Under embargo until 00:01 Friday 11 November

Institute for Fiscal Studies

IFS Report R229

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Early years spending update: the impact of inflation

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Published by **The Institute for Fiscal Studies**

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ISBN 978-1-80103-107-3

The authors gratefully acknowledge funding from the Nuffield Foundation (grant number EDO/FR-000022637). They are also grateful for the support of the ESRC Centre for the Microeconomic Analysis of Public Policy (ES/T014334/1).

Executive summary

With the COVID-19 lockdowns and the ongoing cost-of-living crisis, the importance of the early years system for children and their parents has been made particularly obvious over the last few years. In this report, we analyse how public spending on early childhood education and care has changed over the last two decades.

Overall spending on the early years in England has grown from around £1.5 billion in 2001–02 to more than £5.3 billion last year (all figures in today's prices). But within this growing envelope, the relative amount of spending on the different childcare programmes has changed dramatically. The 'free entitlement' to funded childcare hours – for all 3- and 4-year-olds and some 2-year-olds – has seen its budget grow substantially, while spending on childcare subsidies through the working-age benefit system has been cut.

Spending has been on a bumpy path for the last few years, with slight falls in free entitlement spending and a significant fall in spending through the tax and benefit systems during the COVID-19 pandemic. More recently, the main pressure on early years spending has been rising prices, which on average have risen more quickly for childcare providers than for either households or the economy as a whole. Going forward, high levels of inflation mean that even substantial cash-terms increases in the early years core funding rate will struggle to keep up with providers' rising costs.

Key findings

1. Overall **spending on the early years in England has grown substantially over the past 20 years**, from around £1.5 billion in 2001–02 to more than £5.3 billion last year (all figures in today's prices). The growth in spending over the last decade has been **entirely driven by the free entitlement to a funded childcare place**, which has seen its budget rise from £1.7 billion in 2009–10 to over £4 billion last year.

2. While spending per hour has increased somewhat over this period – in 2021–22 it was about 28% higher in real terms than it was in 2009–10 – **the bulk of the increase in free entitlement spending has been driven by the addition of new entitlements**, for disadvantaged 2-year-olds and for 3- and 4-year-olds in working families.

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3. Economy-wide measures of inflation have recently understated the cost pressures facing childcare providers. With many workers earning at or near the minimum wage – and a high share of costs going towards staffing – recent rises in the National Living Wage have pushed up costs. Last year (2021–22), **prices facing childcare providers were 11% higher than they had been three years earlier**, before the pandemic. By comparison, over the same period, **consumer prices had risen by 7%**, while the **prices in the economy as a whole had risen 9%**.

4. The prices facing childcare providers are set to grow even more quickly over the next few years. **We estimate that providers' costs will grow by 16% between 2021–22 and 2024–25.** Over the same period, recent forecasts suggest that economy-wide inflation (as measured by the GDP deflator) will be around 14%.

5. Higher-than-expected inflation has eroded the value of the uplift to the free entitlement budget announced at the 2021 Spending Review (worth £500 million over three years). Based on the inflation forecasts that were in place at the time, this settlement would have kept total resources in 2024–25 around 2% lower than they were in 2021–22. But **more recent forecasts for the GDP deflator suggest total real-terms funding for the free entitlement will be 8% lower in 2024–25 than it was in 2021–22**, and the cut will be 9% if measured against the prices facing childcare providers.

6. A falling population of 2- to 4-year-olds helps to offset some of the pressure on the free entitlement budget. Indeed, at the time of the 2021 Spending Review, the budget uplift agreed would have allowed the Department for Education to raise the core hourly funding rate in real terms in 2023–24. Higher inflation forecasts make that more difficult: **under our illustrative scenario, today's core funding rate of £5.06 an hour for 3- and 4-year-olds will fall by 10p in real terms by 2024–25** (in today's prices as measured by the GDP deflator), or by 14p an hour when compared against our index of childcare providers' prices.

7. While free entitlement spending has risen, spending on **childcare subsidies through the working-age benefit system fell from £1.8 billion in 2009–10 to £640 million in 2021–22**. This was partly due to a sharp fall in spending during the pandemic, with spending falling from £900 million in 2019–20 to £620 million the following year as childcare use declined. But **most of the decline in benefit system spending since 2009 predates the pandemic**, with a longer-term trend of falling spending through the benefit system, linked to less generous payments, a squeeze on caseloads and, more recently, the transition to universal credit.

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1. Introduction

With the COVID-19 lockdowns and the ongoing cost-of-living crisis, the importance of the early years system for children and their parents has been made particularly obvious over the last few years. Childcare and early learning can affect children's development and the inequalities between children from different backgrounds. They also affect parents' working decisions and their mental health. And, of course, childcare policy can have a significant impact on families' budgets.

Over the last two decades, England has developed and expanded a range of policies that aim to support early childhood education and care (ECEC), which are summarised in Table 1. As the table shows, the system of support for ECEC in England is complex and reflects changing decisions over whether to prioritise supporting child development or helping working parents.

Overall spending on ECEC has grown from around £1.5 billion in 2001–02 to more than £5.3 billion last year (all figures in today's prices). But within this growing envelope, the relative amount of spending on each of England's different childcare programmes has changed dramatically, as Figure 1 shows.

Financially, the most important group of programmes, and the one most closely aligned to educational spending, is the set of 'free entitlements' to a specific number of funded hours of early education. There are currently three distinct free entitlement offers: a universal part-time place for all 3- and 4-year-olds; an additional 15 hours a week for 3- and 4-year-olds in working families; and a part-time, 15-hour place for 2-year-olds in roughly the 40% most disadvantaged families. In Section 2, we describe how funding for these programmes has changed over the past two decades.

The free entitlements are complemented by subsidies through the tax system (including tax-free childcare and the legacy employer childcare vouchers, now being phased out) and through working-age benefits (with parents on universal credit eligible to get 85% of their childcare expenses reimbursed, up to a cap). Spending on these programmes, and especially support through the benefit system, has been declining over the past few years; in Section 3, we explore these trends.

One of the biggest challenges facing early years providers at the moment is the impact of rising costs. Staffing accounts for three-quarters of providers' total costs. As many staff earn at or around the minimum wage, a rising minimum wage has significantly affected providers'

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finances. Other major budget lines, such as energy and rent, are also rising quickly. In Section 4, we develop a price index specific to childcare providers' main costs, and explore what different measures of inflation mean for providers' resources going forward.

Table 1. Current and legacy schemes supporting early education and childcare in England

Type of policy	Legacy scheme	Current scheme	Eligibility
Subsidy through benefit system	**Working tax credit (WTC)** Reimbursement of up to 70% of childcare expenses, up to a cap.	**Universal credit (UC)** Reimbursement of up to 85% of childcare expenses, up to a cap.	Both schemes are open to children in low-income working families – WTC for children aged 14 and under and UC for children aged 15 and under. Both have a cap of £175–£300 per week (depending on number of children).
Tax reliefs and related subsidies	**Employer-supported childcare (including childcare vouchers)** Salary sacrifice scheme: 32% subsidy for basic-rate taxpayers.	**Tax-free childcare** £2 government top-up per £8 in a designated account.	Childcare vouchers were available to parents who were employed by a company offering a voucher programme. Tax-free childcare is open to families with children below age 12 where all parents work and earn below £100k a year.
Free entitlement	**Universal offer** 15 hours/week, 38 weeks/year **Extended offer** Additional 15 hours/week **2-year-old offer** 15 hours/week, 38 weeks/year		The universal free entitlement is open to all 3- and 4-year-olds. Introduced in 2017, the extended entitlement is open to 3- and 4-year-olds whose parents all work (earning at least the equivalent of 16 hours a week at minimum wage) and earn below £100k a year. The 2-year-olds scheme is available to 2-year-olds whose families receive certain means-tested benefits, such as universal credit, or who are otherwise disadvantaged (e.g. in care or care leavers, or with special educational needs).

Note: Adapted from table 3.1 in Farquharson and Olorenshaw (2022). For sources, see the next page.

