Tax-free childcare: Consultation on design and operation

Response by Dr Jerome De Henau and Prof. Susan Himmelweit, ESRC-funded GenIX research project, The Open University.

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The aim of this research was to understand the factors that influence the entitlements of individuals to household resources. By focussing on heterosexual couples with or without children, it aimed to uncover the ways in which such factors were gendered, that is had different effects according to whether they pertained to men or to women, and in particular were influenced by different perceptions of the contributions and interests of men and women. The study was conducted cross-nationally to explore the effect of socio-economic, cultural and policy differences, mainly by comparing the UK, Australia and Germany in the decade before the crisis but also other EU Member States in the 1990s.

Overview

The main finding of this research of relevance to this consultation is that in all countries, and in the UK in particular, the employment status of individuals affects not only the size of their household resources but the benefits that an individual gains from those household resources (De Henau and Himmewleit, 2013a). Thus one partner not being in employment can have a damaging effect on equality within households, particularly over access to financial resources. This is particularly important in couples where resources are tight. Other research has shown that the amount individuals contribute to their household matters to their control over household resources (see Bennett, 2013, for a review). Our research adds that employment status matters over and above the size of individual contributions; and full-time employment more than part-time. We also found for the UK that children under five years old had a negative effect on how much women benefited from household income, which we interpreted as a result of mothers having to bear the brunt of childcare costs, thereby reducing their perceived contribution to household resources (De Henau and Himmelweit, 2013b).

Childcare, and support with childcare costs, can be of vital help to parents in entering and progressing in employment. High quality childcare by qualified professionals is also key to fostering a child's development and socialisation. The issue is thus to create the correct incentives to enable mothers to return to work after childbirth, and preferably in a way that leads them into full-time employment eventually, even if not immediately.

Government policies on flexible working are quite rightly designed to encourage this. By enabling women to stay in jobs where they can use their existing skills even if working reduced hours, flexible working can enable a smooth transition back to full-time employment. It is an excellent idea to design child care support with this same aim in mind. For this it is important above all that it facilitates women returning to work after maternity leave at hours that suit them, but does not put in place any hurdles to later increasing those hours.

In practice, the incentives for couples under Universal Credit (UC) have been designed to focus first on transforming a no earner “workless” couple into one with at least one earner and then on increasing the earnings of the household, both of which are important for containing the costs of the system. However, this does not distinguish situations in which the total household income is earned by one or by two earners, even though there are good reasons consistent with aims of UC to do so. Two-earner couples are much more robust in terms of keeping an attachment to the labour market and have better earning prospects in the longer run. As the consultation document notes ,one-earner families are five times more likely to be in poverty than two-earner families (para 6.10). The findings of our research show that two earner couples are also more likely to use their household resources in ways that benefit both partners.

The system of childcare support under UC does recognise the difference between two earner and one earner couples, in that it is only open to the former. However, we believe that the proposals to increase support for childcare under UC could be better designed to encourage more equal dual earning, which is by now the standard pattern of couples who earn enough not to need tax credits or UC, and leaves the family in a much more secure financial position for the future.

