

## 7. Childcare subsidies

The link between the affordability of good-quality childcare and the ability of mothers to undertake paid employment remains at the centre of policy debate, even though a higher proportion of mothers are currently active in the formal labour market than ever before. There are concerns that mothers are constrained from paid employment by a lack of suitable childcare options<sup>1</sup> and that care costs are rising, consuming a greater proportion of families' financial resources. In addition, there is an ongoing debate about whether the type of care that is available and affordable is beneficial to children.

In his Pre-Budget Report of November 2002, the Chancellor said the government wanted to help 'parents to make real and effective choices on balancing work and family life'. Over the last decade, several initiatives have been introduced to help families with the cost of childcare. A childcare deduction was introduced in family credit in 1994 and expanded with the introduction of the working families' tax credit (WFTC) in 1999. The Childcare Voucher Scheme (later the nursery education grant) was implemented in 1997. In April, the childcare credit currently included in the WFTC will transfer to the new working tax credit (WTC). The types of care eligible for the childcare credit will be extended in a limited way 'to include those who use *approved* childcare in their own home, benefiting, among others, parents of disabled children and those who work outside conventional hours' (italics added).<sup>2</sup> Further plans for the expansion of the types of care covered by the credit have been announced, although many are relatively minor extensions.<sup>3</sup>

This chapter considers the potential effects on the number of eligible families and the annual budget cost of further expanding the scope and generosity of the childcare credit. The estimates are initially made under the unrealistic

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<sup>1</sup> For example, see paragraph 3.26 on page 21 of HM Treasury and Department of Trade and Industry, *Balancing Work and Family Life: Enhancing Choice and Support for Parents*, January 2003 ([www.dti.gov.uk/er/individual/balancing.pdf](http://www.dti.gov.uk/er/individual/balancing.pdf)).

<sup>2</sup> Page 91 (chapter 5) of HM Treasury, *Pre-Budget Report 2002*, Cm. 5664, London, 2002 ([www.hm-treasury.gov.uk/pre\\_budget\\_report/prebud\\_pbr02/report/prebud\\_pbr02\\_repchap5.cfm](http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr02/report/prebud_pbr02_repchap5.cfm))

<sup>3</sup> It has been announced that the Home Childcarers Scheme will be opened to existing childminders and that consideration will be given to 'how to widen entry into the scheme to include people who are not already childminders'. The type of care eligible for the childcare credit will also be broadened by expanding the regulation required for eligibility to domiciliary workers and nurses employed through agencies and to providers who offer childcare exclusively to children over the age of 7 (paragraphs 4.59 and 4.60 on page 36 of HM Treasury and Department of Trade and Industry, *Balancing Work and Family Life: Enhancing Choice and Support for Parents*, January 2003 ([www.dti.gov.uk/er/individual/balancing.pdf](http://www.dti.gov.uk/er/individual/balancing.pdf))). In addition, the government is considering reforms to tax and National Insurance incentives to expand employer-supported childcare (box 1.1 on page 3 of HM Treasury and Department of Trade and Industry, *Balancing Work and Family Life: Enhancing Choice and Support for Parents*, January 2003 ([www.dti.gov.uk/er/individual/balancing.pdf](http://www.dti.gov.uk/er/individual/balancing.pdf))).

assumption that childcare and employment behaviour remains unaltered by the changes, but this is followed by a discussion of the possible reactions in family childcare and work choices.<sup>4</sup>

Section 7.1 briefly reviews the arguments for government subsidies in the childcare market, while Section 7.2 describes the current employment and childcare choices of families. A description of options for expanding the childcare credit is presented in Section 7.3, followed by the estimated potential impacts in Sections 7.4–7.7. Section 7.8 concludes.

## **7.1 Why subsidise childcare?**

The case for subsidising childcare is essentially twofold. First, it is argued that mothers should be encouraged to work in formal paid employment: to reduce gender inequalities in the labour market; to make the best use of the potential labour force and thereby improve economic efficiency; and to reduce the dependence of poorer households on the state. Secondly, if pre-school children benefit from childcare (other than that of family), it may be desirable on equity grounds to ensure that it is available to poorer families.

In the absence of government intervention, families may not make the best employment and childcare choices, for several reasons: the benefits may be social as well as private; parents may lack complete information or be short-sighted; or parents may be unable to afford adequate childcare. For these reasons, it may be desirable for government policies to help families with the cost of care.<sup>5</sup> The design of the subsidy may depend upon the particular rationale and potential cost.

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<sup>4</sup> Budget costs of different childcare subsidies have been estimated previously in A. Duncan, C. Giles and S. Webb, *The Impact of Subsidising Childcare*, Research Discussion Series no.13, Equal Opportunities Commission, Manchester, 1995, and in A. Duncan and C. Giles, 'Should we subsidise pre-school childcare, and if so, how?', *Fiscal Studies*, 1996, vol. 17, no. 3, pp. 39–61. These publications use data from the Family Resources Survey from the early 1990s together with childcare information from the 1991–92 General Household Survey. They include potential labour supply responses, but only consider formal types of childcare for pre-school children and limit changes in childcare choices to those related to employment responses. The budget cost of a particular childcare tax credit has also been analysed using aggregate statistics in Ernst & Young, 'Potential cost of the childcare tax credit', Tax Policy Discussion Paper, 2001.

<sup>5</sup> In addition, there may be supply constraints in the provision of childcare due to inefficiencies in the childcare market. This problem may be addressed by more direct measures to improve the supply of childcare, such as those included in the government's National Childcare Strategy and financed by the combined budgets for Sure Start, childcare and early years programmes (paragraph 2.2 on page 1 of HM Treasury and Department of Trade and Industry, *Balancing Work and Family Life: Enhancing Choice and Support for Parents*, January 2003 ([www.dti.gov.uk/er/individual/balancing.pdf](http://www.dti.gov.uk/er/individual/balancing.pdf))).

