Briefing

Resolution Foundation

Gingerbread
Single parents, equal families

Childcare support and the hours trap

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23 May 2011

Overview

In its planned reform of the welfare system and the introduction of Universal Credit, the Government aims to help and encourage families to use work as a route out of poverty. For many low-to-middle income families with young children, a crucial issue is whether it pays to work after covering childcare costs, which have been rising steeply and are among the highest in OECD countries (Daycare Trust, Childcare costs survey 2011; OECD, *Doing better for families*, 2011). The Universal Credit reforms will for the first time help parents working fewer than 16 hours to pay for childcare. However, the Government has said that it will not spend more on support for childcare than it currently does, despite more parents being eligible for support. This inevitably means that many parents will receive less support towards their childcare costs than they currently receive. This briefing shows the impact on incomes and work incentives of possible reform options.

Overall, the briefing shows that restructuring support for childcare, in combination with the other changes that Universal Credit will bring, could introduce serious disincentives to work for parents working more than a few hours a week. While the situation will vary according to the circumstances of each family, in some cases it will trap families below the poverty line, by making them lose 83p of every additional pound earned if they work more than 7 hours a week, rising to 94p in the pound if they work more than 24 hours. Moreover, the reform options being considered would reduce caps on eligible childcare costs. This would make many families worse off if they worked full time rather than a few hours because they would have to pay the full cost of any childcare above the cap. This would deny many families on low-to-middle incomes the opportunity to earn their way to a more acceptable standard of living. Such conditions directly contradict the major Government priorities of incentivising work and helping economically disadvantaged families to improve their lives through hard work.

On the other hand, if the Government were willing to give the same level of support for childcare under Universal Credit as existed until recently under the tax credit system, this would ensure, for the first time, that most parents will be better off for each additional hour that they work.

Two policy options and their overall impact

Until March 2011, the tax credit system reimbursed 80% of childcare costs up to £175 a week for one child and £300 for two or more children, to families working at least 16 hours a week on low-to-middle incomes. The rate was reduced to 70% in April 2011. The Universal Credit system, due to be introduced from 2013, will extend support to people working fewer than 16 hours but aims to do so without raising the total cost of childcare support from its present level[1]. Since the Universal Credit aims to extend childcare support to new clients and overall take up is expected to increase, reductions in existing childcare entitlements would be necessary in order to keep to present spending levels. There are two possible parameters that can be changed: the percentage of childcare costs covered and the cap on eligible costs. To remain within current spending, this implies the following two reform options that are analyzed in this paper: retaining the reimbursable amount of 70% and reducing eligible childcare costs from £175 to £125 for one child and from £300 to £215 for two or more children; or restoring the 80% coverage rate but lowering the cap more severely, to £100 for one child and £170 for two or more children.

The examples considered below compare these two reform scenarios to the system in operation in 2010/11[2]. That system is taken as a starting point, recognizing that it provided adequate support to families prior to the reduction from 80% to 70% of eligible costs as of April 2011. The main focus of the analysis is the impact of childcare on the incentive to work extra hours, assuming that each extra hour of work for a single parent or second earner in a couple with children leads to an extra hour's childcare requirement. The analysis also considers the consequences of working various numbers of hours for the overall level of disposable family income, against two benchmarks. One is the official "poverty line" of 60% median income after housing costs. The other is an "adequacy line" showing the minimum that people actually require in order to get to an acceptable living standard as defined by the general public (see notes on Illustration 1 below).

