Lifting Families' Incomes

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Introduction

On 27 May 2004 the minister of social development announced a number of tax-benefit reforms (collectively known as Working for Families), to be phased in by 1 April 2007 (Nolan, 2005). These reforms increased the generosity and lowered the clawback of the Family Tax Credit, established the In-Work Tax Credit, indexed the Working for Families Tax Credits to inflation, removed the child components of main welfare benefits, changed the assessment, generosity and abatement of the Accommodation Supplement, and increased the Childcare and OSCAR Subsidy rates.[2]

Working for Families will account for an additional $1.6 billion of welfare spending per annum, significantly reduce child poverty, and improve financial incentives to work for many sole parents. Yet there are concerns over the complexity and administrative cost of these reforms, financial disincentives to work facing secondary earners, exclusion of recipients of main benefits from some assistance, and extension of assistance to middle-to-high income families. Further, personal income tax burdens have been increasing due to the failure to increase income tax thresholds with inflation since 1998, and labour productivity and wage rates remain much lower in New Zealand than in Australia. This paper thus argues that with the milestone of full implementation of Working for Families being reached, focus should now move beyond these reforms to a broader agenda for lifting families' incomes.

To encourage debate on this agenda, this paper provides an assessment of four policy instruments for lifting families' incomes. These are the:

- minimum wage;
- personal income tax scale (thresholds, rates and base);
- family and working tax credits; and
- main welfare benefits.[3]

The following section of this paper discusses trade-offs required in the design of income assistance policies and how increasing population heterogeneity makes reconciling these trade-offs more difficult. Four sections then summarise key issues related to the instruments for lifting families' incomes. A conclusion summarises the general strengths and weaknesses of these instruments and emphasises the need for greater integration and reduced complexity in the design of income assistance policies.

Diversity and complexity

The design of income assistance policies requires trade-offs between objectives to be made. For instance,

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2 This paper uses the recently introduced names for the Working for Families Tax Credits (formerly Family Assistance). The four programmes are the Family Tax Credit (formerly Family Support), Minimum Family Tax Credit (formerly Family Tax Credit), In-Work Tax Credit (formerly In-Work Payment) and Child Tax Credit (replaced by the In-Work Tax Credit but also grandfathered to ensure no 'losers'). A fifth credit, the Parental Tax Credit, is not discussed. A similar re-branding of these programmes occurred prior to the 1999 election and drew the following comment from the Hon Dr Michael Cullen: 'The other issue that I really am totally baffled by is this issue of the change of names. ... As soon as one changes the name of anything of this sort in legislation, it means that the forms have to be changed. That will create additional expenditure for no purpose at all. I have, I suppose, just a sneaking suspicion that perhaps part of the reason for this is that it gives the Government an excuse for a larger advertising campaign on this legislation between now and the election' (Hansard, 20 May 1999).

3 Given space constraints this paper omits discussion on accommodation and childcare assistance and child support. Discussion of these programmes can be found in Stephens (2003) and Cronin and Chapple (2007).

competitive labour markets do not generally adjust wages (paid to individuals) according to the number of children in a worker's family. Yet in order to ensure families have adequate incomes, policies target assistance according to family size. Consequently, when wages are low and family sizes large the income from work could fail to provide an adequate family income and be less than the income from transfers when not working. As a consequence of this dilemma, the design of income assistance needs to balance the goals of encouraging the supply of labour and ensuring adequate incomes, and this balance has to be found within a constraint of limited government funds (Mendelson, 2005; Nolan, 2006).

Reconciling trade-offs between objectives has become increasingly difficult due to changes in patterns of family structures, labour market outcomes and policy settings. In the decades since 1984 New Zealand has experienced significant changes in family structures, including the breakdown of the breadwinner model of social arrangements, increasing numbers of sole-parent families and increasing numbers of dual-income families. Important changes in the labour market have also taken place, with labour market liberalisation being associated with increasing part-time and casual work, variations in weekly hours of work and variations in wage rates. There has been a decline in employment among prime working-aged men, particularly low-skilled workers, and an increase in women's employment rates and representation in managerial and professional occupations (Callister, 2004).

Further, while the social assistance and income tax systems were largely devised as separate systems, large proportions of the population are now affected by both systems simultaneously (Stephens, 1997). This greater interaction reflects changes in family structures, labour market outcomes, and the designs of tax-benefit programmes, such as the taxation of main welfare benefits and the provision of supplementary assistance to non-beneficiaries. Over the last 20 years the income tax system has taken an increasingly prominent role in the provision of social assistance payments. This role has expanded further with Working for Families (Nolan, 2005).

