4 April 2011

REGULATORY IMPACT STATEMENT

Working for Families - Options for Budget 2011

Agency Disclosure Statement

This Regulatory Impact Statement (RIS) has been prepared by the Treasury, Inland Revenue and the Ministry of Social Development. It provides analysis on policy options for reforming the Working for Families (WFF) scheme to be included in Budget 2011.

The reforms seek to:

- generate fiscal savings given the current budget constraints faced by the government;
- better distribute the allocation of WFF funding to lower income families[1];
- protect the disposable incomes of lower income families;
- simplify the Family Tax Credit (FTC) payment schedule by, over time, merging the amounts for children 16 and over with the younger rates; and
- minimise the impact on those families affected by making small changes over a long timeframe to coincide with the indexation of the FTC amounts.

The analysis undertaken includes:

- modelling of savings, expenditure, and distributional impacts (estimates are based on Treasury's micro simulation model, Taxwell, which uses reweighted Household Economic Survey data);
- consideration of how well a particular option changes the relative allocation of assistance to lower income families;
- equity considerations including impact on poverty, inequality and income distribution analysis;
- consideration of work incentives and efficiency including analysis of replacement rates and effective marginal tax rates;
- consideration of compliance and administration impacts for Inland Revenue and the Ministry of Social Development;
- consideration of the overall coherence of the policy and the compliance costs on recipients; and

[1] Lower, middle and high income families are defined in the Regulatory Impact Analysis section below.

- detailed implementation and design work.

Note that the options analysed were narrowed down to those that could feasibly be considered (from a policy, fiscal, and operational perspective) for inclusion in the 2011 Budget. Areas of reform that make more fundamental changes to the Working for Families scheme were not considered.

Ministers wanted to reform the Working for Families scheme to generate fiscal savings, but ensure any changes protect lower income earners and minimise any impact on work incentives. Officials first presented Ministers with a broad set of options. Officials, in conjunction with Ministers and their advisors, narrowed these options using five key criteria developed by officials early in the process:

- impact on the cost to the Crown;
- how well the option improves the targeting of the scheme;
- impact on disposable income, income inequality and poverty measures;
- impact on work incentives and efficiency; and
- affect on administrative complexity and compliance.

A key constraint in the process was the need for Budget secrecy, which made extensive consultation on options impossible. Further constraints related to the timeframe for analysis. The timeframe for providing advice was often short, especially given number of potential options under consideration and the introduction of new options late in the process. For example, officials were only able to model the child poverty impacts of Option 1 (removing the automatic indexation of the FTC entirely).

The policy options discussed in this RIS affect areas that the government has stated require a strong case before regulation is considered as the options analysed alter incentives to work for beneficiary and working families. Officials consider that regulation is appropriate as it is the only means to achieve the desired objectives.

This RIS provides a summary of the analysis undertaken by officials on the impacts of changes to the Working for Families scheme and provided to Ministers in policy reports. More detailed analysis and discussion of the major implications of changes to the Working for Families scheme is provided in the policy reports, which will be released in the post-budget information release. These policy reports outline the full analysis of distributional impacts, disposable income impacts, work incentive impacts and compliance and administration impacts.

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Status quo and problem definition

The current components

The Working for Families (WFF) scheme has four main components:

- The Family Tax Credit (FTC) – a payment for each dependent child aged 18 or younger;
- The In-work Tax Credit (IWTC) – a payment for families who are in paid work;
- The Minimum Family Tax Credit (MFTC) – a payment made to families with dependent children aged 18 or younger, so they have a minimum income of $408 a week after tax; and
- The Parental Tax Credit (PTC) – payment for a newborn baby for the first eight weeks or 56 days after the baby is born.

The FTC, IWTC, and the PTC are abated at 20 cents in the dollar from an income of $36,827. The MFTC is abated dollar for dollar until a family's income reaches $21,216 after tax. The FTC amounts are adjusted for inflation when the CPI movement cumulatively reaches 5%. The MFTC is reviewed each year to ensure incentives to move from benefit into work are maintained. The amounts for the IWTC and PTC are reviewed every 3 years and can be increased by Order in Council.

Recent changes

The WFF package was introduced in 2005. The original package abated tax credits at the rate of 30c per dollar from a threshold of $27,500. Following the election in 2005, the Government decreased the abatement rate to 20c per dollar and lifted the abatement threshold to $35,000. In 2008, the threshold was indexed to its current level of $36,827.

