MINISTRY OF SOCIAL DEVELOPMENT
TE MANATŪ WHAKAHIATO ORA

Evidence Brief

The quantitative impacts of financial incentives for non-work tested groups

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Evidence Brief: The quantitative impacts of financial incentives for non work tested groups

Key points

- Financial incentives aim to 'make work pay' by creating an appreciable income gap between a benefit and paid employment.
- Financial incentives are rarely delivered in isolation but as one component of a wider welfare reform package. It is often difficult to isolate the quantitative impacts of financial incentives delivered as part of a package.
- There are two main types of financial incentives: 1) in-work benefits such as in-work payments, in-work tax credits and assistance payments, and 2) abatement thresholds and income support levels.
- International experience of time-limited in-work payments suggests that they are effective at increasing the employment and benefit exit rates of sole parents and people with disabilities. There is mixed evidence about the continued impact of these payments once they expire.
- In-work tax credits can be an effective mechanism for moving sole parents off a benefit and into employment. The potential 'Hours Effect' created by in-work tax credits is not supported by international experience.
- Assistance payments, such as childcare subsidies, can have a positive impact on the labour force participation of sole parents, with reasonable cost-benefit to the government.
- Lowering the abatement thresholds and/or the level of benefit payments for sole parents and people with disabilities can be effective in reducing benefit receipt for these groups, as well as increasing their employment rates. This is despite significantly raising the Effective Marginal Tax Rates (EMTRs) faced by these groups. Research suggests that this approach is most effective at encouraging sole parents or people with disabilities who have partial work capacity, or who are already in some part-time employment, to move off a benefit and into employment.
- There is no available evidence on the quantitative impact of financial incentives on people who are receiving carer's benefits.

Decreasing welfare dependency and supporting people into work has been a primary focus of recent welfare reforms in several OECD countries. Financial incentives often feature as a key component of these reforms. Financial incentives aim to 'make work pay' by creating an appreciable income gap between a benefit and paid employment.

This brief provides an overview of the quantitative impact of types of financial incentives on the off-benefit outcomes of non-work tested groups.

Financial incentives are rarely delivered in isolation but rather as one component of a wider welfare reform package. Other components of such packages can include tightened eligibility criteria, work obligations, employment assistance programmes, and sanctions. It is therefore often difficult to isolate the impacts of financial incentives delivered as part of a wider reform package from much of the published quantitative information. This brief has attempted to place parameters around quantitative figures where this is the case.

Who are the 'non-work tested' groups?

Work-testing refers to the policy of requiring benefit recipients who meet certain criteria to be available for and seeking work. In New Zealand, under the proposed welfare reforms, people who are not subject to a work test are generally:

- Domestic Purposes Benefit (Sole parent) recipients caring for children under the age of five.
- Supported Living Payment (consisting of Invalid's Benefit (IB) and Caring for Sick and Infirm Domestic Purposes Benefit (DPB-CSI) recipients.

Work-testing policy for sole parents and disabled people varies among OECD countries. For example, sole parents receiving income support are subject to a work test once their youngest child is either seven (Australia and the United Kingdom), three (Austria, France, Norway, Germany) or younger (United States). In Denmark and Sweden, work-testing for sole parents is applied at the discretion of case managers and subject to childcare availability (Finn & Gloster, 2010). Given this variation, this brief focuses on the impact of financial incentives on the three groups not work-tested in New Zealand: sole parents, people with disabilities, and carers; recognising that they all face similar barriers to work.

Types of financial incentives and evidence of their quantitative impacts

In-work benefits

In-work benefits are employment-conditional payments made to individuals or families who face labour market challenges. In-work benefits can be a cost-effective mechanism to 'make work pay', as they also reduce in-work poverty (OECD, 2008).

There are three types of in-work benefits that have featured in recent welfare reforms in OECD countries: 1) time-limited in-work payments, 2) in-work tax credits, and 3) assistance payments to help with the costs of working.

Time-limited In-work payments (such as the proposed benefit run-on):

International experience of time-limited in-work payments in the United Kingdom and Canada suggests that these payments are effective at increasing the employment and benefit exit rates of sole parents and disabled people. There is mixed evidence about the continued impact of the payments once they expire.

