30 June 2008

Minister of Finance
Minister for Social Development and Employment
Minister of Revenue
cc: Associate Minister of Finance (Hon Phil Goff)
Associate Minister of Finance (Hon Trevor Mallard)
Associate Minister of Finance (Hon Clayton Cosgrove)

Working for Families Tax Credits: a review of the in-work tax credit and the parental tax credit

Executive summary

A mandatory requirement in the Income Tax Act 2007 requires the Minister of Revenue to cause a review to be undertaken, in consultation with the Minister for Social Development and Employment, of the amounts of the in-work tax credit and the parental tax credit by 30 June 2008. The credits are components of the Working for Families Tax Credits.

The requirement for this review was included in the Income Tax Act at the time that the Working for Families package was introduced. The requirement was intended to ensure that the policy objectives of the instruments would continue to be met over time.

This report fulfils the statutory requirement, and recommends no changes to the amounts at this time. Based on available evidence, the in-work tax credit appears to be fulfilling its objective of making work pay for families with children, as well or better than it was at the time it was designed and implemented. This report also provides background and contextual information on the in-work tax credit and the parental tax credit.

The in-work tax credit was introduced from 1 April 2006 as part of the package of Working for Families reforms and is designed to assist working people, especially low to middle income families, to make the most of economic opportunities by improving the returns from work. It supports working-age parents, especially sole parents to take up and stay in employment by providing a boost to the earned incomes of those low to middle income families. This helps to ensure that they are better off in work than on a benefit. The in-work tax credit requires a direct attachment to work by requiring for the care-giver, and/or the spouse or partner of the caregiver, if there is one, to be normally a full-time earner receiving income from a work activity. In its first year following implementation, the in-work tax credit was received by over 197,300 families.

When the Working for Families package was designed it was considered that the relevant consideration for setting future levels of the in-work tax credit would be the change in the "gap" between benefit levels and wages rates for low and middle income families over the preceding three years. As the credit was introduced only from 1 April 2006, the comparisons for the purpose of this review have been between benefit rate and wage movements from 1 April 2004, when the decisions were made, and 1 April 2008. In that period, benefit rates have increased by approximately 12% for sole parents and 6% for couples. By contrast, average earnings have increased by 17% and the minimum adult wage by 32%.

In addition, the reduction in personal income tax rates from 1 October 2008 and the concurrent increase in the amounts of the family tax credit will further improve incentives to work.

Finally, the focus of the Working for Families evaluation during the second half of this year is also expected to produce highly relevant information on the impact of the Working for Families package on movement into work. Officials therefore consider that it would be premature to change the in-work tax credit at this time and recommend no change. The legislative requirement is for a further review in three years time, by 30 June 2011.

The parental tax credit was introduced in 1999 to assist with the initial extra costs faced by a family in the weeks immediately following the birth of a new child. The maximum amount of the credit, which has not changed since its introduction, is $1200. It represents payment for the first 56 days following the birth of a child and is not available to families receiving an income-tested benefit, student allowance, New Zealand Superannuation or veteran's pension, or paid parental leave.

The parental tax credit has been largely replaced by paid parental leave, which is now the government's main instrument for helping with costs associated with a newborn child. Since paid parental leave was introduced in 2002, there has been a steady decline in the numbers of people receiving the parental tax credit. However, there was a slight reversal of that trend in the 2007 tax year showing that the parental tax credit is still a better option for some families.

Ministers have, over the past year, considered a number of options for possible enhancements to the paid parental leave scheme. However, officials understand that the Minister of Labour has obtained approval from the Cabinet Policy Committee to defer further consideration until December 2008.

Officials therefore propose no change to the amount of the parental tax credit now, but that Ministers consider it concurrently with their further consideration of paid parental leave in December 2008. This would allow Ministers to provide for any increase in the amount of the parental tax credit to recognise the loss of value over time in the context of their decisions for Budget 2009.

