



The child care subsidy

Options for increasing support for caregivers who want to work



Executive summary

Affordability of child care looms as one of the key factors in parents' ability to secure their desired place in the workforce as we look to rebuild the Australian economy. Parents of young children who want to contribute more to household income too often find themselves looking at an insufficient financial reward from taking on extra work, once child care costs are deducted. This occurs across all family income levels. In particular, it is currently women's workforce participation that suffers most when child care is unaffordable.

KPMG in Australia (KPMG) believes there are also considerable long-term benefits for our society of transitioning to near fully-funded child care for children under the age of five (that is, a subsidy for all such children of 95 percent of the current hourly rate cap). This transition can involve interim steps which progressively improve parents' situations.

These benefits include the social and cognitive development of the children themselves, the scope for both parents to take on as much work as suits their

circumstances during the child care years, and the increased career-long productivity of those parents from having had the ability to strengthen their engagement with the workplace and with professional development opportunities during the child care years.

There are also non-financial factors including availability, flexibility and quality that influence a family's decision on whether to access additional child care services in order for a parent to be able to take on work opportunities. This paper does not explore these factors.

KPMG has estimated that the annual benefit to gross domestic product ("GDP") from increasing the federal government child care subsidy ("CCS") to a near fully funded 95 percent of the current hourly rate cap (Option 1 in this paper) could exceed the additional CCS expenditure (net of additional income tax receipts) by almost 40 percent.

The additional CCS expenditure (net of additional income tax receipts) is estimated to be \$5.4 billion, and the annual GDP benefit is estimated at up to \$7.5 billion.

There would be a further cumulative benefit to GDP which arises from the increased productivity of these parents over the longer term. KPMG has estimated that over 20 years this could grow to \$10 billion.

Recognising the extent of the additional CCS expenditure relative to the current budget position, we have explored the possibility of an interim measure which, while retaining the ultimate goal of achieving

Option 1, would allow the government to alleviate many families' situations at less cost.

This measure (Option 2 in this paper) involves the elimination of per-child subsidy caps, an increase in the maximum subsidy for the lowest income families, and also involves every child attracting some federal government subsidy for child care, which is not the case currently.

We estimate that the GDP benefit of this measure could exceed the additional CCS expenditure (net of additional income tax receipts) by more than 110 percent.

The additional net CCS expenditure for this measure is expected to be \$2.5 billion, and the annual GDP benefit arising from the extra days worked in response is estimated at up to \$5.4 billion.

The additional cumulative GDP benefit of individual productivity enhancement arising from Option 2 over a 20-year period is estimated at \$7 billion.

The Parent Equality Model, which we have been advocating for some time, envisages parental responsibility being fairly divided over the long term, with parents sharing work and caring responsibilities differently at different times, each making active choices about the appropriate balance. There are considerable economic benefits that would flow from the Parent Equality Model as well as greater personal well being.

Implementing Option 1 would support the achievement of this goal. It would allow both parents to explore their potential as much as they can and want to, without being inhibited by the financial considerations of paying for incremental child care costs.

Unfortunately, we currently remain far away from a Parent Equality Model.

The unequal share of care responsibility that currently is borne predominantly by women can have adverse consequences. Their needs and ability to reach their capabilities, can get left behind and become absorbed in those of the family. Women have also suffered a substantial long term disadvantage in terms of ownership of assets, earning capacity and superannuation savings.



Background

The federal government's CCS has been in place since July 2018 and provides support for families by subsidising up to 85 percent¹ of the cost of child care, including long-day care for children of below primary school age and out-of-hours care for children who are in school. In calendar year 2019, the federal government spent \$8.1 billion on the CCS, which is approaching 0.5 percent of GDP.

The suspension of the CCS from April to July 2020, to facilitate the rapid deployment of temporary, more targeted business continuity payments for the sector and additional support for disadvantaged children, highlighted the crucial role that the early childhood education and care (ECEC) sector plays in Australian society.

