

Tony Burton

Financial Incentives for Welfare Recipients with No Other Income

Introduction

The Welfare Working Group final report in 2011 focused on households whose working age members have a marginal attachment to the labour market. The main conclusion of this article is that a better understanding of the available options is needed if the welfare system is to motivate people in those households to move into paid work.

A large majority of working-age people whose main income is a welfare payment do not declare other income; thus, where the policy objective is increased

participation in paid work, the focus needs to be on motivating that participation. Policy to improve work incentives has been based on mapping bureaucratic rules, but these rules do not adequately reflect the incentives and the decision to start work. A better analysis would

examine the sources of income and the uncertainty of work for people with low skills. It would also look at the incentives created by additional sources of benefit income and informal income.

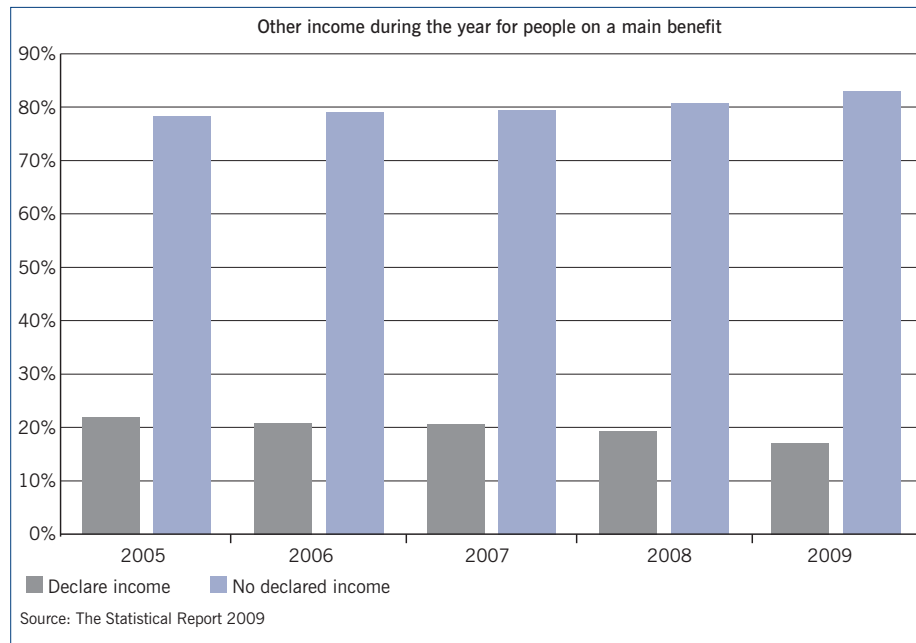
This has important practical implications for policy to increase participation in paid work. Most importantly, there need to be increased resources for support to find and maintain work, and non-financial interventions which change work motivation. Financial incentives need to be targeted where they are likely to be effective, such as encouraging more than minimal participation in work.

Benefit payments and labour market participation

The great majority of people receiving a main benefit, mostly unemployment, invalid's, sickness or domestic purposes benefits, do not declare additional income. As Figure 1 shows, this has been true during recessionary and non-recessionary years. While there is variation between benefit types, more than two thirds of the recipients of each benefit have no other income each year (Ministry of Social Development, 2010, tables OB.1 and OB.2). Of those who first went onto a benefit in 1999, this was the main source of income for most of the following ten years for a third of the individuals, and for

Tony Burton is a Principal Advisor in the Labour Markets and Welfare team at the New Zealand Treasury

Figure 1: Proportion with a benefit income declaring earnings



more than five of the subsequent ten years for a further third (WWG, 2010, p.10). This article discusses work incentives for these people, the substantial majority of those receiving a main benefit. This article discusses these incentives.

Before doing so, however, it is worth noting two alternative approaches which claim that participation incentives are irrelevant to policy on the labour market participation of people receiving welfare payments.

One approach argues that a person's participation in paid work is an ethical, not an incentive, issue. It emphasises the obligations created by receipt of taxpayer-funded payments and that people should support themselves wherever possible, even if they are financially worse off by doing so. In this view, a focus on the financial rewards of working provides an excuse for moral failure. A different ethical perspective focuses on income as a requirement for a decent life and draws attention to the adequacy of payments. From this perspective, giving some priority to participation incentives creates additional hardship for people already suffering great personal and financial distress through low income.

