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Making the Child Care Tax Credit Permanently Refundable Could Benefit Low-Income Families

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Making the Child Care Tax Credit Permanently Refundable Could Benefit Low-Income Families

Gabrielle Pepin

The Child and Dependent Care Credit (CDCC), a tax credit based on income and child care expenses, subsidizes child care costs for working families. The federal CDCC is available to households with children younger than 13 in which all parents have positive annual earnings. While many families meet these criteria, from its introduction in 1976 through 2020, the CDCC was nonrefundable, so only families with positive tax liability after other deductions benefited. This generally precluded very-low-income families from receiving CDCC benefits, and many policymakers advocated making the credit refundable. In response to the COVID-19 pandemic, the American Rescue Plan Act of 2021 made the CDCC refundable and increased its generosity during tax year 2021 only. I estimate how CDCC eligibility, benefits, and marginal tax rates would change for different groups if the credit were made *permanently* refundable.

Using data from the Survey of Income and Program Participation, which documents income, demographics, and child care expenses of U.S. households, I find that making the CDCC permanently refundable would lead to relatively large increases in eligibility among single-parent, Black, and Hispanic households, which are all less likely to qualify for the nonrefundable credit. Specifically, some 3 percent of Black households, 2 percent of Hispanic households, and 1 percent of white households would gain eligibility, all else equal. About 5 percent of single parents would gain eligibility and receive on average over $1,000 in benefits annually. This increase is substantial, constituting 18 percent of existing child care spending and 10 percent of adjusted gross income (AGI). Nevertheless, refundability would generate small increases in marginal tax rates for some moderate-income taxpayers. Making the CDCC permanently refundable would increase government spending each year by about $800 million, or 21 percent of CDCC spending during the late 2010s.

ARTICLE HIGHLIGHTS

- *The Child and Dependent Care Credit (CDCC) subsidizes child care costs for working families.*
- *In 2021, the CDCC was made temporarily refundable, so even families with no positive tax liability after other deductions could benefit.*
- *If refundability were made permanent, around 5 percent of single parents would gain eligibility and receive on average over $1,000 per year in benefits.*
- *Permanent refundability would also lead to large increases in eligibility among Black and Hispanic households.*
- *Some moderate-income taxpayers would experience small increases in marginal tax rates.*

How Does the CDCC Work?

Congress implemented the CDCC in 1976 and expanded it in 1981 and 2001. The latter expansion took effect in 2003, and between 2003 and 2020, households were able to claim up to $3,000 worth of child care expenses per year for each of up to two children younger than 13. Such households could receive a tax credit worth up to 35 percent of those expenses, up to $1,050 per child. Beginning at $15,000 in AGI, the benefit rate decreased by 1 percentage point for each additional $2,000 until it remained at 20 percent for those with $43,000 or more in AGI, who could receive up to $600 per child in benefits. The CDCC, however, was nonrefundable, so taxpayers without positive tax liability were ineligible.

If the CDCC were made permanently refundable, low-income taxpayers would receive larger benefits.

Moreover, CDCC claimants must work to qualify for benefits, including both spouses among married taxpayers filing jointly. Additionally, if either spouse's earnings are less than child care expenditures, the CDCC is capped by the pay of the lower-earning spouse. Almost any child care expenditures are eligible for the credit, except care provided by a noncustodial parent, but to claim the credit, taxpayers must list their earnings, child care expenditures, and child care providers' tax identification or Social Security numbers.

How Would Permanent Refundability Affect CDCC Eligibility and Benefits?

Nonrefundability generates a difference between statutory and actual benefits received. In Figure 1, I compare maximum effective CDCC benefits with and without refundability as of 2020.[1] Taxpayers' incomes must exceed the tax filing threshold of $18,650 to be eligible for nonrefundable benefits. For taxpayers with incomes above this threshold, nonrefundable benefits (red lines) increase with income before reaching peaks of about $860 at $27,600 in AGI for households with one eligible child and $1,530 at $34,100 in AGI for households with two or more eligible children. Benefits then decrease until they plateau at $600 per child for taxpayers with $43,000 or more in income.

