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Redesigning the Welfare State

rethinking the indexation of cash and non-cash assistance

Abstract

Since the beginnings of the welfare state, Aotearoa New Zealand has lacked a principled, comprehensive and consistent system for indexing social assistance to movements in consumer prices and/or wages. This deficiency applies not only to cash transfers but also to in-kind benefits. The absence of a robust and durable indexation regime is no accident. It reflects, among other things, an unwillingness of governments to determine an acceptable minimum standard of living for citizens and then protect, if not enhance, this standard over time. No doubt, the fiscal implications of a more consistent approach to indexation have loomed large in the political calculus. Yet if the current and future governments are to meet ambitious child poverty reduction targets and ensure greater distributional fairness, a new framework for indexation is essential. This article discusses the nature and purpose of indexation, the principles and other considerations that should inform the design of an indexation regime, the policy options available, and how a durable and defensible policy framework might be secured.

Keywords: social assistance, indexation, adequacy, relative poverty, fairness, fiscal costs

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Among the many issues that must be addressed in designing a welfare state, two are crucial: adequacy and indexation. Adequacy is about determining an acceptable minimum standard of living for citizens and then designing a package of social assistance with the aim of meeting this standard or benchmark.

Indexation is about linking rates of social assistance to various indices of prices and/or incomes (e.g. average wages or median household incomes), ideally to ensure that any agreed standard of adequacy is maintained over time. Even in an environment of low inflation, without a comprehensive and effective indexation regime, the *real* value of any package of cash and non-cash assistance will fall, leaving some or all of those who are reliant on such assistance increasingly worse off. Similarly, in a context of rising average real wages, if there is no formal linkage between wages and social assistance, then the value of any package of social assistance will fall in *relative* terms. In short, a poorly designed indexation regime is almost certain to result in extended periods of time during which citizens who are partially or fully dependent on social assistance become progressively worse off, both in *real* and *relative* terms. Unfortunately, this has been the pattern in New Zealand since the foundations of the welfare state more than a century ago.

Both adequacy and indexation are complex and controversial. They raise fundamental issues about the nature of social justice, what it means for citizens to live in dignity, and how adjustments in social assistance should be made over time to reflect evolving economic circumstances, such as improvements in productivity or changes in the overall level and/or structure of consumer prices. Equally, they pose questions about the role of economic incentives, ensuring prudent fiscal management in the face of inevitable economic shocks, and determining how much social assistance (and of what kind) is fiscally affordable and/or politically feasible.

The focus of this article is on indexation rather than adequacy. While the two are closely connected, it is not possible to do justice to both in a brief contribution of this nature. Four main arguments are advanced in what follows. First, New Zealand lacks a principled and comprehensive system for the indexation of social assistance (in its many and varied forms). This constitutes one of the core weaknesses of our welfare state. On various grounds, not least fairness, reform is essential. Second, to achieve the primary goal of the Child Poverty Reduction Act – namely, a 'significant and sustained reduction in child poverty' – a more comprehensive and effective indexation regime will be essential. Third, designing a new indexation framework raises a multiplicity of issues. It will require rigorous analysis and an informed public debate. Fourth, to be durable over multiple governments, any new framework for indexing social assistance will need a measure of cross-party support and a mechanism to enable adjustments to accommodate major economic shocks. Creating an independent body to undertake authoritative reviews of the framework and recommend periodic changes is likely to enhance the credibility and durability of any new regime.

The current indexation regime

New Zealand's welfare state is complicated, multifaceted and evolving (see, for instance, Berentson-Shaw and Morgan, 2017; Cheyne, O'Brien and Belgrave, 2009; McClure, 1998; Rashbrooke, 2013; St John and So, 2018). It includes numerous forms of cash and non-cash assistance. Among these are dozens of separate welfare benefits (covering first-tier, second-tier and third-tier assistance), several types of tax credits for low- to middle-income families, various forms of housing assistance (both cash and in-kind), a range of subsidies for childcare and early childhood education, several forms of assistance for tertiary students, and numerous different subsidies for primary healthcare, dental care, education costs, transport costs and energy costs. Altogether, across the many domains of social policy there are literally hundreds of distinct policy instruments. Describing how and to what extent these varied instruments are indexed, let alone how such indexation has changed over time, would be a major undertaking. Such an exercise is not possible here. Nevertheless, one observation can be offered with high confidence: the current approach to indexation is ad hoc, inconsistent and unfair (Boston and Chapple, 2014; St John and So, 2018). Moreover, this has been the case since the early days of the welfare state.

