

9. Reforms to childcare policy

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Summary

- The government launched its 10-year childcare strategy in December. The government intervenes in the market for childcare to improve children's prospects and make it easier for parents to work. If achieved, these goals can promote both equity and economic efficiency.
- The childcare tax credit offers some working parents a subsidy to help pay for formal childcare. The cost and number of beneficiaries have risen sharply under Labour. Criticisms of the childcare tax credit include complexity, inadequate targeting on poor families and a lack of incentives to improve childcare quality.
- The government might have more influence on childcare quality if it diverted money from the credit to subsidies for providers. Money could also be recycled within the tax credit system better to encourage work or help families with children, without trying to influence choice between formal and informal childcare.
- The 10-year childcare strategy includes the eventual goal of offering free nursery education to all 3- and 4-year-olds for 20 hours a week for 38 weeks a year. This could double the annual cost of free nursery provision from approximately £1.3 billion today to £2.6 billion, excluding the cost of necessary extra physical infrastructure.
- If the government wants to give all children equal access to high-quality childcare, expanding free provision may not be the most cost-effective way to do so. The expansion could be targeted on the most deprived areas or access could be means-tested. But this might have other drawbacks.

9.1 Introduction

The government's 10-year childcare strategy, released with the 2004 Pre-Budget Report, announced a number of measures to improve the quality and quantity of childcare, nursery education and wraparound care for children aged 14 years and under, as well as an increase in subsidies to help parents with the costs of childcare. Box 9.1 summarises the proposals.

In this chapter, we discuss why the government might intervene in the childcare market, and then focus on two of the reforms outlined in the childcare strategy: the extension of the childcare element of the working tax credit, and the expansion of free nursery provision for 3- and 4-year-olds. For each reform, we examine what is in place at the moment (in both cases, the proposals constitute an extension of existing policy), how much both the current

and proposed policies cost, who currently benefits and who is likely to benefit in future, and whether the announced reforms are the best means of achieving the government's objectives.

Box 9.1. Key initiatives in the government's 10-year childcare strategy

- Increase in the limits of the childcare element of the working tax credit to £300 per week for two or more children (£175 for one child) from April 2005, and an increase in the percentage of total childcare costs that can be claimed from 70% to 80% in April 2006.
- Extension of free early years education for 3- and 4-year-olds, with 15 hours a week for 38 weeks a year envisaged by 2010 and 20 hours a week for 38 weeks a year as the eventual goal.
- Legislation to be introduced in 2008 to place a duty on local education authorities (LEAs) to ensure a sufficient supply of nursery places such that all 3- and 4-year-olds can receive the statutory minimum level of provision (as outlined above).
- Introduction of a Transformation Fund of £125 million each year from 2006 to assist LEAs with the capital costs of increasing the number of high-quality, affordable and sustainable childcare places.
- Expansion of the number of children's centres, offering support to families through information, health and childcare services, with a view to having 2,500 centres in place by 2008 and 3,500 by 2010.
- Provision of an out-of-school childcare place for all children aged 3 to 14 between 8am and 6pm every weekday by 2010.
- Improved inspection and regulation of childcare providers, including the introduction of new qualifications for staff.
- Confirmation that, from April 2005, employers will be able to give employees childcare vouchers of £50 per week that are free of tax and National Insurance contributions, irrespective of income.
- Extension of paid maternity leave, with a target of nine months by April 2007 and 12 months by the end of the next Parliament. This includes the freedom to transfer some of that entitlement to the child's father.

This chapter proceeds as follows: Section 9.2 outlines the justifications for government involvement in the childcare market, Section 9.3 analyses changes to the childcare element of the working tax credit and Section 9.4 examines the extension of free nursery provision for 3- and 4-year-olds. Section 9.5 concludes.

9.2 Why intervene in the childcare market?

The government's 10-year childcare strategy has two stated aims:

- to expand labour supply choices and improve work–life balance for parents;
- to advance the long-term social and educational outcomes of children, particularly those from more disadvantaged backgrounds.

Why would the government want or need to intervene in the childcare market to achieve these aims? There are two broad arguments: equity and efficiency.

Equity

- The government believes access to high-quality pre-school education should be available to all children, regardless of parental income. Indeed, it could be argued that children from more disadvantaged backgrounds have the most to gain from nursery education, and thus should be given priority access to nursery places.¹ There is also evidence that supporting child development in the early years is a more cost-effective way of improving people's lifetime economic (and social) outcomes than intervening in later life.² Allowing parents equal access to the labour market (by removing or reducing their inability to work because they do not have access to affordable childcare) may also be seen as a desirable outcome on equity grounds.³

Efficiency

- **Externalities:** The government may believe that strong benefits accrue to society (and not just to the families directly involved) if parents use high-quality childcare. For example, economic efficiency may be increased if children are better able to benefit from subsequent education and if the supply of skilled labour increases as parents are able to spend more time in the labour market. If the government believes that individuals consume less-than-socially-optimal levels of high-quality childcare or hours of work, then it may choose to intervene by subsidising or directly providing high-quality childcare.
- **Information failure:** Evidence suggests that high-quality pre-school education can have a beneficial impact on children's cognitive and social development.⁴ But these benefits are not guaranteed and some may not be realised until later on in the child's life, so parents may not perceive the existence of these long-term benefits or may underestimate their effect. In this case, parents will choose a level of consumption of pre-school education for their child that is too low for the child's own good – in other words, that does not capture all the available benefits. If the government believes this likely, it may wish to intervene to provide more information about the benefits of early years education to parents.
- Another source of information failure may also exist, this time concerning parental knowledge of the quality of pre-school education on offer. If quality is underestimated, then 'too little' nursery education will be consumed, while if quality is overestimated,

¹ This can be seen through the previous government policy of prioritising funding for the provision of maintained nursery places (see Box 9.7 for a definition of maintained provision) in the least deprived areas of the country.

² P. Carneiro and J. Heckman, 'Human capital policy', in J. Heckman and A. Krueger (eds), *Inequality in America: What Role for Human Capital Policies?*, MIT Press, Cambridge, 2003.

³ G. Paull and J. Taylor with A. Duncan, *Mothers' Employment and Childcare Use in Britain*, Institute for Fiscal Studies, London, 2002.

⁴ See, for example, K. Sylva, E. C. Melhuish, P. Sammons, I. Siraj-Blatchford and B. Taggart, *Final Report: Effective Pre-School Education*, Effective Provision of Pre-School Education (EPPE) Project, Technical Paper no. 12, Department for Education and Skills / Institute of Education, University of London, London, 2004. It should be noted, however, that the balance of evidence has not always underlined the beneficial impact of pre-school education.

then ‘too much’ nursery education will be consumed. To ensure that the optimum level of pre-school education is undertaken, the government may choose to intervene to provide better information regarding educational quality.

- **Financial constraints:** On the demand side, parents from low-income families in particular may not have the financial resources to obtain the optimal level of high-quality nursery education for their children. This is compounded by the fact that a sizeable proportion of parents have children relatively near the start of their careers, when current earnings are low relative to average earnings over the life cycle, thus making it difficult to borrow.⁵
- On the supply side, non-maintained childcare providers⁶ may have much greater difficulty raising financial investment to open nurseries in relatively deprived areas, as there are likely to be considerably more financial risks setting up in such locations. If, at the same time, state provision is insufficient to meet demand, then the government may wish to subsidise the setting-up of non-maintained nurseries in such areas.

The government has introduced a number of policies, both in the 10-year childcare strategy and previously, that address these issues. For example, the Transformation Fund (see Box 9.1) is a way for the government to increase directly the supply of high-quality childcare places, thus tackling part of the externalities issue outlined above. The targeting of such provision on the most deprived areas (for example, via the Neighbourhood Nurseries Initiative)⁷ also assists with the equity considerations underlying government intervention in the childcare market.

In this chapter, we are going to focus on two of the main reforms set out in the 10-year childcare strategy: the extension of the childcare element of the working tax credit, and the expansion of free nursery provision for 3- and 4-year-olds. These reforms, together, tackle a number of the government’s aims, as outlined above.

9.3 The childcare tax credit

The childcare element of the working tax credit (referred to hereafter as ‘the childcare tax credit’) is a payment made to the main carer of some working families to subsidise their use of certain types of formal childcare.⁸

This section discusses how the childcare tax credit works, the changes to it announced in the 2004 Pre-Budget Report, what it costs, who benefits and what impacts it has. It then discusses some criticisms that have been made, and suggests alternative policies to the childcare tax credit for achieving the government’s stated objectives for its 10-year childcare strategy.

⁵ This is a similar argument to that used to justify the provision of student loans for higher education participants.

⁶ See Box 9.7 for the definition of non-maintained nursery provision.

⁷ Deprived areas, for the purposes of NNI, are usually defined as the most deprived 20% of wards in the country.

⁸ It should be noted that although the childcare tax credit is notionally part of the working tax credit, parents who do not qualify to receive any working tax credit may still benefit (financially) if they claim the childcare element.

How does it work and what does it cost?

To be entitled to the childcare tax credit, parents must pass three tests:

- **The work test:** Are all adults in the family in paid work for at least 16 hours a week? (A couple where one adult works 16 or more hours a week and one is incapacitated will also pass this test.)
- **The childcare test:** Is the family spending money on registered childcare for children under the age of 15? (Definitions of both 'formal childcare' and 'registered childcare' are provided in Box 9.2.)
- **The income test:** Is the family's income sufficiently low?⁹

Parents who pass these three tests will receive up to 70% of their formal childcare costs (80% from April 2006), with the actual size of the subsidy depending in a complicated way upon the family's joint income, the number of children and the amount they spend on formal childcare. We show later that the way in which these three elements interact makes it very difficult for parents to understand what they might be entitled to.

