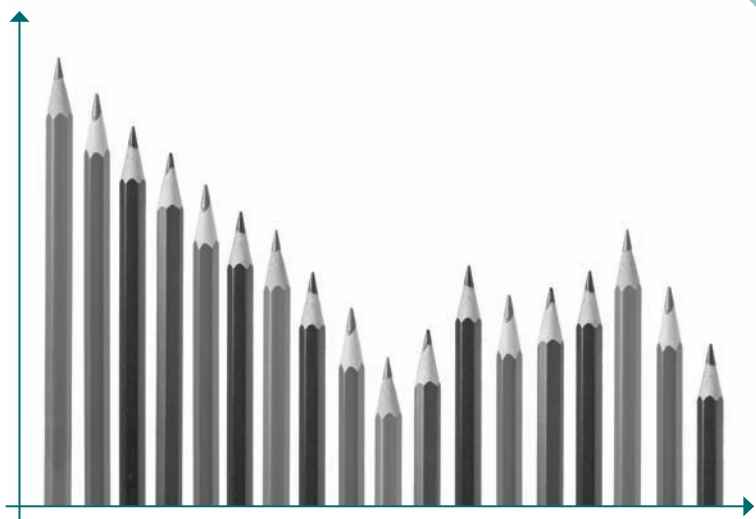


# THE PARENT TRAP

Illustrating the growing cost of childcare



*Analysis*

Ian Mulheirn and Ryan Shorthouse

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By Ian Mulheirn and Ryan Shorthouse

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## EXECUTIVE SUMMARY

High-quality formal childcare<sup>1</sup> improves children's development, especially the most deprived, and supports parents – particularly mothers – to secure and retain employment. Good early years' provision is vital for improving educational standards and hence contributes to raising workforce productivity and driving economic growth.

But unlike other parts of the education system, formal childcare is unaffordable for a sizeable minority of families, despite parents being able to access a wide range of support for their childcare costs from government. This report shows how the affordability of formal childcare will deteriorate in the years ahead.

Since the high-water mark of childcare support in 2006-07, formal childcare has become increasingly expensive for families and things are set to get worse. This report seeks to establish how the amount that typical families have to pay for formal childcare has changed in recent years and project how it will change over the next four years.

Parents find themselves caught between two deteriorating trends that drive childcare affordability. First, childcare costs across the UK have risen inexorably in recent years, usually well above the rate of inflation in the wider economy.

Second, public financial support for childcare costs is now falling. This is due to the reduced generosity of two key support systems. From April 2011, the Coalition Government cut the amount parents

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<sup>1</sup> The Department for Education defines formal childcare providers as day care centres, nursery classes attached to an infants or primary school, reception classes, special day schools, playgroups, childminders, nannies, au pairs, breakfast and after-school clubs and holiday clubs. All formal childcare providers have to be registered with OFSTED to deliver childcare. Only formal providers can benefit directly from government support. Informal childcare includes relatives, friends and neighbours.



can receive through the childcare element of the Working Tax Credit from 80% of their childcare costs to 70%. Additionally, the amount that parents can receive through tax and National Insurance (NI) exemption on employer-supported childcare vouchers has remained frozen for basic rate taxpayers since 2006-07, despite rising costs. Voucher support for higher and additional rate taxpayers was cut substantially with effect from April 2011. The current government has no plans to increase the generosity of the system for either group so voucher values will continue to dwindle as a proportion of overall childcare costs.

This report examines how typical childcare costs and the public support available to pay for them have evolved since 2006-07. It then looks at the level of public financial support available by 2015-16, on current plans, and combines that with the likely path of childcare costs to that date.

This gives a clear picture of how the amount of childcare costs that families bear will develop in the years to come. The picture is one of deteriorating childcare affordability across the income spectrum, particularly for low-income working families.

- Typical childcare costs between 2006-07 and 2015-16 are forecast to rise by 13.5% in today's prices from £91.81 per week to £104.16 per week.
- For the same amount of childcare, a low-income family in 2015-16 can expect to pay 62% more in today's money – over £600 per year - from their own resources, compared to in 2006-07.
- A middle-income family in 2015-16 is likely to pay 25% more, or £900 per year, for their childcare in today's prices compared to in 2006-07.
- A higher-income family in 2015-16 will face a 42% rise in real costs, or £1,400 per year, for the same quantity of childcare in today's prices, compared to in 2006-07.

To return the value of public support in 2015-16 to its high-point of 2006-07 would require substantial increases in the generosity of the Universal Credit system and childcare voucher scheme.

- To leave low-income families in 2015-16 facing the same level of childcare costs they faced in 2006-07, the proportion of childcare costs covered by the Universal Credit would have to rise from the current 70% to 82.4%. This would cost the exchequer in the region of £400m per year from 2015-16, in today's prices.
- Returning the childcare purchasing power of vouchers to their 2006-07 level in 2015-16 would mean raising the face value of the voucher. The current £55 tax-free voucher for basic rate taxpayers would have to rise to £83 per week by 2015-16. For higher rate taxpayers, it would need to rise to £78 per week. This would cost the exchequer around £300m per year in today's money.

Across all income groups, formal childcare is becoming increasingly unaffordable. This is worrying. Key aims of government departments – rising education standards for the Department for Education, increased labour market participation for the Department for Work and Pensions, more social mobility for the Cabinet Office, and greater gender equality for the Home Office – will fail if high-quality formal childcare becomes unaffordable for large numbers of families. In the current fiscal environment, reversing these trends is difficult. Creative solutions are called for if access to this most important element of the education system is to be maintained.

## INTRODUCTION

### The benefits of formal childcare

Formal childcare produces private benefits for both children and parents. US and UK evidence shows that the cognitive development of children, particularly from the most deprived backgrounds, is improved by attending high-quality childcare from the age of two.<sup>2</sup> Longitudinal studies demonstrate that attendance in formal childcare also leads to improved educational attainment, lower criminality and increased earnings at a later age.<sup>3</sup>

Affordable formal childcare enables parents – particularly those who cannot rely on the informal services of relatives and friends – to maintain attachment to the labour market when their children are young. Labour market attachment is related to higher long-term earnings, while long periods out of employment can impose large pay penalties when parents do return to work. All of this has consequences for child poverty.<sup>4</sup>

These private advantages of childcare also generate significant public benefits. Boosting mothers' employment improves gender equality and also means a larger number of people paying tax and moving off benefits.<sup>5</sup> Higher human capital also drives economic

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2 Kathy Sylva, Edward Melhuish, Pam Sammons, Iram Siraj-Blatchford, Brenda Taggart, *The effective provision of pre-school education project: findings from pre-school to end of key stage 1* (Nottingham: Department for Education and Skills, 2004), 1-2.

3 For example, the Perry Pre-School Project and Abecedarian Project. See UNICEF, *The child care transition: a league table of early childhood education and care in economically advanced countries* (Florence: The United Nations Children's Fund, 2008), 10-11.

4 Wendy Olsen and Sylvia Walby, *Modelling gender pay gaps* (Manchester: Equal Opportunities Commission, 2004), 16; Department for Education and Department for Health, *Supporting families in the foundation years* (London: HMSO, 2011), 47.

