

The delicate balance on parental leave

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A combination of policies — parental leave, loans and tax credits — is necessary to deal with possible conflicting market failures in relation to decisions to take parental leave. This would allow for social insurance, provide parental leave that promotes child development and help to improve gender equality in the workplace.¹

Following widespread calls from unions and business groups for some form of paid parental leave, the Productivity Commission is currently undertaking an inquiry into Paid Maternity, Paternity and Parental Leave. However, there are many delicate issues associated with paid parental leave. Is it fair to fund leave where

the benefits are primarily private? Will paid parental leave improve workplace outcomes for families? And what policy responses might balance the difficult trade-offs that arise?

What is the goal of parental leave policy?

The starting point for any analysis of parental leave policy is to ask: If economics were not an issue, what would we want our parental opportunities and activities to look like? My examination of public discussions of parental leave suggests that parents would like to be able to move between work and home lives in a frictionless manner. Specifically, following the birth of a child, one or both parents would like to be able to 'pause' their work life, take time off to spend with the baby (perhaps between 6 and 12 months) and then to 'resume' their work life where they left off prior to the birth.

There are various impediments to a frictionless movement between work and home life around the birth of a child. First, if the period of leave is long enough, a parent's human capital may depreciate. Second, a parent's attitudes towards their career may change when a child is born and the parent may not wish to resume work at the same level of intensity as before. Third, parental 'pauses' may be disruptive to the workplace. Teams may be broken up, skilled replacements may be difficult to find and uncertainty may be created.

Thus the goal of parental leave policy may be to create a frictionless ability and incentive for parents to take a break from, and then resume, their working life around the time of childbirth but some costs or



frictions are inevitable. From this perspective, the first best, or most economically efficient outcome, will arise if the benefits accrued from parental leave outweigh the costs.

So what are the social costs that arise when parents take leave? First, a parent gives up any job satisfaction for that period of time. Second, to the extent that there is depreciation in human capital or workplace disruptions, there is

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a loss in productivity. Thus some of the costs are felt by the parent making the leave decision while some are incurred by their employer and co-workers. Finally, there are costs associated with caring for a child. However, to a large extent, it is the decision to have that child that creates those costs and not the leave choice itself.

What of the benefits? First, there is the raft of benefits that parents get from spending time with their children. And, to the extent that there are developmental benefits to the child, the parents feel that benefit too. Second, it may be that, like the benefits of education, the benefits associated with child development also spill over to the rest of society. That is, there could be positive externalities that are not captured by the parents.

However, we must take care in understanding these benefits. After all, many of the child development benefits can be achieved without specific parental involvement. Indeed, parental involvement is most likely not necessary all of the time. Non-parent child carers can do this job and, in some cases, may do things better because they have more experience and formal training. Even with breast-feeding there are

technological options that reduce the need for 24/7 maternal availability making the individual's ability to engage in breast-feeding easier (or at least no harder).

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What are the possible market failures?

A market failure arises when social decisions and private decisions do not match up. In the case of parental leave, the private decision involves what parents choose to do given their negotiations with their employers. The decisions centre around who will take leave, for how long and what the return to work conditions may be.

Clearly, many of the benefits and costs associated with parental leave are internalised in the private decision of the parents. For instance, they will internalise some of the child-development benefits and their own pleasure in spending time with their children. In addition, they will internalise some of the costs felt by employers through terms and conditions they accept for continuing employment.

However, even in these cases, there may be some constraints



on a parent's ability to make the optimal decision.

- **Liquidity constraints:** a parent may wish to take leave for the purposes of enhancing child development but may not have access to the income to support

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themselves during the time of leave. In theory, parental leave is one activity that does not have a significant impact on lifetime income. In a world with perfect capital markets, parents could borrow money to support themselves during the time they wish to take parental leave. However, for some households, particularly low-income households, that liquidity may not be available. Imperfections in capital markets caused by information asymmetry (namely, the commitment to earning income post-child rearing) may mean that income support is unavailable. This is very similar to the income constraints that make it difficult for students to obtain loans to support themselves while obtaining higher education.

