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**Can the 'In Work Tax Credit' be justified as an in-work benefit?<sup>1</sup>**

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### **Abstract**

The In Work Tax Credit (IWTC) was introduced as part of the Working for Families package that was phased in between 2005-2007. While New Zealand's IWTC may, on the surface, appear similar to the Earned Income Tax Credit (EITC) in the US, and to the Working Tax Credit in the UK, there are important differences. This paper contributes to the international pool of knowledge about the design and impact of in work benefits. It examines the logistical problems in identifying the impact of the IWTC in the New Zealand labour market, and critiques the attempts to do so. The IWTC, like the EITC in the US is a dual- purpose tool: to improve labour market participation, and to address poverty issues among working populations. Yet holding to the two objectives is problematic. The IWTC has been a costly experiment. Among other issues, it has raised human rights concerns; necessitated other complex adjustments in the tax system; and as unemployment grows in the 2009 recession its design has been called into question.

Keywords: In work benefits, Tax credits, work incentives

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<sup>1</sup> This paper represents work in progress. Please do not quote without authors' permission

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## **1 Introduction**

The objective of this research is to contribute to the international pool of knowledge about the variety and effectiveness of differently designed ‘in work benefits’ (IWBs) often referred to as ‘make work pay’ policies (OECD, 2009). This paper focuses on New Zealand’s *In Work Tax Credit* (IWTC) introduced in 2006 as part of the Working for Families package.

The *Earned Income Tax Credit* (EITC) as used in the US has a long history as a tool to improve labour market participation and address poverty issues among working populations. While New Zealand’s IWTC may on the surface appear similar to the EITC in the US, and to the *Working Tax Credit* in the UK, there are important differences.

If the IWTC is solely aimed at increased workforce participation by beneficiaries it is an expensive tool. If it achieves distributional objectives, for example, by reducing child poverty, it does this only selectively. The use of the IWTC has, among other issues, raised human rights concerns in New Zealand and has necessitated complex adjustments in the tax system. In addition, the appropriateness of the IWTC design is called into question as unemployment grows in the 2009 recession.

## **2 In work benefits**

### **2.1 The nature of in work benefits**

The focus of in work benefits (IWBs) may be either the individual or the family unit, and their use is generally explained in the context of social policy that aims to “enhance opportunities for groups at the margins of the labour market” (Pearson & Immervoll, 2008, p. 2). The focus is those who have “difficulties in obtaining and maintaining rewarding jobs, and as a result they and their families often face protracted periods in poverty” (Pearson & Immervoll, 2008, p 2).

The major premise is that the IWB should ‘make work pay’, so that an income gap is created between those in paid work and those not in paid work, but, importantly without making the latter group worse off as that would simply increase poverty (Pearson & Immervoll 2008, p 2).

In work benefits (IWBs) are specific cash transfer programmes, rather than more generic tax reductions or changes to abatements of welfare benefits which reduce

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effective marginal tax rates (EMTRs)<sup>3</sup>. Nevertheless they can be located within a spectrum of means of enhancing returns to labour and encouraging work effort and higher participation. These wider means include use of minimum wage legislation, ‘welfare to work’ case management, and labour market regulations.

The purpose of IWBs is usually couched in terms of the benefits to the recipients themselves, rather than, for example to alleviate the pressures of an ageing population, or to improve long-term growth of the economy. Nevertheless increasing the proportion of the population in paid work, whether by the rapid return of people to work after a health crisis or the birth of a child or any other major life event; or by encouraging low skilled young people to find work rather than rely on a state benefit, is generally seen as a ‘good’ thing not only for them but critically also for society.

So ingrained has this thinking been (and so different to past eras, where for example, women’s labour force participation was often deliberately discouraged) that few have questioned whether the gains to society have always been worth it. In the tight labour market of 2004-2007, sole parents on the Domestic Purposes Benefit (DPB) were viewed as a big source of untapped labour in New Zealand. Dalgety, Dorsett, Johnston, & Spier (2009, p. 1) note, for example, that family assistance is designed to have an impact on the employment of sole parents “who in recent decades have had a relatively low level of engagement with the labour market”. Means of increasing sole parent employment have however been subject to little total society welfare analysis and virtually none incorporating the perspective of the young child or children.

## **2.2 Other factors affecting the work decision**

It is difficult in any real world analysis to disentangle the impact of any one in work benefit, such as the IWTC, when a number of factors, including the economic environment, may change at the same time. Clearly policies designed to incentivise work effort may appear to work well in buoyant times when labour is scarce, but appear to be ineffectual when jobs are scarce. Nevertheless a presumption has been that beneficiaries will work, if only given the right incentives. But as Lunt, O’Brien &

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<sup>3</sup> The EMTR is the combined loss from tax and benefit abatement when an extra dollar is earned. A poverty trap for low income people may occur when earning extra income does not materially increase disposable income.

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Stephens (2008, p. 4) note, many beneficiaries have other problems that preclude work activity:

*A significant number of those receiving social security benefits are there not because of adverse labour market conditions or traditional caring responsibilities, but because they have a raft of other social difficulties, ranging from health and psychiatric conditions through to substance abuse, domestic violence, lack of self-esteem and absence of labour market skills.*

Factors such as “the parenting role” for sole parent beneficiaries; “poor health” for the long-term unemployed; and “employer discrimination” for beneficiaries with disabilities, are often at work alongside financial disincentives to seek and retain work (Singley, 2004, pp. 33-36). A wide variation in work behaviour found among at-risk individuals may reflect differences in social support, in personal and contextual “barriers” and “bridges” to employment, and their interplay.

*While a lack of social support can be named as a barrier to employment, it is perhaps more accurate to name the presence of social support as a bridge to employment that helps individuals overcome the barriers they face. Thus, a key factor distinguishing benefit use patterns among those facing the same cluster of barriers could be access to social support. (Singley, 2004, p. 49)*

In the New Zealand context, employment of sole parents has been found to be affected by attitudes to non-parental care of young children by the sole parents themselves, lack of effective case management, lack of information, low skills transition costs, health of child or parent, by the costs of care, and by abatement of benefits (Singley, 2004, p. 47). Financial returns to paid work are but one of the factors that influence the labour supply decision.

The minimum wage is the most significant of broader labour market interventions in New Zealand and discussed in Section 3. The IWTC as New Zealand’s in work benefit is then described and evaluated in Section 4. The nature of other ‘in work benefits’ in New Zealand such as childcare subsidies is outlined in Appendix A.

### **2.3 Spectrum of In Work Benefits**

IWBs are a narrow part of the spectrum of enhancing returns to labour and encouraging workforce participation. They may take a wide variety of forms: for example, tax credits, wage-related transfers or lump-sum payments where the choice of the programme type largely depends on the target group (Leppik, 2006, p. 3). They may be as simple as a small cash advance to ease the transition from welfare to work, or as

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complex as family-based, targeted tax credit measures that are also designed to impact on poverty levels. In Australia, for example, the only official ‘in work benefit’ (the Employment Entry Payment) is a one off lump-sum of around A\$100 for sole parents or long-term benefit recipients when they get a full-time job (Pearson et al, 2008). In contrast, New Zealand has a range of minor transitional measures (see Appendix A) and the IWTC which is a full-blown, expensive, time-unlimited, lightly targeted, and child-related tax credit.

IWBs may impact adversely on an ineligible group’s employment. For example Bryson, Evans, Knight, LaValle, & Vegeris (2007, p. 9) note that “financial inducements to parents with children to enter the labour market may increase their chances of employment at the expense of adults without children”

Regardless of type, IWBs share some fundamental design and trade-off issues:

- They are supply-side tools and do not directly affect the demand for labour;
- They may reduce the employment of the non-targeted groups;
- They increase the disincentive to work if and when they are abated;
- They can be difficult to administer and evaluate;
- They may be fiscally costly, especially if not targeted and time limited or focused just on the transition to work;
- If tightly time-limited, and/or of a low value they may be ineffective in achieving the broader labour-market attachment goals;
- Their costs have to be paid for by higher taxes elsewhere or reduced government spending. These effects can also undermine work and distributional objectives;
- They have implications for the support of those, who for a raft of reasons (see Lunt et al, 2008) are unable to leave the welfare system.

To summarise these trade-offs: IWBs may be extensive and expensive on the one hand, with offsetting labour market effects elsewhere and implications for those on welfare. On the other hand, they may be inexpensive but then may be ineffective in achieving meaningful behavioral change. This paper suggests that the IWTC is in the first category, but may also fail to achieve meaningful behavioral change.

## **2.4 Employment v poverty goals**

IWBs may differ from other labour market interventions such as the minimum wage by having a dual objective: to increase work incentives and employment, and, to redistribute resources to low income families by taking family situations into account.

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Indeed, one of the political attractions is that it may appear that both employment and distributional goals may be achieved at the same time (Pearson et al, 2008, p 2). A stronger political constituency for the fiscal cost may be possible for supporting people while in paid work as opposed to supporting them in the welfare system.

Child poverty elimination has become a focus of policy attention in many developed countries in recent years. After a dramatic rise in child poverty in the 1990s, the New Zealand government pledged to make it a top priority (Ministry of Social Development, 2002a). The concern about child poverty has clearly been a factor in the choice of design of New Zealand's IWTC, and is explicitly stated as a goal of the Working for Families package (Centre for Social Research and Evaluation, 2007).

Redistribution that favours work may reflect a belief that that work is 'the way out of poverty'. But it is possible here to fall in to the trap of circular thinking. Does work pay only because of the state subsidies? Are these subsidies a benefit in another form? Pearson et al (2008, p. 13) illustrate the circularity:

*[IWBs] provide additional benefits to low-income families, so reduce the incidence of poverty among those families with children. They also increase the incentive to work, and as poverty rates among those in work are lower than those out of work, any increase in the number of parents moving into work would reduce child poverty.*

The conclusion to be drawn may not be that work is the way out of poverty but that if work is 'subsidised' enough then it can be 'made to pay' and thus reduce poverty. Thus it would be possible to reduce poverty of the working old by 'making retirement pay' or the poverty of women by 'making being female pay'. Sloganistic thinking is not very productive. However, as discussed below, attachment to the labour force even at the low end of the pay scale may be thought to create future opportunities for more highly paid work that will provide an unsubsidised path out of poverty.

If IWBs are used as a major method of addressing poverty however, there is a risk of creating and perpetuating an underclass who cannot access the IWB and who thus must remain in poverty. The argument that the 'underclass' are choosing not to access work is hard to sustain for those who are sick, injured or disabled or where child caring means paid work is not an option. It is also hard to sustain the argument of involuntary unemployment in times of recession. Immervol and Pearson (2009) note that the conditionality on work may magnify some income losses for those whose earning or

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working hours fall below entitlement to IWBs. They suggest that the design of IWBs needs to be revisited:

*Because severe economic downturns can have marked effects on the earnings distribution, policymakers should review whether the eligibility conditions and payment profiles of existing IWBs are still appropriate or should be adapted in order to exploit their potential as a measure that cushions income losses during a recession. (Immervoll & Pearson, 2009, p. 46)*

This aspect is relevant to any overall evaluation of the IWTC in New Zealand as discussed in Section 4.

### **2.5 The effectiveness of use of IWBs**

Recent research has thrown into doubt the value of work incentives for achieving any long-term benefit. In Canada an experiment randomly divided a group of 5,600 welfare recipients into two. One group was left in the existing welfare regime, the members of the other group were put on a self-sufficiency project (SSP) which gave them generous incentives to get full-time work. The SSP group was given a year to obtain full-time employment; and the scheme gave participants an earnings subsidy for up to three years (Card & Hyslop, 2005).<sup>4</sup>

New Zealand-based economist Brian Easton notes that the study's findings about the long-term effects of the SSP are salutary as in effect they were nil (Easton, 2008). Certainly the scheme gave some of the eligible beneficiaries an incentive to get a job earlier than those who had no such incentive. But after the scheme ended, their labour force participation was much the same as those who were not on the programme. More of both groups were employed than when the scheme started, but those without the incentive took longer to get a job because the net cost of job-seeking was higher for them. The substantial public spending on the incentives to get people off welfare worked in the short run, but gave no long-term employment return.

Even more disappointing, the programme seems to have done nothing to improve the incomes of subsidised workers. One might have expected that getting a beneficiary into a job should trigger an improvement in the long run and because they got their jobs

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<sup>4</sup> The experiment was investigated by David Card of the University of Berkeley, and New Zealander Dean Hyslop of the NZ Treasury. Their paper was published in the journal *Econometrica* and awarded the prestigious Ragnar Frisch prize for the best econometric article published in the last two years' issues.

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earlier, subsidised workers should have been better paid than the unsubsidised by the time the scheme ended. Card and Hyslop (2005) were unable to find any such effect. Instead, they found that both groups were largely on or near the minimum wage, and there was no significant difference between the two groups. Formally, the study concludes that the incentives had an effect, but only in the short term while they were operating. There were no long-term gains in terms of higher rates of employment or increased earnings. The public spending was a subsidy, not an investment in good quality, long-term jobs (Card & Hyslop, 2005).

Similarly, a study in Minnesota that aimed to “make work pay” by allowing families to keep more of their benefit when they worked, found that the improved earnings of most single-parent families were not maintained. The study also found that for some two-parent families, the scheme reduced employment among second earners, thus did not operate as a work incentive. While the study found some effects, in particular improved primary school performance, may persist for the most disadvantaged recipients, these gains did not come cheaply, with Minnesota spending more money than it would have under the old welfare regime (Gennetian, Miller, & Smith, 2005).<sup>5</sup>

### **3 The New Zealand “In Work Tax Credit”**

The “Working for Families” package was a complex set of policies including an increase in subsidies for childcare for working parents. This paper largely focuses on the part of the package that that was expected to encourage work effort directly, specifically, the In Work Tax Credit (IWTC), but as discussed in section 4, it is difficult to isolate this from other parts of the package including non-financial aspects.

#### **3.1 Context of the minimum wage in New Zealand**

The Minimum Wage Act (1983) provides protection for workers by creating a wage “floor” for all workers, union and non-union. Youth workers aged under 18 years were initially paid at 60% of the minimum wage, but in two steps over 2001 and 2002, this was increased to 80%, and the age of eligibility for the adult minimum wage was

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<sup>5</sup> The Minnesota Family Investment Program was conducted under the legislation that replaced Aid for Families with Dependent Children (AFDC), which had been in existence since 1935. The new regime, Temporary Assistance for Needy Families (TANF) was designed to encourage parents into work by making welfare less generous and harder to get. Despite the less generous welfare payments of TANF, the Minnesota programme cost more than it would have under AFDC.

