Innovative Financing Strategies for Early Childhood Care

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Executive Summary

Spending funds on human capital, especially children, is one of the most effective investments a government can make. Healthy, educated children grow into productive adults, contributing more to society and posing fewer burdens on public systems than those whose early lives lacked proper nurturing and support. By improving long-term outcomes for kids, investments in early childhood development can yield significant returns to the city, state, and nation and to the investor. At the same time, the cost of foregoing these investments is high. Neglecting children during their critical formative years (specifically ages 0–5) results in increased spending on remedial education, prisons, job training, and many other costly public programs.

Notwithstanding the public benefits from investing in early childhood programs, not enough funding flows to this area. Many programs known to improve long-term outcomes (such as parenting education, nutrition programs, health services, and quality child care) need to be scaled up and targeted to the most vulnerable populations. Closing the gap in long-term outcomes between low- and higher-income families requires additional funding to address the lack of quality programming for at-risk segments of the population.

However providing that funding is often the stumbling block, even in times of relative economic well-being. It is especially difficult during a period in which state and federal budgets are being cut. Given limited public funding, how can the size and scope of investments in early childhood be increased? How can we leverage existing public and private financing tools to promote early childhood care? This paper, commissioned for the Partnership for America’s Economic Success, explores methods to increase resources for early-childhood care and development.

All of the financing strategies discussed in this paper, and summarized in table 1, are currently under-utilized or non-existent in this sector. While the majority of these strategies raise funds specifically to finance facilities, several of them could also be used to increase funding for operating expenses. It should be noted that the implementation time varies for each strategy. While some can be carried out quickly, others will require substantial work to transition from a promising idea into a concrete strategy. Despite potential challenges, it is imperative that we explore new options to support our nation’s future.
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<td>Allows the borrowing entity to possibly increase its credit rating</td>
<td>Nonprofits may find it difficult to identify revenue sources for PRI repayment</td>
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Financing Strategies

1. Qualified section 501(c)(3) bonds

Public bonds are well known: state and local governments often use them to fund new construction or other initiatives. Less well known, however, is a private version that can be targeted to nonprofit organizations. State and local governments can make greater use of private activity bonds (bonds for which the proceeds are used for private business purposes) to fund early childhood care. A specific type of private activity bond, a qualified section 501(c)(3) bond, makes loan capital from private investors available to nonprofit organizations. It is typically issued with the purpose of helping nonprofits finance capital improvement projects. The government acts as the issuer of the bonds, but the bonds are non-recourse to the government. In other words, the government issuing the bonds cannot be held responsible for repayment (unless it specifically agrees to do so as in the example of Connecticut described in the box below). Instead, the nonprofit agrees to pay back the debt from the revenue of the project being financed.

Qualified section 501(c)(3) bonds are appealing not only because they engage the capital markets and limit the government’s financial obligation, but also because they provide nonprofits with an inexpensive financing option. Like most municipal bonds, interest is tax-exempt. As a result, interest rates are lower than conventional banking products, making these bonds an attractive low-cost alternative for nonprofits.

Nevertheless, owners of nonprofit early childhood care facilities may find repayment of bonds challenging. These facilities tend to rely largely on parental fees to cover costs. Increasing fees to repay bonds would likely be unrealistic, especially if care is directed at poorer children most in need of low-cost services. To limit investors’ potential loss, a nonprofit should secure credit enhancement (e.g., a letter of credit or bond insurance) in advance of issuing the bonds. Although their credit ratings are not directly affected by 501(c)(3) bond activity, government issuers typically require that bonds carry a minimum credit rating. Credit enhancement, discussed in more detail later in this paper, can help raise the bonds’ credit rating.