- **Indivisibilities:** parents may wish to share responsibilities for parental leave but may be constrained because of

indivisibilities associated with a job or career. Essentially, some jobs cannot easily be broken up into smaller parts, whether it is on a day-by-day, week-by-week or career-long basis. Career indivisibility presents a problem

because it implies that workers who are away from their jobs for long periods or who cannot commit to long work weeks may be less productive than those who do. The key areas in which productivity can be affected include working with teams, the demands of a firm's customers (e.g. this is particularly relevant for legal partnerships) and the potential depreciation of training and job-specific skills. Put simply, it may not be possible for one or both parents to scale back their jobs easily. Indeed, indivisibilities may exist within the home, making it costly to outsource some child care activities while maintaining parental involvement in others. This means that 'market size or demand' effects can be important and there may be gains from one parent specialising in child rearing in the household.

These factors may mean that parents take a sub-optimal amount of leave

or allocate it sub-optimally between the parents relative to what might be socially desirable.

Each of these factors gives rise to flow-on effects or externalities and



may lead to an under-provision of parental leave in a pure market environment. First, there may be externalities associated with child development. These may be health-related or involve some social and intellectual issues. To the extent that there are liquidity constraints that may make it difficult for parents to take the requisite amount of leave, there is a case for subsidising leave to ensure that it is actually taken.

Second, there is the potential for discrimination; not just on the basis of gender, but also on the basis of any preference to spend more time with one's children. Consider an employer with a job that requires full attention.

Suppose also that the employer has to invest in the worker for that job. If you were that employer and you faced candidates from identifiable groups (say, a man versus a woman) with different statistical likelihoods of wanting to scale back their careers at some point, who are you going to choose? And, if every employer decides to react the same way, what does that do to overall patterns of employment? The answer: it reaffirms the employer and you have gender roles and pay differentials between genders. And the inefficiency here is that the wrong people may end up in the wrong jobs.

This discrimination can take many forms. The fact that when a baby arrives, maternity leave is taken more than paternity leave may be because of stereotyping that constrains fathers who would like to take more leave. It is not an unreasonable hypothesis that one of the reasons that fathers are not taking time off is that the discrimination against them is far worse than against mothers. They potentially face greater stigma and far greater harm from signalling their family-oriented preferences relative to social norms. These add up to greater costs associated with staying at home.

This is not just a theoretical concern. There is longstanding and mounting evidence that expressing a preference for spending time with one's family can damage career prospects in the workplace. My Melbourne Business School colleague, Isabel Metz, conducted in-depth interviews with 44 women who had left their primary employment over a space of six years. She found that many who had had

children and had taken maternity leave found re-integration back on their chosen career paths difficult. In some cases, this was because of unfriendly work practices. In others, it was because of promises (say, to limit work hours) that were unfulfilled, while, most disturbingly, there was a seeming loss in status and pressure to move ahead within their organisations.

Thus there are obvious reasons for market failure to occur with regard to a parent's decision to take leave. The two consequences may be a sub-optimal amount of parental leave and also a misallocation of that leave between parents.

Evaluating policy options

I now turn to consider various policy options and how effective each is in correcting the potential market failures identified above.

Mandated leave entitlements

In Australia mandated unpaid parental leave for up to 12 months is widely available. It isn't available to everyone (e.g. for the self-employed and those who have not been in their jobs long enough) but it does give a right to return to work at roughly the same position as that from which the



employee left. And it is available for one of the parents.

This mandate increases the incentive to take parental leave by removing one barrier: the ability to return to one's job. To that extent, it addresses the indivisibility issue and, by allowing more leave to be taken than might otherwise be the case, it serves to mitigate any externalities associated with child development. There is, however, little concrete evidence that parental leave mandates are associated with improved maternal or child health (Baker and Milligan 2007).

The main criticism of mandated leave is that it does not deal with liquidity constraints and so there is a diminished incentive to take leave because it is unpaid — something that some employers negotiate away.

