



(Un)Taxing Child-care

Boosting Choice and Labour Supply through
Subsidised & Tax-Deductible Child-care in Australia

Rosalind Dixon, Richard Holden & Melissa Vogt

**New Economic
Policy Initiative**



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Introduction & Executive Summary



Australia's child-care system has a number of strengths: it ensures high-quality care for a large number of Australian children. It is sensitive to the needs of disadvantaged children and families. And it contributes to child-care being accessible and affordable to large numbers of Australian families.

But it also has clear limits: a significant number of families report difficulties in accessing and/or affording adequate child-care. Lack of access to appropriate child-care is also a major obstacle to female labour-force participation in Australia.

In this report, we therefore argue that broadening the accessibility and affordability of child-care would offer important benefits for female labour-force participation — and the Australian economy more broadly. And we propose doing so in a quite specific way — by:

- Allowing any households who want to use the current arrangements to continue to use them with no modification, and;
- Allowing any household to opt to forego the current arrangements and instead receive a tax deduction for child-care expenditures up to \$60,000 per annum.

Under our proposal, in two-parent households, *each* parent would qualify for 50% (of their marginal tax rate) deductibility. By construction, this ensures that no household is worse off under our proposed reform—they can always stick with their current subsidy if they so choose. Only households that would be better off under the tax-deductibility option would choose to avail themselves of that option.

Benefits

In addition to recognising child-care as a legitimate work-related tax deduction, our proposal is designed to give parents the choice to increase their labour-force participation. A tax-deductible child-care option gives parents who want to return to the workforce, or work more hours, the ability to do so—at an affordable cost.

This is also a key step in reducing the gender-pay gap, which currently stands at 14.0% for full-time workers.¹ There is overwhelming evidence that workers essentially get paid for their skill or 'human capital'.² Time out of the workforce for parents has many benefits, but it hinders the ability to further develop human capital, and hence future earnings—especially relative to those who do not take time out to engage in care. And while not every parent wishing to return to work is female, and not every mother wishes to return to work, there is a clear correlation between gender and child-care responsibilities.

Survey evidence further suggests that lack of access to appropriate child-care is a major obstacle to parental, and *especially*, *female* labour-force participation.

An obvious potential objection to our two-pronged approach is that it would disproportionately benefit high income earners. We argue, however, that this ignores the significant potential benefits of the policy for Australian families in the second-, third- and fourth-income quintiles; the true nature of the policy (as focused on worker productivity rather than welfare); and the powerful gender equality and fairness arguments in favour of the policy.

Cost

Modelling of child-care deductibility was estimated by Ben Phillips using the ANU PolicyMod model of the Australian Tax and Transfer system. Our policy would leave more than 205,000 households better off, representing 22.5% of households with children. The average couple with children would be \$618 per annum better off.

Although households in the top quintile of the income distribution benefit the most on average—with an average benefit of \$1,080 p.a.—those in the second quintile (the bottom 20%-40% of the income distribution) are on average \$626 p.a. better off. This represents a 1.9% increase in disposal income.³

Without any behaviour change, the additional cost of the policy is estimated to be \$608 million a year, or 7.4% of the cost of the current child-care subsidies.

We estimate that a relatively modest increase in female labour supply—consistent with the best existing evidence on child-care and labour supply using Australian (Household, Income and Labour Dynamics in Australia or ‘HILDA’) data—would lead to the policy more than recouping its tax cost, making it revenue positive for the Commonwealth government.

Moreover, **assuming only 50% take-up of the full amount of tax deductibility among households that would be better off under our policy, Australian GDP would increase by \$3.9 billion per annum—which is roughly equivalent to the size of the entire Australian dairy industry.**







The Current Australian System

Since the 1960s, a growing demand for child-care to support increased female participation in the workforce and child development has led to the introduction and continual reform of Australian federal governmental funding for child-care services.

Government subsidies have improved the accessibility of child-care services for Australian families, and have increased demand for these services nationally. This growing demand, alongside increasingly strict regulations intended to ensure quality in child-care services, has led to significant rises in the costs of child-care, for both families and the government.⁴ Child-care subsidies were predicted in 2018 to reach an annual cost to the federal budget of \$9.5 billion within four years.⁵

The federal government's approach towards child-care reflects the important role child-care services play in society. Child-care services support increased female labour force participation by allowing mothers to return to the workforce. High-quality child-care has also been shown to have significant short- and longer-term benefits for children, including improved academic achievement and general development. The OECD has also identified the contribution of child-care towards increased fertility rates, reduction in poverty, and greater intergenerational social mobility.⁶ These various benefits, however, also present challenges to government policy on child-care services. While government subsidies are intended to lower costs for parents to secure broad access and consequent effects, regulations aimed at raising the quality of child-care also raise costs for parents.⁷

Historical Overview

The provision of federal government financial assistance for child-care services has a long history in Australia. In 1972, the Whitlam Government first began providing funding to non-profit services offering centre-based long day care (LDC). This was extended in the mid-1970s to include pre-schools, family day care (FDC) and outside school hours care (OSHC).

In 1984, standardised fee relief for non-profit centre-based LDC services was introduced (later named Child Care Assistance (CCA)), in order to enable centres to contain fees, making child-care more accessible to low- and middle-income families. In 1990, the CCA was extended to for-profit services, with payments received directly by the services. In 1994, a non-means tested Child-care Cash Rebate Scheme (CCRS) was introduced to provide additional child-care support to families. Following an initial contribution (\$16.50 per week), families could claim either a 20 or 30% rebate, depending on income, on the remaining fees. The CCRS could be claimed for formal or informal care, including nannies.⁸

As a result of these changes, private centres came to dominate the Australian child-care market, leading to the removal of operational subsidies for community-owned LDC services in 1996. This year also the limitation of the CCA to 50 hours per week, the freezing of CCA and CCRS ceilings for two years, and a reduction of the CCRS from 30% to 20% for families whose incomes were above the Family Tax Initiative income cutoff. Further, the 1997-98 budget introduced a limit on CCA of 20 hours per week for families using child-care for non-work-related purposes.⁹

In July 2000, the Howard Government replaced the dual benefit scheme of the CCA and CCRS with a single benefit system, the Child Care Benefit (CCB). Under the CCB, families could receive benefits for up to 50 hours of approved care per week, dependent on means testing.¹⁰ The focus thus shifted from fee-relief to benefit, which was said to allow for a greater choice of providers for consumers.¹¹

“The government projected that its expenditure would rise to \$8.5 billion by 2017-18.”