This report will be discoverable in the proceedings *Child Poverty Action Group v The Attorney-General* and is concurrently being made available to the Crown Law Office. Officials recommend that you agree to it being published on the websites of the Ministry of Social Development and Inland Revenue.

Recommended action

We recommend that you:

[a] **Note** the mandatory requirement for a review of the in-work tax credit and the parental tax credit to be undertaken by 30 June 2008.

Noted Noted Noted

[b] **Note** that the in-work tax credit was designed to improve the returns from work for low and middle income families, especially sole parent families, by ensuring that they are better off in work than they are on a benefit.

Noted Noted Noted

[c] **Note** that the in-work tax credit appears to be fulfilling its goal of making work pay and therefore there is no need to increase the in-work tax credit at this time.

Noted Noted Noted

[d] **Note** that the current phase of the evaluation of the Working for Families package will provide information on the effectiveness of the package in meeting its work incentive objectives, but will not be reported on until 2009.

Noted Noted Noted

[e] **Note** that the evidence to date, particularly the significant fall in the numbers receiving the Domestic Purposes Benefit, suggests that the in-work tax credit is having a positive impact and is contributing to movement off benefit.

Noted Noted Noted

[f] **Agree** to no change in the amount of the in-work tax credit at this time.

Agreed/Not agreed Agreed/Not agreed Agreed/Not agreed

[g] **Note** the legislative requirement for a further review in the amount of the in-work tax credit in three years time, by 30 June 2011.

Noted Noted Noted

[h] **Note** that the amount of the parental tax credit has not changed since it was introduced in 1999.

Noted Noted Noted

[i] **Note** that the parental tax credit has been largely replaced by paid parental leave, which is now the government's main instrument for helping with costs associated with a newborn child, but parental tax credit is still a better option for some families.

Noted Noted Noted

[j] **Note** that officials understand that options for possible enhancements to the paid parental leave scheme are to be considered again by Ministers in December 2008.

Noted Noted Noted

[k] **Agree** that there be no change to the amount of the parental tax credit at this time.

Agreed/Not agreed Agreed/Not agreed Agreed/Not agreed

[l] **Agree** that officials should report further on options for the parental tax credit concurrent with the report on further consideration of paid parental leave in December 2008.

Agreed/Not agreed Agreed/Not agreed Agreed/Not agreed

[m] **Note** that this report will be discoverable in the proceedings *Child Poverty Action Group v The Attorney-General* and is concurrently being made available to the Crown Law Office.

Noted Noted Noted

[n] **Agree** to the report being published on the websites of the Ministry of Social Development and Inland Revenue.

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<tr><td>Agreed/Not agreed</td><td>Agreed/Not agreed</td><td>Agreed/Not agreed</td></tr>
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Background

1. In making its final decisions on the Working for Families package, the government acknowledged that it was important to maintain the effectiveness of the real value of family income assistance over time, both in terms of maintaining income adequacy and the effectiveness of the work incentive measures. However, whereas a link for the family tax credit (formerly family support) to movement in the Consumers Price Index was appropriate, the factors to consider to maintain the effectiveness of the in-work tax credit as a work incentive are more complex. Similarly, any future adjustments to the parental tax credit, as well as considering the value of the credit, must have regard to developments in the provision of paid parental leave. The government therefore decided to provide for a review of the in-work tax credit and the parental tax credit every three years [CAB Min (04) 13/4 refers].

2. The need to maintain the effectiveness of the Working for Families Tax Credits is given effect through mandatory requirements in the Income Tax Act 2007 for periodic reviews of each of the component credits. In the case of the family tax credit, the amount and the abatement threshold[1] are automatically increased from the following tax year when there has been a five percent movement in the New Zealand Consumers Price Index. The annual adjustment of the minimum family tax credit responds to changes in benefit rates. However, a review of the amounts of the in-work tax credit and the parental tax credit is required to be undertaken no later than 30 June 2008, and no later than 30 June in the third year after each preceding review.

