



# TARGETING AFFORDABLE CHILDCARE

A sustainable expansion of free childcare hours

# About Localis

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- **Reshaping our economy.** How places can take control of their economies and drive local growth.
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We also run a membership network of local authorities and corporate follows.

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Any errors or omissions, of course, remain my own.

**Kulvir Channa**

# Introduction

Since the introduction of tax-free childcare provision in 1990, Government has increasingly invested in childcare to make it more affordable for parents. Government is set to be the biggest buyer of childcare in the UK,<sup>1</sup> investing a total of £6 billion in the market by 2020.<sup>2</sup> This money has mainly been allocated toward free hours of childcare, provided universally for all three and four year olds, and for two year olds on a means-tested basis.

From September 2017 the provision of free hours of childcare will be extended: all working families (providing both parents earn the equivalent of 16 hours on the minimum wage per week, and less than £100,000 per year) will be able to use a total of 30 hours free childcare a week for their three and four year old children. Until this extension is rolled out, we will not know its true cost and impact. However, concerns over funding arrangements have led to uncertainty over how childcare providers will react – will there be sufficient funding, will providers be able to absorb the costs, or will they opt out of the scheme altogether?

This report does not seek to radically reshape Government intervention in the childcare market. Government's role in this space is increasing and optimising is preferable to overhauling it. State-subsidised hours of free childcare are advantageous for two reasons. Firstly, increasing the amount of structured learning for small children will improve their life chances.<sup>3</sup> Secondly, increasing the affordability of childcare makes it easier for parents (especially mothers) to enter employment.

However, providers of childcare have reacted against the Government's proposed extra free hours. Concerns have been raised over the cost pressure this places on providers and research suggests many will simply opt out of the scheme altogether.<sup>4</sup> Therefore consideration should be given to an alternative sustainable method of allocating free childcare which would help to relieve pressure on the childcare market and target an important benefit at

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1 Sam Gymiah MP, Westminster Hall Debate, 12th July 2016

2 Sam Gymiah MP (2014) – Parents eligible for more than £8,000 in childcare support

3 Save the Children (2010) – The impact of early education and childcare on life chances

4 BBC (2017) – Free nursery hours plan risks higher fees, say campaigners

those who are most in need.

Our proposal allows childcare providers to receive additional money through the Early Years Pupil Premium (for 3 and 4 year olds) whilst also increasing the capacity for providers to make ends meet through cross-subsidisation. By expanding the means test, provision can also be made for one year old children in low income households. Thus our proposal takes the planned 30 hours free childcare for 3 and 4 year olds (half of which is means-tested via the 'working families' criteria) and turns that into 30 free hours for 3 and 4 year olds (half of which is means-tested for 'low income' families) and provides a new provision of 15 free hours for one year olds (means-tested for 'low income' families). Combined with the reversal of Government's planned extension of childcare, this will save the Government an estimated £64 million.<sup>5</sup>

### Free childcare provision for a low-income family

| Age of child | Current free provision  | Government's planned extension  | Our proposed expansion of free provision           |
|--------------|-------------------------|---|--|
| 1 year old   | No provision            | No provision  | 15 hours (means-tested)                            |
| 2 year old   | 15 hours (means-tested) | 15 hours (means-tested)   | 15 hours (means-tested)                            |
| 3-4 year old | 15 hours free childcare | 15 hours (universal), plus 15 hours for 'working families' (not all low-income families eligible) | 15 hours (universal), plus 15 hours (means-tested) |
| 5 year old   | School starting age     | School starting age   | School starting age                                |

We recognise that not all parents of one year olds will opt into such a scheme (much as some parents of two year olds do not opt into the current

<sup>5</sup> See Appendix

scheme which is offered via means test). However, for those low income families that wish to participate these additional hours of free childcare provide a meaningful incentive to return to the labour market.

Secretary of State for Work and Pensions, Rt Hon Damian Green MP, has made clear the Government's desire to see more parents in work and has highlighted the negative impact workless homes have on a child's life chances: "children growing up in workless families are almost twice as likely as children in working families not to reach the expected level at every stage of their education".<sup>6</sup> This paper is a contribution in support of the Government's goal to support more parents back into work and provide greater choice and flexibility to lower income families.