Currently, 501(c)(3) bonds are used throughout the U.S. for a number of purposes. In 2006, state and local governments issued $56.3 billion in long-term (bonds with maturities of 13 months or more) 501(c)(3) bonds. Hospitals, colleges, and universities are the primary beneficiaries of the bond proceeds,¹ but these bonds are also used for early childhood purposes. For example, Indiana and Illinois offer this type of bond to finance child care facilities,² and California and New York have funded the construction of children’s hospitals with the vehicle.³

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2. Real Estate Investment Trusts (REITs)

A state or local government could also finance early childhood expenses through more efficient management of existing assets. Education-related hard assets (e.g., child care facilities and/or schools) could be pooled into a Real Estate Investment Trust (REIT) and professionally managed. REITs are companies that manage commercial properties, mortgages, and other real estate assets. REITs can purchase assets in two forms: equity or debt. REITs that invest in equity purchase properties and receive cash flows from rental payments. REITs that invest in debt buy property mortgages and earn revenue from mortgage payments. After a REIT manager has compiled a portfolio of properties, shares of the REIT are offered to individual and institutional investors (e.g., pension funds, endowments, insurance companies, and mutual funds). Shares can be sold privately or issued publicly on major stock exchanges. To help fund public or private early childhood programs, the owners of these facilities could enter into long-term contracts with REITs to manage the construction, maintenance, and development of these assets.

For investors, REITs provide numerous benefits. REITs allow investors the advantage of diversification, as their returns are not highly correlated with returns in other asset classes. REITs have had low relative historical volatility, providing investors a stable source of income and some degree of inflation protection. Moreover, REITs often outperform other investments. Between 1978 and 2008, the compound annual total return on equity REITs was 12.0 percent, higher than the total return on the S&P 500 (11.0 percent), Russell 2000 (10.8 percent), and Barclays Capital Aggregate Bond Index (8.6 percent) over the same period. While commercial real estate markets and REITs have suffered due to fallout from the housing crisis and REIT returns fell sharply in 2007 and 2008, they have since shown signs of recovery.

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For providers of early childhood programs, private management of assets could offer several benefits. A private sector management company introduces competition and market forces in the construction and management of facilities. REITs would have a financial incentive to increase the value of the assets as much as possible. By contracting out these tasks, early childhood providers could focus on their programs, rather than get distracted by tasks related to building maintenance. The providers could retain oversight of the REIT so that it would still control decisions relating to programs and be able to fire building managers as deemed necessary.

Although REITs have not yet been used to finance early childhood care, they have been discussed with regard to school districts and used to finance higher education facilities. American Campus Communities (ACC), which became the first publicly traded student housing REIT when it began trading in 2004, has developed more than $1.5 billion in properties and has acquired over $2 billion in student housing since 1996. The management and construction of facilities by a third-party has reduced the financial burden on the public sector. Another version of this concept was proposed in the ultimately unsuccessful California Hope Endowment (see box below). The Endowment planned to bring different types of publicly owned real estate under professional management to produce income that would help needy students finance higher education.

A challenge to using this approach is identifying property to incorporate into a REIT. Furthermore, it may be difficult to secure political approval in support of contracting with REITs to manage public assets.

### The California Hope Endowment

The proposed California Hope Endowment recommended the creation of a public trust, the CalHope Trust, to support higher education. The Endowment, outlined in California’s Assembly Bill 593 in 2005 and sponsored by then State Treasurer Phil Angelides, would have brought more than $5 billion in state-owned real estate assets, including offices, industrial property, and warehouses, under professional management. More efficient management of these assets would allow profits to accrue to the Trust. These profits, estimated at $300 million per year after start up, were intended to offset the costs of higher education for needy students. The Endowment was ultimately never created, however. Governor Schwarzenegger vetoed the measure for two reasons: revenue generated from the sale of the state’s surplus property was already designated for another purpose, and the new entity was not designed to be held accountable to the public.


