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RATE SETTING IN REALITY: Moving Beyond the Myth of Market-Based Pricing

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The notion of linking public reimbursement rates for child care subsidy to market prices dates back to the late 1980's, when the federal government enacted welfare reform legislation that included funding for child care. Recognizing that the child care system in the US was a private, fee-for-service system in which parents act as consumers when purchasing care, policymakers wanted to ensure that low-income families who received child care vouchers were able to purchase the same care as non-subsidized families. Requiring bi-annual market price surveys, and basing reimbursement levels on the price of care in local markets, appeared to be a good way to accomplish this goal. Initially it was. Following enactment of the law, child care reimbursement rates rose steadily, and significantly.

But now—thirty years later—the market approach to rate-setting is no longer effective. A deeper look at rate policy underscores significant systemic problems that must be addressed, most especially inequities for infants and toddlers and rural or under-resourced communities. Driving these inequities are several deep-seated beliefs. This issue brief will focus on seven myths that shape child care rate policy and underscore needed reform.

MYTH

Market prices are a good proxy for the cost of child care.

FACT

Market prices typically reflect the incomes of families in a region, not the cost of delivering child care.

Time and again, advocates seeking to increase public child care reimbursement rates use market prices as the benchmark for success and encourage states to increase "the market rate". What these well-meaning advocates fail to recognize is that market prices can vary widely across any given state and are actually more likely to reflect the incomes of families in the area than the actual cost of running a child care program. Data from Virginia, below, illustrate a pattern observed in many states across the US. The difference in wages, and child care market prices (expressed as the 75th percentile) is huge. The average family in Fairfax earns almost 2.5 times as much as a family in Richmond, and child care prices appear to correlate with this increase.

Location	Median Household Income (census, in 2018 dollars)	Monthly Child care Market Price Infant (@75th %)	Monthly Child care Market Price Preschool (@75th %)	Monthly CCDF Co-Pay Single mom @ $30K w/ 1 child	BLS* Annual Mean Wage ECE Director / Admin	BLS* Annual Mean Wage ECE Teacher
Fairfax, VA	$121,133	$1,779	$1,519	$125	$65,730	$29,530
Richmond, VA	$45,117	$759	$629	$125	$55,090	$22,030

**Data from the federal Bureau of Labor Statistics, updated 2019*

The Virginia data also underscore another key challenge—while the price of care can vary widely by location, the cost of delivering child care services does not vary in equal measure. Note that the wages earned by child care center staff—which is the largest cost driver in most programs—are not 2.5 times higher in Fairfax than in Richmond. This underscores the fallacy of myth number two.

MYTH

The cost of running a child care center or home varies by region of the state.

FACT

The actual cost of operating a child care center or home is more likely linked to compliance with higher quality standards (such as NAEYC accreditation or Head Start) or lower child:staff ratios (such as for infant care) than region of the state.

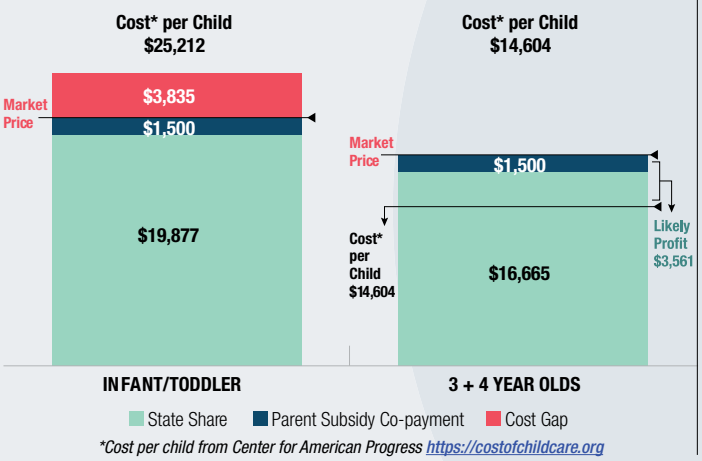
For consistency, the data on child care staff wages included in the previous table comes from the same Bureau of Labor Statistics (BLS) source as the median wage data. However, to deepen our understanding let's look at data from the **child care cost calculator**, an interactive tool developed by the Center for American Progress to estimate the cost of high-quality child care in each state. In addition to calculating the monthly cost per child in a center-based program, the tool includes a breakdown of the main expenses that contribute to that cost. Data sources used in the interactive tool are included in a **methodology guide**, which indicates that the following assumptions were made regarding annual wages in the Virginia model:

- Program Director $51,490, Lead Teacher $37,420 and Assistant Teacher $23,030 (Minimum Quality Scenario)
- Program Director $70,026, Lead Teacher $50,891 and Assistant Teacher $31,321 (Top Quality Scenario)

Using the CAP calculator as a proxy for likely cost, the bar charts below illustrate the impact of basing public reimbursement on market prices. A Fairfax center that meets higher quality standards is likely to earn a profit when serving preschool age children but is likely to lose a significant sum if they serve infants. More importantly—raising the reimbursement rate based on the market price is likely to exacerbate, rather than ameliorate, the inequity (note the bar charts, below, which indicate that market prices are below the likely cost of care for infants but above the likely cost of care for preschoolers.)

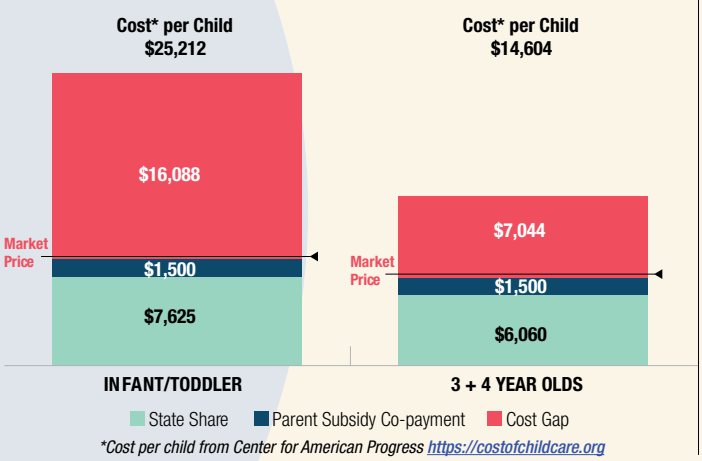
A Richmond child care center faces a significant cost gap regardless of the age of child served. Because rates are based on market prices, not likely cost, and prices are depressed due to lower median incomes in Richmond, the center in this example is not able to generate even close to the revenue needed to cover the cost of services that comply with higher quality standards.

Top Quality-Fairfax SINGLE MOM + CHILD @ $30K



*Cost per child from Center for American Progress https://costofchildcare.org

Top Quality-Richmond SINGLE MOM + CHILD @ $30K



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The Virginia tables also underscore a persistent challenge that appears in nearly every state and city: caring for infants is costly, and market prices rarely cover the cost gap. Both the Fairfax and the Richmond examples show a cost gap for babies. Indeed, the Richmond gap is impossible to fill without significant fundraising. It should come as no surprise that the cost vs price gap is a key reason why so few child care centers even offer care for infants and that, overall, regulated care for infants and toddlers is scarce. This issue is discussed in more detail in an **issue brief** published by Opportunities Exchange earlier this year.

Government should not pay more for child care than the provider's tuition or standard rate.

Capping public subsidy based on private tuition is inequitable. It hurts providers located in low-income communities and any provider that adjusts rates to make care affordable to low- and moderate-income families.

When market prices were first established as the benchmark for child care rate-setting, federal rule required states to establish a market rate *ceiling* and reimburse providers at the price they charge so long as it does not exceed this rate ceiling. While rate-setting has evolved significantly since the law was first enacted, this provision appears to have lingered —with serious consequences.

We have all heard **the legend of "the $600 hammer"** purchased by the Defense Department in the 1980s. This cautionary tale underscored a broken accounting system, focused largely on making sure that money is spent as Congress directed rather than making sure it is spent wisely. But rather than address the root problem, we've allowed this cautionary tale to define child care policy, assuming that expecting government to pay more than an ordinary citizen is wrong. When it comes to child care, the opposite is true: it's the right thing to do.