Figure 1 also shows that if the CDCC were made permanently refundable (blue lines), low-income taxpayers would receive larger benefits. For very-low-income taxpayers, refundable benefits increase as income increases and then hold steady at $1,050 per child at incomes up to $15,000. For taxpayers with AGI above $15,000, refundable benefits steadily fall as income increases until they converge with nonrefundable benefits. Hence, making the CDCC permanently refundable would increase generosity among low-income taxpayers without affecting benefits for those with higher incomes.

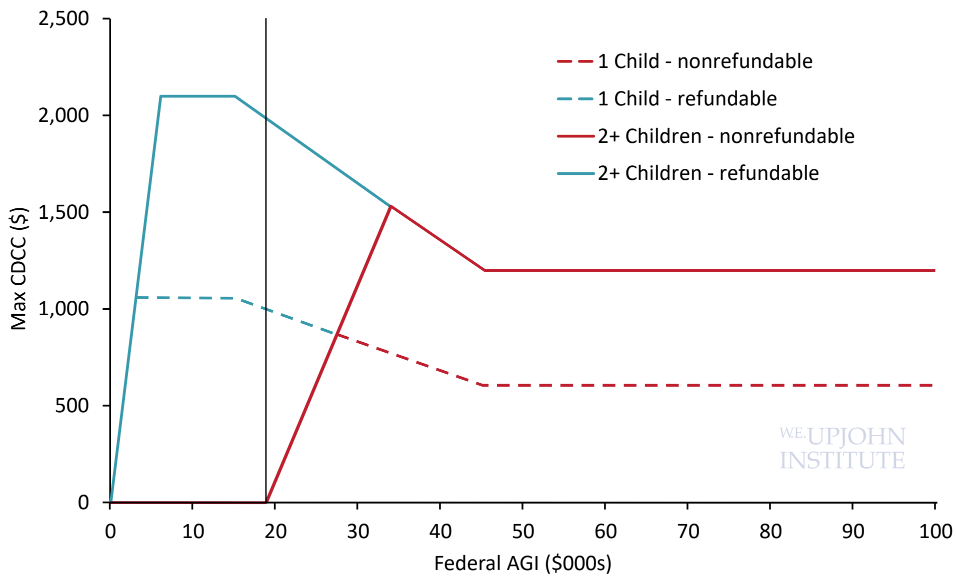
How Would Permanent Refundability Affect Work Decisions?

As a subsidy for child care, CDCC benefits encourage child care spending and effectively increase wages net of child care costs. Since all parents must work to receive benefits, increases in benefits promote labor force participation. However, the CDCC generates complex work hours incentives. To examine how making the CDCC permanently refundable would affect work hours, I compare marginal tax rates with respect to income—the taxes that parents would owe on an additional dollar of income—with and without refundability. When marginal tax rates increase, the value of an additional dollar of earnings falls, which discourages parents from working more.

Figure 2 displays these marginal tax rates for households with the maximum qualifying child care expenditures as of 2020.[2] Panel A, which shows marginal tax rates for single parents with one eligible child, indicates that making the CDCC permanently refundable would decrease marginal tax rates by 35 percentage points for those with less than $3,000 in AGI. (Marginal tax rates are already negative in this range, implying that an additional dollar of earnings is worth *more* than a dollar because of the credit.) Refundability would not affect marginal tax rates for single parents between incomes of $3,000 and $15,000, but it would increase rates by 1.5 percentage points between incomes of $15,000 and $25,000 and by 11.5 percentage points between incomes of $25,000 and $33,000.

Marginal tax rates for married parents with two eligible children, depicted in Panel B of Figure 2, exhibit a similar pattern. Thus, a permanently refundable CDCC would reduce marginal tax rates for households with very low incomes, incentivizing increases in their work hours, but it would increase marginal tax rates for households with low to moderate incomes, discouraging their work hours.

