Regulatory Impact Statement: $25 per week increase to the In-Work Tax Credit

Coversheet

Purpose of Document	
Decision sought:	Analysis produced for the purpose of informing final Cabinet decisions in relation to the $25 per week increase to the In-Work Tax Credit
Advising agencies:	Inland Revenue
Proposing Ministers:	Hon Simon Watts, Minister of Revenue
Date finalised:	24 April 2024

Problem Definition

The effectiveness of the In-Work Tax Credit (IWTC) as an incentive to take up and stay in employment has been diminished over time, and the real value of the tax credit has eroded relative to wage growth. Recent inflation means families require more in-work support where available. The impact of inflation has been especially significant for families and their ability to meet household costs.

The policy objective of the Working for Families (WFF) package, which includes the IWTC, is to:

- increase financial incentives to work;
- 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.

It must also achieve these objectives at a sustainable cost to government.

Executive Summary

<u>In-work Tax Credit increase</u>

The IWTC is one of two key instruments to “make work pay” within the wider context of the WFF package. It supports parents to take up and stay in work by providing a boost to their net income, provided they are in employment, and not receiving a main benefit or student allowance.

Currently, the IWTC is paid at a maximum rate of $3,770 per year ($72.50 per week) for a family of up to three children, with an additional $780 each year ($15 per week) for each subsequent child. This proposal (Option 2) would see the base rate of IWTC increased to $5,070 per year ($97.50 per week) from 31 July 2024.

Options considered for assessment

This proposal is a Government manifesto initiative – alternative options, other than the status quo, have not been considered.

Option 1: Status quo – no legislative or policy change

The IWTC would continue to be paid at a maximum rate of $3,770 per year ($72.50 per week) for a family of up to three children, with an additional $780 each year ($15 per week) for each subsequent child.

The impacts of option one

This option risks the policy objectives of the IWTC being further eroded if the value of the IWTC in relation to minimum wage continues to decrease. As such, this option is out of step with improving income adequacy for low to middle income families, increasing work incentives for low to middle income families, and helping the Government meet its child poverty reduction targets. However, this option does not bear an additional cost to the Government and would not require Inland Revenue to implement any changes.

Option 2: Increase of the in-work tax credit by $25 per week from 31 July 2024

Under option two, none of the existing statutory parameters in relation to eligibility and abatement would be adjusted.

The proposed implementation date would be 31 July 2024. The updated rate would take effect alongside the proposed changes to personal income taxes and the Independent Earner Tax Credit. Ad hoc notices of entitlements will need to be sent to WFF customers in June 2024 to inform them of the change. This is likely to increase administrative costs for Inland Revenue as these notices will be sent out during Inland Revenue's busiest period and are likely to drive increased customer contact.

Consultation has shown general support for increases to tax credit rates

In 2018, the previous Government established the Welfare Expert Advisory Group (WEAG) to advise them on the future of New Zealand's social security system, including the WFF scheme. The WEAG recommended fundamental changes to the design and targeting of WFF, as well as significant increases to main benefits and the Family Tax Credit (FTC).

In response, the previous Government established the WFF Review as a result of those recommendations. This review included a targeted engagement process with many stakeholders, including several academics and those representing groups who advocate for children. Most survey respondents were of the view that WFF does not currently pay enough support for families.

The impacts of option two

There will be increased financial resources available to low and middle income working families

This change will benefit approximately 170,000 families who currently receive the IWTC. They will benefit by a net average of $16.97 per week when factoring in the average rate at which the IWTC abates amongst all IWTC recipients.

There will be increased incentive for low and middle income families to take up and stay in paid employment

This change will lower replacement ratios, which measures the gap between income when receiving a benefit versus receiving income when in work. By increasing the IWTC, a family's income in employment would decrease by a greater proportion if they went onto a main benefit or vice versa.

Currently, a coupled family working 40 hours per week at minimum wage would retain 80.5% of their income if they left employment and went on benefit, and for a sole parent in the same situation 66.3% of their income would be retained. After the increase to the IWTC, and all other things being equal, these replacement ratios would decrease to 78.8% for a coupled family, and 64.5% for a sole parent family.

There will be reductions to child poverty

The impact on child poverty of option 2 (increase the IWTC by $25 per week from 31 July 2024) has not been modelled independently to of the other Tax Package changes, due to time constraints.

It is estimated that the Tax Package, which includes a $25 increase to the In-Work Tax Credit, will reduce child poverty by around 14,000 children (+/- 6000) on the fixed-line AHC50 measure,[1] and by around 3,000 children (+/- 7000) on the BHC50 measure[2] in the 2027 tax year.[3]

The tax package increases the incomes of low-income working households faster than the increase in the cost of living, which reduces fixed-line AHC50 child poverty. However, the tax package may slightly reduce moving-line BHC50 child poverty, since the poverty line for this measure is set at 50% of the median household income, and the tax package is expected to increase the median household income.

The overall cost to the Government of Option 2 is estimated to be $607 million over the forecast period

The increase to the IWTC will cost $607 million over the forecast period which extends to 30 June 2028. There is an average cost of $152 million per annum of increasing the rates by $25 dollars per week for the 170,000 recipients who currently receive the IWTC.

Preferred option

Officials support the proposal to increase the IWTC by $25 a week. This will ensure that the real value of the support increases with wage growth and acts as an effective incentive to take up, and stay in, employment.

Minimum Family Tax Credit consequential amendment

The base rate of IWTC effects the calculation of the Minimum Family Tax Credit (MFTC) threshold. Therefore, any time the IWTC is adjusted, a consequential amendment to the MFTC should be considered.

