New investment in childcare: who benefits?


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In response to the growing burden of childcare costs, the Chancellor announced in this year's Budget close to an extra £1 billion investment in childcare. At a time of cuts to most government budgets, this is to be celebrated and offers a clear indication of the political priority that childcare now enjoys. But a question remains as to who will benefit most from this new investment. Will it help those for whom childcare represents a major barrier to employment or will it predominantly benefit the better off? Vidhya Alakeson **provides some answers.**

Understanding the costs of childcare

A couple in the UK on an annual salary of £40,000 with two children under five in childcare spend 19 per cent of their income on childcare, compared with an OECD average of 13 per cent.[1] However, the situation varies significantly by income. Parents on lower incomes receive significant amounts of support towards the costs through the childcare element of working tax credit and housing benefit. This means that they pay a very low percentage of their childcare costs from their own pockets. While childcare support will reduce under universal credit for the least well off families, they will continue to receive more support towards the costs of childcare than better off parents. Parents whose income puts them outside the tax credit system receive less support with the costs of childcare. Beyond the free entitlement for three- and four-year-olds, they largely pay for childcare out of pocket and, therefore, spend a greater share of their disposable income on childcare than a lower income family.

We tend to think of the affordability of childcare in these terms – what percentage of disposable income do families spend on childcare? But this picture can be misleading because it does not tell us much about the impact of childcare costs on work incentives. Looked at this way, it is clear that low-income parents, particularly second earners, face real disincentives to work as a result of childcare costs, despite only spending a small proportion of their income on childcare. As Figure 1 shows, a second earner on the minimum wage whose partner already works full time on the minimum wage would be only £4 better off a week if she worked full time compared to not working at all. If she does not work, her family income is £22,489. If she works full time, her family income after childcare costs is only £22,700. For every extra pound she earns, she loses tax credit support, eventually has to start paying national insurance and income tax and then has to pay for childcare, leaving her almost no better off in work. Childcare costs also affect the work incentives of higher income parents, particularly those with more than two children. However, they tend to earn more and, therefore, less of their earnings are eaten up by high childcare costs.

Given the serious disincentives to work that families on low and modest incomes face as a result of high childcare costs, it is important to examine the extent to which the support announced in the Budget will benefit them.

Who benefits from the proposals?

The Budget announced two separate childcare initiatives. The first, a new tax-free childcare voucher, will be available to families in which both parents work and who are not eligible for universal credit. Of the £1 billion, £750 million is to be spent on this element and families with incomes up to £300,000 will be entitled to this support. The voucher will be worth £1,200 per child up to the age of 12 and parents will be able to claim for any number of children. This element of the offer is expected to be introduced in September 2015 for under-five-year-olds and will subsequently be extended to older children. A further £200 million is on offer to support working parents eligible for universal credit. From 2017, families on universal credit with both parents working and paying income tax will be entitled to claim back 85 per cent of their childcare costs, rather than the standard 70 per cent.

To see who benefits from each initiative, it is necessary first to identify how families with children are spread across the household income distribution. Perhaps surprisingly, almost half of all families with children will be eligible for universal credit. Among families with children under five, 53 per cent will be eligible. Although the perception is that universal credit is for low-income families, eligibility for support will extend to those with children in childcare on incomes as high as £45,000. This means that the new childcare voucher will only be available to half of all families with children.

Figure 2 shows the families who are likely to be eligible for the new childcare voucher in grey and those who are likely to be eligible for increased support through universal credit in black. Approximately two million families will benefit from the new voucher. As such, this is an improvement on the current employer-supported voucher scheme because eligibility will not depend on whether or not employers choose to offer the voucher. It is, as yet, unclear how the new voucher will be administered, but it will be less arbitrary than the scheme it will eventually replace. However, as Figure 2 reveals, better off families will predominantly benefit from the voucher scheme, including wealthy families on incomes of up to £300 million. The vast majority of those who will benefit from the new voucher are in the top half of the household income distribution. A recent survey commissioned for the government's own Childcare Commission highlighted that higher income families are less likely to change their working patterns as a result of lower childcare costs. If they are not working full time, it is generally because they choose not to do so. They face high childcare costs, but, on a high income, these do not act as a significant barrier to employment.[2]

Despite this, over three-quarters of the new investment in childcare announced in the Budget is targeted at these better off families. The £200 million that will be made available to families on universal credit will help a far smaller number of working families – only 570,000 or 38 per cent of working families with children on universal credit. For those who will be eligible for the higher rate of childcare support, their childcare costs will halve. This will significantly improve their work incentives and is likely to mean that a second earner who is already working part time can increase her/his hours and continue to see their family income rise.