United Kingdom: In-Work Credit (or 'Lone parent benefit run-on')

The In-Work Credit (IWC) in the United Kingdom is a fixed, tax-free payment of £40 per week (£60 per week in London) for sole parents with children under the age of 16. To receive the credit, a sole parent must be working at least 16 hours per week (with the work expected to last at least five weeks in duration). It is paid for up to 52 weeks on top of earnings.

- Research on the influence of the IWC found that it had a positive impact on benefit exit rates: after 12 months, exit rates increased by 1.6 percentage points; 2.0 percentage points after 24 months (Brewer et al., 2009).
- 67 percent of IWC claims lasted for the full 52 weeks, and there was no evidence of employment status change in this group when the IWC ceased (Brewer et al., 2009).
- A qualitative evaluation of the IWC found that sole parents valued the IWC as a means of paying unexpected costs associated with working, and provided some financial security (Harries & Woodfield, 2002).

United Kingdom: Return to Work Credit

The Return to Work Credit (RTWC) is a component of the Pathways to Work reform package, aimed at encouraging employment among people claiming incapacity benefits (IB). The RTWC offers Pathways participants who find work (of at least 16 hours a week) a payment of £40 per week for up to 52 weeks if their gross annual earnings are no more than £15,000. The RTWC is only offered to Pathways participants.

An evaluation by (Adam, et al., 2008) of the RWTC found the following quantitative impacts. Note that the RWTC was introduced in conjunction with the larger Pathways reform package, which also introduced work-focused interviews for most people and condition management programmes. It is therefore likely that any quantitative impacts of the RWTC have been contributed to by a mix of these factors.

- Take-up of the RTWC was relatively low: 8.7 percent of people eligible for the pathways package claimed the RTWC. The low take-up is most likely due to a lack of awareness of the payment, since the process for claiming the RWTC was relatively simple.
- The majority of RWTC claims did not last the full 52 weeks – the average length of a claim was 36 weeks.
- The RTWC was effective in moving existing IB recipients into work: 83 percent of existing claimants who moved into paid work received the RTWC.
- The RTWC was also effective in increasing the employment of new IB claimants, however less effective than for existing claimants: 63 percent of new IB claimants who moved into paid work received the RTWC.

Canada: Self-Sufficiency Program

A pilot of Canada's Self-Sufficiency Program (SSP) offered the program to select sole parents receiving income support, using a control group for comparison. The SSP provided sole parents with an income-based, temporary earnings supplement for up to three years which approximately doubled their earnings from employment.

- Evaluation of the SSP pilot found it was effective in moving sole parents off a benefit and into full-time employment. After 18 months of the pilot, full-time employment among the SSP-eligible group was 12 percentage points (or 28 percent) higher than the control group (Hanson, 2006)
- However, the impact of SSP on the employment outcomes of sole parents reduced once payments ceased (Card & Hyslop, 2007).

Note: SPP receipt was conditional on leaving benefit for **full-time** work – not clear if this is a requirement of benefit run-on, or just that one leaves benefit?

Modelling of implementing SSP-type incentive instead of TANF (earnings disregard) in US:

Modelling found that it would cause more people to switch from part-time to full-time employment: increase of 13 percentage points for less generous SSP ($20,000), 24 percentage points for more generous SSP ($30,000).

In-Work Tax Credits

In-work tax credits serve as a financial incentive to take up work by allowing people to keep more of their earnings from paid employment while still receiving income support.

In New Zealand and other OECD countries, in-work tax credits have been an effective mechanism for moving sole parents off a benefit and into employment. The possible financial disincentive that in-work tax credits can present to beneficiaries in increasing their work hours above credit thresholds (the 'Hours Effect') is not supported by international experience.

New Zealand – Working for Families In-work Tax Credit

An additional 8,100 sole parents moved into paid employment as a result of policy changes which included the introduction of the in-work tax credit. The percentage of sole parents working 20 hours or more (the hours requirement of the in-work tax credit) increased from 36 percent in June 2004 to 48 percent in June 2007.

- Around three-quarters of this increase was attributed to the policy changes in financial incentives and support (MSD & IR, 2009).

