Save the Children
Action Network™

Innovative Financing for Early Childhood Education

State and Local Options

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Foreword

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

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

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

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

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

PHOTO: SUSAN WARNER

Introduction

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

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

Save the Children Action Network (SCAN) believes policymakers should have a wide range of financing tools to consider as potential ECE proposals. In the short term, we are focused on levers that can incentivize public and private dollars going into successful state and local programs that are already showing success. Our "toolbox" of finance ideas is designed to use resources to catalyze public and private financing tools that create flexibility for local and state leaders to pursue their own solutions while demonstrating results that can be mirrored at a national level. In time, we believe these short-term opportunities will create a clear set of financing policies that will scale ECE for all American children who need it.

Save the Children Action Network's recommendations include a number of areas for policymakers to explore.

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By the Numbers

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

70% more likely to be arrested for a violent crime

50% more likely to be placed in special education

60% more likely to never attend college

40% more likely to become a teen parent.

Innovative Financing for Early Childhood Education

STATE AND LOCAL OPTIONS

Incentivizing Private Dollars and Reforming Tax Credits

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

Social Impact Financing

There may be opportunities to direct more private dollars into ECE through bipartisan pay-for-performance legislation. At the Federal level, Senator Orrin Hatch (R-UT), the Chairman of the Finance Committee, Senator Michael Bennet (D-CO), a member of the Finance Committee, Congressman Todd Young (R-IN), a member of the Ways & Means Committee, and Congressman John Delaney (D-MD), a member of the Financial Services Committee, have championed pay-for-performance legislation.[1]

As background, pay-for-performance legislation directs resources to states and local communities to support innovative public-private partnerships addressing societal needs.[2] Under the system, a state or local government enters into a contract with a service intermediary working to deliver services that will eventually generate measurable savings to local, state, and federal governments. As the savings to government accrue, they are then used to pay back investments in the same service that generated those savings. This win-win arrangement is more efficient than many existing government funding structures for social services and is particularly suited for use with early interventions such as ECE.

SCAN believes social impact bonds/pay-for performance legislation will be a popular issue the next few years. State legislation could support projects that produce measurable, clearly defined outcomes such as employment for the unemployed, increased kindergarten readiness and high

school graduation rates, and a reduction in teen and unplanned pregnancies as well as incidences of child abuse and neglect. Because this is a relatively new concept in many areas, there is an opportunity to engage very early in the legislative process and advocate for specific inclusion of outcomes directly achievable through ECE, such as kindergarten readiness for children from low-income families.

State Examples

Different legislative avenues have been taken on social impact bond (SIB) initiatives, but most action has been taken through state legislatures. Seven states (California, Connecticut, Maryland, Rhode Island, Texas, Utah, and Washington) have considered bills on SIBs in their legislatures. In Massachusetts, Oklahoma, and Utah, the state legislatures passed legislation on SIBs that the governors then signed into law. New Jersey passed a bill in January 2014 that established a five-year SIB pilot program focused on healthcare, but the bill was vetoed by Governor Chris Christie (R). In Illinois and New York, the governors have launched SIB programs of their own initiative. In addition, Hawaii, Nebraska, Nevada, Michigan, and South Carolina have requested reports or studies on the effects of potential SIB programs.

Massachusetts became the first state to enact a social finance program in 2012 when then Governor Deval Patrick (D) announced Social Innovation Financing initiatives targeting juvenile justice and chronic homelessness. The Massachusetts General Court passed the bill for this program in January 2012, which Gov. Patrick signed into law in July 2012.

There is precedent at the state level for legislation creating grant funding from the government as the genesis for SIB proposals. In Oklahoma and Utah, the state legislatures passed bills that created funds for social service providers in the areas of criminal justice and education, respectively. Following the legislations' passage, the states accepted proposals on how to award the grants. In these cases, social impact bond projects have started within the government with the empowering grant legislation.

Local Examples

In August 2013, the Goldman Sachs Urban Investment Group along with the United Way of Salt Lake and J.B. Pritzker formed a partnership to create the first ever SIB designed to finance early childhood education. The first $1 million investment in this program enabled 450-600 children to attend preschool in the fall of 2013.

Private capital from J.B. Pritzker and Goldman Sachs financed the expansion of the Utah High Quality Preschool Program. Goldman Sachs loaned approximately $4.6 million to the United Way of Salt Lake while J.B. Pritzker provided a subordinate loan of approximately $2.4 million to the United Way of Salt Lake. This financial structure reduces the risk to the senior lender, in this case Goldman Sachs, if the preschool program proves to be ineffective. The Salt Lake County Council also invested $350,000 to the preschool program, which would be paid to Goldman Sachs and the Pritzker Foundation if the program produces positive outcomes.

