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Home truths

Policy snapshot: Better targeting the Child Care Subsidy

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KEY POINTS

- The Child Care Subsidy has the most generous income cut off of any means tested Commonwealth payment, with support available to families with combined pre-tax income up to $535,000.
- Our preferred option to better target the Child Care Subsidy lifts support for low- and middle-income families, with a 95% subsidy (instead of 90%), and the full subsidy available up to $133,000 of household income (instead of $85,000).
- The subsidy would phase out by $250,000 of household income, for a family's first child in care, and $400,000 for second or younger children (each down from $535,000 at present).
- These changes would save about $3.2 billion a year, with almost all savings coming from higher-income families in the top 20% of the income distribution.
- More than 180,000 lower- and middle-income families would see a modest increase in support.
- The changes have been designed to minimise the workforce disincentive associated with paid child care where it is strongest — for lower and middle income families, and for families with more than one child in care.

1 Better targeting the Child Care Subsidy

1.1 A tighter income test, with more support for low and middle income families

The Child Care Subsidy reduces the out-of-pocket cost of approved child care. In December quarter 2025, the Child Care Subsidy was provided for 1.4 million children from 1.0 million families.[1] Families with very high incomes of up to $535,000 a year are eligible for the Child Care Subsidy.

Our 'preferred option' better targets the Child Care Subsidy, while minimising a potential change in financial incentives for parents to remain in paid work.

- It lifts the standard Child Care Subsidy rate from 90% to 95% for the first child of families with income up to $133,000, which increases support (and reduces a barrier to work) for families more in need.
- It tightens the income test at the top, so that the standard subsidy for the first child falls to 0% when family income reaches $250,000, down from $535,000 at present.
- It lifts the threshold for second and younger children, so that the higher subsidy remains at 95% up to $250,000 before also falling to 0%. This novel structure separates the phase out for the first and second child rates to minimise the disincentive to work associated with paid child care where it is strongest — for families with two children in paid care.[2]

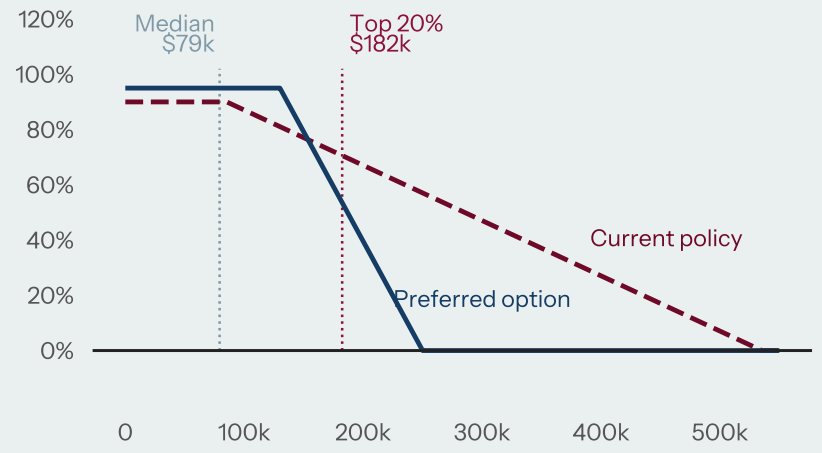
Figure 1 compares our preferred option and the current income test.

[1] Department of Education (2025).
[2] Using HILDA, we estimate that fewer than 5% of families receiving the Child Care Subsidy have more than two kids in pre-school child care. Disincentives to work are discussed in Section 1.3.

