UNDERSTANDING CHILD CARE SUBSIDIES IN THE TAX SYSTEM

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before the Democratic Women's Working Group

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Chairwoman Frankel and members of the committee, thank you for inviting me to appear today to discuss child care benefits in the tax system. My name is Elaine Maag, and I am a senior research associate in the Urban-Brookings Tax Policy Center in Washington, DC. The Urban Institute, as an organization, does not take a position on legislation; the views I express today are my own and should not be attributed to the Tax Policy Center, the Urban Institute, the Brookings Institution, their trustees, or their funders.

Two primary individual benefits are directed at subsidizing child care costs in the federal income tax system: the child and dependent care tax credit and employer-provided flexible spending accounts. The US Department of the Treasury estimates that together they provided $5.3 billion in benefits in 2016, with larger benefits going to higher-income families. During his presidential campaign, President Trump proposed adding three additional subsidies for child care, which the Tax Policy Center (TPC) estimates would cost about $11 billion a year. About 70 percent of these benefits would go to families with at least $100,000 in income, and 25 percent of benefits would go to families with at least $200,000 in income. Very few of the proposed benefits would go to the lowest-income families.

I will briefly describe the current child care benefits and the additional proposed benefits. I will then discuss other options that could help low- and moderate-income families who often have trouble paying for child care, with the caveat that the tax system has some inherent difficulties related to subsidizing child care, most notably that many tax benefits are delivered long after child care expenses are incurred and typically go to one family, even if a child moves during the year.

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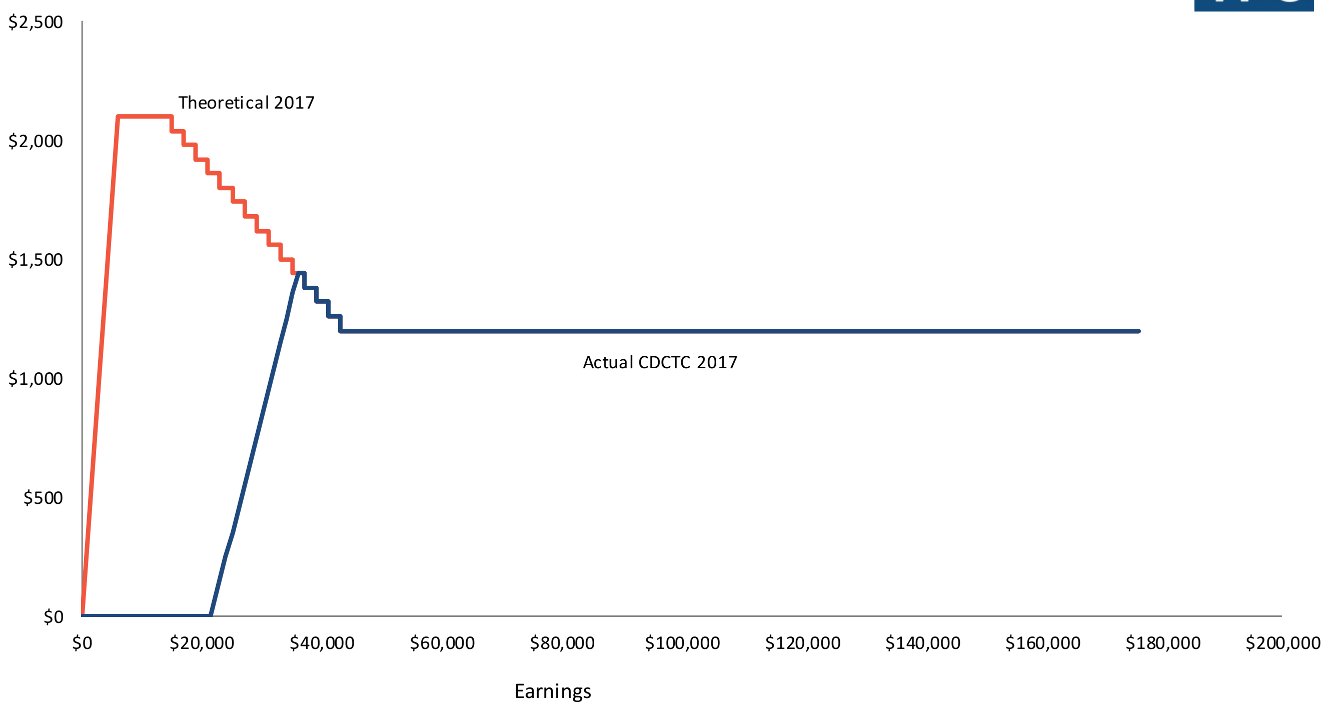
DESCRIPTIONS OF THE CHILD AND DEPENDENT CARE TAX CREDIT AND FLEXIBLE SPENDING ACCOUNTS FOR CHILD CARE

