The Treasury

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THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: Working for Families - Options for Reform

Date:	19 November 2010	**Report No:**	T2010/2353

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	**Indicate** further work, if any, on options to reform Working for Families	Friday, 26 November 2010

Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact
Simon MacPherson	Manager Workforce Attachment and Skills	[1]	✓
[1]	Analyst Workforce Attachment and Skills		

Minister of Finance's Office Actions (if required)

If agreed, forward this report to the Prime Minister, the Minister for Social Development and Employment, and the Minster of Revenue for their information

Enclosure: **No**

Treasury Report: Working for Families - Options for Reform

Executive Summary

This report responds to a request you made for advice on ways to de-index Working for Families (WFF) rates without affecting lower income earners, and broader advice on the feasibility of changing WFF. This request was made at the Fiscal Issues on 15 September when discussing potential savings options for Budget 2011.

WFF has undergone some minor reform in recent years. Most recently Budget 2010 removed the automatic indexation of the income threshold for WFF tax credits, and from 1 April 2011, will broaden the definition of income for eligibility and abatement purposes. These two reforms will generate fiscal savings of $40 million and $32 million per year respectively by 2013/14.

To respond to your request for advice on de-indexing and broader changes we have divided reform options into three categories: options that tweak the existing scheme; options to defer the inflation adjustment of family tax credit (FTC) rates; and major reform options. The three categories are summarised in the following tables with some high level preliminary analysis of the pros and cons:

Tweaking Options

Option	**Pros**	**Cons/Tradeoffs**
1. Simplify the FTC payment schedule, by reducing higher rates for teenagers (e.g. one rate for one child and one rate for subsequent children)	• Fiscal savings without grandparenting (approximately $70m in 2011/12). • Can grandparent current recipients so there are no direct financial losers but fiscal savings will be less. • Simplifies the administrative system.	• Decreases assistance to all families including low income families. • Not well targeted. • Removes acknowledgement of higher costs associated with teenagers.
2. Remove or better target the Parental Tax Credit (different from paid parental leave)	• Fiscal savings (approximately $20m in 2011/12 if removed). • Will better target spending.	• Decreased assistance to parents with new born children.
3. Increase the abatement of the In-work Tax Credit	• Fiscal savings of approximately $30m in 2011/12 ($180m if you change the ordering of abatement). • Can grandparent current recipients so there are no direct financial losers but fiscal savings will be less. • Better targets assistance.	• Financial losers but is targeted at middle to high income earners. • Higher EMTRs decrease incentives to work.
4. Change the In-Work Tax Credit to a single child rate of $15 per week (currently $60 p/w for first 3 children and $15 p/w for subsequent children)	• Fiscal savings (approximately $370m in 2011/12). • Can grandparent current recipients so there are no direct financial losers but fiscal savings will be less.	• Significantly decreases incentives to work. • Sole parent beneficiaries possibly no longer better off in work than on benefit. • Decreases assistance to families in paid work.

		• Not well targeted at reducing assistance to higher income earners.
5. Split the rate for the Minimum Family Tax Credit (MFTC)	• Small fiscal savings (unquantifiable at this stage). • Can grandparent current recipients so there are no direct financial losers but fiscal savings will be less. • Improves incentives for sole parents to increase earnings once in work.	• Reduces assistance for those claiming the MFTC. • Reduced incentives for sole parents to leave the benefit for work.

Deferring the Indexation of FTC rates

Option	Pros	Cons/Tradeoffs
6. Defer indexing for 2 years but ensure the payment in 2014 reflects full increases	• Fiscal savings (potentially $215m over four years). • No nominal financial losers.	• Recipients will receive a fall in their real payment. • Temporary reduction in assistance to low income families.
7. Defer indexing for 2 years but cap payment levels to 2012 rates	• Fiscal savings (potentially $380m over four years. • No nominal financial losers.	• Recipients will receive a fall in their real payment. • Decrease in assistance to low income families.
8. Remove automatic indexation of FTC rates with future decisions on an ad hoc basis	• Fiscal savings (potentially $590m over four years). • No nominal financial losers. • Indexation can be assessed against other govt priorities.	• Recipients will receive a fall in their real payment. • Significant decrease in assistance to low income families over time. • Effectively removes indexation of part of the benefit system as child component of benefits was transferred to FTC in 2005.

Major Reform Options

Option	Pros	Cons/Tradeoffs
9. Index FTC rates but only for lower income earners	• Better targets assistance. • Fiscal savings (to be provided at a later stage). • No nominal financial losers. • No abatement cliff-face (Option 9B).	• Complex. • Difficult to administer. • Reduces incentives to work – magnitude depends on the design.
10. Start abating all tax credits earlier (excluding MFTC)	• Significant fiscal savings (approximately $370m in 2011/12). • Better targets family assistance.	• Financial losers. • Decreases assistance to low income families. • Reduction in incentives to leave benefit for work (but improved incentives for higher earners to increase earnings).
11. Increase the abatement rate (e.g. from 20% to 30%)	• Significant fiscal savings (approximately $350m in 2011/12). • Better targets spending.	• Financial losers. • Higher EMTRs decrease work incentives for middle income families.
12. Reduce payment levels	• Significant fiscal savings (approximately $380m in 2011/12).	• Increased poverty. • Takes away benefits from all families including those most in need of assistance.

		• Not very well targeted.
13. Change the definition of income	• Fiscal Savings (unknown at this stage). • Better targets family assistance.	• Financial Losers.
14. Remove the In-work Tax Credit	• Significant fiscal savings (approximately $600m in 2011/12).	• Likely to be costly to change. • Highly uncertain outcomes – may not achieve objectives.

We have provided six criteria to help assess the above options:

- **Criterion 1**: The impact on the cost to the Crown;
- **Criterion 2**: Better targeting (i.e. reduces costs but protects low income families);
- **Criterion 3**: Whether there are nominal financial losers;
- **Criterion 4**: Affect on work incentives;
- **Criterion 5**: Horizontal and vertical equity considerations; and
- **Criterion 6**: Affect on administrative complexity.

