# 8. SOCIAL POLICY

Social policy presents the Government with a dilemma.

On one hand, many people depend on state support for the essentials of life.

On the other hand, poorly designed state support can prevent people from achieving dignity, security and participation in society. In addition, its cost can prevent the rest of the economy from creating opportunities for the disadvantaged.

There are signs that current social and economic policies do not achieve the right balance.

A growing number of people rely on the state for the majority of their income. Many individuals are confronted with the knowledge that, compared with benefits, they will not be substantially better off by working. The quality and availability of health care is not meeting community expectations. The education system is not making the contribution it might to improving New Zealanders' skills and adaptability.

Given the high cost of these policies, a "vicious circle" is operating. The taxes required to pay for social services create a drag on the economy's ability to create jobs. The resulting unemployment adds further to tax burdens, creating a further drag on the economy.

The challenge of reformed economic and social policies is to reverse this into a "virtuous circle". As more people are encouraged into jobs, they would reduce the need for welfare payments and would add to tax revenue. This can create a positive impetus which gathers momentum over time. Combined with better results from health spending and improved education, the groundwork can be laid for economic growth.

## INTRODUCTION

Strong underlying demographic, technological and economic forces will drive increasing demands for health and welfare services. Securing better educational outcomes will be critical to achieving a high-wage, high-employment economy. Growing demands for social services must now be addressed in a climate of fiscal stringency. Social expenditure accounts for 80% of discretionary public spending and so to reduce aggregate spending significantly the Government will need to reduce expenditure on social programmes. The challenge is to ensure that spending cuts are consistent with progress toward the Government's longer-term social objectives. The current design and operation of social policy makes it very difficult to achieve both fiscal and social objectives simultaneously.

Reforms are essential to reduce the level of state dependency and to avoid the social problems that persistent high levels of dependence can create. The last five years have seen rapid growth in beneficiary numbers and in the duration of benefit dependence. When superannuitants are included, nearly one third of the adult population and one quarter of families rely on welfare as their primary source of income. There is now a substantial risk that the current high levels of state dependency would persist even in the face of a strong economic recovery.

The challenge is to ensure that beneficiaries have increased ability and incentive to move into the workforce. If higher employment can be achieved this would act to reduce beneficiary numbers and lead to lower tax burdens, which in turn would encourage more employment.

### Policy Integration

Social and economic objectives need to be well integrated. Economic growth may help reduce inequality, but it is not usually enough on its own to meet wider social concerns. No matter how effective social policies are, securing objectives like dignity, security and opportunity is intimately linked to economic performance. For most people, these social objectives are met through the self-reliance that comes from working, saving and investing, and through the support offered by their nuclear or extended family at critical points in their life-cycle. Social policy is likely to be most effective when it strengthens and supplements, rather than supplants, the mechanisms that permit self-reliance and family and voluntary community support.

Social policy cannot be thought of merely as a way to distribute the benefits of growth. That is because social policy itself has a major impact on growth prospects, both short- and long-term. Given the current state of the economy, this is especially true over the next year. The fiscal cost of social policy needs to be addressed, as do its effects on the willingness of people to work and train.

These concerns must be reconciled with the Government's wider social goals. Even from a narrowly fiscal perspective, any dividends secured at the expense of valued social objectives are likely to be short-lived, since such failure would lead to new spending pressures. Thus fiscal and social considerations together require that any expenditure cuts be well thought-out and accompanied by reforms that minimise any negative social impact.

Over the longer term, a high-employment, high-wage economy can only be secured by improving the productivity of the workforce. Benefit arrangements aimed at inducing people back into the work force need to be supported by labour-market regulations that avoid unnecessary barriers. To break the cycle of dependency the margins between wages and benefits need to widen over time. Such policies need to be supported by stronger performance from our education and training institutions. While recent reforms are likely to be useful, much more could be done to ensure that at each educational level the best form of government intervention (i.e., regulation, funding or state provision), and the right mix between private and public funding and provision, are employed.

The design of social programmes needs to consider the extent to which they undermine self-reliance. For example, do they reduce the capacity of individuals to make decisions that improve their own earnings potential and health and educational status? It is important to consider the incentives on individuals to look after themselves or for families or voluntary community organisations to assist. These considerations are complicated by the ways in which various social policies interact to affect the level of support received and the incentives faced by different groups.