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Take, for instance, the main form of family assistance during the mid-20th century, the universal family benefit: this was never indexed, whether to prices or incomes. Instead it was adjusted occasionally, typically by Labour governments. The lack of indexation meant that the family benefit gradually lost much of its value, all the more so during the rapid price inflation of the 1970s and 1980s. This helped seal its eventual demise in 1991. Had the family benefit retained its value (as originally set in the mid-1940s), or, indeed, had its real value been increased regularly in line with the rise in average living standards (as reflected in changes in real wages or household incomes), it would have been much harder to abolish, at least politically.

The unsatisfactory nature of the current approach to indexation is highlighted by the inconsistent treatment of different forms of social assistance (see Boston, Dalziel and St John, 1999) and the implications of this for the distribution of incomes (see Perry, 2018). Compare, for instance, New Zealand Superannuation (NZS) and first-tier welfare benefits (i.e. jobseeker support, sole parent support and the supported living payment) or family assistance, such as the family tax credit and the in-work tax credit. NZS is indexed to both consumer prices and average wages. Under the provisions of the New Zealand Superannuation and Retirement Income Act 2001, the rate of assistance (after tax) to those aged 65 years and older must be adjusted annually to reflect movements in both prices[1] and wages (i.e. average ordinary time weekly earnings, for males and females combined, after tax). The Act requires that the rate of assistance for married couples or those in equivalent circumstances must not fall below 65%, or exceed 72.5%, of average ordinary time weekly earnings. These arrangements ensure that the incomes of elderly citizens are tied to the average earnings of those in paid employment. If average real wages increase from year to year, as has been the usual pattern for more than a century, then so do the real incomes of those receiving NZS.

The situation facing welfare beneficiaries and families with low market incomes is markedly different. First, welfare benefits and family assistance have never been indexed to wages. As a result, the value of welfare benefits and family assistance has typically fallen relative to average real wages over long periods of time – sometimes decades. Hence, many of those who are dependent on public assistance have become gradually worse off relative to the average living standards of those in paid employment. For instance, as highlighted in Figure 1, net benefit rates as a percentage of net average wage rates (including family assistance) have fallen almost continuously since 1986. During the same period, those on low market incomes with children have witnessed extended periods when the value of their child-related assistance has fallen in real terms.

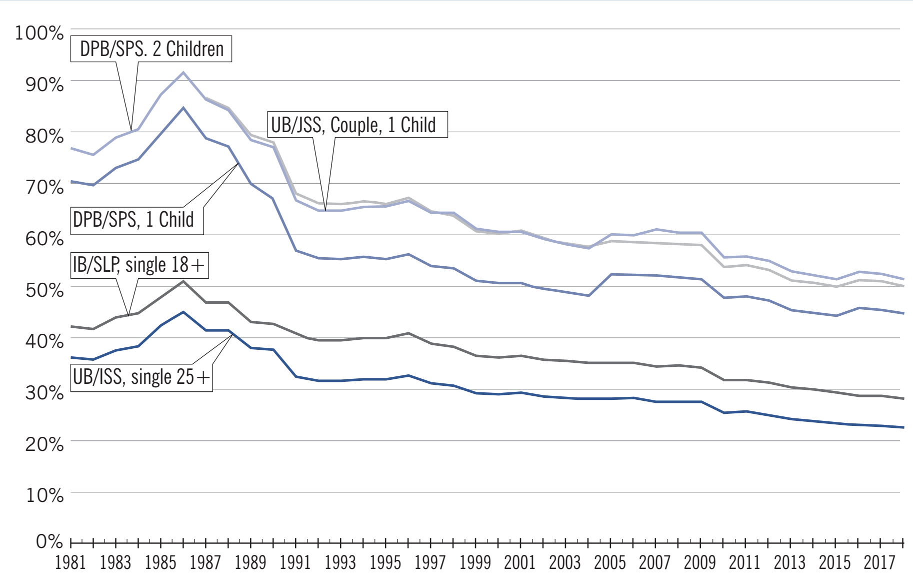
Second, many forms of social assistance are not *fully* linked to movements in the consumers price index (CPI). To be sure, in the case of most welfare benefits the basic rates of assistance are linked to the CPI (or, in recent times, the CPI excluding cigarettes and other tobacco products).[2] But the same linkage often does not apply to the income thresholds beyond which financial assistance is abated; nor does it apply to the value of assets (i.e. where asset tests apply). This means that over time some people will become ineligible for assistance, or the amount to which they are entitled declines. To compound matters, some important forms of social assistance are not indexed at all (e.g. the accommodation supplement), some have been only partially indexed for extended periods of time (e.g. the family tax credit), and some are only adjusted periodically when a particular trigger point is reached (e.g. price movements beyond a certain amount). Accordingly, other things being equal, those dependent on such assistance become worse off, not just in *relative* terms, but also in *real* terms (i.e. they experience a fall in their absolute standard of living over several or more years).

