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Briefing on reform of the In-Work Tax Credit

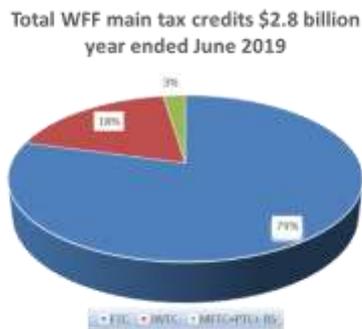
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Child Poverty Action Group (CPAG) is an independent charity working to eliminate child poverty in New Zealand through research, education and advocacy. CPAG believes that New Zealand's high level of child poverty is not the result of economic necessity but is due to policy neglect and a flawed ideological emphasis on economic incentives. Through research, CPAG highlights the position of tens of thousands of New Zealand children, and promotes public policies that address the underlying causes of child poverty.

Introduction

This briefing examines reform of the In-Work Tax Credit in the context of needed reform to the whole of Working For Families (WFF) tax credits for children.

Figure 1



WFF is made up of four tax credits, the relative expenditure on each is shown in Figure 1. The main two are the In-Work Tax Credit (IWTC) (18%) and the Family Tax Credit (FTC) (79%).

The Family Tax Credit (FTC) is paid to the caregiver based on the number of children. Table 1 shows the maximum weekly amounts when the household income is under \$42,700. All low-income children qualify on the same basis.

Table 1 the Family Tax Credit

Eldest child			
Age of children	Current	From 1 July 2018	Weekly increase
0-15 years	\$92.73	\$113.04	+\$20.31
16-18 years	\$101.98	\$113.04	+\$11.06
Second or subsequent child			
Age of children	Current	From 1 July 2018	Weekly increase
0-12 years	\$64.44	\$91.25	+\$26.81
13-15 years	\$73.50	\$91.25	+\$17.75
16-18 years	\$91.25	\$91.25	Nil

The second major tax credit is also child-related and also has addressing child poverty as one of its goals. It is, however, not paid to the worst-off families. The IWTC is added to the FTC if the family qualifies and abates only after the FTC has been fully abated.

The IWTC is paid at a maximum rate of \$72.50 where there are 1-3 children and an extra \$15 above that for additional children. The criteria are both being off-benefit and meeting weekly hours of paid work of 20 hours for a sole parent and 30 hours for a couple.

The composition of FTC and IWTC for any one family depends on family size and income. For example, a very high-income family may get 100% of its entitlement to WFF from the IWTC as it abates last. A low-income family that does not meet the work criteria, on the other hand, would get 0% from the IWTC. The one-child family that does meet the criteria gets the highest percentage from the IWTC of nearly 40%.

Context of overall WFF reform

CPAG believes that reform of Working for Families is well overdue. The poor design has entrenched child poverty for the worst-off children. As a first step to transformation of the current untenable income and wealth situation of many families the following can be actioned immediately:

- Annual indexation for all aspects of WFF including the threshold for abatement (with a link to wages as is the case for New Zealand Superannuation).

- Make Best Start a part of WFF for simplicity, fairness and cost-effectiveness
- Removal of the discrimination in WFF by removing paid work-based eligibility criteria in the In-Work Tax Credit and paying the full WFF tax credit to all low-income children.

Indexation

For many years WFF was neglected, with no commitment to annual Consumer Price Index (CPI) inflation adjustments for any aspect of WFF, let alone adjustments to movements in the net average wage (as occurs annually to NZ Superannuation). Since the inception of WFF, inflation adjustment occurs only when cumulative inflation passes 5%. This rule was not amended by the Families Package in 2018 and was not addressed in Budget 2019.