### Proposal:

1. Government should not proceed with its planned extension of free childcare for working families with three and four year olds.
2. Government should re-invest the money saved from cancelling its planned extension into providing free childcare on a means-tested basis to the most disadvantaged families (and based on current criteria for two year olds). This would consist of 15 hours for one and two year olds and an extra 15 hours (on top of the current universal allocation of 15 hours) for three and four year olds.
3. A more targeted means-tested allocation of free childcare would encourage well-financed local childcare markets by:
  - increasing the scope for childcare providers to cross-subsidise funds
  - ensuring that childcare providers are given additional money, through the Early Years Pupil Premium, for the majority of 3 and 4 year olds who will be eligible for a further 15 hours

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<sup>6</sup> Rt Hon Damian Green MP, The Times (2017) – Workless parents stunt a child's prospects for life

# 1. Reverse the planned extension of free childcare hours

## High costs for childcare providers

Nurseries already face large financial pressures. When taking inflation into account, there has been a 4.5% cut in real terms funding for the provision of 15 hours free childcare since 2013,<sup>7</sup> costing each nursery, on average, £34,000.<sup>8</sup> Even Government's increase in funds to £4.94 per hour per child from 2017/18 will fall short. This is a result of both difficulties in passing all of the funds directly to childcare providers and the increasing costs of providing childcare. Once 7% of funds have been retained by local authorities centrally for administrative purposes, the actual amount passed onto childcare providers will be, on average, £4.59.<sup>9</sup> On the cost side of the equation, rises in the National Living Wage are increasing the costs for childcare providers. Taking these things into account, we have estimated that **the funding arrangements for 2017-18 will lead to a £103.5 million black hole**<sup>10</sup> – a gap that will have to be plugged in by childcare providers, with some suggesting that providers may charge top up fees for these 'free' places. Given the scale of this black hole, it is not surprising that a majority of respondents to a NDNA survey said they were unlikely to extend the free hours.<sup>11</sup>

For many providers, the average funds being provided for the childcare extension is too low. Yet, the childcare market is highly localised. As the work is labour-intensive, and focused on retaining statutory minimum staff to child

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7 National Audit Office (2016) – Entitlement to free early education and childcare

8 NDNA (2016) – Annual Nursery Survey: England

9 Department for Education (2016) – Early years funding: changes to funding for three- and four-year olds. Government consultation response

10 Allocated funds have been calculated through using the average fund per hour per child for 2017/18, minus 7% that Government expects local authorities to retain centrally, with the actual numbers of 3 and 4 year olds benefiting from some free early education in 2016. These actual numbers of 3 and 4 year olds were then divided into estimated numbers in a private, voluntary or school setting using the proportion of Ofsted registered places by ownership, 2013.

Actual costs have been calculated through using the representative costs per contact hour, England 2014/15 for aged three and four at average staff ratios, multiplied by the rise in national minimum wage/living wage up to April 2017.

The funding gap was calculated using the difference between the actual funds and actual costs for all 3 and 4 year olds receiving some free early education in 2016 for the first fifteen hours. The funding gap for the 15 hours extension was calculated using Government's estimates that 42.9% of these children will be eligible for the additional hours.

11 NDNA (2016) – Annual Nursery Survey: England



ratios, providers cannot take advantage of economies of scale that national corporate structures provide to cut costs.<sup>12</sup> The emphasis on staffing numbers means that the costs of childcare are strongly connected to regional costs of living, making London, where the mean hourly pay for full day care was £10 compared to £7.50 in the East Midlands, the most expensive area to run a nursery.<sup>13</sup> This means that the affordability of the childcare extension will greatly vary according to the local make-up of the market.

There are also a wide variety of types of provision and business models that have different funding needs to take into account different parenting needs.<sup>14</sup> Different forms of provision cost less than others with voluntary providers needing, on average, 44p less per child per hour than private providers to meet costs.<sup>15</sup> At an average cost of £4.37 per child per hour, the cost is highest in primary schools that have some form of nursery provision. Such is the cost for these providers that only 44% of school-based nurseries plan to offer the 30 hours extension in September.<sup>16</sup>

This means that the extension of childcare hours will have more of an impact on local areas dependent on the more expensive forms of childcare. Local authorities such as Sunderland – where 44% of three and four year olds are in maintained nurseries and state-funded primary schools – will find it harder to provide childcare places compared to areas that are less reliant on such settings (such as Manchester where the equivalent proportion is only 1%).<sup>17</sup>

Government has sought to ensure that the average level of funding that each local authority receives will be proportional to the local costs of providing childcare. Yet, there is a substantial mismatch between the baseline funding of local areas and the proportion of high-cost childcare providers. This will mean that places like Sunderland, with large proportions of places within maintained nurseries and state-funded primary schools, will be denied the ability to properly fund these extra hours.<sup>18</sup>

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12 Lloyd, E. and Penn, H. (2013) – Childcare markets: can they deliver an equitable service?

