

## The Child Care Tax Credit: Not Just Another Middle-Income Tax Break

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In this article, Viard argues that the child and dependent care tax credit plays a valuable role in promoting work.

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The section 21 child and dependent care tax credit has received little attention in recent tax policy debates. When the credit is discussed, its supporters and opponents often treat it as simply another middle-income tax break. The credit is sometimes even confused with the section 24 child tax credit.

The child care tax credit, however, is not just another middle-income tax break. By providing tax relief for work-related costs, it helps offset the work penalty imposed by the income tax and promotes economic efficiency. Common objections to the credit are based on a failure to understand the appropriate tax treatment of work-related costs, such as child care.

In Part A of this article, I describe the current provisions of the child care tax credit. In Part B, I discuss the appropriate tax treatment of work-related costs, as applied to child care. In Part C, I respond to misconceptions about the credit. I explore ways to strengthen the credit in Part D and conclude in Part E.

### A. The Child and Dependent Care Tax Credit

As detailed in the appendix, tax relief for child care costs has a convoluted history. An itemized deduction was provided from 1954 through 1975 and a credit has been in place from 1976 to the present. From 1954 through 1971, gender-specific rules prevented most men from claiming relief for child care costs. Some type of income-based phaseout or phasedown has always applied, except from 1976 to 1981. From 1954 to 1963, tax relief applied to the care of children ages 11 or younger; to children ages 12 or younger through 1971; and to children ages 14 or younger through 1988. From 1989 to the present, however, the credit has applied to children ages 12 or younger. The maximum creditable costs have been raised and lowered at various times.

Section 21(a)(1) refers to creditable costs as "employment-related expenses" and section 21(b)(2)(A)

defines them as expenses, either for household services or for the care of a qualifying individual, that are "incurred to enable the taxpayer to be gainfully employed." Section 21(b)(1) defines a qualifying individual as a dependent of the taxpayer who is 12 or younger or is a dependent or spouse of the taxpayer who shares the taxpayer's principal place of abode and is physically or mentally incapable of self-care.

Several provisions further refine the definition of creditable costs. Section 21(b)(2)(A) disqualifies the costs of overnight camps. Section 21(b)(2)(B) states that expenses for care outside the taxpayer's home are creditable only if the qualifying individual is a dependent of the taxpayer who is 12 or younger or regularly spends eight hours per day in the taxpayer's household. Section 21(b)(2)(C) and (D) provides that expenses incurred at a day-care center that charges a fee and provides services to more than six individuals not residing at the center are creditable only if the center complies with applicable state and local laws. Section 21(e)(6) disqualifies payments made to the taxpayer's dependents and unmarried minor children.

The Treasury regulations, as revamped in 2007, interpret and apply the statutory definition of creditable costs in a manner that strikes a balance between conceptual purity and administrative practicality. The costs of nursery school, preschool, and similar prekindergarten programs are eligible for the credit. Costs of kindergarten through higher grades, summer school, and tutoring are not eligible, although costs of before- and after-school care are. The costs of specialty day camps are creditable, while boarding school costs are creditable only to the extent they are properly allocable to care, rather than to food, lodging, and education. The costs of room and board for a caregiver are creditable.<sup>1</sup>

Section 21(c) limits creditable costs to \$3,000 for one qualifying individual or \$6,000 for two or more qualifying individuals; these amounts are not indexed for inflation. Section 21(d) further limits creditable expenses to the taxpayer's labor income. Creditable expenses for a married couple generally cannot exceed the labor income of the spouse with lower labor income, so that no credit is available if one spouse has no labor income. Section 21(d)(2) removes this last restriction if the spouse is a full-time student or a qualifying individual incapable of self-care. Section 21(e)(2) through (4) provides, with some exceptions, that the credit may not be claimed by married taxpayers filing separate tax returns.

Under section 21(a)(2), the credit rate is 35 percent if adjusted gross income is \$15,000 or less, but drops to 34 percent if AGI is \$15,001. It remains at 34 percent until

<sup>1</sup>Reg. section 1.21-1(d) and (e).

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AGI reaches \$17,001, at which point it drops to 33 percent, with further declines of 1 percentage point occurring at \$2,000 intervals. The credit rate reaches its minimum value of 20 percent when AGI reaches \$43,001. These income levels, which are not indexed for inflation, are the same for married and unmarried taxpayers.<sup>2</sup> For a taxpayer with two or more qualifying individuals and \$6,000 of creditable costs, the phasedown (abstracting from its step function nature) adds 3 percentage points to the taxpayer's effective marginal income tax rate.<sup>3</sup>

The credit will become somewhat less generous if the 2001 tax cuts expire, as scheduled, at the end of 2010. The credit rate will decline for taxpayers with AGI of \$43,000 or less, with the maximum credit rate falling from 35 to 30 percent. Also, the maximum creditable amounts will be reduced from \$6,000 and \$3,000 to \$4,800 and \$2,400, respectively. There is broad bipartisan support for extending the relevant provisions of the 2001 tax cuts, but such an extension has yet to be adopted.