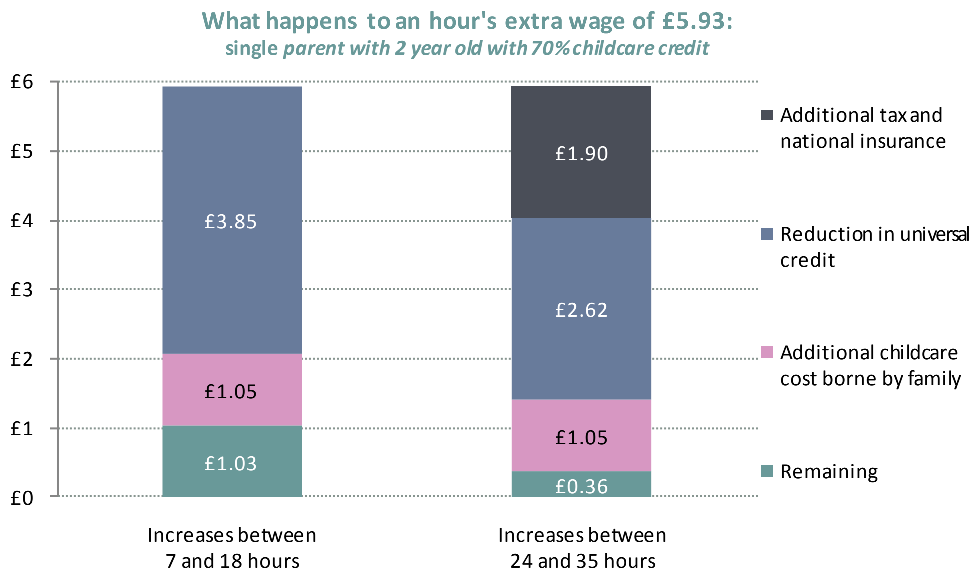
The hours trap for single parents

People on the lowest wages would find it especially hard to improve their incomes through working more hours if support for childcare were reduced. The example of a single parent on the minimum wage with a small child paying average childcare costs (£3.50 an hour- see Daycare Trust survey cited above) is shown in the first illustration at the end of this briefing.

At present, such a family can get comfortably above the poverty line if the single parent works for at least 16 hours, although because of very sharp withdrawal rates of benefits and tax credits above that point, there is little incentive to work longer hours. Under Universal Credit, unlike today, if the parent finds a "mini-job" of say seven hours, the family will be better off than if she is not working – but still below the poverty line. However, with childcare support limited to 70%, for every hour that she works beyond this amount, she will lose most of what she earns.

[1] In the Committee stage of the Welfare Reform Bill, Minister for Work and Pensions, Chris Grayling, commented: "We accept that this is a complicated area. There have been a number of changes. Some issues arise from the Budget last year and some from our desire to reduce the threshold, from the current 16 hours, below which child care costs cannot be paid, because we recognise that the mini-jobs that we have discussed are a vehicle to get many people back into the workplace. By definition, that leaves us with some hard challenges. We are committed to retaining the current spending on child care; that is important to do".

[2] The analysis looks at the relationship between gross earnings and disposable income at 2010/11 prices and benefit levels.



As shown in the graph based on 70% reimbursement, even when this single parent is earning too little to pay tax, once she is earning enough for tax credits to be reduced (above 7 hours), she will lose £4.90 of the £5.93 that she earns for each extra hour worked – a withdrawal rate of 83p in the pound. Working anything more than 24 hours, she will be paying tax and national insurance contributions, and keep only 36p for each additional hour that she works – a withdrawal rate of 94% which means keeping only 6p of each additional pound earned. The cap on eligible childcare costs would in this case only take effect at 36 hours a week, after which extra earnings would bring no additional net income.