We recommend that any further reform decisions take these criteria into account. In particular, we recommend that the first two criteria should be used as a basis for further work on reform options. Those options that generate fiscal savings and better target financial assistance to those most in need include options 2, 3, 9, 10, 11 and 13. Note that in some cases, however, work incentives are reduced and administrative complexity could increase. If in addition to better targeting you wanted to ensure that there were no financial losers, then we would recommend you focus only on Option 9.

If however, you were mainly concerned with generating fiscal savings and ensuring that there are no nominal financial losers then we would recommend further work on options to defer the indexation of the FTC (Options 6, 7 and 8) and Option 9. The deferral options (6-8) could also be designed with a lump sum transfer to beneficiaries, to protect low income earners. No nominal financial losers could also be achieved through grandparenting arrangements – which reduces fiscal savings, but would allow consideration of all options.

Based on a preliminary assessment of the options, in the <u>short term</u> we recommend focusing attention on those options where there are fiscal savings and spending is better targeted at those most in need of assistance (Options 2 and 3), and those options where there are fiscal savings but no nominal financial losers (Options 6, 7, and 8). Note that these options could potentially be announced at Budget 2011, to be implemented by 1 April 2012.

[3]

Lastly, this report provides you with an update and background on the WFF scheme. Our preliminary analysis of the options draws on recent domestic and international developments in families' policy including the WFF evaluation and the UK welfare reforms.

Recommended Action

We recommend that you:

a **note** that you have requested advice on de-indexing WFF rates and the feasibility of changing working for families in the context of generating fiscal savings without affecting lower income earners;

b **note** that you previously agreed for us not to undertake any further work on de-indexing WFF rates but asked for further advice on the deferral of WFF rates;

c **note** that this report outlines some potential options for reform with some preliminary analysis and indicative fiscal savings;

d **[3]**

e **indicate** whether you would like to focus on options that generate fiscal savings but also better target financial assistance. This would include work on:

- **Option 2:** Remove or better target the Parental Tax Credit;
- **Option 3:** Increase the abatement rate of the In-work Tax Credit (e.g. from 20% to 30%);
- **Option 9:** Index WFF rates but only for certain groups e.g. lower income earners;
- **Option 10:** Start abating all tax credits earlier (excluding the MFTC) e.g. shift the income threshold down to $30,000;
- **Option 11:** Increase the abatement rate (from 20%); and
- **Option 13:** Changing the definition of income to further enhance integrity measures.

Yes/No

f **indicate** whether you would like to focus on options that generate fiscal savings, better target financial assistance, and ensure that there are no nominal financial losers. This would only include work on:

- **Option 9:** Index WFF rates but only for certain groups e.g. lower income earners; and
- **Options 6-8:** Deferring the indexation of FTC, with a lump sum payment to beneficiaries.

Yes/No

g **indicate** whether you would like to focus on options that generate fiscal savings but ensure that there are no nominal financial losers. This would include work on:

- **Option 6:** Defer the indexation of FTC rates for two years until 2014 but ensure the payment in 2014 reflects full increases;

- **Option 7:** Defer indexation for two years but cap payment levels to 2012 rates;

- **Option 8:** Remove automatic indexation of FTC rates with future decisions to be decided by Ministers on an ad hoc basis; and

- **Option 9:** Index WFF rates but only for certain groups e.g. lower income earners.

Yes/No

h **indicate** whether you are interested in grandparenting arrangements to ensure there are no financial losers;

Yes/No

i **[3]**

j **indicate** if you would like us to undertake further work on revisiting WFF's objectives and report on their cohesion with current government priorities (*further work recommended*);

Yes/No

k **indicate** whether you would like further advice on the automatic and periodic indexation of other government support, excluding tax changes (outlined in Annex 2):

- The child support living allowance;

Yes/No

- The child support minimum and maximum liabilities;

Yes/No

- Paid parental leave; and

Yes/No

- Student loan interest;

Yes/No

l **note** that Treasury, Inland Revenue, and the Ministries of Education and Social Development are reporting to you separately on the indexation of the student loan repayment threshold;

m **note** that we have had initial discussions with the Ministry of Social Development and Inland Revenue about these reform options;

n **indicate** whether you would like your office to forward this report to Prime Minister, the Minister for Social Development and Employment and the Minister Revenue for their information; and

Yes/No

o **note** that officials plan to discuss this paper with you in the coming weeks.

Simon MacPherson
Manager
for Secretary to the Treasury

Hon Bill English
Minister of Finance

Purpose of Report

1. The purpose of this report is to respond to a request for advice on de-indexing Working for Families (WFF) rates and the feasibility of making broader changes to the scheme. In this report:

   - Some background on the WFF scheme including recent changes;
   - Some insights from the WFF evaluation;
   - Some options for reform including fiscal costs/savings and some preliminary analysis on the feasibility of making those changes;
   - A summary of the UK spending review; and
   - An outline of Treasury's work plan over the next 12-18 months.

Background

2. At the Fiscal Issues meeting on 15 September 2010, you asked whether it was possible to de-index WFF in general, but ensure that beneficiaries/low income earners are protected. You subsequently requested advice on the feasibility of changing WFF including potential options for reform. This section presents recent changes to working for families and outlines the latest government decisions.