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lowered from 20 to 18 years (Pacheco & Cruickshank, 2007). The Act specifies a review of the minimum wage in December of each year, and minimum wage rates have been increased every year, rising from \$7.55 in 2000 to \$12.00 in 2008 (Department of Labour, 2008). In February 2009, the Prime Minister announced a further increase to \$12.50 per hour, effective 1 April.<sup>6</sup>

**Table 1. Increases in Minimum Wage, 2000 to 2009 (nominal \$)**

Year	Hourly rate (before tax)	Weekly rate (40 hours, before tax)	Percentage Increase
2000	\$7.55	\$302.00	
2001	\$7.70	\$308.00	2%
2002	\$8.00	\$320.00	6%
2003	\$8.50	\$340.00	6.25%
2004	\$9.00	\$360.00	5.8%
2005	\$9.50	\$380.00	5.5%
2006	\$10.25	\$410.00	7.9%
2007	\$11.25	\$450.00	9.75%
2008	\$12.00	\$480.00	6.6%
2009	\$12.50	\$500.00	4.17%

(Source: various, including Department of Labour website: [www.dol.govt.nz](http://www.dol.govt.nz))

Because of strong economic conditions during the early 2000s, it is hard to gauge the full effect of minimum wage increases on employment in New Zealand. While there is little convincing evidence that a minimum wage has a negative effect on employment, there are arguments that minimum wage could lead to reduced flexibility for employers and may cause a percentage of the low skilled labour force to remain in long term unemployment (Pearson & Immervoll, 2008, p. 14).

It is noted here that the significant rises in the minimum wage have been part of the story of the larger gap between wages and benefits, that, in itself, provides an increased incentive to be in work.

### **3.2 Working for Families Tax Credits:**

The current Working for Families Tax credits programme (WFF) consists of four different types of refundable tax credits available for eligible families with children under the age of 18. These are the Family Tax Credit (FTC), the In Work Tax Credit (IWTC), and the Minimum Family Tax Credit (MFTC), with the Parental Tax Credit (PTC) of minor interest for this paper as set out in Table 2 below..

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<sup>6</sup> The increase to \$12.50 represents a 4.2 per cent rise. Consumer prices rose 3.4 per cent and the average wage increased by 5.4 per cent in the year to December (Collins, 2009).

**Table 2. Working for Families Tax Credits**

<b>Tax Credit</b>	<b>Abbreviation</b>	<b>Nature of payment</b>
Family Tax Credit	FTC	Child-related weekly supplement
In-Work Tax Credit	IWTC	Child-related weekly supplement with work requirement
Minimum Family Tax Credit	MFTC	Guaranteed Minimum Family income top-up with 100% abatement
Parental Tax Credit	PTC	Paid \$150 a week for 8 weeks for new child

Source: IRD, <https://interact1.ird.govt.nz/forms/famcalc2008/>

The FTC is paid to all families on the basis of numbers and ages of children and household income and is not work-related. Eligible families are entitled to the FTC and if in work, the IWTC. These are paid as one sum to the caregiver for the ongoing costs of the child(ren). The amount paid for FTC and IWTC depends on the combined annual income of the family, the number of dependent children and their age. The IWTC requires that families are not accessing any main welfare benefit and are working at least 20 hours per week if a sole parent, or 30 hours per week if a couple.

The MFTC differs from the child-related tax credits as it is a top-up payment to guarantee a minimum level of income for those with children in work and the level is not child-related. The MFTC ensures that families have a minimum income of \$395 a week after tax or \$20,540 net or \$24,493 gross a year (2009/10). The amount paid depends on the family's income with an abatement of 100 percent of the MFTC for each extra dollar earned. As for the IWTC, to be eligible for the MFTC, couples have to work a minimum of 30 hours a week between them and sole parents have to work for at least 20 hours. The IWTC and the MFTC are both designed to improve the returns to working for those with children and are discussed more extensively below.

### **3.3 Background**

The IWTC was introduced in April 2006 as part of a broad package of tax credits called Working for Families. New Zealand is one of only six countries to use a child-related work incentive. The others are Austria, Belgium, Ireland, South Korea, the Netherlands, and the Slovak Republic (Human Rights Tribunal, 2008, p. 10). While the IWTC is designed to provide a work incentive, it is important to understand its place in the overall pattern of family assistance payments in the New Zealand system.

The presence of children requires special recognition in the assessment of the ability to pay tax. In New Zealand, tax exemptions have not been used since the 1970s.

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By 1986 there was a simple system in which children, whether in families on benefits or in work on a low income, were all treated the same. Per week per child Family Assistance comprised Family Support, a refundable tax credit that reduced against joint parental income, and Family Benefit, a universal cash payment of \$6 per child per week. In 1991 the Family Benefit was added to Family Support, so that all Family Assistance became a single refundable tax credit that was abated above a threshold of joint parental income. This was accompanied by significant cuts to main welfare benefits (St John & Rankin,2009)

Family Support was paid to the caregiver for the children, regardless of whether the families of the children concerned were on benefits or earned low incomes. Unlike welfare payments, however, there was no automatic adjustment for inflation and income thresholds were rarely increased. Over the 1990s the real value of Family Assistance was eroded at the same time as child poverty emerged as a major social issue (St John & Craig, 2004).

In 1996, the weekly per-child Family Assistance was increased by \$20 per child per week, but \$15 of this increase was separated off from Family Support, and only paid for children whose parents were not on a benefit. Rather than an explicit work incentive, it was a reward for not being “dependent” on the state. This payment of \$15 per week per child was initially called the Independent Family Tax Credit (IFTC), reflecting that role.

In 1996 also, the IFTC was renamed the “Child Tax Credit” (CTC), and became part of a raft of similar tax credits called Family Plus, available only to families not on a benefit. The renaming indicated recognition that it was a payment to help with the costs of children rather than primarily a work-related payment, but its design ensured that it was paid only to those parents in work. In practice, the CTC denied beneficiary families an overdue inflation catch-up in 1996; meanwhile the purchasing power of their Family Support continued to fall (St John & Craig, 2004).

The Labour Government, elected in 1999, acknowledged that child poverty had become a major social problem, and in 2002 vowed to eliminate it (Ministry of Social Development, 2002b). The 2004 budget announced “Working for Families” (WFF)

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would be introduced with a two-year phase-in beginning in 2005, a package initially worth over a billion dollars.<sup>7</sup>

WFF included a range of improvements such as increased Accommodation Supplement and childcare subsidies. The major thrust, however, was a very significant increase in financial assistance for children in “working families”. The clear intention was to encourage and reward attachment to the labour market and by doing so reduce child poverty.

The package on the surface appeared to increase Family Support (now called the Family Tax Credit (FTC) significantly for all, but the government had taken the opportunity to use this extra assistance to offset a range of cuts to benefits, so that some families were left only ‘no worse off’. In addition, these same families were excluded from the new In-Work Tax Credit (IWTC) that replaced the CTC from 1 April 2006. The IWTC was much more generous than the CTC, at \$60 a week for families with up to three children and an additional \$15 a week for the fourth and subsequent children. By 2007 the full Working for Families package was implemented, with current parameters as set out in Table 3.

Criticism of the WFF package in 2004 stressed that the poorest of poor children had been left out, but the government claimed to have no money left to help beneficiaries further. Then, in a surprise move pre-election in 2005, it was announced that from 1 April 2006, an additional \$500m per year would augment the WFF package. However, the additional money went only to families earning more than \$27,500, well above welfare benefit levels.

The threshold for the IWTC’s joint parental income test was raised to \$35,000, (\$36,827 from Oct 2008) and the rate of abatement was reduced from 30 percent to 20 percent. These moves could reasonably be justified, as the previously higher EMTRs on low incomes were seen to counter the work incentive thrust of the government’s intentions. But if work incentives were the objective, the opportunity was not taken to revisit the design of the In-Work Tax Credit, or its ongoing relevance as a work incentive (St John & Wynd, 2008).

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<sup>7</sup> WFF was expected to absorb 4.4% of total government spending between 2004 and 2008.

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There now appeared to be no clear connection between the original rationale for the IWTC and the final form in which it was enacted. Because the IWTC is like the FTC in every respect, the two tax credits are added together for abatement purposes. The FTC abates first and then the IWTC. The end result, and perhaps unintended consequence of the 2005 changes, is that the IWTC is paid to families a long way up the income scale. The legitimacy of this payment is challenged by child advocacy groups as outlined in Section 5.

**Table 3. WFF weekly and annual payment from 1 October 2008**

<b>Weekly payments: Age and number of children</b>	<b>FTC Rate from 1 October 08</b>	<b>Lump sum, annual end of the year payments Annual rate 2009/2010</b>
First child if under 16	\$86	\$4487
First child if 16, 17 or 18	\$99	\$5198
Subsequent rate if child under 13	\$60	\$3119
Subsequent rate if child 13 to 15	\$68	\$3557
Subsequent rate if child 16 or over	\$89	\$4651
<b>“Working Families” Numbers of children (Assuming all under 13)*</b>	<b>IWTC Rate from 1 October 08</b>	<b>IWTC + FTC</b>
1	\$60	\$7,607
2	\$60	\$10,726
3	\$60	\$13,845
4	\$75	\$17,744
5	\$90	\$21,643

\* Higher amounts are paid for older children. WFF abates from \$36,827, so that a family with 5 children can still access some part of the IWTC up to an income of \$145,042. (IRD <http://www.ird.govt.nz/wff-tax-credits/entitlement/>)

While the overall WFF package reduced the rate of child poverty from 30% to 22% (Perry, 2008, p. 78),<sup>8</sup> the remaining poverty is largely concentrated in families that are ineligible for the IWTC. Child Poverty Action Group (CPAG) estimated that approximately 185,000 children live in families not eligible for the IWTC, and remained in some degree of hardship, with about 150,000 of them in severe and significant hardship (St John & Wynd, 2008). For this group there was little respite in view, only

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<sup>8</sup> Using the poverty line of 60% current after housing costs equivalised median household income.

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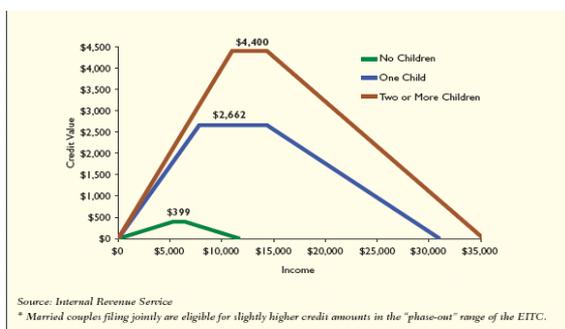
exhortations for their parent or parents to get a job, regardless of how inappropriate or infeasible that might be.

**3.4 Influence of the US and the UK**

Policy on the IWTC appeared to have been influenced by the UK tax credit system; but as outlined in Appendix B, since 2003 Britain’s child-related assistance has not differentiated between working and non-working families (St John & Craig, 2004). The UK, child-related per-week payments comprise a universal child benefit and a child tax credit, paid for all children on the same basis, regardless of the source of their parents’ income. As Table 4 shows, the UK Working Tax Credit is quite different to New Zealand’s IWTC – it is aimed at the transition to work and abates from a low level at a high rate. It is not related to the numbers of children; it is available to all low-income workers; and it is paid to the worker, not to the principal caregiver of the child.

The US system of the Earned Income Tax credit is also outlined in Appendix B. It is also aimed at the transition to work, paid to the worker and not restricted to those with children. It subsidises extra hours worked up to a maximum and then eventually claws that subsidy back as shown in Figure 1.

**Figure 1 The Earned Income Tax Credit in the US (\$)**



Source: Holt, (2006, p. 4)

The EITC has been judged to have had a positive effect on the working poor, but has experience a raft of other problems as outlined in Appendix B. New Zealand’s IWTC is very unlike its counterparts in the US and the UK, in particular it is only paid to those with children and is paid to the caregiver not the worker. The IWTC is worth less than the EITC but is not received at all by the very poor and is paid a long way up the income scale, especially for large families, compared to the EITC. As noted in table 3 a

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family with 5 children can still receive the IWTC on incomes up to \$145,000. Table 4 highlights the critical differences.

**Table 4. Comparing In Work Benefits: UK, US, and NZ**

<u>UK- WTC</u>	<u>US EITC</u>	<u>NZ- IWTC</u>
Minimum hours worked required, Adult based	No minimum hours, Adult based	Minimum hours worked required, Child-based
Paid to worker	Paid to worker	Paid to carer
Abates from very low income level. Affects transition to work	Phased in over low income and phased out over transition	Abates from level above transition
Abates quickly	Abates moderately quickly	Abates slowly

### **3.5 The IWTC- carrot or stick?**

The In-Work Tax Credit was the “carrot” of the government’s welfare reforms. It was designed to boost the rewards for parents moving from benefits into paid work, that is, to “make work pay”. At \$60 per week for up to three children, plus an additional \$15 per week per child thereafter, it is a generous payment, and would appear at first glance to be an incentive to re-attach to the workforce.

Like the CTC before it, New Zealand’s IWTC conflated policy goals of child-related income security with adult workforce participation. It is however a child-related payment first and foremost (as established in CPAG v Attorney General 2008). In every respect except as to who gets it, it is just an addition to the Family Tax Credit, adding on top of it, and abating after the FTC has disappeared. To reinforce the role of the IWTC as a work incentive, claimants must now meet the weekly work criterion of 30 hours for a couple and 20 hours for a sole parent, a condition not required for the CTC.

The “work incentive” is paid to the caregiver of the child (who may not be “in work”), not the worker. Once in receipt of the IWTC, many families in two-parent households may actually afford for the primary caregiver, or both parents, to work less (see section 3.6). While anecdotal, a case cited in a 2007 MSD newsletter illustrates the point. Setoga (Toga) and Liz Tofilau live with their three children aged six, three and one, in Petone. Toga works for the Salvation Army centre in Wellington as a youth worker. Liz is an early childhood teacher in Lower Hutt.

*Tax credits and some childcare assistance have made it possible for Toga to reduce his working week from five to four days, and spend one day a week studying towards a degree in health and psychology at WelTec...The extra funds*

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*make it possible for Liz to spend more time with the children while they're young. This year, the whole family went to Samoa. It was the first time in years they had been able to go anywhere as a family.* (Ministry of Social Development, 2007)

Improved family work-life balance for 2-parent families due to fewer hours worked may be socially desirable, but the intent of the IWTC was to increase labour market participation not reduce it.