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3. Tax Increment Financing (TIF) districts

Tax Increment Financing (TIF) is an economic development tool that local governments can use to finance improvements to property, particularly distressed or blighted areas. Prior to redevelopment, the local government designates an area as a “TIF district” and freezes the rate of taxes at the site at its existing, relatively low, level. The expected rise in tax revenue after completion of the project (the “tax increment” due to the increased property value) serves as a revenue stream to finance a bond or loan, which pays for the redevelopment.

Local governments take advantage of TIF in various ways. Some cities and states use TIFs only for private development gap financing and clearly define the TIF district as a small area covering just the project to be financed. Other communities designate large areas of the city, or even the entire city, and use the TIF revenue like general obligation bonds to fund capital projects.\(^9\)

TIF legislation is authorized at the state level. Currently, Arizona is the only state without a TIF statute.\(^10\) Each state enumerates certain project costs that may be financed using the future increase in tax revenues. Some eligible project costs include expenses associated with land acquisition (such as environmental remediation), costs of rehabilitation and repair of existing buildings, construction or improvement of public works (e.g., water and sewers), and financing costs (such as capitalized interest and underwriting expenses). Some states, such as Maine and Illinois, also allow child care expenses for families working within the district as an eligible TIF project cost.

Once authorized by legislation, TIF funds can be used to help finance child care. After a TIF district is identified, redevelopment and renovation of the area take place. Over time, the area improves in value, creating more jobs and consequently leading to a higher demand for child care. Designating child care as an eligible TIF project cost allows the property appreciation to finance the new demand. States that do not allow child care as a permissible TIF cost would need to amend their laws.

Maine’s TIF districts

Maine established a Tax Increment Financing program in 1985. In 1999, an amendment to the statute added quality child care as a project cost eligible for TIF funds. Eligible child care-related costs include construction of the facility, staffing, training, certification, and accreditation costs. Because the statute does not define “child care,” the municipality determines what type of child care services to allow and what populations to serve (i.e., whether to serve only low-income children).


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4. Developer impact fees

Some states and local governments have established legislation that requires any new real estate development project to pay a share of the cost resulting from the project’s impact on demand for child care. Generally known as linkage programs, these initiatives link the additional need for services to the real estate project and ask the developer to provide some compensation for them. For example, the city of Palm Desert, California charges developers a Child Care Facilities Impact Mitigation Fee for new commercial developments. Fees range between $0.47 and $1.15 per square foot depending on the building’s use (e.g., light industrial, retail, office). The funds collected are used to construct new child care facilities or expand or improve existing facilities in the city. These additional spaces serve the child care needs of the employees working in the newly constructed buildings.

Local governments that do not already use developer impact fees may institute them to support the construction of child care facilities in growing neighborhoods. It is worth noting that areas that are considering initiating such a program may face some backlash from various stakeholders. For example, in 2006, when Alameda County, California proposed to assess impact fees to fund upgrades to child care facilities, individuals in the affected areas complained. They feared that these higher fees would cause their neighborhoods to be less attractive to developers compared to areas of the county where the fees did not apply and would therefore have a negative impact on their economic development.

<table>
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<th>San Francisco’s Child Care Capital Fund</th>
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<tr>
<td>San Francisco requires developers of large office and hotel projects to offset the impact of their projects on the demand for child care. Developers can either build a child care facility on-site or pay an in-lieu fee to the Child Care Capital Fund. This fund is part of the Child Care Facilities Fund, managed by the Low Income Investment Fund (LIIF). LIIF provides child care providers with affordable financing, technical assistance, and training in order to expand high-quality child care facilities for low-income families in the San Francisco area.</td>
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5. Paid family leave laws

Unlike the previous financing strategies, federal and state family leave regulations do not provide capital to early childhood programs. Nevertheless, they are critical in supporting the health of children in their early years. These policies allow parents adequate time to spend with their newborns and the option to take time off when a child is sick. They enable increased parental involvement, as they decrease workers’ anxiety about taking time off for fear of losing their jobs or sacrificing earnings. Two types of policies protect workers in this respect: the U.S. Family and

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12 Palm Desert, California, Municipal Code §3.45.010.
13 Karen Holzmeister, “County Weighs Child Care Fees for New Development” (Oakland Tribune, September 30, 2006).
Medical Leave Act (FMLA) and state laws, some of which provide paid leave under certain circumstances.