The credit is nonrefundable and subject to the limitations of section 26. The permanent provisions of the code do not allow the credit to be used to offset the alternative minimum tax. A series of patches incorporated in section 26(a)(2), however, allowed the credit to be used against the AMT from 2000 to 2009. There is broad support for a similar patch for 2010, but it has yet to be enacted.

The credit is computed on Form 2441, "Child and Dependent Care Expenses," and may be claimed on forms 1040 or 1040A, but not on Form 1040EZ. IRS Publication 503 provides detailed instructions. Section 21(e)(9) requires the taxpayer to report the name, address, and taxpayer identification number of any person to whom creditable payments are made, unless the taxpayer was unable (with due diligence) to obtain the information. Section 21(e)(10) requires that the taxpayer report the TIN of each qualifying individual.

Use of the credit is relatively (and surprisingly) modest and has been stable in recent years. In each year from 2005 through 2008, 6.5 million to 6.6 million returns, less than 5 percent of all returns claimed the credit, worth roughly \$3.5 billion.<sup>4</sup>

In 2008, 55 percent of the credit went to taxpayers with AGI below \$75,000, with only 6 percent claimed by taxpayers with AGI below \$25,000. Five percent of the credit went to those with AGI above \$200,000. The average credit per tax return (including returns not claiming the credit) peaked at \$58 in the \$100,000-\$200,000 range; the amount of tax returns claiming the credit peaked at 11 percent in that same range.<sup>5</sup>

<sup>2</sup>The phase down is based on adjusted gross income, without the common modifications for tax-exempt interest, foreign earnings excluded under section 911, and income from U.S. possessions excluded under sections 931 and 933.

<sup>3</sup>The taxpayer's credit is reduced by \$60 (1 percent of \$6,000) for each \$2,000 of income, implying an additional marginal tax rate of 3 percent (\$60/\$2,000).

<sup>4</sup>See rows 122 and 123 of the spreadsheet, available at <http://www.irs.gov/pub/irs-soi/08intba.xls>.

<sup>5</sup>Author's computations, based on the data in columns B, E, and F of the spreadsheet, available at <http://www.irs.gov/pub/irs-soi/08in33ar.xls>.

The code offers one other significant benefit for child care.<sup>6</sup> Section 129(a) excludes from gross income up to \$5,000 of employer-provided dependent care assistance, regardless of the number of qualifying individuals. Section 129(b) limits the exclusion based on the taxpayer's and spouse's labor income the same way section 21(d) limits the credit. Section 129(d)(8) imposes a nondiscrimination requirement. The exclusion applies under the AMT, and section 3121(a)(18) extends the exclusion to payroll taxes. The exclusion is not phased out or down based on income. Section 125 allows workers to obtain the benefit of the exclusion by paying for child care through flexible spending accounts. Section 129(e)(7) disallows the credit for any amounts that receive the exclusion and section 21(c) further reduces the maximum amount of expenses for which the credit can be claimed by any amount excluded under section 129.<sup>7</sup>

The Joint Committee on Taxation and the Treasury Department classify the credit and the exclusion as tax expenditures. The JCT lists them under the budget function for social services, putting the combined tax expenditure at \$4.3 billion for fiscal 2009.<sup>8</sup> Treasury places them in the training, employment, and social services function, listing a fiscal 2009 tax expenditure of \$4.3 billion for the credit and \$800 million for the exclusion.<sup>9</sup>

### B. Child Care and Work

Tax relief for child care costs has a straightforward economic justification: Child care is a work-related expense. In more precise economic terminology, reductions in the relative price of child care increase labor supply.

Categorizing child care costs as work related has driven Congress's decision to provide tax relief for such costs. When the itemized deduction was adopted in 1954, the House Ways and Means Committee justified the deduction on the grounds that such expenses "are comparable to an employee's business expenses."<sup>10</sup> Distinguished tax scholar Joseph Pechman noted that Congress had a similar outlook when it replaced the deduction with the credit in 1976.<sup>11</sup> This categorization continues to be reflected in the labeling of creditable costs as employment-related expenses, the requirement that those

<sup>6</sup>Section 45F also provides a credit to employers equal to 25 percent of expenditures to construct, acquire, or operate child care facilities and 10 percent of expenditures to provide child care resource and referral services to employees. This credit, not discussed in this article, was enacted as part of the 2001 tax cuts, section 205(a) of the Economic Growth and Tax Relief Reconciliation Act of 2001.

