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Tax Credits for Child Care Increase Take Up and May Help More Mothers Work

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POLICY BRIEF

Tax Credits for Child Care Increase Take Up and May Help More Mothers Work

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BRIEF HIGHLIGHTS

- *The Child and Dependent Care Credit reduces child care costs for working families.*
- *About 20 percent of households with children younger than 13 years old qualify for benefits.*
- *A 20 percent increase in benefits increases paid child care use by about 10 percent.*
- *Increases in generosity also increase work participation among married mothers.*
- *CDCC benefits may help mothers remain in the labor force around childbirth.*

For additional details, see the working paper at https://research.upjohn.org/up_workingpapers/331/.

Child care in the United States is expensive. According to a 2018 Care.com survey of 1,300 U.S. parents, 33 percent of families with kids spent at least 20 percent of their incomes on child care. Child care costs matter because high costs may push parents to leave the labor force or to place their children in low-quality child care arrangements. In light of this, many U.S. policymakers have advocated measures to reduce child care costs.

Currently, the Child and Dependent Care Credit (CDCC), a tax credit based on income and child care expenditures, subsidizes child care costs for working families. The federal CDCC is available to households with children younger than 13 years old in which all parents have positive annual earnings and are working or looking for work. While many families meet these criteria, the federal CDCC is nonrefundable, so only families with positive tax liability after other deductions can benefit. Nonetheless, several states offer their own refundable CDCCs that can mitigate child care costs for lower-income families.

In 2003, the Economic Growth and Tax Reconciliation Act expanded the CDCC and led to large increases in both state and federal CDCC expenditures. To understand who benefited from the CDCC before and after its expansion, I document CDCC eligibility and expenditures over time and across income and demographic groups. I find that around the time of the expansion, about 20 percent of households qualified for CDCC benefits and that the majority of federal expenditures were allocated toward low- and middle-income taxpayers. I then estimate the effects of benefit increases on paid child care participation and parent employment outcomes. I find that among households with eligible dependents, a 20 percent increase in CDCC benefits—an additional \$150 on average for those receiving benefits at baseline and about the typical increase within that group—raises annual paid child care participation by 2 percentage points, or about 10 percent. I also find that CDCC benefits increase work and earnings among married mothers. In particular, evidence suggests that CDCC benefits help married mothers remain in the labor force around childbirth, which may subsequently lead to increases in their lifetime earnings.

How Does the CDCC Work?

Congress implemented the federal CDCC in 1976 and expanded it in 1981. To receive CDCC benefits, working households with children younger than 13 years old claim child care expenses on their tax forms and receive tax credits worth a fraction of those expenses that depends on their income. For two-parent households, if either parent's earnings are less than child care expenditures, then the CDCC is based off of the lesser-earning parent. Eligible child care spending includes care provided by anyone outside the household, excepting a noncustodial parent. In claiming the credit, households must list their earnings, child care expenses, and child care providers' tax identification or Social Security numbers on federal income tax Form 2441. Benefits decrease taxes due at tax filing time the following year.

Tax Credits for Child Care Increase Take Up and May Help More Mothers Work

If the federal CDCC were made refundable, an additional 4 percent of single mothers, 2 percent of single fathers, and 2 percent of married households would qualify for benefits.

The value of the CDCC, however, was not indexed to inflation, and its real value decreased substantially over time until the Economic Growth and Tax Reconciliation Act expanded the federal credit in 2003. Beginning that year, households could claim up to \$3,000 of child care expenditures per child for up to two children. Such households technically could receive benefits worth up to 35 percent of those expenses, or \$1,050 per child, if their adjusted gross income (AGI) did not exceed \$15,000. As income rises, however, the credit fraction falls, reaching only 20 percent, or \$600, for those with \$43,000 or more in AGI.