Countless research has underscored that high-quality child care costs more than the average US family can afford—especially when that care is for babies or located in rural or under-resourced neighborhoods. So when we cap government payment at what consumers spend—and even worse, apply that cap to the individual fees charged by programs—we've made it impossible for child care providers in low-income neighborhoods (who simply cannot charge hard-working parents a penny more) to generate the income they need to pay their staff a living wage. Yet across town, in upper income neighborhoods—providers can and do charge top dollar—to families and to government. Bottom line—the policy might, on its face, appear be written to ensure that federal funds are spent as Congress directed, it is simply not equitable or fair.

Government funding for child care should be linked to attendance, to prevent fraud and ensure that children show up every day.

Paying for child care on the basis of attendance, rather than enrollment, can significantly reduce provider income as well as teacher compensation.

The fixed costs of a child care center or family child care home do not change simply because children are not in attendance—yet their revenue often does. A significant number of states will pay for only a few absence days per month, and anything above that is lost revenue. This means that if Johnny has the chicken pox and is out for 2 weeks, the child care center will not be paid for the full two weeks.

The programmatic implications of payment based on attendance are profound. It is not uncommon, for example, for centers to send a teacher home (leave without pay) because s/he is not needed to meet mandated ratios that day, and the center director knows that low attendance means reduced revenue. This practice not only makes teacher wages unpredictable, and teacher recruitment challenging, it counters efforts to professionalize the field. Can you imagine if public schools sent teachers home without pay because census was low during flu season? Even the suggestion is unthinkable.

Basing funding on student enrollment is common practice among K-12 schools and Head Start programs. These entities receive an annual fund allocation for the entire school or, in the case of Head Start, an entire classroom of children. Funding is often adjusted based on Average Daily Attendance however these data are collected in the aggregate—an average number for the whole school or classroom—rather than an individual child.

Many states have revised payment policies during the COVID pandemic and, to mitigate

the impact of low attendance, are now paying on the basis of enrollment rather than attendance. These policies have played a significant role in stabilizing the finances of child care programs and should be continued.

States have been conducting child care market price surveys since they were first required by the federal Child Care Bureau. Child Care Resource and Referral Agencies (CCR&Rs) have been gathering and reporting child care price data for even longer. Neither have found that high-quality child care programs charge, on average, significantly higher prices than programs meeting minimum quality standards.

MYTH	FACT
Because it costs so much more for a child care program to meet quality standards, higher quality child care programs charge higher prices.	**Child care programs set prices based on what families can afford, and are willing, to pay. Child care programs that meet higher quality standards often lose money—especially on infants and toddlers.**

Most states have chosen to differentiate quality among child care programs via a Quality Rating and Improvement System (QRIS). The 2018 **North Carolina Child Care Market Rate Study**, which was based on a survey of all regulated child care centers and family child care homes in the state, offers an illustrative example of the price vs quality challenge. North Carolina gathers market price data by the center's quality star rating. Raw market price data (Appendix H of the 2018 study) reveals that the price charged (at the 75th percentile) by star level 1 centers was higher than that charged by star level 3 or 4 centers for preschool age children in 24 counties and for infants in 20 counties. The largest city in the state—Charlotte—as well as many mid-sized cities like Gouldsboro, Asheville and Wilmington—were among those reporting higher prices among centers with lower star ratings.

To help address the cost vs price challenge, North Carolina adjusts raw market price data using an 'imputed rate' methodology and then conducts a regression analysis to ensure that higher rates correlate with higher star levels. While this analysis helped address market inequities, in some cases the results were almost insignificant. For example, in Charlotte the 'modeled' rate for one-star infant care is $1,204 per month and the three-star rate is $1219—only $15 per month more.

Not surprisingly, the North Carolina Market Price Survey also revealed that almost 28% of all centers in the state require that parents who receive a child care subsidy pay an additional fee—essentially a second co-payment. This 'second co-payment' represents the difference between the state required co-payment (which is designed to reflect what families can afford) and the tuition charged by the center. The statewide average—which reflects all centers but is not weighted by slot—is somewhat misleading. Disaggregated data underscore that the percentage of centers reporting this second co-payment was significantly higher in cities—that is, areas where more families live and work. In Charlotte, for example, 37% of all centers (and 54% of five-star centers) reported charging this additional fee.