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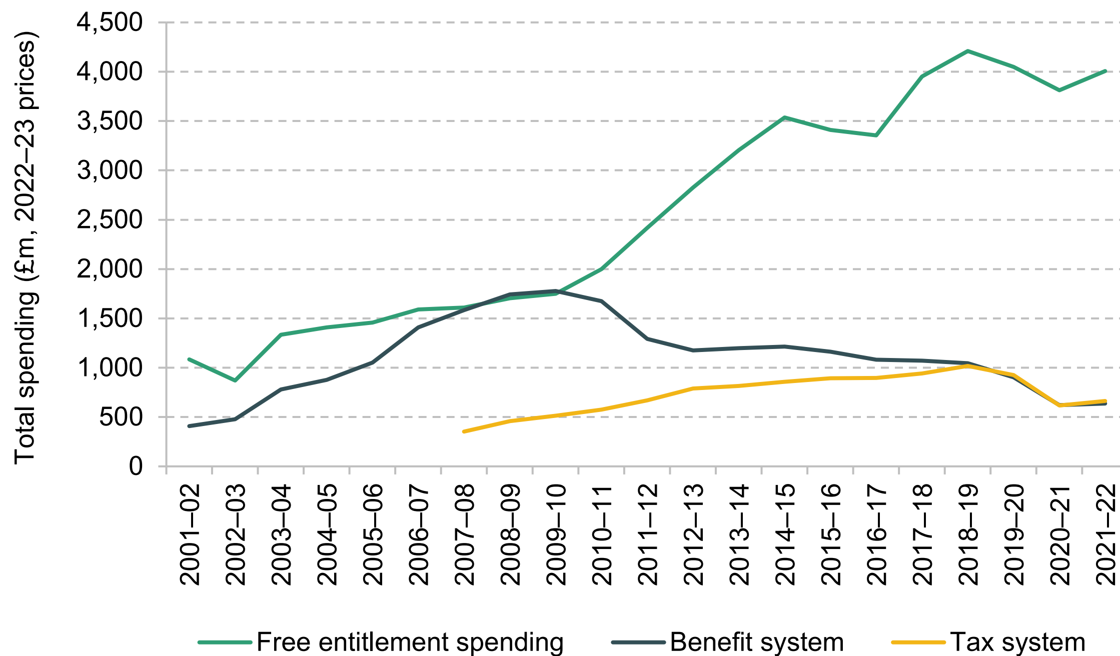
Source for Table 1

More information on the schemes, including eligibility requirements, can be found at the following webpages: working tax credit https://www.gov.uk/working-tax-credit; universal credit https://www.gov.uk/help-with-childcare-costs/universal-credit; employer-supported childcare https://www.gov.uk/guidance/employer-supported-childcare-480-appendix-11; tax-free childcare https://www.gov.uk/tax-free-childcare; universal offer https://www.gov.uk/help-with-childcare-costs/free-childcare-and-education-for-2-to-4-year-olds; extended offer https://www.gov.uk/30-hours-free-childcare; and 2-year-old offer https://www.gov.uk/help-with-childcare-costs/free-childcare-2-year-olds.

Figure 1. Total real-terms spending on different types of early education and childcare support in England



Note: Free entitlement spending includes spending on the universal entitlement for 3- and 4-year-olds, the extended entitlement for 3- and 4-year-olds in working families, and the entitlement for disadvantaged 2-year-olds. Spending through the tax system includes the value of tax reliefs via employer-sponsored childcare vouchers and tax-free childcare, but not the value of VAT exemptions. Spending through the benefit system includes childcare subsidies in universal credit and its predecessors. Spending through universal credit is imputed based on modelling estimates from TAXBEN (the IFS tax and benefit microsimulation model), adjusted to reflect actual take-up. Spending both in the tax system and in the benefit system is reported on a UK-wide basis. We approximate spending in England by rescaling by the English share of the UK's under-15 population. Spending in both the tax and benefit systems includes spend on children aged 5 or above. For most schemes, the vast majority of take-up is by families with children under the age of 5; hence we make no adjustment, though we recognise that total spend goes on a wider age range. More detail of our methodology can be found at https://ifs.org.uk/education-spending/methods-and-data.

Source: See https://ifs.org.uk/education-spending/methods-and-data.

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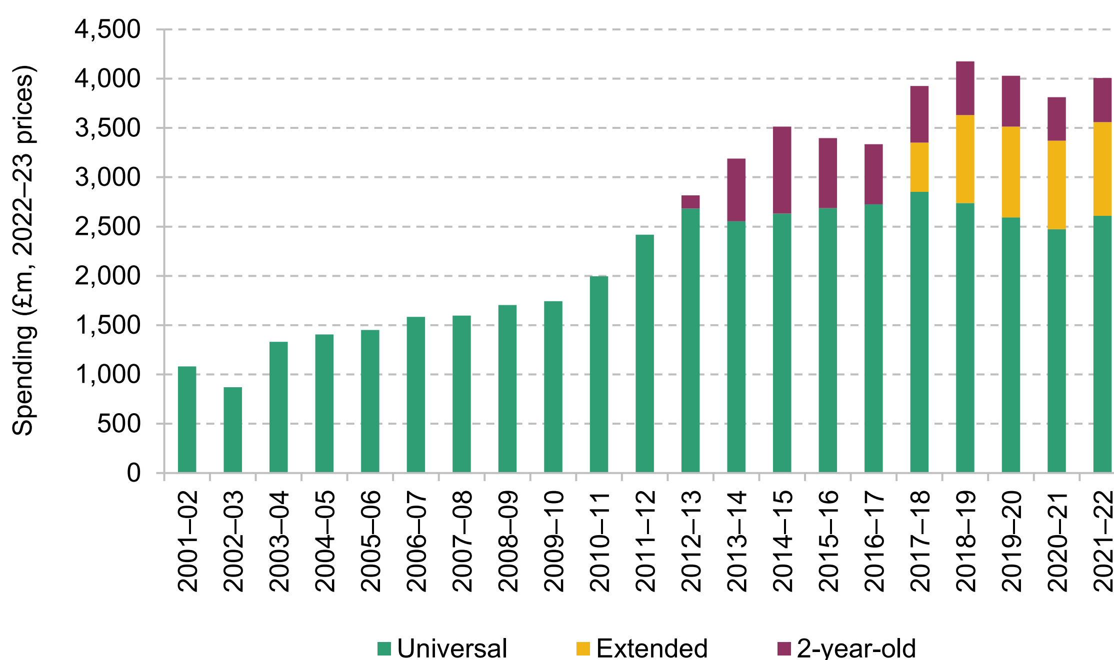
2. Early years education spending

Total spending on the free entitlement

Following a drop during the first year of the pandemic, by 2021–22 total real-terms spending on the free entitlement had returned to its pre-pandemic level of around £4 billion. Free entitlement spending has grown rapidly over the last two decades with the introduction and expansion of successively more generous offers. (See Figure 2.)

Figure 2. Total real-terms spending on free entitlement hours in England



Note: 'Universal' entitlement refers to the entitlement to 15 weekly hours of funded care for 3- and 4-year-olds during term time. The 'extended' entitlement captures the additional 15 hours a week that 3- and 4-year-olds in working families can access. The 2-year-old offer provides 15 hours of funded childcare to 2-year-olds in disadvantaged families. It was initially piloted in a small number of areas in 2012, before being rolled out nationally in 2013. Since our data on total spending do not split out the universal and extended entitlements, we allocate total spending proportional to their budgets from the Dedicated Schools Grant.

Source: See https://ifs.org.uk/education-spending/methods-and-data.

During the height of the COVID-19 pandemic, free entitlement spending dropped off somewhat, falling to £3.8 billion in 2020–21. Compared with other areas of early years spending (discussed

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in Section 3), this drop was relatively muted. Free entitlement spending continued to be distributed through the pandemic based on *registered* childcare places, offering providers continued funding even if children were not actually taking up places. But despite this protection, there was still some effect on registrations and hence on finances – we discuss these effects in the next subsection.

While *total* free entitlement spending is now similar to levels seen on the eve of the pandemic, expenditure on the 2-year-old offer barely changed between 2020–21 and 2021–22. This area of spending both fell more sharply than 3- and 4-year-old spend (by 15% versus 4%) during the first year of the pandemic and rebounded by less between 2020–21 and 2021–22 (2% versus 6%).

Free entitlement take-up during the pandemic

The COVID-19 pandemic significantly affected attendance in early years settings. During the first national lockdown in Spring 2020, settings were closed to all but the children of key workers. Early years settings remained open in subsequent lockdowns, but attendance was much lower than usual: statistics from the Department for Education showed attendance was around 50% of expected levels during the third lockdown in Spring 2021 (La Valle et al., 2022).

Despite this, official measures of take-up of the free entitlement remained relatively high. This is due to the distinction between the number of children *registered* for a free entitlement place (which is reported in Department for Education statistics and feeds into funding calculations) and the number of children physically attending the setting. During the pandemic, there was a significant divergence between the number of children *registered* for a free entitlement place and the number of children physically taking it up (Crawford and Farquharson, 2021). Many children remained registered with their providers (who continued to receive funding for them), even if in practice they stayed at home.

While free entitlement registrations were more resilient to the pandemic than physical take-up, even registrations were not completely unaffected. As Figure 3 shows, this is particularly true for 2-year-olds, where registrations fell by 12% between 2019–20 and 2020–21 (compared with a drop of just 3% among 3- and 4-year-olds). Partly, this reflects the bigger drop in registration among children entering the childcare system for the first time (La Valle et al., 2022); while parents of 3- and 4-year-olds who were already receiving the free entitlement may have decided to keep their children registered, parents of 2-year-olds just entering the childcare system may have chosen to wait until their child actually needed a place to go through the process of registration.

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By 2021–22, however, the take-up rate of 2-year-olds had more than returned to pre-pandemic levels, reaching 72% of eligible 2-year-olds (similar to the previous peak in 2017–18). While some of this reversal will reflect increases in attendance following the relaxation of COVID-related restrictions and resolution of uncertainty, the jump also captures changing eligibility among 2-year-olds. This is illustrated in Figure 4, which shows that the high take-up rate in 2021–22 is driven by *both* a post-pandemic increase in the number of 2-year-olds taking up the free entitlement and a decline in the size of the eligible population (the denominator of the take-up rate).