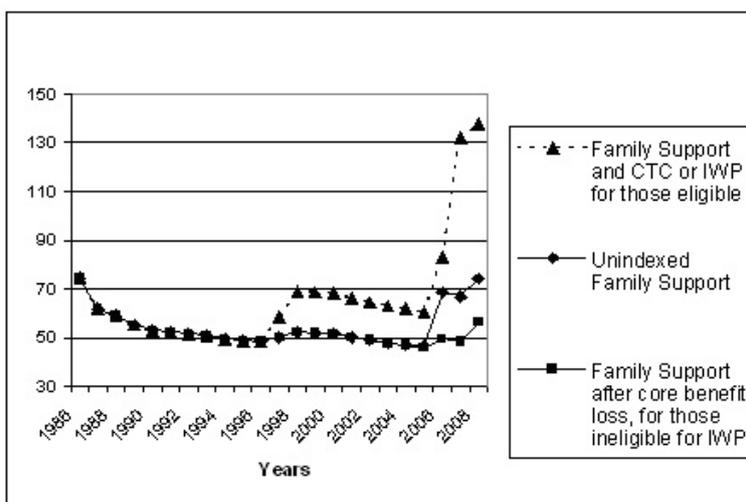
The target of the policy was clearly sole parents for whom the 20 hours paid work criterion is particularly harsh compared to the two-parent 30 hour requirement. Sole parents are already doing the job of two parents. Participants in a recent study noted that the sheer relentlessness of doing everything on their own – felt most acutely by those with two or more children – was a contributor to rising stress levels, deteriorating mental and physical health, depression and in some cases hospitalisation or suicidal thoughts (The Rotorua Peoples Advocacy Centre (RPAC) Inc., 2007).

### **3.5.1 Contradictions in the IWTC entitlement criteria**

The rules of independence from the state for the IWTC require that parents cannot receive any main social welfare benefit or student allowance. Anomalies abound in this requirement. Thus if caregivers receiving the state pension, New Zealand Superannuation, also meet the paid work requirements, they may also qualify for the IWTC, as may some parents receiving accident compensation payments even if they do not work. A partnered women who works 20 hours, but whose partner is unemployed, does not qualify for the IWTC. On the other hand, even though her actual hours of work are zero, a partnered woman whose partner works for 30 hours may receive the IWTC.

Because of the IWTC and other changes introduced as part of the WFF package, a much bigger gap has opened up between families “in work” and those not “in work”. Using the one-child low-income family to illustrate, Figure 2 shows how the changes in 1996 and in 2005 with WFF affected the real spending power of family assistance for those families who qualified for the CTC/IWTC, and those that did not. Figure 2 also shows how the core benefit cuts which accompanied WFF have made the gap even larger. Overall, the cuts to benefits and other hardship provisions for the worst off group was estimated to save \$237m per year ( St John & Craig, 2004).

Figure 2. 1-child maximum real per week family assistance 1986-2008 (\$2004)



(Source: St John & Craig, 2004)

Despite the intent of IWBs internationally not to create the gap by reducing the relative income of those out of work, (see Section 2.1) this has been the effect in New Zealand, with implications for the achievement of the other goal of the IWTC, that of child poverty reduction. In defending these changes, the government argued that “...great care was taken in developing Working for Families to ensure that nobody was worse off as a result of the changes” (Mallard, 2004). In a time of improved real redistribution to working low-income working families, to be “no worse off” in nominal terms has increased social exclusion and entrenched the relative poverty of the poorest children. The inclusion of the poorest children in the IWTC would cost approximately NZ \$450m per annum (St John & Craig, 2004).<sup>9</sup>

New Zealand’s Māori and Pacific Island populations are disproportionately disadvantaged by their exclusion from the IWTC because they have a younger demographic structure and a lower socio-economic status than the general population, (Wynd, 2006). These ethnic groups have already experienced a much larger decline in their living standards between 2000 and 2004 than the rest of the population (Ministry of Social Development, 2006). It can be argued that the IWTC in effect, treats children of different races differently. This discrimination is being debated politically under

<sup>9</sup> In contrast in 2005 the government extended family assistance to families well up the income scale

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Treaty obligations to the indigenous people and illustrates another vulnerability of the IWTC policy (see section 5.2).

The IWTC was designed in a time of economic strength and labour market shortages. In such an environment it could be interpreted as a carrot. In 2008, as the global recession began to impact many families experienced a sharp drop in living standards. In the past, when low income parents needed to go on to a benefit, their Family Support could be expected to increase as a result of their lower income. Now, because the IWTC is tied to employment, total family assistance falls when income falls below the family assistance threshold, and thus fails to provide a cushion that might protect the income needs of children. The loss of the IWTC for the children of the newly unemployed is compounded by the now very low adult benefit levels for their parents.

### **3.6 The Minimum Family Tax Credit**

The minimum family tax credit (MFTC) is not child-related, but is designed to provide a guaranteed minimum family income for those working the required number of hours. It ensures that these families have \$24,493 gross (2009/10) per year or \$395 a week after tax, \$20,540 net per year regardless of the composition of the family, with Family Tax Credit (the old Family Support) and the In-Work Tax Credit paid on the top of the net guarantee to recognise the impact of different family size. The MFTC is reduced by one dollar for each additional dollar of disposable income earned. Thus it resembles a welfare benefit. Use of this top-up increased under Working for Families.

Families coming off benefits may need to access the Minimum Family Tax Credit in order to attain a level of income comparable to that of a benefit plus part-time work. Figure 3 shows the disposable income and the effective marginal tax rates faced by a single parent on the minimum wage as a function of the number of hours worked.<sup>10</sup> Moving from benefit and working 19 hours per week at the minimum wage and then working 20 hours and coming off the benefit and getting the MFTC results in an increase in disposable income of around \$30 a week. However, there is no incentive for the single parent to work any more than 20 hours a week until they can work around 38 hours a week, because the Minimum Family Tax Credit abates at 100 cents for each

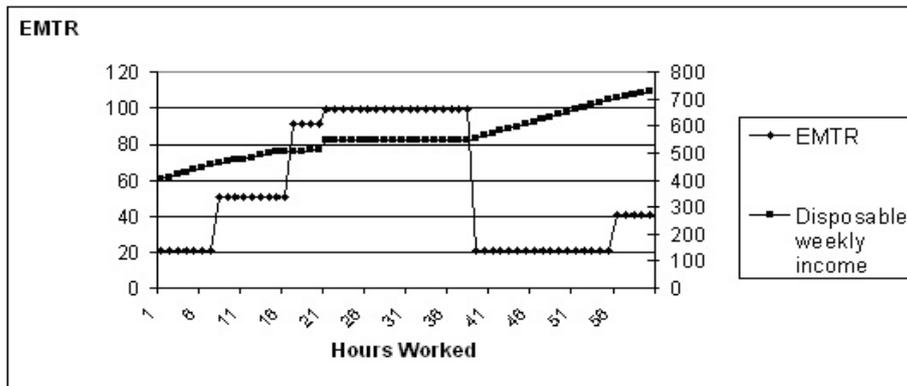
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<sup>10</sup> The Minimum Wage rose to \$12 an hour in April 2008, and \$12.50 in April 2009. For higher minimum wages the figure would be more compressed towards the left.

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additional dollar of net income, resulting in no increase in income for the additional 17 or 18 hours worked.

**Figure 3. Disposable weekly income 2007 (RHS axis) and effective marginal tax rate (LHS axis) for single parent with two children**



Source: (St John & Wynd, 2008, p. 53) based on sole parent 2-children working at the minimum wage

While the move from being employed for just below 20 hours a week and being in receipt of a benefit, to being employed for 20 hours and not receiving a benefit, is technically a move off welfare to “independence,” in reality it is no such thing. The amount of assistance provided by the state in each case is almost exactly the same, if not more, for being in work. The main difference is that the name for the assistance from the government has changed, avoiding the stigma which may be associated with “welfare”.

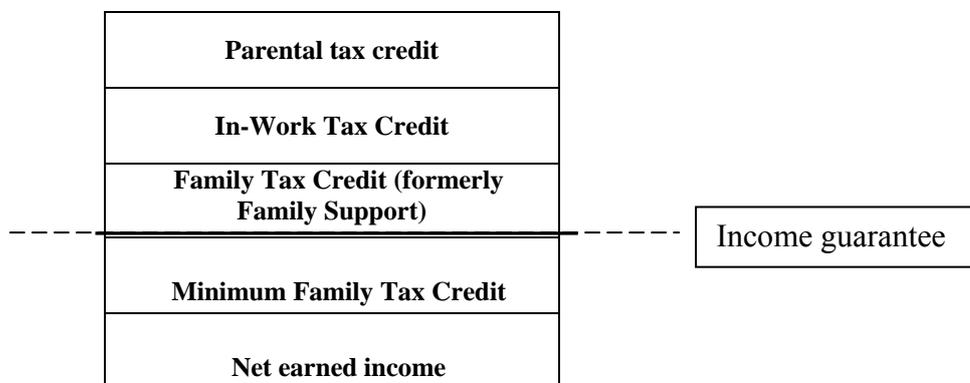
The way tax credits are structured is illustrated in Figure 4. The tax credits above the minimum family income line are the means by which additional children are recognized. As net earned income increases, the net MFTC reduces dollar for dollar.

It is difficult for families receiving family assistance to understand the impact of earning more income because they are given a total WFF tax credit amount on their tax reconciliations, even though different credits are treated differently for abatement purposes. The severe abatement of the MFTC is of concern, as families may find at the end of year that they have to repay, dollar for dollar, any unanticipated income they have earned.

Data for 2006 shows that nearly a quarter of families who were getting the MFTC had to repay some at the end of the year. The MFTC was received by only 960 families in the year ended March 2006, but this had jumped to 3,020 in the year ended March 2007,

suggesting the increased importance of this benefit for ‘making work pay’ (Inland Revenue Department, 2009).<sup>11</sup>

**Figure 4. Structure of tax credits**



### **3.7 Theoretical justifications for the IWTC**

In general a wage subsidy has income and substitution effects. Work is made more attractive by the increase in the marginal return so there is a substitution in the positive direction, while the income effect makes the worker better off, and so may be encouraged to work less. In the low wage, low income areas in which in work benefits usually operate, the substitution effect is expected to dominate. In the phase-out period, the substitution effect works to discourage extra hours of work. In so far as the phase-out applies to joint income for the couple, there may be a strong disincentive for the secondary earner whose EMTR would also include the abatement of Family Assistance. The overall impact on hours worked will be a subtle balancing of these effects.

The IWTC is a lump-sum payment and as such can be expected to have income effects. There is an incentive to work the required number of hours to receive it in full, but once it is received it does not increase the marginal returns to extra work effort. Eventually the IWTC abates at 20 cents in the dollar, so that for additional hours of work there is a substitution effect away from work effort.

For sole parents, the incentive operates in a complex way. To receive the IWTC a sole parent must work 20 hours but must also come off the benefit. Those who stay on the benefit, can work 20 hours and receive a part benefit but no IWTC. If they come off the benefit and still work only 20 hours it is likely that low wages there is not enough

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<sup>11</sup> See section 4.4 for more detail.

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income to live on. The WFF package then adds the MFTC to disposable income to guarantee the family a minimum income level.

As described in section 3.5, MFTC has a 100% abatement so that any income earned above the income from the 20 hours is effectively confiscated, providing a very strong work disincentive for those in that income band.

For couples, the hours of work requirement is less onerous at 30 hours a week. For most secondary earners the income and substitution effect work in the same direction which should unambiguously reduce her/his hours of work.

The theoretical justification for the IWTC must be that the work incentive aspects for sole parents outweigh the disincentives for secondary earners in couples with children. Additionally there may be some social benefit from ‘making work pay’, ie redistribution, to those families already in low paid work.

Other a priori considerations:

- If there is an increase in subsidised work by mothers with children, there may be a corresponding decrease in unsubsidised work elsewhere;
- The IWTC has to be paid for by higher taxes which also have disincentive effects;
- Encouraging low wage employment may keep wages low.

## **4 Evaluation of the IWTC**

### **4.1 Methodologies for evaluating IWBs**

Methodologies for evaluating IWBs were set out in Pearson et al (2008, p 25) as follows:

1. Experiential. Pilot studies allow for a control group not affected by policy.
2. Simulation. Projection of likely effects before policy put in place based on characteristics of the population.
3. Statistics approach. Difference-in-Differences approach eliminates other effects by use of statistics and is most generally used.

New Zealand is a small country without regional or state differences in policy. The IWTC was a national programme and there was no pilot study for the IWTC. This rules out method 1 as an evaluation methodology. The other two approaches are discussed below.

## **4.2 Expected results**

A March 2004 paper to Government Ministers on the expected impacts of Working for Families reached the following conclusions about the anticipated key effects of the original package on employment:

*As a result of the reforms there may be a small increase in labour market participation amongst both beneficiaries and non-beneficiaries who decide to enter the labour force. Depending on the skills of these new entrants and general economic conditions, this may lead to a small increase in employment. Needless to say, the package has been developed against the background of strong economic growth. In the event of an economic downturn, employers are less likely to absorb any increase in labour supply generated as a result of improved work incentives. Families already engaged in work are not generally responsive to financial work incentives and may, depending on the structure of assistance, reduce the work effort of second earners in dual-income households. These findings are confirmed by preliminary micro-simulations applied to the labour market in New Zealand. (Ministry of Social Development, 2004, paras 89-92)*

The micro-simulation the MSD refers to is a study based on the second methodology. The Kalb, Cai, & Tuckwell (2005) study by the New Zealand Treasury prior to the introduction of WFF predicted the impacts of the first version of IWTC based on labour supply elasticities derived from 1990-2001 data (Kalb & Scutella, 2003). The simulation assumes a perfectly elastic demand for labour (Kalb, Cai, & Tuckwell, 2005, p. 10).

The changes that were modelled were decreased benefit rates, increased family assistance partly dependent on the labour supply, and the improved accommodation supplement. The effects of the latter were expected to be small and can be ignored for the purposes of this paper.

Sole parents were the only group for whom a positive labour supply effect was expected as a result of the WFF policy changes. According to this 2005 research, around 1.8 percent of single parents were expected to enter the labour force as a result of the WFF package. About 2.4 per cent of all sole parents were expected to work less and about 1.9% was predicted to prefer longer working hours with an overall average increase of average 0.63 hours a week. The tax revenue for the group as a whole would decrease, due to negative supply responses for those already working full-time, who are more likely to earn more than new entrants in the labour force. The authors found an increase in the probability of working was largest for one-child families as would be

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expected because the increase in IWTC over the previous CTC is largest for the 1-child family (Kalb, Cai, & Tuckwell, 2005).

Only 8% of couples in the sample observations worked less than 30 hours a week and for these, higher incomes “may actually induce a reduction in labour supply of one or both partners” (Kalb, Cai, & Tuckwell, 2005, p. 13). The results showed the labour supply of married men and women was predicted to decrease by 0.22 and 0.23 hours per week respectively. “For married women, the most popular choice is to reduce labour supply to zero” (Kalb, Cai, & Tuckwell, 2005, p. 13). All effects by the number of children are negative. It was also noted that the abatement of family assistance post reform applies further up the income scale, providing a higher EMTR for some women in higher income families.

