

November 2024

Time to Stop Throwing Good Money After Bad

Delivering **Universal Childcare**
Through Market Reform



A report prepared for **Minderoo Foundation**

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Acknowledgement of Country

We acknowledge Aboriginal and Torres Strait Islander peoples as the Traditional Owners of Australia and their continuing connection to both their lands and seas. We also pay our respects to Elders – past and present – and generations of Aboriginal and Torres Strait Islander peoples now and into the future.



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Overview

Should Australia move towards universal early childhood education and care and if so what is the best model? Is it time to abandon the Child Care Subsidy which has failed to put downward pressure on costs, and implement a flat \$10 day fee model for child care? These are the questions the Government is currently contemplating as it considers two major inquiries from the ACCC and the Productivity Commission on early childhood education and care.

The first report, by the ACCC reported in December 2023 and looked at impact of previous increases in rebates on prices in the sector. The second, by the Productivity Commission was released in September 2024 and explored paths to universal early childhood education and care in Australia.

Both reviews recommended that the Australian Government abolish the Activity Test for early childhood education and care, which is undermining access for the most disadvantaged children. This mirrors recommendations from the Government's Economic Inclusion Advisory Committee and the Women's Economic Equality Taskforce.

In addition, both reviews highlighted serious issues with the current market for early childhood education and care. The ACCC found:

“Childcare markets under current market settings are not delivering on accessibility and affordability for all children and households across Australia.”

In a supplementary statement to the Productivity Commission Inquiry Report Deborah Brennan also raised significant concerns about the current market for early childhood education and care:

“aspects of Australia’s highly marketised approach to ECEC will work against equitable, high quality provision unless moderated.”²

Notwithstanding these issues, both the ACCC and Productivity Commission recommended that the basic architecture of the current system be retained, with an ongoing reliance on the Child Care Subsidy and limited use of supply side subsidies to address lack of access in some markets.

1. ACCC (2023), Childcare Inquiry – Final Report

2. Productivity Commission (2024), A path to universal early childhood education and care - inquiry report - volume 3

The Productivity Commission recommended abolishing the Activity Test and lifting the Child Care subsidy for low income families, increasing the cost of subsidies by 37 per cent to \$17.4 billion a year.³

The ACCC concluded that the current design of the Child Care Subsidy has not placed downward pressure on costs.⁴ Its recommendations, while addressing under supply in some markets would not address the fundamental issues it identifies in its report.

In this report we make the case for fundamental market reform. The current market settings are leading to higher fees, rather than driving cost effective and higher quality care. There are large benefits from reforming early childhood education and care and moving to a universal system, but the current system is not working. Increasing Child Care Subsidies further to deliver a universal system would risk throwing good money after bad, and fail to deliver on the promise of a universal system. A \$10 per day flat fee model would provide an opportunity for market reform, delivering cost effective and higher quality care.

The Case for Reform

Early childhood education and care is an important sector for our economy:

- Educates 1.4 million children a year⁵
- Facilitates 1 million women to work each year
- Employs 216,000 people⁶

Universal early learning and care would improve childhood outcomes and equity, and support families with one of their biggest household costs. However, it is the impacts on female participation that can provide the biggest immediate economic benefit.

Latest ABS data show that 140,000 women in 2023-24 cite the cost and lack of availability of childcare as the reasons they either don't want to work more or are unable to work more.⁷ This compares to 10,500 men that indicated they don't want to work more due to either the cost of or access to child care, highlighting the gendered impact of child care on labour force participation.

Questions have been raised about the rationale for reform due to the Productivity Commission modelling showing that a universal system with a flat \$10 a day fee would only lift labour force participation by 7,200 – especially given the \$8.2 billion cost of such reform.

The Productivity Commission's modelling, if correct, would mean that female participation would only increase 1 day for every 8 additional days of childcare. These findings are not consistent with current childcare use or stated preferences for mother's to look after their own children.

In this report we identify a number of limitations in the modelling approach that would explain why the Productivity Commission's model has underestimated the benefits of universal early childhood education and care.

3. Productivity Commission (2024), A path to universal early childhood education and care - inquiry report - volume 1

4. ACCC (2023), Childcare Inquiry - Final Report

5. Department of Education (2024), Quarterly Report

6. ABS (2022), 2021 Census of Population and Housing, Table builder

7. ABS (2024), Barriers and Incentives to Labour Force Participation

Current System is Failing to Deliver on Affordability or Access

Australia's childcare system relies on demand side subsidies, which are designed to reduce the cost of early childhood education and care for families. But the efficiency of these subsidies has been called into question with the ACCC finding they do little to put downward pressure on costs, and that the trend of prices increasing when subsidies increase is likely to recur.

Successive governments have attempted to reduce the cost of childcare for families and improve access, but despite billions in additional subsidies childcare remains a major cost burden for Australian families. Average out-of-pocket costs faced by families are 28.2 per cent higher than they would have been if increases had matched inflation over the period.

Over the past 12 months early childhood education and care fees have increased by 10.6 per cent⁸, eroding the benefits of the \$5 billion Cheaper Child Care Reforms introduced on 1 July 2023.

Analysis for this report has found that excluding the impact of government subsidies, the underlying cost of early childhood education and care has increased by 499.6 per cent since 1991 – almost four times the rate of CPI. Excluding tobacco and insurance it represents the fastest growing good or service in the ABS CPI basket over the period. Government efforts to lower costs have had the opposite effect, fuelling price increases in the sector.

Access remains a critical issue for many families, with research finding that 1 in 4 Australians live in childcare deserts with inadequate access to early childhood education and care.⁹ The Mitchell Institute has highlighted in its recent report the link between the use of demand side subsidies and under-supply in disadvantaged areas. The Activity Test, which limits access based on parental labour market activity, has also undermined access to early childhood education and care for disadvantaged children.¹⁰

Meanwhile, workforce shortages are widespread with low wages in the sector making attracting and retaining staff difficult. Recent decisions of the fair work commission to award a wage increase and the Australian Government to fund the increase should help address these issues over time, however labour shortages in the sector remain a concern.

Delivering Universal Childcare Through New Market Reform

Our analysis highlights how the current market design means providers are incentivised to increase fees rather than drive efficiencies or improve the quality of care. As a result, the system is not delivering affordable, high-quality services for Australian families or value for taxpayers.

Moving towards a universal early childhood education and care system provides an opportunity for government to undertake reforms that can underpin greater access, more affordable and higher quality care.

In this report we find that this requires fundamental reform of the market that reflects the nature

8. ABS (2024) Consumer Price Index Australia, Table 7. CPI: Group, Subgroup and Expenditure Class, Weighted Average of Eight Capital Cities

9. Hurley, P., Tham, M and Nguyen, H. (2024). International childcare: Mapping the deserts. Mitchell Institute, Victoria University.

10. ACCC (2023), Childcare Inquiry – Final Report and Productivity Commission (2024) Early Childhood Education and Care

of early childhood education and care services, including moving to fixed prices that reflect the cost of delivering services in different regions and cohorts. Such reform would underpin a better functioning early childhood learning and care market, that delivers for children, families and taxpayers.

We identify a number of key market characteristics needed to deliver better outcomes, including the role that setting an efficient price for early childhood education and care can play in driving better outcomes.

Finally, we undertake analysis of the recommendations from the Centre for Policy Development on options to deliver universal early childhood education and care through the introduction of a \$10 a day flat fee model for families, with a fixed efficient price¹¹ for providers.¹² The report concludes that such reforms are the best path forward as they would deliver market reform that would produce lower costs, higher quality and better access to early childhood education and care.



11. An efficient price is set centrally, but accounts for different cost drivers across providers based on the children being educated e.g. higher payments for children with additional needs or for children in rural locations.

12. Centre for Policy Development (2024), A future universal early childhood education and care system for Australia

What are the Likely Gains from Universal Early Childhood Education and Care?

Early childhood education and care plays an important role in our economy – it represents an investment in children and through allowing mothers to work, an investment in female participation in paid work.

The potential gains from expanding access to early childhood education and care include:

- **Increased Workforce Participation:** Access to affordable and high-quality early childhood education and care enables parents, particularly mothers, to enter or re-enter the workforce, contributing to higher household incomes and overall economic productivity.
- **Long-Term Economic Gains:** Research shows that investments in early childhood education lead to better educational outcomes, reduced crime rates, and improved health, which ultimately reduce societal costs and generate long-term economic returns through a more skilled and productive workforce.
- **Improved Equity:** High-quality early education reduces disparities in educational achievement and career opportunities, helping to break the cycle of poverty and fostering a more equitable society, which supports long-term economic stability and growth.

Both the ACCC and Productivity Commission conclude that there are significant benefits to children's outcomes and equity from improving access to early childhood development and care.