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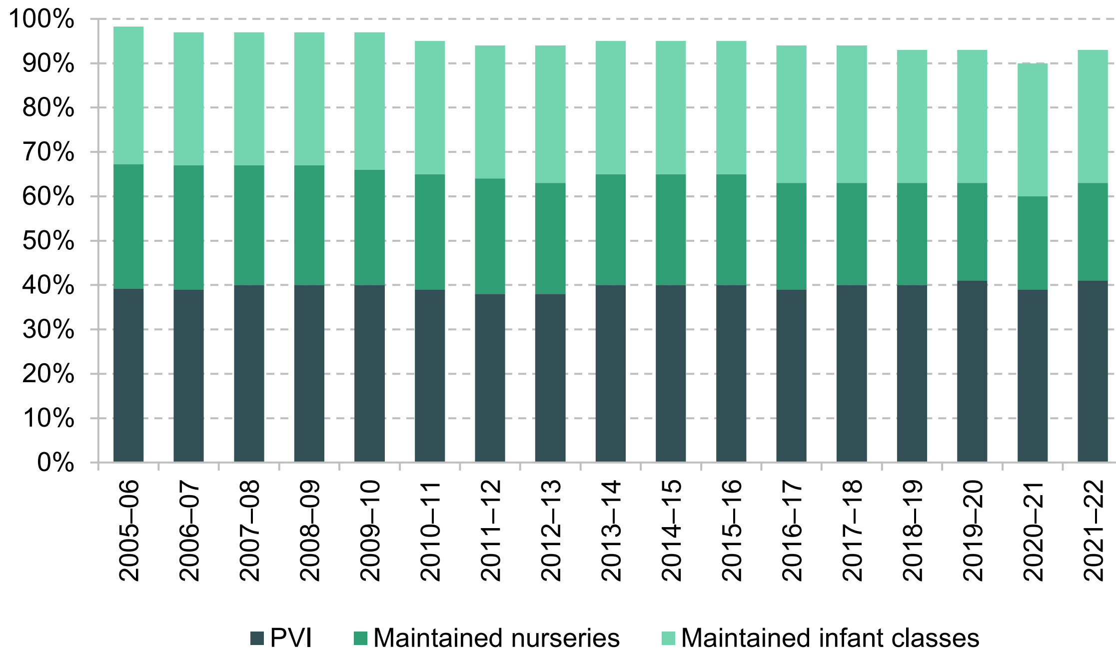
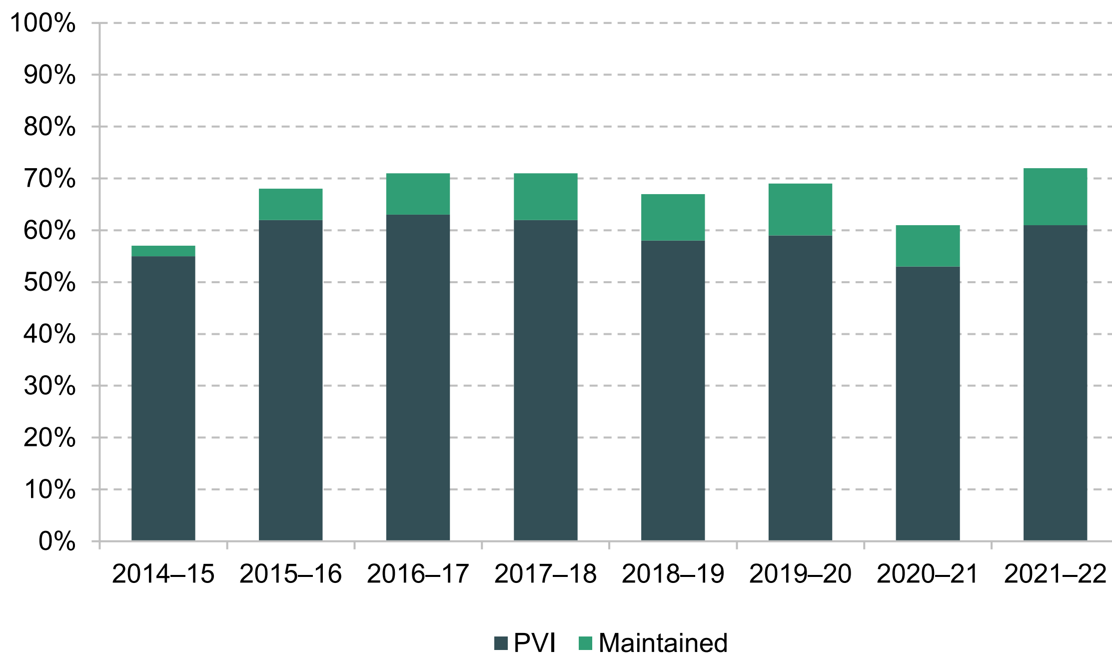
Figure 3. Take-up of the 3- and 4-year-old universal offer and the 2-year-old offer

Panel A. 3- and 4-year-olds



Panel B. 2-year-olds



Note: 'PVI' refers to private, voluntary and independent settings. Take-up for the 3- and 4-year-old universal offer is amongst all 3- and 4-year-olds; take-up of the 2-year-old offer is amongst eligible 2-year-olds. See Table 1 for more information on eligibility for the 2-year-old offer.

Source: Department for Education, 'Education provision: children under 5 years of age', various releases (https://explore-education-statistics.service.gov.uk/find-statistics/education-provision-children-under-5).

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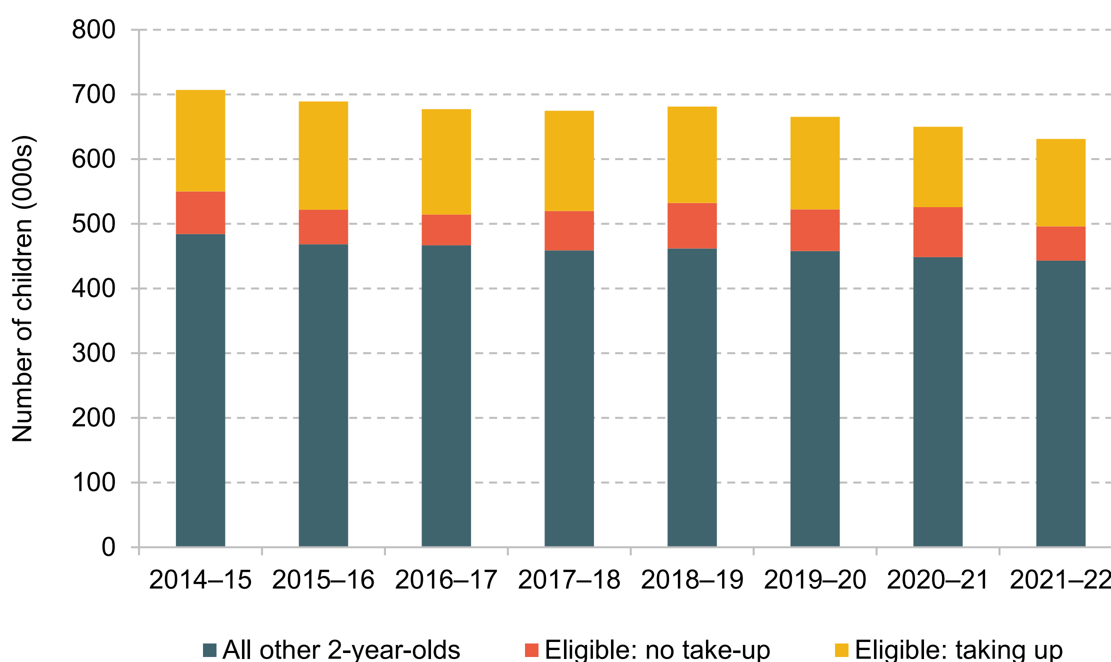
The falling number of 2-year-olds who are eligible for the free entitlement is partly down to demographic change: there were around 630,000 2-year-olds in England in 2021–22, compared with 650,000 the year before (Office for National Statistics, 2022). But it also reflects a changing eligibility rate, linked to changes in the benefit system (Department for Education, 2022).

Eligibility for the 2-year-old offer is linked to eligibility for other benefits, including working tax credit (a legacy benefit which is being phased out) and universal credit (which replaces WTC and several other benefits). Fewer families have moved onto UC than have stopped claiming legacy benefits. Moreover, for families on UC or WTC to be eligible for the 2-year-old offer, they need to have earnings below a threshold.[1] These thresholds have been frozen in cash terms since before the introduction of universal credit, meaning that they have become less generous over time as wages have risen. We return to this point in Section 3.

Figure 4. 2-year-old population: eligibility for and take-up of 2-year-old offer



Note: Total bar height represents the whole 2-year-old population. 2-year-olds eligible for the 2-year-old offer are split into those taking up the free entitlement and those not. See Table 1 for more information on eligibility for the 2-year-old offer.

Source: Department for Education, 'Education provision: children under 5 years of age', various releases (https://explore-education-statistics.service.gov.uk/find-statistics/education-provision-children-under-5).

[1] The threshold is £15,400 in annual net, pre-benefit income for families claiming universal credit and £16,190 in pre-tax, pre-benefit household income for those still on legacy benefits.

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Per place and hourly spend

Over the last decade, early years spending has been prioritised relative to other stages of education: the increase in free entitlement spending contrasts with the stagnation or cuts to real-terms resources experienced by other areas of education. This headline increase in spending reflects the changing population and the increasing generosity of the free entitlement, as well as changes in the resources that providers have available to look after children. In Figure 5, we examine how changes in total spending on the free entitlement for 3- and 4-year-olds compare with changes in spending per place and per hour.