3. In the case of the in-work tax credit, the current maximum amounts are $3,120 per year for a family of up to three children, with an additional $780 per year for each additional child. The maximum amount of the parental tax credit is $1200, representing payment for the first 56 days following the birth of a new child.

4. Fifteen member countries of the OECD[2] have significant in-work schemes. They range from lump sum payments on entering the workforce, as in Australia, to ongoing allowances, some in combination with an entry payment.

5. This paper presents first the issues for consideration in reviewing the in-work tax credit and, second, the issues to consider in relation to the parental tax credit.

In-work tax credit

The purpose of the in-work tax credit

6. The three key objectives of the Working for Families package as a whole were to:

[1] The abatement threshold applies to all the Working for Families Tax Credits except for the minimum family tax credit.
[2] www.oecd.org

- make work pay;
- ensure income adequacy;
- achieve a social assistance system that supports people into work.

7. The in-work tax credit is the key instrument designed to make work pay within the context of the whole package. It supports working-age parents, especially sole parents, to take up and stay in employment, by providing a boost to the earned incomes of low to middle income families to help ensure that they are better off in work than they are on a benefit.

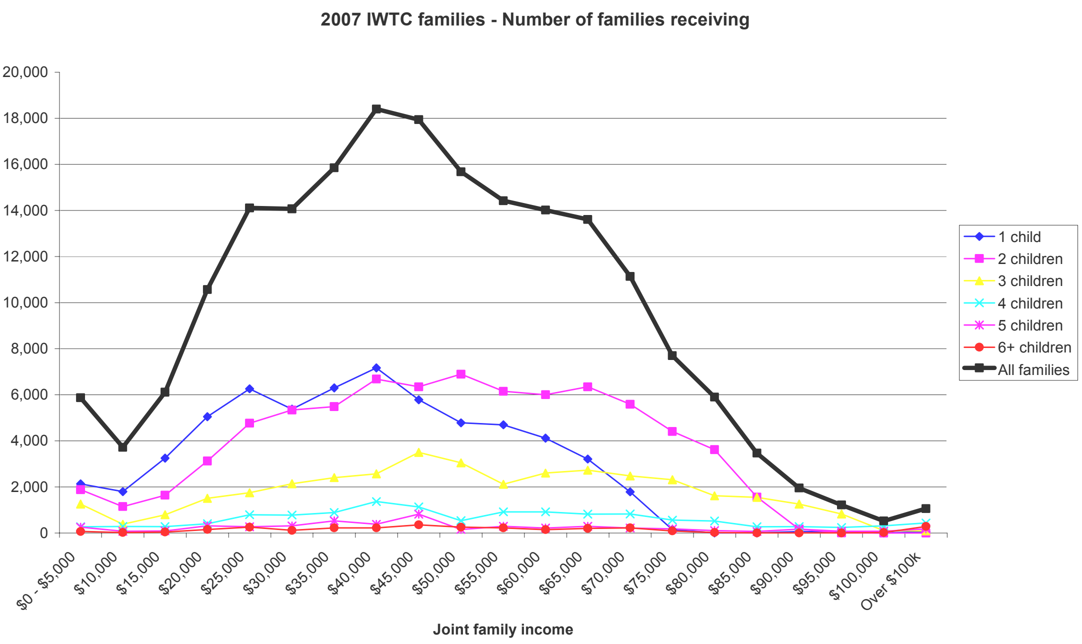
8. The child tax credit, which was replaced by the in-work tax credit, was a payment to families who met a simple test of not being in receipt of an income tested benefit, a veteran's pension, New Zealand superannuation, a student allowance or earnings-related compensation (ACC) for more than three months. The in-work tax credit goes further, requiring a direct attachment to work by requiring the care-giver, and/or the spouse or partner of the caregiver, if there is one, to be normally working a minimum of 20 hours per week in the case of a sole parent or, for a couple, a minimum of 30 hours per week between them. The in-work tax credit also extends assistance to several other groups of parents who were not eligible for the child tax credit, including superannuitants, people caring for an orphan or unsupported child and long-term recipients of ACC.