5 The Social Market Foundation, Daycare Trust and PriceWaterhouseCoopers calculated that government funding of universal formal childcare provision for all 1-4 year olds would be far exceeded over a 65-year period by the revenue and savings from improved parental employment and long-term productivity of children. See Daycare Trust, Social Market Foundation and PriceWaterhouseCoopers, *Universal early education and care in 2020: costs, benefits and funding options* (London: Daycare Trust, 2004).

growth.<sup>6</sup> As such, government funding of childcare is a rarity in public policy, achieving both equitable and efficient outcomes.<sup>7</sup>

### Public funding for formal childcare

Public funding of childcare has risen substantially since the mid-1990s. The OECD has commented that, between 1997 and 2007, “the UK strengthened its position as one of the biggest investors in families”.<sup>8</sup> Parents are currently entitled to a range of different forms of public support for childcare costs, including:

- The **childcare element of the Working Tax Credit**, which currently covers 70% of formal childcare costs for lower income families, up to a maximum of £175 per week for one child and £300 per week for two children. Families with higher incomes receive less as support tapers away, which occurs once all other main elements of their tax credit support have been withdrawn. In April 2011, 493,000 families were benefitting from this support.<sup>9</sup>
- An income tax and National Insurance contributions (NICs) exemption on employer-supported **childcare vouchers**. Tax relief is available on up to £55 per week for basic rate taxpayers, £28 per week for higher rate taxpayers and £22 per week for additional rate taxpayers. As these vouchers are typically provided by employers through employee salary sacrifice, voucher recipients who also claim tax credits also benefit from higher tax credit entitlement as a result of the voucher. HMRC estimate that 450,000 families are currently benefitting from this support.<sup>10</sup>

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6 Peter Dolton and Oscar Marcenaro-Gutierrez, “Teachers’ pay and pupil performance”, *Centre piece*, 16:2 (2011), 22.

7 Rebecca M.Blank, “Can equity and efficiency complement each other?”, Adam Smith Lecture, European Association of Labour Economists, Finland. September 15, 2001, <http://www.fordschool.umich.edu/research/papers/PDFfiles/02-001.pdf>.

8 OECD, “Doing better for families: UK children”, <http://www.oecd.org/dataoecd/61/32/47701096.pdf>.

9 HMRC, *Child and working tax credit statistics: April 2011* (London: HMSO, 2011), 25.

10 HM Revenue and Customs, “Reform of the tax treatment of employer-supported childcare: technical note”, <http://www.hmrc.gov.uk/employers/employersupportedchildcare.pdf>.

- Childcare costs are disregarded from family income for the purposes of **Housing Benefit and Council Tax Benefit** claims, for families on the lowest incomes.
- The **early years free entitlement**, which provides 15 hours' free childcare per week at any formal setting for families of all three and four year olds, as well as the 20% most deprived two year olds.

### Changing affordability of formal childcare

Despite this public funding, formal childcare remains unaffordable for many families. Parents in the UK typically contribute more to total childcare costs than their counterparts anywhere else in the EU.<sup>11</sup> Many parents simply cannot afford it, and high costs deter many others, forcing them to rely on friends and relatives instead. Overall, 11% of full-time mothers say they stay at home because they cannot afford the costs of childcare and 24% of those using formal childcare struggle to pay the costs.<sup>12</sup>

Since the high water mark of public subsidy for childcare in 2006-07, there has been a steady deterioration in childcare affordability for families, as the face value of childcare vouchers remained frozen in value for basic-rate taxpayers (and reduced for higher-rate taxpayers) and costs generally grew faster than inflation.

From April 2011, the Coalition Government reduced the amount of support parents could get through the tax credit system from 80% to 70% of weekly childcare costs. Parents of two children now have to find up to £30 per week more from their own pocket to

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11 Antonia Marherita, Sile O'Dorchai, Jelle Bosch, *Reconciliation between work, private and family life in the European Union* (Luxembourg: Office for Official Publications of the European Commission, 2009), 61.

12 Kelly Ward and Shirley Dex, *Millennium cohort study: employment and education, briefing 9* (London: Institute of Education, 2007); Ruth Smith, Eloise Poole, Jane Perry, Ivonne Wollny, Alice Reeves, Cathy Coshall, John d'Souza, Caroline Bryson, *Childcare and early years survey of parents 2009* (London: Department for Education, 2010), 83.

fund formal childcare costs compared to in 2010-11.<sup>13</sup> A quarter of parents surveyed in May and June 2011 in severe poverty (in households earning less than £12,000 a year) cited the costs of childcare as their reason for giving up work.<sup>14</sup>

What is more, in the years ahead, the affordability of childcare looks set to deteriorate further. This is because the amount provided through the different forms of public support is now either fixed or falling, while the costs of childcare look likely to continue to rise in real terms. One exception to this is that the Universal Credit will for the first time, from 2014, offer childcare support to parents working fewer than 16 hours per week.

## Methodology of this report

The aim of this report is to inform the debate about childcare affordability by quantifying how childcare affordability has changed in recent years and is likely to change in the run-up to 2015-16. Affordability is defined here as the cost to a typical family of a fixed quantity of childcare, in today's prices. To assess changing affordability, this level of contribution will be compared across the decade from 2006-07 to 2015-16 for families at different points in the income distribution.

The report is structured in the following way:

- **Chapter One** shows the type and amount of public support for formal childcare available to a typical family at different points on the income scale. It then illustrates how the amount of public support has changed between 2006-07 and 2011-12, and how it will change, owing to the reforms of the Coalition Government, between 2012-13 and 2015-16.

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13 Daycare Trust, *The impact of the Spending Review on childcare* (London: Daycare Trust, 2010), [http://www.daycaretrust.org.uk/data/files/Policy/the\\_impact\\_of\\_the\\_spending\\_review\\_on\\_childcare.pdf](http://www.daycaretrust.org.uk/data/files/Policy/the_impact_of_the_spending_review_on_childcare.pdf).

14 Daycare Trust and Save the Children, *Making work pay – the childcare trap* (London: Save the Children, 2011), [http://www.daycaretrust.org.uk/data/files/Research/making\\_work\\_pay.pdf](http://www.daycaretrust.org.uk/data/files/Research/making_work_pay.pdf).

- **Chapter Two** shows indicative childcare costs faced by a typical family, and how much the cost of this quantity of childcare is likely to have changed between 2006-07 and 2011-12. Using past childcare unit cost increases, the chapter then projects how that typical quantity of childcare might be expected to change in price by 2015-16.
- **Chapter Three** brings together the findings from chapters one and two to demonstrate the changing affordability of childcare for a typical family at different points on the income scale between 2006-07 and 2011-12. It goes on to project how affordability is likely to change from now until 2015-16 given what we know about future policy and can assume about the cost of childcare provision.
- **Chapter Four** shows what level of public support would be needed by 2015-16 to restore affordability to its 2006-07 level. Approximate costings are given.

