Joint Report: Welfare Overhaul - Review of Working for Families - Options for Change

Executive Summary

Working for Families tax credits play an important role for families with children in supporting income adequacy and maintaining financial incentives to work. They are a significant lever for government to achieve direct and immediate reductions in child poverty rates.

There are still some concerns that WFF, while achieving its key objectives for some groups, has several issues, including that it is complex, results in a poor interface between benefit and work, and results in high effective marginal tax rates for many families.

This report identifies options for a review within four key priority areas (none of which are mutually exclusive):

- improving income adequacy, for example, by s9(2)(f)(iv) [redacted]
- improving the interface between benefit and work and the design of in-work assistance, for example, by s9(2)(f)(iv) [redacted]
- 'making work pay' for lower income families, for example, by s9(2)(f)(iv) [redacted]
- improving the client experience and operational settings between IR and MSD.

These options inevitably involve trade-offs between these objectives. For example, income support changes can typically not achieve improvements in income adequacy at the same time as improvements in financial incentives to work and/or low fiscal costs. These trade-offs can be explored in further advice.

The changes within the current system of payments, which could be developed for Budget 2021, include:

- s9(2)(f)(iv) [redacted]
- [redacted]

More fundamental changes, such as s9(2)(f)(iv) [redacted], could be developed over the medium term. s9(2)(f)(iv) [redacted].

If Ministers wish to make substantial income support changes, and consider a s9(2)(f)(iv) [redacted], then it would be ideal to consider these in tandem so that they could be implemented at the same time. This would avoid large numbers of people being financially disadvantaged. s9(2)(f)(iv) [redacted]

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s9(2)(f)(iv) [redacted]

There are also other complementary policy areas that support employment outcomes being put forward as Budget Bids by the Minister for Social Development and Employment, which could be considered alongside changes to WFF, including:

- s9(2)(f)(iv) [redacted]
- childcare assistance to help make work pay – to help address concerns over whether families are better off in work than on a benefit, particularly in the case of sole parents once childcare costs are taken into account

There also a number of other options focused on working families, not currently being actively progressed as a Budget 2021 initiative, that officials can provide further detailed advice on, including:

- s9(2)(f)(iv) [redacted]
- [redacted]
- [redacted]

Officials have not undertaken a feasibility assessment of these options yet. Options such as a s9(2)(f)(iv) [redacted] are likely to have longer implementation timeframes than rate increases.

s9(2)(f)(iv) [redacted]. There will be limited fiscal headroom to progress significant income support packages this term, alongside your existing manifesto commitments and cost pressures.

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Recommended Actions

It is recommended that you:

a **note** that the Prime Minister and Ministers of Finance, Education, Social Development and Employment, Revenue, and Children are scheduled to meet on Tuesday 1 December to discuss income support changes within the context of Budget 2021

b **note** that the Ministry of Social Development, Treasury, Child Poverty Unit, and Inland Revenue have prepared additional material to support discussion at the meeting

c **discuss** the options identified in this paper alongside other potential Budget 2021 initiatives, and indicate to officials which initiatives you would like further advice on

d **provide** feedback to officials on the scope and focus of the review beyond immediate Budget 2021 initiatives.

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Purpose of Report

1. Under the previous Government, the Minister for Child Poverty Reduction asked officials to review Working for Families (WFF) as part of the welfare overhaul. This was subsequently put on hold due to the COVID-19 response. This report now seeks direction as to the priorities for a review.

2. The report outlines current issues with WFF, potential options for change in the short-term through Budget 2021, and more fundamental options you could look to include in a review over the medium to longer-term. The paper also discusses options that would be complementary to WFF changes, and alignment with the wider system settings.

3. This report has been finalised in a short timeframe in order to inform discussion at the meeting of joint Ministers scheduled for Tuesday 1 December.

