

APPENDIX C - UNDERSTANDING THE INTERFACE BETWEEN TAX, TAX CREDITS AND SOCIAL ASSISTANCE

Why is it important to understand the social assistance¹ system?

The provision of basic income support through the benefit system, and of supplementary assistance through the wider social assistance system has implications for the tax and tax credit systems. The social assistance system is complex and multi-layered. Primarily its objectives are social and distributional and these are balanced against employment and economic objectives. Due to its complexity and the primacy of non-economic objectives the social assistance system is best considered in depth elsewhere, but it does have relevance for the consideration of tax/transfer reform for several reasons:

- the social assistance system impacts on incentives
- the systems have shared goals in some cases
- a major use of tax revenue is to fund the social assistance system

Aspects of any future reforms to the transfer system will need to be delivered as part of the wider system of social assistance – either by the Ministry of Social Development or Inland Revenue - and delivery can make a big difference to the success or failure of any tax/ transfer system.

The provision of financial assistance can reduce the relative return from work. In the New Zealand context most social assistance is provided on a targeted basis, and the withdrawal of that assistance increases effective marginal tax rates (EMTRs), reducing incentives to work. It is not all one way traffic though, and some assistance is provided specifically to help overcome barriers to work (such as assistance with childcare and into work costs) or to create a specific incentive for some groups to enter or remain in employment (for example the in-work tax credit and wage subsidies). There are no free lunches, and all these forms of assistance come with costs – in fiscal or work incentive terms.

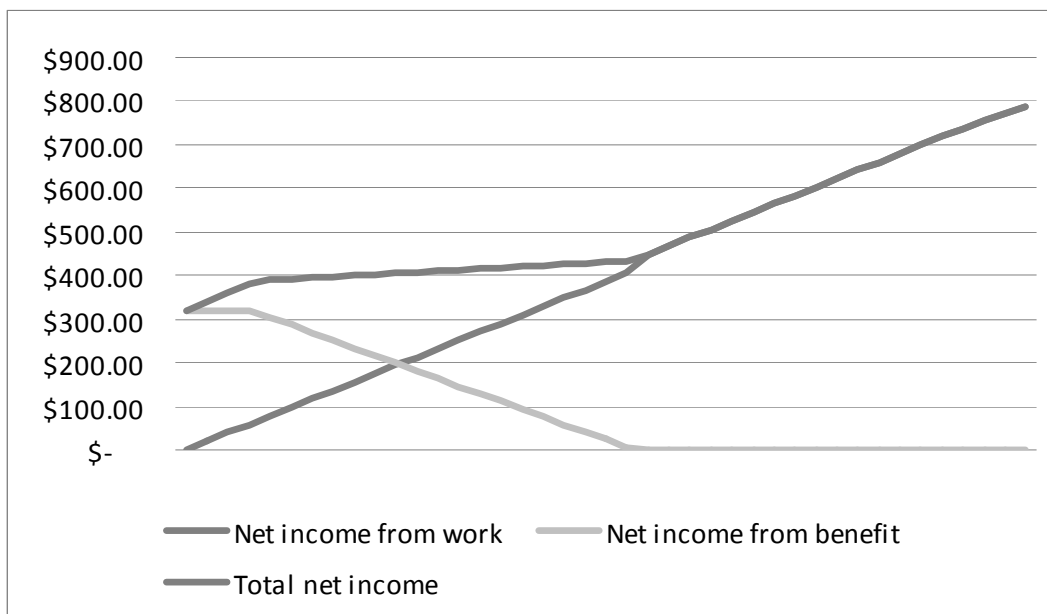
There are also cases where the objectives of the tax, tax credit and social assistance systems overlap – instances where the social assistance system seeks to achieve economic goals and where the tax/ transfer system seeks to achieve distributional, equity and poverty alleviation objectives.

¹ In this paper the term “social assistance” is used to refer to the benefit system, and the system of supplementary financial assistance that is delivered alongside the benefit system to beneficiaries and low income people. It includes a range of transfer payments, but excludes the Working for Families tax credits delivered by Inland Revenue.