The CCB could be paid either to the service as an offset to the fees, or claimed by the person as a lump sum at the end of the financial year. All families had access to 24 hours of CCB per child per week, regardless of activity level, with access of up to 50 hours per week available to families where both partners (or the sole parent) undertook at least 15 hours per week of work, study or training. The maximum hourly subsidy rate in 2017-18 was \$4.30. There was an annual family income limit (for a single child) of \$159,914.¹²

The Grandparent CCB was also available for grandparents who acted as primary carers, and the Special CCB was available for families experiencing hardship or for children at risk.¹³

Following pressure from families excluded by the CCB means test, in 2004, the government introduced a non-means tested Child Care Tax Rebate (CCTR). The CCTR allowed families with a tax liability to offset up to 30% of out-of-pocket child-care expenses, up to an indexed cap of \$4,000 per child per year.¹⁴ The CCTR was available to any families eligible for the CCB, even at a zero rate, but subject to an activity requirement without any minimum hours. The payment could be made to a child-care service fortnightly or to the individual fortnightly, quarterly or annually. However, some argued this system unfairly favoured high-income earners, as those with a low tax liability would potentially receive no or a very small rebate.¹⁵

In July 2006, the Rudd Government removed the CCTR from the tax system, and began delivering it as a family assistance payment through Centrelink, meaning families with no or low tax liability could also receive the payment (later renamed the Child Care Rebate (CCR)). Two years later, the CCTR was increased to 50% of out-of-pocket costs, after any CCB was deducted, with an indexed cap of \$7,500 per child per year. Because payments increased with the actual cost of child care, strong demand and a steep increase in the cost of child-care meant the CCR began to consume a larger share of the Federal Budget.¹⁶ After reaching \$7,941 in 2010-2011, in July 2011, the CCR cap was reduced to \$7,500, and indexation was paused for three years.

In addition, the Jobs, Education and Training Child Care Fee Assistance (JETCCFA) provided assistance to eligible parents who qualified for the maximum rate of CCB. It paid most of the gap in out-of-pocket costs not covered by the CCB, while a parent was working, studying or training.¹⁸ The government also provided various concessions and tax exemptions to formal child-care providers.¹⁹

In 2013-14, government expenditure on child-care subsidies amounted to \$6.7 billion overall, with \$2.9 billion spent on the CCB, \$2.7 billion on the CCR, and \$0.1 billion on the JETCCFA. Around 686,000 families received both the CCB and CCR, with 89,000 families receiving only the CCB, and 35,000 families also receiving the JETCCFA alongside these payments. The government projected that its expenditure would rise to \$8.5 billion by 2017-18.²⁰ The cost to taxpayers of child-care assistance grew from 0.8% of total Australian Government expenditure in 2003-4, to a projected 1.7% in 2014-15.²¹

In an effort to counter the increasing costs, in 2013, the federal government commissioned the Productivity Commission to undertake a detailed inquiry into child-care and early childhood education, with a focus on possible options for future regulation and funding.²² The Commission found that the government overall paid around two thirds of the cost of approved child-care, with families paying the residual. It also noted that an increasing proportion of taxpayer assistance was going to higher-income families,²³ and suggested a need to shift the focus of subsidies 'toward those employed on low to middle level family incomes that may, in the longer term, provide savings for the community in terms of reduced transfer payments and reduced intervention to address child development problems'.²⁴

In its report, the Commission recommended a single, child-based subsidy with means- and activity-testing. The benefit would be paid directly to the family's choice of approved services, for up to 100 hours per fortnight, with the amount based on a benchmark price for early education and care.²⁵ The Commission also made several recommendations to improve accessibility, 'particularly for those families with parents needing to work irregular or non-standard hours', including the extension of government assistance to home-based care services, such as approved nannies.²⁶ The Commission further recommended changes to child-care service regulations for this purpose, including removing operating hours restrictions.²⁷ However, the Commission recommended against making child-care costs tax deductible, on the basis that it is 'not an effective means of support for lower and middle income families', and 'non-transparent, inefficient, inequitable, inconsistent with established tax deductibility principles and unsustainable'.²⁸

Current System



Following the Commission's report, in 2018, after significant debate and reformulation, the Child Care Subsidy (CCS) was introduced to replace the CCB and CCR. The CCS provides a capped, means-tested subsidy directly to a family's chosen child-care provider.

According to then-Minister for Education and Training, Simon Birmingham, the CCS is intended to [target] child-care subsidies to people who really need it to be able to engage in the type of activities we want people to be active in our society doing'.²⁹ The package was debated for two years in the Australian Parliament, with early childhood advocates expressing concern that it would reduce the capacity of disadvantaged families on low and irregular incomes to access child-care.³⁰

The CCS is largely based on the benchmark price model proposed by the Productivity Commission.³¹ It is paid as a percentage of the child-care fee charged, up to an hourly cap set to increase in line with the consumer price index (CPI). At July 2018, the hourly rate caps were \$11.77 for Centre Based Day Care, \$10.90 for Family Day Care, and \$10.29 for Outside School Care.³² The amount that a family receives per child is based on the combined family income. For families with an income of \$66,958 or less, the maximum rate is 85% of the fee charged, which tapers to 50% at an income of \$171,958, and then tapers again at an income of \$251,248, reaching a rate of 20% at \$341,248. Families with an income of \$351,248 or above are not eligible for the CCS. In addition, for families with a joint annual income over \$186,958, there is a subsidy cap of \$10,190 per child per year. For families with lower incomes, there is no cap.³³

The number of hours of subsidy a family is entitled to is subject to an activity test. For couples, the activity test is based on the hours of activity of the member with the fewest hours. Recognised activities include paid work, being self-employed, doing unpaid work in a family business, looking for work, volunteering and studying. Where 8-16 hours of activity are engaged in per fortnight, 36 hours of subsidy per fortnight are available per child. For 16-48 activity hours, 72 hours are available, while 100 hours are available for 48 activity hours. In addition, under the Child Care Safety Net (CCSN), families with an annual income of \$66,958 or less who do not meet the activity test are entitled to 24 hours of subsidized care per fortnight.³⁴

The current system also incorporates an Additional Child Care Subsidy (ACCS) to provide greater fee assistance to families facing barriers in accessing affordable child-care. The ACCS is available where children are at risk of serious abuse or neglect; to grandparents who act as primary carers; to families experiencing significant financial stress with the cost of child-care due to exceptional circumstances; and to parents transitioning from income support to work by engaging in work, study or training activities.³⁵

In addition, when the new child-care subsidy package was originally developed by the Abbott Government in 2015, it also included the Nanny Pilot Programme (NPP). The NPP was intended to make child-care more flexible by allowing eligible families to use subsidized nanny care at home when needed.³⁶ The trial was discontinued in July 2018 due to a lower than anticipated take up rate, likely due to the high out-of-pocket costs for families.³⁷



