NATIONAL FOUNDATION FOR AUSTRALIAN WOMEN

# SUBMISSION TO THE Senate Education Employment and Workplace Relations Committee Inquiry into the Provision of Child Care

## FINANCING CHILD CARE

The National Foundation for Australian Women (NFAW) has made a prior submission to the Committee's Inquiry into the Provision of Child Care. This paper complements that submission with a more extensive discussion of the arrangements for financing child care.

### 1. Objectives

#### *1.1. Rationale for government involvement in child care*

Government has a role in child care arising from the public policy objectives of supporting:

- The development of children; and
- The participation of parents in the labour force.

#### *1.2. Desirable outcomes of a financing mechanism*

Financing mechanisms for child care should promote the following outcomes:

- *Quality care* - the requirements and incentives of the system do not compromise quality
- *Financial sustainability* - costs constrained to a level that is sustainable in the longer-term
- *Efficiency* - maximises the quality of care and the number of children who benefit.
- *Accessibility and affordability* - child care is genuinely available to all who need it
- *Equity* - those who have the greatest need have priority in the allocation of resources
- *Stability* - promotes continuity of service for users[1]
- *Responsiveness* - providers of care are responsive to the needs and concerns of users
- *Choice*- users have some level of choice of who will provide care.

All financing mechanisms involve trade-offs between these outcomes.

### 2. Broad framework

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[1] In this paper, the term 'user' may refer to either or both of the direct recipient of the care (ie. the child) or the agent who makes decisions on behalf of the child (ie. generally the parent(s)).

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### 2.1. *How can government provide finance for services?*

Broadly, government has three main ways of financing a service:

a) Direct provision by a government agency.
b) Funding external[2] providers via grants or contracts.
c) Demand-side subsidies that enable users to choose from a range of approved providers. These subsidies may be paid as either (i) direct payments to users (eg. cash, direct deposit, vouchers, etc) (ii) tax-expenditures available to users (eg. credits, rebates, deductions), or (iii) reimbursements to providers (ie. based on the actual people supported as distinct from contracts where a provider is required to service a given number of people).

There are many variants within each of the approaches, the boundaries between them are not always clear-cut, and more than one approach may be used for any given service.

### 2.2. *Regulation of Providers*

Given the vulnerability of the direct users of child care (ie. young children) and the prevalence of market failure in child care services,[3] regulation and quality assurance are needed to ensure that providers meet minimum service standards. A system of stringent regulation of the standard of care given by providers is essential, regardless of the financing mechanism that is chosen.

### 2.3. *What is Required - Overview*

The current system of providing government finance for child care, based almost entirely on demand-side subsidies, is intrinsically flawed. In many respects it has worked against the achievement of the objectives set out in Section 1. In particular, the extensive use of taxation expenditures is a poor use of scarce resources (as detailed in Section 3).

Child care (as part of Early Childhood Care and Education Services) is part of the national early education strategy, and as an essential human service similar to schooling, tertiary education, and health. [4]

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[2] 'External' here means external to the government unit that is providing the funding. This may include government and non-government providers, but government providers are usually from a different level of government (eg. local councils) or from a different agency or section of the government agency that provides the funding, (eg. as with the former Employment National under the Job Network, and the current Home Care Service within DADHC in NSW).

[3] These market failures are those common to most human services (See Davidson (2009)).

[4] http://www.deewr.gov.au/EarlyChildhood/Policy_Agenda/Pages/home.aspx

The Australian Government's agenda for early childhood education and child care focuses on providing Australian families with high-quality, accessible and affordable integrated early childhood education and child care. The agenda has a strong emphasis on connecting with schools to ensure all Australian children are fully prepared for learning and life. Investing in the health, education, development and care of our children benefits children and their families, our communities and the

In consequence, Governments need to make a fundamental commitment to establishing a stable and comprehensive *supply* of child care services in all communities across the nation, together with ensuring that the systems and resources to implement this commitment are in place.

Because of the prevalence of market failure and the risks involved in providing poor services to vulnerable people, demand-side subsidies in human services can only achieve their goals when combined with appropriate supply-side mechanisms that ensure (i) the planning of the overall allocation of resources (ii) direct public provision or public organisation of a basic level of service in all areas (iii) regulation of service standards (iv) requirements on, and regulation of, individual providers, including constraints on the entry and growth of providers. Currently only [iii] exists in the provision of child care in Australia.

Within an effective system of planning and managing supply, there may be scope for demand-side subsidies other than tax expenditures (e.g. continuation of the current Child Care Benefit (CCB) for lower-income parents, and/or provider-reimbursement mechanisms such as used in Medicare and residential aged care) to promote greater efficiency, responsiveness, and choice.

## 3. The Current System

### *3.1. Data on the Provision and Financing of Child Care*

Appendix 1 presents data concerning the provision and financing of child care in Australia.

The major points concern:
- The growth of child care places and funding over the last twenty years
- The growth of for-profit organizations (FPOs)
- The relative decline of non-for profit organizations (NPOs)
- The regional disparity in places
- The high cost of child care
- Substantial funds are going to shareholder profits and large remuneration at the same time as there are queues for places in less affluent areas.

### *3.2. Major Concerns*

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economy, and is critical to lifting workforce participation and delivering the Government's productivity agenda.

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The revenue for most child care centres and provider organisations now comes almost entirely from payments by individual users, who draw on three main sources of finance:

- A means-tested government payment (Child Care Benefit (CCB))
- A non-means-tested tax rebate, up to a maximum of $7500 per child per year (Child Care Tax Rebate (CCTR))
- Their own funds (possibly supplemented in cash or kind by their employers).

