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Childcare in the tax and benefit system: first principles

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The challenge

- Multiple objectives
- Complex behaviour
- Multiple policy instruments
 - Childcare elements of tax credits and universal credit (UC)
 - Tax-free childcare (TFC)
 - Tax exemption of employer-provided childcare (and previously vouchers)
 - VAT exemption
 - Free provision
 - Regulation, information provision, etc.
 - Others that might be devised
- Political sensitivities
- Practical constraints

This analysis

- Theoretical analysis from first principles
 - Put aside political constraints
 - Largely put aside practical aspects
 - Little reference to empirical evidence
- These aspects are crucial
- But theoretical analysis is still useful (and largely missing from existing literature)
 - What evidence do we need? Which policy parameters should depend on which empirical magnitudes? (And on which value judgements?)
 - When choosing a practically and politically feasible system, what ideal are we trying to approximate? What compromises are we making to satisfy these constraints?
- Some practical policy guidance along the way

Standard objectives of childcare policy

1. Increase mothers' employment
 - But is more employment always good?
 - Not 'wrong' for parents to prefer to care for young children themselves
 - When and to what extent should the government influence the decision?
2. Help hard-pressed families
 - But with limited resources, how much support some relative to others?
 - Those with vs without children; those working and paying for childcare vs caring for children themselves; those spending more vs less on care;...
3. Promote child development
 - But won't parents already have the best interests of their child at heart?
 - What's good for child vs family; child's short-run vs long-run interests
 - When should government intervene to "correct" parents' decisions?

An economic approach

Two-stage analysis:

1. What should policy look like if people left to themselves always did the right thing?
2. How change that policy to account for real-world complexities?
 - Poor decision-making, market failures and particular equity concerns create a rationale for government intervention

Focus mainly on the first of these

- Good reasons for government to intervene
- But intervene relative to what baseline?
 - What would policy look like if *not* trying to intervene? What is neutral, minimum-distortion policy?
- Surprisingly tricky!

Return to consider arguments for intervention at the end



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Perfect parents, perfect markets, perfect gov't