Box 9.2. Definitions of 'formal childcare' and 'registered childcare'

Formal childcare is defined as a child being looked after by someone who is neither a member nor a friend of the family. For example, it includes nurseries, playschemes, out-of-school clubs, childminders, nannies and au pairs. Childcare provided by relatives or friends is known as *informal childcare*, whether paid or unpaid.

The childcare tax credit and its predecessors (see Box 9.3 for further details), and the new tax-free childcare vouchers (see Box 9.1), can reduce the cost to parents of certain types of formal childcare known as *registered care*. To be registered, childminders and other formal carers for the under-8s will have to meet 14 minimum national standards assessed through on-site inspections by the Office for Standards in Education (Ofsted), but nannies and au pairs just need a relevant childcare qualification, a recent first-aid certificate and to undergo an enhanced criminal records check. All registered childcare is formal, but not all formal childcare is registered: for example, the childcare tax credit does not help parents who use unregistered childminders.^a

^a In the 2003 Pre-Budget Report, the government confirmed that a registration system for nannies and other child carers who provide care in the parental home would start in April 2005. This means that parents who employ registered nannies will, from April 2005, be able to use the childcare tax credit to cover some of their childcare costs.

The childcare tax credit cost around £735 million in 2003–04, and is likely to cost around £880 million in 2004–05.¹⁰ There are currently 331,000 recipients – two-thirds of whom are lone parents – benefiting from an average payment of £51.35 a week.¹¹

⁹ Income here and throughout the chapter refers to the gross income of a lone parent, or the combined gross income of the two parents in a couple with children.

¹⁰ Our estimate for 2003–04 is based on weekly spending in July 2003, October 2003 and January 2004. Our estimate for 2004–05 is based on weekly spending in December 2004.

¹¹ Figures on numbers of recipients give the number receiving childcare tax credit on a particular day; we do not know how many families received the childcare tax credit at any point in 2003–04, for example.

The cost of this programme has increased dramatically since its introduction in 1997 (see Box 9.3 for the history of childcare subsidies to working parents). In real terms, spending on the childcare tax credit in December 2004 was more than 16 times greater than spending on its equivalent in November 1998: the average award has doubled in real terms, and more than eight times as many families are now benefiting (see Figure 9.1).¹² This rapid rise in spending on the childcare tax credit is expected to continue, with the government predicting expenditure of over £1 billion by 2007–08.¹³ It is by far the largest programme that helps parents with the cost of formal childcare (unless one includes the provision of free nursery education, described in Section 9.4).¹⁴

Box 9.3. The recent history of childcare subsidies

The childcare tax credit has gone through three incarnations since the introduction of its predecessor under the previous Conservative government:

- Between April 1997 and October 1999, low-income working families had some of their income disregarded when means-testing family credit, housing benefit and council tax benefit if they were using formal childcare.
- When working families' tax credit replaced family credit in October 1999, the childcare disregard was replaced with a childcare tax credit. This reimbursed low-income working families up to 70% of their formal childcare costs, with the size of the reimbursement depending on the family's income, the number of children and the amount spent on formal childcare. The generosity of income disregards in housing benefit and council tax benefit calculations was also increased.
- When working tax credit and child tax credit were introduced in April 2003, the childcare tax credit was replaced by the childcare element of the working tax credit. This worked in almost exactly the same way as the childcare tax credit.

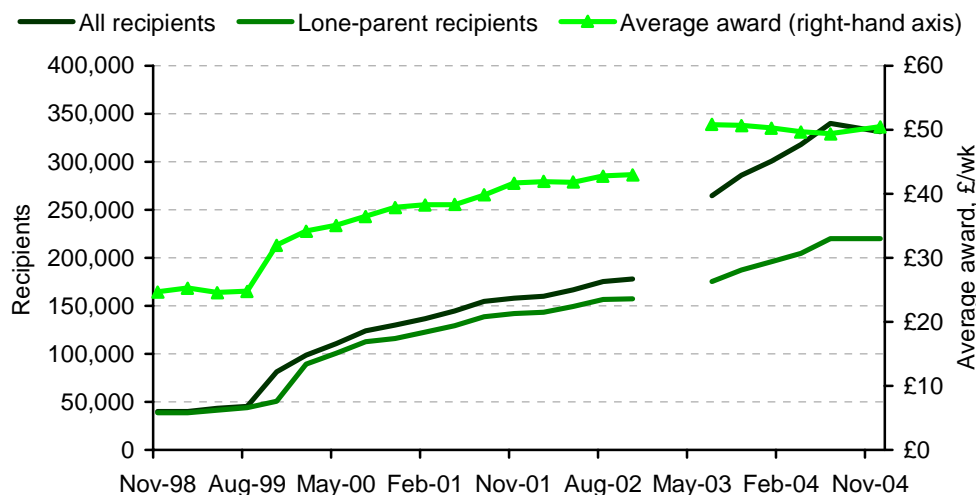
There has been a considerable change over time in who benefits from the childcare tax credit: in its last months of existence, 96% of families who benefited from the childcare disregard under family credit were lone parents. Under the working families' tax credit, this proportion fell gradually to 88%, and it then fell dramatically when the new tax credits were introduced in April 2003, so that a third of families benefiting are now couples.

¹² Annual spending on the childcare disregard under family credit (see Box 9.3 for more details) in November 1998 was £45.6 million, rising to £883.8 million by December 2004.

¹³ See paragraph 7.14 of HM Treasury, *Choice for Parents, the Best Start for Children: A Ten Year Strategy for Childcare*, TSO, London, December 2004 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr04/assoc_docs/prebud_pbr04_adchildcare.cfm).

¹⁴ Figures for 2002–03 are given in Strategy Unit, *Inter-Departmental Childcare Review: Delivering for Children and Families*, London, November 2002 (<http://www.number-10.gov.uk/su/childcare/index.htm>).

Figure 9.1. Average award and number of recipients of childcare tax credit and its predecessors



Notes: Deflated using RPI to April 2004 prices. No statistics were published between November 2002 and July 2003 while the new tax credits were being introduced. Average weekly award is the mean award paid at particular dates. Sources: Authors' calculations from various editions of *Family Credit: Quarterly Enquiry*, *Working Families' Tax Credit Statistics: Quarterly Enquiry* and *Child and Working Tax Credits: Quarterly Statistics*, published by the Department of Social Security, the Inland Revenue and the Inland Revenue respectively.

Several factors can explain the sustained rise in the number of beneficiaries and the cost to government:

- The current government made the childcare tax credit more generous to families than its predecessor when it was introduced in October 1999. The government further increased its generosity in April 2001, April 2005 and April 2006.
- Although the proportion of working parents who pay for childcare does not seem to be rising, the growth in the proportion of mothers who work means that more families in total are now spending money on formal childcare than in 1997.¹⁵
- The cost of childcare is rising in real terms, with one survey estimating that the cost of an hour of childcare has rise by an average of 4% a year in real terms since 1995.¹⁶
- Take-up of the childcare tax credit seems to be growing over time. Although data are not available on the take-up rate of the childcare tax credit, there was a dramatic increase in the number of couple families receiving the childcare tax credit when the new tax credits were introduced in April 2003 that was not matched by an increase in the number of families eligible under the new policy. This strongly suggests that some couples with children who were previously eligible for, but not claiming, the working families' tax credit and associated childcare tax credit were prompted to claim the childcare tax credit when they first claimed the new tax credits.

¹⁵ See M. Brewer and J. Shaw, 'Childcare use and mothers' employment: a review of British data sources', Department for Work and Pensions, Working Paper no. 16, 2004 (<http://www.dwp.gov.uk/asd/asd5/wpaper16.asp>).

¹⁶ See M. Brewer and J. Shaw, *ibid.*

Several changes to the childcare tax credit were announced or confirmed in the 2004 Pre-Budget Report:

