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Federal support for child care: Current policies and a proposed new system

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Introduction

Child care is rapidly becoming one of the most important social issues of the 1980s. There are now over 25 million women in the United States with children under the age of 13 and more than three-fifths of them (close to 15 million) are in the labor force.[2] Because the child care needs of the population are so diverse, the problem of ensuring access to affordable, adequate child care for the more than 25 million children of working mothers represents a significant national challenge.

This article examines alternative mechanisms for financing child care at the federal level and discusses the economic implications of government interventions now in use. Currently, a wide variety of government programs supply or subsidize child care, but there is no coordinated policy. This fragmented system has led to inefficiencies in the distribution of child care benefits. Furthermore, although government subsidies for child care have recently increased, most of the benefits have gone to middle- and upper-income families. This represents a growing inequity in the distribution of child care benefits.

Recent trends in federal spending for child care

A large number of federal programs provide some form of child care assistance, but it is difficult to obtain precise figures on direct expenditures for child care because many of the programs do not separately identify the child care component. One of the consequences of this fragmented system is that benefits often overlap, creating perverse incentives for families.

At least 22 separate federal programs currently provide some form of child care assistance. These programs are listed in Table 1, along with the authorizing legislation (arranged chronologically) and a brief description of the form of child care assistance.[3] The programs vary considerably in the types of services provided, the form and intent of the federal financial assistance, the eligible population, and the child care standards required for assistance. For only a few of the programs have expenditures specifically for child care been identified.

Although federal child care assistance comes in a variety of forms, it can be categorized as either supply subsidies or demand subsidies. Examples of supply subsidies are the Head Start program, direct subsidization of child care facilities under the Title XX Social Services Block Grant Program, and the Child Care Food Program. Examples of demand subsidies are voucher programs under Title XX, the Child and Dependent Care Tax Credit, Dependent Care Assistance Programs (commonly referred to as Flexible Spending Accounts), and the work-expense disregard in the Aid to Families with Dependent Children and the Food Stamp programs.

Some programs offer a mixture of supply and demand subsidies. For example, a Title XX program in Florida enables families to choose the child care provider, and the state then reimburses the facility directly.[4] This approach exemplifies the increasing trend under Title XX to expand consumer choice by placing greater reliance on demand-type subsidies. In fact, most child care funds are now being distributed in the form of demand subsidies, consistent with the emphasis on "privatization" by the Reagan administration. However, the demand subsidies vary considerably in the degree to which they restrict consumer choice. In some cases, families must use specific types of licensed child care facilities in order to qualify for benefits; in other cases, considerable consumer choice is allowed. For example, in-home care is not generally subsidized under Title XX, but is partially reimbursed under the child care tax credit. Hence, blanket categorization of demand subsidies as expanding consumer choice relative to supply subsidies can be misleading.

Table 2 presents estimates (based on a variety of sources) of changes in federal spending under the ten largest programs during the 1977–86 decade. In 1977 the largest source of federal funding for child care was the Title XX program, which represented close to 40 percent of the total. By 1986, however, Title XX accounted for only about 7 percent of total spending. There are two reasons for this dramatic change. First, the Omnibus Budget Reconciliation Act of 1981 (OBRA) amended Title XX to create the Social Services Block Grant, eliminating the separately funded Title XX social services program. Total Title XX funds were cut by about 20 percent, and states were given considerable flexibility in allocating program expenditures. As a consequence, Title XX spending for child care declined by more than one-half (close to three-fourths in constant dollars)