Since state support for, and the costs of, childcare vary hugely dependent on family structure and circumstances, as well as place of residence, it is hard to make a meaningful assessment of how childcare affordability is evolving for every different type of family. Throughout the report, we therefore seek to understand those changes for a fixed specimen household: a two-adult, two-child family with average childcare costs, in which the main earner works full-time and the second earner works part-time. While the specific results of our analysis relate to this family, the broad conclusions on changing affordability can be generalised to many others (with the notable exception of those working fewer than 16 hours).

## CHAPTER 1: PUBLIC SUPPORT FOR CHILDCARE

The first stage in the analysis involves building a picture of available government financial support for childcare costs for a typical family. This model will then be used to illustrate the financial support available to a typical family as their income rises, clearly demonstrating the part that different forms of government support for childcare play.

The model parameters can then be adapted to show how public support has changed between 2006-07 - the high point of public support for formal childcare<sup>15</sup> - and 2011-12. This involves taking into account the changes to the amount of tax and NI exemption for voucher claimants as well as and the proportion of childcare costs covered through the tax credit system implemented in April 2011.

It will then be used to examine how support will change in the years up to 2015-16 on the basis of the existing tax credits childcare support system for those working over 16 hours per week. The new Universal Credit – due in 2013-14 – will, for the first time, offer support to families working fewer than 16 hours. But the structure and level of support for other parents is likely to remain broadly the same as what is offered through the existing tax credit system.

### Existing support

Parents are entitled to four main forms of public support for their childcare costs: the childcare element of the working tax credit; tax and NI exemption on childcare vouchers; childcare cost disregards on Housing Benefit and Council Tax Benefit; and a number of hours'

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<sup>15</sup> In 2006-07, tax-free childcare vouchers rose to £55 per week from £50 per week. See HM Revenue and Customs, "Reform of the tax treatment of employer-supported childcare: technical note", <http://www.hmrc.gov.uk/employers/employersupportedchildcare.pdf>. As will be shown below, in 2006-07, tax credit support available to families was at its highest point: 80% of childcare costs up to a maximum of £175 per week for one child and £300 per week for two children.



free provision for young children known as the “early years free entitlement.”

Parents’ eligibility for these support systems, and the amount they are entitled to, is contingent on a range of factors, including:

- Income, both household and personal
- The number of hours parents work
- Employment status (e.g. whether employed or self-employed)
- The age of their children
- The number of children
- The total cost of childcare
- Whether parents’ employers participate in the voucher scheme

The amount parents receive is calculated using different criteria for the different forms of support. The early years free entitlement, for example, is universal for children aged three and four, and available to the 20% most deprived two year olds. Eligibility for tax and NI exemption on vouchers is calculated on an individualised basis and depends on employer participation. Eligibility for tax credits, by contrast, is calculated on a household income basis.

Below is a detailed description of the forms of public support available for families. This describes how each element of the available support works, including: how generous it was in 2006-07; how it has changed since then; and how it is likely to change up to 2015-16 given what we know and can assume about childcare policy.

### **1. Childcare element of the Working Tax Credit**

The childcare element of the Working Tax Credit enables low- and middle-income families with children under the age of 16, where each parent is working at least 16 hours a week, to get financial support for formal childcare costs. Working parents registered

with a formal childcare provider report their forecast annualised childcare costs and receive their tax credit entitlement on a weekly or monthly basis.

In 2006-07, the childcare element of the Working Tax Credit covered 80% of childcare costs to a maximum of £175 per week for one child and £300 per week for two or more children. The maximum amount a claimant was entitled to was tapered away, once the other main elements of tax credits had been withdrawn, at 37p for every extra £1 earned. In 2008, the taper rate was increased to 39p for every extra £1 earned, meaning those higher up the income scale saw support withdrawn more quickly.

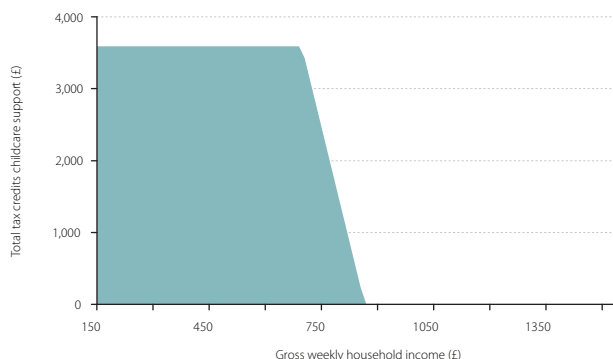
The tax credits support level was reduced in April 2011 so claimants could access only 70% of childcare costs at the same maximum award levels. The taper rate for tax credits was also increased to 41%.

It is important to remember that these maximum awards do not indicate what every family at a given point of the income scale will receive. The award is dependent on the amount of childcare costs they claim for. Chart 1.1 shows the level of public support available to a two-adult, two-child family with typical childcare costs as their income rises. 'Typical' childcare costs are defined here as the average costs reported by tax credits claimants in December 2010: £94.43 per week.<sup>16</sup>

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16 HMRC, *Child and working tax credit statistics: December 2010* (London: HMSO, 2010), 25.

**Chart 1.1 Annual financial support for typical childcare costs through childcare element of the Working Tax Credit, 2011-12**



As Chart 1.1 demonstrates, support is rather binary in nature, with high levels available for lower income families and none for higher income ones, since the support is quickly tapered away. Those with very low incomes are not represented in this chart. This is because to claim the childcare element of the Working Tax Credit, parents in a couple family need to be working at least 16 hours per week.

The amount of support for childcare through the Universal Credit system from 2013 will be broadly the same. Those parents working fewer than 16 hours a week will for the first time receive support for their childcare costs. Nonetheless, the proportion of costs covered will remain at 70% at the current maximum award levels and, as with tax credits, most claimants will either receive the full amount of support or none at all.

Families on or near the point where tax credits support for childcare is withdrawn may see some changes depending on the exact design of Universal Credit.

## 2. Tax and NI exemption for employer-supported childcare vouchers

Employers may choose to offer childcare vouchers as a benefit to their staff. Typically these are offered through a salary sacrifice arrangement by which employees agree to forego part of their salary and receiving a corresponding value in childcare voucher which is exempt from tax and NI. The financial value to the parents is the tax and NI no longer payable, as well as any higher tax credits that may result from a lower gross income, not the face-value of the voucher. Parental access to the scheme is entirely dependent on whether the employer – who also benefits from exemption from Class 1 NI – offers the vouchers.

In practice, where it is offered as salary sacrifice, this scheme is only available to those earning above the minimum wage. This is because the salary sacrifice cannot take an employee's earnings lower than the minimum wage. Self-employed people are not entitled to this support, even if their earnings are sufficient.

Between 2006-07 and 2010-11, parents in all income tax bands were entitled to tax and NI exemption on up to £55 per week. Consequently, higher rate taxpayers received more tax relief for the same voucher face value than basic rate taxpayers.

Since April 2011, voucher values vary for new claimants according to the income tax bracket of the employee. Higher-rate taxpayers who joined the scheme during or after April 2011 are now eligible for tax and NI exemption on up to just £28 per week. Additional rate taxpayers are eligible for exemption on up to £22 per week.<sup>17</sup> A further change in 2011-12 was that the threshold for higher rate income tax was reduced, meaning more recipients of childcare vouchers will now be entitled to the lower value vouchers.