Over the 2010s, growth in spending *per place* and *per child* were similar to growth in *total* spending, with each roughly doubling in real terms between 2009–10 and 2018–19. One major driver of the increase in spending per child has been the introduction of the 30-hour extended entitlement, which doubles the entitlement of some 3- and 4-year-olds in working families.

In order to strip out the impact of rising entitlements on total spending, Figure 5 also shows the changes in spending *per hour*. Compared with overall spending and spending per child, spending per hour has grown more slowly. At its peak, in 2017–18, hourly spending was around 34% higher in real terms than in 2009–10, but this path has not been smooth. During the 2010s, core hourly funding from the Department for Education tended to follow a ratchet pattern, with multi-year cash-terms freezes causing the real value to be slowly eroded by inflation before the cash-terms value was increased again. For example, core funding per hour was increased in 2017–18 but then frozen in cash terms for the next two years.

More recently, spending per hour has increased slightly in the last two years. Partly, this reflects increases in the average hourly core funding rate set in the Early Years National Funding Formula, which rose (in cash terms) from £4.77 between 2017 and 2019, to £4.85 in 2020–21 and £4.91 in 2021–22. However, when measured against the standard measure of inflation, these cash-terms increases in funding still left real-terms spending per hour on a bumpy path. In Section 4, we explore the path of core funding using alternative measures of inflation that are more closely linked to childcare providers' costs.

However, our overall measure of spending per hour (shown in Figure 5) will incorporate not just changes in this core funding rate, but also changes in additional funding uplifts (such as the Early Years Pupil Premium and the Disability Access Fund) as well as any additional funding that local authorities add. Up until 2021–22, these uplifts had largely been frozen in cash terms. In 2022–23, however, many of these targeted uplifts have been increased.

Overall, while the last few years have seen more consistent year-to-year increases in the cash-terms core hourly funding rate, the real-terms path of overall spending per hour has been much

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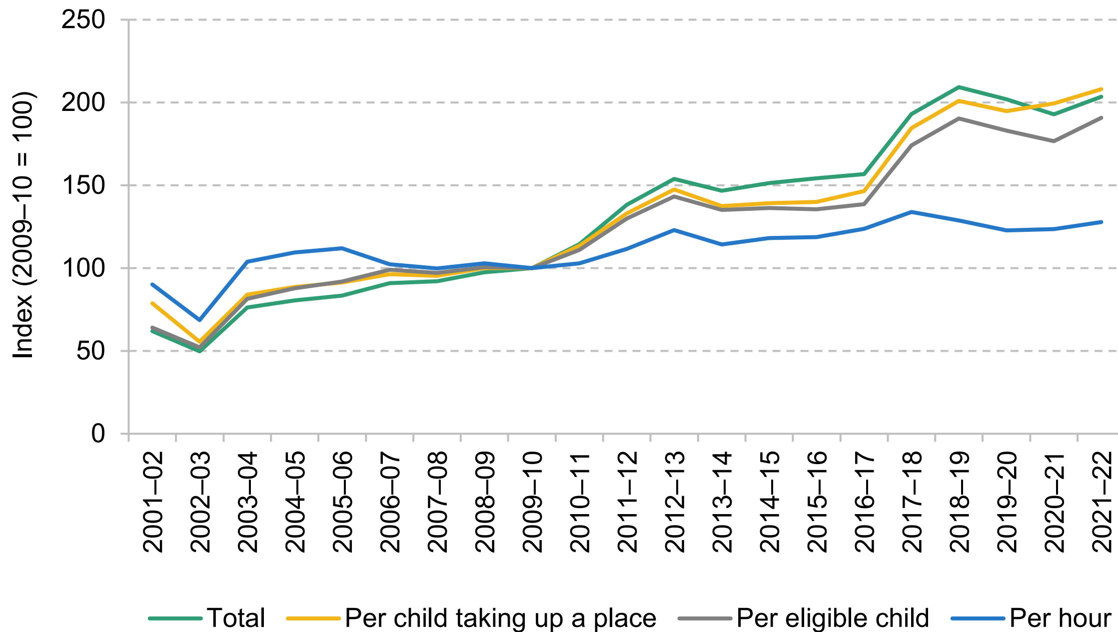
bumpier. Spending per hour has not yet returned to its peak in 2017–18, and ongoing pressures from rising costs mean that the landscape over the next few years could look more difficult still. We return to this point in Section 4.

Figure 5. Growth in real-terms spending on the free entitlement for 3- and 4-year-olds



Note: Spending on universal and (from 2017–18) extended entitlements for 3- and 4-year-olds. Spending per place is spending per part-time-equivalent place (15 hours) across both entitlements, so a child accessing their full universal and extended entitlement would count towards two PTE places; see https://ifs.org.uk/education-spending/methods-and-data for more details.

Source: See https://ifs.org.uk/education-spending/methods-and-data.

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3. The declining role of the tax and benefit systems

The nature of early years funding has changed significantly over the past 20 years. As Figure 1 showed, this period has seen rapid growth in free entitlement spending, the rise and then fall of benefit system spending as the largest area of early years expenditure, as well as – until recently – a more measured rise in support with childcare costs through tax relief.

While the free entitlements are largely intended to offer 'early education' with quite generous support for parents during a limited period of their child's life, subsidies through the tax and benefit systems are an important complement to help working families with the costs of childcare over a longer period. The programmes discussed in this section are open to families from birth until their child is a young adolescent (the precise age varies by programme). These are the main programmes of government support for people whose children are too young for the free entitlement, or who need wrap-around and holiday care for school-aged children, or who need to use more childcare than the free entitlement offers.

Falling benefit spending

Low-income working families claiming in-work benefits are eligible for support with their childcare costs, with the government reimbursing up to 85% of eligible childcare expenses. For most of the last two decades, the main source of support has been through legacy benefits, chiefly working tax credit. More recently, families with young children have started to move onto universal credit in significant numbers.

Figure 6 shows how spending on childcare support through these two benefit systems has changed over time. After rising very quickly over the 2000s, spending peaked at just under £1.8 billion in 2009–10. It then fell sharply over the next three years as the wider squeeze on benefit spending fed through into lower support with childcare expenses. While there were falls in the number of families claiming childcare support in this period, the drop in spending was chiefly down to less generous average payments as the reimbursement rate was cut from 80% to 70% in 2011–12 (Britton, Farquharson and Sibieta, 2019).

A second noticeable decline in benefit spending, starting in 2015–16, was driven by falling caseloads (while average payments remained largely constant). Between 2015–16 and 2017–18 (when very few families with young children were claiming universal credit), the number of

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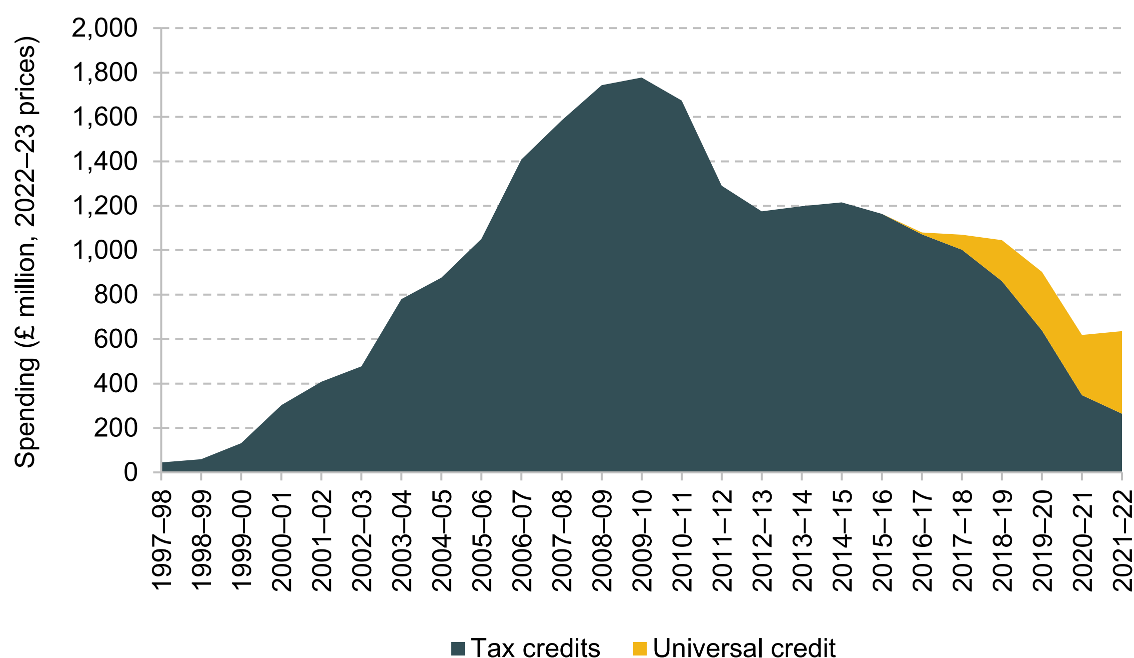
families claiming childcare subsidies through the legacy benefits system fell by more than 10% (Britton, Farquharson and Sibieta, 2019), even as the under-15 population grew by 3%. This was driven by a more-than-20% fall in the number of couples claiming these benefits. Part of this decline might reflect additional support for 2-year-olds through the 2-year-old offer, whose eligibility criteria overlapped the eligibility for subsidies through the benefit system to some extent.