United Way of Salt Lake oversees the daily implementation of the Utah High Quality Preschool Program in the Granite School District and the Park City School District. The United Way of Salt Lake is also responsible for managing repayments to the investors. In this "results-based financing" model, if the preschool program does not result in increased school readiness and decreased use of special education services, the Salt Lake City County gets its money back from the United Way and there is no obligation on the part of United Way to repay Goldman Sachs and the Pritzker Foundation.

Also at the local level, Fresno, Calif., New York City, Cuyahoga County, Ohio, and Salt Lake City have each launched SIB programs within the past three years. Additionally, Santa Barbara, Calif., and Philadelphia have each commissioned studies on the impacts of potential SIB programs. At the local level, however, there are limited details as to which piece of the funding structure initiates the SIB process (the investor, the intermediary, or the government). From the municipalities that have successfully launched social-impact bond initiatives (New York City, Salt Lake City, Cuyahoga County, and Fresno), the programs were not officially announced until the full financing mechanism was established.

There has been some flexibility as to which entity to approach first. However, Social Finance US emphasizes that "the catalyst for SIB progress is executive leadership." The organization notes that cities and states that have initiated the first SIB projects in the U.S. all had strong leadership from a mayor or governor.

Early Childhood Education is a No-Brainer

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

Using Municipal, Nonprofit and Private Activity Bonds

Municipal Bonds:

Expanding the use of tax-exempt municipal bonds could provide an avenue for driving more private dollars to local ECE programs.

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

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

501(c)(3) Nonprofit Bonds

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

These bonds are most typically used to finance facilities used for the operation of nonprofit organizations, such as educational facilities, health care facilities, or even libraries. But at its core, the law requires that the proceeds be used for the activities related to the organization's tax-exempt purpose. It is reasonable to propose, therefore, that their permitted use be expanded to drive investment in 501(c)(3) preschool facilities and program startup and launch expenses that support and carryout early childhood education.

Private Activity Bonds

State and local governments are also able to issue a limited amount of tax-exempt private activity bonds (PABs) to finance certain projects, including for qualified public educational facilities that are part of public elementary or secondary schools. Unfortunately, the rules for issuing PABs for educational facilities are too onerous, so they are not fully utilized by state and local governments, and they are not available for pre-K facilities.

The President's budget for fiscal year 2016 proposes three rule changes that would enhance the use of PABs for educational facilities. In addition to these technical changes, we support expanding qualified public educational facilities to include preschools, childcare facilities, and other ECE centers. However, we still encourage state and local governments to look for innovative ways to utilize PABs under existing authority to either directly invest in or free up government dollars to invest in ECE facilities and programming.

Higher Ed – Early Childhood Education Parity

The federal government and certain states provide financial assistance for higher education expenses in two ways: (1) tax benefits, and (2) traditional student aid (loans, grants, and work-study assistance). There are 14 federal tax benefits currently available for college students and their parents to help pay for higher education.[3] The available tax benefits are a mixture of credits, deductions, exclusions, and other incentives. At the state level, incentives vary widely. Extending any number of these benefits so that they equally apply to early education in addition to higher education is an avenue worthy of exploration.

Higher education benefits can be placed into one of three general categories: incentives for current year expenses, preferential tax treatment of student loans, and incentives for saving for college. Several of these credits and deductions could be expanded to equally apply to preschool costs as they already apply to higher education costs – justified as "Higher Ed – Early Ed Parity."

Focusing on federal incentives for current year expenses, the Hope Tax Credit, temporarily replaced by the American Opportunity Tax Credit (AOTC), is a $2,500 credit (40 percent refundable up to $1,000) per student for postsecondary expenses including tuition, fees, books, and supplies.[4] AOTC could be expanded to include parents' expenses related to pre-K education, operating in conjunction with the Child and Dependent Care Tax Credit. Some states have similar credits, which could also be expanded.

There is also the federal Lifetime Learning Credit that helps individuals pay for tuition and related expenses for higher education. The credit is nonrefundable and worth up to $2,000 per tax return.[5] This credit, and similar state credits, could be expanded to include parents' qualified early education and care expenses.

Scholarships, fellowships and tuition reductions for qualified higher education expenses are also excluded from income for federal tax purposes.[6] This same exclusion from income does not apply for early education expenses, however. So, if a low-income family receives tuition assistance for their child to attend preschool, the value of that assistance is generally considered taxable income. Therefore, for state income tax purposes, the exclusion from income could be expanded to include tuition reductions or financial assistance for preschool and early childhood care.

