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# Childcare subsidies, labour supply and public finance: an AGE approach

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## Abstract

This paper uses an applied general equilibrium approach to analyse the impact of childcare subsidies on the labour market and government budget. Simulation results show that an increase in childcare subsidies has a relatively large impact on labour supply, because childcare subsidies accrue to people who feature a relatively high labour supply elasticity. General equilibrium wage effects cause an increase in employment. Moreover, since only workers benefit from childcare subsidies, this policy lowers the replacement ratio, reducing unemployment. The resulting additional tax receipts do not fully compensate for the rise in subsidies. However, public expenditure also partly decreases because of the wage reduction. As a result, childcare subsidies largely pay for themselves. © 2000 Elsevier Science B.V. All rights reserved.

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## 1. Introduction

Recently, the Dutch government presented the coalition agreement for its 4-year term. One of the policy targets is to raise the labour market participation of (married) women with children. Besides the emancipatory goal of enhancing the independence of women, this serves an economic goal. First, it prevents the loss in

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human capital caused by the (temporary) withdrawing of women from the labour market who have young children. Second, it strengthens the financial base of social security in the future in light of the ageing of the population in the next decennia.

In order to stimulate labour participation by (married) women, the government intends to double the public subsidies on childcare costs. The extra subsidy is partly spent on enlarging the number of places that are subsidised by local governments, partly on subsidising firms that arrange childcare places for their employees, and partly on raising the deductibility of childcare costs of private places. This three-sided subsidy policy reflects the opinion of the Dutch government that the costs of childcare should be shared by the government, employers and parents.

This paper investigates the effectiveness of various forms of subsidies on childcare costs in raising labour market participation of women with children. Although most micro-econometric research on this subject indicates that subsidising childcare does increase the labour supply of mothers, it provides insufficient evidence on the aggregate effects. Rosen (1996) argues that subsidising childcare may just provoke substitution from household and informal activities to formal activities without raising the total level of activity in the economy. The policy's only effect would then be that it monetises the care for people: Instead of taking care of their own relatives, some women will look after the children of other women, who take care of the parents of those who are looking after the children.

In order to analyse macro-economic consequences of subsidising childcare, CPBs applied general equilibrium model MIMIC is used. This model is particularly suitable, because it contains a highly disaggregated household model describing labour supply of households of, among others, couples with children and lone parents. Moreover, and more important, MIMIC not only describes the partial effect of childcare subsidies on labour supply, but also equilibrium effects stemming from the impact on human capital, value added, employment, wage and price formation and the informal economy, which all influence the net effect of childcare subsidies on government finance.

The contents of this paper are as follows. First we highlight several aspects of the Dutch childcare market, like the capacity of subsidised childcare places and the cost involved in hiring a childcare place. Section 3 gives a detailed description of those parts of MIMIC that are important for the analysis of the effects of childcare subsidies. In particular, this section presents a model of the childcare market (including informal childcare), which has been included in the MIMIC model for the purpose of this paper. Section 4 presents the simulation results for several types of policies. Section 5 investigates the robustness of the simulation outcomes by presenting sensitivity analysis with respect to those parameters that lack a substantial empirical base. Section 6 discusses our results in light of some other research on the impact of childcare subsidies on labour supply. The main conclusions are summarised in Section 7.

## **2. The childcare market in the Netherlands**

In the Netherlands various types of childcare arrangements exist. Childcare can

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