Innovative Financing for Early Childhood Education
Recommendations from the Early Childhood Education Action Tank

January 2017
Our nation has made significant strides in creating a social safety net for struggling Americans over the last 50 years. America’s safety net now consists of an elaborate assortment of programs and policies which have significantly reduced poverty for seniors and low-income working parents. Our nation provides cash assistance through refundable tax credits, health insurance coverage through Medicaid and food assistance through the Supplemental Nutrition Assistance Program (SNAP) and other food programs. Too many of our children still live in poverty, but we have made progress in reducing poverty and hunger and improving health.

There is one area in which our social safety net is conspicuously lacking: helping low-income parents afford high-quality early learning services and care for kids from birth through age 5. We are not doing enough in the very sphere where low-income parents currently need the most help and where young children could most benefit.

The changing demands of our nation’s economy, the stress of our demanding labor market and the challenge created by an increasing number of children being raised in single-parent families have all left low-income parents struggling with the demands of work and parenting. Yet ensuring access to high-quality early childhood education (ECE) is not just about supporting strained parents and families or increasing employment rates. More effective programs that advance young children’s learning and development while meeting the demand for high-quality care would also improve the long-term social and economic prospects of children born into poor households.

At its root, ECE is an economic issue that can assist in breaking the cycle of poverty. Research has shown that investments in high-quality ECE offer potential for long-term economic impact and growth. James Heckman, the Henry Schultz Distinguished Service Professor of Economics at the University of Chicago, released a new report in December 2016 that demonstrates that the annual rate of return on investment in early childhood development for children from disadvantaged backgrounds can be 13 percent, due to improved outcomes in education, health, sociability, economic productivity and reduced crime. Studies are also clear that children who receive quality early education demonstrate greater cognitive and socio-emotional growth than children who do not. Disadvantaged children who do not participate in high-quality early education programs are 50 percent more likely to be placed in special education, 25 percent more likely to drop out of school, 60 percent more likely to never attend college, 70 percent more likely to be arrested for a violent crime and 40 percent more likely to become a teen parent.

Despite this evidence, fewer than half of low-income children in the U.S. have access to quality ECE programs. To change this dynamic, we must identify the resources to bring these education-based interventions to scale to ensure all children have access to quality ECE.

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In response to this challenge, children’s advocacy groups, businesses and financial institutions have joined forces to form the Early Childhood Education Action Tank. This group of unlikely allies has forged agreement on a series of recommendations to increase children’s access to high-quality early childhood education as part of comprehensive tax reform. It is our view that, in the context of always-scarce federal funds, reforms to the tax code offer the best opportunity to allocate the resources needed to meet this challenge. Tax reform is a unique opportunity to make significant, forward-looking changes to fiscal policy, and to make designations through tax expenditures to help fund ECE as a commitment to future generations of Americans.

We are not alone in our support for investing in ECE. Recent polling finds extremely strong support for expanding ECE to all eligible children between the ages of 0 and 5. A 2015 national survey in key battleground states conducted by ECE Action Tank convener Save the Children Action Network (SCAN) found that 90 percent of likely voters think ECE is extremely or very important to the learning, growth, and development of children, with 71 percent of likely voters supporting increasing access to quality ECE even if it means a slight increase in their taxes. First Five Years Fund, an Action Tank member, conducted a 2016 poll of Florida voters, finding that nearly three-quarters support a federal plan to help states and local communities provide better access to quality ECE.

Making such a significant investment is not without cost. However, we believe that the cost of deferring this investment may be even greater. We also understand that reforming the tax code comprehensively is a massive undertaking, which should be achieved without further increasing our nation’s long-term debt. We are prepared, if Congress and the Trump Administration instead pursues piecemeal reform, to offer options to yield revenue to offset additional ECE investments. Action Tank members seriously debated specific options, including changes to the mortgage interest deduction, national excise taxes and repatriation, and we are ready and willing to have these conversations when and if warranted. We understand policymakers face tough budgetary decisions, many times in the context of an insistence on revenue neutrality. Yet, even in this environment, we believe that access to high-quality early learning and care must be prioritized.