There are two major problems with the current system.
Firstly, there is an absence of planning and management mechanisms at both a systemic and provider level that are essential to ensure (i) the most efficient and effective allocation of child care places between regions, taking account of the special needs of all groups of users; and (ii) the appropriate incentives to support those child care providers whose prime commitment is to the welfare of the children.
Secondly, the use of tax expenditures has created a set of incentives, opportunities, and barriers that have proven to be counter-productive for achieving the objectives set out in Section 1.[5] Together these two factors have combined to create a funding system that has generated new sources of market failure to add to the market failures that generate government involvement in the sector.
Sections 3.3-3.5 below examine these problems and the contribution of these two factors in more detail.

These shortcomings have generated - and been exacerbated by - the substantial growth in sector for-profit organisations (FPOs) to the point where they now dominate the provision of child care in Australia. In an increasing number of communities, parents do not have the option of choosing a non-profit provider (NPO), even though a range of studies have shown that many parents prefer NPOs.
FPOs per se are not necessarily a problem[6], but the potential for clash between profit maximisation and achieving the objectives set out in Section 1 is most likely to be realised when listed FPOs[7] are a major source of care, within a context where there is very little discipline in the planning of supply, the transfer of licences between providers, and the growth of the size and market power of individual providers.
Government management of provision through supply-side measures would enable a more efficient use of FPOs.

### *3.3. <u>Specific Problems</u>*

The major problems in the current arrangements for the funding of child care are *intrinsic* to the current system of funding. In summary, these problems are:

1. *Locational and socio-economic inequity in the supply of places*

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[5] See Spies-Butcher & Stebbing (2009) for an analysis of the broader effects of tax expenditures

[6] See Davidson (2009) re the presence of 'dwarves of capitalism' in human services. These are small FPOs owned by experienced people who have the welfare of clients as their prime objective, but believe they can achieve better outcomes by working independently rather than as employees of government or of large bureaucratic NPOs. Sustainability, not profit maximization, is their main financial objective. A number of such people own child care centres.

[7] That is, companies traded on the stock exchange that have legal obligations to stockholders to maximise profit.

- Demand side subsidies provide an incentive for FPOs to focus on the most affluent groups and areas (where they can obtain a higher co-payment). This leads to supply shortages in some areas and high fees in others. Lower-income families thus miss out in both types of areas. This is accentuated where such subsidies include tax expenditures where the cash benefit increases with income and thus give disproportionately greater benefits to higher income groups.

2. *Incentives for providers to reduce quality*
   - The pressures for FPOs to maximise profits creates incentives for them to (i) limit the quality of care for each child in the daily operation of centres (e.g. limiting the employment of trained/experienced staff, limit time available for each child, limit quantity and quality of food provided, etc), and (ii) block systemic quality improvements (e.g. reduction of regulated minimum staff/child ratios)[8].

3. *Limited control over total cost to government*
   - The cost to government is a function of the number of children that gain places, and the average cost per child. There is a maximum amount that any one user can obtain from government, but little control over the total number of places that are offered. In addition, the opportunities for FPOs to seek ever higher co-payments generates higher fees which in turn generate political pressure from more powerful groups to increase the level of assistance for each child. This is not fiscally sustainable.

4. *Potential for instability in supply at the local level and the loss of trained staff*
   - The largely unfettered operation of the market in child care has seen frequent and substantial disruptions in communities through the closure of centres or transfers to new owners. In addition to disruption for parents (which may be lengthy and even permanent if there are limited alternative places elsewhere in the area), a major effect has been the loss of trained staff.[9]

5. *When supply is very constrained, subsidies to users essentially only increase fees*
   - It should be self-evident that if there is a shortage of places and limited capacity to increase supply in the short-term, a subsidy to users can only bid up the price of a place and enable providers to charge higher fees. This can especially occur where there are users whose demand is inelastic as is more likely in high income areas.[10]

[8] As has occurred in NSW in recent years

[9] Note, however, that such disruptions can also occur in a contract-based system as shown by the recent tendering process for the Job Network

[10] Whelan (2009, as reported by Horin 2009) apparently suggests that price did not have any impact on decisions by parents receiving the Child Care Tax Rebate about whether or not they used child care.

- This is exacerbated by the use of tax expenditures that are disproportionately used by higher income users. Thus "Tax expenditures…add to purchasing power without necessarily addressing supply-side capacity constraints, and this can lead to inflationary pressure - simply pushing up the prices of services like child care… rather than increasing their affordability" (Spies-Butcher & Stebbing (2009:14)

6. *Choice and diversity have been reduced*
    - The lack of discipline on the growth of providers and the transfer of licences has facilitated a process of 'creeping acquisition' (Treasury 2008) that in some areas limits the choice of providers to different outlets of the same FPO chain. Further, as noted above there are major constraints on the growth of NPOs, which are the provider of choice for many users.
      Thus choice and diversity have actually been *reduced.*

### *3.4. Demand-Side Subsidies*

The proponents of demand side subsidies argue that they have the following main advantages over the direct funding of providers:

- They generate market signals to ensure that a service is provided where it is most needed and to the level that users need (allocative efficiency).
- They generate market signals and market pressures that give service providers an incentive to (i) provide high quality care if they are to attract users and remain viable (ii) make the most efficient use of their resources (technical efficiency) (iii) continually innovate and improve their services and efficiency (dynamic efficiency).
- They promote diversity, enabling users to choose between providers and service types.

However, demand-side subsidies have some significant limitations that reinforce the market failure inherent in human services. In particular:

- *They assume that all buyers have perfect information about the quality of care and the efficiency of resource usage by each provider.* However, like most human services, child care is characterized by the lack of observability and measurability of inputs and outputs. Thus information for consumers is restricted and marketing techniques can be used to shape the expectations and choices of users, leaving them vulnerable to advertising and the superficial attractions of a provider. Many studies show that parents overestimate the quality of care received by their children (eg. see Press and Woodrow (2005: 282)).
- *They do not take account of the capacity to pay of different users.* Unless government is prepared to pay the full cost of care and all associated services and prohibit co-payments and/or limit the subsidies to lower income groups, there will be tendency for at least some providers to move to areas where families have a

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While this would clearly not be not true for all parents using child care, it may well be the case for some high income earners for whom child care cost are only be a small proportion of their salaries.

greater capacity to make co-payments. This will distort supply away from the socially efficient allocation of resources.