The microsimulation was based on the Household Economic Surveys (HES) which did not include the increased childcare subsidies of WFF. These can be expected to increase work participation of parents with young children. The authors note “the effect is probably largest for low-wage families where the price of childcare might otherwise cancel out nearly all additional earnings to be obtained from additional working hours” (Kalb, Cai, & Tuckwell, 2005, p. 24).

Other qualitative analyses include a report published by the Business Roundtable which concluded that the WFF package was unlikely to have a noticeable, if any, net positive effect on aggregate employment. It noted that the WFF package provided no encouragement for secondary income earners to seek employment where one parent was already working 30 hours a week (Dwyer, 2005). Analysis by Nolan (2004) and St John & Craig (2004) drew the same conclusions.

In summary, prior to the IWTC becoming payable in 2006 and prior to the unexpected extension announced pre-election 2005, it was expected that there would be only a modest effect on movement of sole parents from benefits to work (in other words large numbers would remain reliant upon benefits). The employment of couples, in particular secondary earners (usually mothers) was likely to decrease.

The analysis ignores the role of childcare subsidies and of the MFTC and its importance to sole parents who are moved off benefit, discussed below, and assumes that the demand for labour is perfectly elastic. The effect of cuts to welfare benefits for the target group is also not easily disentangled from the effects of the IWTC alone.

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The MSD expressed concern that the policies might have consequences for other labour market policies:

*On balance, we expect the increase in labour market participation as a direct result of Future Directions – Working for Families reform to be modest. Should there be an increase in labour supply, any downward pressure on wages would reduce the returns to work for people without children and make these workers increasingly reliant on minimum wage provisions.* (Ministry of Social Development, 2004, paras 89-92)

### **4.3 Statistical studies**

Using the third methodology, there was some preliminary research on the impact of tax credits using a difference-in-differences approach (Fitzgerald, Maloney, & Pacheco, 2008). This report found small labour market gains and other small impacts such as the effect on partnering. It concluded that

*... we provide some evidence of employment increases and more solid evidence of work hour increases for those working due the family assistance policy [tax credits] changes. Evidence on partnering is more elusive but there are certainly no large impacts currently.* (Fitzgerald, Maloney, & Pacheco, 2008, p. 48)

This study did not provide a policy analysis, and did not answer the critical questions such as whether the tax credits are appropriate labour market tools; whether they are well-designed; whether they are worth the cost; and what their unintended consequences may be.

It would appear that the statistical approach employed by Fitzgerald et al (2008), while problematic, largely confirms the earlier results from microsimulation. They show however that partnered women increased their hours of work. This outcome may reflect the positive incentive effect of the reduced abatement of family assistance and higher than originally intended threshold that were introduced with the pre-election 2005 changes.

### **4.4 Official reviews of the In Work Tax Credit**

The IWTC is a new policy and official assessments have been preliminary to date. There was a statutory requirement for the review of the level of the IWTC by the 30 June 2008 (Inland Revenue, 2008b) and for ongoing evaluations (see for example Centre for Social Research and Evaluation, 2007). Other evaluations of timeliness etc provide some additional information (Inland Revenue, 2008a).

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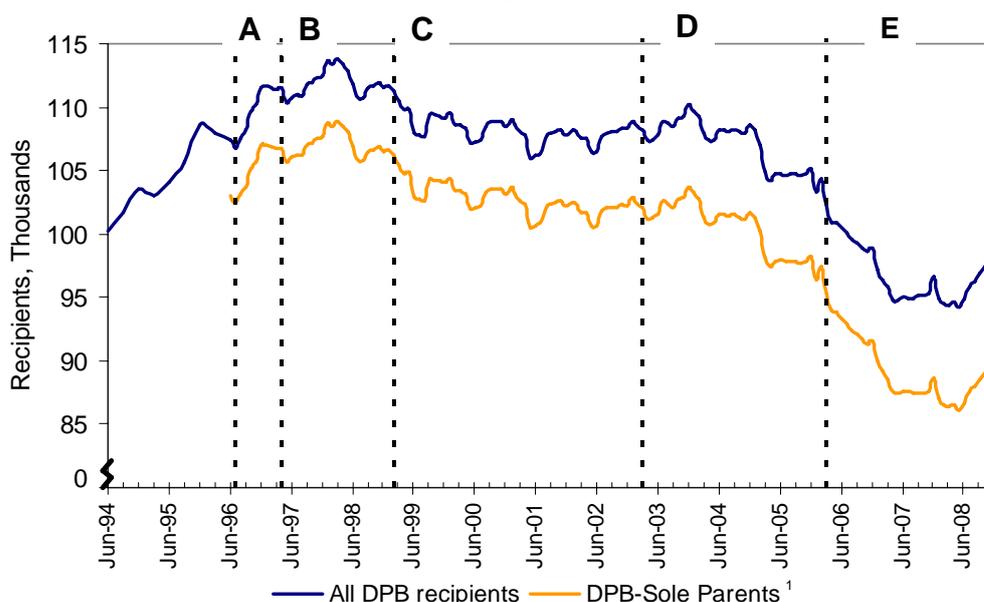
The first IRD evaluation of WFF acknowledged the difficulty of assessing the work incentive aspect of the IWTC. While it found that “nearly two thirds of families agreed that the In-Work Tax Credit is a good incentive to stay off a benefit”(Centre for Social Research and Evaluation, 2007, p. 38), this is a long way from proving that it is a sensible and effective work incentive. On the contrary, it may simply serve to illustrate the gap between those who are able to work and those who cannot.

**4.4.1 Has the IWTC improved employment of sole parents?**

*...since WFF has been implemented, New Zealand has experienced the largest fall in numbers receiving DPB since the benefit was introduced in 1973 – the number of families receiving the DPB has fallen by 12,500 (from 109,700 at August 2004 to 97,200 at August 2007). (Centre for Social Research and Evaluation, 2007)*

Figure 5 makes clear that exits from the DPB were indeed occurring at a faster pace between 2004 and 2007.

**Figure 5. Domestic Purposes Benefit recipients, all classes 1994 – 2008**



1. Domestic Purposes Benefits comprise Sole Parent, Domestic Purposes Benefits – Care of Sick or Infirm, Domestic Purposes Benefits – Women Alone, and Emergency Maintenance Allowances.

Source: (Dalgety et al, 2009)

But this is not evidence of the efficacy of the IWTC because:

- The labour market was exceptionally tight and unemployment itself was falling rapidly until 2007. Demand for unskilled labour was high;

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- Child care subsidies and supply also increased markedly (see Appendix A);
- Minimum wage was lifted each year see Table 1
- Case management can be expected to have helped;
- Exits may not have entailed a significant increase in hours of work;
- The role of the MFTC is ignored.

It was suggested in the 2007 report that:

*...WFF is having a positive impact on incentives to work and is contributing to movement off benefit into work, particularly for sole parents who already had some labour market attachment. Specifically: The in-work tax credit is being received by a large and growing number of families. One year after its implementation the number of recipients is continuing to increase and 184,700 families received in-work tax credit in the tax year ending March 2007. (Centre for Social Research and Evaluation, 2007, p. vi)*

Overlooked here is that the eligibility for the IWTC was widened considerably to higher income people by the time the IWTC was implemented in 2006. As this tax credit must be applied for it could be expected that over time, the numbers would increase as high income families realized their eligibility. Implicitly acknowledging this point the report went on to state:

*Legislation passed in November 2005 gave effect to earlier commitments to further enhance the WFF package by raising the income threshold and lowering the rate of abatement for income in excess of the threshold. These enhancements were expected to provide additional WFF Tax Credits to an estimated additional 160,000 families, including 60,000 newly eligible families. These families have higher incomes than the previous target group. By 1 April 2007 nearly all families with children earning under \$70,000, many earning \$70,000 to \$100,000, and some earning more, qualified for WFF. (Centre for Social Research and Evaluation, 2007, p. 2)*

The large and growing number of higher income families contrasts with the stated intention of WFF's which was to reduce poverty and make work pay for the low-paid families.

It was claimed that the IWTC "appears to be contributing to the decrease in the numbers of DPB recipients" (Centre for Social Research and Evaluation, 2007, p. 36) and in support, the report cited the work of Fitzgerald et al (2008) as discussed above. The 2007 report acknowledged that the fall in numbers was greatest among those with other income, that is, people who had an *existing* attachment to the labour market (see Table 5 below). Of these, "some would have been already working sufficient hours (20 a week)

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to qualify.” (Centre for Social Research and Evaluation, 2007, p. 40) Between 2005 and 2006 the biggest fall in numbers was for those already working in some way with a large drop for those earning over \$300 a week (-25%).

**Table 5. Number of DPB recipients with and without income in addition to benefit**

DPB Recipients at end of August	No other income	With other income (\$ per week)					Total
		All with other income	\$1-80	\$81-180	\$181-300	>\$300	
2005	80,000	26,400	8,900	9,000	5,900	2,600	106,400
2006	78,000	23,600	8,200	8,200	5,200	2,000	101,500
2007	75,600	21,600	7,300	7,500	4,800	2,000	97,100
Change							
2005-2006	-2,000 -3%	-2,800 -11%	-700 -8%	-700 -8%	-700 -12%	-600 -25%	-4,800 -5%
2006-2007	-2,400 -3%	-2,000 -8%	-900 -11%	-700 -8%	-300 -7%	0 -1%	-4,400 -4%
2005-2007	-4,400 -6%	-4,800 -18%	-1,600 -18%	-1,400 -16%	-1,100 -18%	-700 -25%	-9,200 -9%

Source: MSD Information Analysis Platform (IAP).

Note: Numbers may not sum due to rounding. Percent change calculated on unrounded data.

(Source: Centre for Social Research and Evaluation, 2007, p. 40)

The IWTC started in 2006 and between 2006 and 2007 of the reduction of 4,400 only 2,400 were not working at all and most would not have gone into full-time work.

#### **4.4.2 Impact of the recession**

More recent economic events are reflected in the upward trend in the last 12 months of 2007-2008 shown in Figure 5. Overall between March 2008 and March 2009 numbers on benefits rose by around 33,000 see Table 6 (Ministry of Social Development, 2009).

Between March 2008 and March 2009 the numbers on the DPB increased sharply by 6139 and while these may not be the same people, it suggests that overall the IWTC has not operated to help DPBs retain jobs in the downturn.

In conclusion, a close analysis of the composition of the numbers is required. But it can be inferred that of the total reduction in DPB numbers a very small number had no connection to the labour market already, and of those who had left the benefit it is not clear how many would be working more than 20 hours as discussed below or how many have since returned to the benefit in the downturn.

**Table 6 Numbers of working aged clients<sup>1</sup> receiving main benefits at the end of March, 1999 - 2009**

End of quarter	Unemployment Benefits <sup>2</sup>	Domestic Purposes Benefits <sup>3</sup>	Sickness Benefits <sup>4</sup>	Invalid's Benefits	Other main benefits <sup>5</sup>	All main benefits
March 1999	144,895	111,448	31,726	49,584	31,820	369,473
March 2000	140,157	109,681	32,133	53,196	30,105	365,272
March 2001	128,529	109,154	33,258	57,729	29,408	358,078
March 2002	114,627	108,567	34,660	62,172	23,238	343,264
March 2003	100,986	109,104	38,315	66,563	19,398	334,366
March 2004	75,164	108,569	42,217	69,783	16,974	312,707
March 2005	54,936	105,682	43,789	72,286	15,265	291,958
March 2006	44,549	103,362	46,072	74,401	15,200	283,584
March 2007	28,845	97,142	47,862	76,619	15,279	265,747
March 2008	19,034	95,861	45,676	81,130	14,053	255,754
March 2009	37,146	102,003	51,041	83,961	14,808	288,959

Notes:

Source National Factsheets MSD <http://www.msd.govt.nz/about-msd-and-our-work/publications-resources/statistics/benefit/2009-national-benefit-factsheets.html>

Another confounding factor not addressed in any analysis is the role of child support (payment from the non-custodial parent). This payment may be large enough to sustain a sole parent off benefit and may have profound work incentive implications. While on the DPB the child support payment is used to offset her benefit and many sole parents prefer to stay on a part-benefit even when working so that this payment is effectively secured. Child support problems can be expected to worsen in the recession.

#### **4.4.3 Role of the MFTC**

A significant number of those who moved off a part benefit on to the IWTC would have also needed the MFTC. The figures for the MFTC shown in Table 7 confirm this as between 2006 and 2007 the numbers of sole parents on the MFTC jumped from 621 to 2,167. The number was similar for 2008.

The average entitlement for MFTC in 2008 was \$2,801. The MFTC can in fact result in sole parents receiving more from the state when they are off the DPB than when they are on a part benefit. (Gray, 2008)

**Table 7. Data for the receipt of the MFTC**

	2004	2005	2006	2007	2008
Numbers entitled to MFTC (year)	1,412	1,007	863	2,727	2,397
% Couple	29%	30%	28%	21%	16%
% Sole	71%	70%	72%	79%	84%
<b>entitlement</b>					
<b>Mean</b>	<b>\$2,274</b>	<b>\$2,298</b>	<b>\$2,325</b>	<b>\$2,748</b>	<b>\$2,801</b>
25 <sup>th</sup> percentile	\$625	\$827	\$786	\$985	\$881
75 <sup>th</sup> percentile	\$3,418	\$3,427	\$3,493	\$3,945	\$4,139
Total WFF tax credits					
<b>Mean</b>	<b>\$7,618</b>	<b>\$7,650</b>	<b>\$9,632</b>	<b>\$10,914</b>	<b>\$12,025</b>

Data from Inland Revenue, personal communication, ( 2008)

#### 4.4.4 The MSD and IRD evaluation 2009

In 2009, the results of a further difference-in-differences study using the Household Labour Force Survey and Income Survey (June Quarters), and a Survival analysis of recipients of DPB-Sole Parent using MSD and IRD linked data were released (Dalgety, Dorsett, Spier, & Johnston, 2009) These results showed a more marked increase than the micro-simulation study described above in section 4.2 had predicted.

The estimated employment rates allowed the conclusion that WFF had resulted in another 8,100 sole parents in employment for pay of at least one hour or more a week by June 2007 and that this could be attributed to the changes. The effect was due to the whole of the WFF package, not the IWTC alone. Dalgety et al (2009) are strangely silent on the role of the MFTC. However the authors also report that the percentage of sole parents working 20 hours or more increased by 12 percentage points to 48%, with three-quarters of this attributed to the changed financial incentives and support.