This paper looks firstly at how the CCS currently affects the out of pocket child care costs that families incur. It then explores how the CCS interacts with the income tax and family tax benefit (FTB) systems and highlighting how the progressive withdrawal of CCS and FTB and the increase in marginal tax rates can combine to create large disincentives to a parent working more hours.

The paper then looks at some options for modifying the CCS so as to reduce these financial disincentives, and the impact on the cost of the CCS and on GDP that those modifications could have.

1. Children in certain disadvantaged circumstances can attract additional CCS of more than 85 percent under current rules. This report does not address these situations.

What are families currently paying for childcare after CCS?



Using data from the most recent Household Expenditure Survey (HES) from the Australian Bureau of Statistics (ABS), we have calculated the average out of pocket cost that families incur for a day's child care, and what percentage this represents of the family's after tax income.

Our cohort included all income units within the HES with at least one child aged nought to five years, plus income units with older children who attend some form of child care. This cohort is representative of an estimated 1.6 million families, and so each quintile would include around 320,000 families.

Table 1: Out of pocket costs for families using paid child care across the income quintiles

Income quintile	Average annual out of pocket cost of child care (\$)	Average percentage of family's after tax income spent on child care
Bottom quintile (family income up to \$67,000)	2,764	7
2nd quintile (family income from \$67,000 to \$92,000)	2,824	4
3rd quintile (family income from \$92,000 to \$137,000)	4,663	5
4th quintile (family income from \$137,000 to \$198,000)	7,774	6.5
Top quintile (family income over \$198,000)	12,453	6.5

The workforce disincentive rate



KPMG's has defined the workforce disincentive rate (WDR) as the percentage of income from an additional day's work that a parent would lose to additional income tax, withdrawn FTB, the reduced CCS percentage and increased out of pocket child care costs.

KPMG regards a WDR above 70 percent as being excessive at any family income level. It is more than 20 percentage points above the highest marginal income tax rate. Yet WDRs of this magnitude can be seen across all income quintiles.

At lower family income levels, the withdrawal of FTB Part A can be a big contributor to high WDRs, at 20 cents for every additional dollar earned. At higher family income levels, the combination of marginal income tax rates of 39 percent or 47 percent (including Medicare levy) can combine with lower CCS percentages to ramp up the WDR.

Table 2: Average WDR by income quintile under current CCS structure

Income quintile	Percentage of families facing a WDR of more than 70 percent	Highest WDR within income quintile (percent)
Bottom quintile (family income up to \$67,000)	10	89
2nd quintile (family income from \$67,000 to \$92,000)	21	91
3rd quintile (family income from \$92,000 to \$137,000)	18	88
4th quintile (family income from \$137,000 to \$198,000)	11	107
Top quintile (family income over \$198,000)	24	120

Case study 1

A two-parent family has a combined income of \$68,000. One parent works three days a week for an annual salary of \$27,000. Due to the pandemic, this parent's working hours are cut by half on each day, and their pay is reduced to \$13,500.

The family has one child in long day care and has been incurring child care costs of \$2,340 per year for the weekly three days of care (after 85 percent CCS reimbursement). As this is the maximum CCS

percentage, the reduction in income does not cause an increase in the CCS. However in this particular family's circumstances, it still needs to pay for three full days of child care in order to keep the child's place with the child care provider.

While the family could obtain additional FTB due to the reduction in income, the child care expense remains a significant cost to the family budget.

Case study 2

A family has two children in long day care for three days each week. One parent works full time on a salary of \$55,000. The other parent works three days a week and earns \$24,000. The parent working-part time has the opportunity to take an extra day's work.

The family currently pays \$5,700 per year for three days' child care per week for the two children. The extra day's income will result

in a reduction in the family's CCS percentage (applying to all four days' child care it is now using) and a reduction in FTB. The child care costs that this family pays will increase to around \$8,760.