13 Table 6.24: mean hourly pay by region, childcare and early years provider survey: 2013, ONS

14 Department for Education (2015) – Review of childcare costs: the analytical report

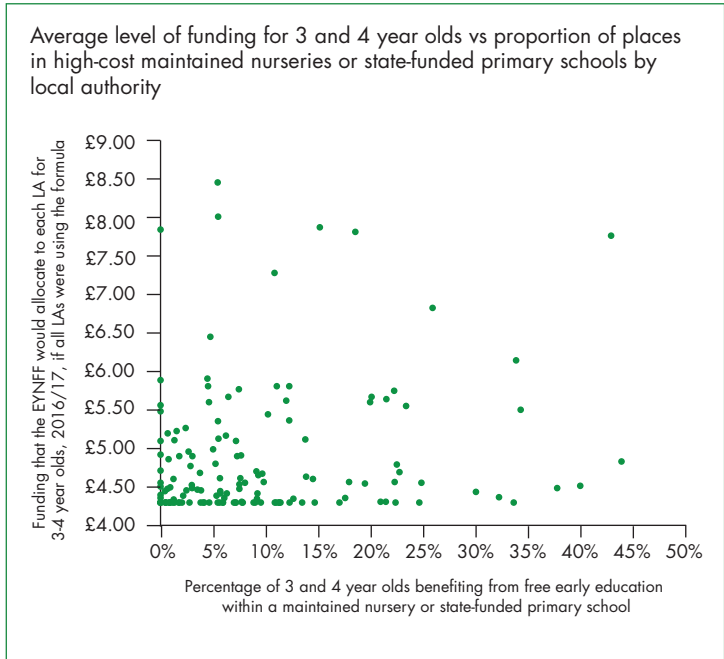
15 Based on representative costs per contact hour, England 2014/15 at average staff ratios. Source: Ibid.

16 Table 15: How provisions plan to offer 30 hours of government funded entitlement, Childcare and early years provider survey 2016, ONS

17 Table 21A, Provision for children under 5 years of age, 2016, ONS

18 Department for Education – Local authority allocations under the early years national funding formula

Source:  
Department for  
Education –  
Local authority  
allocations  
under the early  
years national  
funding  
formula; Table  
21A, Provision  
for children  
under 5 years  
of age, 2016,  
ONS



## High cost to Government

On the other side of the spectrum, the childcare extension is coming at a huge cost to the Government purse. By 2020, Government will be spending £6 billion per year on childcare<sup>19</sup> and **we have estimated that the true cost to Government of the extension in free childcare hours, once fully rolled out, will be £1.6 billion.**<sup>20</sup> As even this large sum of money will not meet the funding expectations of childcare providers, it must be questioned whether the childcare extension should even be implemented. An alternative policy for making childcare provision more affordable should be funded with the money initially allocated towards this childcare extension.

### Proposal #1

Government should not proceed with its planned extension of free childcare for working families with three and four year olds.

<sup>19</sup> Guardian [2017] – Parents on zero-hours contracts ‘could miss out on free childcare’

<sup>20</sup> See Appendix

## 2. Expand free childcare hours for the worse off

### Change the means-test for additional free childcare

Government's criteria for 'working families' is a form of means-testing for accessing free childcare. There was a clear rationale in this eligibility criteria: by only extending this scheme to working families it would incentivise non-working families to work whilst increasing the affordability of childcare for parents of three and four year olds. Government impact assessments have referenced the "strong academic evidence" that a reduction in the cost of childcare increases employment, especially from mothers.<sup>21</sup> Beyond this, the CBI have calculated that an extension of free childcare hours for all one to four year olds would increase the female employment rate by 0.9% in the first two years, rising to 2.6% in the medium term.<sup>22</sup>

However, a majority of families — 57.1% — will be ineligible for Government's proposed extension of childcare.<sup>23</sup> Based on feedback given during research for this paper, it appears most of these families will fall short of qualifying by not earning the required 16 hours on the minimum wage per week, rather than earning over £100,000 annually.<sup>24</sup> It is likely that these families, unable to afford childcare and ineligible for other Government support such as Tax Free Childcare (which has the same 'working families' criteria), will have to resort to informal childcare, for example relying on friends and family. Whilst informal childcare is not necessarily something to be discouraged, the need for parents to rely on the availability of friends and family during the working week to look after their children is arguably less stable than a formal childcare arrangement and would have knock on effects regarding the level of employment these parents enjoyed.

