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Welfare Reform, Child Care Costs, and Taxes: Delivering Increased Work-Related Child Care Benefits to Low-Income Families

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Recent welfare reform proposals prompt a closer look at work-related child care assistance available to low-income families. The proposals considered by Congress during the past eighteen months¹ would impose additional mandatory work requirements, either by making existing federal provisions more

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1. The Clinton administration's proposal, introduced in June 1994, would have imposed a two-year limit on welfare benefits without work, and provided limited job training and child care support to assist welfare recipients in their transition from welfare to work, including work in temporary, publicly subsidized jobs. The Work and Responsibility Act of 1994, H.R. 4605, 103d Cong., 2d Sess. (1994); S. 2224, 103d Cong., 2d Sess. (1994). For a more detailed description of the bills' child care provisions, see text accompanying notes 151-152, and notes 153-155.

The House GOP "Contract With America" welfare reform proposal introduced in January 1995 also contained work requirements, cutting off benefits to all adults after a lifetime limit of two to five years of assistance (whether or not jobs are available), with no additional funds for child care. The Personal Responsibility Act, H.R. 4, 104th Cong., 1st Sess., Title II, §§ 201-204 (1995). However, after the Contract proposal was introduced, another proposal supported by a group of Republican governors and members of Congress, including the Chair of a House subcommittee dealing with welfare reform, eliminated categorical programs such as AFDC and food stamps and substituted capped federal block grants to the states. That proposal gave the states greater flexibility to impose their own requirements or restrictions in mandatory work programs without having to apply for waivers of federal requirements or otherwise qualify for alternative state options. See H.R. 1214, 104th Cong., 1st Sess., § 101 (1995). The block grant proposal was accepted as a substitute for the earlier version of H.R. 4, and after additional minor amendments, was passed by the House by a vote of 234-199. Personal Responsibility Act of 1995, H.R. 4, 104th Cong., 1st Sess. (1995), 141 CONG. REC. H3790 (daily ed. Mar. 24, 1995).

The Senate welfare reform bill evolved during the six-month period following adoption of the House bill. See S. Rep. No. 96, 104th Cong., 1st Sess. (1995) (Senate Finance Committee recommending passage of the "Family Self-Sufficiency Act" of 1995, an amendment in the nature of a substitute for H.R. 4.). Although alternative bills were introduced by the Senate leadership in early August, the Senate postponed consideration of welfare reform until after the August recess. Compare S. 1120, 104th Cong., 1st Sess. (1995) (proposing "Work Opportunity Act of 1995," introduced by Senator Dole on August 3, 1995, to eliminate welfare as an entitlement and provide for block grants to the states) with S. 1117, 104th Cong., 1st Sess. (1995) (proposing "Work First Act of 1995," introduced by Senator Daschle on August 3, 1995, to repeal AFDC and provide work program block grants); see Robert Pear, *Dole Postpones Further Debate on Welfare Bill*, N.Y. TIMES, Aug. 9, 1995, at A1. In September 1995, the Senate passed a compromise bill by a vote of 87-12. Work Opportunity Act of 1994, H.R. 4, 104th Cong., 1st Sess., Title I, § 101, Title VI, §§ 601-603 (1995), 141 CONG. REC. S13802 (daily ed. Sept. 19, 1995). At this writing, it is unclear whether President Clinton and Congress will be able to reach agreement on a compromise bill. See *infra* notes 161-62, and accompanying text.

restrictive or by giving the states increased flexibility to impose such restrictions themselves.² Although work requirements are not new, the reform proposals place an increased emphasis on mandatory wage work for mothers with young children.³

Several broad trends emerge when examining work-related child care assistance in light of current approaches to welfare reform. First, although insufficient state and federal funding for child care has been a significant obstacle to full implementation of the work requirements imposed by prior welfare reform efforts,⁴ the political reluctance to expand work-related welfare support programs such as child care assistance seems to be increasing.⁵ Under the Family Support Act of 1988, certain participants in welfare-related education, training, and employment programs are guaranteed child care assistance.⁶ Experience with Family Support Act programs has shown that the related child care assistance costs nearly as much as the work programs themselves.⁷ Despite the federal statutory directive to provide such care, state budget constraints, combined with federal program structures requiring states to provide matching funds,⁸ have resulted in significant deficiencies in the provision of child care assistance. In addition, the competition for available child care subsidies has resulted in the shifting of scarce child care funds from

2. Although both Republican and Democratic welfare reform proposals favored more stringent work requirements, the proposals differed both with respect to child care funding and fundamental views about the proper role of the federal government in social welfare programs. The welfare reform bills passed by the House and Senate combine "devolution" of federal authority to the states with rejection of the entitlement approach to welfare benefits. *See, e.g.*, Daniel Patrick Moynihan, *The Devolution Revolution*, N.Y. TIMES, Aug. 6, 1995, at D15 (defining "devolution" as "'causing to descend'- of social welfare programs from the Federal Government to the states", and crediting Richard P. Nathan of the Rockefeller Institute of Government as having coined the phrase).

3. *See infra* notes 50-51, 128 and accompanying text.

4. *See infra* discussion in Subsection I.A.1.

5. House Republican proposals capped funding at current levels and provided for budgetary savings over the next five to seven years. During the welfare reform debate in the House, efforts by Democrats to offer substitute bills that would expand job training, increase the work program participation rates, and increase funding for child care were defeated. *See* 141 CONG. REC. H3695 (daily ed. Mar. 23, 1995) (Deal amendment failed by a vote of 205-228); 141 CONG. REC. H3777 (daily ed. Mar. 24, 1995) (Mink amendment failed). Senator Moynihan's bill to strengthen existing jobs programs and to provide increased funding for child care was not reported out of the Senate Finance Committee. *See* S. 828, 104th Cong., 1st Sess. §§ 101-104 (1995) (proposing the "Family Support Act of 1995"). Efforts by Democrats and moderate Republicans to increase funding for child care were more successful during floor consideration of Senator Dole's bill. A child care amendment by Senator Dodd that would have doubled the funds available under Senator Dole's proposal was tabled by a very close vote. Senator Dole later agreed to increase the amount of child care funds by about \$3 billion for a total of \$8 billion over five years. Robin Toner, *Senators Gain in Move to Pass a Welfare Bill*, N.Y. TIMES, Sept. 15, 1995, at A1, A30.

6. Pub. L. No. 100-485, Title I, 102 Stat. 2343 (1988) (codified as amended at 42 U.S.C. § 602 (1988)). For a more complete description of these programs, the political process leading to their adoption, and a discussion of utilization issues, see Ann Collins & Barbara Reisman, *Child Care Under the Family Support Act: Guarantee, Quasi-Entitlement, or Paper Promise?*, 11 YALE L. & POL'Y REV. 203 (1993).

7. *See infra* text accompanying note 55.

8. *See infra* discussion in Subsection I.A.1.

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low-income working families to families receiving welfare benefits.⁹ Unless child care funding levels are increased and delivery issues are addressed, the proposed new work requirements will magnify current problems. Without consistent and reliable child care, the new work requirements may result in continued cycling between work and welfare,¹⁰ or worse, in the endangerment of children.¹¹

Second, the income tax system has been used to deliver increasingly substantial work-related federal income transfers. An important example of integration of the tax and income transfer systems¹² is the recent expansion¹³ of the refundable earned income tax credit.¹⁴ The earned income tax credit (EITC) provides a refundable tax credit for certain low-income workers and operates as an income support transfer mechanism or an earnings subsidy delivered through the tax system.¹⁵ The EITC now provides work-related income transfers to low-income families in amounts exceeding the total federal contribution¹⁶ to the Aid to Families with Dependent Children¹⁷ (AFDC)

9. See *infra* discussion in Section II.A.

10. See MARY JO BANE & DAVID T. ELLWOOD, *WELFARE REALITIES: FROM RHETORIC TO REFORM* 65 (1994) ("The recognition that long-term welfare use often involves considerable cycling strongly suggests that single mothers may simply be unable to sustain self-support in an economic climate in which jobs pay too little, medical care is often not provided, and child-care costs are high.").

11. See *infra* Section II.A.

12. Tax-transfer integration refers to administering income transfer programs through the tax system. Consolidation of tax and transfer programs need not necessarily result from integration, although replacing numerous income transfer programs with refundable tax credits has been suggested by some. The earned income tax credit (EITC), I.R.C. § 32 (1995), for example, has attempted only tax-transfer integration. See Anne L. Alstott, *The Earned Income Tax Credit and the Limitations of Tax-Based Welfare Reform*, 108 HARV. L. REV. 533, 564 n.122, 564-89 (1995) (challenging the "simple case" for tax-transfer integration and describing how debate over earned income tax credit overstates importance of behavioral disincentives).

13. The earned income tax credit was revised and expanded by the Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, §13131, 107 Stat. 312, 433 (1993).

14. I.R.C. § 32. The earned income tax credit is a refundable credit that reduces the tax liability of an eligible recipient by the amount of the credit. If the recipient does not earn enough to be subject to income tax, the credit amount is refunded by the government after the taxpayer has filed a return for the taxable year. Alternatively, the credit is paid during the year in the form of an "advance payment" option, in which the taxpayer's employer reduces the employment tax withholding amount so that the employee receives a higher take-home amount with each paycheck. See I.R.C. § 3507(c)(2)(i) (providing an advance payment of not more than 60 percent of the credit percentage in effect for an eligible individual with one qualifying child). For a description of benefits levels, see *infra* note 164.

15. See Regina T. Jefferson, *The Earned Income Tax Credit: Thou Goest Whither? A Critique of Existing Proposals to Reform the Earned Income Tax Credit*, 68 TEMP. L. REV. 143 (1995). The EITC is structured as a work incentive for low-income families by phasing in the credit by a percentage of the taxpayer's earned income up to a given income range, at which the maximum benefit applies. When income exceeds a specified amount, the credit is phased out by a percentage rate over a range of income, eventually reaching zero at the end of the phase-out range of income. Thus, the amount of the credit initially increases with earnings, then remains constant as earnings increase, and then decreases with earnings until it is fully phased out. See Janet Holtzblatt et al., *Promoting Work Through the EITC*, 47 NAT'L TAX J. 591, 593-94 (1994) (discussing effect of EITC on work effort). See *infra* discussion accompanying note 164.

16. George K. Yin et al., *Improving the Delivery of Benefits to the Working Poor: Proposals to Reform the Earned Income Tax Credit Program*, 11 AM. J. TAX POL'Y 225, 228-29 (1994). Unless the 1993 expansion is repealed, by FY 1998, the earned income tax credit will cost an estimated \$24.5 billion, taking into account both the revenue reduction and the outlay portion of the EITC. The federal

program, the public assistance program that most people identify as "welfare."¹⁸

The need for additional funds to support work-related child care for the poor and the increased use of the federal income tax system to deliver income transfer payments invite rethinking of the tax system's treatment of child care expenses. This Article examines the current federal child care programs, describes the need for increased assistance, and addresses the issue of whether additional federal child care assistance to low-income families should be provided through the transfer payment system, through the tax system, or through some combination of the two systems. The appropriate delivery mechanism should be separated analytically from the question of how to fund increased child care benefits; practically, however, the two issues often merge.

Proposals to make the child and dependent care tax credit¹⁹ a refundable credit²⁰ have long been offered to reform the federal approach to child care assistance.²¹ In addition, some have advocated further targeting the credit to assist low-income families by completely phasing out the credit at higher income levels, making middle- and upper-income taxpayers ineligible for any benefit.²² Others have made the more categorical suggestion that a family

contribution to the AFDC program by FY 1998 will be an estimated \$16 billion. *Id.* at 229 n.3. As Anne Alstott points out, the EITC will pay "annual aggregate benefits" as large as those paid under the AFDC program (including both federal and state contributions) by FY 1997. Alstott, *supra* note 12, at 534 n.2.

17. 42 U.S.C. §§ 601-687 (1988).

18. Jason DeParle, *In Welfare Debate, It's Now Not How? but Why?*, N.Y. TIMES, May 8, 1994, at D1 (describing President Clinton's campaign promise to "end welfare as we know it").

19. I.R.C. § 21 (1995).

20. A tax credit reduces a taxpayer's tax liability dollar for dollar in the amount of the credit. If the taxpayer owes no tax, a tax credit is of no benefit unless it is refundable.

21. *E.g.*, ABA Section of Taxation, *Report of the Child Care Task Force*, 46 TAX NOTES 331 (1990); Jonathan B. Forman, *Beyond President Bush's Child Tax Credit Proposal: Towards a Comprehensive System of Tax Credits to Help Low-Income Families With Children*, 38 EMORY L.J. 661, 678-79 (1989); Edward J. McCaffery, *Taxation and the Family: A Fresh Look at Behavioral Gender Biases in the Code*, 40 UCLA L. REV. 983, 1059 (1993); Brian Wolfman, *Child Care, Work, and the Federal Income Tax*, 3 AM. J. TAX POL'Y 153, 191 (1984); June H. Zeitlin & Nancy D. Campbell, *Strategies to Address the Impact of the Economic Recovery Tax Act of 1981 and the Omnibus Budget Reconciliation Act of 1981 on the Availability of Child Care for Low-Income Families*, 28 WAYNE L. REV. 1601, 1624-27 (1982) (advocating refundable credit and noting bills were twice approved by the Senate, but not adopted as final legislation, based "less on objection to its cost than on objection to the concept of a refund generally"); Note, *Into the Mouths of Babes: La Familia Latina and Federally Funded Child Welfare*, 105 HARV. L. REV. 1319, 1333-37 (1992).

22. *E.g.*, CARNEGIE TASK FORCE ON MEETING THE NEEDS OF YOUNG CHILDREN, STARTING POINTS: MEETING THE NEEDS OF OUR YOUNGEST CHILDREN 59-60 (April 1994) (recommending (1) that substantial new federal money be channeled into child care in order to make it affordable for parents, perhaps in the form of supplementary block grants to states for child care; and (2) that the Dependent Care Tax Credit be made refundable, with the additional costs of refundability met by lowering the income levels at which the Dependent Care Tax Credit phases out or by decreasing benefit levels for high-income families); Wendy Gerzog Shaller, *Limit Deductions for Mixed Personal/Business Expenses: Curb Current Abuses and Restore Some Progressivity Into the Tax Code*, 41 CATH. U. L. REV. 581, 612 (1992) (proposing that the child care credit be refundable and subject to more restrictive income phase-out provisions); *see also* Douglas J. Besharov, *Fixing the Child Care Credit: Hidden Policies Lead to Regressive Policies*, 26 HARV. J. ON LEGIS. 505 (1989).

A Democratic alternative to the Republican welfare reform initiative, offered on the House floor last

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allowance or refundable children's allowance be delivered through the tax system.²³ Such proposals are now receiving renewed attention,²⁴ as are revived proposals for the adoption of a per-child nonrefundable tax credit.²⁵

This Article focuses specifically on tax-transfer integration of work-related child care assistance. Part I discusses the current child care assistance available to low-income workers through direct transfer programs and through the income tax system. Part II describes the need for increased child care funding and the failure of current welfare reform proposals to meet that need. Part III examines the theoretical and practical issues that must be addressed before the tax system is used as a mechanism for delivering increased child care assistance to low-income families. Part IV critiques a proposed funding mechanism that would redirect tax benefits to lower income taxpayers by eliminating the child care tax credit for middle- and upper-income taxpayers.

March by Representative Deal (then D-Ga), proposed to increase direct funding for child care, to make the child and dependent care tax credit refundable, and to phase it out for families earning between \$60,000 and \$80,000 per year. H.R. 1267, 104th Cong., 1st Sess. §§ 221, 222 (1995). The phaseout was opposed by ranking Republicans, and was defeated as part of the House's rejection of the Democratic alternative. *Archer: Child Care Credit Proposal Would Raise Middle-Class Taxes*, Congressional News Release, reprinted in 95 TNT 58-13 (LEXIS, Fedtax library, TNT file) (Mar. 24, 1995); see *supra* note 1.

23. E.g., Yin et al., *supra* note 16, at 283-86 (proposing that the earned income tax credit be replaced with a social security tax exemption for low-income workers and with a family allowance benefit by providing a refundable income tax credit to any family with children living in the home); NATIONAL COMM. ON CHILDREN, BEYOND RHETORIC: A NEW AMERICAN AGENDA FOR CHILDREN AND FAMILIES 80 (1991); C. EUGENE STEUERLE & JASON JUFFRAS, A \$1,000 TAX CREDIT FOR EVERY CHILD: A BASE OF REFORM FOR THE NATION'S TAX, WELFARE, AND HEALTH SYSTEMS 3-4 (Urban Inst. Changing Domestic Priorities Series 1991); Jonathan B. Forman, *Beyond President Bush's Child Tax Credit Proposal: Towards a Comprehensive System of Tax Credits to Help Low-Income Families With Children*, 38 EMORY L.J. 661, 693-96 (1989); see also C. Eugene Steuerle, *Tax Credits for Low-Income Workers with Children*, 4 J. ECON. PERSP. 201 (1990).

A children's allowance, a more categorical program operated through the tax system, similar to a social insurance system in which families are provided assistance on a per child basis, poses somewhat different conceptual issues. Such transfer payments could be broadly utilized for family support, including expenditures for food, shelter, medicine as well as for child care, and except for generally applicable issues relating to governmental support of families with children, are beyond the scope of this article.

24. See generally Lawrence Zelenak, *Children and the Income Tax*, 49 TAX L. REV. 349 (1994) (discussing various proposals for change).

25. During the 1994 Congressional campaign, over three hundred Republican candidates and incumbents announced their "contract with America" on the steps of the capitol, outlining their legislative agenda if the Republicans gain control of the House of Representatives. The "contract" included a \$500-per-child tax credit. David E. Rosenbaum, *Republicans Offer Voters Deal for Takeover of House*, N.Y. TIMES, Sept. 28, 1994, at A16; John Godfrey, *GOP Unveils Campaign Plan Featuring Tax Cuts*, 94 TNT 191-3 (LEXIS, Fedtax library, TNT file) (Sept. 28, 1994). See H.R. 1215, 104th Cong., 1st Sess. § 101 (1995) (proposing a \$500 tax credit for families with young children, which would be completely phased out at incomes above \$250,000); see also Fred Stokeld, *Senate Republicans Unveil Family Tax Credit Bill*, 95 TNT 156-1 (LEXIS, Fedtax library, TNT file) (Aug. 10, 1995) (reporting introduction of proposed "American Family Tax Relief Act of 1995," under which a \$500 per-child tax credit would be provided to families of all incomes, indexed annually for inflation, and without a phaseout at higher incomes, costing roughly \$164 billion over 7 years and thus comprising about two-thirds of the \$245 billion tax cut authorized by the Senate).

The House and Senate conferees recently agreed to a \$500-per-child tax credit, phasing it out at adjusted gross incomes above \$110,000 for joint returns, and \$75,000 for unmarried individuals. H.R. 2491, 104th Cong., 1st Sess. Title XI, Subtitle A, § 11001 (1995).