<sup>7</sup>The exclusion was enacted by section 124(e)(1) of the Economic Recovery Tax Act of 1981.

<sup>8</sup>JCT, "Estimates of Federal Tax Expenditures for Fiscal Years 2009-2013," JCS-1-10, at 41 (Jan. 11, 2010), *Doc 2010-631*, 2010 TNT 7-22.

<sup>9</sup>Office of Management and Budget, "Analytical Perspectives, Budget of the United States Government, Fiscal Year 2011," Feb. 2010, at 211.

<sup>10</sup>House Ways and Means Committee, Internal Revenue Code of 1954, House Report No. 1337, 83d Congress, 2d Session, *reprinted in* 1954 U.S.C.C.A.N. 4025, 4055.

<sup>11</sup>Joseph A. Pechman, *Federal Tax Policy*, at 96-97 (Brookings Institution, 5th ed. 1987).

costs enable the taxpayer to be gainfully employed, and the limitation of such costs to the amount of the taxpayer's labor income.

Of course, the relevant issue is the optimal tax treatment of child care costs, not Congress's purpose or its description of the tax relief. To address this question, I review the theory of optimal taxation and the evidence on child care and labor supply.

The modern theory of optimal taxation provides a rigorous foundation for taxing work-related goods at lower rates than other goods. The theory assumes that individuals differ in their ability to earn income, so that income inequality arises in the absence of taxation. To promote redistribution, the government taxes wages and makes transfer payments, even though doing so violates economic efficiency by discouraging work.<sup>12</sup>

The government can deviate from a simple uniform wage tax through provisions — such as adding surtaxes or granting tax relief — that tax different goods at different rates. One might think that using such tools would ease the trade-off between redistribution and efficiency. In one case, however, using differential tax rates is undesirable.

The special case in which differential tax rates should be avoided occurs when consumers' choice between the various goods is weakly separable from their decisions about how much to work. Under weak separability, an individual with a fixed amount to spend on consumer goods would divide that money among the various goods in the same way, regardless of how many hours she had to work to earn that money. In intuitive terms, working more or less does not alter the relative attractiveness of the various consumer goods because no good has any special relationship to work.<sup>13</sup>

If weak separability holds, all consumer goods should be taxed at a uniform percentage rate at any given income level. Taxing goods at different rates would not ease the redistribution-efficiency trade-off because it would provide no way to distinguish those with more ability from those with less ability. Although taxing luxuries at a higher rate would increase redistribution, that goal could be advanced at lower efficiency cost by raising marginal tax rates across the board and providing larger transfer payments to those with low wages. Conversely, although taxing necessities at a higher rate would reduce inefficiency, that goal could be advanced with less impairment of redistribution by lowering marginal tax rates across the board and cutting transfer payments. In this special case, uniform taxation is desir-

able, regardless of how much weight policymakers place on redistribution versus efficiency. If policymakers become more (or less) concerned with redistribution, they should raise (or lower) marginal wage tax rates and transfer payments but not use surtaxes or exemptions for specific goods.

Differential tax treatment becomes desirable, however, when consumer preferences deviate from weak separability. One good should be taxed more heavily than another if the former becomes more attractive relative to the latter as the consumer works less. In other words, goods that are substitutes for labor (leisure-related goods) should be taxed at higher rates, and goods that are complements to labor (work-related goods) should be taxed at lower rates. This differential tax treatment increases labor supply and thereby promotes economic efficiency without impairing redistribution.<sup>14</sup> The case for tax relief for work-related goods is closely related to the case for the deductibility of pure costs of earning income (expenditures on goods that increase labor earnings without providing any other consumer benefit).

Economic theory offers two ways to test for deviations from weak separability that can justify differential tax treatment. One possibility is to look at how the demand for different goods responds to changes in the wage rate, which is the price of labor. Work-related goods are those that experience unusually large increases when wage income, as opposed to nonlabor income, rises. But the testing can also proceed in the opposite direction, by looking at how labor supply responds to changes in the prices of various goods. Under weak separability, the impact of each good's price on labor supply depends only on the size of the good in the consumer's budget.<sup>15</sup> A good is work related, and therefore merits lighter taxation, if reductions in its price generate unusually large increases in labor supply.

Labor economists have performed many statistical analyses of the relationship between the cost of child care and work. The weight of the evidence indicates that reductions in child care costs significantly increase labor supply.<sup>16</sup> This finding is intuitively plausible and accords

<sup>14</sup>See Louis Kaplow, "Taxing Leisure Complements," National Bureau of Economic Research Working Paper 14397, Oct. 2008, forthcoming in *Economic Inquiry*.