Users and Providers of Child-care in Australia

The proportion of Australian children who attend some form of formal child-care has gradually increased overtime, with 19% of children aged 0 to 12 engaging in formal child-care in 2017, up from 9% in 1996. Meanwhile, the proportion of children in informal care has decreased, from 31% in 1996 to 19% in 2017, and the proportion of children using both types of care has increased slightly from 6% in 1996 to 9% in 2017.³⁸ The numbers are higher for younger children, with 55.1% of all children aged 2 years, 61.8% of 3-year-olds, and 54.2% of 4-year-olds attending government-approved child care in 2015.³⁹ Overall, in 2014, the AMP reported that 887,000 families use formal child-care in Australia, with nearly 1.3 million children attending around 13,000 approved child-care centres.⁴⁰ Comparatively, Australia ranks in the middle of OECD countries in respect of the proportion of children using formal child-care.⁴¹

In terms of child-care providers, most child-care services are delivered by private providers on a fee-for-service basis.⁴² LDC is the most commonly used form of formal child-care, with around 630,000 Australian families accessing LDC in 2014. LDC is mostly targeted at children aged five and under who are not yet in primary school. Meanwhile, FDC, or home-based care from registered carers, is used by around 109,000 families, while around 117,000 families access before school care, and around 241,000 families use after school care.⁴³

Reflecting this demand, as of July 2018, there were more than 15,000 approved child-care services in Australia.⁴⁴ The child-care market in Australia is considered relatively unconcentrated, consisting of a number of large-scale corporate and non-profit providers, alongside many small, local providers.⁴⁵ Private, for-profit providers operate 47% of all approved child-care services nationally, including 64% of LDC services, with the remainder being various non-profit and community-based services. Around 8% of child-care services are directly managed by state and local governments.⁴⁶

Advantages of the Current System



The current child-care subsidy system plays an integral role in ensuring the affordability and accessibility of formal child-care across Australia for a significant percentage of families, including low-income households. In so doing, the system provides essential support to families, and especially mothers, seeking to re-enter the workforce.

Affordability and Access

The cost of formal child-care across Australia has increased significantly overtime. Of the 87 expenditure categories monitored by the ABS between 2009 and 2014, the price growth in child-care was eclipsed only by utilities and tobacco. Child-care prices in this period increased by 44.2%, 12 percentage points higher than education services and 8 percentage points higher than petrol.⁴⁷ From 2008 to 2017, hourly fees for LDC increased at an average annual rate of 6.5%, well above inflation.⁴⁸

Given these rising costs, the government subsidy system has been integral in largely preventing long-term out-of-pocket child-care prices from rising much faster than the CPI.⁴⁹ In 2014, the Productivity Commission noted that out-of-pocket costs in Australia, while constituting 27% of average wages, and thus above the OECD average of 17%, sat well below those in the United Kingdom, United States, New Zealand and Canada.⁵⁰ In 2017, the HILDA survey found that more than 90% of families using approved child-care services were eligible for government subsidies, which reduced their out-of-pocket costs by up to 50%. Without government subsidies, out-of-pocket costs would be as high as 28% of weekly disposable income for families on an annual income of \$35,000, but with government subsidies, costs were reduced to 7.6% of weekly disposable income on average.⁵¹

Government subsidies thus play a key role in ensuring access to child-care services, as affordability is generally ranked by parents as one of the most important factors in selecting child-care.⁵² In particular, the hourly subsidy cap under the current system is believed to be aimed at 'discourag[ing] child-care services from raising prices above the benchmark price, as fees in excess of the cap will not be subsidised'.⁵³

Low-income Households and Equality

The current system targets low-income households in particular to enhance equality in accessing formal child-care. This can be seen in the tapering of the subsidy rate received, with families with an income of \$66,958 or less receiving the maximum rate of 85%, as well as access to 24 hours of subsidized care per fortnight regardless of activity. The ACCS can also be accessed by families experiencing significant financial difficulties in affording child-care, or seeking to transition from income support to the workforce.⁵⁴ The provision of a guaranteed subsidy to low-income households, regardless of activity level, is in part a reflection of the greater need children from these households may have for the benefits associated with formal child-care services. Research has consistently demonstrated that high-quality child-care provides particularly strong short- and long-term outcomes for children from disadvantaged families.⁵⁵ These benefits include improved educational outcomes and general development, reduction in poverty, and increased intergenerational social mobility.⁵⁶

Whether the current system is effective in ensuring equality of access to formal child-care is unclear. However, in respect of the previous subsidy system, the AMP in 2014 found that reported difficulties with affording child-care were lower in areas of relatively low advantage (30%), compared with households from areas of middle to high advantage (37 and 40% respectively). This may reflect the effect of government subsidies aimed at low-income households, although it may also be influenced by the greater use of child-care by middle- and high-income households where two parents are participating in the paid workforce.⁵⁷

Female Labour Force Participation

Encouraging female labour-force participation is an essential component of gender equality, in addition to having many significant national benefits, including increases in tax payments and reductions in government pension, allowance and family payments.⁵⁸ For families, however, the cost of child-care, loss of government benefits and increased personal income taxation can mean that when a household's secondary earner (usually female), or single parent, returns to work or increases their hours, the financial return may be negligible.⁵⁹

Government child-care subsidies thus play a key role in encouraging greater participation by parents, especially mothers, in the labour force. Although the extent of the influence child-care affordability has on female labour force participation is disputed,⁶⁰ studies have estimated that a one% increase in the gross price of child-care for pre-school children leads to a decrease in hours worked by women in relationships of 0.10%, and a decrease in the employment rate of 0.06%.⁶¹

Consistent with this, between 1980 and 2014, female labour participation in Australia increased by about 15 percentage points, rising from 44% in the late 1970s to 59% in 2013, with much of this increase in part-time and casual employment. Women now account for around 39% of the total hours worked, up from 30% in 1978.⁶² More specifically, in 2014, it was reported that the workforce participation rate of mothers with a child under 15 years had grown from 57 to 67% over the previous two decades.⁶³ While this increase may be partially attributed to changing societal attitudes towards working mothers and increased educational opportunities for women, the greater availability and affordability of child-care is considered to have had a strong effect.⁶⁴ At present, Australia sits in the middle of international rankings of female to male employment ratios.⁶⁵

In addition, while the ABS has found that caring for children remains the most common perceived barrier to female participation in the labour market, a drop in the number of women reporting that they felt unable to start work or increase their working hours due to perceived barriers was reported in 2016-17 (down from 740,000 women in 2014-15 to 665,000 in 2016-17).⁶⁶ This decrease may be related to the increased affordability and accessibility of child-care.

“Government child-care subsidies thus play a key role in encouraging greater participation by parents, especially mothers, in the labour force.”

Disadvantages and Limits of the Current System

Despite efforts to improve the child-care subsidy system, many Australian families continue to experience challenges in accessing child-care that is both affordable and sufficiently flexible to meet their varied needs.