This article does not offer an ethical judgement on whether or not people should respond to financial incentives. Practical policy design is helped by understanding the reasons why people

do not meet their obligations to take up paid work; or why a person who wants to work does not take an available job. Thus, the argument in this article is about what we need to do if we wish to encourage participation in the labour market.

The second alternative is to argue that demand for labour is the reason for unemployment, and thus an analysis of supply-side incentives is simply irrelevant for understanding Figure 1. If there are no jobs for people on benefits it is hardly surprising that they are not working. The rise in unemployment since 2008 makes this a particularly salient argument.

However, participation incentives still matter. Even in periods when there is an overall decline in the number of jobs, jobs are being created, people are moving between jobs and others are retiring (March 2010 quarter LEED data, at www.stats.govt.nz). Thus, disincentives created by welfare payments act as a barrier to people taking up what opportunities are available when the labour market is tight.

Further, in the recent past long-term unemployment and persistent unfulfilled demand for labour co-existed, and it is reasonable to believe that this will happen again when the labour market improves (WWG, 2010, p.32). Since substantial policy reform requires several years of detailed development, legislation and implementation, the process needs to

start now to have settings in place, ready for when the economy improves again.

An analysis of current welfare incentives

The economic analysis of work incentives describes the choices faced by a person deciding on a 'work/life' balance. The result is referred to as a 'budget constraint' which maps the feasible levels of time in paid work that will give the highest income. The actual balance chosen will depend on the individual and their circumstances.¹ For example, a person whose only income was working 20 hours a week at \$15 an hour could not feasibly earn more than \$300 minus any taxes in that job. The budget constraint would include this and other options for doing different hours of work, subject to the cost and availability of things like child care, transport and so on. Knowing what people actually choose requires doing the empirical research.

Broadly, there are two measures of the incentive to work. One is the extra amount earned by taking up work, usually expressed as the 'replacement ratio' of unemployment income to income when in work. The other is the proportion lost of each extra dollar earned; that is, the effective marginal tax rate (EMTR). The lower both measures are, the greater the work incentive.

As noted by Prebble and Rebstock,

in considering the effects of taxes and benefits we cannot focus only on effective marginal tax rates. We must also consider the margin between the amount that can be earned in paid employment and the amount that could be received when living on a benefit. (Prebble and Rebstock, 1992, p.9)

Moreover, recent evidence suggests that:

the range of estimates reported by different studies is in fact rather similar across countries The bulk of this evidence indicates that ... a 1% change in the income gap between working and not working is associated with a 0.2% change in the participation rate in the same direction. (Immervoll and Pearson, 2009, p.26)

Despite this, design of welfare policy has focused on changing EMTRs, even when there is an explicit intent to incentivise people to *begin* participating in the labour market. For instance, despite one of the objectives of Working for Families being to ‘achieve a social assistance system that supports people into work’, incentives were analysed using only the EMTR (Ministry of Social Development and Department of Inland Revenue, 2010, p.7; for other examples see Fletcher, 2011 and Department of Work and Pensions, 2010). Even worse, these analyses, including the Working for Families evaluation, are typically done by naively analysing bureaucratic tax and benefit rules, and usually only a proportion of these.

Five reasons why EMTRs do not tell us about the financial incentives on households with no earnings

