messaging strategy are key steps to take to establish successful systems. Moreover successful ECE tax credit initiatives have typically embedded efforts to enact credits focused on early care and education in broader movements to use the tax system to improve aspects of society—for example, movements to promote economic development via tax credits.

**ACCESSIBLE TO TAXPAYERS:** *The tax credit should be easy to use, and it should be refundable—or if not, the taxpayer should be able to apply some or all of it to taxes owed in future tax years.* All four states have worked over time to streamline the processes and paperwork required to apply for credits. Even Oregon, which has the most administratively complicated credit, has created a one-page application. Additionally, most of the states have made the credits refundable or have allowed them to carry over into future tax years.

**REWARDING FINANCIALLY:** *The percentage of the tax credit, the state's aggregate allocation for the credit (in cases where there is a cap on the amount of the allocation), and the amount of eligible expenses should be significant enough to promote participation.* Tax credits will not be successful incentives unless their financial rewards are large enough to change behavior. In the case of credits that go to families, a small reward may be enough to get the attention of parents and encourage them to use higher-quality care (the jury is still out on this point—so far there is not enough evidence to determine how large credits must be in different settings to encourage widespread use of high-quality care). Credits that are designed to give providers incentives to maintain or boost the quality of their services must be large enough to have an impact on the cost of meeting higher-quality standards. Similarly, credits intended to stimulate contributions to quality-improvement efforts must be ample enough to attract donors.

Evidence from the four states is that the financial rewards offered by the ECE credits have had enough power to affect behavior: Participation in the Louisiana SRTC program has risen significantly since the credit was enacted—a clear sign that the credit levels are sufficient. Similarly, participation in Colorado's Contribution Tax Credit has remained high—a significant trend especially because, as noted, most child care tax credits that target employers go unused. The interest of ECE providers in the Pennsylvania tax credits has risen significantly since the time that the PSKO program was enacted, and while some of this rising interest has very likely been a result of publicity and outreach efforts, those efforts arguably would not have succeeded if the size of the credits had been too small. Finally, Oregon lawmakers and policy leaders have discovered that their state's tax credits sell out very quickly—a clear testament to the value of the credits.

**TRACKABLE:** *The tax credit should produce measurable results that are collected and promoted year after year.* Even though tax credits in general, including the ECE credit, have been suspended in Colorado, the careful tracking of economic returns of the credit that were reported to the State Department of Revenue has allowed the credit's proponents to make a strong case for the program—an advantage that will be important as the credits are again phased in.

## CONCLUSION

Today's landscape of political decision making about how to support ECE in the U.S. is dominated by two realities that pull in opposite directions: first, the compelling research evidence on the economic value of high-quality services, and second, the budget crises facing most state and local governments. Given this mismatch between the widely acknowledged benefits of high-quality ECE and the bleak climate for public spending, it is more important than ever to continue the search for financing strategies to maintain and improve the quality of ECE services. The experiences of the four states that have been profiled in this policy brief illustrate ingenious uses of tax credits, a familiar financing mechanism for public purposes in the U.S., to promote the use of high-quality ECE services.

Not surprisingly, ECE tax credits are not a problem-free funding strategy. For example, they are not immune from cuts due to revenue shortfalls. However, they tend to be more stable than appropriations that must be authorized each year. And overall, the story of the use of these credits in the four states profiled in this issue brief is a hopeful one. Information on what has thus far been accomplished in these very different locales suggests that further experimentation with ECE tax credit strategies, along with careful tracking of their results and efforts to find out more precisely what levels of incentives trigger changes in behavior, are steps well worth taking. ✨





<sup>1</sup> Some of the language that discusses and analyzes tax credits in this issue brief was originally part of a longer report, *Briefing Paper: Tax Credit Financing for Early Care and Education*. 2005 <http://www.partnersinced.org/TaxCreditBriefingPaper.pdf>. ECED (Partners in Early Childhood and Economic Development) is grateful to Jan Stokley, the author of the 2005 briefing paper, for her permission to use this language. The authors particularly want to acknowledge her concept of SMART (System-Building, Motivating, politically Accessible to Taxpayers, Rewarding Financially, and Trackable) to describe the attributes of a successful tax credit system to support ECE. (See pages 5-6 for a discussion of the concept.)

<sup>2</sup> For research on the economic returns of high-quality ECE, see, for example, Warner, Mildred E. "Overview: Articulating the Economic Importance of Child for Community Development." Pages 1-6 in *COMMUNITY DEVELOPMENT: Journal of the Community Development Society*. 37 (2), Summer, 2006.

<sup>3</sup> [www.investorwords.com/4888/tax\\_credit.html](http://www.investorwords.com/4888/tax_credit.html)

<sup>4</sup> This pattern is illustrated by the higher utilization rates (by eligible families) of the Earned Income Tax Credit than the rates of use (again by eligible families) for the Food Stamp Program (now called the SNAP Program) and the Temporary Assistance for Needy Families public assistance program. See Lower-Basch, Elizabeth. *Tax Credits and Public Benefits: Complementary Approaches to Supporting Low-Income Families*. 2008. [http://www.clasp.org/publications/tax\\_credits\\_and\\_public\\_benefits4-9-08.pdf](http://www.clasp.org/publications/tax_credits_and_public_benefits4-9-08.pdf)

<sup>5</sup> <http://www.mshomecorp.com/homebuyers/mortgage%20credit%20certificate.htm>

<sup>6</sup> <http://nccic.acf.hhs.gov/node/23356>

<sup>7</sup> <http://www.rgbrenner.com/blog/tag/deloitte-tax/>

<sup>8</sup> <http://www.rgbrenner.com/blog/tag/deloitte-tax/>

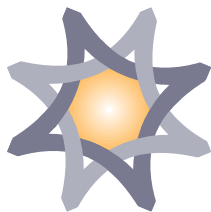
<sup>9</sup> Louisiana State University/Tulane Early Childhood Policy and Data Center. "Louisiana Quality Start Child Care Rating System and the School Readiness Tax Credits: A Survey of State Child Care Centers." Unpublished survey, December 2008.

<sup>10</sup> §39-22-121, C.R.S.

<sup>11</sup> Development Research Partners. *The Benefits of the Child Care Contribution Credit in Colorado*. Early Childhood Leadership Commission and Executives Partnering to Invest in Children. April 2011.

<sup>12</sup> p. ii.

<sup>13</sup> Personal communication with Bill Thomas, Women's Community Revitalization Project, April 2011.



## Opportunities Exchange

Opportunities Exchange helps organizations that work with low income people to improve financial sustainability and program or product quality through the formation of Shared Service Alliances.

**SUSAN BLANK** is a writer and editor for nonprofit organizations specializing in social policy issues. She has written extensively on early childhood and family policy, welfare reform, and education. She has been a program officer at the Foundation for Child Development and an editor at MDRC, a social policy research organization.

**LOUISE STONEY** is the Co-Founder of Opportunities Exchange, and the Co-Founder of Alliance for Early Childhood Finance. She has worked on early care and education policy and finance with state and local governments, foundations, national policy organizations, service providers, industry intermediaries and child advocacy groups in more than 38 states. Her publications are available at [www.earlychildhoodfinance.org](http://www.earlychildhoodfinance.org).

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