3. WFF has undergone a number of changes in recent years. A timeline of significant events is below:

Table 1: WFF Timeline of significant events

2005	• Family Tax Credit (FTC) rate increased – families receive an extra \$25 for first child + \$15 for additional children. • The child component of main benefits moved into the family tax credit.
2006	• In-work Tax credit replaces Child Tax Credit – families receive \$60 per week (for first three kids) but must be working full-time (20 hours per week for sole parents). • WFF income thresholds increased and abatement rate reduced from 30% to 20%. • Income limit for the Minimum Family Tax Credit (MFTC) increased.
2007	• FTC increased by \$10 per child per week. • Income limits for the MFTC increased. • Income Tax Act amended so that the FTC rates and income abatement threshold automatically increase when cumulative quarterly inflation reaches 5%.
2008	• Indexation of WFF rates and abatement threshold was brought forward to coincide with the October 2008 tax cuts

2010	• Budget 2010 – removed the automatic indexation of WFF income abatement threshold, and definition of income to be widened to address integrity concerns.[1] • The FTC base rates increased by 2.02% due to the change in GST. • WFF evaluation released (discussed in further detail below).

4. There have been only some instances in the past few years where Treasury has provided advice on the WFF scheme. However following similar fiscal saving initiatives prior to Budget 2010, Treasury provided you advice on de-indexing WFF income thresholds and rates [T2009/2549 refers]. That report covered:

- advice on what forms of Government assistance should, or should not, continue to be indexed;
- advice on de-indexing WFF *rates*; and
- a possible direction on the preferred process for de-indexing WFF *income thresholds.*

5. In that report you agreed to de-index WFF income thresholds through Budget 2010, and indicated that that you did not want Treasury to undertake any further work on de-indexing WFF rates. As mentioned in the table above, income thresholds were de-indexed in Budget 2010 as part of the tax package. WFF rates remain automatically indexed to inflation – due to be adjusted by 5.43% on 1 April 2012 costing approximately $229m for the full year (as at HYEFU 2010).[2]

6. For completeness the fiscal cost of the various WFF components are presented in Table 2 below and Annex 1 contains a graphical simplification of the tax credits. These will be useful background when discussing the reform options in the next section.

Table 2: The Fiscal Cost of WFF as at Budget 2010 ($ millions)

Fiscal Year	**2010/11**	**2011/12**	**2012/13**	**2013/14**
Family Tax Credit	$2,229	$2,216	$2,286	$2,170
In-work Tax Credit	$597	$568	$577	$585
Parental tax Credit	$20	$18	$19	$18
Minimum Family Tax Credit	$10	$10	$11	$11
Total	**$2,856**	**$2,812**	**$2,893**	**$2,784**

The Working for Families Evaluation

7. In July 2010, the Ministry of Social Development and Inland Revenue released the results of the WFF evaluation. The evaluation covered the implementation of the scheme until 31 March 2008. The results were mainly positive on the outcomes of the scheme so far. That is, the WFF changes:

- contributed to sole parents' employment increasing through the in-work tax credit;
- assisted, through the MFTC, sole parent families to transition from benefit to paid work;

[1] The WFF de-indexation will generate fiscal savings of $40m in 2013/14 and WFF integrity measures will generate another $32m in 2013/14.

[2] Of this figure, around $61 million is due to the 1 October 2010 increase which has already occurred, leaving $168 million due to the further 5.43% lift that occurs on 1 April 2012.

- did not affect the total hours spent in paid work by second earners in couple parent families;

- lowered the Effective Marginal Tax Rates (EMTRs) of many low-to-middle income parents; and

- increased the amount of money low-to-middle income earners received from financial support.

8. However, not all results were positive. After the tax credits were extended to more families, the increased EMTRs of these higher income families lowered incentives to work.

9. Overall, the evaluation concluded that the WFF changes met their objectives without significant disincentive effects. That is, the changes improved the income adequacy of low-to-middle income earners, improved incentives to work, and improved "delivery that supports people into work". While higher income families faced higher EMTRs, the evaluation concluded that the impact on employment appears to be muted.

10. However, the most notable omission is any comment on its value for money. That is, the evaluation does not assess whether the same objectives can be substantially achieved with less expenditure. Since WFF was introduced it has cost an additional $1.5 billion in the year to March 2008 compared with the year March 2004. Treasury's view is that more work is required to find out whether the substantial fiscal cost could be better spent on other policies that achieve the same objectives.

11. The evaluation is also vague about the extent to which some of the outcomes mentioned above can be attributed to WFF. WFF was introduced during a period of economic growth and a favourable labour market when employment and wages were increasing. As a result, the decrease in child poverty rates could be as much due to cyclical factors as well as WFF.[3]

Analysis of the Options

12. At the Fiscal Issues meeting you indicated that you would like analysis on the feasibility of changing WFF. This section outlines some potential options for reform focussing on the key design issues facing WFF. We recommend that any decisions about reform to WFF are assessed against the following criteria:

    - **Criterion 1**: The impact on the cost to the Crown;

    - **Criterion 2**: Targeting considerations. For example, how will a particular reform better focus WFF resources on those most in need of assistance;

    - **Criterion 3**: Whether the reform result in any nominal financial losers;

    - **Criterion 4**: Affect on work incentives. For example, would a particular reform negatively incentivise people to change their behaviour, e.g. lower their work hours;

    - **Criterion 5**: Equity considerations, both horizontal and vertical. For example, does the reform treat people in similar circumstances differently through

[3] There is some evidence to suggest that a significant proportion of the falling poverty rates between 2004 and 2007 can be attributable to the WFF changes (Perry, 2009).

grandparenting arrangements and do people on higher incomes receive less assistance; and

- **Criterion 6**: Administrative simplicity and public understanding of their entitlements.

13. While the above criteria are a helpful guide to reform decisions, each situation will need to be assessed on its own merits. Below we have outlined a number of reform options – divided into three categories:

- Minor reform options for announcement at Budget 2011 that tweak the existing scheme;
- Options to defer the indexation of the Family Tax Credit; and
- Significant reform options for announcement at Budget 2012.

14. These options include some preliminary analysis and indicative fiscal savings/costs where possible. However, the indicative savings/costs provided below are not linear. That is, they are dependent on making only that particular change. If more than one option were selected, e.g. Options 1 and 9, any potential savings/costs would have to be recalculated.