The MFTC was designed to create a financial incentive, at the margin, for families to work and be better off not receiving a benefit. As of 1 April 2024, the MFTC threshold is set at $35,204. For people receiving MFTC, their after-tax earnings are topped up to this amount to ensure that they are better off in work, and receiving the MFTC, than they would be receiving a main benefit whilst employed. The MFTC ensures that a sole-parent family who

[1] AHC50 measures the number of children in households with incomes much lower than a typical 2018 household, after they pay for housing costs, and is measured by the threshold line set at 50 percent of the median income in 2017/2018 (base financial year), after housing costs are removed.

[2] BHC50 is a moving-line income measure, with the poverty threshold taken the year the data is gathered (low income before housing costs – moving-line measure). BHC50 measures the number of children in households with much lower incomes than a typical household, and is measured by the threshold line set at 50 percent of the median household income in the year measured.

[3] Note on TAWA modelling: poverty estimates use HES 2020/21 augmented using IDI data, inflated and population adjusted with HYEFU 2023 inflation estimates.

works more than 20 hours per week will always be at least $1 better off on a weekly basis than they would be on a benefit.

The IWTC and MFTC are both work incentive payments. Together, these payments can be considered to 'top up' a person's after-tax earnings to ensure that an individual is financially better off in work without a main benefit. Any increase in the IWTC is generally combined with a decrease in the MFTC threshold, as less of a 'top up' is required.

Impending overlap of the MFTC threshold and the WFF abatement threshold

As the MFTC threshold increases annually, it is also forecast that on 1 April 2027 it will overlap with the WFF abatement threshold. The WFF abatement threshold is currently fixed at $42,700 and is not periodically increased. There is a conflict of respective policy intents if this overlap were to occur. On the one hand, the MFTC threshold is a guaranteed minimum income for low income working families. On the other hand, the WFF tax credit abatement threshold is set at a level at which a family's income is considered to be too high for full entitlement. The overlap would also result in WFF customers facing effective marginal tax rates (EMTR)[4] of well over 100%.

This issue will also be considered when assessing the options for the MFTC consequential amendment.

Options considered for assessment

Option 1: Allow MFTC recipients to gain from both the IWTC increase and the personal income tax reductions

The MFTC threshold would increase marginally (by $112) following the increase to the IWTC and personal income tax changes on 31 July 2024. This would ensure that MFTC recipients receive the IWTC increase and benefit from the personal income tax change. This option has a fiscal cost of approximately $0.2 million per annum.

This option would support income adequacy and child poverty reduction. It would also increase the incentive for beneficiaries to move off benefit and to take up and stay in employment at the margin. However, this continues the wide hours range (from 20 to 34 hours of work) over which the 100% abatement rate applies for the MFTC. Given the high EMTRs that apply for MFTC recipients over this period, incentives for MFTC recipients to take up more work are decreased under this option.

This option would also speed up the impending cross-over of the MFTC threshold and the WFF abatement threshold. If these two thresholds cross over, both the work incentive aspects of these payments and the broader WFF income adequacy objective will be significantly hindered due to the resulting EMTRs for recipients being well over 100%.

Option 2: Decrease the MFTC threshold in line with existing policy, so that MFTC recipients receive less than they would currently

The MFTC threshold would decrease by approximately $27 per week or $1,404 per annum. This option will result in a reduction of $2.9 million per year for the IWTC costing. Lowering the MFTC threshold by $27 ensures that MFTC recipients remain $1 better off

[4] Effective marginal tax rates show the percent by which a dollar increase in gross income is reduced by taxes and the abatement of social security assistance.

per week compared with those working and receiving a benefit following changes to the IWTC.[5]

This option does not improve income adequacy or support child poverty reduction, as MFTC recipients will be worse off by this change. However, the earnings range over which the 100% abatement applies would be reduced, increasing the incentive to work longer hours.

This option would also mitigate the urgency of addressing the impending overlap of the MFTC threshold and the WFF abatement threshold, as reducing the MFTC threshold will delay this issue.

Option 3: Decrease the MFTC threshold so that MFTC recipients will receive the same amount that they do currently

The MFTC threshold would decrease by $23 per week or $1,196 per annum when the increase to the IWTC is introduced. MFTC recipients will not benefit from the IWTC change but will not be made worse off either. This will result in a reduction of $2.5 million per year for the IWTC costing.

Lowering the MFTC threshold by $23 is a minimal departure from the MFTC calculation as the threshold is set at a rate greater than $1 above the weekly after-tax earnings from employment whilst still on benefit. However, option 3 does not impact the work incentive aspect of the payment and does not leave any MFTC recipients worse off.

As this option reduces the MFTC threshold, it will delay the impending overlap of the MFTC threshold and the WFF abatement threshold.

Preferred option

Officials prefer the proposed changes under option 3 to lower the MFTC threshold by $23 per week or $1,196 per annum. This option delays the eventual MFTC/WFF abatement threshold cross-over without making MFTC recipients worse off. The MFTC's function to incentivise people to move off-benefit and into full time employment will also be preserved.

Limitations and Constraints on Analysis

Inland Revenue is responsible for the analysis and advice set out in this Regulatory Impact Statement, except as otherwise explicitly indicated (this includes reference to "officials"). The analysis and advice have been produced for the purpose of informing key policy decisions to be taken by Cabinet.

The decision to increase the IWTC by $25 a week is a manifesto initiative included within the National Party Tax Plan (the Tax Plan) and was not affected by coalition negotiations. This policy proposal is solely concerned with an increase to the existing rate. Changes to the policy settings of the IWTC, including the rules for eligibility and abatement, are not in scope for any of the proposed options. The proposed changes are also premised on cost-of-living pressures having significant impacts on families raising children.