According to the federal Family and Medical Leave Act, covered employers must grant an eligible employee up to 12 weeks of unpaid leave during any 12-month period for any of the following reasons:

- the birth and care of the employee’s newborn child,
- placement with the employee of a child for adoption or foster care,
- an immediate family member (child, spouse, or parent) with a serious health condition requires the employee’s care, or
- an employee’s health condition prevents him or her from working.\(^\text{14}\)

Some states, including California, Washington,\(^\text{15}\) and most recently, New Jersey (for more information on New Jersey’s policy, see box below), have passed legislation that allows (but does not enforce) employees paid leave for all businesses for some of the same reasons as FMLA. Advocates argue that these policies make economic sense because they generate savings for the public sector and employers. Furthermore, California’s and New Jersey’s policies (Washington has not yet identified the revenue source to pay for its policy) are fully funded by employees’ contributions. California’s Paid Family Leave insurance, which covers 13 million California workers, is part of the State Disability Insurance (SDI) program. Employees currently pay 1.1 percent of their wages up to a taxable wage limit of $90,669 into the SDI program.\(^\text{16}\)

Paid family leave is a useful part of the toolkit supporting children’s healthy development. Although the time granted is generally short-term, these policies are important to support early bonding between parent and child, as well as time to attend to a child’s health. In states where a paid leave law does not exist, child advocates can make a case for implementing such a policy to support the state’s human capital. Passing legislation may be difficult in the face of likely backlash from the business community. Opposing California’s paid leave law, the California Chamber of Commerce made a number of arguments. For example, the Chamber claimed that the law would impose additional costs on businesses, such as to hire replacement workers and pay overtime for workers to complete absent employees’ work. The Chamber also argued that the law would make California businesses less competitive compared to other states without such

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\(^\text{15}\) Washington’s policy was to take effect October 2009. Due to the state’s budget crisis, however, the law’s implementation has been pushed back to October 2012. HR.BLR.com, “Washington’s Paid Family Leave Law Delayed 3 Years,” June 9, 2009, http://hr.blr.com/news.aspx?id=80082 (accessed September 9, 2009).

a law. However, the law was enacted and since the policy became effective in July 2004, approximately 740,000 people have received more than $4 billion in benefits.

New Jersey’s Family Leave Insurance

In May 2008, New Jersey became the third state to pass a paid family leave law. The policy allows eligible employees up to six weeks of paid leave (up to $546 per week) due to the birth or adoption of a child, or to care for a family member with a serious health condition. Eligible employees are those individuals who have worked at least 20 weeks or earned at least $7,200 in New Jersey during the previous year. The insurance is funded entirely by employee contributions. Employees began contributing 0.09 percent of their paycheck on January 1, 2009. Benefits through the program became available July 2009.


6. Credit enhancement

As noted above, credit enhancement reduces a lender’s credit risk by increasing a borrower’s credit-worthiness. It can take one of several forms. For instance, a highly-rated organization can lend its credit rating to a lower-rated public or private entity for the purpose of borrowing money. The highly-rated organization agrees to pay the borrower’s interest and/or principal payments in the event it cannot meet the payments. Purchasing credit enhancement enables the lower-rated entity to obtain financing at lower interest rates than would otherwise be possible. Tools of credit enhancement include a letter of credit, liquidity enhancement, line of credit, or loan guarantee.