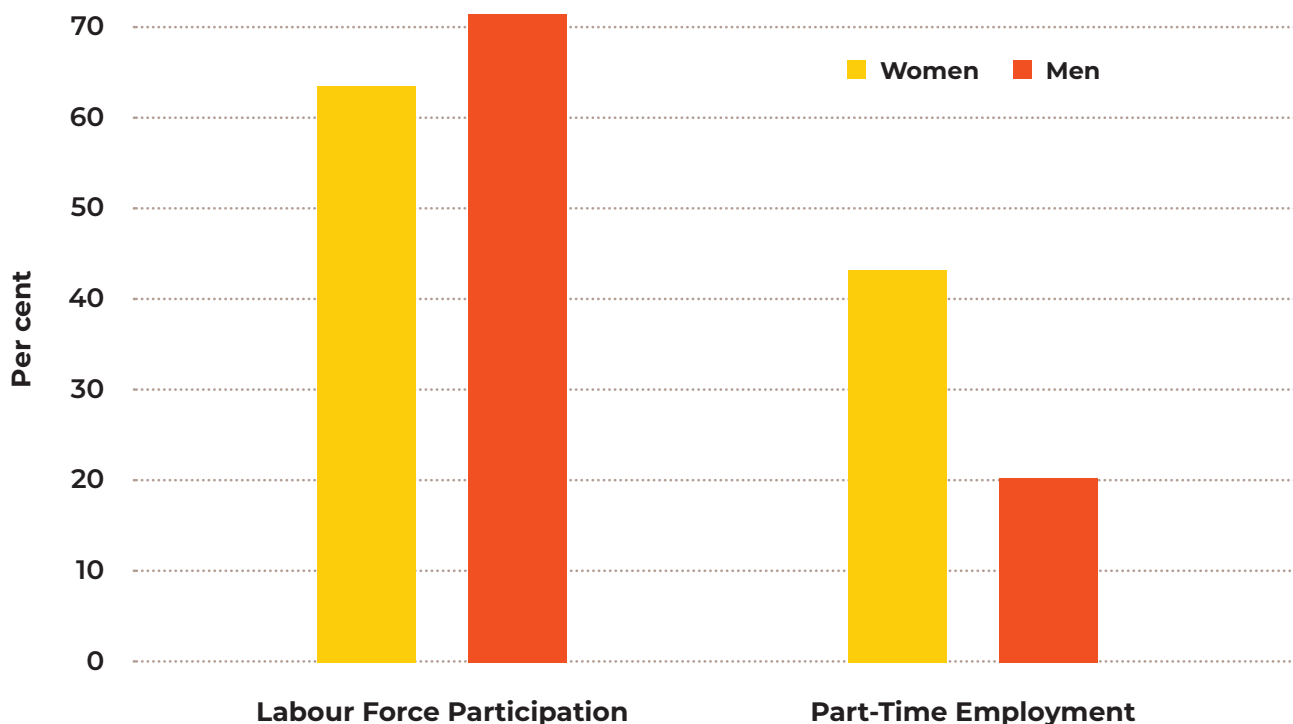
However, the Productivity Commission's modelling of female participation found only small gains.¹³ Given that moving to a universal early childhood education and care system would cost up to \$8.3 billion a year, this raises the question of whether such reform represents value for taxpayers.

The Productivity Commission's modelling involved making a number of assumptions, and as a result has a number of limitations. Analysis for this report highlights that these limitations are likely to significantly underestimate the impacts of female labour force participation of reforms.

Below we re-examine the evidence on whether the potential gains from higher female participation have been reached, and whether early childhood education and care costs are a factor in decisions to work by women with young children.

13. Preferred model from Productivity Commission has negligible impact on labour force participation (option A); moving to a universal 90 per cent subsidy rate and retaining the activity test increases labour force participation by 11,500 and moving a flat \$10 a day fee and removing the activity test increase labour force participation by 7,300.

FIGURE 1 Gender gap remains significant in labour market



Source: ABS (2024) Labour Force

Don't Australian Women Already have High Rates of Labour Force Participation?

Australian women are amongst the most educated in the world, and have relatively high rates of labour force participation which have increased overtime.

However, Australian women remain more likely to work part time than Australian men, and women in most comparable OECD countries.¹⁴ 33 per cent of Australian women work part time, which compares to the OECD average of 23 per cent. This higher rate of part time work is driven by mothers, with 47 per cent of mothers with dependent children aged 0-14 working part time.¹⁵

Overall and despite recent gains, there remains significant untapped economic potential from women working more hours.

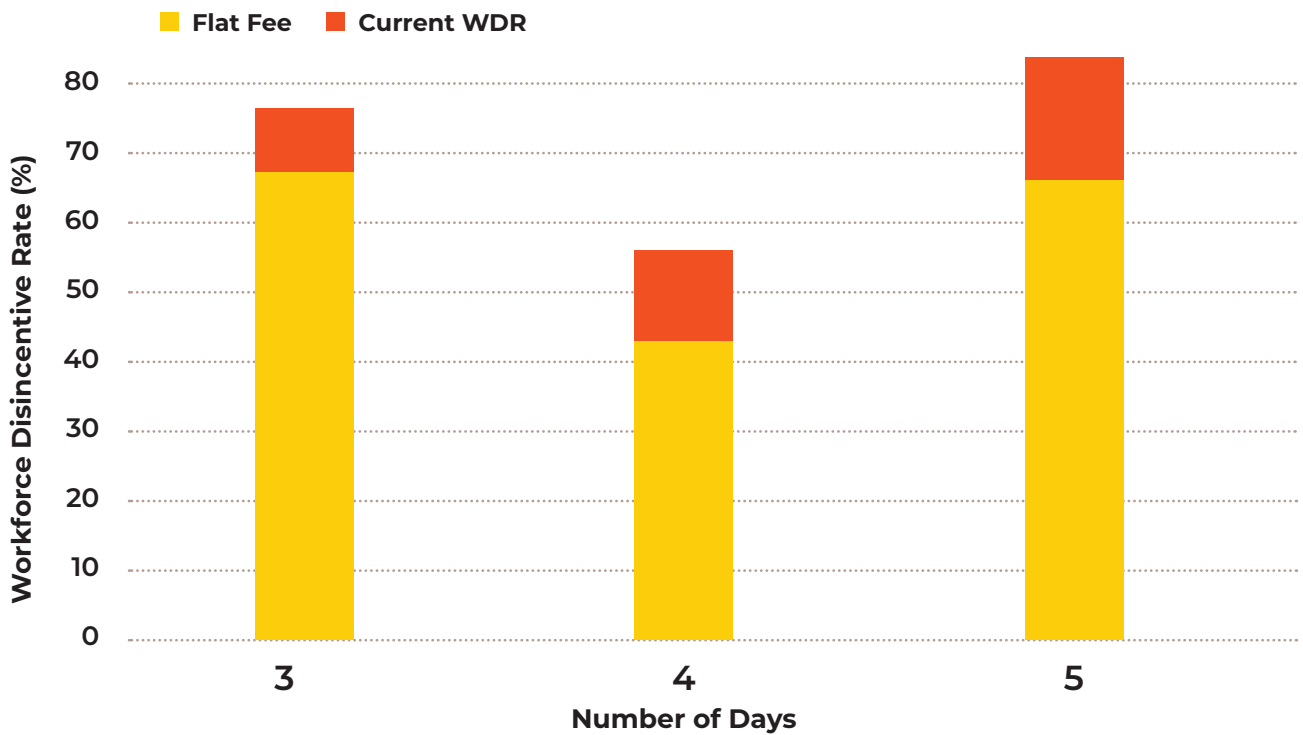
Would Reducing the Cost of Childcare Improve Incentives to Work?

It is argued that Australian women may have a preference for working part time, which is different from women globally and as a result reducing the cost of care will not have a major effect on labour force participation. Care is required that the observed preference of Australian women is not the result of social norms being established by policy settings that have historically incentivised working 2 or 3 days a week.