The WDR in relation to the extra day's work would be around 80 percent. The family would have just \$32 a week extra, after paying for child care, from the parent taking on an extra day's work each week.

Case study 3

A couple has two children in long day care. One parent earns \$100,000 working full time, while the other earns \$60,000 per annum working three days per week.

For this professionally trained couple, the WDR from moving from three to four days of work per week is 74 percent. If the parent currently working part time were to increase working days from four to five per week, the family would face a WDR of 120 percent. This is due to the per-child cap, which limits a family with income above \$189,390 to a maximum annual CCS of \$10,560.

This means the family budget would shrink by 20 cents for every extra dollar earned on the fifth day, making the household financially worse off by \$78 per week.

This effectively places a hand-brake on the secondary income earner's incentive to work more paid hours where other flexible work arrangements are not available.

Policy options for consideration

We have estimated the impacts of two policy options for modifying the CCS.

Option 1

Increase the CCS to 95 percent of the hourly rate cap for all families and eliminate the annual per-child CCS cap.

Option 2

Increase the maximum CCS to 95 percent of the hourly rate cap, and commence the family income-based reduction at \$80,000.

The CCS would then decrease by 1 percentage point for every additional \$4,000 of family income until the family received only a 30 percent subsidy. This would be the minimum subsidy. The annual per-child cap, the cause of WDRs in excess of 100 percent, would also be eliminated.

The two options could also be considered together as stages of a progressive strategy, where Option 2 represents an interim (and perhaps more readily implementable) stage on the path towards near fully funded child care.

For each policy option we have estimated the additional annual CCS cost for the federal government, and the annual GDP impact of the additional days worked as a result of reductions in families' WDRs. We have done this for both conservative and responsive assumptions, based on responsiveness expectations for a year where there are no restrictions on business activity arising from COVID-19.

We have also illustrated the potential impacts in a year affected by COVID-19 restrictions by assuming that parents' capacity to respond to the increased subsidy would be reduced by around two-thirds. This is solely for the purpose of illustration, as the severity and duration of the restrictions would determine the outcomes.



Analysis of longer-term impacts of the policy options

We examined a study on the impact of having a child on the labour market outcomes of male and female parents in Denmark.² An important finding of this study is that female parents have lower wages in the years after having their first child, compared with the counterfactual scenario where they did not have a child. The authors estimated that in the 10th year of having their first child, the wages of female parents were around 15 percent lower than the wages of females who did not have a child.

The findings of this study have been used as a guide to estimate the potential longer-run benefits of the policy options we have considered. Our calculations are based on the assumption that, by strengthening the engagement with work and professional development, these policy changes would reduce the persistent and negative impacts on wages observed by the authors.

Assuming an improved wage trajectory compared with outcomes described in the study, we test the case where the productivity of primary carers, who were previously working no more than three days per week, increases by one percentage point every year, and remains at five percentage points higher between the fifth and 20th year of the policy. We represent this in terms of an estimate of the cumulative benefit to GDP over 20 years, compared to the situation where the CCS modification had not been implemented.

This cumulative benefit would be additional to our estimate of the current annual GDP benefit derived from the additional days worked in response to the improvement in the parent's WDR. We note that if it is assumed that our society would naturally move closer to a Parent Equality Model over 20 years, then some of this cumulative productivity benefit could still accrue, even without the support from modifications to the CCS.



2. Kleven, H., Landais, C. and Søgaard, J.E., 2019. Children and gender inequality: Evidence from Denmark. *American Economic Journal: Applied Economics*, 11(4), pp.181-209.

Option 1

Increase the CCS to 95 percent of the hourly rate cap for all families

This is the more expensive of the two policy options we have considered, and we appreciate that the current budgetary situation makes it more of a challenge to implement. Further, the impact on supply and demand for services of appropriate quality would need to be considered as part of an implementation strategy.