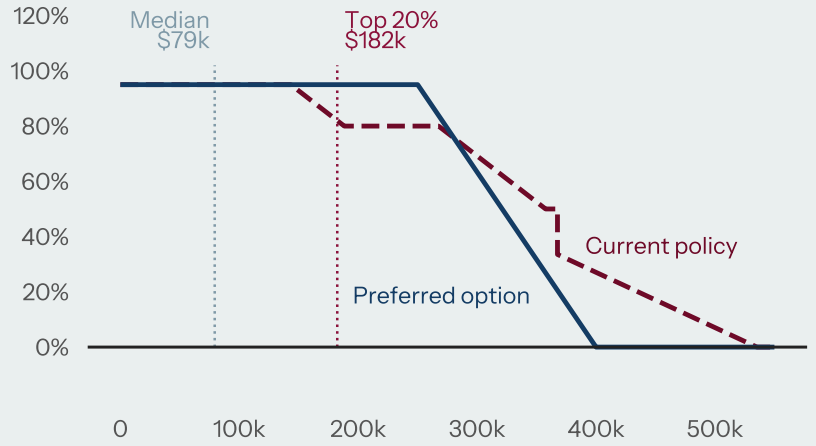
FIGURE 1

Child Care Subsidy test: current vs preferred option

***First Child**: Child Care Subsidy rates against pre-tax household income*



***Second and Younger Children**: Subsidy rates against pre-tax household income*



Note: Under current policy, second and younger children use the higher-rate schedule only while family income is less than $367,563. At $367,563 and above, they fall back to the first-child standard rate.

Source: Policy Institute Australia Microsimulation Model (PIAMM).

1.2 The preferred option generates savings and improves equity

As shown in Figure 2, our preferred option modestly increases average support for recipient households across the income distribution, except for the top 20%. This result is driven by the higher first child subsidy rate (95% v 90%) and higher threshold for the full subsidy ($133,000 v $85,279).

Smaller average subsidies are being paid to households in the top 20% of the income distribution, with annual income above $182,000.

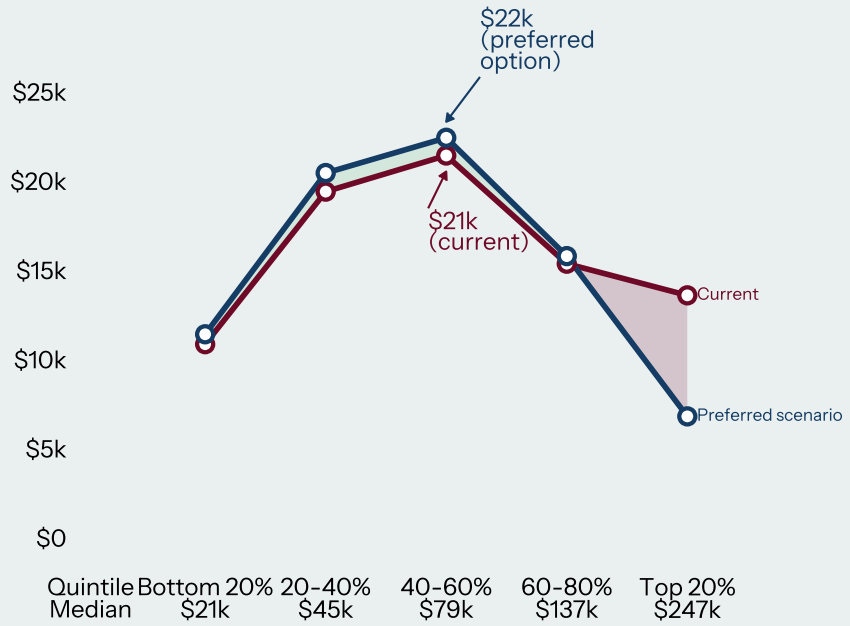
The reform meaningfully improves the targeting of the Child Care Subsidy. Under current settings, a *lower* average benefit of $10,800 is paid to families in the bottom 20% of the income distribution, while the average benefit to the top 20% is $13,600 — a ratio of 0.8 (Figure 2). Average benefits are regressive in part because high income families are more likely to use more approved child care. Under our preferred option, this switches, with the ratio increasing to 1.7 — that is, recipient households in the bottom 20% of the income distribution receive 1.7 times the benefit of recipient households in the top 20%.

Child care is expensive. 'Approved' child care costs about $150 per day, or $39,000 per year for one child in care five days a week. With no subsidy, the family must meet this cost themselves — a significant expense even for a high income family. But if the family was eligible for a 95% subsidy, the benefit would be worth $36,136 per year. While examining how the Child Care Subsidy affects prices is beyond the report's scope, the ACCC has found that 'when subsidies increase, out-of-pocket expenses decline initially but then tend to revert to higher levels … because subsequent fee increases erode some of the intended benefit for households over time'.[3]

FIGURE 2

Modelled outcome: Better targeting shifts the Child Care Subsidy away from high income families

Average annual Child Care Subsidy per current recipient household, by income



Source: Policy Institute Australia Microsimulation Model (PIAMM).

Our preferred option would reduce expenditure on the Child Care Subsidy by about $3.2 billion a year. Almost all of that comes from high-income families in the top 20% of the income distribution.