This Article concludes that significant practical and theoretical obstacles must be overcome before embracing tax-transfer integration of work-related child care assistance as a welfare reform measure. Although the past political viability of tax-transfer integration and the expansion of the EITC²⁶ have made refundability a pragmatic option²⁷ worth considering for those in favor of increased federal support for child care, the tax system has inherent limitations as a transfer payment delivery mechanism. The EITC provides useful data for evaluating the advantages and disadvantages of using the tax system as a way to administer income transfer programs. Based on experience with the EITC, direct child care assistance (including voucher programs) for low-income workers may make more sense given the practical difficulties of making tax credit advance payment options workable.²⁸ However, a policy decision to redesign the child and dependent care tax credit to provide child care assistance to low-income taxpayers warrants analysis separate from that applied to the EITC. Although the EITC was originally viewed primarily as a means of offsetting the regressive effect of social security taxes on working families,²⁹ the expanded EITC now plays a much greater role as an earnings supplement for poor workers.³⁰

26. Although the earned income tax credit (EITC) enjoyed bipartisan support for nearly twenty years, the 1993 expansion of the EITC has attracted increased political scrutiny and criticism. *See, e.g.,* Steven Pearlstein & Edward Walsh, *Tax Credit for Poor Comes Under Attack: Used and Abused By Many, Program Draws GOP Knives*, WASH. POST, July 30, 1995, at A1. Proposals to reform the EITC or to repeal some of the increases scheduled to take place under the 1993 expansion of the EITC are currently being considered by Congress. *See, e.g.,* STAFF OF THE JOINT COMMITTEE ON TAXATION, SIDE-BY-SIDE COMPARISON (JCX-52-95) OF ESTIMATED BUDGET EFFECTS OF EARNED INCOME TAX CREDIT PROVISIONS OF HR 2491 AS PASSED BY HOUSE AND SENATE, Issued Nov. 8, 1995, *reprinted in* 217 Daily Tax Rep. (BNA) at L-20 (Nov. 9, 1995); STAFF OF THE JOINT COMMITTEE ON TAXATION, DESCRIPTION OF PRESENT LAW AND CURRENT ISSUES RELATING TO THE EARNED INCOME TAX CREDIT, Prepared for June 8 Senate Finance Committee Hearing, Issued June 7, 1995, *reprinted in* 110 Daily Tax Rep. (BNA) at L-7 (June 8, 1995).

27. In addition, the politics of tax legislation can be affected by the distributional effects of a tax bill. For example, the expansion of the EITC was originally viewed as an offset for a regressive BTU energy tax. *See infra* note 30. As has been pointed out in the EITC context, “[c]hanges in the tax law, but not in transfer programs, are taken into account in determining the distributional effect of a tax bill.” Alstott, *supra* note 12, at 540 n.29 (citing Staff of the Joint Comm. on Taxation, 103d Cong., 1st Sess., Methodology and Issues in Measuring Changes in the Distribution of Tax Burdens 2 (Comm. Print 1993)). For example, if revision of the child and dependent care tax credit were to be proposed as part of a tax revision bill containing tax relief for upper income taxpayers, a refundable child care tax credit would provide a distributional offset to such tax provisions. In contrast, an increase in direct child care transfer programs would not be treated as an offset for purposes of describing distributional burdens of tax legislation. *See* Michael J. Graetz, *Pain-By-Numbers Tax Lawmaking*, 95 COLUM. L. REV. 609, 657-61 (1995).

28. *See supra* note 14, and discussion accompanying note 171.

29. Tax Reduction Act of 1975, Pub. L. No. 94-12, § 204, 89 Stat. 26, 30 (1975). *See* S. Rep. No. 36, 94th Cong., 1st Sess. 1, 11 (1975), *reprinted in* 1975 U.S.C.C.A.N. 54, 64 (explaining that the credit was “set at 10 percent in order to correspond roughly to the added burdens placed on workers by both employee and employer social security contributions” and identifying “taxpayers with dependent children [as] those most in need of relief”); H.R. Conf. Rep. No. 120, 94th Cong., 1st Sess. 57, 59 (1975), *reprinted in* 1975 U.S.C.C.A.N. 122, 124 (adopting the Senate version of the earned income credit as the conference substitute).

30. *See* H.R. Rep. No. 111, 103d Cong., 1st Sess. iii, 4, 6, 608-10 (1993), *reprinted in* 1993 U.S.C.C.A.N. 378, 382, 384, 839-41 (explaining that the “expanded EITC allows a full-time minimum

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By contrast, the child and dependent care tax credit may be viewed either as an allowance necessary to reflect employed parents' ability to pay taxes (a structural provision), or as an offset (or "second best" response) to existing nonneutralities created by current approaches to the taxation of the family.³¹ Under either view, the child care tax credit plays a more tax-driven role, serving purposes that must be considered independently from its potential use in facilitating the delivery of child care benefits.

In any event, any increases in federal funding for child care should not be derived from eliminating or capping the credit at upper income levels. A phase-out of the credit would exacerbate already problematic tax nonneutralities affecting two-earner middle- and upper-income families. The goal of more targeted assistance could be better achieved by making the equivalent amount of additional federal outlays available for federally subsidized child care programs.

I. THE CURRENT SYSTEM OF WORK-RELATED CHILD CARE SUPPORT

The current system of work-related child care assistance includes both direct federal child care expenditure programs and various income tax provisions relating to child care expenses. At first glance, the current federal approach to child care assistance appears in need of reform: the largest single source of child care assistance, estimated to total approximately \$2.7 billion in forgone revenue in fiscal year 1995,³² is delivered through the tax system in the form of a nonrefundable credit utilized mostly by middle- and upper-income

wage worker with two children to bring his or her family at least up to the poverty line," and that the EITC would help offset the regressive effects of the BTU energy tax, which the Clinton administration proposed but was not adopted by Congress as part of the final revenue package); H.R. Conf. Rep. No. 213, 103d Cong., 1st Sess. 399, 534-37 (1993), *reprinted in* 1993 U.S.C.C.A.N. 1088, 1223-26. For a detailed description of the legislative history of pre-1990 versions of the earned income tax credit, and the evolving purposes of the credit, see Jonathan B. Forman, *Improving the Earned Income Credit: Transition to a Wage Subsidy Credit for the Working Poor*, 16 FLA. ST. U. L. REV. 41, 45-58 (1988).

31. See *infra* Section III.B.

32. For a more complete explanation of the specific direct expenditure programs being compared to the income tax provisions, see *infra* notes 39-45. The child and dependent care tax credit provides child care assistance in the form of a nonrefundable credit, estimated to total \$2.7 billion in forgone revenue in FY 1995. JOINT COMMITTEE ON TAXATION, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 1995-1999 (JCS-6-94) 18 (Nov. 9, 1994), *reprinted in* Daily Tax Rep. (BNA) No. 216, at L-1, L-43 (Nov. 10, 1994) [hereinafter 1994 JCT TAX EXPENDITURE ESTIMATES]. The estimate remains at \$2.7 billion in forgone revenue for FY 1996. JOINT COMMITTEE ON TAXATION, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 1996-2000 (JCS-21-95) 17 (Sept. 5, 1995), *reprinted in* Daily Tax Rep. (BNA) No. 172, at L-1, L-9 (Sept. 6, 1995) [hereinafter 1995 JCT TAX EXPENDITURE ESTIMATES]. The federal outlay equivalent for 1993 (the year used for comparison purposes with direct expenditure programs) was projected to be \$2.45 billion. HOUSE COMM. ON WAYS AND MEANS, 103d Cong., 2d Sess., OVERVIEW OF ENTITLEMENT PROGRAMS, 1994 GREENBOOK, 546, Table 12-10 (Comm. Print 1994) [hereinafter 1994 GREENBOOK]. The exclusion for employer-provided child care provided by § 129 of the Code was estimated to reduce federal revenues by \$600 million in FY 1995, and \$700 million in FY 1996. 1994 JCT TAX EXPENDITURE ESTIMATES at L-43; 1995 JCT TAX EXPENDITURE ESTIMATES at L-9. For a discussion of § 129, see *infra* text accompanying notes 116-125.

taxpayers;³³ and another set of programs, totalling just over \$2 billion,³⁴ is delivered to low-income families through a patchwork of direct assistance programs designed to serve various political and social goals.³⁵ Tax-transfer integration could be accomplished by delivering increased benefits to low-income working families through the use of a refundable tax credit, with or without the elimination of tax benefits for middle- and upper-income taxpayers. Alternatively, consolidation could be achieved either (i) by repealing the tax credit and reallocating the resulting additional federal revenues to the various direct assistance programs; or (ii) by repealing some or all of the direct assistance programs, and providing increased benefits to low-income families through a refundable tax credit.³⁶

Upon closer examination, however, the comparison of the direct expenditure programs and funding levels with the amount of revenue forgone by the tax system through child care allowances suggests a false fungibility between the two systems. Solving the funding issue by reallocating child care assistance provided through the tax system ignores basic differences in purpose and design between the two systems.³⁷ Attempting to target the tax provisions to assist low-income families, while at the same time eliminating benefits for middle- and upper-income taxpayers, may exacerbate basic structural problems related to taxation of the family.³⁸ At least initially, therefore, consideration of the appropriate delivery mechanism for increased benefits should be analyzed separately from the funding issues.

In considering the appropriate delivery mechanism for increased benefits, the advantages and disadvantages of tax-transfer integration need to be evaluated in light of past experience with program design issues. This Part focuses on design features of the current direct expenditure programs and the tax system. The following section discusses the direct federal child care expenditure programs designed to provide work-related child care assistance to welfare recipients and to other low-income persons in danger of becoming welfare recipients. It describes the direct expenditure programs in some detail as a background for Part II's discussion of the availability and quality of such

33. See *infra* Subsection I.B.1.

34. For an explanation of how this amount was derived, see notes 40-45. It is difficult to estimate total federal expenditures for child care with any precision because of reporting gaps and the existence of numerous child care components within separate federal programs. See generally 1994 GREENBOOK, *supra* note 32 (depending on how child care is defined, studies have listed from 28 to 46 separate federal programs that include some type of child care or related assistance, such as federal student aid assistance provided to students with child care expenses or supportive services for participants under the Job Training Partnership Act). *Id.* at 544-45. The amount of federal funds for child care services under many such programs is unknown. *Id.* at 545.

35. See *infra* Section I.A.

36. See generally Jonathan B. Forman, *Synchronizing Social Welfare Programs and Tax Provisions*, 59 TAX NOTES 417, 421-23 (Apr. 19, 1993) (proposing replacement of most of current social welfare system with system of refundable tax credits).

37. See *infra* discussion at Part III.

38. See *infra* discussion at Part IV.

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work-related child care. This Part ends with an explanation of the income tax provisions and the structural features that lead to greater utilization of the child care provisions by middle- and upper-income taxpayers.

A. Direct Financing of Child Care Services

Key direct assistance programs include child care³⁹ provided under the Family Support Act of 1988 to AFDC and former AFDC recipients,⁴⁰ the At-Risk Child Care Program,⁴¹ the Child Care and Development Block Grant Program,⁴² various expenditures under the Social Services Block Grant Program of Title XX of the Social Security Act,⁴³ and to a limited extent, the Head Start program.⁴⁴ Not counting federal expenditures for Head Start,

39. Although it does not directly provide child care, the Child and Adult Care Food Program, part of the National School Lunch Act of 1946, codified at 42 U.S.C. § 1766 (1988), provides commodities and federal grants-in-aid for food served to children in licensed child care centers, and in family or group day care homes. 42 U.S.C. § 1766(a); *see also* 42 U.S.C. § 1766(a)(1) (licensing requirement). The subsidies and reimbursement rates vary depending upon whether the services are provided in child care centers or a family or group home setting. 42 U.S.C. § 1766(f). It is difficult to ascertain amounts expended on work-related pre-school and after-school child care programs. The program as a whole was funded at \$1.3 billion for FY 1993. 1994 GREENBOOK, *supra* note 32, at 580 (stating that the "vast majority of children served are between 3 and 5 years old").

40. Pub. L. No. 100-485, Title III, 102 Stat. 2343 (1988), (codified as amended at 42 U.S.C. § 602 (1988)). Fiscal year 1993 outlays for AFDC and transitional child care assistance combined totaled \$588 million. 1994 GREENBOOK, *supra* note 32 at 546, Table 12-10.

41. Pub. L. No. 101-508, Ch. 6, § 5081, 104 Stat. 1388-233 (1990) (codified at 42 U.S.C. § 602(i) (Supp. 1992)). Total federal outlays for fiscal year 1993 were \$308 million. 1994 GREENBOOK, *supra* note 32, at 546, Table 12-10.

42. 42 U.S.C. §§ 9858, 9858a-q (1992). Fiscal year 1993 outlays totaled \$732 million, out of \$893 million appropriated for the program. 1994 GREENBOOK, *supra* note 32, at 546, Table 12-10, 574.

43. 42 U.S.C. § 1397 (1988). The Social Services Block Grant Program was created by the Omnibus Budget Reconciliation Act of 1981, Pub. L. No 97-35, § 2352, 95 Stat. 357. No figures are available on the total child care assistance provided through this program. Based on information from thirty-three states, The Ways and Means Committee estimated that child care services accounted for 15 percent of FY 1989 expenditures. HOUSE COMM. ON WAYS AND MEANS, 103d Cong., 1st Sess., OVERVIEW OF ENTITLEMENT PROGRAMS, 1993 GREENBOOK 1015 (Comm. Print 1993) [hereinafter 1993 GREENBOOK]; *see also* 1994 GREENBOOK, *supra* note 32, at 578 (estimating based on data from twenty-three states that child care services accounted for 16 per cent of FY 1990 Title XX expenditures). That percentage may decline after implementation of the Child Care and Development Block Grant program, adopted in 1990, and with the increased child care funds available for AFDC recipients after enactment of the Family Support Act of 1988. *See* 1993 GREENBOOK, *supra*, at 1016-17. Legislation permanently authorized \$2.8 billion annually for the program, beginning in FY 1990. 42 U.S.C. § 1397b(c)(5). Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, Title VIII, § 8016, 103 Stat. 2470. The total fiscal year 1993 federal outlays for the program amounted to \$2.8 billion. 1994 GREENBOOK, *supra* note 32, at 546, Table 12-10.

44. 42 U.S.C. §§ 9831-9852 (1988) (Head Start Programs); 42 U.S.C. §§ 9855, 9855a-g (1988) (Head Start Transition Project). The Head Start program was not originally designed to be a child care program for parents working full-time; it had only a part-day schedule and no summer program. In 1993, Head Start served only 36% of eligible children, with total federal funding of \$2.7 billion. *See* CHILDREN'S DEFENSE FUND, THE STATE OF AMERICA'S CHILDREN 29-30 (1994); 1994 GREENBOOK, *supra* note 32, at 835, Table 18-37. The Human Services Amendments of 1994, approved May 18, 1994, expanded the program and now allows local programs to offer full-day, full-year programs for working parents with eligible children. Congress authorized increased funding levels "consistent with the President's fiscal year 1995 budget request for Head Start, including a projected annual increase of \$700 million for each of the next four fiscal years." H.R. Conf. Rep. No. 497, 103d Cong., 2d Sess. (1994), *reprinted in* 1994 U.S.C.A.N. 666, 667; Pub. L. No. 103-252, Title I, § 104, 108 Stat. 623, 625 (1994). The 1994 amendments direct the Secretary of Health and Human Services to conduct "a

federal child care assistance from these programs totalled roughly \$2.05 billion for fiscal year 1993.⁴⁵

Several design features of federal direct assistance programs affect the availability and quality of work-related child care. First, some of the federal program funding structures require states to provide their own funds as a prerequisite for receiving federal money. The states' failure to allocate sufficient funds, as well as federal limitations on certain federal matching funds, have resulted in deficiencies in implementation of the programs. Second, some of the federal funding programs, especially the block grant programs, have required expenditures to improve the quality of the child care services. The possibility of losing child care improvement funding in the current round of welfare reform, along with any resulting relaxation of minimum standards, is worrisome. Even at current funding levels, the child care received by many low-income children has raised concerns about their health and safety.⁴⁶ In addition, the block grant programs have provided child care assistance to low-income families that do not receive welfare. The increased child care needs of welfare recipients under new work requirements, without increased funding levels, may prevent these other low-income families from receiving the assistance they need.⁴⁷

The following discussion of the key programs first addresses the programs structured as entitlement-type, federal matching fund programs, the Family Support Act programs and the At-Risk Child Care Program, and then turns to a discussion of the program requirements under the current federal child care block grant programs.

study of the extent to which Head Start programs are addressing the need for Head Start services during a full working day or full calendar year among eligible low-income families with pre-school children," and to report the findings of the study to Congressional committees by January 31, 1997. Pub. L. No. 103-252, Title I, § 126, 108 Stat. 623, 650 (1994). Some limited programs are also to be made available for pregnant women, and for infants and children under three years of age. Pub. L. No. 103-252, Title I, § 112(c), 108 Stat. 623, 639 (May 18, 1994) (to be codified at 42 U.S.C. § 9840). In addition, \$35 million was authorized for each fiscal year 1995 through 1998 to provide funding for the Head Start Transition Project (which provides particular services to Head Start children during their elementary school years), and the programs designed to enhance parental involvement and transition coordination with the schools their children attend. 42 U.S.C. § 9834.

Although the 1994 amendments authorize additional funds for Head Start expansion, members of congressional appropriations committees predicted that funding would fall short of the amounts authorized. See Helen Dewar & Barbara Vobejda, *Clinton Signs Head Start Expansion: President's \$700 Million Promise on Crash Course With Budget Caps*, WASH. POST, May 19, 1994, at A1 (reporting that the Senate Appropriations subcommittee "could finance only 18 cents for every dollar Clinton has proposed, an estimate based on the spending freeze required by the budget and preliminary allocations among appropriations accounts"); 1994 GREENBOOK, *supra* note 32, at 835, Table 18-37 (estimating FY 1994 appropriations totalling \$3.32 billion).

45. That amount includes \$588 million for AFDC and TCC child care, \$308 million for the At-Risk program, \$732 million for the Child Care and Development Block Grant program, and approximately 15 per cent of the \$2.8 billion for Title XX child care. Head Start was not included in the estimate because it provides mostly part-day services. See *supra* notes 40-44.

46. See *infra* Section II.A.

47. See *infra* Subsection II.A.

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1. Entitlement-Type Federal Matching Fund Programs

The major entitlement-type federal matching fund programs are provided under the Family Support Act of 1988 (FSA), which was enacted during the last major reform of the welfare system.⁴⁸ The FSA created the Job Opportunity and Basic Skills (JOBS) program⁴⁹ to replace the Work Incentive Program (WIN), established in 1967.⁵⁰ It also mandated improved procedures for child support enforcement and the establishment of paternity, guaranteed federal assistance for child care during participation in education, training, and employment (AFDC-related child care),⁵¹ and provided transitional eligibility for a year of extended child care and medical assistance for former AFDC recipients who become ineligible for AFDC because of increased income from employment (transitional child care).

The JOBS program is funded through a capped federal entitlement under which states are partially reimbursed (pursuant to a federal matching rate) for each dollar spent on JOBS until they reach the maximum amount allocated to them.⁵² Few states, however, have fully utilized their allotment.⁵³ Budget

48. See *supra* note 40. The Family Support Act revised the AFDC program to emphasize work, child support, and family benefits, and amended Title IV of the Social Security Act to assist parents in obtaining education, training, and employment needed to avoid long-term welfare dependence. H.R. Conf. Rep. No. 998, 100th Cong., 2d Sess. 1 (1988).

49. 42 U.S.C. §§ 681-687 (1988). All States were required to have a JOBS program in place by October 1, 1990, and to offer services statewide by October 1, 1992. 42 U.S.C. § 682(a)(1)(D)(i). All of the states met both deadlines. Hearings Before the House Comm. on Gov't Operations, 103d Cong., 2d Sess. (May 3, 1994) (statement of Diann Dawson, Acting Director, Office of Family Assistance, Administration for Children and Families, U.S. Dept. of Health and Human Services).