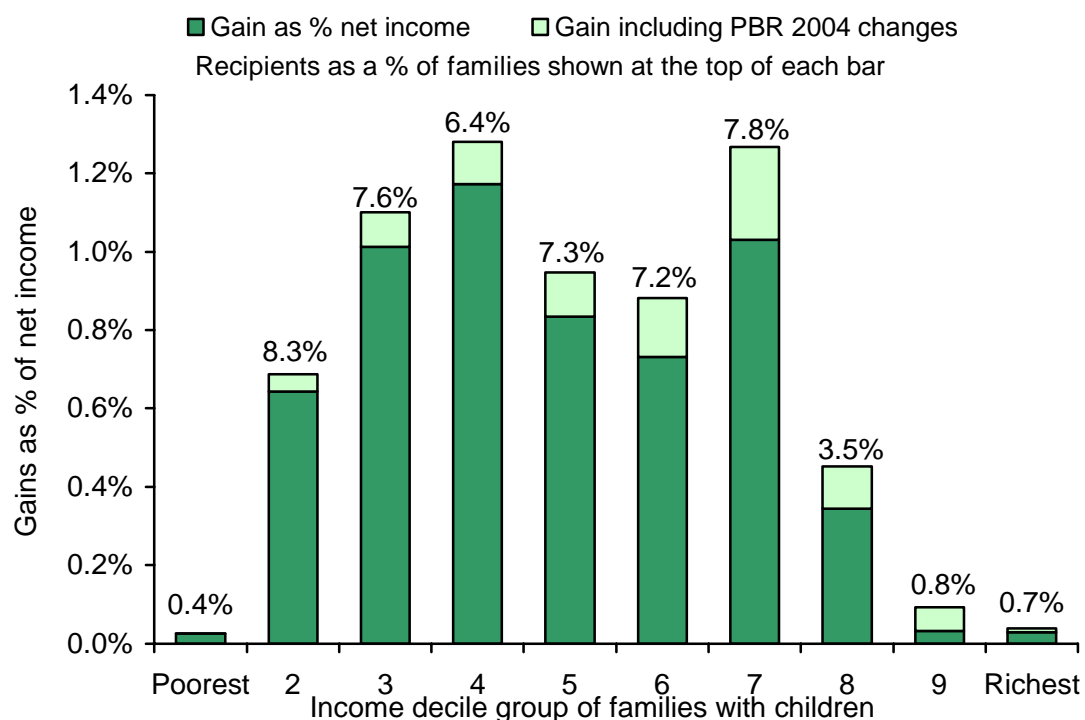
- The ceiling on eligible childcare costs will rise to £175 or £300 a week for families with one or more than one child respectively from April 2005.
- The subsidy rate will be increased from 70% to 80% of total childcare costs from April 2006.
- Parents will be able to use the childcare tax credit to subsidise the cost of people caring for their children in the family home, such as nannies and au pairs, and who register with an official body.

The combined cost of these reforms is estimated to be £170 million a year from 2006–07; the estimated distributional effects of the first two reforms are shown in Figure 9.2.

What does the childcare tax credit achieve?

This section looks at what the childcare tax credit achieves. We first ask ‘Who benefits?’ and then look at how the credit alters incentives to work and use formal childcare.

Figure 9.2. The distributional impact of the childcare tax credit



Notes: Deciles are of families with children only; there are around 700,000 families with children in each decile. Results assume full take-up of tax credits, but have been calibrated so that the estimated number of recipients and total spending match administrative data shown in Figure 9.1 (see Box 9.4). The graph does not show impact of childcare disregards in means-tested benefits, which will disproportionately benefit low-income families. Source: Authors' calculations using the IFS tax and benefit microsimulation model, TAXBEN, run on data from the Family Resources Survey 2002–03 uprated to current prices.

Who benefits directly from the childcare tax credit?

By its design, the childcare tax credit can only benefit working families who use formal childcare. These families tend not to be the poorest in society, because families with the lowest incomes tend to be those where no adults are working. The majority of the recipients are families on middle or average incomes, with around 7% of families in each of the 3rd to 7th deciles receiving the childcare tax credit (see Figure 9.2, which shows our estimate of the proportion of families in each tenth of the income distribution of families with children who benefit from the childcare tax credit in 2004–05).

Box 9.4. Modelling changes to the childcare tax credit: technical note

The data-set most frequently used for modelling the distributional impact of tax and benefit changes, the Family Resources Survey (FRS), appears to significantly under-record spending on formal childcare compared with administrative data. We have therefore adjusted the outputs from our analysis so that they are consistent with administrative totals of the number of recipients and the average award (or, for the changes announced in the 2004 Pre-Budget Report, with official estimates of the cost of the changes).

We have done this by assuming that the likelihood that a family in the FRS under-reports spending on childcare does not depend upon income or family type. However, if it were the case that, say, low-income families were less likely to report spending on childcare, then Figure 9.2 would be understating how well the childcare tax credit helps poorer families compared with richer ones.

The beneficiaries from both the programme as a whole and the changes announced in the 2004 Pre-Budget Report are mostly in the middle of the income distribution, with the largest gains to net income (as a percentage of net income) being found in the 4th decile from the bottom, followed by the 7th. As we show below, the childcare tax credit could theoretically benefit families with relatively high joint incomes: up to £43,668 in 2004–05 for a family with two children (£54,179 in April 2005 and £58,666 in April 2006). Indeed, our data suggest that some of the richest 10% of families are benefiting from the childcare tax credit, and the largest average cash gains from the childcare tax credit are in the 7th decile.

This means that the childcare tax credit has almost no direct impact on child poverty as measured by the government: the vast majority of its beneficiaries are not in poverty, and many are in the top half of the income distribution of families. To the extent that the childcare tax credit encourages low-income mothers to work, though, it will have an indirect effect that reduces poverty.

How does the childcare tax credit affect incentives?

There are a number of ways in which the childcare tax credit affects parents' incentives when they are deciding whether and how much to work, and what sort of childcare to choose.

If we think that mothers choose both whether or not to work and whether or not to use formal childcare, then, in general, the childcare tax credit increases the attractiveness of one combination of these decisions – using formal childcare and working 16 or more hours – compared with the other three. This means that the childcare tax credit should be thought of as improving the joint incentive for mothers to work and use formal childcare. In addition, the

detailed structure of the childcare tax credit means that for parents who are currently receiving the credit, it affects the choices they make about how many hours to work (or whether to seek a better-paid job) and whether to consume more or less childcare. In particular:

- Because of the way the childcare tax credit is means-tested against family income, each £1 increase in the gross income of a family receiving the childcare tax credit – for example, through getting a pay rise or working more hours – benefits them by 37p less than it would have done had they not received the childcare tax credit. An individual paying basic-rate tax and not receiving the childcare tax credit usually faces an effective marginal tax rate of 33%: this rises to 70% if they are receiving the childcare tax credit.¹⁷ Some higher-rate taxpayers receiving the childcare tax credit will face an effective marginal tax rate of 78%.
- Because of the way that the childcare tax credit is related to spending on childcare, each extra £1 of formal childcare only costs the family an extra 30p (20p from April 2006) up to the limits of £175 or £300 a week. In other words, recipients will be much less sensitive to the actual price of childcare, because they will be paying only 30% (20% from April 2006) of the true cost at the margin.

Criticisms of the childcare tax credit

A number of criticisms have been made both about the design of the childcare tax and benefit system and about the basic principles. In this section, we discuss some of these problems.

Criticisms of the administration of the childcare tax credit

One criticism is that the childcare tax credit can lead to cash-flow problems for parents. Although the childcare tax credit means that families whose income falls below the first threshold in Table 9.1 only pay 30% (20% from April 2006) of the market price of childcare, families have to manage the cash-flow arrangements themselves: they pay the full market price of childcare to the provider, and then rely on the Inland Revenue paying their tax credit award on time. This can cause problems for low-income families for whom gross childcare costs are a large component of family income. One way to solve this would be to pay the childcare tax credit to the provider, and make them responsible for the cash-flow problems, but some way would need to be found to ensure that providers charged parents the discounted rate.

A second criticism is that unlike the situation under the working families' tax credit, parents do not have to provide any evidence to the Inland Revenue that they are actually spending money on formal childcare when they apply for the childcare element of the new tax credits, although they do have to say which providers they are using. (The Inland Revenue has not yet said what levels of fraud or error it has uncovered using this information for awards in 2003–04.) If the government wished to address this problem, then it could require parents to submit

¹⁷ The effective marginal tax rate measures how much of a small increase in earnings is lost to income tax, National Insurance and forgone benefits and tax credits. Changes in the number of people facing high effective marginal tax rates from the government's reforms are documented in M. Brewer and A. Shephard, *Has Labour Made Work Pay?*, Joseph Rowntree Foundation, York, 2004 (<http://www.jrf.org.uk/bookshop/eBooks/1859352626.pdf>).

more evidence when they applied for tax credits, such as copies of contracts, invoices or receipts from providers, or require providers to certify that the information that parents supply to the Inland Revenue is correct. But this would increase parents' or providers' compliance costs, and may prevent the tax credits from responding quickly to changes in parents' circumstances.

Fundamental criticisms of the childcare tax credit

In addition to poor administration, some more fundamental criticisms have been made about the childcare tax credit system, including the following:

- it is not transparent;
- it is not well designed to raise the quality of formal childcare;
- it is not the best-designed instrument for encouraging mothers to work;
- it is not particularly targeted on helping the poorest families.

We expand on these points, and put forward suggestions for reform.

Table 9.1. Implicit income thresholds for the childcare tax credit

		Highest income on which family can receive full value of childcare tax credit	Income above which no family can receive childcare tax credit
One child	April 2004	£19,601	£32,882
	April 2005	£20,179	£37,396
	April 2006	£20,544	£40,220
Two children	April 2004	£23,992	£43,668
	April 2005	£24,666	£54,179
	April 2006	£25,139	£58,666
Three children	April 2004	£28,384	£48,060
	April 2005	£29,152	£58,869
	April 2006	£29,735	£63,463

Notes: For more than three children, add £4,392/£4,486/£4,595 to each threshold for each extra child. Thresholds are the same for couples and lone-parent families with the same number of children, except that, if a lone parent is working less than 30 hours, £1,729/£1,784/£1,824 should be subtracted from each threshold. Thresholds will be different for families claiming extra credit for having disabled adults or children. Values for April 2006 are consistent with the uprating assumptions in the forecast of tax credit spending in the government's public finance forecasts.

The childcare tax credit is not transparent

We noted above that parents have to pass three tests to be eligible: a work test, a childcare test and an income test. Parents who pass these three tests will receive up to 70% of their formal childcare costs (80% from April 2006), but the size of the subsidy depends upon the family's joint income, the number of children and the amount they spend on formal childcare:

- Families whose income is at or below a lower threshold are eligible for a subsidy equal to 70% (80% from April 2006) of their registered childcare costs up to certain ceilings.
- Families whose income is above an upper threshold are not eligible.