- *They maximise the opportunities for FPOs that are focused primarily on profit maximisation rather than the welfare of children*. This flows from the two above points.

Subsidies in the form of tax expenditures exacerbate these problems in a number of ways.

- Firstly, they disproportionately favour higher income earners.
- Secondly, tax expenditure *requires* a co-payment by the user[11], which has at least two undesirable effects. FPOs are attracted to those areas with higher income earners, pushing fees up in those areas and increasing the disparity in supply. Secondly, it means that in cases where a provider is prepared to waive or reduce the co-payment for low-income parents, then no or little assistance is available to these parents from this source.

Commonwealth funding for a number of other human services use demand-side subsidies that give users the right to choose their provider, but these subsidies are generally paid in the form of reimbursements to providers and exist in the context of other mechanisms for the planning and management of supply. These services include Medicare bulk-billing[12] and payments for residential aged care.[13]

Providing they operate in a context of a system designed to plan and manage supply, these reimbursement-based subsidies overcome a number of the negative impacts of tax expenditures.

A further advantage of such subsidies is that they help government obtain better data about the demand and supply, especially by location and about individual providers. Much of this data can be passed on to users to enable them to make more informed choices.

Child care should be financed by either (i) reimbursement-based subsidies, or (ii) funding providers for a given number of children and places on a contractual or grant basis.

### 3.5. *Planning and Management of Supply*

[11] Note that a co-payment may be either required, permitted, or banned in programs using the other two major forms of demand subsidies

[12] Note that 30% of the cost of private health insurance (generally used for different types of medical treatment) is subsidised by tax-expenditure.

[13] The amount of the subsidy in residential aged care varies by the level of care required by the user.

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Currently, the location and organisation of the supply of child care is dependent on decisions by providers in response to the demand from users. Other than State and Territory regulation of service standards, government has little capacity to influence the provision of child care.

The earlier NFAW submission (point 10) notes that '… over the past decade, there has been a diminution of the role of the Commonwealth in planning, local contact with providers, and …(thus)… a loss of grass roots information and feedback on the implications of policy.' This has also led to the Commonwealth losing control over the use of its dollars.

Consequently there is currently:

- no centralised planning of services to ensure that all regions and communities have sufficient places to meet local needs
- few controls over (i) the location of centres (other than as prescribed by Development Application (DA) requirements of local councils) (ii) the transfer of licences (other than that the new licensee must met state regulations) or (iii) the capacity of any licensed operator to expand the number of centres it operates.

i) <u>Lack of public transparency of child care providers</u>

Governments now substantially underwrite the revenue of all approved child care operators. For example, a major (former) ABC Learning selling point to investors was the 'government-guaranteed' nature of much of its revenue base[14]. Yet there is very little information about the inputs, outputs, outcomes, user satisfaction, or finances of services. Reporting obligations are minimal.

Thus there is a lack of information available to users to enable them to make an informed choice of provider, and no transparency in the finances of a provider to ensure that government is getting best value for money (e.g. such that it was possible for a provider to make sufficient profit to purchase the franchise for a professional basketball team)

Three specific problems with ABC Learning arising from the lack of transparency were:

- Vertical integration with non-essential subsidiary products meant that child care was being as the vehicle for profit-making and high salaries in a range of other enterprises.
- Vertical integration also meant that while investors were being told that substantial profits were being made from child care, any profits that did exist were actually coming from other aspects of the group operation (eg. property management).
- Effectively this was a Ponzi scheme whereby returns to current shareholders could only be paid for by the funds from future investors.

[14] ABC Learning Centres (2005) stated that a key element of its 'successful child care model' is to 'maximise government funding [to] underwrite income sources'.

ii) Impediments to competition

There are no mechanisms to prevent 'creeping acquisition' to a point where a provider is able to exercise monopoly power. In conventional commercial industries, monopoly power can be shown to lead to lower output and higher prices, but it also has implications for quality, which is especially likely with 'products' that are difficult to observe or measure, such as child care.

Moreover, there has been evidence of un-competitive and inefficient behaviour by large corporate FPOs in child care, such as blocking of local development applications made by competitors, and buying out smaller ones at prices well above the market value (sometimes as a prelude for forms of predatory pricing).

Further, a system using demand-side subsidies operates more like a conventional market, allowing greater scope for takeovers, a point acknowledged by the Productivity Commission (2002) in its study of the Job Network, where it noted that such a system would be 'likely to lead to some consolidation" of providers.
The reality, as shown by the child care experience in recent years, is that demand-side subsidies (especially tax-based ones), without complementary mechanisms to plan and regulate supply is thus highly likely to reduce diversity and choice.

iii) Limitations on the growth of non-profit organizations (NPOs)

There are strong theoretical arguments and substantial empirical evidence for ensuring a key role for NPOs in the provision of child care.

FPOs often argue that special tax provisions available to NPOs prevent a 'level playing field' and contravene the principle of 'competitive neutrality' (Hilmer 1993). In practice, however, NPOs suffer from a lack of competitive neutrality in the overall 'marketplace' with a number of factors in the current child care system creating substantial barriers to the development of NPOs.

Two factors of particular significance in limiting NPOs are:

a) *Lack of access to growth capital*:

It is well-documented that (despite any taxation advantages) NPOs have less capacity to raise capital given their *non-distribution constraint*[15] (Krashinsky 1986:116). In the past, NPOs had access to Commonwealth Government capital funds, but the abolition of this program in the 1990s has imposed severe constraints on the capacity of NPOs

[15] This refers to the fact that NPOs are (in most jurisdictions) legally barred from distributing surpluses (or profits) to individual shareholders. Thus, investors have much less incentive (if any) to put money into an NPO enterprise.

