The McKell Institute

Why reform of the Child Care Subsidy would strengthen Australia's economy

8 October 2020

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Executive summary

The McKell Institute has been contributing to the public policy debate on early childhood education and care for more than five years

- *Baby Steps or Giant Strides*, June 2015
- *The Crucial Early Years*, December 2016
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In its present form, the Child Care Subsidy is economically inefficient, unfair to working mothers and a waste of women's talent.

Reform of the Child Care Subsidy would boost female workforce participation and productivity, strengthening the Australian economy as it emerges from COVID-19.

In this report, the McKell Institute advocates a universal Child Care Subsidy and evaluates the Working Family Child Care Boost announced by Labor Leader, Anthony Albanese, in his budget reply speech of 8 October 2020.

Medicare, the NDIS and education in government schools are provided on a universal basis and so, too, should government childcare support.

The Working Family Child Care Boost would increase workforce participation and strengthen the economy in its own right. It can be viewed as a standalone reform. It could also form a down payment on an eventual move to a universal system.

By increasing workforce participation and productivity, the Working Family Child Care Boost, if applied on a continuing basis, could be expected to achieve an economic return on investment of at least 100 per cent and possibly much more.

The Working Family Child Care Boost would also narrow the gender pay gap, income gap and superannuation gap and enable a more even sharing of childrearing responsibilities between parents.

Why reform the Child Care Subsidy?

Key Points

1. Reform of the childcare system is a microeconomic reform essential to achieving strong, sustained economic growth and job creation in the private sector.

2. All up and down the income scale working mothers face punishing disincentives to do extra hours of paid work.

A comprehensive overhaul of the Child Care Subsidy is a fundamental microeconomic reform essential to Australia's successful emergence from the COVID-19 pandemic. If we are to achieve strong and sustained job creation, we need an economy that is healthier than it was before the pandemic struck. Reform of the Child Care Subsidy would boost two of the three P's identified by successive Intergenerational Reports as contributing to economic growth: workforce participation and productivity.

As the Intergenerational Reports point out, higher rates of workforce participation by Australians of working age will be needed to support not only themselves but also to help support those too old and too young to work. And stronger productivity growth – which the various Intergenerational Reports have shown has contributed more than 80 per cent of the growth in Australia's GDP per person over the past four decades – will be required for sustainable job creation in the private sector. A Child Care Subsidy that deters women, including highly trained women, from participating more fully in the workforce and contributing to Australia's productivity growth is economically inefficient and wasteful.

More than 58 per cent of Australians graduating from university each year are women. Society encourages women to go to university and contributes financially to their university education, yet the childcare system discourages mothers of young children from working more than three days per week. This is not only contradictory government policy it is a wilful waste of women's talent.

Reform of the Child Care Subsidy would also help remedy a longstanding injustice against working women, who are expected to bear most of the responsibility for unpaid family caring work while their male partners continue to progress in their paid working careers. This highly uneven distribution of caring duties is largely responsible for a gender pay gap, a gender income gap and a gender superannuation savings gap.

The disincentives for women to work extra hours and days created by the design of the Child Care Subsidy are not confined to university graduates. Low-paid working mothers, too, face heavy penalties from working additional hours. Mothers who wish to help repair family budgets hit hard by the pandemic are being discouraged from doing so.

The Australian economy was already weak before COVID-19

Since 2012, Australia's real GDP has grown on average by a weak 2.4 per cent per annum. Population growth – mostly from immigration – has accounted for two-thirds of this sub-par economic growth rate. In the year before the pandemic struck, GDP growth had slumped to just 1.9 per cent, far below its long-term average of more than 3 per cent.

Productivity growth, historically the main driver of Australia's economic growth, had slumped to very low rates before COVID-19 and actually went backwards in 2018-19 (Productivity Commission 2020, Table 1, p. 3).

Productivity growth has contributed more than 80 per cent of Australia's GDP growth over the last four decades, which makes the sharp pre-pandemic productivity slowdown a bad portent for Australia's economic future.

The Child Care Subsidy is holding back workforce participation

Although female workforce participation rates in Australia are above the OECD average, they are below those of the Nordic countries and of the more directly comparable countries of Canada and New Zealand. Women are far more likely to work part time than men. This has given rise to what is referred to as the typical Australian 1.5-earner household (Wood, Griffiths and Emslie 2020, p. 6).

Around 37 per cent of employed women in Australia work fewer than 30 hours per week, which is well above the OECD average of 25 per cent and of New Zealand (31 per cent) and Canada (26 per cent) (Wood, Griffiths and Emslie 2020, p. 9).