- Families whose joint income lies between these two thresholds are eligible for a subsidy of between 70% (80% from April 2006) and 0% of their registered childcare costs up to certain ceilings.

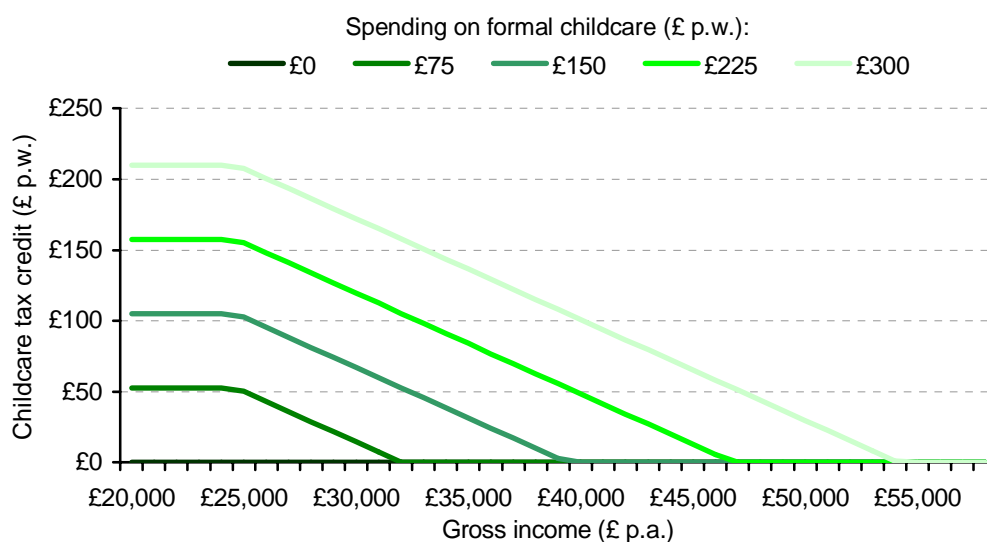
This alone is nearly comprehensible, but the thresholds referred to above depend on the number of children, on whether the family is considered to be working full-time (i.e. whether the total number of weekly hours of work done by the parents in the family is at least 30) and on the amount spent on registered childcare. Table 9.1 shows what these thresholds are in April 2004, April 2005 and April 2006 for various sorts of families.

There is a relatively large section of the income distribution within which it is not immediately obvious how much subsidy a family will receive from the childcare tax credit. For example, from April 2005, families with two children with incomes between £24,666 and £54,179 might benefit from the childcare tax credit depending on how much they spend on registered childcare. Between these two thresholds, there are two factors at work:

- Given a certain level of family income, the amount of subsidy rises as spending on childcare increases up to £300 a week, beyond which it remains constant.
- Given a certain level of childcare spending, the amount of subsidy falls as family income increases.

The way these factors interrelate is shown in Figure 9.3, which shows how awards of the childcare tax credit vary as income and childcare spending vary for a family with two children. The picture would be different for a family with a different number of children because, given childcare spending and family income, the amount of subsidy in pounds per week rises with the number of children in the family.

Figure 9.3. Entitlement to childcare tax credit: family with two children



Notes: The graph shows awards of childcare tax credit from April 2005 and how they vary with annual income and spending on formal childcare. Awards with incomes below £20,000 would be the same as those shown for incomes of £20,000.

Complications in the tax and benefit system may be a price worth paying to achieve desired policy goals effectively, and the childcare tax credit is by no means the most complicated

transfer programme in the UK. But it is highly likely that mothers who are thinking about returning to work and using formal childcare will find it very hard to work out how much childcare tax credit they will be entitled to, and this uncertainty may reduce the extent to which the childcare tax credit can encourage mothers to alter their behaviour.

That the childcare tax credit lacks transparency has been recognised by the government:

Although the childcare element can offer a substantial reduction in childcare costs, parents are often unaware of the net cost they face. The Government will therefore work with providers to help parents understand the help available and therefore make the net cost more transparent.¹⁸

But, as Figure 9.3 shows, this is a challenging task, given the current structure of the childcare tax credit. Short of sending all parents their own customised version of Figure 9.3, it is likely that true transparency could only come about through a radical change in the structure.

The childcare tax credit does not drive up the quality of formal care

One of the goals of the government's childcare strategy is to improve the quality of childcare provision.¹⁹ This is mostly to be achieved through regulation and supply-side reforms, but the childcare tax credit, which represents a substantial proportion of state spending on childcare, contributes little to this goal.

For one thing, other than having to use registered formal childcare, there are no restrictions on the sorts of childcare parents can spend the money on. Registered childcare does have to meet minimum standards, but these are not necessarily high enough to ensure that formal childcare is always beneficial for children. This criticism particularly applies to the new scheme for registering nannies and au pairs. Childminders and other formal carers for the under-8s have to meet 14 minimum national standards assessed through on-site Ofsted inspections as a legal requirement, but nannies and au pairs just need a relevant childcare qualification, a recent first-aid certificate and to undergo an enhanced criminal records check in order for parents to be eligible to claim 70% of their costs (80% from April 2006) back from the Inland Revenue.²⁰

Although the generosity of the childcare tax credit means that parents may be able to afford higher-quality childcare, research from the US (none is available from the UK) suggests that subsidies like the childcare tax credit are not good ways of increasing the quality of care used by parents. A recent review of the economics literature on childcare found that the most reliable study of the link between the price and quality of formal childcare showed that 'when price falls, consumers substitute towards quantity and away from quality'.²¹

¹⁸ Paragraph 7.18 of HM Treasury, *Choice for Parents, the Best Start for Children: A Ten Year Strategy for Childcare*, TSO, London, December 2004 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr04/assoc_docs/prebud_pbr04_adchildcare.cfm).

¹⁹ See chapter 6 of HM Treasury, *ibid.*

²⁰ See <http://www.ofsted.gov.uk/childcare/> and <http://www.childcareapprovalscheme.co.uk/> respectively.

²¹ D. Blau, 'Child care subsidy programmes', in R. A. Moffitt (ed.), *Means-Tested Transfer Programs in the United States*, University of Chicago Press, Chicago, 2003. The actual study is D. Blau and A. Hagy, 'The demand for quality in child care', *Journal of Political Economy*, 1998, vol. 106, pp. 104–46.

In addition, another criticism arises because payments of the childcare tax credit stop if families stop meeting the work test – if, for example, a job comes to an end.²² Many parents in this situation will be unable to afford formal childcare without the substantial subsidy provided by the childcare tax credit, and may have to stop using it. This disruption to childcare arrangements is unlikely to be beneficial for children.

The childcare tax credit is not well targeted on encouraging mothers to work

A consistent theme of this government's changes to taxes and benefits since 1997 has been to 'make work pay', particularly for low-income parents.²³ The childcare tax credit is often described as contributing to that goal, and it does help make working pay more than not working for mothers who need to use formal childcare if they work.²⁴ But there is little reliable evidence from the UK on whether childcare subsidies are effective in encouraging mothers to work. Evidence from the US suggests that they are reasonably effective in increasing what parents spend on formal childcare, but have little or no impact on mothers' labour supply decisions.²⁵

While the childcare tax credit increases the incentive for mothers to work for a given level of formal childcare use, whether or not it provides sufficient incentive for a mother to work (or work more) depends on the joint responsiveness of formal childcare use and working. The less willing the mother is to use formal childcare, the bigger the incentive will need to be in order to encourage her to return to work.

The childcare tax credit is not well targeted on helping the poorest families

The childcare tax credit does encourage some mothers working 16 or more hours to use formal rather than informal childcare, and the government may see this as being beneficial for children. However, the childcare tax credit does little to help the poorest families use formal childcare, because of the work test: it will not encourage the use of nurseries, childminders or out-of-school or holiday clubs, for example, amongst children whose lone parent chooses to be a full-time carer.

Alternatives to the childcare tax credit

Below, we present some alternatives to the childcare tax credit. They fall into two types:

- To give the government greater control over the quality of childcare provision, the demand-side subsidy of the childcare tax credit could be turned into a supply-side intervention that directly increases quality.

²² Parents are currently allowed to be out of work for a week before the work test is failed: the government is consulting on lengthening this period (paragraph 7.16 of HM Treasury, *Choice for Parents, the Best Start for Children: A Ten Year Strategy for Childcare*, TSO, London, December 2004 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr04/assoc_docs/prebud_pbr04_adchildcare.cfm)).

²³ See M. Brewer and A. Shephard, *Has Labour Made Work Pay?*, Joseph Rowntree Foundation, York, 2004 (<http://www.jrf.org.uk/bookshop/eBooks/1859352626.pdf>).

²⁴ For example, see paragraph 7.13 of HM Treasury, *Choice for Parents, the Best Start for Children: A Ten Year Strategy for Childcare*, TSO, London, December 2004 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr04/assoc_docs/prebud_pbr04_adchildcare.cfm).

²⁵ D. Blau, 'Child care subsidy programmes', in R. A. Moffitt (ed.), *Means-Tested Transfer Programs in the United States*, University of Chicago Press, Chicago, 2003.

- To refocus the childcare tax credit on its objectives, it could be replaced by tax credit changes that encourage all mothers to work. This boost to in-work income could benefit their children.