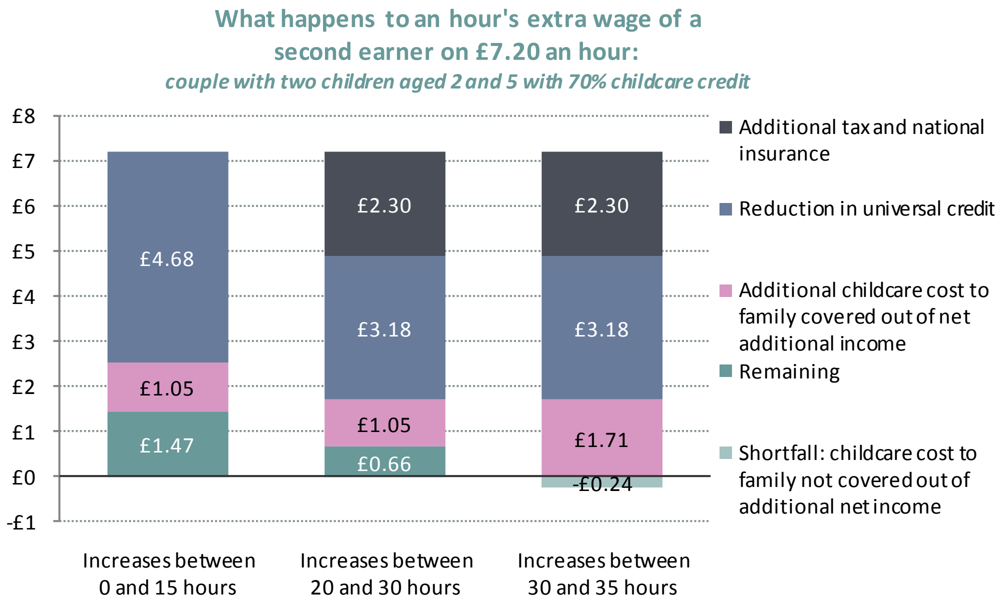
Under the alternative scenario, with Universal Credit reimbursing 80% of childcare costs but a lower cap, the net income of the same family would rise to just above the poverty line if the single parent increased her hours to 28. However, at that point she would hit the £100 limit in childcare costs above which she would have to pay all additional charges herself. This means that she would lose money by working any more hours, and as a result, sink below the poverty line.

For a single parent on a modest but not very low wage (around £20,000 full-time equivalent), both options put a tighter lid on aspirations than the present system (see illustration 2). Under the old system, someone in an entry-level career job such as a midwife could reach an adequate income if she worked more than three days a week, even with relatively high (London level) childcare costs. She could never expect to do so under either of the scenarios of reduced childcare support. For someone in this situation paying average national childcare costs, the typical withdrawal rate of extra income would rise from 57% under the old system to 86% with 70% reimbursement under Universal Credit.

The hours trap for second earners

For couples with children, the issue of childcare arises when a second adult goes out to work. As shown in illustration 3 below, the starting point for such a family, if the first earner is on a very modest wage, is more favourable under the Universal Credit than under the old system, potentially allowing the family to rise above the poverty line on the basis of a single earner. However, the changes being considered would again put a tight lid on aspirations for such families. Under the 70% reimbursement scenario, the partner would lose 80% of her wages even by working a few hours on the minimum wage, and 91% if she increased her hours from 20 to 30. Above that level, she could not become better off, since childcare support would be capped.

Three examples of withdrawal rates for couples with two children under this scenario are as follows:



Where the second earner is working for up to 30 hours a week, there is a small gain, shown in green, but once the cap on eligible childcare costs is reached, at 30 hours, the family's additional income is less than they need to pay to cover additional childcare. The overall effect of these potential changes on second earners would be to enable many couples on low wages just to escape poverty with a single earner, but deny them the chance of using a second person's earnings to reach a more acceptable standard of living.

In cash terms, the potential reforms analysed here could result in significant losses to families in the amount of financial support for childcare they receive from Government. This is illustrated in the tables below.

a) One child aged 2, average national childcare costs (£3.50 for childminder)

	Working part time (18hrs/wk) *(£63 a week to childminder)*			Working full time *(£131.25 a week to childminder)*		
£ per week	Paid by state	Paid by family	Loss compared to old system	Paid by state	Paid by family	Loss compared to old system
Tax credit system 80% of up to £175 for one child (old system - to Apr 2011)	£50.40	£12.60	-	£105.00	£26.25	-
Universal Credit at 70% of up to £125 for one child	£44.10	£18.90	£6.30	£87.50	£43.75	£17.50
Universal Credit at 80% of up to £100 for one child	£50.40	£12.60	£0.00	£80.00	£51.25	£25.00

b) Two children aged 2 and 4, the older one getting free 15-hour a week childcare entitlement, average childcare cost for London £4.75 for childminder

