

WebMemo



Published by The Heritage Foundation

No. 2794
February 4, 2010

Impact of Child Care Tax Credit Increase on Families and Economy

Curtis S. Dubay and Chuck Donovan

President Obama's budget proposes to increase the child and dependent care tax credit for low- and middle-income families.¹ The economy could use a tax cut to help it recover, but increasing this credit would do nothing to encourage growth.

The credit also discriminates among families with comparable incomes and work effort simply on the basis of their decision to use or not use paid day care providers. Increasing the credit only worsens the unfair treatment.

Discriminates Among Working Families. The child and dependent care credit is currently based on a sliding scale. Taxpayers with adjusted gross income (AGI) below \$15,000 multiply their out-of-home child and dependent care expenses by 35 percent. The percentage that taxpayers can claim declines iteratively to 20 percent for taxpayers with AGI up to \$43,000 and remains there for everyone above. The maximum expenses any taxpayer can claim are \$3,000 for one child or up to \$6,000 for two or more children.

President Obama would nearly double the percentage of child and dependent care expenses that taxpayers with AGI up to \$85,000 could claim. This plan is similar to the one proposed by President Clinton in 1998, and the same criticisms apply today.²

To qualify for this credit, parents must pay someone else to care for their children. Parents who make different arrangements cannot claim the credit. These include families in which parents split shifts, as well as families where one parent foregoes wage

income entirely in order to stay home and raise the children.

The variety of child care arrangements among U.S. families is great.³ Tax relief for families with children is a need that can be addressed in many ways as well, but whatever way is chosen should be equitable to all families and all work-family time options. The child and dependent care credit provides a benefit only for families that choose to pay for child care outside the home. President Obama's plan to increase the credit only makes the failure greater.

Playing Favorites. The credit is also bad tax policy, because the tax code should not be used to curry political favor with particular groups or to reward taxpayers that engage in behavior or activities Washington deems beneficial. Unfortunately, the tax code is already rife with provisions that do so. Expanding the credit only adds to this growing problem.

Using the tax code in such ways often leads to damaging unintended consequences. Taxpayers alter their behavior to benefit from the favorable provisions, and new special interest lobbies form to ensure that the tax break remains entrenched in law. And doling out favors through the tax code results

This paper, in its entirety, can be found at:
www.heritage.org/Research/Taxes/wm2794.cfm

Produced by the Thomas A. Roe Institute
for Economic Policy Studies

Published by The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002-4999
(202) 546-4400 • heritage.org

Nothing written here is to be construed as necessarily reflecting
the views of The Heritage Foundation or as an attempt to
aid or hinder the passage of any bill before Congress.

in those without strong representation in Washington—or those not part of a politically coveted group—paying higher taxes.

The Obama Administration has already succeeded in expanding other credits that benefit politically valuable groups as part of the stimulus package. It created the new Making Work Pay Credit that was also focused on middle- and low-income families⁴ and increased the Hope Scholarship Credit, the Earned Income Tax Credit (EITC), and the child tax credit.⁵ Each of these credits benefited a specific group for political reasons at the expense of other taxpayers that needed a tax cut just as badly.

Increasing the child and dependent care credit adds to families' financial incentives to use outside day care, pressuring them to do something against their wishes. Evidence is strong that use of day care—particularly for younger children—is due to families' personal preferences and not merely economic conditions. A 2007 study found that of all mothers with children from birth to age four, only 16 percent prefer full-time work, a figure that declined by half between 1997 and 2007.⁶ New evidence also underscores the lack of educational benefit to children from preschool participation in programs like Head Start.⁷

Moreover, each time Congress creates a new credit or expands an existing one based on political considerations, it erodes its ability to make broad-based, pro-growth tax cuts that the economy des-

perately needs. President Obama and Congress need to stop playing politics with the tax code and focus on cutting taxes in a way that will put money back in the pockets of all families and individuals and help get the economy growing again.