To illustrate, consider the following:

- The regime of tax credits for low-income families is not fully indexed to prices. The largest single tax credit, the family tax credit, is currently indexed, but during 2011–18 the top rate was not indexed. The next largest tax credit, the in-work tax credit, is not indexed at all, although it was adjusted as part of the Child Hardship Package which took effect in April 2016.
- The accommodation supplement has never been indexed since its introduction in the early 1990s, whether to the CPI or a specific index of housing costs. It was adjusted in 2005 (based on 2003 data), but then the nominal rate of assistance remained unchanged until April 2018, notwithstanding large increases in house prices and rents during the intervening period. Inevitably, many of those dependent on the accommodation supplement to help pay their housing costs gradually became worse off.
- Many income thresholds for various forms of social assistance have remained unadjusted for decades. The amount of income that jobseeker support recipients can earn before their benefit payments are reduced was last increased in 1996, while the cash asset limits for accessing the accommodation supplement have remained unchanged since 1988 (Ministry of Social Development, 2017, p.19). The failure to adjust the parental income threshold for accessing student allowances resulted in 20% fewer students being eligible for such assistance between 2011 and 2015.
- Many other forms of social assistance, including primary healthcare, disability assistance, early childhood education, tertiary education and legal aid, have never been fully or automatically indexed to prices – or the form of indexation has been altered on an ad hoc basis.
- Income tax thresholds are not indexed to prices. Hence, as incomes rise, the average tax burden gradually increases.

The failure to index social assistance on a consistent and principled basis has contributed to large (and increasing) income gaps between those in paid employment and those dependent on welfare benefits (see Raven, 2015; Perry, 2018). This gap was exacerbated in the early 1990s when the real value of most welfare benefits was cut and then again in the mid-2000s with the introduction of the in-work tax credit. Many families with one or both parents in paid employment have also been negatively affected by the absence of a robust system of price and wage indexation for the assistance they receive for their children (i.e. via the Working for Families tax credits), housing

Figure 1: Net benefit rates as a percentage of net average wage rates, including family assistance, 1981–2017



Source: Fletcher, 2018 – also with acknowledgement to the work of Kay Goodger and David Rea in the Ministry of Social Development

Notes: 1. Family assistance includes the Family Tax Credit, Family Support, and the Family Benefit over the relevant years. It does not include the In-Work Tax Credit or any partial entitlement to the Family Tax Credit that a person/couple on the average wage might have.
2. The average wage refers to the all industries, all persons, average ordinary time earnings on a full-time equivalent basis.
3. DPB = Domestic Purposes Benefit; JSS = Jobseeker Support; SPS = Sole Parent Support; SLP = Supported Living Payment; UB = Unemployment Benefit.

costs, and the costs of childcare and early childhood education.

Such problems are not, of course, unique to New Zealand (Adema, 2006; Barr, 1998; Social Welfare Benchmarking and Indexation Group, 2001; Weaver, 1988). But our heavy reliance on means-tested assistance rather than social insurance exacerbates the impact. Where citizens are covered by social insurance (as in the case of accident compensation in New Zealand), they typically receive earnings-related compensation (albeit with a monetary cap) if they are unable to undertake paid employment. Because such compensation is earnings related, there is an automatic link in the system to market incomes. Typically, too, the level of compensation is more generous in social insurance schemes than in means-tested systems.

benefits is modest (at best), with only a minority supporting more generous levels of assistance (see Rashbrooke, 2016).