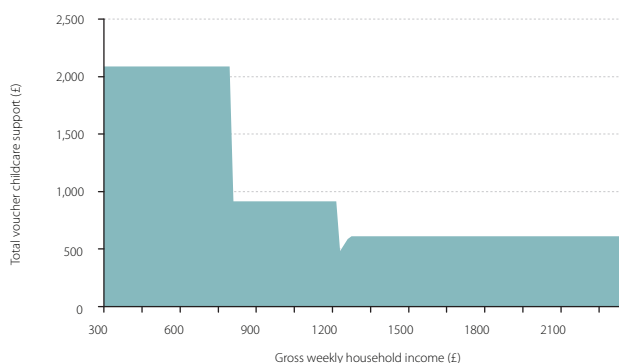
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<sup>17</sup> Higher-rate taxpayers who were already receiving childcare vouchers before April 2011 are still eligible for a tax-free voucher worth £55 a week until they change employer, stop receiving childcare vouchers for longer than 12 months, or are no longer eligible for the scheme. However, for in the purposes of this report, it is assumed that the level of public support for higher-rate taxpayers from 2011-12 is the £28 per week available to new claimants.

Chart 1.2 shows the amount of public support a typical family at different points on the income scale receive from employer-supported childcare vouchers in 2011-12. As vouchers are awarded on an individualised basis, it could be the case that both parents in the household are receiving childcare vouchers. For the purpose of this report, only one parent in a household is assumed to take up the voucher. Of course, it is important to remember that parents employed by a firm that is not participating in the scheme will be unable to access this support.

Voucher recipients who also claim tax credits benefit from higher tax credit entitlement as a result of the voucher. So a basic rate taxpayer, claiming a £55 childcare voucher in 2011-12 would benefit from tax relief at 20% and NI relief at 12% - total support equal to 32% of the voucher value, or £17.60 in 2011-12. If the same family were also claiming tax credits, their tax credit award would also rise by 41% of the voucher, as their gross income falls by £55. For this family, total support would therefore be 73% of the voucher value, or £40.15 in 2011-12.

**Chart 1.2 Annual financial support for childcare costs through childcare vouchers, 2011-12<sup>18</sup>**



<sup>18</sup> A dip in support occurs when the claimant is on the threshold between basic-rate and higher-rate tax. At this point they become eligible for the reduced £28 per week tax-free voucher. However, at this point they only receive basic-rate tax relief on the value of the voucher.

The Coalition Government has not announced any changes to the face value of childcare vouchers. This paper assumes that in 2015-16, taxpayers will still be entitled to tax and NI exemption on the current nominal voucher values.

### 3. The early years free entitlement

All parents of three and four year olds, and the most deprived two year olds, are entitled to a set number of free hours at a formal childcare setting per week. Government funding of the free entitlement is paid to local authorities who distribute the money to local childcare settings based on the Early Years Single Funding Formula.

Since 2006-07, the free entitlement has been extended: from 33 weeks in the year to 38 weeks in the year in 2006, and from 12.5 hours a week to 15 hours a week in 2010. In addition, the free entitlement was rolled out to the 20% most deprived two year-olds in 2011. The Government has no plans to change the free entitlement between now and 2015-16.

The early years free entitlement represents a significant subsidy for the childcare consumed by families. It is not explicitly included in the affordability model developed here, but is implicitly accounted for. This is because the average tax credit amount awarded to families takes into account those families with three and four year olds whose awards have been granted to cover costs for provision over and above the free entitlement. Hence the free entitlement subsidy is effectively included in the modelling here even though its effect is not observed in the charts.

### 4. Benefit disregards

Parents on very low incomes working at least 16 hours a week are currently able to disregard childcare costs from their income for the purposes of calculating their Housing Benefit and Council Tax Benefit awards. In 2005-06, the maximum level of the disregard was raised in line with the Working Tax Credit.

The effect of these disregards, for parents in 2011-12, is that it covers up to 85% of childcare costs for some very low income families. In combination with tax credit support, benefit disregards could mean very low income working families seeing up to 95.5% of childcare costs met by government.

These disregards will end for those families that move onto Universal Credit after 2013. Government funding for the disregards will be transferred to the childcare element of the Universal Credit. In most cases, this will mean a reduction in childcare support for those in high cost housing and on very low pay.

The model presented in this paper does not take into account these disregards as a form of public support for a number of reasons. First, disregards affect only a small number of people. 28% of those claiming Housing Benefit have children and only 18% of claimants are in work.<sup>19</sup> The number of in-work Housing and Council Tax Benefit claimants using childcare is therefore small in comparison to the other support systems available, so the benefit disregard for childcare is a less significant form of support.

Second, it is difficult to ascertain a typical amount of childcare support for families benefiting from the disregard. Support is very much dependent on income and exact housing costs: there is consequently no 'typical' level of support derived from the Housing Benefit disregard. Any meaningful comparisons of the level of support over time therefore is even more difficult. This paper therefore focuses on the level of public support for a typical family at points on the income scale higher than the very low income where families are eligible for help through these disregards.

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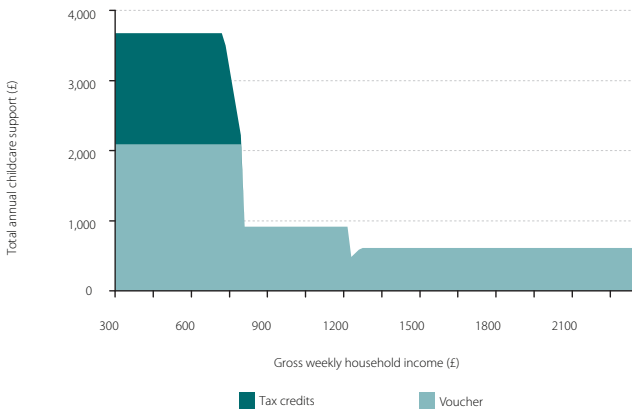
19 Department for Work and Pensions, *Housing benefit and council tax benefit caseload*, (London: HMSO, 2011), [http://research.dwp.gov.uk/asd/asd1/stats\\_summary/stats\\_summary\\_oct11.pdf](http://research.dwp.gov.uk/asd/asd1/stats_summary/stats_summary_oct11.pdf).

## Current public support

Chart 1.3 combines the two main forms of public support – the childcare element of the Working Tax Credit and tax and NI exemption on childcare vouchers – to show the total amount of public support available for couple childcare costs to a typical family at different points on the income scale.

The amount of public support parents are entitled to through the tax credit system differs from family to family, and is very dependent on family circumstances. It would be impractical to illustrate the whole picture of how childcare support is changing for families of all incomes and needs. Instead, as illustrated in Chart 1.3, this report examines the public support for a family with *typical* childcare costs at different points on the income scale.

**Chart 1.3 Annual tax credit and voucher support available to a typical family, 2011-12**



This stylised assumption allows us to show broad trends in affordability for a typical family, even though some families with more unusual circumstances may see either better or worse affordability trends than the stylised household represented here.