These changes, particularly increased heterogeneity of family structures and incidence of part-time and part-year work, increased the complexity of designing income assistance programmes. Greater variations in hours of work, for instance, have made it increasingly difficult to design hours-based thresholds to encourage people to move from part-time to full-time employment. Further, by the early 1980s increased numbers of social assistance recipients made responding to changes in the level and incidence of poverty through increasing levels of main welfare benefits more fiscally costly. Consequently, additional demands were placed upon supplementary assistance and private charity to address areas of emerging needs (Stephens, 1999). These additional demands upon supplementary assistance themselves led to increased complexity, due to the administration and compliance issues associated with these programmes.

The Working for Families reforms are the flagship of the Labour-led government's response to these issues. While there is much to commend in these reforms, it has been argued that they failed to recognise a number of implications of increasing diversity for the income assistance system (Nolan, 2005). This article thus aims to encourage debate on a broader agenda for lifting families' incomes through providing an assessment of four policy instruments for doing so.

Minimum wage

On 1 April 2007 the largest increase in the minimum wage over the last two decades took effect, with the rate for people 18 years and over increasing from $10.25 to $11.25 per hour and for people aged 16 and 17 from $8.20 to $9.00 an hour. The government's goal is to increase the adult minimum wage to $12.00 an hour by the end of 2008 if economic conditions permit. Concepts of fairness of reward and socially acceptable incomes are key reasons for having a minimum wage. However, raising the minimum wage may do little for affected workers for two reasons. First, increasing the minimum wage will increase the cost to employers of hiring low-wage workers relative to other inputs and could reduce demand for low-wage labour (Brown, 1999). Secondly, the increase in the minimum wage may translate in little extra take home pay as wage increases reduce the income assistance that people on low and middle incomes may be entitled to (NZIER, 2007).

An increase in the minimum wage will raise a worker's gross wage income (assuming they are not laid off or change their hours), but the change in their take home pay (net income) is less clear, being subject to a complex set of tax-benefit programmes. The New Zealand Institute of Economic Research (NZIER, 2007) estimated the gains from minimum wage increases for three family types for a range of hours of work. These estimates included income taxes, the ACC levy, clawback of main welfare benefits, and clawback of the Working for Families Tax Credits and the Accommodation Supplement. They showed that:

- The largest group of minimum wage workers was single people without children. The increase in the minimum wage to $11.25 increased the gross income of a single person working for 10 hours by $10.00 per week. Of this, however, they kept only $1.26 more in the hand, with $8.74 being clawed back by the government. For a further minimum wage increase to $12.00 (a gross increase of a further $7.50) this person kept only 95 cents more in the hand.
- A sole parent at 20 hours of work received no extra income in the hand from the increases in the minimum wage due to the dollar-for-dollar clawback of the Minimum Family Tax Credit (interaction with the ACC levy meant that the wage increase slightly reduced net income).[4]
- Calculations for partnered parents also showed that clawback can leave little income from the minimum wage increase in the hand. More generally, part-time workers (accounting for significant proportions of low-wage and sole parent workers) were particularly likely to lose the bulk of any increase in the minimum wage through clawback.

The NZIER concluded that many of the people that minimum wage increases aim to assist are the same people losing most, if not all, of their wage increases through clawback. Interaction between wage rates and tax-benefit programmes means that even significant increases in minimum wage rates (or more general increases in wage rates for low-wage workers) may do little for these workers' net incomes, incentives for paid work and standards of living. It is thus necessary to recognise that individual policies that aim to lift gross wages will be affected by their interaction with the personal income tax scale and the clawback of income assistance.

Personal income tax

Clawback of minimum wage increases is one example of the interaction between wage rates and tax-benefit programmes. A more general example of this interaction is reflected in how the distributions of wage rates and hours of work (making up gross incomes) determine the coverage of personal income tax rates and levels of tax burdens. This can be illustrated by comparing differences in gross incomes and tax burdens in New Zealand and Australia.