Importantly, too, a lack of proper indexation constitutes a classic 'creeping problem'.[3] During times of low inflation, the fall in real and/or relative incomes experienced by those receiving social assistance is gradual. It thus attracts relatively little notice. To be sure, the cumulative effect over time may be large. But the process of gradual decline fails to generate specific 'focusing events' which spark the public's attention and concern (see Kingdon, 2014). Experienced politicians understand such matters and know that they will probably not be held to account – or at least not for many years. Equally, they know that a properly indexed regime generates few, if any, opportunities for positive, vote-catching announcements. By contrast, the absence of a fully indexed system enables governments to make periodic upward adjustments to the value of particular forms of social assistance, thereby giving voters a sense that the government cares and is doing something to assist those who have become worse off.

The fiscal cost of indexation is the other critical factor explaining the current ad hoc and inconsistent policy regime in New Zealand. For instance, fully indexing each and every form of cash assistance to an appropriate price index would be costly – probably over $100 million annually. Extending the current indexation system for NZS to first-tier welfare benefits and other important forms of income support (e.g. the family tax credit) would increase the fiscal cost further. And assuming that average wages continue to increase gradually in real terms, then the additional fiscal cost will be cumulative, not simply a one-off increase. For instance, if average real wages increased by, say, 10% over the next five years, the additional annual fiscal cost of a similar increase in the main welfare benefits would be around $450 million in 2024. (This would be on top of the extra cost arising from the current system of price indexation.) Moreover, if the main welfare benefits were linked to median household incomes, and if such incomes rose even faster than real wages, then the fiscal cost would be yet higher.

While fiscal considerations are very important, they should not have overriding priority. The current indexation framework is unfair. It has a negative impact on many of New Zealand's most deprived and vulnerable citizens. It needs reform.

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Explaining the current flawed indexation regime

Why have governments, including those of the centre-left, failed over at least three generations to develop a fairer and more consistent approach? Plainly, two factors are critical, one political, the other fiscal. In brief, indexation attracts remarkably little interest, whether academic, political or otherwise. There are very few academic papers on the topic and media coverage is limited (for a rare exception see Stock, 2016). Partly for this reason, the impact of indexation (or a lack thereof) on both *real* and *relative* incomes is often poorly understood. Equally, there are few votes at stake. Most of those negatively affected by an inadequate indexation regime are poor. They tend to be politically inactive and/or lack the means to protect their long-term interests. Similarly, survey evidence suggests that public sympathy in New Zealand for those receiving welfare

Indexation and reducing child poverty

Currently, there is another factor of high relevance to any discussion of indexation in New Zealand. In December 2018, Parliament enacted the Child Poverty Reduction Act. Significantly, the legislation passed with cross-party support. The new Act requires governments to set child poverty reduction targets for four primary measures. One of these is a relative (or moving-line) poverty measure. The threshold in question is 50% of median disposable household incomes before adjusting for housing costs. As a relative measure, it is adjusted annually to reflect movements in median disposable household incomes; these, in turn, are affected by changes in wages.

The current government has set a long-term target for this primary poverty measure, namely a reduction of two thirds – from around 15% in recent years to 5% by 2028. This is consistent with a promise made during the 2017 election campaign by Sir William (Bill) English (the then prime minister and leader of the National Party). By any standards, this child poverty reduction target is ambitious. In order to achieve it, the incomes of the country's poorest families will need to be raised relative to median disposable household incomes. Moreover, if such median incomes continue to rise, as is likely, it will also be necessary to ensure that the incomes of poor families increase at the same rate. Otherwise, the proportion of children living in households with disposable incomes below the 50% threshold will rise.