Background

4. Earlier WFF advice provided a high-level overview of WFF tax credits and considered the effectiveness of the In-Work Tax Credit (IWTC) and its settings (6 December 2019, T2019/3745). As a consequence, changes have been made to IWTC to support incentives to enter and remain in work, and to be consistent with a potential longer-term reform to the design of in-work payments.

5. The requirement for working families to meet the hours test has been removed, effective from 1 July this year, so people will continue to be eligible for IWTC as long as they have some income from paid work each week. The Government also announced the 'two-week grace period' as part of the Covid-19 Response Recovery Fund, to take effect from 1 April 2021. This will allow a family to continue receiving the IWTC payment for up to two weeks when taking an unpaid break from work.

6. The Minister for CPR also requested a broader review of WFF off the back of the Welfare Expert Advisory Group's report *Whakamana Tāngata: Restoring Dignity to Social Security in New Zealand*. This recommended fundamental changes to the design and targeting of WFF, and significant increases to main benefits and the FTC. The key WFF changes included:

   - a new 'Earned Income Tax Credit' to replace three existing tax credits – the In-Work Tax Credit (IWTC), Minimum Family Tax Credit, and Independent Earner Tax Credit
   - significant increases to FTC rates
   - making the Best Start Tax Credit universal for all children aged under three years.

7. The Government also has a specific priority to improve the wellbeing of children and to achieve a significant and sustained reduction in levels of child poverty, having set 10-year targets to more than halve the rates on the primary measures of the Child Poverty Reduction Act 2018. This review has been included as part of the work programme for the welfare overhaul.

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8. As part of the earlier advice on WFF we noted the following:

WFF payments go to a relatively higher proportion of sole parent families than couple families …

1. WFF is made up of the following tax credits:

- Family Tax Credit: main income adequacy payment received by both beneficiary and working families, which pays $113pw for the eldest child and $91pw for each subsequent child. It is paid to 267,000 mainly lower-income families, with some higher-income larger families – 63% are sole parent families, and 37% are couples.
- In-Work Tax Credit: main in-work payment which pays $72.50pw for families with 1-3 children (with an extra $15pw for fourth and subsequent children) to 191,000 households in work – 42% are sole parents, and 58% couples.
- Minimum Family Tax Credit: payment to 3,000 non-beneficiary households – 93% are sole parents and 7% couples. MFTC tops up the wages of low-income working families with children to a guaranteed minimum of $27,768 a year (after tax).
- Best Start Tax Credit: provides payments of $60pw to families for the child's first year, and for the subsequent two years if they earn $79,000 or less.

WFF combines dual objectives of income adequacy and work incentives …

2. WFF has two objectives:

- to support income adequacy and reduce child poverty
- to improve financial incentives for low-income earners to participate in the labour market.

WFF has achieved its key objectives for some groups, but has resulted in mixed effectiveness for others

3. WFF improved income adequacy in working households, increased the labour force participation of sole parents, but reduced it for secondary earners:

- the introduction of WFF reduced child poverty in working households, though not in 'non-working' households
- however, subsequent increases to the FTC in the Families Package in 2018 are estimated to have further significantly reduced poverty across working *and* 'non-working' households with children
- WFF had relatively modest impacts on labour supply, with some evidence that it increased the labour force participation of predominantly low-income sole parents, and reduced the labour force participation of relatively higher-income secondary earners in couples with children.

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The labour market has changed since the WFF package was introduced, which could impact on the adequacy and work incentive objectives of WFF

9. The WFF package was phased in during a buoyant labour market (between 2004 and 2007). Demand for labour was relatively high and unemployment low. The country is now facing a period of rising unemployment, decreasing labour market participation and reduced hours, with the full extent of COVID-19 on the economy yet to be felt.

10. While the economic impact of COVID-19 will be far reaching, WFF recipients are likely to be amongst the hardest hit. We are seeing early signs of a disproportionate impact on women and workers occupying lower qualified, part-time positions in vulnerable sectors. Women are experiencing higher rates of underutilisation and underemployment, and these rates are highest for Māori and Pacific women who are over-represented in low-wage employment, and casual, temporary and other forms of insecure employment.

