

CHILDCARE VOUCHERS: WHO BENEFITS?

An Assessment of Evidence from
the Family Resources Survey

Joanna Konings

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EXECUTIVE SUMMARY

The Prime Minister's 2009 party conference announcement proposed changes to the system of childcare vouchers, and kick-started a high-profile debate on the issue. But discussion of the role of vouchers has been hampered by limited evidence about who uses this form of childcare support. This evidence paper aims to fill that gap. Using the most recent data from the Family Resources Survey, a nationally representative survey of 24,000 UK households, this paper seeks to answer the following questions.

1. How do childcare vouchers complement other forms of financial support that the Government offers for childcare?
2. What are the income and other characteristics of childcare voucher users?
3. What does the scheme cost the exchequer, and how much will the Government's recently proposed reforms save?

The main observations of this report on the role of childcare vouchers are that:

- Childcare vouchers provide support for working families throughout the income distribution apart from people on, or very close to, the minimum wage.
- Under the 2007 system, voucher support was worth up to £944 per year for a basic rate taxpayer and £1,173 per year for higher rate taxpayers. Couples can both claim vouchers and hence double the level of support they receive as a household.
- From 2011, under the Government's proposed reforms, the voucher system will become more progressive, with higher-rate taxpayers only able to claim tax relief at the basic rate.
- Vouchers provide part of a patchwork of childcare support available to working parents, becoming increasingly important for families earning between £20,000 and £30,000 when tax credit support typically runs out.

The analysis of who actually uses childcare vouchers in the UK suggests that:

- Around 190,000 people were using childcare vouchers in 2007.
- The vast majority of voucher users are on middle incomes, with around 83% of users paying income tax at the basic rate, a higher proportion than had previously been thought.
- There is no evidence that the income distribution of voucher users is different to that of the whole population.
- Childcare vouchers appear to be used more intensively by working lone parents than by couples.
- All occupational and socio-economic groups are well-represented among voucher users, with manual and unskilled workers being the best represented group.
- Voucher users are diverse in terms of family structure, gender, geographic location and ethnicity.

From the exchequer's perspective, this analysis shows that:

- The current scheme cost the exchequer around £240m in 2007, of which around £170m went to families.
- Tax relief for higher rate earners made up around £40m of this expenditure.
- Recent and imminent changes to the tax and benefit system will make little overall difference to the cost of tax relief.
- The Government's proposed reforms, by restricting higher rate taxpayers to basic rate relief from 2011, promise savings of just £20m per year for the exchequer.

INTRODUCTION

This report uses evidence from the Family Resources Survey (FRS) to show how childcare vouchers are being used in the UK. A review of this evidence has become overdue in the recent debate surrounding the future of childcare vouchers, triggered by Gordon Brown's announced intention at the Labour party conference to stop new entrants to the voucher scheme in 2011, and ultimately remove tax relief on childcare vouchers by 2015. This policy has since been modified to leave the system unchanged for basic rate taxpayers. Higher rate taxpayers will still be able to enter the scheme after 2011, but will receive tax relief on childcare vouchers only at the basic rate.

The Government's stated aim of reforming the tax relief on childcare vouchers is to improve the targeting of financial support for working parents towards basic rate taxpayers on lower incomes. As a tax-relief system, childcare vouchers have the potential to provide greater savings to higher rate taxpayers than basic rate taxpayers. However, childcare vouchers were never intended to represent the only financial support available to working parents, but to form one part of a bigger network of support. Another major component is the childcare support available through tax credits. Parents on low and middle incomes can claim the childcare element of Working Tax Credit (WTC) against the costs of childcare up to a maximum of £175 each week for one child and £300 for two or more children.¹

Childcare vouchers are made available by employers, who either administer the vouchers themselves or pay a private company to take over the administration of the scheme in their workplace. The vouchers have been designed as a closed-loop system, meaning that they are only redeemable at registered or 'formal' providers of childcare. These providers include childminders, nurseries and after-school clubs, and must be accredited and inspected by Ofsted. Parents are only

¹ In order to receive the childcare element, parents must first pass a means-test and a working requirement to be eligible for WTC. £175 and £300 are the maximum childcare costs that can be claimed-for each week. Any costs must be for a 'formal' provider of childcare, and after any childcare vouchers have been used. Parents claiming the childcare element of WTC will receive 80% of the costs they claim for, i.e. up to £140 or £240 each week.

able to access the vouchers if they are working and their employer participates in the scheme.