Ongoing Affordability Issues

Although government subsidies play an essential role in making child-care more affordable for Australian families, ongoing affordability issues remain. As noted above, in 2014, out-of-pocket costs for child-care in Australia constituted 27% of average wages, above the OECD average of 17%.⁶⁷ These costs have continued to grow. From 2011 to 2017, the average weekly out-of-pocket costs of formal child-care increased by 48.7% in inflation-adjusted terms, amounting to an average real increase in fees of 6.8% annually (without a substantial increase in the hours of formal child-care attended).⁶⁸

Furthermore, between 2002 and 2010, more than 3 out of 10 Australian households reported difficulties affording child-care.⁶⁹ The 2017 HILDA survey also found that the proportion of parents experiencing substantial difficulties with the costs of child-care had risen significantly since 2002.⁷⁰

The reasons behind the continuing increase in child-care costs are uncertain. Child-care services are necessarily high cost, and governmental regulations requiring, for example, low ratios of staff to children and certain staff qualifications make these services 'very labour intensive and expensive to operate'.⁷¹ There is considerable dispute as to whether these regulations, at both a federal and state level, are an essential component of ensuring safe, high-quality child-care services, or an unnecessary burden on child-care services preventing competition and driving up costs.⁷² The Australian Child-care Alliance NSW, for example, in February 2019 called for an inquiry into the increasing cost of child-care, with a focus on issues such as red tape, regulation and planning which it claims burden NSW families more than families in any other state.⁷³

However, there is also strong evidence that government subsidies themselves have contributed to an increase in the average cost of child-care.⁷⁴ By increasing demand for child-care services, government subsidies allow for child-care providers to react with increased prices, which leads to the need for greater assistance and thus an ongoing cycle.⁷⁵ In support of this, the Productivity Commission in 2014 suggested that some of the increase in the average price of child-care had little relevance to the actual costs of child-care.

“By increasing demand for child-care services, government subsidies allow for child-care providers to react with increased prices, which leads to the need for greater assistance and thus an ongoing cycle.”



For example, although children aged 0 to 2 years can be twice as expensive to care for in LDC, when compared with children aged 3 to 5, there is usually little or no difference in fees charged to parents.⁷⁶ The positive correlation between government subsidies and increasing child-care costs is also supported by several international studies on child-care affordability.⁷⁷ As a result, '[i]mprovements in affordability have been short lived, with benefits quickly absorbed through higher costs charged to families. The result is an ongoing game of catch up between government and service providers with families stuck in the middle'.⁷⁸

There is also some evidence to suggest that child-care is less affordable for low- and middle-income families under the CCS system, in comparison with the previous CCB and CCR system. When the CCS was announced, reports suggested that 161,003 such families would be worse off under the new system, and a further 15,692 families would receive no assistance at all, due both to the more burdensome activity requirements under the new system and the linkage between payments and how much child-care centres charge for their services.⁷⁹ While the government argued the system would encourage more than 230,000 families to work or study more, the opposition suggested it would lead to children from lower socioeconomic backgrounds spending less time in early education.⁸⁰ This may be a particularly strong issue for families where at least one parent is engaged in more unstable, insecure work, as changes in working hours week-to-week will affect the number of hours of subsidized child-care that can be accessed.⁸¹

Availability and Accessibility Challenges

Alongside affordability issues, Australian families continue to experience challenges in finding available and accessible child-care. These factors necessarily impact on the ability of parents to engage in the Australian labour force, and for children from all backgrounds to experience the benefits of formal child-care.

The extent to which Australian families experience difficulty in finding available child-care places is contested. This may partly reflect significant variation in availability across different areas and age groups. As such, while the majority of child-care services regularly report the existence of vacancies to the Department of Education and Training,⁸² the Productivity Commission in 2014 noted long waiting lists for some groups, especially babies in city LDC centres.⁸³ The Commission also noted a lack of access to suitable services for children with additional needs, including those at risk of abuse or neglect, with a diagnosed disability, or developmentally vulnerable (such as children who do not speak English at home).⁸⁴

More recent reports have suggested waiting lists reach as high as two years in some urban areas, with places for children aged under two and after-school care services particularly undersupplied.⁸⁵ For example, a 2017 survey of community-run child-care services found almost 70% had waiting lists, with waiting lists for children aged under two averaging around one to two years, while waiting lists for children aged two to three were six to 12 months on average.⁸⁶

Surveys of parents also support the existence of availability issues. In a 2013 study, availability difficulties were reported by 24% of households in areas of relatively high socio-economic advantage, 15% of households in areas of medium advantage, and 14% of households in areas of relatively low advantage.⁸⁷ The 2017 HILDA survey found that the majority of parents who experienced persistent difficulties in obtaining child-care reported availability as a key concern.⁸⁸ Parents surveyed by HREOC also frequently raised issues of availability, suggesting this is a critical issue for many families.⁸⁹

In addition to broader availability issues, the accessibility of child-care services remains a key issue. The ability of families to access child-care services at needed times and locations is integral to enabling greater parental, and particularly female, participation in the labour force. The 2017 HILDA survey identified finding accessible child-care as one of the most common difficulties experienced by parents using, or considering using, child-care.⁹⁰ The Productivity Commission in 2014 also reported that many parents had difficulty accessing services that enabled them to increase their work hours, particularly before and after school hours care.⁹¹

Factors contributing to ongoing availability and accessibility issues likely include a greater demand for such services, due in part to governmental subsidies, and the impact of regulatory restrictions. These restrictions, which place limitations on operating hours and locations, as well as mandating certain teaching requirements and staff-to-child ratios, limit the possibility for flexibility and variation between different child-care services.⁹² This is despite evidence that many parents have a preference for more flexible child-care which may have more limited educational benefits, such as nannies, au pairs and family day care.⁹³ There is support for the need for child-care services to 'have greater autonomy to tailor their services to parents' individual preferences', for example by providing a "no-frills" services ... offer[ing] other benefits, such as flexible opening times or lower prices', in order to improve families' access to child-care.⁹⁴

The significant challenge in ensuring more flexible, accessible child-care services is illustrated by the largely unsuccessful flexible child-care trial introduced in June 2013 by the Gillard Labor government. This trial offered families after-hours, overnight and weekend care, in addition to more outside school hours care. While it was anticipated that more than 500 families would participate, by February 2014, only 80 to 100 families had taken part. The trial's failure was attributed in part to incompatibilities between when extra care was actually available and the times at which it was needed, and between where providers were located and where families needed care. In addition, while many families wanted to access the care only on an ad-hoc basis, providers needed a regular commitment from parents to remain viable.⁹⁵