There are also preferential savings vehicles to help pay for K-12 and higher education that do not apply to pre-K education. Coverdell education savings accounts, for example, are accounts set up to pay the qualified education expenses of a designated beneficiary.[7] They allow families to invest up to $2,000 per year per beneficiary to grow tax free until distributed. The savings account can then be used to pay for qualified education expenses at either an eligible postsecondary school or an eligible elementary or secondary school. The eligible educational institutions for Coverdell accounts could be expanded to include pre-K; however, the value of tax free growth for only the few years between a child's birth (at which point the child can be designated as a beneficiary) and when the child begins preschool is minimal. But if Coverdell accounts could be set up in advance of a beneficiary's birth, it would significantly increase the value of this savings vehicle for pre-K education.

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

Although these suggestions are mainly based on examples at the federal level, it is worth considering the same kind of parity with higher education benefits at the state level.

Expanding Tax Credits and Deductions

The federal government provides approximately $3 billion annually in tax credits to individuals and employers supporting early child care and education.[8] Many states also provide similar credits. Expanding the value of these credits and exploring ways to address ECE through other existing credits could provide opportunities for ECE financing.

The federal Child and Dependent Care Tax Credit (CDCTC) helps reduce an individual's employment-related child care costs by providing a non-refundable tax credit of between 20 percent and 35 percent of the first $3,000 spent on care for one child and the first $6,000 on care for two or more children. The credit is determined on a sliding income scale, and net can be worth as much as $2,100.[9] In addition to the federal tax credits, 28 states, including the District of Columbia, have their own child and dependent care tax credit.[10]

In practice, the way the credit is currently constructed is not optimal for low-income families, both because the credit is only worth up to 35 percent of what is spent, and the credit is non-refundable, meaning you cannot be reimbursed for more than your total tax liability. For example, a single parent earning $15,000 and spending $1,200 on child care would only qualify for a $86 credit, because that is the total tax she owes.[11] Many low-income families owe little or no tax, so the credit is virtually useless for them. On the other hand, high-income families can take full advantage of the credit.

Luckily, there is precedent at the state level for improving the CDCTC. Thirteen states have improved the credit by making it either fully or partially refundable to benefit low-income families with little income tax liability. Maine, Vermont and Arkansas have increased the value of their credits for higher quality child care.[12] These are both options for improving the state credits and providing low-income working families with additional resources for child care. States can also raise the ceiling on eligible expenses to more closely reflect the actual costs of quality child care.

PHOTO: SAVE THE CHILDREN

In addition to CDCTC, the federal government subsidizes individuals' child care expenses through the employer-provided child care exclusion. The exclusion allows employees to pay for up to $5,000 in child care with pre-tax dollars. To take advantage of this exclusion, employees need to arrange through their employer to exclude up to $5,000 in pre-tax dollars from their salary. The exclusion applies to both payroll (FICA) and income taxes.[13]

There is room to improve similar state-based employer-provided child care exclusions. First, many are only available to taxpayers whose employers offer the exclusion. Second, like the CDCTC, most exclusions are fixed and not indexed for inflation regardless of the number of children needing care. States can increase the maximum allowable exclusion to better reflect the actual cost of child care by making the exclusion $5,000 per child or indexing the credits for inflation.[13]

Maine, Oklahoma and Florida have experimented with tax credits or exemptions for early child education and care businesses.[14] The effectiveness of these credits has not been fully studied, but they are widely popular with lawmakers. In Maine, a child care provider or an individual center owner can get up to a $1,000 credit for costs associated with improving the quality of care. Businesses and institutions may claim a 30 percent tax credit on up to $30,000 in similar expenses.[15]

Lastly, there are additional state-provided benefits for child care and ECE that could be pursued or expanded. The State of Iowa, for example, offers the Child Care Assistance program and participates with the Dependent Care Flexible Spending Accounts to help working parents with their child care costs. Child Care Assistance, administrated by the Department of Human Services, covers all or a portion of child care costs for households with income up to 145 percent of the federal poverty level. And Dependent Care Flexible Spending Accounts (FSA) are a tax benefit where employers can offer employees the option to set aside up to $5,000 in pre-tax income each year for eligible child care expenses.

PHOTO: SUSAN WARNER

Identifying New Public Resources

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

Excise Tax Parity

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

"E-Cigarette" Tax

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

There are some concerns with taxing e-cigs. Some see them as a healthier option compared to traditional cigarettes and worry that taxing them will discourage people from changing bad habits. However, a tax that only applies to the nicotine content is unlikely to be rejected out of hand because the chemical is equally present in both products.

There is precedent for directing revenue from nicotine products to help children. When the State Children's Health Insurance Program (SCHIP) was signed in February 2009, it raised the federal cigarette tax from $0.39 per pack to $1.01 per pack and directed those funds to pay for children's health care. Traditional cigarette and e-cig taxes could also be targeted at the state level for additional ECE funding.