9. The purpose of the in-work tax credit, as stated in the supporting policy paper to joint ministers on 19/3/2004, "Future Directions: Regular Adjustment of Family Income Assistance", was "to improve replacement ratios, i.e. the gap between income on benefit and income when in work". The relevant consideration for setting the level of the in-work tax credit is therefore the existing "gap" between benefit levels and wages rates for low and middle income families, and how the size of that gap has moved over the preceding three years. In relation to adjustments, the 2004 paper stated:

> "Over time, this gap is affected by changes in both benefit and wage rates. Assuming benefit rates are CPI indexed suggests that the rate of IWP should be adjusted in relation to movements of real wages for low- to middle-income earners. That is, when these real wages rise, the need for an IWP to maintain work incentives declines (and conversely, when real wages fall). One option for allowing this to occur is not to index the IWP at all".

Who is receiving the in-work tax credit?

10. Approximately 197,300 families have received the in-work tax credit for the tax year ended 31 March 2007, its first year of implementation. The number may increase slightly as late end-of-year tax returns are filed. The majority of these families had income in the range of $25,000 to $65,000, as illustrated in the following graph. It should be noted that families at the low end of the income range would have met the qualifying hours for less than a full year.



What has happened to wages and benefits?

11. When the Working for Families package was designed, the AOTWE[3] (for the December 2003 quarter) was $736.26. It had increased to $783.98 (December 2005 quarter) by the time the in-work tax credit was introduced from 1 April 2006. It has further increased to $861.55 (December 2007 quarter), an increase of 17 percent from December 2003, or almost 10 percent from the time of implementation of the in-work tax credit.

12. Over that same period the minimum adult wage has increased from $8.50 per hour in December 2003[4], to $9.50 per hour in December 2005 and $11.25[5] per hour in December 2007. For a 30 hour week (the minimum qualifying hours for the in-work tax credit for a couple), this would equate to an increase from $255 per week to $337.50 per week, a 32 percent increase over the time since the policy decisions were made; or an 18 percent increase since the in-work tax credit was implemented.

13. Social security benefits are, by convention, increased from 1 April each year in response to inflationary movement as measured by the Consumers Price Index in the year to the previous December quarter.

14. At the time the Working for Families policy decisions were made, the rate (applying from 1 April 2004) of sickness or unemployment benefit for a couple with children was $290.72, while the rate for a sole parent with one child was $235.12.

[3] Average ordinary time weekly earnings (males and females combined, as measured by the Quarterly Employment Survey conducted by Statistics New Zealand.
[4] All amounts are for December quarter for better comparisons.
[5] The rate has further increased to $12.00 per hour from 1 April 2008.

15. From 1 April 2005, concurrent with an increase in the family tax credit (formerly family support), those benefits were restructured to remove the child component in the case of the couple rate, and to remove the component for children after the first child in the case of the sole parent rate. The rates (after tax) were:

	From 1 April 2005	From 1 April 2006	From 1 April 2008
Sole parent	$241.47	$249.10	$263.78
Couple	$280.96	$289.84	$306.92

16. It should be noted that the couple rate reduced between April 2004 and April 2005, when the child component was removed from the benefit. The percentage movements in benefit rates have been:

- For a sole parent from 1/4/04[6] to 1/4/08 — 12.18%
- For a sole parent from 1/4/06 to 1/4/08 — 5.89%
- For a couple from 1/4/04 to 1/4/08 — 5.79%
- For a couple from 1/4/06 to 1/4/08 — 5.89%

Current context/environment

17. As reported to the Cabinet Business Committee [CBC (08) 262], the early findings of the evaluation of the implementation of the Working for Families package are that it is having a positive impact and is contributing to movement off benefits into work, particularly for sole parents who already had some labour market attachment. In particular, the in-work tax credit is being received by a large and growing number of families and appears to be fulfilling its objective of making work pay for families with children, as well or better than it was at the time it was designed and implemented. In its first year of implementation, the tax year ended March 2007, the in-work tax credit was received by over 197,300 families.