Child-care Caps and Barriers to Female Labour Force Participation

Although government subsidies provide an incentive for greater participation by mothers in the labour force, there is substantial evidence that limitations to the affordability, availability and accessibility of child-care continue to impact on participation levels. In particular, the Productivity Commission in 2014 suggested that families appeared to be cutting back on their use of child-care in order to keep their out-of-pocket costs below the CCR cap, with only around 5% of families reaching the cap.⁹⁶ It estimated that there may be close to 165,000 parents who would like to work, or increase their working hours, but are not able to do so due to difficulties affording and accessing suitable child-care.⁹⁷

In addition to an increase in out-of-pocket child-care costs, the Commission identified the tax and transfer system as creating 'a strong disincentive for some parents to enter the workforce or to increase their hours of work'.⁹⁸ For some second income earners who return to work and use child-care, the Commission reported that 'the combination of a drop-off in Family Tax Benefits once family income rises, progressive income tax rates, reduced CCB assistance at higher income levels and the cap on CCR assistance, can result in an effective marginal tax rate approaching 100%, particularly once work exceeds 3 days per week'.⁹⁹

This is a particularly significant issue for low- and middle-income families, due to the greater loss of government benefits associated with a return to work or an increase in working hours.¹⁰⁰ For example, in 2014, the AMP estimated that a mother from a low-income family returning to work part-time (20 hours) would lose about 69% of her income to income tax, loss of government benefits and paying for child-care. If she decided to increase her hours to full-time (40 hours), this would result in a loss of around 75% of her pay for those extra 20 hours.¹⁰¹ A mother from a middle-income family would lose 45% of her income if working part-time, and 60% if she went back full-time, while a mother from a high-income family would lose 47.7% of her salary at part-time, and 53% at full-time.¹⁰²

As a result, if the Australian government wants to seriously encourage greater female participation in the workforce, the AMP and Productivity Commission have suggested the need for a continuing focus especially on the affordability of child-care, and how the tax and benefits systems interact with family income.¹⁰³







Towards Tax Deductibility

Our Proposal

The proposal we consider in this report takes the existing child-care subsidies as a baseline and *adds the option* of tax deductibility for parents.

Our proposal involves:

- Allowing any household to opt to forego the current arrangements and instead receive who want to use the current arrangements to continue to use them with no modification; and
- current arrangements and instead receive a tax deduction for work-related child-care expenditures up to \$60,000 per annum to choose that option (for two-parent households, the deduction is split 50-50 between both income-earners).

By construction, this ensures that no household is worse off under our proposed reform—they can always stick with their current subsidy if they so choose. Only households that would be better off under tax-deductibility option would choose to avail themselves of that option.

The cap we propose acknowledges that child-care in Australia is expensive, particularly in cities like Sydney and Melbourne. It was widely reported earlier this year that LDC per day costs in Sydney were around \$200 per child.¹⁰⁴ On a 5-day per week, 48-week per year basis this is \$48,000 in expenses for one child.

An experienced nanny can easily cost \$35 per hour, amounting to over \$80,000 for similar hours to LDC. The \$60,000 cap for legitimate, work-related out of pocket expenses strikes a balance between recognising the high cost of child-care and putting some limits on overly-expensive ‘gold-plated’ nanny options.

“The cap we propose acknowledges that child-care in Australia is expensive, particularly in cities like Sydney and Melbourne.”

Female Labour Force Participation and Wages

An important part of the rationale for our plan is that it will increase choice about work and care for women and potentially increase female labour force participation. As discussed above, under the existing child-care subsidy arrangements, it is estimated that there may be close to 165,000 parents who either do not work or work fewer hours than they would like to due to difficulties in affording and accessing suitable child-care.¹⁰⁵

In addition, the *effective marginal tax rate* on additional work can be extremely high. As the Productivity Commission has noted, the tapering off of Family Tax Benefits and child-care benefits, combined with standard marginal income tax rates, ‘can result in an effective marginal tax rate approaching 100%, particularly once work exceeds 3 days per week’.¹⁰⁶

Our plan directly addresses these issues, and provides more choice for parents that will boost the overall labour supply in Australia — and especially female labour supply. While not every parent wishing to return to work is female, and not every mother wishes to return to work, there is a clear correlation between gender and child-care responsibilities.¹⁰⁷ Making formal child-care more affordable, through increased tax deductibility, is therefore likely to have a significant impact on female labour supply in particular.

How large this increase in female-labour supply would be is, of course, uncertain. There is, however, good evidence that provides guidance on the potential impact.

To assess the potential impact of our proposal on female labour supply requires an understanding of how labour supply and child-care decisions are jointly determined. Gong and Breunig (GB) perform just such an exercise, estimating a structural model of labour supply and child-care demand using Australian data and the architecture of the Australian tax and transfer system.¹⁰⁸

(GB) find that tax credits have a larger positive

effect on labour supply, household incomes, and government revenues than child-care subsidies. For each dollar of tax rebate received, a mother’s labour supply increases by 75% more than under a subsidy system. The GB model a 30% rebate up to a cap of \$4,000 of tax rebate per annum, but the treatment effect of their analysis is broadly applicable to tax deductibility at the relevant marginal tax rate.

GB point out that there are different distributional impacts of tax rebates/deductibility versus child-care subsidies. Our proposal allows households to make a choice between the existing, and quite generous, child-care subsidy and tax deductibility—and thus a choice based on which will make them better off. Consequently, no household is worse off under our proposal.

Boosting female labour-force participation is also a vital step in reducing the gender-pay gap. Among full time workers, women earn only 86% of their male counterparts’ earnings.¹⁰⁹ Due to legal prohibitions on active gender-based discrimination, this gap is more related to opportunities and skill development, than with women being paid less for doing the same job just as well as a man.

There is overwhelming evidence that workers essentially get paid for their skill or ‘human capital’.¹¹⁰ Time out of the workforce for women has many benefits, but it hinders the ability to further develop human capital, and hence future earnings—especially relative to those who do not take time out to engage in care.

Fairness to Australian Workers and Families

One potential objection to this two-pronged approach is that it would benefit high income earners. There are, however, three important answers to this: first, it ignores the actual distribution of the likely benefits of the policy; second, it misconceives the nature of the policy (as welfare— rather than productivity-focused); and third, it ignores the significant gender equality and fairness arguments in favour of the policy.

To assess the impact of our proposal, Professor Ben Phillips conducted modelling of child-care deductibility using the ANU *PolicyMod* model of the Australian Tax and Transfer system. This analysis takes existing labour-supply choices as *given* (i.e. assumes no behavioural response to the policy) and looks at which households would be better off, and by how much, under our proposal.

This analysis also showed that the proposal would benefit a large number of Australian families in the second, third, and fourth income quintiles—not just the top income bracket. Figure 1 shows that, overall, more than 205,000 of the just over 1 million ‘child-care households’ are better off under our proposal. Although the majority of these are among the top 20% of household by income, there are between 20,000 and 30,000 households in each of the second, third, and fourth income quintiles that also benefit. Related to this, Figure 2 shows that more than 20% of households in the top income quintile benefit from the proposal, while around 5% of households in the second, third, and fourth income quintiles benefit.