14. OECD (2024), Part-time employment

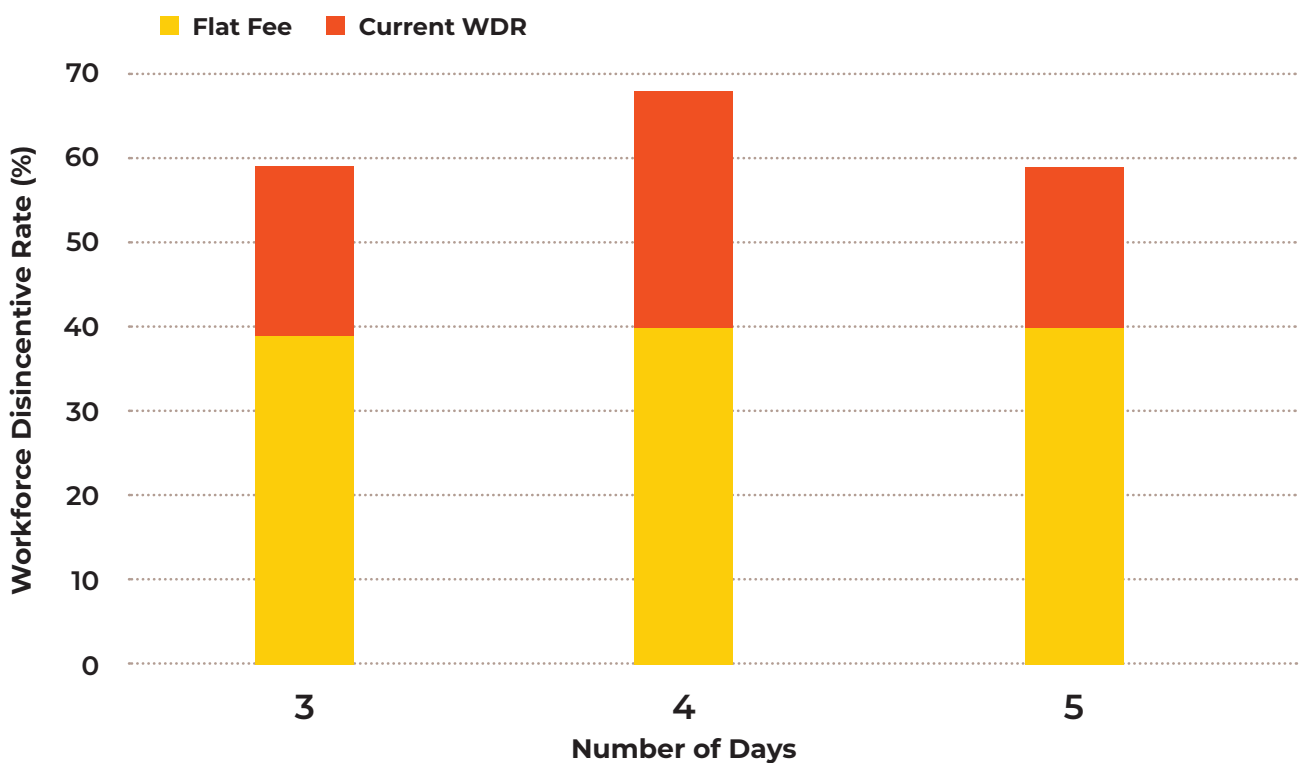
15. ABS (2024), Labour Force Status of Families

FIGURE 2 Both parents \$60,000 FTE, impact of secondary earner working additional days



Source: Productivity Commission (2024), A path to universal early childhood education and care - inquiry report - volume 2

FIGURE 3 Both parents \$100,000 FTE, impact of secondary earner working additional days



Source: Productivity Commission (2024), A path to universal early childhood education and care - inquiry report - volume 2

Productivity Commission analysis for its recent report highlighted that mothers working more than three or four days a week continue to face workforce disincentive rates of over 80 per cent.¹⁶ This represents an ongoing and significant disincentive to work.

As the Productivity Commission notes these high effective marginal tax rates are the result of a combination of policy settings including marginal tax rates, the withdrawal of benefits and increases in out-of-pocket childcare costs.

The Productivity Commission analysis finds that while on average the effect of out-of-pocket childcare costs is not a significant contribution to high work force disincentive rates – they continue to be a big contributor to the very high rates for women working 3, 4 or 5 days a week. The proposed \$10 flat fee would help reduce these disincentives across both low and high income families.

Given many of the gains to participation come from women increasing their hours of work, rather than entering the workforce, this is a significant finding – the current system is supporting women to work 1, 2 and up to 3 days a week but continues to disincentivise women working 3 or 4 days a week.

The impact of reforms on the incentives to work will vary based on individual family circumstances and incomes, however the Productivity Commission analysis highlights large gains for many family types from the move to a \$10 flat fee model.

Workforce Participation Benefits of Reform Likely to be Substantial

The Productivity Commission estimates that a move to a flat and universal \$10 per day childcare in Australia would result in an increase of:

- Childcare demand by 76,600 FTE
- Mother's participation by 8,900 FTE

The Productivity Commission's findings imply that women would only work one additional day for every eight additional days of childcare used. These findings do not reflect current use of early childhood education and care, or the stated preferences of mothers to look after their own children rather than work.

Of particular concern is that the results do not reflect previous research in Australia, including by the Productivity Commission, and causal analysis of similar reforms, such as the move to flat \$5 then \$7 per day daycare in Quebec. Post reform analysis of the Canadian reforms finds that they¹⁷:

- Increased average hours of attendance at childcare by 10.85 hours per week
- Increased average participation in work by 5.62 weeks per year

16. Productivity Commission (2024), A path to universal early childhood education and care - inquiry report - volume 3

17. Lefebvre, P., & Merrigan, P. (2008). Child Care Policy and the Labor Supply of Mothers with Young Children: A Natural Experiment from Canada. *Journal of Labor Economics*, 26(3), 519–548. <https://doi.org/10.1086/587760>

If these results were replicated in the Australian context, which while highly unlikely provide a useful benchmark, it would imply that such a policy could increase:

- Childcare demand by 226,000 FTE
- Mother's participation by 134,000 FTE

This is likely an upper estimate and corresponds with the Productivity Commission's analysis of ABS data that shows potential gains from removing all barriers to early childhood education and care of 143,000 FTE workers.¹⁸

What Could be Driving the Underestimation of Participation Benefits?

Economic modelling requires making a number of assumptions and can be prone to bias as a result. Accurately estimating policy impacts is not always possible, especially when data is not available to establish a credible counter-factual.

The move to a universal early childhood education system would represent such a systematic change from the current system, and any model based on the status quo would struggle to factor in the full impact of changes in social norms and behaviours. However, there are a number of specific issues and limitations with the Productivity Commission's approach that have likely underestimated the potential benefits of reform.

Limitation One: Estimates rely on a single data snapshot rather than observing people over time – making it harder to say accurately what is actually driving decisions to work and what the impact of a change on the price of child care would be.

IMPACT ON MODELLING RESULTS

UNCERTAIN

Limitation Two: The impact of local access to early childhood education and care is not included despite its established importance in a mother's decision to work. Because access is greater in areas where prices are higher this will be acting to underestimate the participation impacts of reforms that lower the cost of care.

IMPACT ON MODELLING RESULTS

UNDERESTIMATE LABOUR FORCE PARTICIPATION IMPACTS

18. Productivity Commission (2024), A path to universal early childhood education and care - inquiry report - volume 1

Limitation Three: Unlike the modelling in the 2014 Productivity Commission report, the enjoyment and value mothers place on looking after their own children is not factored into the results. This is likely to overestimate the assumed increase in demand for early childhood education and care without a corresponding increase in labour force participation.

IMPACT ON MODELLING RESULTS

OVERESTIMATE INCREASE IN DEMAND EARLY CHILDHOOD EDUCATION AND CARE

Limitation Four: Including fixed costs from working in the model, but not modelling any reduction due to the abolition of the Activity Test which would make it easier for women with children outside the labour force to search for and secure work.

IMPACT ON MODELLING RESULTS

UNDERESTIMATE LABOUR FORCE PARTICIPATION IMPACTS

Limitation Five: In comparing the different models, the Productivity Commission underestimates the potential benefits of the flat \$10 a day fee model. The proposal through introducing a fixed price would not result in any subsequent increase in costs faced by families. However, the other options modelled would result in subsequent increases as seen after previous reforms were implemented.

IMPACT ON MODELLING RESULTS

UNDERESTIMATE LABOUR FORCE PARTICIPATION IMPACTS

Taken together, the limitations in the Productivity Commission model have under-estimated the increase in labour force participation from a \$10 a day funding model and the net economic benefits of reform.

It has greatly under-estimated the labour force participation impact of a \$10 a day system by failing to account for a benefits of increased access under a universal system including for families in childcare deserts and families excluded by the Activity Test.

In an environment characterised by increasing cost of living pressures on families with young children and skill shortages across the economy an increase in the participation rate is a likely outcome of this reform.





Australia's Market for Early Childhood Education and Care

The market for early childhood education and care in Australia has evolved from its early origins during the depression of the 1890's through to today where 7,200 providers educate 1.4 million children across Australia.¹⁹

The Commonwealth Government first started funding services in 1972, which were mostly delivered by small not-for-profit community providers. It wasn't until 1991 that for-profit providers were eligible for assistance. This extension and the move to funding based on enrolments was the start of a reliance on market forces to deliver early childhood education and care services in Australia.

Demand side subsidies – funding to improve purchasing power of consumers, strengthening competitive forces to deliver outcomes e.g. current Child Care Subsidy.