United States – Earned Income Tax Credit

The Earned Income Tax Credit (EITC) reduced the number of sole mother families receiving welfare payments and increased their employment rates.

- It is estimated that the EITC contributed to 15 percent of the 3 million reductions in welfare caseloads between 1994 and 2001 (The major contributing factor was a decline in welfare entry) (Meyer, 2007).
- The employment of single mothers in 1996 was 7 percentage points higher because of the EITC (Meyer and Rosenbaum, 2001).

United Kingdom – Working Families Tax Credit

The Working Families Tax Credit (UK) is similar to the New Zealand in-work tax credit. The impact of the credit has been positive on sole parent employment rates.

- The WFTC has resulted in an increase of sole parents' employment rates of around five percentage points (OECD, 2008).

The 'Hours Effect'

A key consideration with in-work tax credits is the 'Hours Effect': the extent to which they generate financial disincentives for people to increase their work hours beyond the credit's income thresholds (thus making them ineligible for the credit). However, evidence from the use of the EITC shows that recipients did not appear to reduce their work hours when they reached the tax credit threshold (Meyer 2007). Meyer (2007) posits that this is likely to be due either to recipients having limited understanding of the effect of EMTRs, recipients being unable to vary their hours with their employer, or system errors with recording the number of hours EITC recipients are working.[1]

Assistance Payments

Sole parents and people with disabilities can often face additional costs in employment compared to other jobseekers, due to their individual circumstances. Employment-conditional assistance payments, such as help with the costs of childcare or transport, can 'make work pay' by reducing the costs of working for those groups.

- Modelling scenarios using the MITTs micro-simulation model found that increasing the Childcare Tax Rebate (CCTR) in Australia from a reimbursement of 30 percent of formal childcare costs to a reimbursement of either 50 percent or 100 percent of formal and informal childcare costs (up to a maximum of $AU 20,000 per annum) would increase the work hours of sole parents currently receiving income support (Kalb & Lee, 2007).

- The labour force participation of these sole parents was expected to increase by 1 percentage point under a 50 percent reimbursement, and 5 percentage points at a 100 percent reimbursement. Much of this rise was contributed to not only by the rise in reimbursement levels but also the inclusion of informal childcare costs (Kalb & Lee, 2007).

- The cost to the government of introducing the 50 percent reimbursement was almost neutral for sole parents, given the expected increase in income tax and reduction in benefit payments 1
  (Kalb & Lee, 2007).

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[1] Note that as the EITC was introduced alongside the Personal Responsibility and Work Opportunity Reconciliation Act, which also introduced lifetime limits on benefit receipt and imposed a mandatory work requirement, it is difficult to quantify the relative impact of the EITC alone on this observation.

Abatement and income support levels

Changing the level of income support received by individuals and/or the abatement regime they are subject to can act as a financial incentive to move off a benefit to employment.

Higher levels of benefit payment tend to be linked with higher rates of benefit receipt, particularly for disability beneficiaries (OECD, 2009). Reducing the level of a benefit payment can therefore act as a financial incentive to encourage people to move into employment.

Abatement is the rate at which people's benefits are reduced as they start to earn income from work. In New Zealand, DPB and IB recipients are currently subject to part-time abatement, whereas UB, SB and IYB are subject to full-time abatement. Part-time abatement has higher abatement thresholds, to encourage part-time work. However, this can also act as a disincentive for people to take up full-time work. A study looking at the impact of 24 different welfare-to-work programmes implemented across the United States found that increasing the amount beneficiaries were allowed to keep through abatement delayed the process of moving off a benefit (Ashworth et al., 2004).

Welfare policy changes in Australia and the United States that lowered the level benefit payment and/or the abatement thresholds for sole parents and disabled people have been effective in reducing benefit receipt for these groups, as well as increasing their employment rates:

Australia – Welfare to Work reforms (2006)

The 2006 Welfare to Work reforms in Australia tightened eligibility criteria for recipients of sole parent (Parenting Payment Single – PPS) and disability (Disability Support Pension – DSP) benefits, moving recipients of these benefits who are able to work between 15 and 29 hours per week to a different benefit (either Newstart Allowance or Youth Allowance).[2] These allowances provided a lower payment than the PPS and DSP benefits and had a less generous abatement regime – ceasing income support at a lower level of earning.