## Policy Design

Policy design needs to carefully balance the costs and benefits of alternative arrangements. In particular a number of recurring issues need to be faced:

- The mix of interventions: governments may regulate, fund or provide services, or use some combination of these interventions.

- The structure of assistance: governments can fund goods and services in many ways, by subsidising producers or consumers, on a universal or targeted basis, and by partial or total subsidies.

- The form of assistance: governments may make cash available to purchase goods or services or can offer those goods and services directly (i.e., "in-kind").

Different policy choices will be appropriate to different types of problems. For example, there are instances where assistance "in-kind" is preferable to cash, or where regulation is preferable to the supply of funding for services. However, it is important for the integrity and robustness of policy that those choices be guided by some underlying principles. For example, this should help reduce anomalies that can lead to a gradual erosion of policy and a steady expansion of eligibility. It can also make it easier to recognise when changes aimed at protecting a narrow interest will compromise the wider benefits of policy.

Principles useful in designing policy are:

- Make best use of the *information* available to different groups. Those with the best information should often be left to make the decisions. For example, the effectiveness of publicly provided welfare is severely limited by an inability to vary the level and form of assistance sufficiently to take into account the tremendous variation in individual circumstances. Indeed, to

prevent abuse, officials are constrained to treat people who fall into extremely broad categories in the same way. In the health and education areas, it is hard for departments to monitor the quality, quantity and cost of service. This points to the desirability of relying more heavily on the information available to consumers, and therefore of giving consumers a larger role.

- Strengthen the *incentives* on consumers to take care of themselves and the incentives on parents, administrators and social-service providers to act as effective agents of social policy. The extent to which government can rely on the detailed information held by groups like administrators, doctors and consumers will depend in part upon the incentives these groups face. Providers need incentives to act in the interests of the intended beneficiaries of social policy. But providers are also called upon to control expenditure and ration services. Problems in creating the appropriate balance between incentives to serve beneficiaries and incentives to control expenditure may sometimes be eased by separating the roles of funding (rationing) and provision and developing competition among funders and providers. The better these incentives, the greater reliance can be placed on decentralised decision-making.

- Consider carefully the *allocation of risk* between individuals, and the taxpayer. Avoidable risk is best carried by those who can influence it and unavoidable risk carried by those best placed to insure against it. The former suggests that consumers and beneficiaries should probably face some direct costs of social services when they can influence their demand for these services by, for example, avoiding accidents, improving diet, and through less drinking and smoking. This can be achieved using instruments like partial user charges in health and stand-down periods for benefits. The desirability of spreading unavoidable risk suggests that attention be given to the role that private insurance might play in securing social objectives.

Careful consideration of these factors can help bring a consistency to policy design without imposing stereotyped solutions onto complex problems. As circumstances differ they are likely to point to different answers to the big recurring choices noted above.

## SOCIAL WELFARE

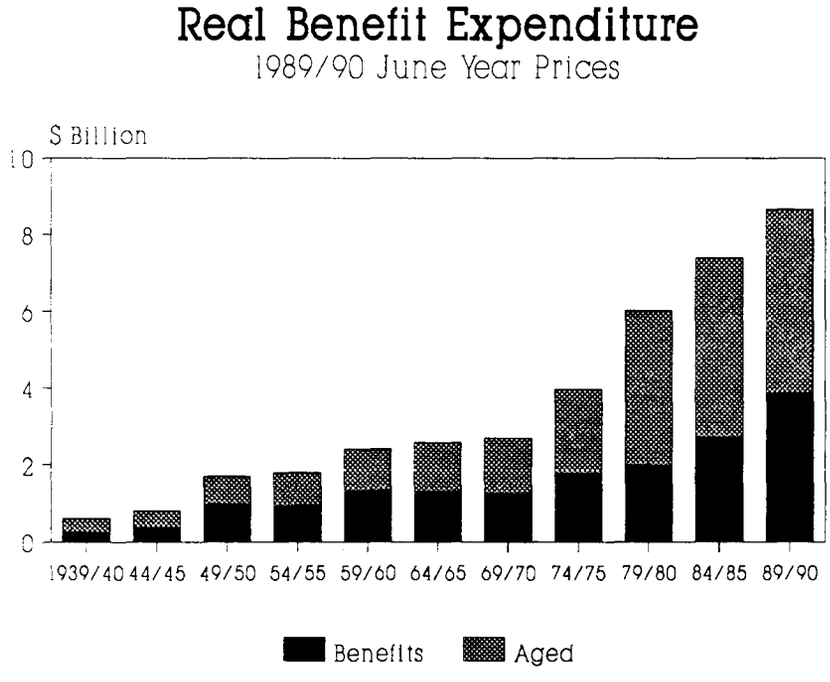
In recent years there has been a rapid growth in the cost of social-welfare benefits and in the number of staff employed to administer them. More importantly, there has been a large increase in the number of people who are dependent on state benefits for regular income.