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Table 1

Selected Federal Programs Providing Child Care Assistance, 1987

Program	Authorizing Legislation	Type of Assistance
1. Child Welfare Services	Title V, Social Security Act of 1935 (Title IV-B since 1967)	Child care services
2. Child Care Food Program	Section 17, National School Lunch Act of 1946	Food for licensed child care facilities
3. Child Welfare Research and Demonstration Projects	Title V, Social Security Act Amendments of 1960 (Title IV-B since 1967)	Funds for research and demonstration projects in field of child care
4. Aid to Families with Dependent Children	Title IV-A, Social Security Act Amendments of 1962	Work-expense benefit for child care
5. Child Welfare Training	Title V, Social Security Act Amendments of 1962 (Title IV-B since 1967)	Funds for training child care workers
6. Food Stamps	Food Stamp Acts of 1964, 1977	Work-expense benefit for child care
7. Area Economic and Human Resource Development Program (formerly Jobs and Private Investment Program)	Appalachian Regional Development Act of 1965	Child care services
8. Head Start	Economic Opportunity Act Amendments of 1966	Child care services
9. Special Milk Program	Section 3, Child Nutrition Act of 1966	Milk for licensed child care facilities
10. Work Incentive Program	Title IV-C, Social Security Act Amendments of 1967	Child care services
11. Child Care as a Business Expense	Section 162, Internal Revenue Code, 1973	Tax deductions for child care services provided by businesses
12. Title XX (Social Services Block Grant)	Title XX-A, Social Security Act Amendments of 1974 (Block Grant since 1981)	Child care services
13. Community Development Block Grant	Title I, Housing and Community Development Act of 1974	Child care services
14. Child and Dependent Care Tax Credit	Section 21, Internal Revenue Code, 1976	Tax benefits for child care
15. Indian Child Welfare Act	Title II, Indian Child Welfare Act of 1978	Child care services
16. Dependent Care Assistance Programs	Section 129, Internal Revenue Code, 1981	Tax benefits for child care
17. Accelerated Cost Recovery System	Section 168, Internal Revenue Code, added by Economic Recovery Tax Act of 1981	Business-provided child care center eligible for accelerated depreciation
18. Community Services Block Grant	Omnibus Budget Reconciliation Act of 1981; Human Services Reauthorization Act of 1986	Child care services
19. Dislocated Workers Program	Title III, Job Training Partnership Act of 1982	Child care services
20. Job Training Partnership Act	Title II-A, Job Training Partnership Act of 1982	Child care services, child care training
21. Child Development Associate Scholarship Program	Human Services Reauthorization Act of 1986	Scholarships to candidates for child development associate credential
22. Dependent Care Planning and Development	Human Services Reauthorization Act of 1986	Child care services

Source: Adapted from Sharon Stephan and Susan Schillmoeller, "Child Day Care: Selected Federal Programs," Paper 87-303 EPW, Congressional Research Service, Library of Congress, April 7, 1987.

Table 2

Federal Spending for Child Care, 1977–1986

Program	Administering Agency	Federal Spending (millions of current dollars)			
		1977	1980	1984	1986
Title XX (Social Services Block Grant)	Department of Health and Human Services	$809[a]	$600[b,c]	$535[c]	$387[c]
Head Start	Department of Health and Human Services	448[a]	735[b]	996[b]	1,040[c]
Area Economic and Human Resource Development Program	Appalachian Regional Commission	9[a]	11[c]	1[d]	0[d]
Child Care Food Program	Department of Agriculture	120[a]	217[b]	357[d]	484[d]
Job Training Partnership Act	Department of Labor	—	—	30[e]	30[e]
Aid to Families with Dependent Children (work-expense disregard)	Department of Health and Human Services	84[a]	60[b]	35[b]	35[c]
Work Incentive Program (WIN)	Department of Health and Human Services	57[a]	115[b]	—	—
Food Stamps (work-expense disregard)	Department of Agriculture	35[e]	35[e]	35[e]	50[e]
Tax Exclusion for Employer-Provided Child Care	Internal Revenue Service	—	—	40[b]	110[e,d]
Subtotal (1986 dollars)		1,562 (2,826)	1,773 (2,360)	2,028 (2,141)	2,136 (2,136)
Child and Dependent Care Tax Credit	Internal Revenue Service	521[f]	956[f]	2,649[f]	3,410[e]
Total (1986 dollars)		2,083 (3,769)	2,729 (3,632)	4,677 (4,937)	5,546 (5,546)