18. New Zealand has also experienced a significant fall in the number of people receiving the Domestic Purposes Benefit (DPB)[7] since the Working for Families package was implemented, with a particularly rapid fall just prior to and following the introduction of the in-work tax credit.[CBC (08) 262]

19. Now that we have data available for a full tax year during which the in-work tax credit was in place, the evaluation of Working for Families in the second half of 2008 will focus on evaluating the Working for Families package against the objectives of making work pay and improving income adequacy. This will include an analysis of the whether people have

[6] Benefit rates from 1 April 2004 were known at the time of the original policy decisions and had regard for CPI movement to the December 2003 quarter.

[7] DPB numbers fell from 108,768 at the end of August 2004 (just prior to the introduction of the first WFF changes) to 96,480 at the end of August 2007.

responded to the in-work tax credit by moving into or out of work. Interim findings from that work are not yet available. The first phase of analysis should be available to be presented early in 2009, with detailed analysis due to be reported in June 2009,

Upcoming changes

20. In Budget 2008, the government announced the following changes to tax rates and the Working for Families Tax Credits from 1 October 2008, and further tax changes from 1 April 2010 and 1 April 2011. The changes are relevant to these considerations as they increase the gap between wages and benefits:

From 1 October 2008

Income tax on the first $14,000 of income will reduce to	12.5%
Income tax on income $14,001 — $40,000	21%
Income tax on income $40,001 — $70,000	33%

The income threshold at which the Working for Families Tax Credits begin to abate will increase to $36,827 and family tax credit rates will increase to:

First child if under 16 years	$4,487 pa	$86 per week
First child if 16 years or over	$5,198 pa	$99 per week
Subsequent child under 13 years	$3,119 pa	$59 per week
Subsequent child 13-15 years	$3,557 pa	$68 per week
Subsequent child 16 years or over	$4,651 pa	$89 per week

21. The reduction in tax rates and the concurrent increases in the amounts of the family tax credit will further improve incentives to work. In addition, the increase in the income threshold in combination with the increases in family tax credit rates will move entitlement to the in-work tax credit further up the income scale.

Actual in-work tax credit expenditure data

22. Progress figures for the in-work tax credit, subject to late income tax returns being filed, is that it was received by 197,300 families in the tax year ended 31 March 2007. The average amount received was $2,564 per family.

23. Total expenditure on the in-work tax credit was $80 million for the fiscal year ended 30 June 2006, and $461.1 million for the year ended 30 June 2007.

Conclusion

24. In the time since the in-work tax credit was implemented, benefits have increased by approximately 6 percent, whereas average earnings have increased by 10 percent and the minimum adult wage has increased by 18 percent.

25. Comparisons from the time that the Working for Families policy decisions were made are complicated by the removal of the child component from main benefits. They are further complicated by the increase in the abatement threshold and the reduction in the abatement rate, concurrent with the introduction of the in-work tax credit from 1 April 2006. From 1 April 2004 to 1 April 2008, benefits for sole parents have increased by 12 percent, but for couples by approximately 6 percent. In that period, average earnings have increased by 17 percent and the minimum adult wage by 32 percent.

26. In addition, the tax changes from 1 October 2008 will increase the take-home pay of working families earning above the threshold for the minimum family tax credit. The incomes of all eligible working families will be boosted further by the increases in the family tax credit.

27. The focus of the Working for Families evaluation during the second half of this year is also expected to produce highly relevant information on the impact of the package on work incentives. Officials therefore consider that it would be premature to consider any change to the in-work tax credit at this time, and recommend no change.

28. The law requires a further review of the in-work tax credit in three years time, by 30 June 2011, and the current situation indicates that this is appropriate. The review would need to consider changes in the period 1 July 2008 to 30 June 2011. However, officials will assess the extent to which the evaluation findings change the findings of this review and, if necessary, they will report further.