£ per week	Working part time(18hrs/wk) *(99.75 a week to childminder)* Paid by state	Paid by family	Loss compared to old system	Working full time (37.5 hrs/wk) *(£285 a week to childminder)* Paid by state	Paid by family	Loss compared to old system
Tax credit system at 80% of up to £300 for two children (old system - to Apr 2011)	£79.80	£19.95	-	£228.00	£57.00	-
Universal Credit at 70% of up to £210 for two children	£69.83	£29.93	£9.98	£147.00	£138.00	£81.00
Universal Credit at 80% of up to £170 for two children	£79.80	£19.95	£0.00	£136.00	£149.00	£92.00

As the first table shows, for a single parent or second earner in a couple working part time with one child, the losses may be relatively modest – about £6 a week or £300 a year, as a result of a 70% rather than 80% reimbursement rate. This is because childcare costs for these families remain below the cap. On the other hand, as the second table illustrates, for a family in London requiring full-time childcare for two small children, childcare costs would be well above the reduced caps analyzed here. As a result, they could potentially lose £4,000 to £5,000 a year in childcare support. In reality, few families would incur such losses because faced with such a heavy price for working full-time, most single parents or second earners would be likely to reduce their hours. This confirms the negative impact on work incentives of possible changes to support for childcare illustrated in the previous analysis, particularly for those trying to move from part-time into full-time work.

Variations in the hours trap

The pattern described above applies in general terms to any parent on a low-to-middle income who wants to become better off by working more hours, but needs to finance more childcare in order to do so. More expensive childcare, or having more children to pay for, can make the penalties of working and paying for childcare even worse. In all the scenarios considered, this would make the caps on eligible childcare more important and reduce the number of hours above which parents would not find it worth working because footing the entire childcare cost themselves would leave them worse off overall. For example, with the average London childcare cost of £4.75 an hour rather than the national average of £3.50, the "hours cap" for a single parent on the minimum wage with one child aged two would reduce from 28 to 21 in the 80% scenario, and from 36 to 26 hours in the 70% scenario.

The alternative: pre-April 2011 levels of childcare support under Universal Credit

In the illustrations below, a yellow line shows what would happen if the rules for childcare support that were in place prior to April 2011 were kept under Universal Credit. This would mean an 80% reimbursement rate up to £175 for one child or £300 for two or more children, which are enough to allow support for a full 40 hour week unless childcare costs are very high. In every example tested, this scenario would address the hours trap by allowing a steady if modest increase in net income over the entire range of hours worked. This would be a significant improvement over the present system where taking a job on a modest wage for less than 16 hours may be pointless because childcare costs are not supported. Removing this barrier, without creating new ones above 16 hours, would boost the Government's objective of making work pay.

The cost of such a system would be relatively small compared to the overall cost of Universal Credit. It may even be lower than currently anticipated since the additional cost arises partly from the assumption that significant numbers of parents will work very short hours and use paid childcare to which they were not previously eligible. It is unclear whether finding such short-hours childcare will be possible or whether people working such short hours will have to rely on informal arrangements that are not eligible for childcare support.

