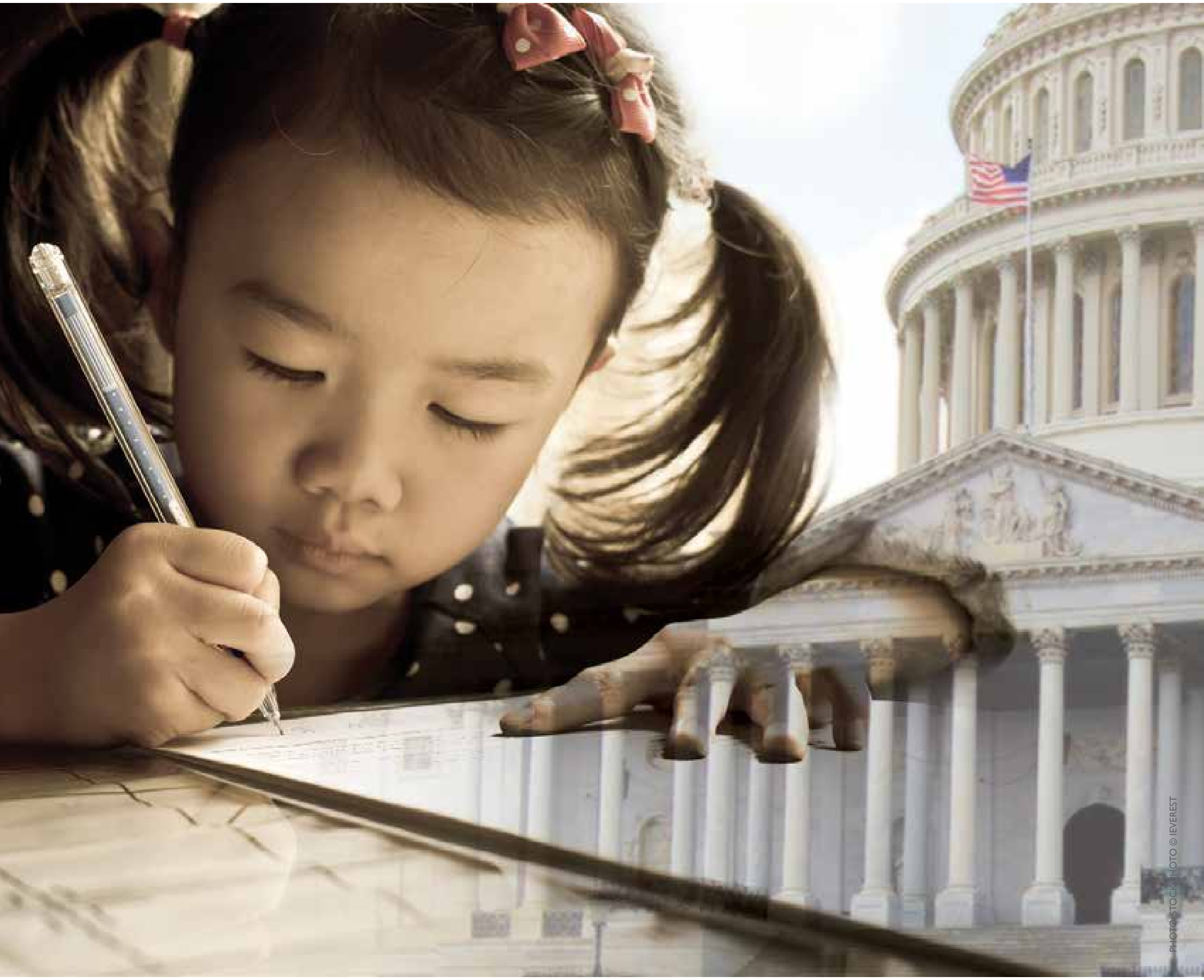

Innovative Financing for Early Childhood Education

Federal Options

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Foreword

All kids deserve an opportunity to make the most out of their early years. Without access to high-quality early learning programs, children fall behind. Many never catch up.