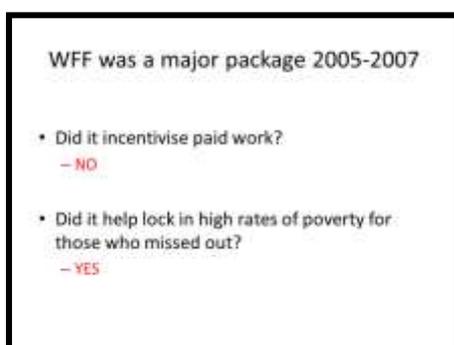
The Families Package effectively brought the date for inflation adjustment forward nine months to 1 July 2018, and at the same time reset the indexation clock to 1 July 2018. Inflation forecasts from Treasury indicate that the next 5% breach (following the 1 July 2018 reset) is likely to occur in March 2021. This means there will be no adjustment until April 2022 under current settings. The 5% cumulative rule is very disadvantageous to low-income families in times of low-inflation and has no justification except as a cost-saving measure. It can be politically manipulated by governments to claim credit for what looks like a big increase when the adjustment is finally made - but that is only because families have had to wait so long for the overdue inflation catch-up.

Poor indexation not only affects the real spending power of the maximum WFF tax credits; the lack of adjustment to the threshold for abatement also means an additional serious erosion of WFF for low-income working families.

Under National policy, the abatement threshold was due to be cut to the very low level of \$35,000 by 2018. The Labour-led government raised the abatement threshold to \$42,700, helping low-income working families retain more of their entitlements. CPAG welcomed this as an essential change, but points out that \$42,700 is well below the current threshold applying in Australia (A\$54,677) where regular indexation applies, and represents only a partial catch-up. The threshold was first set at \$35,000 in 2005 and a CPI adjustment means that it should be around \$47,000 in 2020/21. Ideally, it should be adjusted annually in line with movements to net average wages.

Without proper annual price (and, where relevant, wage) indexation of most forms of social assistance, sustained reductions in child poverty/material deprivation, will not be achieved.

The In-Work Tax Credit fails in its objectives



While both the In-Work Tax Credit and Family Tax Credit are aimed at reducing child poverty, the In-Work Tax Credit has a second aim: to incentivise paid work.

There are many ways in which the In-Work Tax Credit fails to achieve this second objective and indeed could scarcely be designed more inappropriately for the task. Rather than being a minor tool to aid the transition to paid work, it is paid well up the income scale and is very expensive at around \$620m p.a. For larger families on well over \$120,000, much as a payment may be justified for their

children, it begs the question, do high income families *really* need a paid work incentive? Moreover, the In-Work Tax Credit is paid to the stay-at-home carer and acts only to disincentivise their entry to the labour force, as any dollar that they earn is likely to cause a 25-cent loss of Working for Families.

The In-Work Tax Credit incentivises meeting fixed hours of paid work: 20 hours a week for a sole parent and 30 hours for a couple. If a person 'normally' works these hours but is, for example, sick or on paid holiday leave, then the hours for the IWTC are assumed to be met. Otherwise the correct number of hours must be met each week.

CPAG have long drawn attention to the Inland Revenue case studies (no longer on their website) that included cases where the hours of work are not met. See for example three IR case studies that were analysed by CPAG in 2012 ([The In-Work Tax Credit in practice: a reality check for the IRD](#)):

Case study 1

Dale is a single parent who works as a teacher's aide for 22 hours a week. She's contracted to work for the school from February to December although she doesn't work during the two-week term holidays. She's entitled to receive an in-work tax credit from early February until mid-December because she normally works the required hours. She can't receive an in-work tax credit during the summer holidays because she's not contracted to work for that period.

Case study 3

Rob worked 40 hours a week as a salesperson. He got a new job as a store manager, also working 40 hours a week. He resigned from his sales job, but had two weeks after he finished before his new job started. He couldn't receive an in-work tax credit for the two weeks while he was between jobs, because he wasn't working at all.

Case study 4

Chris is a single parent who works 15 hours a week as a receptionist. Occasionally she works for six hours on a Saturday for another employer, selling takeaways. Chris qualifies for an in-work tax credit for the weeks she works for 21 hours.

It is hard to discover the rationale for the choice of hours, but it seems to have been adopted randomly from other policies in the late post-war period with little thought or analysis as to whether it is realistic. For example, it is much harder for a sole parent to be in paid work for 20 hours a week, than it is for a couple to work 30 hours between the two of them, particularly when you consider child-care arrangements. There is an unconscious gender bias as well; 20 hours a week for a sole parent, usually female, is much harder to achieve than 30 hours between a couple and this devalues the vital caring role of parenting.