The main difference between these alternatives is that the first moves state subsidy from parents to childcare providers to give the government more control over childcare quality, while the second keeps the money with parents but gives them more freedom over how to spend it. (These are not mutually exclusive options: it would be perfectly possible for a government to do both.)

Replacing the childcare tax credit with supply-side measures

One advantage to the government of intervening in the supply side of the childcare market is that it ‘increase[s] government leverage over quality’.²⁶ This suggests that the government could raise the quality of childcare services without spending extra money by increasing supply-side interventions – those that directly affect providers – at the expense of the childcare tax credit. Such interventions could be universal, limited to deprived areas or means-tested against parents’ incomes in some way. To take an example, the government is proposing a £125 million a year Transformation Fund from April 2005 to support local authorities’ investment in high-quality childcare provision; this fund could be made considerably larger if money were diverted from the childcare tax credit.

Refocusing the childcare tax credit

Below, we describe two ways in which the money spent on the childcare tax credit might be redirected within the tax credits system so that the money remains with parents but is more closely focused on achieving government objectives whilst not being tied to spending on formal childcare. (Box 9.5 discusses some options for reform recently mentioned by the government.) Of course, the government could have no guarantee that parents would spend additional tax credits on their children, let alone on formal childcare: instead, these reforms would be consistent with the idea that parents – not the government – are the best judge of what is best for their children and for themselves.

Because the majority of spending on the existing childcare tax credit goes to families with a pre-school child, we consider reforms that only benefit such families. The cost of each of our reforms is around £1 billion a year, which is the likely cost of the childcare tax credit in 2007–08. The restriction to the under-5s does mean that the 121,500 families with no pre-school children currently receiving the childcare tax credit (most of whom are lone parents) would lose, in the absence of any transitional protection, from our reforms, although other families would gain.

²⁶ Paragraph 7.6 of HM Treasury, *Choice for Parents, the Best Start for Children: A Ten Year Strategy for Childcare*, TSO, London, December 2004 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr04/assoc_docs/prebud_pbr04_adchildcare.cfm).

Box 9.5. Other proposals to reform the childcare tax credit

The 2004 Pre-Budget Report mentioned two ideas for reforming the childcare tax credit: extending it to families who work but use informal childcare, and extending it to families who fail the work test but who want to use formal childcare.

The government has ruled out supporting informal care, arguing that 'It is not the Government's role to offer financial support for care that is freely given within families'.^a (Indeed, the government's desire not to subsidise informal care means that families cannot claim the childcare tax credit if the person who cares for their children is a relative of the children who has registered as a nanny, but they can claim a 70% subsidy if the carer is registered as a nanny but is unrelated to the children.)

Aside from this principled objection, supporting informal childcare with the current structure of the childcare tax credit would be extremely difficult because informal childcare takes place in a non-market environment. This means that it would be very difficult for the Inland Revenue to establish how much was being paid for childcare, and there would be no incentive for parents to minimise the payments.^b However, the reforms that we described in the text would use the tax credits system indirectly to help families who want to use informal childcare by giving parents extra money for them to spend as they wish, whether on formal childcare, informal childcare or something else entirely.

The current work test requires 16 hours of work a week, in common with other parts of the tax and benefit system. It is argued by some that 16 hours a week is more than some mothers returning to work would ideally like to work. For example, a lone parent working two days a week and using formal care would not pass the work test, but one working three days a week would. So the government is considering reducing the number of hours of work required to pass the work test of the childcare tax credit.^c Such a move would increase the proportion of children who could potentially benefit, and would therefore cost money.

It would be surprising if the government were to change the work test, though, because the 16-hour rule is built into the entire means-tested benefit and tax credit system. And, arguably, if the government wished to allow more families to benefit from formal childcare, then it might prefer to use any extra money to drive up quality, perhaps through supply-side measures, rather than by giving even more parents an incentive to use formal rather than informal care even when formal care need not be beneficial for their children.

^a Paragraph 5.14 of HM Treasury, *Choice for Parents, the Best Start for Children: A Ten Year Strategy for Childcare*, TSO, London, December 2004 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr04/assoc_docs/prebud_pbr04_adchildcare.cfm).

^b These issues were discussed in chapter 7 of R. Chote, C. Emmerson and H. Simpson (eds), *The IFS Green Budget: January 2003*, Commentary no. 92, Institute for Fiscal Studies, London, January 2003 (<http://www.ifs.org.uk/budgets/gb2003/ch7.pdf>).

^c Paragraph 4.10 of HM Treasury, *ibid.*

One option for reform is to mirror the effect on work incentives in the childcare tax credit by encouraging lone parents and second earners in couples to work 16 or more hours, but without giving working parents an incentive to use formal childcare over informal childcare. This can be done by increasing the working tax credit for families who meet the work test in

the childcare tax credit.²⁷ We estimate that an increase of £2,860 a year for each child under 5 in families that meet the work test in the childcare tax credit would cost around £1 billion a year.

A second option for reform is to redirect extra money to families with children regardless of whether or not the parents are working. This could be done by increasing child benefit, increasing the family element of the child tax credit or increasing the per-child element of the child tax credit. These options vary in how well targeted they are on the poorest children: child benefit goes to all families, but only the poorest half of children would benefit from the per-child element of the child tax credit. This means that £1 billion would roughly pay for a rise in child benefit of £6 a week for all children under 5, an extension to all families with children under 5 of the existing £545 a year credit in the child tax credit currently available to families with children under 1, or a rise in the per-child element of the child tax credit of £620 a year for all children under 5.

9.4 Expansion of free nursery provision

In this section, we discuss the proposed expansion of free nursery education for 3- and 4-year-olds. Our analysis looks at the evolution of free nursery education; how the provision of free nursery education places is currently managed; how take-up of free places by 3- and 4-year-olds has changed over the last five years; how much provision costs now and what it is likely to cost if the proposed reforms are realised; what types of families are likely to gain most from these reforms; and finally, whether the reforms are sensible from an economic perspective.

Background

Until 1997, the decision on whether to provide free nursery education was left to local education authorities. This led to significant variation in access to free nursery education across the country. In 1986, for example, when a comprehensive survey of the availability of pre-school places was carried out across English LEAs,²⁸ provision ranged from zero to approximately 27.5 places per 100 children, with the latter figure still representing relatively low availability.

In the 1990s, central government devoted more attention to the needs of pre-school children and their parents, with the Conservative government piloting a nursery education voucher scheme towards the end of its term in office. This offered parents of all 4-year-olds vouchers worth £1,100 to purchase nursery provision of their choice. The idea was to create a market for nursery education, by giving parents the choice to send their children to maintained, private or voluntary institutions.²⁹

²⁷ This is one of the policies to help working families being considered, at the time of writing, by the Conservative Party: see *Conservative Plans for Childcare*, 11 November 2004 (http://www.conservatives.com/tile.do?def=news.story.page&obj_id=117187&speeches=1).

²⁸ C. Owen and P. Moss, 'Patterns of pre-school provision in English local authorities', *Journal of Education Policy*, 1989, vol. 4, pp. 309–28.

²⁹ Audit Commission, *Counting to Five: Education of Children under Five*, London, 1996.

In 1997, the incoming Labour government continued nationwide roll-out of the Conservative voucher scheme. However, the fact that vouchers were given directly to parents (rather than institutions) meant that administrative costs were relatively high. This and the lack of nursery places being created were cited as reasons to abolish the scheme.³⁰

In 1998, the government launched its own solutions to the issues of childcare provision, including early years education, in the form of its first national childcare strategy.³¹ This aimed to provide accessible, affordable and high-quality childcare for children aged 0 to 14 in every neighbourhood. Many of the reforms in the strategy involved increasing the supply of high-quality childcare places, particularly in the most deprived areas, although financial assistance towards childcare costs was also introduced via the working families' tax credit. (For details, see Box 9.6.)

Box 9.6. Key initiatives in the national childcare strategy (1998)

National initiatives

- Immediate introduction of free nursery places for all 4-year-olds and over time for all 3-year-olds, starting with those from the most deprived LEAs.
- Heavy investment in the training and development of the childcare workforce, and targeted recruitment into the sector.
- Financial assistance towards the cost of childcare via introduction of the working families' tax credit, including a childcare tax credit element.

Initiatives targeted on the most deprived areas

- Sure Start programmes on a partnership basis, aiming to improve the health and well-being of children up to the age of 4 in the most disadvantaged areas of the country.
- The Neighbourhood Nurseries Initiative targets the creation of early education places on under-5s from the most deprived areas.
- Major expansion of childcare provision in a variety of sectors, including an increase in the number of quality out-of-school places, particularly in disadvantaged areas.

Alongside these reforms, the government also announced its intention to provide free nursery education places, initially for all 4-year-olds, expanding to include all 3-year-olds over time, starting with those children living in the most deprived LEAs.

What is currently on offer and how the policy works

Since April 2004, it has been mandatory for LEAs to provide free nursery places for all 3- and 4-year-olds for 12.5 hours a week (to be taken in up to five 2.5-hour sessions) and for 33

³⁰ <http://www.bbc.co.uk/politics97/news/05/0522/nursery.shtml>.