Supply side subsidies – funding directly to providers to supply a certain amount of service at a given price e.g. operational subsidies for public kindergartens or centrally determined efficient price for child care.

In 1997 the operational subsidies for non-profit providers were removed, and the system became a true quasi market, driven by choice and competition.

The market for early childhood education and care is underpinned by government subsidies and regulated to ensure quality. Providers are free to establish centres in response to market demand and set their own prices.

Australian Government support for early childhood education and care has increased, from \$1.9 billion in 1997 to over \$14 billion today – a seven fold increase in real terms.²⁰ This reflects the large increase in the number of children using services, increases in the costs of service delivery and attempts by successive governments to reduce the out-of-pocket costs for families.

19. Royal Commission into Early Childhood Education and Care Centre for Policy Development (2023), A Brief History of Commonwealth Government Involvement in Early Childhood Education and Care in Australia

20. Bray, J Rob (2023) Childcare in Australia: Historical trends in provision and Australian Government Funding. A Statistical compendium 1969-2022 updated for 2024 prices and Department of Social Services (2024), Child Care Subsidy date report – June quarter 2024

Standard economic theory holds that greater choice and competition between providers drives more efficient allocation of resources and delivers optimal levels of quantity and quality. However, this relies on the local market for early childhood education and care having the characteristics of a 'perfect' market, including a large number of providers for each type of service, low switching costs, and easily accessible information on provider quality.

When these characteristics are not in place, poorly designed markets can fail to produce outcomes that leave both buyers and sellers better off. In the market for early childhood education and care services, such a failure can result in unnecessarily high costs, low quality services and inadequate supply.

There are growing indications that the market for early childhood education and care in Australia is producing such failures, reflecting fundamental issues with the design of the market.

Unnecessarily High Costs

Successive Australian Governments have, in recognition of its impact on families and the broader social and economic impacts, attempted to decrease the out-of-pocket costs of using early childhood education and care for families.

- July 2000 – introduction of means tested child-care benefit reduced out-of-pocket costs by 15.1 per cent.
- July 2004 – introduction of the non-means test child-care tax rebate.
- July 2007 – conversion of the child-care tax rebate to a cash rebate reduced out-of-pocket costs by 33.4 per cent.
- July 2008 – increase in the child-care tax rebate to 50 per cent reduced out-of-pocket costs by 22.9 per cent.
- July 2018 – replacing child care benefit and child care tax rebate with a single child care subsidy reduced average out-of-pocket costs by 11.8 per cent
- July 2023 – cheaper child care package which increased maximum subsidy to 90 per cent reduced out-of-pocket costs by 17.1 per cent.

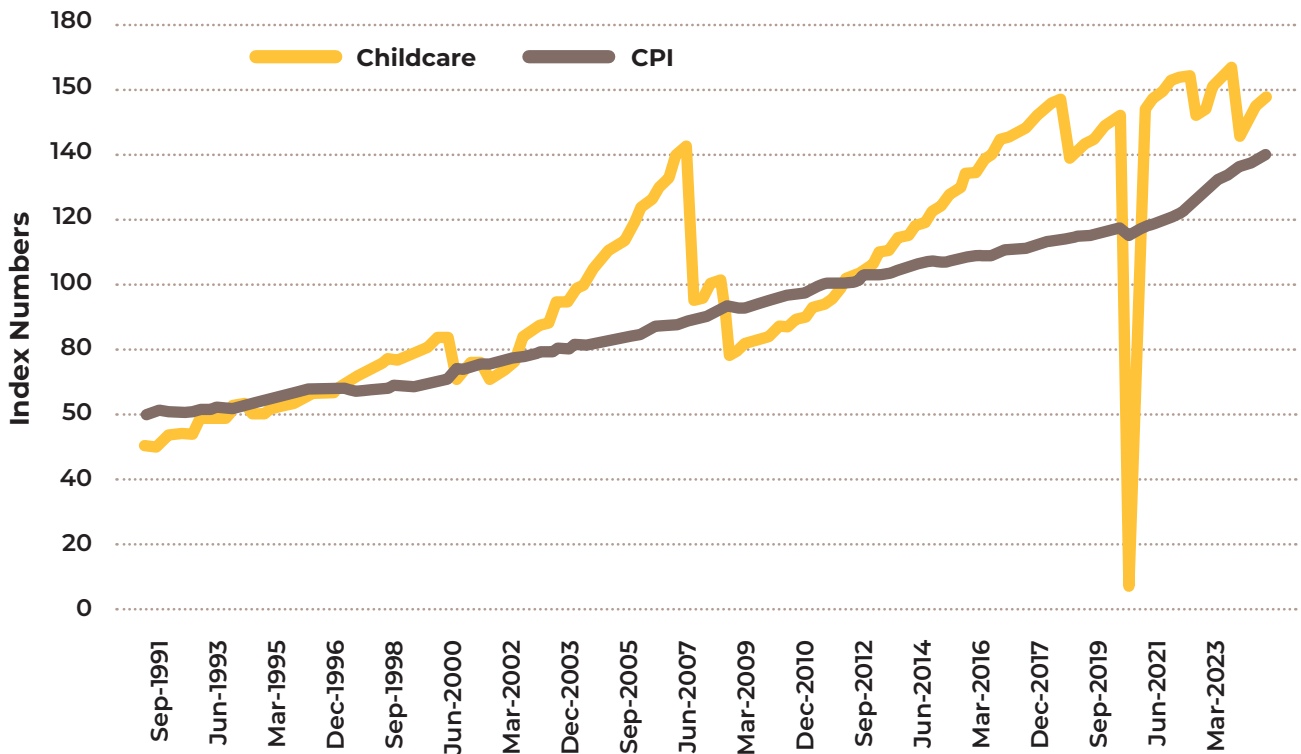
Despite these investments average out-of-pocket costs have risen at a faster rate than inflation since 1991. Average out-of-pocket costs faced by families are 28.2 per cent higher than they would have been if increases had matched inflation over the period – including the impact of government subsidies.

Both the Productivity Commission and the ACCC acknowledge this trend²¹:

“when government subsidies increase, out-of-pocket expenses decline sharply in the immediate term, but then quickly revert to levels preceding the subsidy change.”

ACCC, CHILDCARE INQUIRY FINAL REPORT, 2023

21. Productivity Commission, A path to universal early childhood education and care, Draft Report, pp 361–362

FIGURE 4 Out of pocket costs have grown faster than inflation

Source: ABS (2024)

However, this only tells part of the story of rising costs. Removing the impact of increased government subsidies on out-of-pocket costs, provides greater insight into the scale of cost increases – to both taxpayers and families using services – across the period.

Since 1991, removing the impacts of government subsidies, the underlying cost of early childhood education and care has increased by 499.6 per cent – almost four times the rate of CPI.

Excluding tobacco and insurance it represents the fastest growing good or service in the ABS CPI basket over the period.