Figure 3 shows how families across the income distribution are affected by the preferred option to change the Child Care Subsidy.

For high-income families in the top 20% of the income distribution, around 500,000 families — half of all current recipients — would see a reduction in the benefit they receive.[4] This reflects the current concentration of Child Care Subsidy recipient families towards the top of the income distribution, as high-income families are more likely to access formal child care. For example, a household with combined income of $250,000 and two kids in child care 5 days a week might see a decrease in their annual subsidy from $52,100 to $36,100.

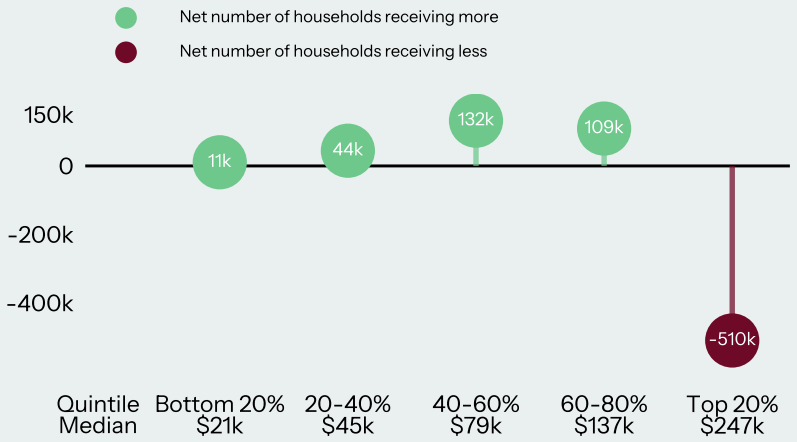
More than 180,000 lower- and middle-income families in the bottom 60% of the income distribution, or about one fifth of current recipients, would see a modest increase in the total subsidy they receive. The scatterplot in Figure 3 shows how this would affect households across the distribution, with an average increase of around $500 to $1,000 for lower income and middle income families. For families who are high users of child care, this could be even higher. For example, a household with combined income of $120,000 and two kids in child care 5 days a week might see an increase in their annual subsidy from $67,700 to $72,300. These are the families for whom affordability is most likely to shape parents' decisions about work (Section 1.3).

The reform reduces the cost of formal care and supports workforce participation, while pulling back support for households with the greatest means.

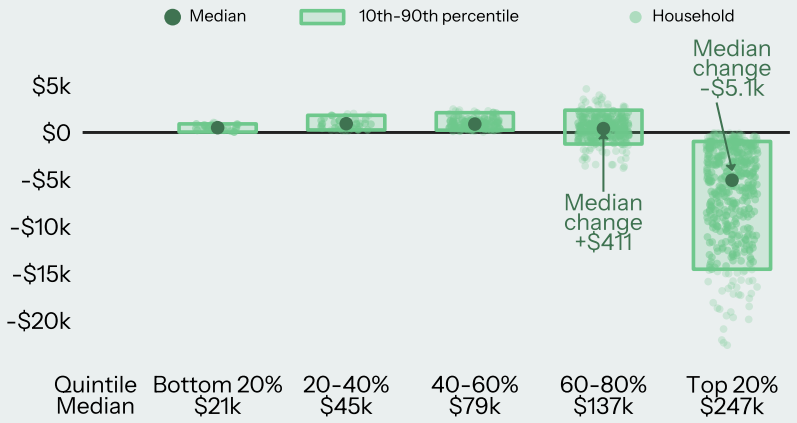
FIGURE 3

Modelled outcome: Reductions concentrated in the top 20%

Net number of current recipient households receiving more/less Child Care Subsidy, by income



Distribution of Child Care Subsidy payment changes among current recipient households, by income



Source: Policy Institute Australia Microsimulation Model (PIAMM).

[4] Policy Institute Australia estimate using the HILDA dataset (Melbourne Institute (2025)).

1.3 How would this change affect incentives to work?

A key aim of the Child Care Subsidy is to encourage workforce participation by reducing the cost of child care, thereby increasing the financial incentive for paid work.