Note: Data are for the fiscal year except for child care tax credit, which is measured over the calendar year. Minor programs listed in Table 1, for which data are not available, have been excluded.
[a]U.S. Congress, Congressional Budget Office, *Childcare and Preschool: Options for Federal Support,* Background Paper, September 1978, Table 9.
[b]Private communication from William Prosser, Department of Health and Human Services.
[c]Alfred J. Kahn and Sheila B. Kamerman, *Child Care: Facing the Hard Choices* (Dover, Mass.: Auburn House, 1987), Table 1.8.
[d]Sharon Stephan and Susan Schillmoeller, "Child Day Care: Selected Federal Programs." Paper 87-303 EPW, Congressional Research Service, Library of Congress, April 7, 1987.
[e]Based on quality control data from the Food and Nutrition Service, courtesy of Julie Isaacs, Congressional Budget Office.
[f]U.S. Department of the Treasury, Internal Revenue Service, *Individual Income Tax Returns* (Washington, D.C.: GPO, 1977, 1980, 1984).

from 1977 to 1986. Second, over the same period, the child care tax credit expanded greatly, increasing by a factor of almost 7 from 1977 to 1986 (a factor of just over 3 1/2 in constant dollars). This expansion was the result of liberalized provisions and increased use by eligible families. By 1986, the tax credit had become the dominant form of government subsidization of child care, representing over 60 percent of all federal spending for child care, up from 25 percent in 1977.

As Table 2 indicates, spending has increased significantly in only four programs. These are Head Start (which was generally insulated from the 1981 budget cuts but only provides half-day care in most instances), the Child Care Food Program (which was initially cut but later expanded), employer subsidies, and the child care tax credit. These four programs currently account for more than 90 percent of all federal spending for child care. Excluding the tax credit, federal spending for child care declined by almost 25 percent in constant dollars from 1977 to 1986. Because most of the child care benefits accruing to low-income families are from programs other than the tax credit, there has been a decided shift in the distribution of federal child care benefits. The Congressional Budget Office estimated that in 1977, 60 percent of all non-tax-related benefits for child care but less than 1 percent of the tax-related benefits accrued to low-income families.[5] Hence, although federal spending for child care has risen by almost 50 percent since 1977, virtually all of the increased benefits have gone to middle- and upper-income families.

Table 3

Use of the Child Care Tax Credit
1976–1986

Year	Maximum Credit Available—Two or More Children		Number Claiming Credit (thousands)	Percentage of Total Returns Claiming Credit[a]	Number Claiming Credit as a Percentage of Families with Working Mothers[b]	Total Amount of Credit ($ millions)	Average Credit per Family	Average Credit as a Percentage of Average Tax Liability[c]
	Poor[d]	Nonpoor[e]						
1976	$1,541	$1,541	2,660	3.9%	18.2%	$ 883	$332	7.7%
1977	1,447	1,447	2,875	4.2	18.9	943	328	7.2
1978	1,345	1,345	3,431	4.7	21.5	1,100	321	6.8
1979	1,208	1,208	3,833	5.2	23.3	1,198	313	7.0
1980	1,065	1,065	4,231	5.6	24.5	1,273	301	6.7
1981	964	964	4,578	5.8	25.6	1,384	302	6.7
1982	1,636	1,091	5,004	6.3	27.9	1,706	341	8.4
1983	1,585	1,057	6,367	7.9	35.2	2,258	355	9.3
1984	1,520	1,013	7,546	8.9	40.4	2,796	371	9.7
1985	1,468	978	8,445	9.8	44.3	3,132	371	9.5
1986	1,440	960	n.a.	n.a.	n.a.	3,410[f]	n.a.	n.a.

Sources: U.S. Department of the Treasury, Internal Revenue Service, *Individual Income Tax Returns* (Washington, D.C.: GPO, 1976–1985); U.S. Department of Labor, Bureau of Labor Statistics, *Handbook of Labor Statistics*, Bulletin 2217 (Washington, D.C.: GPO, 1985).
Notes: n.a. = Not available. All dollars are 1986 dollars, adjusted by using the Consumer Price Index.
[a]Denominator is number of returns with positive tax liability before credit.
[b]Working mothers in one- and two-parent families with children under the age of 18.
[c]Average tax liability measured before credits.
[d]Those eligible for maximum credit (20 percent until 1982, 30 percent thereafter).
[e]Those eligible for minimum credit (20 percent).
[f]Estimated; see Alfred J. Kahn and Sheila B. Kamerman, *Child Care: Facing the Hard Choices* (Dover, Mass.: Auburn House, 1987, Table 1.8).