50. Pub. L. No. 90-248, Title II, Part 1, § 204, 81 Stat. 884. Work requirements were imposed on AFDC recipients under WIN, but were not very effective due to weak funding and enforcement. See, e.g., JOEL F. HANDLER & YEHESKEL HASENFELD, *THE MORAL CONSTRUCTION OF POVERTY: WELFARE REFORM IN AMERICA* 141-42 (WIN I), 156-58 (WIN II); LAWRENCE M. MEAD, *BEYOND ENTITLEMENT: THE SOCIAL OBLIGATIONS OF CITIZENSHIP* 148-68 (1986). Although potentially subject to the original WIN work requirements, mothers with preschool children were determined by many states to be "inappropriate" for job training or work and thus as exempt from the work requirement. See MIMI ABRAMOVITZ, *REGULATING THE LIVES OF WOMEN: SOCIAL WELFARE POLICY FROM COLONIAL TIMES TO THE PRESENT* 341 (1988) (attributing the exemption to limited funding, a lack of child care, and an excess of welfare recipients over WIN slots). As amended in 1971, WIN II required participation by mothers with children 6 years of age or older. See HANDLER & HASENFELD, *supra* at 154.

51. All AFDC recipients, except those exempted by law, are required to participate in JOBS. 42 U.S.C. § 602(a)(19)(B)(i). The parent caretaker of a child under six years of age may be required to participate only if child care is guaranteed and participation is limited to 20 hours per week. 42 U.S.C. at § 602(a)(19)(C)(iii)(II). A parent caretaker of a child under three years of age is exempt from participation, unless required to participate under State option. 42 U.S.C. at § 602(a)(19)(C)(iii)(I). Most states, however, exempt caretakers of children under the age of three from the work requirements. See 1994 GREENBOOK, *supra* note 32, Table 10-4, at 344-48 (listing eight states exempting only those caretakers with children under age one, and four states and the Virgin Islands exempting those with children under age two). See generally MARY JO BANE & DAVID T. ELLWOOD, *WELFARE REALITIES: FROM RHETORIC TO REFORM* 62 (1994) (arguing that the evidence from a 21-year panel study of income dynamics suggests that past targeting of women with older children was incorrect).

52. The JOBS program has a capped entitlement of \$1 billion in FY 1993, \$1.1 billion in FY 1994, \$1.3 billion in FY 1995, and \$1.0 billion thereafter. 1994 GREENBOOK, *supra* note 32, at 342. The federal match rate for JOBS is 90% for expenditures up to the amount that each state was allotted under

constraints on the states as well as the cost of child care are among the reasons identified for the less than full implementation of the JOBS program.⁵⁴ In many states, the same amount was spent on AFDC and transitional child care as on the JOBS program itself.⁵⁵

In contrast to the capped entitlement funding for the JOBS program, the federally mandated child care assistance for JOBS participants is an open-ended entitlement for which the states receive federal matching funds at the Medicaid rate.⁵⁶ State welfare agencies administer the program, and may provide child care directly, arrange for care through providers by purchase of service contracts or vouchers, provide families with advance cash or vouchers, reimburse families, or use other appropriate arrangements.⁵⁷ Under a method

the WIN program, and funds above that amount are matched at the Medicaid matching rate. The Medicaid matching rate is adjusted annually; in 1994, the rate was 50% to 83% (with a high rate of 78.85%) depending upon the state's per capita income. *Id.* at 789. There is a minimum of 60% for certain types of expenditures such as JOBS staff and nonadministrative costs). *Id.* at 342. Under WIN, the total allotment for all the states was \$126 million, and the remainder of the JOBS entitlement cap is allocated to each state according to its relative number of adult AFDC recipients. *Id.*

53. About 70 percent of the federal funds available were claimed by the states in FY 1993 (stating that only sixteen states were able to "draw down" their full federal allotment). Of the \$1.0 billion federal funds authorized for the JOBS program in FY 1993, \$738.8 million was obligated to the states and \$646.6 million had been expended for the program through September 30, 1993. 1994 GREENBOOK, *supra* note 32, at 349, Table 10-5. The states' total expenditures for FY 1992 equaled approximately two-thirds of the \$1 billion available. 1993 GREENBOOK, *supra* note 43, at 634, 641, Table 4 ("Due to tight budgets, only about two-thirds of the eligible Federal funds were claimed by States in fiscal year 1992."); *Hearings on H.R. 4605 Before the House Ways and Means Comm.*, 103d Cong., 2d Sess. (July 14, 1994) (Statement of Donna E. Shalala, Secretary of Health and Human Services) ("States spent only slightly more than two-thirds (68 percent) of the total available Federal JOBS allotment in fiscal year 1992.").

54. The states are required to reach certain participation levels, starting at 7% in 1990 and reaching 20% by 1995. *Hearings Before the Subcomm. on Human Resources of the House Comm. on Ways and Means*, 103d Cong., 2d Sess. (Mar. 15, 1994) (statement of Irene Lurie, Co-Principal Investigator, JOBS Implementation Study, Rockefeller Institute of Government); *see also Hearings on the Work and Responsibility Act of 1994, S.2224, Before the Comm. on Finance*, 103d Cong., 2d Sess. (July 13, 1994) (Statement by Donna Shalala, Secretary, U.S. Dept. of Health and Human Services) (stating that only 16 percent of mandatory participants engaged in JOBS work or training activities in fiscal year 1992, and that only 43 percent of the adult caseload are considered mandatory participants); *Hearings Before the Subcomm. on Human Resources of the House Comm. on Ways and Means*, 103d Cong., 2d Sess. (Mar. 15, 1994) (statement of Mark Greenberg, Senior Staff Attorney, Center for Law and Social Policy) (stating that national participation is approximately 11% of adult AFDC recipients, based on FY 1992 data, and even if states were spending all of their capped entitlements, JOBS would reach no more than about 20% of the AFDC population); *see also* 1994 GREENBOOK, *supra* note 32, at 356 (stating that "[a]pproximately 16% of adult non-exempt AFDC recipients were counted as participants of the JOBS program during fiscal year 1992").

55. *Hearings Before the Subcomm. on Human Resources of the House Comm. on Education and Labor*, 103d Cong., 2d Sess. (Apr. 19, 1994) (statement of Raymond C. Scheppach, Executive Director, National Governor's Association); *see* 1994 GREENBOOK, *supra* note 32, at 349, Table 10-5 (\$646.6 million total federal funds expended on JOBS in 1993, compared to \$582.5 million in JOBS-related child care). It is estimated that about \$668 million will be expended on AFDC child care and for TCC in fiscal year 1994. *Id.* at 553, Table 12-11.

56. 42 U.S.C. § 602(g)(3); *see* 1994 GREENBOOK, *supra* note 32, at 342. For a discussion of the Medicaid matching rate, *see supra* note 52.

57. 42 U.S.C. § 602(g)(1)(B); *see* 1994 GREENBOOK, *supra* note 32, 554-55, Table 12-12 (state-by-state listing of methods used in providing AFDC child care). *See generally* JAN L. HAGEN & IRENE LURIE, ROCKEFELLER INSTITUTE OF GOVERNMENT, CHILD CARE SERVICES AND JOBS: LOCAL IMPLEMENTATION (July 1993) (describing field research findings of a ten-state study, conducted June-

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of providing assistance referred to as a child care “disregard,”⁵⁸ states may also exempt a certain amount of the value of child care services from the income of a family in determining the amount of AFDC benefits to which they are entitled. Reimbursement for child care costs are subject to certain limits.⁵⁹ States vary in the mix of AFDC child care arrangements provided to JOBS recipients. On the whole, however, about forty percent of the children are in child care centers, about twenty-five percent in non-relative family day care, and about eighteen percent are provided care by a relative.⁶⁰

As stated above, the FSA also guarantees time-limited Transitional Child Care (TCC), to the extent that child care is necessary for employment, in the case of families no longer eligible for AFDC support because of increased hours or increased income from employment, or because of the loss of the child care disregard due to time limitations.⁶¹ Families are eligible for TCC “for a period of 12 months after the last month for which the family received [AFDC],”⁶² if they “have received [AFDC] in at least 3 of the 6 months immediately preceding the month in which the family became ineligible for [AFDC].”⁶³ They must contribute to the cost of child care under a sliding scale formula established by the state.⁶⁴ The federal share of TCC is based on the state’s Medicaid matching rate,⁶⁵ and the program generally operates under the same rules as the child care program for AFDC recipients. The limited data available show that the mix of TCC child care arrangements used by the states roughly echoes that of the child care provided to AFDC JOBS recipients, with a slightly greater percentage in center-based care and a smaller percentage receiving care from relatives.⁶⁶

August 1991, on the local implementation of child care services in conjunction with the JOBS program).

58. 1994 GREENBOOK, *supra* note 32, at 549; *see* 42 U.S.C. § 602(g)(1)(E) (providing that the value of child care “(i) shall not be treated as income for purposes of any other Federal or federally-assisted program that bases eligibility for or the amount of benefits upon need, and (ii) may not be claimed as an employment-related expense for purposes of the [dependent care tax] credit”). The maximum of the child care disregard is \$175 per month per child age 2 and over and \$200 per month per child under age 2. 42 U.S.C. § 602(a)(8)(A)(iii).

59. The payment may not be more than the lower of the cost of the care or a statewide limit (either the child care disregard amount or some higher amount). 42 U.S.C. § 602(g)(1)(C)(i). In addition, it may not be more than the 75th percentile of the local market rate for the type of care being provided, as determined by each state. *See* 42 U.S.C. § 602(g)(1)(C)(ii); 1994 GREENBOOK, *supra* note 32, at 549 n.8 (“To determine the 75th percentile, child care rates are ranked from lowest to highest. Starting from the bottom of the list, the amount separating the 75 percent of the providers with the lowest rates from the 25 percent with the highest rates is the 75th percentile.”). This restriction on the cost of care has been criticized as having a “chilling effect” on state payment rates and as preventing families from being able to pay for quality care. Collins & Riesman, *supra* note 6, at 229.

60. 1994 GREENBOOK, *supra* note 32, at 563-65, Table 12-16.

61. 42 U.S.C. § 602(g)(1)(A)(ii); 42 U.S.C. § 602(a)(8)(B)(ii)(II).

62. 42 U.S.C. § 602(g)(1)(A)(iii).

63. 42 U.S.C. § 602(g)(1)(A)(iv).

64. 42 U.S.C. § 602(g)(1)(A)(vii).

65. 42 U.S.C. § 602(g)(3)(A)(ii).

66. Of the total number of families served by TCC, about 46 percent use center care, about 21 percent are in family day care provided by a nonrelative, and 12 percent are receiving child care from a relative. 1994 GREENBOOK, *supra* note 32, at 573, Table 12-20.

In addition to the FSA child care programs, a capped entitlement program established in 1990, the At-Risk Child Care Program,⁶⁷ provides federal matching funds⁶⁸ for states to provide child care services for low-income families⁶⁹ who are "at risk" of becoming welfare recipients if they do not receive work-related child care.⁷⁰ Families are required to contribute to the cost of care on a sliding fee schedule based on the family's ability to pay.⁷¹ The At-Risk Child Care program is otherwise structured similarly to the AFDC and TCC child care programs.⁷² Child care providers, except those providing care solely to family members, must be licensed, regulated, or registered.⁷³ States are allocated limits based on an allocation formula⁷⁴ (with allocation amounts carried over to the following year if not utilized),⁷⁵ and the amount received by the state is based on the state's Medicaid matching rate.⁷⁶ However, the shortage of state child care matching funds has made it difficult for states to draw their full allotment of federal At-Risk Program funds.⁷⁷

2. *The Federal Child Care Block Grant Programs*

The Child Care and Development Block Grant (CCDBG) program,⁷⁸ also created in 1990,⁷⁹ provides funding for child care services to low-income

67. The program was created by the Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, Ch. 6, § 5081, 104 Stat. 1388-233 (1980) (codified as amended at 42 U.S.C. § 602 (Supp. IV 1992)). A total of 48 states were approved to operate programs in 1992, with 26 actually operating programs during the first six months of 1992. 1993 GREENBOOK, *supra* note 43, at 992. As of 1993, all states except Louisiana had been approved to operate programs, and only one state, Mississippi, did not operate a program in that year. 1994 GREENBOOK, *supra* note 32, at 551.

68. The program is authorized as a capped entitlement at \$300 million annually. 42 U.S.C. § 603(n)(2)(B) (Supp. IV 1992).

69. The states decide how "low-income" is defined. Some states use the federal poverty index (or some percentage of it, such as, 120% of the poverty index). Some states use the state median income (with an eligibility ceiling, such as, 33% of state median income). Others use the sliding fee scale devised to calculate the family's contribution to the cost of the care. 1993 GREENBOOK, *supra* note 43, at 992.

70. 42 U.S.C. § 602(i)(1).

71. 42 U.S.C. § 602(i)(3)(A).

72. *See* 42 U.S.C. § 602(i)(2); 1994 GREENBOOK, *supra* note 32, at 558-60, Table 12-14 (state-by-state summary of at-risk child care options).

73. 42 U.S.C. § 602(i)(5)(C)(i); *see* 1994 GREENBOOK, *supra* note 32, at 550.

74. 42 U.S.C. § 603(n)(2)(A) (Supp. IV 1992).

75. 42 U.S.C. 603(n)(2)(C) (Supp. IV 1992). In FY 1993, federal outlays for the program totalled \$308 million. 1994 GREENBOOK at 546, 557 (\$271.8 million to the states).

76. 42 U.S.C. § 603(n)(1) (Supp. IV 1992). *See* 1994 GREENBOOK, *supra* note 32, Table 12-10, at 546.

77. *See* CHILDREN'S DEFENSE FUND, THE STATE OF AMERICA'S CHILDREN YEARBOOK 34 (1994) [hereinafter 1994 YEARBOOK] ("As of August 1993, states had failed to claim a total of \$63.5 million—21 percent—of the \$300 million budgeted for FY 1992."); 1994 GREENBOOK, *supra* note 32, Table 12-13, at 557 (preliminary data showing \$271 million in 1993 actual expenditures, which may include carryovers of previous year allotments).

78. 42 U.S.C. §§ 9858, 9858a-q (Supp. V 1993).

79. Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, Title V, Subtitle A, Ch. 6, § 5082, 104 Stat. 1388-236, which amended the Omnibus Budget Reconciliation Act of 1981, Title IV, subtitle A, Ch. 8, Pub. L. No. 97-35 by inserting a new subchapter C, the Child Care and Development Block Grant Act of 1990.

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families,⁸⁰ as well as for efforts to improve the quality and supply of child care in general.⁸¹ Federal funds are distributed to states, territories, and tribes under a formula,⁸² and no matching funds are required. States are required to use twenty-five percent of their allotments for activities to improve the quality of child care⁸³ and to increase the availability of early child development and before- and after-school programs.⁸⁴ Child care services are funded from a portion of the remaining seventy-five percent of the state's allotment.⁸⁵ Payment rates for child care services provided under the program must be "sufficient to ensure equal access for eligible children to comparable child care services . . . that are provided to children whose parents are not eligible to receive" federal or state child care assistance.⁸⁶

States are required to give eligible families the option of enrolling their children with an eligible provider or receiving a child care certificate with which they can purchase child care.⁸⁷ Providers must meet all state or local licensing or regulatory requirements,⁸⁸ and must meet certain health and safety requirements.⁸⁹ In addition, states are required to conduct a review of

80. Low-income families are families with incomes at or below 75% of the state's median income for a family of the same size. 42 U.S.C. § 9858n(4)(B). Children of such families are eligible for child care services if they are under age thirteen and reside with a parent (or parents) who are working or attending a job training or educational program. 42 U.S.C. § 9858n(4). In addition, children in need of protective services are eligible regardless of their parents' job or school status. *Id.* Priority must be given to serving children in very low-income families and children with special needs. 42 U.S.C. § 9858c(c)(3)(B)(i). The value of any child care provided to families under the program is not treated as income for purposes of other federal or federally-assisted programs that base eligibility or benefits on need. 42 U.S.C. § 9858q.

81. 42 U.S.C. §§ 9858a, 9858c(c)(3).

82. 42 U.S.C. § 9858m.

83. 42 U.S.C. §§ 9858c(c)(3)(C), 9858e.

84. 42 U.S.C. §§ 9858c(c)(3)(C), 9858f. School-age child care programs and services also receive limited federal funding support from state dependent care planning and development grants. Augustus F. Hawkins Human Services Reauthorization Act of 1990, Pub. L. No. 101-501, 104 Stat. 1222 (1980) (codified as amended at various sections of 42 U.S.C.). Funds are allocated based on state population, and states are required (unless a waiver is requested) to use 60 percent of their grants on before- and after-school child care programs and services targeted to low-income families. The services are required to meet state and local licensing requirements. For FY 1993, the program received \$12.9 million in appropriations. The program is authorized through FY 1994. 1994 GREENBOOK, *supra* note 32, at 579.

A recent national study of before-and-after-school programs reported that such programs serve a small percentage (12%) of families receiving public assistance. PATRICIA S. SEPPANEN ET AL., U.S. DEPT' OF EDUCATION, NATIONAL STUDY OF BEFORE & AFTER SCHOOL PROGRAMS 3 (1993). In addition, it concluded that because the programs depend heavily on parent fees for operating revenue, "[t]he development of a school-age child care system that is accessible to all families depends on the availability of additional support for the tuition costs of families ineligible for government support who nevertheless want to use before- and after-school care but cannot pay the whole cost." *Id.* at 16.

85. 1994 GREENBOOK, *supra* note 32, at 575 (stating that although regulations provide that 90% of the remainder must be used for services, grantees can spend more than the limit on administrative costs of setting up a voucher program if granted federal permission).

86. 42 U.S.C. § 9858c(c)(4)(A).

87. 42 U.S.C. § 9858c(c)(2)(A)(i). A provider receiving direct assistance from the program may not use the assistance for any sectarian purpose. 42 U.S.C. § 9858k(a). No such restriction applies to providers that receive a child care certificate from a parent. *See* 42 U.S.C. § 9858k(a); *see also* 42 U.S.C. § 9858l (religious nondiscrimination provisions).

88. 42 U.S.C. § 9858c(c)(2)(E).

89. 42 U.S.C. §§ 9858c(c)(2)(F) and (G).

their child care licensing and regulatory requirements and policies, unless they have done so in the last three years.⁹⁰

In addition to the CCDBG program, some child care funds are available through the Social Services Block Grant Program of Title XX of the Social Security Act.⁹¹ Title XX block grants operate as a capped entitlement, with no state matching requirement, under which states are allocated funds pursuant to a formula based on their relative population.⁹² The program gives the states flexibility in designing their social services programs.⁹³ Most states spend some portion of their block grants on child care services,⁹⁴ and some but not all states determine eligibility for child care services based on income standards.⁹⁵

B. *The Income Tax Work-Related Child Care Provisions*

The Internal Revenue Code provisions specifically addressing child care expenses are § 21, the child and dependent care tax credit, and § 129, the exclusion from income for certain employer-provided child care benefits.⁹⁶ These provisions provide tax benefits to all working parents, but upper- and middle-income taxpayers utilize them the most for reasons explained below.⁹⁷ The following subsection describes in greater detail how the child care credit and employer-provided child care exclusion provisions work, and how the current design of these provisions makes it difficult for low-income taxpayers to benefit from them.

90. 42 U.S.C. § 9858c(c)(2)(I).

91. 42 U.S.C. §§ 1397 (1992), 1397a-f (1992 & Supp. 1995).

92. 42 U.S.C. § 1397b(b).

93. 42 U.S.C. §§ 1397, 1397a(a)(1), (a)(2)(A) (stating that services funded may include child care services).

94. *See supra* note 43.

95. 1994 GREENBOOK, *supra* note 32, at 578-79 (summarizing FY 1990 data indicating that 20 states determined eligibility for child care services based on income standards; 16 states considered AFDC recipients as eligible for Title XX child care; and 15 states considered individuals to be eligible for Title XX child care without regard to income).