The majority of the employers who do participate offer vouchers through 'salary sacrifice', where employees voluntarily sacrifice up to £55 each week from their gross salary in return for vouchers to the same value, thus benefiting from income tax and National Insurance Contributions (NICs) exemptions on this amount. In effect, employees can pay for up to £55 per week of childcare out of their pre-tax income. Employers also save through NI exemptions of up to 12.8% of the value of the vouchers they provide (on up to £55 of vouchers per week per employee).²

The administrative burden of providing childcare vouchers is designed to be as light as possible, to encourage employers to participate in the scheme. As part of this approach, employers are not required to report the number of their employees who use childcare vouchers, with the result that official administrative data covering the scheme does not exist.³ This makes it impossible to be absolutely certain about who and how many are using vouchers in the UK today. A 2006 study commissioned by HM Revenue and Customs and carried out by Kazimirski et al. at the National Centre for Social Research estimated that some 174,000 parents in the UK were using vouchers in late 2005, based on a small survey of employers who offered vouchers.⁴ However, HM Revenue and Customs considers that "these figures are likely to have increased since this research was carried out."⁵ This report tackles the question of the number of recipients more directly, deploying household survey data to estimate the number of beneficiaries in the UK.

2 Employers for Childcare Ltd, *Childcare Vouchers: Information for Employers* (2006), http://www.employersforchildcare.org/filestore/library-documents/Employers_For_Childcare_E-Vouchers_Employers_Information_Sheet.pdf.

3 Anthony Seely, *Tax Relief for Childcare*, House of Commons Library, <http://www.parliament.uk/commons/lib/research/briefings/snbt-00019.pdf>.

4 HM Revenue and Customs, *Monitoring of the Reform of Income Tax and National Insurance Rules for Employer-Supported Childcare* by Anne Kazimirski et al. (London: HMSO, 2006). Stephen Timms quoted this report in the House of Commons on 4th November 2009 in answer to a question about the use of childcare vouchers by parents in the different tax bands. The more widely reported figure is 340,000 parents using the vouchers in September 2009 – see for example "Brown defends childcare changes", *BBC News*, 11 November 2009, <http://news.bbc.co.uk/1/hi/8353866.stm> - an estimate based on recent, unpublished information produced by private companies who administer the vouchers.

5 Anthony Seely, *Tax Relief for Childcare*, 11.

In addition, this report aims to:

- show where in the income distribution tax relief is available to working parents under the current system, and compare it to the situation after the most recently proposed reforms have been made;
- present evidence about the income and other characteristics of parents who actually use childcare vouchers; and
- quantify the cost to the exchequer of providing tax relief through childcare vouchers both under the current system and after the proposed reforms.

This report finds that childcare vouchers are part of a mix of financial support available to working parents. This mix changes with parents' income, and the proposed reforms to childcare relief make the tax relief on childcare vouchers more progressive. The 2007-08 FRS shows that 83% of the parents using childcare vouchers in the UK are basic rate taxpayers, a higher percentage than has previously been thought. The FRS also shows that childcare vouchers are used by a wide range of parents, challenging the perception of vouchers as something used only by privileged and/or very narrowly-defined groups.⁶

The body of the report is structured as follows. The first section illustrates the support available to different specimen families from childcare vouchers and the childcare element of WTC. The support available under the current system is contrasted with that available under the proposed reforms. The second section shows the characteristics of the parents who use childcare vouchers, using data from the FRS. The third section discusses the cost of childcare vouchers to the exchequer, highlighting changes to the cost of the system that can be expected by April 2011 when the proposed reforms take effect. The final section discusses and concludes.

6 It has been reported, for example, that parents use childcare vouchers towards boarding fees at schools including Ampleforth and Wellington college, see: Michael Crick, "Cat out of the bag on vouchers for boarding school" *Michael Crick's Blog*, 12 November 2009, http://www.bbc.co.uk/blogs/newsnight/michaelcrick/2009/11/cat_out_of_the_bag_on_vouchers.html, and Jessica Assato, "Keep tax relief on childcare vouchers", *The Guardian*, 13 November 2009, <http://www.guardian.co.uk/commentisfree/2009/nov/13/keep-tax-relief-childcare-vouchers>.

SPECIMEN FAMILY ANALYSIS

This section compares the value of financial support available to different families through the use of childcare vouchers and the childcare element of WTC. It contrasts the current system with the proposed reforms. The focus of the analysis is on the maximum level of support that is available, given the various rates of income tax and NICs in operation at different levels of income. Table 1 shows the rates and thresholds used in the analysis. 2007-08 rates and thresholds are shown here, corresponding with the available survey data that is used later in this report.

Table 1: Rates and thresholds of income tax, NICs and NMW, 2007-08 and 2010-11

	2007-08	2010-11
Income tax	Personal allowance: £5,225 Starting rate 10% £0 - £2,230 Basic rate 22% £2,231 - £34,600 Higher rate 40% £34,600 upwards	Personal allowance: £6,475 No starting rate Basic rate 20% £0 - £37,400 Higher rate 40% £37,400 - £150,000 Top rate 50% £150,000 upwards
NICs	11% between the primary threshold and upper earnings limit; 1% thereafter. Primary threshold £5,200 Upper earnings limit £34,840	11% between the primary threshold and upper earnings limit; 1% thereafter. Primary threshold £5,720 Upper earnings limit £43,888
NMW	£5.73/hour	£5.80/hour (estimate)

Source: HM Revenue and Customs.