Figure 1 Maximum Federal CDCC Benefits by Federal AGI



NOTE: The figure shows expected federal CDCC benefits for households with one (dashed line) or two or more (solid line) eligible children as of 2020. The maximum credit with refundability is shown in blue and without refundability is shown in red.

SOURCE: Author's calculations using federal tax forms.

How Would Permanent Refundability Affect Different Families?

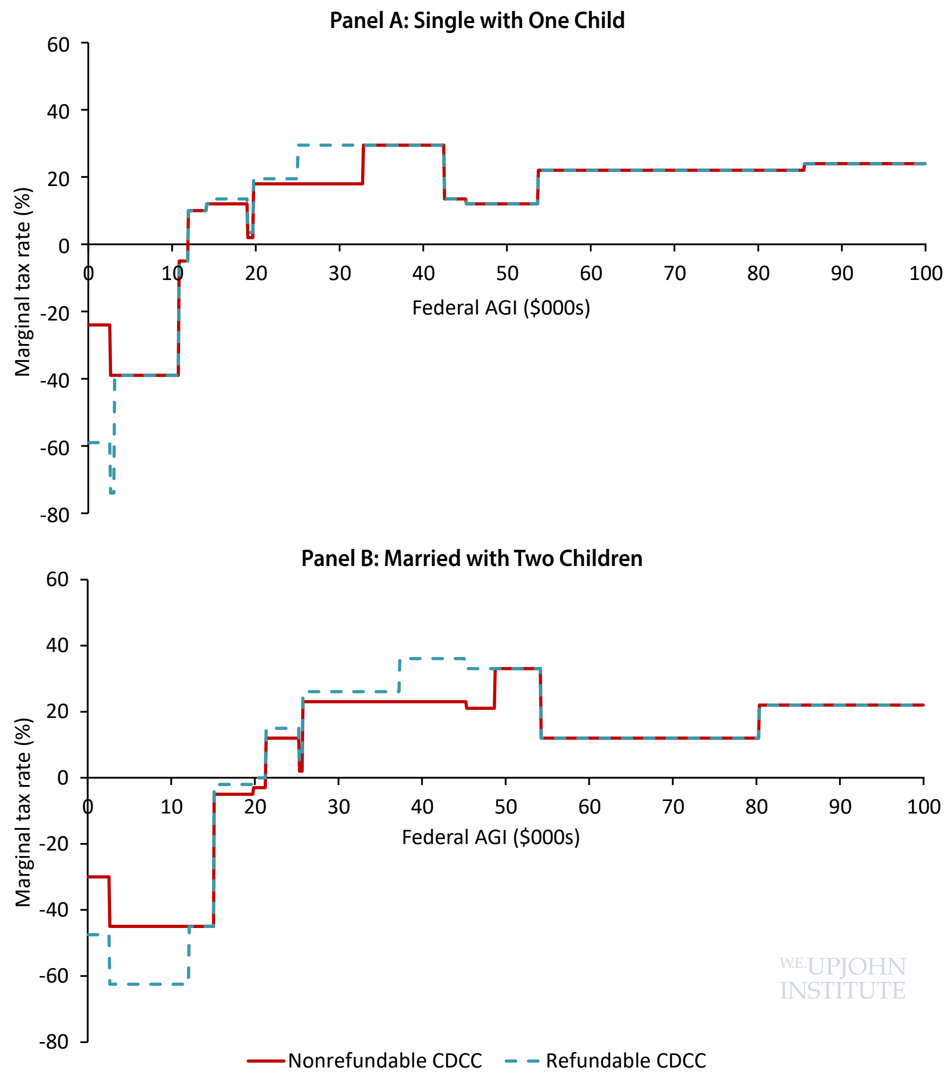
As refundability has different impacts on tax rates across the income distribution, which households would likely benefit from a permanently refundable CDCC? To answer the question, I simulate impacts of refundability, drawing on the 2018 Survey of Income and Program Participation for taxpayer characteristics and child care spending among households with children younger than 13. The data allow me to estimate CDCC eligibility rates by family structure and race and observe how permanent refundability would affect CDCC benefits and marginal tax rates across households that face different child care and labor supply incentives.