Some statistics on the size and growth in benefit payments give an idea of the scale of the fiscal issues. Data on the duration of benefits, and information on the population receiving benefits, give some indication of the degree of dependency.

### Fiscal Cost

The Department of Social Welfare is the biggest government department with approximately 7,600 employees and a total budget (including Vote: Senior Citizens) of over $10 billion. Figures 8.1 and 8.2 show the total spending (expressed in constant 1990 dollars and as a share of GDP) on all social-welfare benefits for the period since the welfare state took its present form following the implementation of the Social Security Act of 1938.

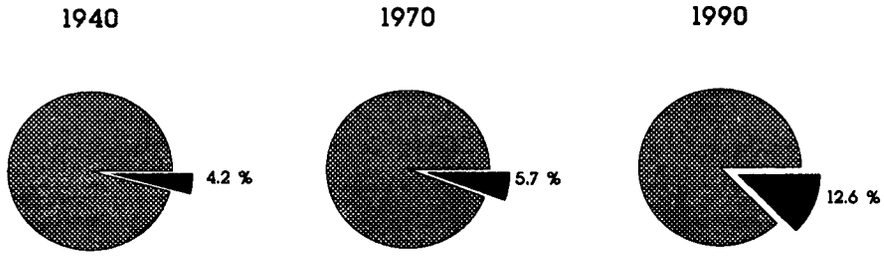
*Figure 8.1*




Year to 31 March
Other benefits = income tested benefits + family assistance.
Source: Department of Social Welfare

*Figure 8.2*

## Benefit Expenditure Compared with GDP




Sources: Department of Statistics, Budget tables

Rapid growth occurred between 1940 and 1950, and between 1970 and 1990. But if the rate of growth in welfare spending that prevailed during the prosperous 1950s and 1960s had continued in the next 20 years, welfare spending would be only half of the actual 1990 cost.

During the 1980s many OECD countries have adjusted welfare commitments in line with reduced economic growth. However, New Zealand has been slow to act, so welfare costs and welfare dependency have increased strongly. By contrast, in Australia, where benefits have always been less significant than in New Zealand, total spending on welfare and social security was equivalent to around 7% of GDP in 1987-88, but in New Zealand in the same year it was just under 13%.[1]

1 This comparison should be seen as indicative rather than exact. It is difficult to strictly compare welfare systems and spending, as Australia delivers some assistance through the tax system, indirect taxes are different and the demographics of the two countries are not precisely the same. Nonetheless, we consider the general conclusion is robust to these minor differences.

## Social Impact

Widespread long-term joblessness sometimes has been found overseas to be associated with increases in sickness, both physical and mental, increased crime, family break-up, low educational attainment of children and inhibited acquisition of work skills. There are fears that prolonged welfare dependence can create an underclass of citizens unable to live without state support or to participate fully in the community. The Royal Commission on Social Policy noted the impact of unemployment can extend "to a more general breakdown in the social framework".[2] Until recently, these potential social costs have been unthinkable in New Zealand. As benefit dependence grows, these social risks are of increasing concern.

One indication of the social impact associated with the payment of benefits is the length of time individual beneficiaries continue to receive the benefit. The demand for labour is a dominant factor in this area, but statistical studies in other countries suggest that the level and structure of benefits are also important influences. The number and duration of unemployment benefits is shown in the following table. Over 92,000 unemployment beneficiaries have been unemployed for more than six months.