During the first few years after 2017–18, when a significant number of families with pre-school children first transitioned onto universal credit, rising spending through UC roughly compensated for falling spending through the tax credit system. This changed through the pandemic, when total spending on childcare subsidies fell by nearly a third, from £900 million in 2019–20 to £620 million the following year. Spending through the benefit system had not recovered in 2021–22, largely because of the still-low take-up of childcare in this year (as discussed in Section 2).

Figure 6. Real-terms spending on childcare subsidies through the benefit system



Note: See Figure 1 for notes and sources.

However, the gradual decline in spending on childcare support through the benefit system will also relate to a long-term squeeze on generosity. In the legacy benefits system, the cap on reimbursable childcare expenses has stood at £175 per week for one child or £300 for multiple children since 2005–06. Had they increased in line with inflation, the caps would now be over

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£270 and £460 respectively. Under universal credit, the effective cap on reimbursable childcare expenses has continued to be frozen in cash terms at the same level as under legacy benefits.[2]

In addition to the increasingly less generous caps on childcare support through the benefit system, there are signs that families are struggling to access the support they are entitled to. In February 2022, only 25% of working families on universal credit with a child under 5 took up the childcare component (Department for Work and Pensions, 2022).

It is not clear what full take-up would look like, since not all of these families will be using formal childcare. Even so, these figures suggest that some low-income working families might be struggling to access support with childcare costs. This could be related to the need for families to pay the full cost of their childcare expenses up front, before waiting up to five weeks for reimbursement. This approach reflects the way that universal credit has been designed, but it is controversial: it has been criticised by the House of Commons Work and Pensions Committee (2018), which found that 'these upfront costs for childcare are not only a disincentive to work: for some Universal Credit claimants they will either make working unaffordable, or force them to take on debt in order to do so', and it was the subject of a legal challenge (Salvato v Secretary of State for Work and Pensions, 2021).

The role of tax reliefs

While the benefit system provides support with childcare costs for low-income working families, those with higher earnings who are not eligible for in-work benefits instead rely on various programmes of 'tax relief' to offset some of the costs of childcare. Employer-supported childcare vouchers (which allowed employees to sacrifice some salary for childcare vouchers, with a 32% subsidy due to basic-rate tax and National Insurance relief) are being phased out. They are being replaced with tax-free childcare accounts, which allow parents to save into a dedicated account with a £2 top-up for every £8 saved (up to £8,000 of parental contributions per child per year).

Tax-free childcare is a better-designed programme than the childcare vouchers it replaces. Childcare vouchers were available only to parents whose employers offered the programme. This meant that self-employed parents and parents whose employer did not sign up to deliver vouchers were not able to access vouchers. Since the programme was administered on a per-parent basis, families with a lone parent had less potential subsidy than those with two parents in work. And the cap on childcare vouchers was not linked to the number of children, meaning that those with several young children were not able to access additional support to reflect their

[2] Under universal credit, the cap is a maximum of £646 a month in government reimbursement, which works out to a weekly £149. Since 85% of childcare expenses are reimbursed, this corresponds to £175 a week in childcare costs.

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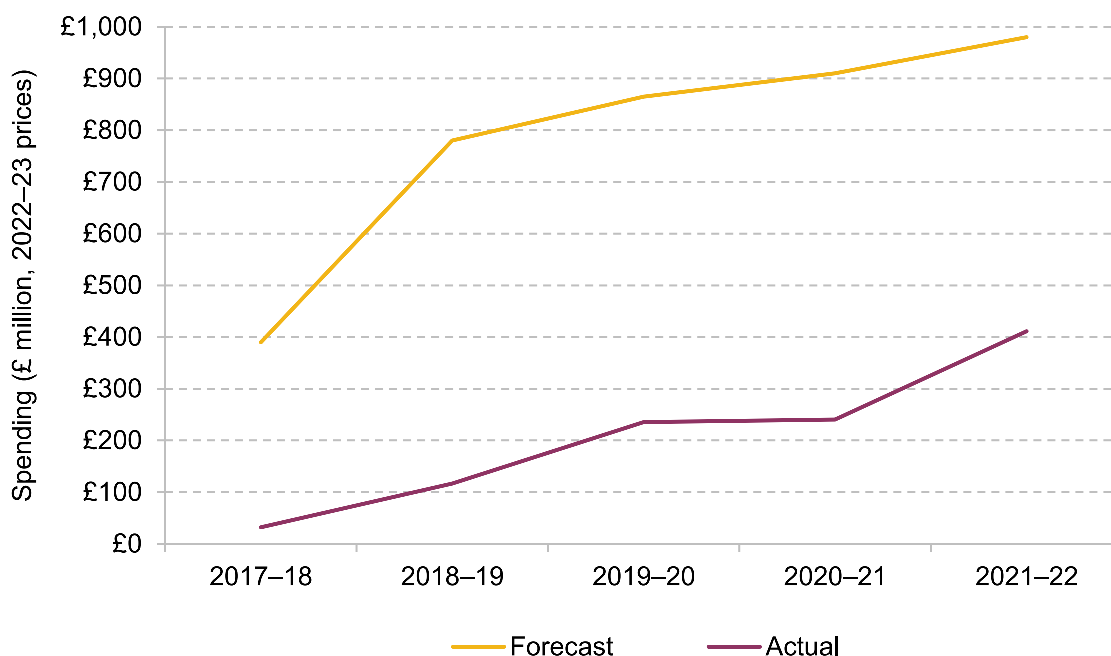
higher childcare costs. By moving to a system of childcare accounts linked to children rather than parents, tax-free childcare overcomes many of these design flaws.

But tax-free childcare has so far failed to live up to its potential. Families have struggled to use the system, and awareness is very low – in 2019, just 40% of parents with a pre-school-aged child had even heard of the programme (Farquharson and Olorenshaw, 2022). Partly because of these challenges, spending on tax-free childcare has consistently undershot expectations. As Figure 7 shows, in each year of operation, expenditure on the scheme has fallen far below the government's expectation. In the first three years of tax-free childcare, the government spent a total of £1.7 billion less on the scheme than it had planned. Partly as a result, as Figure 8 shows, the rise in tax-free childcare spending did not fully offset the decline in employer-supported childcare in the year before the pandemic.

There are some positive signs that awareness and take-up might be rising. Over the last year, the government has undertaken several information campaigns aimed at advertising the potential help that is on offer. Figure 8 suggests that these schemes might be working: spending through tax-free childcare has risen to £360 million in 2021–22, up by more than half from its pre-pandemic peak of £220 million.

Figure 7. Anticipated and actual spending on tax-free childcare



Note: Updated figure 3.3 in Farquharson and Olorenshaw (2022).

Source: Forecast spending from HM Revenue and Customs (2017). Actual spending from tax-free childcare statistics, various releases (https://www.gov.uk/government/statistics/tax-free-childcare-statistics-june-2022).

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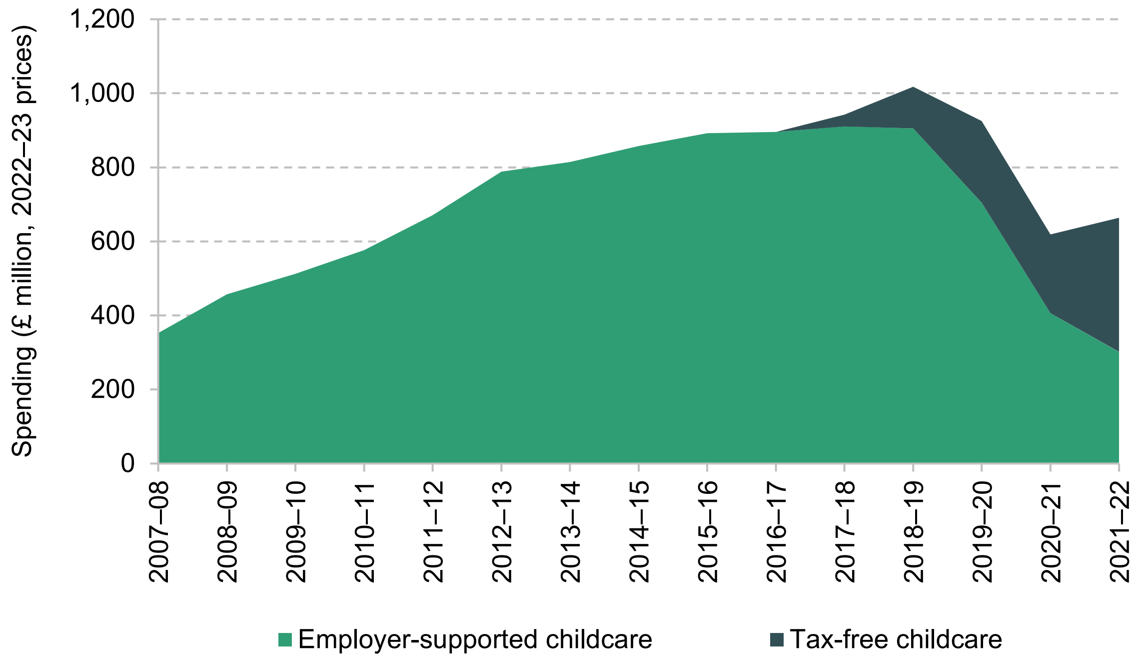
Figure 8. Spending on tax reliefs through childcare vouchers and tax-free childcare



Note: See Figure 1 for notes and sources.