The profound number of centers that charge a "second co-payment" exemplifies the next common myth, and actually calls into question the entire notion of basing reimbursement on market prices.

MYTH	FACT
Child care subsidy rates based on market prices give low-income families comparable "buying power" to ensure they have "equal access" to care.	**The amount that parents pay is only partially based on the child care subsidy reimbursement rate; the parent co-payment is the real differentiator. And many parents must make two co-payments—the one required by government and the one required by the center in which they enroll their child.**

The amount paid by families who receive subsidy from the Child Care and Development Fund (CCDF) is often misunderstood. **Federal guidance** clarifies that states must "establish a sliding scale that provides for cost-sharing for families receiving CCDF funds … based on family size and income … not the cost of care or the amount of a child's subsidy co-payment." While this guidance appears, on its face, to be laudable, a second provision undermines its value. The second provision clarifies that states may allow providers to charge an additional amount (a second co-payment) if the provider's tuition exceeds the subsidy payment.

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The combined financial impact of these co-payment and market price rate-setting policies can be profound. This is especially true in states that—with good intentions—crafted co-payment policies designed to avoid the 'cliff effect' which can occur when a small increase in income leads to a large jump in child care fees.

Concerns about the 'cliff effect' are well-intentioned, however experience suggests that children are much more likely to 'age out' of child care (and enter K-12 school) before parent income rises to the point that the family is no longer eligible for a child care subsidy. Thus, sliding fees structured to avoid the cliff effect often result in making child care unaffordable in the short-term, under the guise of avoiding a potential future financial 'cliff' that the family may never face.

MYTH

Basing co-payments on a % of family income ensures that child care is affordable, and calibrating co-payments to avoid the 'cliff effect' is a helpful strategy.

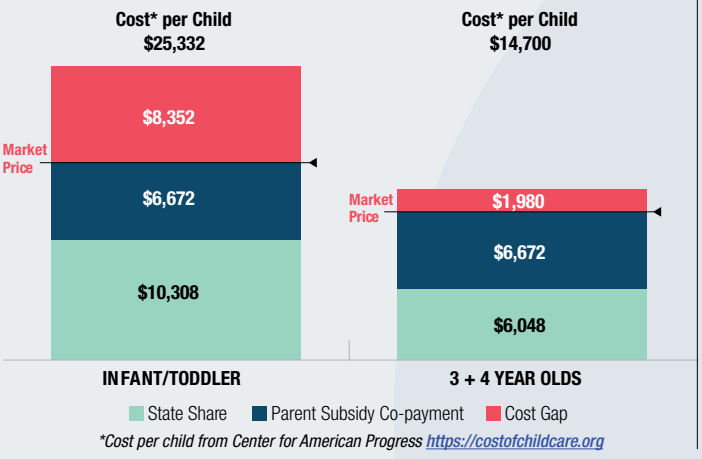
FACT

Families that receive child care assistance struggle to pay their bills and often choose between making child care co-payments or paying for rent, food, and other essentials. All too often, even with a child care subsidy, the price of care (e.g. the co-payment) is too high—especially if co-payments are adjusted to avoid the "cliff effect".

The Oregon experience, described in the bar charts below, is an example of a state that sought to craft effective child care rate and co-payment policies that, in practice, have had a disproportionate impact on both families and child care providers. Oregon has been a leader in ECE policy and, to support program quality and parent choice, established CCDF reimbursement rates at the 75th percentile. The bar charts below show the impact of this rate policy on infant and preschool care in Portland (an urban area with high market prices) vs a rural area like Coos and Curry Counties. Note however that the greatest impact on provider revenue and parent affordability is actually the parent fee—which is not only too high but does not vary by region. The result is that the *state's payment* for child care in Coos and Curry Counties is 76% lower than in Portland, but the *family payment* ($6,672 per year for one child) is exactly the same in both regions. In short, the policy not only fails to ensure equal access to care, it actually results in inequitable family expenditures. This practice occurs in every state—parent fees are held constant while state reimbursement rates vary.