But here is a crucial point: in order achieve a significant and *sustainable* reduction in child poverty on this particular measure, it will not be enough simply to link social assistance to movements in the CPI (or a similar index); it will also be essential to link some of the most important forms of social assistance to movements in median or average wages, if not median disposable household incomes. This conclusion applies especially to those forms of income support which deliver the largest amount of cash assistance to our poorest families, namely first-tier welfare benefits and the family tax credit. Indeed, even if a government were to set a less ambitious long-term reduction target for the 50% poverty measure (before housing costs), the same basic logic would apply. If average wages (or median disposable household incomes) rise slightly faster than the CPI (as has generally been the case for many generations), then without linking major forms of income support – like first-tier benefits and the family tax credit – to wages (or median disposable household incomes), those families at the bottom of the income distribution (especially those largely or wholly dependent on welfare benefits) will gradually fall behind those in the middle of the distribution. As a result, relative rates of income poverty will increase. In short, if governments are serious about reducing child poverty on all four primary measures, they will have no choice but to revise the current system of indexation, especially for core areas of income support.

Designing a new indexation framework – issues and options

It is unclear whether the Welfare Expert Advisory Group will tackle the problem of indexation in a comprehensive manner. But if it does not, a further independent review may well be required. Arguably, such a review should consider the full range of cash and non-cash social assistance currently provided by the government and then assess what type of indexation is most applicable in each case.

Any such exercise should also consider overseas models. But it is not clear what lessons New Zealand might glean from experience elsewhere in the OECD, particularly in relation to wage indexation (see Adema, 2006). As noted earlier, most developed economies rely more heavily on social insurance than New Zealand. To the extent that such arrangements include earnings-related benefits, there are automatic linkages to wages. Aside from social insurance, the use of formal wage indexation is relatively uncommon. Equally, many other OECD countries, like New Zealand, have struggled to develop consistent and durable systems of price indexation.

If New Zealand's current system for indexing social assistance were to be redesigned, numerous policy issues would require detailed attention. These include:

- Which forms of cash and non-cash assistance should be indexed?
- What is the purpose of the various forms of social assistance? For instance, is it to cover part or all of the cost of a particular good or service, provide income replacement, or fulfil some other goal?
- Is the overall policy goal simply to maintain purchasing power over time or is it to ensure that social assistance is linked to changes in average living standards? If the latter, what is the appropriate measure of living standards and what are the appropriate benchmarks?
- What particular form (or forms) of indexation should be applied to each of the different forms of assistance? For instance, which particular indices of prices, wages or household incomes should be used? If there is a formal link to wages, should this be to median or to average wages and should a gross or net measure be used?
- Should all or only some aspects of a particular policy instrument be indexed (e.g. the rates of financial assistance, abatement thresholds, etc.)?
- Should all adjustments be mandatory (via appropriate legislation) and thus automatic in nature or should some be subject to annual budget decisions or other review processes?
- Should all adjustments be annual or should some be subject to numerical triggers (e.g. an increase in the CPI or average wages beyond a specified amount)?
- Should provision be made for independent periodic reviews of the indexation regime and, if so, how should such reviews be conducted? Equally, what provision should be made for adjustments to the regime in response to major economic shocks?

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Any serious analysis of such matters will need to consider a range of principles. These include: (1) practicality (e.g. is there an accurate and timely index available?); (2) simplicity; (3) fiscal affordability; (4) the role of indexation as an instrument for enhancing macroeconomic stability; (5) political acceptability; and (6) the wider policy implications (e.g. the indexation of income tax thresholds).

Several matters need stressing. First, a principled and consistent approach to indexation does not imply that every form of social assistance should be treated in the same way. For instance, there is a good case for housing assistance – most notably the accommodation supplement – being adjusted on the basis of an index of housing costs rather than the CPI (let alone average wages). For instance, Statistics New Zealand has developed the household living-costs price indexes, which could be used for adjusting the accommodation supplement.

Second, any systematic review of indexation would be challenging. There are many complex matters to address and many policy options. The accommodation supplement is a case in point. Currently, for the purposes of determining subsidy rates, various parts of the country have been assigned to four areas, each with a different maximum level of financial assistance. To the extent that housing costs change at different rates across the country, there may well be a case for a disaggregated system of indexation. But costs will also be rising at different rates within each of the four areas, which implies the need for a regular review of area designations as well as maximum rates.

New Zealand's lack of a principled, consistent and comprehensive regime for indexing social assistance constitutes a serious and enduring policy weakness.

