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Insight

Is Working for Families working for families?

Working for Families (WFF) was introduced between 2004 and 2007 to “make work pay” and ensure income adequacy for families with children.

The policy has reduced child poverty, drawn an extra 8,100 sole parents into some paid work, encouraged more of them to work 20 hours or more, and reduced the time they receive a benefit. But it also resulted in 9,300 fewer second earners in paid work, and over half of non-beneficiary families with worse incentives to earn more, at an additional cost of $1.5 billion per year.[1]

The objectives are laudable, but we worry about the cost-effectiveness and poor incentives of WFF. To ensure value for money of government spending, it is time to reconsider WFF.

WFF had clear and worthy objectives

WFF sought to improve workforce participation by beneficiaries and reduce child poverty. Child poverty is largely due to parents’ lack of market income. Beneficiaries with children, mostly Domestic Purpose Benefit (DPB) recipients, are a clear target group.

Expenditure on WFF cost an extra $1.5 billion by the end March 2008, almost double the amount spent on relevant social assistance in 2004. It did reduce the number of DPB recipients by 13,500 (12%) although some of that was due to better economic conditions.[2] But WFF is:

- poorly targeted – middle and high income families receive almost 40% of the extra $1.5 billion
- poor at encouraging people in work to work more
- a costly way to make work pay for beneficiaries.

[1] CSRE. 2010. *Changing Families’ Financial Support and Incentives for Working. The summary report of the evaluation of the Working For Families package*. Report to IRD and MSD

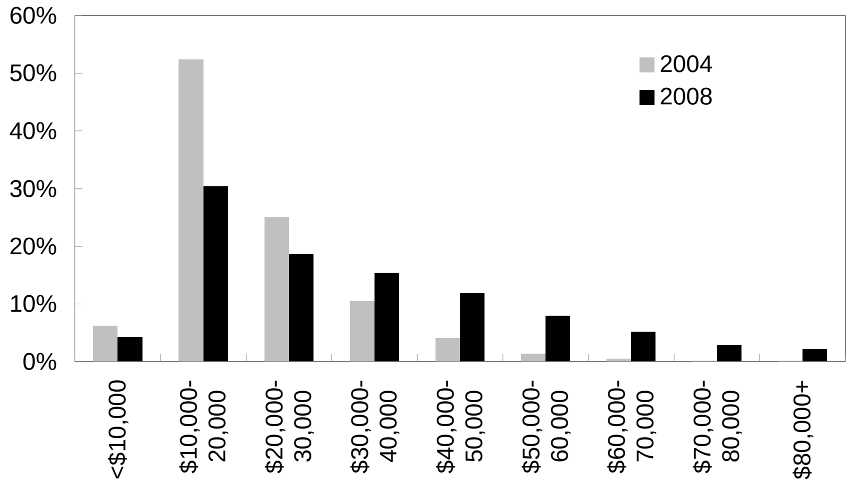
[2] ibid.

1. WFF is poorly targeted

WFF appears to have succeeded at reducing the percentage of children living in poverty. It is estimated to have dropped by 8 percentage points or more from 2004 to 2008, depending on the poverty measure used.[3] This is a real positive.

But we question whether this is a cost-effective way of reducing child poverty. A considerable slice of the WFF assistance, probably a third, is distributed to families that are not deemed to be in poverty. If we define low income as 60% of household median income, then $45,000 or less would be considered low for a couple with children in 2008. Figure 1 shows that a third of WFF money goes to households with an annual income of $40,000 or more, compared to 6% in 2004 (see Figure 1).