When the Commonwealth Government introduced the Child Care Subsidy in 2018,[5] they indicated it would draw 230,000 families into more paid work.[6] However, the impact was much more limited, with about one tenth that number reporting more work — and an overall 1.4% increase in hours worked for single parents, and 0.3% for coupled parents.[7]

In 2004, the introduction of the Child Care Tax Rebate had a similarly limited effect — boosting mothers' hours of work by just one hour on average.[8]

Even these limited gains may *not* be the result of child care subsidies, since in both cases the employment uptick roughly aligned with pre-existing trends.[9]

In general, Australian studies suggest the labour supply response to child care prices is modest. A 1% reduction in child care cost is associated with an increase in maternal participation of roughly 0.02–0.29% and hours worked of 0.02–0.65%. Most estimates sit below 0.2%, broadly consistent with international evidence.[10] This means that to increase maternal hours worked by 2%, child care costs would need to decline by *more than 10%*.

Responsiveness is higher among lower-wage and lower-income mothers, single parents, mothers with preschool-aged children, and secondary earners; it is lower for higher-income families, fathers, married men, and households whose work decisions are shaped more by preferences, job flexibility, or service availability.[11]

Workforce disincentive rates

Workforce disincentive rates reflect how much pre-tax income is retained. This is the result of tax rates, but also the phase out of social transfer payments. For example, depending on the income of their partner, someone earning $50,000 in pre-tax income may face a tax rate of 32% and a 30% phase out of Family Tax Benefit A, meaning a workforce disincentive rate of 62%.[12] This means that for every $100 of additional pre-tax income that is earned, only an additional $38 is pocketed by the worker.

Evidence indicates that workers' responses to changes in workforce disincentive rates are real but modest on average, with the decision of whether or not to work at all more responsive to workforce disincentive rates than decisions around how many hours to work. Primary earners are relatively unresponsive; secondary earners, single parents, and those on lower incomes are much more likely to adjust their hours. Where workforce disincentive rates are very high they can strongly discourage extra work, particularly for sole parents and secondary earners.[13]

Overall workforce disincentive rates reflect the broader tax-transfer system, and for most households, child care costs are not the primary driver.[14] However,

[5] Replacing the Child Care Tax Rebate and the Child Care Benefit.
[6] Porter (2016).
[7] Bray et al. (2021).
[8] Productivity Commission (2024b).
[9] Bray et al. (2021).
[10] Productivity Commission (2024b).
[11] Department of the Treasury (2024); Dandie and Mercante (2007).
[12] Including 2% the Medicare levy.
[13] Productivity Commission (2024a); Department of the Treasury (2024); Dandie and Mercante (2007).
[14] Productivity Commission (2024a).

the effect of child care can be material, and for some households may affect workforce decisions.

Child care subsidies affect parents' work decisions through two main channels. First, they reduce the price families pay for child care, making work more financially attractive.[15] Second, as subsidies phase out with income, workers keep less of each extra dollar earned, weakening the incentive to work more. The relative magnitude of these effects on work decisions is actively debated, and varies by income, education, and sex.[16]

We combine these together to calculate the 'net child care' effect on workforce disincentive rates. For example, a single parent with capacity to earn $150,000 a year full time is currently working four days a week and has their only child in paid care for that many days. If they choose to work a fifth day each week, then under our preferred option the additional amount they pay for child care for that day each week is about $34 ($150 total cost minus a subsidy of 77%). But because their subsidy rate falls from 95% to 79%, they must also pay an additional $93 each week in relation to the other four days their child is in care. So their net child care cost is $127, or 22% of the additional money they expect to earn, which is added to their workforce disincentive rate.[17]

