The Future Costs of Working-Age Welfare

New Zealand Treasury

BACKGROUND PAPER FOR THE

2013 STATEMENT ON THE LONG-TERM FISCAL POSITION

JULY 2013

THE TREASURY
Kaitohutohu Kaupapa Rawa

New Zealand Government

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MONTH/YEAR	July 2013
URL:	Treasury website at July 2013: www.treasury.govt.nz/government/longterm/fiscalposition/2013

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The Future Costs of Working-Age Welfare

1 Summary

1.1 The focus of this paper is on how best to project welfare spending pressures over the next 40 years for incorporation into the Treasury's *2013 Statement on the Long-Term Fiscal Position* (i.e. establishing a robust *base case* scenario)*.*

1.2 In the 2009 and 2006 long-term fiscal (LTF) Statements, the Treasury had assumed a constant proportion of recipients, and the indexation of payment rates to the Consumers Price Index (CPI).

1.3 While the main welfare benefit types have generally been adjusted to capture changes in the CPI over the last 40 years, there have however been other trends that were not adequately incorporated in the modelling utilised in the two previous LTF Statements (including changes to supplementary assistance and family tax credits, and rising receipt rates for health- and disability-related benefits).

1.4 The Treasury's assessment, therefore, is that a change to the *base case* for projecting future welfare cost pressures is appropriate for the *2013 Statement.*

1.5 The *2013 Statement* will incorporate an amended CPI-indexed scenario which specifically reflects higher trend growth for some payments and recipients, while continuing to index the main benefit types to changes in the CPI.

2 The New Zealand Welfare Framework

2.1 Objectives of the welfare system

2.1.1 The benefit system in New Zealand is a safety net. It provides temporary help to people in times of unemployment and adversity when they have no other means of support, and provides permanent or long-term support for those who have no means of supporting themselves. This help is given in two ways, by providing income when someone cannot work, and by helping many people to find work so they can be more financially independent.

2.1.2 This support can be thought to be given with three objectives in mind:

- **Equity:** To increase the living standards (or minimise poverty) of low-income households;
- **Labour-market incentives:** To provide incentives to work; and
- **Fiscal cost:** To meet the above two objectives at least cost to the government.

2.1.3 These three objectives are often referred to as the *iron triangle* of welfare policy. This is because it is impossible to find policies that fulfil all three of these objectives. Generally a particular policy will fulfil one or two objectives, while adversely affecting the other one, creating unavoidable trade-offs. The emphasis placed on each of these objectives can change through time and differ across countries.

2.2 The living standards framework

2.2.1 These three objectives also feature in the living standards framework that is the basis for Treasury analysis across spending and tax in the *2013 Statement*. The framework looks at these objectives from a longer-term perspective and includes:

- Equity
- Economic growth
- Fiscal sustainability
- Risk, and
- Social institutions.

2.2.2 In the case of welfare policies and scenarios we can interpret the above objectives as:

- Equity/distributional: How does the scenario impact on the distribution, e.g. relative poverty measures and/or comparisons against average wages? Will this impact on some groups more than others (older vs. younger, by ethnicity etc)?
- Economic growth/efficiency: How does the scenario impact on economic growth by changing incentives to participate in the labour force?
- Fiscal sustainability: How does the scenario impact on the cost to the Crown?

- Risk: How does the scenario impact on national savings (macro) and how does it impact on the risk individuals bear from a change in their circumstances (micro)?, and

- Social institutions: How does this scenario impact on the implicit social contract?

2.3 The structure of the welfare system

2.3.1 The benefit system is comprised of the main benefit payments (such as the Unemployment Benefit, the Domestic Purposes Benefit, the Sickness Benefit and the Invalid's Benefit) and several supplementary payments (often described as second and third tier payments), including Accommodation Supplement and the Disability Allowance. These second and third tier payments are generally paid to help meet a specific cost.

2.3.2 From 15 July 2013 the five main working-age benefits, namely the four listed in the last paragraph and Widow's Benefit, will be replaced by three new benefits. These are Jobseeker Support, Sole Parent Support and Supported Living Payment. These changes are part of a programme of welfare reform to increase the work-focus of the benefit system. The changes will utilise more up-front investment in groups of people who are at a greater risk of remaining on benefit long term and who may have more success in returning to work with an increased level of support to assist them to move off benefit. Most beneficiaries aged 16 or 17 have also been moved to another new benefit type, the Youth Payment. Receipt of this new benefit is aligned with helping young people into education, training or work-based learning that will help them build their skills and find a job.

2.3.3 Much of the information and many of the tables and graphs in this paper are historical in nature. As such, they will use and refer to the benefit types that existed at the time, such as Unemployment Benefit. However, any discussion, graphs or tables that deal with future welfare-related issues will utilise the new benefit system that will be in operation then. For example, it would seem somewhat pointless to depict a projection of Unemployment Benefit recipient numbers out to the year 2060, when this benefit type will not even exist at the end of 2013.

2.3.4 The above approach, i.e. history reflecting one benefit system while forecasts and projections reflect another, has an obvious potential to be confusing. However, at the level of total spending or aggregate recipient numbers, comparisons are still relatively straightforward. This is because all existing beneficiaries, in any of the affected categories on the changeover date of 15 July 2013, will be moved into one of the new categories. Their benefit payments will not change.

2.3.5 The whole focus of the welfare changes is to assist beneficiaries to find and retain paid employment. Hence it would be misleading to state that, five or ten years into the future, a projection of the current Unemployment Benefit would simply be a subset of the new Jobseeker Support projection. However, it will take time for the effects, of the increased work focus for beneficiaries and support to find and retain jobs, to change recipient levels. Consequently it is possible to explain how the old and new benefit categories align at the time of the changeover, which is as follows:

- Most Invalid's Benefit recipients will move to the Supported Living Payment, which will also pick up a small group of those currently receiving Domestic Purposes Benefit in the Care of the Sick or Infirm sub-category.

- Sole Parent Support will be the new category that the majority of Domestic Purposes Benefit recipients and some Widow's Benefit recipients will move to, as it is designed, in terms of work test conditions, for those in the current sub-category of Sole Parent whose eldest child is under 14 years of age.

- Jobseeker Support will be the new benefit category for those working-age beneficiaries currently receiving Unemployment or Sickness Benefit, and also for any current Domestic Purposes or Widow's Benefit recipients who are not transferring to either Sole Parent Support or Supported Living Payment.

2.3.6 Sitting alongside the benefit system is *Working for Families*, a series of tax credits targeted at families, which are administered by the Inland Revenue Department. The Family Tax Credit is available to low-income beneficiary and working families while others (the In-Work Tax Credit and the Minimum Family Tax Credit) are targeted solely at low-income working families. These tax credits can form a significant part of the income of beneficiary and low-income families.

2.3.7. Paid parental leave is also administered by the Inland Revenue Department and provides for up to 14 weeks of paid parental leave to eligible people after the birth or adoption of a child. These payments go towards the loss of income that parents experience when they take parental leave from work to care for a new baby or adopted child.

2.3.8 The broader welfare system includes a number of other supports and services. Some of these are directly related to the benefit system, and also administered by Work and Income. These include case management of beneficiaries, employment assistance, health and disability support and other employment-related services. Child, Youth and Family, and Family and Community Services, are also included in welfare spending and offer a variety of support and services to vulnerable children, families and communities. The Ministry of Social Development (MSD) also includes policy and corporate services to support these service delivery organisations.

2.3.9 This paper is focused on income support payments, including main benefits, supplementary payments and Working for Families tax credits, as these comprise around 80-90% of working-age welfare spending.

Table 1: Structure of the income support system

First tier - main benefit	Second tier – cost related	Third tier – other payments
Unemployment Benefit	Accommodation Supplement	Special Needs Grant (e.g. Food)
Domestic Purposes Benefit	Disability Allowance	Temporary Additional Support
Sickness Benefit and Invalid's Benefit	Childcare Assistance	Advance payment of benefit
Other main benefits	Other second tier payments	Other third tier payments
Working for Families tax credits		

2.3.10 The table above refers to the current (pre-15 July 2013) New Zealand income support system. As explained above, Unemployment, Domestic Purposes, Sickness, Invalid's and Widow's Benefits will be replaced by Jobseeker Support, Sole Parent Support and Supported Living Payment from 15 July 2013 onwards. These new benefit categories would still be considered to be the first tier, along with some other benefits like Orphan's Benefit.