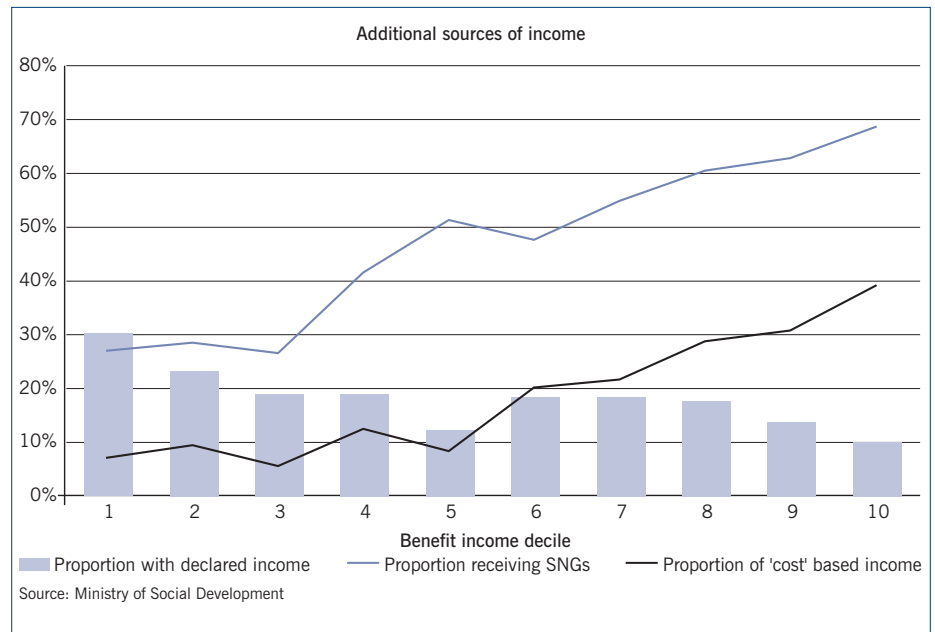
For policy purposes, the question is whether or not focusing on this one measure leads to poorer policy design. This section discusses five reasons for believing that there are significant gaps in understanding incentives when using an EMTR analysis; the following section considers how policy might change with a better understanding of the incentives.

The arguments below are based on neo-classical economics to the extent they are derived from thinking that is part of that tradition; however, they are framed in terms of influences on the choice of whether or not to work, rather than ‘costs of working’. Partly this is to avoid discussion of what is essentially an ethical judgement about the extent of the state’s obligations to subsidise work participation. But more importantly, it recognises that ‘people make their decisions on the basis of their perceptions and beliefs – and these perceptions can be related in a systematic way to the parameters set by policy’ (Millar et al., 1989, p.80). Thus, the focus for policy is the people making decisions between available options, not government welfare rules.

Work is not a feasible option

The budget constraint is made up of different potential ways of balancing

Figure 2: Inverse relationship between earnings from paid work and level of benefit income



paid work and other activities. In this sense, doing no paid work is a point of balance as much as any other; but the obvious impossibility of doing less than no work qualitatively alters whether the motivation provided by financial incentives will change behaviour (Borjas, 2009, sections 2.5 and 2.6). One possibility is that a person is not working because there are no feasible job opportunities, because of, say, lack of child care, poor transport options, or lack of jobs available locally. The outcome is not the result of a lack of financial motivation to work but of a lack of real job options. Since the incentive is not the reason for doing no work, changing the incentive does not alter behaviour unless it also makes work feasible.

Other activities than work are more highly valued

Similarly, welfare payments themselves may reduce the incentive to work. Of those doing no work: around a third of those receiving the unemployment benefit, more than three quarters of domestic purposes and sickness beneficiaries, and more than 90% of those on an invalid’s benefit report that they are not looking for work. Indeed, the majority of people on the latter three benefits report that they do not intend to look for work for at least a year (Department of Labour, 2008–2010).² The constraint is not the financial

incentive, but the high value placed on having the time to do other activities. An example of this might be a sole parent whose family are willing and able to provide child care, but who does not work because he or she places a high value on looking after the children themselves. In these circumstances, altering the EMTR, even for small amounts of work, makes no practical difference to the work incentive because time spent working has not been balanced against the time spent engaged in other activities. The level of benefit income is enough that time can be spent on activities regarded as more valuable.

Benefit as an alternative to paid work

A further problem with using EMTRs is that they are developed using administrative rules that are assumed to describe the choices faced by those receiving welfare payments.³ Intuitively, it seems odd, and a little patronising, to treat the rules prescribed by an agency as a description of how people make their choices. For instance, the tax rules for schemes like KiwiSaver are designed to encourage savings, and, while these rules influence savings choices, a diagram of them does not describe why people choose to save.