Conclusion

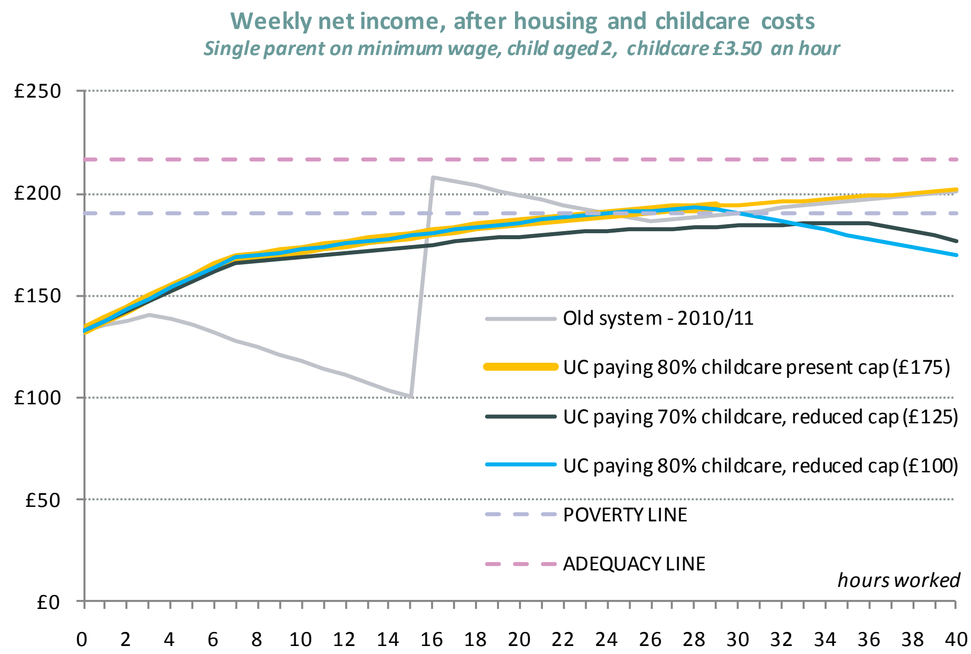
In an effort to contain costs, the Government has already reduced the amount of childcare support available to working parents and is considering how it might maintain this lower cost under its Universal Credit reforms when it may need to cover more claimants. This briefing has shown that cuts in entitlements, however structured, could badly damage the primary Government objective of making work pay. Reducing the rate of childcare support would recreate the very work disincentives that Universal Credit is trying to abolish, making it not worth working more than a few hours a week for many parents.

Maintaining a 70% reimbursement rate means that families have to pay half as much again for childcare as they did prior to April 2011 (30% rather than 20% of the cost). For a single parent working on or close to the minimum wage, this typically creates very little reward for working more than a few hours a week. For example, she would have only £7.50 a week more in her purse if she decided to work two full days a week rather than one, and only £3 more if she increased from three days to four. In the latter case, she would lose 94p for every extra pound that she earned.

The alternative of retaining the 80% rate but only applying it to the first £100 of childcare for one child would avoid a particularly high withdrawal rate for people in very part-time jobs. However, it would put an even more severe cap on aspirations for those moving towards full-time employment. Having to foot all the extra cost of childcare once the limit was reached would in many cases mean that longer hours would leave families significantly worse off, in some cases falling back into poverty. Typically this would start happening when people worked more than between 22 and 28 hours a week, depending on hourly childcare costs. We have not modeled here the impact on families with significantly higher childcare costs, for example those with three or more children or those with a disabled child (where the cost of appropriate childcare is much higher), but the impact would clearly be more severe.

Either of the changes considered here would put a cap on work incentives and aspirations. In many cases, they would only allow families to get just above the poverty line before it was not worth working additional hours. The alternative is to invest a relatively small extra amount in restoring previous levels of entitlement. This would cost about two per cent of the £30 billion presently spent on the tax credit system. This could be considered a small price to pay in order to avoid a damaging new hours trap which would undermine the objectives at the core of the Universal Credit reform.

ILLUSTRATION 1



Notes

These examples illustrate how much extra someone's family would have available in disposable income according to how long they work, once all taxes, credits, benefits and childcare costs have been taken into account. They consider how this disposable income changes for each hour worked from 0 to 40 hours. The slopes of the lines show the extent to which families can increase their earnings through additional hours. For reference, these graphs show the "poverty line" of 60% median income (after housing costs). They also show an "adequacy line" based on real evidence of what families need as a minimum income. This is the Minimum Income Standard, based on what members of the public say families require for an acceptable standard of living3.