For the purposes of this paper, a typical family is assumed to be a two-parent family where the main earner works full-time and the second earner part-time, and they have two children requiring childcare support. This typical family is assumed to be incurring the average childcare costs claimed through tax credits in December 2010, and the main earner claims the maximum childcare voucher value.

Tax credit and childcare voucher support interact with one another, changing a claimant's eligibility. Parents cannot claim through both of the two financial support systems in respect of the same childcare costs. For example, a low-income family incurring costs of £100 a week in 2011-12 could claim the entire costs through tax credits, and receive help to the value of 70% of those costs. Alternatively, they could claim the first £55 of the costs through childcare vouchers - effectively receiving 73% support<sup>20</sup> - and the remaining £45 through tax credits at 70% support.

Low-income parents entitled to both forms of support therefore face a difficult task of assessing which form of support – tax credits or childcare vouchers – to claim first. Prior to April 2011, when families could receive 80% coverage through tax credits, it was always advantageous to claim for all of their costs through the tax credit system. But now, owing to the reduction in support offered through tax credits, low-income parents are better-off claiming the full childcare voucher first, and only those costs above the £55 per week voucher limit through tax credits (or Universal Credit).

Chart 1.3 shows clearly how the level of available support for a given family varies abruptly at different points on the income distribution. Three distinct income groups emerge. These groups are characterised as low-, middle- or high-income.

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20 See the explanation above. A childcare voucher offered through salary sacrifice would give tax relief at 20%, NICs relief at 12% and higher tax credits to the tune of 41%. These sum to 73% of the £55 costs covered by the voucher, or £40.15.

- A **low-income group** between a weekly household income of about £300 to £700 per week - annual income of around £15,000 to £37,000 – have a combined childcare support level at around £3,675 per year in 2011-12. They are entitled to tax credits and childcare vouchers.
- A **middle-income group** between a weekly household income of around £810 to £1,215 - annual income of approximately £42,000 to £63,000 – tax credits are not available for this group, but vouchers provide around £900 per year.
- A **high-income group**, once the main earner becomes a higher rate taxpayer, for the same family on a weekly household income of above about £1,215 - annual income of above about £63,000 in 2011-12. Vouchers provide around £600 per year.

These rough income bands for the three groups are subject to the distribution of earnings within the household. Here we assume that the second earner's income is always half that of the main earner. Assuming a different distribution of household earnings would move the position of the high and middle income bands.

In 2010, the median gross weekly earnings for a full-time employee was £499 per week; for a part-time employee the figure was £154.<sup>21</sup> For our assumed typical family – where the main earner works full-time and the second earner part-time – the sum of these two numbers gives a sense of the middle of the income distribution for a working couple family, around £653 per week or around £34,000 per year in 2010. This corresponds to the top end of what we define above as the lower-income bracket.

Using these three groups it is possible to compare how support for this typical family will change over the period.

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21 Office for National Statistics, *2010 Annual survey of hours and earnings* (Newport: ONS, 2010), 2.

## Changing public support

Earlier in this chapter, the major changes to the main forms of public childcare subsidy between 2006-07 and 2015-16 were outlined. Between 2006-07 and 2010-11, much of the system remained unchanged apart from a minor change to tax credits. But, from April 2011 significant changes took effect. Box 1.1 below gives a chronology of the changes.

### **Box 1.1 Chronology of changes to tax credits and childcare vouchers, 2006-07 to 2015-16**

#### **2008-09**

- Taper rate for childcare element of the Working Tax Credit raised to 39p for every extra £1 earned once the other main elements of tax credits have been withdrawn.

#### **2011-12**

- Support offered by the childcare element of the Working Tax Credit is reduced from 80% to 70% of costs up to £175 per week for a family with one child and £300 per week for a family with two or more children.
- Taper rate for childcare element of the working tax credit raised to 41p for every extra £1 once the other main elements of tax credits have been withdrawn.
- The total amount of childcare costs that can benefit from tax and NI exemption through childcare vouchers for higher rate taxpayers was reduced to £28 per week. For additional rate taxpayers, the voucher face value is £22 per week. This represents a fall from the £55 per week still available to basic rate taxpayers.

#### **2013-14**

- Childcare element of the Working Tax Credit moved into the Universal Credit. Broad structure remains in place, especially as transitional relief is offered to existing claimants, who will consequently remain on tax credits until their circumstances change.

Chart 1.4 shows how the proportion of childcare costs met through the childcare element of the Working Tax Credit and childcare vouchers changes for a typical family at different points on the income scale, for selected years between 2006-07 and 2015-16.<sup>22</sup>

**Chart 1.4 How support is changing: proportion of costs met through childcare support systems, selected years**



Chart 1.4 demonstrates declining public support for overall childcare costs for our low-, middle- and high-income groups. For low-income families, overall public support is set to fall from 80% of overall costs in 2006-07 to just over 70% in 2015-16. For a middle-income family, public support will decline from 23% in 2006-07 to 15% in 2015-16. Meanwhile, a family in the high-income group will face a fall in public support from 28% of overall costs in 2006-07 to just 10% by 2015-16. But while the proportion of costs met by state support is changing, so too is the overall cost of childcare. This is the focus of the next chapter.

<sup>22</sup> The typical level of public support available in 2006-07 and 2015-16 is dependent on typical childcare costs in those years. The calculation of these costs is described in Chapter Two.

## CHAPTER 2: THE RISING COST OF CHILDCARE

The last chapter sought to establish how state financial support for childcare is changing. Financial support for childcare is important, but what really matters for families is childcare affordability. Affordability can be defined as the gap between the ticket price of childcare and the proportion that is met by the state: the private contribution of parents.

The total amount of childcare used by families varies. This chapter will establish a typical level of costs for a family using childcare, and look at how the cost of this quantity of care has changed, and will change, between 2006-07 and 2015-16.

Combined with the amount of public support available, this will enable a projection of the changing private contributions – the affordability – of childcare for a typical family at different points on the income scale between 2006-07 and 2015-16.

### What are 'typical' childcare costs?

Childcare costs differ depending on where a parent lives, the type of childcare setting used, the number of children, the age of the child and the amount of childcare consumed. London, for instance, has the most expensive childcare in the country. Care for very young children is more costly than for older children. Childminders and after-school clubs tend to be cheaper than daycare settings. and free entitlement for three and four year olds is likely to mean typical costs in respect of these children will be lower than for younger or older children.

Every family's circumstances are different. This variety in childcare expenditure means we need to construct a scenario of typical childcare costs. An accurate indicator of the typical weekly childcare cost can be derived from the biannual HMRC Child and Working Tax Credit statistics, which details the average total

childcare costs claimed for by parents. In December 2010, this was £94.43 a week. For the purposes of this report, the December 2010 average costs are assumed to represent typical childcare costs for 2010-11.<sup>23</sup>

### Typical unit childcare costs in the past

It would be incorrect to use the past yearly figures from HMRC Child and Working Tax Credit statistics to define typical childcare costs in each year between 2006-07 and 2009-10. This is because the average costs claimed may vary from year to year not just because of rising childcare prices, but also due to changing quantities of care demanded, or variable regional take-up. Instead, to make a fair comparison of childcare costs over time, it is important to hold constant the quantity of care our specimen family uses.