15. Note that most of the options below can involve some form of grandparenting. Grandparenting has the advantage of protecting current recipients from any direct financial loss. However, grandparent results in less fiscal savings and can add complexity to the implementation and administration of any reform. Under the analysis of the options below, we have only mentioned where grandparenting could become particularly problematic.

Minor Reform Options

Option 1: Simplify the FTC Payment Schedule

16. The FTC's current payment schedule has five different rates where families receive more money depending on the age of their child. There are two payment rates for a first child, and three rates for subsequent children described in Table 3 below:

Table 3: Current FTC payment schedule

Age/number of children	Weekly payment rate*
First child if under 16	$88.03
First child if 16 or over	$101.98
Subsequent child rate if under 13	$61.19
Subsequent child rate if 13 to 15	$69.78
Subsequent child rate if 16 or over	$91.25

*Rates current as at 1 October 2010

17. If the rates were simplified so that there was only one rate for a first child (paid at the under 16 rate) and one for a subsequent child (paid at the under 13 rate), this would **generate savings of around $70 million in the 2011/12 tax year**. While it costs more to care for older children than younger children, the WFF evaluation concluded that the benefits of investing in children are greater for those of a younger age. Simplifying the rates schedule could be carried out either on its own, or else as part of an option to remove FTC rates indexation.

Option 2: Remove or better target the Parental Tax Credit

18. This option could either involve completely removing or better targeting the Parental Tax Credit (PTC) – a payment for a new born baby for the first eight weeks after the baby is born. New parents can claim up to $150 per week over this time depending on their income. Note that the PTC is separate and distinct from paid parental leave and you cannot claim both. To be eligible a family must be not be receiving state support such as a main benefit. If they are eligible for paid parental leave, in most cases they will get less from the PTC.

19. The PTC has low coverage and is not particularly well targeted. Depending on their circumstances, spouses of high income earners can claim the tax credit. **The cost is approximately $20 million per year**. An advantage of removing the credit is that it could be removed without adversely affecting incentives to work. A variant of this option would be to change the eligibility criteria so only those households on lower incomes are able to claim the credit e.g. those on household incomes of $50,000 and over would no longer qualify. Removing the credit completely could have adverse effects on some families in need of assistance when their children are born.

Option 3: Increase the Abatement of the In-work Tax Credit

20. The In-work Tax Credit is a tax credit that is paid to families in work – $60 per week for the first 3 children, $15 per week for each additional child. It is currently abated at 20 cents in the dollar. The standard option (3A) would increase the abatement rate, e.g. to 30 cents in the dollar **generating fiscal savings of approximately $30m in 2011/12**. It also has the advantage of only affecting middle to higher income earners, better targeting the tax credit. However, removing the credit could adversely affect incentives to work as middle/high income earners would face higher EMTRs until the In-work Tax Credit is abated away. This option is also administratively complex, especially if grandparenting were introduced.

21. Option 3A could also be accompanied by a change in the abatement ordering to generate even larger fiscal savings. Currently the Family Tax Credit is abated first, followed by the In-Work Tax Credit and then the Parental Tax credit (the MFTC is on a different abatement regime). This alternative option (3B) would change the ordering of the abatement regime so that the In-work Tax Credit was abated first, **generating larger fiscal savings of approximately $180m in 2011/12**.

22. The difference between the costs of these two options is explained in Annex 3 using an example of a typical In-work Tax Credit recipient. The larger fiscal savings in Option 3B mean there are greater fiscal losers under this option. Grandparenting is possible but this could become extremely complex with different ordering of abatement for different recipients.

Option 4: Change the In-work Tax Credit to a single child rate

23. As mentioned above the In-work Tax Credit is a payment of $60 per week for the first 3 children and $15 per week for each additional child. This standard option (4A) would change the payment schedule to $15 per week per child, or $780 per child per year, removing the single rate for one, two or three children. This would **generate fiscal savings of approximately $370m in 2011/12**.

24. However, this could adversely affect the majority of low to middle income families and especially those with one, two, or three children. It also has large implications for the 'make work pay' objective of the In-work Tax Credit and would send mixed signals to recipients. The In-work Tax Credit has a key role in making work pay more than a benefit for people with children. Significant reductions in its value would mean that sole

parents in particular may not be better off undertaking paid work, and it could end up undermining work testing to some degree.

25. An alternative to this option (4B) would change the payment to $20 per week per child for the first three children and $15 per week for subsequent children. This has similar effects to above but would **generate fiscal savings of approximately $260m in 2011/12.**

Option 5: Split the rate of the Minimum Family Tax Credit

26. The Minimum Family Tax Credit (MFTC) is a payment made to families with dependent children aged 18 or younger, so they have a minimum income of $408 a week after tax. There is currently a fixed rate for couples and single parents of $21,008. This rate could be split for couples and single parents, e.g. maintain the couple rate at $21,008 and lower the single parent rate to $18,000. The total cost of the MFTC is approximately $10m per year so any savings are likely to be small.

Deferral Options

27. The Income Tax Act 2007 currently requires the automatic indexation of the Family Tax Credit (FTC) when the cumulative quarterly change in the CPI reaches 5%. As mentioned above, this will be triggered on 1 April 2012 when rates will need to be adjusted by 5.43%. Below we present three options for delaying the indexation of the FTC:

    Option 6: Defer indexation for 2 years – from 2012 to 2014 – but ensure the payment in 2014 reflects the full accumulation of quarterly CPI increases during that time;

    Option 7: Defer Indexation for 2 years, but cap the payment increase in 2014 to the same level as would otherwise have taken place in 2012; and

    Option 8: Remove automatic indexation requirements entirely, with decisions about future increases made on an ad hoc basis by Ministers at Budget time.