An example of one such program is the California State Teachers’ Retirement System (CalSTRS) Credit Enhancement Program. Through a letter of credit, line of credit, or liquidity enhancement, CalSTRS loans its credit rating to local government entities, nonprofit organizations, and state agencies looking to issue debt. CalSTRS partners with banks and serves in either a co-front or second-loss position. By securing a higher credit rating, these entities gain access to the capital markets, as well as the ability to pay a lower interest rate on their debt. CalSTRS benefits from the agreement by generating fee revenue for its investment portfolio. From its inception in 1994 to June 2009, CalSTRS had earned over $48 million in fee income through this program.

Aside from increasing access to low-cost funds, credit enhancement is beneficial to the borrowing entity as the successful repayment of loans may have a reinforcing effect—financial institutions could adjust its assumed default rate downward and lift its credit rating. In order for this to happen, the borrowing entity must ensure it makes all loan repayments. At times, this may mean passing the cost of financing onto clients, perhaps in the form of fees.

An established early childhood program could utilize the credit rating of its state, one of its agencies, or a philanthropic organization to lower the cost of bank loans or debt issuances. The state, agency, or organization would agree to pay the debt’s principal plus interest in the event of a default. In return, the program would be able to obtain access to less expensive debt financing. A number of states, including Arkansas, Connecticut, Maryland, Tennessee, and West Virginia, guarantee loans for child care providers. In the current economic climate, guarantees may be difficult to secure as state budgets have tightened, and entities nationwide have less liquidity to cover defaults. Where credit enhancement is available, it may come at greater cost than in years past.

### Arkansas Child Care Facilities Guaranteed Loan Fund

Arkansas’ Division of Child Care and Early Childhood Education administers a Child Care Facilities Loan Fund that the state uses to guarantee loans for child care providers. This program helps child care providers that have trouble securing a loan from conventional sources. The state decreases a bank’s risk of loaning funds to a provider by promising to reimburse the bank for 80 percent of the outstanding principal balance, up to a maximum of $25,000, in the case the provider defaults on the loan. Licensed child care family homes or centers that would like to build a new facility or expand an existing one are eligible for the guaranteed loan. Approved uses of the funds include construction and remodeling costs, temporary support for staff salaries and operating expenses, equipment for playgrounds and learning environments, training expenses, advertising, and transportation costs.


### 7. Program-related investments (PRIs)

Program-related investments (PRIs) are concessionary investments made by foundations to support charitable activities. Private foundations can use PRIs as an alternative to grants, and under certain circumstances, they may be able to count PRIs toward their IRS-mandated annual 5 percent payout. PRIs are typically structured as loans, but they can also be loan guarantees, equity investments, or recoverable grants, among other financial tools.  

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21 A PRI counts toward a private foundation’s 5 percent payout if the primary purpose of the investment is to accomplish at least one of the foundation’s exempt purposes, the production of income or appreciation of property is not a significant purpose, and the funds are not used for lobbying or political purposes. Internal Revenue Service, “Program-Related Investments,” [http://www.irs.gov/charities/foundations/article/0,,id=137793,00.html](http://www.irs.gov/charities/foundations/article/0,,id=137793,00.html) (accessed September 10, 2009).

PRIs are advantageous to both foundations and PRI recipients. For the recipients (who can be nonprofit or for-profit as long as the PRI is used to further a charitable purpose), PRIs mean access to capital at more favorable terms than may otherwise be available. It also allows new organizations to build a credit history, positioning them to gain access to capital through more traditional means in the future.

From the foundations’ point of view, PRIs have enabled them to leverage significant amounts of capital from conventional sources by absorb real or perceived higher risk. For instance, in the early 1990s, the Living Cities program used approximately $150 million in foundation PRIs and corporate support to leverage $750 million in community development investment. PRIs also allow foundations to have greater programmatic impact, as they can recycle PRI repayments for other charitable investments. In the economic downturn, as declines in endowments have reduced their annual payout, increasing numbers of foundations are exploring the use of PRIs as an alternate use of capital that enables them to continue to serve their mission.