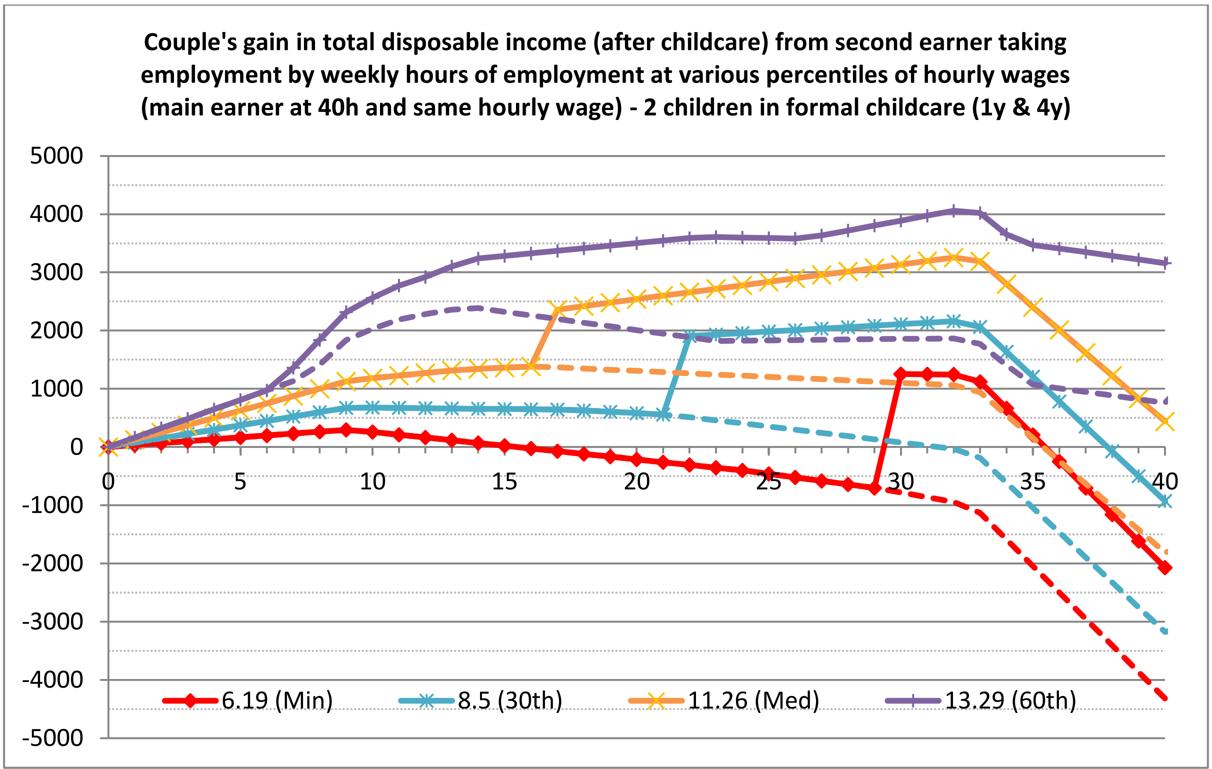
In 2011, the Government cut childcare support within the present tax credit system from 80% to 70% of eligible childcare costs to save £335m. The level of childcare support under tax credits had previously been raised to 80% because 70% was found to still leave many parents finding childcare too expensive to make employment worthwhile (even though in practice that 70% was higher when effects on the withdrawal rate of housing benefit and council tax benefit were taken into account). While there are some features in childcare support under UC which make it more flexible and useful than under tax credits, that only a strict maximum of 70% of eligible childcare costs are refunded makes formal childcare too expensive for many low earning parents (see dotted lines in Figure 1 below, representing this 70% level), many of whom, particularly mothers of pre-school children, consequently remain out of the labour market.

It is undesirable for childcare costs to make any mother, not only a lone parent, unable to take employment. Not only are second earners likely to keep families out of poverty and resources likely to be better shared in two-earner families, but also there can be serious consequences for the future of periods out of the labour market. Mothers who return to employment after maternity leave and stay throughout the period when they have pre-school children end up with much higher earning power. Retaining the mother’s earning power is important for the well-being of the whole family, including the children, and especially so for the significant number of mothers and children who will end up living in a lone parent family. Separated mothers are much more likely to be able to support themselves and their children if they have remained in employment while the relationship was intact

We recognise that the current proposal to increase the level of support through UC to 85% of childcare costs for parents both of who earn above the tax threshold is designed to encourage dual full-time employment. However, in practice this will not help families with low to middle earners as it would not enable them to build up to those hours and could create considerable insecurity for those looking for full-time employment as explained below.

Figure 1 below illustrates how couples with two children at various second earner wage rates would be affected by the proposed 85% subsidy to childcare costs (where the first earner is assumed to be in full-time employment and earning at the same rate – see annex for details). It shows the net gain in disposable income after childcare costs from the weekly employment hours of the second earner.

Figure 1



Note: dotted lines represent the situation before the proposed changes. See annex for calculations

Couples both on the minimum wage rate lose from the second earner being employed between 15 and 29 hours per week and therefore not earning enough to pay income tax. Further if the second earner is employed for any more than nine hours, increasing those hours reduces the couple's income. At such low wage levels, Figure 1 reveals that the proposals will create a steep cliff edge in gains to employment for the second earner when the tax threshold is reached (and a narrow plateau before the maximum allowable childcare claim is reached and gains taper down again). Both edges of this plateau are important because falling off it on either side, particularly to lower hours, could result in a serious drop in income.

Such a second earner loses out from working more than nine hours unless they work between 30 and 35 hours. This puts them in a real dilemma, which is likely to result in many choosing to stay on low hours. Those who do not return to full-time employment, as the majority of mothers currently do not, are therefore faced with being able to work only very few hours without losing money. To pose such an extreme choice makes progression very difficult and may result in some leaving employment altogether and others being trapped in low paid part-time employment.

For higher earners the situation is less extreme but even for earnings at the 30th percentile of the wage distribution there is a range of employment hours which produces a negative gain to increasing employment (between 9 and 21 hours). Only when childcare subsidised at 85% kicks in, at different hours according to different wage levels, does increasing hours of employment become a viable strategy.