The increased spending for child care under the child care tax credit has been the result of more extensive use of the credit by the working population rather than greater subsidies per family. Table 3 shows how changes in the tax credit have increased its use since its inception in 1976. First, in 1982, the tax credit was increased to 30 percent of child care expenses for low-income families and was reduced gradually on a sliding scale to 20 percent for families with incomes above $28,000. Prior to this the credit was a flat 20 percent for all families. Second, also in 1982, the maximum amount of child care expenses to which the credit could be applied was increased from $2,000 to $2,400 for one child and from $4,000 to $4,800 for two or more children. Third, and perhaps most important, in 1983 the credit was added to the short income tax form (1040A), which extended coverage to more low-income families.

As Table 3 indicates, the 1982 changes had only a minor effect on utilization of the credit, although they did significantly increase the average credit per family (from $302 in 1981 to $341 the following year; 1986 dollars). The changes were not enough, however, to make up for the inflation that had occurred since the late 1970s. As the first two columns indicate, even though the credit was increased from 20 percent to 30 percent for low-income families, the maximum *real* benefit for this group was only 6 percent higher in 1982 than it was in 1976 ($1,636 in 1982 versus $1,541 in 1976). For middle- and upper-income families, the maximum real benefit fell by 29 percent (from $1,541 to $1,091), despite the increase in qualifying expenses. Hence, although the average credit per family in 1982 was 13 percent higher than in 1981, it was only 3 percent higher than in 1976. The addition of the credit to the short form in 1983 significantly increased the number of taxpayers using the credit but had little effect on the size of the average credit.

Overall, then, from 1976 to 1985 child care subsidies through the child care tax credit increased by 350 percent in constant dollars. This increase came about primarily because of more extensive use by eligible families. I estimate that the percentage of families with working mothers using the credit increased from 18.2 percent in 1976 to 44.3 percent in 1985.[6] In contrast, the average real credit per family increased by only about 12 percent from 1976 to 1985.

Interactions among programs

The diverse and fragmented child care system in the United States has created significant overlaps and interactions among programs that can lead to perverse decision making on the part of families. Gordon Lewis examined the effects of some of these interactions in Pennsylvania before and after OBRA.[7] In his analysis, the choices faced by families involved private day care (the expenses for which were eligible for subsidization under AFDC, food stamps, and the child care tax credit) and public day care (funded under Title XX). The interactions arose because federal tax withholdings were deducted from earned income in determining the AFDC grant, Title XX payments were based on family income, and the AFDC grant had to be included in income used to calculate the food stamp benefit. Generally, Lewis found that the interactions among the programs made it financially desirable to utilize publicly funded child care facilities at some income levels and privately funded child care facilities at other income levels. Hence, if income were to change over time, families might be induced to change child care arrangements in order to maximize their subsidy from the government. If stability of child care arrangements is important to a child's overall emotional well-being, then such a system of overlapping benefits is socially undesirable.

More recent tax legislation has created additional complications and inequities in the distribution of federal child care benefits. These pertain to use of the tax system to provide employee benefits in the form of Flexible Spending Accounts (FSAs) and provisions of the Tax Reform Act of 1986. An FSA is a reservoir of funds upon which employees can draw to pay for certain expenses, including child care.[8] FSAs are almost always funded through salary-reduction plans rather than through employer contributions, because salary-reduction plans are costless to employers (but not to taxpayers). Because the funds accumulated in FSAs escape taxation (both federal income and social security taxes), families receive a subsidy from the federal government equal to the taxes saved as a result of the voluntary salary reduction. In fact, employers are also subsidized because they do not pay social security or federal unemployment insurance taxes on the reduced salary amount.[9] Although it is estimated that only about 800 firms provided child care benefits in the form of FSAs in 1985,[10] the number has been increasing rapidly. Since there are more than 5 million business concerns in the United States, and more than 44,000 have 100 employees or more, this form of child care benefit can expand enormously.

Currently, the maximum in child care expenses that can be applied to FSAs is $5,000 per year. If the family is in the 15 percent tax bracket and applies for and spends the total allotted amount, the family will receive a child care subsidy of $750 (excluding savings in social security taxes). If the family is in the 28 percent tax bracket, it will receive a subsidy of $1,400. Hence, unlike the child care tax credit, which is progressive (higher percentage subsidies to lower-income families), FSAs are regressive (higher percentage subsidies to higher-income families). The regressivity of FSAs is even more pronounced because most low-income families do not currently work for firms providing such benefits.