Female workforce participation rates in Australia have been rising steadily over the last four or so decades, but they remain low for women with young children. In many cases this is a matter of personal preference. However, in other cases women would like to work extra hours but are deterred from doing so by the high cost of childcare and the little or no take-home pay they receive from those extra hours after losing income support payments and paying personal income tax.

KPMG (2018a, pp. 12-13) has modelled the net benefits from halving the 10-percentage point gap between Australia's female and male workforce participation rates over a five-year period. For modelling purposes, KPMG assumes that this would require a doubling over five years of government spending on the Child Care Subsidy. KPMG estimates that after 20 years, Australia's annual real GDP would be $60 billion greater and Australian households would be better off by more than $38 billion.

The Child Care Subsidy is holding back productivity growth

Many working mothers will tell you it's just not worth their while to increase their working days per week from three to four or from four to five. If they try to do this, they stand to lose some of their Child Care Subsidy and, if they receive them, Family Tax Benefit, Parenting Payment and Rent Assistance. And they will pay more income tax as well as the out-of-pocket childcare expenses for each extra hour worked.

In many family situations, working women receive very little or no gain from working extra hours. In fact, in some circumstances working mothers will send the family budget backwards from working more.

As KPMG (2019, p. 3) has noted:

> *"Economists and the Reserve Bank have repeatedly referred to productivity growth as being the key to higher standards of living in Australia. Technological innovation has the capability to significantly influence this, but another factor is making the most use of the skills and experience that are present in the population. Many parents who have taken time out of the workforce to care for young children will have the experience and skills that enable them to increase the productivity of others, and therefore the economy needs them to contribute as much as they are willing to, without the imposition of steep financial disincentives."*

If the economy is to become stronger than it was before COVID-19 it will need the skills and talents of women working more hours if that is their desire. But by erecting high barriers to mothers doing extra hours of paid work, the system is needlessly holding back productivity growth.

The Child Care Subsidy is contributing to three gender gaps

The amount of time in their working-age lives that women spend having babies and caring for them puts them at a disadvantage in the workforce relative to men. Young women and men leaving school, post-school vocational education or university together might start out on the same rung, but as women have babies and care for them while their male counterparts continue their work and career progression, they fall behind men in terms of work experience and promotion. The time mothers take out of the workforce for child-rearing responsibilities contributes to the gender pay gap, the gender income gap and the gender superannuation savings gap.

The gender pay gap

The gender pay gap is measured as the difference between women's and men's average weekly full-time equivalent earnings, expressed as a percentage of men's earnings. Although the gender pay gap has been narrowing slightly over recent years, in the year before COVID-19 it was still at 14 per cent (Workplace Gender Equality Agency 2020b). Women earn on average $242.90 per week less than men (Workplace Gender Equality Agency 2020a).

A gender pay gap exists even in industries heavily dominated by women such as administration, education and training and accommodation and food services (Workplace Gender Equality Agency 2020a), usually because men on average have uninterrupted or less interrupted time in these occupations than women.

The gender income gap

Women's time out of the workforce from child rearing, and from receiving lower hourly rates of pay than men arising from fewer promotions, contribute to a gender income gap. As early as age 30 the gender income gap opens up to around 25 per cent and during the peak earning years it exceeds 30 per cent (KPMG 2018a, Chart 1, p. 6).

The gender superannuation savings gap

The gender pay gap and the gender income gap create a large difference in average superannuation payouts of men and women. The average superannuation balance at retirement for women is around $105,000 and for men it is about $197,000 – a difference of more than $90,000 – producing a gender superannuation savings gap of 47 per cent (KPMG 2018a, p. 9).

An injustice for women

Men presumably gain as much satisfaction and fulfilment from their children as women, yet women are being expected to take on most of the caring responsibilities. Then, as women seek to re-enter the workforce, they face punishing disincentives to increase their hours of work from the design of the Child Care Subsidy and its interaction with other income support payments and the personal income tax system.

How big are the workforce disincentives for mothers?

To quantify these disincentives facing working mothers, KPMG has developed the concept of a Workforce Disincentive Rate (WDR). It is the percentage of earnings from an extra day worked that is lost from:

- A reduction in Child Care Subsidy;
- A reduction in Family Tax Benefit and other government payments;
- Increased personal income tax; and
- Increased out-of-pocket childcare expenses.