How does the In-Work Tax Credit stack up in the face of the changing nature of work in the 21st century?

Meeting the required hours of work every week to qualify is problematic, especially when work is casual or variable. For the self-employed, the actual hours of paid work are very hard to estimate and even harder for Inland Revenue to police.

It has been problematic to ensure the right amount of WFF is paid weekly, so that there is no end-of-year square-up required. Although it is appealing to think that technology might allow the right amount to be determined weekly and avoid overpayment problems, CPAG made a submission to the

IRD in 2017 on [Making Tax Simpler Better Administration of Social Policy: Working for families \(WFF\)](#), highlighting the dangers and unforeseen consequences of the real-time adjustment project.

Our conclusion was:

- Technocratic solutions to complex social problems do not have a good history in New Zealand or elsewhere.
- Simplification objectives and less debt are better achieved by simplifying the policy itself. This is also more likely to be in the interests of the child/ren and promote goals of reducing child poverty and social equity.
- Before proceeding with the tax simplification exercise, there needs to be a complete overhaul of the definition of income and relationship status to get consistency and rationality between the departments. The danger is that the proposed real-time adjustments to mitigate the problems of overpayments and debt may end up just making a poor system work more efficiently and more ruthlessly.
- Inland Revenue could play more of a leadership role in advising the government of sensible reforms to meaningfully simplify WFF. Some things could be usefully recommended by IR to the incoming government e.g.:
 - Remove hours of work requirement from the In-Work Tax Credit (IWTC).
 - Remove need to be off-benefit from IWTC and the Parental Tax Credit (PTC).
 - Hold back some of WFF until the end of the year for a final reconciliation.
 - Reduce harsh abatement provisions of WFF.

Did the IWTC work? Who was left out?

Evaluations of its effectiveness have been scarce but there was one that suggested when Working for Families was introduced there was a minor increase in hours worked by sole parents, while partnered mothers reduced their hours of paid work. The Treasury study (Mercante & Mok, 2014) did not join the dots and make the observation that, in aggregate, hours of paid work appeared to have reduced. So much for the In-Work Tax Credit being a successful paid work incentive!

Ironically, the In-Work Tax Credit prolongs paid work disincentives (by creating high Effective Marginal Tax Rates when it is abated at 25%). But worse, the attempt to masquerade as a paid work incentive makes it less likely to achieve the other primary objective, that of reducing child poverty. Sadly, the collateral damage for the excluded worse-off children is not even acknowledged in the Treasury evaluation. To succeed as a paid work incentive, the children of parents who are not 'working' have to be denied at least \$72.50 week of the In-Work Tax Credit.

Working for Families did reduce child poverty for low-income working families who got the full package but failed the poorest children as it denied them a critical component to alleviate their poverty. This has meant a cumulative \$7-10 billion loss from poor families' balance sheets since 2006. For over a decade the annual MSD household incomes report has drawn attention to this problem. For example, the latest report says:

“WFF had little impact on the poverty rates for children in workless households” (Perry, 2019, p. 175) and “The fall in child poverty rates from 2004 to 2007 for children in one-FT-one-workless 2P households was very large (28% to 9% using the 50% CV-07 measure), reflecting the WFF impact, especially through the InWork Tax Credit.” (Perry 2019, p. 168)

Figure 2 The worst-off children

Our base line statistics: REL thresholds 40%, 50% and 60% of the median HH income (AHC)

Red is extreme danger-children in Poverty in NZ

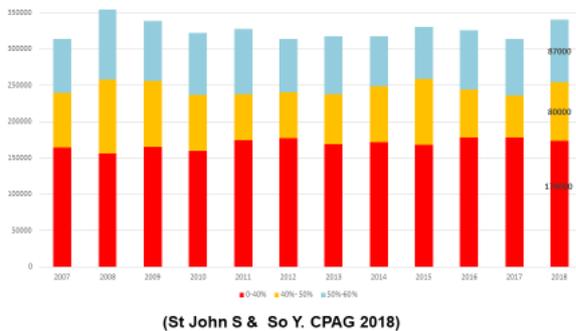


Figure 2 shows that in 2018, 174,000 children fell into the red or danger zone of the after-housing costs (AHC) poverty line statistics. They are under the impossibly low 40% AHC line and are the children who miss out on the In-Work Tax Credit.