Officials have not considered alternative options that could also target low to middle income working families. This includes options that would address income adequacy of beneficiary families who are not in receipt of the IWTC. Our analysis is based solely on

[5] This decrease does not directly correlate to the IWTC increase due to the way main benefits abate.

evidence supplied to the WEAG, as consultation has not been undertaken due to the constraints that apply to Budget initiatives.

Inland Revenue was directed by the Government to implement this change by 31 July 2024 as part of the Budget process. This date allows the funding to be assessed against other government initiatives.

Assumptions underpinning the impact analysis

Treasury's micro-simulation model of the tax and welfare system (TAWA) has provided the distributional impact of the Tax Package, and particularly the impacts on child poverty reduction. This modelling considered the cumulative impacts of all changes, including the personal income tax changes, changes to the Independent Earner Tax Credit and the introduction of FamilyBoost. The impacts of the increase to the IWTC cannot be viewed individually because of this modelling.

Responsible Manager(s) (completed by relevant manager)

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Families and Individuals

Inland Revenue

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24 April 2024

Quality Assurance (completed by QA panel)

Reviewing Agency:	Inland Revenue
Panel Assessment & Comment:	The Quality Assurance panel from Inland Revenue has reviewed the "$25 per week increase to the in-work tax credit" regulatory impact statement (RIS) prepared by Inland Revenue and considers that the information and analysis summarised in the RIS partially meets the quality assurance criteria. This is because the scope of the options analysis has been constrained by the lack of time to fully consider other options given the directive by the Government. A comprehensive analysis of other options may have provided a more appropriate option. The analysis also does not consider the impact of the preferred option on current inflation and whether it has the potential to be inflation inducing itself. In addition, the panel considered that the problem definition could be clearer but given the direction, assumptions and limitations imposed on the analysis there is limited scope to further define the problem the policy is addressing. Consultation has not been undertaken. The RIS would have benefited from feedback from consultation, including the views of the stakeholders on the options considered in the RIS.

Section 1: Diagnosing the policy problem

What is the context behind the policy problem and how is the status quo expected to develop?

Context within which action is proposed

Government commitment to reducing the cost of living:

Currently there are high cost of living pressures as New Zealand families are feeling the effects of inflation. The cost of living for the average New Zealand household increased 7.4 percent in the 12 months to the September 2023 quarter.[6] Higher prices for interest payments and grocery food were the biggest contributors to the 7.4 percent increase, however price increases to rent, insurance, and property rates also contributed.[7]

Government commitments in the Tax Package are intended to increase the after-tax pay of low to middle income earners through the following changes:

- Shifting income tax brackets to compensate for inflation;
- Introducing the FamilyBoost childcare tax credit; and
- Increasing WFF tax credits for working families.[8]

The proposed changes to WFF are premised on cost-of-living pressures having significant impacts on families raising children.

The IWTC is the key instrument to increasing financial incentives to work within the wider context of the WFF package:

WFF was implemented between 2004 and 2007 with the purpose of substantially boosting earlier Family Assistance entitlements. The key objectives of the WFF package were to:

- Increase financial incentives to work, and remain in work, 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.

It must also achieve these objectives at a sustainable cost to government.

Around 56 percent of all families currently receive WFF, at an annual cost of $2.8 billion for the 2022 income tax year. WFF is made up of the following tax credits:[9]

- Family Tax Credit: (264,400 families, $1,966 billion annually): the main payment received by both beneficiary and non-beneficiary families and is not dependent on work status.

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[6] Taken from the household living-cost price index released by StatsNZ on 26 October 2023.

[7] Taken from the household living-cost price index released by StatsNZ on 26 October 2023.

[8] “National’s Back Pocket Boost” on 30 August 2023.

[9] These numbers are based on the 2021-22 income tax year.

- In-work Tax Credit: (170,500 families, $502 million annually): the main in-work payment for families who do not receive a main benefit or student allowance.
- Best Start Tax Credit (138,200 families, $296 million annually): this payment provides $73 per week to all families with a child under one year old, and for lower income families with a child under 3.
- Minimum Family Tax Credit (3,200 families, $13 million annually): this payment tops up incomes of working families and guarantees a minimum income level for those working at least 20 hours per week in low-paying jobs and who do not receive a main benefit.

The IWTC is the primary instrument in the WFF package designed to incentivise employment uptake. It supports working parents, especially sole parents, to take up and stay in employment, by providing a boost to the earned income of low and middle income families to help ensure that they are better off in work than they are on a benefit. The payment depends on how much a family household earns, and the abatement rate is 27%.

The IWTC specifically addresses the effect of in-work poverty. Work has costs associated with it – both financial costs such as transport and childcare, and non-financial such as effort and opportunity costs, for example less time spent with children. Any additional income from work may be insufficient to meet the various costs associated with work. That is, a person may judge they are overall better off not working, particularly if they can rely on benefit payments.

As well as increasing families' financial incentives to move off benefit and into employment, the IWTC, alongside the Family Tax Credit , contributes to reducing child poverty by increasing the incomes of low-income working families with dependent children.

The real value of the IWTC has eroded over time:

Incomes derived from employment have increased by significantly more than benefit incomes due to wage growth exceeding the rate of income support over previous decades. This has reduced the real value of the IWTC given the payment rate has not increased as much when compared to wages. Over time the IWTC has become less important to the decision to work compared to wages. The value of the IWTC in relation to the minimum wage has decreased from 9.8 percent to 7.7 percent since 2018.

However, recent changes such as indexing main benefits to wage growth, and regular across the board increase to main benefits,[10] have increased the level of income a family can receive whilst on benefit. The effect of these changes on financial incentives to work are usually offset by corresponding increases to the minimum wage.