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4. Provider cost pressures

Rising costs are a key challenge currently facing the UK population, with inflation returning to double digits for the first time in 40 years. So far in this report, we have used economy-wide inflation to assess the real-terms resources that providers have available and the amount of support that families can access.

But early years providers' costs are different from those faced by the government as a whole, and there are particular pressures on some of providers' main budget lines. In this section, we look at how the prices facing providers are changing, and what impact that might have on their resources to deliver the free entitlement going forward.

How are the costs faced by childcare providers changing?

To get a sense of how much resource childcare providers have today (and in the future) to deliver the free entitlement, we construct an index of the prices facing childcare providers. This index summarises how the prices facing childcare providers (excluding childminders) have, on average, changed since 2018–19 – the final financial year before the COVID-19 pandemic. This index is a weighted average of the prices of the main components of provider expenditure (namely, staff costs, materials, rent and utilities), with weights reflecting each component's share of providers' overall costs (sourced from the Childcare and Early Years Providers Survey in 2019). We give an overview of the measures and weights we use in Table 2.

By far the most significant cost for early years providers is staffing, which accounts for around three-quarters of providers' total costs (Department for Education, 2019). Many workers in the early years sector are paid close to the national minimum wage, meaning that rises in the minimum wage over recent years are an important driver of rising provider costs. Between April 2017 and April 2022, the headline minimum wage (for those aged 25 and over) rose by 27% in cash terms. Younger age groups have seen even larger rises, reflecting expanded coverage of the headline rate to those aged 23 and above in 2021, and the headline rate is expected to be expanded further with all workers aged 21 or above covered by 2024 (Low Pay Commission, 2022).

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Table 2. Components of the index of prices facing childcare providers

Cost area	Weight	Childcare providers' price index (2018–19 = 100)			Method
		2018–19	2021–22	2024–25	
Staff at minimum wage	17%	100	113.8	139.8	We assume the 22% of workers at or below the minimum wage (Department for Education, 2021) experience growth according to the path of the headline national minimum wage, as set out by the Low Pay Commission (2022). As staff costs account for 75% of total costs, minimum wage costs receive a weighting of 17% (= 22%×75%). We expect this approach to underestimate the extent to which wage costs have been affected by minimum wage rises, since younger workers and apprentices have seen faster growth in their minimum wages than the headline rate. Other work suggests that the share of workers below the headline minimum wage could be as high as 40% (Social Mobility Commission, 2020).
All other staff	59%	100	112.7	127.7	We assume the remaining 78% of non-minimum-wage staffing costs rise by average weekly earnings growth. Since staff costs account for 75% of total costs, average wage growth costs receive a weighting of 59% (= 78%×75%). Data on average weekly earnings are sourced from the Office for National Statistics (for 2018–19 and 2019–20) and the Bank of England (for subsequent years).
Food	3%	100	102.3	121.1	We source the share of providers' costs that go towards food from the providers' survey and assume this evolves according to the food component of the CPI until 2021–22. As forecasting specific components of inflation is challenging, we assume food costs follow overall CPI inflation in forecast years.
Rent/mortgage and utilities	11%	100	103.6	122.6	We source the share of providers' costs that go towards rent and utilities from the providers' survey and assume this evolves according to the energy and housing component of CPI until 2021–22. As for food, we assume rent and utilities costs follow overall CPI inflation in forecast years.
Other	11%	100	108.7	123.5	We assume the remainder of provider costs follow GDP deflators (based on Citi's October 2022 forecast) in each year, as this is the broadest measure of inflation.

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Note and source for Table 2

Note: 'The providers' survey' refers to the Childcare and Early Years Providers Survey in 2019 (https://www.gov.uk/government/statistics/childcare-and-early-years-providers-survey-2019). All provider's cost shares sourced from this survey. Weights do not sum to 100% because of rounding.

Source: The share of workers affected by the national minimum wage is sourced from Early years funded entitlement cost changes forecasts, England: spending round 2021 to 2022, 2021 (https://www.gov.uk/government/publications/early-years-funding-2021-2022/early-years-funded-entitlement-cost-changes-forecasts-england-spending-round-2021-to-2022).
Historical national minimum wage rises are sourced from National Minimum Wage and National Living Wage rates, 2022, (https://www.gov.uk/national-minimum-wage-rates); forecasts come from The National Minimum Wage in 2022, Low Pay Commission (https://www.gov.uk/government/publications/the-national-minimum-wage-in-2022). Past average wage growth is taken from Average weekly earnings time series, 2022, the Office for National Statistics (https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/earningsandworkinghours/datasets/averageweeklyearnings) and Monetary Policy Report, November 2022, Bank of England (https://www.bankofengland.co.uk/monetary-policy-report/2022/november-2022); forecasts of average wage growth come from the same Bank of England report.
We take CPI up to 2021–22 from Monetary Policy Report, August 2022, Bank of England (https://www.bankofengland.co.uk/monetary-policy-report/2022/august-2022); forecasts of CPI are sourced from the November 2022 Monetary Policy Report. Individual components of CPI come from Inflation and price indices, 2022, the Office for National Statistics (https://www.ons.gov.uk/economy/inflationandpriceindices).
GDP deflator historical data and OBR forecasts are taken from 'GDP deflators at market prices, and money GDP September 2022' (historical series updated 30 September 2022; forecasts last updated in March 2022) and Citi forecast is from estimates produced by Citi for the IFS Green Budget in mid October 2022 (https://ifs.org.uk/collections/ifs-green-budget-2022).

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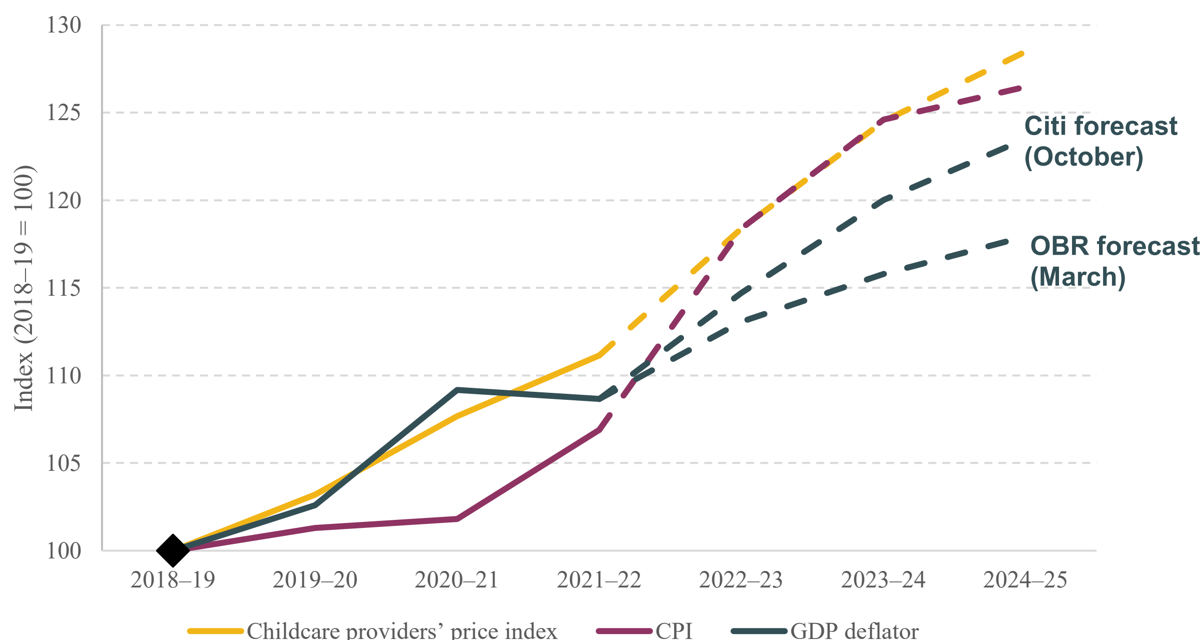
Prior to 2022–23, our index of childcare providers' prices is based on the actual change in the price of each component. For future years, we rely on the latest forecasts of CPI inflation and average wage growth from the Bank of England (2022), as well as the expected future path of the national minimum wage as set out by the Low Pay Commission (2022).

Figure 9. Comparing the prices facing childcare providers and other measures of inflation



Note: Index of childcare providers' prices is a weighted average of staff costs, materials, rent and utilities (with weights determined by the share of total costs in each category in 2019). CPI forecast comes from the Bank of England's forecasts of 3 November 2022. GDP deflator forecasts are taken from GDP deflators at market prices, and money GDP September 2022 (historical series updated 30 September 2022; forecasts last updated in March 2022) and from estimates produced by Citi for the IFS Green Budget in mid October 2022.

The path of future inflation is still highly uncertain. Our index provides an illustration of how the prices faced by childcare providers might change over the coming years. Figure 9 compares this index with two more general measures of prices, the overall Consumer Prices Index (CPI) and the GDP deflator. The CPI captures how the prices facing households have changed over time, while the GDP deflator measures economy-wide inflation, including goods and services purchased by the government (and is the main measure of inflation used earlier in this report).