An important example of bureaucratic rules poorly describing the choices for people receiving welfare payments is when recipients choose between welfare

income and earnings. For example, obtaining temporary additional support (TAS), for which a person needs to re-apply every 12 weeks, requires that person to go through a process of gathering information, collating and reviewing their costs, an interview with a case manager, and other administrative tasks, all of which can take several hours' work. If the applicant is choosing between the time and difficulty involved in applying for TAS and the time and difficulty involved in work, then they are choosing *between* income from TAS, and income from paid work. However, a typical EMTR analysis ignores the time taken to apply for TAS and just assumes the recipient is deciding

whether or not to do paid work in addition to receiving the benefit income. Some evidence of people treating benefit payments as an alternative to paid work is shown in Figure 2. The graph is derived from Ministry of Social Development data of households paid a main benefit for longer than a year in March 2010. The horizontal axis is the benefit income decile: decile '1' includes the people whose income from a benefit (excluding Working for Families and special needs grants (SNG)) is in the lowest 10% of benefit incomes, '2' is those in the next 10% of benefit incomes, and so on. The bars show the proportion receiving earnings from work in each of these deciles.

benefit income decile. However, there is still a strong relationship between income from SNGs and other sources of income, with the proportion receiving these grants decreasing as income from earnings increases. The diagram understates the effect, since those on higher benefit incomes also receive more SNGs, as well as being more likely to receive SNGs. In fact, the New Zealand system exacerbates this problem by linking benefit income to costs over which the person receiving welfare has some control. This is the case for most supplementary benefits, including accommodation supplement, temporary additional support, disability allowance, the tax credits (which are

asked about paid work, with the risks of losing any job they find frequently cited as an important reason for remaining on a benefit (Millar et al., 1989; Jenkins and Millar, 1989; Benyon and Tucker, 2006). Assessment of LEED data suggests that New Zealand is no different from other countries in this regard. Crichton and Dixon (2007) found that during 2001–02, a period of sustained economic growth, the average number of employers worked for in the two years after going off a benefit was 2.7 and the average employment spell was nine–ten months (Crichton and Dixon, 2007).

Again, this is a problem exacerbated by the way welfare payments are made. In particular, most benefits are paid after a 'stand down' period during which people are expected to use their savings to cover costs – of up to two weeks for those who have been working for longer than 26 weeks and up to 13 weeks if a person is judged to have left work voluntarily. Thus, a person thinking of coming off benefit has the strong disincentive of knowing that if they need the welfare system again – and it is reasonable to believe they will – they will have at least two weeks without income.

Two key policies can be re-balanced to better use available incentives: policy to motivate welfare beneficiaries to take up paid work, and targeting financial incentives in the welfare system.

intended to cover the cost of children) and child care subsidy. If an individual can alter their circumstances to increase benefit payments then the individual's budget is not limited by the "budget constraint" and the ETMR does not describe the incentives.

Attitude to income from different sources
A fourth reason EMTR analyses may be misleading is that they assume people do not care about the source of income. If it is not true, however, that 'income is income from whatever source it is derived from', then the incentive property of (say) \$20 earned and a \$20 TAS will be different, regardless of tax and abatement rules (Cowell, 1986; Moffitt; 1983).

More importantly, the riskiness of earnings for people with low skills is so great, no sensible person could ignore those risks, particularly if they are responsible for children. The 'employment lottery' is raised whenever people receiving welfare payments are

Informal material support
The issue of informal support that is not declared to authorities is often confused by the question of legality; yet many forms of informal support are not only legal, they are crucial in ensuring people on benefit remain engaged with society. Such support would include in-kind payments such as family meals, swapping services (hairdressing in exchange for child care, for example), gifts and so on. While these may seem of low financial value, the cost of purchasing these goods and services will be much higher than the cost of receiving them informally. Because these are often arrangements with friends and family, their non-monetary value increases the financial compensation from formal work be needed to replace them.

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family, yet the cash equivalent of these arrangements might easily be more than the earnings from a day's paid work at a low wage.

Some policy implications

Incentives to take up work are only one objective of welfare systems, and welfare policy requires this to be balanced with other practical and ethical objectives. But even where the focus is these incentives, the realities of the labour market and alternative options for income mean analysing the EMTR of payment rules is inadequate for policy development.