28. The costs and benefits of the Options 6, 7, and 8 are similar but just of different magnitude. There are two main advantages of deferring the indexation of rates: the fiscal savings (represented in Table 1 below), and the ability to avoid any nominal financial losers. However, there is a trade-off. Deferring indexation and greater fiscal savings means real payments will fall further and if the cost of living rises substantially during this time, families could be made financially worse off lowering their standard of living and increasing child poverty.

29. In addition to the above benefits, Option 8 has the added advantage of assessing rate increases against other spending priorities ensuring welfare spending is allocated to where it is needed most.

Table 4: Fiscal savings of the Deferral options ($ millions)

	2011/12	2012/13	2013/14	2014/15	Total deferral Costs / (Savings)
Option 6	$40	$170	$90	$-85	$215
Option 7	$40	$170	$125	$45	$380
Option 8	$40	$170	$165	$215	$590

30. Note that these three options are illustrative only. Any decision to proceed would need to consider Cabinet's view on what types of assistance should be automatically

indexed (e.g. main benefits), and which ones should be at the discretion of Ministers (e.g. accommodation supplement). Annex 2 contains information about what other types of government assistance is indexed and by what method. Also, all of the above scenarios would require an amendment to the Income Tax Act 2007.

31. Also note that if beneficiaries were to be adversely affected by these options, lump sum payments could be considered. This could be one way of ensuring that beneficiaries were protected from inflation without across the board increases in WFF rates. Fiscal savings would be less but the effects on the standard of living of the lowest income earners would be much less. While not too difficult to administer, a lump sum payment would entail difficult policy issues about the size of the payment, work incentive effects and how to pro-rata it.

Major Reform Options

Option 9: Index FTC rates but only for lower income earners

32. As mentioned above, Treasury has previously provided you advice on de-indexing FTC rates. There were two variations presented in that paper: index the rates but only for those with incomes below the current income threshold of $36,827 (referred to in this paper as Option 9A); and index the rates but start abating payments earlier to remove the abatement cliff-face (Option 9B).

33. Both these options are represented in Figures 1 and 2 below:

Figure 1: Option 9A – FTC rates indexed only for families with incomes below current income threshold

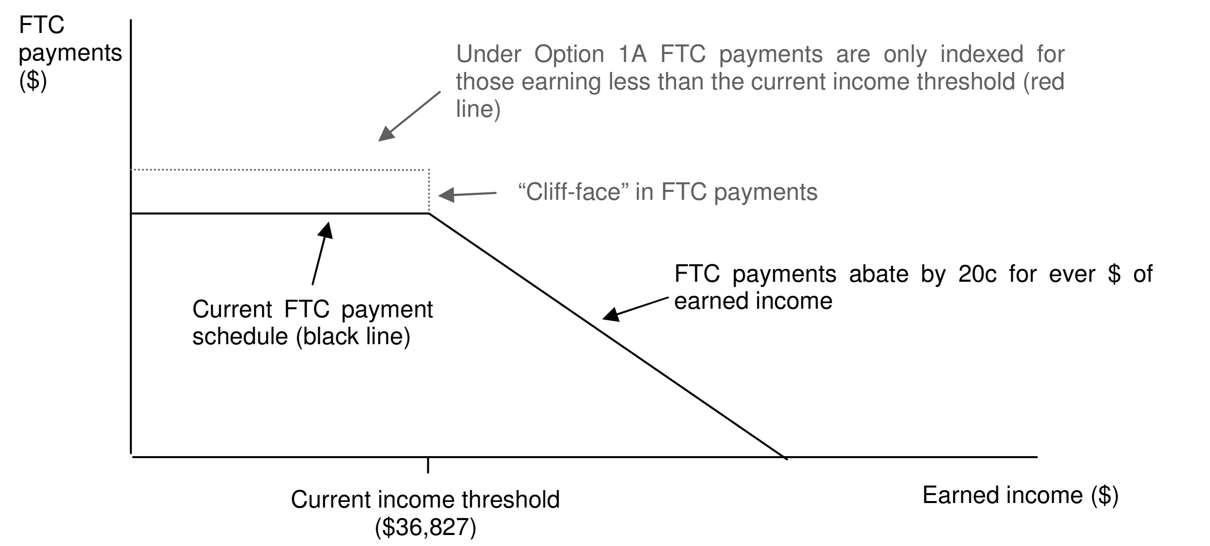
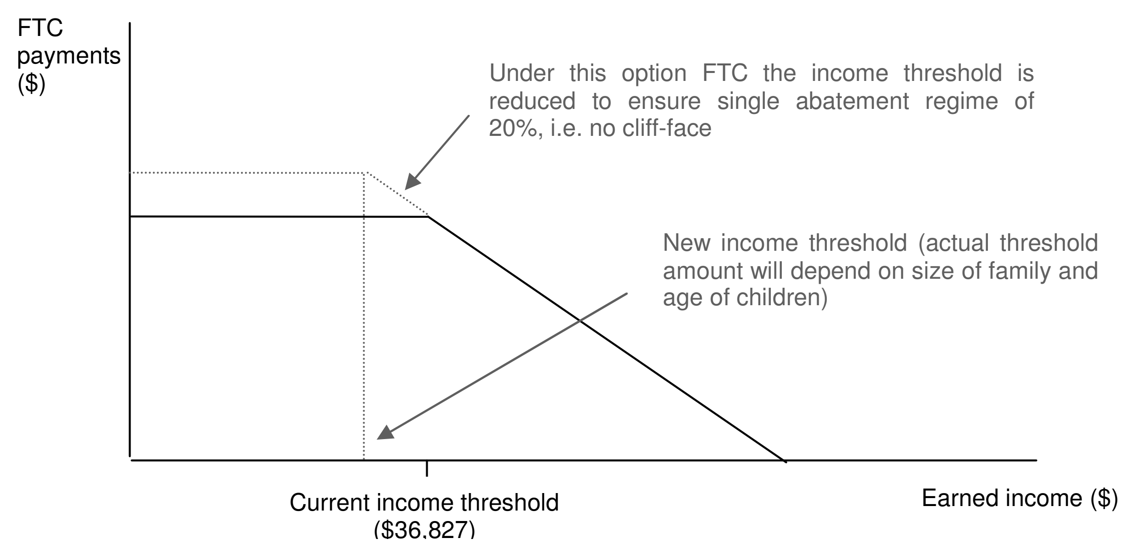