³¹ Department for Education and Employment, *Meeting the Childcare Challenge: A Framework and Consultation Document*, Cm 3959, London, 1998 (www.surestart.gov.uk/doc/0-BB628F.doc).

weeks of the year. All 4-year-olds have been entitled to this statutory minimum level of free provision since September 1998, and all 3-year-olds since April 2004.³²

Box 9.7. Eligible providers of free nursery places

Free nursery places can be taken up in any of the following establishments (split into 'maintained' and 'other' providers), assuming that Ofsted has inspected and passed them:

Maintained (i.e. funded by the LEA)

- **Nursery schools** have their own funding and management system, and can be distinguished from **nursery classes**, which are staffed, managed and funded through primary schools. Nursery schools tend to have a more teaching-orientated staff (in terms of their qualifications) and higher pupil–staff ratios than nursery classes. Provision is usually on a part-time basis.
- **Day nurseries** primarily provide places for children 'in need', and focus on their care and protection, as well as education. Staff are not required to hold a teaching degree (in common with nursery classes), emphasising the focus on care; pupil–staff ratios are much lower, usually around 8:1. Places are usually full-time.

Other (includes private, voluntary and independent provision)

- **Playgroups** or **pre-schools** may be private or, more commonly, voluntary, and offer places on a part-time basis. Staff are frequently volunteers and may have little or no formal training. Pupil–staff ratios are similar to those found in day nurseries. Cost to parents is usually relatively low compared with that of other types of non-maintained provision.
- **Registered childminders** can care for a small number of under-5s in their own home. Costs and qualifications vary widely between providers. **Nannies**, who provide childcare in the user's home, are due to become eligible under this scheme in April 2005.
- **Private nurseries** usually have a pupil–staff ratio similar to that of childminders for the youngest children, rising to a level similar to those in day nurseries and playgroups for older children. Staff have similar qualifications to those found in nursery classes and day nurseries, but cost to parents can be extremely high. Places can be on a full-time or part-time basis, dependent on parents' needs.
- **Independent schools** may provide nursery or reception classes similar to those found in the maintained sector. Staff qualification levels are likely to be similar to, although pupil–teacher ratios may be lower and cost to parents higher than, in the maintained sector. Places may be full-time or part-time.

Sources: P. Moss and H. Penn, *Transforming Nursery Education*, Paul Chapman Publishing Ltd, London, 1996; Sure Start, *A Code of Practice on the Provision of Free Nursery Education Places for Three and Four Year Olds – 2004–05*, Department for Education and Skills, London, 2004.

³² Fifty-seven of the most deprived LEAs were given funding to increase provision of free nursery education for 3-year-olds in 1999–2000. This was extended to all LEAs in 2000–01, with the aim of meeting the target of 'provision for all' by September 2004. This target was, in fact, achieved early, in April 2004.

Table 9.2 demonstrates how total take-up³³ of free nursery education places, as well as the composition of these places, currently stands. It is clear that the maintained sector (for definition, see Box 9.7) has insufficient capacity to provide all 3- and 4-year-olds with a nursery education place for 12.5 hours per week, 33 weeks per year: only 38% of three-year-olds and 80% of 4-year-olds are currently receiving their free nursery education from the maintained sector. To meet its aim of universal provision, therefore, the government also permits free places to be taken up in the private or voluntary sector. As these settings usually require payment from individual users, however, funding must be transferred from the LEA to the providers of these additional places, who then pass this money on to childcare users to reimburse them for fees they have paid.³⁴ It is unclear from government publications whether private providers are obliged to offer 12.5 hours per week for 33 weeks of the year at zero additional cost to the user (this is unlikely to be the case), or whether the LEA or the user would have to make up any shortfall between the government subsidy and the actual cost of provision.

Take-up over time

As we can see in Table 9.2, the latest figures show that 461,600 3-year-olds were taking up free early education places in January 2004, around 82% of the total 3-year-old population.³⁵

Table 9.2. Take-up of free nursery education places by 3- and 4-year-olds

	Total places (places per 100 children)		
	Maintained ^a	Other ^b	Total (England)
3-year-olds			
2000 ^c	229,900 (38)	40,300 (7)	270,200 (44)
2001	226,600 (38)	108,800 (18)	335,400 (56)
2002	223,500 (38)	184,700 (31)	408,300 (69)
2003	218,700 (38)	226,100 (39)	444,800 (77)
2004	215,300 (38)	246,200 (44)	461,600 (82)
4-year-olds			
2000	483,700 (80)	114,800 (19)	598,500 (98)
2001	482,800 (79)	106,500 (17)	589,300 (97)
2002	477,700 (80)	106,800 (18)	584,500 (97)
2003	472,200 (80)	109,600 (18)	581,800 (98)
2004	461,100 (80)	110,000 (19)	571,200 (98)

^a Includes maintained nursery and primary schools. See Box 9.7 for further details.

^b Includes private, voluntary and independent providers. See Box 9.7 for further details.

^c Consistent figures were only available from 2000 onwards.

Source: Department for Education and Skills, *Provision for Children under Five Years of Age in England: January 2004 (Final)*, SFR 39/2004, London, October 2004 (<http://www.dfes.gov.uk/rsgateway/DB/SFR/s000531/sfr39-2004v5.pdf>).

³³ We assume that take-up and provision are highly positively correlated.

³⁴ It should be noted that private nursery fees often have to be paid by parents in advance of the time that LEA funding reaches the provider. This issue of timing may therefore prevent some users from taking up places at private institutions if financial constraints are an issue.

³⁵ The figures for 3-year-olds may under-represent the current level of take-up, given that compulsory universal provision of free nursery education for 3-year-olds was introduced in April 2004.

This proportion has almost doubled in the last four years, rising from 44% in 2000. The equivalent figure for 4-year-olds is 571,200, around 98% of the total 4-year-old population in 2004.³⁶ This ratio has not changed since 2000, emphasising the impact of statutory minimum levels of provision on the take-up of free nursery education places.

Over the same period, the composition of free provision has changed significantly for 3-year-olds but has remained roughly constant for 4-year-olds. Among 3-year-olds using free nursery education, the proportion in the maintained sector fell from 85% in 2000 to 47% in 2004. For 4-year-olds, the relevant proportions were roughly 81% in the maintained sector and 19% elsewhere throughout the period.

It is interesting that during this period of mandated expansion of free nursery education places for 3-year-olds (prior to the September 2004 deadline), all of the growth in available places has been in the 'other' sector. This suggests that there are likely to be significant supply constraints in the maintained sector, and this will have implications when analysing who is likely to benefit from these proposed reforms. We return to this issue later.

Proposed reforms

The government's vision for the expansion of free nursery places, as outlined in its 10-year childcare strategy, is as follows:

- From 2006, entitlement will be extended from 12.5 hours for 33 weeks per year to 12.5 hours for 38 weeks per year.
- By 2010, entitlement will be increased from 12.5 hours for 38 weeks per year to 15 hours for 38 weeks per year.
- Eventually (no dates specified), the government envisages an increase in free nursery provision from 15 hours per week to 20 hours per week, again for 38 weeks of the year.

These proposals clearly aim to increase the length of time that children spend in nursery, both through the total number of weeks and through the number of hours per week. Evidence on the respective benefits of these policies for children is limited, although one recent report concludes that it is total number of weeks, rather than number of hours per week, that is of most benefit to children.³⁷ It should be noted, however, that the government's policy of increasing the number of hours that children spend in nursery each week may have less to do with generating benefits for the children than with generating benefits for the parents (in terms of easing access to the labour market).

The costs of current provision and future reforms

The exact cost of extending free early education places for 3- and 4-year-olds is unclear. From September 1998 (when minimum provision for 4-year-olds was introduced) until April

³⁶ Take-up figures may overestimate the total number of nursery places on offer, as some children may not use all of their entitlement and so two (or more) children may benefit from a single free place.

³⁷ K. Sylva, E. C. Melhuish, P. Sammons, I. Siraj-Blatchford and B. Taggart, *Final Report: Effective Pre-School Education*, Effective Provision of Pre-School Education (EPPE) Project, Technical Paper no. 12, Department for Education and Skills / Institute of Education, University of London, London, 2004.

2003, free nursery places were funded via the nursery education grant and paid directly to providers by central government. Since April 2003, however, funding has been distributed from central government to LEAs via the formula spending share, which allocates a basic amount per pupil to each LEA and then allocates additional funding according to pupil needs (for example, if they live in a particularly deprived area). LEAs can then distribute funds as they see fit to providers (in the case of establishments for which they are responsible) and to parents using private or voluntary providers.

The recent inclusion of funding for free nursery education as part of the under-5s education category in the formula spending share means that separate expenditure figures on the minimum level of provision for 3- and 4-year-olds are no longer published. In what follows, we therefore assume that the amounts given for parental reimbursement on various LEA websites are also allocated to maintained providers for the children that they support; it is unclear whether this assumption will over- or under-estimate the total cost of provision.

As of April 2004, the approximate amount redistributed to parents taking up free nursery education places in the private or voluntary sector stood at around £420 per term, or £1,260 per year, according to LEA websites.³⁸ Based on these assumptions and using the take-up figures cited in Table 9.2, free nursery education currently costs the exchequer around £1.3 billion per year.³⁹

From 2006, entitlement to free nursery education will be extended to 38 weeks per year (up from 33 weeks per year in 2004). Using the same take-up figures and rates per session as for 2004, this proposed extension will cost the exchequer around an extra £200 million per year.

Table 9.3. Cost of proposed expansion of free nursery education for 3- and 4-year-olds

	33 weeks	38 weeks
	<i>Assuming current take-up rate for 3-year-olds (82%)</i>	
12.5 hours per week	£1.3bn (current situation)	£1.5bn
15 hours per week	n/a	£1.8bn
20 hours per week	n/a	£2.4bn
	<i>Assuming take-up rate for 3-year-olds increases to 98%</i>	
12.5 hours per week	£1.4bn	£1.6bn
15 hours per week	n/a	£1.9bn
20 hours per week	n/a	£2.6bn

Note: Table assumes current take-up rate for 4-year-olds (98%).