Impacts on work incentives

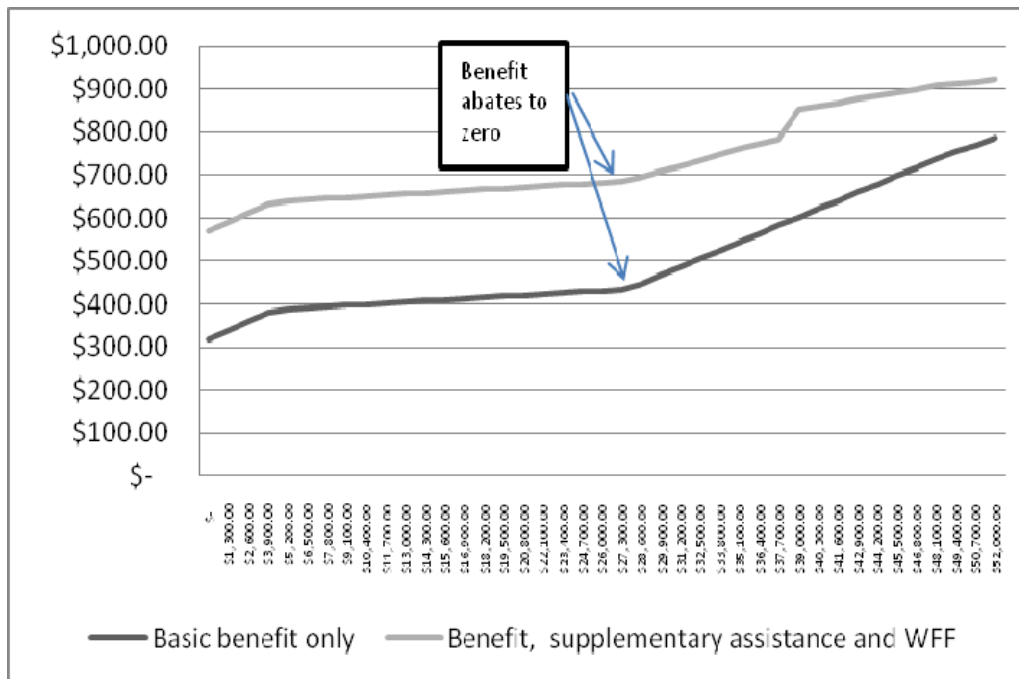
The social assistance system impacts on the structure of work incentives. Figure 1 shows the basic unemployment benefit for a couple with one child. While couples with children make up only a small proportion of people receiving benefits, they are an important population group for tax/transfer considerations. Compared with the tax system alone, the provision of a benefit lifts incomes for those with zero or very low income from work. It retains relatively good incentives to do a small amount of work while on benefit, but very little incentive to increase incomes over the period where the benefit is reducing. The focus for this benefit type is on encouraging the couple to move off benefit and into full-time work.

Figure 1: Income after tax and transfers, couple with 1 child, excluding Working for Families and supplementary assistance



Adding supplementary assistance and tax credits into the mix changes the picture. Figure 2 shows that the addition of supplementary assistance increases net income levels at the lower end of the income distribution, and flattens the increase in take home income as employment income increases. The incentives to work are low over the range of income over which supplementary forms of assistance abates, and the in-work tax credit provides a discrete incentive to increase hours to 30 or more per week (the upward 'kink' in the top line of Figure 2).

Figure 2: Income after tax and transfers, couple with 1 child



Objectives of the social assistance system

The social assistance system’s primary concern is with achieving social objectives. Social assistance is provided to assist people to meet their family care commitments, to cope with adverse circumstances and to support working age people to move into financial independence, generally through paid work.

Social assistance aims to:

- help people to support themselves and their dependants while not in paid employment
- support people to find and retain employment
- help people for whom work may not currently be appropriate because of sickness, disability or caring responsibilities
- alleviate hardship

These aims in turn seek to underpin wider social and economic goals. Employment is the best way out of poverty for most people, and is associated with better social outcomes as well as economic ones. There are known relationships between income and physical health, mental health, crime, education and child welfare. The provision of social assistance also seeks to achieve distributional goals and promote social cohesion by lessening the differences in standards of living between the wealthy and the poor.

Design of the social assistance system

The New Zealand Government spent around \$23.4 billion in the 2008/09 financial year on social security and welfare expenses. Core government spending on social security and welfare increased until the early 1990s, and then decreased. These changes reflect expenditure on superannuation and benefits, which are influenced by both the numbers of recipients, as well as the average level of payments.