Table 2: Working-age welfare spending in 2011/12[1]

Payment type	$ billion	% of non-NZS welfare	Recipients[2]
Main benefits	**5.1**	**42**	
DPB	1.8	15	114,000
Unemployment benefit	0.9	7	73,000
SB/IB	2.1	17	147,000
Other	0.3	3	
Supplementary payments	**2.8**	**22**	
Accommodation supplement	1.2	10	311,000
Income-related rents	0.6	5	61,000
Disability assistance	0.4	3	290,000
Childcare assistance	0.2	1	46,000
Other[3]	0.4	3	
Working for Families	**2.7**	**22**	
Family Tax Credit	2.1	17	352,000
In-Work Tax Credit	0.6	5	233,000
Other	0.03	0.3	21,000
Paid parental leave	**0.2**	**1**	33,000
Other[4]	**1.7**	**13**	
TOTAL	**12**	**100**	

2.3.11 Compared with many other developed countries, the New Zealand benefit system is a tightly targeted system that offers support to mostly low-income recipients. Unlike a contributory social/employment insurance system (which is more common overseas), the New Zealand system is funded from general taxation and offers flat rates of payment that are not dependent on previous wages. These payments are also not time limited.

[1] This data was sourced from Treasury, MSD and Inland Revenue.

[2] These are the average number of recipients over a fiscal year. Working for Families measures recipient families and are March year, as opposed to June year figures. The Working for Families recipient family numbers are also provisional, as the 2011/12 data is not complete at the time of publishing.

[3] This includes hardship assistance and other MSD, Defence and Housing-administered benefits.

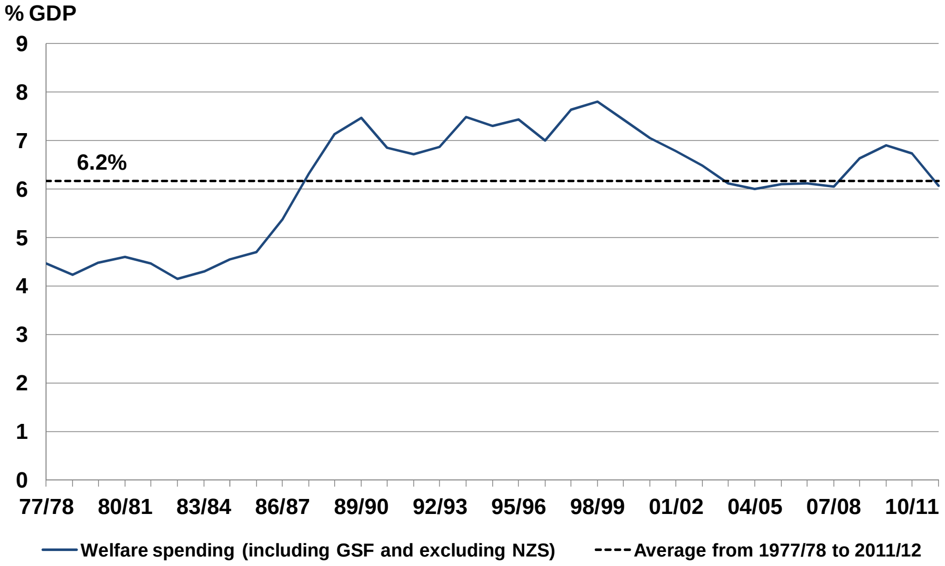
[4] This includes departmental and non-departmental spending, and also a few other appropriations that we need to look at a bit more (including child support impairment and social rehabilitation and compensation). For this reason, movements in 'other' spending should be taken with a grain of salt.

3 History of welfare spending

3.1.1 In order to determine the most appropriate *base case* for projected future costs of welfare spending, it is important to carefully examine the history of welfare spending over the last 40 years.

3.1.2 Spending on welfare (excluding New Zealand Superannuation, but including the Government Superannuation Fund[5]) has been quite volatile, mostly due to the cyclical nature of the spending, as shown in the graph below. It has increased substantially from 4.5% of GDP in 1977/78 to 6.1% of GDP in 2011/12, but within that time period has been as high as 7.8% of GDP and as low as 4.1% of GDP, with an average of 6.2% of GDP.

Graph 1: Historical non-NZS welfare spending to nominal GDP, 1977/78 to 2011/12[6]

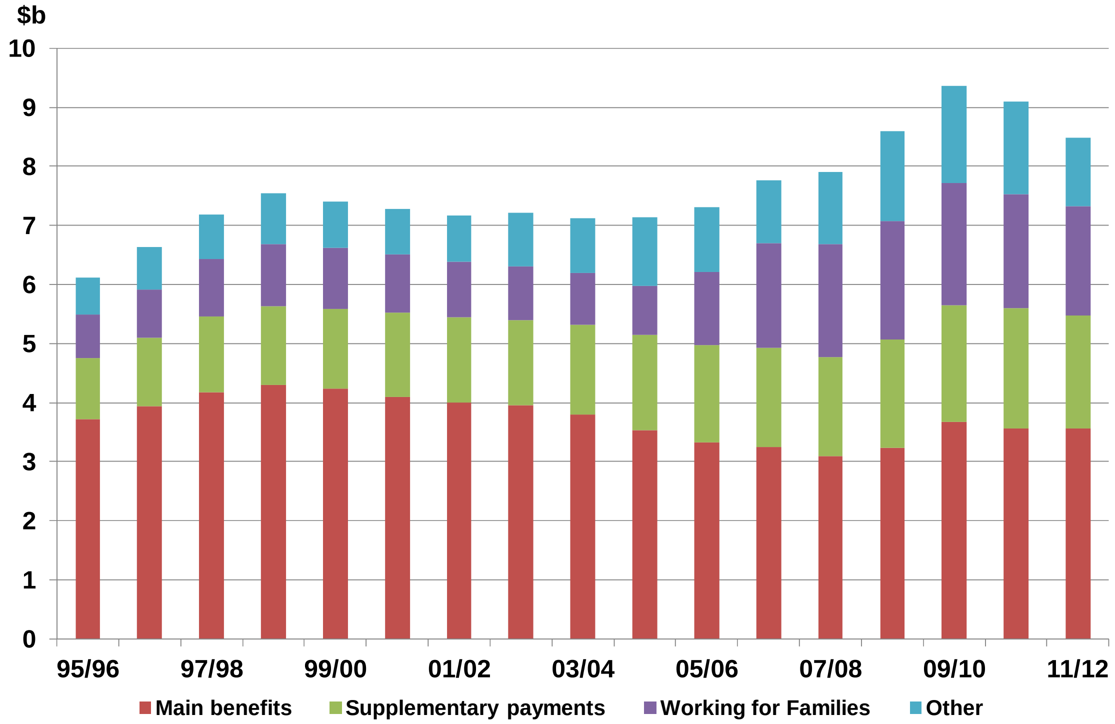


3.1.3 Excluding the effects of GDP and inflation, Graph 2 below shows real spending on each of the main components of welfare. This shows that, in real terms, the spending on main benefits has been relatively flat, decreasing slightly in real terms between 1995/96 and 2011/12. However real spending on supplementary payments, and particularly *Working for Families*, has increased substantially - from 1995/96 to 2011/12, real spending on supplementary payments increased by about 85%, and increased by nearly 150% on *Working for Families*.

[5] This is included because it cannot be excluded from our series before the mid-90s. It comprises a very small proportion of welfare spending and does not materially impact the analysis.

[6] All graphs in this paper (unless otherwise stated) were created by the Treasury using data from Treasury, MSD and Inland Revenue.