The OECD's recent *Taxing Wages* report concluded that a family at average gross manufacturing earnings with two children under 12 would face a lower tax wedge (including income taxes, superannuation contributions, social security levies and family tax credits) in New Zealand than in Australia. Yet this result is driven by differences in the distributions of gross incomes, rather than by relatively low income tax rates or generous tax credits (as claimed by some commentators), with New Zealand having relatively low labour productivity and wage rates. A partnered household with one worker at average manufacturing wage and two children under 12 would have an average gross weekly income of NZ$805.00 in New Zealand but in Australia this would be AU$1,054.40. Adjusting the tax wedge for these differences in gross incomes illustrates that workers in New Zealand face higher tax wedges, as at most income levels the same income (adjusting for differences in the costs of goods and services) is taxed more highly and the levels of tax credits provided are lower.[5]

Changes to the distributions of wage rates and hours of work thus influence the coverage of personal income tax rates and levels of tax burdens. Wage increases, for example, mean that over time people slip into higher income tax brackets unless income tax thresholds also increase (fiscal drag). Yet in New Zealand since 1 April 1998 the lower and middle personal income tax rates and thresholds have remained unchanged, and a new

4 The Minimum Family Tax Credit underwent an inflation adjustment of around two per cent from 1 April 2007. While recipients' total net incomes may increase due to this adjustment, they would receive no additional income in the hand from the minimum wage increase.

5 While some commentators claim that in New Zealand income taxes are lower on low incomes and higher on high incomes than in Australia, even a cursory comparison of tax scales and other transfer programmes illustrates that this is incorrect. Average income tax rates are only lower in New Zealand than in Australia at very high incomes (around NZ$180,000) (ANZ, 2006).

top rate and threshold were introduced on 1 April 2000. To illustrate the extent of this fiscal drag, increasing income tax thresholds to account for inflation between 1 April 2000 and the final quarter of 2006 would require thresholds of:

- 15% up to $11,330 (currently $9,500);
- 21% up to $45,315 (currently $38,000);
- 33% up to $71,550 (currently $60,000); and
- 39% on income above $71,550.

Based on these thresholds and using the Treasury's 'ready reckoner' for estimating the revenue effects of changes to tax thresholds, rates and bases (Treasury, 2006), the effect of fiscal drag can be estimated as being in the order of an additional $1 billion in income tax revenue per annum. (This figure is only a broad estimate of magnitude as it does not include estimates of the behavioural or macroeconomic effects of fiscal drag.) This ongoing increase in taxation due to failure to increase tax thresholds with inflation has a real impact on family incomes, leads to increasing incentives for income tax avoidance and evasion, and has amplified the growth in trans-Tasman income differentials (reducing the income tax base which, *ceteris paribus*, means forgone tax revenue).[6]

Increasing tax thresholds to account for inflation from 1 April 2000 would provide individual workers at a wage rate of $11.25 with the same dollar benefit ($2.11 per week) whether they work 10, 20 or 40 hours per week. In contrast, if tax relief was provided through lowering income tax rates by two per cent (leaving thresholds at their 1 April 2000 levels) at a wage rate of $11.25, workers would receive $2.25 at 10 hours of work and $9.00 at 40 hours of work. In general, a reduction in tax rates provides a benefit that increases with incomes and hours of work, whereas an increase in tax thresholds provides an equal (capped) benefit to all people with incomes above the new threshold, irrespective of their total incomes or hours of work. For these reasons, *ceteris paribus*, a tax rate reduction is likely to have a higher fiscal cost than an increase in tax thresholds. The two per cent income tax rate reduction would, for example, account for a fiscal cost in the order of $1.6 billion per annum compared to $1 billion to increase income tax thresholds to offset fiscal drag since 1 April 2000.

Under the personal income tax schedule (based on individual incomes), the tax changes above would also provide single people and single-income couples (with and without children) on the same incomes with the same dollar benefit. Some commentators have proposed providing tax relief through allowing couples to split their incomes for tax purposes. However, moves towards a broad-based and low-rate tax system over the last 20 years have reduced the dispersion between primary and secondary earners' marginal tax rates and consequently the potential for income splitting to provide tax relief. Income splitting poorly targets assistance to low-income households, with almost 80% of the expenditure on income splitting going to the top 20% of earners (Nolan and Fairbrother, 2005). Income splitting would discourage secondary earners from working and would increase administrative complexity.[7] Among OECD countries there has been a clear movement away from income splitting, partly motivated by desires to fund reductions in income tax rates through increasing tax bases.

Family and working tax credits

Family and working tax credits are able to provide tax relief on a more targeted (less fiscally costly) basis than changes to personal income tax scales, and as they are generally provided through personal income tax systems they are seen to more strongly reinforce work effort than main welfare benefits (Alstott, 1995; Nolan, 2005). The use of working tax credits is often part of a reform strategy emphasising active labour market policies (Adler, 2004). In New Zealand family and working tax credits provide assistance only to families with children (Nolan, 2006).