As mentioned in the introduction, the majority of the employers who participate in providing childcare vouchers for their employees do so through a 'salary sacrifice' scheme. This allows employees to pay for up to £55 worth of childcare vouchers each week from their gross salary, making savings on income tax and NICs exemptions on this amount. The value of exemptions on income tax and NICs changes as income rises.

Chart 1: Support for different families using childcare vouchers at 2007-08 rates and thresholds

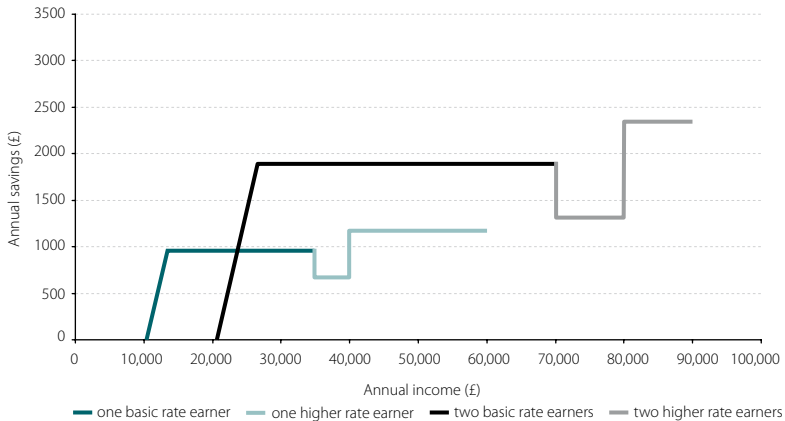


Chart 1 shows the value of these rates of tax relief⁷ for families with one and two earners, as their incomes rise. In 2007-08 the 10p tax threshold, basic tax rate threshold, and NIC low earnings limit were all lower than the earnings of an individual working full-time at the NMW: the level above which an employee can begin to sacrifice part of their salary to receive childcare vouchers. Basic rate taxpayers received tax relief at 33%, comprising the 22p income tax and 11p NICs. Once earnings cross the upper earnings limit for NICs, tax relief briefly drops to 23%, comprising 22p income tax and 1p NICs. When earnings reach the higher rate threshold for income tax, support jumps to 41%, comprising 40p income tax and 1% NICs. The chart illustrates how the current system is regressive, in that larger amounts of tax relief are available to parents who earn higher incomes.

As the chart shows, the maximum tax relief available to a single basic rate earner is £944 per year. For single earners between the threshold of higher rate income tax and the upper earnings limit for NICs, relief falls to £658. For higher rate earners, the maximum relief is £1,173. In households with two working parents, the maximum tax relief available is doubled, since vouchers, like income tax

⁷ Here, 'tax relief' is used as short-hand for the combined value of income tax and NICs relief.

and NICs, are available on an individual rather than a household basis. For two parents earning at the basic rate, the maximum tax relief available is £1,888. This drops to £1,316 for basic rate earners who are both above the NICs upper earnings limit. For all incomes above the higher rate threshold, there is £2,346 available in tax relief.

Addressing the regressive effect of tax relief on childcare vouchers is one of the factors driving attempts to reform the current system.⁸ From April 2011, the income tax exemption on childcare vouchers will change for new entrants to the scheme who are higher rate taxpayers. They will receive income tax relief at the basic rate. The system will remain unchanged for basic rate taxpayers, as well as all those who currently use childcare vouchers (even those currently receiving higher rate tax relief). As yet, no changes have been proposed relating to users' rates of NICs.

Chart 2 shows the value of the relief that will be available to all new entrants to the childcare vouchers scheme after 2011.⁹ Basic rate taxpayers will receive tax relief at 31%, comprising 20p income tax and 11p NICs. When earnings reach the higher rate threshold that support drops to 21%, comprising 20p income tax relief and 1p NICs relief. In 2010-11, there will also be a top rate of income tax for those earning more than £150,000 a year. Under the newly proposed system these earners will also receive support at 21%, comprising 20p income tax and 1p NICs.

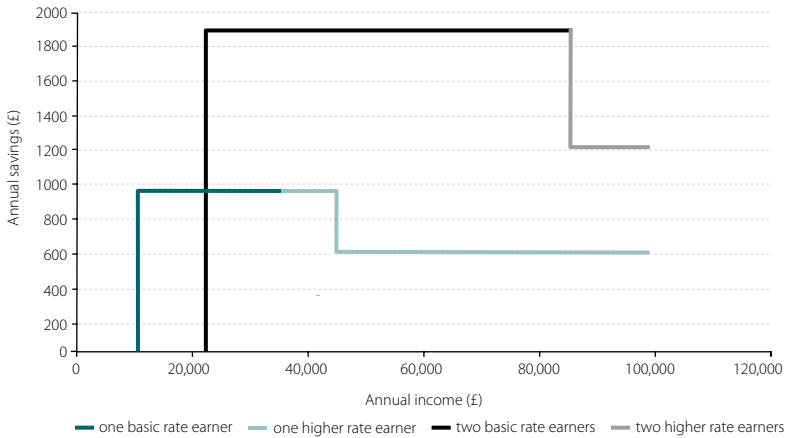
As the chart shows, the value of the maximum annual support available to a single basic rate earner is £887. For single earners above the upper earnings limit for NICs, relief will fall to £601 per year, remaining at this level for incomes above this limit. For two basic rate earners using vouchers, the maximum relief available is £1,773,

8 The Pre-Budget Report 2009 states that all receipts from the 'Government's 'employer supported childcare tax relief measure', i.e. the reform to tax relief on childcare vouchers from April 2011, will be "used to fund expansion of free care for 2 year olds." Table B4, footnote 3, 173.