This white paper lists a toolbox of solutions aimed at bridging the gap between lawmakers' desire to expand access to early childhood education and balance the budget. Offering ideas that appeal to Republicans and Democrats alike, Save the Children Action Network's report gives lawmakers a variety of options for smart and innovative ways to fund the early learning programs that ensure the future success of our children and country. These ideas range from expanding private investment through municipal bonds, to levying excise taxes, to harnessing savings through cutting wasteful government spending, to creating parity between tax credits and deductions for higher education and early education.

In the short term, we are focused on encouraging the use of public and private dollars in successful state and local programs that are already showing results. This will provide flexibility for local and state leaders to pursue their own solutions while demonstrating results that can also happen at the national level.

We understand that funding is a large hurdle in the debate. That's why we are working to identify innovative and viable funding mechanisms to support expanded investment in early education nationwide. These ideas could provide the necessary resources to make universal early childhood education a reality for all kids.

Mark K. Shriver
President, Save the Children Action Network
July 2015

PHOTO: SUSAN WARNER

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Introduction

Americans of all political stripes support early childhood education (ECE). A July 2014 poll commissioned by the First Five Years Fund found that 60 percent of Republicans, 67 percent of Independents and 84 percent of Democrats support greater investments in early childhood education.

Beyond the bipartisan goodwill around this issue, there is mounting scientific evidence of early childhood education's short- and long-term economic benefits. Financing the expansion of early childhood education, however, remains a challenge. In an era of budget deficits and a high degree of scrutiny over federal spending, new and innovative financing mechanisms are needed to drive new resources into early childhood education or support legislation expanding and improving access to 0-5 services.

PHOTO: SAVE THE CHILDREN

SCAN believes policymakers should have a wide range of ECE financing tools to consider, and that these ideas should move forward as Congress debates tax reform and beyond. In the short term, we are focused on federal levers that can incentivize public and private dollars to flow into successful state and local programs that are already showing results. These levers are designed to leverage federal resources to catalyze public and private financing with ample flexibility for local and state leaders to pursue their own solutions while demonstrating results that can be mirrored at a national level.

Over the long term, we seek to develop viable policy ideas and build political consensus for a scalable finance plan for early childhood development programs. In time, we believe these short-term opportunities will create a clear set of federal financing policies to support all American children who need access to ECE.

By the Numbers

Disadvantaged children who don't participate in high quality early education programs are:

70% more likely to be arrested for a violent crime

50% more likely to be placed in special education

60% more likely to never attend college

40% more likely to become a teen parent.

Innovative Financing for Early Childhood Education

FEDERAL OPTIONS

Recommendations for Financing

Save the Children Action Network's recommendations fall into two broad categories – incentivizing private dollars and reforming tax credits, and identifying new public resources.

Incentivizing Private Dollars and Reforming Tax Credits:

- Social impact financing
- Expanding municipal, nonprofit and private activity bonds
- Higher education – early childhood education parity
- Expanding tax credits and deductions

Identifying New Public Resources

- Excise tax parity
- Harnessing savings and new revenue mechanisms

Incentivizing Private Dollars and Reforming Tax Credits

These concepts can help increase investments of private dollars into ECE programming and facilities.

Social Impact Financing

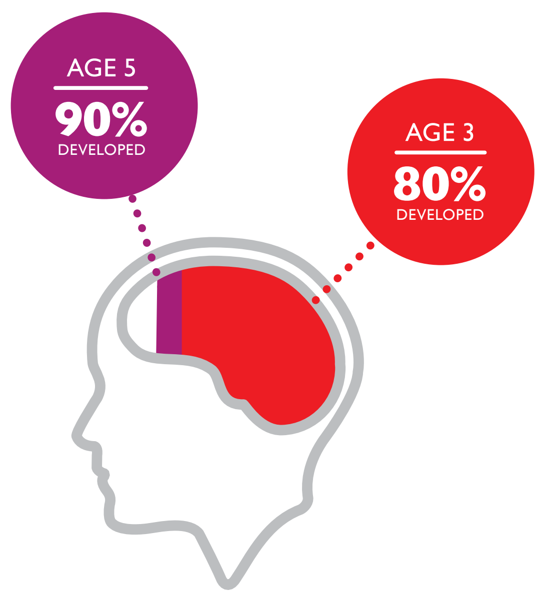
There may be opportunities to direct more private dollars into ECE through bipartisan pay-for-performance legislation. Senator Orrin Hatch (R-UT), the Chairman of the Finance Committee, Senator Michael Bennet (D-CO), a member of the Finance Committee, Congressman Todd Young (R-IN), a member of the Ways & Means Committee, and Congressman John Delaney (D-MD), a member of the Financial Services Committee, championed pay-for-performance last Congress and reintroduced their legislation, the Social Impact Partnership Act (H.R. 1336 and S.1089) in 2015.