The Working for Families reforms represent a significant increase in the generosity of family and working tax credits in New Zealand and will bring about a significant reduction in the headcount rate of child poverty (Perry, 2004). Financial incentives for sole parents to work will be improved, but secondary

6 Although Working for Families also creates work disincentives for secondary earners, these are larger with income splitting. Further, although income splitting would provide low-wage primary earners with a small improvement in their work incentives, this would not be as large as the incentives created by Working for Families.

7 Johnson (2005) considered Working for Families prior to the extension of the reforms following the 2005 general election. However, this extension reinforces the conclusions he reached, as the majority of higher income families receiving the extension are likely to be partnered.

earners will face increased financial disincentives for labour supply, which is significant given the increasing proportion of expenditure going to partnered families (increasing from approximately one third to one half of the recipients of the Working for Families Tax Credits) (Johnson, 2005).[8] There will be an increase in the compliance and administration costs of the tax-benefit system, particularly due to the extension of an hours-based eligibility criterion, and the greater receipt of assistance by working families may increase demand for combining the administration of assistance of tax-based and welfare-based programmes. Concerns over the accuracy of payments to eligible recipients and ineligible recipients fraudulently receiving payments will become more prominent (Nolan, 2005).

As noted above, under the Working for Families reforms an hours-based eligibility criterion now applies for both the Minimum Family Tax Credit and the In-Work Tax Credit. Yet basing assistance on a prescribed number of hours of work is inconsistent with the market-based setting of employment conditions, as a feature of many employment contracts is that an employee's hours of work may fluctuate with seasonal or economic conditions. Having thresholds based on work hours (in addition to abatement based on income) would increase the complexity of administration and may lead to greater uncertainty regarding the level of assistance available when making the transition from benefit to work and when hours of work and earned incomes fluctuate. Removing the hours-based eligibility threshold for the In-Work Tax Credit would improve financial incentives for some primary earners to supply labour and would not lead to any fall in recipients' assistance from Working for Families (Nolan, 2005).

The tight targeting of the Minimum Family Tax Credit means that under-payments or over-payments are relatively likely for this programme. Since this programme's establishment in 1986, liberalisation of the labour market has been reflected in greater part-time and part-year work, and family structures have become less stable and more heterogeneous. Recipients of the Minimum Family Tax Credit are therefore increasingly likely to change circumstances during the income tax year, and although the Inland Revenue Department can automatically adjust entitlements during the year for many taxpayers, the tight targeting of the Minimum Family Tax Credit reduces the effectiveness with which this assistance may respond to these fluctuations. With the extension of this programme under Working for Families, these difficulties will become more common. Removing the Minimum Family Tax Credit would provide sole parents who take up this programme with relief from the poverty traps that it creates, although this could lead to some sole parents delaying their exit from the Domestic Purposes Benefit and could lower the level of assistance they receive from Working for Families (Nolan, 2005).

The levels of assistance provided by the Family Tax Credit currently increase with the ages of children in the family. These age-related scales are based on the assumption that children become more expensive as they age. However, the strength of this assumption has been questioned, particularly by research in the United Kingdom which found that age-related scales in tax-benefit programmes in that country overestimated the extra costs of older children. There is a paucity of research on families' spending on children by age of child in New Zealand against which to judge the age-related scales in the Working for Families Tax Credits. Yet providing greater assistance to families with younger children would recognise the greater difficulties that these families face in allowing both caregivers to work in the labour market (female participation increases strongly with age of children (Johnston, 2005)). Subsidising the withdrawal from the labour market of a caregiver with young children would also accord with child development objectives.

Main welfare benefits

Working-aged benefits differ in the degree to which they emphasise short-term fluctuations in need, such as temporary loss of employment and support for childrearing, or longer-term incapacity to work due to invalidity or sickness. The total numbers of people in receipt of a main welfare benefit have fallen since 1999. Yet there have been concerns at the rates at which, in response to increases in work requirements associated with the Unemployment Benefit and Domestic Purposes Benefit, recipients have switched to the Invalids Benefit and Sickness Benefit in order to remain eligible for assistance. To address this switching, measures to provide intensive employment support to people able to work have been extended to the Invalids Benefit and Sickness Benefit recipients.

As well as the active labour market policy of intensive employment support, the government has revisited a proposal developed by the fourth Labour government in 1989 for a single core benefit, where recipients receive a core benefit with supplementary assistance provided on the basis of need rather than benefit category. These reforms could significantly simplify and reduce the administrative and compliance costs of the main benefit system. Such simplification, however, presents many challenges, including possible creation of short-term fiscal losses for some families, and requires significant political support. For many families short-term losses from simplification would likely be offset through increased rewards from work effort and changes to other components of the income assistance system.