However, many of the least well off working families will miss out on support because they do not earn enough to pay income tax.

Figure 1: **Work incentives for a second earner on the national minimum wage**

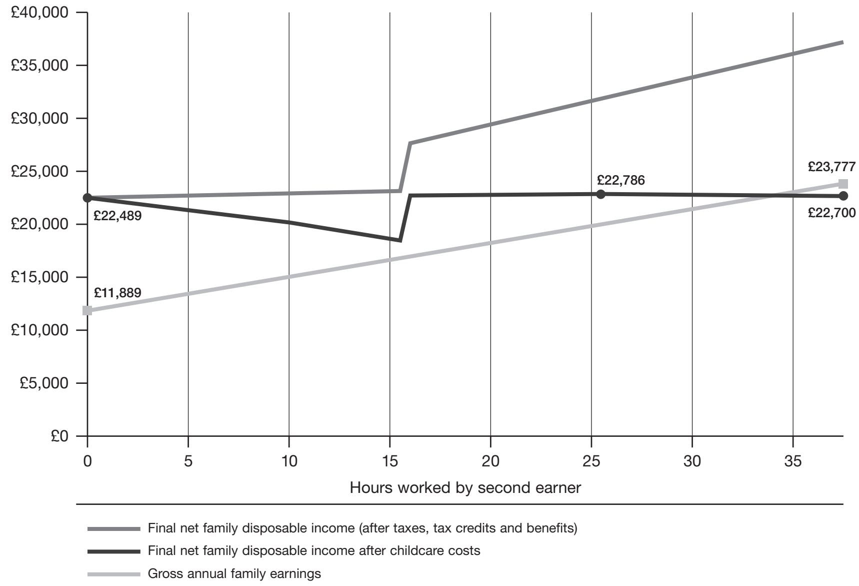
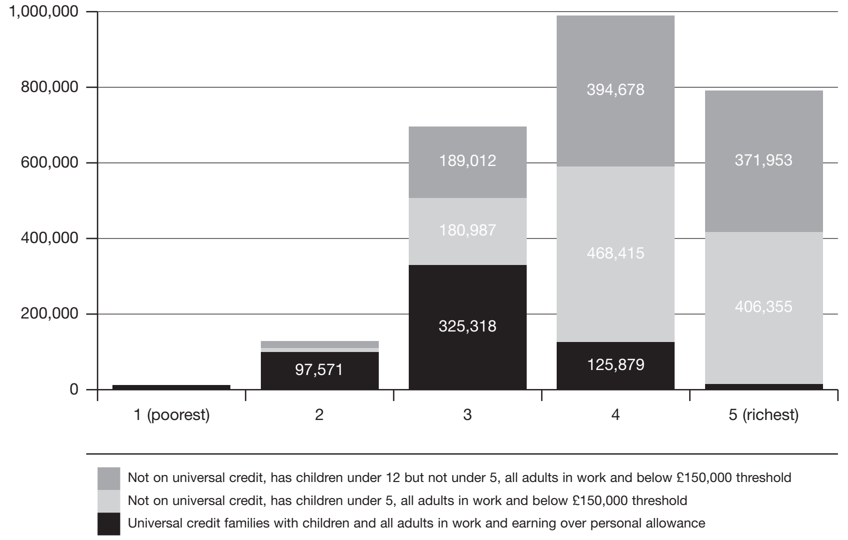


Figure 2: **Families eligible for the new types of childcare support**



Assuming that the personal tax allowance in 2015 is £10,000, a parent earning the minimum wage would have to work over 30 hours a week to earn above the personal tax allowance and start paying income tax. We know that single parents and second earners are least likely to work full time when their children are young, but this is exactly the point when their childcare costs are highest. In fact, each time the personal allowance is raised, fewer low-earning working parents will benefit from the additional childcare support. As a result, even among families on universal credit, those who will benefit from the 85 per cent support are more likely to be in the middle of the income distribution, as shown in Figure 2. Very few families in the bottom 20 per cent of the income distribution will benefit.