11. There are also changes associated with 'the future of work', which are widely accepted to shift working arrangements (to a greater or lesser extent) away from permanent full-time employment towards temporary, non-standard, and more flexible forms of work, with transitions between jobs more likely. The OECD Jobs Strategy, prior to COVID-19, argued that countries needed to step up their efforts to adapt policy to the challenges of the changing world of work and the rise in various forms of non-standard work, focusing on helping those at risk of being left behind, ensuring everyone has access to social protection, and a tax and benefits system that makes work pay and protects workers.

12. The 'working poor' make up a sizeable group of those in financial hardship. Around half of all those aged under 65 in low-income households are from households with at least one full-time worker or with self-employment as the main source of income: the other half are from workless households or households with only a part-time worker or workers. The same proportions are found when using material hardship measures.

These effects are likely to increase numbers eligible for WFF and increase the need for a flexible system that can respond to a changing labour market environment

13. The need for a more flexible system that encourages and facilitates people to remain in, re-enter or enter the labour market, in an environment of uncertainty, could be heightened in the future. Objectives could include the need to further improve the transition between work and benefits, with support that provides income smoothing in recognition that people may have ongoing irregular hours and earnings. Recent IWTC changes have responded to this issue to some extent, but may not go far enough in the context of the current and projected future labour market changes.

14. Consideration of settings that enable or encourage greater risk taking around participating in the labour market (such as taking on temporary work) while still maintaining a level of guaranteed income, will be important considerations in this context.

Issues with Working for Families

15. Working for Families has achieved its key objectives for some groups. Around 57% of all NZ families with children received a WFF tax credit in tax year 2019, at an annual expenditure of $2.1 billion. However, like any transfer system that is designed to target particular groups of the population, it has several issues, including that it is complex, results in a poor interface between benefit and work, can be fiscally costly when altered, and results in high effective marginal tax rates for many families.

16. Officials have identified four broad (and inter-linked) issues/areas that could be addressed by a review of WFF, either separately or combined:

    - *Improving the adequacy of income support for families with children* – WFF is less cost-effective as a lever for child poverty reduction than a main benefit payment to

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families with children because the FTC payment (the primary 'lever' within WFF to reduce child poverty), goes a fair way up the income distribution. Therefore, even relatively small increases carry a fairly high fiscal cost and, while improving income adequacy for lower and middle-income households, have less of an impact on child poverty reduction compared to increasing main benefits for families with children.

- *Improving the interface between benefit and work and structure/design of in-work assistance* – complexity in the system creates problems for people whose circumstances change frequently, both for those moving in and out of employment and those with varying employment arrangements, hours and earnings. The off-benefit rule creates a threshold for being 'in-work'.

  There are design issues generally with the MFTC – it is complicated administratively, and is limited in its effectiveness as a work incentive payment, given its 101.2% effective marginal tax rate that discourages greater working hours.

- *'Making work pay'* – despite increases in the minimum wage and wage growth generally, there continue to be concerns that work 'does not pay', mainly for sole parents (given high effective marginal tax rates), and particularly once childcare costs are taken into account. Low and middle-income families face high effective marginal tax rates – the MFTC withdraws on a dollar-for-dollar basis, and at certain income levels both AS and WFF payments withdraw simultaneously.

- *Improving client experience and operational settings between IR and MSD, particularly in the context of varying circumstances* – the current system of payments is complex, involves multiple payments, and primarily relies on families 'seeking out' their entitlements rather than proactive engagement.

  The high effective marginal tax rates and complexity with payments are challenging for clients, and delivery of payments sits across IR and MSD. Entitlements and levels change depending on amount of work undertaken and, if this is variable, the compliance and admin costs are high as part of ensuring correct payments or avoiding overpayments and subsequent debts. There are additional specific operational issues at this interface between benefit and work that create problems for clients, particularly where clients transition between the two payment systems.