While we have up-to-date forecasts of CPI from the Bank of England's 3 November meeting, the last official forecast for the GDP deflator comes from the Office for Budget Responsibility in March 2022. Since there have been considerable changes to policy and the economic outlook since then, we also show the forecast produced by Citi for the IFS Green Budget in mid-October, which predicts higher inflation over the next few years (Emmerson and Stockton, 2022). Figure 9 therefore shows both of these forecasts.

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As Figure 9 shows, the prices faced by childcare providers (shown in yellow) have grown more quickly than the prices facing households or the economy as a whole. Last year, in 2021–22, prices facing childcare providers were 11% higher than they had been three years earlier, before the pandemic. By comparison, over the same period, consumer prices had risen by 7%, while prices in the economy as a whole had risen 9%.

Going forward, the prices facing childcare providers are set to grow somewhat more slowly than consumer prices, as the growth in prices outstrips growth in wages (which are a large component of our childcare costs index). But the prices facing childcare providers will still come out substantially higher than economy-wide prices as captured by the GDP deflator.

Between 2021–22 and 2022–23, we estimate that the prices facing childcare providers have grown by 6.5%. Between this year and next, they are set to grow another 5%. Over the period between 2021–22 and 2024–25, we estimate that providers' costs will grow by 16%. Over the same period, the more recent forecast has economy-wide prices (as measured by the GDP deflator) growing by 14%.

This means that childcare providers have experienced faster inflation than the economy as a whole in the last few years, and are set to continue to see more rapid price rises. Taken together, in the six years between 2018–19 (the last year before the pandemic) and the end of our forecast horizon in 2024–25, we estimate that our childcare providers' price index will have grown by 29%. Depending on the forecast, the GDP deflator might have grown by 18–24% (with the higher number coming from a more recent forecast by Citi). This means that analysis of the 'real-terms' change in providers' resources based on the GDP deflator – the traditional approach when analysing public spending – will tend to understate the squeeze on resources that providers are likely to face.

How does inflation affect providers' resources?

How do the rising prices facing providers affect their ability to deliver free entitlement hours? In this subsection, we compare overall free entitlement funding and the 'core' funding per hour with the different measures of inflation outlined in the previous subsection. We focus on changes since the start of the COVID-19 pandemic to give a sense of how inflation has affected providers over the last few years, and show how inflation might affect the resources that providers have at the end of this parliament.

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Overall funding for the free entitlement

Figure 10 shows how total funding for the free entitlement (as allocated through the Dedicated Schools Grant) has changed over the last few years, as well as its path for the next few years.[3] We look at how funding is changing in cash terms as well as in real terms (measured both using the economy-wide GDP deflator and our index of prices facing childcare providers).

In cash terms, total funding for the free entitlement remained fairly steady between 2018–19 and 2021–22 (especially after the oddities of the pandemic year are considered). Cash-terms funding then jumped up in 2022–23, reflecting the budget uplift agreed in the 2021 Spending Review. This uplift of £500 million over three years was split roughly evenly between 2022–23, 2023–24 and 2024–25, so cash-terms total funding remains relatively constant until the end of the forecast period. Based on the inflation forecasts that were in place at the time (shown in light grey), this settlement would have kept total resources in 2024–25 around 2% lower than they were in 2021–22.

However, higher-than-expected inflation is set to erode the value of that settlement. Measured by recent forecasts for the GDP deflator, total real-terms funding for the free entitlement will be 8% lower in 2024–25 than it was in 2021–22. Measuring inflation using the prices faced by childcare providers suggests an even larger real-terms cut to total funding. As the yellow series on Figure 10 shows, this measure of inflation suggests a 9% real-terms cut between 2021–22 and the end of the Spending Review period, or a 19% cut since 2018–19. By comparison, the 2- to 4-year-old population will have fallen by 13% over that six-year period.

[3] Data for 2022–23, 2023–24 and 2024–25 are based on the allocations made in the 2021 Spending Review, which topped up the free entitlement budget by £500 million roughly evenly split across the three years (in cash terms). Focusing on the total budget allocated through the Dedicated Schools Grant captures uplifts (such as the Early Years Pupil Premium) but will not capture any additional spending done by local authorities, so this series is not directly comparable to the total spending series in Figures 1, 2 and 5.

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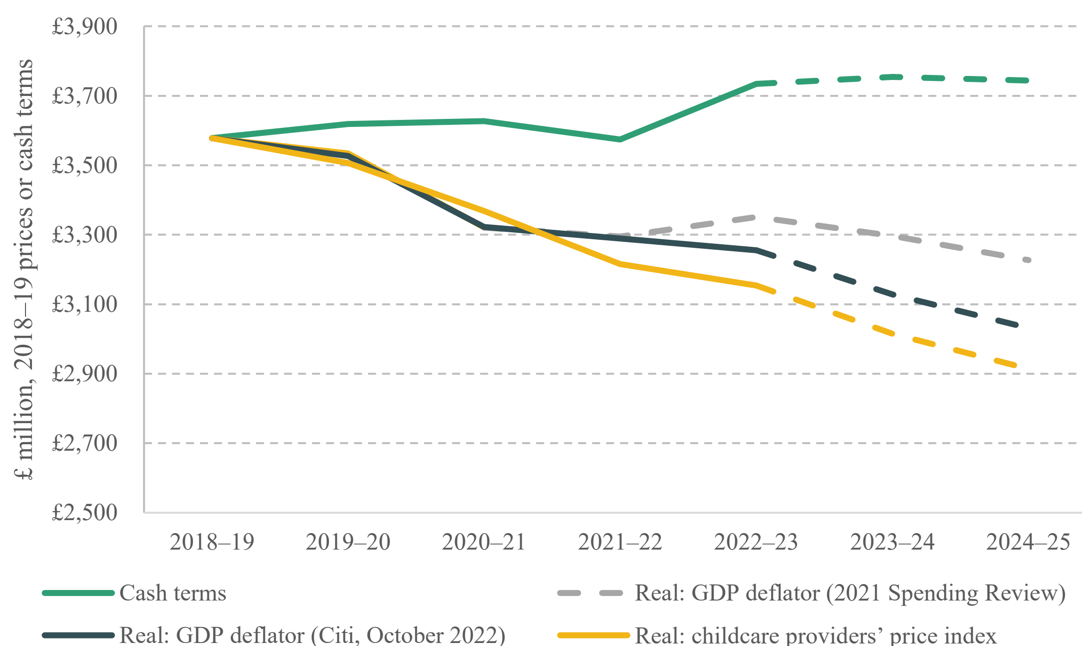
Figure 10. Total free entitlement funding



Note: Real-terms series are in 2018–19 prices. GDP deflator forecasts are based on Citi's forecasts for the IFS Green Budget (last updated mid October 2022), shown in dark grey, and projections as they stood at the 2021 Spending Review, shown in light grey. Forecasts for the childcare providers' price index are as set out in Table 2. Cash-terms funding is for the total early years block in the Dedicated Schools Grant, and for 2022–23 onwards is based on the profile of uplifts set out in the 2021 Spending Review. This excludes additional funding for the teachers' pay and pensions grants, which the Department for Education is considering rolling into the early years block from 2023–24, as well as additional funding of about £10 million for maintained nurseries which is currently under consultation.

Core hourly funding for the free entitlement

Of course, the total funding available for the free entitlement does not give a complete picture of the resources available to providers, since the total number of free entitlement hours required has been falling over time as the population of 2- to 4-year-olds declines. To analyse how inflation is impacting funding per hour, we therefore analyse a measure of core funding per hour in Figures 11 and 12. This is based on the actual core funding rate per hour between 2018–19 and 2022–23, but for future years we need to construct an **illustrative scenario** for how the free entitlement funding rate might evolve (described in Box 1).

In Figures 11 and 12, we show how the core funding rate for 2-year-olds and for 3- and 4-year-olds has been affected by inflation. For both ages, core hourly funding rates were frozen in cash terms between 2018–19 and 2019–20. Since then, rates have increased significantly in cash terms (shown in green): for 2-year-olds, the core funding rate rose from £5.40 in 2019–20 to £5.77 in 2022–23; 3- and 4-year-olds saw their core funding rate rise from £4.77 to £5.06 over this period.

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Box 1. An illustrative scenario for 'core' free entitlement funding

In this report, we have largely focused on measures of *spending* per hour. These 'bottom-up' spending measures are based on historical data on what was actually spent on the free entitlement, including core funding from the Department for Education, additional uplifts such as the Early Years Pupil Premium or Disability Access Fund, and any additional spending done by local authorities.

In order to forecast how per-hour resources might evolve in the future, we need to consider a narrower measure of *core funding* per hour. This is a weighted average of the hourly base rates that local authorities receive from the Department for Education (DfE) through the Early Years National Funding Formula (EYNFF). We use data from the Dedicated Schools Grant (DSG) allocations to measure core funding up to (and including) the current year, 2022–23.

For next year (2023–24), we derive core funding rates from the DfE's consultation on changes to the EYNFF. The consultation centres on rolling additional funding from the teachers' pay and pensions grants into the core EYNFF funding rates for 3- and 4-year-olds. For consistency with previous periods, we ignore this additional funding, which is worth about £60 million in total and is designed to compensate local authorities for higher employer pension contributions. We instead divide core spending on the universal, extended and 2-year-old entitlements by DfE's estimate for the number of part-time-equivalent (PTE) places each programme will provide.