## 7.2 Families' employment and childcare use

This section outlines the current employment status of parents and the patterns of childcare use by working families. These tables and the analysis below use a sample of families with dependent children (those aged under 16, or under 19 and in full-time education) from three years of the Family Resources Survey (1998–99 to 2000–01).<sup>6</sup>

Over three-quarters of families (78%) have at least one parent working in paid employment for 16 or more hours each week. Some 39% of all families have two working adults, while single parents working 16 or more hours each week constitute 10% of all families. But, as Table 7.1 shows, the likelihood that a parent is in paid employment depends considerably on whether there is a partner present and on the age and number of children in the family. Single parents (predominantly single mothers) are much less likely to be working than mothers with a partner. Mothers are less likely to be in employment if at least one child is of pre-school age or if there is more than one child.

**Table 7.1. Employment patterns among families with children**

	Couples				Single parents				All
	Pre-school children		Only school children		Pre-school children		Only school children		
	1	2+	1	2+	1	2+	1	2+	
<i>Percentage of families with weekly hours of work:</i>									
no one works 16+	7	10	9	9	73	83	48	59	22
only mother works 16+	2	2	5	4	–	–	–	–	3
only father works 16+	38	53	23	31	–	–	–	–	26
both parents work 16+	53	35	62	56	–	–	–	–	39
single parent works 16+	–	–	–	–	27	17	52	41	10
Number of families (1,000s)	679	1,207	1,344	1,977	255	316	615	559	6,952

Notes: The category 'pre-school children' includes families with at least one pre-school child. The symbol '–' denotes a cell that is not applicable to the family group. The numbers of families have been grossed to the national level.

Source: Family Resources Survey (1998–99, 1999–2000 and 2000–01)

To be eligible for the childcare credit in the current working families' tax credit (and also for the childcare credit to be introduced in April 2003), both parents in a couple and single parents must be in employment for at least 16 hours each week (with certain exceptions for incapacitated parents). Table 7.2 presents the current use of childcare for families fulfilling this requirement.

When asked whether 'anyone else normally looks after the children because you or your partner are working', 44% of working families (defined as those where all parents are in employment at least 16 hours each week) respond that

<sup>6</sup> A full description of the survey and extensive analysis of the childcare information can be found in G. Paull and J. Taylor with A. Duncan, *Mothers' Employment and Childcare Use in Britain*, Institute for Fiscal Studies, London, 2002.

they use childcare and only 23% report that they pay for the care. Given that almost three-quarters (73%) of the families with no parent working less than 16 hours each week contain only school-age children, this is not surprising as parents may be able to fit work around school hours or the children may be old enough to look after themselves. Indeed, Table 7.2 shows that the majority of working families with pre-school children do use childcare, while around half pay for it.

**Table 7.2. Childcare use for families with no parent working less than 16 hours each week**

	Couples				Single parents				All
	Pre-school children		Only school children		Pre-school children		Only school children		
	1	2+	1	2+	1	2+	1	2+	
<i>Any type of non-parental care:</i>									
% using care	77	72	23	34	85	90	38	47	44
% paying for care	50	49	10	15	51	51	16	20	23
Average weekly cost	£76	£90	£33	£42	£63	£68	£33	£37	£62
<i>Formal care:</i>									
% using care	42	40	7	10	43	39	11	12	18
% paying for care	41	39	7	10	40	37	10	11	17
Average weekly cost	£80	£97	£35	£46	£68	£71	£35	£44	£69
<i>Informal care:</i>									
% using care	47	45	18	26	56	68	31	39	31
% paying for care	19	19	5	8	24	25	9	12	11
Average weekly cost	£52	£49	£28	£33	£46	£48	£28	£25	£38
Number of families (1,000s)	361	419	830	1,112	70	54	320	229	3,394

Notes: The category 'pre-school children' includes families with at least one pre-school child. The average weekly cost is the total cost for all children and is averaged over those paying for care. All monetary values are in approximate April 2003 prices. Formal care includes nurseries, crèches, school clubs, childminders, nannies and au pairs. Informal care is that provided by relatives and friends. The numbers of families have been grossed to the national level.

Source: Family Resources Survey (1998–99, 1999–2000 and 2000–01).

Childcare can be divided into two types: formal care, provided in a market setting by nurseries, crèches, school clubs, childminders, nannies and au pairs; and informal care, provided by relatives and friends. Childcare subsidies have typically covered only the costs of formal care. Even so, only 18% of the working families report using formal care, while 31% have used informal care (the use of each type is not mutually exclusive, so the proportions sum to slightly more than the total for 'any type of childcare'). Almost all formal care, but only about one-third of informal care, is paid for. The average weekly cost (for those who pay) is higher for formal than for informal care. Hence, families using formal childcare tend to spend more than users of informal care, both because they are more likely to pay for it and because, if they do pay, they pay more.

Working single parents use informal care more than working couples with children. Families with only school children are also more likely to rely on informal sources of care than families with at least one pre-school child. Families with more than one child tend to pay less per child for care than those with a lone child.

These patterns in childcare use and the differences across different types of families will have important implications for the effects of various kinds of childcare subsidies. In particular, the substantial proportions of working families not using care or using only informal care suggest that there might be room for considerable expansion in the use of childcare by these families.

### **7.3 Options for subsidising childcare**

This section reviews the current system of support for the childcare costs of working families and how this will change from April 2003. It then describes some modifications to the childcare credit that would increase the generosity of the childcare subsidy.

#### **Current programmes: the working families' tax credit**

The current childcare subsidy available in the working families' tax credit has the following features:

- The subsidy is 70% of actual childcare expenditure, subject to a fixed upper limit (a maximum credit of £94.50 for £135 of expenditure each week for families with one child and £140 for an expenditure of £200 for families with more than one child).
- Only approved formal care is covered – namely: registered childminders, play schemes or out-of-school clubs, other childcare schemes that do not need to be registered and providers of care that are approved by specifically accredited organisations.
- To receive the care subsidy, all parents in the family are required to be in paid employment at least 16 hours each week (with some exceptions for incapacitated parents).
- The subsidy is subject to a means test based on family net earnings.