The “difference in differences” approach compares the employment rates of unemployed matched single persons with that of sole parents. While the methodology is clearly the best that can be done with the data, the comparator group in a time of very low unemployment is questionable. Single unemployed people also face a higher abatement of their earnings from part-time work than do sole parents, a fact made worse as the minimum wage increases. The threshold for earnings after which a 70% abatement applies for single people has been \$80 a week since 1986 when the minimum wage was \$4.25. Then it represented 19 hours work. The minimum wage in 2009 of

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\$12.50 means that a beneficiary can work just 6.4 hours before losing extra income at a rate of almost dollar for dollar.

It is also likely that there are some displacement effects between the two groups. The employment of the one that is subsidised may be at the expense of the non-subsidised. Displacement may also occur between partnered women and sole parents as the incentives for partnered women to work are reduced. It has been mentioned above that many of the 8,100 who left the DPB would now have exited employment as the recession makes an impact on low-wage, casualised work.

The growth in employment is claimed by Dalgety et al (2009) to be driven by increased numbers of sole parents working 20 hours or more and thus eligible for the IWTC of off benefit. As discussed above there is little appreciation of the role of the MFTC and that working more than 20 hours is actively discouraged.

*The percentage of sole parents meeting the eligibility threshold for the in-work tax credit requirement increased from 35.9% in June 2004 to 47.5% in June 2007, an increase of 11.6 percentage points. Difference-in-Differences analysis suggests that around three-quarters (9.2 pp ± 4.5 pp) of this increase was due to the policy changes. (Dalgety et al, 2009, p16)*

While it may contribute to the goal of “making work pay” overall, it is hard to see that the IWTC has been successful in achieving its goal of increasing paid work for sole parents. Moving off a benefit does not necessarily equate to moving to full-time employment or even significantly increased hours. The increased use of the MFTC, which is arguably just a benefit in a different guise with a 100% EMTR provides a very strong work disincentive to those working 20 hours to increase hours beyond that.

As noted by the OECD, IWBs are not a magic bullet:

*[They are] costly and must be financed by increased taxes elsewhere or cuts in government spending. So they need to be well targeted and implemented carefully and their interaction with social benefits has to be taken into account. The financial incentive should sufficiently large and the duration of the measure long enough to modify behaviour and improve career prospects. (Pearson & Immervoll, 2008, p. 3)*

### **4.4.5 Young people and the IWTC**

The Social Security Amendment Act 2007 targets young people through close monitoring and by making it more difficult for them to obtain benefits, but offers no tax incentives to work. There may however be minor “in work payments” as outlined in Appendix A.

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In 2003, officials from the Treasury and IRD suggested to the then Minister of Finance, Michael Cullen, that there was merit in increasing incentives amongst those without dependent children because: sustained employment can enhance future earnings potential, thereby improving individuals' capacity to support themselves and any children they may have in the future. Providing in-work assistance solely to those with children may be perceived as discriminatory and using a single individual without children as the baseline makes the construction of in-work assistance clearer ie which parts of the payment relate to work incentives and which parts relate to family formation (Ministry of Social Development, 2004, para. 13).

In addition there was some recognition that work incentive measures aimed solely at parents could have adverse effects on single people. For example, the effect of the IWP could be to reduce pressure on employers to pass on wage increases, thus preventing wage rises for single people as well as parents (Ministry of Social Development, 2004, Para. 132). Financial inducements to parents to enter the labour market may increase their chances of employment at the expense of adults without children (A. Bryson, Evans, Knight, La Valle, & Vegeris, 2007).

### **4.5 Policy assessment against criteria**

Using standard public policy criteria the IWTC may be assessed against equity, efficiency, and simplicity criteria, and for its cost effectiveness in meeting specific goals. Confounding the analysis is that the IWTC is part of a complex package; the policy is relatively new; and the macro environment, minimum wage and tax policies have also been changing.

The IWTC was introduced on 1 April 2006, and has been running for 3 years. In this period, the minimum wage has gone up; thresholds for Family assistance abatement have gone up; the rate of abatement has come down; benefits for those with children have been reduced; unemployment has fallen from record low levels, then risen; and tax rates have changed.

#### **4.5.1 Equity**

In horizontal equity terms, the IWTC can be seen to recognise the effect of family size on ability to pay tax, and to provide some horizontal equity even well up the

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income scale for those with children. The converse is that it fails to recognise the need for extra assistance for those on benefits as family size increases.

This feature has made the IWTC vulnerable to criticism. Because the IWTC has two objectives, work incentive and income adequacy, it fails to achieve the second for those who do not access it by the appropriate attachment to the labour market. The arbitrary fixed hours worked requirement also creates inequity for those who just miss out.

The 2005 changes were not rationalised in terms of their work incentive effects, but were largely seen as a way to deliver a tax cut to “working” families and not to others. This inequity in turn has led to the need for complex compensatory policies (see section 4.6).

### **4.5.2 Efficiency**

The use of a fixed-amount, targeted, child-related payment such as the IWTC to reward paid work effort is problematic because, once a family qualifies, it provides no extra incentive to work more. As discussed above, it may eventually provide a disincentive to work, through high effective marginal tax rates abating against extra income (Nolan, 2002).<sup>12</sup> Universal payments, unfashionable and long since abandoned, have the advantage that they do not reduce as extra income is earned, so they are more work-friendly than targeted payments.

Moreover as the analysis above has shown, the IWTC is not a stand-alone work incentive and once it is coupled with the MFTC whose EMTR is 100%, there is strong incentive to work only the required number of hours and no more, unless the leap to well-paid, full-time work can be made.

The overall efficiency effects must be the balance between the slight improvements in incentives for some sole parents to increase hours of work to 20 hours a week versus the disincentives to work more than 20 hours, and the disincentive effects on a large increased group of higher income secondary earners.

Less easily quantified, there is also the social value placed on certainty of income by sole parents. In CPAG V Attorney General, the Deputy Chief Executive of Social Policy, Ministry of Social Development, acknowledged that where work has been

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<sup>12</sup> Work incentives linked to the care of children also exclude the childless, who may be more in need of a work incentive than parents with young children.

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precarious people may choose to stay on a benefit (Gray, 2008, p. 105). Churning and unstable employment can lead to income insecurity for some people, with high risks of debt, and may lead some to return to the benefit (Ministry of Social Development, 2004). Sole parents who may have to rely on uncertain child support from ex partners may prefer the state collects this contribution and uses the money to help pay for their benefit. These effects can be expected to increase as hours of work are cut in the current recession.

### **4.5.3 Simplicity**

The IWTC is a complex intervention in family assistance. It has necessitated other complex discriminatory policies to redress the problems. It has made family assistance much harder for people to understand, especially now the IWTC, the FTC, and the MFTC have different criteria and abatements. It requires fixed weekly hours of work be met which is difficult to police or monitor.

### **4.5.4 Cost Effectiveness**

In 2003, the Treasury suggested that an appropriate policy solution should distinguish between groups of sole parents. For sole parents with low wage earning potential and costly child-care challenges, the policy aim should be to encourage only a moderate amount of work to supplement benefit income, while encouraging child and personal development. The intention would be that over time, full-time work would be viable as childcare requirements became more manageable and the sole parent's wage earning potential rose. According to the Treasury, until that point was reached, attempts to heavily subsidise the return from longer hours of low paid work seem relatively pointless and costly. There should be greater work expectations of sole parents for whom full-time work is a reasonably attainable goal, for example, because their children require little direct supervision, or they can command a good wage in the labour market (Hurnard, 2007).

A Treasury document also noted that proposals to lift labour force participation amongst young women aged 20-34 should be evaluated carefully because early childhood education is expensive and there is a risk of low value for money from spending in this area. The document states: "It is also not clear to what extent increased participation by young women leads to real increases in output, if in part it substitutes paid for unpaid work." (The Treasury, 2005, para. 7)

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Figures obtained from the Crown Law Office, shown in Table 8, break down numbers of families and total amount spent on the IWTC specifically in \$10,000 income brackets for the 2006/2007 year. The estimated cost of the IWTC is approximately NZ \$500m per annum. In 2008, if the number moved into equivalent full time work was 2,000, the cost per beneficiary moved into work is \$250,000. In the extreme, if all the extra employment disappears in the recession, the cost still remains and the cost per job becomes infinite. This calculation however attributes the entire cost of providing income assistance to people on the DPB to the objective of increasing employment by making work pay. It does not take into account distributional objectives and it is not possible to allocate the cost of WFF among its objectives.

**Table 8. Joint Income, Number of Families, Millions paid in IWTC**

<b>Joint Income</b>	<b>Number of Families</b>	<b>Amount IWTC paid (\$m)</b>
Under \$15,000	14,660	27.8
\$15,000 to \$25,000	23,420	45.3
\$25,000 to \$35,000	28,650	74.6
\$35,000 to \$45,000	34,890	103.6
\$45,000 to \$55,000	28,690	87.0
\$55,000 to \$65,000	26,370	73.8
\$65,000 to \$75,000	18,180	45.5
\$75,000 to \$85,000	8,620	14.4
Over \$85,000	4,390	8.3
Progress Total	187,870	480.3

In an OECD report *Economic Survey of New Zealand, 2007* it was stated:

*No matter what strategy is selected, a number of distortions within the present tax bases should be reviewed. First, the government has increasingly used the tax system as a tool to deliver on other policy objectives. This has complicated the tax system and has had some adverse effects on individual economic behaviour. The Working for Families package provides assistance to families with children. The package has increased the incentives for some of those on welfare to move towards work and for some to increase their hours of work. But changes in the last Budget [2005] extended the income range over which assistance is withdrawn, which has raised the numbers of families for whom additional hours of work becomes less attractive financially because of higher effective marginal tax rates. Alternative ways of supporting families without these negative effects on incentives to work could do more to raise living standards and should be investigated further. (OECD, 2007, p. 10)*

The OECD goes on to suggest that “Shifting the balance of funding towards more generalised assistance with childcare costs for working parents could be one option.” Not suggested, but also possible, universalizing part of family assistance could also be investigated as a mechanism to reduce EMTRs.

## **4.6 Employer perspectives**

An ‘hours of work’ requirement can create perverse incentives to overstate hours, while the work subsidy implicit in the MFTC can be appropriated by the employer. The guaranteed income floor for those who meet the hours of work requirement may allow the employer to reduce the hourly rate, constrained only by the minimum wage legislation. Lower wages for subsidised workers may create an unfair bias against unsubsidised workers. There has been little empirical analysis of these possible labour market distortions.

## **5 Unintended consequences and human rights considerations**

### **5.1 New consequential policy developments**

One of the consequences of the IWTC has been the need for compensating policy elsewhere. Workers who got nothing out of Working for Families were effectively denied a tax cut in 2005 when the WFF programme was extended well up the income scale, increasing the original cost by 50% (\$0.5 billion).

The National-led Government elected in 2008 acknowledged the problems faced by unusually high levels of taxation of some categories of lower-income people, and the inequities that arise with Working for Families when New Zealand's economy endures a period of contraction and rising unemployment. Two new compensating policies: a new tax credit for workers who had received nothing under the WFF package, and a package to support newly redundant workers, have been introduced as described below.

#### **5.1.1 The Independent Earner Tax Credit**

Table 9 gives the current and future income tax scales for individuals in New Zealand. WFF tax credits substantially offset income tax for middle and low income families, while others have had very little tax relief. The Independent Earner Tax Credit (IETC) is a tax credit to the maximum of \$520 a year for the year 2009-2010. This was to rise to \$780 per year by 2010-2011, but that increase was abandoned in the 2009 Budget. The tax credit is aimed at working New Zealand residents who do not receive any

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income-tested benefit or New Zealand Superannuation, or Working for Families assistance.<sup>13</sup>

**Table 9 Income tax scales 2009**

*From 1 April 2009*

<i>Income tax rates</i>	
\$0 – \$14,000	12.5%
\$14,001 – \$48,000	21%
\$48,001 - \$70,000	33%
\$70,001 and over	38%

The IETC is available for people earning at least \$24,000 per year and it abates at 13 cents per dollar for every dollar over the yearly income of \$44,000.

Since the threshold of \$24,000 a year is less than the full-time income of someone earning the statutory minimum wage, it was intended to supply an incentive to expand the number of hours supplied by an individual in order to reach the threshold (New Zealand Government, 2008). The EITC however introduces yet more complexity to overcome the perceived anomalies created by the IWTC.

It also takes New Zealand further from the path of tax reform adopted in the late 1980s of simple low rate broad base comprehensive income taxation (St John, 2007).

### **5.1.2 The redundancy package**

In addition to the IETC, the National-led government introduced a package called ReStart that will continue to pay the In-Work Tax Credit (IWTC) to workers with children who have been made redundant from full-time work for their first 16 weeks of unemployment, thereby softening for some the double blow of unemployment. The In Work Tax Credit is only paid to redundant workers who have children, and is renamed “ReCover”. The policy effectively acknowledges that the IWTC is a payment to assist with the support of children, and not simply or even primarily a work incentive.

The second component of National's ReStart is a plan to raise, for 16 weeks, the maximum Accommodation Supplement payable. This will mainly help people who

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<sup>13</sup> For employees who qualify, this tax credit will essentially reduce the amount of PAYE deduction from their salary or wages. Self-employed or non-PAYE workers would also be able to access this tax credit provided they qualify and fill out a tax return or request a personal tax summary from the IRD.

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have overextended themselves with respect to their housing; in particular, people who face the prospect of losing their homes if unemployment causes them to default on their mortgages. It will not help renters with cash assets (eg savings for a deposit on a house) who will therefore be unlikely to qualify for an Accommodation Supplement.

A payment that is supposed to be a work incentive made to those who are not working, and to only a selected group of those who are not working and who meet stringent criteria, is likely to produce a new raft of inequities and inconsistencies. These issues are likely to be brought into sharp focus as the recession deepens in 2009. Data has been scanty, but the figures obtained under the OIA show that only 762 families were receiving the ReCover payment (MSD, personal communication).

### **5.2 Human rights breaches by IWTC alleged**

Another unanticipated consequence of the IWTC has been a sustained attack on it by New Zealand child rights advocates who have argued that the IWTC is unlawful discrimination in terms of Human Rights legislation.

A claim between Child poverty Action Group (CPAG) Incorporated, Plaintiff, and The Attorney-General, Defendant, was brought under the Human Rights Act 1993 and its amendments. This case, CPAG v Attorney General was heard in the Human Rights Review Tribunal in June/July 2008. The case had originally been filed in 2002 against the CTC which became the IWTC in 2006. The history, documents and decision of this protracted and expensive exercise can be accessed at [www.cpag.org.nz](http://www.cpag.org.nz).