Graph 2: Cumulative real non-NZS welfare spending (1995/96 dollars), 1995/96 to 2011/12



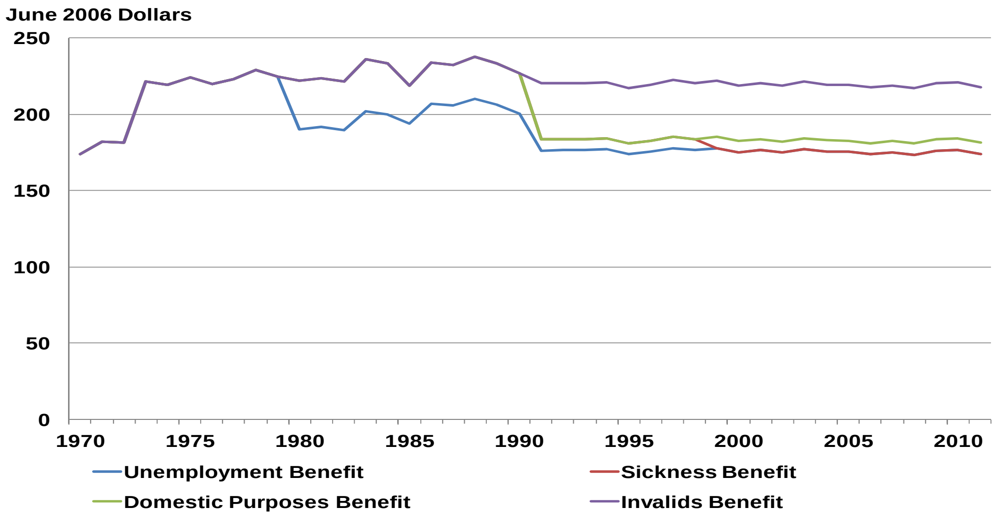
3.1.4 Welfare spending is determined by how much is paid per recipient[7] multiplied by the number of recipients. Over the last 40 years, main benefit payments have tended to grow in line with the rate of consumer price inflation and this was eventually explicitly written into legislation in 2010. The number of recipients, of course, also significantly determines the overall cost of the system. This number can be driven by economic conditions (i.e. unemployment in booms and recessions), by policy changes (such as the introduction of the Domestic Purposes Benefit), or by other factors (such as the increasing proportion of people on sickness/invalid's benefits). The following sections attempt to disaggregate welfare spending into the effects of price and volume.

3.2 Major trends and policies

3.2.1 The payment rates of main benefits have been broadly benchmarked to the rate of CPI inflation, particularly since 1992 (although there were real increases in payment rates in the 1970s, and real cuts in 1991, as captured in the graph below).

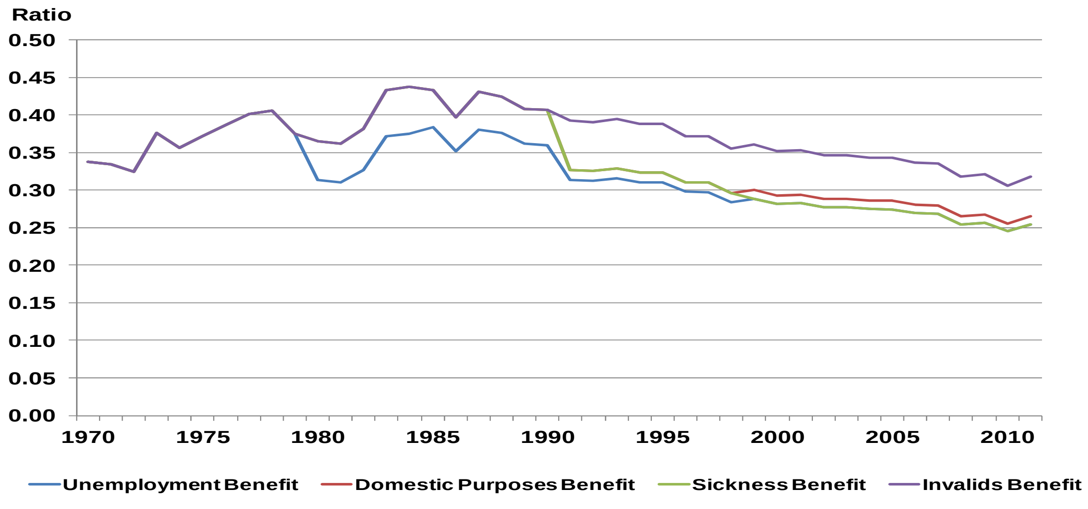
[7] How much you pay each recipient is further determined by three factors: the maximum payment rate, the threshold at which the payment begins to be abated away, and the abatement rate.

Graph 3: Real benefit levels



3.2.2 The graph below shows that, compared with average wages, benefit payments have declined in value, particularly since 1990. In the 1970s and 1980s benefit payments, relative to both inflation and wages, were more volatile. This was partly due the economic changes at the time and the high level of inflation (as wage growth did not always exceed or even match inflation).

Graph 4: Ratio of benefit payments to net average wage



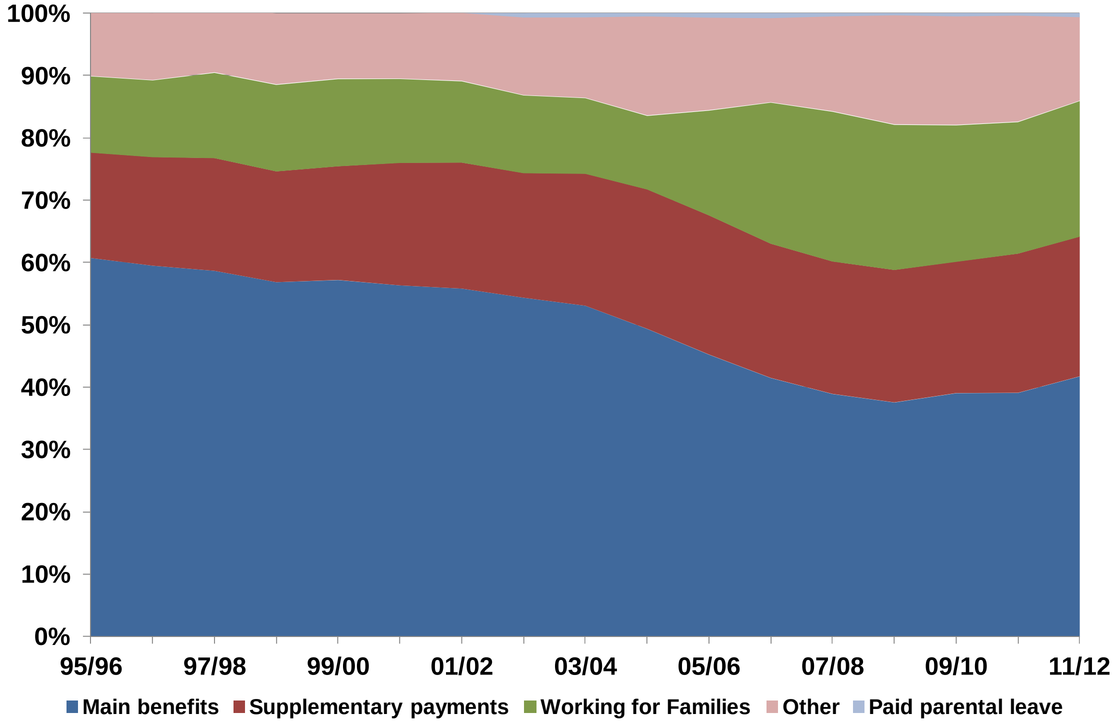
3.2.3 Supplementary payments (including *Working for Families* tax credits) have become an increasingly larger proportion of beneficiaries' (and non-beneficiaries') incomes in the last ten or so years.[8] This appears to have largely been driven by the *Working for Families* changes from 2004 to 2007. These increased the payment amounts of family assistance (the family tax credit, the in-work tax credit and the minimum family tax credit) and the accommodation supplement and childcare assistance. Changes were also made to eligibility thresholds and abatement rates

[8] Ministry of Social Development's statistical report sets out the maximum payment rates of supplementary payments as at April 2011 http://statistical-report-2011.msd.govt.nz/

which also increased the payments that people received. The changes that were made were mostly targeted at low-income working families, rather than beneficiaries.