Further, in practice few people can choose their hours exactly; indeed in today's more flexible labour market, many may not know exactly what hours they will be expected to work in taking on a job. This is particularly true of those on the lowest wage rates who often have less control over their hours of employment than those on higher wages. This includes people doing valuable and vital work, such as carers, nearly all of whom are on contracts which do not guarantee weekly hours. Under the current proposal being asked to work an extra hour or having to give up a shift could dramatically change the family's income. This would be an undesirable source of labour market inflexibility and impossible for families to manage. Few are likely to be willing to put themselves in this situation.

We would therefore suggest that to simplify the system and meet its goals more effectively, there should not be two different rates of childcare support under UC. Instead there should be a single rate of 85%. This will cost more than the existing scheme, but if the money needs to be found from within childcare spending, it could be funded by reducing the upper limit of eligibility for TFC for higher income families since for them employment already pays without childcare support. This would be a more cost effective way of encouraging longer hours of employment for parents.

Specific questions

More specifically in answer to some of your questions (the remaining ones relate to areas on which we do not have any expertise):

Question 6: Does the proposed definition of 'parents' ensure that all individuals who have responsibility for a child can benefit from Tax-Free Childcare?

Yes it is a good definition of a "parent" to include everyone who has responsibility for a child. However it is not clear what requiring co-residence adds – it may just exclude a few worthwhile cases eg a non-resident parent who pays the childcare fees, which could well be the result of an arrangement that separating couples make. The government is keen that couples make their own arrangements in these circumstances, which can be finally balanced and disruptive to change. Adding that the person holding (and thus paying into) the childcare account must be the parent co-resident with the child seems an unnecessary interference in such arrangements. We also see no reason why parents should not be able to share the TFC account for their child.

Question 7: Is the proposed definition of 'the household' fair and workable?

The proposed definition of a household is fine but the way it is used in combination with the requirement for all parents to be in work is problematic. There is a slippage from defining members of the same household to claiming that the partner of any parent is effectively another parent. This "parent" is then implicitly expected to do full-time childcare if not in employment, since a parent moving in with new partner who is not in employment lose entitlement to TFC (para 3.11). This is neither good for children nor is it likely to encourage the repartnering of lone parents. It is a step considerably further than requiring that new partner's income be taken into account in determining benefit levels and takes no account of the child's well-being, who may not be best looked after by an adult just because that adult is unemployed. Taking that into consideration, parents moving in with a new partner may decide to give up employment rather than force their new partner to become a full-time parent. This would defeat the purpose of the measure by creating a new workless household.

We suggest instead that only new partners who have been offered and accepted parental responsibility be required to do childcare, and therefore only in those circumstances would a parent lose their entitlement to TFC. We suggest a similar amendment to UC conditions.

(We suspect "parent" in para 3.12 is a misprint. Whether or not a partner in custody is a parent, we assume that the parent not in custody will be eligible for TFC)

Question 8: What are the potential benefits and risks of a minimum income rule or hours rule in defining qualifying employment?

We can see no good reason to have different rules for TFC than the conditions outlined in Box 6A for eligibility for the childcare element of Universal Credit. In particular, the argument for supporting childcare for those employed for short hours remains the same for TFC as under UC.

However, since TFC is designed to encourage employment, it should be available only for hours of employment (plus an amount of time for travelling to and from the workplace). This would be better implemented by limiting the amount of TFC available than by putting overall conditions on its eligibility.

It is also important to allow a period of before and after employment in which TFC will be available so that children's care arrangements do not need to be arbitrarily changed whenever their parents' circumstances change (as is currently the case under UC) and for a parent who is unemployed to be able to look for jobs.

Question 9: What alternative ways are there to define qualifying employment, and what are the potential risks and benefits of these approaches?

We see no reason why qualifying employment should not include periods of unpaid maternity and sickness leave (para 3.16) since the reasons given in 3.15 for including periods of paid leave apply to periods of unpaid leave too. Including couples where one partner is in receipt of Carers Allowance or contributory ESA as qualifying for TFC is important. Regulations will have to be carefully designed to ensure that families where a carer does not claim Carers Allowance because s/he would not gain from doing so (if any) remain eligible for TFC. See also comment in question 8 about keeping jobseekers within the TFC system to minimise disruptions.

Question 32: The proposal is to use gross taxable earnings as a proxy for people whose earnings are above the tax threshold. What other proxies could the Government use?

As we argue above we see no good reason for having a two tier system of childcare support under UC and the tax threshold, because it is dependent on potentially variable earnings, is a particularly bad place to create a cliff-edge.

Question 33: The Government wishes to ensure help is targeted at those who need it most within the fiscal constraints it faces. Should people who are getting Statutory Sick Pay, Statutory Maternity Pay, Ordinary Statutory Paternity Pay, Additional Statutory Paternity Pay, Statutory Adoption Pay and Maternity Allowance be entitled to the 85 per cent support or not?