But there is another problem: by making leave a mandated entitlement, it increases discrimination towards those who prefer to actually take that leave. This is because employers face costs of temporary worker turnover (something that is more likely to be an issue for smaller than larger firms) and so, in choosing which workers to hire, promote and train, there will be a commercial bias towards the non-family oriented. Moreover, to the extent that women are identified as most likely to be family-oriented, this mandate will disadvantage them relative to men in the labour market.

There is some evidence that supports such consequences. Parental leave mandates have been found to be associated with greater employment of women but lower relative wages

(Ruhm 1998; Edwards 2008). But there is evidence that such mandates do improve the chances women will not quit their jobs and return to their pre-birth employers (Baker and Milligan 2005).

Paid parental leave

To alleviate liquidity constraints, there are calls for paid parental leave (as exists in many other countries). The pay may be for some fraction of the parent's income and for a certain period of time.

Issue No. 1 is, of course, the obvious. Mandating paid leave and requiring



Issue No. 2 is that another government entitlement that involves a private benefit accrued by some people means a cross-subsidy from those not receiving the benefit. To be clear, we have all sorts of things that involve this type of cross-subsidy. But most of them can be rationalised on the basis of social risk bearing; for example, we do not know who will be disabled or unemployed, so we agree before the fact to a payment from the winner to the loser in the game of life. The decision to have children is under the control of parents and cannot be characterised as a clear-cut losing proposition in any case. So on a social contracting basis, there is no rationale for a cross-subsidy.

That said, when you have a child, your costs of living goes up. So, to the extent that there is social security, there is an incentive for greater payments to low-income households for social insurance reasons. There is a strong case for targeting paid parental leave on the basis of income — say, by capping it at the minimum wage. Indeed, to have benefits available for unemployment but not for parental leave seems quite inconsistent.

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Thus we must move on to the externality issue. We might be concerned that too few parents are taking the requisite time during the first six months to take care of their

babies. Again, this has to be relative to the child care option, as we are targeting a parent's role here. This brings us to issues of breast-feeding and bonding (which involves both parents). Reducing the income cost associated with exercising parental leave options will either mean (a) more parents will take leave or (b) employers will pay parents more not to take leave. However, only (a) reduces the externality.

The issue is with (b). If parents are offered only a fraction of their wage, paid by government, there is less chance that the leave will be taken; hence the push for a larger amount to be paid. But doing this raises incentive issues. We can solve this problem by capping the total level of pay but this will mean that some parents will not take leave. Clearly, however, taking all child development opportunities as equal,



Income-contingent loans

Chapman, Higgins and Lin (2008) have proposed using income-contingent loans to fund a system of paid parental leave. This would involve parents taking leave for a certain duration and being able to borrow from the Federal Government

What is very attractive about this proposal is that it directly alleviates a potential source of market failure — liquidity constraints — and then enables parents to take leave based on what is good for the child. Moreover, because individual households fund their own leave, there is no cross-subsidy issue or an issue of taxation on the economy. Hence, it is very low cost in economic efficiency terms, making it far superior to schemes that directly fund paid parental leave.

Income-contingent loans have been established as being practically viable. In Australia, they are most renowned in higher education funding (through the HECS arrangement).

Of course, it continues to suffer from the same discrimination possibilities associated with any scheme that creates an incentive to take leave although, in this case, it is a muted incentive given that it is a loan rather than a payment.

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the parents who have less attractive employment prospects — i.e. those with low wages — are the best households to fund in terms of birth-related parental leave).

But there is no getting around the discrimination issue: the greater the ability and the incentive to take parental leave, the greater the costs on employers from temporary replacement of the employee and the greater the level of discrimination that will be observed.

a certain fraction of their pre-birth salary to be paid back when the parent returns to the workforce. The Chapman et al. proposal targets only women and their salaries. However, this seems distortionary and it would be better to base the scheme on household decision-making and allow either or both parents to access the scheme. To allow for such gender neutrality in leave decisions, the income that forms that basis for loan repayments would have to be household based.