The relevant consideration for setting the level of IWTC is how much a family's income would decrease if they left employment and went onto a main benefit or vice versa. The table below compares the incomes a coupled family and a sole-parent family could receive if they each work 40 hours per week at the minimum wage, contrasted against the payments they would receive if they did not work and were on a main benefit.

[10] $25 per week increase to main benefits from 1 April 2020; $20 per week increase to main benefits from 31 July 2021; and $15 per week increase to amin benefits from 1 April 2022.

Replacement ratios: Sole parent and coupled family working 40 hours at minimum wage versus on benefit						
Year (rate applying from 1 April)	**2018[1]**	**2019**	**2020**	**2021[1]**	**2022**	**2023**
Family net income: 40 hours per week at minimum wage + Family Tax Credit + In-Work Tax Credit	$733.71	$777.66	$816.52	$852.15	$898.46	$940.05
IWTC as a % of family net income	9.8%	9.3%	8.9%	8.5%	8.1%	7.7%
Rate of replacement: Coupled Jobseeker Support + Family Tax Credit + Winter Energy Payment	68.9%	66.5%	67.9%	70.1%	78.6%	80.5%
Rate of replacement: Sole Parent Support + Family Tax Credit + Winter Energy Payment	62.0%	59.9%	61.4%	62.1%	64.7%	66.3%

Increases to benefit rates have negatively changed the proportional returns to employment over the previous two years, which means replacement ratios have not remained stable. In addition, the minimum wage now sits above the WFF abatement threshold. Currently, a coupled family working 40 hours per week at minimum wage would retain 80.5 percent of their income if they left employment and went on benefit, and for a sole parent in the same situation 66.3 percent of their previous income would be retained. This is an increase from 68.9 and 62.1 percent respectively.

The IWTC is intended to be a key factor contributing to the returns to employment for low and middle income New Zealand families. As these returns have not remained consistent over the previous two years the policy intent of the IWTC is not being fulfilled.

Key features of the regulatory system and its objectives

The Income Tax Act 2007 (the Act) contains provisions that determine the eligibility and entitlement for the IWTC. These are outlined in more detail below:

Eligibility:

A principal caregiver is entitled to the IWTC for a dependent child when:

- they meet the common eligibility criteria for WFF;
- the principal caregiver, or their partner, do not receive an income-tested welfare benefit, a student allowance or a partner’s allowance;
- the principal caregiver, or their partner, must normally be an ‘earner’; and
- Also, the ‘earner’ must derive income. Income can be a PAYE income payment such as salary and wages, and income other than a PAYE income payment such as interest, rents and dividends.

Entitlement:

The IWTC is currently paid at a maximum rate of $3,770 per year ($72.50 per week) for a family of up to three children, with an additional $780 each year ($15 per week) for each subsequent child. For instance, a family with four children would receive up to $87 per week and a family with seven children would receive up to $132 a week.

All WFF tax credits are subject to an income test, so the amount received is reduced as family income increases over the $42,700 abatement threshold. The FTC is abated first, followed by the IWTC. Both payments abate at a rate of 27 cents for each additional dollar of family scheme income (FSI).

FSI represents the pooled financial resources of a family unit. FSI is net income of the principal caregiver and their partner plus or minus any relevant adjustments. There are several adjustments that can be made to the net income in order to determine FSI.

Consequential impacts on the MFTC

Changes to the IWTC and the personal income tax rates have a consequential impact on the MFTC threshold.

Main objective of the MFTC

The MFTC was designed to create a financial incentive, at the margin, for families to work and be better off not receiving a benefit. For people receiving MFTC, their weekly after-tax earnings are topped up to this amount to ensure that they are at least $1 better off per week in work than they would be receiving a main benefit whilst employed.

Eligibility:

A principal caregiver is entitled to MFTC for a dependent child when:

- they meet the common eligibility criteria for WFF;
- the principal caregiver, or their partner, do not receive an income-tested welfare benefit, a student allowance or a partner's allowance;
- the principal caregiver, or their partner, are considered a "full-time earner". Full-time is defined as 20 hours or more per week for a sole parent, and 30 hours per week or more for a two-parent family;

Generally, only the hours worked to receive PAYE income payments – such as salary and wages – are counted towards the above work hours requirement. Hours worked to derive non-PAYE income payments – such as interest, rents, and dividends – do not satisfy the work hours requirement.

Entitlement:

As of 1 April 2024, the MFTC threshold is set at $35,204 per annum – the threshold is increased annually to account for increases to main benefits. For people receiving MFTC, their after-tax earnings are topped up to this amount to ensure that they are marginally better off in work than they would be receiving a main benefit whilst employed. The MFTC abates at a rate of 100% for every dollar earned over the MFTC threshold.

The impending overlap of the MFTC threshold and the WFF Families abatement threshold

The WFF tax credit abatement threshold is currently set at $42,700. This is the point at which the FTC and IWTC entitlements start to reduce at 27%. Unlike the MFTC threshold, which is increased every year in line with benefits, the WFF tax credit abatement threshold is not periodically adjusted. It should be noted that the WFF threshold is a gross threshold, whereas the MFTC threshold applies to a customer's net income. This is due to the MFTC's function in topping up a customer's after tax earnings so that they are always marginally better off in work than they would be receiving a main benefit whilst employed.

As the MFTC threshold increases annually, it is forecasted that on 1 April 2027 it will overlap with the WFF abatement threshold. This will mean that WFF customers will face EMTRs of well over 100%. MFTC recipients who are some of the lowest income working families would face decreases in their income as they work additional hours.