Our group proposes specific action to expand upon what is “right” with existing tax policy and to create new incentives that promote state, local and private collaboration. As Congress considers our recommendations, we also note that the federal government must ensure that any policies and programs are built on a standard of high quality to ensure the best outcomes are achieved for enrolled children in both the short and long term. It is our hope that these tools will help break down the two greatest barriers to early childhood education: cost and lack of access to quality programs. In doing so, our nation would close a major gap in our social safety net and empower the next generation to achieve prosperity for themselves and their families to come.
Expanding Tax Credits and Deductions

The federal government provides approximately $3 billion annually in tax credits to individuals and employers supporting early child care and education. By modifying the structure of these credits, it is possible to greatly expand their value and give more children access to quality early education and care programs, especially those from middle- and lower-income families.

Currently, the federal government uses the tax code to subsidize early child care expenditures through two programs: the Child and Dependent Care Tax Credit (CDCTC) and the Dependent Care Assistance Program (DCAP).

Child and Dependent Care Tax Credit (CDCTC)—The federal 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 spent on care for two or more children. The credit is determined on a sliding income scale, and its net worth can be as much as $2,100. In addition to the federal tax credit, 28 states, including the District of Columbia, have their own child and dependent care tax credit. 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 because the credit is non-refundable, meaning someone cannot be reimbursed for more than their 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 he or she owes. Despite contributing to payroll and sales taxes, many low-income families owe little or no federal income tax, so the credit does little to offset their child care costs. On the other hand, higher earning families can take full advantage of the credit. As it is currently structured, the CDCTC does not provide adequate funding to cover the full cost of care or reach all families who are in need of support.

There is precedent at the state level for improving the CDCTC, as many states offer their own CDCTC in addition to the federal credit. Thirteen states have improved upon the federal credit by making it either fully or partially refundable in order to benefit low-income families with little income tax liability. For example, Maine, Vermont and Arkansas have increased the value of their credits for higher-quality child care.

The ECE Action Tank suggests the federal government follow the examples set forth by the states in addition to the creation of a new, high-quality component to the CDCTC.

- Make the federal CDCTC partially or fully refundable. Making the CDCTC refundable would ensure that low-income families would be able to receive the full benefit of the credit, as middle- and upper-income families are already able to do. It is particularly important for lower-income families to be able to access the full value of the credit, as they spend a higher percentage of their income on child care.

- Raise the ceiling on eligible expenses to more closely reflect the actual costs of high-quality child care. In recent years, child care costs have skyrocketed to an average of $12,000 per year for a 4-year-old and $17,000 for infants. With rapidly increasing costs for care, increasing the ceiling for allowable expenses on the credit would provide families, particularly low- and middle-income families, with greater child care assistance.

- Create a new high-quality credit option within the CDCTC to support low- and middle-income families and expand access to high-quality child care. The tax credit would be worth up to $14,000 per child to offset the cost of child care. Families living at or below 400 percent of the federal poverty line—$97,000 for a family of four in 2016—would be eligible to receive the tax credit and would contribute up to 12 percent of their income on child care.

4 Mitchell, Anne and Stoney, Louise. 2007. “Using Tax Credits to Promote High Quality Early Care and Education Services.”
5 Alliance for Early Childhood Finance. November 2006. “Can We Use Tax Strategies to Help Finance Early Care and Education?”
percent of their income to child care expenses on a sliding scale, with families in poverty contributing two percent. Unlike other tax credits or deductions, which provide benefits to families at the end of the tax year, this tax credit would be advanced to families on a monthly basis and paid directly to the high-quality child care provider of the parents’ choice. This ensures that low-income families pay only what they owe and do not have to wait to be reimbursed for costly child care payments. The proposed tax credit would increase the current service level by more than fourfold. A high-quality child care tax credit would also expand access with a particular eye toward promoting quality. Research confirms that child development is enhanced in high-quality early learning environments where there are appropriate teacher-to-child ratios, research-based curricula, credentialed early childhood educators, and well-paid staff. As such, the tax credit amount of $14,000 is based on an estimate of the cost of high-quality care. In addition, this proposal includes progressively higher quality standards over time. Initially, providers would have to be licensed in order to receive the tax credit. Over a 5- to 10-year time horizon, only those providers rated in the top level or top two levels of quality would be eligible for the tax credit.

Dependent Care Assistance Program (DCAP)—The Dependent Care Assistance Program (DCAP) is an employer-sponsored program that allows employers to provide assistance directly or, more commonly, allows employees to set aside funds for child and dependent care in a flexible spending account. Up to $2,500 annually ($5,000 for married couples) in assistance or employee contributions is excludable from employee wages for income and payroll tax purposes. According to the Office of Tax Analysis at the Department of Treasury, the total current income tax benefit from DCAP on the individual side is $1.14 billion.