Points to note:

- Under the previous system (grey line), a single parent on the minimum wage paying a childminder for one child does not benefit from working very short hours, but can get above the poverty line once they work 16 hours. The Universal Credit system will make short working hours more worthwhile (black and light blue lines).

- However, under a 70% reimbursement rate with Universal Credit, it would barely be worth this family working more than a few hours a week: above 7 hours, they would have to earn £6 more to raise their net income by £1, and above 24 hours a week they would have to earn £16.

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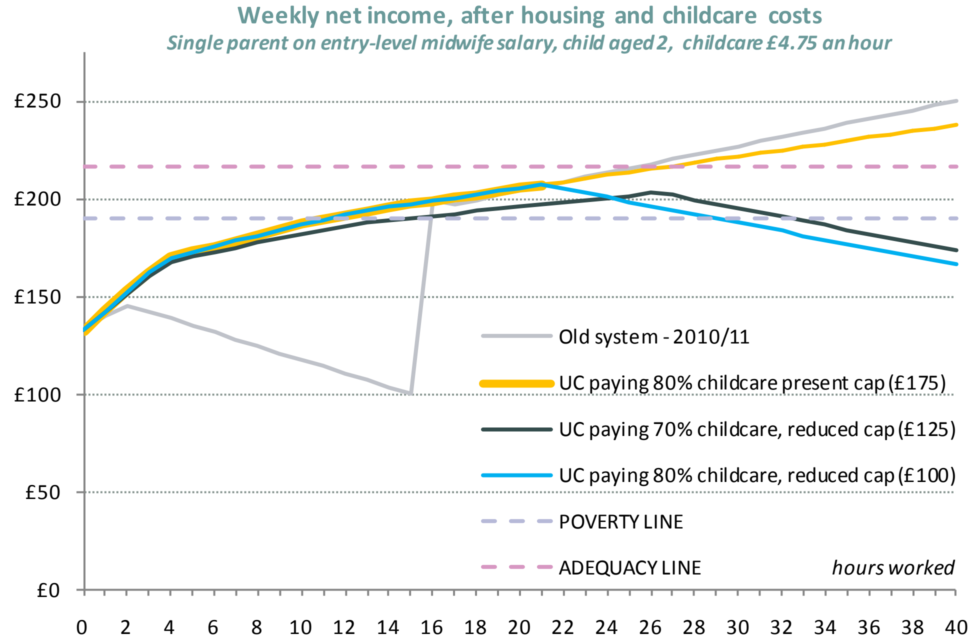
3 A Minimum Income Standard for the United Kingdom is produced annually by the Centre for Research on Social Policy based on detailed research involving members of the public and experts. Groups of members of the public meet to negotiate a consensus about what items should be included in a budget for various household types in order to afford a "minimum acceptable" standard of living allowing families to cover the basics and participate in society. These lists are checked by subsequent groups and by experts who ensure that certain physical requirements such as nutrition and warmth are adequately met.

- Incentives would be slightly better if an 80% reimbursement rate were retained, but if the maximum eligible childcare were capped at a lower rate, this would cap incomes at about the poverty line (see light blue line). This is because it is at the point where net income gets just above the poverty line (working 28 hours on the minimum wage) that childcare credits are capped, so extra hours of childcare need to be covered entirely by the family.

ILLUSTRATION 2



Notes (see also notes on Illustration 1):

This example shows the situation for a single parent working in a job with a modest salary, earning the equivalent of just over £20,000 a year full time. It also assumes a somewhat higher childcare cost than the previous example: the £4.75 rate represents the average for childcare in London.