**TABLE 8A - CURRENT DURATION OF UNEMPLOYMENT BENEFIT**
(including Emergency Unemployment Benefit)
as at 30 June 1990

| | Number on Benefit | Proportion of Total |
|---|---|---|
| Up to 13 Weeks | 27,346 | 19.6% |
| 13 to 25 Weeks | 19,812 | 14.2% |
| 26 to 51 Weeks | 27,496 | 19.7% |
| 1 to 2 Years | 32,309 | 23.1% |
| 2 to 3 Years | 16,997 | 12.2% |
| Over 3 Years | 15,665 | 11.2% |
| TOTAL | 139,625 | 100.0% |

Source: Department of Social Welfare

In the year to December 1978, those who moved off the Unemployment Benefit had been receiving it for an average of under 15 weeks. In the year to June 1990, the equivalent duration on benefit had increased to 33.8 weeks. Similarly, for those receiving the Domestic Purposes Benefit, the average period on the benefit was around two and a half years in 1980, but is now around three and a half years.

Obviously, these trends in benefits are partly a result of wider social, economic and demographic factors. Any reversal of these trends must involve policies which promote well-functioning labour markets, including efficient education and training systems. However, the levels of support and eligibility rules also play an important part in the fiscal picture and in determining the likelihood that individuals will become dependent

2 Royal Commission on Social Policy, Volume II, p542

on the state. The 1988 Royal Commission on Social Policy stated "most beneficiaries are able to move off the Domestic Purposes Benefit but only because they remarry. A 1983 survey of benefit records found that only 4% of domestic purposes beneficiaries were able to find jobs which paid enough after meeting all the costs of employment (including childcare) to allow them to move off the benefit into financial independence."[3]

The size of spending is much too big for benefits to be exempt from fiscal reviews, and the social risks of high levels of benefit dependency are too serious to be ignored. The following sections explore the issues that must be considered in any comprehensive review of redistribution policies. The first section discusses the role of the state in redistribution. This leads on to a consideration of the equity of payments and their adequacy to meet real needs. The subsequent section discusses the effect of benefits on incentives to be dependent on the state. These issues are then very briefly applied to some specific policy areas, and to the administration of redistribution.

## The Role of Redistribution Policies

The basic aim of an equitable welfare state is to provide assistance to those in need, at the least overall cost to society (including the cost of encouraging undesirable behaviours that promote poverty, as well as the direct cost to the taxpayer). In a fair redistribution system, "need" implies both a lack of resources and an absence of any reasonable opportunity to acquire further resources. Measuring a lack of resources is difficult; identifying the absence of opportunity is even more difficult.

The state has limitations in this area which can be highlighted by comparison with family sharing or voluntary community support. Neighbours, family and friends are able to use information on personal effort and motivation to assess the extent to which the needy are suffering from events beyond their control, or whether they are neglecting opportunities to meet their own needs. They are also often better placed to determine the most appropriate form of assistance. Voluntary organisations, for example, often require treatment for alcoholism as a corollary of giving assistance to impoverished alcoholics.

By contrast, Cabinet Ministers obviously have no means of assessing the relative need of thousands of applicants for assistance. Instead, the Government relies on Social Welfare staff to make the necessary judgements of who is in need. In order to ensure that those judgements are exercised in line with the priorities of the Government, formulae are used to allocate applicants into categories to determine eligibility for assistance. These categories, such as the elderly or low-income invalids, can never represent a full assessment of need. For example, some of the elderly may have comfortable incomes from private superannuation or continued work, or could be in work if they chose to be. Those people either have sufficient resources, or have a reasonable opportunity to acquire them, and so are not really in need.

3 Royal Commission on Social Policy, Volume II, p542.

Even if the Government were able to define precise categories, the state can never collect accurate and full information on the opportunities facing individuals. For example, a benefit may be provided by the state on the mistaken understanding that the beneficiary is incapable of work; in fact, it may be that a modestly paid job is available, but is not worth pursuing if a benefit is on offer.