Figure 2: Option 9B – FTC rates indexed with income threshold reduced to ensure no cliff-face



34. Option 9B represented in Figure 2 above, has certain advantages including: targeting assistance to those on the lowest incomes; producing fiscal savings for the Crown (to be provided at a later stage); the ability to avoid financial losers; and having no abatement cliff-face. However, while this option may seem appealing initially, there are two major drawbacks: complexity for clients and difficulties in administering the policy. Avoiding a cliff-face requires pushing back the income threshold but determining this threshold depends on how many children are in the family and the ages of these children. Therefore, administering the scheme could become very difficult.

35. Therefore we would caution against implementing this option independently of other changes. When combined with other options such as simplifying the current payment schedule (see Option 1 above), this option certainly has merit.

Option 10: Start abating all tax credits earlier

36. Currently the WFF tax credits start abating from an income of $36,827 at 20 c/$. Note that when we refer to all tax credits we are referring to the Family Tax Credit, the In-work Tax Credit and the Parental Tax Credit. The Minimum Family Tax Credit is on a different abatement regime. Before April 2006, the abatement regime looked as follows:

Table 5: WFF Pre-April 2006 Abatement Regime

Income	Abatement per $ of income
Under $20,356	0 c/$
$20,356-$27,481	18 c/$
Over $27,481	30 c/$

37. This option would start abating the WFF tax credit from a lower income potentially like the regime before April 2006. This option could be combined with lowering the abatement rate for those on lower incomes to soften the affect on lower income earners. The main advantage of this option is the significant fiscal savings and the refocus of spending on toward those most in need of assistance. For example, reverting back to the old regime would save approximately **$920m per year**, decreasing the abatement threshold to $27,481 would save approximately **$370m per year**.

38. However, this would involve a number of nominal financial losers including many middle to high income households, some of which will suffer a fall in standard of living and hence cause increases in child poverty. Also those individuals below the current abatement threshold will face higher EMTRs having a negative effect on work incentives. The interface with the benefits system will also need to be considered as the remaining on benefit could become increasingly attractive.

Option 11: Increase the abatement rate (from 20%)

39. The abatement rate for the WFF tax credits is currently 20 c/$ from an income of $36,827. This option increases the abatement rate of all tax credits from this income band reducing the coverage of WFF, lowering the payments of many middle to high income households. If the rate were increased to 30 c/$, this would **generate fiscal savings of approximately $350m per year.** Apart from fiscal savings, the main advantage would be the better targeting of assistance to those most in need by taking away credits from higher income earners. However, higher EMTRs for middle-income families would increase – lowering incentives to work. There will also be many nominal financial losers under this option leading to a lower standard of living, although child poverty is unlikely to be affected.

Option 12: Reduce the Payment Levels

40. The option reduces the rates of all WFF benefits e.g. by 10 percent. This would **generate fiscal savings of approximately $380m**. However, across the board reductions in benefits would increase poverty levels and take away benefits from those most in need of assistance.

Option 13: Refine the Definition of Income

41. The definition of income for assessing a family's entitlement to WFF tax credits is important in terms of the policy objective of targeting assistance to those families in genuine need of government financial assistance. An adjusted taxable income approach is used for WFF tax credits. This assumes that in most instances that taxable income is a reliable proxy of the family's income that is readily available for spending on day-to-day living needs. However, where taxable income is not a reliable proxy adjustments are made to taxable income to better reflect the family's income available for day-to-day living needs.

42. As part of Budget 2010, the Government is addressing a number of integrity concerns in relation to eligibility or abatement of WFF tax credits by including some income types that have not been previously counted such as some fringe benefits and trustee income. [4] These changes are to improve the integrity by:

- countering some arrangements that have the effect of inflating entitlements beyond what a family's true economic circumstances justify; and

- including some type of income that is not included in the taxable income of an individual.

43. Due to the need for any changes to be in place from 1 April 2011, the existing income definition approach was used and some of the changes were more targeted such as only including fringe benefits provided to shareholder/employees who control the company for which they work for rather than all employees.

44. A more comprehensive review of the definition of income for WFF tax credit purposes may provide an opportunity to better target this assistance to families. Such a review

[4] The definition of income for WFF tax credits will also apply for the parental income test for student allowances and for some community service card recipients.

could consider whether the current adjusted taxable income approach is the most appropriate basis for determining income and if not what should be the basis. For example, the definition of income for welfare benefits is more based on a cash concept of income of what amount of income is received and actually spent on day-to-day living. For example, income could include either the income from a business or the drawings from the business. If an adjusted taxable income approach is still appropriate, the review could consider what other forms of income should be included. A move away from the current approach would have compliance and administrative implications.

Option 14: Remove the In-work Tax Credit

45. The In-work Tax Credit is a payment to families in paid work. The payment is designed to incentivise families to move off benefit into paid work. Removing the In-work Tax Credit has the advantage of **generating fiscal savings of approximately $600m per year** and would simplify administrative systems**.** However, incentives on beneficiaries to undertake paid work will decrease substantially and the extra support that it provides is in many cases essential to maintain a basic standard of living for lower income families. Therefore, removing this tax credit would increase child poverty.

Other Reform options

46. There are potentially other reform options that could arise by revisiting the objectives of the scheme and redesigning accordingly. The WFF evaluation could also be important to guide any future design changes. The main disadvantage of major reform is that the outcomes are very uncertain and we are currently unsure of whether similar policies could better achieve current or any future objectives. We would recommend revisiting the objectives of WFF to test their cohesion with current government priorities.