A WDR of 75 per cent indicates that the working mother keeps only 25 per cent of her earnings from working an extra day. If her WDR is 100 per cent, she is working for nothing. If her WDR is 120 per cent, for every extra dollar she earns the family loses $1.20; that is, the family actually goes backwards.

Men earning high incomes complain about a top marginal tax rate of 47 per cent. Yet KPMG analysis has demonstrated that working mothers commonly face WDRs of 75-120 per cent from working a fourth or fifth day per week (KPMG 2018b, pp. 3, 4, 10 & 11).

The top marginal personal income tax rate facing men is 47 per cent yet working mothers can face Workforce Disincentive Rates of 75-120 per cent.

A low-income couple

If a couple with two young children in longday care both earn the minimum hourly wage rate, the family is only $2.50 an hour better off from the mother increasing her working days from three to four per week. This working mother would be taking home just 12 per cent of the minimum hourly wage. Her Workforce Disincentive Rate is 88 per cent.

A middle-income couple

If the father earns $80,000 per annum and the mother earns the part-time equivalent of a $40,000 per annum full-time wage, by increasing her working days from three to four per week the mother would gross an extra $8,000 per annum, but only $294 per annum in net terms. She would be working for less than $1.00 an hour on her fourth working day. Her Workforce Disincentive Rate is 96 per cent.

A high-income couple

In the case of a professional couple where the father earns $100,000 per annum and the mother earns the part-time equivalent of $100,000 per annum, if the mother increases her weekly working days from four to five, she costs the family budget more than $4,000 per annum, losing $85 every extra day she works. Her WDR is 120 per cent.

What are the specific causes of this problem?

The phasing down of the Child Care Subsidy is based not on the working mother's income but on the combined household income of mother and father. So, too, is the phasing down of Family Tax Benefit A, Parenting Payment and Commonwealth Rent Assistance.

Although the working mother might be earning only a low or modest income, her additional income from working extra days, combined with the father's income, could cause her to lose greater amounts of Child Care Subsidy and these other income support payments for each additional day she works. The phasing down or out of these various income support payments has a large, damaging impact on Workforce Disincentive Rates (Wood, Griffiths and Emslie 2020, Figure 2.4, p. 29).

To these losses the working mother must add her extra personal income tax payable, possibly accentuated by moving into a higher tax bracket, and the out-of-pocket childcare expenses net of the Child Care Subsidy.

At higher-income levels, two further design faults in the Child Care Subsidy create huge workforce disincentives:

- An annual cap; and
- Two cliffs.

If annual family income is greater than $186,958, the Child Care Subsidy is capped at a fixed amount of $10,190 per child. At this family income level, an extra dollar of family income for a couple with a child in long-day care for four or five days per week would send the family over a cliff that would cause the Child Care Subsidy to plunge by more than $4,000.

A second cliff occurs at annual family income of $351,248 per annum. If the mother earned just one dollar more, the family would go from receiving Child Care Subsidy equal to 20 per cent of the cost of childcare fees to receiving no Child Care Subsidy at all. This could cost the family more than $5,500 for earning one extra dollar.

A universal childcare system

A universal childcare system featuring a Child Care Subsidy available equally to all working parents would enable them to choose the hours of work that best suit them and their families. This would maximise the gains to the economy from extra productivity and workforce participation.

Some will ask: don't we usually have needs-based government support? Well no, not in many cases, and that's how Australians prefer it. Consider some important examples.

Medicare, introduced by the Hawke Government, is a universal system. The wealthiest person in Australia can walk into a bulk-billing GP's surgery, present his or her Medicare card, and walk out after seeing the doctor without paying anything. Various proposals have been floated to means test Medicare and the Australian people have rejected them all.

The National Disability Insurance Scheme (NDIS), introduced by the Gillard Government, is also a universal system.

Education provided to children in government schools is a universal system. It is incongruous that schooling for children aged five years and older is universally available but early childhood education for children aged four years is not. What a weird difference a year makes.

Benefits of a universal system

KPMG has modelled a Child Care Subsidy set at 95 per cent of the present hourly rate cap (KPMG 2020). The estimated annual increase in GDP is up to $7.5 billion at an estimated cost to taxpayers of $5.4 billion. Importantly, KPMG estimates an additional cumulative benefit to GDP from the increased productivity of working mothers over the longer term of $10 billion.

Wood, Griffiths and Emslie (2020, p. 60) propose very similar reforms and calculate that theirs would reduce Workforce Disincentive Rates to less than 60 per cent for most families and to less than 40 per cent for many of them. They estimate the return in extra GDP from a universal system at more than twice the cost.