#### **Working tax and childcare credits to be introduced in April 2003**

The working tax credit and child tax credit, which replace the WFTC and children's tax credit in April 2003, will basically replicate the current system for families with children.<sup>7</sup> There will be some adjustments:

- The means test will be based on gross family income rather than net earnings.
- Some of the rates will be slightly adjusted.
- The 30-hour premium in the WTC will be given to families where the combined work hours of all parents are at least 30 each week (rather than one parent being required to work at least 30 hours each week as in the WFTC).

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<sup>7</sup> See Chapter 4 for further details on the new tax credits.

- The credits will be divided into a working tax credit (paid through the employer), a childcare credit and a child tax credit (both paid directly to the 'prime carer').
- The childcare credit will benefit some families further up the income distribution.

In considering alternative ways to subsidise childcare, the baseline WTC scheme is subjected to several variations in three main dimensions.

### **Changing the amount of childcare expenditure covered by the subsidy**

Under the WTC, 70% of expenditure on formal types of childcare will be refunded by the credit, up to ceilings of £94.50 (for £135 of expenditure) each week for families with one child and £140 (for £200 of expenditure) for families with more than one child. We consider two options that would allow the amount of expenditure covered to be expanded:

- 1) Doubling the ceilings for the childcare credit to £189 for families with one child and £280 for families with more than one child
- 2) Raising the eligible proportion of childcare costs to 100 percent

Options that extend the type of care covered by the credit are also considered. Expanding coverage to informal care has been the subject of much discussion. The Interdepartmental Childcare Review of November 2002 recognised the importance of informal care for working families but expressed concern that more evidence was required on 'the outcomes of informal care for the child and for parents using it; the extent to which the cost of informal care is a barrier to parental employment; and whether paying informal carers would lead to an overall growth in available childcare'<sup>8</sup> before it could be decided whether the government should intervene in the informal market. It might also be desirable to know the potential cost. So the third option considered is:

- 3) Including informal care, such as that provided by friends and relatives, as eligible for the credit

One difficulty with allowing the credit to cover informal care is the question of how the price of care might be set. In particular, the 30% of the cost not covered by the subsidy may not be a constraint on the price paid by the parent if the money is going to a friend or relative. One way to address this would be to set a maximum hourly rate. This would be equivalent to issuing vouchers that could be cashed by the carer for each hour provided. Two variants of a fourth option are therefore considered:

- 4a) A voucher scheme of £1.80 per child for each hour of care (formal or informal), with a maximum number of eligible care hours equal to the prime carer's work hours (the prime carer in a couple being the parent working the shortest hours, which is typically the mother)

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<sup>8</sup> Page 25 of Department for Education and Skills, Department for Work and Pensions, HM Treasury and Women & Equality Unit, *Delivering for Children and Families*, London, 2002 ([www.strategy.gov.uk/2002/childcare/report/downloads/su-children.pdf](http://www.strategy.gov.uk/2002/childcare/report/downloads/su-children.pdf)).

4b) As for (4a) with a voucher value of £2.67 per child per hour

The figure of £1.80 is the average hourly amount spent on paid informal sources of care, while £2.67 is the average hourly amount spent on care for children in formal childcare. The voucher value could, in practice, be any desired level of subsidy. It should be noted that the maximum value of the subsidy under the voucher scheme depends not only on the number of children in the family, but also on the work hours of the prime carer.

### **Changing the work requirements**

Eligibility for the WTC requires that one parent be working at least 16 hours each week, while eligibility for the childcare credit requires that no parent be working less than 16 hours each week. It has been argued that it might be desirable to offer the WTC and childcare credit to parents working less than 16 hours each week in order to encourage them to have at least some involvement in formal employment, be it at very low hours. Hence, the fifth option is:

- 5) Weakening the work requirement for the childcare credit from 16 hours each week to any hours of employment

Such a modification could affect a considerable proportion of families. Some 12% of couples with children have one partner working at least 16 hours each week and the other in formal employment at less than 16 hours each week, while 6% of single parents are in paid employment but working less than 16 hours each week.

### **Changing the means-testing**

Entitlement to WTC and the childcare credit will be means-tested on gross family income. But limiting support for childcare costs only to mothers in low-income families may not be desirable if the objective is to encourage all mothers to work for reasons of economic efficiency or gender equity. Three options are considered for extending eligibility for the childcare credit to mothers in higher-income households:

- 6) Doubling the income threshold for means-testing the childcare credit from £94.50 to £189 each week
- 7) Means-testing on the prime carer's gross earnings for the childcare credit, where the prime carer in a couple is the parent working the shortest hours (typically the mother)<sup>9</sup>
- 8) Removing all means-testing for the childcare credit

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<sup>9</sup> In the estimation below, option 7 is implemented by removing the couple element from the maximum credit entitlement so that the prime carer is effectively treated as a single person. In addition, the 30-hour addition to the credit is only included if the prime carer is working at least 30 hours each week.

## 7.4 Potential numbers of eligible families and budget costs, holding childcare and employment constant

The impacts on the number of families eligible to benefit from the childcare credit and the potential budget cost for each option described above are presented in this section. It is assumed that employment and childcare behaviour do not alter from current choices. The possible impacts of responses in childcare and employment choices are discussed in the following sections.

The estimated numbers of eligible families and annual budget costs for the baseline case of WTC and the options for modifications to the childcare credit are presented in Table 7.3. It should be noted that the estimated numbers of 'eligible families' include not only those directly entitled to receive the childcare credit, but all families that benefit indirectly because their WFTC/WTC or child tax credit payment is higher on account of the fact that they pay for childcare. The annual budget cost is the additional cost of the WFTC/WTC and child tax credit programmes arising from the childcare credit.