The plaintiff argued that the IWTC is a part of weekly family assistance to help meet the needs of low income children. Yet children can miss out on this payment solely because of the work status of their parents. It was claimed that the IWTC constitutes unlawful discrimination under Part 1A of the Human Rights Act 1993 (HRA) and breaches New Zealand's obligations under the United Nations Convention on the Rights of the Child (UNCROC). The fall in the rate of child poverty in New Zealand, as a consequence of the IWTC and attributed to the WFF package, was, it was alleged, achieved by reducing the poverty only of those children whose parents are in work.

This case is of considerable international interest as it is the first time the government's own policies have been challenged under Human Right legislation in a class action. In a 100 page judgment, the judge upheld the claim of discrimination against 230,000 of the

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poorest children in New Zealand who do not benefit from the part of their family assistance called the IWTC. In particular, Paragraph 192 stated:

*We are satisfied that the WFF package as a whole, and the eligibility rules for the IWTC in particular, treats families in receipt of an income-tested benefit less favourably than it does families in work, and that as a result families that were and are dependent on the receipt of an income-tested benefit were and are disadvantaged in a real and substantive way. (Human Rights Tribunal, 2008, p. 72)*

The Tribunal expressed concern at the lack of human rights considerations in the IWTC policy formation and in its extension in 2005:

*... we have significant concerns about the decision to make the WFF tax credits available to families with incomes in the mid to high range. (Human Rights Tribunal, 2008, p. 4 footnote).*

OECD witnesses for the defendant also questioned the appropriateness of having an IWB apply so far up the income scale (Human Rights Tribunal, 2008, p. 27). Despite these criticisms, and the strong finding of discrimination, the Tribunal did not, in the end, uphold the claim that there had been a breach of Part I A of the Human Rights Act, finding the discrimination to be “of a kind that is justified in a free and democratic society” (Human Rights Tribunal, 2008, p. 4). The justification arguments related to the intention of the policy, but there was no attempt to quantify either the total costs or total benefits to society from the work incentive aspect. The decision has been appealed and is likely to be heard in late 2009.

The IWTC as a work incentive raises important equity and social issues because of its unusual design. It is tied to children, and denied to workers without children although some of these workers may be more in need of an incentive, or more sensitive to the effects of a tax incentive. The human rights implications, including its disproportionate impact on the indigenous population have yet to be resolved.

### **5.3 The young child’s perspective**

Paid childcare has been promoted as preferable to parenting one’s own child under the making work pay regime. OECD economists (see Appendix C) are among those who have advised the New Zealand government, and expressed views such as:

*...at some point between six months and one year would seem to be the appropriate amount of time, from the point of view of the child, for child development purposes. From the labour market point of view, design of parental leave involves a trade-off. Providing some parental leave can*

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*encourage women to enter the labour market. Providing too much parental leave can mean that they spend so long outside of the labour market that their skills decline. Again, that tends to point to something round about six months as being the ideal, the optimal amount of paid parental leave.(CPAG v Attorney General, 2008)*

In contrast there is an emerging body of research that suggests that day care, especially for children under three may be harmful to their development:

*A great change is coming over childhood in the world's richest countries. Today's rising generation is the first in which a majority are spending a large part of early childhood in some form of out-of-home child care. At the same time, neuroscientific research is demonstrating that loving, stable, secure, and stimulating relationships with caregivers in the earliest months and years of life are critical for every aspect of a child's development. Taken together, these two developments confront public and policymakers in OECD countries with urgent questions. Whether the child care transition will represent an advance or a setback – for today's children and tomorrow's world – will depend on the response.(Adamson, 2008)*

In a downturn there are other dynamics, as women with young children are early casualties in the casual hours job market. The commercialisation of the early childhood care holds fiscal risks especially in a downturn when government, as in Australia, finds they have to rescue the industry they have created through subsidies.

## **6 Conclusion**

New Zealand has adopted a radical and unusual work incentive programme for selected members of the working age population, of which the IWTC is the centerpiece. There are superficial similarities to the US EITC and the UK WTC but the NZ IWTC has unique design features.

The target of the work incentive is sole parents on benefits, based on the assumption that sole parents are not working because 'work does not pay'. While the IWTC is child-focused it is not nuanced or graduated to allow for either age, health and numbers of children in smaller families, nor the health status of the sole parent. These factors may critically affect the ability to work. Because the IWTC is a part of family assistance that is only paid to those parents who are off benefit and working set minimum hours a week, it excludes approximately 230,000 children (22% of all children under 18). The effect is that sole parents in particular who cannot respond to the work incentive to work at least 20 hours a week, do not get this child-focused payment and are significantly disadvantaged. The policy has proved vulnerable to challenge on human rights grounds.

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The overall WFF package was a complex set of measures that are best not seen in isolation. While family assistance was increased for all low income families, benefit cuts facilitated at the time along with the IWTC produced a relative income gap that has perpetuated the poverty of those not in work. Thus there is a direct conflict between the income adequacy/poverty prevention goal and the work incentive goal. In Section 2.1, it was noted how one should not be achieved at the expense of the other. This situation is unlikely to be sustainable in the recession when work incentives can no longer operate to keep parents in work. Given the reality of child poverty in developed countries and its measurable and permanent negative outcomes, at very least a child impact assessment should be included in future evaluation and development of policy.

The empirical results are difficult to evaluate and are at best mixed, with the small improvements in employment attributed to the WFF package not likely to be sustained in the recession of 2009. Empirically, it is difficult to attribute the recorded improved employment results for sole parents to the IWTC alone. Significantly increased child care subsidies and access, and the operation of the MFTC, have both been very important. A stronger economic environment; higher minimum wages; lower tax rates; and changes in the abatement of family assistance, are other factors.

The New Zealand experience demonstrates what can happen when IWBs are not carefully designed and understood as to their objectives. The payment of the IWTC to high income families resulting from the extension (pre-election 2005) cannot be rationalised in work incentive or 'making work pay' terms. Once introduced, such a payment is costly, and difficult to abolish. It also creates the necessity for other complex compensating policies such as the new Independent Earner Tax Credit and the ReCover payment (see section 5.1)

Other mechanisms to assist the transition in work may bear more fruit. It is noted also that the less distortionary tools of raising the minimum wage, raising the threshold and reducing the rate of abatement for family assistance, are potent work incentive tools. In this respect, the pre-election 2005 changes had positive work incentive effects for families earning between \$27,000 and the new threshold of \$35,000, and from the lower rate of abatement (20% down from 30%) above \$35,000. This was therefore a missed opportunity to abandon the IWTC as part of a trade-off.

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The IWTC is not necessarily paid to the worker and so is less directly related to work effort than the WTC-UK or the EITC-US. It is frequently paid to the caregiver who may not be in work at all. At the higher income level this payment is more clearly understood to achieve a degree of horizontal equity for families of different sizes. At lower income levels, the vertical equity and child poverty prevention effects suggest that it ought to be available for all.

From a work incentive perspective, paying the IWTC to higher income families unambiguously acts to reduce work effort especially of the secondary earner due to the income effect. It has further disincentive effects as EMTRs rise once the payment is abated at 20 cents in the dollar. The EMTRs for couples in 2009 tax terms range between 32.5% and 58%.

An overall assessment of the IWTC must balance the employment gains against the employment losses and count the full cost to the government revenue. The fiscal costs of the IWTC (approximately \$500m pa) plus child care subsidies, plus increased MFTC payments, plus case management costs, are offset only minimally by reduced welfare benefits for sole parents. These fiscal costs in turn produce deadweight losses elsewhere as they are paid for by higher taxes or borrowing.

The most convincing argument for the IWTC may be that as a lump-sum approach it *may* encourage attachment to the full-time labour market which *may* have long-term benefits. There is little or no evidence that the IWTC can or will operate this way for sole parents especially with young children. The positive gain for the economy from additional hours of work by low-wage sole parents is at least partially, if not fully offset by the increased costs of childcare services. If more women are working, but many more are working in the commercialised childcare sector, or other low paid service work there are few gains for the economy.

If, however, labour market attachment is the intention there is no reason to exclude the young, single, and childless from it. The policy implication of this paper however indicates that the design of the IWTC is inappropriate for meeting the work incentive objective.

The dual requirement of meeting hours of work and being off benefit to qualify for the IWTC makes it difficult to administer and reconcile with income earned on an annual basis. Repayments demanded at the end of the year when incomes are higher than

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anticipated or work hours have fallen can reverse work incentive effects and create a distrust of accessing such tax credits. An ‘hours of work’ requirement can also create perverse incentives to overstate hours, while the work subsidy implicit in the MFTC can be appropriated by the employer who then may pay lower wages creating an unfair bias against unsubsidised workers.

It is likely that New Zealand and other countries will have more focused policy debates on these and other issues in the near future. In these discussions the role of the IWTC may be seriously questioned. However once a policy such as the IWTC is implemented it may be difficult to reform. In the case of New Zealand the trade-offs that were possible with the raising of the threshold for family assistance and the reduction of the rate of abatement in 2006; and the redesign of tax rates in 2008 and 2009; are not open to being exploited in the future. This implies that a reform of the costly IWTC may create losers.

One possibility is not to index the payment for inflation and allow it to erode over time. If the poverty objective is to receive due attention, the IWTC could be added to the rest of family assistance so that all poor families receive it as a child supplement, leaving work incentives to come from the non-discriminatory policies of lower taxes, a higher minimum wage, and lower abatement. However, this path would cost more than the existing policies.

## 7 Appendix A : use of 'in work benefits' in New Zealand

As noted, the IWTC was introduced in New Zealand in 2006 as part of the WFF package. This section provides a brief overview of the nature of that welfare and tax system, and documents the nature of in-work benefits and other labour market interventions since the mid 1980s.

### 7.1 Background<sup>14</sup>

Fragmentation and inefficiency in the delivery and administration of welfare payments had been the subject of several Treasury papers throughout the 1980s. Treasury economists had also stressed the problems of overlapping income tests, and the work disincentives of the high EMTRs that are implicit in such tests.

Treasury's 1990 briefing papers to the incoming National government noted that more people faced higher EMTRs over longer ranges of potential income implying greater costs to society and a greater probable loss of output:

*An indication of the effect of such scales is the fact that very few people are in jobs with an income at the level where the maximum rate of benefit abatement applies; instead they tend to have no job at all, rather than work for little gain. This is worrying since it discourages part-time work, which may be the most appropriate employment for some beneficiaries.* (The Treasury 1990, p. 110)

The 1991 Budget document "Welfare that Works" (Shipley, 1991) put forward a vision of a seamless, global system of abatement of all social assistance. The mechanisms were described with the aid of 3-dimensional diagrams that showed that a single-family income test and a single phase-out rate were to apply across all forms of social assistance (Shipley 1991, p. 43). The Treasury had also identified high levels of benefits as a major factor preventing a more gradual abatement system, and it was announced late in December 1990 that benefits would be cut significantly. Reducing benefits to very low levels can be seen as the policy approach to "in work benefits" in this period.

In brief, these changes involved making virtually all social assistance targeted by income testing and included:

- Significant benefit cuts;
- Lengthened stand down periods and tighter eligibility rules for welfare benefits;
- No change to rates of abatement of benefits for other income, the level of exempt income was held at 1986 levels;
- All 'per child per week' family assistance became targeted using the test of combined parental income. ( St John and Rankin, 2009)

High EMTRs are required if targeted payments are bled out as quickly as possible and thus the poverty trap problem is confined to as few people as possible. As St John and Rankin (2009, p 5) note, "the more that is included for abatement, the longer the income range over which abatement applies, and the more people are affected." Even using a single bleed out rate, the rate of abatement under the welfare to work reforms would have needed to be high because lower rates would prolong the abatement range unrealistically.

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<sup>14</sup> This section draws on (St John & Rankin, 2009) detailing the Labour government's policies of the late 1980s, those of the National government in the 1990s, and Labour again in the 2000s. Remarkably few changes in policy directions were made in this area as these transitions occurred.

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*Unfortunately, a clawback of 50% coupled with marginal tax rates of 21% or 33% gives rise to effective marginal tax rates of 71% or 83%. And, even with a 50% abatement rate, the range of income over which a couple or an individual might be affected is wide. (St John and Rankin 2009, p. 5)*

Despite the highly integrative view stated in “Welfare that Works”, family accounts were unworkable and eventually abandoned (St John and Rankin 2009, p. 6). This left a highly targeted welfare system with overlapping income tests and the work disincentive effects of high EMTRs.

In 1996, The Tax Reduction and Social Policy Programme (Birch, 1996), announced three critical policy changes to ease the inherent disincentives in the welfare system:

- lower statutory rates of tax;
- the introduction of the Independent Family Tax Credit (IFTC) (later renamed the child tax credit (CTC)); along with increases in Family Support, especially for older children; and
- increased earning allowances for some beneficiaries.

Some of these changes lacked a consistent basis of agreed principle.

*Thus, in contrast to the previous policy that treated all children of low-income families the same for weekly income support, the CTC discriminated against the children of parents regarded as dependent on the state. And, while the claimed intent was to strengthen families, the new claw back procedures for those on benefits discriminated against intact marriages with children. (St John and Rankin 2009, p. 6)*

It was planned that by 2008 the system of entry into social security based on unemployment, sickness, disability and sole-parenting would be replaced by a single core benefit, with entry on the basis of income insufficiency. While the core benefit has not been implemented to date, as Lunt, O’Brien & Stephens (2008, p. 3) note: “Rules of eligibility and entitlement have been altered to make explicit the work-first nature of benefit delivery for all income-tested beneficiaries.”

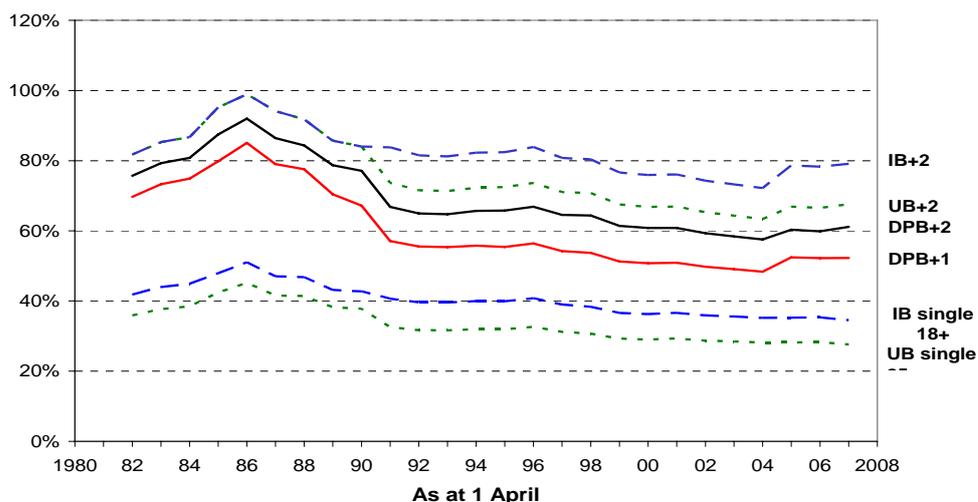
Much of the welfare system as developed in the 1990s remains in force in 2009. In family assistance, the CTC has been replaced by the IWTC discussed in detail below. Benefits remain at historically low relative levels (except for the state pension). Benefits are income-tested against joint income for a couple, and a couple and an individual have exactly the same threshold of allowable earnings before abatement occurs. This threshold of \$80 a week has not been adjusted for inflation since 1986.<sup>15</sup> This provides a severe disincentive to engage in part-time work with EMTRs of 92.3% for earnings above \$80.