To do this, we use data on recent cost inflation for a fixed unit of childcare from the Daycare Trust's annual costs survey, which surveys two-thirds of Children's Information Services.<sup>24</sup> This survey is published annually in January, capturing average childcare costs in November of the previous year. The costs reported in 2011 capture the 2010-11 mid-year childcare prices. This rule applies to all other years.

By finding out the annual childcare inflation for a child under the age of two in England for the past five years, the average yearly change in childcare costs for a fixed amount of care can be identified. This is shown in Table 2.1.

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23 HM Revenue and Customs, *Child and working tax credit statistics December 2010* (London: HMSO, 2010), 25. As December is near the mid-point in the financial year, the £94.43 week average childcare cost is assumed to represent the typical costs for 2010-11, rather than the April 2011 figure.

24 The alternative source is Laing and Buisson annual childcare cost survey, but this only samples 15% of children's day nurseries in the UK. See Philip Blackburn, *Children's nurseries UK market report 2009* (London: Laing & Buisson Ltd, 2009), 34.

**Table 2.1 Unit cost inflation for childcare, 2006-07 to 2010-11**

Year	Annual % change from previous year
2006-07	5.6%
2007-08	4.6%
2008-09	5.0%
2009-10	4.8%
2010-11	2.1%

Table 2.1 shows that childcare costs have generally been rising above broader consumer price inflation for the past five years, at an average rate of 4.4% per annum.<sup>25</sup> Taking into account broader consumer price inflation, most years have seen a significant real terms rise in the cost of a given quantity of childcare.

The percentage changes identified in Table 2.1 can be used to give an estimate of the typical childcare costs for the same quantity of care in each year between 2006-07 and 2010-11. This is done by taking the average childcare costs from the December 2010 HMRC Child and Working Tax Credit statistics (£94.43 per week) to represent typical 2010-11 costs, and deflating this cost by the relevant amount each year to find how much the same quantity of care would have cost in the years back to 2006-07.

Forecasting future childcare cost inflation is more problematic. The reasons behind the persistently higher cost increases in recent years are unclear. It may be that reduced state support will restrain future prices increases. Alternatively, the rising birth rate may put further upward pressure on prices. Given the huge uncertainties here and the rudimentary nature of the data, we take a simple

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25 CPI inflation over the period averaged 2.7%. The reasons given for this increase above-inflation increase in costs are complex and diverse, including the introduction and raising of the minimum wage, demands for greater staff qualifications and a focus on attracting children lower down the age range, which requires more stringent child-staff ratios.

approach to estimating the future path of typical childcare costs by projecting the average recent annual rate of increase – 4.4% – forward from 2011-12 onwards. On this basis, the cost of the 2010-11 typical amount of childcare in each of the relevant years is presented in Table 2.2 below.

**Table 2.2 The changing cost of childcare**

Year	Typical childcare costs mid-point of year	% change over past 12 months
2006-07	£80.32pw	5.6%
2007-08	£84.03pw	4.6%
2008-09	£88.25pw	5.0%
2009-10	£92.49pw	4.8%
2010-11	£94.43pw	2.1%
2011-12	£98.61pw	4.4%
2012-13	£102.98pw	4.4%
2013-14	£107.54pw	4.4%
2014-15	£112.30pw	4.4%
2015-16	£117.27pw	4.4%

Table 2.2 shows that typical weekly childcare costs are projected to be £117.27 by 2015-16 for the same quantity of care. In today's money, this equates to a 13.5% rise from £91.81 (2006-07) to £104.16 (2015-16).

In the next chapter we combine the rising cost of childcare with the likely level of state support to assess how the necessary private contributions, and hence affordability, have changed and are likely to change between 2006-07 and 2015-16.



## CHAPTER 3: THE PRIVATE CONTRIBUTION OF PARENTS TO CHILDCARE COSTS

Having established likely levels of public support for childcare to 2015-16, and the likely evolution of childcare unit costs over the period, this chapter assesses how childcare affordability will develop as a result of those two trends.

This is done by calculating the proportion and absolute amount of childcare costs privately borne by families in different income groups – low, middle and high - in selected years between 2006-07 and 2015-16.

### Private contributions to childcare costs

Chart 3.1 takes the costs of a fixed quantity of childcare for selected years between 2006-07 and 2015-16 and combines this with the level of public support available to our specimen family at different points on the income scale. This shows how the level of private contributions changes over the years being considered.

It must be remembered that although many families are entitled to different forms of public support, not all of them take up the full amount of the support. This could be because they consume fewer childcare hours, and so do not claim the maximum amount. Or they may simply not take up the form of public support they are entitled to at all. This could be for several reasons: perceptions of stigma, complexity or a lack of understanding about what is available. Specifically for childcare vouchers, it could be the case that the employers have simply decided not to offer them.

Essentially therefore, Chart 3.1 shows the level of private contributions made by our specimen family facing childcare costs were they to take up both vouchers and typical tax credits support.

**Chart 3.1 Annual residual childcare costs for a family with typical childcare costs, 2006-07 to 2015-16<sup>26</sup>**

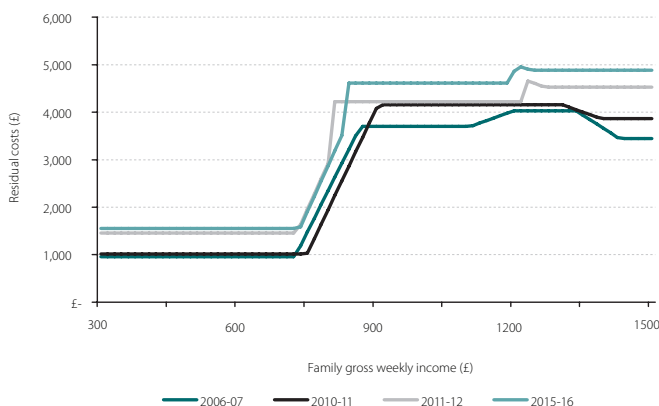


Chart 3.1 demonstrates that typical private contributions, in constant 2011 prices, are likely to rise substantially between 2006-07 and 2015-16. The analysis shows a marked deterioration in affordability across the income scale by 2015-16.

Chapter One identified three groups of families that emerge from plateaus on Chart 1.3: the low-income group, the middle-income group and the high-income group. These groups are identified by the flat areas on each line on Chart 3.1.