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to respond to excess demand. Government support for capital construction should be part of the overall commitment to ensure a comprehensive supply of child care across the nation.

*b) Limited supporting infrastructure available to small NPOs*:

A frequent debate in child care, as in many human services, is that of the (claimed) benefits of large organisations (eg. economies of scale and scope, access to wider sources of advice, etc) versus the (claimed) benefits of small locally-controlled centres (eg. greater awareness of local needs, management closer to users).

There are large NPOs operating ‘chains’ of centres (eg. Kindergarten Union Children’s Services) that are generally acknowledged as providing high quality care. However, studies (eg. Rush 2006) have indicated that problems arise with large FPO chains.

There is also an important place for smaller NPOs in child care. Importantly, there is very limited potential for productivity gains or for direct economies in scale in the way that services are provided directly to children[16]. Most economies arise from elements of the service ‘infrastructure’ such as (i) the training and professional development of staff (ii) back office organisation (eg. payment mechanisms, personnel matters) (iii) pecuniary economies of scale (eg. being able to negotiate a cheaper rate for supplies because it is a big organisation).[17]

Collaboration between small NPOs, especially via membership of peak bodies or similar organisations can enable smaller providers to obtain these benefits, while retaining local input and control over the operation of centres. Again, as with capital costs, the cost of these services could be covered by a grant from government to the peak bodies or by incorporating an allowance into the per child subsidy paid on behalf of users.
A further consideration is that the willingness of schools to co-locate and integrate child care into their suite of education services and programs is likely to be adversely affected by funding mechanisms so completely different to those available to them for staff in pre-school and primary education programs.

iv) <u>State Regulation</u>

The current State and Territory regulations on standards of care are an important element in sustaining the quality of child care. However, action is needed firstly, to address the variations between different State and Territory licensing standards (NFAW , point 11), and secondly, to strengthen the current regulations, especially in

[16] Unlike manufacturing, there is no ‘machine’ that can be installed to produce a greater quantity more quickly or with fewer faults. Baumol’s classic example of this aspect is that of a string quartet – cutting it back to three people and getting them to play quicker does not give a better result. And so it is with child care.
[17] Pecuniary economies of scale have no efficiency gains for the overall society as they simply involve transfers between different parties.

relation to key staffing and workload issues. There needs to be consideration by COAG to develop a set of frameworks on standards and accreditation.

## 4. What is Needed?

### *4.1. The Need for Planning*

There is an obligation on government to ensure that some minimum level of child care is available for all children, supported by an equitable, stable and accountable system of funding.
This inevitably requires a more systemic approach than occurs the current 'market-based' system. Ostensibly the process of decision-making is one of atomized suppliers; in practice the development of the sector has increasingly been largely determined by the goals of a private corporation.
Child care is a basic societal need that raises complex philosophical and policy questions - it cannot just be turned over to the market to determine the allocation of resources and the quality of providers. There clearly has to be some constraints on the operation of markets in this field. The question is 'what constraints?

### *4.2. Further Inquiry*

NFAW recommends that:

- 'The Commonwealth Government should refer to the Productivity Commission the development of appropriate financing mechanisms for ECCES' (15)
- 'Terms of Reference for the Productivity Commission … (should include) … the identification of the entirety of State and Commonwealth funding for ECCES, including both explicit and implicit (taxation) expenditures, with a view to reporting on the possibility of establishing a single government funding source using pooled funds.' (126)

### *4.3. Mechanisms*

The system for planning and financing child care needs to incorporate a number of mechanisms and principles. Some key ones are listed below:

i) Commonwealth-State Agreements

NFAW recommends that the '…Commonwealth should develop with States and Territories a set of agreed national principles, and to enter into individual bi-lateral agreements with State and Territory Governments regarding the implementation of those principles in service delivery, tied to Commonwealth funding agreements (12).

ii) A mechanism to plan the regional allocation of places

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The Commonwealth should develop enforceable models of child care service planning by LGA and regions.

There needs to be a means of ensuring an equitable central allocation of places between region so that parents can access a place near their home or work or on the transport corridors between home and work. This involves both (i) a basis for allocation taking into account population and employment patterns (ii) a body responsible for determining the allocations.

It is anticipated that at community level, local government will have a key role to play in the process. It may also be that market mechanisms such as provider-based reimbursements can play a role in facilitating responsiveness to both continuing shifts in local demand and user satisfaction with individual providers

iii) <u>Development of a financial model for 'standard' child care centres</u>

The allocation of funding, whether by a contract/grant process or reimbursement-based demand side subsidies, requires the development of a financial model of the revenues and costs for a standard centre. This can provide the basis for adequate funding for both the necessary infrastructure and the marginal cost of each child, whether these elements are funded separately or via a unit cost approach merging the two elements.[18]

Such a model is particularly necessary as a basis for funding places in less affluent areas where there is limited scope to obtain higher co-payments and too low a level of funding will threaten the viability of centers and/or make care unaffordable for many parents.

It will also provide the basis for governments and users to ensure that resources are being directed to quality care for children and that (i) quality is not being reduced by cuts to critical costs (ii) surpluses/profits are not being diverted to excessive executive remuneration or dividends.

iv) <u>Mechanisms to determine providers</u>

Three main elements are necessary:

a) *The right to operate*: Providers must meet regulations regarding service standards and quality (as per current state government agency requirements).
b) *The right to receive government funds or for their users to be eligible to receive subsidies* (eg. as occurs with a Medicare provider number): These additional requirements should include (i) transparency of finances to ensure public dollars are focused on actual care (ii) reporting on processes, input, outputs, and user satisfaction.[19]

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[18] It is important that no single 'unit cost' can apply to all centres. Such an approach requires a recognition of differences between centres especially in regard to their location.