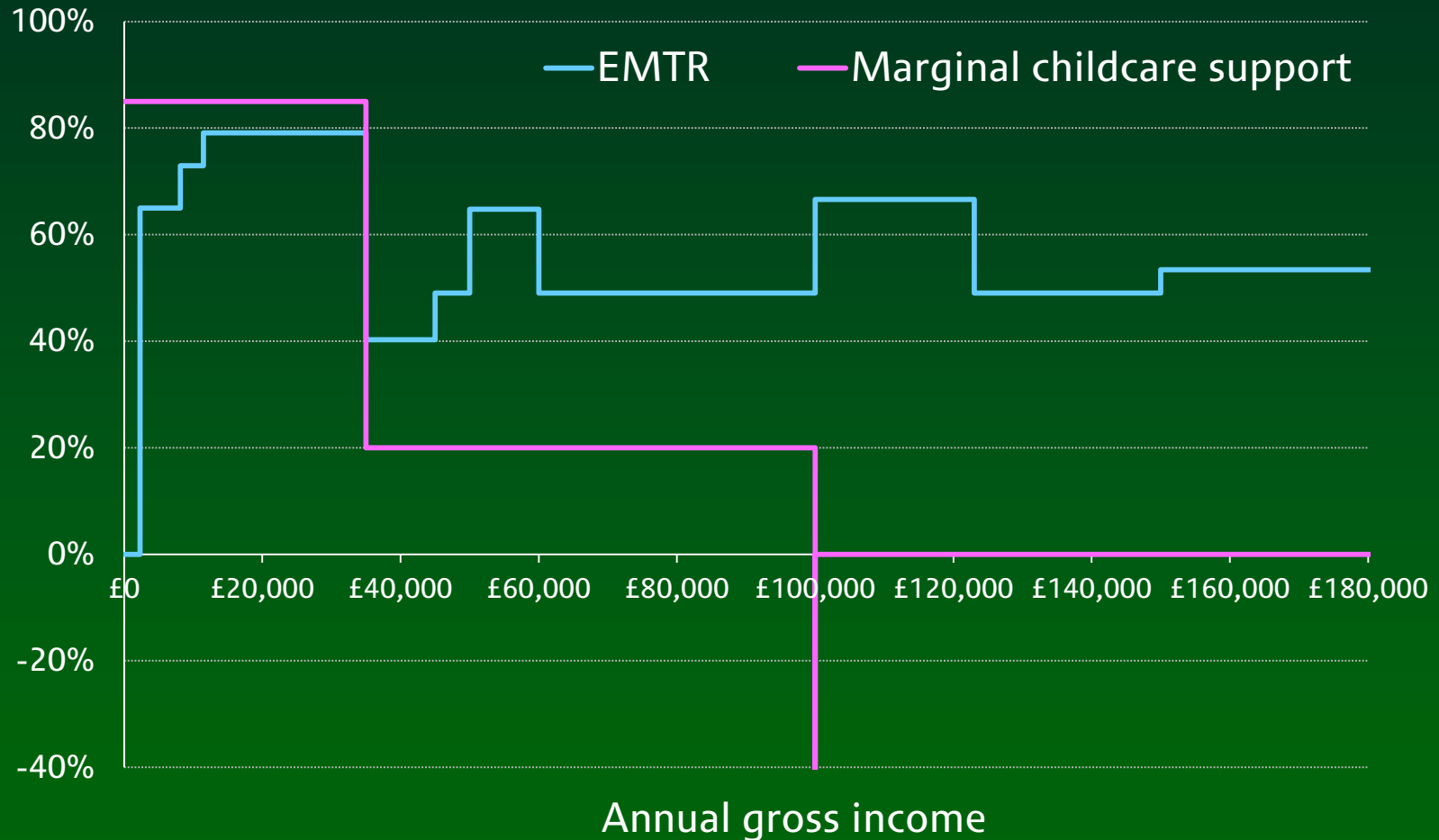
- Suppose:
 - Parents make the best choices for their families
 - These choices have no impact on the rest of society
- In the absence of taxation, no rationale for intervening in parents' decisions about work and childcare
- But government raises taxes for public services and redistribution
- How should these taxes and benefits treat childcare?
 - Equity: measuring families' needs / ability to pay
 - Efficiency: minimising deadweight cost of taxation
- Encompasses much of labour market and distributional motivations
 - Objective not “increase employment”, but “minimise the reduction in employment that taxation causes” relative to people's free choices
 - Child development still left to parents

Two benchmark cases

- Is childcare a work expense or a consumption good?
- If a pure work expense, should be untaxed
 - Deduct from income for tax and benefit assessments; zero-rate for VAT
 - Someone earning £150 and spending £50 on childcare should be taxed like someone earning £100 with no childcare costs
- If a pure consumption good with no connection to work, should be taxed in full
 - Don't deduct from income for tax and benefit assessments; full VAT
 - Someone earning £150 and spending £50 on childcare should be taxed like someone earning £150 and spending it on anything else
- Reality is somewhere in between