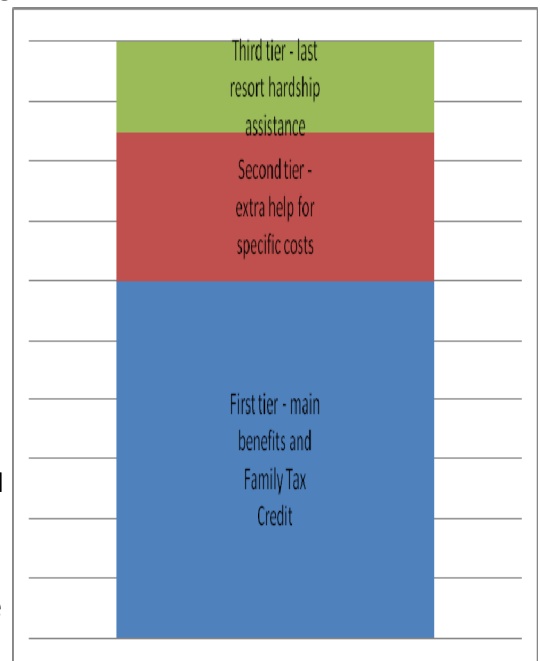
Compared with the OECD as a whole, however, New Zealand's expenditure is relatively low. The main reason is the overall costs of New Zealand Superannuation compared to the pension schemes of many countries.

In the area of benefits expenditure, it appears that New Zealand spending is roughly the same as the OECD average. The OECD social expenditure database shows above average spending on incapacity and family related benefits, while less on unemployment compensation.²

New Zealand's currently social assistance system has grown over a long period of time and in an often ad hoc manner. Old age pensions were introduced around the turn of the 19th/20th centuries, with basic benefits added in the 1940s. The 1980s and 1990s saw increased emphasis on providing targeted financial assistance and improving work incentives. The evolution of the social assistance system means that while there is coherence to the system overall and to its individual programs, there are anomalies in the system, parts that are dated and others that are not well targeted. It also means many elements of the system are highly interrelated both with each other, with the tax system, and with other government systems (health, education, etc).

The current social assistance system is best described as having three tiers:

- The **third tier** has extra financial help for people in unusual circumstances or in severe hardship. It is tightly income and asset tested.
- The **second tier** has extra financial help for people in particular situations and/or for specific ongoing costs like accommodation, disability and childcare. This assistance is generally non-taxable, more closely reflects the actual costs faced and usually available to people not receiving a main benefit.
- **First tier or main benefits** are for basic living costs and are subject to income tax. Family Tax Credit sits alongside first tier benefits as the main form of financial support for the care of children. In this sense



² Source: Rea, forthcoming from *New Zealand's Long-Term Fiscal Position*. Wellington: Treasury (2006).

basic benefits for children are delivered primarily through the tax system, and are portable into work but not subject to income tax.

Main benefits are generally the most tightly targeted on income grounds. The second and third tiers of assistance are generally available to both people receiving and those not receiving main benefits. Second tier assistance is often available to low-to-middle income families, and often overlaps with abatement of transfers through the tax system.

A worked example

The following chart gives a worked example of how the three tiers layer to provide a package of support. The example is of a sole parent with two children. The left hand column shows the basic entitlement rates for key forms of social assistance, and the right hand column indicates what the example sole parent would receive.