<sup>15</sup>In economic terminology, the derivative of the compensated labor supply with respect to the price of each good is proportional to the good's marginal expenditure share, as noted by William A. Barnett, "The Joint Allocation of Leisure and Goods Expenditure," *Econometrica* (May 1979), at 539-563 and the sources cited therein.

<sup>16</sup>Some of the recent studies include Michael Baker, Jonathan Gruber, and Kevin Milligan, "Universal Child Care, Maternal Labor Supply, and Family Well-Being," *Journal of Political Economy* (Aug. 2008), at 709-745; David Blau and Erdal Tekin, "The Determinants and Consequences of Child Care Subsidies for Single Mothers in the USA," 20(4) *Journal of Population Economics* (Oct. 2007), at 719-741; Jean Kimmel and Rachel Connelly, "Mothers' Time Choices: Caregiving, Leisure, Home Production, and Paid Work," *Journal of Human Resources* (summer 2007), at 643-681; Rachel Connelly and Jean Kimmel, "Marital Status and Full-Time/Part-Time Work Status in Child Care Choices," *Applied Economics* (2003), at 761-777; and Jonah B.

(Footnote continued on next page.)

<sup>12</sup>A clear exposition is provided by Louis Kaplow, *The Theory of Taxation and Public Economics*, at 122-145 (Princeton University Press, 2008). The underlying result of the desirability of uniform taxation in the presence of weak separability was derived by Anthony B. Atkinson and Joseph E. Stiglitz, "The Design of Tax Structure: Direct Versus Indirect Taxation," *Journal of Public Economics* (July-Aug. 1976), at 55-75.

<sup>13</sup>In economic terminology, the marginal rate of substitution between any two goods depends on the quantity of goods, but not on the quantity of labor. Equivalently, the utility function may be written in terms of labor and a separate subutility function for the goods.

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with the experience of welfare programs, in which access to affordable child care has played a central role in efforts to promote work by welfare recipients.<sup>17</sup> In view of these findings, optimal tax theory suggests that tax relief for child care costs is appropriate. Even so, several objections to this tax relief are often heard.

**C. Misconceptions About Taxes and Child Care**

The most common objections to the child care tax credit revolve around its alleged nonneutrality. These objections miss the mark because they fail to recognize that the income tax is biased against work and work-related goods such as child care and fail to understand the appropriate tax treatment of such goods.

One objection is that tax relief for child care costs artificially encourages work or unfairly favors parents who work over those who stay at home.<sup>18</sup> This is clearly incorrect. Because the income tax imposes a penalty on work, the allowance of tax relief for work-related costs does not create a net subsidy to work. This objection takes as its neutrality touchstone a system that imposes no tax on stay-at-home parents while taxing working parents on their wages without offering tax relief for work-related costs. It is easy to see there is nothing neutral about such a system.

At bottom, this objection views the credit as nonneutral simply because it is more valuable to those who work than to those who do not work. Far from being objectionable, this characteristic is shared by any tax relief that mitigates the work disincentives of the income tax, including simple marginal tax rate reductions.

A variant of this objection alleges that the credit is nonneutral between parents who purchase child care in the marketplace and those who provide child care by staying at home.<sup>19</sup> In its strongest form, the argument runs as follows. A parent who stays home to provide child care produces a valuable service, a fact not altered by the failure of the national income accounts to record the production. Further, the stay-at-home parent incurs a cost to produce this service by forgoing the opportunity to earn wages by working outside the home. This opportunity cost is as real as any other economic cost. Because there is no tax relief for the opportunity cost of producing child care at home, there should be no tax relief for the financial cost of purchasing child care in the market.

The argument is correct, except for a fatal flaw in the last step. The assertion that there is no tax relief for the

opportunity cost of producing child care within the home is completely mistaken. On the contrary, the opportunity cost receives full tax relief under both the income and payroll taxes. When a parent gives up wages to provide child care at home, she avoids the taxes that would have been imposed on those wages; stated differently, only after-tax wages are given up by staying at home. Because the opportunity cost of producing child care at home already receives tax relief, the provision of tax relief to the financial costs of purchasing child care promotes neutrality between the two types of child care. In the absence of tax relief for purchased child care, the tax system would artificially favor child care produced at home by imposing income and payroll taxes on parents who work to purchase child care while imposing no taxes on parents who produce child care within the home.<sup>20</sup>

A different objection pertains to neutrality between child care and other consumer goods. This argument is that the credit artificially favors the purchase of child care over the purchase of other goods, distorting consumer behavior in the same manner as a tax credit that applies to apples but not oranges.<sup>21</sup> Although the argument's flaw is somewhat subtle, it again reflects the failure to recognize the work-related nature of child care costs. Because child care costs are work related, the income tax penalty on work causes a disproportionate reduction in purchases of child care relative to other goods. By offsetting this disproportionate impact, tax relief for child care promotes, rather than impedes, economic neutrality. Of course, if reductions in the price of paid child care primarily caused the substitution of paid care for unpaid care — with little effect on labor supply — tax relief for paid child care would be undesirable. As discussed above, however, the statistical evidence shows that reductions in the price of paid child care result in significant increases in work, indicating that such substitution is not the dominant behavioral response.