9 The 2010-2011 rates and thresholds of income tax and NICs are used, see: <http://www.hmrc.gov.uk/rates/it.htm>, and <http://www.hmrc.gov.uk/rates/nic.htm>.

falling to £1,202 when both earners exceed the NICs upper earnings limit.¹⁰ The chart shows how the proposed reform to the system has the effect of making tax relief on childcare vouchers more progressive.

Chart 2: Support for different families using childcare vouchers at 2010-11 rates and thresholds



Charts 1 and 2 have shown that childcare vouchers in the current system and under the proposed reforms make tax relief available to all but the lowest-paid parents. The option of ‘salary sacrifice’ is only open to employees whose earnings, after paying for childcare vouchers, are still above the hourly rate of the National Minimum Wage (NMW). However, childcare vouchers were always intended as part of a mix of financial support available to working parents.

Chart 3 shows the tax relief available to parents from childcare vouchers as in Chart 1, and also the childcare element of Working Tax Credit available to three specimen families.

¹⁰ As the reform only applies to new entrants to the childcare vouchers scheme, it will be up to 15 years after the reform is implemented (when no users of childcare vouchers at the original rates can remain) before the system is fully progressive.

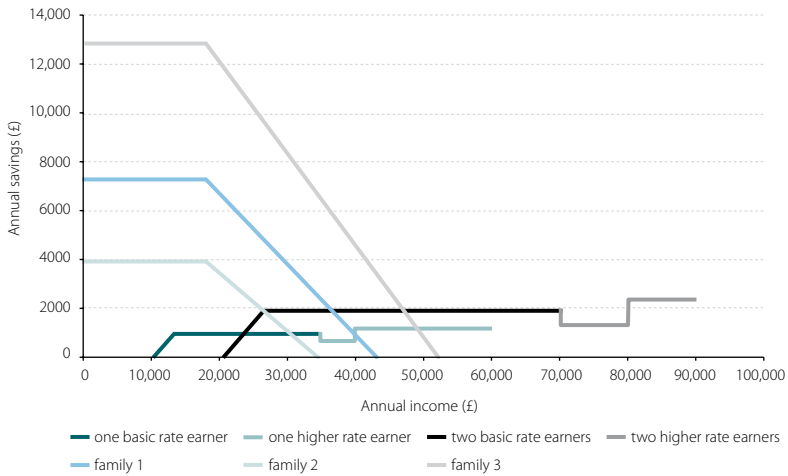
- **Family 1** have one child, and claim the maximum of £175 in childcare costs each week. As the childcare element of WTC is paid for 80% of the costs that are claimed for, the maximum amount of WTC they receive towards these costs is £140 per week.
- **Family 2** have two children, and claim the maximum of £300 in childcare costs each week. The maximum amount of WTC they receive towards these costs in payments of the childcare element is £240 per week.
- **Family 3** claim £94.12 in childcare costs each week. This was the average cost allowed in claims for the childcare element of WTC in 2008-09,¹¹ an indicator of the price that families typically pay for formal childcare.¹² As they receive 80% of the costs that are claimed for, Family 3 receive payments of the childcare element of £75 per week.

The chart is drawn assuming all three families are eligible for the same elements of WTC support: the basic element, the element paid to a couple or lone parent, and the 30-hour element for people working more than 30 hours a week. The specimen families are each eligible for the childcare support element through their eligibility for WTC. The chart illustrates the significance of the childcare element of WTC within the mix of financial support for working parents. In contrast to childcare vouchers, where the amount of tax relief largely depends on the number of earners in the household, entitlement to the childcare element of WTC depends on the number of children whose childcare is paid for by the household. The maximum entitlements for one child and two children, shown by Family 1 and Family 2, amount to annual sums of the childcare element of WTC that are far greater than the savings made by using childcare vouchers at most levels of income where both benefits are available. For Family 3, a family with typical childcare costs, the WTC childcare element represents the main component of support at the lowest levels of income, dovetailing with the support available from vouchers at mid-income levels. At incomes between £20,000 and £30,000, tax relief on childcare vouchers is an increasingly important part of the support available.

11 <http://www.hmrc.gov.uk/stats/personal-tax-credits/cwtc-apr09.pdf>, 14.

12 Estimates of these costs vary – see note 16.

Chart 3: The system of financial support for childcare costs of working parents



Note: Chart 3 uses the 2007-08 rates and thresholds of income tax and NICs and the 2009-10 rates for the various Tax Credit elements.