Example of overlap:
Under this example the Minimum Family Tax Credit threshold is increased to $43,000 (before tax) and the Working for Families tax credits abatement threshold remains at $42,700 (before tax).

Mila is a sole parent who works at a supermarket for 35 hours per week on minimum wage and earns $42,900 dollars. Following the crossover, she will face an effective marginal tax rate of 128.6%. This means that for an additional $1 she earns, her tax credits reduce by $1.28 and her total income drops as a result. She is not incentivised to work any additional hours.

This is a result of the following reductions of her income via:

- 17.5% personal income tax;
- 82.5% Minimum Family Tax Credit;
- 1.6% ACC levy; and
- 27% Working for Families abatement (the additional abatement once the overlap happens).

This could be made worse if Mila has student loan repayments (12%) or receives the Accommodation Supplement (25%).

There is a conflict of respective policy intents if this overlap were to occur. On the one hand, the MFTC threshold is a guaranteed minimum income for low income working families. On the other hand, the WFF tax credit abatement threshold is set at a level at which a family's income is considered to be too high for full entitlement.

What is the policy problem or opportunity?

Problem definition

The IWTC has helped increase incomes amongst low and middle income working households, however the real value of the support has diminished overtime. Over previous decades, incomes derived from employment have increased by significantly more than benefit incomes due to wage growth exceeding the rate of income support over an extended period. Over time the IWTC has become less important to the decision to work compared to wages. The value of the IWTC in relation to the minimum wage has decreased from 10.7 percent to 7.7 percent since 2016.

As such, the IWTC is not meeting its policy objective as a work incentive payment, nor does the IWTC rate reflect the desires of the Government and national, social, and economic contexts, particularly in relation to the cost of living. This is in part due to the lack of legislative requirement to automatically increase the rate of IWTC over time, unlike the regular Consumers Price Index (CPI) adjustments to the FTC and BSTC. The rate of IWTC was last increased in Budget 2015, from $60 a week to $72.50 a week (from 1 April 2016), as part of the Child Material Hardship package.

Stakeholders involved

The primary stakeholders are low to middle income working families who are in receipt of the IWTC. They have a significant, personal interest in increases to their income. At the margin the IWTC can have a significant impact for parents to move off-benefit and into employment. In addition, the IWTC also contributes to reducing poverty and improving adequacy for this demographic. Restricted access to material goods or restricted capacity for social participation can have significant flow on effects to other areas of life such as physical and mental health. These flow on effects can impact a household's access to work opportunities, which has negative ramifications for the household's living standards.

Wider society is also a stakeholder in this issue. The consequences of poverty lead to greater public expenditure, particularly on healthcare and the justice system, as well as the loss of potential tax revenue. Increased expenditure on in-work welfare has the capacity to encourage work force participation, and any reduction in poverty rates will lead to savings in other areas.

What objectives are sought in relation to the policy problem?

Working for Families scheme objectives

WFF has three primary objectives:

1. Increase financial incentives to work, and remain in work, by supporting families with dependent children, so that they are rewarded for their work effort;
2. ensure income adequacy, with a focus on low and middle income families with dependent children to address issues of poverty, especially child poverty; and
3. 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.

It must also achieve these objectives at a sustainable cost to government.

These objectives must be considered when evaluating any proposed changes to WFF along with any more specific objectives that are being sort in relation to a particular proposal. It is generally possible to achieve two of the three objectives for any given policy change, but not all three.

1. Improving financial incentives to work

Improving financial incentives to work will encourage people who are able to work to seek (and remain in) employment. For most people, paid work is a key means of achieving improved wellbeing. However, financial incentives are only one (and not necessarily the most important) of many factors that influence people's decisions on whether, or how much, to work.

2. Improving income adequacy for low and middle income people

While recent changes to the welfare system (including the Families Package, the $25 a week increase to main benefits on 1 April 2020 and the indexation of main benefits to average wage) will help to improve the living standards of low-income people, income adequacy and child poverty issues remain. Any changes to WFF should have a net positive impact on these issues, particularly as these credits are an important tool to meet child poverty reduction targets as required under the Child Poverty Reduction Act 2018.

3. Achieve a social assistance system that supports people into work

There is a continued need to modernise and simplify the WFF system to better respond to changing work and care arrangements. Any changes to WFF should seek to improve the client experience and improve the interface between benefit and work.

Paying welfare support at a cost that is sustainable to government

The government is required to act and pursue its policy objectives in accordance with the principles of responsible fiscal management as set out in the Public Finance Act 1989. These principles include managing fiscal risks facing the government, having regard for the impact on present and future generations, and ensuring the Crown's resources are managed effectively and efficiently. The WFF scheme should be delivered in accordance with these principles.

Specific objectives relating to the $25 per week increase to the IWTC

The policy objective of this change can be viewed as twofold:

Help increase financial incentives to work by increasing the gap between income on benefit and income when in-work

A fundamental purpose of the IWTC, as stated in the supporting policy paper to joint Ministers when it was introduced was "to improve replacement ratios, (i.e., the gap between income on benefit and income when in work") .[11] The relevant consideration for setting the level of IWTC is therefore generally the existing "gap" between benefit levels and wages for low and middle income families, and how the size of the gap has moved.

Decrease the cost-of-living pressures for families raising children

Inland Revenue understands that Government commitments are intended to increase the after-tax pay of low to middle income earners. The proposed increase to the IWTC is premised on the cost-of-living pressures having significant impacts on families raising children.

[11] "Future Directions: Regular Adjustments of Family Income Assistance" on 19 March 2004.

Section 2: Deciding upon an option to address the policy problem

What criteria will be used to compare options to the status quo?