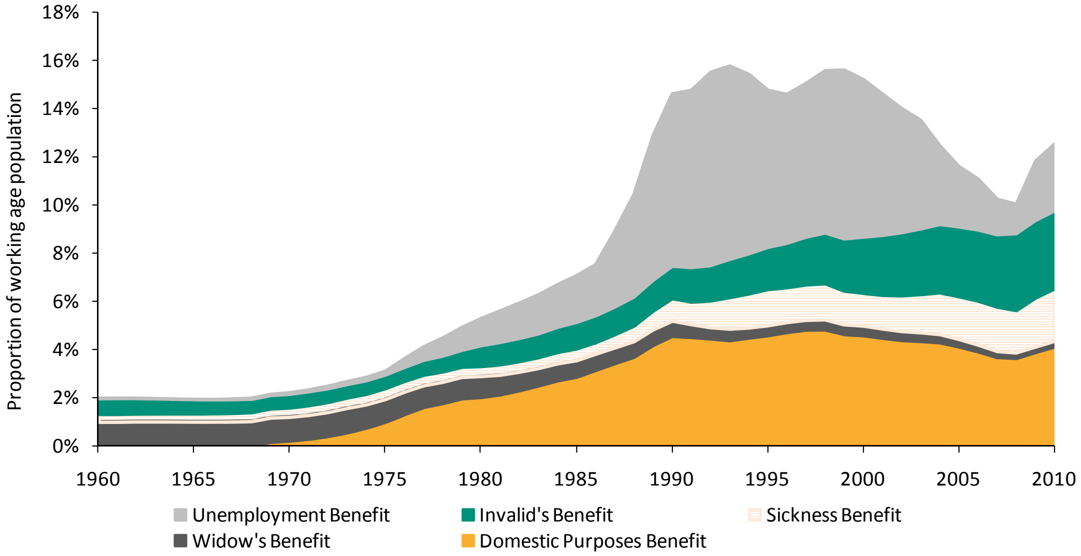
3.2.4 Total welfare spending also reflects this change, as shown in the graph below. Main benefits have gone from 61% of total (non-NZS) welfare spending in 1995/96 to 42% in 2011/12. This has largely been driven by increased spending on *Working for Families*, and to a smaller extent by increases in spending on supplementary payments.

Graph 5: Components of welfare spending



3.2.5 The graph below shows the substantial increases in benefit recipients since the 1960s. The number of people claiming the domestic purposes benefit (DPB) continually rose from its introduction in 1973 until 1990. Since 1990, DPB recipient numbers have been relatively stable, with small increases and decreases generally associated with the economic cycle, though NZ does have a relatively low rate of sole parent labour market participation, compared with other countries. The number of people claiming the unemployment benefit is largely cyclical.

Graph 6: The growth in the prevalence of benefit receipt among the working age population, 1960 to 2009[9]



Note: The historical series is a count of main benefit payments. It is across all working age groups (18-64 year olds) and does not include partners.

Source: Ministry of Social Development Statistical Reports and Statistics New Zealand population estimates.

3.2.6 There is also an issue with increasing long-term benefit dependency. This appears to have been largely driven by a substantial increase in the proportion of the working-age population who claim health- and disability-related benefits. This trend has also been observed across many other OECD countries. As shown in the graph above, in NZ, rates on the sickness and invalid's benefits (SB/IB) have risen from under 1% of the working-age population in the mid-1970s to almost 5% of the working-age population in 2009. There is no evidence that the health of the working-age population has declined over this period of time. This trend has only recently been arrested, with the number of SB/IB recipients remaining broadly the same from 2009 to 2012 at just under 150,000 recipients.

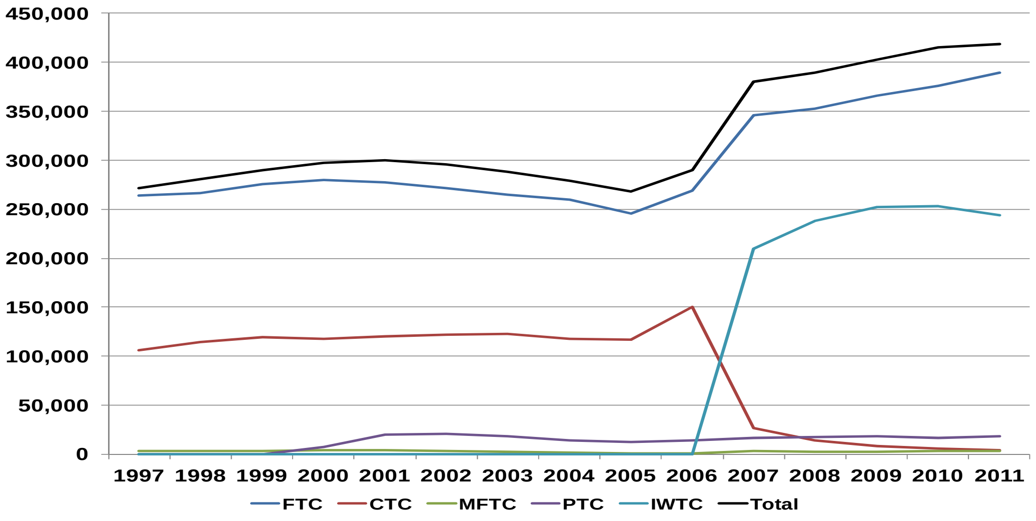
3.2.7 Michael Fletcher argues[10] that this substantial increase was primarily driven by changes in the labour market and the operation of the benefit system. On the labour market side, substantial and persistent increases in unemployment in the 1980s and 1990s increased SB/IB numbers and meant that these beneficiaries were pushed to the back of an increasingly long queue for jobs. Successive governments then focused on reducing the number of unemployment beneficiaries, while paying less attention to SB/IB recipients until more recently. Small parts of the increase can also likely be attributed to increasing the age of retirement from 60 to 65 in the 1990s (and a generally ageing population), and a small increase in the prevalence of mental health disorders.

[9] Welfare Working Group, 'Long-Term Benefit Dependency: The Issues', p.9

[10] Fletcher, M., 'Addressing the growth in Sickness and Invalid's Benefit receipt'.

3.2.8 The *Working for Families* package also increased recipient numbers, as shown in the graph below. The increase in recipients was among non-beneficiaries (i.e. low-income working families). In 1997, 65% of the recipient families of family assistance received payments only from MSD, while 31% received payments only from IRD. In 2011 these numbers were 28% and 68% respectively, a substantial shift. Eligibility for these payments stretches relatively far up the income spectrum. This is simply the consequence of a relatively gradual abatement rate, which minimises the increase in the effective marginal tax rates (EMTRs) of those affected. However, a gradual abatement rate also increases the number of households affected by this higher EMTR.

Graph 7: Number of families in receipt of Working for Families, 1997 to 2011[11]



3.2.9 The *Working for Families* package also contained changes to the accommodation supplement and childcare assistance (supplementary payments) that increased the number of eligible families.[12]

3.2.10 Marrying payment rates with recipient numbers assists analysis into the growth in *per recipient* spending over time in inflation-adjusted terms and relative to changes in average wages. The graph below shows the average annual growth in payment per recipient for the four main benefits, the accommodation supplement, disability assistance, the family tax credit and income-related rents.