96. Although not specifically aimed at the child care expenses of working parents, the earned income tax credit, I.R.C. § 32 (1995), provides a refundable tax credit for certain families with children (and after 1993, limited benefits to certain workers without children), and the personal exemption deduction for dependents, I.R.C. § 151 (1995), provides an adjustment in computing taxable income to account for the added household costs for those taxpayers supporting children. *But see* I.R.C. § 151(d)(3) (providing for a phaseout of personal exemptions for taxpayers with adjusted gross incomes above certain threshold amounts). *See generally* Zelenak, *supra* note 24 (discussing current law child tax benefits, including dependency exemptions, head of household status, the refundable earned income credit, and the child care credit, and reviewing proposals for reform); Deborah H. Schenk, *Simplification for Individual Taxpayers: Problems and Proposals*, 45 TAX L. REV. 121, 127-49 (1989) (proposing simplification reforms for low-income taxpayers including issues related to the dependency exemption, marital status and filing status, the earned income tax credit, the child care credit, and proposing a support allowance).

97. *See infra* text accompanying notes 104-115.

Child Care Tax Credit

1. Section 21—How It Works

Section 21 provides a nonrefundable tax credit, the amount of which is equal to an “applicable percentage”⁹⁸ of the eligible employment-related child care expenses⁹⁹ paid by the taxpayer during the year.¹⁰⁰ The applicable percentage, which ranges on a sliding scale of twenty to thirty percent, varies with adjusted gross income. The amount of child care expenses that may be taken into account depends upon the number of children¹⁰¹ included in the taxpayer’s household. Eligible expenses are limited to \$2,400 per year for one child, and \$4,800 per year for two or more children.¹⁰² A taxpayer with adjusted gross income of \$10,000 or less receives a credit of thirty percent of employment-related expenses. The credit percentage declines by one percentage point for each \$2,000 (or fraction thereof) in adjusted gross income above \$10,000, but in no case is the applicable percentage reduced below twenty percent.¹⁰³ For taxpayers with adjusted gross incomes greater than \$28,000, therefore, the applicable percentage is twenty percent. For taxpayers with adjusted gross income of \$10,000 or less, thus qualifying for the highest applicable percentage of thirty percent, the maximum credit is \$720 for one child, and \$1,440 for two or more children. For taxpayers with incomes in excess of \$28,000, thus qualifying for the lowest applicable percentage of twenty percent, the maximum credit is \$480 for one child, and \$960 for two or more children.

The amount of the dependent care credit and the applicable percentage income phase-down schedule have not changed since 1981. Income tax thresholds, however, have substantially increased since then.¹⁰⁴ Thus,

98. I.R.C. § 21(a)(2) (1995).

99. Section 21(b)(2) defines employment-related expenses as amounts paid for household services and for the care of any “qualifying individual,” but only if the expenses are “incurred to enable the taxpayer to be gainfully employed for any period for which there are 1 or more qualifying individuals with respect to the taxpayer.” Employment-related expenses do not include “any amount paid for services outside the taxpayer’s household at a camp where the qualifying individual stays overnight.” I.R.C. § 21(b)(2) (1995).

100. I.R.C. § 21(a)(1) (1995).

101. Section 21(a) refers to “qualifying individuals” rather than children. Section 21(b)(1) defines “qualifying individuals” as including three categories of individuals: (1) a dependent under the age of 13; (2) a dependent who is physically or mentally incapable of self-care; or (3) the spouse of the taxpayer, if physically or mentally incapable of self-care. I.R.C. §§ 21(a), 21(b)(1) (1995).

102. I.R.C. § 21(c) (1995). The amount is reduced by any amount excludable from gross income under section 129. *Id.* In addition, the amount of the employment-related expenses may not exceed the lower of earned income of the taxpayer or the taxpayer’s spouse. I.R.C. § 21(d)(1) (1995). However, if the taxpayer’s spouse is a full-time student or incapable of self-care, a monthly amount of income is deemed to be earned by the spouse in the amount of \$200 (if the \$2,400 limit applies), or \$400 (if the \$4,800 limit applies). I.R.C. § 21(d)(2) (1995).

103. I.R.C. § 21(a)(2) (1995).

104. See Jonathan B. Forman, *Beyond President Bush’s Child Tax Credit Proposal: Toward a Comprehensive System of Tax Credits to Help Low-Income Families With Children*, 38 EMORY L.J. 661, 686 (1989) (observing that in 1989, a hypothetical family of four “would not be subject to income taxation until its income exceeded \$13,200, up from \$7,400 in 1982”). The applicable percentage phase-down schedule is even more out of date now. See *infra* text accompanying notes 110-115.

although § 21 appears to target low-income taxpayers, the relationship between the credit percentage income phase-down and current income tax thresholds makes it unlikely that poor taxpayers receive any benefit from the credit. The Tax Reform Act of 1986¹⁰⁵ removed a large number of poor families from the tax rolls¹⁰⁶ by increasing standard deduction¹⁰⁷ and personal exemption amounts,¹⁰⁸ and adjusting those amounts on a yearly basis for inflation.¹⁰⁹ In 1995, for example, a family of four (two parents and two children) would owe no taxes on up to \$16,550 of adjusted gross income,¹¹⁰ which is above the federal poverty threshold for a family of four.¹¹¹ Although the family would be entitled to a tax credit of twenty-six percent of up to \$4,800 of child care expenses, for a credit of \$1,248, they would have no income tax liability to offset through use of the credit.¹¹² A single head of household with one child would owe no taxes up to \$10,750 of income,¹¹³ which is above the poverty level for a family of two.¹¹⁴ Although such a taxpayer would be entitled to a child care credit of twenty-nine percent of up to \$2,400 of expenses, for a maximum credit of \$696, the credit could not be utilized if no taxes are owed on that amount of income. The current thresholds for tax liability combined with the nonrefundability of the credit thus make it unlikely

105. Pub. L. No. 99-514, 100 Stat. 2085.

106. Changes made by the 1986 Act removed an estimated six million poverty level families from the income tax rolls. MICHAEL J. GRAETZ & DEBORAH H. SCHENK, *FEDERAL INCOME TAXATION PRINCIPLES AND POLICIES* 428 (3d ed. 1995).

107. I.R.C. § 63(c)(2) (West 1995).

108. I.R.C. §§ 151(b)-(c).

109. I.R.C. §§ 63(c)(4) (requiring inflation adjustments to the standard deduction amounts beginning after 1988), 151(d)(4) (requiring inflation adjustments to the \$2,000 personal exemption amount for tax years beginning after 1989).

110. For 1995, the inflation-adjusted standard deduction amount for a married taxpayer filing a joint return is \$6,550. The inflation adjusted personal exemption amount is \$2,500. Rev. Proc. 94-72, 1994-2 C.B. 813 (Dec. 12, 1994). Thus, a family of four claiming a standard deduction (\$6,550) and four exemptions (4 x \$2,500 = \$10,000) would pay no tax on up to \$16,550 of income.

111. The federal poverty guideline for a family of four is \$15,150 for 1995. Federal poverty income guidelines for 1995, listed by size of family unit are as follows for all states (except Alaska and Hawaii) and the District of Columbia: 1—\$7,470; 2—\$10,030; 3—\$12,590; 4—\$15,150; 5—\$17,710; 6—\$20,270; 7—\$22,830; 8—\$25,390. For family units with more than eight members, the poverty guideline is determined by adding \$2,560 for each additional member. Poverty guidelines are required by §§ 652 and 673(2) of the Omnibus Budget Reconciliation Act of 1981, Pub. L. No. 97-35, 95 Stat. 357 (1981) (codified at 42 U.S.C. §§ 9847 and 9902(2)), and are used as an eligibility criterion for various federal programs. Programs that use the poverty guidelines in determining eligibility may use administrative definitions of "income" or other definitions that differ from the statistical definitions used in determining the poverty guidelines. In certain cases, programs use the guidelines as one of a number of criteria for eligibility or use a percentage multiple of the guideline amount. Notice, Annual Update of the HHS Poverty Guidelines, 60 Fed. Reg. 7772 (Feb. 9, 1995).

112. Thus, even families below the poverty line would be subject to an applicable percentage of less than 30%. For example, a family with \$14,500 of income would be entitled to a credit of only 27% of its eligible child care expenses.

113. For 1995, the inflation-adjusted standard deduction for a single head of household is \$5,750. The inflation adjusted personal exemption amount is \$2,500. Rev. Proc. 94-72, *supra* note 110, §§ 3.04, 3.08. The standard deduction (\$5,750) plus two personal exemptions (\$5,000) equals \$10,750.

114. For 1995, the federal poverty income for a family of two is \$10,030. *See supra* note 111.

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that poor families benefit from the child and dependent care tax credit.¹¹⁵

2. Section 129—The Exclusion for Employer-Provided Dependent Care Assistance Programs

Section 129 provides an exclusion from the gross income of employees of amounts up to \$5,000 paid by the employer under a dependent care assistance program.¹¹⁶ The dependent care assistance program must be a separate written plan of the employer for the exclusive benefit of employees¹¹⁷ and must meet certain other requirements.¹¹⁸ The amount of the exclusion may not exceed the lesser of the earned income of the employee or the earned income of the employee's spouse.¹¹⁹ Payments for child care made to the employee's spouse or certain other related individuals (another child of the employee, for example) are ineligible for exclusion.¹²⁰

Employers most frequently provide the dependent care assistance benefit through reimbursement accounts, sometimes referred to as flexible spending accounts, which may also cover other types of expenses, such as out-of-pocket health care expenses.¹²¹ Up to \$5,000 may be paid into a dependent care assistance account (through a salary reduction plan) from which child care expenses of the employee are reimbursed. The effect of such a program is that the employee may pay child care expenses (or out-of-pocket health care expenses) with pre-tax dollars. About one-third of full-time employees at large

115. The Joint Committee on Taxation staff prepares estimates by income class for the child and dependant care credit. The estimates illustrate the concentration of benefits in the middle and upper income ranges. Of the total \$2.72 billion in credits claimed, less than 500 returns in the below \$10,000 income class claimed the credit (no dollar amount indicated). Only \$166 million in credits were claimed by the \$10,000 to \$20,000 income class, and \$402 million in credits were claimed by the \$20,000 to \$30,000 income class. The rest went to income classes above \$30,000, with the largest dollar amount, \$672 million, concentrated in the \$50,000 to \$75,000 income class. \$247 million in credits were claimed by those with \$100,000 to \$200,000 in income, and \$43 million in credits were claimed by those in the \$200,000 and over income class. 1995 JCT Tax Expenditure Estimates, *supra* note 32, at 23, Table 3, at L-12. Income tax returns were placed into income classes based on adjusted gross income plus certain nontaxable income sources, including tax-exempt interest, employer contributions for health plans and life insurance, employer share of FICA tax, workers' compensation, nontaxable Social Security benefits, the insurance value of Medicare benefits, alternative minimum tax preference items, and the excluded income of U.S. citizens living abroad. *Id.*, Table 3, at n.2.

116. I.R.C. § 129(a) (1995).

117. Although self-employed taxpayers may qualify for the exclusion by treating themselves as the employer, not more than 25 percent of the amounts paid may be provided for dependent care assistance of owners or shareholders owning more than 5 percent of the stock or of the capital or profits interest in the employer. I.R.C. §§ 129(e)(3)-(4), 129(d)(4) (1995).

118. I.R.C. §§ 129(d)(1)-(8) (1995) (including requirements that contributions to the plan not discriminate in favor of highly compensated employees, *id.* at (d)(2), and that employees be notified of the terms and availability of the program, *id.* at (d)(6)).

119. I.R.C. § 129(b)(1) (1995). The same rules as are applicable to the child and dependent care tax credit apply for determining a deemed amount of earned income for a student spouse or a spouse incapable of self-care. I.R.C. § 129(b)(2) (1995) (incorporating by reference the provisions of § 21(d)(2)).

120. I.R.C. § 129(c).

121. 1994 GREENBOOK, *supra* note 32, at 708 (citing Employee Benefits in Medium and Large Firms, 1991, Bureau of Labor Statistics, Department of Labor (May 1993)).

and medium-sized private firms were eligible for such accounts in 1991, compared to nearly one tenth of such workers who were eligible for child care benefits provided by the employer in the form of child care facilities provided at or near the workplace, or through direct reimbursement of employee expenses.¹²²

Generally, taxpayers choose whether to claim eligible child care expenses under the § 21 credit or the § 129 exclusion. Double dipping is not permitted.¹²³ For most middle- or upper-income taxpayers, the § 129 exclusion provides the largest benefit.¹²⁴ For example, for taxpayers subject to the current highest marginal tax rate, the § 129 exclusion is worth \$1,980, compared to the maximum § 21 credit of \$480 for one child or \$960 for two or more children.¹²⁵

II. WELFARE REFORM AND THE CHILD CARE DILEMMA: THE NEED FOR INCREASED CHILD CARE ASSISTANCE

Although some kind of federal work requirement has been imposed on welfare recipients for nearly thirty years,¹²⁶ recent welfare reform proposals emphasize more stringent time limits on benefits without work¹²⁷ and impose

122. *Id.*

123. See I.R.C. § 21(c) (providing that the amount of employment-related expenses claimed for purposes of the credit shall be reduced by the amount excludable from gross income under § 129 for the taxable year).

124. See generally 1994 GREENBOOK, *supra* note 32, at 708 ("The credit generally is less valuable than the exclusion for taxpayers who are above the 15-percent tax bracket.").

125. The dollar value of the exclusion is equal to the value of the child care provided (up to a maximum of \$5,000) times the taxpayer's marginal tax rate ($\$5,000 \times 39.6\% = \$1,980$).

126. Federal work requirements were first imposed on welfare recipients by the WIN program in 1967. The WIN program was replaced in 1988 with the JOBS program. For a discussion of these programs, see *supra* text accompanying notes 49-54; HANDLER & HASENFELD, *supra* note 50, at 132-200 (describing history of federal welfare to work programs and their participation rates). Long before the federal government imposed such requirements, however, some states used "employable mother" rules to deny welfare assistance to women with school-age children, especially African-American women, on the grounds that they should work. FRANCES F. PIVEN & RICHARD A. CLOWARD, REGULATING THE POOR: THE FUNCTIONS OF PUBLIC WELFARE 134, 138 (1971) (noting that the first "employable mother" rule was adopted by Louisiana in 1943, refusing assistance to AFDC families with children seven years old or older as long as the mother was presumed to be employable in the fields; and that Georgia adopted a similar rule in 1952, denying assistance to mothers with children over three years of age if suitable employment were deemed to be available); ABRAMOVITZ, *supra* note 50, at 318-19, 333 (pointing out that "as late as 1966, New Jersey sent a letter to AFDC recipients telling them that their grants would be cut because seasonal farm work was available"). See generally ALICE KESSLER-HARRIS, OUT TO WORK: A HISTORY OF WAGE-EARNING WOMEN IN THE UNITED STATES 16-19, 119-27 (1982) (historically, poor women, including mothers, have had to work for wages out of necessity); PIVEN & CLOWARD, *supra* at 3-41, 123-45 (1971).

127. See generally THEODORE R. MARMOR ET AL., AMERICA'S MISUNDERSTOOD WELFARE STATE: PERSISTENT MYTHS, ENDURING REALITIES 22-31 (1990) (describing four different conceptual approaches to social welfare policy that compete with each other whenever welfare programs are revised). Recent proposals appear to emphasize the behaviorist vision, in which the poor are induced to behave "in a more socially acceptable manner" by denying public assistance "when the behavior at issue is immediately correctable, as with the able-bodied poor who need only submit themselves to the discipline of the labor market." See *id.* at 23-24 (describing the behaviorist vision of social welfare policy); see also, HANDLER & HASENFELD, *supra* note 50, at 25-26, 35-36, 134 (1991); PIVEN &

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such requirements on mothers with younger children.¹²⁸ The historical shift in the welfare paradigm¹²⁹ toward mandatory work for mothers with young children has not been accompanied, however, by universal child care.¹³⁰

The child care now provided AFDC children by their mothers¹³¹ must be replaced if they are at work.¹³² Inadequate funding for work-related child

CLOWARD, *supra* note 126, at 341-48. An evaluation of the behaviorist approach to welfare reform is beyond the scope of this article.

128. See Martha Minow, *The Welfare of Single Mothers and Their Children*, 26 CONN. L. REV. 817, 832 (1994); see *supra* notes 50-51. The Clinton administration proposal would have required participation in work programs for welfare recipients born after 1971, but would have exempted custodial parents of a child of less than a year old and women in their third trimester of pregnancy. See S. 2224, *supra* note 1, at § 101(a). The bill adopted by the House last March by the House would give the states latitude to impose their own requirements, but would "require at least one parent of a child in any family which has received benefits for more than 24 months (whether or not consecutive) under the program to engage in work activities." See H.R. 4, *supra* note 1, at § 101 (adding § 402(a)(1)(B), relating to the work requirements, and § 404, specifying state program minimum participation rates).

129. The change in approach, seen in historical perspective, represents a shift away from the origins of the Aid to Dependent Children, which developed from "mothers' pensions" or "mothers' aid" programs. Such programs were intended by social welfare reformers to enable widows and certain other "deserving" mothers to care for their young children without being compelled to work outside of the home. See, e.g., LINDA GORDON, *PITIED BUT NOT ENTITLED: SINGLE MOTHERS AND THE HISTORY OF WELFARE 1890-1935* (1994); ABRAMOVITZ, *supra* note 50, at 181-206, 315-19. The shift in approach also coincides with the trend of increased labor market participation by women with young children. E.g., GORDON, *supra*, at 12-13; Minow, *supra* note 128, at 826; HANDLER & HASENFELD, *supra* note 50, at 135-37.

130. E.g., Sylvia A. Law, *Women, Work, Welfare, and the Preservation of Patriarchy*, 131 U. PA. L. REV. 1249 (1983) (discussing history of relationship between welfare and waged work, describing ways in which federal welfare and labor policy impede women's access to wage labor market through lack of child care services, and arguing that welfare policy should recognize value of work other than wage labor, including work involving care and nurture of children); see Barbara R. Bergmann, *The Economic Support of Child-Raising: Curing Child Poverty in the United States*, 84 AM. ECON. REV. 76 (May 1994) (comparing cost of welfare and wage supplementation solution that would allow mother earning the minimum wage to meet minimum basic needs budget, and estimating that at \$400 per month per child for full-time child care, \$36 billion would be required to provide subsidized child care to children of low- and middle-income families); see also Peter Pitegoff, *Child Care Enterprise, Community Development and Work*, 81 GEO. L. J. 1897, 1902-13 (1993).

131. Some have suggested that work requirements reveal an implicit devaluation of the child care that welfare mothers provide for their own children (as opposed to the child care they may provide to other people's children). See Gwendolyn Mink, *Welfare Reform in Historical Perspective*, 26 CONN. L. REV. 879, 881-83 (1994); Dorothy E. Roberts, *The Value of Black Mothers' Work*, 26 CONN. L. REV. 871, 873-75 (1994). Others have questioned the underlying assumption that the wage work required of welfare recipients will provide benefits greater than the cost of providing (or not providing) substitute child care for their children. See Lance Liebman, *Evaluating Child Care Legislation: Program Structures and Political Consequences*, 26 HARV. J. ON LEGIS. 357, 360-61 (1989) (observing that recent welfare reform efforts have been based on the assumption that single mothers should work and that the government should pay some of their child care costs, and questioning whether it is better if children of the poor are cared for outside of their parents' homes and whether it is important that single mothers work, even if child care costs more than their short-term earnings); see also Martha L. Fineman, *Images of Mothers in Poverty Discourses*, 1991 DUKE L.J. 274. This article does not address the important prior question of whether the shift toward requiring market work for welfare recipients constitutes wise social welfare policy.