As such a more targeted form of Government intervention in the childcare market in order to bolster employment rates should focus on the most disadvantaged, who fall short of its current criteria for childcare extension.

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21 Childcare Payments Bill 2014: Impact Assessment

22 CBI – A Better Off Britain

23 Children & Young People Now (2017) – More than 500,000 children to miss out on free 30 hours childcare

24 Although precise data on this does not exist, only 10% of the population earn over £50,220: a figure far below the upper cap of £100,000. Source: Table 6.7a Annual pay – Gross, Annual Survey of Hours and Earnings, ONS, 2016

## Current childcare support for disadvantaged families

Aside from the provision of 15 hours for two year olds, disadvantaged families are able to claim back a high proportion of their childcare costs. Providing that a family is on either the Working Tax Credit or Universal Credit, they can claim up to 70% of their spending on formal childcare.<sup>25</sup> Such support is useful, but limited in its eligibility criteria and levels of reimbursements.

The eligibility criteria, dependent on receiving certain types of welfare, does not include other low-income families who still need help with childcare costs. On top of this, despite a commitment to extend this support to families on Universal Credit who work under 16 hours a week,<sup>26</sup> current provision is solely provided for families working above these hours.

Reimbursements for families on the Working Tax Credit can only be claimed on childcare that costs £175 per week for one child or £300 per week for more than one child.<sup>27</sup> Given the localised nature of the childcare market, the ability for these pay outs to improve the affordability of childcare for eligible families will be dependent on where they live. This would make it much more difficult for a low-income family to afford childcare in London, where the average cost for 25 hours childcare in a nursery is almost £149, compared to Yorkshire, where the equivalent cost is only £94.<sup>28</sup>

The reimbursement of childcare costs for those on Universal Credit and Working Tax Credits certainly helps with the affordability of childcare, but has limited capacity as the primary source of childcare support for disadvantaged families beyond the 15 hours of free childcare for 2 year olds.

The £1.6 billion cost of Government's planned changes could be reallocated into dramatically expanding its current offer of 15 hours of free childcare for two year olds on a means-tested basis. For £64 million less, Government could fund 15 hours of free childcare for one and two year olds, whilst providing a further 15 hours (30 hours total) to three and four year olds on a means-tested basis. Also, existing Government support that allows families on Universal Credit and Working Tax Credit to claim a large proportion of childcare costs back should continue to support families beyond these free hours.

25 Institute of Economic Affairs (2016) – Getting the state out of pre-school and childcare

26 Universal Credit (2014) – Universal Credit: Increasing the Childcare Offer

27 With the maximum 70% payout, the actual reimbursement would be £122.50 per week for one child or £210 per week for more than one child. Source: Money Saving Expert – Childcare Costs Help

28 Family and Childcare Trust – 2016 Childcare Survey

## Free childcare provision for a low-income family

| Age of child | Current free provision  | Government's planned extension  | Our proposed expansion of state help               |
|--------------|-------------------------|---|--|
| 1 year old   | No provision            | No provision  | 15 hours (means-tested)                            |
| 2 year old   | 15 hours (means-tested) | 15 hours (means-tested)   | 15 hours (means-tested)                            |
| 3-4 year old | 15 hours free childcare | 15 hours (universal), plus 15 hours for 'working families' (not all low-income families eligible) | 15 hours (universal), plus 15 hours (means-tested) |
| 5 year old   | School starting age     | School starting age   | School starting age                                |

### Our proposed criteria for additional hours of free childcare

Government's proposed criteria of 'working families' is restrictive, particularly at the lower end of the income threshold. For example, in a two-parent family, both parents must be working to be eligible. The need to earn at least the equivalent of 16 hours on the minimum wage per week has also placed doubt on whether parents on zero hour contracts will be able to prove their eligibility.<sup>29</sup> Such problems can be removed by simply using the existing criteria for means-tested free childcare for two year olds. Such criteria, as it is largely based on the receipt of certain types of welfare, is much clearer and has already proven to work for the 167,000 two year olds who currently receive some free early education.