The core benefit reforms, along with the shifting of the child component of main benefits into the Working for Families Tax Credits, represent a significant shift in the balance of the income assistance system towards supplementary assistance, with the Working for Families Tax Credits now accounting for a fiscal cost greater than either the Unemployment or Domestic Purposes Benefits. The balance of the tax-benefit system has not been shifted to this degree since the 1991 reductions in main benefits, yet the indexation of the Working for Families Tax Credits will mean that, unlike after the 1991 reforms, the annual increase in main benefits for inflation will not erode the relativities between main and (previously non-indexed) family and working tax credits.

The New Zealand Child Poverty Action Group has argued that the Working for Families Tax Credits should not be targeted on the basis of work effort and that the child component of main welfare benefits should be restored (St John and Craig, 2004; St John, 2006). These arguments reflect a concern with immediately reducing child poverty. However, the relatively low degree of targeting of the Family Tax Credit would mean that increasing the generosity of this programme to offset any losses to low-wage families from the removal of the Minimum Family Tax Credit and In-Work Tax Credit would lead to a significant increase in fiscal costs of the Working for Families Tax Credits. By increasing levels of main benefits, this approach would also fail to reduce the poverty traps facing low-wage families created by benefit abatement.

The abatement of main benefits is a major contributor to poverty traps, where, due to taxation and the clawback of assistance, families have little or no financial incentive to increase their incomes or hours of work. Currently Domestic Purposes beneficiaries receive relatively good returns from part-time work. Returns for part-time work for beneficiaries without children are less strong, as they face higher rates of benefit abatement than Domestic Purposes Benefit recipients on earned income between $80 and $180 per week. For all beneficiaries financial incentives for full-time work are less strong, however, as once full abatement of the main benefit is faced there are relatively few financial rewards from increasing hours of work until it is possible to exit the benefit. Disincentives for full-time work are strongest for Domestic Purposes beneficiaries, as due to the lower rates of abatement at lower income levels and the higher levels of unabated assistance the benefit exit point is reached later for beneficiaries with children. The Minimum Family Tax Credit aims to improve financial incentives for full-time work for families with children, but creates poverty traps of its own.

This discussion illustrates a key trade-off when aiming to improve financial incentives to work through lowering benefit abatement at lower income levels: lowering this abatement comes at an economic cost of increasing abatement further up the income distribution (unless levels of assistance are also reduced, which may sacrifice income adequacy objectives). The degree to which these economic costs further up the income distribution outweigh the benefits from reduced abatement depends on numbers of people affected, estimated behavioural responses to financial incentives from income assistance programmes, and value judgements regarding the income distribution.

Conclusion

This article contains a general assessment of four ways of lifting families' incomes. The general advantages and disadvantages of these approaches are summarised in Table 1. Although discussed separately in this paper, the four approaches should be seen as components of a single income assistance system. As the case of the minimum wage illustrated, for example, it is important to recognise that individual policies that aim to lift gross wages will be affected by their interaction with taxation and the clawback of income assistance. Government policy often fails to take an adequately integrated view of these policies.

Table 1: General advantages/disadvantages of income assistance programmes

Minimum Wage	Personal Income Tax Schedule
• Supports concepts of fairness of reward and socially acceptable incomes • Reduces demand for low-wage labour • Low (static) fiscal cost to government, but increases costs faced by businesses • Effectiveness at lifting incomes reduced by poverty traps	• Simple • Broadly received • Fiscally costly (rate changes more costly than threshold changes, *ceteris paribus*) and low poverty reduction effectiveness • Reduction (although often small) in poverty traps
Family and Employment Tax Credits	**Main Welfare Benefits**
• Complex design • Able to target assistance on basic criteria (e.g. joint taxable income, numbers and ages of children) • Cost-effective way of providing moderate levels of assistance to many households • Seen to reward work effort, although they create poverty traps	• Complex design • Able to narrowly target assistance • Cost-effective way of providing a lot of assistance to relatively few households • Able to respond to fluctuations in need or family circumstances • Create poverty traps

Government policy must also recognise limits to the role of the income assistance system and the need to remove unnecessary complexity. The current system is complex because it aims to tailor assistance to a wide variety of needs, yet complexity leads to significant administration and compliance costs and a system designed to be responsive being far from it. If the rationale for new programmes is to offset the impact existing programmes are already having on families (e.g. due to fiscal drag or poverty traps), then reform of existing programmes is required, not new programmes. Without this discipline there is a risk that the legacy of recent and proposed reforms will be an unsustainably complex and costly income assistance system.

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