It should also be recognised that the results are presented in terms of the number of families eligible to benefit rather than the actual number who receive any benefit. In reality, the number actually receiving any subsidy may be considerably smaller, as take-up of the WFTC is far from complete. Recent estimates suggest that take-up rates are in the range of 62–65% among those eligible, with considerably lower rates for couples with children (49–53%) than for lone parents (77–83%).<sup>10</sup> The estimated annual budget costs are based on 100% take-up and will be smaller if not all eligible families claim the credit to which they are entitled.

Just over 1.5 million families are estimated to be eligible for WFTC, with 115,000 benefiting from the childcare credit.<sup>11</sup> Only a small proportion of those eligible for WFTC are also eligible to benefit from the childcare credit both because many couples have one parent (typically the mother) working less than 16 hours and because many recipient families do not have any

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<sup>10</sup> Table 1 on page 4 of Inland Revenue, *Working Families' Tax Credit: Estimates of Take-Up Rates in 2000–01, 2002*. The take-up of the childcare tax credit has not been estimated.

<sup>11</sup> The official statistics for the WFTC caseload as of August 2002 are 1,307,000 recipients of WFTC and 170,200 recipients benefiting from the childcare tax credit (tables 1.1 and 1.3 of Inland Revenue, *Working Families' Tax Credit Statistics: Quarterly Enquiry: United Kingdom: August 2002*, January 2003). The number of eligible families reported here may be higher than the official number of recipients due to incomplete take-up, while the estimated numbers eligible for the childcare credit may be lower than the official figure because of under-reporting of childcare use in the Family Resources Survey data. Additional sources of these discrepancies could be the differences in the time period considered or the sampling and weighting procedures used in this analysis.

eligible childcare costs. The average benefit from the childcare credit for families receiving it is £30 each week,<sup>12</sup> at an annual cost of £179 million.

Under WTC, 124,000 families will be eligible for the childcare credit, a modest rise due to the adjustments listed above in the replacement of WFTC with the WTC and child tax credit. The value of the average weekly care subsidy for each family in receipt is estimated not to change from what it is under WFTC, but the total budget cost of the care subsidy is estimated to rise to £195 million.

**Table 7.3. Number of eligible families and costs of the childcare credit: childcare unchanged**

	Number of families eligible to benefit (1,000s)	Average weekly benefit per family	Annual budget cost
<b>Baselines:</b>			
WFTC	115	£30	£179m
WTC	124	£30	£195m
<b>Options affecting eligible childcare expenditure:</b>			
(1) Double ceilings for eligible childcare expenditure	125	£32	£205m
(2) Raise eligible proportion of childcare costs to 100%	146	£42	£317m
(3) Include informal childcare as eligible for childcare credit	188	£27	£263m
<i>Voucher scheme for all types of care:</i>			
(4a) £1.80 per child per hour of care	198	£30	£305m
(4b) £2.67 per child per hour of care	210	£35	£382m
<b>Option affecting work requirements:</b>			
(5) Reduce work requirement to any hours	135	£30	£208m
<b>Options affecting means-testing for childcare credit:</b>			
(6) Double income thresholds	169	£31	£270m
(7) Means test on prime carer's earnings	425	£33	£739m
(8) Remove means-testing	584	£45	£1,370m

Notes: Families are eligible to benefit from the childcare credit if the WFTC/WTC or child tax credit payment is higher on account of the fact that they pay for childcare. The average weekly benefit is averaged over those entitled to benefit from childcare credit. The annual budget cost is the additional cost of the WFTC/WTC and child tax credit programmes on account of the childcare credit. All monetary values are in approximate April 2003 prices. The numbers of families have been grossed to the national level.

Source: Author's calculations using the Family Resources Survey (1998–99, 1999–2000 and 2000–01) and the IFS tax and benefit model, TAXBEN.

<sup>12</sup> Official statistics indicate that families benefiting from the childcare tax credit receive an additional £41 on average (table 8.1 of Inland Revenue, *Working Families' Tax Credit Statistics: Quarterly Enquiry: United Kingdom: August 2002*, January 2003). The lower amount reported here may be due to incomplete take-up if families with a smaller childcare credit claim are less likely to claim it.

Options 1–4 show the impacts of modifying the amount of childcare expenditure that is eligible for the childcare credit. Doubling the ceilings on the amount of eligible childcare expenditure has little impact on the number of eligible families and only a slightly larger impact on the annual cost. This is because the vast majority of families spend less than the ceilings, although the few who spend more could push the annual budget cost up by £10 million if the ceilings were doubled. The second option – of raising the eligible proportion of childcare costs from 70% to 100% – has a much greater impact on the budget cost. It increases the number of eligible families to 146,000, as some new families now pass the means test for the care credit, and raises the estimated annual cost to £317 million, as all families currently eligible benefit from a 43% rise in the childcare credit.<sup>13</sup> The average childcare credit rises from £30 per week for each family to £42 per week.

Making spending on informal care eligible for the credit (option 3) increases the number of eligible families considerably, to 188,000, but has a more modest impact on the annual budget cost, raising the annual tally to £263 million. Those using informal care spend less, on average, than those using formal sources, and the average childcare credit for each family declines from £30 each week to £27.

The most generous voucher scheme, considered in option 4b, is the most expansionary of this group of options, raising the number of families eligible for the childcare credit to 210,000 and the annual cost to £382 million. This is a mixture of options 2 and 3. It is similar to option 2 because the hourly price of £2.67 is, by construction, greater than 70% of the average informal costs and allows a greater proportion of the costs to be covered. It is also similar to option 3 in that the voucher can be used for both formal and informal care. It is not surprising, therefore, that this voucher scheme raises the number of eligible families by an amount slightly greater than option 3 and increases the annual cost by an amount somewhat greater than option 2. The lower annual budget cost (£305 million) and slightly lower number of eligible families (198,000) under the less generous voucher scheme (option 4a) highlight how limiting the voucher value can reduce the budget cost.