Figure 1: Households Better Off by Income Quintile

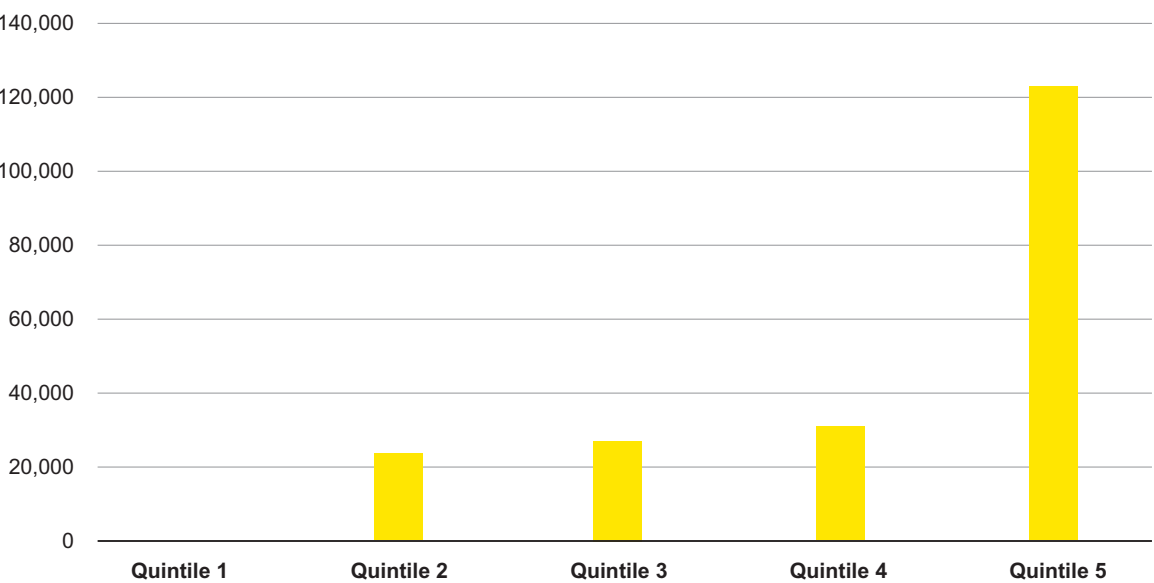


Figure 2: Proportion of (couple) Households Better Off by Income Quintile

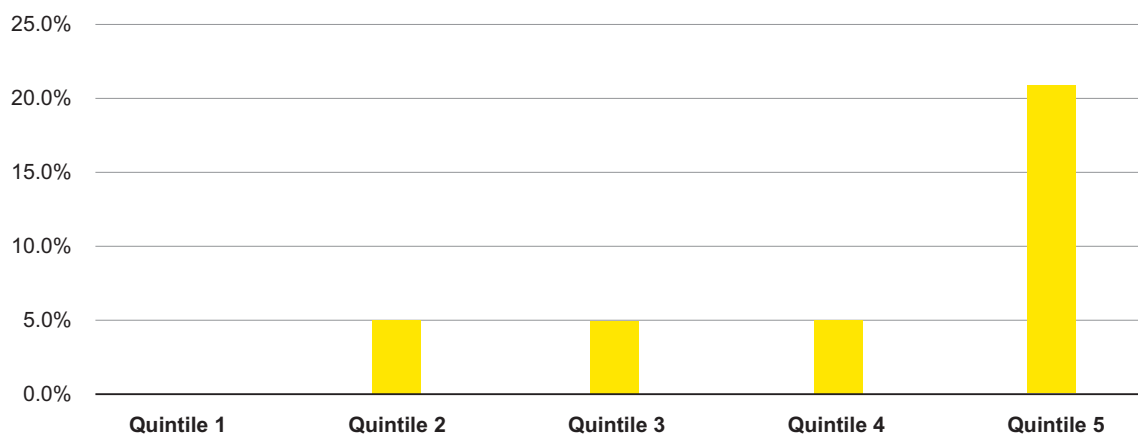
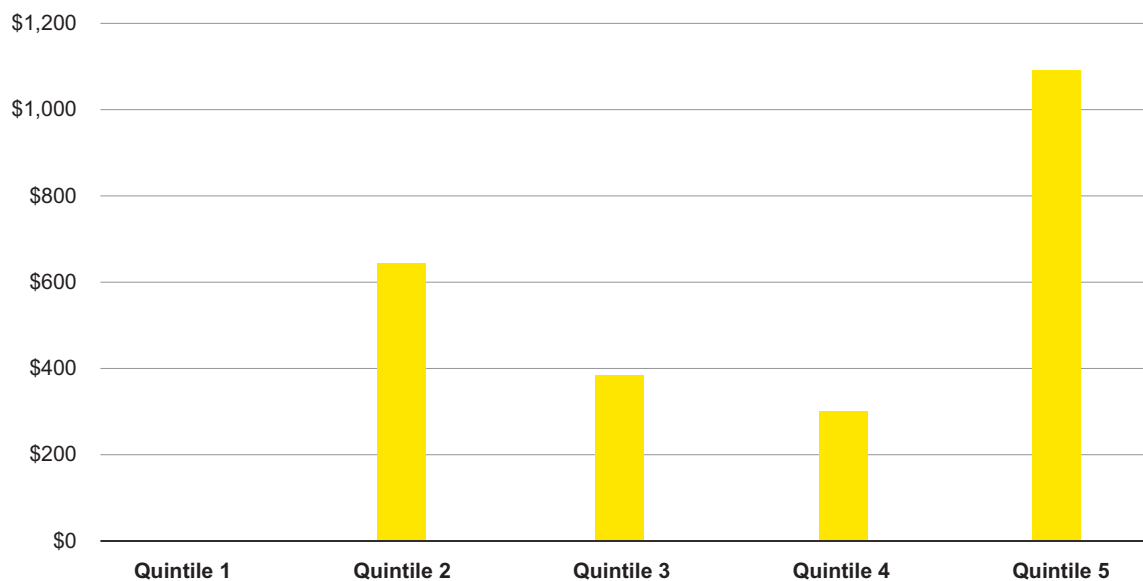


Figure 3 highlights the annual dollar benefit to households by income quintile. Although the top quintile benefits the most, with an average annual benefit of just over \$1,000, it is the fourth income quintile that benefits the second most, with an average annual benefit of more than \$600, materially higher than quintiles 3 and 4.

This is a reminder of the complexities of the Australian tax and transfer system and, importantly, that the tax deductibility of child-care is not merely beneficial to high-income households.