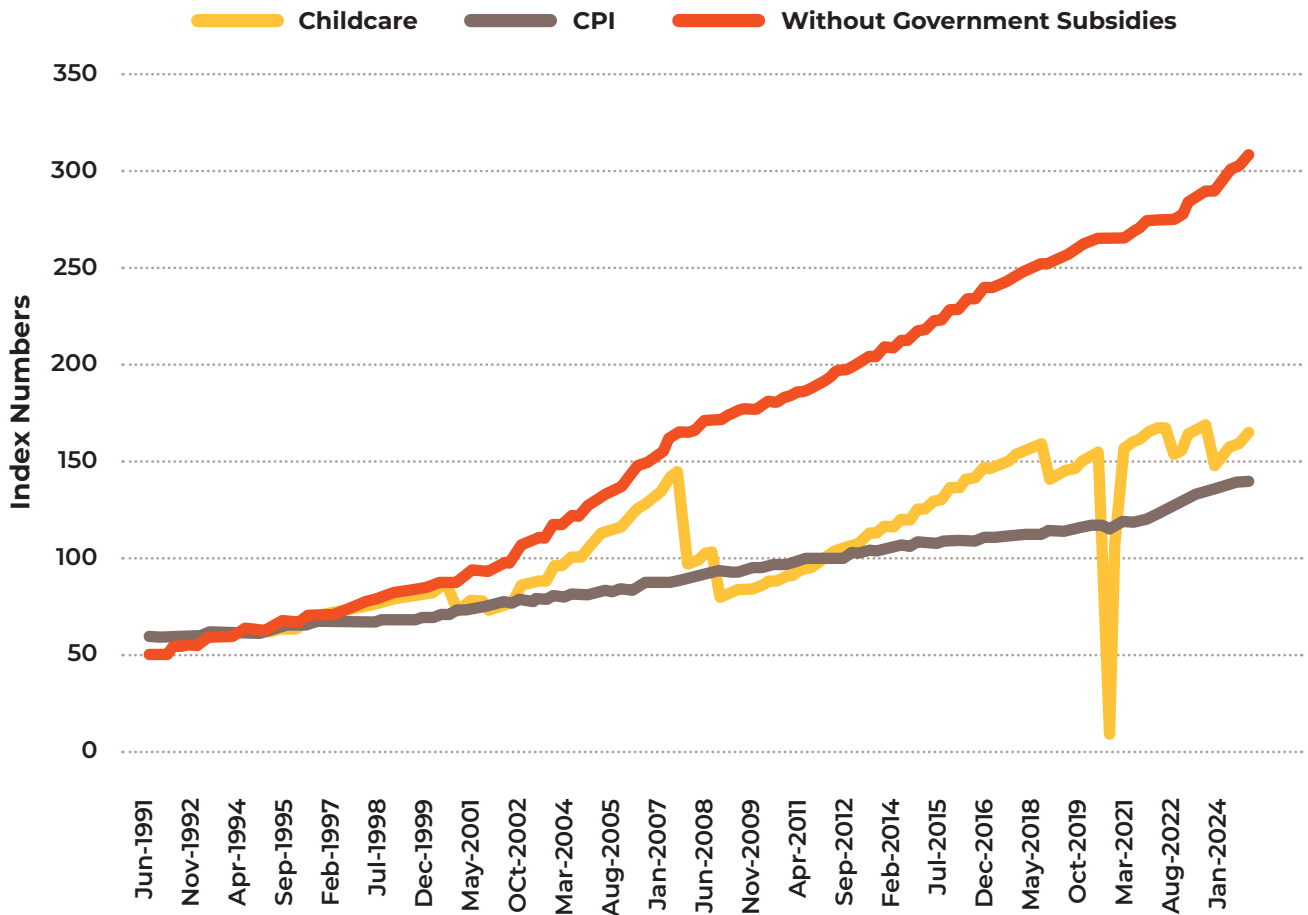
Child care costs excluding the impact of subsidies have grown faster than education (34 per cent higher) and medical, dental and hospital services (27 per cent higher).

While this increase partly reflects rising labour costs and improvements in quality, it is also indicative of a poorly designed market resulting in unnecessarily high costs.

The ACCC report concludes that if current regulatory settings remain, the trend of affordability gains through increased subsidies being eroded by increases to fees, will recur.²² This will mean additional government spending will benefit providers, and not families or the broader economy.

22. ACCC (2024), Childcare Inquiry – Final Report

FIGURE 5 Excluding impact of government subsidies shows underlying costs of child care



Source: ABS (2024) and Impact Economics and Policy Analysis

Inadequate Supply

The number of childcare places has expanded over the past 30 years, supported by funding linked to the number of places.

- In 1991 there were 81,326 centre based child care places in Australia – the equivalent of one for every 15 children aged 0-4.
- By 2022 this had increased to 617,545 places – the equivalent of one for every 2.4 children aged 0-4.

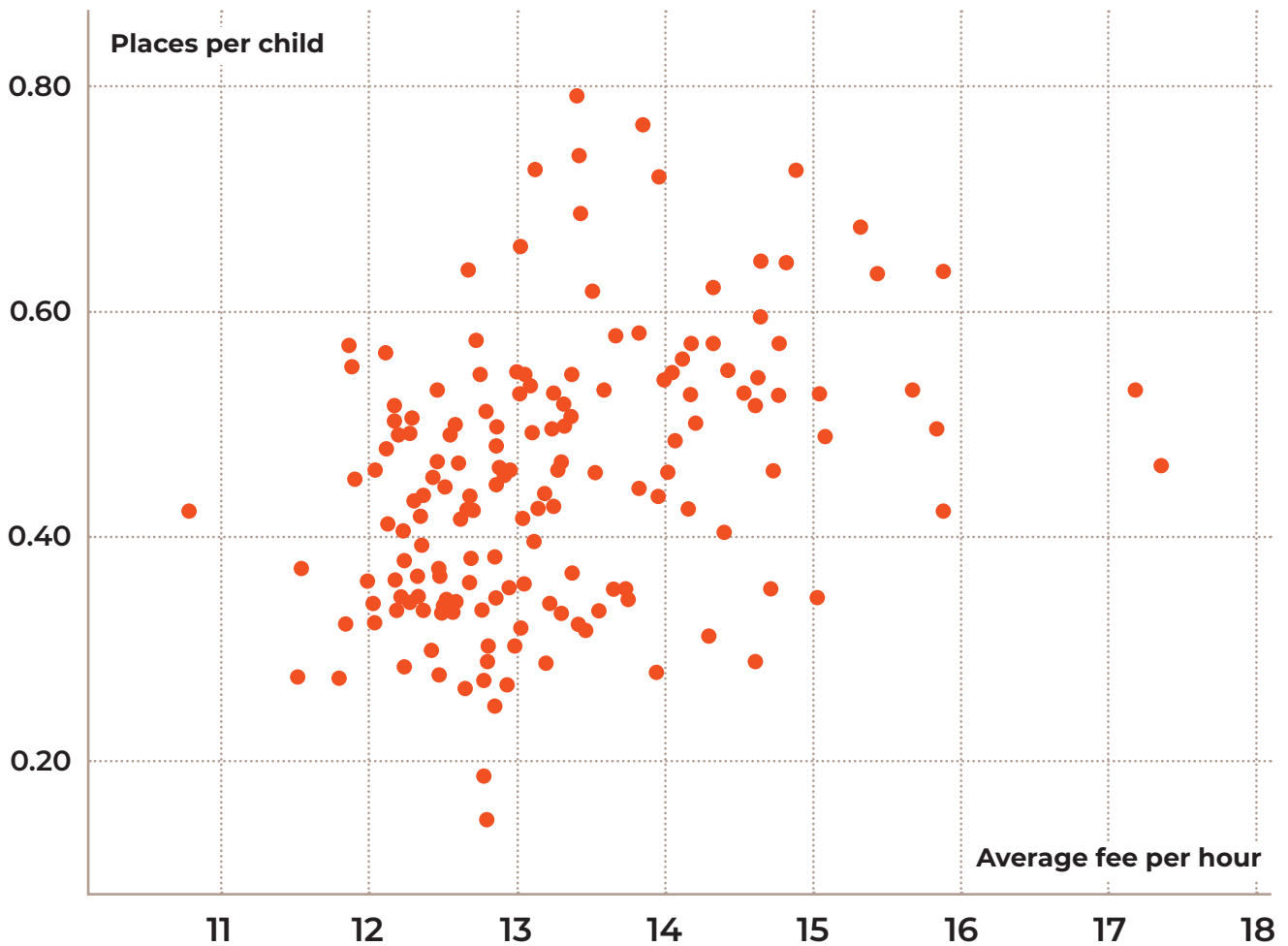
However, not all regions have benefited from this growth in supply with significant variation across regions. Latest figures from the Mitchell Institute highlight that 24 per cent of households live in areas considered ‘child care deserts’ and 700,000 Australians live in areas with virtually no access to early childhood education and care.²³

Access to early childhood education and care has been concentrated in wealthier areas where providers can charge higher fees, and has been constrained in lower socio-economic areas where fees tend to be lower.²⁴

23. Hurley, P., Tham, M and Nguyen, H. (2024). International childcare: Mapping the deserts. Mitchell Institute, Victoria University.

24. ACCC (2024), Childcare Inquiry – Final Report

Greater Access in Areas with Higher Prices



Research has highlighted that accessibility is greater where providers charge more, which generally correlates with higher socio-economic areas.

As a result, lower socio-economic areas are more likely to be childcare deserts. Low SES areas have 41 per cent fewer long day care places than high SES areas.²⁵

Recent research has found that this relationship is common in systems that rely on demand side subsidies such as Australia – with countries that rely on supply side subsidies more likely to see disadvantaged suburbs with the greater access.²⁶

25. Mandala (2024), Paving the path: Addressing market imbalances to achieve quality and affordable childcare in more places

26. Hurley, P., Tham, M and Nguyen, H. (2024). International childcare: Mapping the deserts. Mitchell Institute, Victoria University.

TABLE 1 Countries with supply side subsidies do better in terms of access for disadvantaged areas

Main form of childcare funding	Country	Best access neighbourhoods	Children living in a childcare desert
Supply side	France (3 to 5 years)	Lowest SES	1%
Supply side	Norway	Lowest SES	6%
Supply side	Sweden	Lowest SES	7%
Supply side	Netherlands	Lowest SES	25%
Demand side	Australia	Highest SES	24%
Demand side	Wales	Highest SES	27%
Demand side	England	Highest SES	45%
Demand side	France (under 3 years)	Highest SES	86%

Source: Hurley, P., Tham, M and Nguyen, H. (2024). International childcare: Mapping the deserts. Mitchell Institute, Victoria University.