However our estimates of the cost and the economic impact show what a near fully-funded ECEC environment could mean for the budget and for the economy. The federal government's spend on the CCS could increase by up to \$5.4 billion (net of additional income tax receipts from the additional days worked), but the economic

benefit (in a year not affected by COVID-19 restrictions on business) could be a GDP increase of more than \$7 billion.

The cumulative benefit to GDP over a 20 year period arising from the increased productivity of parents who have had stronger connection to work and professional development while their children are very young is estimated at an additional \$10 billion in constant 2019 prices.

To these benefits we should add the valuable advantage of further supporting the social and cognitive development of the children who attend the additional days of child care.

Table 3: Annual costs and economic impacts of increasing CCS to 95 percent for all families (and removal of CCS annual per-child cap)

Projection type	Estimated number of additional work days per week	Additional CCS expenditure net of income tax paid on additional work days (\$ million) ³	Estimated GDP impact (\$ million) ⁴	Estimated additional cumulative productivity benefit over the 20 years following policy change (\$ million) ⁵
Responsive projections	284,969	5,403	7,463	10,000
Conservative projections	229,828	5,444	6,019	10,000

3. For the responsive projections, gross additional CCS cost is estimated to be \$6.7 billion and additional tax collections \$1.3 billion. For the conservative projections, gross additional CCS cost is estimated to be \$6.4 billion and additional tax collections \$1 billion.

4. For illustrative purposes, one could assume that the impact of these proposals in a year affected by COVID-19 restrictions on business activity would be reduced by two-thirds. In that case, under our responsive assumption the net CCS cost is estimated to be \$4.89 billion and the GDP impact \$2.49 billion.

5. We have estimated that due to the enhanced productivity arising from parents' increased connectivity to the workforce and to professional development during the years of using child care, over the 20 years following the year of the policy change, GDP could be cumulatively higher by approximately \$10 billion (discounted to 2019 values). This GDP benefit is additional to the benefit the economy is estimated to gain from the direct workforce participation response to the annual additional CCS spend.

Option 2

Modifying the CCS curve to eliminate cliffs and provide CCS to all families

The features of this policy option are:

- Maximum CCS increases to 95 percent of the hourly rate cap.
- The phase-down of CCS based on family income commences at family income of \$80,000 (up from the current \$68,000).
- CCS would then decrease by 1 percentage point for every additional \$4,000 of family income until the family received only a 30 percent subsidy. This would be the minimum subsidy.
- The annual per-child cap, the cause of WDRs in excess of 100 percent, would also be eliminated.

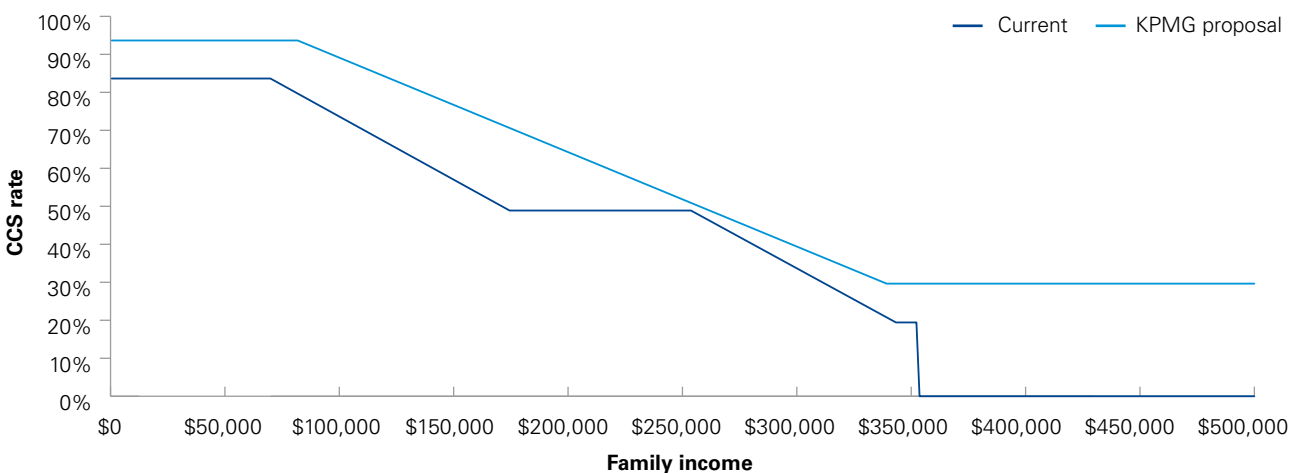
We have selected family income of \$80,000 as the commencement of the phase-down as it represents the equivalent of two adults working full-time on the national minimum wage. It is reasonable for a family with less income than this to continue to receive the maximum CCS.