In addition, between 2007 and 2010, the government is aiming to further extend the availability of free nursery education, from 12.5 to 15 hours per week, for 38 weeks. This is equivalent to an increase of one session per child each week. Based on current take-up figures

³⁸ The figures quoted on LEA websites range from £416 per term to £426 per term, with an average of around £420, the figure that we have used in our calculations. As the government publishes no costs, however, it is difficult to know whether or not this is a reasonable estimate.

³⁹ Our costings of current provision are significantly lower than some estimates. For example, a recent report for the Social Market Foundation and the Daycare Trust conducted by Pricewaterhouse Coopers suggested that spending in 2004–05 for nursery education for 3- to 4-year-olds would be £3.3 billion. See Pricewaterhouse Coopers, *Universal Early Education and Care in 2020: Costs, Benefits and Funding Options*, Leading the Vision Policy Paper no. 2, Daycare Trust, London, October, 2004.

and session rates, this expansion in free nursery education of 2.5 hours per week will cost an extra £300 million per year once phase-in is complete.

The ultimate aim for free nursery education, as announced in the recent 10-year strategy for childcare, is to provide places of up to 20 hours per week, 38 weeks per year, for every 3- and 4-year-old in the country. Based on current take-up figures and session rates, this further expansion in free nursery education from 15 to 20 hours per week would cost the exchequer an additional £600 million.

In total, therefore, the reforms outlined above will cost the exchequer around £1.1 billion, almost doubling the current cost. The cumulative costs are summarised in Table 9.3.

It should be noted that the current take-up rate for 3-year-olds is likely to underestimate the long-run steady-state take-up rate. This is because in January 2004 (the date our figures were collected), the deadline for statutory provision of places for all 3-year-olds had not yet been reached. Using a take-up rate of 98% for 3-year-olds (the same as the take-up rate for 4-year-olds in 2004) instead of 82% (as used in the above calculations), the total proposed cost of the reforms outlined above will be £1.2 billion. When coupled with the higher cost of current provision (amounting to £1.4 billion, assuming a 98% take-up rate for 3-year-olds, at 12.5 hours per week for 33 weeks per year), this means that government spending on free nursery places for 98% of 3- and 4-year-olds would be £2.6 billion if all the above reforms were implemented.

In addition, it is likely that our estimated costs for the expansion of free provision from 15 hours a week to 20 hours a week will underestimate the true cost of such an expansion, as we assume that there will be no need for additional government investment on the supply side. Currently, a large proportion of maintained provision for 3- and 4-year-olds involves using the same setting, with, for example, 4-year-olds using a 2.5-hour morning session and 3-year-olds using a 2.5-hour afternoon session, often within school hours. Increasing provision to 20 hours per week (i.e. 4 hours per session) will mean that maintained providers are no longer able to do this within school hours without expanding the size of the setting.

Who benefits?

To understand the types of families that are likely to benefit from the proposed reforms, we first examine the types of families that currently benefit from free nursery provision for 3- and 4-year-olds. To do this, we split the 150 LEAs in England into five groups of 30, with group 1 consisting of the poorest (most disadvantaged) fifth of LEAs and group 5 consisting of the wealthiest (most advantaged) fifth of LEAs. In order to rank the LEAs by deprivation, we use the 2004 Indices of Multiple Deprivation, published by the Office of the Deputy Prime Minister. These indices contain information relating to measures of deprivation in income, employment, health, education, housing, environment and crime.⁴⁰

We then examine how take-up of free nursery education varies across LEAs in each of our five groups. To do this, we use published figures on the number of 3- and 4-year-olds taking

⁴⁰ For each LEA, we calculated the mean IMD score based on the unweighted score from each of its Super Output Areas (SOAs). There are approximately 32,000 SOAs in England, with each SOA consisting of, on average, 1,500 households.

up free nursery education places in each LEA⁴¹ and then estimate the population of 3- and 4-year-olds by LEA, such that our estimated total population figures are consistent with the most recent estimates published by the Department for Education and Skills.⁴² The results of this exercise are shown in Figures 9.4 and 9.5.

Take-up of free nursery education places by 3-year-olds, as shown in Figure 9.4, clearly varies according to whether a family lives in a deprived LEA or an advantaged LEA. Across quintiles of the deprivation index, the lowest take-up rate of free nursery education by 3-year-olds in England is 73% (in the 4th quintile), whilst the highest is 91% (in the 2nd quintile). Underlying these figures, however, are substantial differences in the type of provision across quintiles. Families living in the least deprived areas have access to relatively low levels of maintained provision and relatively high levels of private and voluntary provision. Families living in the most deprived LEAs have access to relatively high levels of maintained provision and relatively low levels of private and voluntary provision.⁴³ It is interesting to note that it is the composition of provision, rather than the total level of provision, that varies most clearly according to deprivation, although there is clear evidence that take-up is highest for LEAs in the two most deprived quintiles (at around 90%).

Figure 9.4. Take-up of free nursery places by 3-year-olds



Note: Data are for January 2004.

The pattern of provision for 4-year-olds varies similarly according to deprivation, as shown in Figure 9.5. In all quintiles, take-up (and hence, we assume, provision) of maintained places is significantly higher than that for 3-year-olds. This is partly due to the earlier introduction of

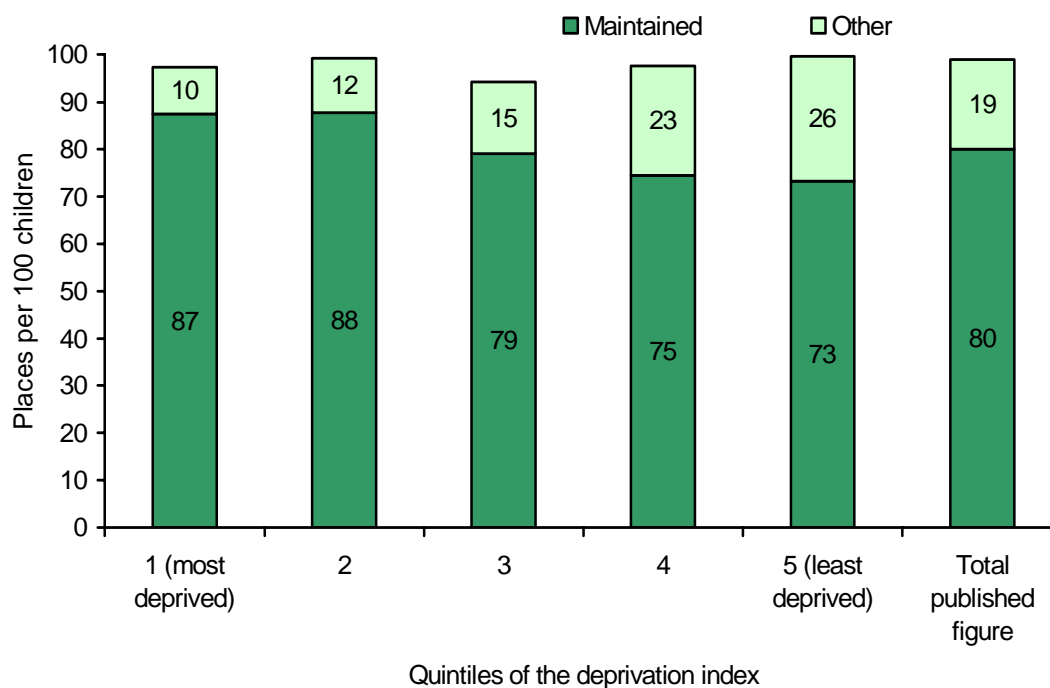
⁴¹ Department for Education and Skills, *Provision for Children under Five Years of Age in England: January 2004 (Final)*, SFR 39/2004, London, October 2004 (<http://www.dfes.gov.uk/rsgateway/DB/SFR/s000531/sfr39-2004v5.pdf>).

⁴² To do this, we assumed that the proportion of 3- and 4-year-olds in each LEA was the same as the proportion of 5-year-olds in each LEA, as given in the latest annual school census returns.

⁴³ We assume that these take-up figures also reflect the composition of free provision in each quintile.

compulsory provision for 4-year-olds and partly due to the fact that at least some 4-year-olds will be in full-time primary (rather than part-time nursery) education, which is usually provided by the state. The burden of provision on the private and voluntary sector is consequently lower in all quintiles than for 3-year-olds.

Figure 9.5. Take-up of free nursery places by 4-year-olds



Note: Data are for January 2004.

This picture of the composition of provision across quintiles, particularly in the case of 3-year-olds, reflects previous targeting of maintained nursery places on children who are most in need.⁴⁴ It also reflects the response of the private sector to market forces: private sector nurseries tend to set up in areas where families are more likely to demand their services. With this in mind, it may be fair to say that the majority of users of private nursery provision, at least in the higher quintiles of the deprivation index, will be paying for additional nursery provision for their children, on top of their free allocation of hours. For these users, therefore, it may be the case that increasing the amount of free provision has no impact on the number of nursery hours that they use, other than via an income effect (where the fall in expenditure on a given number of nursery hours resulting from the increase in free provision may induce greater consumption of nursery hours). This is because a parent who sends their child to nursery for 20 hours per week and for 38 weeks each year currently has to pay for 7.5 hours of that provision each week, and for total provision for an additional 5 weeks per year. But, if government expansion plans go ahead, within a decade they will no longer have to pay for any childcare at all. This implies a straight cash transfer from the government to such users, perhaps without any change in their demand for childcare facilities.