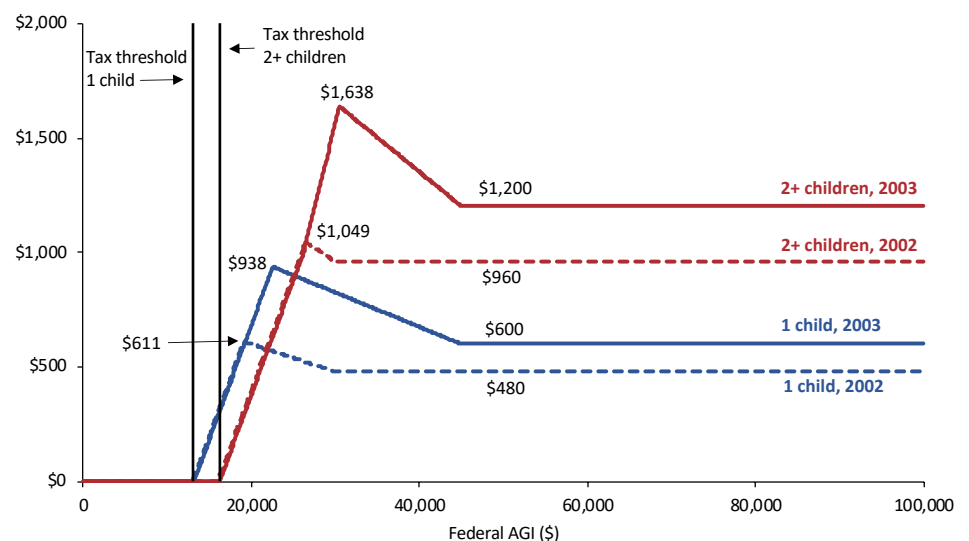
Who Benefits from the CDCC?

In practice, the nonrefundability of the federal CDCC—the credit cannot exceed taxable income—generates a difference between statutory benefits and those that low-income households actually receive. Very-low-income households have little, if any, tax liability after other deductions. In Figure 1, I use tax filing thresholds—AGI levels at which households begin to have positive tax liability—to show that, consequently, households with children must have incomes of between \$13,000 and \$16,000 to be eligible for federal CDCC benefits, both before and after the federal expansion.

Before the reform, effective CDCC benefits for households with one eligible child peak at just over \$600, when AGI reaches approximately \$19,000; benefits then fall to about \$480 for households with \$30,000 or more in income. After the federal expansion, benefits instead peak at about \$940 for households with \$22,500 in income, and then fall to \$600 for households with \$43,000 or more in income. Households with two or more eligible children receive more generous credits but otherwise face similar increases and decreases with income.

Using data from the March Current Population Survey (CPS), which has demographic and income data for U.S. families, and the Survey of Income and Program Participation, which has child care expenditure data, I find that 21 percent of single mothers, 22 percent of single fathers, and 21 percent of married-parent households qualified for CDCC benefits, after accounting for nonrefundability, right before the reform. (In the absence of

Figure 1 Maximum Effective Federal CDCC Benefits by Federal AGI

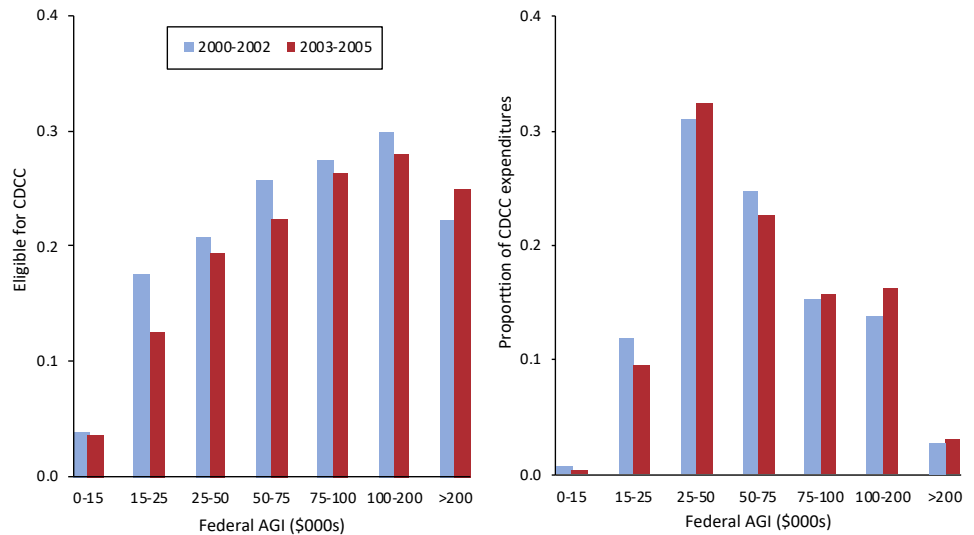


NOTE: The figure shows expected federal CDCC benefits for households with one (blue line), or two or more (red line), eligible children, as a function of adjusted gross income (AGI) before and after the federal CDCC expansion in 2003.

SOURCE: Author's calculations from federal tax forms.

Because benefits are tied to work, increases in CDCC generosity should increase employment, as larger benefit amounts drive parents to enter the labor force.

Figure 2 CDCC Eligibility and Expenditures by Federal AGI



NOTE: Left panel: Proportion of households with children presumed eligible for CDCC benefits, by adjusted gross income (AGI), in 2000–2002 and 2003–2005. Right panel: Proportion of federal CDCC benefits, by AGI of households, from 2000–2002 and 2003–2005.