The difficulty in precisely identifying need can be addressed by applying the principles identified at the beginning of this chapter. Redistribution policies aim to protect people from suffering in circumstances when they could not look after themselves. However, risks which the individual can influence should generally be borne, at least partially, by that individual, rather than being fully shifted to the state. For example, the fact that a self-employed person has a low income in any given year is not in itself sufficient reason to offer income support, as that person could consider alternative employment. Likewise, questions of risk sharing and individual responsibility surround the support of sole parents (especially the responsibilities of the non-custodial parent), protection against loss from injury, and the wait period before entitlement to receive Unemployment Benefit when redundancy payments exist.

Since it is not possible for the state to identify need with any precision, it is important to construct the system in a way which encourages individuals to choose to look after themselves where that option is available, rather than accept a benefit. This is a matter of the incentives to accept benefits, compared with the incentives to remain in or form family relationships, accept work or make savings. Preferably the system will encourage people to select themselves into the appropriate category, so that only those in true need, and without reasonable alternatives, will accept state benefits. It is not clear that the current benefit system is effective in discriminating in this way.
These issues of the nature of need, the role of the state, the sharing of risk and the incentives to provide for oneself all raise questions of the fairness or adequacy of redistribution systems, and the incentives to pursue options other than state support. These are the practical questions that must be addressed when considering fiscal concerns and the social consequences of redistribution. They are canvassed in the next two sections.

## The Equity of Benefits

Any effective and fair redistribution system must provide enough assistance to all of those truly in need. Equally, it should not make unnecessary payments or provide support to those not in need. These two concerns lead to a consideration of who should receive assistance, and the level of benefits.

### *Benefit Eligibility*

Who should receive state benefits is, at a practical level, a question of what tests to use to measure need. Very broad tests, such as age or the presence of children, have the advantage of being simple. However, they do not necessarily bear any close relationship to need. It is hard to see any compelling reason why taxes, which are

substantially raised from people with modest means, should be spent on benefits for high-income people who happen to have children, or on other wealthy people who happen to be elderly. These broad tests ignore some of the information that the state could assemble and use. A more complete measure of need would, at least, include some assessment of income, and possibly of assets.

In considering whether income tests should be used for particular benefits, the question is whether social characteristics (such as age or health status) alone are sufficiently comprehensive to give a good idea of personal circumstances. For example, though virtually any individual who has been bed-ridden for a period of years is in need, some of those who are in that state for a long time are not impoverished. The issue is whether these exceptional cases are sufficiently common to make it worthwhile to use an income test.

The clearest application of this issue is in superannuation. The fact that someone has turned 60 is not evidence of a loss of earning capacity nor of low income; many people aged over 60 continue to work in paid employment, and others have substantial savings. It is not until a significantly greater age (maybe 68, as suggested by the 1988 Royal Commission on Social Policy) that most people are so elderly that it is best to assume that paid work is not an option.

For those who have a real prospect of remaining in paid work, the use of an income test (with other tests like the presence of dependants or personal incapacity) is an important means of collecting sufficient information to determine relative need. New Zealand is unusual in having a tax-funded age benefit with very generous income testing. As a result the proportion of the population receiving state-funded superannuation, and its total cost, is unusually high by world standards. In 1989 a sum equivalent to about 3.6% of the Australian GDP was spent on age and veterans' pensions; the equivalent percentage of the New Zealand GDP spent on the Guaranteed Retirement Income net of tax was about 5.3%.

Selecting the right set of tests involves juggling considerations of:

- simplicity (for beneficiaries and government departments)
- incentives to alter personal circumstances deliberately to qualify for aid
- the need to collect enough information to form an adequate picture of relative need
- the preservation of personal privacy.

Proposals to target benefits more precisely to those in need are sometimes dismissed as stigmatising or administratively costly. However, the current systems of collecting and assessing information on personal circumstances were largely dictated by technologies that are now 50 years old. More modern techniques could be investigated to identify discreet and simple methods to assess relative need.