The following criteria is derived primarily from the WFF objectives. The income adequacy and financial incentives to work criterion will be given the highest weighting, as they align with specific objectives relating to the $25 per week increase to the IWTC.

Income adequacy

This will measure the degree to which the incomes of low and middle income households are improved. It will demonstrate the average increases households can expect to their incomes once abatement of financial assistance is considered.

Impacts on child poverty

These will be measured using fixed line AHC50[12] and moving line BHC50.[13] Options which have greater reduction in the number of children in AHC50 and BHC50 poverty are preferred. Options should not be so tightly targeted that, as a result, more children are pushed under the poverty line.

Administrative benefit

This will measure the degree to which changes to WFF improve the client experience and improve the interface between benefit and work.

Financial incentives to work

The impact of these proposals on financial incentives to work are considered. These are primarily measured using replacement ratios, which consider the gap between income on benefit and income when in work.

Fiscal cost

This will measure the overall cost to the government of each individual option.

Ease of implementation

This will measure the difficulty for Inland Revenue to implement each individual option.

What scope will options be considered within?

- Options are solely concerned with an increase to the existing rate.

Out of scope

- Changes to the policy settings of the IWTC, including the rules for eligibility and abatement, are not in scope for any of the proposed options.

[12] The percentage of children living in households with less than 50 percent of the median equivalised disposable household income after housing costs are deducted (for the 2017/18 base financial year).

[13] The percentage of children living in households with less than 50 percent of the median equivalised disposable household income before housing costs are deducted.

- Alternative options have not been explored that could also target low and middle income working families. This includes options that would address income adequacy of beneficiary families who are not in receipt of the IWTC.

What options are being considered?

Option One – *No increase of the in-work tax credit*

The status quo is no legislative or policy change. The IWTC would continue to be paid at a maximum rate of $3,770 per year ($72.50 per week) for a family of up to three children, with an additional $780 each year ($15 per week) for each subsequent child. This option risks the policy objectives of the IWTC being further eroded if the value of the IWTC in relation to minimum wage continues to decrease. As such, this option is out of step with improving income adequacy for low to middle income families, increasing work incentives for low to middle income families, and helping the Government meet its child poverty reduction targets. However, this option does not bear an additional cost to the Government and would not require Inland Revenue to implement any changes.

Option Two – *Increase of the in-work tax credit by $25 per week from 31 July 2024*

The IWTC standard rate would be increased to $5,070 per year ($97.50 per week) from 31 July 2024. The IWTC subsequent child rate would remain at $780 each year ($15 per week) for each subsequent child.

None of the existing parameters in relation to eligibility and abatement would be adjusted. The principal caregiver, or their partner, must not receive an income-tested welfare benefit, a student allowance or a partner's allowance. The IWTC would continue to abate at a rate of 27% for each additional dollar of family scheme income earned over the WFF abatement threshold ($42,700), following the full abatement of the FTC.

The implementation date would be 31 July 2024. The updated rate would take effect alongside the proposed changes to personal income taxes and the Independent Earner Tax Credit. Ad hoc notices of entitlements will need to be sent to WFF customers in June 2024 to inform them of the change.

Modelling of impacts

This change will benefit approximately 170,000 families who currently receive the IWTC. They will benefit by a net average of $16.97 per week when factoring in the average rate at which the IWTC abates amongst all IWTC recipients.

There will be increased work incentives

This change will lower replacement ratios, which measure the gap between income when receiving a benefit versus income when in work. The increase to the IWTC means there is more income available for low and middle income families who are in paid work. This will increase the "gap" between benefit levels and wages for these families.

After the increase to the IWTC, and all other things being equal, these replacement ratios would decrease to 78.8 percent for a coupled family, and 64.5 percent for a sole parent family.

There will be implementation implications for Inland Revenue and customers

To progress this change through Budget 2024, and include it in Budget night legislation, ad hoc notices of entitlement are required to be sent to WFF customers. Usually, notices of entitlement are sent out in February, during the standard WFF rollover process. This could cause confusion for these impacted customers, who already have a high customer contact rate with Inland Revenue due to their reliance on WFF support. This customer contact will coincide with busy time for Inland Revenue in which it is issuing individual income tax assessments.

Inland Revenue will need to undertake significant preparatory work before Budget 2024 announcements. This includes issuing communications and guidance material, as well as updating Inland Revenue's website.

There will be reductions to child poverty

The impact on child poverty of option 2 (increase the IWTC by $25 per week from 31 July 2024) has not been modelled independently to of the other Tax Package changes, due to time constraints.

It is estimated that the Tax Package, which includes a $25 increase to the In-Work Tax Credit, will reduce child poverty by around 14,000 children (+/- 6000) on the fixed-line AHC50 measure,[14] and by around 3,000 children (+/- 7000) on the BHC50 measure[15] in the 2027 tax year.[16]

The tax package increases the incomes of low-income working households faster than the increase in the cost of living, which reduces fixed-line AHC50 child poverty. However, the tax package may slightly reduce moving-line BHC50 child poverty, since the poverty line for this measure is set at 50% of the median household income, and the tax package is expected to increase the median household income.

The overall cost of this option is estimated to be $607 million over the forecast period 2024/25 to 2027/28

The increase to the IWTC will cost $607 million over the forecast period which extends to 30 June 2028.

Consequential impact on the Minimum Family Tax Credit

Any increases to the IWTC will have a consequential impact on the MFTC threshold. Options for addressing this impact will be assessed using the following criteria.

Income adequacy

This will measure the degree to which the incomes of low and middle income households are improved.