132. Research conducted by the Institute for Women's Policy Research shows that about forty percent of mothers receiving AFDC also work in paid employment, and that they work approximately half time. That labor force participation is about as much as all mothers, on average, who "work in paid employment about half time, devoting the other half of the 'normal' work week as well as the 'second shift' to child and family care." Heidi Hartmann & Roberta Spalter-Roth, *Reducing Welfare's Stigma: Policies that Build Upon Commonalities Among Women*, 26 CONN. L. REV. 901, 908 (1994). But cf. 1994 GREENBOOK, *supra* note 32, at 404 n.2 (reporting that in 1992, 16.1% of AFDC mothers or other

care for low-income families raises serious concerns. Without increased federal or state support of work-related child care, new work requirements cannot succeed in reducing dependence on welfare by mothers of young children. In addition, low-income children will be placed in increased danger of receiving inadequate or unsafe care. The following subsections discuss the inadequacies of current funding levels, and the failure of welfare reform proposals to fund necessary child care support.

A. *The Insufficiency of Current Programs*

Under current federal funding levels, the states have been unable to meet the need for child care assistance for low-income families.¹³³ Between five and six percent of the AFDC caseload received AFDC child care subsidies,¹³⁴ and only about one out of three JOBS participants received JOBS-related child care.¹³⁵ About 20 percent of those eligible received Transitional Child Care (TCC) assistance for the first year after leaving welfare for work.¹³⁶ Surveys conducted in 1993 and 1994 found that most states either had lengthy waiting lists¹³⁷ for child care assistance or had stopped accepting new applications.¹³⁸ In addition, the competition for slots has resulted in the shifting of scarce state child care funds from low-income working families to families receiving AFDC.¹³⁹ Families that have used up their one year of

caretakers were at school or training, 2.2% worked more than 30 hours per week, and 4.2% worked fewer than 30 hours per week). The discrepancy in statistics could be explained, at least in part, by nonreporting of work by recipients. See additional studies cited in Alstott, *supra* note 12, at 546-47 n.52 (stating that data typically show that few AFDC recipients work and citing other studies indicating that a majority of women work at some point while receiving welfare).

133. For a discussion of some of the reasons that the states have fallen short of the Family Support Act child care guarantee, see Collins & Reisman, *supra* note 6, at 219-28.

134. U.S. GENERAL ACCOUNTING OFFICE, CHILD CARE: WORKING POOR AND WELFARE RECIPIENTS FACE SERVICE GAPS 4-5 (GAO/HEHS-94-87, May 1994) [hereinafter GAO CHILD CARE REPORT] (based on preliminary fiscal year 1992 data reported to the Department of Health and Human Services by the states).

135. See *The Impact of Welfare Reform and Work Requirements on the Demand for Child Care: Hearings Before the Senate Committee on Labor and Human Resources*, 104th Cong., 1st Sess. (1995) available in LEXIS, Legis Library, CNGTST File (statement of Sandra L. Hofferth, University of Michigan Institute for Social Research) (discussing the impact of welfare reform and work requirements on the demand for child care; citing reports published in 1991 and 1992).

136. *Id.* (based on 1991 TCC data from 20 states).

137. The Children's Defense Fund found in 1993 that thirty-one states and the District of Columbia had waiting lists:

Illinois had 30,000 children waiting for assistance, Florida had 25,000, Georgia and Nevada each had about 15,000, and Alabama had more than 8,000. In 16 counties in Minnesota, the wait for assistance is at least one year.

1994 YEARBOOK, *supra* note 77, at 32. In 1994, a similar survey found 8 states with at least than 10,000 children on child care assistance waiting lists, including 1) Georgia, 41,000; 2) Texas, 35,692; 3) Illinois, 20,000; 4) Florida, 19,757; 5) Alabama, 19,699; 6) New Jersey, 14,000; 7) North Carolina, 13,000; and 8) Kentucky, 10,000. CHILDREN'S DEFENSE FUND, THE STATE OF AMERICA'S CHILDREN YEARBOOK 42 (1995) [hereinafter 1995 YEARBOOK].

138. 1994 YEARBOOK, *supra* note 77, at 32.

139. A six-state study by the U.S. General Accounting Office found that the current system provides little incentive to serve the working poor:

Given the inadequate supply of funds, it necessarily follows that some states will seek to satisfy

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guaranteed TCC assistance after leaving welfare have to compete with other low-income, non-AFDC families for child care assistance.¹⁴⁰ If they do not receive assistance, many have no choice but to go back on the welfare rolls because they cannot afford the full cost of child care.¹⁴¹

The cost of child care remains a significant obstacle for low-income families making the transition from welfare to work. In general, the type of child care purchased and the amount spent on care varies by the family's economic situation and the type of care used. Lower-income families spend on average about twenty-three percent of their incomes on child care even though they spend significantly less, in absolute terms, on child care than families with higher incomes.¹⁴² Without subsidized child care, low-income families will likely rely on lower-quality child care or informal arrangements and relative-provided care.¹⁴³ Those who pay for relatives to care for their children pay

their mandates in a way that minimizes state costs. By law, states must serve those currently or recently on AFDC but have little incentive to serve other low-income families in like or even worse economic circumstances. As a result, the well-intentioned emphasis on providing services to assist welfare recipients in leaving welfare has overshadowed the importance of the provision of child care to prevent welfare dependency.

GAO CHILD CARE REPORT, *supra* note 134, at 15.

According to another study, "twelve states shifted state funds previously used for child care assistance for working families to help cover the state match required for federal child care funds for AFDC families," and sixteen states diverted Child Care and Development Block Grant funds (which do not require a state match) to pay for welfare-related child care. 1994 YEARBOOK, *supra* note 77, at 34. See also 1995 YEARBOOK, *supra* note 137, at 41-42.

140. 1995 YEARBOOK, *supra* note 137, at 41-42 (noting that in Illinois, it "had been a full year since child care funds were available for former AFDC families losing their one year of TCC benefits").

141. 1994 YEARBOOK, *supra* note 77, at 34 (reporting findings from a 1992 study of 48 Minnesota families leaving the Transitional Child Care Program "in which one in five of the families returned to AFDC while waiting for child care assistance"). See also GAO CHILD CARE REPORT, *supra* note 134, at 9-13.

142. The national child care survey defines child care as care provided while the mother is at work, and includes care provided by fathers, mothers, and children themselves. 1994 GREENBOOK, *supra* note 32, at 540 n.3 (citing SANDRA L. HOFFERTH, ET AL., NATIONAL CHILD CARE SURVEY, 1990 (1991)). Families below poverty had an average weekly cost of \$37.3 for child care (23.2% of income spent on care), compared to an average weekly cost of \$65.5 for families above poverty (8.7% of income spent on care). *Id.* at 541. The average weekly cost of child care for those purchasing care ranged from about \$38 for those with annual family incomes of under \$15,000, and \$51 for those with annual incomes of \$15,000 to \$24,999, to an average weekly cost of \$85 for those with annual incomes of \$50,000 or above. *Id.* at 541 (Table 12-8, prepared from published and unpublished data from the National Child Care Survey). Although not all families pay for child care, families with higher incomes were more likely to pay for child care than families with lower incomes. The study found that over half of all families with employed mothers (both part-time and full-time employment) paid for child care for their youngest child under age five compared with about two-thirds of families with mothers working full-time. *Id.* at 540-41 (stating that "57 percent of families with employed mothers paid for child care for their youngest child under age 5 during November 1989 to May 1990" and that "[a]mong mothers working full-time, 66 percent paid for care for their young children"). However, the percentage of families paying for child care tended to decline when grouped by income. The study reported that 42% of families with annual incomes below \$15,000 and 48% of families with annual incomes of \$15,000 to \$24,999 purchased child care. *Id.* at 541.

143. A recent study of children in family child care and relative care concluded that "regardless of maternal education, the lower the child's family income, the lower the quality of the child care home in which he or she is enrolled." ELLEN GALINSKY ET AL., THE STUDY OF CHILDREN IN FAMILY CHILD CARE AND RELATIVE CARE: HIGHLIGHTS OF FINDINGS 90 (1994). That finding, the study noted, differed from findings from research on center-based care, in which low-income children in subsidized

the lowest average weekly costs, with increasingly higher weekly average costs for family child care, center care, and in-home care by a non-relative.¹⁴⁴ The family and relative care received by children from low-income families and the center-based care for very young children raise developmental concerns.¹⁴⁵

Although the federal block grant programs have made improvements in the states' quality control of center-based or licensed family day care homes, many low-income children are enrolled in unregulated, informal child care settings. Many states do not require care-givers to meet even minimal standards and few states conduct inspections of family child care homes that are exempt from licensing requirements.¹⁴⁶

Programs with low reimbursement rates and retroactive reimbursement tend to steer families toward informal child care.¹⁴⁷ A recent study concluded that children, particularly low-income and minority children, who are in the care of family and relatives are receiving substandard care from providers who are "taking care of children to help out the mothers and not because they want to care for children."¹⁴⁸ Its authors recommend that low-income families receive a child care subsidy sufficient to pay for higher quality care.¹⁴⁹ In addition, they caution against requiring welfare recipients to become family child care providers and urged states to screen all welfare-to-work recipients for interest, commitment, and aptitude before they become providers.¹⁵⁰

B. *The Inadequacies of Welfare Reform Proposals*

Current welfare reform proposals fail in greater or lesser degrees to provide for adequate work-related child care. After the November 1994 congressional

care were in better-quality arrangements than middle-income children. *Id.* at 91.

144. 1994 GREENBOOK, *supra* note 32, at 540-41; *see also* COST, QUALITY & CHILD OUTCOMES STUDY TEAM, ECONOMICS DEPARTMENT, UNIV. OF COLO. AT DENVER, COST, QUALITY, AND CHILD OUTCOMES IN CHILD CARE CENTERS: EXECUTIVE SUMMARY 5 (1995) [hereinafter CHILD CARE CENTER EXECUTIVE SUMMARY] (finding little difference in fees for centers providing high- or low-quality care, and that average center in the study expended \$95 per week per child for full-time care).

145. In family or relative care, low-income families "are more likely to be using care that is rated as being of inadequate quality [growth-harming] whereas middle-income families tend to use care that is adequate/custodial [neither growth-enhancing nor growth-harming]." GALINSKY ET AL., *supra* note 143, at 4, 90 (finding overall that 35% of a sample of 226 providers who cared for children in their homes offered care harmful to the children's development). The quality of center-based care has also been questioned, especially for the youngest children. A recent study has concluded that the worst quality care is received by toddlers and infants, with about forty percent of those studied receiving below a minimally adequate level. CHILD CARE CENTER EXECUTIVE SUMMARY, *supra* note 144, at 2.

146. *See* 1994 YEARBOOK, *supra* note 77, at 34-35; *see also* Giselle Sered, *Day Care and Tax Policy*, 12 AM. J. TAX POL'Y 169, 171-76 (1995) (describing quality issues related to family and relative care).

147. 1994 YEARBOOK, *supra* note 77, at 35.

148. *See* GALINSKY ET AL., *supra* note 143, at 5, 97 (reporting the "surprising" finding that "[c]hildren are not more likely to be securely attached to providers who are relatives than to nonrelatives" and recommending that "low-income parents should receive enough subsidy so that they can afford to choose quality care").

149. *Id.* at 97.

150. *Id.*

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elections, the welfare reform debate shifted from the Clinton administration proposal introduced in June 1994, which contained additional job training funds and child care assistance, to various Republican proposals. The Clinton proposal would have cost an estimated \$9.3 billion over five years, with additional costs in the second five years.¹⁵¹ Of that amount, child care increases represented approximately \$4.2 billion.¹⁵² The administration's 1994 plan proposed no major changes to the underlying structure of current direct assistance programs for child care, although it expanded some programs and funded them at higher levels.¹⁵³ The plan also revised state match rate

151. See H.R. 4605, 103d Cong., 2d Sess., §§ 901-11; and S. 2224, 103d Cong., 2d Sess., §§ 901-911 (1994) (financing provisions); EXECUTIVE OFFICE OF THE PRESIDENT, OFFICE OF MANAGEMENT AND BUDGET, FINANCING THE PRESIDENT'S WELFARE REFORM PLAN, in OMB RELEASE ON PRESIDENT'S PLAN TO FINANCE WELFARE REFORM, 94 TNT 121-23 (LEXIS, Fedtax library, TNT file) (June 14, 1994) (reporting that of the \$9.3 billion cost over five years, about \$7.2 billion would come from entitlement cuts, \$1.6 billion from extending the Superfund tax, \$200 million from extension of railroad safety user fees, \$100 million from denying the earned income tax credit to nonresident aliens, and \$200 million from requiring income reporting for earned income tax credit purposes for Defense personnel living abroad); see also Susan Chira, *If Welfare Mothers Must Go to Work In Clinton Plan, Will Children Gain?*, N.Y. TIMES, Aug. 9, 1994, at B8 (noting that the cost of the program was reduced to \$9.3 billion over five years from \$19.5 billion and stating that some child care experts fear that the plan did not allocate enough money to pay for quality child care).

152. As summarized by Department of Health and Human Services Secretary Shalala in her opening remarks before the House Ways and Means Committee hearings, "[o]ver the next five years, we would also increase child care funding for those in mandatory education and training and in the work slots by \$2.7 billion, with an additional increase of \$1.5 billion for child care for the working poor." *Hearing Before the House Ways and Means Committee on H.R. 4506*, 103d Cong., 2d Sess. (July 14, 1994), Document 94-6764 (LEXIS, Fedtax library, TNT file) (July 19, 1994) (unofficial transcript).

153. The Clinton administration proposal would have continued the Transitional Child Care program without expanding the benefit beyond the current one year period after discontinuance of AFDC benefits due to increased income from work. The proposal expanded the At-Risk Child Care program from the current level of \$300 million per year to over \$1 billion by the year 2000. H.R. 4605, 103d Cong., 2d Sess. § 306(a) (1994); and S. 2224, 103d Cong., 2d Sess. § 306(a) (1994) (providing authorization for \$1.3 billion by FY 2004). Eligibility for the At-Risk Child Care program was limited to families ineligible for the Transitional Child Care program. *Id.* at § 303.

In addition, the Clinton plan extended child care assistance to the newly created WORK program for those AFDC recipients unable to find a private sector job, see H.R. 4605, 103d Cong., 2d Sess. § 301(a) (1994); and S. 2224, 103d Cong., 2d Sess. § 301(a) (1994), and extended transitional child care assistance under certain circumstances to those leaving the WORK program. H.R. 4605, 103d Cong., 2d Sess. § 301(b) (1994); and S. 2224, 103d Cong., 2d Sess. § 301(b) (1994). The plan proposed that the WORK program be created to provide work assignments to welfare recipients who have reached the two-year time limit for cash assistance. Participants would be required to perform a job search before entering the WORK program, and after each WORK assignment. No WORK assignment was to last more than 12 months, and workers would receive a paycheck based on the hours they actually worked (typically at the minimum wage rate). Each state would have been required to operate a WORK program, and states could pursue a range of strategies to locate and create temporary positions of employment for welfare recipients who are unable to secure unsubsidized employment after reaching their two-year limit on benefits, including providing wage subsidies to nonprofit, for-profit and public employers, establishing programs to encourage self-employment efforts, entering into contracts with placement firms, and making payments to employers to employ participants as child care providers. H.R. 4605, 103d Cong., 2d Sess. § 201; and S. 2224, 103d Cong., 2d Sess. § 201 (amending Title IV of the Social Security Act by adding new part G) (1994). Remuneration received under the WORK program would be excluded from gross income and would not be eligible for the earned income tax credit. *Id.* at § 207.

requirements¹⁵⁴ and imposed additional quality control requirements on the states.¹⁵⁵

By contrast, the proposal passed by the U.S. House of Representatives last March would dramatically revise programs, and would give the states increased flexibility to design their own programs through expansion of the block grant approach. Although the states would have more latitude to allocate welfare funds to child care and to otherwise consolidate programs, the proposal does not increase the overall funding level for programs currently structured as open-ended, AFDC-related entitlements and decreases federal funding for child care over five years.¹⁵⁶ Like the Clinton administration proposal, the House bill does not affect the child care tax credit or the exclusion for employer-provided care. Unlike the Clinton proposal, the House bill eliminates the concept of entitlement to AFDC-related benefits. Thus, the states will have increased flexibility, but decreased access to federal child care funds, if the approach adopted by the House wins the day.

The welfare reform bill passed by the Senate follows the block grant approach adopted by the House, and, like the House bill, eliminates the entitlement to welfare benefits. With respect to child care funding, however, it is significantly more moderate than the bill passed by the House. The Senate bill requires states to maintain eighty percent of historic state expenditures for five years, including state child care expenditures, and provides slightly increased federal funds for child care for a five-year period.¹⁵⁷ It exempts single custodial parents caring for a child under the age of six from work requirements if they have a demonstrated inability to obtain needed child care, and permits the states, by state option, to exempt from the work requirements a parent or caretaker relative of an infant less than twelve months of age.¹⁵⁸

154. The Clinton administration proposal increased the child care federal match rates consistent with the proposed increase in the JOBS match rate. Under the proposal, the federal match rate for JOBS was increased by five percentage points over the current JOBS match rate in 1996, by seven percentage points over the current rate in 1998, and rising to 10 percentage points over the current match rate by FY 2000. H.R. 4605, 103d Cong., 2d Sess. § 202 (1994); S. 2224, 103d Cong., 2d Sess. § 202 (1994). As explained in the previous part, the federal match rate for JOBS is the same as the state's Medicaid federal match rate, which may range from 50% to 83%, with a minimum JOBS federal match rate of 60% for certain types of expenditures. The minimum match rate would apply to all JOBS expenditures under the Clinton proposal. Thus, by the year 2000, the minimum federal match rate for JOBS expenditures would be 70%. *See supra* note 52.

155. Child care provider health and safety and other quality standards were made more consistent with those of the Child Care Development Block Grant program, *see* H.R. 4605, 103d Cong., 2d Sess. §§ 301(c), 302(a) (1994); and S. 2224, 103d Cong., 2d Sess. §§ 301(c), 302(a) (1994), and states were permitted the option of administering all federal child care funds through one agency, *id.* at § 304.

156. H.R. 4, 104th Cong., 1st Sess., Title I, § 101, Title III (1995) (placing a 24 month limit on welfare benefits without work, authorizing states to use up to 30 per cent of their family assistance block grants for other purposes, including for Title XX and Child Care and Development Block Grant programs, and authorizing \$2.09 billion per year for child care block grants).

157. *See supra* note 5.

158. H.R. 4, 104th Cong., 1st Sess., Title I, § 101, Title VI (1995) (Senate amendment in the nature of a substitute for the House version of H.R. 4) (placing 24-month limit on welfare benefits without work along with five-year cap on benefits, authorizing states to use up to 30 percent of their family assistance grants for Child Care and Development Block grant activities, and setting aside funds

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Both the House and Senate versions of welfare reform would cut welfare spending over the next five to seven years,¹⁵⁹ and would increase the number of children in poverty.¹⁶⁰ Whether Congress and the President will be able to reach a compromise¹⁶¹ that will result in enactment of major welfare reform legislation remains to be seen.¹⁶²

III. DELIVERING ADDITIONAL CHILD CARE ASSISTANCE TO LOW-INCOME FAMILIES THROUGH THE TAX SYSTEM: PRACTICAL CONSEQUENCES AND THEORETICAL IMPLICATIONS

Using the income tax system as a mechanism for delivering increased child care assistance to working families should be evaluated in light of the strengths and weaknesses of the tax system as an income transfer mechanism. As described below, there are serious practical and institutional problems with implementing a child care transfer program for low-income workers through the tax system. In addition, any such proposal should not be considered in isolation from the tax and social policy concerns involving taxation of the family. Using the tax system to deliver increased assistance in the form of an income transfer presupposes that such assistance constitutes a subsidy external to the tax structure itself.¹⁶³ That presupposition needs to be examined more closely. Accordingly, this Part considers both the practical consequences and theoretical implications of using the income tax system to deliver increased work-related child care benefits.

improve quality of child care). Under the Senate bill, a demonstrated inability to obtain child care (as determined by the state) may occur for one or more of the following reasons: 1) unavailability of appropriate child care within a reasonable distance of home or work; 2) unavailability or unsuitability of informal child care by a relative or under other arrangements; or 3) unavailability of appropriate and affordable formal child care arrangements. *Id.* at Title I, § 101 (new § 404(d)(2)).