This analysis underscores the critical role of incentives in the distribution of childcare places. In Australia's early learning sector, providers consist of a mix of for-profit, not-for-profit, and government organisations, with their primary revenue coming from hourly fees charged to families. The existing research indicates that providers respond not only to parental demand for childcare but also to the opportunity to charge higher fees in specific areas.

Inadequate Quality of Services

In a well-functioning market, providers should be rewarded and incentivised to provide high quality care to attract greater market share, and increase profits. However, the indications are this is not occurring in the current market for early childhood education and care in Australia.

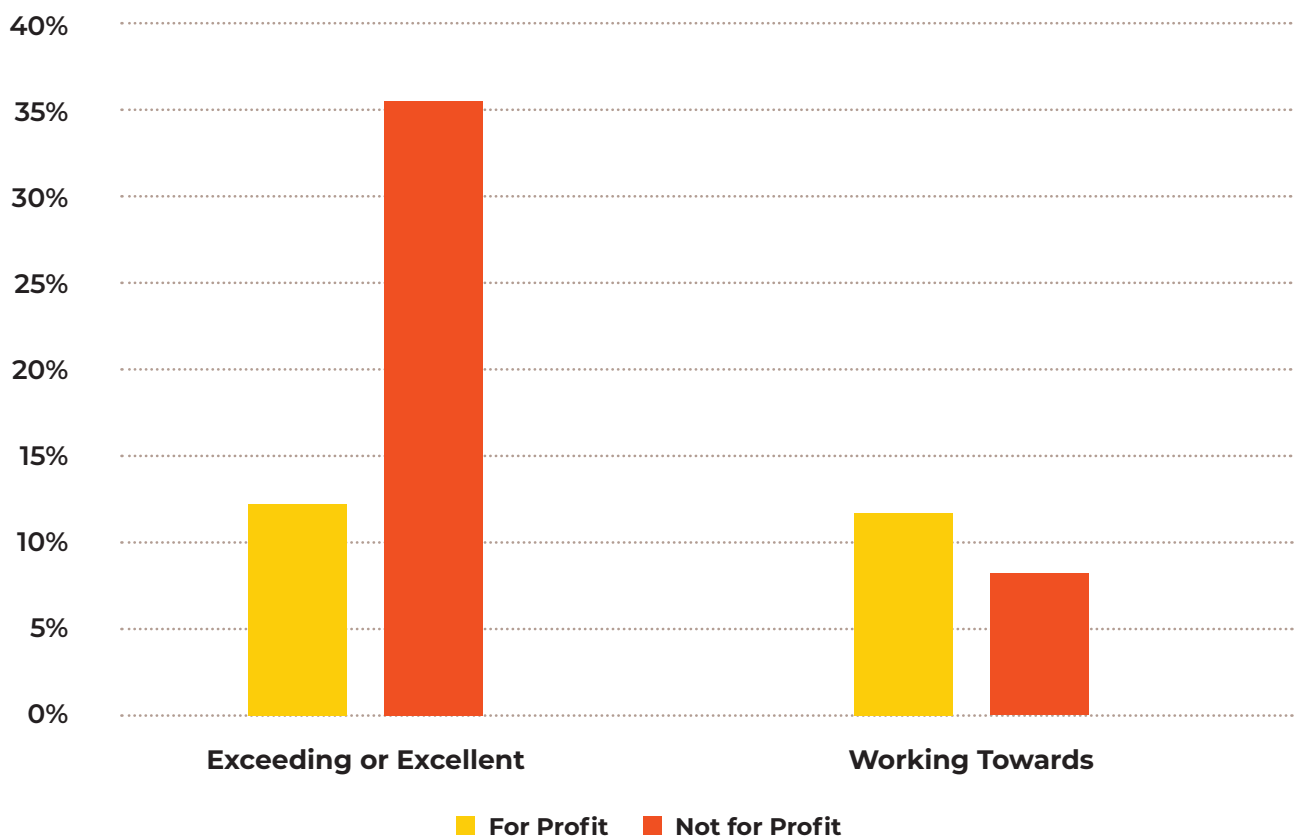
The quality of early childhood education and care and the extent to which they improve over time varies widely, depending on location and profit status.

For-profit providers are less likely than non-profit providers to be rated by the regulator as excellent or exceeding the national quality standards. Whereas 35.4 per cent of non-profit providers are judged to be exceeding or excellent, only 12 per cent of for-profit providers receive this ranking.

Meanwhile for-profit providers are more likely to be assessed as not meeting the national quality standards, with 12 per cent working towards the standard.

For-profit providers are half as likely as non-profit providers to improve their quality rating overtime.²⁷

FIGURE 6 For profit providers are lower quality

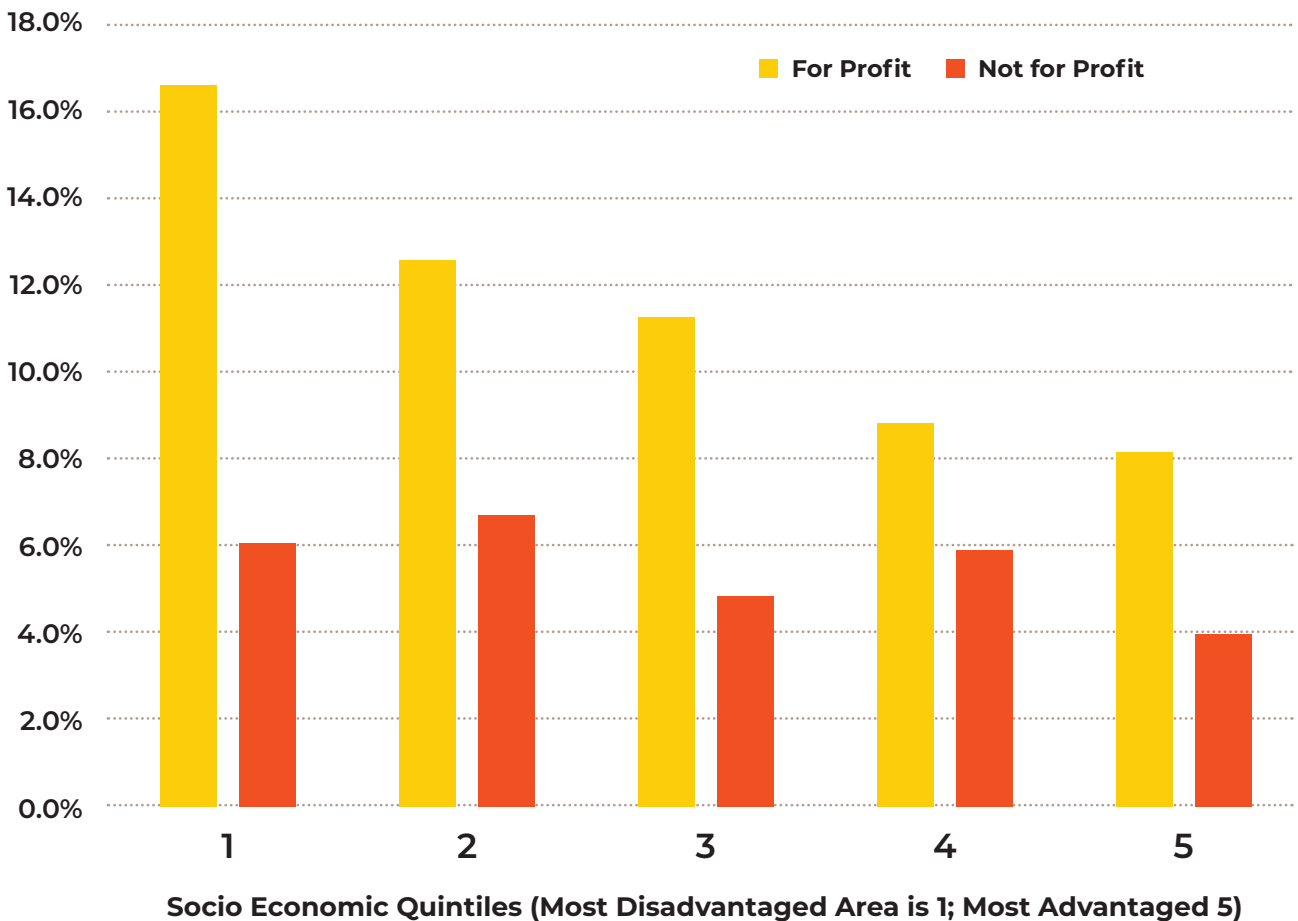


Source: National Quality Agency (2024) and Impact Economics and Policy Analysis

27. Harrison, L. J., Waniganayake, M., Brown, J., Andrews, R., Li, H., Hadley, F., ... & Hatzigianni, M. (2024). Structures and systems influencing quality improvement in Australian early childhood education and care centres. *The Australian Educational Researcher*, 51 (1), 297-319.