Reducing the work requirement from 16 hours each week to any hours (option 5) has moderate impacts. This may reflect the fact that families with a parent in paid employment but working less than 16 hours each week are not likely to be using childcare or spending large amounts on it.

The final three options in Table 7.3 (options 6–8) consider the effects of modifying the means-testing for the childcare credit. Simply doubling the thresholds for the means-testing has a moderate impact, increasing the number of eligible families to 169,000 and raising the estimated annual cost to £270 million. On the other hand, moving to means-testing on the basis of the prime carer's earnings has substantial effects, raising the number of families eligible for the childcare credit over three times to 425,000 and increasing the annual budget cost by almost a factor of four, to £739 million. This is not surprising, given that mothers in couples with both partners working at least 16 hours each week are often considerably 'poorer' than their partners: on average, such

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<sup>13</sup> The rise is 30/70 (43%) corresponding to the movement from 70% to 100% of expenditure.

mothers contribute only 38% to total family earnings, partly because 43% work less than 30 hours each week. They are therefore likely to be eligible for the credit as individuals if not as couples. The rise in annual cost is proportionally greater than the rise in the number of eligible families because families further up the income distribution tend to spend more on formal childcare.<sup>14</sup> Removing all means-testing for the childcare credit (option 8) would increase the number of eligible families even further (to 584,000) and would have a very large effect on the estimated annual cost. Indeed, the annual cost would increase more than seven times from the baseline WTC case, to well over £1 billion. Not only would the removal of all means-testing increase the size of the eligible group, but the average value of the childcare credit would rise considerably from the baseline of £30 per week per family to £45.

Overall, assuming no response in employment or childcare choices, the options that alter the amount of eligible childcare expenditure, including extending coverage to informal care, have moderate effects on the potential number of families that benefit and on budget costs. Altering the means-testing has more substantial effects, particularly any movement towards means-testing on an individual rather than family basis. However, the next section shows that if families respond to changes in policy by expanding their childcare use, these conclusions need to be modified.

## 7.5 Allowing childcare responses (holding employment constant)

### Will childcare use and expenditure expand?

Modifying the childcare credit would create incentives for parents to alter childcare choices even in the absence of any change in employment. In particular, options that effectively reduce the price of childcare may lead to an expansion in childcare use and expenditure. Parents may see greater use of childcare as a way to work longer hours, to have more time free of their children or to give their children the benefit of different types of care.

However, there are two important reasons why childcare use might *not* expand in response to an increase in the generosity of the childcare credit:

- Parents may feel that more time in paid-for childcare would be bad for their children, even if it were effectively costless.
- Sufficient formal childcare places or informal sources of childcare may simply not be available to meet all the extra demand.

Yet even if the numbers of hours of childcare do not change, the amount spent on care might rise:

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<sup>14</sup> Section 6.6.3 of G. Paull and J. Taylor with A. Duncan, *Mothers' Employment and Childcare Use in Britain*, Institute for Fiscal Studies, London, 2002.

- Parents may spend more money on childcare by choosing care options of higher quality at a higher price.<sup>15</sup>
- If the supply of formal childcare places is slow to respond to any increases in demand, providers may raise their prices. The incidence of the care subsidy is then said to fall in part on the providers because they gain part of the benefit rather than the direct recipients.<sup>16</sup> In the longer term and in the absence of any barriers to new entry, new suppliers should enter the market and bid down the price and parents should then receive the full benefit of the subsidy.
- The non-market nature of the provision of informal care generates large incentives to expand the cost of this type of care without altering the hours of care. In the informal arrangement, the amount of monetary transfers between the parent and carer may be of no relevance, either because the transfers can be returned in some other way (monetary or non-financial) or because the parent and carer care sufficiently about each other that they effectively operate as one household. Indeed, the provision of a large proportion of informal care at no cost is evidence that financial payment for care is not relevant for many parents and informal carers.<sup>17</sup> Any childcare subsidy for this type of care creates an incentive for both parent and carer to report the greatest possible cost of the care (either through a high hourly cost or through long hours) in order to maximise the amount of the childcare credit that can be shared between them.

For these reasons, it is likely that any increase in the generosity of the childcare credit would generate an expansion in the expenditure on childcare. Whether there would also be an increase in the use and hours of care would depend upon how much the demand for care and the supply of formal childcare places and informal sources of care react to changes in the effective price.

### **Scenarios for childcare expansion**

How childcare use might respond to the modifications in the childcare credit is not estimated here. Instead, the impacts of several scenarios for different childcare reactions are explored. Many of these scenarios consider the upper limits on the responses in childcare use and thereby provide approximate upper bounds to the potential changes in the numbers eligible and budget costs.

These scenarios for childcare expansions are applied to the four options that would have the greatest potential impact on the use and cost of care: options 2–4b. Option 2 reduces the effective price of formal care from 30% of the cost to zero. Option 3 includes informal care as eligible for the subsidy and

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<sup>15</sup> G. Paull and J. Taylor with A. Duncan, *Mothers' Employment and Childcare Use in Britain*, Institute for Fiscal Studies, London, 2002, find in chapter 7 that quality responses to variation in the price of childcare may indeed be greater than quantity reactions.

<sup>16</sup> A discussion of incidence is contained in Chapter 9.

<sup>17</sup> An alternative explanation is that the carer actually enjoys caring for the child and does not require financial compensation for doing so.

generates the incentives described above to expand the cost and use of such care. Options 4a and 4b contain incentives for both formal and informal care to expand by reducing the effective price to zero for costs at or below £1.80 and £2.67 per hour for both types of care respectively.