[19] This of course assumes the possibility of a provider operating without its users being eligible to then claim their subsidies. Thus in more affluent areas, they could soak up excess demand from those for

c) *Local allocation of places:* This will be determined by the way in which payments are made (see [vi] below). Allocations could be made either directly by periodic allocations to specific providers or by reimbursement-based payments. It would be desirable to ensure that one or more NPOs in each area had a guaranteed allocation.

It is important to note that contestability only requires the *threat* of new entrants - it does not require expensive tendering processes or demand-side subsidies. The transparency provision proposed above would enable the funding agency (in conjunction with local government) to determine if a provider is no longer meeting the requirements and it could then reallocate the places or call for new expressions of interest.

NFAW also recommends that:
- Transfers of licences should be subject to agreement within the Commonwealth/State planning arrangements for each jurisdiction. (18)
- The Commonwealth expedite the 'creeping acquisitions' powers currently under consideration for ASIC to further protect childcare from market failure. (17)

v) Link to local schools and other services

Encouragement should be given to school based or linked childcare systems, and not-for profit childcare service systems providers to take on board the co-location and management of family day care services (NFAW-20). Individual schools or school systems could apply to be a child care provider or could allow or contract a provider to operate on school premises

vi) Payment of funds

There needs to be three levels of funds

- *A core level of funding*

This could be provided on the basis of contract/grant arrangements or by introducing a provider-reimbursement model. Contract and grant arrangements involve individual negotiations and agreements with each provider, but allow for closer monitoring and quality control. Alternatively, if entry is carefully monitored (as under [iv] above), quality control may be less of a concern and the provider-reimbursement model can reduce direct administrative costs and create incentives for providers to be more responsive to user needs.

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whom cost is not a major constraint. (Of course, it would not be long before claims of unfairness and discrimination were raised and similar arguments to those now used by private schools to justify funding were used).

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The amount of assistance would be based on the financial model described in [iii] above, and should incorporate an allowance for infrastructure support, which could come either from the provider's own organisation or be 'purchased' from a peak body or other support body.

- *Assistance for low income parents*

This could continue to be provided via the current CCB payment (subject to some amendments in its design) or be a supplement to the core funding through contract/grant payments. One important advantage of a CCB-type payment is that gives lower income people greater privacy and greater power in determining their care provider.

- *Capital funding for NPOs*

See discussion under 3.5.(iii) (a) above.

vii) Support for NPOs and small FPOs

This can be provided through
- The procedures for the approval of providers, which should include provisions for greater transparency and limits on the use of surpluses/profits.
- Availability of funding for capital construction and infrastructure support

viii) Dissemination of information about providers

Full information for all participants is a central assumption for a competitive market, but there is substantial asymmetry of information with governments and parents having limited information about the costs, revenue, and 'production function' used by child care providers.

The greater transparency proposed above would make much more information about providers publicly available, giving users both stronger voice and exit options (Hirschmann 1970). There needs to be an independent body to monitor and disseminate this information.

## 5. Conclusion

Two major changes are necessary:

1. Tax expenditures are counterproductive and the CCTR must be replaced by either direct funding of providers or provider-reimbursement models based on actual clients. If CCTR is restructured, an equivalent amount of funding can be redirected to more effective ends using one of these alternative mechanisms.

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2. Outcome-focused mechanisms for the planning and management of the supply of child care need to be introduced (along the lines set out in section 4).

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## Appendix 1

[Extracts from Davidson , B (2008), 'Non-Profit Organisations In The Human Services Marketplace: The Impact Of Quasi Voucher-Licensing Systems', paper presented at the 37th Annual Conference of the Association for Research on Nonprofit Organisations and Voluntary Action (ARNOVA), Philadelphia, 20 November].

<u>*Child Care in Australia*</u>

Prior to the 1970s [20] there was no on-going formal government financial support for *child care* in Australia, with long day care '…provided by a mix of philanthropic organisations and private businesses… 520 of the 560 day care services operating in 1969 were operated on a commercial basis' (Brennan et al 2007:3). In 1972, the Commonwealth government introduced the *Child Care Act* which enabled it to make capital and recurrent grants to non-profit child care organisations. This led to the development of an extensive network of community-based neighbourhood centres operated by NPOs over the next decade. The move towards a quasi-voucher licensing (QVL) system began in 1985 when the Commonwealth restructured its model for funding child care 'so that it was paid on the basis of the number of children enrolled in a service, not on the basis of the staff employed' (Brennan et al, 2007:4). In 1990, FPOs became eligible for the assistance. Between 1992 and 2008, a series of decisions have been made (Brennan et al 2007:3-4; Lyons 1995:131) so that the current system consists of a means-tested Child Care Benefit plus an additional Child Care Tax Rebate (which can meet 50% of costs up to $7500 per child per year). A major change in the early 1990s was to remove the capacity to make capital grants to the NPO centres that had existed for twenty years.

Over the last twenty years, during which the QVL system was introduced and continuously expanded, there has been a major growth of FPOs in the sector and a substantial takeover by big corporates of *child care* in Australia. Table 1 (adapted from Brennan et al 2007:14) shows two major phases in the development of the pattern of ownership between 1991 and 2004. The first was from 1991 until 1996. In 1991, NPOs provided 52% of long day care places. By 1996, the number of places in NPOs had increased by 15%, but by then NPOs provided only 27% of places, because total places had increased by 120% and FPO places by 234%. This was a smaller share for NPOs of a much bigger cake, but there was still an increase in the number of places that NPOs provided. Then, in 2000, the Howard Government extended the Child Care Benefit, and ended the remaining operational subsidies for NPOs. Following these changes, there was an 18% increase in the total number of places between 2001 and 2004, with 89% of the growth going to FPOs.[21]

[20] There had been some short-term provision of Government funded care for priority occupations during World War 2

[21] In addition, the corporatisation of the sector galloped ahead after 2000 with one company, ABC Learning, floating on the Stock Exchange in 2000 and engaging in a major takeover campaign that led to it increasing the number of places it provided in Australia by 1,435% (sic) between 2001 and 2005, and purchasing major companies in the US and elsewhere. For a range of reasons, however, this growth has not proved to be sustainable, and since February 2008 the future viability of ABC has been in question.