I find that 15 percent of single parents and 19 percent of married parents are eligible for nonrefundable CDCC benefits. About 5 percent of single parents have incomes too low to qualify for the nonrefundable benefits but would become eligible if the credit were made permanently refundable. Another 56 percent of single parents would gain eligibility if refundability led them to pay for child care. The remaining 25 percent of single parents do not work and have incomes too low to qualify for the nonrefundable CDCC. Among married parents, 10 percent have incomes too low to qualify for the nonrefundable CDCC, but virtually none of these households pay for child care and therefore would remain ineligible under a refundable credit. Most married parents are ineligible for the CDCC because they do not pay for child care or one of the parents does not work.

CDCC eligibility rates also vary by parents' race and ethnicity. Black and Hispanic households, which tend to have lower incomes, are less likely than white households to be eligible for the nonrefundable CDCC. Whereas 21 percent of white households are eligible, only 17 percent of Black households and 13 percent of Hispanic households are eligible. Making the CDCC permanently refundable would increase eligibility by about 3 percentage points among Black households, by about 2 percentage points among Hispanic households, and by about 1 percentage point among white households. Another 14 percent of Black households, 8 percent of Hispanic households, and 7 percent of white households have incomes too low to qualify for the nonrefundable CDCC but would become eligible if refundability led them to pay for child care. These results suggest permanent CDCC refundability would decrease eligibility gaps between whites and underrepresented groups.

Permanent refundability would also change benefit amounts for different families. Among single parents who work and already pay for child care, 23 percent are ineligible for the nonrefundable CDCC, another 23 percent fall in the phase-in region of the CDCC, where benefits increase as income rises, and the remaining 54 percent fall in the phase-out/plateau region of the credit, where benefits decrease or remain constant as income rises. Households in the ineligible and phase-in regions on average spend about $6,000 and $11,000 per year,

Figure 2 Marginal Tax Rates for Different Families by CDCC Refundability



NOTE: The figure shows marginal tax rates with respect to AGI under the federal CDCC, Child Tax Credit, Earned Income Tax Credit, and federal individual income tax schedule as of 2020, assuming the CDCC is nonrefundable or refundable.

SOURCE: Author's calculations using TAXSIM and federal tax forms.

respectively, on child care. If the CDCC were made permanently refundable, average annual benefits would increase from $0 to $1,037 in the ineligible region and from $617 to $1,249 in the phase-in region. These increases are substantial: in the ineligible region, the increase constitutes 18 percent of existing child care spending and 10 percent of AGI. In the phase-in region, it constitutes 6 percent of child care spending and 3 percent of AGI.

These benefit increases also affect marginal tax rates. In the ineligible region, the average marginal tax rate on an additional dollar of income would fall by 5 percentage points under refundability, while in the phase-in and phase-out/plateau regions it would rise by about 2 percentage points. However, the benefits also subsidize the cost of child care, effectively making it cheaper. For households in the ineligible region, the effective (postsubsidy) cost of an additional dollar of child care spending decreases by 16 percent. In the phase-in and phase-out/plateau regions, the cost decreases by 9 and 4 cents on the dollar, respectively. Thus, moderate-income households have slightly higher marginal tax rates on their incomes offset by cheaper child care costs, with the latter possibly mitigating work disincentives caused by the former.

How Would Permanent Refundability Affect Government Spending?

Finally, CDCC benefit increases under refundability would increase government spending. If all households with benefit increases were to claim the CDCC, making it permanently refundable would increase government spending annually by about $800 million, or about 22 percent of total CDCC spending in the late 2010s.

Notes

1. I assume single taxpayers file as head-of-household, married taxpayers file jointly, and all income comes from earnings among very-low-income taxpayers.

2. I assume households do not have older children, all income comes from earnings, and married parents have equal earnings, though results are similar for married parents with unequal earnings.

For additional details, see the working paper at https://research.upjohn.org/up_workingpapers/344.

Gabrielle Pepin is a postdoctoral researcher at the Upjohn Institute.

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