International Developments – The UK Spending Review

47. A number of different countries have been grappling with the problem of striking the appropriate balance between fiscal cost, work incentives and reducing poverty. This has proven difficult and there does not appear to be a perfect model. This section explores how the UK is altering their welfare system to better meet changing objectives.

48. The UK has recently announced the results of a comprehensive Spending Review – a major commitment by the government to achieve a cyclically-adjusted operating balance by 2014/15. The package includes the biggest spending cuts in decades amounting to £81 billion (5.8% of GDP), of which £11 billion relates to welfare spending.

49. The reforms to all welfare spending aim to deliver these savings of £11 billion a year by 2014-15. The goal of the reforms is to ensure that the welfare system promotes work and personal responsibility while controlling expenditure. Their current system is similar in many ways to WFF. Therefore their options for reform are a useful case study of potential options for New Zealand. In summary the reforms that relate to families include:

- **Withdrawing the child benefit** from families with higher rate taxpayers so people on lower incomes are not subsiding those who are better off – saves £2.5 billion a year by 2014-12;

- **Freezing the rates of the child benefit** – used to fund significant above indexation increases in the Child Tax Credit;

- **Changing the eligibility rules** for the Working Tax Credit (WTC) so that couples with children must work 24 hours a week between them, with one partner working at least 16 hours a week in order to qualify for the WTC, saving £390 million a year by 2014-15; and

- **Increasing the child element** above indexation by a further £30 in 2011-12 and £50 in 2012-13, in addition to the £150 and £60 increases provided at the June Budget. This will ensure that the overall outcome of the Spending Review will have no measurable impact on child poverty in the next two years.

Treasury's Work Plan

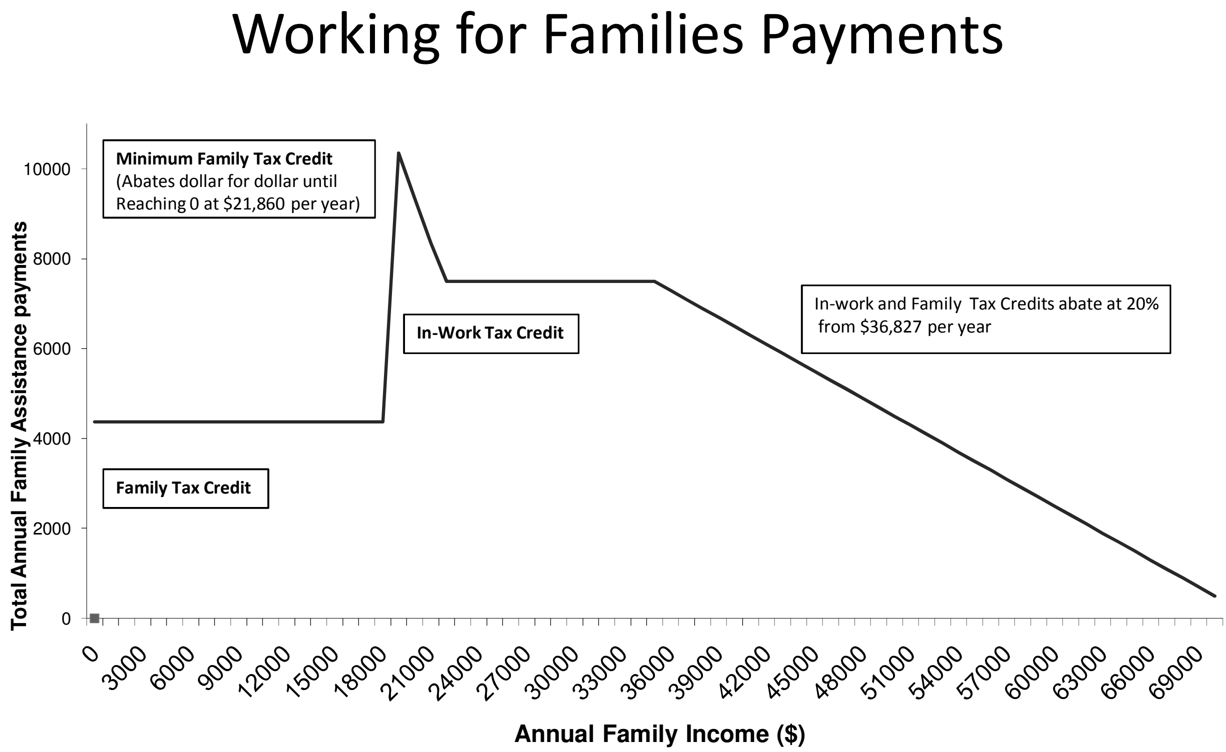
50. Treasury is currently developing its work programme on WFF for the next 12-18 months. We would therefore like to take this opportunity to gauge your interest in any of the above options to avoid working through certain options that the Government has no interest in pursuing.

51. As outlined above, there are some minor reform options that could be announced at Budget 2011 to be implemented by 1 April 2012. Based on the criteria we set out above, in the short term we would recommend focusing attention on those options where there are fiscal savings and no nominal financial losers (the deferral package), and those options where there are nominal financial losers but there is the ability to grandparent current recipients (Options 1, 2, 3 and 4).

52. **[3]**

53. In addition to reform options we are also seeking your feedback on whether you wish to revisit the WFF objectives and whether you would like advice on the indexation of other government assistance (outlined in Annex 2). Since adopting the policy from the previous government in 2008, the objectives have yet to be tested for their cohesion with current government priorities. If further advice on the objectives or the indexation of other government assistance is required, we envisaged that this would form part of the major reform work programme.

54. Lastly, any policy development on WFF will require input from the Ministry for Social Development and Inland Revenue. You and your office will need to consider how to engage with the Minister of Social Development and Employment, and the Minister of Revenue.