Associated with the growth of FPOs in the sector has been much concern about the effect on the quality of care, for example in the time devoted to children and the qualifications and experience of staff in corporate-run centres (Rush 2006; Press & Woodrow 2009; Brennan et al 2007; Hill 2007). Most community NPOs and child care neighbourhood centres have retained a strong allegiance to quality care, with the community sector childcare peak body very active in defending the need for high service standards, in the face of more commercial concerns from corporate FPOs. The development of the sector is also complicated by the significant undersupply of places in some areas which gives providers (including NPOs) significant leverage over parents and dilutes 'consumer sovereignty'. There has also been a clear example of corporate influence on government with the successful efforts by FPOs over the last 5 years to block the reduction of the child-to-carer ratio from 5 to 4.[22]

The child care industry in Australia thus illustrates some of the major propositions from earlier sections. For much of the 1970s and 1980s, childcare was substantially provided by locally-based NPOs. Then, despite the fact that there was an increase in the actual number of places provided by NPOs in virtually every year from 1991-2004, they now have a much smaller share of total places. FPOs now provide over 70% of long day care places after the introduction and continuous expansion of a QVL system based on individualised subsidies, periodic increases in both the value of the subsidies and the proportion of the target population that could claim them, and the end of capital assistance for NPOs. In this context, the FPO lobby has also been able to contain the capacity of the regulator to exert greater control over quality.

[22]Most recently, in 2007, the NSW Government rejected the majority findings of a inquiry it set up and accepted the minority recommendations of the two FPO representatives to not reduce the ratios. In NSW, NPOs have supported higher mandatory staff-user ratios in child care (ie. more staff per child), one effect of which is that costs rise and profits fall.

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**TABLE 1**
**Funded Long Day Child Care Places in Australia, 1991-2004**

| *Year* | *Number of Places* | | | *Proportion of Total* | | *Percentage Growth from Previous Year* | | | *Percentage Cumulative Growth after 1991* | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | *NPO* | *FPO* | *Total* | *NPO* | *FPO* | *NPO* | *FPO* | *Total* | *NPO* | *FPO* | *Total* |
| 1991 | 39,567 | 36,700 | 76,267 | 51.9 | 48.1 | n.a | n.a | n.a | n.a | n.a | n.a |
| 1992 | 40,262 | 53,210 | 93,472 | 43.1 | 56.9 | 1.8 | 45.0 | 22.6 | 1.8 | 45.0 | 22.6 |
| 1993 | 42,777 | 61,375 | 104,152 | 41.1 | 58.9 | 6.2 | 15.3 | 11.4 | 8.1 | 67.2 | 36.6 |
| 1994 | 43,399 | 80,374 | 123,773 | 35.1 | 64.9 | 1.5 | 31.0 | 18.8 | 9.7 | 119.0 | 62.3 |
| 1995 | 44,566 | 99,909 | 144,475 | 30.8 | 69.2 | 2.7 | 24.3 | 16.7 | 12.6 | 172.2 | 89.4 |
| 1996 | 45,601 | 122,462 | 168,063 | 27.1 | 72.9 | 2.3 | 22.6 | 16.3 | 15.3 | 233.7 | 120.4 |
| 1997 | 46,294 | 136,571 | 182,865 | 25.3 | 74.7 | 1.5 | 11.5 | 8.8 | 17.0 | 272.1 | 139.8 |
| 1998 | 51,710 | 142,844 | 194,554 | 26.6 | 73.4 | 11.7 | 4.6 | 6.4 | 30.7 | 289.2 | 155.1 |
| 1999 | 50,589 | 139,737 | 190,326 | 26.6 | 73.4 | -2.2 | -2.2 | -2.2 | 27.9 | 280.8 | 149.6 |
| 2000 | 50,368 | 140,547 | 190,915 | 26.4 | 73.6 | -0.4 | 0.6 | 0.3 | 27.3 | 283.0 | 150.3 |
| 2001 | 61,248 | 132,561 | 193,809 | 31.6 | 68.4 | 21.6 | -5.7 | 1.5 | 54.8 | 261.2 | 154.1 |
| 2002 | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | na | na | na |
| 2003 | 64,255 | 147,390 | 211,645 | 30.4 | 69.6 | 4.9 | 11.2 | 9.2 | 62.4 | 301.6 | 177.5 |
| 2004 | 65,260 | 164,343 | 229,603 | 28.4 | 71.6 | 1.6 | 11.5 | 8.5 | 64.9 | 347.8 | 201.1 |

* - 2003 is growth from 2001

*Derived from Brennan et al (2007), Table 3 , p.14*

Table 2 shows the profiles of providers in each state in child care. While the data in the table must be approached with caution[23] they indicate some significant differences in the relative presence of NPOs and FPOs between states. Both nationally and in every state and territory, FPOs are more prevalent in child care. There are also major differences between jurisdictions with the proportion of FPO providers in child care ranging from 26.2 per cent (NT) to 82.5 per cent (Queensland). In part, these differences in the provider profiles are driven by local circumstances including the size, structure, and location of the target group and the history of NPOs in the state, and by the development strategies of major providers. But they also reflect differing policy and practice of state and territory governments, with for example, the licensing function in child care being carried out by state authorities.

**TABLE 2**

[23] See notes on table.