Currently, DCAP plans are not universally offered and only employees whose employers participate in this program are able to receive this benefit. Startup and operations costs can pose an administrative burden that is prohibitive to employers; others are unsure if their employees would value a DCAP plan offering. Particularly for small employers, this could result in costs outweighing the short-term perceived benefit.

Members of Congress from both sides of the aisle, including Reps. Mike Kelly (R-PA) and Linda Sanchez (D-CA), as well as Sens. Kelly Ayotte (R-NH) and Shelly Moore Capito (R-WV), introduced legislation to expand DCAP in the 114th Congress. The ECE Action Tank believes that more employers and employees could benefit from DCAP by:

- **Increasing the maximum amount that employers can provide or that employees can exclude from income.** As the average annual cost of child care has skyrocketed to more than $10,000, benefits like the CDCTC and DCAP program have effectively decreased in value because the maximum amount a family can claim has remained stagnant. Increasing the amount that an employer can provide to an employee or that an employee is allowed to contribute pre-tax to a Flexible Spending Account would benefit all families, especially those with lower incomes who see a greater share of their pay go toward child care.

- **Indexing the benefit to inflation.** Like the CDCTC, the maximum amounts allowed under DCAP are not currently indexed for inflation. At a minimum, the limits specified under DCAP should be sensitive to inflation so that the value of the program does not decrease annually as child care costs continue to rise.

- **Providing a tax credit for small employer DCAP startup costs.** Many small businesses would like to offer greater child care benefits to their employees. However, the administrative costs of implementing a DCAP can be too steep. By providing a tax credit to

“*The first five years have so much to do with how the next 80 turn out.*”

–Bill Gates

small businesses who create a DCAP program, more employees—and therefore more children—will see a benefit from these programs.

- **Providing a tax credit to employers who match DCAP contributions by employees.** Employer matching programs have spurred greater use of workplace retirement savings plans. By creating a tax incentive for employers to match their employees’ DCAP contributions up to a set limit, we believe more employees will take advantage of this benefit as they have with retirement savings plans.

### Expanding Municipal and Private Activity Bonds

While reforming the CDCTC and DCAP would provide families more money to put toward early learning programs, expanding the use of federally tax-exempt municipal bonds and private activity bonds (PABs) could drive more private dollars toward the construction of and improvements to the facilities in which early learning takes place.

The uses for municipal and private activity bonds vary but 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 is generally exempt from federal income tax, and while interest rates on municipal bonds are lower than other securities, investors are willing to purchase them because the 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 ECE 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 several ideas that may prove promising for funding ECE. We also see an expanded role for PABs and ask that Congress considers the following reforms for each:

- **Expand “qualified public educational facilities” under section 142(k) of the tax code to include early care and education facilities.** Current law permits tax-exempt private activity bond financing for different specified types of eligible exempt facilities and programs, including, among others, “qualified public educational facilities” under section 142(k) of the code that are part of public elementary or secondary schools. This proposal would expand the code to include early care and education facilities.

- **Eliminate the private corporation ownership requirement to allow any person or entity to own the school facilities or operate them through a lease.** The current eligibility rules require that a private “corporation” own the public school facilities under a public-private partnership agreement with a public state or local educational agency. The requirement that only private “corporations” may own the school facilities has limited use by private owners that are organized as other kinds of private entities (such as partnerships, limited liability companies or sole proprietors) or that operate the school facilities under arrangements without ownership.

- **Remove the requirement to transfer the facility to a public agency at the completion of the bond.** Under current law, the owner of public school facilities under a public-private partnership agreement with a public state or local educational agency must transfer the ownership of the school facilities to the public...
agency at the end of the term of the bonds for no additional consideration. Legal uncertainty has arisen over the apparent conflict between the private ownership requirement for the school facilities and the requirement that the private owner also transfer the school facilities to a public agency at the end of the term of the bond, and this has impeded any significant use of tax-exempt bond financing for qualified public educational facilities.

- **Remove the separate volume cap for qualified public educational facilities and put them under the annual state bond volume cap for PABs, or remove altogether.** A separate annual volume cap (equal to the greater of $10 multiplied by the state population or $5 million) applies to PABs used for educational facilities. The separate bond volume cap for these bonds adds complexity in comparison with the unified annual state bond volume cap for most categories of tax-exempt private activity bonds. Removing the separate volume cap and including these facilities under the unified annual state bond volume cap would encourage their use.