The analysis in this section has shown that the Government’s proposed changes to the system of relief mean that all but the very lowest-paid will continue to be able to benefit from vouchers. At the same time, the reforms will make the system of relief as a whole more progressive. Having shown who can benefit from vouchers, the next section of the report analyses who does benefit from vouchers in reality.

QUANTITATIVE ANALYSIS USING THE FRS

This section presents evidence from the 2007-08 FRS showing the characteristics of the users of childcare vouchers. The FRS is a large-scale survey of private households which combines a large sample size with very detailed questions about household members' use of social security benefits. It is commissioned by the Department of Work and Pensions to meet its own requirement for data to monitor the system of social security benefits in the UK.

The annual target sample size of the FRS is 24,000 private households. Each year, the sample for Great Britain is drawn from the small users' Postcode Address File as a stratified, clustered probability sample of addresses.¹³ Within households taking part in the survey, all non-dependent adults¹⁴ are interviewed individually and specific questions are asked about salary; the costs of childcare that they pay; their receipt of tax credits; and use of childcare vouchers, among many other questions.

The 2007-08 survey reports 153 recipients of childcare vouchers, which is 0.56% of the total sample population of the FRS, and 0.7% of the total sample population of parents in the FRS. For the kind of high-level analysis attempted here, and in the absence of any less biased survey data, this sample size is sufficient to draw broad conclusions for policy. Being drawn from a national household survey, the sample of voucher users in the FRS is more reliably representative than a number of previous attempts to identify the user population. Each respondent to the survey is weighted so that they can be considered representative of hundreds of similar families in the UK. The FRS weighting regime is designed and periodically reviewed by the ONS.

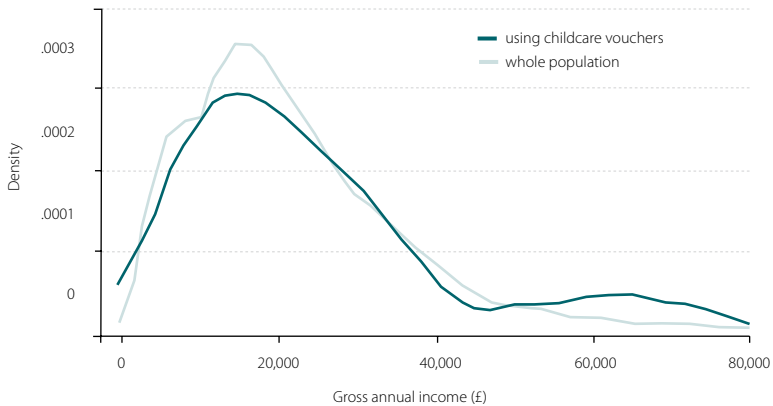
Chart 4 plots the income distribution of voucher recipients alongside the income distribution of the whole population. The earnings distribution of voucher users sits almost exactly on top of that of the overall working population, indicating that

13 This is one measure taken to ensure a representative sample, see: Department for Work and Pensions, Family Resources Survey, prepared by the Office for National Statistics and NatCen (Newport: ONS, 2009) http://www.statistics.gov.uk/downloads/theme_social/FRS-Tech-Report-2007-08.pdf, 9.

14 Aged over 16.

voucher users are evenly represented throughout the income distribution. Most users are bunched around the middle of the income distribution, well below the £40,000 annual income mark. It is worth noting, however, that it is difficult to draw conclusions from this analysis about where voucher users sit in the household income distribution, as opposed to the individual one.

Chart 4: Income distribution of childcare voucher users



Source: FRS 2007-08.

Using weights to approximate the UK population, the FRS shows there are 192,000 users of childcare vouchers in the UK. 159,000 of these users are basic rate taxpayers at the 2007-08 thresholds and 33,000 are higher rate taxpayers. This amounts to a proportion of 83% of those using childcare vouchers being basic rate taxpayers. Small sample sizes mean that this proportion should be interpreted cautiously. To consider how this compares with the proportion of higher rate beneficiaries reported by Kazimirski et al. (2006), it is worth examining their methodology in more detail.

In their study, they find the mean and median proportion of employees in the different tax bands from a survey of employers. They oversample large organizations in order to get a large enough sample of employers who participate in providing vouchers

to their employees. They then use weights to make the sample representative in terms of organization size. However, as there is no individual-level data, the extent to which employees are representative of the UK population is not addressed.