NATIONAL FOUNDATION FOR AUSTRALIAN WOMEN

**Centre-based Long Day Care child care providers in Australia and each state/territory**
**Proportion of providers by type of provider, 2004-05***

| Type of Provider | NSW | VIC | QLD | WA | SA | TAS | ACT | NT | Total |
|---|---|---|---|---|---|---|---|---|---|
| Community-managed | 22.4 | 23.7 | 15.5 | 34.8 | 51.2 | 48.7 | 68.4 | 73.8 | 25.7 |
| Private-for profit | 77.6 | 64.6 | 82.5 | 62.5 | 46.5 | 29.5 | 31.6 | 26.2 | 71.0 |
| Government ** | na | 11.7 | 2.0 | 2.6 | 2.3 | 21.8 | - | na | 3.3 |
| Total | 100 | 100 | 100 | 100 | 100 | 100 | 100 | 100 | 100 |
| Total providers | 1,938 | 913 | 1,197 | 531 | 258 | 78 | 98 | 65 | 5,078 |

* The Productivity Commission (2006:14.13) notes that its data on child care services by provider type 'needs to be interpreted with care because the scope of data collection varies across jurisdictions'.

** Includes local government owned services, but excludes Australian government supported services.

Source: Derived from Steering Committee for the Review of Government Service Provision (2006), *Report on Government Services 2006*, Tables 14.2 (p. 14.13); Tables 14A.33, 14A.42, 14A.51, 14A.60, 14A69, 14A78, 14A.87, 14A96

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## Appendix 2

### Chapter from Submission to the Review of Australia's Future Tax System

### Child Care and Tax Expenditures

Government has a role in child care arising from the public policy objectives of supporting the development of children and the participation of parents in the labour force.

Financing mechanisms for child care should promote the following outcomes:

- *Quality care* - the requirements and incentives of the system do not compromise quality
- *Financial sustainability* - costs constrained to a level that is sustainable in the longer-term
- *Efficiency* - maximises the quality of care and the number of children who benefit.
- *Accessibility and affordability* - child care is genuinely available to all who need it
- *Equity* - those who have the greatest need have priority in the allocation of resources
- *Stability* - promotes continuity of service for users[24]
- *Responsiveness* - providers of care are responsive to the needs and concerns of users
- *Choice*- users have some level of choice of who will provide care.

All financing mechanisms involve trade-offs between these outcomes.

Broadly, government has three main ways of financing a service:

d) Direct provision by a government agency.
e) Funding external[25] providers via grants or contracts, with the providers chosen by a government agency.
f) Demand-side subsidies that enable users to choose from a range of approved providers. These subsidies may be paid as either (i) direct payments to users (eg. cash, direct deposit, vouchers, etc) (ii) tax-expenditures available to users (eg. credits, rebates, deductions), or (iii) reimbursements to providers (ie. based on the actual people supported as distinct from contracts where a provider is required to service a given number of people).

There are many variants within each of the approaches, the boundaries between them are not always clear-cut, and more than one approach may be used for any given service.

Given the vulnerability of the direct users (ie. young children) and the prevalence of market failure in child care services,[26] regulation and quality assurance are needed to

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[24] In this paper, the term 'user' may refer to either or both of the direct recipient of the care (ie. the child) or the agent who makes decisions on behalf of the child (ie. generally the parent(s)).

[25] 'External' here means external to the government unit that is providing the funding. This may include government and non-government providers, but government providers are usually from a different level of government (eg. local councils) or from a different agency or section of the government agency that provides the funding, (eg. as with the former Employment National under the Job Network, and the current Home Care Service within DADHC in NSW).

ensure that providers meet minimum service standards. A system of stringent regulation of the standard of care given by providers is essential, regardless of the financing mechanism that is chosen.
The current system of providing government finance for child care, based almost entirely on demand-side subsidies, is intrinsically flawed. In many respects it has worked against the achievement of the objectives set out above. In particular, the extensive use of taxation expenditures is a poor use of scarce resources (as detailed below).

Child care (as part of Early Childhood Care and Education Services) should be viewed as part of the national education strategy, and as an essential human service similar to schooling, tertiary education, and health. Thus governments need to make a fundamental commitment to establishing a stable and comprehensive *supply* of child care services in all communities across the nation, together with ensuring that the systems and resources to implement this commitment are in place.

Because of the prevalence of market failure and the risks involved in providing poor services to vulnerable people, demand-side subsidies in human services can only achieve their goals when combined with appropriate supply-side mechanisms that ensure (i) the planning of the overall allocation of resources (ii) direct public provision or public organisation of a basic level of service in all areas (iii) regulation of service standards (iv) requirements on, and regulation of, individual providers, including constraints on the entry and growth of providers. Currently only [iii] exists in the provision of child care in Australia.

Within an effective system of planning and managing supply, there may be scope for demand-side subsidies other than tax expenditures (e.g. continuation of the current Child Care Benefit (CCB) for lower-income parents, and/or provider-reimbursement mechanisms such as used in Medicare and residential aged care) to promote greater efficiency, responsiveness, and choice.
The revenue for most child care centres and provider organisations now comes almost entirely from payments by individual users, who draw on three main sources of finance:

- A means-tested government payment (Child Care Benefit (CCB))
- A non-means-tested tax rebate, up to a maximum of $7500 per child per year (Child Care Tax Rebate (CCTR))
- Their own funds (possibly supplemented in cash or kind by their employers).

[26] These market failures are those common to most human services (See Davidson (2009)).

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The most recent figures for the actual cost of the Child Care Tax Rebate (CCTR) are contained in the ATO's *Taxation Statistics 2006-07*, which shows that the value of rebates claimed for 2006-07 was $358.5 M.