It is initially assumed that families do not alter the type of care that they use, but only increase the hourly cost or hours of care. This means that any expansion is initially limited to those currently using formal care for option 2 and currently using formal or informal care for options 3, 4a and 4b. However, it is obviously unrealistic to assume that parents would not alter the type of care that they use in response to greater subsidies. It is particularly likely that parents who do not currently use care may begin to do so. Therefore, three progressively more expansionary scenarios are applied, first, only to current users of childcare and, second, to all families fulfilling the work requirements for the childcare credit:

- a) The hourly cost rises to £2.67 (the current average for formal care)
- b) The hourly cost rises to £2.67 and the hours of care per child rise to equal the prime carer's work hours
- c) Total care expenditure rises to equal the ceiling on eligible expenditure through any combination of increasing hourly price or weekly hours

As the expansion in scenario a is dependent upon some current usage of care, it has identical impacts whether applied only to current users or to all working families. Scenarios b and c are identical for the voucher schemes, as scenario b implies the same maximum benefit as scenario c in these cases. Scenario c, when applied to all families fulfilling the work requirement to be eligible for the childcare credit, generates an upper limit on the costs of the childcare credit assuming that no new families become eligible for the childcare credit through changes in employment or family income.

It should be stressed again that these are upper limits and actual childcare use and expenditure are very unlikely to approach these levels.

### **Potential eligibility and budget costs with an expansion in childcare**

The impacts on the number of eligible families and the annual budget cost from each of these options and childcare expansion scenarios are presented in Table 7.4. These estimates continue to assume that families do not alter their employment choices in response to modifications in the childcare credit. It should be noted, not least as a hint towards the conclusions, that the annual budget costs are now presented in billions of pounds in contrast to the millions of pounds in Table 7.3.

Option 2 increases the proportion of formal care costs that are covered by the childcare credit from 70% to 100%. If those using formal care react to this by expanding their hourly cost to £2.67, there would only be a moderate impact on the number of eligible families and annual cost (scenario a). This is because average hourly care costs are already quite high for this group. If, in addition, current formal care users expand care hours to match the prime carer's work hours (scenario b), there would be a further moderate impact on the numbers

eligible but a dramatic rise in the estimated annual budget cost, to £1.2 billion. Allowing expansion by formal care users to reach the ceilings for eligible care costs in the credit (scenario c) increases the number of eligible families to over 300,000 and would raise the estimated budget cost by over five times, to £1.8 billion.

**Table 7.4. Number of eligible families and costs of the childcare credit: with potential childcare responses**

	Number of families eligible to benefit (1,000s)			Annual budget cost		
	Expansion scenario:			Expansion scenario:		
	(a)	(b)	(c)	(a)	(b)	(c)
<b>(2) Raise eligible proportion of childcare costs to 100%</b>	<i>No expansion: 146</i>			<i>No expansion: £0.3bn</i>		
formal users expand care	185	270	319	£0.5bn	£1.2bn	£1.8bn
all working families use care	185	1,849	2,163	£0.5bn	£8.9bn	£13.6bn
<b>(3) Include informal childcare as eligible for childcare credit</b>	<i>No expansion: 188</i>			<i>No expansion: £0.3bn</i>		
all current users expand care	607	742	871	£1.7bn	£2.6bn	£3.9bn
all working families use care	607	1,567	1,840	£1.7bn	£5.4bn	£8.2bn
<b>(4a) Voucher scheme of £1.80 per child per hour of care</b>	<i>No expansion: 198</i>			<i>No expansion: £0.3bn</i>		
all current users expand care	526	746	746	£1.1bn	£2.9bn	£2.9bn
all working families use care	526	1,579	1,579	£1.1bn	£5.9bn	£5.9bn
<b>(4b) Voucher scheme of £2.67 per child per hour of care</b>	<i>No expansion: 210</i>			<i>No expansion: £0.4bn</i>		
all current users expand care	609	898	898	£1.8bn	£5.0bn	£5.0bn
all working families use care	609	1,887	1,887	£1.8bn	£10.3bn	£10.3bn

Notes: Families are eligible to benefit from the childcare credit if the WFTC/WTC or child tax credit payment is higher on account of the fact that they pay for childcare. The annual budget cost is the additional cost of the WFTC/WTC and child tax credit programmes on account of the childcare credit. All monetary values are in approximate April 2003 prices. The numbers of families have been grossed to the national level. Expansion scenario a expands the hourly cost to £2.67; scenario b expands the hourly cost to £2.67 and care hours to equal the prime carer's hours; and scenario c expands care expenditure to the ceiling on eligible expenditure. Source: Author's calculations using the Family Resources Survey (1998–99, 1999–2000 and 2000–01) and the IFS tax and benefit model, TAXBEN.

Any modification to the childcare credit that enticed those not currently using care to begin to do so could have very large effects: more than half (56%) of families fulfilling the work requirement report that they do not currently use any childcare and 82% do not use any formal care. It is not surprising that the scenarios where new working families may begin to use paid childcare in response to the subsidy generate much larger impacts, raising the estimated number of families eligible to benefit to around 2 million in the case of option 2. The annual budget costs are estimated to increase dramatically, to almost £9 billion if hourly cost rises to £2.67 and hours of care rise to equal the prime carer's work hours (scenario b) and to over £13 billion if expenditure by all rises to the maximum amount covered by the childcare credit (scenario c).

Returning to the cases where the care expansion is limited to current users, the impacts are more dramatic if eligible care costs are extended to informal care (option 3). Because initial hourly costs are so low (and a substantial proportion free) for informal care, even increasing the hourly cost (scenario a) would

increase the number of eligible families from 188,000 to 607,000 and the estimated annual cost from under £0.3 billion to £1.7 billion. Because the hours used also tend to be low, expanding the hours to match the prime carer's work hours (scenario b) would have a further substantial impact, particularly on the annual budget cost, which is estimated to rise to well over £2½ billion. Allowing expenditure to reach the ceilings for current users (scenario c) would increase the number of eligible families to 871,000 and raise budget costs to approach £4 billion.