As background, pay-for-performance legislation directs resources to states and local communities to support innovative public-private partnerships addressing societal needs.[1] Under the system, a state or local government enters into a contract with a service intermediary working to deliver services that will eventually generate measurable savings to local, state and federal governments. As the savings to government accrue, they are then used to pay back investments in the same service that generated those savings. This win-win arrangement is more efficient than many existing government funding structures for social services and is particularly suited for use with early interventions such as ECE.

SCAN is pushing for social impact bonds/pay-for performance legislation to progress this Congress alongside broader tax reform. This legislation has the potential to support early intervention services for kids across the country, in addition to other projects that produce measurable, clearly defined outcomes including employment for the unemployed, increased high school graduation rates and reduction of teen and unplanned pregnancies as well as incidences of child abuse and neglect.

Early Childhood Education is a No-Brainer

A child's brain development
is nearly complete before kindergarten.



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Using Municipal, Nonprofit and Private Activity Bonds

Municipal Bonds:
Expanding the use of federally tax-exempt municipal bonds and private activity bonds could provide an avenue for driving more private dollars to local ECE programs.

State and local governments generally issue municipal bonds for long-term financing of capital projects. Uses vary greatly, but can include the construction of schools, hospitals, public housing, infrastructure and various other public benefit projects. The types of projects funded through a municipal bond affect the taxability of income received by bond holders. Interest income earned on bonds that fund public good projects are generally exempt from federal income tax, and although interest rates on municipal bonds are lower than other securities, investors are willing to purchase them because that interest is tax exempt. This trade-off encourages private investments in these public-good projects and could be a mechanism for drawing additional private financing into early childhood education capital projects.

For favorable treatment, tax regulations governing municipal bonds generally require all money raised in a bond sale to be spent on one-time capital projects within three to five years of issuance. This traditional use of a municipal bond could finance the construction of a public preschool, for example. Incentivizing states to utilize qualified municipal bonds to fund more early childhood education facilities could help drive more private investment into ECE while simultaneously freeing up state funding for early childhood education programming.

Under the umbrella of tax-exempt municipal bonds, there are two types we see as most promising for funding ECE: Bank Qualified Bonds and 501(c)3 Nonprofit Bonds. We also see an expanded role for Private Activity Bonds.

Bank Qualified Bonds
The first type of bonds we propose examining are bank-qualified bonds, or BQ bonds. Historically, commercial banks were the largest purchasers of municipal bonds as they could deduct 80 percent of their interest expense used to purchase the bonds.

The Tax Reform Act of 1986 effectively repealed this deductibility for banks, except for bonds that met certain criteria – aka "bank-qualified bonds." To qualify, BQ bonds must, among other rules, come from a municipality issuing no more than $10 million in bonds in a calendar year. This provision effectively limits banks' bond purchases to rural counties, smaller towns and school districts. Congress recognized the problem with this limitation and the American Recovery and Reinvestment Act passed in 2009 temporarily lifted the $10 million limit to $30 million. This increase expired in 2011, but there have been several efforts to reinstate it, most recently with H.R. 2229 in the 114th Congress. This bill has attracted strong bipartisan support from Ways and Means Committee members. Given the ability for school districts to issue BQ bonds, early childhood education could benefit from lifting the $10 million limit in addition to expanding BQ bonds to direct bonding for early childhood education program launch expenses and facilities.


PHOTO: SUSAN WARNER

501(c)(3) Nonprofit Bonds
Another type of municipal bonds are those issued through a state or local government on behalf of 501(c)(3) organizations. While only government agencies can issue tax-exempt bonds, federal law and state law also permit "conduit revenue bond financing" where a municipality issues bonds and loans the proceeds to a 501(c)(3) organization at rates much lower than traditional bank loans.