159. Under a Republican compromise plan, House and Senate Republican conferees have agreed to reductions of spending on welfare of \$81.5 billion over seven years, and \$32.5 billion of reductions in the earned income credit. *GOP Agrees on Cutting Welfare by \$80 Billion*, L.A. TIMES, Nov. 11, 1995, at A21.

160. The President's Office of Management and Budget found in a study requested by congressional Democrats that the House proposal could move from 500,000 to 2.1 million children into poverty, and the Senate bill could move from 300,000 to 1.2 million into poverty, depending on the strictness of the definition of poverty. Alison Mitchell, *Greater Poverty Toll Is Seen in Welfare Bill, But White House Says It May Be Forced to Accept Senate Measure*, N.Y. TIMES, Nov. 10, 1995, at A27.

161. See Robert Pear, *Republicans in Accord on Welfare Bill*, N.Y. TIMES, Nov. 15, 1995, at B10 (describing the Republican conferees' compromise plan). President Clinton's chief of staff, Leon E. Panetta, has said that President Clinton would veto the welfare bill emerging from Congress. See Robert Pear, *Clinton Will Veto Welfare Bill, Rejecting a G.O.P. Compromise*, N.Y. TIMES, Nov. 13, 1995, at A1, A20 (reporting that compromise legislation "would cut projected spending on welfare, child care, food stamps, child nutrition and other programs by about 11 percent in seven years").

162. See *supra* note 161. As a veteran of past legislative battles about welfare predicted two years ago, "[i]f history is any teacher, the contest to reshape the welfare system will be a long, tendentious, sometimes nasty, occasionally arcane discussion among conservatives and liberals, blacks and whites, men and women, federal and state governments, taxpayers and the poor." Joseph A. Califano, Jr., *Introduction to Overview: Welfare Reform*, 11 YALE L. & POL'Y REV. 109, 110 (1993).

163. See, e.g., Zelenak, *supra* note 24, at 392-93 (arguing that a refundable credit ceases to be part of the tax system).

A. *The Practical Advantages and Disadvantages of Delivering Targeted Child Care Assistance through the Income Tax System*

Making the child care tax credit a refundable credit would have all the institutional advantages and disadvantages of delivering a transfer payment through the tax system. We have experience delivering income transfer benefits through the income tax system in the form of the earned income tax credit (EITC). In 1993, without much fanfare, and with relatively little partisan rancor, Congress significantly expanded the EITC.¹⁶⁴ Some described this development as using the federal income tax system as an instrument of welfare reform.¹⁶⁵

Although the income tax system has been extolled as an advantageous transfer payment mechanism because of its relative privacy, reduced bureaucracy, and lack of stigma associated with filing tax returns,¹⁶⁶ the workability of the earned income tax credit as a transfer payment mechanism has been extensively critiqued. As noted by those who have studied implemen-

164. See I.R.C. § 32. The earned income tax credit was revised and expanded by the Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, §13131, 107 Stat. 312, 433 (1993) (codified as I.R.C. § 32(c)(1)(A)(ii)). Under the 1993 law, benefits are increased gradually over a period of time, until 1996, when the maximum benefit for a family with two or more "qualifying children" (under age 19, or a full-time student under the age of 24, living in the household for more than one-half of the year) will be \$3,370 (in 1994 dollars, to be adjusted for inflation, equal to the credit percentage of 40% times the earned income amount of \$8,425). The maximum benefit applies at incomes between \$8,425 and \$11,000, and declines thereafter. A phase-out percentage (21.06%) applies to adjusted gross income (or, if greater, the earned income) in excess of \$11,000. Thus, the benefit will be fully phased out at \$27,002 of adjusted gross income for a taxpayer with two or more qualifying children. See I.R.C. § 32(b). Beginning in 1996, the maximum benefit for a taxpayer with one qualifying child will be \$2,040 at incomes ranging from \$6,000 to \$11,000, and will be fully phased out at \$23,766 adjusted gross income (1994 dollars, to be adjusted for inflation). *Id.* See generally Alstott, *supra* note 12, at 541-44.

In addition, although the availability of the EITC was originally restricted to low-income working families with children, see *supra* note 29, the 1993 expansion of the EITC made it available for the first time to eligible working individuals without children (at a lower maximum benefit level), Pub. L. No. 103-66, 107 Stat. at 433-35. The EITC is now available to an eligible childless individual, if aged 25 through 64, not a dependent of another taxpayer, and whose place of abode is in the United States for more than one-half of the taxable year. The credit for taxpayers with no qualifying children is equal to 7.65% of earned income up to \$4,000, reduced by the phase-out percentage of 7.65% of adjusted gross income (or, if greater, earned income) in excess of \$5,000. That provides a maximum benefit of \$306, which is phased out as income increases from \$5,000 to \$9,000. After 1994, the dollar amounts are to be adjusted for inflation. I.R.C. § 32(i)(1). Because the social security tax rate is 7.65% on wages earned by most eligible individuals, the EITC for childless taxpayers offsets the effect of the employee portion of social security taxes on wages within certain income ranges.

165. The expansion of the earned income tax credit has been described by the Clinton administration and members of Congress as an element of welfare reform efforts to "make work pay":

... Congress has already passed the first crucial element of welfare reform by expanding the EITC, a key initiative of the Clinton administration. ... The EITC ensures that a family with a full-time worker earning minimum wage would, with the help of food stamps, no longer be poor.

Hearing of House Ways and Means Committee on H.R. 4605 (July 14, 1994), available in LEXIS, Fedtax library, TNT file, 94 TNT 137-14 (July 15, 1994) (statement of Donna E. Shalala, Secretary of Health and Human Services). See also *Moynihan Urges Welfare Bill's Passage*, 1994 DAILY TAX REPORT 133 available in LEXIS, Fedtax library, TNT file (July 14, 1994).

166. See, e.g., DAVID T. ELLWOOD, POOR SUPPORT 115 (1988).

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tation of the EITC, integrating income-tested transfer programs with the income tax system poses inherent tensions between a system designed to provide need-based income support benefits and one designed to raise revenue within a taxable year.¹⁶⁷ These differences in the design and purpose of the tax and transfer systems manifest themselves in different income measurement and family definition rules, and in compliance problems and institutional difficulties with having the IRS administer income transfer programs through the tax code.¹⁶⁸

Regardless of the practical difficulties of grafting an income support mechanism onto the tax system, however, the earned income credit historically has been a politically viable means to address the economic plight of the working poor. The political advantage has been a considerable one: the use of the income tax system to deliver work-related transfer payments has received political support at a time when there has been increased reluctance to fund pure needs-based programs. That political consensus, however, has been eroding over the past year.¹⁶⁹ Since the 1994 congressional elections, there have been attempts in Congress to repeal the scheduled expansion of EITC benefits provided by the 1993 legislation.¹⁷⁰

Proposals to make the child care credit refundable now face a different political environment, and must overcome the criticisms based upon our more extensive institutional experience with the EITC. That experience suggests that proposals to target the child care credit underestimate the difficulty of designing an effective tax transfer mechanism for the truly poor. A key disadvantage includes the difficulty of implementing an advance payment mechanism for a population that cannot easily wait until tax refund time to pay for their child care expenses. Without an advance payment mechanism, the program has limited practicality as a way of delivering cash advances or reimbursement for weekly or monthly child care payments. As experience with the EITC has shown, the practical problems with an advance payment

167. Anne L. Alstott, *The Earned Income Tax Credit and Some Fundamental Institutional Dilemmas of Tax-Transfer Integration*, 47 NAT'L TAX J. 609 (1994); Yin et al., *supra* note 16, at 235-78 (suggesting specific changes in the EITC to improve administration and compliance).

168. Alstott, *supra* note 12, at 564-89 (identifying the institutional tradeoffs between the goal of tax-transfer integration and important goals of transfer policy as those involving the accurate measurement of need, accurate measurement of the family unit, responsiveness to changing needs, and compliance with the terms of assistance).

169. There have been frequent recent criticisms of the EITC as a welfare hand-out susceptible to fraud. *See, e.g.*, Ryan J. Donmoyer, *EITC Comes Under Fire As Wasteful Program at Senate Hearing*, 95 TNT 67-4 available in LEXIS, Fedtax library, TNT file (Apr. 6, 1995); *Hearings Before the Senate Governmental Affairs Committee*, (statement of Chairman William V. Roth, Jr.), 95 TNT 66-29 available in LEXIS, Fedtax library, TNT file (Apr. 4, 1995) (stating that "[t]he fraud and error rate that runs rampant in the earned income tax credit is totally unacceptable . . . [and the program] must be the subject of intense scrutiny."); *see also* Michael J. Caballero, *The Earned Income Tax Credit: The Poverty Program That Is Too Popular*, 48 TAX LAWYER 435 (1995).

170. *See supra* note 26.

mechanism are difficult to solve.¹⁷¹

In addition, although need-based programs require periodic family needs assessments to respond to changed circumstances, the tax system is designed to measure income with the purpose of raising revenue on a taxable year basis.¹⁷² Accordingly, the tax system is much less responsive to fluctuating incomes, and could be made more responsive only with basic structural changes in the income tax.¹⁷³

State experiences with refundable child care tax credits¹⁷⁴ suggest that effective tax-transfer integration requires alternative payment and income measurement structures. Unless the credits are based on a more comprehensive definition of income than used for income tax purposes,¹⁷⁵ the credits do not effectively target the working poor. In an attempt to address this problem, Minnesota's refundable child and dependent care credit starts with the dollar amount of the federal credit, but utilizes a comprehensive definition of income for the phase-out of the maximum credit.¹⁷⁶ Minnesota is planning a pilot

171. For a description of the EITC advance payment mechanism, see *supra* note 14. Although EITC participation rates are relatively high, very few claimants receive advance payments. A recent study reported that 80-86% of eligible persons were receiving the EITC in 1990. John Karl Scholtz, *The Earned Income Tax Credit: Participation, Compliance, and Antipoverty Effectiveness*, 47 NAT'L TAX J. 63 (Mar. 1994). However, less than 1% of EITC recipients receive advance payments from their employers. U.S. GENERAL ACCOUNTING OFFICE, EARNED INCOME TAX CREDIT: ADVANCE PAYMENT OPTION IS NOT WIDELY KNOWN OR UNDERSTOOD BY THE PUBLIC 2, 29-31 (GAO/GGD-92-26, Feb. 1992); Clinton Seeks to Spread Word of Available Earned Income Tax Credit, *Payment Options*, 46 DAILY TAX REPORT (BNA) G-1 (Mar. 10, 1994).

As a means of exploring alternative advance payment procedures, the Clinton administration welfare reform proposal made provision for up to four states to conduct demonstration projects promoting the use of an advance EITC payment option by shifting the outreach and administrative burden from employers to selected public agencies. See H.R. 4605, 103d Cong., 2d Sess. § 741 (1994) and S. 2224, 103d Cong., 2d Sess. § 741 (1994) (proposing to add subsection (g) to I.R.C. § 3507, which would permit advance payments from a responsible state agency of between 60% and 75% of the credit percentage in effect for an eligible individual with the corresponding number of qualifying children). That proposal undercuts the bureaucratic advantage of having the program administered through the tax system.

172. Several problems arise from the taxable period, including potential overpayment or underpayment of advance payments, and determination of eligibility based on an annual rather than a monthly basis, as is the case for many need-based transfer programs. For an excellent discussion of income-measurement problems in tax-transfer integration, see Alstott, *supra* note 12, at 566-79.

173. See discussion of similar problems with the EITC in *id.* at 579-84.

174. See JANICE STEINSCHNEIDER ET AL., MAKING CARE LESS TAXING: IMPROVING STATE CHILD AND DEPENDENT CARE TAX PROVISIONS 13 (April 1994) (noting that four states provide child care tax credits that are fully refundable—Hawaii, Iowa, Minnesota, and New Mexico—and that in Arkansas, the credit is refundable for child care expenses of children ages 3 to 5 in "developmentally appropriate early childhood programs").

175. Social welfare agencies typically use a more comprehensive definition of income to determine eligibility for need-based benefits than the income tax does for the purpose of determining taxable income (taking into account various deductions and exclusions). For example, because the amount of EITC received is based on a percentage of income, up to a threshold, and then phased out at a percentage of income, using a more comprehensive definition of income could affect the type of population eligible for the credit, the amount of the credit at phase-in levels, and the dollar amount by which the credit is phased-out at higher income levels.

176. See Paul Wilson & Robert Cline, *State Welfare Reform: Integrating Tax Credits and Income Transfers*, 47 NAT'L TAX J. 655, Table 1 at 657 (1994) (explaining that for a single parent with two children, the maximum child care tax credit is reduced by \$10.30 for each \$100 increase in compre-

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project that would provide coordinated tax credits and transfers for welfare recipients administered through state agencies.¹⁷⁷ The state's more long-range plans include the development of an expanded, unified tax-transfer system for all households (including non-AFDC households) eligible for tax credits such as the state EITC, the refundable child care tax credit, and various other state credits. Preliminary plans would have the state revenue department process applications and determine monthly prepayments of credits.¹⁷⁸ The Minnesota project suggests that tax-transfer integration will require "simultaneous and significant changes" in both the welfare and tax systems.¹⁷⁹

Finally, efforts to increase the quality of child care through regulatory requirements are more difficult to implement in a program delivered through the tax system. Although the child and dependent care tax credit requires that center-based care meet state and local licensing requirements,¹⁸⁰ the in-home care need not be provided by licensed providers. The federal child care block grant programs have imposed requirements on the states for improvement of child care standards. Similar requirements would be quite difficult to impose on the states for child care benefits delivered through the tax system because of the relative difficulties of enforcing the standards through the individual taxpayer audit system.

B. *Theoretical Implications of Viewing the Child Care Tax Credit As An Income Transfer or Subsidy: The Tax Policy Debate*

In addition to the practical problems of designing an effective tax-transfer system, theoretical problems with viewing the current child care tax provisions as a direct government subsidy program must be addressed. These issues are different from those posed by the EITC. As explained earlier, the EITC currently operates as an earnings subsidy, although it was initially conceptualized as an offset to the impact of social security taxes on low-income workers. The child care tax provisions arguably play a different, more structural role within the tax system itself. If seen as a legitimate work-related expense, child care costs should be deductible as a means of ensuring proper income measurement. If not, permitting a deduction or credit would amount to a tax allowance for personal consumption expenses, and thus would be equivalent to a subsidy.

hensive income (a measure different from the federal adjusted gross income amount used by I.R.C. § 21) between \$15,180 and \$28,830, with no credit available for those earning more than \$28,830, and noting that the state revenue department has difficulty checking the validity of components of comprehensive income). The more comprehensive measure of income prevents refundable credits from being paid to households with little earned income but significant unearned income or those households with earned income offset by net tax losses from farming or other businesses. *Id.* at 672.

177. *Id.* at 674.

178. *Id.*

179. *Id.* at 675.

180. I.R.C. § 21(b)(2)(C). Even so, it would be quite difficult for the IRS to enforce such licensing restrictions other than through individual taxpayer audits.

Congress has never really decided whether to treat the child care credit as a cost of earning income or as a subsidy for child care. Both concepts have been articulated by Congress in adopting and expanding the Code provisions relating to child care expenses.¹⁸¹ Tax theorists also disagree about the proper treatment of such expenses. The conclusion one reaches with regard to these theoretical issues may have as much to do with one's view of the family, and the role of women within the family, as one's understanding of tax policy.¹⁸²

Under the Haig-Simons concept of income, which is frequently used in tax policy analysis, income is defined as personal consumption plus the market value of the net change in wealth during the taxable period.¹⁸³ The definition can be treated as an equivalence, that is, the sources of income during the taxable period are equal to the uses of income during the same period for personal consumption or for savings.¹⁸⁴ The Haig-Simons definition of income has itself been understood as a compromise between the norms of ability-to-pay (or "fairness")¹⁸⁵ and neutrality.¹⁸⁶

The following subsections consider whether an adjustment to income to

181. See *infra* discussion in Section IV.B.

182. See Boris I. Bitker, *Federal Income Taxation and the Family*, 27 STAN. L. REV. 1389, 1463 (1975).

183. HENRY C. SIMONS, PERSONAL INCOME TAXATION 50, 140 (1938) (stating that "it would be hard to maintain that the raising of children is not a form of consumption on the part of the parents—whether one believes in the subsidizing of such consumption or not"); Robert M. Haig, *The Concept of Income—Economic and Legal Aspects*, in THE FEDERAL INCOME TAX 1, 7 (Robert M. Haig ed., 1921) reprinted in AMERICAN ECONOMIC ASSOCIATION, *Readings in the Economics of Taxation* 54 (Richard A. Musgrave & Carl S. Shoup eds., 1959).

184. See DAVID F. BRADFORD, U.S. TAX POLICY STAFF, BLUEPRINTS FOR BASIC TAX REFORM 27 (2d ed. 1984). Because the sources of income such as wages, investment earnings, and so forth, may be seen as equivalent to uses of income for personal consumption expenditures (payments for food, clothing, entertainment, for example) and savings (by putting money in a bank account, buying stock, or making an income-producing investment), an income tax base may also be described as taxpayers' sources of income with no deduction for consumption or savings.

185. Ability to pay may be understood in both horizontal and vertical equity terms. Questions concerning the normative underpinnings of the traditional tax policy equity analysis have recently provoked much commentary, and several theorists have emphasized that if two taxpayers pay different amounts in tax, the difference must be consistent with an appropriate theory of distributive justice. *E.g.*, Thomas D. Griffith, *Should "Tax Norms" Be Abandoned?: Rethinking Tax Policy Analysis and the Taxation of Personal Injury Recoveries*, 1993 WIS. L. REV. 1115; Thomas D. Griffith, *Theories of Personal Deductions in the Income Tax*, 40 HASTINGS L. J. 343, 385-394 (1989); see also Louis Kaplow, *A Note on Horizontal Equity*, 1 FLA. TAX REV. 191 (1992); Paul R. McDaniel & James R. Repetti, *Horizontal and Vertical Equity: The Musgrave/Kaplow Exchange*, 1 FLA. TAX REV. 607 (1993); Richard A. Musgrave, *Horizontal Equity: A Further Note*, 1 FLA. TAX REV. 354 (1993). Analysis under the traditional tax norm of horizontal equity, under which similarly situated taxpayers should be similarly taxed, tends to be conclusory because of the lack of a tax-determined method of identifying similarly situated taxpayers. The conclusion reached with regard to horizontal equity may depend upon whether one begins with a worker with or without children, see William A. Klein, *Tax Deductions for Family Care Expenses*, 14 B.C. INDUS. & COM. L. REV. 917, 937-40 (1973), and how one views one-earner versus two-earner working families, Wolfman, *supra* note 21, at 167-74 (observing that child care expenses could be viewed as business-related because they have their origin in the decision to maintain gainful employment or as personal because they arguably originate in the decision to have a child). Thus, the prior question of how taxpayers with equal incomes are identified determines the outcome of the horizontal equity analysis.

186. See Joseph M. Dodge, *Taxing Human Capital Acquisition Costs—Or Why Costs of Higher Education Should Not Be Deducted or Amortized*, 54 OHIO ST. L.J. 927, 951 (1993).