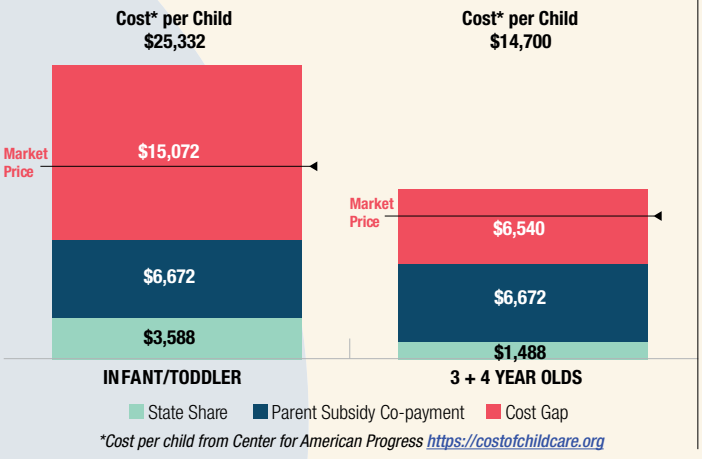
The good news is that Oregon, along with many other states, has currently waived all parent CCDF co-payments due to the COVID pandemic. Hopefully that policy will continue.

Top Quality-Portland SINGLE MOM+CHILD @ $30K



*Cost per child from Center for American Progress https://costofchildcare.org

Top Quality-Coos-Curry SINGLE MOM+CHILD @ $30K



*Cost per child from Center for American Progress https://costofchildcare.org

While between 7% and 10% of family income is the industry benchmark for **affordable child care**, it must be recognized that a family with a $100,000 annual income has greater buying power than a family with a $30,000 annual income. Indeed, the latter likely has no discretionary income after expenses such as housing, food, transportation and clothing are considered. In short, the goal should be equity, not equality. It must also be acknowledged

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that public PreK and Head Start programs charge no fees, so the choices available to families are not of equal value. Money matters, and when choosing between CCDF-funded child care (which requires a co-payment) and free Head Start or PreK, families almost always choose the latter. It is not surprising that many child care centers and homes struggle to fill spaces for 3 and 4 year olds and frequently raise concern about unfair competition from publicly-funded preschool.

RECOMMENDATIONS

This issue brief focuses on seven myths that have fueled inequitable rate policy and family co-payments. States that seek to revise rate policies should consider the following recommendations.

1. **Base child care reimbursement rates on cost modeling, not market prices.**
   The federal government permits states to use 'alternative rate-setting strategies' and the **CAP child care cost calculator** offers an opportunity to do so without costly research. Anticipated amendments to the calculator, designed to model the impact of COVID ratio and group size restrictions, will be a valuable addition. Cost modeling also makes it possible to establish higher public reimbursement rates for providers that meet higher quality standards, even if the provider does not charge higher tuition.

2. **Remove any barriers to receipt of higher public reimbursement rates among child care centers and homes that establish affordable rate policies for non-subsidized families.**
   Child care providers that struggle to raise prices due to local incomes, or who have created their own sliding fee scales to ensure care is affordable for families, should not be penalized.

3. **Keep child care co-payments as low as possible, ideally no more than 5% of income.**
   Best policy is for states to waive subsidy co-payments completely (which most did during the COVID pandemic). This not only helps low-wage parents but also levels the playing field with free public PreK and Head Start. If co-payments are waived, states should pay providers the total reimbursement rate (versus current policy of paying providers the state rate minus the anticipated family co-payment). If state payment systems are not revised to cease subtracting the co-payment before reimbursing providers, the policy will help families but leave providers with an even greater income gap.

4. **Assuming rates are based on cost modeling, child care centers and homes should be prohibited from charging a 'second co-payment' to families on public subsidy.**
   Public rates should be structured to cover the cost of operating an efficient early care and education program, with higher rates for programs that meet more costly higher quality standards.

5. **Base reimbursement of child care centers and homes on enrollment, not attendance.**
   If an attendance accountability measure is needed, establish a benchmark of at least 85% attendance, on average, across all children attending the program.

6. **States should consider contracting with large multi-site centers, or provider networks, for child care slots.**
   Stable, predictable revenue is a cornerstone of sustainability in early care and education. Predictable revenue makes it possible to structure rate policy and fund allocations based on assumptions rooted in quality at scale.

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