Currently, the EMTR is adjusted so that a person receives almost 90% of the earnings for each hour of work for one day of work, and is then varied to target different levels of work for people on different benefits. For instance, the unemployment benefit rules create a disincentive for two to four days of work a week, while the combination of domestic purposes benefit and Working for Families create a disincentive for three to four days of work a week.⁴ A person working this number of days a week will pay 90–100% of their earnings for some of the hours they work.

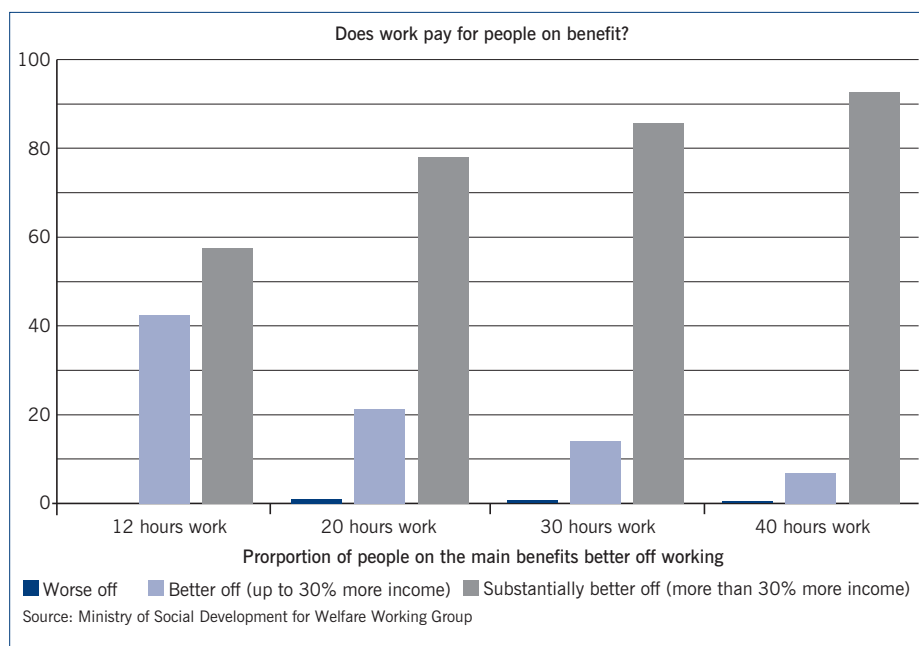
Two key policies can be re-balanced to better use available incentives: policy to motivate welfare beneficiaries to take up paid work, and targeting financial incentives in the welfare system. To do this we need to take into account total additional earnings, as well as the marginal payment for each hour, because this has a greater influence on participation decisions. The discussion below also links the analysis to recommendations in the Welfare Working Group report.

The enhanced role of non-financial motivation

If manipulating payment rules has a limited influence on the motivation to take up work, then policy to increase participation needs to have a greater focus on non-financial reasons why people do not work.

First, where people are not engaging with the labour market, there need to be stronger work expectations attached to welfare payments so that far more people are motivated to take up work (WWG,

Figure 3: Improvement in income from working at the minimum wage in March 2010⁶



2011, p.1). The main instruments include early intervention for those with sickness and disability problems, assessment focused on capability, building stronger partnerships with the medical profession and employers, and motivating the welfare agency by making them more accountable for the financial implications of long-term welfare dependence (ibid., particularly sections 4.5, 4.6, 9.5 and 9.6).

Second, there needs to be a far greater emphasis on services to support people into work, and these services need to go to people who were not previously supported. The scale of this is such that the WWG recommended increasing by up to a third the resources to support participation in work (an increase of \$285m on the \$770m currently spent) (ibid., pp.83, 171).⁵ The services discussed include improved provision for sole parents, more help for people with sickness and disability, and placement services catering for those needing additional support (ibid., sections 10.4, 10.3). In addition, it was recommended that more child-care funding be targeted at people moving into work, and that more of the funding for people with disabilities be available to facilitate work (ibid., p.26, recommendations 17 and 18; pp.89-90).