Surveying employers also means that Kazimirski et al. only arrive at individual level data indirectly. The survey responses of 373 employers give them a mean proportion of childcare voucher users in the higher rate tax band as 31%, while the median proportion across the organisations surveyed is reported as 11%. Kazimirski et al. note that the sample size means that these proportions are associated with a confidence interval of between 6% and 8%.¹⁵

In comparison to the Kazimirski et al. study, the FRS is more recent; it is weighted to be representative; and it provides evidence directly from the parents who use childcare vouchers. This evidence is now considered in more detail. The 2007-08 FRS shows that:

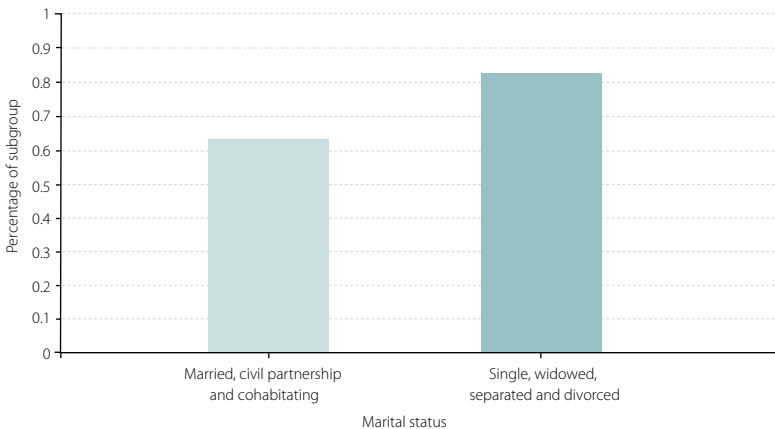
- There are approximately 27.4 million parents in the UK.
- More than one million parents in the UK feel they are prevented from working or looking for work 'due to their children'.
- Parents pay an average amount of £40 per week for childcare for each of their children, amounting to annual costs of £2,080 per child.¹⁶
- 87% of the parents using childcare vouchers do not receive any tax credits.
- More than 70% of the parents using childcare vouchers have a salary sacrifice arrangement with their employer.
- The mean value of vouchers used by each parent in a week is £50, with three-quarters receiving the maximum amount of £55 each week.
- Basic rate earners and higher rate earners use the same mean value of £50 in childcare vouchers each week.

15 HM Revenue and Customs, *Monitoring of the Reform of Income Tax and National Insurance Rules for Employer-Supported Childcare*, Appendix B, Table B10, 21-22.

16 In its instructions to interviewers, the 2007-2008 FRS notes a persistent understatement of childcare costs in comparison to other surveys. See also Institute for Fiscal Studies, *Government surveys of parents disagree on how many working families use childcare*, Press Release, www.ifs.org.uk/pr/childcare_surveys.pdf. The annual Childcare Costs survey published by the Daycare Trust found that the average cost of a full-time nursery place for a child under two was between £7000 and £8000 in 2008. Average allowed costs for the childcare element of WTC are closer to £5,000.

The FRS also shows the characteristics of the parents who use childcare vouchers, including their gender, marital status, the ethnic and socioeconomic groups they belong to, and the geographical region in which they live. According to the survey, just over 50% of the parents using childcare vouchers are female. In the sample, a majority of the users of childcare vouchers – some 60% - are in couples. Chart 5 shows the percentage of parents in different family types (lone or couple parents) who use childcare vouchers. The chart shows that childcare vouchers are an important source of support for working single parents.

Chart 5: Users of childcare vouchers by marital status



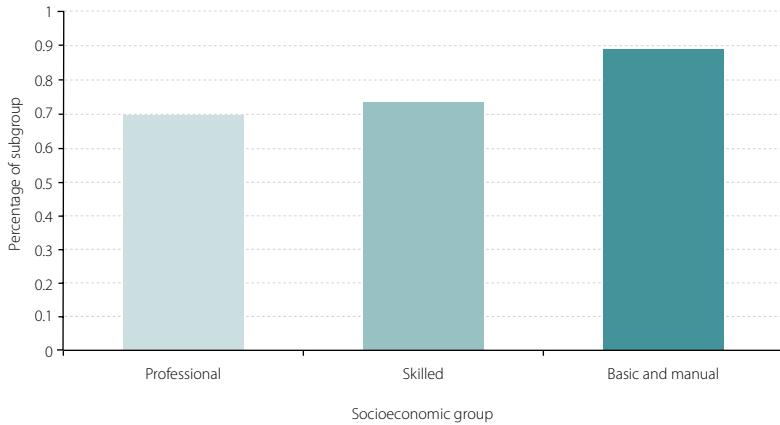
Source: FRS 2007-08.

A parent's professional occupation largely determines whether they will have access to the voucher scheme, as an employer must participate in the scheme before any of their employees can use childcare vouchers. Chart 6 shows the percentage of parents employed in different occupations using childcare vouchers. The three groups shown in the chart are each composed of several standard occupational groups recorded in the FRS.¹⁷ The chart suggests that

¹⁷ The groups are aggregated as follows: 'professional' includes managers, senior officials, professionals, associate professionals and those in technical occupations; 'skilled' includes administrative, secretarial, skilled trades, personal service, sales and customer service occupations; and 'manual' includes processing, plant and machine operatives and elementary occupations.

parents in the basic and manual occupations disproportionately use vouchers. While the limited sample size does not bear drawing concrete conclusions, at the very least, there is evidence that a wide range of occupational groups are well represented among voucher users, not just professionals.