Over 900,000 working families on universal credit will not benefit from the 85 per cent childcare support introduced in the Budget. One possible rationale for the government's decision to target the new support at parents paying income tax could be that many of those who will miss out on the 85 per cent have already benefited from the extension of childcare support to parents working fewer than 16 hours. Under universal credit, families with both parents working will be eligible for childcare support regardless of how many hours they work. Under working tax credit, single parents must work at least 16 hours a week to claim support and couple parents at least 24 hours per week, with one person in the couple working at least 16 hours. However, only one-fifth of families who miss out on the 85 per cent support will benefit from the new support for those working fewer than 16 hours a week. Over 700,000 working families on universal credit will not benefit from either type of new childcare support on offer under universal credit. In fact, these families have experienced a cut in the support they receive for childcare since April 2011, from 80 per cent of childcare costs to 70 per cent.

Over three-quarters of the new investment… is targeted at better off families

Fixing the current proposals

The government came under significant criticism when it announced the new childcare voucher that it was making support available to some of the wealthiest families in Britain when some of the least well off working families will miss out. There is a strong case to be made for the government to limit eligibility for the voucher in order to be able to extend the 85 per cent support to all working families on universal credit. These families are the ones who face particularly high barriers to employment as a result of childcare costs and, in the current environment of difficult public spending choices, it makes sense for the government to prioritise lowering their childcare costs rather than providing financial support to families for whom childcare is not a major disincentive to work.

Eligibility for the voucher could be limited in several ways. The upper income threshold for eligibility could be lowered; vouchers could be limited to two children in line with childcare support under universal credit; or the cash value of the voucher could be reduced. Which option, or combination of options, would be best will depend, in part, on how much additional money would be required to extend 85 per cent support to all working parents eligible for universal credit.

Improving the current proposals will be important but there is a question mark over whether or not they are ever likely to be implemented as proposed. None of the proposals is due to come in before the next election and their fate will be decided by who wins in 2015. A Conservative government may continue with the voucher but not necessarily with the universal credit proposal. A Labour government is unlikely to implement the proposals as they currently stand and a repeat of today's coalition seems less likely with every new disagreement between the two governing parties. So it may be that, post-election, there is a decision to be made about what is the most effective and efficient way of spending an additional £1 billion on childcare.

A major international study of childcare systems has concluded that no country has developed a sustainable system of affordable childcare predominantly through demand-side funding.[3] This suggests that, if we want to improve childcare in the UK and sustain provision, particularly in less affluent areas, the smart thing to do would be to switch the £1 billion from the voucher and universal credit – both demand-side mechanisms – and channel it instead directly to providers. To ensure that this reached parents, government could regulate prices. This could be done on an income-related basis, as in Norway, to ensure that the least well off pay no fees and that the better off cross-subsidise some of the public investment. The simplest approach would be to extend the existing universal offer by a small number of hours, but charge for the additional hours.

When Liz Truss became Minister for Childcare in 2012, one of her strongly held views was that the current funding of childcare was too complex and wasteful. The government's proposals only increase that complexity. Childcare vouchers introduce a whole new funding stream for better off parents and there are now two thresholds of support within universal credit. The risk is that additional complexity makes it even more difficult to create a simpler, more efficient childcare system that is more affordable for parents. But this assumes that the government's proposals will go forward. The silver lining for childcare is that they do not and that the £1 billion can be spent in a more effective way. ■

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1 V Alakeson and A Hurrell, *Counting the Costs of Childcare*, Resolution Foundation, 2012
2 I Borg and A Stocks, *A Survey of Childcare and Work Decisions Among Families With Children*, DWP, 2013
3 K Stewart, L Gambaro and J Waldfogel, *Equal Access to High Quality Early Education and Care: lessons from other countries*, Presentation given at IFS/MISOC event, 8 May 2013