A final concern pertains to whether child care should be singled out for tax relief, given that many other consumer expenditures with a potential relationship to work do not receive tax relief.<sup>22</sup> Examination reveals, however, that there are sound justifications for treating child care more favorably than many other arguably work-related goods. Moreover, if any unwarranted disparities exist, they should be corrected by providing greater tax relief for the other work-related goods, not by reducing tax relief for child care.

To begin, some goods that appear to be related to work are not work related in the relevant economic sense because they do not affect work on the margin. For example, one could view food as a work-related good, on the grounds that someone who consumes no food will

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Gelbach, "Public Schooling for Young Children and Maternal Labor Supply," *American Economic Review* (Mar. 2002), at 307-322. These papers provide citations to the earlier literature.

<sup>17</sup>For a recent discussion, see Peter S. Goodman, "Cuts to Child Care Subsidy Thwart More Job Seekers," *The New York Times*, May 24, 2010, at A1.

<sup>18</sup>See Curtis Dubay and Chuck Donovan, "Impact of Child Care Tax Credit Increases on Families and Economy," *Doc 2010-2861*, 2010 TNT 25-86. The authors complain that the credit is not "equitable to . . . all work-family time options" and note that only a minority of mothers with young children work full time.

<sup>19</sup>Dubay and Donovan, *id.*, criticize the credit as not being available to "families where one parent forgoes wage income entirely in order to stay home and raise the children."

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<sup>20</sup>This point is discussed by Jonathan Gruber in his prominent textbook, *Public Finance and Public Policy*, at 600-603 (Worth Publishers 2005).

<sup>21</sup>Dubay and Donovan, *supra* note 18, emphasize that the credit provides "incentives to use outside day care, pressuring them to do something against their wishes."

<sup>22</sup>Richard Goode raised this concern in *The Individual Income Tax*, at 79-80 (Brookings Institution 1976).

starve to death and permanently exit the work force. The relevant issue, however, is the impact on work of a *marginal* change in food consumption, not the impact of reducing food consumption to zero. It is unlikely that a marginal change in food expenditures, resulting from a marginal change in the price or tax treatment of food, would have a noticeable impact on hours worked or productivity of work in the United States today (although a different situation might prevail in some impoverished countries). In the United States, therefore, the tax system is correct not to treat food as a work-related cost.

Even with goods that are work related in the relevant economic sense, it is necessary to consider administrative complications. While there may be many goods for which weak separability does not exactly hold, the impact on work will often be too small to warrant tax relief because of administrative and compliance costs. It is particularly difficult to provide tax relief for expenditures that are made to many providers in small increments and are therefore difficult to record and verify. Moreover, the setting of different tax rates for numerous goods based on small effects on work would invite endless lobbying by industries contending that their goods are work related.

Therefore, tax relief should be limited to goods that have a clear and significant link to work and for which relief is administratively practical. Child care meets these criteria. As discussed above, the impact of child care on work has been verified by statistical evidence. Tax relief for child care is also administratively practical, as the typical taxpayer makes payments to only a limited number of providers during a given year. Verification of the payments can be, and is, facilitated by requiring taxpayers to list the identification numbers of the providers. The above description of the credit shows that the definition of creditable costs involves some complications but that the code and regulations set forth a reasonable and workable set of rules. These factors set child care apart from other expenditures that may have some significant relation to work, such as commuting costs.

In summary, the objections to the credit fail to recognize the work-related nature of child care costs. To effectively counter those objections, supporters of the credit must emphasize its link to work. Marketing the credit as just another middle-income tax break leaves it vulnerable to these misconceptions.

When the Obama administration recently proposed an expansion of the credit (as detailed below), it adopted a mixed marketing approach. On one hand, the proposal was made by the White House Task Force on the Middle Class rather than the (nonexistent) White House Task Force on Work Promotion. On the other hand, the task force's report emphasized that child care is important for enabling work and promoting economic mobility.<sup>23</sup> The Treasury green book lists the proposal under "tax cuts for families and individuals" but justifies the change by stating that assistance with child care costs "increases the ability of individuals to participate in the labor force or in

<sup>23</sup>"Annual Report of the White House Task Force on the Middle Class," at 30 (Feb. 2010).

education programs."<sup>24</sup> The emphasis on work should be strengthened in future discussions of the credit.