Child and Dependent Care Tax Credit

The larger of the two current child care benefits is the child and dependent care tax credit, or CDCTC. The CDCTC provides a credit worth between 20 percent and 35 percent of child care costs up to $3,000 for a child under 13, or up to $6,000 per household. Higher credit rates apply to families with lower adjusted gross income. However, the CDCTC can only be used to offset taxes owed. As a result, low-income families who owe little or no income tax get little benefit (figure 1).

FIGURE 1

Value of CDCTC: Single Parent with Two Children, 2017



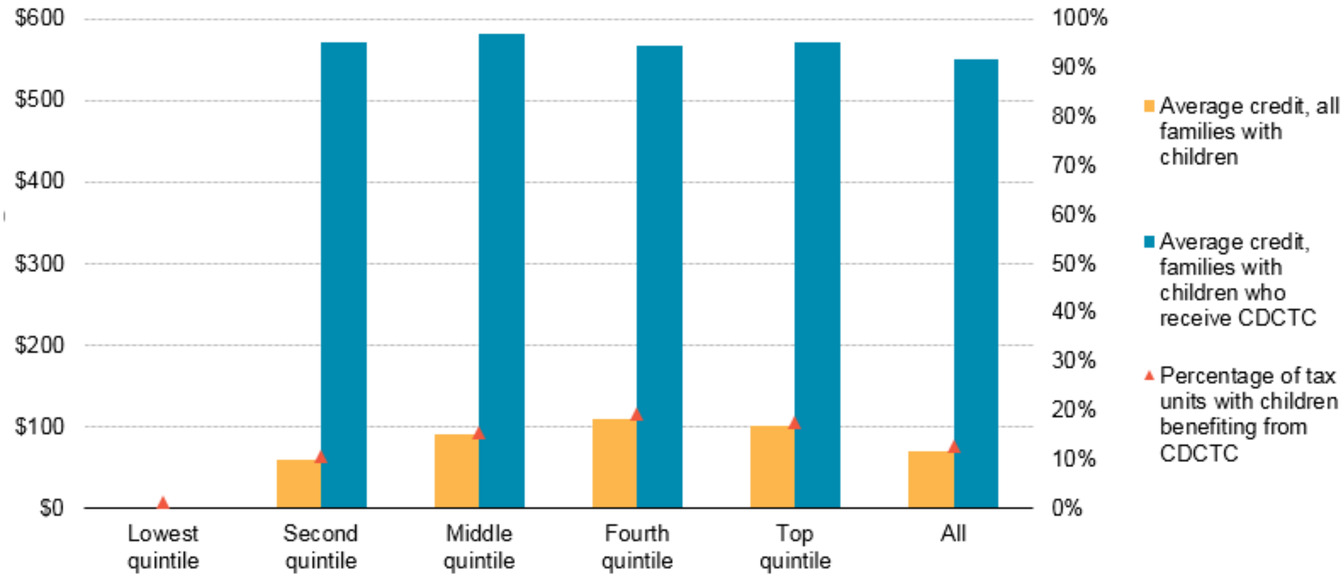
Source: Tax Policy Center, 2017.
Notes: Assumes all income is from earnings and families report $8,000 in childcare expenses

Relatively few families with children benefit from the CDCTC. According to TPC calculations, 12.7 percent of families with children benefited from the CDCTC in 2016. Some families with children do not benefit because they have no child care expenses. Others have a stay-at-home parent, which precludes eligibility. Among families with children who do receive a benefit, taxes were reduced by an average of about $550 (figure 2). The only families with a tax reduction significantly different from this average are families with children in the lowest 20 percent of the income distribution, who receive almost no benefit. The credit is nonrefundable: it cannot exceed income taxes owed.

FIGURE 2

Child and Dependent Care Tax Credit for Families with Children, Average Benefits and Participation

2016



Source: Urban-Brookings Tax Policy Center Microsimulation Model, (version 0516-1).