There is not yet any information available on what funding rates might be in 2024–25, so we need to make further assumptions. We start from the total free entitlement budget, set in the 2021 Spending Review. We then allocate this to the different entitlement programmes and funding uplifts in the same proportions as implied by the 2023–24 consultation document. Finally, we estimate PTE places using the historical relationship between the 2-, 3- and 4-year-old populations and the PTE places assumed in past DSG allocations. We then predict PTE places in 2024–25 by applying this relationship to population estimates for that year from the Office for National Statistics.

These forecasts for spending are only illustrations of one plausible path for the core funding rates. There are still significant policy decisions to be made on how to prioritise resources within the overall free entitlement budget, which could see the core funding rates evolve quite differently from the path presented here.

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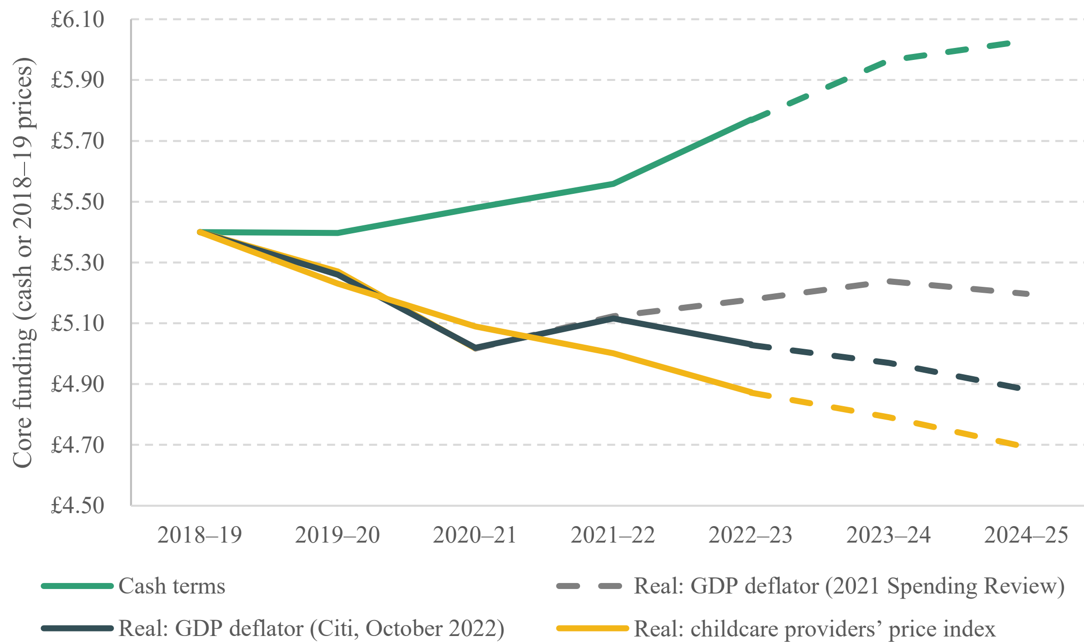
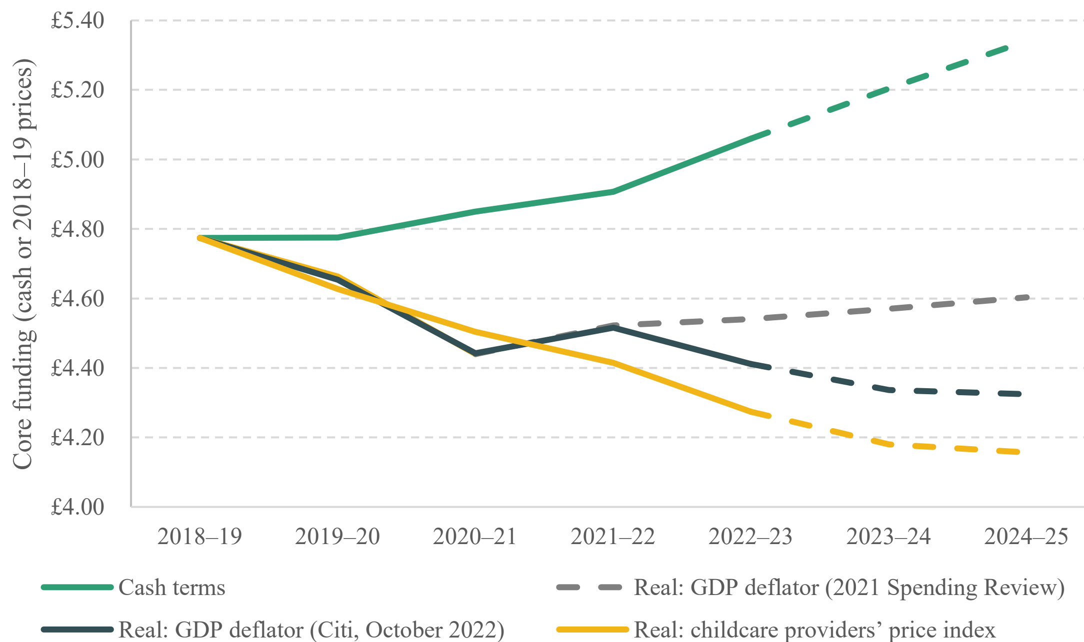
Figure 11. The impact of inflation on core funding for the 2-year-old entitlement



Note: See notes for Figure 10. Future cash-terms funding rates are illustrative only; see Box 1 for more information on the evolution of cash-terms funding rates.

Figure 12. The impact of inflation on core funding for the 3- and 4-year-old entitlements



Note: See notes for Figure 10. Future cash-terms funding rates are illustrative only; see Box 1 for more information on the evolution of cash-terms funding rates.

But these cash-terms increases have not been enough to offset the impact of inflation, whether measured by the GDP deflator (in dark grey) or our index of prices affecting childcare providers

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(in yellow). For 3- and 4-year-olds, the core funding rate fell by 8% between 2018–19 and 2022–23 versus economy-wide prices; compared with prices facing childcare providers, the fall was 10%. By contrast, under the inflation forecast in place at the time of the 2021 Spending Review, the fall in core funding for 3- and 4-year-olds would have been 5%.

Looking forward, we can provide an illustrative scenario for how inflation might continue to affect core funding rates. Even with continued growth in cash-terms funding in this scenario, high inflation will continue to erode spending per hour. For 3- and 4-year-olds, while the Spending Review settlement might have been enough to keep hourly core funding rising in real terms, higher-than-expected inflation will see it on a decisively downward path. Under our illustrative scenario, today's core funding rate of £5.06 an hour will fall by 10p in real terms by 2024–25 (in today's prices as measured by the GDP deflator), or by 14p an hour when compared against our index of childcare providers' prices.

Summary

Funding for the free entitlement has more than doubled over the past 15 years, with significant growth in core funding per hour in some years. More recently, the free entitlement received a substantial uplift in its total funding at the 2021 Spending Review. But even on the inflation projections in place at the time of the Spending Review, that uplift was set to be more than fully eroded by inflation by the end of the Spending Review period, in 2024–25. Now, with inflation much higher than what had been expected, total real-terms resources will fall in every year of the Spending Review period.

This decline will be partially offset by a falling population of young children, but our illustrative scenario of spending per hour suggests that higher-than-expected inflation could mean that core hourly funding, rather than growing in real terms, will instead decisively fall.

At the same time, childcare providers' costs have been growing more quickly than economy-wide inflation. Measuring the funding rate against this metric, providers' purchasing power will be eroded even more quickly, putting more pressure on their ability to deliver the free entitlement.

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5. Conclusion

The early years sector has been buffeted by a series of shocks over the last few years. Childcare use fell significantly during the COVID-19 pandemic, reducing total spending through the tax and benefit systems. Neither system had returned anywhere close to pre-pandemic levels of spending by 2021–22; it remains to be seen whether this is down to the lingering effects of the pandemic, or represents a more lasting reduction driven by changes in the support that families can access.

In the free entitlement system, providers were relatively well protected during the pandemic as funding continued to flow based on registrations rather than actual take-up. The free entitlement has also attracted significantly more resources over the last decade or so; total spending more than doubled in real terms between 2009–10 and 2021–22. The extra funding that has flowed into the free entitlement system is unusual during a period when other stages of education, and many other public services, were seeing their budgets cut.

Much of the increase in funding has been driven by successive expansions of the free entitlement to cover more hours and more children, but there has also been real-terms growth in spending per hour over the last decade. Most recently, the 2021 Spending Review allocated an extra £500 million over three years to raising free entitlement funding rates.

But rising costs mean that these cash-terms increases are not as generous as planned. Higher-than-expected inflation has turned what was intended to be a 2% real-terms cut in total funding between 2021–22 and 2024–25 into an 8% cut, and will put core funding per hour on a decisively downward real-terms path following a rise last year. Measured against a price index that more closely reflects providers' main costs, the funding situation looks even more difficult. On this measure, the real-terms hourly core funding rate has steadily trended downwards since 2018–19, the last year before the pandemic.

Taken together, these findings suggest that the early years sector will face greater pressure in the coming years. Both the pandemic and the cost-of-living crisis have highlighted the importance of the early years system, but the wider context of tax rises and/or spending cuts across public services will make getting policy right an even trickier task.

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