Figure 1 WFF expenditure by family income
Share of WFF spending



Source: CSRE 2010

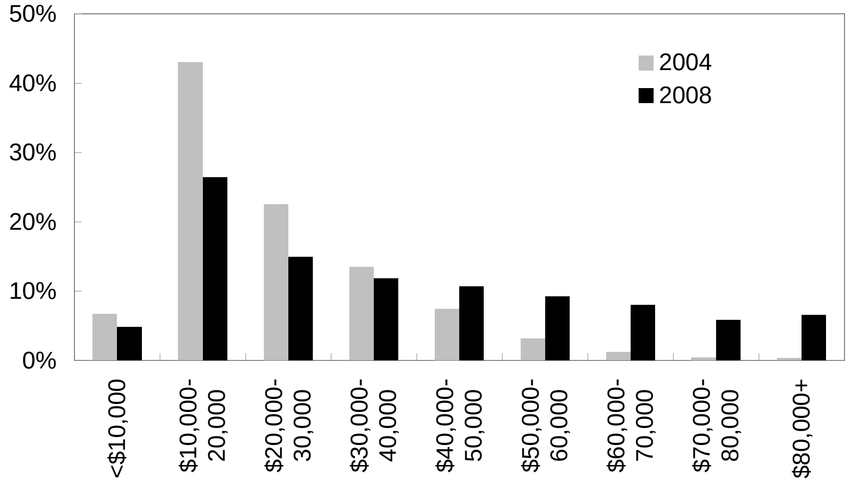
Figure 2 shows about 40% of families receiving WFF earn more than $40,000 per year. The number and share of people with middle to high incomes receiving social assistance grew between 2004 and 2008. The fall in the number and share of the lowest income groups is in part due to the strong labour market over that time.

Taken together, middle income people are taxed and then can claim back money through tax credits and other assistance. That suggests there is an opportunity to reduce administrative costs and more importantly the disincentives of higher-than-necessary tax rates. It should also be possible to better target child poverty. But children in poverty are most likely in beneficiary families, while one of WFF's larger components – the In Work Tax Credit – is only available to working families.

3 ibid.

Figure 2 Families receiving WFF by family income

Share of families



Source: CSRE 2010

2. High marginal tax rates deter workforce participation

WFF is also about giving beneficiary families incentives to participate in paid work. In part because of WFF, and in part because of the strong labour market until 2008, employment rates of solo mothers grew strongly from 2004 and the number of DPB recipients dropped. This narrowed the employment rate gap between solo and partnered mothers.

WFF tends to reward the transition from no work to part-time work far more than it rewards the transition from part-time to full-time work (which would raise income from work and reduce poverty). But a sole parent does not gain much additional income by working beyond 20 hours. Much of income earned above 20 hours (30 hours for a two-spouse family) gets wiped out by the combination of personal income tax rates and reduced benefits (abatement). The *effective* marginal tax rates (EMTRs) people face can exceed 100%.

High EMTRs discourage people from working more hours or striving for a promotion or a higher paying job. These short-term incentives are harmful to motivating individuals to invest in themselves for the long run, and harmful to economic growth.

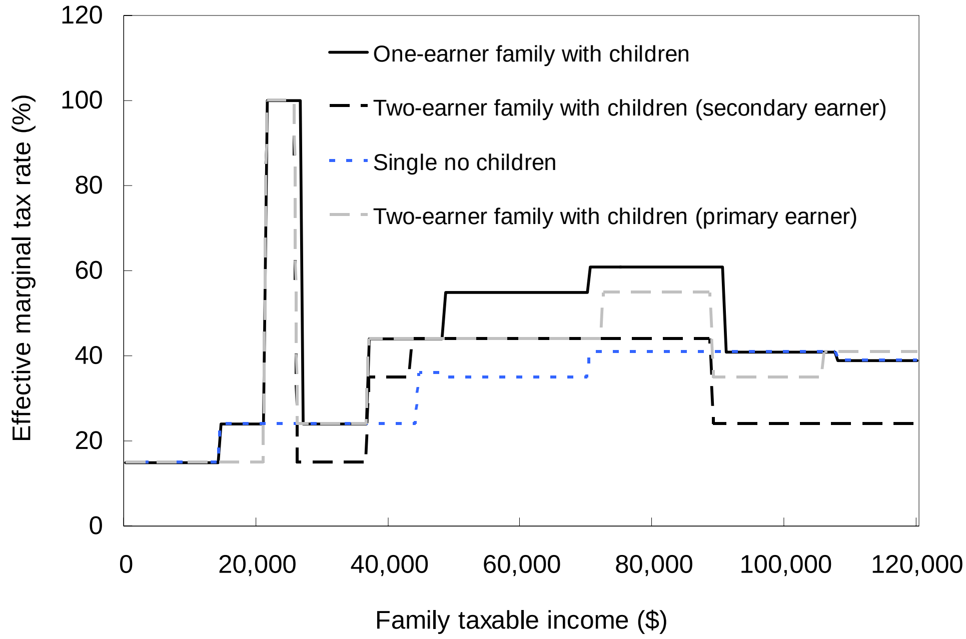
The evaluation of WFF shows that WFF had some success at reducing EMTRs faced by low income working families and beneficiaries.[4] But another group, including those working families newly drawn into the WFF system, faced higher EMTRs. In 2008, 161,000 (45%) of families receiving WFF faced EMTRs of 50% or higher. In other words, for every additional dollar earned these families would end up with somewhere between zero and 50 cents in the hand.