The effect of these changes resulted in an increase of the EMTRs of PPS and DSP recipients moved to the new lower allowance. Modelling by NATSEM found that the disposable income of affected PPS recipients would be up to about $100 a week lower, and up to $120 lower for affected DSP recipients (Harding et al., 2005a).

An evaluation of Welfare to Work found that the 2006 reforms reduced levels of benefit receipt by sole parents and people with disabilities and increased the rate with which these groups moved off a benefit and into employment. The key quantitative findings of the Welfare to Work Evaluation are listed below (Department of Education, Employment and Workplace Relations, 2008):

- Sole parents and disabled people assessed with a capacity to work 15 to 29 hours per week left income support faster than in the

[2] Note that these changes only affected sole parents with children over the age of 7, as Australia does not subject sole parents with children aged under 7 years to a work test.

years prior to the reforms. In 2006-07, 38 percent of sole parents (with children aged over 7) with partial work capacity had left income support after six months, compared to 15 percent in previous years. 10 percent of people with disabilities with partial work capacity left income support after six months, compared to 4 percent in previous years.

- This move off-benefit was primarily into employment: Over 70 percent of sole parents left income support for employment.
- There was also an increase in the number of people with disabilities in employment who remained on income support. Fourteen percent of affected DSP recipients with partial work capacity reported earnings after six months while also receiving income support, compared to 10 percent in previous years.
- However, the number of sole parents in employment while remaining on income support decreased: 40 percent were in paid employment after six months, slightly below the rate in previous years. This may have been offset by the higher number of sole parents leaving income support for employment.
- There is some evidence of benefit flows of affected sole parents to non-work tested benefits such as DSP or Carer Payment as a result of the changes.

Note that the Welfare to Work reforms also imposed part-time employment obligations for sole parents. It is therefore difficult to quantify the relative impact of the abatement and payment level changes alone on these quantitative results. The evaluation also reports that the majority of sole parents and disabled people affected by the Welfare to Work reforms participated employment services (over 70 percent of sole parents; 64 percent of disabled people), which may also have been a contributing factor in the off-benefit outcomes listed above (Department of Education, Employment and Workplace Relations, 2008).

United States: Omnibus Budget Reconciliation Act welfare changes (1981)

In the United States, the 1981 Omnibus Budget Reconciliation Act (OBRA) introduced welfare policy changes that affected financial incentives for people with dependent children. OBRA tightened the eligibility criteria for Aid to Families with Dependent Children (AFDC) through changing the abatement rates for people who receive some income from employment.

Prior to OBRA, AFDC recipients would have their benefit decreased $.67 for every $1 earned from work. OBRA changed this to dollar for dollar abatement (benefits decreased by one dollar for every dollar earned) (Duncan, 2000). As a result, OBRA significantly reduced the incentive to work part-time while receiving AFDC.

Key impacts of the OBRA abatement changes:

- More AFDC recipients moved into work. The majority of these recipients were parents that previously worked part-time while receiving AFDC.
- Following the OBRA changes, the number of people on AFDC who were also in some employment decreased.

- The percentage of people receiving only AFDC remained unchanged after OBRA.

The impact of the OBRA abatement changes on off-benefit outcomes was mixed. The results indicate that lowering the abatement threshold was most effective in moving parents already in some form of employment off a benefit. Duncan (2000) suggests this was because these parents' existing earnings would have been close to the new threshold level, and so would have been 'better off' moving into employment when OBRA lowered the abatement thresholds.

However, the lack of impact the abatement changes had on the number of people receiving AFDC and not participating in any employment suggests that it was not an effective incentive to encourage previously inactive parents into part-time employment. The decrease in the number of people in employment while on AFDC following OBRA is conceivably partly offset by the exit of those parents who were working part-time, however may also be a result of some AFDC recipients ceasing part-time work due to the increased EMTRs created by the abatement change.

What we don't know

There is no available evidence on the quantitative impact of financial incentives on people who receive carer's benefits. Research has shown that many carers wish to work in some capacity, however it is their caring responsibilities, not financial considerations, that act as the primary barrier to taking up employment (Alden et al., 2009).

The impact of financial incentives in an economic downturn is also unclear.

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