The numbers include a disproportionate number of Maori and Pasifika children.

Families supported by core benefits alone fall well below the 40% line and require additional means-tested supplementary

support to survive. They are also likely to call on foodbanks for help with food and loan sharks to manage.

If we must have a paid work incentive, it is necessary to be designed well to achieve its aims. The desirable characteristics of a work incentive might be:

- Simple to understand;
- Concentrates on transition to work/low incomes;
- Rewards an extra dollar earned;
- Based on the individual not the family;
- Not related to payments to reduce child poverty; and
- Not beset by disincentives i.e. impact of overlapping abatements.

The Welfare Expert Advisory Group's suggestion of introducing a new tax credit – the Earned Income Tax Credit – to replace the IWTC has a number of consequences; among these are increased complexity and expense (\$1.2 Billion). CPAG has critiqued the EITC¹ and urges the government to simply add the IWTC to the FTC and not to confuse it with implementing a new paid work-based incentive, especially not one for families getting WFF.

Alleviating unintended consequences of IWTC policy reform

The logical and cost-effective first step to alleviate the worst child poverty is to join the IWTC to the first child FTC. Those on higher incomes will notice no difference, while incomes at the bottom with be markedly boosted. Nevertheless, there is always a fear in policy making that there will be unforeseen consequences, impacts on behaviour, for example, and the creation of losers. Two groups who may be losers are examined below. They are easily dealt with and must not be a justification to delay the needed reforms. We must be very careful that we do not let the tail wag the dog.

Larger families

The Families Package missed the opportunity to remove the extra per child payment of \$15 week of the IWTC for families with four or more children when the FTC was lifted. The significant rise in the

¹ St John, S (2019) [The Earned Income Tax Credit](#), CPAG Summit; Whereto from here, the Whakamana Tangata Report, Otago medical school, Wellington 18th November 2019

second and subsequent child's FTC arguably may have over-compensated large families while ignoring the plight of those poorer smaller families who do not qualify for the IWTC.

If the IWTC of \$72.50 was joined to the first child FTC, larger families would be losers compared to their treatment currently. If this is of concern, then a higher FTC payment for the second and subsequent children could eliminate this. For example, if the second and subsequent FTC payment was increased by \$10, a four-child family would get an extra \$30 that would more than compensate for the \$15 IWTC loss, a five-child family would be \$10 better off and a six-child family \$5 better off.

The simplest way to effect this is to raise the current additional child rate of \$91.25 to the current eldest child rate of \$113.04. The new eldest child rate would then become \$185.50 to include the IWTC.

Shared care

Another concern is that some of those parents with shared care may also be losers. Current policy is hard to find on the IRD website but work that CPAG did ten years ago on a case study is relevant.

Section MD 4 (2) (ITA 2007) of the legislation states:

When another person entitled to in-work [tax credit] or child tax credit

(2) If 2 persons are entitled to an in-work [tax credit] or a child tax credit for a child for an entitlement period, the entitlement of each is not affected by the entitlement of the other person.

Sect MC 10 (2) (ITA 2007) of the legislation states:

Meaning for [abating WFFTC tax credit], [family tax credit], child tax credit

- (2) For the purposes of sections MD 3 and MZ 1 (which relate to [family tax credit] and the child child tax credit), a person is a principal caregiver of a dependent child if the person -
- (a) lives apart from another person who qualifies under section MC 2 in relation to the dependent child; and
 - (b) has the dependent child in their exclusive care for periods totalling at least one-third of -
 - (i) a 4-month period:
 - (ii) the tax year:
 - (iii) the entitlement period, in the case of the parental tax credit.

For shared care, there are lots of different scenarios relating to the child's age and the actual nature of the care hours of each parent. The website is not very helpful.