An additional complication is created by the fact that employees qualifying for an FSA can also use the child care tax credit. For example, an employee in the 28 percent tax bracket who incurs $7,000 in child care expenses for two children can apply the maximum ($5,000) to the FSA and the remainder qualifies for child care tax credit. Hence, all of the employee's child care expenses are eligible for a subsidy, even though the expenses incurred exceed the allowable amounts under each program. Excluding savings in social security taxes, the subsidy will amount to $1,800 ($1,400 from the FSA and $400 from the tax credit), which is about 26 percent of total child care expenses. If the employee is in the 15 percent tax bracket (and has income above $28,000), it would be better to apply the first $4,800 to the tax credit (because the subsidy rate is higher) and the remainder to the FSA. This employee will receive a subsidy of $1,290 ($960 from the tax credit and $330 from the FSA), which is about 18 percent of total child care expenses.

The Tax Reform Act of 1986 has added further regressivity to the system of tax-related child care benefits. Currently, the child care tax credit is nonrefundable, which means that it is limited to the amount of the individual's tax liability.[11] The 1986 Tax Reform Act reduced taxes for most low-income families. Ironically, many of them will lose part of their child care subsidy as a consequence. The tax credit loss is greatest for families with incomes between $10,000 and $16,000.[12] For these families the subsidy is now about 30 percent lower on average than it was before the Tax Reform Act. The entire loss in the tax credit is concentrated among families with incomes below $16,000—the bottom three deciles of the income distribution. I estimate that the Tax Reform Act will eliminate roughly $164 million in child care subsidies for the poorest 30 percent of families.

The above examples illustrate how a fragmented system of overlapping child care subsidies can create inefficiencies, inequities, and perverse incentives. From a public policy standpoint, it appears to make more sense to develop a system in which the benefits complement one another, rather than interact in a way that leads to a situation (such as regressivity) that may be inconsistent with overall national objectives. In the remainder of this article I discuss some of the alternatives currently being debated in Congress and offer some recommendations on how the current system can be improved.

Alternatives being debated in Congress

In 1987, more than 70 bills related to child care were introduced into Congress.[13] Many call for increased spending under existing programs while others create new programs. The bills cover virtually every aspect of financing, from tax credits to service delivery. In the tax area, for example, bills were introduced to make the child care tax credit refundable, to make it more progressive, and to phase it out at high incomes to help finance a system of child care vouchers. There are bills to expand employer subsidies by establishing a tax credit for employer-sponsored child care and requiring cafeteria plans[14] to provide a child care option.

In the service delivery area, numerous bills deal with the child care problems of special groups: Several bills call for subsidized child care for welfare recipients participating in new or existing work/training programs; others request child care funds for residents in public housing, disadvantaged youth, participants in English literacy programs, dislocated workers, college students from disadvantaged backgrounds, unemployed individuals, students in health care education programs, and persons receiving foster-parent training. Other bills call for restoring cuts in Title XX funding, increasing funds under Head Start and food programs for children in day care, and financing demonstrations to develop model child care systems within the public school system. Other bills provide funds for improving state licensing and regulatory systems, and several call for the establishment of a federal agency to coordinate national child care policy. There is even a bill to establish a national lottery to assist in financing child care under the Title XX program. The most comprehensive bill currently before Congress, the Act for Better Child Care Services (HR 3660, S 1885), calls for $2.5 billion per year to fund a broad range of child care services. This bill is supported by more than 100 national activist groups (members of a coalition known as the Alliance for Better Child Care) and has close to 200 cosponsors in both houses of Congress.

With few exceptions, virtually all of the proposed legislation would require additional federal spending.[15] This poses a problem during an era of large federal deficits. Few members of Congress are likely to find a constituency supportive of new initiatives that would lead to an expansion in federal spending. Nevertheless, it should be pointed out that in comparison to other social programs, current expenditures on child care are extremely modest. In 1986, federal child care expenditures of $5.5 billion represented under 4 percent of total federal spending on education, training, employment, social services, and income security (excluding spending on Medicare, other health programs, and Social Security). Thus, it would appear there is some justification for reorienting national priorities to increase the federal commitment to child care.