In 2006 $1.5 billion of WFF tax credits were paid out to 159,000 people. By 2009 this had risen to $2.7 billion paid out to 419,200 people. A family with two children, for example, does not currently lose their entitlement to WFF tax credits until they earn $91,227.

More recently, Budget 2010 removed the automatic indexation of the abatement threshold for WFF tax credits. This holds constant the abatement threshold of $36,827 and will ensure over time, the WFF scheme is more targeted towards those on lower incomes.

Problem definition

Concerns still exist with the current scheme. A consequence of extending assistance to more working families and increasing the levels of assistance was the large increase in fiscal cost. Given the current constraints on government spending due to global financial crisis, the Christchurch earthquake, and the fears of a double dip recession, paying family assistance to those on higher incomes, is difficult to justify. As mentioned above, a family with two children does not lose all WFF payments until their income reaches $91,227.

The current FTC payment schedule is divided into amounts for a first and second child, and for different ages of children. The current FTC amounts for the eldest first and second child provide a much higher level of financial support relative to the younger child amounts. The Government discussion document *Supporting Children* estimated the cost of raising children in New Zealand.[2] Based on those estimates, The FTC covers anywhere between 45% and 75% of the costs. There does not appear to be a consistent relationship between the level of support provided by the FTC and the cost of the child.

In addition to reducing the fiscal costs, aligning FTC amounts would also simplify the administration of WFF tax credits. This is particularly the case when children move from one age bracket to another within the tax year, triggering a recalculation of WFF entitlements. Therefore, the proposal is to move towards alignment of the amounts gradually over time.

The options considered in this RIS seek to address the concerns noted above with the constraint of making changes that generate fiscal savings, protect lower income earners, minimise effects on work incentives, and are able to be included in Budget 2011.

Objectives

The objectives of WFF are to:

- make work pay by supporting families with dependent children so that they are rewarded for their work effort;
- ensure income adequacy with a focus on low and middle income families with dependent children to address issues of poverty, especially child poverty; and
- achieve a social assistance system that supports people into work, by making sure that people get the assistance they are entitled to, when they should, and with delivery that supports them into, and to remain in, employment.

In addition to the stated objectives above, Ministers' current objectives for reform are to:

- generate fiscal savings for Budget 2011 given the current fiscal environment and the need for spending constraint;
- better target assistance to lower income families;
- protect the disposable incomes of lower income families;
- minimise the impacts on work incentives;
- not make structural changes to the scheme, i.e. ensure the changes are able to be announced at Budget 2011 and are implementable by 1 April 2012; and
- ensure any reform is consistent with the original objectives of WFF.

Regulatory impact analysis

As mentioned above, the scope of options that Ministers received advice on is in relation to the options that satisfy the Ministerial objectives stated above. Therefore, the main options considered did not address any wider issues with family assistance or the tax-benefit interface more generally.

The WFF scheme has four main parameters or levers that are able to be changed without structurally altering the scheme: the tax credit amounts; the abatement rate; the abatement

[2] *Supporting Children* released in September 2010 (see http://taxpolicy.ird.govt.nz/consultation/supporting-children).

threshold; and the indexation rules. Within these levers there are many potential options for reform that could be considered. In November 2010, a number of reform options were first presented by Treasury to the Minister of Finance. These potential options were narrowed by officials, Ministers, and their advisors, by reference to a number of criteria as set out in the Agency Disclosure Statement.

Following this, the Ministers of Finance and Revenue, and the Minister for Social Development and Employment narrowed these potential options to a final option to take to Cabinet for Budget 2011. This RIS summarises officials' advice on the development of the options considered by joint Ministers in early 2011, and the final option taken to Cabinet on 4 April 2011.

The key policy tradeoffs that informed this advice were:

- The level of fiscal savings;
- The allocation of funding directed toward lower income earners;
- Equity tradeoffs including poverty, income inequality and disposable income;
- The impact on incentives to enter full time work or increase work hours; and
- The impact on compliance and administration.

Throughout this RIS we refer to lower, middle and high income families. For the purposes of this analysis these groups are defined as:

- Lower income families – Those families with income under the current abatement threshold of $36,827.
- Middle income families – Those families with income above the current abatement threshold of $36,827, but below the threshold for the current top personal tax rate of $70,000.
- Higher income families – Those families with income above the current top personal tax rate threshold of $70,000.