The two modelling exercises use different methodologies and assumptions, but they both point to strong economic returns from a universal Child Care Subsidy.

Economic modelling points to strong economic returns on investment from a universal Child Care Subsidy.

A down payment on a universal Child Care Subsidy

A universal system could be phased in over time. This would be necessary in any event to enable the sector to increase its capacity to manage a universal system. A less expensive down payment could be made with a move to a universal system over time.

KPMG (2020) has proposed a first-stage reform involving eliminating the cap that comes into play at $186,958 per annum and replacing the termination of the Child Care Subsidy at $351,248 with a phase-down rate of 1 percentage point for every $3,000 of extra annual income earned.

KPMG estimates the extra GDP generated by its proposal at more than twice the budgetary cost, plus a productivity boost of $7 billion over 20 years.

An option considered by Wood, Griffiths and Emslie (2020) is to increase the Child Care Subsidy Rate from 85 per cent to 95 per cent, remove the annual cap and flatten the taper by reducing the subsidy by 1 percentage point for every extra $5,000 of household income instead of the existing 1 percentage point for every extra $3,000.

This “subsidy boost option” would reduce most WDRs to less than 70 per cent, which is still very high but better than more than 100 per cent in some cases under the existing system. Wood, Griffiths and Emslie (2020, p. 55) estimate the GDP generated by their proposal at 220 per cent of the budgetary cost.

Economic modelling of various options for down payments towards a universal Child Care Subsidy indicates a return on investment of more than 100 per cent.

Labor’s budget reply announcement

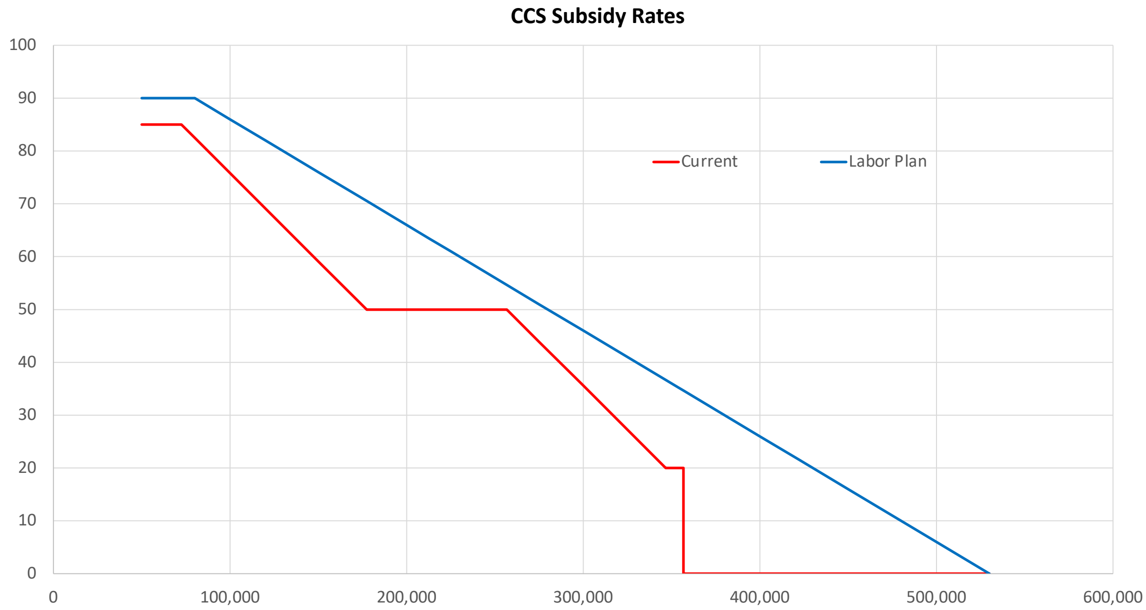
In his budget reply of 8 October 2020, Labor Leader Anthony Albanese announced a Labor government would introduce a Working Family Child Care Boost from 1 July 2022. It would increase the maximum Child Care Subsidy rate, remove the annual subsidy cap and increase subsidy rates, income thresholds and taper rates as set out in ***Table 1***.