Figure 3: Annual Benefit for (couple) Households by Income Quintile



First, as we explain below, when factoring in the labour-supply response, treating child-care as tax deductible would likely generate far more gains than costs to the Australian economy overall, and should therefore be viewed as a form of government investment in labour productivity, and not a form of welfare payment or transfer. As such, it also need not be designed as targeted to benefit the neediest or most economically disadvantaged Australians.

Second, 'untaxing'—or offering deductibility—for child-care is ultimately a matter of fundamental fairness. Almost all other legitimate work-related expenses are currently treated by the Australian tax system as deductible against labour income, at least up to some amount — including the costs of uniforms and laundry, tools and equipment (eg, computers, software), some work-related travel, and work-related training and education.¹¹¹ This system is intended to 'encourage individuals and companies to engage in particular behaviours (and to discourage others)', including work-related activities.¹¹²

Child-care also has the same logical nexus to work: without child-care, many parents simply cannot participate in the labour force. Some families have access to informal child-care, through a spouse or family member. But not all families have that choice — or wish to exercise it.

And government policy should respond to and reward the choices and opportunities facing all Australian families — both those wishing to spend time out of the workforce engaging in care, and those wishing to return to the workforce by relying on formal child-care.

To hold otherwise would simply be to uphold an unfair and outmoded view of family structure, and the role of Australian women and men at home and in the workforce. Those committed to equality should also be concerned to end discrimination on both economic and gender-based grounds. Commitments to equality and fundamental fairness therefore demand that, where informal care is not available either because of family structure or choice, the costs of formal care should be viewed as a legitimate work-related expense.



Windfall Gains to Some Families?



One important consideration in allowing for tax deductibility of child-care expenses is the possibility of delivering a windfall gain to certain high-income households without encouraging female labour force participation.

For instance, a family that has one earner and one stay-at-home parent could be significantly better off with blanket tax deductibility and no activity test, than under the current scheme. Under the current scheme, such households would generally not qualify for the CCS, but under an unrestricted tax-deductibility model, the child-care cost would be in the name of the higher income earner for tax purposes and that person would receive benefit equal to the cost of child-care multiplied by their marginal tax rate.

To address this concern, under our proposal, in two-parent households each parent would qualify for 50% (of their marginal tax rate) deductibility (deductibility splitting). This would not completely eliminate a windfall gain for some parents, who choose to claim deductibility but without any change in their existing household work or care arrangements. But it at least *partly* addresses the ‘windfall benefit’ concern just outlined — by limiting it to at most 50% of the proposed deductibility threshold.

In a sense, deductibility splitting provides a kind of ‘implicit’ activity test encouraging the stay-at-home parent to work, at least some amount. But it would be much more robust than standard activity tests.

Standard activity tests involve significant, and costly, information gathering, processing, and auditing. These tests are subject to the well-known phenomenon of ‘gaming’,¹¹³ can provide counterproductive incentives, and involve substantial enforcement and compliance costs.

By contrast, our approach sidesteps such issues because, in the language of game theory, it is an *incentive-compatible* mechanism. That is, the incentives are designed such that an individual will find it in their interest to behave as the designer of the scheme predicts they will. In this setting, it means that the tax deductibility split encourages female labour-force participation at the margin. Moreover, it does so in a way that does not involve a lot of information gathering and administrative work.

Cost of the proposal

As part of his analysis, using the ANU *PolicyMod* model of the Australian Tax and Transfer system, Professor Phillips estimated the cost of our proposal to the government. Table 1 contains the full set of results from the Ben Phillips-PolicyMod Analysis. It also shows a projected budgetary cost of \$608 million assuming no behavioural/labour-supply change, and notes that this is relative to the \$8.267 billion budgeted to be spent on existing child-care subsidies in the 2019 fiscal year.

Family Type by Income Quintile \$pa change in disposable income*

	Quintile 1	Quintile 2	Quintile 3	Quintile 4	Quintile 5	Total
Couple with Children	\$0	\$116	\$115	\$134	\$555	\$221
Single Parents	\$0	\$9	\$23	\$0	\$0	\$8
Family Type by Income Quintile, Childcare families only						
Couple with Children	\$0	\$626	\$390	\$298	\$1,080	\$618
Single Parents	\$0	\$35	\$103	\$2	\$0	\$42
Family Type by Income Quintile % change in disposable income, childcare families only						
Couple with Children	0.0%	0.8%	0.4%	0.2%	0.4%	0.4%
Single Parents	0.0%	0.1%	0.1%	0.0%	0.0%	0.1%
Winner Share (All Households)						
Couple with Children	0.0%	5.1%	5.1%	5.0%	21.0%	7.6%
Single Parents	0.0%	0.6%	0.3%	0.0%	0.0%	0.2%
Winner Share (Childcare Households)						
Couple with Children	0.0%	26.2%	16.5%	10.6%	33.8%	21.2%
Single Parents	0.0%	1.5%	0.4%	0.0%	0.0%	1.3%
Winner Number (Childcare Households)						
Couple with Children	0	23,173	27,160	29,186	107,474	186,993
Single Parents	0	1,291	495	16	0	1,802
All Households (winners)	0	24,464	27,655	29,202	123,867	205,188
All Childcare Households	58,620	160,903	209,900	299,167	347,125	1,075,715
Total Cost \$m (2019-20)	\$608					
Base Expenditure \$m	\$8,276					
Alternative policy \$m	\$8,884					
2019 Budget Projection (base)**	\$8,267					

Source: ANU PolicyMod (ANU Model of the Australian Tax and Transfer System)

* Use caution with single parent results, particularly higher income single parents due to small sample size

** Budget paper number 1

Net Costs

In terms of the cost of the proposal, it is useful to note that any increase in female-labour force participation due to the tax-deductibility option will increase government tax revenues. Indeed, it could be the case that increased female labour force participation eliminates the baseline \$608 million cost to the government, or indeed leads to a net positive tax take for the government. This naturally depends on two factors: (i) the amount of increased labour supply, and (ii) the average marginal tax rate (AMTR) of the workers who work more.

Assuming an AMTR of 40.17% (the average of the top three marginal tax rates including the Medicare Levy) the 'budget breakeven point' would be \$1.69 billion in additional earnings as a result of the proposal. Given that households in the top four income quintiles stand to benefit from increased labour supply, the budget-breakeven additional work per female member of such households is approximately \$2,800 per annum.

This is a very modest increase in labour supply and demonstrates that there is a high likelihood that our proposal would pay for itself (or more) from a fiscal standpoint, as well as having the other benefits that we have emphasised.

We can quantify the potential economic impact of increased female labour-supply using the GB estimates of elasticities and Australian Bureau of Statistics data on total hours worked in the economy, Gross Domestic Product, and the labour share of national income.¹¹⁴

To be conservative, we assume that only 50% of the eligible child-care cap (of \$60,000 per annum per household) is used. We further assume that it is only utilised by those households (205,188 of them) that are better off with no behavioural change. This is clearly an underestimate since there would be additional households that benefit from tax deductibility given behavioural change.