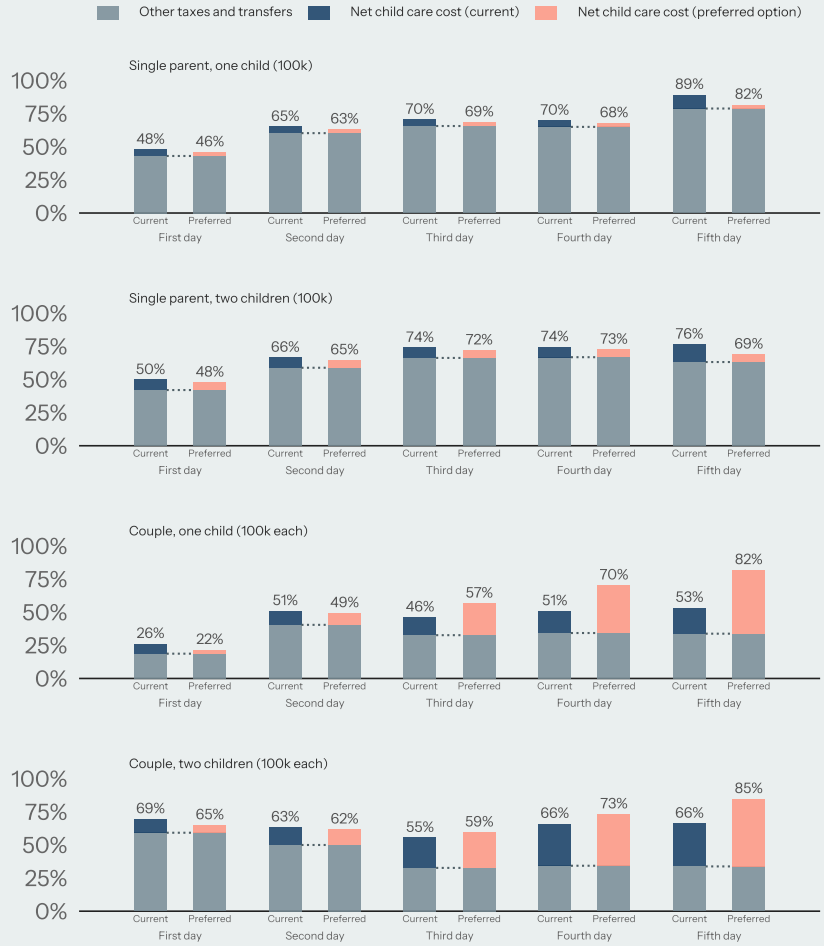
Figure 4 shows how workforce disincentive rates vary for parents under current settings and under our preferred option for the Child Care Subsidy.

[15] Noting subsidies may increase system costs over time.
[16] Productivity Commission (2024b); Department of the Treasury (2024); Dandie and Mercante (2007).
[17] Our approach follows Wood et al. (2020).

FIGURE 4

A better targeted Child Care Subsidy reduces workforce disincentives for some households

Workforce disincentive rate shown includes average child care cost net subsidy, plus taxes and the phase out of other transfers. A higher WDR reduces incentive to work.*



* A workforce disincentive rate measures the share of pre-tax income lost to tax and the phase-out of social transfers, reducing the financial return from earning more.
Source: Policy Institute Australia modelling.

Each panel shows a different representative family (single/dual parent; 1 or 2 kids in child care) and maps how disincentive rates change: for the 'first day' in the week they work (and put their child in care), the 'second day', and so on.[18] In dual parent families, we assume one parent works full time, and the decision about how much to work is just for the second parent. Figure 4 assumes that all parents earn the median full-time employee earnings of $100,000 per year.

We assume that the number of days worked by the single or second parent is equal to the number of days their kids are in formal child care. In reality, many families have alternative arrangements — such as those who opt to put children in child care for more days than they work, or where care is provided at no cost by a relative — so that working an extra day would not require an extra day of paid child care. Of 1 to 4-year-olds receiving care outside the home, around half received some informal care, most often from a grandparent.[19]

The grey bars in Figure 4 represent the workforce disincentive rates for other taxes and transfers (that is, *not* including child care). These do not vary between the preferred option and current settings, as shown by the dotted lines. The pink and blue bars show the 'net child care' effect on workforce disincentive rates. For example for a single parent family with one child and earning capacity of $100,000 per year looking at working a fifth day (shown in the top panel), the workforce disincentive of other taxes/transfers is about 80%, the net child care effect raises this to 89% under current settings. Under our preferred option it is lower at 82%. This means that the parent would pocket $18 instead of $11 out of every $100 of pre-tax income earned.

[18] We estimate that just 4.5% of families who access the Child Care Subsidy have more than 2 children in formal child care at a time.

[19] Australian Institute of Health and Welfare (2019)

This example fits with the Productivity Commission's finding in its 2024 Child Care report that child care is *not* the primary driver of high workforce disincentive rates for lower income earners. Rather, the PC suggested the disincentive sits in income tax settings combined with the steep phase out of other social supports as incomes rise. Child care subsidies should be designed with this in mind.[20]

Our 'preferred option' has been designed to better target the Child Care Subsidy at those who need it, *reduce* the disincentive to work for lower income earners, and minimise the disincentive for higher income earners.