SOURCE: Left panel: Author's calculations from March CPS and SIPP data. Right panel: Author's calculations from IRS Statistics of Income data.

other changes, an additional 4 percent of single mothers, 2 percent of single fathers, and 2 percent of married households would have qualified for benefits if the federal CDCC were refundable.)

The left panel of Figure 2 shows that the likelihood of CDCC eligibility generally rises with income, as high-income households are more likely both to pay for child care services and to have positive tax liability after other deductions. Less than 4 percent of households with AGI under \$15,000 are eligible for CDCC benefits, both before and after the federal CDCC expansion. Conversely, nearly 30 percent of households with AGI between \$100,000 and \$200,000 are eligible for the CDCC.

The right panel of Figure 2 uses data from the Internal Revenue Service to show that low- and middle-income households received the majority of federal CDCC benefits in the early 2000s; households with federal AGI between \$25,000 and \$50,000 received over 30 percent of benefits both before and after the federal expansion. Very-low- and very-high-income households combined received less than 4 percent of benefits.

In addition, households in about half of states in 2002 could receive additional CDCC benefits through state supplements to the federal credit. These state benefits are either a share of the household's federal benefits or based on the child care expenses used to calculate them, and some are refundable. Because of these linkages, the 2003 federal CDCC expansion increased benefits differentially across states, as well as across family sizes.

Impacts on Paid Child Care Participation and Employment Outcomes

Because the CDCC decreases child care costs, increases in CDCC generosity should increase child care spending. Because the benefits are tied to work, generosity increases should also increase employment, as larger benefit amounts drive parents to enter the labor force. Estimating these causal relationships can be tricky, however, especially if households change their behavior in response to changes in the CDCC. For example, increases in CDCC generosity may cause households to start paying for child care

Tax Credits for Child Care Increase Take Up and May Help More Mothers Work

Increases in the use of paid child care indicate that the CDCC helps working parents pay for child care.

services and thus newly qualify for benefits. Hence, it becomes a challenge to estimate effects because benefits change simultaneously with paid child care participation and other outcomes.

To overcome these issues, I create a “simulated” measure of CDCC generosity that is based on average benefits for household groups defined by year and state of residence, as well as household characteristics such as marital status, number and age of children, and educational attainment. These simulated averages capture the tax policy change but smooth over individual household decisions that could affect eligibility.

Using data from the March CPS, I find that a 20 percent increase in CDCC benefits increases annual paid child care participation by about 2 percentage points among households with children younger than 13 years old. Among single mothers, who are less likely to qualify for the nonrefundable federal credit and are more likely to work before the federal expansion, I do not find statistically significant impacts on employment or earnings. Among married women, however, a 20 percent increase in CDCC benefits leads, on average, to a 1 percent increase in annual employment, a 1.6 percent increase in hours worked per week, and a 10 percent increase in annual earnings, although these average responses likely reflect little change for some mothers and even larger increases for others. Still, these effects suggest that, at least to some extent, increases in work among married mothers help drive increases in paid child care use.

Since child care is perhaps most critical to families with very young children, I also examine workforce outcomes among families with children younger than two. For these families, a 20 percent increase in CDCC benefits increases maternal employment by 4 percent, a much larger increase than for families with only older children. This implies that CDCC generosity may help mothers remain in the labor force around childbirth, which could increase their earnings in the long run.

Policy Implications

Upticks in the use of paid child care as benefit generosity increases indicate that the CDCC helps working parents pay for child care. Nevertheless, making the federal CDCC refundable would increase eligibility and benefits among the lowest-income working parents, who largely do not benefit from the current credit. In particular, likelihood of eligibility among single mothers would increase by 19 percent if the federal credit were made refundable. If low-income parents, who often have low work participation rates, were to enter the labor force to receive benefits, refundability of the credit could even further expand eligibility.

Moreover, substantial earnings responses to increases in CDCC generosity among married mothers, who tend to have incomes high enough to qualify for the existing (nonrefundable) credit, suggest expanding CDCC generosity could have high returns even for those with higher incomes. Effects of CDCC benefits on earnings may be even larger amid the COVID-19 pandemic, which has led to school closures and increased child care costs for many families. By tying benefits to work, the CDCC may help keep parents in the workforce and reduce need for currently overburdened safety net programs.

Reference

Care.com. 2018. “This Is How Much Child Care Costs in 2018.” <https://www.care.com/c/stories/16221/cost-of-child-care-survey-2018-report/> (accessed July 30, 2020).



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