The children for whom consumption of nursery education is likely to increase are those who currently receive only their statutory minimum entitlement. This is most likely to be the children who receive their current provision via the maintained sector. If these children are to continue receiving their free entitlement from the maintained sector, then, as argued above, there is likely to be a need for a significant increase in capital expenditure by central government or LEAs (greater than that allocated via the Transformation Fund, which amounts to under £1 million per LEA per year from 2006) in order to physically accommodate each child for more hours per week. (This assumes that buildings are currently running at full capacity, which is likely to be the case, given the expansion of places in the 'other' sector for 3-year-olds over time, as seen in Table 9.2.)

If, on the other hand, the government is assuming that all additional free provision will be contracted from the private sector, then it may need to induce more private nurseries to locate in the least deprived areas, where private provision is currently limited. This may again incur additional expenditure for the government, on top of the costs outlined above.

Critique of proposed reforms and possible alternative strategies

The government's proposals for the future of free nursery education for all 3- and 4-year-olds centre round universal expansion of provision. This means that every child, regardless of parental income, will eventually be entitled to 20 hours of free nursery education per week for 38 weeks of the year.

Will this increase the amount of nursery education undertaken by 3- and 4-year-olds? For families currently only using the free entitlement (generally in the maintained or voluntary sector), the reform will clearly lead to an increase in hours of nursery provision as the price for additional care (from 33 to 38 weeks a year and from 12.5 hours to 15 hours and eventually 20 hours) will fall to zero and will induce these families to increase their hours.⁴⁵ For people using a mixture of free provision and other paid provision, it could reduce hours of nursery provision, increase hours or have no effect. For instance, a family currently using 25 hours of provision, of which 12.5 hours are in the maintained sector and 12.5 hours are private provision, may decide to switch completely to 20 hours of maintained provision and use the extra income from the reform to reduce hours of work and hours of childcare.⁴⁶ Alternatively, the family might decide to keep provision at the current level or increase it and/or switch to higher-quality care. Finally, there are families that currently only use private provision for more than the current and prospective minimum hours (for example, a nanny or private nursery for over 20 hours a week) who currently receive a fixed-fee reduction per term or cash payment per term of approximately £420. The effect of the reform for these families is purely to increase the amount of subsidy they receive for their private care. This is very

⁴⁴ It should be noted that children from the most deprived family backgrounds do not always reside in the most deprived neighbourhoods, and similarly for children from wealthier families.

⁴⁵ In economic terms, for these families there is only a substitution effect, and the reduction in price will lead to an increase in demand.

⁴⁶ In economic terms, there will be a substitution effect (price effect) which will induce the purchase of more care, *and* an income effect, which will reduce the need for care if the family uses the extra income to reduce hours of work.

unlikely to increase demand for nursery education significantly,⁴⁷ and in fact may be used by the family to reduce hours of work and buy more leisure.

As some children will not necessarily receive more hours of nursery education per year, this reform is unlikely to expose all 3- and 4-year-olds to more high-quality nursery education. But the policy should succeed in exposing all children to a given level of nursery education, assuming that those who currently receive less than the eventual goal of 20 hours per week take up the additional free provision.

The impact on hours of paid employment worked is a more complicated issue. By itself, the policy of expanding free nursery provision for all 3- and 4-year-olds is unlikely to have a substantial effect on the labour supply decisions of parents. For individuals who fit paid employment around the current level of free provision, an increase in the number of hours of care available, together with greater flexibility over the times at which provision can be taken up, may lead to an increase in hours worked. This is most likely to affect families using the maintained or voluntary sectors. For parents currently working more than 15 hours per week (and, eventually, 20 hours per week) who cannot rely solely on free provision, the increase in the statutory minimum will reduce the average cost of childcare, but not the marginal cost. In isolation, this will not lead to individuals choosing to work more hours, and in fact the additional transfer received from the government could lead to them choosing to work fewer hours. This is most likely to affect families using the private sector. Labour market participation is unlikely to be affected, except in the case where the increased number of hours of free nursery education is sufficient to overcome the fixed costs of work that previously prevented the individual from participating.⁴⁸

When analysing the government's proposals, however, it should be remembered that it is trying to achieve several policy objectives using a package of reforms. We therefore need to be careful when assessing the relative merits of one particular policy in achieving specific objectives. But given the impacts on both demand for nursery education and labour supply that we have predicted, it may be that there is a more cost-effective way of achieving similar outcomes for both children and parents – for example, by targeting free nursery provision on children from more disadvantaged families and combining it with greater access to affordable wraparound care. It is clear from our analysis above that the best value for money would be achieved by focusing the extended provision on those only using free nursery education in the maintained and voluntary sectors.

9.5 Conclusions

There are a number of ways in which the government can, and does, intervene in the childcare market to promote both equity and efficiency. In this chapter, we have considered two of the

⁴⁷ In economic terms, the effect of the reform does not lower price but just increases income for these families, and if this increase in income is used to buy more leisure for either of the parents, it may reduce demand for childcare. If, however, childcare is seen also as a consumption good, the family may use the income to buy more childcare. Whether or not additional income increases childcare use will depend on whether the income elasticity of childcare is positive, and if so the amount extra consumed will depend on the size of this elasticity. Of course, for those using full-time nursery care, the reform cannot increase childcare use, but could lead to an increase in childcare quality.

⁴⁸ It should be noted that our analysis has excluded any impact of the benefit system, including childcare tax credit, on labour supply decisions.

main reforms outlined in the 10-year childcare strategy: the extension of the childcare element of the working tax credit, and the expansion of free nursery provision for 3- and 4-year-olds. In both cases, we have outlined a number of criticisms of and possible improvements to the current proposals.

The childcare tax credit has undergone a dramatic transformation since its inception under the last Conservative government in April 1997. It has changed from a small and precisely targeted measure, primarily intended to help lone parents move into work, into one of the main ways in which the government is making formal childcare more affordable for working families. But despite an eightfold increase in the number of beneficiaries and a sixteenfold rise in its cost, the basic structure has changed little: the childcare tax credit provides a potentially generous subsidy for formal childcare used by working families, but one that is means-tested against income in a complicated way.

We have identified a number of drawbacks to the current childcare tax credit system. One is that the complex way in which the childcare tax credit relates to family income and spending on childcare makes it very difficult for parents to work out how much credit they might be entitled to, and this must reduce the ability of the credit to encourage mothers to move into work. More fundamentally, we have also argued that the childcare tax credit may not be the best way to contribute to the government's objectives. While it is of undoubted benefit to families that want to work and use formal childcare, it does not act as a general incentive for mothers to work, because it is of no use to mothers who cannot or will not use formal childcare, and it does not help the poorest children to benefit from formal childcare, because children whose lone parent cares full-time cannot receive the subsidy. Because parents are free to spend the money on any sort of formal childcare that meets minimum standards, it is also unlikely that the childcare tax credit can play a role in raising the overall quality of childcare provision.

We have argued that replacing the credit with supply-side interventions might give the government greater control over the quality of childcare, although perhaps at the expense of the degree of targeting inherent in the childcare tax credit. We have also suggested two ways in which the money spent on the childcare tax credit could be recycled within the tax credit system in a way that is not linked to spending on formal childcare but would help the government achieve its objectives of encouraging mothers to work and improving outcomes for all children. It should be noted that our proposals would lead to losers as well as winners, however, and would have implications for financial incentives to work that we have not fully analysed within this chapter.

The proposed extension of universal nursery provision will increase the amount of time that some children, particularly those who receive provision in the maintained sector (usually those from the most deprived backgrounds), spend in nursery. For those children who receive their free allocation from the private sector, and are therefore also likely to receive additional hours of nursery education already, the proposed reform is unlikely to increase the quantity of nursery education that they receive, unless their parents use the extra income they receive as a result of the reform to buy more hours of care.

In terms of hours of paid employment, extending free nursery provision, on its own, is unlikely to achieve any substantial deviation from current parental behaviour, with the possible exception of parents who fit their work commitments in only using free provision.

However, if additional free nursery education could be combined with the use of more affordable wraparound care – another priority of the 10-year childcare strategy – then the impact on labour supply, and the decision to enter paid employment in particular, could be more significant.

Given our predicted outcomes in terms of both demand for nursery education and labour supply, a universal increase in free nursery education for 3- and 4-year-olds may not be the most cost-effective way for the government to achieve the dual outcomes of increasing parents' labour market options and increasing children's exposure to high-quality nursery education. The policy is likely to have the largest effect for those solely or partially reliant on care in the maintained and voluntary sectors, and that tends to be families living in the most deprived areas of the country. If the aim is solely to increase the amount of childcare demanded by parents and to increase parents' employment opportunities, then the government would get the best return on its investment by targeting this supply-side expansion on expanding completely free maintained provision and combining this core of free provision with a package of affordable and integrated wraparound care.

When considering both the extension of the childcare tax credit and the expansion of free nursery provision for 3- and 4-year-olds, it is important to remember that they are part of a package of reforms designed to meet numerous objectives. So it is difficult to assess the effects of any one policy independently of the other reforms. With this in mind, the key to the success of the 10-year childcare strategy will be in assessing how effectively it meets the government's objectives and, at the same time, offers the best value for taxpayers' money.