[4] ibid.

People adjust their working and earning patterns to avoid high EMTRs. Even though the average EMTR for a sole parent in 2008 was found to be 32% (compared to 47% in 2004), this likely reflects sole parents making careful work choices to avoid the higher EMTRs they would have faced if they worked just a bit more.

Figure 3 shows that EMTRs remain high for working families. Most of the 47,000 families earning between $25,000 and $35,000 in 2008 faced lower EMTRs, averaging around 33%. But the 160,000 families earning more than $35,000 faced an average EMTR of 54%. It is difficult to conclude that there have been significant improvements to making work pay. This kind of design also works against the general policy efforts to reduce personal income tax rates.

Figure 3 Effective marginal tax rate (EMTR) under current WFF



Source: Tax Working Group. 2010. A Tax System for New Zealand's Future. Report of the Victoria University of Wellington Tax Working Group.

3. Employment gains come at huge cost

The evidence indicates that WFF drew an extra 8,100 sole parents into some paid work, and encouraged more to work 20 hours or more. But it also resulted in 9,300 fewer second earners in paid work (although in total their hours did not decrease).[5]

It seems reasonable to conclude that WFF increased employment to some extent, but also that there was a substantial amount of displacement between partnered women and sole parents. There is also a hidden cost stemming from the disincentive effects (and thus economic losses) of

[5] ibid.

high EMTRs on higher income earners. Overall, it is not clear whether the employment gain from the extra WFF spend represents good value for money.

4. What could we do instead?

Based on the evidence reviewed here, we conclude that WFF does not represent good value for money. It has reduced poverty, but achieved only modest employment gains. Work incentives have improved for a small group, but at a cost of high effective marginal tax rates for 161,000 families. In addition, there are the unseen costs of high EMTRs. This makes addressing WFF an important part of any economic growth strategy.

There are no easy solutions. With benefits it is almost impossible to avoid high EMTRs. More modest abatement of social assistance that would avoid high EMTRs would make social assistance unaffordable. And the sheer complexity of the system (involving various agencies) makes it difficult to just tweak it and expect substantial improvements. A more fundamental rethink – ideally linked to a revamp and simplification of the welfare system – is going to be needed.

Rather than the current slow phasing-out of a complex net of support instruments that creates poor incentives for many families, one alternative is a simpler, more closely targeted approach that makes use of other approaches to determine what assistance people can expect. This could be consistent with the Welfare Working Group's recommendations of simplifying income support, changing expectations and obligations, and providing more active support to help people into work.

We recommend using just one instrument to address a clear problem. For example, if child poverty is the problem, then this suggests a lump sum child support type payment to people on benefits or low incomes, instead of a bewildering and overlapping array of tax credits, subsidies and in-kind services provided by various agencies that address consequences of the same problem: a lack of income.

A lump sum would not destroy incentives to work or work more for many, as is the case now. But to keep it affordable it would need to go hand-in-hand with more black-and-white eligibility rules, such as a time limit on assistance, or limiting the support payment over a limited income range, with a single, sharp cut-out put at a point where it least interferes with work choices.

The opportunity exists to get better value. Better design and tighter targeting could avoid the costs of high EMTRs for a large group of people over a large income range, and possibly yield $500m per annum which could then be used to support those in real need and/or cut government spending.

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