- **Specifying Nonprofit Bonds for ECE use.** Municipalities are permitted to issue bonds and loan the proceeds to a 501(c)(3) organization at a reduced rate compared to traditional bank loans. These bonds are often used to finance facilities used for the operation of a nonprofit organization and could be expanded and directed to finance the construction of ECE facilities and potentially fund startup and launch expenses for an ECE program.

- **Expand the use of PABs to include early learning facilities.** State and local governments are able to issue a limited amount of tax-exempt PABs to finance certain projects, including for qualified public educational facilities that are part of public elementary or secondary schools. Technical changes could be made to expand the use of PABs to include qualifying preschools, childcare facilities and other early learning facilities.

**Social Impact Financing/Pay for Success**

Social impact financing, or pay for success, is another way the federal government can help states and communities fund innovative public-private partnerships to address societal needs.

These partnerships begin with the state or local government setting a specific target for solving an identified societal problem, such as improving third grade reading proficiency by increasing access to evidence-based early childhood education and development programs. Private sector investors pay the upfront costs to expand the social service; in this example, the number of children enrolled in ECE programs. A third-party evaluator determines if the goal defined by the government has been met. If the goal has been achieved, the government repays the investors with a return on their investment based on the amount of money they will have saved from fixing the social problem, in this case, having more children achieve success in third grade and not needing remedial reading services.

Importantly, the government only pays for programs that deliver on their intended results. Paying for early childhood education with Social Impact Bonds (SIBs) is a situation in which everyone wins: government, investors and, most importantly, kids across the country.

At the local level, both Salt Lake City, Utah and Chicago, Illinois have already launched pay for success initiatives to fund the expansion of early childhood education with promising results. At the federal level, legislation was passed unanimously by the U.S. House of Representatives in June 2016 that provides for the use of social impact financing for early childhood development. Similar legislation was introduced in the U.S. Senate.

The ECE Action Tank recommends that Congress provides greater support for states and localities using social impact financing to expand access to high-quality early learning. To provide for this in tax reform, Congress should:

- **Encourage states and localities to use SIBs for ECE.** Including a mechanism in tax reform that would explicitly allow states and local governments to scale
up evidence-based interventions for ECE using social impact financing would provide an additional option for expanding access to high-quality ECE. While many states and localities have already launched these kinds of models, federal support would give all states and localities the opportunity to utilize these mechanisms.

Early Education/Higher Education Parity

There are 14 tax benefits available for college students and their parents to help pay for higher education, but the federal government does not currently offer benefits of similar value for the families of pre-K aged children despite the rapidly rising costs of early learning programs. As Congress considers comprehensive tax reform, we recommend extending similar tools to parents with younger children to offset rising costs of early childhood education.

Under current law, several credits and deductions that are currently available for higher education costs could be expanded to equally apply to preschool costs.

- 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 postsecondary expenses including tuition, fees, books and supplies. The AOTC could be expanded to include parents’ expenses related to pre-K education, operating in conjunction with the Child and Dependent Care Tax Credit.

- The Lifetime Learning Credit helps individuals pay for tuition and related expenses for higher education. The credit is nonrefundable and worth up to $2,000 per tax return. 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. This same exclusion from income does not apply for early education expenses, however. As a result, 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. 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. One change would be needed, however, because the value of tax-free growth for 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. Families should be permitted to set up Coverdell accounts in advance of a beneficiary’s birth in order to 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 savings plans, as well as the cancellation of the early IRA withdrawal penalty for qualifying education expenses.

The Action Tank sees additional opportunity to expand the benefits for higher education in the tax code to early education in the following ways:

- **Create parity in existing tax credits.** By extending any of the 14 higher education tax benefits to apply to early education, families could receive additional

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assistance to cover the cost of early learning in conjunction with the Child and Dependent Care Tax Credit, allowing more families to afford quality early education programs. In the context of comprehensive tax reform, should higher education tax credits and deductions be simplified or consolidated into a new system, we support extending the new system to equally apply to early education expenses as well.

- **Create parity for scholarships, fellowships and tuition exclusions.** The exclusion from income for scholarships, fellowships and certain tuition costs currently allowed under the tax code for higher education purposes could be expanded to include tuition reductions or financial assistance for preschool and early childhood care. This would lower the cost of ECE for all families with a qualifying exclusion.

- **Create parity for preferential savings vehicles.** Allowing families to create accounts to save for pre-K education as they already can for K-12 and higher education would help families put more money aside tax-free to cover the costs of high-quality early education programs.