We see no reason not to apply existing UC eligibility rules. People who are on sick leave definitely still need childcare; those on maternity or paternity leave, may still need it not to disrupt arrangements for other children.
Using the tax threshold as a cut-off point for receiving 85 per cent support fails to meet the objective of encouraging full-time work since it produces an undesirable cliff-edge and comes at different hours for different earnings. As a result it is the lowest earners, who need such extra support the most, who are denied it for the largest range of hours.

Question 34: What information will people need to understand the impact of the measure on their own circumstances?

Since the outcomes can be so variable depending on exact hours and hence earnings, people would need to know what their net gain after paying for childcare would be for every possible combination of hours parents' might work. Since they may also be considering jobs at different wage rates, this would require even more information. In practice, even if the first earner already had a job and was not contemplating any changes in that, the second would require a complicated set of figures table giving all the information represented in Figure 1. If both partners were considering their employment options, they would need figures for each possible job that the first earner was considering. This complexity in itself is a good reason for not going down this route.

Question 35: Is offering a choice between Universal Credit and Tax-Free Childcare the best approach without driving up costs to the Government or increasing complexity for claimants? Should there be a limit on the number of times that a parent can switch?

Meaningful choice would not be possible given the complexities involved.

The difference in maximum amounts for which claims under TFC and UC can be made adds to this complexity. This is good reason for bringing the two systems into line with each other in this respect. It is unfair that the UC system does not increase the maximum amount funded when there are more than two children; childcare costs are prohibitive for low income families with three children. Being employed even part-time does not pay for most couples with a full-time employed main earner up to 30th percentile of hourly wages (and there would still be a similar cliff edge and narrow plateau where it does). Of course allowing a higher maximum for larger families will come at a cost, depending on take-up, but if the government is serious about marking work pay for all, this issue should be addressed.

According to our simulations, some families would be better off under TFC than UC with a second earner even before the extra 15% kicks in because the UC taper reduces the amount paid to below that received under TFC, but then better off under UC once they reach the personal tax threshold until the taper again makes TFC the better option[1]. Including any benefits passported through UC makes this even more complex. As the amounts are not negligible (up to £900 yearly) parents would need to be able to make an informed choice. However the information required would be extremely complex – even more so than that required to decide between employment options. This is another argument in favour of scrapping the personal tax threshold for receiving 85% support and its consequent cliff edge.

Summary

The results of our study on effects on intra-household inequalities affirmed the importance of the government's aim of encouraging dual earning in families, and especially dual full-time earning. However, we have shown why the proposed measures will not achieve those aims.

To use an extension to childcare support to meet these aims more effectively, **we recommend that**:

- UC support for childcare should be increased to 85% for all parents to reduce the unfair and potentially counter-productive complexities of the current proposal;
- If the extra funds required (£200m according to the Resolution Foundation) must be found within an overall childcare budget, they could be raised by reducing the TFC support to higher earning families

We also recommend that:

- New partners should not reduce eligibility for childcare support unless they have accepted parental responsibility;
- Sick leave and all forms of paid and unpaid maternity, paternity and parental leave should count for eligibility for both forms of childcare support;
- Both forms of childcare support should make allowances for those looking for employment and those who have recently left employment so that children's care is not too disrupted and job seekers can look for employment.
- No minimum income rule or employment rule should be introduced for TFC eligibility other than being in employment or equivalent (looking for job, caring for others, being disabled, or on maternity, paternity or parental leave for another child, paid or unpaid). However, the amount of TFC could be limited to parental hours of employment (plus an amount of time for travelling to and from the workplace).

[1] In Figure 1, the top line shows the positive effect on the net gain from increasing hours beyond 14 due to TFC kicking in at middle-level wages (around the 60th percentile) but also partly the increased UC support which is more generous than TFC between 27 and 34 hours).

References

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Annex

Assumptions built into the calculation of effects of proposed childcare support in Figure 1 and elsewhere in this document:

- Couple families with no other resident adult
- Youngest child just under 2 year olds, oldest child is 4 years old and the third child, if there is one, is 3 years old
- All household income comes either from state support or market earnings
- UC entitlement does not include housing costs
- Child benefit included
- Employed partners are employees
- One earner is working full-time (40 hours per weekly for 52 weeks per year)
- Both partners have the same hourly wage rate
- Childcare costs are calculated using data from the Daycare Trust's Childcare Costs Survey 2013 and therefore assume a £4.26 hourly cost (applied to all children in our example), for 50 weeks, with 1.25 hours of childcare needed for every hour of employment, so that 20 hours of employment requires 25h of childcare and 40h of employment 50.
- National minimum wage of £6.19 for adults is taken at 2012-13 levels to match average childcare costs of that period.
- All three and four year-olds are entitled to 15h of free childcare, for 38 weeks a year.