Assuming all working families use childcare creates moderately lower numbers of eligible families and annual budget costs under option 3 than option 2, because option 3 provides a maximum credit that is only 70% of that in option 2. The increase in potential costs by assuming that new families use paid childcare over expansion only by current users is of a much smaller magnitude when eligible childcare costs are limited in this way.

The less generous voucher scheme (option 4a) has very similar effects to the WTC extended to include informal care (option 3) when expansions are limited to an hourly cost of £2.67 and hours equal to the prime carer's work hours (scenario b). Yet the advantage of the voucher scheme is that there would be no further impact on the annual budget cost if childcare expanded beyond this point, because childcare expenditure under this scenario has already exceeded the maximum eligible amounts for the voucher scheme. If current users expanded their use further to the ceiling on eligible expenditure (scenario c), the weekly ceilings from the current system used in option 3 mean that option 3 is estimated to cost £1 billion more than the voucher scheme (option 4a) (£3.9 billion compared with £2.9 billion). If all working families used care to the ceiling on eligible expenditure, option 3 is estimated to cost over £2 billion more than the voucher scheme (£8.2 billion compared with £5.9 billion). However, the more generous voucher scheme (option 4b) has implicit ceilings on expenditure that are, on average, far higher than those in the current system. Consequently, the annual budget costs are considerably greater for this voucher scheme than for option 3 under both expansion scenarios b and c.

This emphasises the point that if childcare subsidies contain incentives for substantial expansions in childcare use, the ceilings on the subsidy may play an important role in determining the budget cost. Indeed, given the extremely large magnitude of the estimated costs, political acceptability for consideration of some of these options is likely to require more stringent ceilings on eligible care expenditure to ensure that potential costs would be contained to reasonable levels.

Yet it should also be stressed that these estimated impacts of childcare responses are upper bounds on potential claimant numbers and costs. In the short term, lack of availability is likely to constrain the effects to much more limited rises, while less than complete take-up of the credit and consideration of the desirability of greater use of childcare for the children may mean that the costs do not reach these levels even in the longer run. The estimates in Tables 7.3 and 7.4 are also premised on the assumption that families do not alter their employment behaviour. Relaxation of this assumption is discussed in the following section.

## 7.6 Considering employment responses

With the exception of option 5,<sup>18</sup> the modifications to the childcare credit affect employment choices indirectly by reducing the effective cost of childcare for working families. If childcare is required to facilitate employment, a reduction in the effective hourly price of care is analogous to an increase in the hourly wage rate for the prime carer. It therefore has the same two opposing effects on labour supply:

- A substitution effect: if the effective hourly price of childcare falls, the financial return to each hour of work rises and parents may choose to work more.
- An income effect: a fall in the cost of childcare makes any current use of care less expensive, raising the effective income of parents, which may lead them to feel that they can afford to reduce their hours of work.

Which of these effects is likely to dominate the overall labour supply response cannot be predicted without additional empirical estimation. Nevertheless, several points can be noted:

- The childcare credit only applies to parents working more than 16 hours each week. Any increase in its generosity cannot entice parents to leave employment or reduce hours below 16 each week through the income effect because parents would then not benefit from the subsidy. Hence, an increase in generosity in the childcare credit can potentially raise, but not reduce, the proportion of parents who are working 16 or more hours each week. Families enticed to enter employment must do so at hours and earnings levels that make them eligible for the childcare credit.
- The positive substitution effect on work hours can only operate if additional childcare is both required and available to facilitate an expansion in work hours. For example, parents of older school children may not need additional childcare to work longer and therefore would not react to a change in the effective childcare price.
- The positive substitution effect on work hours will not operate for families already receiving the maximum level of care subsidy. However, if the maximum value of the subsidy is directly linked to the work hours of the prime carer (as in the voucher schemes described above), there will be a positive substitution incentive for all families.
- Given the relative lack of responsiveness in men's working hours to changes in the wage rate,<sup>19</sup> any employment response is more likely to be

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<sup>18</sup> Option 5 reduces the work requirements for the WTC and childcare credit from 16 hours each week to any hours of employment. This encourages parents either to reduce their work hours to below 16 each week or to enter employment in order to work the shorter hours. Hence, this modification has incentives both to reduce weekly hours for those already working and to increase the proportion of parents in employment.

<sup>19</sup> For example, see R. Blundell and T. MaCurdy, 'Labor supply: a review of alternative approaches', chapter 27 of *Handbook of Labor Economics*, Elsevier Science, 1999.

seen in changes in the work choices of the mother than in alterations in the father's hours of work.

- Any reduction in hours of employment due to the income effect could lead to a decline in the number of childcare hours.

If employment does increase (or fall), it is likely, although not automatic, that childcare use would also move in the same direction in line with the change in working hours. In terms of the maximum potential budget costs (where all working families purchase care to the credit ceilings) presented in Table 7.4, employment responses may raise these costs to the degree that families enter employment or increase their weekly working hours to 16 or more. Given that approximately half of all families do not currently fulfil the work requirements for the childcare credit, the impacts could be large if a substantial proportion of these families increased their labour supply in response to a more generous childcare credit. But past empirical evidence suggests that labour supply responses are likely to be much more modest. For example, simulations of the impact of the introduction of the WFTC estimated that the employment participation rate for single mothers would rise by only 2 to 3 percentage points.<sup>20</sup> Yet even if subsidy costs did increase substantially as a result of increased work hours or employment participation, this would be directly paying for achieving the objective of improving the labour market involvement of parents.