The comparative profile of the CCS rate under the current rules and Option 2 is illustrated in Chart 1 below. Note that under the current rules, the maximum subsidy of \$10,560 per child applies once family income reaches \$189,391. This is not shown in Chart 1.

Under Option 2, the additional spend on CCS could be around \$2.5 billion per annum (net of additional income tax receipts from extra days worked in response to the policy) but the GDP increase from the extra days worked in the year is estimated at up to \$5.4 billion.

As a consequence of implementing Option 2, the cumulative additional benefit to GDP over a 20 year period arising from the increased productivity of parents who would have had stronger connection to work and professional development while their children are very young is estimated at \$7 billion in constant 2019 prices.

Chart 1: Profile of the phasing-down of the current CCS and of KPMG’s proposed modified phase-down



Altering the profile of the CCS phase-down results in a lower CCS spend than the near fully-funded policy option, but is estimated to have a greater economic benefit per additional dollar spent. This is because the near fully-funded policy provides a greater amount of subsidy to families that do not have the capacity to take on more work.



Table 4: Annual costs and economic impacts of increasing maximum CCS to 95 percent, changing the taper to 1 percentage point reduction for every \$4,000 additional family income, and increasing minimum CCS to 30%. Annual per child cap also removed.

Projection type	Estimated number of additional work days per week	Additional CCS expenditure net of income tax paid on additional work days (\$ million) ⁶	Estimated GDP impact (\$ million) ⁷	Estimated additional cumulative productivity benefit over the 20 years following policy change (\$ million) ⁸
Responsive projections	207,114	2,489	5,424	7,000
Conservative projections	162,913	2,515	4,266	7,000

6. For the responsive projections, gross additional CCS cost is estimated to be \$3.3 billion and additional tax collections \$0.8 billion. For the conservative projections, gross additional CCS cost is estimated to be \$3.1 billion and additional tax collections \$0.6 billion.

7. For illustrative purposes, one could assume that the impact of these proposals in a year affected by COVID-19 restrictions on business activity would be reduced by two-thirds. In that case, under our responsive assumption the net CCS cost is estimated to be \$2.13 billion and the GDP impact \$1.81 billion.

8. We have estimated that due to the enhanced productivity arising from parents' increased connectivity to the workforce and to professional development during the years of using child care, over the 20 years following the year of the policy change, GDP could be cumulatively higher by approximately \$7 billion (discounted to 2019 values). This GDP benefit is additional to the benefit the economy is estimated to gain from the direct workforce participation response to the annual additional CCS spend.



Change to the CCS to better support and incentivise parents in maximising their contribution to the workforce is an economic recovery measure that the federal government should seriously consider.