Parental tax credit

The purpose of the parental tax credit

29. The parental tax credit was introduced in 1999 to assist with the initial extra costs faced by a family in the weeks immediately following the birth of a new child. The maximum amount of the credit, which has not changed since its introduction, is $1200. It represents payment for the first 56 days following the birth of a child. It is the last of the Working for Families Tax Credits to be abated on account of the family's income. The parental tax credit is not available to families receiving an income-tested benefit, student allowance, New Zealand Superannuation or veteran's pension, or paid parental leave.

Interface with paid parental leave

30. Since 1 July 2002, working parents who qualify have had the option of choosing to receive paid parental leave instead of the parental tax credit. Initially available to employees for up to 12 weeks, paid parental leave has subsequently been extended to self-employed persons and is now payable for up to 14 weeks of parental leave.

31. Paid parental leave is provided to one parent or shared between both parents where they are both eligible. The paid leave replaces 100% of previous earnings of employees, or self-employed recipients, up to a maximum of $407.36 (from 1 July 2008) of gross earnings a week. Self-employed recipients who make a loss, or earn less than the equivalent of 10 hours pay at the highest rate of minimum wage, will receive the minimum rate of $120.00 gross per week from 1 July 2008.

32. The maximum rate of paid parental leave is adjusted annually at 1 July according to any percentage movement upward in average ordinary-time weekly earnings. The minimum rate of payment for self-employed recipients is adjusted annually, consistent with the highest rate of minimum wage that applies under the Minimum Wage Act 1983 at 1 July each year.

33. The number of recipients of the parental tax credit peaked at 20,900 in the year prior to the introduction of paid parental leave. In subsequent years, the number of families who received the parental tax credit dropped each year, concurrent with annual rises in the numbers receiving paid parental leave.

34. Although numbers are not yet final, the trend seems to have reversed slightly for the tax year ended 31 March 2007. The number of recipients of paid parental leave increased to 27,100 (from 24,400 in 2006); however, the number of families who received the parental tax credit also increased (to 15,600 from 13,800 in 2006).

35. Ministers have, over the past year, considered a number of options for possible enhancements to the paid parental leave scheme. However, officials understand that the

Minister of Labour has obtained approval from the Cabinet Policy Committee to defer further consideration until December 2008.

Actual PTC data

36. As indicated above, the number of families receiving the parental tax credit peaked at 20,900 in the tax year ended 31 March 2002. Numbers declined steadily to a low of 13,800 in the tax year ended 31 March 2006, but the progress figure for 2007 shows a rise again to 15,600.

37. For the 2007 year, at a family income of $45,000 and above, most recipients of the parental tax credit were likely to have two or three children. This suggests that the eligibility criteria for paid parental leave are more likely to be met for the first child for those families.

38. Expenditure on the parental tax credit for the fiscal year to June 2007 was approximately $20.7 million.

Conclusion

39. Assuming that the costs of a newborn child have moved approximately in line with inflation, there could be a case for an increase in the parental tax credit of approximately 24 percent or $288.

40. Based on the number of recipients in the 2007 year (15,600), this would have a maximum fiscal impact of approximately $4.4 million.

41. However, officials note that the parental tax credit has not been reviewed since its inception, and that paid parental leave is now the government's main instrument for helping with costs associated with a newborn child. Officials therefore propose no change to the parental tax credit now, but that Ministers consider it concurrently with their further consideration of paid parental leave in December 2008. This would allow Ministers to provide for any increase in the amount of the parental tax credit, to recognise the loss of value over time, in the context of their decisions for Budget 2009.

Publicity

42. In view of the mandatory requirement to carry out the review of these two instruments, you may wish to consider how you wish to release this report and whether it is necessary to announce the outcome.

43. The report itself will be discoverable in the proceedings *Child Poverty Action Group v The Attorney-General* and is concurrently being made available to the Crown Law Office.

44. Officials recommend that the report be published on the websites of the Ministry of Social Development and Inland Revenue. If you agree, we will, in consultation with your offices, develop a strategy for responding to any media enquiries about the outcome of the review.