In low socio-economic areas, one in six for-profit providers is working towards meeting the quality standards, compared to one in sixteen non-for-profit providers.

FIGURE 7 In disadvantage areas there are more low quality for-profit services



Source: National Quality Agency (2024) and Impact Economics and Policy Analysis

Addressing Failures

Government policy is often concerned with addressing these failures individually – Government’s increase the child care subsidy to address affordability, quality standards are strengthened to lift quality or supply side subsidies are introduced to increase access. However, this siloed approach often fails to account or address the systematic issues driving these failures.

In the next section we seek to understand the systematic issues with the current market design that are causing these failures. Through identifying the market characteristics needed to drive better outcomes, we can assess the reforms needed to the current market to simultaneously lower costs, better quality and improved access is possible.

Why is the Market for Early Childhood Education and Care Not Delivering?

The market for early childhood education and care deviates from the perfect market of economic theory in a number of ways:

- Asymmetry of information means that providers have more information on service quality and how it impacts people, leading to 'cream skimming'²⁸;
- Childcare services are 'experience goods', making it difficult to assess quality before receiving the service. This increases the transaction costs associated with moving providers, especially for users who are heavily reliant on services;
- Lack of alternatives due to shortages of supply in many markets making switching providers when unsatisfied more difficult;
- The user and main beneficiary (children) rely on others (parents), who cannot as readily assess quality when making decisions about care.
- Imperfect and often out of date information on quality to choose between providers;
- The assessment of quality can be subjective and heavily influenced by the relationship between carers and users;
- Governments dominate the financing of the sector meaning that providers and users of early childhood education and care may not always be price sensitive; and
- Markets are localised restricting the level of competition.

The nature of early childhood education and care means that the impact of choice and competition will depend on the specific features of the market.²⁹ As a result, poor market design creates the risk of higher costs, lower quality and insufficient supply of services.

Market Features

Every market has specific characteristics which influence how it operates. In the market for childcare services, we are interested in the impact of three market characteristics on quality, costs and access: price setting, quality information, and competition in the market.

28. Mocan, N. Can consumers detect lemons? An empirical analysis of information asymmetry in the market for child care. *J Popul Econ* 20, 743–780 (2007). <https://doi.org/10.1007/s00148-006-0087-6>

29. Propper, C. (2010), *The operation of choice and competition in healthcare: A review of the evidence*, London.

PRICE SETTING

The markets' ability to efficiently set prices relies on consumers being able to reliably assess quality, or at least know as much about quality as providers. When this is not the case, as in the market for child care where providers know more about quality than parents, prices set by the market can become a proxy for quality. Under choice and competition this allows providers to simultaneously increase price and reduce quality (which is not easily observable) leading to higher costs and lower quality.

As a result, when providers have more information than participants, and quality can be hard to assess, there are benefits from having efficient prices set by regulators rather than by the market.

Where prices are efficiently set by regulators, choice and competition can create stronger incentives for providers to compete by improving the quality of services. However, it is important that these prices are set carefully and take into account the different drivers of cost in servicing different locations and groups of children.

Where regulated prices do not vary based on differences in the underlying drivers of cost, providers may give low-quality care to those with higher costs to save money (skimping) and provide too much care to those with lower inherent costs, leading to higher costs overall (cream skimming).

It is also important that government regulated prices are set at or above the marginal cost of service provision. Where prices are set too low, providers are encouraged to skimp on quality, engage in cream skimming or provide additional services to ensure costs are covered. Some providers may pull out of the market because they are unable to remain in business. This can lead to lower than optimal quality, higher overall costs and reduced access to services.³⁰

QUALITY INFORMATION

A key success factor is optimising the availability of high-quality, accessible information on the quality of providers in the market to help participants exercise choice and encourage competition on quality. This is a necessary condition for markets to work well – where this information is not available, providers will not be rewarded for raising their quality, meaning that competition will not necessarily improve outcomes.³¹ Information about provider quality, especially when available at localised level, can also help providers identify and address service gaps in the market.³²

There is also evidence that designing markets so that providers are competing based on quality – for example, by regulating prices (above) and providing trustworthy quality information – can drive better outcomes than mandating minimum quality standards, which on their own give little incentive for providers to increase quality beyond the minimum level required.³³

30 Barber, S. L. et al (2019), Price setting and price regulation in health care: Lessons for advancing Universal Health Coverage, World Health Organization and OECD.

31 Yang, O. et al (2022), "Nursing home competition, prices, and quality: A scoping review and policy lessons", *The Gerontologist*, vol. 62(7); Berta, P. et al (2016),

"The association between asymmetric information, hospital competition and quality of healthcare: Evidence from Italy", *Journal of the Royal Statistical Society A*, vol. 179(4).

32 Forder and Allen (2014).

33 Malbon et al (2019)





COMPETITION IN THE MARKET

Markets will work best when it is possible for new providers to enter and compete. Supply restrictions (i.e. barriers to entry) can reduce the incentive for existing providers to compete in order to maintain their market share.³⁴ There is some evidence that higher market concentration can be associated with lower quality, although researchers have also found the opposite, suggesting other factors may be more important in driving outcomes³⁵

TABLE 2 Evaluative Framework for a well functioning early childhood education and care market

	Price Setting	Quality Indicators	Competition in the Market
Quality	Fixed prices at or above marginal cost	Information on outcomes readily available to inform choice of childcare	Childcare providers are rewarded with greater business if high quality, and exit the market if poor quality
Cost	Fixed prices	Information on outcomes readily available to inform choice of provider	Childcare providers are able to realise economies of scale
Access	Prices reflect additional costs to provide services in thin markets	Information on quality readily available to inform choice of provider	Presence of acceptable alternatives

Source: Hurley, P., Tham, M and Nguyen, H. (2024). International childcare: Mapping the deserts. Mitchell Institute, Victoria University.

Assessing the Current Market for Early Childhood Education and Care

Using the evaluative framework we are able to identify the features of the current market for early childhood education and care that are resulting in it failing to deliver affordable and accessible early childhood education and care.

We conclude that the current market's reliance on demand side subsidies and free pricing, combined with lagged quality indicators is undermining its performance in delivering cost-effective, high quality and accessible care.

34 Yang, O. et al (2022), "Nursing home competition, prices, and quality: A scoping review and policy lessons", *The Gerontologist*, vol. 62(7); Berta, P. et al (2016), "The association between asymmetric information, hospital competition and quality of healthcare: Evidence from Italy", *Journal of the Royal Statistical Society A*, vol. 179(4).

35 Sari, N. (2002), "Do competition and managed care improve quality?", *Health Economics*, vol. 11; Gowrisankaran, G. and Town, R. J. (2003), "Competition, payers, and hospital quality", *Health Services Research*, vol. 38(6).

PRICE SETTING

Early childhood education and care providers are paid on a fee for service basis (e.g. daily rates). While there is a price cap for the level of government subsidies available to users, providers are free to charge above or below this level to users. This price cap has been assessed by the ACCC as failing to put downward pressure on prices.

As noted by the ACCC, there is currently limited price competition within local areas.³⁶ This is explained by the market dynamics where lower prices are a signal of lower quality – which can reduce demand for early childhood education and care, rather than increase as under assumed in a perfect market. Providers in a local area need to match each other on price, or be deemed lower quality and therefore less desirable.

One of the benefits of market pricing outlined by the Productivity Commission is that it allows providers to offer a higher quality product in the market. However, because price acts as a proxy for quality that users find hard to judge, free pricing allows providers to increase prices without necessarily increasing quality. This drives higher costs across the sector, especially in areas with greater competition, which explains the ACCC finding that local child care markets with more competition have higher prices.³⁷

The current system relies on providers being able to charge users more for higher cost services, however users are often unable to meet these costs directly resulting in a lack of market access. This can be seen in markets for children with disability and in low SES areas, where providers are unable to meet the costs through additional user charges leading to undersupply.

QUALITY INFORMATION

Since the introduction of the National Quality Standards in 2012 parents have been able to access quality information on early childhood education and care providers, with providers categorised as:

- Working Towards National Quality Standards
- Meeting National Quality Standards
- Exceeding National Quality Standards
- Excellent Rating

However, these quality ratings are often out of date or non-existent. 20 per cent had their last assessment more than 5 years ago, and 9 per cent of providers are currently not rated.³⁸ The ACCC found that parents, while caring about quality, did not place much importance on officially published data and instead relied on personal networks to gather information about quality.