As shown in Figure 4, our preferred option modestly *reduces* the workforce disincentive rate for the single parent families, and for the second parent in dual parent families to work the first or second day per week (that is, whether to work part time versus not working at all). However, it *increases* the workforce disincentive rates for them to work days beyond that (Figure 4).

In general, our preferred option will *reduce* workforce disincentive rates for lower- and middle-income households, but *increase* workforce disincentive rates for higher-income households. These results are driven by the higher maximum first child subsidy rate of 95%, the higher full subsidy threshold, and the faster phase out beyond this threshold.

The decision of whether and how much to work is rarely just a financial decision. Work decisions are also shaped by non-financial factors — child care availability, job flexibility, career considerations, and other personal preferences.[21]

[20] Productivity Commission (2024a).

[21] Productivity Commission (2024b).

1.4 How would this change affect outcomes for children?

Some proponents of the Child Care Subsidy argue that its primary benefit sits in the benefits that formal, approved child care can bring for children's early learning and development.[22]

There is limited evidence from Australia on whether formal child care improves outcomes for children, but evidence from other countries consistently shows significant benefits *for children experiencing disadvantage*. The benefits for children of higher income families are less clear.[23] In Norway, expanded ECEC increased earnings for children (in adulthood) in the bottom two-thirds of the income distribution — with a much larger effect for the bottom third — but showed no significant effect for children in the top third.[24] In Finland, child care led to significant benefits at the 10th income percentile, but not at the median, and led to *adverse* effects on children at the 90th income percentile.[25]

Of course, child care subsidies can only improve developmental outcomes for children where they increase participation in quality early child care. In line with our findings in relation to labour force participation in Section 1.3, evidence suggests the effect of the subsidy on child care demand is modest, especially at high incomes.[26]

[22] Productivity Commission (2024b).
[23] Productivity Commission (2024b).
[24] Havnes and Mogstad (2015).
[25] Silliman and Mäkinen (2022).
[26] Productivity Commission (2024b).

Alternative options

Our preferred option aims to better target the Child Care Subsidy on families who have less capacity to pay for child care themselves, focusing on means as indicated by income. We have modelled two alternative options, the results for which are presented in Table 1.

The **$1.5m Asset Test** option matches our preferred option, but also adds an asset test so that any family with less than $1.5 million in net assets[27] receives what they would receive under our preferred option, but any family above this assets threshold receives no subsidy. About 10% of all Child Care Subsidy recipient households fail this asset test — putting them in the top 30% of the wealth distribution (and with an average age of just 41 for the adults). The results indicate that even with a much stricter income test, there are many families that are eligible for significant subsidies whose wealth suggests they have capacity to pay for child care themselves.

The **Universal** option reflects public statements by Prime Minister Albanese about his desire for a universal child care system.[28] We follow the Productivity Commission in modelling this as a flat 90% subsidy for all households.[29] The cost is $5.5 billion a year more (over 30% more than the current system), with $7,700 more going to recipient households in the top 20%, and less going to lower- and middle-income households. In its 2024 report, the PC concluded that a universal 90% subsidy comes at a higher cost and does not prioritise families experiencing disadvantage.[30]

[27] Including owner-occupied housing but not including superannuation.
[28] Albanese et al. (2024).
[29] Productivity Commission (2024b).
[30] The PC also modelled a $10 a day flat fee Productivity Commission (2024b).

TABLE 1

Child Care Subsidy: alternative options compared

FEATURE	UNIVERSAL: 90% SUBSIDY	PREFERRED OPTION	PREFERRED + ASSETS >$1.5M
2025–26 fiscal impact	$5.5 billion cost	**$3.2 billion saving**	$3.7 billion saving
2025–26 program spend	$21.1 billion	**$12.4 billion**	$11.9 billion
Change in average household payment: top 20% of income distribution	+$7,710	**-$6,784**	-$7,201
Change in average household payment: bottom 20% of income distribution	-$45	**+$556**	+$556
Ratio: bottom 20% to top 20% average payment by income	0.5 (curr. 0.8)	**1.7** (curr. 0.8)	1.8 (curr. 0.8)

Note: Fiscal impact and payment changes are measured against current settings. Spend under current settings is $16.4 billion. The asset test excludes superannuation and counts full home equity.
Source: Policy Institute Australia Microsimulation Model (PIAMM).

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