Flexible Spending Accounts

Employer-provided flexible spending accounts allow employees to set aside up to $5,000 a year, regardless of the number of children, to pay for child care. The money set aside avoids both income and payroll taxes. The highest-income families, who pay the highest marginal tax rates, consequently receive the largest benefits. Benefits from these accounts further tilt toward higher-income families because lower earners are less likely to have access to these accounts than higher earners.[2]

PRESIDENT TRUMP'S CAMPAIGN PROPOSAL TO SUBSIDIZE CHILD CARE

President Trump proposed three additional benefits to subsidize child care in the federal income tax system during his campaign. These were

1. a deduction based on child care expenses, which would primarily benefit higher-income families, including those who do not pay for child care;
2. a refundable credit for some lower-income families, which would apply only to families who both pay for child care and have no stay-at-home parents; and

[2] See Eli R. Stoltzfus, "Access to Dependent Care Reimbursement Accounts and WorkplaceFunded Childcare," *Beyond the Numbers* 4, No. 1 (2015), accessed May 23, 2017, https://www.bls.gov/opub/btn/volume-4/access-to-dependent-care-reimbursement-accounts-and-workplace-funded-childcare.htm.

3. an expansion of child care savings accounts, which would allow families to save tax free for child care expenses, private school tuition, and some extracurricular activities.[3]

On average, the president's proposed child care benefits would be much larger for high-income families than for low- and middle-income families.[4] The proposals would raise the after-tax income of families with income between $100,000 and $200,000 by 0.3 percent ($360)—much higher than the 0.1 percent ($20 or less) received by families with income below $40,000. A disproportionate share of benefits would go to higher-income families. More than 70 percent of the total tax benefits would go to families with income above $100,000, and more than 25 percent would go to families with income above $200,000.[5]

Deduction for Child Care Expenses

The largest of the proposed child care benefits was an above-the-line deduction for child care costs for children under age 13. This would allow taxpayers to reduce their taxable income by the amount paid for child care. The deduction would be capped at the average cost of child care in the taypayer's state for a same-aged child. In a departure from existing tax benefits for child care, married couples with only one working parent would be allowed to deduct that average amount, even if they paid no out-of-pocket child care expenses.

Deductions provide no benefit to families who do not owe income tax and provide larger benefits for families with higher marginal tax rates. For example, families taxed at a 40 percent rate would see their tax bill decline by 40 cents for every dollar deducted; families taxed at a 10 percent rate would see their tax bill decline by 10 cents for every dollar deducted.

Refundable Child Care Credit

The second prong of the proposed child care benefits was a refundable credit to offset child care expenses for children under age 13. Filers would receive either a 7.65 percent credit for child care expenses or 3.825 percent of the lesser-earnings spouse's income, whichever was less. Unmarried filers with income over $31,200 and married filers with income over $62,400 would be ineligible for the credit.

The credit, while more progressive than the deduction or existing child care benefits, would provide much smaller benefits than the proposed deduction. Unlike the deduction, which would provide benefits to married parents without child care costs, the credit would only be available to families with no stay-at-home parents.

Dependent Care Savings Account

The final child care benefit would allow families to contribute up to $2,000 a year, per child to a new savings account. Contributions would be tax deductible, and the accounts would grow tax-free indefinitely, provided families eventually spend the funds on child care, after-school enrichment programs, private school tuition, or higher education. For low-income families, the president's proposal would match 50 percent of their first $1,000 in contributions.

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[3] Donald J. Trump Campaign, "Child Care Reforms That Will Make America Great Again" (New York: Donald J. Trump for President, n.d.).
[4] This analysis does not include estimates of the savings account benefit. This component would likely increase the tilt of Trump's child care proposals toward higher-income households.
[5] Households with income over $100,000 represent 36 percent of all families, and those with incomes above $200,000 represent 13 percent of all families.