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reflect child care costs can be justified under the tax norms of ability to pay and neutrality. Reaching a conclusion about the propriety of a tax allowance for child care expenses after the application of the tax norms requires the exercise of social and political judgments, as is discussed more specifically below. I conclude that an income tax adjustment for child care costs should not be viewed as a subsidy because it reflects a taxpayer's ability to pay taxes. Even if it were accepted as a subsidy or equivalent to a direct expenditure, however, there are arguments in favor of retaining an income tax adjustment for child care expenses. The adjustment alternatively may be tolerated as a "second best" solution because it offsets other tax nonneutralities between wage work and household labor. Eliminating the "subsidy" would exacerbate already serious allocative inefficiencies involving participation by women in the labor market.

1. *The Ability-to-Pay Norm*

The ability-to-pay norm derives from the idea that taxpayers should contribute to the government according to the relative amount of material resources they control, above subsistence amounts. The application of the ability-to-pay norm generally does not favor deductions unless they relate to (i) minimum subsistence amounts;¹⁸⁷ (ii) certain nondiscretionary expenditures such as medical expenses¹⁸⁸ or personal casualty losses;¹⁸⁹ or (iii) legitimate costs of producing income.¹⁹⁰ Whether one concludes that employment-related child care costs are nondiscretionary expenditures¹⁹¹ or a cost of producing income ultimately turns on assumptions about the role of the family (and in particular, the role of women) in society, the legal and moral obligation to support one's children, and one's view of child care given those assumptions. Child care costs reduce the taxpayer's ability to pay taxes only if one concludes that child care fits within such a category of expenditures. If so, a deduction or credit would be justified based on the taxpayer's reduced capacity to pay taxes.

Debate about the tax treatment of child care costs generally centers on

187. See I.R.C. §§ 151(a), (c) (deduction for personal and dependents' exemption amounts); I.R.C. § 63(c) (the standard deduction).

188. See I.R.C. § 213 (1995); William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 331-43 (1972) (discussing the medical expense deduction).

189. See I.R.C. § 165(c)(3).

190. I.R.C. §§ 162, 212 (1995).

191. See Klein, *supra* note 185, at 941 (concluding that child care costs are discretionary, but citing Canada's 1966 Carter Commission Report for a contrary conclusion); see generally Boris I. Bittker, *Income Tax Reform in Canada: The Report of the Royal Commission on Taxation*, 35 U. CHI. L. REV. 637, 638-45 (1968) (discussing the Commission's conclusion that a taxpaying unit's ability to pay taxes is measured by its discretionary economic power). If child care were categorized as a subsistence or nondiscretionary expenditure, it would not be illogical to impose a limit on allowable expenses, or to limit the tax benefit as income increases. Compare I.R.C. § 21 with I.R.C. § 151(d) (phase-out of exemption amount for dependents above certain income thresholds).

whether such expenses are personal or business expenses, that is, whether to treat such expenses as a cost of producing income or as a personal consumption expenditure. If child care expenses are a legitimate cost of producing income, they should be deductible regardless of the amount or the taxpayer's income level.¹⁹² On the other hand, if child care costs are personal consumption expenditures, they should not be deductible—just as expenditures for the costs of food or shelter are nondeductible.¹⁹³ Although the business/personal boundary is difficult to delineate when the expenses involve additional costs of being employed, child care has been analogized to nondeductible personal expenses such as commuting costs¹⁹⁴ and higher clothing expenses¹⁹⁵—where the person “already at work” marks the boundary between business and personal expenses.¹⁹⁶ Any special tax allowance for personal consumption expenditures may be viewed as a tax expenditure,¹⁹⁷ and thus equivalent to a direct subsidy for child care.¹⁹⁸ Some have argued that child care costs may contain elements of either personal or business expenditures, or a mixture of both,¹⁹⁹ and at least one commentator has suggested that a limit on the amount of deductible expenses may be appropriate as a means of restricting the personal consumption element for middle- or upper-income taxpayers.²⁰⁰

192. See I.R.C. §§ 162, 212. For further articulation of this argument, see Grace Blumberg, *Sexism in the Code: A Comparative Study of Income Taxation of Working Wives and Mothers*, 21 BUFF. L. REV. 49, 64-66 (1971); see also C. Eugene Steuerle, *Tax Credits for Low-Income Workers With Children*, 4 J. ECON. PERSP. 201, 206-07 (1990).

193. Personal consumption expenditures are included in the tax base by not allowing a deduction for personal living expenses. I.R.C. § 262 (1995); see *Smith v. Commissioner*, 40 B.T.A. 1038 (1939) (denying a business expense deduction for child care costs on the basis that child care was one of the basic functions of family living and thus was a “personal” concern), *aff’d per curiam*, 113 F.2d 114 (2d Cir. 1940).

194. See *Commissioner v. Flowers*, 326 U.S. 465 (1946) (deduction denied for travel between residence in one town and business location in another town because travel was motivated by considerations of personal preference rather than exigencies of business).

195. See, e.g., *Pevsner v. Commissioner*, 628 F.2d 467 (5th Cir. 1980) (denying deduction for work clothing expense where it was adaptable for personal or general use as ordinary streetwear).

196. MARVIN A. CHIRELSTEIN, *FEDERAL INCOME TAXATION: A GUIDE TO THE LEADING CASES AND CONCEPTS* ¶ 6.01(a) (7th ed. 1994); John B. Keane, *Federal Income Tax Treatment of Child Care Expenses*, 10 HARV. J. ON LEGIS. 1, 30-35 (1972).

197. Under tax expenditure theory, if child care expenses represent personal consumption expenditures, they ought to be included in the tax base; accordingly, permitting a tax deduction or credit for child care expenses would constitute a tax preference. STANLEY S. SURREY & PAUL R. MCDANIEL, *TAX EXPENDITURES* 3 (1985) (explaining that departures from the normal tax structure are tax expenditures or special preferences and are viewed as equivalent to direct government outlays).

198. See Roland L. Hjorth, *A Tax Subsidy for Child Care: Sec. 210 of the Revenue Act of 1971*, 50 TAXES 133, 138-39 (1972).

199. E.g., McCaffery, *supra* note 21, at 1005-10; Alan L. Feld, *Deductibility of Expenses for Child Care and Household Services: New Section 214*, 27 TAX L. REV. 415, 429 (1972) (“In view of the inherent difficulty in determining what part of the expenditure should be regarded as business related rather than personal, the tax base should not be further eroded by permitting a deduction.”); see also Daniel C. Schaffer & Donald A. Berman, *Two Cheers for the Child Care Deduction*, 28 TAX L. REV. 535, 535-36 (1973) (agreeing with Professor Feld with regard to the mixed personal and business nature of child care expenses).

200. Wolfman, *supra* note 21, at 190-93.

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The categorization of child care expenses as either a personal expense or as a cost of producing income depends upon individual and societal views of children and child-rearing roles.²⁰¹ Arguably, child care costs (up to some generally recognized standard amount for quality care) should be viewed as legitimate costs of producing income, and a child care deduction should be permitted as a proper reflection of a working parent's ability to pay taxes.²⁰² A caretaker is required if both parents work outside of the home, and the tax code should recognize child care as a deductible work-related expense. Single parents have no choice but to obtain such care if they are to earn a living for their family.

On the other hand, those who view child care costs as a personal expense would conclude that an income tax adjustment for such costs constitutes a subsidy. Under such a view, the neutrality norm²⁰³ becomes more important because an adjustment to income cannot be justified on the basis of working parents' relative ability to pay taxes.

2. *Neutrality Norm*

The neutrality norm derives from the notion that taxes should influence the allocation of resources in the economy as little as possible; otherwise, economic inefficiencies may result. Under the neutrality norm, subsidies are suspect and should be discouraged. The neutrality norm is tempered by several other theories. First, under the theory of optimal taxation, nonneutrality does not result in economic distortions when taxes do not affect consumer or other allocative choices (that is, where there is a low degree of elasticity or substitutability of behaviors).²⁰⁴ Accordingly, because economic distortions are a function of elasticity, higher taxes may be imposed on inelastic commodities without creating allocative inefficiencies. Second, under a theory of taxation developed by the public finance theorist A.C. Pigou, departures from the neutrality norm may be justified to correct market failures.²⁰⁵ Pigouvian taxation posits that when free markets do not work, through the presence of externalities or information failures, taxation may legitimately

201. See Zelenak, *supra* note 24, at 361 ("Whatever may be said in theory for the view of children as consumption, there is no political or popular support in the United States today for an income tax generally treating children as just another consumption choice, irrelevant to the determination of tax liability.").

202. A deduction rather than a credit would better reflect the tax-driven role of the child care allowance.

203. See *infra* Subsection III.B.2.

204. For a more detailed discussion of optimal income taxation, see, for example, McCaffery, *supra* note 21, at 1035-46; Joseph Bankman & Thomas Griffith, *Social Welfare and the Rate Structure: A New Look at Progressive Taxation*, 75 CAL. L. REV. 1905, 1919-29 (1987).

205. See generally A.C. PIGOU, *A STUDY IN PUBLIC FINANCE* (3d ed. 1947) (maintaining that taxation legitimately may be used as a correction for observed market failures).

correct the failure.²⁰⁶ For example, an observed market failure of parents or society to invest adequately in children's human capital²⁰⁷ could provide theoretical justification for a tax incentive to correct such market failure. Third, the theory of the "second best" suggests that tax nonneutralities should not necessarily be corrected if allocative inefficiencies would be aggravated because of the existence of other nonneutralities.²⁰⁸

206. For a more extensive discussion of Pigouvian taxation, see McCaffery, *supra* note 21, at 1046-53 (arguing that Pigouvian taxation supports the proposal that the basic tax rate structure be altered to provide lower, or even negative, rates for secondary earners, financed by higher rates on primary earners).

207. Child care costs have been viewed in economic terms as an investment by parents in their children's human capital. See Lynn A. Stout, *Some Thoughts on Poverty and Failure in the Market for Children's Human Capital*, 81 GEO. L.J. 1945 (1993) (arguing that underinvestment in children's human capital is likely to persist in a society that relies upon parents to see to their children's education and training and that social choice obstacles could be overcome by federal deficit financing with sufficient controls to earmark funds for investment); *but cf.* Liebman, *supra* note 131, at 359 (1989) (observing that quality child care may have external benefits, but questioning whether society's concern for children in general is greater than that the commitment of parents to their own children). The view of child care costs as human capital investment has not been extensively discussed by tax theorists. See Bittker, *supra* note 182, at 1447-48 (describing the position that dependents are an investment as used only as a "makeweight" argument when tax theorists debate the propriety of dependency exemptions, but concluding that "[i]f the current vogue for economic theories of familial and other interpersonal relationships grows, . . . the dependents-as-investment rationale may yet come to rival the dependents-as-consumption rationale."); Klein, *supra* note 185, at 940 n.118 (dismissing the notion that children are produced as economic assets with future returns to the parents).

Such an analysis would be problematic. First, there is the threshold issue of whether child care costs represent capital expenditures for tax purposes. See I.R.C. § 263 (defining capital expenditures). Although early childhood development programs such as Headstart have been described as a human capital investment programs, some child care providers could be more accurately labeled as providing custodial or maintenance services rather than programs that are developmental in nature. See MARMOR ET AL., *supra* note 127, at 39-40 (1990); see also Jeffrey S. Lehman, *To Conceptualize, To Criticize, To Defend, To Improve: Understanding America's Welfare State*, 101 YALE L.J. 685, 694-97; see generally CARNEGIE TASK FORCE ON MEETING THE NEEDS OF YOUNG CHILDREN, STARTING POINTS: MEETING THE NEEDS OF OUR YOUNGEST CHILDREN 43-61 (Apr. 1994) (describing need for improvements in child care quality). Furthermore, the personal nature of human capital raises serious questions about whether child care may be treated as an investment in an "asset" with any measurable payoff for parents in the form of future support from their children or any other type of income. See Bittker, *supra* note 182, at 1448 (observing that the concept of children as the "poor man's capital," or as an informal social security system, has made little headway in the analysis of American society). Even if such questions were resolved and such expenses treated as investments by parents in their children, child development expenses would not be deductible under the Code's current approach to the taxation of human capital investment. See generally Dodge, *supra* note 186, at 948-61.

In the context of the neutrality norm, an observed market failure of parents or society to invest sufficiently in children's human capital could provide a different theoretical justification for a tax incentive to correct such a market failure. Further examination of a tax-based response to such a market failure, assuming that such a failure exists, is beyond the scope of this article.

208. The theory of the second best, developed in the context of welfare economics, attempts to evaluate how to maximize welfare in the face of market imperfections. When the economy has complete and perfectly competitive markets, the market equilibrium will be Pareto optimal. However, correcting a single market imperfection may not enhance welfare under certain circumstances. R.G. Lipsey & Kelvin Lancaster, *The General Theory of the Second Best*, 24 REV. ECON. STUD. 11 (1956) ("The general theorem for the second best optimum states that if there is introduced into a general equilibrium system a constraint which prevents the attainment of one of the Paretian conditions, the other Paretian conditions, though still attainable, are, in general, no longer desirable."). The term "second best solution" has been used more generally to refer to solutions to problems that take into account existing imperfections and tolerate compensating imperfections. See generally Dodge, *supra* note 186, at 941-43; Boris I. Bittker, *A "Comprehensive Tax Base" As a Goal of Income Tax Reform*, 80 HARV. L. REV.

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An argument for a tax allowance for child care costs has been made on neutrality grounds based on the objective of achieving tax neutrality between wage work and housework.²⁰⁹ The argument presupposes the desirability of neutrality in this context although the tax system otherwise generally favors nonmarket production by failing to tax imputed income from other types of services taxpayers perform for themselves.²¹⁰ For example, no income tax is imposed on the value of services such as vegetable gardening, house painting, or hair cutting provided by taxpayers to members of their own households. However, for those taxpayers who hire others to perform such services, no deductions from income are allowed for the cost of the services. Unless each taxpayer earns more than the value of the services plus taxes, the tax system encourages taxpayers to provide the services on an in-kind basis to themselves (assuming that they have or can develop the skill to perform the services). A deduction for market-purchased services would eliminate the tax incentive for home production.²¹¹

Nevertheless, child care expenses arguably are different from other types of nondeductible household expenses.²¹² The need for a child care deduction or credit to offset the current tax incentive for a parent to provide child care at home is typically advanced in the context of a constellation of other social and economic factors discouraging women from full labor force participation.²¹³ The neutrality argument therefore achieves special force in a setting otherwise discouraging women from entering or staying in the labor market.²¹⁴ Studies suggest that labor force participation of secondary workers responds to changes in tax rates,²¹⁵ and thus tax nonneutrality between wage work and household labor may result in allocative inefficiencies. Whether neutrality should be advanced in the context of child care when nonneutrality otherwise prevails in other areas of home production depends upon whether a child care “subsidy” should be tolerated as a “second best” solution.

925, 983-84 (1967).

209. *E.g.*, Schaffer & Berman, *supra* note 199, at 537-43.

210. Wolfman, *supra* note 21, at 175-81.

211. Alternatively, nonneutrality could be eliminated by including the imputed income from the self-provided services in gross income. Inclusion of imputed income would be quite problematic, however, due to the administrative difficulties of valuation and enforcement.

212. *See* Schaffer & Berman, *supra* note 199, at 543-45 (distinguishing child care from other self-provided services because of the necessary, although not sufficient, relationship between the expense and the income earned, whereas other tasks such as lawn mowing could go undone or could be performed on weekends or evenings, and concluding that providing a deduction for child care expenses will not “undo the neutrality that now exists as between imputed income from chores and leisure.”).

213. *See* Rachel Connelly, *The Effect of Child Care Costs on Married Women's Labor Force Participation*, 74 *REV. ECON. & STAT.* 83, 90 (1992) (stating that “if legislation is enacted to lower the cost of child care to some families, our results indicate that we should expect a positive impact on [labor force] participation rates especially for those women with preschoolers.”).

214. *See generally* Edward J. McCaffery, *Slouching Towards Equality: Gender Discrimination, Market Efficiency, and Social Change*, 103 *YALE L.J.* 595 (1993) (applying an economic efficiency analysis to pay equity issues and proposing a combination of anti-discrimination deregulation combined with tax reform to address gender discrimination in the workforce); *see also* McCaffery, *supra* note 21.

215. Bankman & Griffith, *supra* note 204, at 1925-27 (discussing studies).

IV. A MISGUIDED FUNDING MECHANISM: FUNDING INCREASED CHILD CARE ASSISTANCE BY PHASING OUT THE CHILD CARE TAX CREDIT FOR MIDDLE- AND UPPER-INCOME TAXPAYERS

As the foregoing Part argues, one cannot evaluate the child and dependent care tax credit in isolation from the Code's taxation of the family in general. Even if one concludes that the child care credit cannot be justified under the ability-to-pay norm, analysis under the neutrality norm suggests that a tax allowance for child care costs could be justified as a "second best" solution to currently existing nonneutralities. Thus, the allowance should be understood as serving a structural function within the tax system. As is argued below, making the credit refundable would not be inconsistent with such a structural function. Nevertheless, repealing or phasing out the credit would create problems that must be addressed.

This Part evaluates a specific funding proposal that would redirect child care resources to low-income families by phasing out the child care credit for middle- and upper-income families. Such a funding mechanism would be a misguided solution, exacerbating certain problems in the "second best" world of family taxation.

As discussed below, the child care tax credit offsets the effects of the conflict among goals of equal taxation of families with equal incomes, progressive taxation, and marriage neutrality. An effort to target the benefits of the credit to low-income families by phasing out the credit for middle- and upper-income taxpayers would exacerbate the current marriage penalty for two-earner families.²¹⁶ Targeting the credit in that manner would necessitate other compensating adjustments to the Code's taxation of the family. A better solution may be to adjust the child and dependent care tax credit to permit greater percentages of child care expenses in a higher range of income thresholds, and to allocate more resources to direct federal assistance for child care services for very low-income families.

A. *The Policy Trade-Offs*

Conflicts among the competing tax policy goals of marriage neutrality,

216. The marriage "penalty" refers to the increase in a couple's joint income tax liability due to marriage resulting from a combination of tax rates and the joint filing regime for married taxpayers. The marriage "bonus" refers to the decrease in a couple's joint income tax liability due to marriage. A recent study of the marriage tax predicted that in 1994, 52 percent of American couples would pay a marriage "penalty" averaging about \$1,244, and that 38 percent would receive a marriage "bonus," averaging about \$1,399. More extreme marriage penalties are experienced by low-income and upper income families. Because of the phase-out of the earned income tax credit, the marriage "penalties" for certain low-income families can exceed \$3,000 per year. Due to higher marginal tax rates, marriage penalties for very high income families can exceed \$10,000 per year. DANIEL R. FEENBERG & HARVEY S. ROSEN, RECENT DEVELOPMENTS IN THE MARRIAGE TAX (National Bureau of Economic Research Working Paper No. 4705, 1994).

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progressivity, and the policy of taxing equal-income married couples equally have forced inescapable trade-offs in the taxation of the family. As many analysts have pointed out, it is mathematically impossible to accomplish all three goals at the same time,²¹⁷ and given a progressive rate structure, nonneutralities necessarily result. The tax system has shifted the balance among these goals over time as Congress has responded to changes in social patterns, distributive goals, and prevailing perceptions of the role of the family in society.

The § 21 child care tax credit and the § 129 exclusion for employer-provided child care serve an important function as offsets to current nonneutralities between married and unmarried primary and secondary earners, given the following features of the current tax structure: (1) the phase-out percentages of the earned income tax credit for low-income workers;²¹⁸ (2) a progressive rate structure;²¹⁹ and (3) a joint filing regime for married taxpayers.²²⁰ Unless these features of the tax structure are altered, the child care tax credit should be retained or expanded as a “second best” solution, regardless of one’s view concerning the advisability of some tax allowance from an ability-to-pay perspective.