Third, any additional indexation to *wages* (or household incomes) is likely to be controversial, not least because of the extra fiscal cost. Realistically, therefore, such indexation may need to be limited to several core forms of social assistance where the justifications are strongest. As noted above, first-tier benefits and the family tax credit are obvious candidates. If such an approach were to be pursued, at least two issues would need to be addressed. What particular index should be used (e.g. average wages (as for NZS), median wages or median disposable household incomes)? Next, should there be a designated range within which the value of first-tier benefits and the family tax credit must remain (as for NZS) or should there be a fixed ratio? Other things being equal, linking to median wages would be fiscally cheaper than linking to average wages or median disposable household incomes, but this would raise the politically sensitive question of whether to alter the current indexation regime for NZS.

Fourth, any new comprehensive indexation regime should ideally be embodied in legislation, thus providing clarity and a reasonable measure of certainty. Having said this, policymakers may be reluctant to support a more comprehensive and mandatory system because of the long-term fiscal implications and the risk of greater policy rigidity. How might these concerns be addressed? Or, to put it differently, how might a durable policy framework be constructed?

Securing a durable indexation framework

For durability at least two conditions must be satisfied: an adequate level of cross-party support and fiscal affordability over time. Both conditions are likely to necessitate an agreed process for responding effectively to significant economic shocks, together with a mechanism to enable periodic adjustments to the indexation regime – for instance, to reflect changing societal norms regarding adequacy. In other words, a well-designed 'flexibility mechanism' is needed.

Securing even a modest level of cross-party agreement for a more principled and consistent indexation regime will almost certainly be difficult. To be sure, a consensus on the indexation of NZS was reached in 1993. But this reflected a distinctive and fraught political context: both major parties had made politically unsustainable policy decisions on retirement incomes during the preceding decade, and both were thus keen to depoliticise the topic and rebuild trust. In short, the two major parties shared a common political interest in securing a negotiated settlement on the level of, and annual adjustments to, retirement incomes. The same situation does not apply currently to the indexation of other forms of social assistance. To be sure, National's support for the Child Poverty Reduction Act provides a possible political 'hook'. But otherwise there are few cross-party drivers for a fairer and more consistent indexation regime, especially given the added fiscal cost.

With respect to the design of a 'flexibility mechanism', one approach would be to establish, via legislation, an independent advisory committee on indexation. Such a committee would be comprised of people with relevant expertise and required to operate in accordance with clear statutory criteria. It would have two main responsibilities. The first would be to undertake periodic reviews (e.g. every five years) of the overall system of indexation, together with the indexation of each specific form of social assistance, and make recommendations to the government for reform. The second task would be to respond to governmental requests to undertake ad hoc reviews – for instance, following a major economic shock. Under such a policy framework, the government would be obliged to receive advice from the indexation committee before making any changes to the indexation regime. The government would retain the right to reject the committee's recommendations but could be obliged (via the relevant legislation) to provide explicit reasons if it did so.

There are various options regarding the form and composition of an indexation committee. One of these would be to establish a new stand-alone entity comprised of independent experts. But this would entail extra costs and may not be justified if the committee's inquiries were infrequent. An alternative approach would be to mandate the proposed Independent Fiscal Institution (IFI) with the task of providing expert advice on indexation as one of its statutory responsibilities. This would entail the IFI employing staff with the requisite expertise to undertake such analyses, but this is highly likely given the IFI's anticipated roles.

Conclusion

New Zealand's lack of a principled, consistent and comprehensive regime for indexing social assistance constitutes a serious and enduring policy weakness. It has been among the major factors contributing to higher rates of relative poverty and income inequality over recent decades. The country's poorest and most vulnerable citizens deserve better. Accordingly, the current indexation framework requires urgent review. Whether the Welfare Expert Advisory Group addresses the matter adequately remains to be seen. If not, other opportunities to tackle the problem will need to be pursued.

1. In recent years, NZS (along with many other forms of income support) has been linked to a modified version of the Consumer Price Index (CPI) (all index groups) which excludes the price of cigarettes and other tobacco products. The use of the modified CPI reflects the desire of recent governments to ensure that large increases in the tobacco excise (designed to reduce smoking) are not reflected in adjustments to income support.
2. See the Social Security Act, S61HA(3). Note that some rates and thresholds are adjusted on the basis of legislative mandates, some are adjusted by successive governments by convention, and others are adjusted on an ad hoc basis.
3. For a discussion of 'creeping problems' see Boston (2017), pp.39-46.

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