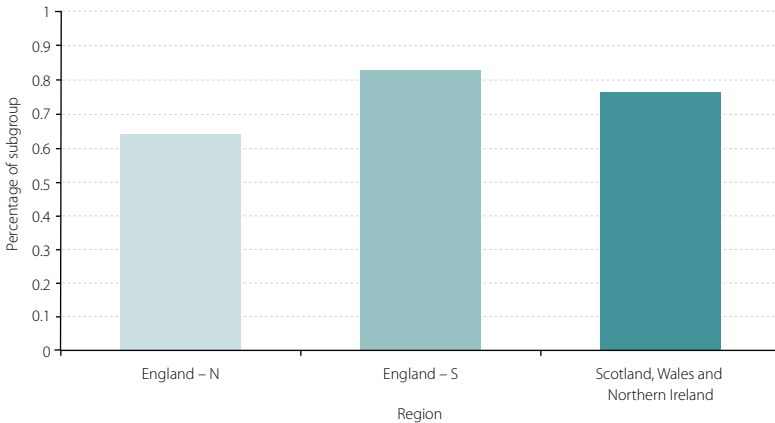
Chart 6: Users of childcare vouchers by socioeconomic group



Source: FRS 2007-08.

Chart 7 shows the number of users of childcare vouchers living in each UK region, per head of population. The South of England has the highest number of users for its size, which could reflect higher childcare costs in the South East and London, compared to the other regions in the survey. The small number of recipients recorded in the sample in Scotland, Wales and Northern Ireland means that the percentage shown for these countries should be treated with caution.

Chart 7: Users of childcare vouchers by region



Source: FRS 2007-08.

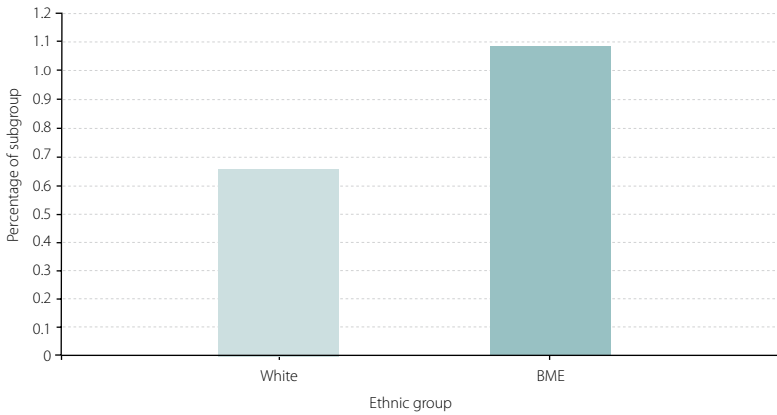
The FRS records 33,000 Black and Minority Ethnic (BME) recipients of childcare vouchers, compared to 159,000 white recipients. Chart 8 shows the percentage of parents in different ethnic groups using childcare vouchers. The chart suggests that, when taking into account the size of the different ethnic groups, childcare vouchers are being used by BME parents slightly more intensively than white parents, suggesting once again that vouchers are a diverse form of support taken up by a wide range of people.

The analysis in this section has presented data from the FRS, an important resource for its large sample of households and the degree of precision in its questions relating to childcare vouchers. The FRS provides recent, representative evidence directly from the parents who use childcare vouchers. The evidence shows that the majority of parents using childcare vouchers take advantage of the maximum amount of tax and NICs exemptions, allowing them to benefit from the levels of relief that were described in the specimen analysis in the previous section.

In 2007-08 all income groups are well represented, indicating that middle-income earners are the biggest users of the scheme. Vouchers are clearly used by a diverse

range of ethnic groups and socioeconomic groups, as well as across the different geographic areas of UK. Having formed a picture of the use of childcare vouchers, the next section discusses the cost of the scheme and the proposed reforms from the point of view of the exchequer.

Chart 8: Users of childcare vouchers by ethnic group



Source: FRS 2007-08.

COSTING

This section draws on the FRS to examine the exchequer costs of the existing voucher system. It also discusses the consequences for the exchequer of the proposed reforms to childcare vouchers, which would remove relief at the higher rate for new entrants to the scheme from April 2011. HM Revenue and Customs state in their 2009 report of National Statistics that the ‘employer supported childcare exemption’ was worth £500m in 2008-09, commenting that this estimate is “particularly tentative and subject to a wide margin of error.”¹⁸ It is difficult to measure the cost of the scheme due to the absence of official administrative data, and once again the FRS is the best household level data available to estimate it.

Using the findings in the previous two sections of this report, about the number of parents using the scheme and the levels of tax relief taken up, we estimate that in 2007-08 the programme cost the exchequer approximately £240m in tax and NICs relief. Of this, around £170m went to families and some £40m to higher rate taxpayers. Thus, tax relief for higher rate earners is approximately 17% of the total cost to the exchequer. For the same year, the savings made by reducing tax relief for all higher rate earners to the basic rate – the proposed reform for 2011 – would have been approximately £20m. This is a very small sum in exchequer terms.