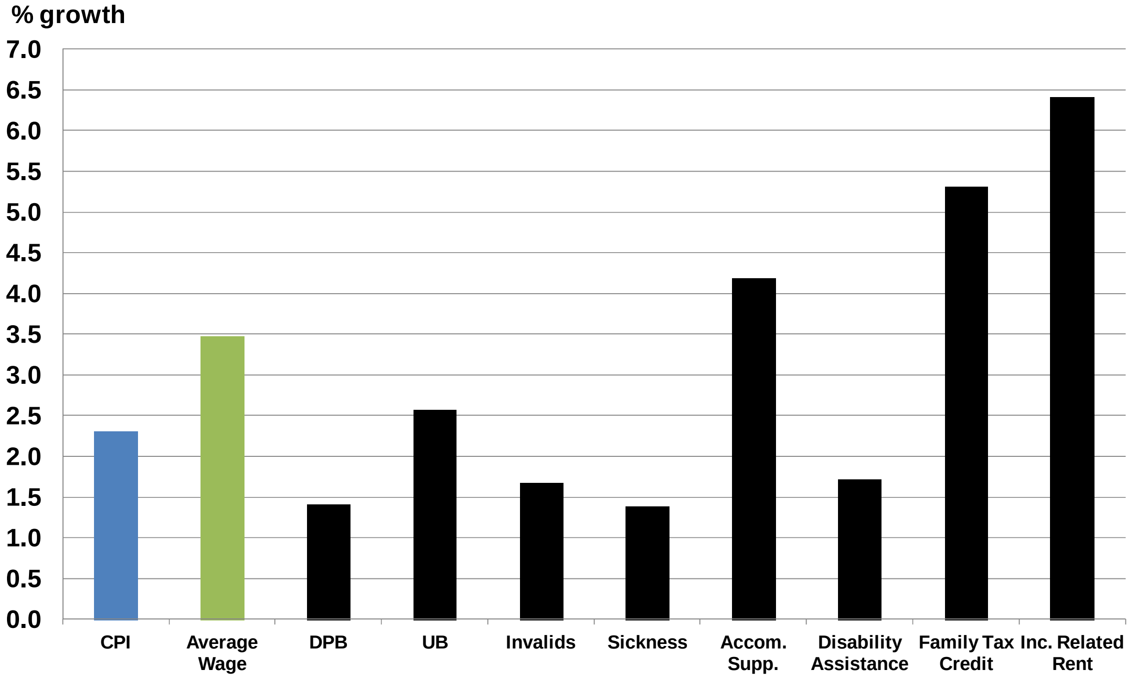
3.2.11 This graph shows that main benefits payments per recipient have increased at around the rate of inflation[13].

[11] FTC = Family Tax Credit, CTC = Child Tax Credit, MFTC = Minimum Family Tax Credit, PTC = Parental Tax Credit and IWTC = In-Work Tax Credit.

[12] For more information on supplementary benefits received by beneficiaries and non beneficiaries as at April 2011 refer to the Ministry of Social Development's statistical report

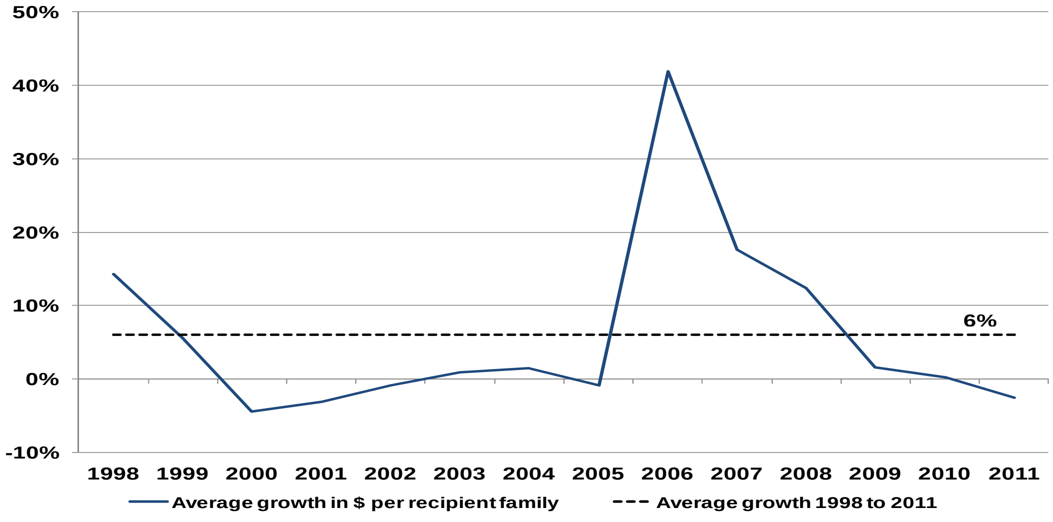
[13] In graph 8 some of the main benefit types' average annual percentage growth of per recipient expenditure has grown at less than inflation. While the maximum payment rates of these main benefits are indexed to inflation, the average payment per recipient will also be influenced by factors other than the maximum rate, such as the changes to the proportion of recipients receiving the maximum and the proportion receiving a partially abated amount. Policy changes can also influence these numbers, including the shift of child rates from benefits to the family tax credit.

Graph 8: Average annual percentage growth of per recipient expenditure from 1996/97 to 2011/12, compared to CPI and average wage growth



3.2.12 In *Working for Families*, the average annual growth of payment per recipient family has been 6% from 1997 to 2011, but has been very volatile as shown in the graph below.[14]

Graph 9: Average growth in Working for Families payment per recipient family[15]



[14] Prior to the introduction of Working for Families the data depicted captures Family Support

[15] Includes all Working for Families payments (FTC, IWTC, MFTC, CTC and PTC).

4 Scenarios

4.1 The focus of this section is to compare two alternative approaches to determining how to best project potential welfare[16] spending pressures over the next 40 years and to explain how the Treasury decided on selecting the *base case* that it *has* adopted for the *2013 Statement e.g.* an amended *CPI-indexed* scenario which specifically reflects higher trend growth for some payments and recipients while continuing to index the main benefits to changes in the CPI as was the approach in the two previous LTF Statements.

4.2 An approach examined by the Treasury, but not adopted for the Statement, was to project the Crown expense implications that would arise out of maintaining welfare spending as a roughly stable share of the economy over time.

4.3 An important distinction between the two potential approaches is around how prescriptive they would be able to be. A GDP-based approach would necessarily need to be presented as less specific and able to be made up of a variety of difference assumptions about payments and recipients whereas a CPI+ approach is able to be more prescriptive in terms of the composition of its component assumptions.

4.4 The other major difference is that a CPI+ scenario continues to project declining welfare spending-to-GDP track, ending the projection period at a little over 1% of GDP below the starting point (though a simple CPI-indexed track would end at nearly 2% of GDP below the start). A GDP approach would in contrast maintain a broadly constant share of welfare spending as a ratio to GDP across the projection period.

4.5 In previous LTF Statements, the Treasury precisely defined its interpretation of current policy as the CPI indexation of payment rates, and a constant proportion of recipients by age groups. In these LTF Statements this track has also shown a substantial decline relative to GDP over the projection period.

4.6 Changing the *base case* assumption is a significant decision, with a substantial impact on the fiscal projections of the fiscal gap, debt and other aggregate fiscal measures in the decades ahead. Following external feedback, the Treasury decided to adopt a CPI+ scenario as its base case in the *2013 Long Term Fiscal Statement.*

Background on the Long-Term Fiscal Model

4.7 The Long-term Fiscal Model (LTFM) contains two time periods for welfare spending. The first is the five-year forecast period (2012/13 to 2016/17), which is based on detailed forecasts made by MSD with many complex models including factors like abatement rates, thresholds and recipient movements between, out and in of benefits. This forecast period assumes that current policies continue, i.e. the CPI indexation of benefits. The forecast period also takes into account movements in underlying economic conditions, currently showing a gradual economic recovery.

[16] Throughout this section welfare spending should be taken to mean core Crown social security and welfare expenditure, **exclusive of spending on New Zealand Superannuation** (NZS).

4.8 The projection period (from 2017/18 onwards) is modelled within the LTFM itself, and the growth in welfare spending is simply modelled by the growth of payment rates and recipient numbers of each of the main benefits, supplementary payments and family tax credits. In this period the economy is largely assumed to be in equilibrium, so there are no ongoing cyclical economic effects. The base case we are considering in this paper is the base case for the projection period.