These groups have been defined according to administrative thresholds and are not intended to be seen as a definitive view of what it means to be a lower, middle or higher income family. They are illustrative only. Different family circumstances, special demands on the family budget, or larger numbers of children will mean some families on "middle" or even "higher" incomes may have limited means.

Analysis of the options

The analysis of the options was carried out by the Treasury, Inland Revenue and the Ministry of Social Development. All fiscal costs, distributional analysis and disposable income analysis were modelled using Treasury's micro simulation model (Taxwell). Taxwell uses reweighted Household Economic Survey sample data to produce economy-wide tax change costings, benefit costings, and superannuation policy costings. Treasury's Half-year Economic and Fiscal Update (HYEFU) 2010 forecasts were used to calculate the indexation points.

The analysis of the options is divided into the four levers available to Ministers as follows:

Changes to the indexation of the Family Tax Credit (FTC)

The Income Tax Act 2007 currently requires the automatic indexation of the FTC when the cumulative quarterly change in the CPI reaches 5%. The latest HYEFU forecasts suggest that this will be on 1 April 2012 when rates will need to be adjusted by 5.22%. There were four options considered that would change the indexation of the FTC as follows:

1. *Remove the automatic indexation of the FTC entirely, with decisions about future increases made on an ad hoc basis by Minsters at Budget time;*

2. *Index the FTC rates but only for lower income earners;*

3. *Remove the automatic indexation of the FTC entirely, but introduce a new child allowance to compensate beneficiaries; and*

4. *Remove the indexation of the FTC 16 and over amounts.*

The options generate fiscal savings over time by maintaining the dollar value of payments and avoiding additional expenditure associated with CPI adjustments. The analysis below is divided among the key tradeoffs presented above.

- ***Distributional Analysis*** – All the indexation options showed no significant impact on income inequality measures over the forecast horizon. Option 1 showed modest increases in child poverty levels but these are not expected for the other indexation options. Due to time constraints, we were only able to model the child poverty impacts of Option 1.

- ***Disposable Income Analysis*** – Removing indexation will either lower the real disposable income of all WFF recipients (Option 1) or be more targeted to certain groups (e.g. Option 4 only lowers the real disposable income of those families with children 16 and over). Options 2 and 3 were developed to satisfy the objective of protecting lower income earners. This was largely achieved as Option 3 showed that beneficiary families were no worse off relative to the status quo but approximately 226,000 (57%) non-beneficiary families will have their real disposable income reduced by $16 per week on average. The main advantage of these options is that no family will face a fall in their nominal disposable income.

- ***Work Incentives*** – are largely unaffected by these options. However, if beneficiary families are compensated for the loss of indexation as in Option 3, the incentives for beneficiaries to move off benefit and into paid employment would fall over time. For example, relative to the status quo, Option 3 reduced the returns from moving from benefit into paid work by $16.08 for two children families and $22.76 for three children families by 2014.

- ***Compliance and administration*** – costs vary depending on the option selected. Removing indexation entirely simply requires Inland Revenue not to initiate the inflation adjustment. For introducing a new payment into the benefit system as for Option 3, implementation costs could be up to $2 million, but ongoing administration costs would be low.

Changes to the abatement rate

Currently the abatement rate of the WFF tax credits (excluding the Minimum Family Tax Credit) is 20 cents for each additional dollar earned above an income of $36,827. There were two options considered that change the abatement rate of the WFF tax credits:

5. *Increase the universal abatement rate; and*

6. *Increase the In-Work Tax Credit (IWTC) abatement rate only.*

There were many variations within the two abatement rate options presented above. The scenarios included:

- increasing the universal abatement rate to 22.5%, 25% or 30%;
- increasing the IWTC abatement rate to 25% and 30% and changing the order of the abatement schedule to abate the IWTC first; and
- altering the timing of the abatement changes to coincide with indexation of the FTC amounts. For example, Ministers' preferred option increases the abatement rate by 1.25 percentage points each indexation round to reach 25% by 2018 under current forecasts.

Changes in the abatement rate largely have the same effects with varying degrees depending on the size of the change. Our detailed analysis covered the differences between smaller and larger changes to the abatement rate. The summary below only discusses the general effects of the changes.