Pro-Growth Cuts Needed. The instinct to cut taxes is a step in the right direction for President Obama, but the economy needs a tax cut that will help get it growing again. Increasing the child and dependent care credit will do nothing to generate economic expansion because it does not increase the incentives for workers, families, and businesses to increase productivity, save, and invest more or take on new economic risk.

Families and businesses make decisions about engaging in each of these income-growing pursuits based on expectations of their economic conditions years in the future. Although an expansion of the credit would help a specific group of middle- and low-income taxpayers, it would do nothing to improve the future returns for businesses or investors or make increasing productivity more enticing to employees.

Cut Marginal Tax Rates. The best way to help families is to have a strong, growing economy with a tax code that allows them to increase their income without interference from Washington. The best way to achieve that goal is to reduce marginal tax rates. Congress should start by immediately making permanent the 2001 and 2003 tax cuts for all taxpayers—or at least

1. Press release, "President Obama and Vice President Biden Preview Initiatives for Middle Class Families," The White House, January 25, 2010, at <http://www.whitehouse.gov/the-press-office/president-obama-and-vice-president-biden-preview-initiatives-middle-class-families> (January 27, 2010).
2. Robert E. Rector and Patrick F. Fagan, "The Clinton Day Care Proposal: An Attack on Parents and Children," Heritage Foundation *Executive Memorandum* No. 506, January 14, 1998, at <http://www.heritage.org/Research/Family/em506.cfm>.
3. Kathryn Jean Lopez, "Who's Minding the Kids? Opening the Day-Care-Center Doors," *National Review*, October 1, 2003, at <http://www.nationalreview.com/interrogatory/robinson200310010847.asp> (January 27, 2010).
4. Curtis S. Dubay, "'Making Work Pay' Credit Will Not Stimulate the Economy," Heritage Foundation *WebMemo* No. 2240, January 26, 2009, at <http://www.heritage.org/Research/Taxes/wm2240.cfm>.
5. Curtis S. Dubay, "Obama's Stimulus Has 'Spread the Wealth Around': Are Tax Hikes Next?," Heritage Foundation *WebMemo* No. 2354, March 23, 2009, at <http://www.heritage.org/Research/Economy/wm2354.cfm>.
6. Paul Taylor, Cary Funk, and April Clark, "Fewer Mothers Prefer Full-Time Work: From 1997 to 2007," Pew Research Center, July 12, 2007, at <http://pewresearch.org/pubs/536/working-women> (February 4, 2010).
7. David B. Muhlhause and Dan Lips, "Head Start Earns an F: No Lasting Impact for Children by First Grade," Heritage Foundation *Background* No. 2363, at <http://www.heritage.org/Research/Education/bg2363.cfm>.

extending them until the economy is approaching full employment.

Congress should also cut spending to make room for further reductions in individual and corporate income tax rates for taxpayers at all income levels. This would provide a greater incentive for families to be more productive and for businesses to expand operations and add new workers, because it would allow them to keep a larger share of their returns from those pursuits. A reduction of the tax rate on capital gains and dividends would further encourage families to save and invest more and businesses to take on new risks and opportunities.⁸

Double Bonus. Congress and the President should stop playing politics with the tax code and

focus on the policies that will help families and the economy grow stronger. Spending reductions that facilitate marginal tax rate cuts for all taxpayers would be a double bonus: They would put money in the pockets of the very middle- and low-income families that President Obama wants to help *and* promote economic growth and job creation at the same time. And it would do it all without discriminating against families based on their choice of child care.

—Curtis S. Dubay is a Senior Analyst in Tax Policy in the Thomas A. Roe Institute for Economic Policy Studies and Chuck Donovan is Senior Research Fellow in the Richard and Helen DeVos Center for Religion and Civil Society at The Heritage Foundation.

8. J. D. Foster and William W. Beach, "Economic Recovery: How Best to End the Recession," Heritage Foundation *WebMemo* No. 2191, January 7, 2009, at <http://www.heritage.org/Research/Economy/wm2191.cfm>.