Financial incentives to work

The impact of these options on financial incentives to work are considered. This includes any effect the change will have on the range of working hours over which the MFTC abates, as

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[14] AHC50 measures the number of children in households with incomes much lower than a typical 2018 household, after they pay for housing costs, and is measured by the threshold line set at 50 percent of the median income in 2017/2018 (base financial year), after housing costs are removed.

[15] BHC50 is a moving-line income measure, with the poverty threshold taken the year the data is gathered (low income before housing costs – moving-line measure). BHC50 measures the number of children in households with much lower incomes than a typical household, and is measured by the threshold line set at 50 percent of the median household income in the year measured.

[16] Note on TAWA modelling: poverty estimates use HES 2020/21 augmented using IDI data, inflated and population adjusted with HYEFU 2023 inflation estimates.

this has a corresponding impact on work incentives – particularly given the 100% abatement rate.

Fiscal cost

This will measure the overall cost to the government of each individual option.

The impending overlap of the MFTC threshold and the WFF abatement threshold

This will consider whether the options exacerbate or quicken the eventual crossover between the MFTC threshold and the WFF abatement threshold.

Option One: allow MFTC recipients to gain from the IWTC increase and personal income tax cuts

Under option one, the IWTC would flow through to MFTC recipients and the MFTC threshold would increase marginally (by $112) per annum on 31 July 2024 to allow MFTC recipients to benefit from the personal income tax changes. This is a significant departure from the way the MFTC is calculated, as the guaranteed income provided for by the MFTC would be set approximately $27 above the after-tax earnings from employment whilst still on benefit (which accounts for the IWTC increase and the estimated relief from the personal tax rate changes).

This option would ensure that MFTC recipients receive the IWTC increase and benefit from the personal income tax changes, which will support income adequacy and child poverty reduction. Allowing the IWTC changes to flow through would further increase the incentive for beneficiaries to move off benefit and to take up and stay in employment at the margin, particularly at 20 hours per week.

However, this option continues the wide hours range (from 20 to 35 hours of work) over which the 100% abatement rate applies for the MFTC currently.[17] As MFTC recipients are subject to significant EMTRs, particularly between 20 and 35 hours of work, this option decreases incentives to work more hours.

Increasing the MFTC threshold would also speed up the impending cross-over of the MFTC threshold and the WFF abatement threshold. If these two thresholds cross over, the work incentive aspect of these payments and the broader WFF income adequacy objective will be significantly hindered due to the resulting EMTRs for recipients being well over 100%. There will also be ongoing issue in deciding what to do about the artificially inflated threshold every year; starting 1 April 2025.

This option has a fiscal cost of approximately $0.2 million per annum. This is a result of letting MFTC recipients benefit from the personal income tax changes.

This option is preferred by the Ministry of Social Development and the Child Wellbeing and Poverty Reduction Group in the Department of the Prime Minister and Cabinet.

Option Two: Decrease the MFTC threshold in line with existing policy, so that MFTC recipients receive less than they would currently

Under option two, the MFTC threshold would decrease by approximately $27 dollars per week or $1,404 per annum. Lowering the MFTC threshold by $27 per week adheres to the current MFTC threshold calculation, as this amount ensures that MFTC recipients remain $1

[17] Assuming no change to the minimum wage rate.

better off per week compared with those working and receiving a benefit following the IWTC increase and the changes to the personal income tax rates.[18]

This option reduces the MFTC threshold to account for both the IWTC increase artificially inflating the MFTC guaranteed amount and the personal income tax rate changes. MFTC recipients will therefore be made worse off by this change as their net incomes will decrease. For example, if a family is working less than 33 hours per week, they are likely to experience a reduction in net income of up to $104 per annum under this option. This option therefore does not improve income adequacy or support child poverty reduction.

As MFTC recipients will not financially benefit from the IWTC increase following these changes, the increased incentive to take up and stay in work associated with the IWTC increase will not flow through. However, at minimum wage, the earnings range over which the 100% abatement rate applies would be reduced by one and half hours, increasing the incentive for MFTC recipients to work longer hours.

This option will also mitigate the urgency of addressing the MFTC/WFF abatement threshold cross over, as reducing the MFTC threshold will delay the eventual cross over.

This option will result in a reduction of $2.9 million per year for the IWTC costing.

Option three – Decrease the MFTC threshold so that MFTC recipients will receive the same amount that they do currently

Under option three, the MFTC threshold would decrease by $23 dollars per week or $1,196 per annum when the increase to the IWTC is introduced. This change reduces the MFTC threshold in such a way that a family does not benefit from the IWTC change but are not worse off as compared to status quo. The MFTC threshold would then be readjusted with the next benefit increase as per the usual process on 1 April 2025.

This option is a departure from the existing calculation to the MFTC threshold that has been operating, as it would ensure that the threshold is set at a rate greater than $1 above the after-tax earnings from employment whilst still on benefit. However, option three provides for minimal departure from the MFTC calculation so as to not cause inconsistency with the policy intent of the MFTC.

As MFTC recipients will not benefit from the IWTC increase but will not be made worse off, this option has a neutral impact on income adequacy and child poverty reduction. The MFTC's function to incentivise people to move off-benefit and into full time employment will also be preserved.

As this option reduces the MFTC threshold, it will delay the MFTC/WFF abatement threshold cross over and mitigate the urgency of addressing this issue.

This option will result in a reduction of $2.5 million per year for the IWTC costing.

Officials prefer the proposed changes under option 3 to lower the MFTC threshold by $23 per week or $1,196 per annum. This option delays the eventual MFTC/WFF abatement threshold cross-over without making MFTC recipients worse off. The MFTC's function to incentivise people to move off-benefit and into full time employment will also be preserved.