These bonds are most typically used to finance facilities used for the operation of nonprofit organizations, such as educational facilities, health care facilities, or even libraries. But at its core, the law requires that the proceeds be used for the activities related to the organization's tax-exempt purpose.

It is reasonable to propose, therefore, that their permitted use be expanded to drive investment in 501(c)(3) preschool facilities and program startup and launch expenses that support and carryout early childhood education.

Private Activity Bonds

State and local governments are also able to issue a limited amount of tax-exempt private activity bonds (PABs) to finance certain projects, including for qualified public educational facilities that are part of public elementary or secondary schools. Unfortunately, the rules for issuing PABs for educational facilities are too onerous, so they are not fully utilized by state and local governments. The President's budget for fiscal year 2016 proposes three rule changes that would enhance the use of PABs for educational facilities. In addition to these technical changes, we support expanding qualified public educational facilities to include preschools, childcare facilities and other ECE centers.

Higher Ed – Early Childhood Education Parity

The federal government provides financial assistance for higher education expenses in two ways: (1) tax benefits, and (2) traditional student aid (loans, grants, and work-study assistance). There are 14 tax benefits currently available for college students and their parents to help pay for higher education.[2] The available tax benefits are a mixture of credits, deductions, exclusions and other incentives. Extending any number of these benefits so that they apply to early education in addition to higher education is an avenue worthy of exploration.

Higher education benefits can be placed into one of three general categories: incentives for current year expenses, preferential tax treatment of student loans and incentives for saving for college. The Joint Committee on Taxation (JCT) estimates the cost of these benefits to be around $16 billion per year. Several of these credits and deductions could be expanded to equally apply to preschool costs as they already apply to higher education costs – justified as "Higher Ed – Early Ed Parity."

Focusing on incentives for current year expenses, the Hope Tax Credit, temporarily replaced by the American Opportunity Tax Credit (AOTC), is a $2,500 credit (40 percent refundable up to $1,000) per student for post-secondary expenses including tuition, fees, books and supplies.[3] AOTC could be expanded to include parents' expenses related to pre-K education, operating in conjunction with the Child and Dependent Care Tax Credit.

PHOTO: SUSAN WARNER

There is also the Lifetime Learning Credit that helps individuals pay for tuition and related expenses for higher education. The credit is nonrefundable and worth up to $2,000 per tax return.[4] This credit could be expanded to include parents' qualified early education and care expenses.

Scholarships, fellowships and tuition reductions for qualified higher education expenses are also excluded from income for tax purposes.[5] This same exclusion from income does not apply for early education expenses, however. So, if a low-income family receives tuition assistance for their child to attend preschool, the value of that assistance is generally considered taxable income. Therefore, the exclusion from income could be expanded to include tuition reductions or financial assistance for preschool and early childhood care.

There are also preferential savings vehicles to help pay for K-12 and higher education that do not apply to pre-K education. Coverdell education savings accounts, for example, are accounts set up to pay the qualified education expenses of a designated beneficiary.[6]

They allow families to invest up to $2,000 per year per beneficiary to grow tax free until distributed. The savings account can then be used to pay for qualified education expenses at either an eligible postsecondary school or an eligible elementary or secondary school. The eligible educational institutions for Coverdell accounts could be expanded to include pre-K; however, the value of tax free growth for only the few years between a child's birth (at which point the child can be designated as a beneficiary) and when the child begins preschool is minimal. But if Coverdell accounts could be set up in advance of a beneficiary's birth, it would significantly increase the value of this savings vehicle for pre-K education.

This same model of expansion could also be applied to Section 529 college saving plans, as well as the cancellation of the early IRA withdrawal penalty for qualifying education expenses.