Given these assumptions, the 1.776 billion monthly hours worked across the Australian economy, and the 2018 levels of GDP and the approximately 53% labour income share of national income, our policy would generate an additional \$3.9 billion in economic output. Even under **our conservative assumptions, this is roughly equivalent to the size of the entire Australian dairy industry**, which had farmgate production value of \$4.27 billion in 2018.¹¹⁵

Of course, it is important to remember that unpaid work in the home is not counted as part of GDP, despite its importance. The boost in female labour-force participation is measured, as part of the analysis above, but clearly will substitute in part for unpaid work in the home. A more holistic view of value in the economy would, of course, take this into account. But that raises broader issues that are beyond the scope of this report.

“It is important to remember that unpaid work in the home is not counted as part of GDP, despite its importance. The boost in female labour-force participation is measured, as part of the analysis above, but clearly will substitute in part for unpaid work in the home.”

Similar Models Globally

Our model is not the first of its kind globally, with other countries adopting a tax deductibility or hybrid model. For example, in Belgium, the costs of communal creches are tax deductible, while care in publicly-accredited creches (as well as by accredited childminders) is also subsidised.¹¹⁶ In Germany, up to two thirds of child-care costs for children under 14 are tax deductible (up to a maximum of 4,000€), in addition to childcare subsidies.¹¹⁷

Child-care expenses for children aged 11 or under are also deductible in Norway (up to a maximum of NOK 25,000 for one child, and an additional NOK 15,000 for each additional child), with subsidies also available.¹¹⁸ In Austria, child-care costs are deductible (up to a maximum of 2,300€ per child) for children up to the age of 10, in private or public institutions, alongside subsidies.¹¹⁹ And in Canada, childcare tax deductions are available for parents with children aged under 16, with subsidies also provided by provinces. The deductible amount is limited to Can\$8,000 for children six and under, and Can\$5,000 for children between seven and 15, and with the total deduction generally limited to two-thirds of the lower-income partner's earned income.¹²⁰

Meanwhile, a small number of countries provide a tax credit system for child care costs. For example, although the United States initially introduced a tax deduction for childcare costs in 1954, in 1976 this was changed to a tax credit. At present, the Child and Dependent Care Tax Credit provides a non-refundable tax credit covering 20 to 35% of child-care costs, depending on family income.¹²¹ France also provides a 50% tax credit for child-care expenses for children under 6 years of age, in addition to subsidised care in a government-run creche and nanny subsidies.¹²²



Conclusion



The Australian child-care system faces many pressures: for workers, there are real issues about the terms and conditions of employment. For regulators, there are questions about the appropriate training and education of child-care workers and providers. And for parents, there are hard questions about the best model or form of care for different children.

What is clear, however, is that formal child-care plays a major role in Australian family and economic life. It is also an area where there is consistent and increasing demand for access to affordable, high-quality care that meets the needs of different families and parent work patterns.

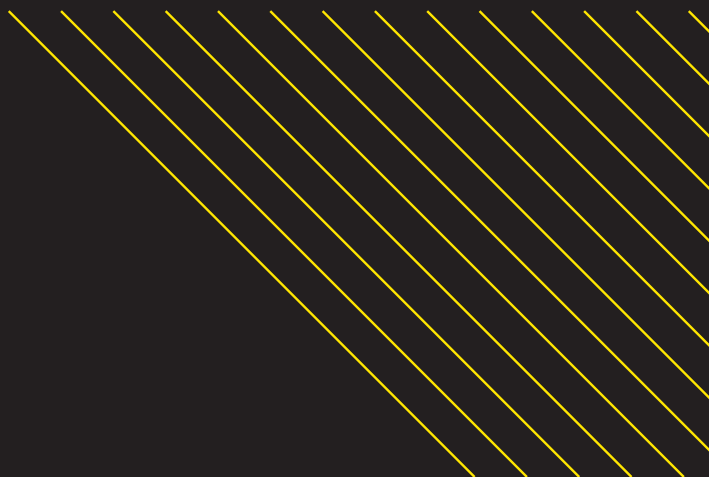
In this report, we also propose a quite specific way of responding to this demand: a model that retains the current system of child-care subsidies, but adds the option of tax deductibility (up to \$60 000 per annum per family) for work-related child-care expenses, as an alternative choice open to families.

There will inevitably be downsides to a model of this kind: it will have a real and significant budget impact. It may increase the price of at least certain forms of child-care, and therefore to some degree benefit private child-care providers as well as families. And it will do so in a way that will benefit many high-income families, as well as those on lower incomes. These are all costs that must be weighed up, as we make choices about the allocation of scarce resources.

But we also note the significant upsides: a policy of this kind is likely to boost labour force participation in ways that ultimately mean that the policy pays for itself. It also responds to the demands of Australian families — and especially Australian women — to rethink how we view the relationship between care and market income.

On the one hand, many Australian women are calling on the government to do more to recognize the value of informal, unpaid care — as contributing to our economy and society, and as fully equal in value—if not more valuable—socially and economically to formal models of care. This is also one reason this report is being launched along with a companion report, *Saving Care*, which calls for more equitable treatment of unpaid, informal care-work within the Australian tax and superannuation system.

But on the other hand, many working Australian families, and especially women, are calling for the government to recognize the close connection between work and formal child-care: for many families, one simply cannot happen without the other. It is therefore high time that, much like uniforms and company cars, at least up to some level, child-care should be treated as a legitimate work-related expense.



About the New Economic Policy Initiative

The New Economic Policy Initiative (NEPI) is a UNSW-based initiative aimed at promoting research and engagement around new public policy ideas—by current and future generations of Australian leaders. It is based in the Centre for Applied Economic Research (CAER), and continues previous work by UNSW scholars in these areas, under the auspices of the UNSW Grand Challenge on Inequality.

About the authors



Rosalind Dixon is professor of law at UNSW Sydney. She was previously on the faculty at the University of Chicago Law School, and holds an LLM and SJD from Harvard Law School.



Richard Holden is professor of economics at UNSW Sydney. He was previously on the faculty at the University of Chicago and MIT and holds a PhD in economics from Harvard University.



Melissa Vogt is a research assistant at UNSW Sydney. She has an LLB (University Medal) and BCCJ (University Prize) from UNSW.

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New Economic Policy Initiative



UNSW Sydney NSW 2052 Australia
Telephone +61 2 93851544
Email: neweconomicpolicy@unsw.edu.au
www.neweconomicpolicy.com

AUTHORS

Rosalind Dixon

rosalind.dixon@unsw.edu.au

Richard Holden

richard.holden@unsw.edu.au

Melissa Vogt

melissa.vogtn@unsw.edu.au