A Worked Example

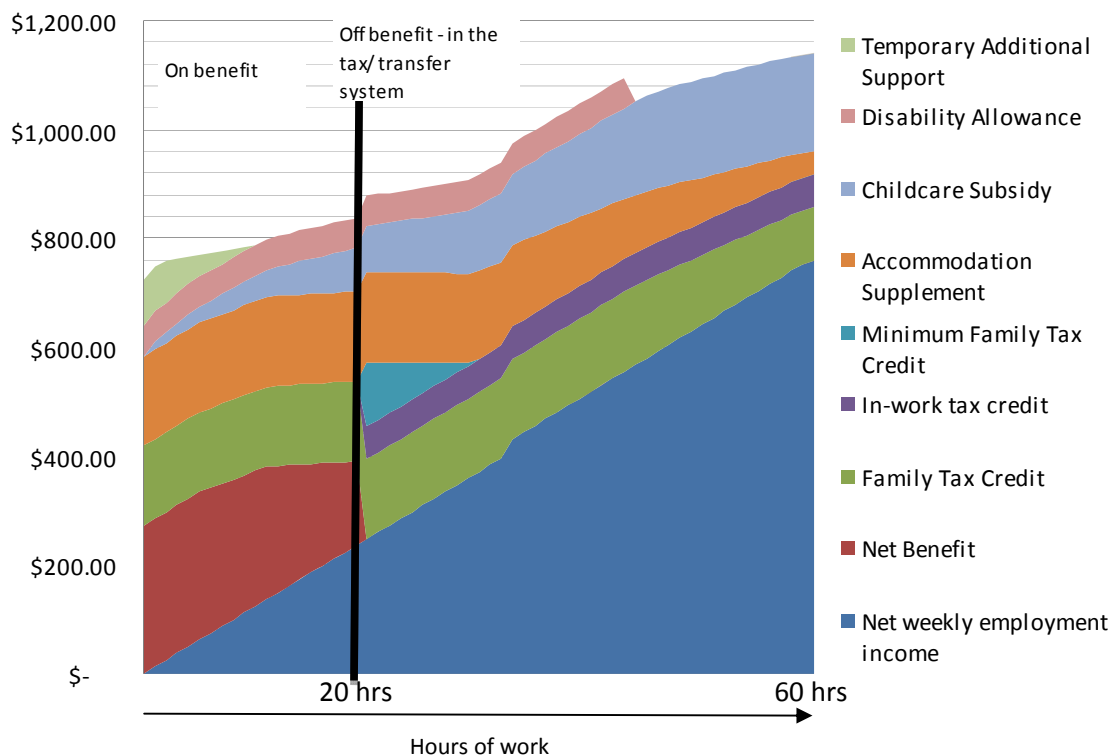
Financial support for families with children								
all rates are weekly maximums								
				Weekly				
Main benefits <i>(main support for adults)</i>					Example: Sole parent with 2 young children			
DPB, UB, SB: Sole parent	\$	272.70			Domestic Purposes Benefit	\$	272.70	
UB, SB: Couple	\$	317.30						
Invalids' benefit: Sole Parent	\$	312.62						
Invalids' benefit: Couple	\$	396.62						
Working for Families tax credits <i>(main support for children)</i>								
<u>Family Tax Credit</u>								
First child, 0-16 years	\$	86.29			Family Tax Credit	\$	146.27	
First child, 16-18 years	\$	99.96						
Subsequent child <13 years	\$	59.98						
Subsequent child 13-15 years	\$	68.40						
Subsequent child 16+ years	\$	89.44						
<u>Credits for working families only</u>								
In-work tax credit	\$	60.00	per family					
	\$	15.00	4th and subsequent children					
Minimum Family Tax Credit	\$	395.00	family income top up					
Parental Tax Credit	\$	150.00	for 8 weeks					
Paid Parental Leave	\$	407.38	for 14 weeks					
Supplementary assistance <i>(additional support for specific costs)</i>								
<u>Accommodation Supplement</u>								
		Area 1	Area 2	Area 3	Area 4			
1 Person	\$	145.00	\$ 100.00	\$ 65.00	\$ 45.00	Accommodation Supplement	\$	165.00
2 People	\$	160.00	\$ 125.00	\$ 75.00	\$ 55.00	<i>(\$360 rent per week, living in Manukau)</i>		
3+ People	\$	225.00	\$ 165.00	\$ 120.00	\$ 75.00			
Childcare Assistance		\$3.63	per hour			Childcare Assistance	\$	32.67
						<i>(1 child in care for 9 hours per week)</i>		
Disability Allowance	\$	55.88						
Hardship assistance <i>(additional support for people in severe hardship)</i>								
<u>Temporary Additional Support</u>								
DPB, UB, SB: Sole parent	\$	81.81			Disability Allowance			55.88
UB, SB: Couple	\$	95.19			Temporary Additional Support	\$	83.05	
Invalids' benefit: Sole Parent	\$	93.79			<i>(including \$50 per week vehicle repayment costs)</i>			
Invalids' benefit: Couple	\$	118.99						
<u>Food Special Needs Grants</u>								
family with 1 or 2 children	\$	450.00	maximum in 26 week period		Total weekly income	\$	755.57	
family with 3 or more children	\$	550.00	maximum in 26 week period			<i>Rent</i>	\$	360.00
						<i>Car repayments</i>	\$	50.00
						<i>Childcare</i>	\$	45.00
					Disposable income	\$	300.57	

Interface with the tax and transfer system

Generally as income rises, social assistance payments reduce. Figure 3 shows how in-the-hand income for the sole parent from the worked example above changes as they increase their hours of work.