State Examples

Only one state, Minnesota, already declared that e-cigs are subject to the tobacco tax. Last May, North Carolina adopted a new e-cig tax as well. Reynolds American Incorporated, which has its own e-cigarette brand in addition to traditional tobacco, actually proposed e-cig legislation for the state legislature to consider. They suggested a tax of $0.05 per milliliter of nicotine mixture, which they said would be "a fair and reasonable" excise tax on e-cigs. Lorillard Inc., another tobacco company that at one point held 49% of the e-cig market share, also supported the legislation. This $0.05 per milliliter tax was eventually signed into law. Ohio, New Jersey, Indiana, and Arizona are among others that are considering state-level e-cig taxes.

There are some groups who oppose state-level e-cig taxes. Washington's governor recently proposed an e-cig tax, and the American Vaping Association (AVA) quickly responded, asserting the law would hurt small businesses (unclear how exactly) and discourage smokers from switching to vapor products - which many argue are healthier than traditional cigarettes. The AVA represents small- and medium-sized businesses in the vapor industry, including NicQuid, VaporKings, VaporCast, and others. Others see e-cig taxes as just another excise tax burden, including Grover Norquist.

In states that do levy these taxes, the money goes to the states' general coffers. However, the recent Washington proposal (opposed by the AVA) would direct some of the revenues toward improving student-to-teacher ratios in Kindergarten to third grade classrooms.

Lotteries and Gaming

States with legalized gambling sometimes impose taxes on receipts from gaming, and may also impose various fees, including on admission to casinos and on annual operation licenses. Casinos in Maine, for example, are required to give up a portion of their profits to fund public education, and in 2014, Maine passed legislation that would earmark some of those casino education revenues toward preschool start-ups. Missouri also partially finances education through gaming revenue, though not specifically toward early childhood education.

Lotteries are another mechanism used by states to finance education measures. According to the National Association for the Education of Young Children, at least 13 states have lotteries with the stated purpose of funding education. These states include Georgia, South Carolina, New Hampshire, Vermont, Washington, Florida, Texas, Missouri, Oregon, and Virginia.

One of the best examples of lottery-funded early childhood education is Georgia. Governor Zell Miller (D-GA) proposed the creation of the Georgia Lottery for Education in 1990. The proposal would use lottery funds to supplement existing educational programs, as well as the development of a preschool program and a college scholarship initiative. Georgia voters passed the proposal in a 1992 referendum, and between 1993 and 1994, the first lottery funds were utilized to provide prekindergarten programs for more than 8,700 at-risk four-year-old children. In 1995, the program opened to all eligible four-year-olds, no longer just those at risk. By 2010, Georgia became the first state in the U.S to serve more than 1 million pre-kindergarten children in a voluntary, universal, lottery-funded program.

PHOTO: RICK D'ELIA

Harnessing Savings and New Revenue Mechanisms

States will likely continue to scrutinize underperforming programs in the coming years, allowing potential savings from these programs to be captured as a viable funding source for ECE programs. In general terms, there are several publicly debated proposals to harness dollars in savings from reducing fraud and abuse and cutting redundant or antiquated state programs. Regardless of where savings are achieved, our objective is to create a policy proposal stating that a portion of these savings should be invested in our future – namely in a fund dedicated to expanding early childhood education.

New revenue mechanisms include often sought-after pots of revenue such as a one-time state windfalls and closing tax loopholes, and there is precedent for earmarking part or all of these new revenues for specific uses.

A comprehensive, national early childhood education program would add

$2 trillion

to the annual GDP within a generation.

Special Assessment Financing

Several urban areas around the country have employed dedicated revenue and spending mechanisms known as "Special Assessment Financing" to fund specific projects for a defined geographic area. In general, once an area is defined, property owners within that district are assessed a fee, which is then used to finance a special benefit for the same area (usually infrastructure). In Washington DC's Golden Triangle district, this revenue is used to fund cleanliness and hospitality, homeless outreach, streetscape improvements, marketing, outdoor summer concerts and other events. Depending on the district type, the involved properties can be either commercial and/or residential. The creation of special districts is typically led by the private sector, with assistance from the public sector in implementation, and the established districts function as quasi-governmental entities with unique powers in the designated area.

Though the majority of districts use these funds for infrastructure projects, some special districts have used their acquired funds for education initiatives. For example, a special district in Denver established a school in the downtown area, and other districts have funded specific education projects, such as arts training. Certain districts in California have used bonds to finance the construction of schools. However, individual districts may limit the types of projects that can be funded by the assessment. For instance, assessment districts in San Mateo, California, are not allowed to finance projects that benefit the general public, such as schools, parks, and childcare facilities.

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Endnotes

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