Between 2007-08 and 2010-11, changes to the income tax and NICs landscape will affect the number of users and the amount of tax relief available to them, even before any reform to childcare vouchers takes place:

- The change in basic rate of income tax from 22p to 20p, announced in the Budget 2007 and amended in 2008, will save the exchequer an amount of tax relief per user of the scheme in 2010-11, compared to 2007-08.
- However, this saving will be offset by increases in the number of basic rate taxpayers following the abolition of the 10p rate, which happened at the same time.

18 HMRC National Statistics (Table 1.5), April 2009.

- The announced rates and thresholds from the 2009 Pre-Budget Report promise to raise the cost of exemptions before any change to higher rate earners' entitlement to tax relief. Significantly, the number of higher rate taxpayers will increase due to the higher rate threshold being frozen at £43,875.
- The exchequer cost of relief will also increase slightly from 2011-12 due to a 1p rise in the level of NICs all the way up the income distribution from the lower earnings limit.¹⁹

It is difficult to be certain of the net effect of all these changes in the exchequer cost of the voucher system in 2010-11, however, since they are broadly offsetting, it seems likely that there will be little change to the overall cost.

Another driver of the scheme's cost is the number of parents in each tax / NICs band. The FRS gives the number of parents using childcare vouchers each year for the years between 2005 and 2008, from which it is possible to find the number of entrants to the scheme each year in the different tax bands. However, any projection of the number of entrants to the scheme in 2011 (and in particular, the number of higher rate earners entering the scheme by this time) is unlikely to be useful. One reason for this is that the childcare vouchers scheme is a young policy, having only been announced in the 2003 Pre-Budget Report. Predicting when the number of participating employers will stabilize is problematic, and it is likely to continue to grow for some years. There may even be an effect related to a general increase in public awareness of childcare vouchers since the announced reforms and subsequent debate.

A further significant increase in the number of higher rate users of childcare vouchers will result from the freezing of the higher rate income tax threshold. Childcare vouchers can be claimed up until the child's 15th birthday, so the numbers who are pushed into this bracket by the freezing of the higher rate threshold will

¹⁹ Steve Lodge, "40 per cent tax to hit more middle-income taxpayers" *Financial Times*, 11 December 2009, <http://www.ft.com/cms/s/2/46d7e162-e686-11de-98b1-00144feab49a.html>.

increase as nominal salaries rise. Indeed, parents earning at the higher rate who begin using childcare vouchers just before April 2011 will continue to receive relief at 41%, potentially until 2026. However, the additional cost of freezing the higher rate threshold disappears once entitlements to higher rate tax relief disappears after April 2011.

CONCLUSION

This report has described who vouchers are targeted at in the current system, and who is using them. It has also provided some initial analysis of the savings to be made through proposed reforms to the system of childcare vouchers. Analysis of the value of tax relief available to different specimen families showed that vouchers form one part of the mix of financial support for working parents. Most of the beneficiaries of the childcare voucher system are on middle incomes, and tax credits provide the main component of support for the lowest-paid. Modelling the proposed changes to the system of relief shows that from 2011, all but the very lowest-paid can benefit from vouchers, whilst the relief available in the system will become more progressive.

The 2007-08 FRS is the most recent evidence available about the use of childcare vouchers and is an important source of information given the absence of official administrative data covering the scheme. Its evidence shows that childcare vouchers are used across the income distribution. This means that the vast majority of users are on middle incomes, with 83% of users paying income tax at the basic rate. This is a greater proportion than has previously been thought.

In addition, childcare vouchers appear to be used more intensively by working lone parents than by couples. There is no evidence that their use is dominated by professionals. Indeed the data suggests that manual and unskilled workers are the best represented group. Their use by diverse ethnic groups and across the regions of the UK suggests that in all dimensions, vouchers have very broad-based take-up among the UK population.

The report has also discussed the cost of the current system and potential savings for the exchequer resulting from the proposed reforms to tax relief on childcare vouchers. The overall cost of the system is estimated at £240m per year. Savings from the proposed reduced exemptions for higher rate taxpayers are likely to be very small, at around £20m per year. This is largely a result of the fact that as spending on the whole higher rate tax group only accounts for around 17% of the total spending on tax relief for childcare vouchers. Over the next few years, under

current tax plans, the cost to the exchequer of operating the voucher scheme is likely to remain largely unchanged owing to broadly offsetting effects from changes to the landscape of income tax and NICs rates and thresholds that will take place.

The proposed reform – allowing voucher recipients only basic rate income tax relief regardless of their marginal rate, from 2011 – will, however, make the system of childcare vouchers more progressive in comparison to the system as it stands today. This seems like a sensible change to make, albeit not one that carries as significant an exchequer saving as might have been hoped. In the context of straitened circumstances for the public finances, it is also worth considering the other advantages to the voucher system. Notably, it cements the link between public money paid to thousands of middle income families in the UK for their childcare and its receipt by accredited childcare providers. By comparison with other financial transfers,²⁰ this closed-loop system has significant benefits in limiting fraud and error.

20 CTC and WTC Error and Fraud Statistics, 2007-08, Table 2: The cost to the exchequer of erroneous and fraudulent claims for all Tax Credits was estimated at £1.9bn in 2007-08.