#### D. Reform Options

I now consider ways to maintain and strengthen tax relief for child care. The first step is to prevent erosion of the existing tax relief. If the 2001 tax cuts expire as scheduled at the end of 2010, the credit rate will decline for taxpayers with incomes below \$43,000, and the maximum creditable amounts will fall by 20 percent. Also, the patch that allows the credit to offset the AMT expired at the end of 2009 and has not yet been reinstated.<sup>25</sup>

Further, it is necessary to prevent the elimination of the child care credit in the name of tax simplification. Some plans to consolidate tax relief related to work and family would eliminate the credit. For example, the plan presented in the Bush tax reform panel's 2005 report would have abolished the credit.<sup>26</sup> In a previous *On the Margin* column, three of my American Enterprise Institute colleagues presented reform options that also would eliminate the credit.<sup>27</sup> One of the simplification options discussed in the recent report by the President's Economic Recovery Advisory Board also would eliminate the credit.<sup>28</sup> It makes sense to replace the child credit, dependent exemption, earned income tax credit, and Making Work Pay credit with one or two consolidated credits because these provisions serve heavily overlapping purposes. But it does not make sense to replace the child care credit, which serves the distinctive purpose of reducing the after-tax price of child care, thereby promoting work.

On a more positive note, options to expand and improve tax relief for child care costs should be pursued. One option is to replace the credit with a deduction — an approach I recommended in a previous article.<sup>29</sup> Unlike the itemized deduction in place from 1954 to 1975, the proposed deduction would be above the line, available to taxpayers who claim the standard deduction. A deduction would be simple and would provide income tax treatment of out-of-pocket child care costs parallel to the

<sup>24</sup>Treasury Department, "General Explanation of the Administration's Fiscal Year 2011 Revenue Proposals," at 15 (Feb. 2010), *Doc 2010-2363*, *2010 TNT 21-20*.

<sup>25</sup>In the absence of an AMT patch, the credit would be significantly less valuable, as documented by Elaine Maag, "The Disappearing Child Care Credit," *Tax Notes*, Oct. 8, 2007, p. 177.

<sup>26</sup>The President's Advisory Panel on Federal Tax Reform, "Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System" (Nov. 2005).

<sup>27</sup>See Kevin A. Hassett, Lawrence B. Lindsey, and Aparna Mathur, "Moving Toward a Unified Credit for Low-Income Workers," *Tax Notes*, Aug. 10, 2009, p. 589, *Doc 2009-16311*, or *2009 TNT 151-10*.

<sup>28</sup>See the President's Economic Recovery Advisory Board's final report, at 8-10 (Aug. 2010), *Doc 2010-19068*, *2010 TNT 167-50*.

<sup>29</sup>Alan D. Viard, "25 Ways to Make the Tax Code Simpler, Fairer, and More Efficient," in *Toward Tax Reform: Recommendations for President Obama's Task Force*, at 99-102 (Tax Analysts 2010), available at <http://www.tax.org>, *Doc 2009-13599*, *2009 TNT 172-34*.

income tax treatment of employer-provided child care under the section 129 exclusion.

The deduction approach is not perfect, however. Notably, an income tax deduction would not be fully parallel to the section 129 exclusion because the exclusion also applies to payroll taxes. Given that a deduction within the payroll tax system is administratively impractical, it may be preferable to continue to employ an income tax credit. A credit with a rate equal to the taxpayer's combined income and payroll tax rate has the same economic effects as a deduction against both taxes. In any case, there has been little interest in replacing the credit with a deduction, so I now turn to possible reform within the credit's existing framework.

The top priority should be higher credit rates. Although the maximum credit rate is 35 percent, that rate applies only to taxpayers with AGI of \$15,000 or less. Almost none of those taxpayers actually receive the 35 percent rate, however, because they have little or no income tax liability against which to claim the nonrefundable credit. The problem is that nominal income levels in the phasedown have remained fixed while nominal income levels at which taxpayers become subject to income tax have risen.<sup>30</sup>

President Obama's 2010 budget proposal would increase credit rates. Starting in 2011, the income-based phasedown from the 35 percent credit rate would begin at AGI of \$85,001 rather than \$15,001. The phasedown would proceed at the same pace as current law, with the credit rate reaching its minimum value of 20 percent when AGI reaches \$113,001. Like the current income levels, the new levels would not be indexed to inflation. The proposal would have a budgetary cost of about \$13 billion over 10 years.<sup>31</sup>

Although the Obama proposal would ameliorate the problems posed by the income-based phasedown, the proposal is too timid. The phasedown is a needless source of complexity, and as discussed above, adds as much as 3 percentage points to the affected taxpayers' effective marginal tax rates. It would therefore be best to eliminate the phasedown.