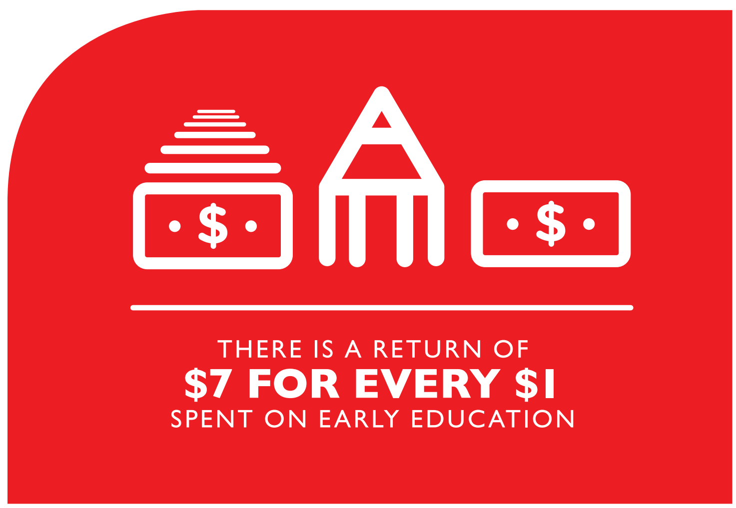
Expanding Tax Credits and Deducations

The federal government provides approximately $3 billion annually in tax credits to individuals and employers supporting early child care and education.[7] Expanding the value of these credits and exploring ways to address ECE through other existing credits could provide opportunities for ECE financing.

The federal Child and Dependent Care Tax Credit (CDCTC) helps reduce an individual's employment-related child care costs by providing a non-refundable tax credit of between 20 percent and 35 percent of the first $3,000 spent on care for one child and the first $6,000 on care for two or more children. The credit is determined on a sliding income scale, and net can be worth as much as $2,100.[8] In addition to the federal tax credits, 28 states, including the District of Columbia, have their own child and dependent care tax credit.[9]

In practice, the way the credit is currently constructed is not optimal for low-income families, both because the credit is only worth up to 35 percent of what is spent, and the credit is non-refundable, meaning you cannot be reimbursed for more than your total tax liability. For example, a single parent earning $15,000 and spending $1,200 on child care would only qualify for a $86 credit because that is the total tax she owes.[10] Many low-income families owe little or no tax, so the credit is virtually useless for them. On the other hand, high-income families can take full advantage of the credit.

Luckily, there is precedent at the state level for improving the CDCTC. Thirteen states have improved the credit by making it either fully or partially refundable to benefit low-income families with little income tax liability. Maine, Vermont and Arkansas have increased the value of their credits for higher quality child care.[11] These are both options for improving the federal CDCTC and providing low-income working families with additional resources for child care. Congress could also raise the ceiling on eligible expenses to more closely reflect the actual costs of quality child care.



In addition to CDCTC, the federal government subsidizes individuals' child care expenses through the employer-provided child care exclusion. The exclusion allows employees to pay for up to $5,000 in child care with pre-tax dollars. To take advantage of this exclusion, employees need to arrange through their employer to exclude up to $5,000 in pre-tax dollars from their salary. The exclusion applies to both payroll (FICA) and income taxes.[12]

There is room to improve the employer-provided child care exclusion. First, it is only available to taxpayers whose employers offer the exclusion. Second, like the CDCTC, the exclusion is fixed and not indexed for inflation – and is capped at $5,000 regardless of the number of children needing care. Congress could increase the maximum allowable exclusion to better reflect the actual cost of child care by making the exclusion $5,000 per child or indexing the credit for inflation.

On the child care and education business side, the federal government could look to our factories of innovation: the states. Maine, Oklahoma and Florida have experimented with tax credits or exemptions for early child education and care businesses.[13] The effectiveness of these credits has not been fully studied, but they are widely popular with lawmakers. In Maine, a child care provider or an individual center owner can get up to a $1,000 credit for costs associated with improving the quality of care. Businesses and institutions may claim a 30 percent tax credit on up to $30,000 in similar expenses.[14]

Also, in the context of tax reform (when the merits of these credits will be evaluated), there has been great interest in ensuring that any reform package is distributionally neutral across income levels. This was a top goal for former Congressman David Camp (R-MI) in his tax reform discussion draft earlier in 2014. Distributional neutrality means that all income segments of the population should carry the same net revenue burden in any new system as they do now. This can be somewhat of a challenge because tax reform will lower the top marginal rate (benefitting high-income earners) and cut many credits and deductions benefiting low-income families. To level the field, the package will need to either tax high-income earners more or give away more credits and deductions to low-income households through the tax code. This is an opportunity to expand ECE credits and deductions for low and moderate income families as a way to even out any distributional inequalities in a socially conscience manner.