EMTR and marginal childcare support

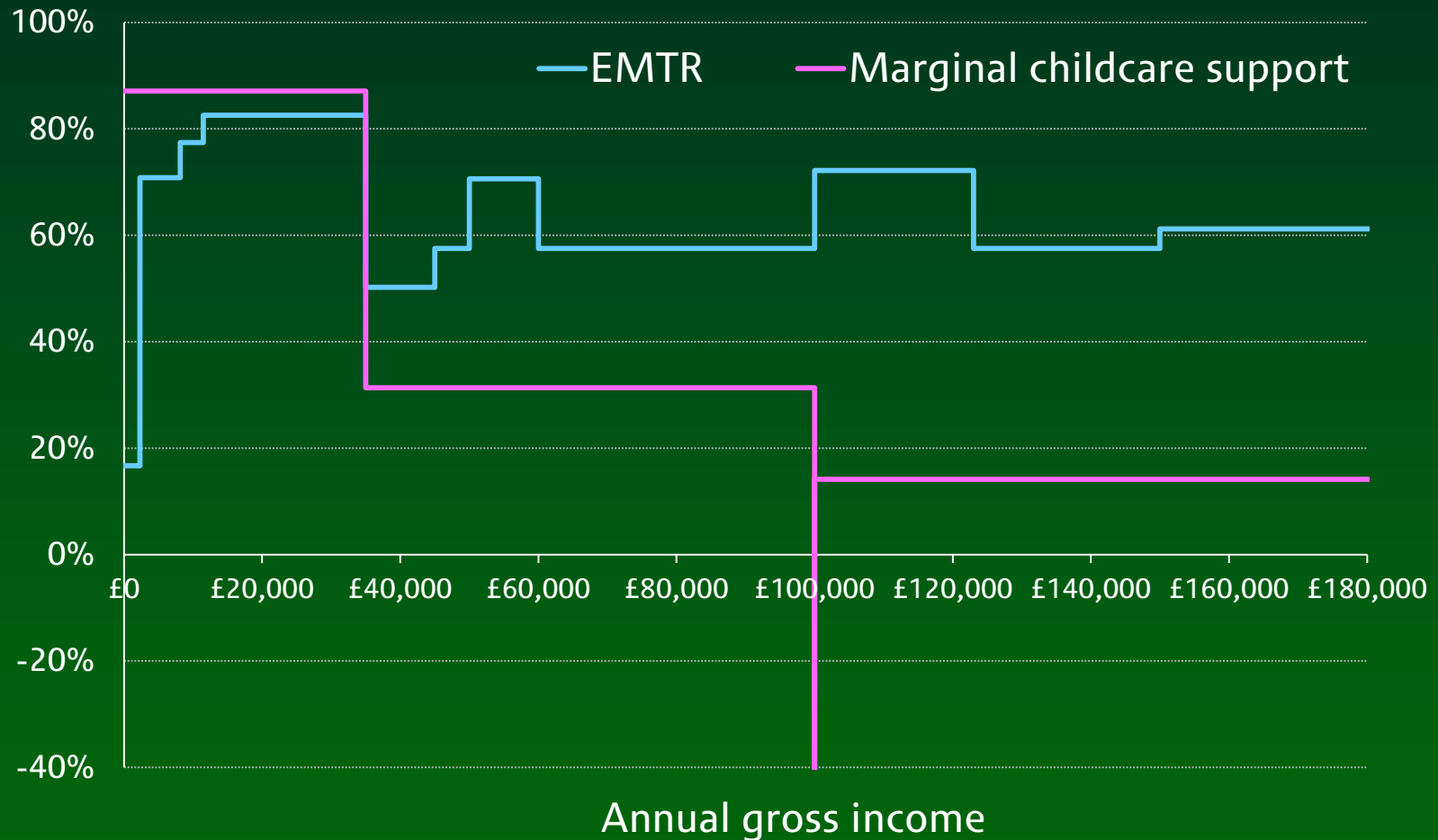
Example lone parent, excluding VAT



Note: Assumes 2 children, rented accommodation, no unearned private income or savings, below childcare support cap and overall benefit cap. UC run-out point arbitrary but realistic.

EMTR and marginal childcare support

Example lone parent, including VAT



Note: Assumes 2 children, rented accommodation, no unearned private income or savings, below childcare support cap and overall benefit cap. UC run-out point arbitrary but realistic.

Partly expense, partly consumption

Two approaches (not mutually exclusive):

1. Identify discrete criteria to indicate whether expense or consumption
 - Are parents in work?
 - Are they only using childcare during work hours?
 - Are they using the cheapest childcare available?
2. Pick intermediate tax rates, guided by empirical evidence
 - Apportionment: to what extent is it expense vs consumption?
 - Optimal tax approach: how far does more generous treatment of childcare increase taxed activity (relative to cutting tax rates)?