The 2008-09 Budget introduced a major increase in the value of the CCTR to each individual, with an increase from 30% to 50% (a 66.7% increase) for the proportion of costs that can be claimed, and an associated increase in the maximum claimable amount from $4,354 pa to $7,500 pa (a 72.3% increase). These increases were estimated to cost a total of an *additional* $340.3M in 2008-09, rising to an *additional* $444.5M in 2011-2012, as follows:

| Year | 2008-09 | 2009-10 | 2010-11 | 2011-12 |
|---|---|---|---|---|
| Cost ($) | 340,282 | 375,981 | 410,229 | 444,479 |
| % increase pa | | 10.5 | 9.1 | 8.3 |

Source: DEEWR Budget Statements, 2008-09, p.21

The government thus estimates that the increases in the 2008-09 Budget will lead to almost a doubling of the cost of the CCTR, with a continuing escalation in the cost of at least 8% until 2011-12. While the increases in the proportion and total cost claimable are around 70%, the changes can be expected to lead to more claimants, including through generating behavioural change by some users.

Thus, based on the government expenditure data and estimates, the actual cost of the CCTR will be substantially more than $700M in 2008-09, rising to around $900M in 2011-12.

Treasury's annual Tax Expenditure Statement (TES) details the cost of CCTR, but does not capture tax foregone through paying for child care with pre-tax dollars (salary sacrificing). Salary sacrificing is limited to those who use employer-provided care located on the business premises. In practice, those who access this form of care are a small number of Australian and State government staff and a few corporations.

Further, the TES 2008 includes an item (D11,p.157) for an 'Exemption for employer contributions to secure childcare places in certain centres'. This covers the fact that 'Payments made by employers to obtain priority of access to certain childcare facilities for children of employees are exempt from fringe benefits tax.'. The cost of this item also does not appear to be captured in the TES.

There are two major problems with the current system.

Firstly, there is an absence of planning and management mechanisms at both a systemic and provider level that are essential to ensure (i) the most efficient and effective allocation of child care places between regions, taking account of the special needs of all groups of users; and (ii) the appropriate incentives to support those child care providers whose prime commitment is to the welfare of the children. Secondly, the use of tax expenditures has created a set of incentives, opportunities, and barriers that have proven to be counter-productive for achieving the objectives set out above. Together these two factors have combined to create a funding system that has

generated new sources of market failure to add to the market failures that generate government involvement in the sector.
This system means that there is no effective limit to the costs to Government. The cost to government is a function of the number of children that gain places, and the average cost per child. There is a maximum amount that any one user can obtain from government, but little control over the total number of places that are offered. In addition, the opportunities for for- profit organisations (FPOs) to seek ever higher co-payments generates higher fees which in turn generate political pressure from more powerful groups to increase the level of assistance for each child.

This is not fiscally sustainable.

It should be self-evident that if there is a shortage of places and limited capacity to increase supply in the short-term, a subsidy to users can only bid up the price of a place and enable providers to charge higher fees. This can especially occur where there are users whose demand is inelastic as is more likely in high income areas.[27]

This is exacerbated by the use of tax expenditures, which are disproportionately used by higher income users. Thus "Tax expenditures…add to purchasing power without necessarily addressing supply-side capacity constraints, and this can lead to inflationary pressure - simply pushing up the prices of services like child care… rather than increasing their affordability" (Spies-Butcher & Stebbing (2009:14)

There are further significant problems associated with demand-side subsidies and the use of tax expenditures.

- *They do not take account of the capacity to pay of different users.* Unless government is prepared to pay the full cost of care and all associated services <u>and</u> prohibit co-payments <u>and/or</u> limit the subsidies to lower income groups, there will be tendency for at least some providers to move to areas where families have a greater capacity to make co-payments. This will distort supply away from the socially efficient allocation of resources.
- Tax expenditures disproportionately favour higher income earners.
- Tax expenditures *require* a co-payment by the user[28], which has at least two undesirable effects. FPOs are attracted to those areas with higher income earners, pushing fees up in those areas and increasing the disparity in supply. Secondly, it means that in cases where a provider may have to waive or reduce the co-payment

[27] Whelan (2009, as reported by Horin 2009) apparently suggests that price did not have any impact on decisions by parents receiving the Child Care Tax Rebate about whether or not they used child care. While this would clearly not be not true for all parents using child care, it may well be the case for some high income earners for whom child care cost are only be a small proportion of their salaries.
[28] Note that a co-payment may be either required, permitted, or banned in programs using the other two major forms of demand subsidies

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for low-income parents, there is an incentive to give a scarce place to a higher income user..

Commonwealth funding for a number of other human services use demand-side subsidies that give users the right to choose their provider, but these subsidies are generally paid in the form of reimbursements to providers and exist in the context of other mechanisms for the planning and management of supply. These services include Medicare bulk-billing[29] and payments for residential aged care.[30]

Providing they operate in a context of a system designed to plan and manage supply, these reimbursement-based subsidies overcome a number of the negative impacts of tax expenditures. A further advantage of such subsidies is that they help government obtain better data about demand and supply, especially by location, and about individual providers. Much of this data can be passed on to users to enable them to make more informed choices.

Child care should be financed by either (i) reimbursement-based subsidies, or (ii) funding providers for a given number of children and places on a contractual or grant basis.

It is our contention that given Government policy to encourage the co-location of child care with other early childhood services, and with primary schools, there is an urgency about making changes to the funding basis which will bring the systems more into alignment with each other.

We consider that the Government should change from the use of taxation expenditures, with their inefficient and non-transparent use of government funding. This should not be seen as a source of savings, but rather as an essential step in redirecting much-needed funds in a more effective, efficient, and equitable way.

In our view, the development of a more transparent and equitable approach to financing child care should be referred to the Productivity Commission. We will make a further submission along these lines to the current Senate Inquiry into the child care issue.

[29] Note that 30% of the cost of private health insurance (generally used for different types of medical treatment) is subsidised by tax-expenditure.

[30] The amount of the subsidy in residential aged care varies by the level of care required by the user.