Figure 6 below shows the drop of value relative to after-tax wages of representative welfare benefits: UB (Unemployment Benefit), IB, (Invalids Benefit) and DPB (Domestic Purposes Benefit), including family assistance.

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<sup>15</sup> This \$80 is just over 8% of the gross average wage of \$957 (October 2008). In 1986, it was 21% of the average wage of \$379 p.w. Between 1986 and 2008, the minimum wage increased from \$4.25 to \$12.00. By 2009, the \$80 threshold should be \$210, and the government has reversed a promise to raise it \$100 from 1 April 2009.

Figure 6. The value of benefits relative to the net average earnings



IB+2 : a couple in receipt of the Invalid's Benefit, with two children

UB+2 : a couple in receipt of the Unemployment Benefit, with two children

DPB+2 : a sole parent in receipt of the Domestic Purposes Benefit, with two children

DPB+1 : a sole parent in receipt of the Domestic Purposes Benefit, with one child

(Source: Perry (2008, p. 40))

For a sole parent with 1 and 2 children, Working for Families in 2005 slightly reversed the downward relativity trend. Not shown in Figure 6 by 2008 and 2009 this downward trend had reasserted itself as tax cuts improved net average earnings but did not affect net benefits which are only adjusted for prices.

## 7.2 Other work-related benefits<sup>16</sup>

As noted, any assessment of the IWTC must take into account other policy changes that also impact on the decision to work. Child care is a critical cost of working and the state-related payments for child care increased under WFF.

### 7.2.1 Childcare subsidy:

The Childcare subsidy programme aims to assist low and middle income families by providing assistance with the costs of any licensed childcare, family day care, home-based care and chartered Te Kohanga Reo<sup>17</sup>. It is paid directly to the childcare provider and is available to any families with children under the age of 5. Childcare subsidy is usually paid for 9 hours per week. In order to qualify for up to 50 hours of paid childcare per week, the main carer of the eligible child must be either in paid employment, training, job-seeking activity, attending a course of study in a tertiary or secondary institution or be involved in a rehabilitation programme.

The amount paid depends on the weekly income of the care-giver and the number of children who are eligible for the childcare subsidy. In October 2004 and again in October 2005, the income limits entitling families to receive Childcare subsidy were raised under the Working for Families package. In July 2007 the government also introduced 20 hours of free daycare for 3 and 4 year olds.

<sup>16</sup> This section draws on the Centre for Social Research and Evaluation's 2007 report: *Receipt of the Working for Families Package: 2007 Update*.

<sup>17</sup> Maori language preschool.

## **Draft only do not quote**

There has been an increase in the number of childcare subsidies granted each year for the last three years. This reflects the combined impact of changes in the number of children aged under 5, increased employment of sole parents, and broadened eligibility of low-income working families under Working for Families.

### **7.2.2 Out of school care**

An OSCAR (Out of School Care) Subsidy assists low and middle income families with the costs of approved before- and after-school care and holiday programmes for children between ages 5 and 13. Parents are eligible to receive an OSCAR subsidy for 20 hours a week in term time and up to 50 hours a week during school holidays if they work or study, or if they or their child have a disability or a serious illness.

In 2004, the Working for Families package raised the income limits for families to receive an OSCAR subsidy. The hourly subsidy rates were also increased from October 2004 to equal Childcare Subsidy rates, as well as being raised in line with inflation from April 2005. Hourly rates were raised again from October 2005.

There has been an increase in the number of children covered by an OSCAR subsidy since 2003. This reflects a combination of the Working for Families package (which widened eligibility and increased subsidy levels) and increased use of subsidies by the carer's benefit recipients who are in education, training or employment.

There has also been a change in the mix of caregivers who receive the OSCAR subsidy. The widening of eligibility to low-income working families under the Working for Families package is shown by the changes between 2004 and 2007. In 2004, around 52% of the children covered by an OSCAR subsidy had caregivers who received no pension or main benefits, but in 2007 around 80% of the children covered by the subsidy had a caregiver who did not receive a pension or main benefit (Centre for Social Research and Evaluation, 2007, p. 21).

The large increase in expenditure on Childcare and OSCAR subsidies since 2003/2004 is largely attributed to the impact of Working for Families, extending the range of incomes eligible for assistance.

### **7.2.3 Hardship Assistance**

Temporary Additional Support (TAS) is available in cases of hardship. Amongst these costs that may affect working people are:

- Repayment for previously purchased vehicles in situations where there is no suitable public transport available and the vehicle is required for employment reasons or because of disability in the family;
- Employment related costs (e.g. childcare, public transport or vehicle costs).

The Recoverable Assistance Programme, introduced in 1996, provides non-beneficiaries with financial assistance that is non-taxable, interest-free, and recoverable, so they can meet essential, immediate needs for specific items or services.

### **7.2.4 Accommodation Supplement**

The Accommodation Supplement is available to assist people with limited income and limited cash assets to meet their accommodation costs.

The Working for Families package increased the income limits for the Accommodation Supplement, and also changed the abatement regime. Under these abatement changes, beneficiaries receiving an Accommodation Supplement and earning additional income no longer have their Accommodation Supplement abated while they remain on a benefit. Once people enter paid work, however, their Accommodation Supplement is abated at 25% above a base level of income. This adds to the EMTR and thus to work disincentives for recipients.

### **7.2.5 Transition to Work Grant**

Transition to Work assistance is paid in order to assist people from benefits to employment and to remain in employment. As well as meeting essential costs for job search and entering employment, Transition to Work Grants may be available to assist with costs related to relocation and safety equipment and to assist with covering living costs between the last benefit payment and the first pay from a new job. A maximum of \$1,500 in Transition to Work Grants is available in any 52-week period.

To qualify for the Transition to Work grant, the person is required, among other things, to:

- Be seeking paid work for a position of 30 hours or more per week;
- Have a verified job interview for a position involving at least 30 hours of work per week, or have a verified job offer involving at least 15 hours of work per week (excluding self-employment);
- Have an essential cost because of the job interview or job offer;
- Be unlikely to make the transition into paid work or to be able to attend the interview without receiving a Transition to Work Grant.

People seeking work involving less than 30 hours per week may access Transition to Work Grants if it is reasonable and appropriate (e.g. if there is no full-time work available, the client is working with the Work and Income (WINZ) to progress towards full-time employment, the person is unable to work full-time but is able to work limited hours).

### **7.2.6 New Employment Transition Grant:**

A new Employment Transition grant, introduced in January 2009, is available to people with one or more dependent children during the first six months after take-up of employment and cessation of their main benefit. To receive the grant, these people must be temporarily unable to meet their work commitments because their partner or child is sick and there is no sick leave available, or they have exhausted their entitlement to paid sick leave. Similarly, the grant can be available if there has been a breakdown in childcare arrangements, and the parent either has no paid leave available or has exhausted their paid leave entitlement.

### **7.2.7 Course participation assistance**

This programme provides non-taxable, non-recoverable financial assistance towards the actual reasonable costs for people participating in a short-term (generally less than 12 weeks) employment-related training course or programme.

### **7.2.8 Welfare to work policy 1998-9**

The Community wage, introduced in 1998 and abolished shortly after the 1999 election, was a policy instrument used to move people from welfare into training and employment. The Community wage replaced the unemployment benefit and contractually obliged the unemployed to accept community work as and when offered. Individuals were also required to undertake training and organised activities as specified by the DWI. It was hoped that increased participation in work-related activities would reduce the “benefit dependency” associated with long term unemployment.

Since 1999 the community wage policy has been replaced by a case management approach (Humpage, 2007).

## 8 Appendix B Tax Credit approaches

### 8.1 The Earned Income Tax Credit in the US

The Earned Income Tax Credit (EITC) was introduced in the US in 1975. It was designed to reduce the burden associated with Social Security taxes in order to supplement income of low income earning families and at the same time strengthen the incentives to seek, take up and retain employment. EITC is a refundable credit, meaning workers can reduce their tax to zero and then receive a refund of any remaining credit. To qualify, taxpayers must meet certain requirements, including earning taxable income.

The EITC underwent expansion during the 1980s under the Reagan administration, but perhaps the largest expansion occurred in 1993 under the Clinton administration and today it is a very significant redistributive programme costing US\$40 billion in 2007 (Pearson et al 2008, p. 13). One of the stated objectives of the 1993 expansion was to ensure that lone parents in full-time, low wage employment were lifted out of poverty. Estimates for late 1990s show that a lone parent in full-time work with two children would indeed have an income above the poverty line (Pearson et al 2008, p. 31)<sup>18</sup>.

The EITC rates differ for families with 1 child, 2 or more children, and no children. While it does not distinguish between single parent families and two parent families, it treats married and unmarried couples differently. Unmarried couples can file separately and thus each receives the tax credit, whereas the earned incomes of married couples are aggregated. If their aggregate income would put them in the phase-out range, there is a perverse incentive for couples not to marry, or if married, to separate and receive separate EITC credits (Ellwood, 2000).

Rather than an “hours worked” basis as used in New Zealand, the EITC entitlement is assessed on an “earned income” basis. The EITC is designed to offer a subsidy to low earnings and operates over three ranges of income. In the first range, the phase-in, the credit increases as income increases. In the second range, the plateau, the EITC credit remains constant; then over the third range, the phase-out, the EITC credit is abated (Pearson et al, 2008, p. 24).

Table 9 includes the ranges for the Phase-in, Plateau and Phase-out stages for families with a single child, 2 or more children and families with no children. Ranges for married couples are higher than for single adults and are included under each respective category.

**Table 9. The US EITC 2007**

Number of children:	Benefit:	Phase-in:	Plateau:	Phase-out:
1	34%	US\$ rates pa in 2007		
single		0-8,390*	8,390-15,390*	15,390-33,241*
married		0-8,390	8,390-17,390*	17,390-35,241*
2 or more	40%			
single		0-11,790	11,790-15,390	15,390-37,783
married		0-11,790	11,790-17,390	17,390-39,783
no children	7.65%			
single		0-5,590	5,590-7,000	7,000-12,590
married		0-5,590	5,590-9,000	9,000-14,590

\* thresholds are indexed for inflation A numerical example illustrates the method of determining a family’s total EITC. Take a family with 2 children and one adult in paid employment earning US \$13,000. The EITC credit is at its maximum of 40% of \$11,790 i.e. \$4,716 and will not

<sup>18</sup> Quoting Hotz, V.J, and Scholz, J.K. (2003), “The earned income tax credit”, in R. Moffitt, ed., *Means-Tested Transfer Programs in the United States*, University of Chicago Press, Chicago.

## **Draft only do not quote**

change unless earnings go beyond \$17,390 threshold, at which point the credit will begin to be abated. Full abatement has occurred by \$39,783 (in 2007, increased to \$41,646 in 2008).

When the EITC exceeds the amount of tax owed by the individual, it results in a tax refund for those who claim and qualify for the credit (Internal Revenue Service, 2008). It is also important to note that the EITC has no effect on certain welfare benefits like Medicaid, Supplementary Security Income, food stamps, low-income housing, or most Temporary Assistance for Needy Families (TANF) payments.

### **8.2 Evaluation of the US EITC**

There is evidence that the EITC has had a positive effect on the labour supply. In particular, this effect is most evident when we look at the percentage change in the labour force participation rate of single women with children. Evidence shows that weekly employment of single women with children increased by about 6 percentage points, while their yearly employment rose by almost 9 percentage points during..... (Meyer & Rosenbaum, 2001).

Other findings also indicate that the EITC had a very significant effect on welfare use, for example, Groger (2003) finds the EITC might be the most significant policy measure that explains the fall in welfare use and increase in employment among female-headed families.

Other groups, such as single women with no children, married women and black men, did not experience similar gains in employment. In one study, mothers with young children and mothers with low education levels saw the most significant gains in employment, but there were also some positive changes for primary earners in two-parent families with low incomes, resulting in a small increase in their employment rate (Eissa & Hoynes, 2004). Other studies found a small decrease in the number of hours worked by the secondary earner in married couples.

There is also evidence of a significant impact of the EITC on the distribution of income within the USA. Statistical evidence shows that a large proportion of the people who receive the EITC are below the poverty line, most notably, around 26% of the recipients of the EITC are on food stamps, which is a major indicator that EITC has a strong anti-poverty focus (Liebman, 2000). On top of that, the EITC has been made more generous over the years and in particular after 1993 and there was an increase in the number of people applying for EITC. The combination of the increase in the number of people that receive EITC and the amount that is available to them is attributed to lifting a large number out of poverty in the US.

### **8.3 Criticisms of the EITC**

There are 4 major criticisms of the EITC system:

- Expenditure associated with the EITC programme;
- Error rate of the EITC programme;
- The effect on the average hours of work;
- Timing of the EITC credit.

The level and growth rate of expenditure associated with the EITC since its inception has been a concern. The cost of running the EITC increased from US \$1.7bn in 1986 to US \$18 billion in 1996 to around US \$40 billion in 2007 (Pearson et al 2008, p. 13). This could be an indication that a large proportion of the EITC expenditures is 'dead-weight' in a sense that it goes to people who are already adequately employed. However, while expenditure has increased over time, in comparison with other developed nations, US social expenditure between 1980 and

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1999 is between 2.7 and 3.6% of GDP, “a far lower level than every other country group” (Scholz, Moffitt, & Cowan, 2008, p. 30).<sup>19</sup>

A second concern is that the EITC has been and continues to be subject of significant error. Payments made in error include fraudulent claims and payments that were made in error due to the complex nature of rules surrounding the EITC. The two main avenues for fraudulent gains with the EITC stem from people filing misleading information about the hours they have worked or wages they have received and secondly, claiming to have children living in the household (Greenstein & Shapiro, 1998; Liebman, 2000). Claiming to have children living in the household is particularly significant, since the number of children or even presence of children in the household has a major effect on the amount of the EITC credit received.