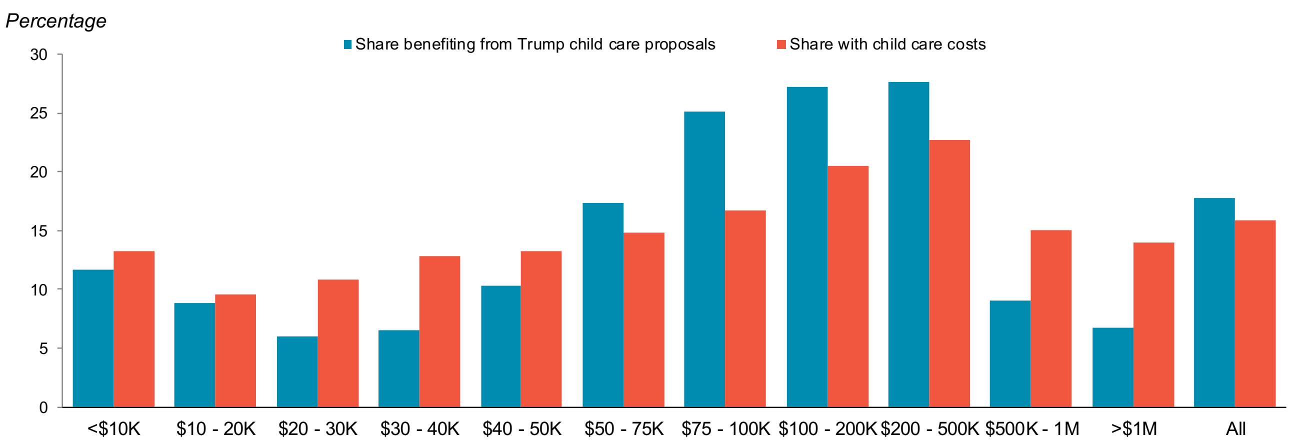
The savings account would likely provide much larger benefits to higher-income families than lower-income families. Low-income families tend to not have extra money to put away in these types of accounts, and past savings matches have been met with very low participation rates. Low-income families who could put money in the accounts would likely leave it there for less time than high-income families, reducing the benefit that accrues from allowing the account to grow tax free. Dependent care savings accounts would provide high-income people a new tax sheltering opportunity.

COST AND DISTRIBUTION OF PRESIDENT TRUMP'S CAMPAIGN PROPOSAL

TPC estimates that the president's child care proposals would cost about $115 billion over 10 years, a small portion of the roughly $6 trillion in proposed tax cuts. Over 70 percent of the total benefit from the child care proposals would go to families with at least $100,000 in income, and about 25 percent of the benefit would go to families with at least $200,000. Fewer low-income families would qualify for benefits. Over 25 percent of families with income between $75,000 and $500,000 would qualify for some benefit under the proposals, but less than 10 percent of families earning between $10,000 and $40,000 would qualify. Because the deduction, which largely benefits higher-income families, goes to families even if they do not have child care expenses, more higher-income families would receive tax benefits than incur child care costs. The opposite is true for lower-income families (figure 3).

FIGURE 3

Share of Families with Children Benefiting Versus Share with Child Care Costs, 2017



Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0516-2).

SUPPORTING LOW-INCOME FAMILIES WITH TAX BENEFITS

Low-income families tend to benefit less from the proposed benefits for several reasons. Primarily, the Trump campaign plan relies on a deduction that provides higher benefits to families with higher tax rates. The benefit directed at low-income families, the refundable credit, is worth much less per dollar of child care expenses than the other benefits. In addition, low-income families tend to spend less on child care than families with higher incomes, simply because lower-income families cannot afford expensive (and, often, higher-quality) care.[6]

Direct spending programs for child care have many advantages for lower-income families that the tax system cannot easily replicate. State child care assistance programs help parents pay for child care each month, as expense are incurred. Tax programs typically deliver benefits when taxes are filed, long after child care expenses might have been incurred. In addition, direct spending programs can adjust with the child's situation through the year. If income rises or falls, benefits can respond. If children move out of a household, benefits can follow that child. In contrast, tax benefits are calculated over the course of the year and go to one household, even if a child moves between homes.

Making the child and dependent care credit refundable would provide a larger benefit to many families than the proposed new credit. It would allow even the lowest-income families to have access to relatively generous credit rates. Rather than receiving almost no credit, families with children in the lowest income quintile who would benefit from a refundable child care credit would receive an average credit of over $500. However, because few families in this low-income range have child care expenses, less than 10 percent of families in this group would benefit. Thus, even making the current CDCTC fully refundable would not provide substantial assistance to most low-income families.

More broadly, Congress could consider expanding the child tax credit, a benefit that goes to almost all families with children. By expanding the credit for families with young children, benefits could be targeted to families that tend to have the highest child care costs, but also help families who do not have formal child care costs. And by expanding the refundable portion of the child tax credit, more of the benefits could be directed to lower-income families.

CONCLUSION

Child care costs can present a substantial barrier to work, especially for low- and middle-income families. The federal income tax system provides some assistance to offset these costs, though that assistance excludes many low- and middle-income families. The additional benefits proposed by the president would more than double tax benefits for child care, and—like his larger plan—would tilt heavily toward higher income families.

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[6] See Ajay Chaudry, Taryn Morrisey, Christina Weil, and Hirokazu Yoshikawa, *Cradle to Kindergarten: A New Plan to Combat Inequality* (New York: Russell Sage Foundation, 2017).