Change of Institute Directors

Charles F. Manski was appointed Director of the Institute for Research on Poverty on July 1, 1988. An economist, Manski received his Ph.D. from MIT in 1973. He taught at Carnegie-Mellon University and at the Hebrew University of Jerusalem before coming to the University of Wisconsin in 1983. His policy research has concentrated on education, crime, and transportation. His methodological work has focused on the econometric analysis of individual behavior. He is coauthor of *College Choice in America* (with David Wise), co-editor of *Structural Analysis of Discrete Data* (with Daniel McFadden), and author of the forthcoming *Analog Estimation Methods in Econometrics.* He has served on the Committee on Law Enforcement and the Administration of Justice of the National Academy of Sciences and on the Economics Advisory Panel of the National Science Foundation. A Fellow of the Econometric Society, he is currently coeditor of the Econometric Society Monograph Series, associate editor of the *Journal of Economic Perspectives,* associate editor of *Econometrica,* and a member of the advisory board of the *Journal of Human Resources.*

Manski succeeds Sheldon Danziger, who completed a five-year term as IRP director. Danziger has joined the faculty of the University of Michigan, where he is Professor of Social Work and Public Policy and Faculty Associate of the Population Studies Center. He continues as an Institute research affiliate.

A suggested two-tiered system of federal support

Much (but not all) of the proposed legislation represents patchwork reform that would perpetuate the inefficiences and inequities of the existing system. Instead, I outline a two-tiered system of federal support that would lead to greater efficiency and equity in the distribution of child care benefits. Although my proposal would increase federal spending, I suggest how this additional cost could be partially offset by reductions elsewhere in child care spending.

The first tier of my proposed system would provide child care benefits for all working families with children. In my view, the most efficient way to provide these benefits is through the existing child care tax credit. Because the tax credit currently provides benefits in an inequitable way, it must be adjusted. One adjustment that would contribute toward greater equity is to make the credit refundable and more progressive. If large federal deficits require financing an expansion of the tax credit, I would recommend repealing the provision of the Internal Revenue Service Code Section 129 that makes child care a tax-free benefit to employees (through the FSAs), and I would recommend phasing out the tax credit at very high incomes. The reason for eliminating the tax advantages for FSAs is not because they are undesirable, but because, as described above, they overlap in an inefficient manner with the tax credit and add to the regressive treatment of low-income families under the current system. Employers would still have the option of offering FSAs, but they would have to be financed by employer contributions and would be taxable benefits to employees. In this sense, such child care benefits would be equivalent to higher wages.

Ideally, an initial refundable tax credit of about 80 percent, gradually reduced to zero at very high incomes, would seem to be a politically feasible goal.[16] To maintain the current tax advantages created by the combined tax credit and FSAs, I recommend increasing eligible expenses under the tax credit to $3,600 for one child and $7,200 for two or more children. Empirical evidence suggests that this general form of "demand" subsidy would have beneficial impacts on society.[17] In particular, it would generate substantial increases in labor force participation among low-income families and would increase the quality of care purchased. Increased labor force participation by low-income families would provide the work experience necessary to escape poverty through future earnings growth.

One criticism of the tax credit as a means of subsidizing child care for low-income families is that families would not benefit from the credit until they filed their tax returns, and thus they might be unable to meet monthly (or even weekly) child care expenses.[18] This problem could be partially avoided by using the existing withholding system to meet monthly child care needs. Families paying positive federal income taxes could have their withholding reduced in order to have enough disposable income to pay monthly child care expenses. For families not paying any regular federal income taxes, monthly child care expenses could be partially met by reducing social security taxes withheld (including the employer's portion). Social security taxes are paid on every dollar earned up to the taxable maximum. Currently, the combined employer-employee contribution rate is 15.02 percent. Reducing the social security withholding tax for low-income families by an amount not to exceed the combined employer-employee contribution rate would lessen (but perhaps not eliminate) the need to develop a system of refunding child care credits on a less than annual basis. When tax returns are filed at the end of the year, reconciliations can be made. If the family elects to receive the credit at the end of the year, the same mechanism can be used to distribute benefits that is currently being used for the earned income tax credit, which is also refundable. A family able to balance its child care account with the government would receive full credit for its appropriate social security contributions.