Identifying New Public Resources

These concepts offer policymakers ideas for harnessing new revenues to be invested in ECE.

Excise Tax Parity

Many lawmakers are reticent to raise taxes given concerns over the federal deficit and the current political environment. Excise taxes, however, can be an exception. There is a case to be made that excise taxes for different categories of like products should be taxed the same: specifically, traditional cigarettes and "e-cigarettes," and brick-and-mortar gambling and Internet gambling. New revenues from these excise taxes could be directed toward early childhood education.

Federal "E-Cigarette" Tax

Cigarettes are taxed at many levels. There are taxes at both the federal and state levels, and many municipalities, such as New York City, have levied high local taxes. The federal government has yet to implement a tax on "electronic cigarettes" (e-cigs), however.

As background, sales of e-cigs have exploded over the last decade. Despite this growth, they have received little attention at the federal level. The Food and Drug Administration (FDA) has announced it would propose regulations to extend its "tobacco product" authority to cover "e-cigarettes." These regulations, if approved, would be limited to how the products are marketed, how they are labeled and to whom they are sold, but it would mark the first real federal action on the industry. A logical next step could be extending a federal excise tax over newly regulated "e-cigarette" products. There is currently no federal tax on e-cigs, but two states have already ventured into this arena. In Minnesota, the taxes are remarkably high – 95 percent of the wholesale cost – and are applied to products containing nicotine. In North Carolina, the tax is much lower at five percent and is based on the amount of liquid each device holds.

Notably, Reynolds American Incorporated, which has its own "e-cigarette" brand in addition to traditional tobacco, actually proposed the e-cig legislation for the North Carolina state legislature to consider. They suggested a tax of $0.05 per milliliter of nicotine mixture, which they said would be "a fair and reasonable" excise tax on e-cigs. Lorillard Inc., another tobacco company that at one point held 49% of the e-cigarette market share, also supported the legislation. This $0.05 per milliliter tax was eventually signed into law. Ohio, New Jersey, Indiana and Arizona are among others that are considering state-level e-cig taxes. There are some concerns with taxing "e-cigarettes." Some see them as a healthier option compared to traditional cigarettes and worry that taxing them will discourage people from changing bad habits. However, a tax that only applies to the nicotine content is unlikely to be rejected out of hand because the chemical is equally present in both products. Additionally, 41 states have banned selling e-cigs to minors, and the FDA proposals include this suggestion. Legislation to impose a federal tax on e-cigs could include a nationwide ban on sales to minors, which could help move the package through Congress. There is also precedent for directing revenue from nicotine products to help children. When the State Children's Health Insurance Program (SCHIP) was signed in February 2009, it raised the federal cigarette tax from $0.39 per pack to $1.01 per pack and directed those funds to pay for children's health care. Traditional cigarette and e-cig taxes could also be targeted at the state level for additional ECE funding.

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Gambling Taxes and Lottery Revenues

There have also been legislative proposals to amend the federal 0.25 percent wager excise tax on gambling to include and regulate online gambling.[15] Nevada, Delaware and New Jersey already have regulated and licensed markets. Former Congresswoman Mary Bono Mack (R-CA), who now heads the Coalition for Consumer and Online Protection, has said that regulating online gambling is the safest way to protect players from all states. If a consensus on the issue emerges at the federal level, then a portion of the new Internet gambling tax revenue could be devoted to ECE. It can also be done on a state-by-state basis.

