TAX POLICY

What are the tools? What are the pros and cons of tax policy to increase investment in early care and education? What have we learned about implementation?

Background

Tax policy addresses broad questions of fairness and justice in taxation, as well as the details of how a tax mechanism works. Tax policy defines the ways in which citizens generate revenue to pay for those things we choose to do collectively, such as roads, public safety and education. It is also about the collective values we support, such as encouraging homeownership (deduction of interest on home mortgages) and business investment (lower tax rates on capital gains). Local and state tax policy has become more important as government has decentralized. And while technology has made tax computing and collecting more efficient, the shift toward e-commerce is creating additional complexities and has had a dramatic impact on state and local tax bases.

Taxation is the major way government raises the general revenue to fund the expenses in its budget. Taxing individual and corporate income is the number one source of revenue for the federal government. All but 7 states also tax individual income, and 2 of these tax corporate income. At both the state and federal levels, the total revenues raised from individual income taxes are usually about four times larger than the total generated from corporate income taxes. For states, income taxes and sales taxes are about equal as revenue sources. For local government, property taxes are the largest source of revenue, followed by sales taxes.

In addition to raising general revenue, taxes can be 'dedicated' or 'earmarked' for a specific purpose. Usually 'dedicated taxes' are sales taxes, excise taxes or fees, rather than income taxes. Examples are California's 50 cent increase in excise taxes on tobacco products earmarked for early childhood development; Aspen, Colorado's local sales tax for child care; and the state of Georgia's lottery for pre-kindergarten.

Tax credits and deductions are mechanisms that redistribute public revenue to taxpayers. These tax policies forego collecting revenue in the first place, and are designed to support certain practices and/or to offset the cost of paying for a service. Colorado's Contribution Tax Credit for Child Care creates an incentive for any taxpayer to invest in child care by offering a credit worth 50% of the contribution. The federal (and state) Child and Dependent Care Tax Credit helps working parents pay for part of the cost of child care. Generally, tax credits are preferable to tax deductions. Deductions reduce the amount of income that is taxed, and thus are more valuable to taxpayers in higher tax brackets, and may be unavailable to lower-income taxpayers who cannot itemize deductions. Credits are a reduction of taxes owed. Refundable credits ensure that a taxpayer who owes no taxes may still claim the credit.

Each issue brief in this series has been written by Anne Mitchell and Louise Stoney, Alliance on Early Childhood Finance, on behalf of Smart Start's National Technical Assistance Center.

Tax-based approaches are attractive funding mechanisms for several reasons:

- Because they are typically available to all taxpayers, they appeal to a wide constituency.
- As part of the tax code, they are simpler to administer than are direct-benefits programs that require more staff.
- Tax cuts are more politically appealing to elected officials than direct spending.
- Historically, tax provisions have been stable funding mechanisms because they are not subject to the debates of regular reauthorization or annual appropriations. In effect, tax provisions are entitlements.

Some principles that have emerged from past experience with tax strategies are useful guidance.

- *Size:* The credit has to be worth enough to make a difference in behavior. For example, child care credits proportionate to the expense of high quality child care.
- *Simplicity*: The mechanism has to be easy to use, e.g., accessible forms, simple instructions.
- *Publicity*: Tax provisions need to be well-publicized. Provisions no one knows about aren't likely to be used.
- *Pace*: Tax provisions should be indexed to inflation so that they do not lose value over time.
- *Equity*: Tax credits should be refundable so that lower income families can benefit.
- *No substitution*: Tax strategies must work together to increase total resources, not substitute one revenue raising method for another.

For finance reform advocates, understanding tax policy is essential to increasing overall investment in early care and education. Public opinion favors tax strategies as the means to finance early care and education. According to the Communications Consortium Media Center (CCMC):

> "Various polls and focus groups have tested what methods of child care financing and assistance the public would support. Generally, the public supports increased revenues for child care from:
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> - So-called 'sin taxes' like tobacco or alcohol
> - Portions of funds raised by state lottery systems, and
> - Higher taxes
>
> The public also supports tax credits paid to working parents who have children in child care (Yankelovich, 1998) and additional credits to employers who make child care available to their employees (Gallup, 1998)." Quoted from [www.earlycare.org/ccpa.htm.](www.earlycare.org/ccpa.htm)

Discussion Questions

1) **Using tax policy fully – both for raising adequate general revenue and constructing tax provisions that work to increase private investment and help families pay for better early care and education – is necessary for increasing overall investment. What are some of the best examples of well-designed tax policy at the state level? The local level?**

2) **What do advocates need to know, or what tools are needed, to expand the use of tax policy for financing?**

Suggested Resources

The National Child Care Information Center (NCCIC) has several useful resources on tax policy:

> *Tax Credits for Employers to Support Child Care* provides information about Federal and State governments that provide tax incentives or credits to encourage employers to support child care for their employees. Includes descriptions and web links for each state's programs. Available at: http://nccic.org/faqs/taxcreditsemployers.html
>
> *Child Care Tax Credits for Parents* lists a Federal agency and national organizations that have information for families about tax laws that apply to child care. Available at: http://nccic.org/faqs/taxcredits.html.

The National Center for Children and Poverty has an online database of federal and all states' earned income tax credits and child and dependent care tax credits, with eligibility information about each and the ability to create comparison tables. Available at: http://lift.nccp.org/item_21.html

The National Women's Law Center tracks federal and state tax policy on child care and has produced several helpful reports, including clearly written guides to federal tax credits for families. A recent report, ***A Catalog of Tax-Based Approaches to Financing Child Care*** (November 2001), explains each type of tax provision and discusses the advantages and disadvantages of each. Available at: http://www.nwlc.org/pdf/ACatalogOfTaxBasedApproachesForFinancingChildCareAndAppendixRev.pdf

For the true policy wonks, a comprehensive resource on tax policy is:
Cordes, Joseph J., Robert D. Ebel and Jane G. Gravelle (eds.) 1999.
The Encyclopedia of Taxation and Tax Policy.
Washington, DC: The Urban Institute Press.