## 7.7 Impacts across families

As highlighted in the initial discussion of the employment choices of families and the use of childcare by working families (Section 7.2), expansions in the childcare subsidy could have diverse impacts for different types of families. In this section, the main distributional consequences of the childcare subsidy modifications are briefly summarised.<sup>21</sup>

The childcare credit in the WTC will benefit different types of families to varying degrees:

- Single parents are much more likely to be eligible to benefit from the childcare credit than couples with children: single parents are estimated to constitute some 67% of the families who are eligible for the childcare credit.
- Families with a pre-school child are more likely to be eligible to benefit from the childcare credit than those with only school children: over half of the eligible families are estimated to have at least one pre-school child.
- Families with more than one child are slightly less likely to be eligible to benefit than those with a single child.

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<sup>20</sup> R. Blundell, A. Duncan, J. McCrae and C. Meghir, 'The labour market impact of the working families' tax credit', *Fiscal Studies*, 2000, vol. 21, pp. 75–103, and A. Duncan, G. Paull and J. Taylor, 'Mother's employment and the use of childcare in the UK', Institute for Fiscal Studies, Working Paper no. 01/23, 2001 ([www.ifs.org.uk/workingpapers/wp0123.pdf](http://www.ifs.org.uk/workingpapers/wp0123.pdf)).

<sup>21</sup> The tables and figures for this summary are available on request from the author.

- Most families who are eligible to benefit from the childcare credit have income levels in the middle of the income distribution.<sup>22</sup>

The options for expansion would distribute benefits unevenly across family types. In terms of the percentage change in each type who would become eligible to benefit from the childcare credit:

- Expanding the proportion of formal care that is covered by the subsidy (option 2) would generate moderately greater benefits for couples over single parents, for those with pre-school children and for those above median incomes.
- Expanding the credit to include informal care (options 3, 4a and 4b) would generate greater benefits for couples, families with only school children and families with more than one child if the use of care expands.
- Expanding the credit to include informal care (options 3, 4a and 4b) would exaggerate the greater benefits drawn by those in the middle of the income distribution, particularly if the use of care expands.
- Those at the very bottom of the distribution would be most likely to benefit if working families not currently using care began to do so if the credit were expanded to include informal care (options 3, 4a and 4b).
- Those in the top of the income distribution would benefit the most if working families not currently using care began to do so if either (i) the proportion of formal care covered by the subsidy were expanded to 100% (option 2) or (ii) the more generous voucher scheme were introduced (option 4b).
- Modifications to the means-testing (options 6 to 8) would generate greater benefits for couples.
- Means-testing on the prime carer's earnings (option 7) would have the greatest benefits for those around the eighth decile in the income distribution, but complete removal of means-testing (option 8) would generate substantial benefits to those at the very top of the income distribution.

## **7.8 Conclusions**

Government support for childcare costs for working families has increased considerably over the past decade, and recent initiatives continue to move gradually in the direction of more generous subsidies. Yet the more radical possibilities for changes in the scope of support, such as covering informal care or increasing support further up the income distribution, remain on the fringes of policy consideration. Concern for a sudden explosion in the budget cost of the more sweeping reforms may be one reason for hesitation. In

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<sup>22</sup> This is due, in part, to the fact that eligibility for the childcare credit requires all parents to be in employment for a minimum of 16 hours each week, generating a reasonably high level of family earnings. It is also due to the fact that the likelihood of using formal childcare is greater for families with higher incomes.

particular, some proposals contain incentives for an unknown and potentially large reaction in the childcare choices of parents that could prove very expensive to subsidise.

This chapter has considered the potential costs of several options for increasing the generosity of the childcare credit. It has included an analysis of some of the most expensive scenarios for an expansion in childcare use and expenditure. It is likely that the corresponding cost estimates overstate the likely outcomes because:

- it is very unlikely that any reforms to the childcare credit would invoke such extreme changes in behaviour, especially in light of reports of a shortage of childcare places;
- the cost estimates assume complete take-up of the credit, while actual take-up rates are currently much lower.

Yet consideration of such upper bounds has shown that whether the potential costs fall within the realms of an affordable policy depends to a large degree on how parents react in their childcare choices:

- Expanding the coverage of the childcare credit to a greater proportion of formal care costs or to include informal care does not have a substantial impact on budget costs *if* childcare choices remain unchanged.
- But *if* childcare choices responded to extreme levels, the budget costs of the childcare credit could escalate enormously to well beyond what is likely to be deemed affordable.
- Modifications to the means-testing for the childcare credit are less likely to alter childcare behaviour substantially and are likely to impose large, but perhaps feasible, increases in budget cost.

In addition, the desired objectives of enhancing childcare use and employment rates among parents may not accompany a rise in budget costs:

- There are good reasons to believe that expenditure on both formal and informal care could rise in response to increases in the childcare credit's generosity without any substantial change in childcare use or hours.
- The employment incentives of increasing the level of the care subsidy are mixed: some parents could be encouraged to enter employment or extend their hours, while others might react by reducing hours.

Therefore, consideration of any expansion in the childcare credit may require modifications in the current design in order to ensure that the costs cannot spiral beyond acceptable levels and to enhance the effectiveness of the subsidy in achieving childcare and employment objectives. Such modifications could include:

- lowering the current weekly ceilings on childcare expenditure;
- relating the value of the credit to childcare hours (as in an hourly voucher) to ensure that the more substantial potential rises in costs are matched by increases in the use and hours of care;

- relating the maximum number of eligible care hours to the prime carer's hours of employment in order both to target resources to those with greatest need in terms of facilitating employment and to improve the incentives to work longer hours;
- relating eligibility for the credit to the employment and earnings of the prime carer (typically the mother) in order to maximise the positive employment incentives for the parent most likely to be responsive.

As it currently stands, the childcare credit does not cost much simply because it does not help many families. Providing greater support for childcare costs for working parents to such an extent that it might encourage more parents into paid employment would inevitably increase the size of the financial burden of the subsidy. If such an objective is desired, a careful redesign of the childcare credit and consideration of the reactions in childcare use and expenditure may be required to ensure that the costs are contained to an affordable level that would make greater support politically feasible.

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