B. *A History of Congressional Approaches to Child Care Expenses*

Although the child care tax credit performs an important function as an offset to other nonneutralities created by our current approach to taxation of the family, Congress has not generally rationalized the tax allowance for work-related child care expenses as a structural correction for such nonneutralities. Instead, Congress has applied mixed, and somewhat contradictory, rationales for the tax treatment of child care costs. It has limited the work-related deduction by using income phase-out provisions, and later, by eliminating family income limitations and redesigning the allowance as a credit rather than as a deduction.²²¹

217. See, e.g., Bittker, *supra* note 182, at 1395-97.

218. See *supra* note 164.

219. I.R.C. § 1 (1995); Rev. Proc. 94-72, 1994-50 C.B. 81. For example, in 1995, for married individuals filing joint returns, the tax rate is 15 percent if taxable income is not over \$39,000, and increases to 28 percent of the excess over \$39,000, 31 percent of the excess over \$94,250, 36 percent of the excess over \$143,600, and 39.6% of the excess over \$256,500. For heads of households, the tax rate is 15 percent if taxable income is not over \$31,250, 28% of the excess over \$31,250, 31 percent of the excess over \$80,750, 36 percent of the excess over \$130,800, and 39.6 percent of the excess over \$256,500.

220. I.R.C. § 1(a). For a discussion of the joint return filing regime, see, for example, Pamela B. Gann, *Abandoning Marital Status as a Factor in Allocating Income Tax Burdens*, 59 TEX. L. REV. 1 (1980); Marjorie E. Kornhauser, *Love, Money & the IRS: Family, Income-Sharing, and the Joint Income Tax Return*, 45 HASTINGS L.J. 63 (1993); Lawrence Zelenak, *Marriage and the Income Tax*, 67 S. CAL. L. REV. 339 (1994).

221. Family income limitations would be consistent with conceptualizing the child care allowance either as a “subsidy” to low-income families or as a minimum subsistence level allowance for families under an ability-to-pay analysis.

Congress first provided a tax adjustment for employment-related child care costs in 1954,²²² as a type of working expense deduction targeted to hardship cases such as single parents and low-income families.²²³ Over the next two decades, Congress increased the statutory dollar amounts²²⁴ and expanded the coverage of the child care provision, but retained the basic structure of the child care deduction.²²⁵

In the 1970s, the rationale for the deduction shifted to include a job development purpose in addition to its continued function as a type of employee business expense in hardship situations.²²⁶ When the deduction was significantly expanded in 1971,²²⁷ the Senate Committee report identified job development for child care and domestic service workers as a reason for the change.²²⁸ The expanded deduction was intended to provide an incentive for the employment of household workers by giving large numbers of welfare recipients the "opportunity to perform socially desirable services in jobs that are vitally needed," while at the same time helping "to remove these individuals from the welfare rolls and reduce the cost of providing public

222. In 1954, Congress enacted § 214, which allowed a deduction for certain employment-related child care expenses. Internal Revenue Code of 1954, Pub. L. No. 591-736, 68A Stat. 70 (1954).

223. Described in the legislative history as a working expense comparable to an employee business expense, the deduction nevertheless was limited in amount and phased out for two-earner households with adjusted gross incomes above low-income levels. See H.R. Rep. No. 1337, 83d Cong., 2d Sess. 30 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4019, 4055 ("Your committee has added this deduction to the code because it recognizes that a widow or widower with young children must incur these expenses in order to earn a livelihood and that they, therefore, are comparable to an employee's business expenses."); see also Detailed Discussion of the Technical Provisions of the Bill, *reprinted in* 1954 U.S.C.C.A.N. 4137, 4197-98 (specifying that the child care deduction in § 214 did not include expenses related to other household duties such as cleaning and cooking). The phase-out of the deduction did not apply to working wives whose husbands were mentally or physically incapacitated. I.R.C. § 214(b)(2) (1954).

224. Section 214 permitted a deduction for up to \$600 of the employment-related child care expenses of women or widowers. For working wives, the amount of the deduction was reduced by the amount that the adjusted gross income of the husband and wife exceeded \$4,500, being completely phased out at incomes exceeding \$5,100. The \$600 deduction limit was increased in 1964 to \$900 for families with two or more dependents. Revenue Act of 1964, Pub. L. No. 88-272, 78 Stat. 19, 49 (1964) (codified at I.R.C. § 214(b)(1)(B) (1964)). For working wives and husbands with incapacitated wives, the deduction was reduced by the amount by which their joint adjusted gross income exceeded \$6,000. I.R.C. § 214(b)(2)(B) (1964).

225. For more detailed discussion of the legislative history of § 214, see, e.g., Klein, *supra* note 185, at 919-32; Feld, *supra* note 199, at 415; John B. Keane, *Federal Income Tax Treatment of Child Care Expenses*, 10 HARV. J. ON LEGIS. 1, 2-7 (1972); see also Wendy Gerzog Shaller, *supra* note 22, at 606-09 (describing legislative background of the child care deduction and credit provisions, including the § 129 exclusion for dependent care assistance).

226. See S. Rep. No. 437, 92d Cong., 1st Sess. 59-60 (1971), *reprinted in* 1971 U.S.C.C.A.N. 1918, 1966.

227. Revenue Act of 1971, Pub. L. No. 92-178, § 210, 85 Stat. 497, 518 (1971).

228. The Senate Committee described the expanded § 214 as a "job development deduction for household services and child care," and discussed it immediately following its description of a proposed tax credit for salaries paid welfare recipients under the Work Incentive Program (WIN). See S. Rep. No. 437, *supra* note 226, at 13-14, *reprinted in* 1971 U.S.C.C.A.N. at 1928-29 (When discussing the proposed WIN tax credit, the Committee observed that the WIN program "has not been as successful as had been hoped, largely because persons have been placed in institutional rather than employment-based training."). For a skeptical analysis of the expectation that the jobs would materialize, see Klein, *supra* note 185, at 936-37.

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assistance.”²²⁹

In 1976, Congress changed the child care deduction to a nonrefundable tax credit²³⁰ by repealing the deduction provision and adopting the predecessor of the current § 21.²³¹ The change to a tax credit was adopted as a way to reach taxpayers who elect the standard deduction,²³² and as a simplification measure.²³³ Although the family income limitations were eliminated²³⁴ and eligibility requirements were somewhat broadened,²³⁵ the credit otherwise

229. S. Rep. No. 437, *supra* note 226, at 14, *reprinted in* 1971 U.S.C.C.A.N. at 1929. In addition, the Committee identified two additional major needs to be met by the job development deduction: (1) the relief of hardship by “recognizing that a spouse with a disabled wife or a working parent who maintains a child in his household (and who does not have a spouse in that household) incurs substantial extra expenses;” and (2) the liberalization of the law “as it affects married couples.” *Id.*

The 1971 amendments eliminated the special income limitations applicable to working wives and instead imposed generally applicable, but substantially increased, family income limitations. The allowable deduction was reduced by one dollar for every two dollars of adjusted gross income in excess of \$18,000 for the taxable year during which the expenses were incurred, properly allocated to each month. I.R.C. § 214(d) (1971).

In 1975, the family income limitation was increased again, to a maximum adjusted gross income of \$35,000 before the modified phase-out of the deduction began. Tax Reduction Act of 1975, Pub. L. No. 94-12, § 206, 89 Stat. 26, 32 (1975); H.R. Conf. Rep. No. 120, 94th Cong., 1st Sess. 57, 59 (1975), *reprinted in* 1975 U.S.C.C.A.N. 122, 124-25. Thus, the amount of the deduction (a maximum of \$4,800 per year) would be phased out by one dollar for each two dollars of income in excess of \$35,000 adjusted gross income.

230. H.R. Conf. Rep. No. 1515, 94th Cong., 2d Sess. 406, 432 (1976), *reprinted in* 1976 U.S.C.C.A.N. 4118, 4141 (stating that the conference agreement follows the Senate amendments except that the credit is not refundable).

231. I.R.C. § 44A (1976). As adopted in 1976, I.R.C. § 44A provided a credit against income tax liability of 20 percent of the employment-related child care expenses paid during the taxable year. Eligible expenses were limited in amount to not more than \$2000 for one child, and \$4,000 for two or more children. Thus, the maximum credit was \$400 for one child and \$800 for two or more.

232. Both the House and Senate Committee reports observed that child care expenses “should be viewed as a cost of earning income for which all working taxpayers may make a claim.” The Committees explained that one method of extending the allowance for child care expenses to all taxpayers, and not just to itemizers, was to replace the deduction with a credit against income tax liability for a percentage of qualified expenses. A credit would also provide more help to taxpayers in lower tax brackets. H.R. Rep. No. 658, 94th Cong., 2d Sess., 147 (1976), *reprinted in* 1976 U.S.C.C.A.N. 2897, 3040; S. Rep. No. 938, 94th Cong., 2d Sess., pt. I, 132, *reprinted in* 1976 U.S.C.C.A.N. 3439, 3565.

233. Several aspects of § 214 were viewed as unduly complex, including the \$400 per month limit on the deductions (which could be simplified with an annual calculation), the distinction between child care expenses incurred inside and outside the home, with different limits applicable to expenses incurred outside the home (replaced by annual ceilings based on one and two or more dependents), and the requirement that expenses for a dependent or spouse incapable of self-care be reduced by their disability income (eliminated). S. Rep. No. 938, 94th Cong., 2d Sess., pt. I, 132-33 (1976), *reprinted in* 1976 U.S.C.C.A.N. 3439, 3565-66.

234. The Committee reports explained the elimination of the income limitation as follows: Your committee views qualified child care expenses as a cost of earning income and believes that an income ceiling on those entitled to the allowance has minimal revenue impact, if the allowance is in the form of a credit. Therefore, it considers it appropriate and feasible to eliminate the income phaseout and to allow all taxpayers to claim such expenses regardless of their income level.

S. Rep. No. 1380, *supra* note 232, at 133, *reprinted in* 1976 U.S.C.C.A.N. at 3566; H.R. Rep. No. 658, *supra* note 232, at 148, *reprinted in* 1976 U.S.C.C.A.N. at 3041.

235. See Pub. L. No. 94-455, § 504, 90 Stat. 1563-65 (codified at I.R.C. § 44A (1976)); Revenue Act of 1978, Pub. L. No. 95-600, § 121, 92 Stat. 2763, 2779; H.R. Conf. Rep. No. 1800, 95th Cong., 2d Sess. 189, 202-03 (1978), *reprinted in* 1978 U.S.C.C.A.N. 7198, 7209.

retained the basic design of the earlier provisions with regard to determination of qualified expenses.²³⁶

The credit design was changed again in 1981, resulting in the current child care tax credit structure.²³⁷ Although the Senate version of the credit included refundability, the conference agreement rejected making the credit refundable.²³⁸ The credit was redesignated as § 21 in 1984,²³⁹ and Congress did some fine-tuning to curtail perceived abuses or to make technical adjustments in 1987,²⁴⁰ and again in 1988.²⁴¹ No major changes have been made to the credit since 1981.

Congress has thus combined at least two or three notions in its approach to work-related child care costs, and has fluctuated in the use of family income limitations. Although it has treated child care expenses as comparable to an employee business expense, it has also targeted the deduction or credit to hardship situations and used the allowance as part of an overall effort to develop jobs for household workers, including former welfare recipients.

C. *Middle- and Upper-income Taxpayers: Current Effects and Possible Solutions*

Numerous factors, including tax rates, child care costs for working parents, and the labor market itself, tend to discourage labor market participation by married secondary workers (the one in a couple with lower potential earnings), generally women. As has been demonstrated in a recent article by Professor Edward McCaffery, the nonneutralities under the current tax system create

236. I.R.C. § 44A(c) (1976 & 1978).

237. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 124, 95 Stat. 172, 197-201 (1981) (codified at I.R.C. §§ 44A, 129). See text accompanying notes 98-115. Congress also increased the dollar amounts of employment-related expenses and added a provision making expenses for child care outside of the household in a dependent care center eligible for the credit only if the center complies with state and local regulations. §§ 44A(d) (dollar limits), 44A(c)(2)(C).

238. H.R. Conf. Rep. No. 215, 97th Cong., 1st Sess. 195, 200-201, (1981) *reprinted in* 1981 U.S.C.C.A.N. 285, 290-91.

239. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 471(c)(1), 98 Stat. 494, 826 (1984).

240. Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, § 10101, 101 Stat. 1330-384 (codified at I.R.C. § 21(b)(2)(A)); see H.R. Rep. No. 391(II), 100th Cong., 1st Sess. III, 1030 (1987), *reprinted in* 1987 U.S.C.C.A.N. 2313-1, 2313-646 (concluding that expenses for overnight camp are not "sufficiently related to the taxpayer's employment to justify providing a tax credit for such costs, as contrasted to the costs of day care," and that such expenses are "a personal consumption expenditure that is not a necessary cost of being able to go to work."); H.R. Conf. Rep. No. 495, 100th Cong., 1st Sess. 499, 916 (1987), *reprinted in* 1987 U.S.C.C.A.N. 2313-1245, 2313-1662.

241. Family Support Act of 1988, Pub. L. No. 100-485, § 703, 102 Stat. 2343, 2426-27 (1988). Although the House bill had proposed adjusting the income phase-out provisions by reducing the credit percentage by one percent for each \$1,500 (or fraction thereof) by which the taxpayer's adjusted gross income exceeds \$65,000, making taxpayers with adjusted gross incomes of \$93,500 ineligible to receive the credit, the Senate amendment contained no such phaseout provision. The Conference agreement followed the Senate amendment, and thus made no change to the phase-out provisions. See H.R. Conf. Rep. No. 998, 100th Cong., 2d Sess. 91, 199 (1988), *reprinted in* 1988 U.S.C.C.A.N. 2879, 2987.

Technical changes related to cafeteria plans were also added in 1988. Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 2004, 102 Stat. 3342, 3598 (1988); S. Rep. No. 445, 100th Cong., 2d Sess. III, 414 (1988), *reprinted in* 1988 U.S.C.C.A.N. 4515, 4921.

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strong incentives against labor force participation by secondary workers that are observable at all income ranges.²⁴²

At middle income levels, the disincentives to labor market participation by secondary workers are not as dramatic as they are at the lower or upper income levels.²⁴³ Nevertheless, the combination of tax costs, additional employment-related expenses, the loss of nontaxable imputed income, and the lack of more part-time work opportunities tend to force secondary workers into all-or-nothing labor participation patterns.²⁴⁴

Elimination of the § 21 child care credit or the § 129 exclusion for middle-income taxpayers would exacerbate nonneutralities that are currently substantially offset by the child care credit, and would thus increase the tendency for secondary workers in middle-income households to work full-time or not at all. Thus, on neutrality grounds, the credit and exclusion should be maintained for middle-income taxpayers.

At upper income levels, the marriage penalty and incentives favoring one-earner families become more significant²⁴⁵ because of the higher marginal tax rates on upper-income secondary earners, which are comparable to those applicable to the earnings of secondary workers in low-income families affected by the earned income credit phase-out percentages.²⁴⁶ Elimination of the child care tax credit or the § 129 exclusion would aggravate these nonneutralities for married, two-earner, upper-income taxpayers with children.

D. Targeting Low-Income Families: Possible Solutions to Nonneutralities

At low income levels, tax costs make working to cover child care expenses

242. McCaffery, *supra* note 21, at 1014-29 (examining hypothetical lower-, middle-, and upper-income families under 1991 tax rates, and examining nonneutralities in the form of a marriage penalty, the all or nothing labor force participation effect, and the one-versus-two earner tension).

243. Assuming that the middle-income family pays a marginal tax rate of 15% on taxable income, the combined income tax and social security tax rate equals 22.65%, nearly offset by the 20% child care tax credit (without taking state taxes or the incidence of the employer's portion of social security taxes into account). The 22.65% combined rate would be exactly offset by the § 129 exclusion for employer-provided child care, if it were available, because the value of the exclusion equals the income tax rate plus the social security tax rate on amounts excluded. See McCaffery, *supra* note 21, at 1020 n.145.

In addition, the marriage penalty is relatively small for middle income married couples with nearly equal salaries. *Id.* at 1020; see also Feenberg & Rosen, *supra* note 216, at 20, Table 2 (showing that the amount of a family's marriage penalty or bonus depends upon the relative incomes of the spouses and the number of their children).

244. McCaffery, *supra* note 21, at 1020-25.

245. McCaffery, *supra* note 21, at 1025-29; see also Feenberg & Rosen, *supra* note 216, at 12, 20.

246. Assuming a marginal income tax rate of 28%, 31%, or 39.6%, and a social security tax rate of 7.65%, the total marginal tax rate on the secondary worker would be 35.65%, 38.65%, or 47.25% (without taking into account state taxes or the incidence of the employer's portion of social security taxes). The child care tax credit offsets only 20% of up to \$2400 (one child) or \$4800 (two or more) of eligible employment-related child care costs, or exactly offsets the total marginal tax rate applicable to the earnings of the secondary worker to pay for up to \$5,000 of child care expenses if the exclusion under § 129 for employer-provided child care applies. For a discussion of the effect of the phase-out of the earned income credit on low-income families, see *infra* Subsection IV.D.

an inherently losing proposition.²⁴⁷ Unless parents remain unmarried or are divorced, the secondary worker generally is better off staying at home to care for the children unless she earns more than it costs to purchase child care, or can rely on unpaid relatives or low-cost providers for child care.²⁴⁸

A possible solution to this tax nonneutrality would be to make the child care tax credit refundable, and to increase the applicable percentage to at least fifty percent of eligible expenses. Another solution would be to make child care available to working families on an income-based, sliding scale, fee-for-service basis. The latter solution involves direct assistance for child care rather than a tax-based delivery mechanism.

V. CONCLUSION

If the current welfare reform efforts are to succeed, more funds must be allocated to child care programs for low-income workers. The increased assistance could be delivered through consolidated direct assistance programs, through an expanded refundable child care tax credit, or both. As discussed above, however, tax-transfer integration of work-related child care benefits remains problematic because of the very different purposes served by the tax provisions and the direct expenditure programs. The structural difficulties posed by using the tax system to deliver increased child care assistance to low-income families make sole reliance on a refundable child care tax credit problematic. A better solution would be to increase funding for work-related child care and for child care block grant programs, or to combine the two efforts.

At the same time, unless current features of the tax system affecting taxation of the family are altered, the child care allowance provided by the current tax system should not be repealed or phased out. The child care credit for moderate- and upper-income taxpayers cannot be eliminated without

247. McCaffery, *supra* note 21, at 1018.

248. As pointed out by Professor McCaffery, this results from a combination of the 15% marginal income tax rate on the additional earned income, the 7.65% employee portion of social security taxes, and the phase-out percentage of the earned income credit (assuming that the secondary worker's wages would bring the family's income into the phase out range of the earned income tax credit). The combined marginal tax rate, social security tax, and earned income phase out rate (12.36%) equaled 34.95% in 1991, greater than the 30% child care credit percentage (even assuming that the credit were fully available to low-income workers). With state taxes, and after considering usual assumptions regarding the incidence of the employer portion of social taxes on employees, the total marginal tax rate facing the low-income secondary worker would approach 50%. McCaffery, *supra* note 21, at 1015-16.

After the changes to the earned income tax credit adopted by Congress in 1993, the phase out rates of the earned income tax credit increase over time to 21.06% (for a family with two qualifying children.) In 1995, for example, the combined marginal income tax rate (15% for low income), employee portion of social security taxes rates, and earned income credit phase out (20.22%) rates equal 42.87% (before state taxes and the incidence of the employer portion of social security taxes are considered). Two observations can thus be made about the above updated examples. First, the earned income tax credit phase-out percentages increase the marriage penalty for families at low income levels; and second, pre-existing problems in low-income family utilization of the child care credit remain a problem that should be addressed.

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producing even greater disincentives to labor force participation by secondary workers. The funds for additional assistance should be raised either by imposing spending cuts in other programs or by identifying alternative sources of tax revenue.