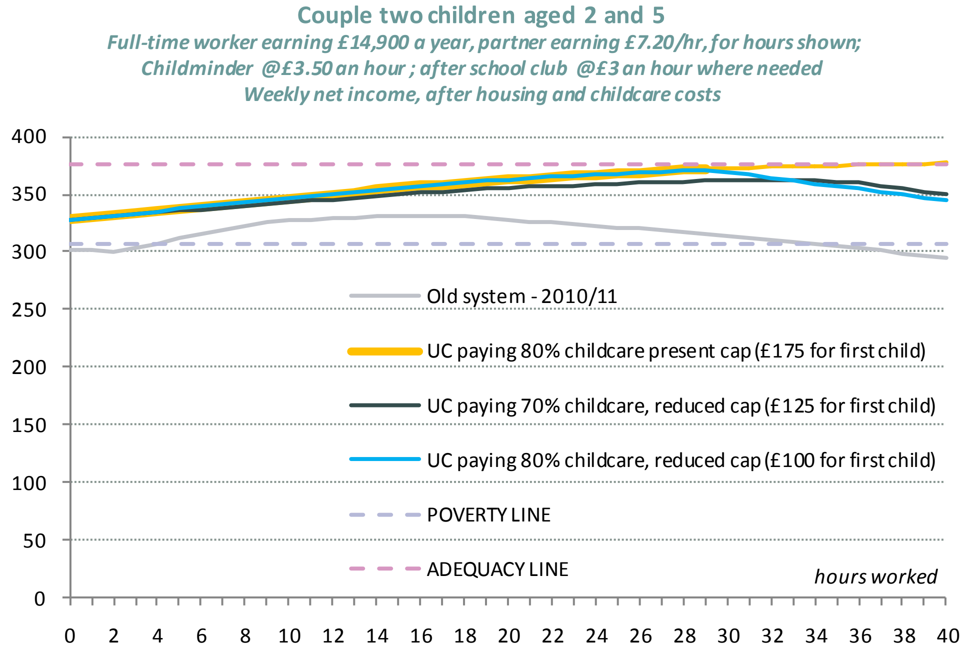
Points to note:

- Under the old system, helped by Government support for childcare, this parent could get her family out of poverty by working at least 16 hours a week and get above a minimum acceptable living standard by working 26 hours a week or more

- With only 70% support for childcare under Universal Credit, the family could just get out of poverty at 16 hours a week, but could not aspire to an adequate income that allowed them to have all the things that members of the public consider necessities for this family with young children (including for example basic forms of social participation such as soft play activities for the toddler, and a short family holiday in the UK).

- With 80% support and a lower cap, they could escape poverty by working just 12 hours, but could never aspire to an adequate income, with any earnings above 22 hours a week being more than offset by extra childcare costs. In both the Universal Credit scenarios shown here, capping childcare costs would actually bring a full-time worker in London on £20,000 to below the poverty line, in terms of net income after childcare costs.

ILLUSTRATION 3



Notes (see also notes on Illustration 1):

This example looks at the case of a couple, and shows the effect of having a second earner in the family, working various hours. It assumes that the two year old needs childcare for each hour worked by the second earner, and the five year old needs after-school care for each hour worked over 30. The hourly wage rate of £7.20 has been calculated as a Living Wage outside London under the present system.

Points to note:

- Where a single earner has very modest earnings (shown here where the second earner's hours are zero), couples with children will be better off under UC.
- The incentive for a second earner to work part time is however very weak under UC, especially with a reduced rate of childcare support
- If both members of the couple work full time, the caps on childcare support modelled here could bring the family income back down towards the poverty line (black and light blue lines)

General notes

The calculations used to produce this briefing represent the actual situation in 2010/11 and, for comparison, the situation under the reform proposals using 2010/11 values. This was chosen as the best "before and after" situation, since in 2011/12 there has already been a cut in the percentage of eligible childcare costs included in tax credits. Since the main aim is to look at the impact of the Universal Credit, not all future policy changes have been taken into account (eg tax allowance rises after 2011/12 and the freezing of Child Benefit are ignored), but the calculations take account of the £1000 increase in the personal tax allowance in 2011/12, in modelling the Universal Credit, since this is an important aspect of the reform of work incentives. Assumptions about rent, other housing costs and council tax are from the Minimum Income Standard research, which uses council rents appropriate to each family type. Childcare costs are based on the Daycare Trust's January 2011 survey.

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