Changes to the abatement rate generate fiscal savings by abating assistance at a higher rate for those over the abatement threshold. The biggest impacts are on higher income earners who are no longer eligible for WFF payments. Larger increases to the abatement rate generate proportionally greater fiscal savings.

- ***Targeting*** – All abatement rate options better target the allocation of WFF assistance as those under the abatement threshold are unaffected by the changes.
- ***Distributional Analysis*** – These options are expected to have no measurable impact on income inequality measures.
- ***Disposable Income Analysis*** – Under a universal abatement rate of 30%, disposable incomes relative to the status quo (i.e. real incomes) are reduced by approximately $35 per week on average across all income bands. Those with the biggest fall in real disposable income are in the $50,000 - $100,000 income band. Approximately 197,000 families are worse off relative to the status quo; however, as these are in real terms, not all will face a fall in their nominal disposable income. Making the change coincide with indexation rounds and spreading the increases over a longer time period can help to reduce the impact on nominal disposable incomes.
- ***Work incentives*** – are altered through the abatement rate increasing Effective Marginal Tax Rates (EMTRs). All those recipients with a family income above the current abatement threshold of $36,827, and below the income level where all tax credits abate, will face a higher EMTR. However, EMTRs will be reduced for those no longer receiving assistance.

  Financial work incentives are part of a wider mix of factors that influence peoples' work choices. The analysis included local and international evidence about how increasing EMTRs might influence labour supply decisions; however, our conclusion was that decisions to alter employment are based on a number of factors and that an increase in the abatement rate of up to 5% is unlikely to be significant.

- ***Compliance and administration*** – costs are estimated to be $1.4 to $1.6 million for the forecast period. The majority of this cost will be incurred in 2011/12 immediately prior to implementation.

Changes to the tax credit amounts

Universally decreasing the WFF tax credit amounts does not achieve the objective of protecting those on lower incomes. Therefore, two options were developed to largely minimise the impacts on lower income earners as follows:

7. Simplify the FTC payment schedule; and

8. Changing the IWTC to individual child rates.

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. Option 7 simplifies the payment schedule: one rate for a first child (paid at the under 16 amount) and one for a subsequent child (paid at the under 13 amount), effectively removing the larger payment amounts for older children.

Option 8 changes the IWTC payment schedule to individual child rates. Officials presented Ministers with two scenarios: removing the single payment of $60 per week for up to the first three children and $15 per week each additional child and replacing it with a $15 per week per child payment; or changing the IWTC to $20 per child per week for the first three children and then $15 per child per week thereafter.

These options generate fiscal savings by reducing the payment amounts for older children (Option 7) and the IWTC (Option 8).

- ***Distributional Analysis*** – Depending on the size of the fall in payment, there could be an increase in the incidence of child poverty, although due to time constraints officials were unable to calculate this effect.

- ***Disposable Income Analysis*** – shows that Option 7 only affects 19% of families and the average weekly change of those families is a loss of just under $20 per week relative to the status quo (i.e. real). However, the analysis for Option 8 show that real disposable incomes were reduced by approximately $25 per week on average and up to 60% of families were affected, especially those families with one or two children.

- ***Work Incentives –*** While these options reduce payments for a number of families, EMTRs are unaffected for the majority of recipients, and will be improved for those families who no longer receive any WFF payments. Option 7 is unlikely to have any effect on work incentives. However, Option 8 reduces work incentives for the majority of WFF recipients. The IWTC is one of the main government incentives for those on a benefit to enter paid employment. Therefore, removing part of the IWTC lowers this incentive. This is highlighted in the replacement rate analysis; our example beneficiary moving into work faces a fall in their weekly income of $20 per week relative to the status quo. However, our conclusion, as with changes to the abatement rate, is that the impact on work incentives is unlikely to be significant.

- ***Compliance and administration –*** Upfront and ongoing administration and compliance costs associated with reducing payment amounts are expected to be low.

Changes to the abatement threshold

Currently the WFF tax credits start abating from an income of $36,827 at 20 cents for each additional dollar earned. There were three options presented to Ministers:

9. *Lower the abatement threshold from $36,827 to $30,000;*

10. *Lower the abatement threshold from $36,827 to $25,000; and*

11. *Lower the abatement threshold by approximately $450 each indexation round to reach $35,000 on 1 April 2018 under current forecasts.*

While these options protect those families below the new abatement threshold, moving to a threshold of $25,000 would significantly reduce the payments to a number of lower income families. These options generate fiscal savings by abating away the tax credits from a lower family income – reducing payments for all those families above the new abatement threshold.