CPI indexation – the previous base case

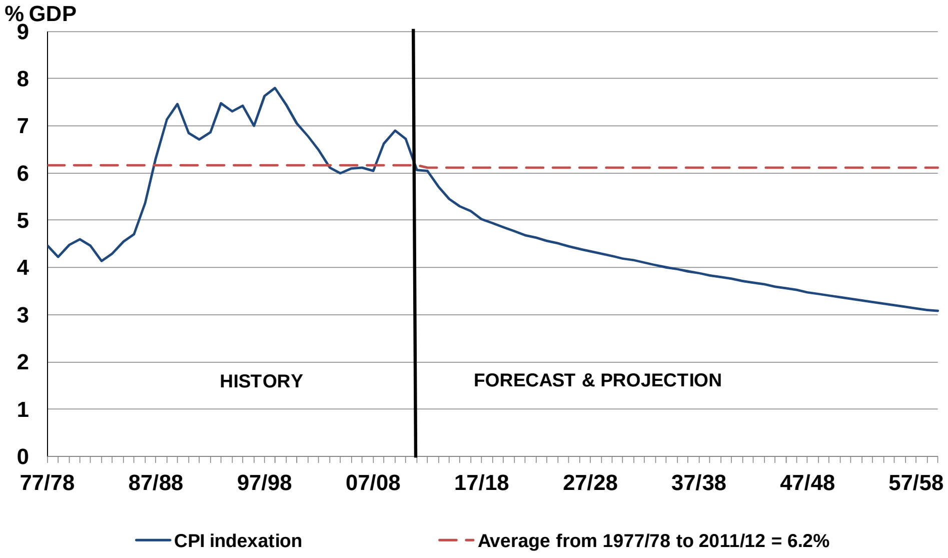
4.9 In the 2009 and 2006 LTF Statements, the base case assumed that all main and supplementary benefit payments and family tax assistance would continue to grow with inflation – i.e. they bought the same basket of goods and services. Eligibility thresholds and abatement rates are not explicitly modelled. The proportion of beneficiaries in each age group in the working-age population was also constant beyond the first five-year forecast period.

Fiscal consequences

4.10 As GDP is projected to grow with inflation and productivity (or wage) growth, and benefits only grow with inflation, this means that spending on welfare decreases as a proportion of GDP over the fifty-year period, from 6.7% of GDP in 2010 to 3.1% in 2060. This is almost entirely driven by the falling value of payments relative to GDP, and to a very small extent by the shrinking proportion of working-age people in the population. It is also important to note that much of this decline occurs in the initial five-year forecast period, which is largely driven by the forecast economic recovery. By the final year of the forecast period (in 2016/17) welfare spending has already fallen to 5.0% of GDP.

4.11 The decrease in relative spending over the projection period (just under 2% of GDP) offsets around two-thirds of the projected increase in spending on NZS.

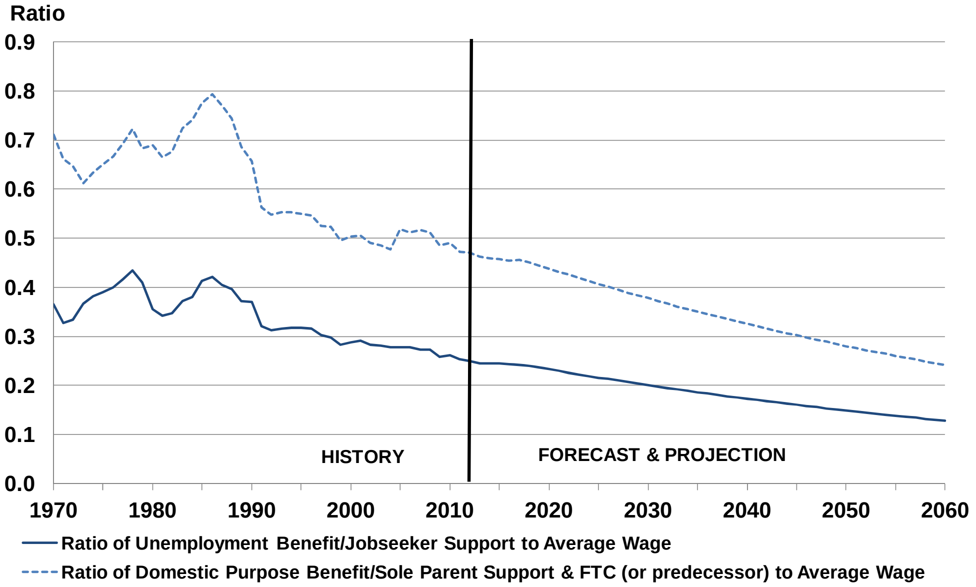
Graph 10: Welfare spending to GDP, 1997 to 2060



Other considerations

4.12 CPI-indexation of benefits for a further 40 years would result in a significant divergence between wages and benefits as shown in the graph below. The ratio of the Domestic Purposes Benefit (or Sole Parent Support beyond 2013) plus the FTC (the component of *Working for Families* that beneficiaries are entitled to) to the average wage would effectively ease by half, from just under 50% currently to around 25% in 2060. The ratio of the Unemployment Benefit (or Jobseeker Support beyond 2013) to the average wage would do much the same, dropping from around 25% currently to around 13% in 2060.

Graph 11: The ratio of select welfare payments to the average wage, 1970 to 2060



4.13 While it is clear that the ratios of benefits to the average wage have been trending downwards for the last twenty years, projecting this trend to continue for a further 40 to 50 years is not the only reasonable interpretation of existing policy settings.

CPI+ approach

4.14 The CPI+ approach to be adopted in the *2013 Statement* continues the assumption of CPI indexation of main benefits, but alters some other key assumptions to better reflect historic trends and averages. This adjustment has been made to better capture what has been happening with supplementary payments and *Working for Families*. As shown in Graph 8, the rate of growth in payment rates for the Family Tax Credit and housing assistance (Accommodation Supplement and Income Related Rents) has been much greater than the rate of CPI inflation in recent years.

4.15 The main changes in the CPI+ approach, relative to previous Long Term Fiscal Statement's projections of welfare spending, are:

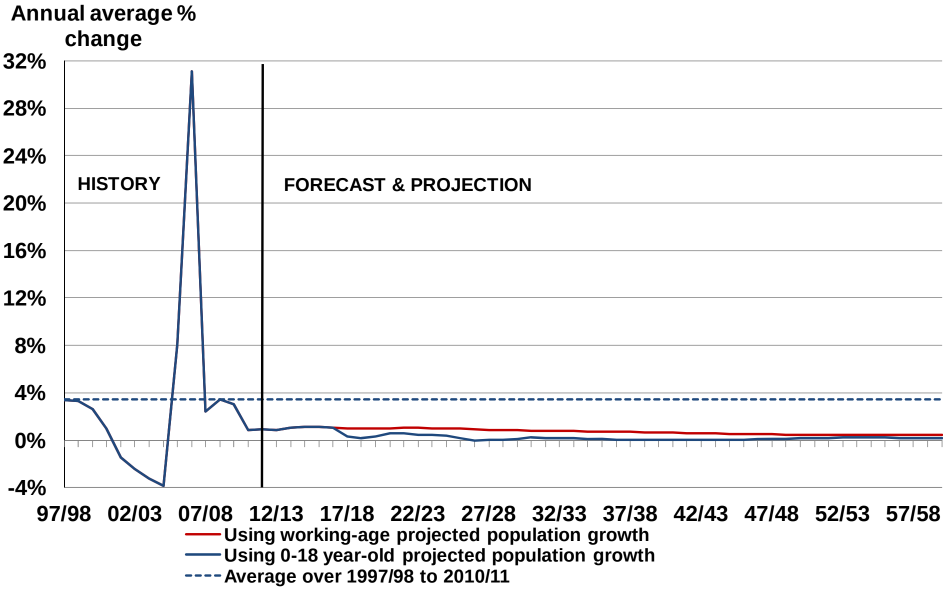
- *Payment rates*
  - Family Tax Credit and housing assistance (AS and IRR) payment rates indexed to wage growth rather than just CPI indexed

- *Recipient numbers*
  - Working for Families Tax Credits recipient growth aligned to that of the working-age population, rather than the population growth of the 0-18 years-old age group.
  - Disability Assistance recipient growth averaged between the growth of the "Under 65" and "65 and over" populations, rather than just set to that of the total population.