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[18] This decrease does not directly correlate to the IWTC increase due to the way main benefits abate.

How do the options compare to the status quo/counterfactual?

	Option One – *Status Quo*	Option Two – *Increase of the IWTC by $25 per week from 31 July 2024*
Income Adequacy	0	+ +
Financial incentive to work	0	+ +
Administrative benefit	0	0
Child poverty impact	0	+
Fiscal cost	0	-
Ease of implementation	0	-
Overall assessment	0	+ + +

What option is likely to best address the problem, meet the policy objectives, and deliver the highest net benefits?

1. As discussed in objectives section, it is difficult to achieve all three objectives of the WFF scheme. Which is demonstrated in the above table.
2. Option Two improves income adequacy and the financial incentives to work, but it comes at a significant fiscal cost.
3. Option Two is an improvement on the status quo.

MFTC consequential change – how do the options compare to the status quo/counterfactual?

	Status quo	Option One – *MFTC threshold is increased*	Option Two – *Decrease the MFTC as per the calculation*	Option Three – *Decrease the MFTC until no one loses*
Income Adequacy	0	+ +	-	0
Financial incentive to work	0	+ / -	+ +	+
Child poverty impact	0	+	-	0
Fiscal cost	0	0	+	+
MFTC/WFF crossover	0	-	+ +	+
Overall assessment	0	+ +	+ + +	+ + +

What option is likely to best address the problem, meet the policy objectives, and deliver the highest net benefits?

1. Option one improves income adequacy and child poverty reduction, unlike options two and three. However, option one exacerbates the MFTC/WFF overlap.
2. Option two mitigates the MFTC/WFF crossover, improves work incentives, and has delivers minimal savings. However, it has a negative impact on income adequacy and child poverty reduction.
3. Option three mitigates the MFTC/WFF crossover and improves work incentives to a lesser degree compared to option two. It also offers minimal savings. However, unlike option two, under option three there is a neutral impact on income adequacy and child poverty reduction.

What are the marginal costs and benefits of the option?

Option Two – Increase of the IWTC by $25 per week from 31 July 2024

Affected groups	Comment	Impact	Evidence Certainty
Additional costs of the preferred option compared to taking no action			
Working for Families recipients	The proposed timing of the change may create confusion for recipients, which cause them to contact Inland Revenue.	Low	High
Inland Revenue	There will be capital and operating costs of these changes but will be self-funding through existing maintenance and development programme for core systems.	Low	High
The Government	Ongoing, annual fiscal cost. This assumes full take-up.	$607 million over the forecast period which extends to 30 June 2028. There is an average cost of $152 million per annum.	Medium
Total monetised costs	Ongoing, annual fiscal cost. This assumes full take-up.	$607 million over the forecast period which extends to 30 June 2028.	Medium
Non-monetised costs	The proposed timing of the change may create confusion for recipients, which cause them to contact Inland Revenue.	Low	High
Additional benefits of the preferred option compared to taking no action			
Working for Families recipients	170,000 households will benefit from an ongoing, weekly increase in income. This assumes full take up.	Average weekly increase of $16.97.	High

Children in poverty (when considered as a component of a wider Tax Package)	Although the rate increase occurs, we cannot predict the duration of its impact. Lifting the income of a child's family above a threshold does not guarantee that they will no longer suffer the effects of poverty or that their income will remain above the threshold permanently.	14,000 children lifted out of AH50 poverty or 3,000 children out of BHC50 poverty	Low. The impact on child poverty reduction of the increase to the IWTC by $25 per week from 31 July 2024 has not been modelled independently of the other Tax Package changes. In addition, there are significant uncertainties with TAWA modelling for poverty impacts.
Increased incentive to take-up and stay in employment	This change will lower replacement ratios, which measure the gap between income when receiving a benefit versus income when in work.	170,000 households will have increased incentive to take-up and stay in employment.	Low. Replacement ratios observe a direct transition between full-time work and benefit for families in a specific scenario. In reality, families' employment decisions are more fluid than being directly in or out of work, and there ae a range of factors that contribute to these decisions beyond the marginal dollar return.
Total monetised benefits	170,000 households will benefit from an ongoing, weekly increase in income. This assumes full take up.	Average weekly increase of $16.97.	High
Non-monetised benefits	170,000 households will have increased incentive to take-up and stay in employment. Child poverty reduction (when considered as a component of a wider Tax Package)	Medium 14,000 children lifted out of AH50 poverty or 3,000 children out of BHC50 poverty	Medium Low

Section 3: Delivering an option

How will the new arrangements be implemented?

To progress this change through Budget 2024, and include it in Budget night legislation, ad hoc notices of entitlement are required to be sent to WFF customers. Usually, notices of entitlement are sent out in February, during Inland Revenue's standard WFF rollover process. This could cause confusion for these impacted customers, who already have a high customer contact rate with Inland Revenue due to their reliance on WFF support. This customer contact will coincide with Inland Revenue's busiest time of the calendar year in which it is issuing individual income tax assessments.

Inland Revenue will need to undertake significant preparatory work before Budget 2024 announcements. This includes issuing communications and guidance material, as well as updating Inland Revenue's website.

As this is an extension of an existing tax credit, it is not expected to create significant implementation costs.

How will the new arrangements be monitored, evaluated, and reviewed?

This proposed change adjusts the rate of the IWTC, therefore no new or additional monitoring is required.

The effects of the proposed changes can be monitored using data Inland Revenue currently collects as part of administering WFF. This data includes the number of WFF recipients, the makeup of those families, the amount and type of payments made, and end of year assessment data on under and overpayments. This administrative data provides descriptive information about WFF recipients, and the actual fiscal cost to the Government of the chosen settings.