Providing a person who shares the care of a dependent child has that child in their care for one third of a 4 month period or one third of a year they qualify for WFFTC. For the purposes of calculating their weekly/fortnightly entitlement, this generally equates to an average of 5 days per fortnight but this is not stated in the legislation. So providing a customer can show exclusive care of a child to meet the legislative requirement, how the time is made up doesn't matter.

The family tax credit portion of the entitlement will be split between the two people sharing the care of the child and the amount paid will depend on the amount of time the child spends in each person's care and the income that each caregiver earns... In the case of the IWTC there is no apportionment. (IRD personal communication 2010).

A 2010 CPAG case study will now be discussed to show some of the possible scenarios:

In 2010 a mother of a 12-month-old baby was living with her partner, who was working in a low-paid job and she was receiving the full WFF weekly. They separated, and after 6 months, she went on the sole parent support benefit. At this point she received a bill from IRD for \$1500 (the 2010 rate was \$60 a week) for 6 months of overpayment of the IWTC because she had not been “working 20 hours a week” since they split and hence was ineligible. Despite months of arguing this was totally wrong, especially as the couple’s financial arrangements were exactly the same as before the separation and no benefit was paid for that 6 months, the IRD did not back down, although they eventually wrote the debt off on hardship grounds. **The suggested reform to the IWTC would remedy this absurd situation.**

In the following 12 months she was on a benefit, and regardless of any paid work, was therefore ineligible for the IWTC (she was, of course, working full time looking after a young baby). He was able to argue that he fulfilled the shared care criteria as he had the child 5 nights a fortnight including every second weekend, i.e. 5/14 while she had 9/14 of care. He did not look after the child during any of the business hours on weekdays. The official line was:

The IWTC will be paid in full to him because he works the required number of hours each week. If both caregivers worked the required number of hours they would both receive the full amount of IWTC (i.e. it's not apportioned between the two) IRD personal communication 2010).

Ironically, when she was doing the vast amount of the care and unable to work at a paid job, he ended up with more WFF than she did. After apportioning for the FTC², her share of the total WFF was under 40%.

In today’s terms, she would get only \$72.60 compared to his \$112.90 (\$40.40 of the FTC, plus \$72.50 from the IWTC). The suggested reform to the IWTC would remedy this absurd situation.

The shared care treatment for WFF appears to be predicated on the hypothetical situation of two individuals in low-paid work that is sufficient for each of them to be self-supporting without a benefit, and where they both care equally for the child or children.

The reality is, especially when there are young children, that she (usually it is a she) will need support from a benefit, in which case it doesn’t matter if she has 20 hours paid work or not, she can’t have the IWTC for her child(ren). The current shared care apportioning rules have a gender bias reinforced by the low level of care that he needs to do to qualify for a full IWTC.

If neither is on a benefit and he is earning above the cut-off for WFF abatement, and she is doing 20 hours then **the suggested reform to the IWTC would leave them both in the same situation.**

It is only the very rare hypothetical case when both qualify for the IWTC in their own right, genuinely share care 50/50 and are both on low incomes that the proposed reforms would create losers. To illustrate in today’s figures, when there is no abatement for either of them, assuming 50/50 care, before reform each parent would get $\$113 \times 1/2 + \$72.50 = \$129$. After reform each would get $\$185 \times 1/2$ or \$92.75.

² 5/14 of the WFF FTC or 5/14 of \$88 for one child = 56.57 a week (2010 figures)

They would each have a loss of \$36.25 per week.

Such rare cases can be dealt with individually.

Conclusion

Meaningful reform to WFF is well over-due. There is much unconscious bias and implicit racism in the current WFF. The reforms suggested in this paper would greatly simplify an unworkable system that has not delivered the gains promised by work incentives or reductions in child poverty and is impossible to police and administer fairly in a modern world of paid work. Tellingly, the discrimination against the approximately 174,000 children in New Zealand's major income support programme for children is inconsistent with inclusive child poverty goal achievements. Any unintended creation of losers is likely to be a rare and minor consideration.

References

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