4.16 The reasons for the payment rate increases have been illustrated and discussed above. Recipient growth was another area where the modelling assumptions used in earlier Statements for projections did not always align very well with what actually occurred in the past. In particular the numbers of families receiving Working for Families tax credits and the numbers of individuals getting Disability Assistance both are areas where past average recipient growth significantly exceeded the projected growth applied under the old techniques.

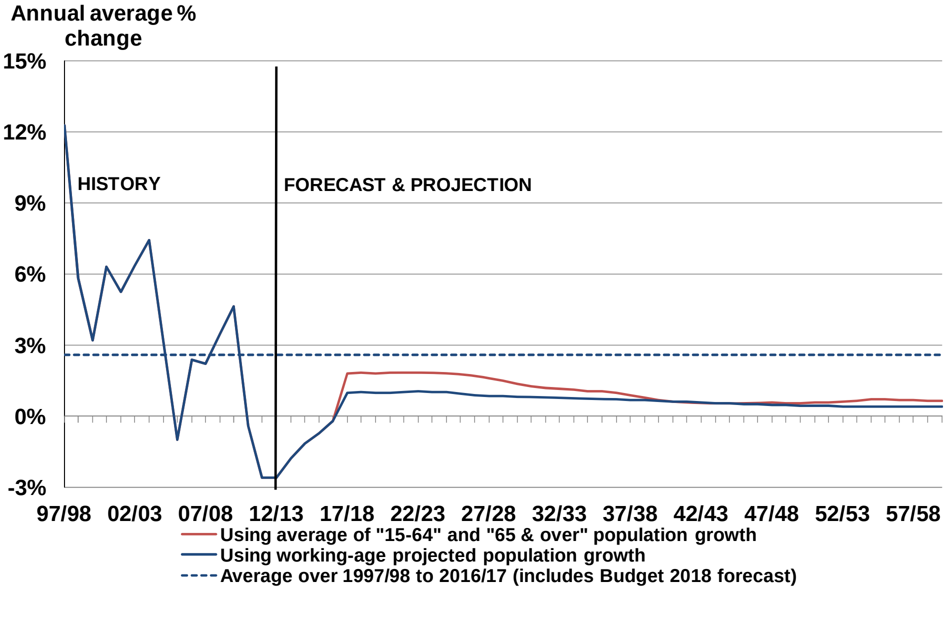
4.17 In the past, the Treasury's projections have assumed almost no growth in Working for Families tax credits recipient families. This is because they have been grown in line with the projected population growth of those aged 0-18, which is broadly static in future. This was done under the logic that it is having children in this age group that makes a family potentially eligible to receive the tax credits. However, once a family has one child in the age group they potentially qualify and further children will not necessarily alter this status, although it probably will alter the amount they receive. Changes in policy regarding the eligibility, abatement and payment rates of the Working for Families tax credits, as well as economic cycles, appear to have had more impact on recipient numbers in the past. The new projection replaces the growth of the 0-18 year-old age group with that of the working-age population (those aged 15 years or more). While this is still lower than the historical average annual growth rate of Working for Families tax credit recipient families over the last 15 years, which is around 3%, it is largely the same demographic driver as that of the economy. Also that average is somewhat distorted by policy-induced spikes in growth over the years 2005/06 and 2006/07. These points are illustrated below in Graph 12.

Graph 12: Annual average growth in Working for Family Tax Credit recipient families, 1998 to 2060



4.18 The previous approach to projecting Disability Assistance recipient numbers was to working-age population growth. However data from the Ministry of Social Development revealed that around half of those who access this supplementary benefit are superannuitants, and this has been the case for more than a decade. The “65 and over” age group is growing, and is projected to continue growing, significantly faster than the entire working-age population. Consequently, a more accurate demographic growth driver for projected Disability Assistance was considered to be an average of the respective annual growth rates of the “15 to 64” age group and the “65 and over” age group. Graph 13 shows that our approach in previous LTF Statements would project much slower growth in recipients of disability assistance than have been experienced in recent years.

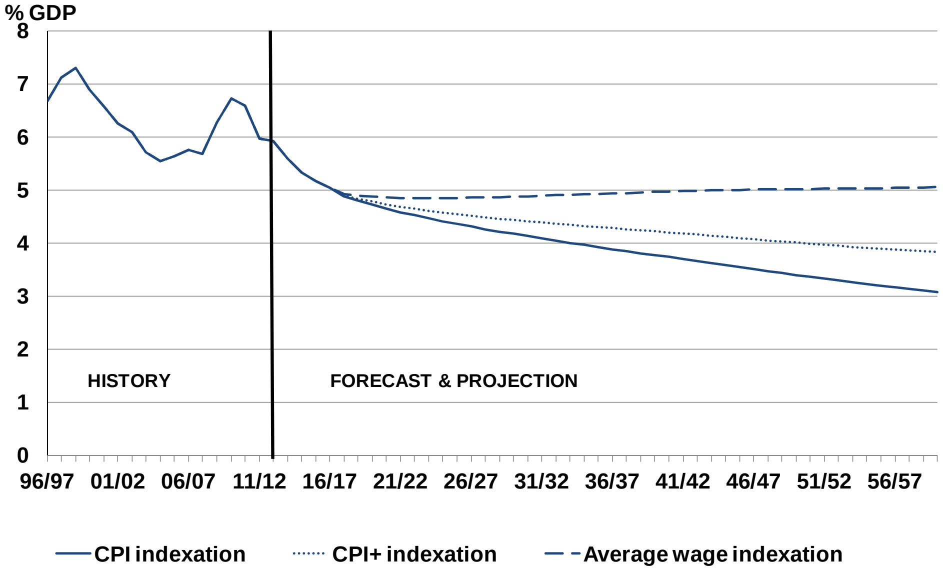
Graph 13: Annual average growth in Disability Assistance recipients, 1998 to 2060



Fiscal consequences

4.20 This CPI+ base case scenario results in a spending track that lies roughly halfway between the CPI indexation and average wage indexation tracks, ending at 3.8% of GDP in 2060, as the graph below shows. It also does imply a substantial divergence between main benefits and supplementary payments and *Working for Families* over the projection period.

Graph 15: Scenarios of welfare spending to GDP, 1997 to 2060



Key advantages and disadvantages of the CPI+ base scenario

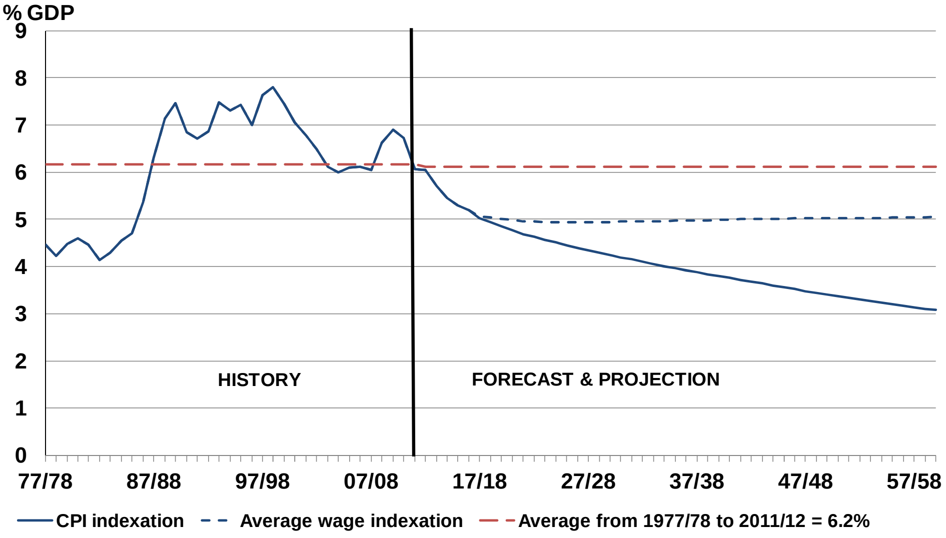
Key advantages:

- It is tied to current (legislated) policy settings around main benefits;
- It is consistent with 40-year trends in growth in main benefit payment rates, and more consistent with trends in other payment rates and recipient numbers in recent years;
- It is more consistent with the approach taken by Australia;
- It is broadly consistent with our approach in the last two LTF Statements, with an appropriate modification.