36 ACCC (2023), Childcare Inquiry – Final Report

37 ACCC (2023), Childcare Inquiry – Final Report

38 ACECQA (2024), NQS Data – Q3 2024

Important real time information is also not available to parents on quality, such as if a provider has had a waiver issued meaning they do not have to meet minimum staffing requirements. Latest figures indicate that 16 per cent of all long day care providers have waivers, with over 80 per cent of these issued to for-profit providers.³⁹

The lack of meaningful and up to date quality information, increases the importance of price as a proxy for quality in the market – which is expected to increase costs and lower quality under greater competition.

Competition in the Market

The ACCC observed that many of the markets for early childhood education and care are under-served or unserved:

- households in remote areas
- households in less advantaged or low socio-economic areas
- households with children with disability and/or complex needs
- First Nations children and households
- culturally and linguistically diverse children and households
- households with children aged 0–2

As a result of limited competition, providers are less likely to be incentivised to provide high quality services in these areas. Official data highlights that lower socio-economic areas have lower quality services on average.⁴⁰ There is also issues with economies of scale not being sufficient in these markets to drive efficiencies and inadequate options for families seeking care.

TABLE 3 Summary outcome for the current early childhood education and care market

Outcomes	Price Setting	Quality Indicators	Competition in the market
Quality	X	—	X
Cost	X	X	X
Access	X	—	—

39 ACECQA (2024), NQS Data – Q3 2024

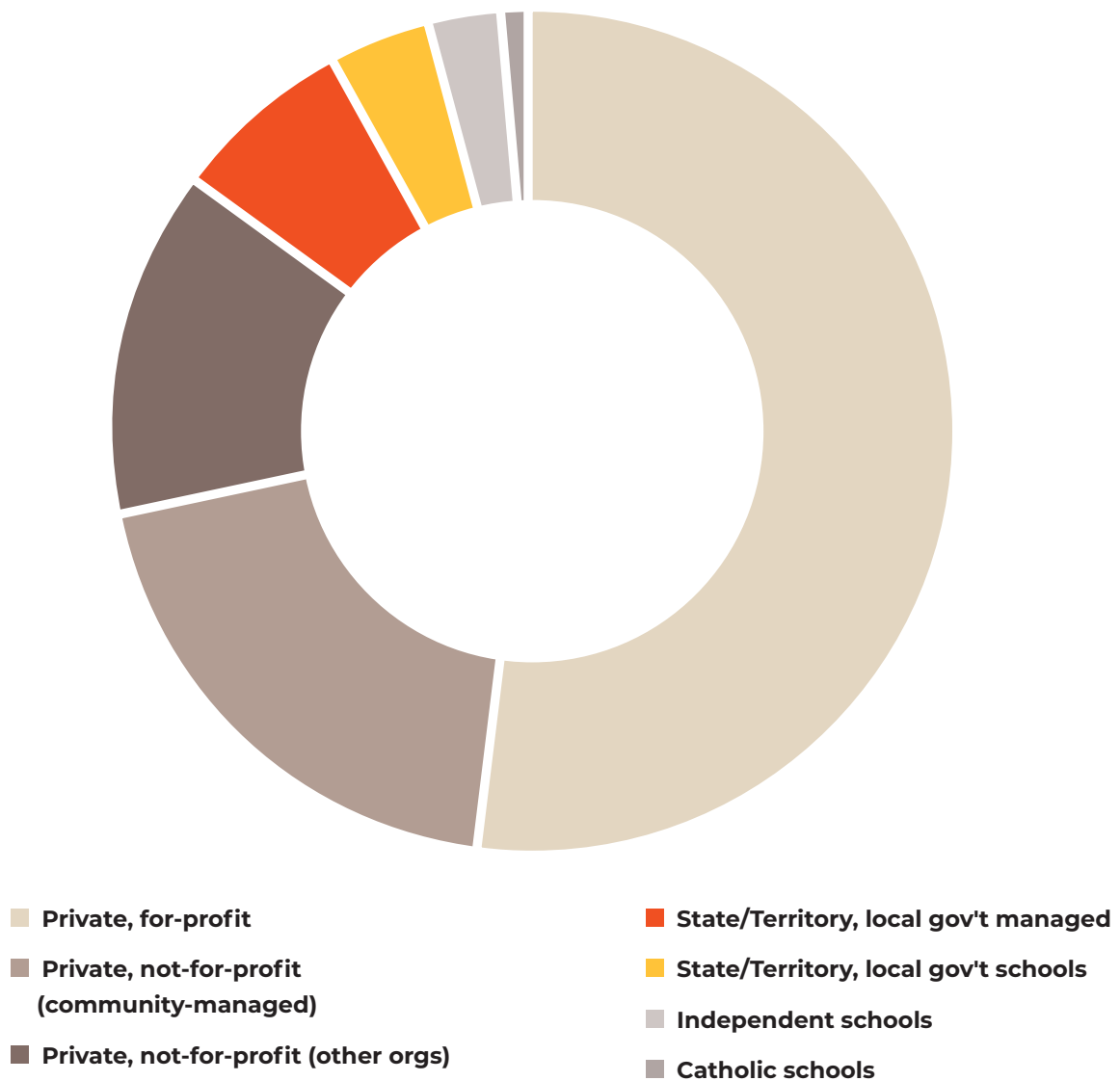
40 ACECQA (2024), NQS Data – Q3 2024

Time to Abandon the Market Altogether?

Given the significant failings, some have proposed moving away from the market altogether in the provision of early childhood education and care, and instead relying on direct government provision.

While local governments and state governments are involved in providing care, they represent a small component of the current supply.

FIGURE 8 Market shares in childcare market



It would be possible overtime to expand the provision by governments, but whether it is feasible in the short term for all provision to be transferred to government is unclear.

RESEARCH HIGHLIGHTS THE BENEFITS OF CHOICE AND COMPETITION UNDER THE RIGHT MARKET SETTINGS:

- Creates incentives to increase quality
- Empowers users and can improve access for disadvantaged groups
- Improves efficiency
- Encourages innovation and diversity in services

Reforms Proposed by The Centre for Policy Development Could Improve Market Design and Outcomes

The Centre for Policy Development has provided a roadmap to deliver a universal three day a week entitlement to early childhood education and care in Australia.⁴¹ Their proposal includes ten elements, including:

- A universal entitlement to three days of early childhood education and care, with a set fee of \$10 per day for out-of-pocket costs.
- Funding based on regulated prices, set with regard to the reasonable cost of providing quality provision based on each child's individual needs, to be determined by a National Early Childhood Pricing Authority
- Supply side grants to encourage new early childhood education and care services
- Better information and support for families

Implementation of a \$10 flat fee model would necessitate a move away from demand side subsidies and free pricing, towards supply side subsidies and fixed prices.

PRICE SETTING

Fixed-price subsidies for early childhood education and care would improve incentives to provide high quality care, and remove the ability of providers to charge higher prices and skimp on quality. This would lead to lower costs, and higher quality. Under this model prices would be determined centrally, based on the average cost of delivering services in different locations and for different cohorts of children.

The fixed price would need to be set at or above marginal cost for delivering the National Quality Standards. This will require the proposed National Early Childhood Pricing authority to set prices that reflect differences in costs across local areas and cohorts. This would ensure that there were not incentives for services to only provide services in low cost areas or for low cost cohorts of children and, act to improve access to care.

41 Centre for Policy Development (2024), A future universal early childhood education and care system for Australia

QUALITY INFORMATION

Improving access to information on quality for parents when deciding between early childhood education and care would help drive improvements in quality across the sector, as higher quality providers would be rewarded with greater market share.

COMPETITION IN THE MARKET

Payments linked to the number of children provided care would ensure that providers were rewarded for higher quality services, and support efficient delivery of high quality early childhood education and care services.

Supply side grants to support new services, alongside the setting of an efficient price which reflected underlying cost differences across areas and cohorts would help support expansion of services into underserved areas and cohorts. This would ensure competition in the market for different services and in different areas, driving higher quality and more cost-efficient care.

TABLE 4 Summary outcome for the current early childhood education and care market

Outcomes	Price Setting	Quality Indicators	Competition in the Market
Quality	✓	✓	✓
Cost	✓	✓	✓
Access	✓	✓	✓

A Path to Reform

Australia's early childhood education and care sector is not delivering for Australian families, it is not delivering for workers, it is not delivering for taxpayers and is in need of fundamental reform.

Each time government's increase subsidies, the value of the gains is eroded by increases in the cost of care. The ACCC concedes that this is likely to reoccur with the current market settings.

The current market settings encourage providers to charge higher fees, rather than drive more cost effective and higher quality care.

Moving towards a universal early childhood education and care system provides an opportunity for government to undertake reforms that can underpin greater access, more affordable and higher quality care.

In this report we find that this requires fundamental reform of the market that reflects the nature of early childhood education and care services, including moving to fixed prices that reflect the cost of delivering services in different regions and cohorts. Such reform would underpin a better functioning early childhood learning and care market, that delivers for children, families and taxpayers.