Partly expense, partly consumption

Note what matters in the optimal tax approach:

- Response to childcare support relative to headline tax rates
 - If a group is generally unresponsive, appropriate policy is higher headline tax rates (i.e. EMTRs and PTRs, not necessarily ATRs), not less generous childcare deductions
 - Note that this can mean more generous childcare support for parents who respond less to it!
- Exchequer impact of responses, not size of responses
 - Deadweight loss more than proportional to tax rate
 - So more important to mitigate high taxation
 - e.g. less case for childcare support for 3rd child once abolished UC element
- All behavioural responses, not just parents' labour supply
 - e.g. if shift from informal to formal childcare increases revenue



Some policy implications of the analysis so far

Under the assumptions maintained so far, should have:

- Higher support where higher EMTRs (e.g. via deductibility/disregards)
 - And keep between 0% and 100% of their EMTR
 - Implies no cliff-edges, free provision, or support for untaxed parents
- Less (if any) support outside working hours
 - Including for families with a non-working parent
- Less (if any) support beyond the minimum cost of available childcare
- More generous support where net tax payments more responsive to childcare support relative to their responsiveness to tax rates
- Employer-provided childcare taxed like third-party childcare
- No VAT exemption

VAT and childcare

- Childcare is VAT-exempt under EU law
 - Brexit may give scope for reform
- Unlike zero-rating, means providers cannot recover VAT on inputs
 - So less generous than zero-rating: increases costs by c. 2.5–3%
 - Highly inefficient: e.g. tax incentive to do cleaning, book-keeping etc. in-house rather than buy them from VAT-registered suppliers
- Could move to zero/reduced rate (Mirrlees Review proposal)
- But preferential VAT rate is a blunt tool for childcare policy
 - Can't easily condition on parents' work status, family income, etc.
- Ideally move to standard rate
 - Can use revenue to provide e.g. more generous TFC instead

Separate caps/thresholds for hours & hourly cost

- UC and TFC currently provide support up to a cap on total spending
- Possible instead to impose separate caps on hours and hourly cost
 - Contracted hours of childcare (and therefore hourly cost) observable
 - Comparing with parents' hours of work and 'reasonable' hourly cost harder
- Separate caps are efficient
 - Under current assumptions, stronger case for supporting extra spending because work more hours (cost of work) than because prefer more expensive provider (consumption choice)
 - Later, might argue opposite: children benefit from more expensive care, not necessarily more care
 - In any case, two objectives (quantity & quality) → two instruments
- Could be thresholds rather than caps
 - (Reduced) support for additional spending may still encourage work



A baseline theoretical policy prescription

Families should receive an IT & NICs allowance and benefit disregard:

- for each child...
- at the EMTR of the lowest-earning parent...
- for X% of the hourly cost of the cheapest childcare available to them...
- times the number of hours worked by the lowest-hours parent...
- plus perhaps Y% (less than X%) of some additional hours / hourly cost

where X and Y depend on the Exchequer yield of all behavioural responses to increasing that childcare support

- as a fraction of the Exchequer yield of behavioural responses to a reduction in the same group's headline marginal rate
- likely to vary by number and ages of children, parental income, etc.

➤ *Clear what compromises are involved in adopting a simpler policy*

Holding other policies fixed

- Analysis so far assumes can adjust all other policies (notably tax and benefit rates) to achieve objectives in the most efficient way
 - To be more generous to (poorer) parents, increase CB (or CTC / UC)
 - If some groups more responsive, use less means-testing for them
- If instead assume other policies cannot be changed, conclusions radically different
 - Use childcare support to achieve above objectives
 - Moving childcare policy towards ideal without offsetting tax rate adjustments may not be an improvement
 - Exact details depend on exact constraints
- But these are second-best policy responses: better to use tax and benefit rates for parents regardless of their childcare use

Assessing the efficiency of a reform in isolation

- Exchequer impact of behavioural response (as % of total Exchequer impact) is a good approximation to economic efficiency of a reform
 - Change in tax base(s) x average of pre- and post-reform tax rates
 - If there are market failures, also account for effect of reform on those
- Seemingly narrow measure captures full effect on aggregate welfare
 - Responses that increase revenue allow bigger tax rate cut at lower cost
 - Reflects social value of activities deterred by higher tax
- Not enough for optimal policy, as doesn't tell us:
 - Whether there's a more efficient alternative
 - Distributional effects (easy to get efficiency gain by being regressive)
- To find most efficient way to achieve objectives, need theory too
- But as a simple comparable measure, this works well