Key disadvantages:

- It assumes that there are no new benefits introduced over the next 40 years;
- It continues to assume that the relative weekly income of beneficiaries drops sharply compared to average weekly wages;
- It assumes broadly constant proportions of benefit recipients so may underestimate the continuation of historical trends (particularly around SB/IB receipt);
- This scenario still shows a declining track of welfare spending as a % of GDP, ending below spending (as a ratio to the size of the economy) in the late 1970s, or at any point since then.

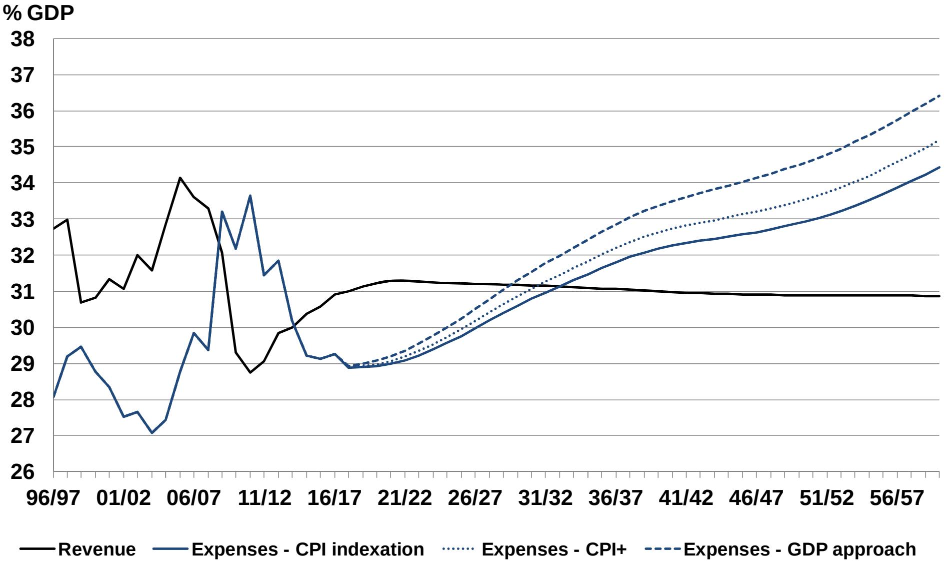
Graph 16: Welfare spending to GDP, 1997 to 2060



4.21 The alternative approach examined by the Treasury, but not adopted for the *2013 Long Term Fiscal Statement*, was to project the Crown expense implications that would arise out of maintaining welfare spending as a roughly stable share of the economy over time. This approach was rejected because to project future welfare costs as a roughly fixed ratio to the size of the economy would be a large variance to the country's experience in recent years and would therefore risk significantly exaggerating the extent of the Crown's future fiscal challenge.

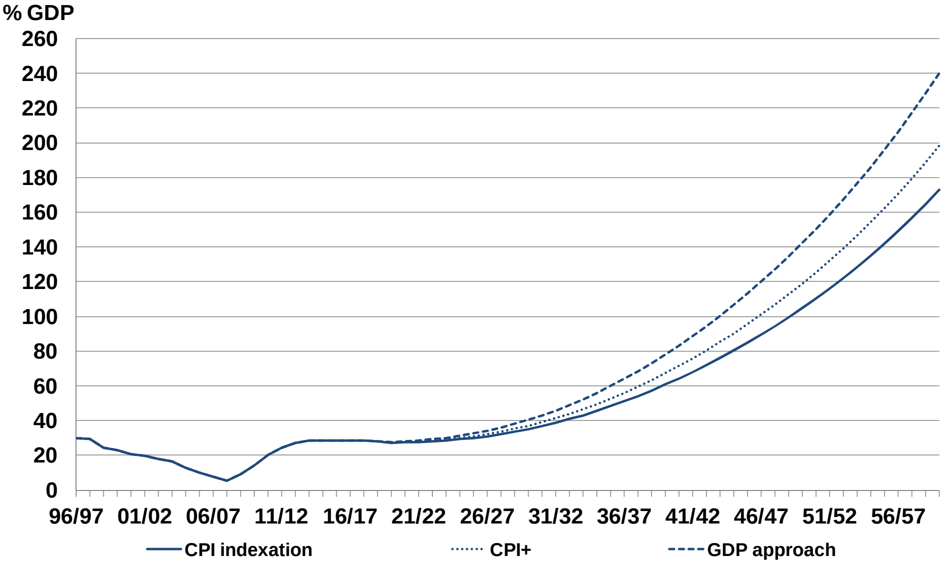
4.22 The graph below shows the impact on core Crown spending excluding debt-financing costs of the three different welfare spending scenarios. By 2060, assuming the CPI+ scenario that is adopted in the *2013 Statement*, expenditure is 0.8% of GDP higher than it would be utilising the approach of adjusting solely to the CPI that was adopted in the last two LTF Statements. Under a constant-ratio-to-GDP approach (proxied by average wage indexation), core Crown expenditure excluding debt-financing costs would be 2.0% of GDP higher by the end of the projection period – implying a much greater fiscal challenge.

Graph 17: Core Crown revenue and expenditure (excluding debt financing costs) to GDP



4.23 Taking into account the impact of debt financing costs, the effects on core Crown net debt from the different approaches would be dramatic. Under the CPI+ scenario, net debt reaches 198% of GDP in 2060, versus 173% under a CPI indexation scenario. Under the GDP approach, proxied by average wage indexation, net debt in 2060 would reach 240% of GDP.

Graph 18: Core Crown net debt to GDP



International context

In long-term fiscal modelling, the *base case* adopted to project expenses in different areas of government activity invariably involves interpretations of what constitutes *'current policy'. Current policy* can be interpreted in different ways. It is often based on legislation (if it applies) and/or historic rates of growth (nominal, real, % of GDP, per recipient, per capita etc), but there is always an element of subjective judgement, usually around plausibility over a 40-year period. Countries with similar systems, policies and histories can create quite different long-term fiscal tracks depending on how they interpret *current policy*, and which parts of their analysis are given the greatest weight.

Australia and the UK have broadly similar flat-rate, CPI-indexed working-age benefit systems as New Zealand. In the Australian *Intergenerational Report* (2010), the Australian Treasury interpreted *current policy* as continuing the legislated increases in benefits with CPI. In the UK, previous reports by HM Treasury similarly assumed continued CPI indexation for working-age benefits. However, more recently the responsibility for long-term fiscal reporting shifted to the new Office for Budget Responsibility (OBR) and in its first annual long-term report, *Fiscal Sustainability Report 2011*, it chose to CPI benchmark benefits in the short term, but to index to wages beyond 2016/17. The OBR judged that its decision is analogous to 'turning off' fiscal drag with tax.

Comparisons to other countries can be less helpful, as many of their welfare systems are employment or social insurance-based and often have an explicit link to wages, so their decision to continue this wage indexation into the future is directly related to current policy. However, many countries do have some forms of social assistance that are indexed to inflation, whether these are working-age benefit or old-age benefits. If these benefits are discussed in these countries long-term reports, CPI indexation is almost always thought to be problematic over such long time periods, though some countries choose to continue it, while others assume that wage indexation will begin at some point in the future.

The approach adopted by the Treasury to projecting future welfare expense pressures in the *2013 Statement* represents a change from the Treasury's approach in its two previous LTF Statements. It is, in the Treasury's assessment, a more realistic approach and more consistent with best international practice.