Potential options for change

17. As you will be aware, in a tight fiscal environment, there will be limited fiscal headroom to progress significant income support packages this term, alongside your existing manifesto commitments (such as lifting benefit abatement thresholds) and cost pressures.

Objectives and options

18. Achieving the objectives of WFF is looking more challenging in a post-COVID context. Hardship and child poverty will likely increase, and improving financial incentives for people to work will be more challenging if labour demand remains low and unemployment high and persistent for some groups.

19. At the same time, changes such as increasing the benefit abatement threshold to enable people to work more hours while on a benefit will increase incentives to work part-time, however worsen incentives to leave the benefit system.

20. For people with children, and sole parents in particular where the margin between benefit and work is already small, the benefit system and part-time work would potentially offer more security than being in work and off-benefit. This could strengthen the need for a

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focus on income adequacy for low-income working households, and what changes may be needed to enable and facilitate greater participation in a flexible labour market.

21. The following table presents the key option/s under each objective and further discussion below on these and other potential complementary options. These options inevitably involve trade-offs between these objectives. For example, income support changes can typically not achieve improvements in income adequacy at the same time as improvements in financial incentives to work and/or low fiscal costs. These trade-offs can be explored in further advice.

Identified issues / objectives	*Potential responses*
Improving income adequacy for families with children	• s9(2)(f)(iv) [redacted] • [redacted]
Improving the interface between benefit and work and structure/design of in-work assistance	• [redacted] • [redacted]
'Making work pay'	• [redacted]
Improving client experience and operational settings between IR and MSD	• Taking a client-centred view to operational / delivery settings – changes to the way payments are delivered that can improve the tax-benefit interface, improve uptake/awareness/ease of access.

Improving income adequacy for families with children

22. Options to support income adequacy could include changes to s9(2)(f)(iv) [redacted], for example:

- s9(2)(f)(iv) [redacted]
- [redacted]

23. There are other options to improve income adequacy that could be considered as part of a review of WFF, such as s9(2)(f)(iv) [redacted]. However, as noted earlier, some of these options have a relatively high fiscal cost in

s9(2)(f)(iv) [redacted]

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terms of achieving the child poverty reduction targets, and/or can reduce financial incentives to work.

24. We understand joint Ministers have signalled their interest in increasing main benefits. Given current fiscal constraints, and the high fiscal cost of s9(2)(f)(iv) [redacted] in particular, progressing these changes in addition to benefit increases may not be feasible for Budget 2021. An alternative option could be to s9(2)(f)(iv) [redacted] as outlined in the MSD report [REP/20/11/1081 refers]. Officials can also provide further information on these options if you are interested in including them in a review.

Improving the interface between benefit and work and structure/design of in-work assistance

25. In order to improve the interface between benefit and work, there could be value in considering structural changes to the tax credit system in the medium to long-term, such as s9(2)(f)(iv) [redacted]

26. s9(2)(f)(iv) [redacted]

27. Another option currently being considered by officials to provide income smoothing for displaced workers is s9(2)(f)(iv) [redacted]

Making work pay

28. Options to help make work pay could include s9(2)(f)(iv) [redacted].

29. s9(2)(f)(iv) [redacted]

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s9(2)(f)(iv) [redacted]

s9(2)(f)(iv) [redacted]

30. Other options to help make work pay could include s9(2)(f)(iv) [redacted]. As above, these options carry significant costs and need to be balanced alongside other priorities in this space. Officials can provide further information on these options if you are interested in including them in a review.

Improving client experience and operational settings between IR and MSD

31. There are a number of known issues that arise with the split of administration of financial support between MSD and IR. Of particular concern are the issues that prevent or delay easy, timely access to financial support, and accurate payments as clients' transition between benefit and work. This relates to clients' experiences from a WFF perspective, and would involve understanding how that interacts with the benefit system.