Harnessing Savings and New Revenue Mechanisms

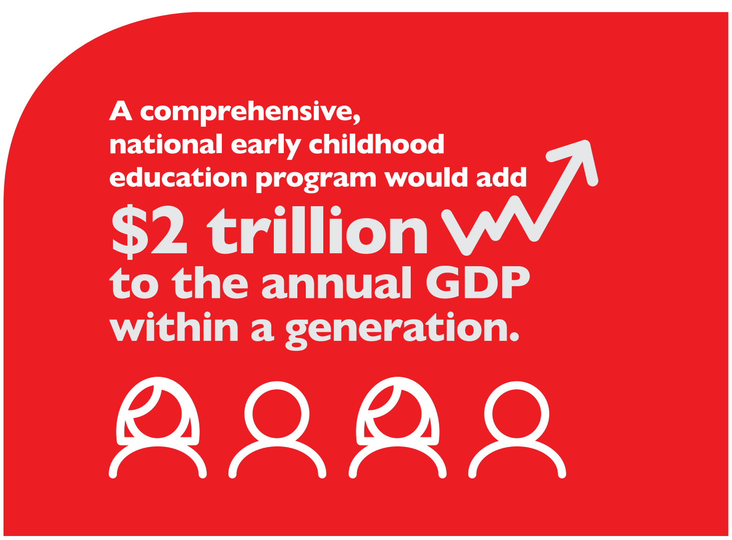
Congress will likely continue its scrutiny of underperforming programs in the coming year, allowing potential savings from these programs to be captured as a viable funding source for ECE programs. In general terms, there are several publicly debated proposals to harness billions of dollars in savings from reducing fraud and abuse and cutting redundant or antiquated federal programs. For examples of these programs, we look to both sides of the political spectrum, including for example: cuts that passed the Republican House in the 113th Congress but did not become law; former Senator Tom Coburn's (R-OK)

Wastebook outlining particularly egregious federal outlays; cost-cutting proposals for defense spending in the Congressional Progressive Caucus's federal budget; and also by consulting with our colleagues on Capitol Hill. Regardless of where savings are achieved, our objective is to create a policy proposal stating that a portion of these savings should be invested in our future – namely in a fund dedicated to expanding early childhood education.

New revenue mechanisms include often sought-after pots of revenue such as a one-time corporate repatriation tax holiday and closing the carried interest tax loophole. While legislators on the tax writing committees are protective of this potential revenue, there is precedent for earmarking part or all of these new revenues for specific uses.[16]

Revenue from Repatriation

A repatriation tax holiday encourages U.S. multinational corporations to return overseas profits to the United States by offering a temporary, much lower U.S. tax rate on those returned profits. Congress last offered a repatriation tax holiday in 2004 with the Homeland Investment Act (part of the American Jobs Creation Act). Businesses were given a one-time deduction of 85 percent of U.S. taxable incomes for extraordinary dividends received from their foreign operations, which resulted in an effective tax rate of 5.25 percent – significantly lower than the ordinary rate of 35 percent. According to the IRS, this prompted 843 corporations to bring $312 billion back to the United States.



Revenue from Carried Interest

Carried interest is defined as the share of profits from an investment paid to the investment manager in excess of the amount the manager contributed to the partnership. The United States currently treats carried interest as a capital gain and thus it is taxed at a preferential rate of 15 percent. However, there is an ongoing discussion on taxing carried interest instead as ordinary income, which would increase the tax rate. The proposal has bipartisan support. Both former Rep. Camp's tax reform bill (H.R. 1) and the President's Fiscal Year 2014 Budget Proposal would have taxed carried interest as ordinary income, though Camp's proposal exempted income earned from real estate. What's more, at a forum on poverty in May 2015, President Barack Obama proposed using the revenue from carried interest for early childhood education.

Legislation Action in the 114th Congress

The financing tools outlined above are intended to provide lawmakers with a solid foundation of viable options for driving new resources into early childhood education or financing ECE expansion. SCAN will work with strategic partners and on a bicameral, bipartisan basis to ensure lawmakers prioritize this issue in the 114th Congress.

Save the Children Action Network is committed to expanding access to early childhood education for every American family. With compelling scientific data, an engaged community of advocates, bipartisan support and viable financing tools, we believe this vision can become a reality in the near future.

Endnotes

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PHOTOS: SAVE THE CHILDREN

Save the Children Action Network aims to mobilize all Americans in a commitment that cannot wait – investing in early childhood now. Together, we focus on securing early education for every U.S. child and helping kids survive around the world – ensuring a better future for us all.