Expand the Maternal, Infant and Early Childhood Home Visiting (MIECHV) Program

Enacted in 2010 as one of the cornerstones of evidence-based policy, the Maternal, Infant and Early Childhood Home Visiting (MIECHV) program provides funding to states, territories, tribes and tribal organizations to implement and expand primarily evidence-based home visiting programs that improve the health, education and economic stability of children and families living in poverty and experiencing other risk factors. Voluntary evidence-based home visiting programs partner parents with trained professionals, such as nurses, social workers and early childhood educators, who meet with the families regularly in their homes to deliver information and assistance during pregnancy; coordinate health, educational, housing and social supports; and provide education and guidance to parents regarding effective parenting skills and healthy child development. In addition, home visiting helps parents establish and meet educational and employment goals, contributing to their economic stability and independence. Research shows that evidence-based home visiting works, ultimately resulting in impressive two-generational outcomes that yield cost-savings to the federal and state governments. It is estimated that evidence-based home visiting can produce a return to society of up to $5.70 for every dollar invested from savings in health care expenditures, remedial educational services and reduced child abuse and neglect and criminal justice expenditures.\(^{18}\)

Now in its seventh year of operation, preliminary evaluations of MIECHV show that it provides services to over 145,000 families in over 850 counties in 50 states, the District of Columbia and five territories.\(^{19}\) Preliminary evaluations show increasing school readiness of children, primarily through increased childhood screenings for developmental delays such as autism, attention deficit disorders and delays in language. In addition, screening rates and subsequent referrals for treatment have increased for intimate partner violence and maternal depression.

Initial assessments of MIECHV also show it improves birth outcomes, early child health and parenting knowledge and skills while also helping young mothers graduate from high school and obtain gainful employment. Yet another important benefit of MIECHV is its sophisticated infrastructure, which is allowing states to develop data and reporting systems that lead to the continuous quality improvement of the program. MIECHV is also fostering states’ efforts to build early childhood service delivery systems that align programs serving parents and young children to break down silos and promote integrated services that produce greater child and family outcomes.

Despite these important outcomes, MIECHV reaches a small fraction of the children and families in need of these services. The ECE Action Tank therefore recommends that Congress reauthorizes MIECHV for a five-year period with increased funding from $400 million annually to $800 million annually over the five-year reauthorization period. Increased funding will enable states to continue to expand their programs to communities with the greatest needs to improve important child and family outcomes that help close the achievement gap and help children and families escape poverty and succeed. Increased funding over a five-year reauthorization will also enable states, territories and tribes to continue to develop the infrastructure that enables them to maintain high-quality services that promote early childhood systems of care with coordinated services, data systems and other supports that help transform the lives of young children and families.


Pre-Kindergarten Scholarship Tax Credit (PKTC)

America’s states are laboratories of innovation for the country as a whole. Many ideas in this report have been pioneered at the state and local levels. The Pre-Kindergarten Scholarship Tax Credit (PKTC) idea is no exception. This proposal is based off of Pennsylvania’s “Educational Improvement Tax Credit Program,” which has been wildly successful in spurring private sector investment in education.

In Pennsylvania, businesses can receive a tax credit equal to 75% of their contribution to an approved entity up to a maximum of $750,000 per year (lower amounts for scholarship organizations), and the credit increases to 90% for multi-year commitments. Organizations eligible to receive contributions must be 501(c)3 nonprofit entities and must dedicate at least 80% of their qualified contributions to ECE services or improvements. There is also a statewide cap on the total dollars available under the credit, and entities seeking to claim the credit must apply to the state.

To adapt Pennsylvania’s program to the federal level, we propose a tax credit for corporations and individuals who make contributions to approved early education scholarship organizations, educational improvement organizations focused on early childhood and pre-K scholarship programs. Like any tax credit, the exact amount could be dialed up or down, but we envision a robust credit equal to a significant percentage of the contribution — above and beyond the current charitable deduction. We do not envision a federal credit as high as Pennsylvania’s, but we do believe that a substantial credit would encourage donations to ECE programs, facilities and scholarships at a much greater level than the current charitable deduction. The eligibility requirements included in the Pennsylvania program could serve as a model for a federal credit.

We are excited about the possibility of expanding a Pennsylvania-style credit at the federal level and look forward to working with Congress to discuss some of the outstanding questions regarding implementation. These include the impact on states with existing credits and how to treat businesses and individuals already using state credits. There are numerous potential solutions including limiting utilization of state credits that would net taxpayers with returns greater than their original investments or offering a phase-in period to give state legislatures time to react and amend their own programs.