<sup>29</sup> Guardian (2017) – Parents on zero-hours contracts 'could miss out on free childcare'

### Current eligibility criteria for means-tested free childcare that can be used for expansion of means-tested scheme:

- Income Support
- income-based Jobseeker's Allowance
- income-related Employment and Support Allowance
- Universal Credit
- tax credits and annual income of under £16,190 before tax
- the guaranteed element of State Pension Credit
- support through part 6 of the Immigration and Asylum Act
- the Working Tax Credit 4-week run on (the payment you get when you stop qualifying for Working Tax Credit)

A child can also get free early education and childcare if:

- they're looked after by a local council
- they have special education needs (SEN) or an education, health and care (EHC) plan
- they get Disability Living Allowance
- they've left care under a special guardianship order, child arrangements order or adoption order

Source:  
Department  
for Education  
(2015)  
– 2-year-  
old early  
education  
entitlement:  
local authority  
guide

### Proposal #2:

Government should re-invest the money saved from cancelling its planned extension into providing free childcare on a means-tested basis to the most disadvantaged families (and based on current criteria for two year olds). This would consist of 15 hours for one and two year olds and an extra 15 hours (on top of the current universal allocation of 15 hours) for three and four year olds.

# 3. How to mitigate the impact of policy on local childcare markets

## Encouraging childcare providers to make ends meet through cross-subsidisation

Government's proposed extension of childcare hours has consistently been at odds with the views of childcare providers, especially due to concerns that providers will no longer be able to maintain profitability through fee-paying parents of three and four year olds. Thus, any use of public funds must be carefully scrutinised to make sure that they do not substantially alter local childcare markets that would leave childcare providers unable to afford any extension of free hours.

Childcare providers have historically adapted methods of obtaining the necessary finance. This is largely through cross-subsidisation; where parents pay for childcare, beyond the free hours, at a price high enough to subsidise the under-funding of the first 15 hours. Government's current proposed extension of childcare would hamper the ability of providers to make ends meet through this means, with 42.9% of families being eligible for the extra hours.<sup>30</sup> As such, the extension of the free hours may force even more providers into operating at a loss, since parents who are currently paying for the additional hours will, from September 2017, receive it for free.<sup>31</sup> Alternatively, as many studies have suggested,<sup>32</sup> it is likely that many providers will simply refuse to opt into the extension of free childcare hours. The danger for many areas is that the extension of free childcare hours for all working families will weaken the ability of providers to sustain their income levels.

*"If you remove some parents, who are historically paying for the additional hours, and you give them free hours, all that does is simply exacerbate the problem. It effectively doubles the loss that [childcare providers] generate on the first 15 hours".<sup>33</sup>*

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30 Children & Young People Now (2017) – More than 500,000 children to miss out on free 30 hours childcare

31 House of Commons Briefing Paper (2016) – Children: Introduction of 30 hours of free childcare (England)

32 For example, NDNA (2016) – Annual Nursery Survey: England and Family and Childcare Trust (2017) – Quality of childcare put at risk by extending free hours of childcare

33 Interviewee

By contrast, our proposed extension of free childcare on a means-tested basis would allow most local childcare markets to continue to make ends meet by means of cross-subsidisation. For one and two year olds, limiting the free hours to 15 will mean that childcare providers could still rely on payments on the latter 15 hours. Also, the reduced numbers of children eligible for this form of free childcare would mean that, even for providers caring for three and four year olds, there would still be large scope to continue the current method of cross-subsidising for the majority ineligible for 30 hours of free childcare. Using the estimated percentage of two year olds currently eligible for some free early education, we have estimated that **only 24.1% of children will be eligible for a means-tested expansion of free childcare.**<sup>34</sup> Although the precise proportion will range by local authority, it will dramatically increase the scope for childcare providers to make ends meet through cross-subsidisation compared to Government's current plans.