Relaxing the assumptions

- Parents and markets aren't perfect
- So a potential role for active government to improve outcomes
 - Though imperfect interventions have costs: do benefits exceed these?
 - Must articulate the specific problem and target it precisely
- Suitable intervention may not be fiscal (regulation, information,...)
- Case may vary by type of care, age of child, parents' work status and income, location, etc.
- Treat as deviations from baseline discussed so far

Arguments for deviating from baseline: efficiency

1. Parents make bad decisions for their families
 - a) Systematically underestimate (or overestimate) benefits of certain types of childcare
 - e.g. long-run effects of high-quality early years education (EYE) on child
 - Giving information is the right initial response, but may not be enough
 - Only a good argument to the extent that parents don't already take into account benefit/harm from childcare
 - b) Systematically underestimate (or overestimate) benefits of moving (back) into work
 - But why use childcare support to address this?
2. Parents make bad decisions for society as a whole
 - Child development has effects on people outside the family



Corrective taxation

- Subsidise (tax) the beneficial (harmful) activity
- Set subsidy equal to the benefit from a slight increase in the activity that parents would not otherwise take into account
 - Guessing what parents already take into account even harder than guessing benefit of activity
- Likely to vary widely by type of childcare and family circumstances
- Not necessarily related to parents' marginal tax rates
 - But layered on top of baseline support that probably is

Arguments for deviating from baseline: equity

3. Mitigate gender inequalities in the labour market
 - Strongly associated with time mothers spend with children
 - How far are differences a problem vs a choice women are happy with?
 - Is childcare policy the best targeted response?
4. Equality of opportunity: ensuring all children get decent start in life
 - Minimise disadvantage from being born to poorer parents
 - Why not just redistribute to poorer parents and let them choose?
 - a) Ensure redistribution benefits the children?
 - b) Care about equal access to particular goods, not just total resources?

Free provision

- Ensures minimum provision available for all
 - Appealing from an equality-of-opportunity perspective?
- Relatively simple for parents
- Gives government a lot of say over quantity, quality and type of care
 - Good or bad? Depends whether government chooses better than parents
- Zero price for parents: expensive and inefficient
 - Families may use (at taxpayer's expense) even if don't need
- Removes role of market in determining price for providers
 - Government must judge what funding will secure enough provision of appropriate quality: inadequate funding → inadequate provision
 - Inhibits competition and associated efficiency improvements

Summary (1/2): Two key magnitudes

1. Exchequer impact of (all) behavioural responses to childcare support vs headline tax/benefit rates
 - Deduct what % of childcare spending at parent's EMTR?
 2. Benefits of childcare that parents do not take into account
 - What corrective subsidy to layer on top?
- ❖ In both cases, crucial to disaggregate
- e.g. ...for more expensive care, during working hours, for 3–4-year-olds with no siblings, with low-income working parents, in disadvantaged area, where childcare cheap,...
- If other policies cannot be adjusted, other things matter:
- Parents' overall responsiveness
 - Extent of unanticipated labour market 'scarring' effects
 - Preference for redistribution to different types of family

Summary (2/2): structural policy changes to explore

- Move away from VAT exemption
 - Ideally to standard rate, not zero/reduced rate
 - Preferential VAT treatment is a blunt tool
- Avoid cliff-edges
- Move (back) from childcare element to childcare disregard
 - i.e. add eligible childcare spending to UC work allowance
- More generally, link support to marginal rate
 - More generous for those on UC taper, but also higher for higher-rate taxpayers, lower for those not subject to income tax / means-testing
- Separate caps / thresholds for hours and spending per hour
- More generally, greater variation in (childcare and broader) support
 - By area, children's ages,...
- Alternatives to free provision (subsidies, vouchers,...?)



Concluding thoughts

- Much depends on using better targeted instruments for some goals
 - CB / CTC to adjust level and progressivity of support for children
 - Tax and benefit rates to target work incentives at groups that are highly responsive, prone to unanticipated scarring, etc.
 - ❖ Steps towards ideal childcare policy not necessarily improvements unless adjust headline rates to offset revenue/distributional/incentive effects
- Theoretically optimal policy looks complicated!
 - Trade-off with simplicity will be crucial