Foundations have used PRIs to finance early childhood initiatives. For example, in March 2008 the Kresge Foundation approved a $1 million program-related investment to First Children’s Finance, a community development financial institution based in Minneapolis that provides financing, technical assistance, and training for child-care facilities in eight states. The PRI was to help First Children’s Finance expand its loan pool to other regions. In the early childhood space, PRIs are most likely to be used to fund construction or renovation of facilities.

More PRIs could support early childhood programs and build or renovate day care centers, health and nutrition centers, and educational facilities. A challenge to doing so is the fact that only a small percentage of foundations in the United States currently make PRIs (though the number exploring the mechanism continues to grow). About one-third of those foundations that make PRIs have formal PRI programs or make PRIs on an annual basis. Furthermore, nonprofits must identify projects that generate streams of capital to repay the PRI (e.g., construction projects). It is not a tool for every expense.

Affordable Buildings for Children’s Development

The Low Income Investment Fund (LIIF) based in California provides affordable capital and technical assistance to organizations working in low-income communities. One of LIIF’s initiatives is called Affordable Buildings for Children’s Development (ABCD). ABCD supports California’s child care sector, providing financing, technical assistance, construction advice, and advocacy to child care providers. The program has been funded with several program-related investments. The David and Lucile Packard Foundation has committed $14.5 million in grants and PRIs to ABCD. One of their PRIs, for $1 million, leveraged $10 million from Impact Community Capital, a consortium of insurance companies. Overall, the ABCD Fund hopes to raise $30 million to $40 million in private and philanthropic capital to finance 10,000 child care spaces in California.

Conclusions

The financing tools outlined in this report provide a variety of alternatives for financing early childhood programs. As state and local budgets continue to tighten, early childhood services will become increasingly difficult to fund. Exploring innovative financing techniques will help sustain these services that are so important to children’s early years. It is especially critical to ensure that low-income Americans have access to such services, as many are forced to forego them when publicly provided programs are unavailable. Furthermore, research suggests that disadvantaged children gain the most from early childhood programs. Such investments can provide major economic returns to society in terms of a more educated workforce and a population that is less dependent on government services.

The tools described above attempt to increase the supply of early childhood care programs by increasing the funds available to them. These funding options aim to reduce the burden on state and local governments by focusing on new sources of capital. In particular, they align the interests of the private and public sectors, encouraging the private sector to participate in financing early childhood. For example, qualified section 501(c)(3) bonds and REITs raise private capital to finance early childhood organizations, while allowing private investors to make a return on their investment. Similarly, private development within TIF districts results in increased revenue to the state, allowing the government to finance child care in these areas. Current paid family leave laws are financed entirely through employee contributions, which decrease state and local burden and spread costs across large pools. Developer impact fees shift some of the cost burden of child care onto the private sector. Additional tools, like credit enhancement, reduce financing costs for early childhood organizations and allow public entities to earn fees. Finally, innovative strategies, like PRIs, are valuable ways of leveraging private dollars and allowing philanthropic organizations to recycle funds.

Obviously, the strategies differ in terms of ease of use. Some methods, such as tax increment financing, developer impact fees, and paid family leave, require updating state or local government regulations in areas where those programs are not currently authorized. Others, like qualified section 501(c)(3) bonds and program-related investments, do not necessarily require new infrastructure. However, they do require the implementing entities to understand their requirements and initiate their regular use. In the latter case, it is often only a matter of recognizing the benefits of the strategy and employing it to complement more commonly used funding methods.

Flexible, low-cost funding is critical for new organizations. Once they have established a credit history, these organizations are more likely to find funding from conventional sources. Still, even more established programs compete for limited funding and continually search for new ways to sustain themselves and retain high-quality staffing and services. Ultimately, the funding sources presented here seek to expand the pool of funds available to children’s programs. With innovation and leadership, these financing strategies can be harnessed to ensure sufficient investment in children’s critical early development.
References


Palm Desert, California, Municipal Code §3.45.010.