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<sup>34</sup> Number of two year olds currently using free provision sourced from Table 11A, Provision for children under 5 years of age, 2016, ONS  
Total number of two year olds estimated by using total number of 1-4 year olds by local authority, assuming that 25% of children within this band were two year olds. Source: Population estimates – local authority based by five year age band, 2015, ONS [accessed via NOMIS]



| Local authority   | Estimated percentage of two year olds currently eligible for means-tested free childcare |
|---|--|
| Areas with highest proportions of two year olds eligible for means-tested free childcare    |  |
| Middlesbrough   | 50.00%   |
| South Tyneside  | 41.19%   |
| North East Lincolnshire   | 40.50%   |
| Newcastle upon Tyne   | 40.00%   |
| Rochdale  | 40.00%   |
| Areas with the lowest proportions of two year olds eligible for means-tested free childcare |  |
| Surrey  | 10.52%   |
| Kensington and Chelsea  | 10.00%   |
| Windsor and Maidenhead  | 9.86%  |
| Wandsworth  | 8.40%  |
| Wokingham   | 7.14%  |

Source: Table 11A, Provision for children under 5 years of age, 2016, ONS; Population estimates – local authority based by five year age band, 2015, ONS (accessed via NOMIS)

## Enhancing funding levels for 3 and 4 year old children

Some areas will be more limited in their ability to cross-subsidise funds; for example in Middlesbrough and South Tyneside where an estimated 50% and 41% of two year olds respectively are currently eligible for means-tested free childcare. However, such funding concerns should be mitigated by the fact that criteria for means-tested childcare and the Early Years Pupil Premium (EYPP) are closely aligned. The only criteria for means-tested childcare that are not covered by the EYPP are: children with special education needs (SEN), an education, health and care plan (EHC) or receiving a Disability Living Allowance.<sup>35</sup> Therefore, most childcare providers that receive funding to deliver an extra 15 hours of funding for 3 and 4 year olds will receive

<sup>35</sup> Department for Education (2015) – 2-year-old early education entitlement: local authority guide; Department for Education (2015) – early years pupil premium: guide for local authorities

much closer to £5.47 per child per hour rather than £4.94: incorporating both the average level of funding for childcare and 53p per hour per child from the Early Years Pupil Premium.<sup>36</sup> Since substantially less children will be eligible for these hours, such extra money through the EYPP will not cost the Government any more money than its current proposed extension.

Through increasing the capacity of childcare providers to cross-subsidise their funds, as well as ensuring that those providing additional hours are able to access funding through the EYPP, this proposal will ensure that childcare providers are given enough money to sustain these free hours of childcare.

### **Proposal #3**

A more targeted means-tested allocation of free childcare would encourage well-financed local childcare markets by:

- increasing the scope for childcare providers to cross-subsidise funds
- ensuring that childcare providers are given additional money, through the Early Years Pupil Premium, for the majority of 3 and 4 year olds who will be eligible for a further 15 hours

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<sup>36</sup> We recognise that this figure is an over-estimation, given that a small amount of the £4.94 average is from the EYPP and that a proportion of these funds will be retained centrally by local authorities.

# Appendix: full costs of proposal

This appendix fully explains the cost calculations made for the proposed policy changes in this white paper.

The total cost of Government's planned 15 hours extension of free childcare for working families has been estimated at £1,618,003,448.40. This was calculated by using the average of £4.94 per child per hour<sup>37</sup> for 15 hours in 38 weeks of the year. This was then multiplied by the 1,339,430 three and four year olds currently using some form of free education<sup>38</sup> and the estimated 42.9%<sup>39</sup> of children that will be eligible for the extension.

The total cost of the proposed extension of means-tested childcare for one year olds was estimated at £512,840,605.20. This was calculated by:

- using the 166,924 two year olds who currently receive some free early education as a proxy for expected number of one year olds who will use the free hours
- multiplying this by the £5.39 per child per hour allocation for two year olds for 2017/18 for 15 hours in 38 weeks of the year

The total cost of the proposed 15 hour extension of childcare for three and four year olds on a means-tested basis was estimated at £1,040,904,679.20. This was calculated by:

- using the number of two year olds who currently receive some free early education as a proxy for expected usage of the extended free hours
- using a total funding amount of £5.47 (combining the average level of £4.94 for 2017/18 and Early Years Pupil Premium of 53p)<sup>40</sup> for 15 hours in 38 weeks of the year

The total estimated cost of extending means-tested free childcare comes to £1,553,745,284.40. Combined with the reversal of Government's planned extension, this will save an estimated £64,258,164.00.

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37 Department for Education – Local authority allocations under the early years national funding formula  
38 Table 2, Provision for children under 5 years of age, 2016, ONS

39 Children & Young People Now (2017) – More than 500,000 children to miss out on free 30 hours childcare

40 This figure is an over-estimation, given that a small amount of the £4.94 average is from the EYPP

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