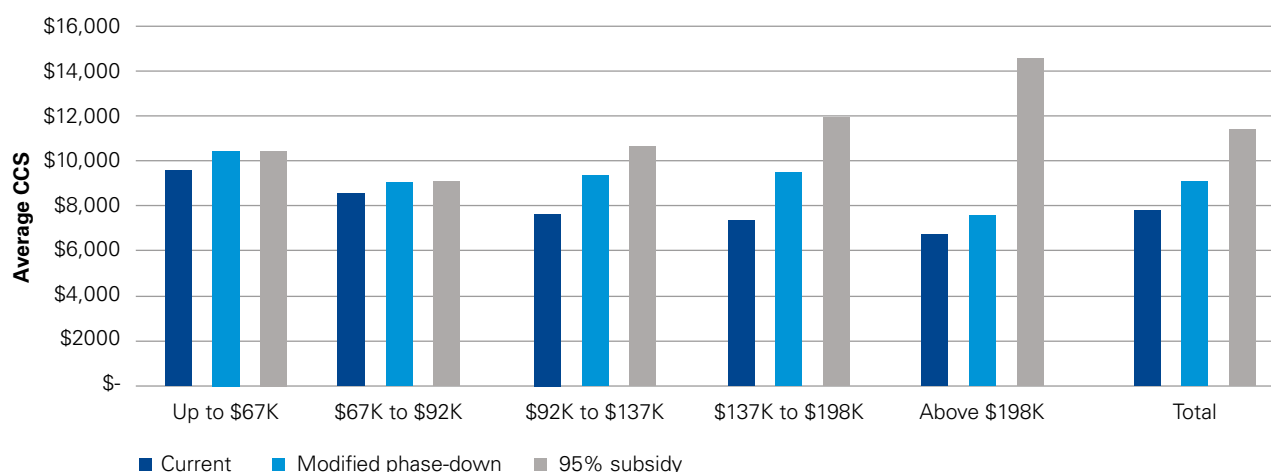
Many other measures are being advocated on the basis of their ability to boost national income. Reform of the CCS would not only reduce one of the barriers to increased workforce participation, particularly for women, delivering a considerable economic benefit to the population, but also enhance the development and welfare of our children. This brings long-term benefit for our society in both a financial and non-financial sense.

We have estimated the results of applying the policy options covered in this paper in terms of average CCS received by families in each income quintile.

Adopting Option 1, near fully-funded child care, would result in families in the highest income quintile receiving on average the highest amount of CCS. This would principally be driven by the fact that on average these families pay the highest hourly rate for child care services.

Applying Option 2, the modified CCS phase-down, would result in families in the lowest income quintile continuing to receive the highest average amount of CCS. All families would receive more than under the current CCS, but the biggest winners would be those in the fourth (second-highest) income quintile.

Table 5: Average estimated CCS received by families in each income quintile under current CCS rules and under the two proposed policy options.



The CCS is not ‘middle-class welfare’, just as government-funded primary and secondary education are not. It represents a productivity-boosting investment in the ability of parents to increase their contribution to the economy according to their needs and preferences.

Therefore, we argue that a trajectory of CCS evolution towards more fully-funded support is the right policy for Australia. As an interim step, the modifications to the phase-down that we have proposed would result in a benefit for all families and for the economy overall, while still targeting the highest levels of support at the lowest income families.

Key assumptions

Tables 3 and 4 contain estimated economic impacts of the implementation of the respective policy options, assuming a year where business is no longer subject to the restrictions on activity caused by COVID-19. The economic impact in year(s) affected by COVID-19 restrictions could be expected to be significantly lower, and we have illustrated impacts of approximately one-third for such years. The calculations are based off the impact of policy proposals on income units (broadly, households) taken from the most recent ABS HES data from 2015-16.

GDP projections are based off an assumed behavioural response by a proportion of those secondary earners who experience a material WDR benefit as a result of the proposals. We applied a WDR benefit threshold (five percentage point WDR benefit as a potential trigger for one additional day’s work, 30 percentage points for two additional days).

We applied a conservative assumption that no secondary earner already working more than three days per week would respond to the policy, and a responsive assumption that some of those working up to four days per week would want to work more. We have assumed that secondary earners would only pick up additional days’ work up to a maximum of five days per week.

In each case, we assumed that only 35 percent of the potential responder cohort who achieved the WDR benefit threshold would actually take on extra working days. The potential relative labour productivity of the relevant secondary earner has been examined with regard to the levels of the beneficiaries of the policy options, taken from the HES data.

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