In absolute cash terms the deterioration in affordability is greater at the top end of the income scale, smaller lower down. By 2015-16 the high-income family can expect to be paying over £1,400 more per year in today's prices for the same childcare. The middle-income family, by contrast, is facing a bill some £900 per

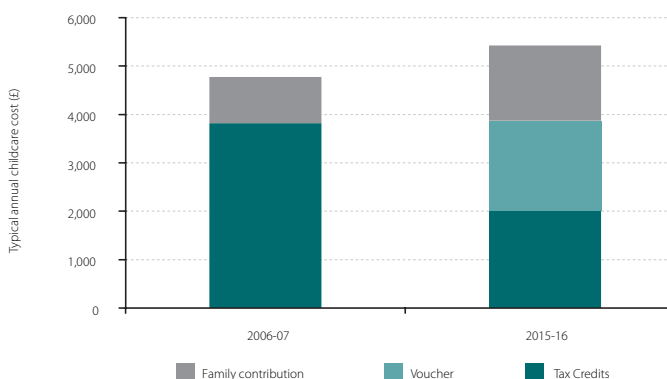
<sup>26</sup> These charts show how entitlement for childcare support would evolve were the current tax credits regime to be in operation in 2015-16. In reality, many families may have migrated onto the new Universal Credit system by then. Families on Universal Credit will be eligible to claim for childcare support at the same percentage and maximum limits as today though support will be available to families working under 16 hours. This support will taper away over a similar income range. This means that our low, middle and high income groups will be eligible to claim for the same level of childcare support, although the household income levels these groups refer to, and therefore the numbers of families within them, may change marginally for those families claiming Universal Credit in 2015-16.

year higher. The low-income family meanwhile will need to find an additional £600 each year.

In proportionate terms, however, the picture is reversed. At the lower income end, families are set to be paying almost two-thirds more – 62% - from their own pocket by 2015-16 compared to 2006-07 in today's prices. The middle-income family can expect to contribute 25% more, while the high-income group will face a 42% up-lift in their contribution compared to 2006-07 for the same amount of childcare.

Charts 3.2, 3.3 and 3.4 illustrate the changing cost of childcare between 2006-07 and 2015-16 for the different income groups, showing what proportion of those costs are met by vouchers and tax credits (or Universal Credit).

**Chart 3.2 Changing affordability for low-income families, 2006-07 to 2015-16**



As explained above, prior to April 2011, tax credits support was more generous than childcare vouchers for the low-income group. After that date, vouchers represent a better deal. Chart 3.2 therefore shows a family claiming entirely through tax credits in 2006-07, with the voucher claim represented only in the 2015-16 bar. Nevertheless, the net effect is that the level of state support in cash terms is effectively static while costs rise significantly.

**Chart 3.3 Changing affordability for middle-income families, 2006-07 to 2015-16**

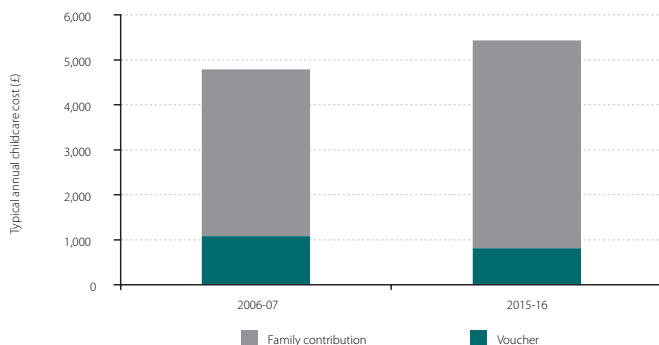


Chart 3.3 shows how the erosion in the real value of childcare vouchers combines with increasing costs to leave the middle-income group around £900 per year worse off by 2015-16.

**Chart 3.4 Changing affordability for high-income families, 2006-07 to 2015-16**

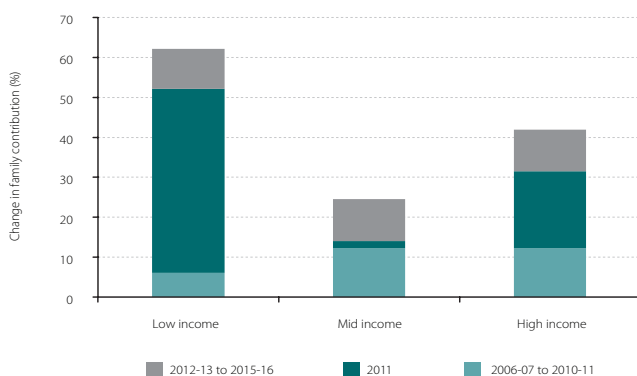


Finally, Chart 3.4 tells a similar story for high-income families, although the cut in the face value of vouchers to higher rate taxpayers means that the level of state support is substantially lower for this group by 2015-16.

Chart 3.5 show the contribution made to changing affordability over the nine years between 2006-07 and 2015-16:

- the light green bars represent changes occurring between 2006-07 and 2010-11, mainly driven by childcare cost inflation;
- the dark green bars show changes between 2010-11 and 2011-12, primarily driven by the tax credits cut for the low-income group and the voucher cut for those families with a higher rate taxpayer; and
- The grey bars illustrate the further deterioration in affordability expected from childcare cost increases in the years up to 2015-16.

**Chart 3.5 Proportionate change in childcare affordability, 2006-07 to 2015-16.**



The reasons why those in the middle-income group see a deterioration in affordability is that the amount of public support available through childcare vouchers remains largely fixed throughout the period, meaning a decline in the purchasing power of the voucher as childcare costs are rising. For the high-income group the rising costs are compounded by the drop in the 2011 face value of their vouchers combined with a freeze on its nominal value.

For lower-income families, three effects are at play. Here too, the relentless growth of unit childcare costs is a key factor eroding

affordability. But tax credit support has also fallen significantly to 70% from 80% of overall childcare expenditure from April 2011. In addition, the real value of the tax and NI exemption on childcare vouchers declines as the face value of the childcare voucher has been unchanged – and looks set to remain frozen – over the period.

The result will be that formal childcare becomes unaffordable for more families. This could have detrimental effects on gender equity, child poverty and educational attainment.

### Example<sup>a</sup>

This rising private contribution to childcare is putting an extra financial burden on all families. But it is those on the lowest incomes who are facing the biggest squeeze. Childcare costs are eating into their household income more and more as time goes on.

Take a family in the low income group in 2006-07. Their overall household income is £20,000 per year. The family has typical 2006-07 childcare costs of £91.81 per week for their two children in today's prices. As claimants of childcare vouchers and the childcare element of the Working Tax Credit, this family has around 85% of their childcare costs paid for through public support, leaving them to find around £957 per year in today's money, to fill the gap. This represents 4.8% of their annual household income.

But with tax credit cuts and a freeze in the childcare voucher value, the rising costs of childcare are increasingly falling on the family's resources. With the proportion paid by the household set to almost double by 2015-16, the same family earning the same real income would have to find £1,553 per year to make-up the shortfall in public support. This represents 7.8% of their household gross income.

<sup>a</sup> All figures are in constant 2011-12 prices.

One way government could tackle this growing affordability gap would be by increasing public support. The next chapter will quantify how the vouchers and tax credits would have to change in order to maintain the real value of tax credits and childcare vouchers since 2006-07.

## CHAPTER 4: MAINTAINING THE REAL VALUE OF PUBLIC SUPPORT

Chapter Three brought together the trends in public support and in childcare costs to show how affordability has declined since 2006-07 and looks set to decline further by 2015-16. This final chapter looks at what it would take to restore some of the lost affordability, using tax credits and vouchers.