Table 1: Working Family Child Care Boost

<table>
<tr><th>Household annual income range</th><th>Existing system</th><th>Working Family Child Care Subsidy Boost</th></tr>
<tr><td>Up to $72,406</td><td>85%</td><td>90%</td></tr>
<tr><td>$72,407 to $80,000</td><td rowspan="2">Tapered reduction from 85% to 50% (percentage reduces by 1% for every $3000 increase in family income).</td><td>90%</td></tr>
<tr><td>$80,001 to $177,406</td><td rowspan="5">Tapered reduction from 90% to 0% (percentage reduces by 0.2% for every $1000 increase in family income).</td></tr>
<tr><td>$177,407 to $256,696</td><td>50%</td></tr>
<tr><td>$256,697 to $346,696</td><td>Tapered reduction from 50% to 20% (percentage reduces by 1% for every $3000 increase in family income).</td></tr>
<tr><td>$346,697 to $356,696</td><td>20%</td></tr>
<tr><td>Above $356,697</td><td>0%</td></tr>
</table>

The Child Care Subsidy rates and taper rates of the existing Child Care Subsidy and the Working Family Child Care Boost are depicted in ***Figure 1***.

Figure 2: Existing Child Care Subsidy and Working Family Child Care Boost
(per cent and annual household income)



The Working Family Child Care Boost:

- Increases the maximum Child Care Subsidy rate from 85 per cent to 90 per cent for families earning up to $80,000 per annum;
- Removes the annual $10,560 per-child Child Care Subsidy cap, which is the cause of Workforce Disincentive Rates in excess of 100 per cent; and
- Tapers down more gradually than the Child Care Subsidy from the new 90 per cent rate and the new household income level of $80,000 per annum.

The cost of the Working Family Child Care Boost to the end of 2022-23 is estimated at around $2 billion. The Labor proposal is for the Working Family Child Care Boost to be reviewed by the Productivity Commission. Since the Productivity Commission has been supportive of publicly funded childcare support, it is unlikely it would recommend the termination of the Child Care Subsidy as bolstered by the Working Family Child Care Boost.

Evaluation of the Working Family Child Care Boost

The KPMG (2020) proposal increases the maximum Child Care Subsidy from 85 per cent to 95 per cent of the hourly cap rate, whereas the Working Family Child Care Boost increases it to 90 per cent of the cap. Both proposals begin to phase down the Child Care Subsidy at a family income of $80,000 per annum and both remove the annual $10,560 per-child subsidy cap.

The KPMG proposal phases down the Child Care Subsidy at the rate of 1 percentage point for every additional $4,000 of family income until the family receives a 30 per cent subsidy, whereas the Working Family Child Care Boost phases down the Child Care Subsidy at 1 percentage point for every additional $5,000 of family income until the family receives $356,696 per annum, at which it and the existing Child Care Subsidy terminate.

The “subsidy boost option” proposed by Wood, Griffiths and Emslie (2020), like the KPMG proposal, increases the maximum Child Care Subsidy from 85 per cent to 95 per cent of the hourly cap rate. It begins phasing down the Child Care Subsidy at a family income of $68,163 per annum and removes the annual per-child subsidy cap. It phases down the Child Care Subsidy at the rate of 1 percentage point for every additional $5,000 of family income until the family receives a 30 per cent subsidy.

Based on the estimated benefits of similar proposals, the return on the budgetary investment in the Working Family Child Care Boost, if it were provided on an ongoing basis, is likely to be at least 100 per cent and possibly much more.

Conclusion

A universal Child Care Subsidy would strengthen the Australian economy, enabling it to generate more jobs and prosperity as it recovers from the COVID-19 pandemic. A universal system could be phased in over time to lessen its budgetary cost while reducing the strong disincentives in the existing system for working mothers to increase their days of work beyond three per week.

A more modest reform, which could constitute a down payment on a universal system, would help families who have lost their jobs or some hours of work from COVID-19 to keep their childcare places so that they are job-ready as more work becomes available. And it would reduce impediments to working mothers wishing to increase their working days to contribute to repairing family budgets savaged by the pandemic.

Over time, a reformed Child Care Subsidy would help close the gender pay, income and superannuation savings gaps.

A reformed Child Care Subsidy would enable Australian society to move towards a new model of sharing child-rearing responsibilities, where men are able to reduce their hours of paid work and be at home more often while, if they choose, women have greater scope to pursue their careers.

The Working Family Child Care Boost outlined by Labor Leader Anthony Albanese in his budget reply on 8 October 2020 would constitute a strong economic reform in its own right, as well as a possible down payment on a universal system. By increasing workforce participation and productivity, the Working Family Child Care Boost, if applied on a continuing basis, could be expected to achieve an economic return on investment of at least 100 per cent and possibly much more.

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