- ***Distributional Analysis –*** Shifting the payment threshold will have no measurable impact on income inequality measures.

- ***Disposable Income Analysis –*** These options reduce the disposable incomes of all those families above the new abatement threshold. The option of a $30,000 abatement threshold, means families above the threshold will lose between $20 and $25 per week on average.

- ***Work Incentives –*** Incentives to work are mixed under changes to the abatement threshold. Those families with income between the old and new abatement threshold will face a 20% higher EMTR, lowering their incentives to work. However, anyone no longer eligible for the WFF tax credits will have their EMTR reduced by 20%. Incentives for beneficiaries to enter paid work are also reduced. The replacement rate analysis shows that under our scenario with a $30,000 abatement rate, our example beneficiary moving into work will be $26 per week worse off compared to the status quo. Overall we expect work incentives to worsen under these options but the effect is likely to be small.

- ***Compliance and administration –*** Upfront and ongoing administration and compliance costs associated with reducing the abatement threshold are expected to be low.

Final option for reform developed by joint Ministers

After consideration of the wide range of options and the associated trade-offs, joint Ministers developed a final option, subject to Cabinet agreement, for inclusion in Budget 2011. This option consists of the following parameters:

- Increase the abatement rate by 1.25 percentage points every indexation round from 1 April 2012 until it reaches 25%;

- Decrease the current abatement threshold of $36,827 by approximately $450 every indexation round from 1 April 2012 until it reaches $35,000; and

- Remove the indexation of FTC amounts for children 16 and over.

Note that the analysis for the final option for reform is not repeated here. The analysis is covered under options 4, 5, and 11 above.

The fiscal savings from this option have been estimated, over the forecast period, to be:

Final Option	Fiscal Savings ($m)*				
	2011/12	2012/13	2013/14	2014/15	4 Year Fiscal Saving
• Increase the abatement rate by 1.25 percentage points every indexation round until it reaches 25% on 1 April 2018; • Remove the indexation of FTC amounts for children 16 and over; and • Reduce the abatement threshold by approximately $450 every indexation round until it reaches $35,000 on 1 April 2018.	25	101	125	197	**449**

*all figures rounded to the nearest $1m.

Consultation

Due to the need for Budget secrecy and the short timeframes involved in developing WFF options for Budget 2011, the ability to consult in the usual manner has been severely constrained.

However, changes to the abatement rate and abatement threshold have been made by previous governments as noted above. In addition, changes to the abatement rates and amounts were considered by the Tax Working Group. The papers prepared for the group, as well as the results of their discussions, were publicly released.

The Treasury, Inland Revenue and the Ministry of Social Development were the only agencies involved in developing the proposals and carrying out the analysis.

Conclusions and recommendations

The options considered by officials that have been discussed in the preceding sections are all considered to be broadly consistent with the stated objectives of the WFF scheme and the objectives for reform for Budget 2011.

Officials consider that the majority of the options identified in this RIS, including the preferred option, will generate fiscal savings, broadly protect lower income earners, and better target WFF without having significant impacts on incentives to work, child poverty, or income inequality.

The main area for debate between the different WFF options is the trade-off between the size of any potential fiscal savings and the impact on the disposable income of WFF recipients. Officials believe that changes to the abatement rate strike the best balance between generating fiscal savings and protecting lower income earners, while also having a minimal impact on work incentives. Making these changes over a longer time period also ensures that there is minimal impact on those families affected by the changes.

Implementation

The reform options proposed for Budget 2011 will be implemented on 1 April 2012. There are no significant issues with the implementation of the preferred option. Changes to the abatement rate and threshold will be incorporated as part of Inland Revenue’s annual WFF application cycle. Part of this process involves communicating to families any changes to WFF eligibility and amounts. There will be no additional compliance costs for affected families.

Monitoring, evaluation and review

There are no plans to specifically and separately monitor, evaluate or review the proposed WFF reform for Budget 2011. The post-implementation phase of the generic tax policy process will help to identify and address any remedial issues post-Budget.