The tax credits (Minimum Family Tax Credit, Family Tax Credit and In-work tax credit in this case) are an integral part of the picture for this sole parent. The benefit and family tax credit work together to provide a basic income for the sole parent and their children. Accommodation Supplement and Disability Allowance provide assistance for specific additional costs. The in-work tax credit and minimum family tax credit together provide a strong incentive to move from benefit to work 20 hours a week. However the incentives to work more from that point until the sole parent is clear of the Minimum Family Tax Credit are poor.

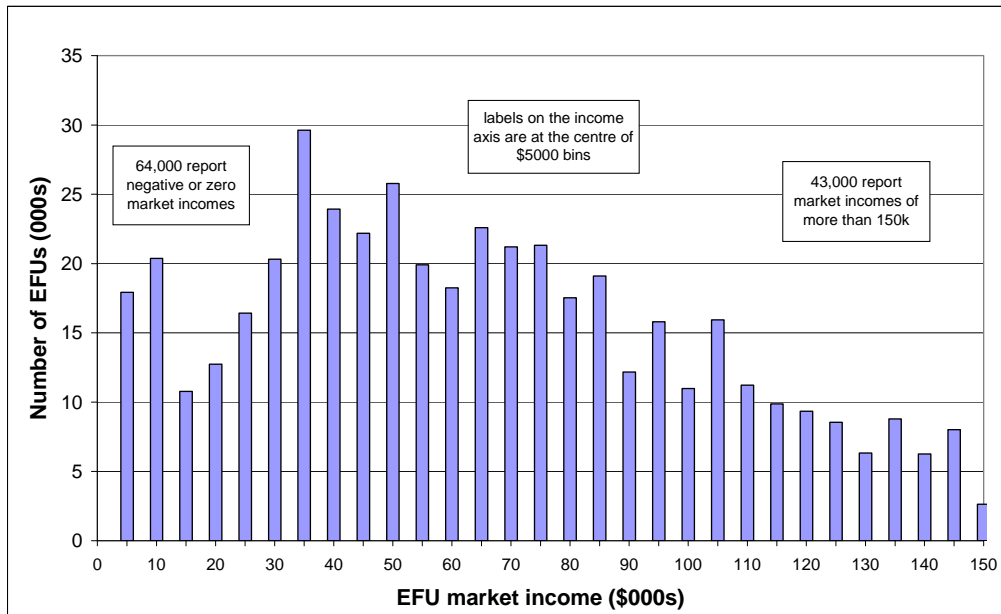
Figure 3: Income after tax and transfers, by source, for a couple with 1 child



Although every individual situation is different, and in some ways this is an extreme example, earning \$16 per hour, this sole parent continues to receive accommodation and childcare assistance working 60 hours per week. And as is clear, there is considerable overlap between the withdrawal of second tier social assistance and tax credits.

Figure 4 shows the distribution of income for families with children estimated from the 2008 Household Economic Survey (HES). In conjunction with Figure 3 above, it gives a sense of the numbers of families potentially affected by the pattern of social assistance abatement illustrated in Figure 3.

Figure 4: Market incomes of economic family units with dependent children (\$5,000 bins), HES 2008



Source: Ministry of Social Development analysis of Household Economic Survey 2008 data

Conclusions

The tax, tax credit and social assistance systems are different but highly interlinked – they have overlapping objectives and population groups. Reform in either system must take account of the implications for the other to be effective. From a social assistance perspective, this means that there are several things that tax/transfer reform must consider:

- The tax/ transfer system delivers social objectives as well as fiscal and economic objectives. The family tax credit is now the primary form of financial support for the care of children and has primarily social objectives as well as distributional objectives
- There are no “right” answers – only tradeoffs between competing objectives. The classic tradeoff is between income adequacy, work incentives and fiscal cost, which form a kind of “iron triangle,” where gains on one objective cannot help but impact on the other objectives
- Improving work incentives for one group will always worsen them for another
- Changes to the tax/ transfer system can impact on the social assistance system by altering the profile of incentives for beneficiaries and low income workers, and vice versa. The complex nature of social assistance entitlements means that these impacts may not be obvious at first glance
- Administration, public and stakeholder acceptance are important in achieving any gains where social objectives of the tax/ transfer system are concerned
- Undue complexity can undo otherwise good policy