It is estimated that around 20.7% of all EITC credit is paid in error. Although this level is very high, it is significantly lower than the 35% error rates reported in the 1980s. Greenstein and Shapiro (1998) also note that not all of the errors associated with the EITC are a result of fraud: a large proportion of errors are a result of complex rules surrounding the EITC. One example given is that of a parent claiming a child under the EITC, but due to the complex nature of the EITC rules, another member of the family should have claimed the child instead. In this case, the amount paid to the person that claimed the child was a lot more than it should have been. Errors of this sort amount to nearly a fifth of all errors associated with the EITC (Greenstein & Shapiro, 1998).

A number of changes and counter-measures have been introduced in order to reduce the error rate of the EITC system. Individuals applying for the EITC must provide the Social Security numbers of the children they claim under the EITC, including the children under the age of 1. This measure should eliminate any errors that were caused by misleading or erroneous information regarding the relationship of the applicant and the child in question. On top of that, there will be no payouts for the claims with lost or invalid Social Security numbers. It will now be the responsibility of the filer to provide the valid Social Security number in order to receive the EITC.

Another area of concern is around the total effect the EITC has on the hours of labour supplied. EITC might have a positive effect on employment, due to the increase in the “gap” between those who are working and those are out of work. But on the other hand, there could be an adverse effect on the total number of hours provided by individuals because of the phase-out. Total effect on the number of hours of work provided by the people who are eligible for the EITC credit depends on numbers of people in each of the phase-in range and the phase-out range.

Finally, there is a major issue with the timing of the EITC credit. Most families that are eligible to receive the EITC credit will choose to receive it at the end of the financial year, thereby reducing the probability of having to pay back some of the EITC credit if they received too much of it during the year (Coutts, 1999). This makes the payment less connected with the reward from the immediate work effort.<sup>20</sup>

Another possible explanation as to why families would choose to receive the EITC credit at the end of the year could be found in the examination of the way in which the family chooses to spend the credit. While most families use the EITC to pay for essentials like food or outstanding bills, some families will choose to invest the money in things that could improve their economic condition, like paying for education, new housing or a new car (Currie, 2006).

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<sup>19</sup> Between 1980 and 1999, social expenditure in other Anglo countries averaged between 4.8% and 7.8% of GDP, and averaged between 8.1% and 15.3% of GDP in the Northern Europe and the Scandinavian countries (Scholz, Moffitt & Cowan, 2008, p. 30).

<sup>20</sup> As shown by the need to file a tax return to get the full refund, and as shown by the maximum an employer can advance which is less than the maximum possible payout.

### **8.3.1 Use of the couple as the unit**

There are several issues that arise from aggregation of income for families with married adults. Since income is aggregated for the purposes of determining the total credit that the family is eligible for under the EITC, there is a disincentive for the secondary earner to increase the number of hours worked. This effect is observable during the periods of EITC expansion (Pearson et al, 2008, p. 26) and is most pronounced for the families with aggregate income within the phase-out range, where the secondary earner is almost 5% less likely to work (Eissa & Hoynes, 2004).

Another effect of the income aggregation for the purposes of determining EITC credit is that it might discourage parents from getting married if both adults are in low-income employment and have children together. The basic concept is that if their aggregate income would put them in the phase-out range, it is more beneficial for both adults not to marry, or to separate and receive separate EITC credits (Ellwood, 2000). This effect on marriage<sup>21</sup> and cohabitation patterns could have a long term impact that is not obviously quantifiable at present, but could become more apparent in the future.<sup>22</sup>

As the EITC has become the significant vehicle of poverty reduction, out of work benefits have been allowed to slip further behind (Scholz, Moffitt & Cowan 2008, p. 11).<sup>23</sup> Poverty among single mother-headed families has fallen from 35.4% to 24.7%. But while poverty decreased, the number of people in deep poverty (i.e. people below 50% of the poverty line) has increased (Acs & Toder, 2007). Those who are able to find employment may experience the benefits of higher earnings under the EITC, but those who are unable to find employment slide further into poverty, due in part to the reduction in spending on non-work related welfare benefits after 2000 (Scholz et al 2008, pp. 10-16), and to the tighter eligibility criteria.

Many commentators note that single mothers with dependent children have had the greatest response to the EITC (Pearson et al 2008; Scholz et al 2008). However, these studies do not go into detail about the kind of employment these single mothers enter and whether or not it is desirable for single mothers to enter employment when they have dependent children at home. It is also noted that in some cases single mothers would be incentivized to remain in low-wage jobs with little flexibility and reduced overtime pay in order to qualify under the work requirement of the EITC (Herbst, 2008).<sup>24</sup>

Finally, there is an issue in measuring the true effect the EITC has had on employment. While the EITC programme has appeared to increase employment levels in the USA, it is hard to tell how much was due to the strong economic environment that the USA experienced during the 1990s and 2000s (Herbst, 2008). More recent data in the US suggests that.....

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<sup>21</sup> Marriage in the US is legally defined as “taking the vows”, and unlike New Zealand, there appears to be no de-facto category.

<sup>22</sup> “By far, the EITC serves as the largest source of both penalties and bonuses for low-income families. Couples composed of one person with children and low or no earnings typically receive a higher EITC on marriage (because their combined earnings are typically below the EITC thresholds) while couples in which both partners have modest earnings are likely to lose their EITC on marriage because their combined income exceeds that which is eligible for the EITC.” (Maag, 2005)

<sup>23</sup> <http://workforcesecurity.doleta.gov/unemploy/uifactsheet.asp> Each US State administers a separate unemployment insurance program under Federal law guide-lines. Although three States also require employee contributions, benefit funding is usually based on a tax imposed on employers. Benefits are based on a percentage of an individual's earnings (up to a State maximum) over a recent 52-week period, and can be paid for a maximum of 26 weeks. Some States provide additional benefits for specific purposes, and additional weeks of benefits during times of high unemployment.

<sup>24</sup> This area is not well addressed in the academic literature, and more information is desirable.

### **8.3.2 Evaluations in summary**

While small gains in employment were experienced by groups such as single women with no children, married women, and black men, the positive effects that the EITC has had on the labour supply are most evident in the percentage change in the labour force participation rate of single women with low education levels, and with children. From 1984 to 1996, their weekly employment increased by about 6 percentage points, while their yearly employment rose by almost 9 percentage points (Meyer & Rosenbaum, 2001).

There have been some positive changes for primary earners in two-parent families with low incomes, resulting in a small increase in their employment rate (Eissa & Hoynes, 2004), at the same time as there has been a small decrease in the number of hours provided by the secondary earner in married couples with children. Orsini (2007) argues the small financial loss caused by this reduction in the hours worked is more than offset by the benefit of an increase in the non-market (ie at home with the children) time of the secondary earner

The EITC has impacted significantly on the distribution of income within the USA. For example, around 26% of the recipients are on food stamps, a major indicator that EITC has a strong anti-poverty focus (Liebman, 2000). Although US social expenditure is comparatively low, the EITC has regularly been made more generous since 1993, and this, in combination with the increase in the number of people that receive EITC, has lifted a large number of people out of poverty.

### **8.3.3 What we can learn**

- The EITC is major redistributive programme that has increased the returns to work for low-paid people. It shows that:
- there may be greater political and public support for such work-based redistribution;
- it may increase attachment to the workforce of sole parents but may decrease that of secondary earners;
- it may perpetuate and even deepen poverty among those not in work;
- there are administrative/fraud problems with the appropriate unit and definition of marriage and presence of children;
- the success of the programme is constrained by the resources, as a percentage of GDP, that are allocated to it; and
- as with other labour market and poverty alleviation programmes, its success may be highly dependent on the prevailing economic environment..

## **8.4 The Working Tax Credit in the UK**

In the UK, although many academic studies on employment effects still refer to the Working Families Tax Credit (WFTC), it was reformed in 2003 when the child-related weekly assistance was separated from the work-related aspect. From this time, the Working Tax Credit (WTC-UK) provided the incentive to work, and the Child Tax Credit (CTC-UK) was the way in which the costs of children were recognized in low income families.

Currently, the CTC-UK is available for all families with children that earn income below the threshold level. The WTC-UK is available for all families with low incomes that satisfy the work requirements. A lone parent must work for a minimum of 16 hours a week, and a person without children must work for 30 hours in order to qualify. Lone parents receive a larger payment than two-adult families. The CTC-UK and WTC-UK are designed to work close together in order to help families with low incomes.

### **8.4.1 Structure and eligibility:**

WTC-UK consists of various elements that combine in order to determine the total amount of benefit that the person is entitled for. Table 10 below summarises the elements of the WTC-UK (Her Majesty's Revenue and Customs, 2008; Pearson & Immervoll, 2008):

**Table 10. UK Working Tax Credit**

Family Type: Working Tax Credit Elements	Rates of credits (in GBP per year)
Basic Element (Paid to all who meet the conditions)	£1,730
Second Adult Element (For couples)	£1,700
Lone Parent Element (Single parents)	£1,700
30 Hour Element (Minimum 30 hours. Couple, 1 child, can share 30 hours work if one works 16 hours pw.)	£705
Disability Element	£2,310
Severe Disability Element	£980
50 plus Element (16-30 hours)	£1,185
50 plus Element (30 hours)	£1,770
Childcare Element (Up to 80 pence a pound that the family spends on registered or approved childcare)	1 child to £175 pw 2+children to £300 pw

(Based on Pearson & Immervoll 2008, p. 24)

CTC-UK is available for families that are responsible for at least one child or qualifying young person who usually lives with the family. CTC-UK is made up of the following three elements:

- Family element, available for all families with one or more children. A higher rate of family element, usually known as the “baby” element, is paid to families with one or more children under the age of 1. There is only one family element, regardless of how many children live with the family;
- Child element, paid for each child the family is responsible for;
- Disability element.

CTC-UK is paid directly to the person who is mainly responsible for caring for the child or children claimed under the CTC-UK. In contrast the WTC-UK is paid to the person who works for 16 hours a week or more. In case of couples, they are given an option of choosing who receives the WTC-UK payment. WTC-UK starts being abated at relatively low levels of income. If the income of the individual exceeds £5,220 a year, the WTC-UK is abated at a rate of 37 pence a pound, or 37%.

### **8.4.2 Effects on labour supply:**

A comprehensive statistical study conducted using data collected before the introduction of the previous WFTC and over the existence of WFTC until 2003 compared the labour participation before and after its introduction and found that labour supply of lone mothers increased by about 5.1%. Mothers in couples with a working partner had a decrease in their labour force participation rate of about 0.6%, while fathers had an increase in their labour force participation of around 0.8%. The study also concluded that, in absence of any in-work benefit, the labour force participation rate of lone mothers would be 45% instead of the 55% participation rate observed by the study (Brewer, Duncan, Shepherd, & Saurez, 2006).

The WTC-UK has a minimum working hours requirement, which means that it creates a “jump” in disposable income when a single person moves from 29 hours of work a week to 30 hours of

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work a week. This acts as a positive work incentive for low wage workers who work for less than 30 hours a week (Her Majesty's Treasury, 2008).

### **8.4.3 Distributional effects:**

Several studies have found that the WTC-UK and CTC-UK serve a strong distributional role, with most of the benefits going to families in the bottom half of the income distribution. The largest proportion of the benefit goes to families whose income is in the lowest two income deciles. This could indicate that families within this range have both the low level of income to qualify for the WTC-UK and CTC-UK, and at least one adult that works at least 16 hours a week (Her Majesty's Treasury, 2008).

It is also estimated that a person on the minimum wage working full-time has seen an increase in weekly earnings from £43 to £61 as the result of introduction of WTC-UK (Her Majesty's Treasury, 2008).

### **8.4.4 Administrative costs**

Administrative costs associated with WTC-UK and CTC-UK are relatively high when compared to alternative in-work benefit programmes. It is estimated that WFTC costs per family in 2003 were around 4 times as high as costs per family associated with EITC in the US (Brewer, Duncan et al. 2006).

## **9 Appendix C**

### **Extract from transcripts of the cross examination of OECD economists CPAG v Attorney General July 2008**

Q Are you aware that in New Zealand we only have 15 weeks paid parental leave following the birth of a child, which is fairly modest compared with certainly some of the European countries?

MR PEARSON: Yes, I am aware of that.

Q. I'm wondering whether that is something to consider in terms of very young children, not necessarily ill, and whether your view is that even when children are very young parents should be encouraged to do significant amounts of work, say 20 hours a week? Do you have a view on that?

MR PEARSON: Yes, yes, I do. The evidence on the effects of whether you should be in collective forms of childcare or whether the best thing is to be looked after by a single adult, which by-in-large tends to mean parents particularly mothers, tends to such that something round about between six months and one year

of care by your - care outside of collective care best, and the reasons for that are largely to do with health when it comes to it, that in collective care young babies are more likely to catch repeatedly minor illnesses which can retard their development. And so at some point between six months and one year would seem to be the appropriate amount of time, from the point of view of the child, for child development purposes. From the labour market point of view, design of parental leave involves a trade-off. Providing some parental leave can encourage women to enter the labour market. Providing too much parental leave can mean that they spend so long outside of the labour market that their skills decline. Again, that tends to point to something round about six months as being the ideal, the optimal amount of paid parental leave.

MR PEARSON: (PAUSE TAKEN TO REFER TO DOCUMENT).

Okay. One of our issues with New Zealand is - has been the large number of women who work part-time rather than full-time. Now, part-time work is great, my wife works part-time, everybody knows that part-time can sometimes be a very good way of reconciling work and family life.

However, there is no doubt that income part-time work can restrict your ability to have a career, and so anything that actually encourages part-time work as opposed to giving people a genuine choice about whether they want to work part-time or not is to be avoided if possible.

As Willem notes there, the childcare financial support of the time was restricted to a certain number of hours per day, 6 hours per day. This is actually quite common in many countries across the OECD and I find it bizarre, I don't understand what the logic behind this policy might be. Six hours a day in a childcare facility, once you've taken into account commuting time to collect the child, obviously restricts the financial support to people who are working part-time or rather full-time workers do not receive any additional support.

I believe that to be wrong; I think there is a case for trying to help parents who wish to work full-time by more than the amount of help that's given to parents who work part-time. And so, such an hours limit, which as I say is relatively common, we find unfortunate, unnecessary and indeed we would rather see more generalised supportive childcare which increases the number of hours that are actually used in childcare.

Q. Can you tell us what you mean by part-time and full-time?

MR PEARSON: We have a working definition for our statistics which uses 30 hours as a cut-off, less than 30 hours in our statistics is called part-time, more than 30 hours, full-time. That's

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a statistical convention, I wouldn't particularly wish to make a very strong case that that's the right absolute deadline; I would rather that people had the choice of how many hours that they could work and this distinction between part-time and full-time is really only a shorthand, but that would be our definition.(CPAG v Attorney General, 2008)

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