If it is not feasible to use the withholding system to meet monthly child care needs, then consideration might be given to a system of direct vendor payments on a monthly basis. Under such a system, licensed child care facilities would periodically bill the government for a portion of child care expenses incurred by the family. Such a "co-payment" system could be patterned after the reimbursement system used by the Medicare and Medicaid programs. If this proves infeasible as well, consideration might be given to a system of child care vouchers, distributed monthly and patterned after the Food Stamp program. In any event, when families file their tax returns at the end of the year, the appropriate amount of the refundable credit would be calculated and reconciliations would be made.

Another criticism of the tax credit is that most low-income families cannot afford to purchase child care in the open market (i.e., from child care centers or licensed homes providing family day care). Instead, they tend to rely upon in-home babysitters or out-of-home arrangements that are usually unlicensed (and hence illegal) and pay less than minimum wages to caretakers who do not declare their income for tax purposes.[19] A refundable credit at the rate of 80 percent for very low-income families would induce some of them to seek higher-quality (licensed) arrangements, and many caretakers might also then seek licenses and declare their incomes for tax purposes. This would indirectly lead to an increase in federal (and state) tax revenues.

The second tier of my proposed system would act as a "safety net" to provide benefits to chronically disadvantaged families who are either unable to take advantage of tax-based benefits or who cannot find decent-quality care at low cost. In particular, "supply"-oriented subsidies, such as financing the establishment of licensed centers within public housing projects or in other areas with a high incidence of poverty, should be instituted on a large scale. Poor families should receive the services of these facilities at little or no cost. Again, empirical evidence suggests that supply subsidies of this type can induce a considerable degree of economic self-sufficiency among low-income families.[20]

A system of publicly funded child care centers could be financed entirely by the federal government or possibly through matching grants to the states, with the federal government providing the bulk of the matching funds. A system of matching grants would be desirable if it induced additional state funding of the centers. Evidence on the effects of matching formulas on state funding of social programs is controversial. One careful study concludes that federal matching at the margin can have a modestly positive effect on the overall amount of benefits provided by states.[21]

In addition to such a two-tiered system of child care support, it would also seem appropriate to centralize the coordination of national child care policies within a federal agency, probably the Department of Health and Human Services (perhaps within the recently created Family Support Administration). The functions of such an agency would be to monitor child care spending and to enforce regulations governing the quality of the child care services being provided. All child care eligible to be subsidized under the two-tiered system would have to meet minimum federal standards, which individual states could upgrade at their discretion.

Conclusions

The current system of federal support for child care in the United States consists of a series of overlapping programs that tend to create inefficiencies and inequities in the distribution of child care benefits. Despite the large number of programs in existence, overall federal assistance for child care, which totaled approximately $5.5 billion in 1986, is quite modest compared to federal spending in other social policy areas. Most child care assistance comes from the child care tax credit and other tax-based methods (primarily flexible spending accounts), which have been increasing in recent years. Tax-based methods of financing child care are generally regressive in nature, benefiting almost exclusively middle- and upper-income families. Direct subsidies for child care, which have been traditionally used to benefit lower-income families, are currently in a state of decline.

In order to achieve efficiency and equity in our nation's child care policies, modifications to the current system are sorely needed. A general two-tiered system of support would go a long way toward meeting our national child care goals. This two-tiered system would be centered on a refundable tax credit considerably more progressive than the current tax credit. A "safety net" of publicly funded child care centers would be established to help meet the child care needs of special groups, principally chronically disadvantaged families. These child care centers would adhere to minimum federal standards regarding quality and would be located in areas, such as public housing projects, accessible to low-income families. To ensure an efficient and equitable distribution of federal child care benefits, a federal coordinating agency should be established within the Department of Health and Human Services. ■

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[2]Howard Hayghe, "Rise in Mothers' Labor Force Activity Includes Those with Infants," *Monthly Labor Review*, February 1986, pp. 43–45.

[3]The table and discussion of it are adapted from Sharon Stephan and Susan Schillmoeller, "Child Day Care: Selected Federal Programs," Paper 87-303 EPW, Congressional Research Service, Library of Congress, April 7, 1987.