One proposal takes that approach. On May 11, Rep. Allyson Y. Schwartz, D-Pa., introduced H.R. 5260, the Support Working Parents Act of 2010, which would eliminate the income-based phasedown and provide a 35 percent credit rate at all income levels. The bill would reduce complexity and provide a credit rate that roughly approximates the combined income and payroll tax rates across a range of income levels. At a June 14 Capitol Hill forum, Tess Stoval, a senior policy adviser for Third Way; Megan Curran, the senior director for family economics at First Focus; and I spoke in favor of this bill.

<sup>30</sup>Sheldon R. Smith and Katherine D. Black have documented the practical unavailability of the higher credit rates in "Dependent Care Tax Benefits: A Second Look," *Tax Notes*, Nov. 12, 2007, p. 718, *Doc 2007-23638*, or *2007 TNT 220-42*.

<sup>31</sup>Treasury estimates \$12.6 billion, while the JCT estimates \$13.2 billion. See Treasury green book, *supra* note 24, at 15, 150, 153; "Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2011 Budget Proposal," JCX-7-10R (Mar. 15, 2010), *Doc 2010-5625*, *2010 TNT 50-13*.

Another issue is whether to make the credit refundable. Without the payroll tax, there would be little case for refundability, as tax relief for work-related costs is unnecessary for individuals who face no marginal tax on work. With the payroll tax, however, workers who earn too little to pay income tax still face a 15 percent marginal wage tax rate. Consideration therefore should be given to making 15 percentage points of the credit refundable.<sup>32</sup>

Also deserving attention is the limit on creditable costs. The current limits of \$3,000 and \$6,000 are only 1.5 times the 1976 values, although the Consumer Price Index rose by a factor of 3.77 from 1976 to 2009. Further, child care costs have risen more quickly than prices overall, at least in the last two decades. The CPI component for child care and nursery costs rose by a factor of 2.26 from 1991 (the earliest year for which data exist) to 2009, while the overall CPI rose by a factor of only 1.56 during that interval.<sup>33</sup>

To be sure, raising the limit on creditable costs may have less impact on labor supply than raising the credit rate. Reducing the relative price of more expensive child care may have a stronger impact on the kind of child care purchased by a working parent than on the decision of whether and how much to work.<sup>34</sup> Even so, it may be desirable to at least index the limits to prevent further erosion from inflation.

The "pay as you go" statute enacted in February 2010 generally requires that tax cuts be offset by spending reductions or tax increases. Because of exemptions in the statute, no offsets would be required for extension of the provisions of the 2001 tax cut pertaining to the credit or for AMT patches for 2010 and 2011.<sup>35</sup> Offsets would be required, however, for any of the other measures considered in this section.

Because of the modest size of the child care credit, the necessary offsets would be small. It would be best to adopt entitlement reductions, preferably by raising deductibles, copays, or Part B premiums for Medicare recipients. If offsets on the tax side are desired, an attractive option would be to accelerate and expand the 40 percent excise tax on high-cost health insurance plans. The tax, set forth in section 4980I, is scheduled to take

<sup>32</sup>Welfare recipients often face high effective marginal tax rates on work, because their benefits are phased out as their earnings rise. It is therefore important for welfare recipients to receive adequate child care assistance — a function that should be handled through welfare programs rather than the tax code. Goodman, *supra* note 17, discusses shortcomings in existing programs.

<sup>33</sup>For discussion of the high cost of child care, see Anne Kim, Tess Stoval, and Mark Donnell, "Third Way Idea Brief, Double the Child Care Tax Credit" (Feb. 2010), available at [http://content.thirdway.org/publications/230/Third\\_Way\\_Idea\\_Brief\\_-\\_Double\\_the\\_Child\\_Care\\_Tax\\_Credit.pdf](http://content.thirdway.org/publications/230/Third_Way_Idea_Brief_-_Double_the_Child_Care_Tax_Credit.pdf).

<sup>34</sup>One of the older statistical studies of child care and labor supply found the child care tax credit rate had a larger effect on labor supply than the limit on creditable costs. See Susan L. Averett, H. Elizabeth Peters, and Donald M. Waldman, "Tax Credits, Labor Supply, and Child Care," *Review of Economics and Statistics* (Feb. 1997), at 125-135.

<sup>35</sup>Section 7(e) and 7(f)(1)(E) of the Statutory Pay-As-You-Go Act of 2010.

effect on January 1, 2018.<sup>36</sup> The excise tax is one of the few significant provisions of healthcare reform that promotes cost reduction; there is no reason to wait until 2018 for its implementation. Of course, there are many other possible offsets. The pay-go requirement should not stand in the way of strengthening the child care credit.

### E. Conclusion

The child care credit is not just another middle-income tax break. It plays an important role in encouraging work by providing tax relief for expenses that are closely linked to work. An improved and expanded credit can help offset the work disincentives of the income tax and boost economic growth.