Thus, the key to 'making work pay' is ensuring people have the motivation

and opportunity to benefit from available work.

The use of financial incentives in the welfare system

While manipulating the EMTRs may not be effective at motivating people on welfare to start work, this is not to say people receiving welfare payments do not respond to financial incentives. If benefit payments are to be targeted at those needing income support, they have to be withdrawn when a person earns enough to support themselves. Both the payment and its withdrawal potentially create disincentives, and the question is whether policy could create more effective work incentives.

In particular, the current policy of not withdrawing payments for small amounts of work increases the rate at which they are withdrawn for higher amounts of work. Thus, to incentivise those staying on benefit to do a very small amount of work, the benefit system creates a disincentive for those wanting to work enough to potentially move out of the benefit system.

As Figure 3 shows, even at 12 hours of work more than two fifths of people on a main benefit will increase their income by less than 30%. Thus, those who highly value time not working would be giving up that time for a relatively small increase in income. Even those looking for more

income than their usual benefit will find earnings similar to their income from additional welfare payments and informal earnings. Further, the fact that such additional benefits are designed to be temporary or one-off merely replicates the uncertainty of labour market income for people on benefit. The current system targets the incentives in payment rules precisely where they are least effective.

If the aim of policy is to encourage participation in work, particularly if this is to be a step to moving off benefit, then a better use of the incentives would be to target them towards higher numbers of hours. As Figure 3 shows, substantially more people are better off when working 20–30 hours, even with the disincentives in the current system, and the financial gain is far greater than alternative sources of income. Thus, the incentive is targeted to financially reward those who have taken a major step towards replacing welfare income with earnings. This was operationalised in the WWG report by starting abatement earlier, and at a higher rate for some people, but maintaining that rate when the current system increases the rate. This is one example of a system that better aligns incentives with the objective of encouraging paid work and has the additional advantage of greater simplicity than the current system (WWG, 2011, section 5.7).

Of course, this decreases overall earnings from smaller amounts of work, and where people are unable to work longer hours would reduce hours worked.

Whether or not this means the welfare system should accept the poorer overall incentive is beyond the scope of this article. However, it should be noted that the current system reduces the earnings of people who could work two to four days a week by discouraging them from working as long as they could. Thus, whichever way the incentive is designed, some people are worse off. Further, there are ways to ameliorate the impact for those unable to work longer. For instance, the WWG report suggested identifying those whose disability or long-term illness meant they were not expected to work and removing abatement altogether for feasible amounts of work.

Conclusion

This article has argued that the incentives created by policy based on analysing EMTRs derived from bureaucratic rules do not meet the need to improve motivation to start paid work. Given that welfare rules are poor at creating incentives to participate, the argument here has been that non-financial motivation is more important for encouraging participation, and that financial incentives should be targeted at increasing the level of work as a step towards no longer needing welfare payments.

- 4 For sole parents see Fletcher (2011), pp.39-41. The shape of the EMTR is broadly the same for other benefits, but they differ as to where the worse incentives start. For full details see the WINZ websites in note 3 above. One alternative is to not target the incentives and thus spread the disincentives evenly. See Rankin (1991) for a supporting view, and Treasury (2010) for an assessment. The key point for this article is that the disincentives still remain and this is just an alternative way of distributing them.
- 5 A substantial part of the \$770m is case-management time spent on administering benefit payments, so this understates the increase needed in resources to encourage participation in work.
- 6 Note that both the minimum wage and the level of benefit payments has increased since March 2010. Most of those worse off are on invalid's benefits.

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Enhancing Performance-Based Regulation

Lessons from New Zealand's building control system

Peter Mumford

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Mumford explores two strategies for resolving the challenges of decision making in a permissive

performance-based regulatory environment: improving the predicative capability of decision-making systems through the better application of intuitive judgement associated with expertise and wisdom, and treating novel technologies as explicit experiments. Peter Mumford works for the Ministry of Economic Development. He has a broad public policy background, ranging from small and medium-sized enterprises policy and technology policy to regulatory impact analysis and regulatory policy in areas as diverse as securities

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Lessons from New Zealand's building control system

Peter John Mumford



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