32. There are a number of factors which can cause delays or gaps in financial assistance for people transitioning between benefit and work including, delays or gaps in the information exchange between MSD and IR and periods where a client's benefit is suspended.

33. Clients can also struggle to understand their entitlements when transitioning between work and benefit as MSD and IR staff lack familiarity and training in each other's products (e.g. the MFTC). Dealing with two agencies can also add significant time and complexity for recipients, particularly given the challenges in contacting each agency over the phone and having to juggle this with work childcare and other commitments.

34. MSD and IR are currently considering how to address these issues. Other, more significant options to help improve client experience between MSD and IR could include:

- Additional training for MSD and IR staff on their respective products to increase understanding and reduce the amount clients have to bounce between agencies when transitioning between work and benefit.
- Improving the information exchange between MSD and IR to reduce delays in accessing financial assistance and minimising debt for clients.
- Explore opportunities for alignment between MSD and IR to make payments simpler and more accessible.

Potential complementary responses in other policy areas

35. There are also other policy areas that support employment outcomes, that are being put forward as Budget Bids by the Minister for Social Development and Employment, that could be considered alongside changes to WFF that would seek to address the same or similar issues, including:

- s9(2)(f)(iv) [redacted]

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s9(2)(f)(iv) [redacted]

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- Childcare assistance to help make work pay – to help address concerns over whether families are better off in work than on a benefit. This is particularly an issue for sole parents on Sole Parent Support, where the gap between work and benefit can be very small once childcare costs are taken into account.

- Increases in benefit abatement thresholds – to provide greater income support to working beneficiary families before their benefit payments begin to abate. Note that if this were to be combined with increases to main benefit rates, this would have a significant flow-on impact to the MFTC threshold (if aligned). The latter would necessitate a review of the Family Tax Credit abatement threshold because the abatement of these supports would overlap and result in high effective marginal tax rates.

36. There are also a number of other changes focused on working families, not currently being actively progressed as a Budget 2021 initiative, that officials can provide further detailed advice on, including:

- s9(2)(f)(iv) [redacted]
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37. Officials have not undertaken a feasibility assessment of these options yet. Options such as a s9(2)(f)(iv) [redacted] are likely to have longer implementation timeframes than rate increases.

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ANNEX ONE: WEAG's package and the EITC

38. The WEAG recommended a package of income support changes in their report *Whakamana Tāngata: Restoring Dignity to Social Security in New Zealand*, which included significant increases to main benefits and the Family Tax Credit (FTC), and changes to the design and targeting of Working for Families (WFF). The WFF changes included:

- a new 'Earned Income Tax Credit' (EITC) to replace three existing tax credits – the In-Work Tax Credit (IWTC), Minimum Family Tax Credit (MFTC), and Independent Earner Tax Credit (IETC). This new in-work payment would provide up to $50 a week for people with and without children. The payment would have a unique 'phase in' structure that means it would increase for a family's earnings over $150 a week[4], and reduce once a family earned over $48,000.

- significant increases to FTC rates: to $170 a week for the eldest child (an increase of $57) and to $120 for subsequent children (an increase of $29). The FTC abatement rate would also be reduced so that it was closer to being universal.

- making the Best Start Tax Credit universal for all children aged under three years, and consideration of a new Living Alone Payment.

39. The EITC proposed by the WEAG is more targeted and less generous than the in-work payments it would replace. The EITC results in relatively few families with children being financially disadvantaged only in the context of the other significant increases in support, particularly to the FTC. Without these substantial increases (and lower abatement), a much larger number of families with children would be disadvantaged by the introduction of an EITC as proposed.

40. s9(2)(f)(iv) [redacted]

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[4] The WEAG package also increased the abatement threshold for main benefits to $150pw. In combination, the effective abatement rate for the main benefit would reduce from 70% to 50%.