### Appendix: History of Tax Relief for Child Care

Congress enacted an itemized deduction for child care costs in 1954. The provision included the requirement, retained ever since, that the costs be incurred to enable the taxpayer to be gainfully employed. The eligibility rules were gender specific, with the deduction available only to women and widowers. The deduction applied to the costs of caring for children ages 11 and younger and dependents incapable of self-care. The deductible amount was limited to \$600 per year, regardless of the number of dependents. An income-based phaseout of the deduction applied to married couples, with the maximum deductible amount lowered by one dollar for each dollar of AGI above \$4,500. There was no phaseout for unmarried women (including married women who were legally separated from their husbands), wives whose husbands were incapable of self-support, and widowers.<sup>37</sup>

Effective in 1964, Congress extended the deduction to cover the care of 12-year-olds, allowed the deduction to be claimed by married men whose wives were institutionalized or incapacitated, increased the maximum deductible amount to \$900 for taxpayers with two or more dependents, and raised the starting point of the phaseout for married couples to \$6,000.<sup>38</sup>

Effective in 1972, Congress liberalized the deduction again. All gender-based eligibility rules were removed, with the deduction now available to "individuals."<sup>39</sup> The maximum deductible amount was dramatically increased to \$400 *per month*; the new limit did not vary with the number of dependents. The deduction was extended to cover the care of 13- and 14-year-olds. The starting

point of the phaseout was increased to \$18,000 and the amount of deduction lost per additional dollar of income was lowered from \$1 to 50 cents. For a taxpayer with \$4,800 or more of expenses, therefore, the deduction did not fully phase out until income reached \$27,600. The phaseout, however, was extended to unmarried taxpayers.<sup>40</sup> Legislation adopted in 1975 would have moved the starting point of the phaseout to \$35,000, starting in 1976,<sup>41</sup> but this provision was superseded by legislation adopted in 1976.

The new legislation replaced the itemized deduction with a credit, effective in 1976. The credit rate was 20 percent, with no phaseout. Creditable costs were limited to \$2,000 for a household with one qualifying individual and \$4,000 for a household with two or more qualifying individuals and to labor income.<sup>42</sup>

In later years, two major expansions of the credit were enacted. Effective in 1982, the 1981 Reagan tax cuts increased the credit rate to 30 percent for households with AGI of \$10,000 or less, phasing down to the original 20 percent rate for those with AGI greater than \$28,000. Also, maximum creditable costs increased to \$2,400 for one qualifying individual and \$4,800 for two or more qualifying individuals.<sup>43</sup> The 2001 Bush tax cuts further expanded the credit, starting in 2003. The credit rate was increased to 35 percent for households with AGI of \$15,000 or less, phasing down to 20 percent for those with AGI above \$43,000. Maximum creditable costs were increased to \$3,000 for one qualifying individual and \$6,000 for two or more qualifying individuals.<sup>44</sup>

Effective in 1989, however, Congress removed the care of 13- and 14-year-olds from the credit, reversing the 1972 expansion of the former deduction to those age groups.<sup>45</sup> Congress also denied the credit for overnight camp expenses, effective in 1988.<sup>46</sup>

<sup>40</sup>Section 210(a) of the Revenue Act of 1971.

<sup>41</sup>Section 206 of the Tax Reduction Act of 1975.

<sup>42</sup>Section 504(a)(1) of the Tax Reform Act of 1976. The new credit was originally placed in section 44A, but the provision was redesignated section 21 by section 471(c) of the Deficit Reduction Act of 1984.

<sup>43</sup>Section 124(a) of the Economic Recovery Tax Act of 1981.

<sup>44</sup>Section 204 of the Economic Growth and Tax Relief Reconciliation Act of 2001.

<sup>45</sup>Section 703 of the Family Support Act of 1988.

<sup>46</sup>Section 10101(a) of the Omnibus Budget Reconciliation Act of 1987.

<sup>36</sup>The excise tax was enacted by section 9001 of the Patient Protection and Affordable Care Act of 2010, and amended by section 10901 of that act and by section 1401 of the Health Care and Education Reconciliation Act of 2010.

<sup>37</sup>Section 214 of the Internal Revenue Code of 1954. Starting in 1963, Congress exempted some married women who had been deserted by their husbands from the phaseout.

<sup>38</sup>Section 212(a) of the Revenue Act of 1964.

<sup>39</sup>On November 22, 1972, a three-judge panel of the U.S. Court of Appeals for the Tenth Circuit, reversing the U.S. Tax Court, unanimously ruled that the gender-based rules in place for tax years before 1972 discriminated against men in violation of the equal protection component of the due process clause of the Fifth Amendment to the U.S. Constitution. See *Moritz v. Commissioner*, 469 F.2d 466 (10th Cir. 1972).