### Restoring the generosity of tax credits

At the 2006-07 high water mark for childcare affordability, the tax credits system covered 80% of childcare costs for eligible families. There are two ways to think about how to restore the earlier generosity of the system. One would be to return tax credits coverage to 80% of costs. However, since the overall cost of childcare has increased markedly, coverage would have to increase to 82.4% by 2015-16 in order to leave childcare affordability for families where it was in 2006-07. This is calculated by finding the proportion of childcare costs covered by tax credits that leaves families paying the same amount as in 2006-07 for the same quantity of care.

Based on the most recent tax credits statistics on take-up of the childcare element, the current 70% tax credits coverage costs the exchequer around £1.5bn in 2011-12, rising to £1.9bn in 2015-16. This increase is due to rising childcare costs and the £300m additional expenditure needed to extend childcare support to families working fewer than 16 hours per week under Universal Credit.<sup>27</sup> Take-up rates and amounts appear to have been steady for some time, hence it is reasonable to assume that this figure represents the steady state cost of the policy. On that basis we estimate that returning to 80% coverage in 2015-16 would cost the exchequer something in the

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27 Department for Work and Pensions, "Universal credit policy briefing note 10: childcare", <http://www.dwp.gov.uk/docs/ucpbn-10-childcare.pdf>.

region of £300m while going to 82.4% would cost around £400m per year in today's money.

### Restoring the generosity of childcare vouchers

For childcare vouchers, restoring generosity to their 2006-07 level could mean one of two things. One could raise the face value of the vouchers to ensure that they offer the same real terms value as they did in 2006-07, after the tax changes and inflation. Alternatively, one could aim to restore their childcare purchasing power in 2015-16 to what it was in 2006-07. This would effectively involve up-rating the value of the vouchers in line with childcare price inflation rather than consumer price inflation. We now calculate each of these in turn. We now calculate each of these in turn for non-tax credit claimants.

To maintain the 2006-07 tax and NICs value of vouchers the face value would have to:

- increase from £55 to £73 per week by 2015-16 for basic rate taxpayers;<sup>28</sup> and
- increase from the current £28 to £69 per week for higher rate taxpayers to restore the real value of the 2006-07 vouchers.

These levels are derived by calculating the level of voucher in 2015-16 that would replicate the 2006-07 tax and NI relief available on the £55 voucher that was then available to all taxpayers.

Three things affect the public support offered by the voucher over subsequent years after 2006-07: the face value of the voucher; the tax system in force; and rising unit childcare prices. Above, we established the 2015-16 nominal face value of a voucher that provides the same level of support in real cash terms. But, since

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28 Note this value would be different if the aim were to restore the generosity of vouchers for tax credits claimants.



childcare costs have risen ahead of inflation since 2006-07, their face value would have to increase to more than the above numbers to maintain the *childcare purchasing power* of the vouchers.

- In 2006-07 the voucher covered just below 23% of a basic rate taxpayer's typical childcare costs. On current plans, the voucher will cover just 15% by 2015-16. It would have to increase to £83 per week to restore the earlier childcare purchasing power.
- For higher rate taxpayers, in 2006-07 the £55 voucher covered just over 28% of typical costs. Yet on current plans, that proportion is set to fall to 10% by 2015-16. The voucher for this group would have to increase to £78 per week by 2015-16 to restore the 2006-07 childcare purchasing power.

Calculating the cost to government of these changes is particularly difficult since no administrative data exists to know the current cost of the voucher scheme with certainty. Since employers tend to operate the scheme on a salary sacrifice basis, there is no need for either claimants or employers to notify HMRC of the claim. Employers simply reduce the amount of the claimant's taxable salary.

Nevertheless, HMRC estimates that in 2011-12, the childcare vouchers will cost some £550m.<sup>29</sup> Laing and Buisson estimate that take-up last year was similar to the year before, implying that it may have stabilised after a number of years' rapid growth.<sup>30</sup> Drawing on this and on SMF's previous estimate of the proportion of 2007-08 claimants who pay higher rate income tax (around 17%)<sup>31</sup> it is possible to estimate that the tax and NI cost of the scheme would increase by around £200m were the 2006-07 cash value

29 Hansard, Parliamentary Answer by David Gauke MP, November 14, 2011, c638W.

30 Philip Blackburn, *Children's nurseries UK market report 2011* (London: Laing & Buisson Ltd, 2011), 42.

31 Joanna Konings, *Childcare vouchers: who benefits? An assessment of evidence from the Family Resources Survey* (London: Social Market Foundation, 2010), 6.

of the vouchers to be restored. On the same basis it would cost somewhere in the region of an additional £300m in foregone tax and NI in 2015-16 to restore the childcare purchasing power to 2006-07 levels. These costs would be higher if increased tax credit claims were taken into account.

## CONCLUSION

This report has explored how the affordability of childcare is changing. The rising private contributions of families is the result of falling generosity of public support combined with rising childcare prices.

The analysis shows rapidly declining affordability for all income groups between 2006-07 and 2015-16. While this report has painted the childcare picture for one form of family – a two-adult, two-child family – the broad results are generally applicable to most users of childcare. With a few exceptions, most families will have to pay substantially more from their own resources to cover their childcare costs in 2015-16 than they did nine years earlier.

Parents in the UK already pay much more towards the total costs of childcare than their counterparts anywhere else in Europe. This situation will worsen in the years ahead. Three things are driving this: a freezing of the face value of childcare vouchers since 2006-07 (as well as a reduction for higher rate taxpayers); the cut in the proportion of childcare costs covered by the tax credit system from April 2011; and ever increasing real costs for any given amount of childcare. Those on the lowest incomes are being hit hardest by these trends, paying 62% more for their childcare by 2015-16. Almost all income groups will pay substantially more in absolute terms. This represents an alarming deterioration in childcare affordability for families at all points in the income spectrum.

This growing affordability gap poses serious problems both for families and government. The increasing costs of childcare may mean work no longer pays for more parents, undermining the Universal Credit reforms being implemented to address that very problem. Already a significant minority of parents report staying at home because of the cost of childcare. If fewer parents work because of even higher childcare costs in the future, this

will raise their susceptibility to poverty and reduce long-term earnings.

The wider public will, in the long-term, lose out from reduced use of formal childcare. For one, fewer parents will be working and thus paying tax. This will have longer term implications for parents' labour market attachment and earning capacity, and hence for tax revenue and benefit costs. Further, since formal childcare boosts children's educational and social development, lower usage may mean higher expenditure on welfare and even the justice system in the future.

Urgent steps are needed to ensure that formal childcare remains affordable for all, for both equity and efficiency reasons. In the current tight fiscal environment, the high cost of restoring past levels of support are problematic. But unless government can find some way to alleviate the burden on family finances, the implications for everyone of deteriorating childcare affordability will be unwelcome.



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High-quality, affordable formal childcare is critical for children's development and parental employment, bringing significant private and public benefits. In this analysis, the SMF explores the changing level of financial support and the rising cost of formal childcare between 2006-07 – the high-water mark of public financial support for childcare – and 2015-16. The paper demonstrates how childcare affordability has deteriorated and will continue to decline in the years ahead.

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