[4]Alfred J. Kahn and Sheila B. Kamerman, *Child Care: Facing the Hard Choices* (Dover, Mass.: Auburn House, 1987), p. 98.

[5]U.S. Congress, Congressional Budget Office, *Childcare and Preschool: Options for Federal Support*, Background Paper, September 1978.

[6]These percentages are calculated using data from two sources: the number of working mothers is from U.S. Department of Labor, Bureau of Labor Statistics, *Handbook of Labor Statistics*, Bulletin 2217 (1985) and the number of families using the credit is from U.S. Department of the Treasury, Internal Revenue Service, *Individual Income Tax Returns* (Washington, D.C.: GPO, 1976–1985).

[7]Lewis, "The Day Care Tangle: Unexpected Outcomes When Programs Interact," *Journal of Policy Analysis and Management*, 2 (4), 1983, 531–547.

[8]For a description of FSAs, see Dana Friedman, "Corporate Financial Assistance for Child Care," Research Bulletin No. 177, The Conference Board, New York, 1985; and Sandra L. Burud, Pamela R. Aschbacher, and Jacquelyn McCroskey, *Employer Supported Child Care: Investing in Human Resources* (Boston, Mass.: Auburn House, 1984).

[9]Friedman, "Corporate Financial Assistance."

[10]Steven D. Lydenberg, "Child Care Update: Business Takes First Real Steps," Newsletter, Council on Economic Priorities, CEP Publication N86-11, New York, November 1986.

[11]As pointed out in U.S. Congress, Congressional Budget Office, *Reducing Poverty among Children* (Washington, D.C.: GPO, 1985), the child care tax credit is applied before the refundable earned income tax credit (EITC). Therefore, the child care tax credit is not limited by the EITC.

[12]See Robins, "Federal Financing of Child Care: Alternative Approaches and Economic Implications," paper presented at a conference sponsored by the Child Care Action Campaign at Wingspread, Racine, Wis., January 1988.

[13]These bills are described in Robins, "Federal Financing of Child Care."

[14]A cafeteria plan is a "menu" of taxable and nontaxable benefits provided by employers to give employees greater flexibility in choosing alternative forms of compensation. FSAs may be one of these benefits. Because of the increasing diversity of the work force, cafeteria plans are growing in popularity. For an excellent discussion of cafeteria plans, see Friedman, "Corporate Financial Assistance."

[15]One notable exception is a $300 million bill (HR 1572) introduced by Representative Nancy Johnson of Connecticut to create a system of vouchers for child care. Johnson's bill calls for phasing out the child care tax credit at higher income levels (over $70,000). Phasing out the tax credit at higher income levels (above $65,000) has also been proposed to help finance the Family Welfare Reform Act (HR 1720) introduced by Representative Harold Ford of Tennessee.

[16]Three bills introduced in 1987 (HR 2456 by Representative Olympia Snowe of Maine, HR 2577 by Representative Patricia Schroeder of Colorado, and S 1309 by Senator Alan Cranston of California) would make the child care tax credit refundable and more progressive, increasing the subsidy rate to 50 percent for low-income families.

[17]See, for example, David M. Blau and Philip K. Robins, "Child-Care Costs and Family Labor Supply," *Review of Economics and Statistics*, forthcoming.

[18]U.S. Congress, Congressional Budget Office, *Reducing Poverty among Children*.

[19]U.S. Commission on Civil Rights, *Child Care and Equal Opportunity for Women*, Clearinghouse Publication No. 67 (Washington, D.C.: U.S. GPO, June 1981).

[20]See, for example, Robins, "Child Care and Convenience: The Effects of Labor Market Entry Costs on Economic Self-Sufficiency among Public Housing Residents," *Social Science Quarterly*, 69 (March 1988), 122–136.

[21]Larry L. Orr, "Income Transfers as a Public Good: An Application to AFDC," *American Economic Review*, 66 (June 1976), 359–371. For a different view, see Robert Moffitt, "The Effects of Grants-in-Aid on State and Local Expenditures: The Case of AFDC," *Journal of Public Economics*, 23 (April 1984), 279–305; available as IRP Reprint no. 493.