Working for Families Payments
Minimum Family Tax Credit
(Abates dollar for dollar until
Reaching 0 at $21,860 per year)
In-Work Tax Credit
In-work and Family Tax Credits abate at 20%
from $36,827 per year
Family Tax Credit
Total Annual Family Assistance payments
0
2000
4000
6000
8000
10000
0
3000
6000
9000
12000
15000
18000
21000
24000
27000
30000
33000
36000
39000
42000
45000
48000
51000
54000
57000
60000
63000
66000
69000
Annual Family Income ($)

Annex 2: Indexation of the tax/benefit system

This annex contains some examples of where the Government indexes benefit rates or thresholds.

Automatic indexation:

Main benefits – These may be increased by Order in Council to take into account the movement in the quarterly all groups index number of the NZ CPI for the previous December year.

- ***The Family Tax Credit*** – This may be increased by Order in Council to take into account the movement in the quarterly all groups index number of the NZ CPI, rounded up to the nearest whole dollar. An Order must be made if the index number has moved 5% or more from the date of the last adjustment. The Order must be made no later than 1 December each year and must apply from the following 1 April.

- ***Child support living allowance*** – An amount is deducted from the taxable income of a liable parent as a living allowance for that parent. The amount of the living allowance is based mainly on gross benefits from Work and Income New Zealand. These are indexed for inflation so this flows though automatically to the living allowance. Also the dependent child component of this allowance is indexed annually by the movement in the quarterly all groups index number of the NZ CPI for the previous December year.

- ***Child support minimum and maximum liabilities*** – The minimum child support liability is adjusted by the CPI each year. The maximum liability is determined each year based on the ordinary average wage.

- ***Paid parental leave*** – The maximum rate of paid parental leave is adjusted every year to account for any increase in average weekly earnings.

- ***Student Loan Interest*** – The interest rate applied to student loans is reset annually based on a formula set out in the Student Loan Act 1992. It ensures that the rate is aligned to its market indicator (10 year government bond yield).

Periodic indexation:

- ***The Minimum Family Tax Credit*** – This may be increased by Order in Council to reflect increases in benefit levels.

- ***The In-Work Tax Credit*** – is subject to periodic review and may be increased by Order in Council. The Income Tax Act 2007 requires a review to be undertaken every three years. The next review needs to be undertaken by 30 June 2011. The Order must be made no later than 1 December each year and must apply from 1 April of the following year.

- ***The Parental Tax Credit*** – is subject to periodic review and may be increased by Order in Council. The Income Tax Act 2007 requires a review to be undertaken every three years. The next review needs to be undertaken by 30 June 2011. The Order must be made no later than 1 December each year and must apply from 1 April of the following year.

- ***Use-of-money Interest*** – The rates are reviewed regularly to ensure they are aligned with market interest rates. Officials have just reported to the Minister of Revenue recommending resetting the review principles. They are recommending new administrative principles be applied to adjust UOMI rates. The rate would be adjusted where there has been a 1% change in the Reserve Bank 90-day bank bill rate or the floating first mortgage new customer housing rate; or adjusted every 12 months where there has been a 20 basis points change in the Reserve Bank 90-day bank bill rate or the floating first mortgage new customer housing rate.

- ***Fringe Benefit Tax*** – The prescribed rate of interest for low interest loans is reviewed periodically to ensure that it is aligned with the market indicator (floating first mortgage new customer housing rate).

- ***The Student Loan repayment threshold*** – reviewed annually.

Annex 3: Further detail including examples of Options 3A and 3B

This annex contains a detailed explanation, with examples, of Options 3A and 3B – a higher abatement rate for In-work Tax Credit (IWTC) with different ordering of the abatement regime.

Assumptions:

- Family income of $60,000 p.a. with one child under 16 years of age.
- Abatement threshold $36,827
- Family tax credit entitlement $4578 (1st child under 16 years of age – 2011/12 amount)
- In-work tax credit $3120

Current rules:

Abatement rate 20% for both the FTC and IWTC
Income subject to abatement: $60,000 – $36,827 = $23,173
Amount of abatement: $23,173 * 0.20 = $4634.60

	$
Amount of FTC	**4578.00**
Amount of IWTC	**3120.00**
Total WFFTCs	**7698.00**
Less Abatement	**(4634.60)**
WFF Tax Credit entitlement for the year	**3063.40**

Family entitled to WFFTC of $3063.40 for the year – consists of the IWTC as the FTC is fully abated.

Option 3A: 30% abatement rate for the IWTC – abate the FTC then IWTC (current order):

Abatement rate and order: 20% for the FTC and 30% for the IWTC
Income subject to abatement: $23,173
Income subject to FTC abatement: $22,890 ($4578 / 0.20)
Income subject to IWTC abatement: $283

	$
Amount of FTC	**4578.00**
Less abatement ($22,890 * 0.20)	**(4578.00)**
Amount of IWTC	**3120.00**
Less abatement ($283 * 0.30)	**(84.90)**
WFFTC entitlement for the year	**3035.10**

Family entitled to WFFTC of $3035.10 for the year – consists of the IWTC as the FTC is fully abated. This is a reduction in entitlement of $28.30 pa.

Option 3B: 30% abatement rate for the IWTC – abate the IWTC then the FTC (new order)

Abatement rate and order: 30% for the I-WTC and 20% for the FTC
Income subject to abatement: $23,173
Income subject to I-WTC abatement: $10,400 ($3120 / 0.30)
Income subject to FTC abatement: $12,773

	$
Amount of I-WTC	**3120.00**
Less abatement (10,400 * 0.30)	**(3120.00)**
Amount of FTC	**4578.00**
Less abatement (12773 * 0.20)	**(2554.60)**
WFFTC entitlement for the year	**2023.40**

Family entitled to WFF Tax Credit of $2023.40 for the year – consists of the FTC as the I-WTC is fully abated. This is a reduction in entitlement of $1040 pa.