Return to work payments

The above discussion suggests that there is a fundamental conflict between policies that create an incentive to exercise parental leave opportunities and discrimination in terms of employers having incentives to favour employees who are less likely to exercise that option. Indeed, to reduce discrimination, policies need to concentrate on reducing the costs faced by employers when their employees take parental leave.

This suggests an alternative way of using government expenditure to promote parental leave. Instead of paying employees who take leave, employers could receive a subsidy or tax concession. The idea is that, should an employee take leave for some minimal period (say, three months), then the employer would receive a tax credit (perhaps in the order of 150–200%) on the wages paid to that employee on a pro-rata basis related to the length of leave taken and whether the returning employment is full- or part-time. The rationale for a tax credit rather than a once-off payment is that it ensures that the parent actually returns to work. However, it is the concept rather than the specific implementation details that I am considering here.

What would a return to work (RTW) payment do? First, it would create an incentive for employers to get employees back to work following parental leave and to give them the employment conditions that would make it happen. This includes flexible arrangements for ongoing child care and family issues as well as meaningful work conditions and career prospects. Second, it would



create an incentive for employers to encourage their employees to take parental leave. And to the extent that giving them paid parental leave is the way to do that, the employer can transfer the payment from the government to the employee. Thus, it is an indirect way of achieving a paid parental leave system but without the potential cost associated with an increase in discriminatory outcomes. Third, it would create an incentive for employers to encourage more highly paid employees to take parental leave. So, to the extent that it pays men more than women, there is a large incentive to get men to take that leave. All of these factors have the potential to change workplace culture and attitudes; something that is a large factor in driving appropriate work-life balances.

Yet, unlike income-contingent loans, this is not potentially self-funding. Instead, like paid parental leave, this will involve direct government expenditures. The key aspect here is that the expenditure is also funding potential work productivity benefits and other externalities. Moreover, it does so in a way that serves to break down rather than reinforce

discriminatory outcomes in labour markets. Put simply, this type of policy will subsidise the ability of family-oriented individuals to compete in the labour market.

Moreover, even if we don't give employees who have been working for a firm for a short period of time a right to parental leave, there is no reason why this payment cannot be made if they are permitted to take this leave and then return to work. That allows labour markets to function more smoothly; something that is generally considered a favourable outcome.

As I have outlined the scheme, the RTW payment would be available only to employers who are attracting back their pre-birth employees. Conceivably, a RTW payment could be made to any employer who hired a worker following parental leave. This would be attractive to parents but, realistically, it would not address the issues of discrimination that derive from firm-specific investments in worker productivity. Consequently, there is much to be said for a RTW payment exclusively to pre-existing employees.



But, why should the payment be made upon return to work (or following it)? Why not during parental leave itself, as some have suggested? The concern here is to eliminate moral hazard — that is, accepting a payment and encouraging leave from employees that a firm might wish to dismiss or limit in their career prospects. To create an incentive that will change workplace culture and attitudes requires that the payment be made to firms who successfully re-integrate parents into the workforce following parental leave. Hence, the payment needs to be made after the fact rather than in expectation of it.

Conclusion

A combination of policies is necessary to deal with the set of conflicting market failures that may exist with regard to decisions to take parental leave. These would include:

- **Minimum-wage parental leave**, paid for by government, for one parent (for three to six months). This would cover the social security element of having children and would provide incentives for parental leave to be taken in contrast to existing payments such as the baby bonus which do not. This leave could be means-tested.
- **Income-contingent loans**, secured by government, based on previous and future household income (for three to six months). This would address the liquidity issue associated with taking parental leave. It would promote child development but would also have a minimal fiscal impact on tax-payers. Consequently, it

would be equitable in contrast to schemes that involve lump-sum government handouts.

- **Return to work tax credits**, paid for by the government to employers who have employees take parental leave and then return to work (for a minimum period). These payments would be made contingent upon criteria that demonstrated re-integration of the employee with their career in the firm.

This combination of policies would allow for social insurance, for parental leave that promotes child development and work to improve workplace culture and labour market outcomes in ways that improve gender equality. ■

ENDNOTE

- ¹ This article is based on Gans (2008).

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