Another important argument against generalised targeting is that universal provision of assistance promotes social cohesion. This argument largely depends on stigma issues, and if more-modern administration options were used the issue would diminish. Alternatively, it assumes that prosperous taxpayers would resent supporting those in need. If this is true, the payment of higher taxes to receive uniform state-provided

resources is a high cost to avoid some resentment. It seems just as likely that the high taxes required to redistribute income to people not in need (and very often the people from whom the taxes were taken in the first place) creates resentment and brings the social-welfare system into disrepute.

Any use of income as a test for eligibility for assistance has the disadvantage of discouraging some people from providing for themselves. That is because some people will deliberately avoid earning income in order to remain eligible for state support. However, this is not an absolute barrier to designing income-based eligibility; rather it requires careful consideration of the issues covered in the following section on incentives. The question is not whether assistance should be targeted on the basis of income, but which Government programmes should be targeted and what is the most efficient design of the assistance. Cash benefits (including superannuation) are clearly intended to improve relative spending power. Therefore, the case for including income among the factors to be tested for cash benefits seems overwhelming.

Our present benefit system implements these principles in only a patchy way. Income is not always tested where it would seem appropriate. Need categories are not always clear; for example, the number of people accepted as eligible for the Invalid and Sickness Benefits seems to rise and fall with unemployment. The extent of choice and opportunity for self-improvement is rarely tested; for example, work tests are not rigorously applied. Much needs to be done to ensure that welfare spending is more effectively directed to those truly in need.

***Benefit Levels***

Having considered questions of eligibility, the next question is the level of benefits. Many people have drawn "poverty lines" for different societies which purport to show the acceptable minimum income. The different methods of determining these, and the variation in the levels, show that judgements in this area are subjective, and dominated by local conditions.

Without attempting the dubious exercise of defining a single poverty line for New Zealand, one possible approach is to define a range of measures using a series of different bases similar to those used in other countries. These different levels could then be compared with the New Zealand benefit levels to give a very broad impression of whether benefits are adequate. Table 8B reports on some of those comparisons, calculated in 1990 terms.

## TABLE 8B - SOME POSSIBLE MEASURES OF INCOME ADEQUACY FOR THREE HOUSEHOLD TYPES[1]

| | Net Weekly Income in June 1990 Dollars[2] | | |
|---|---|---|---|
| | Single | Sole Parent One Child | Two Adult Two Children |
| Household Budget[3] | 120.25 | 169.91 | 261.40 |
| 50% of Median Income[4] | 122.11 | 172.55 | 265.46 |
| 78.6% of Labourers' Award Rate[5] | 138.71 | 196.00 | 301.54 |
| 65% of Average Weekly Wage[5] | 163.22 | 230.63 | 354.82 |
| Standard Income-Tested Benefit Rates | 162.26 | 255.14 | 319.08 |

Notes:

1 Treasury calculations. The figures for the different households are calculated using factors to take account of the assessed levels of need of different households. In this case we have used the Jensen equivalence scale, which is produced in the Research Section of the Department of Social Welfare. Benefit rates are actual rates at June 1990 and include family support and family benefit for sole parent and couple families.

2 All figures are net of tax.

3 Based on the Otago University economy food plan which estimates a household's food budget. The budget for food can be multiplied by a factor to assess total household expenditure needs. In this case the food budget is multiplied by four. Some sources consider it adequate to multiply food needs by three, and others consider five is a more fair figure.

4 Calculated using the 1988/89 Household and Expenditure Survey, inflated by the CPI. This measure depicts benefit adequacy in terms of a proportion, in this case half, of the median income of four-person households.

5 These rates are an attempt to approximate the reference rates used by the 1972 Royal Commission on Social Security. The Labourers' Award Rate is the basic weekly rate. The measures are assumed to apply to a two-adult household and are then adjusted for different household sizes.

These figures should be interpreted with caution as the comparisons do not give a complete picture of the adequacy of benefits.

However, we may conclude that when minimum income levels are calculated using systems similar to those that are accepted as adequate in several other countries, New Zealand's current rates of assistance appear high. A relatively generous approach to benefits is apparent in the comparison with Australia, as shown in Table 8C.

**TABLE 8C - COMPARISON OF BENEFIT PAYMENT LEVELS BETWEEN AUSTRALIA AND NEW ZEALAND AS A PERCENTAGE OF NET AVERAGE WEEKLY EARNINGS IN 1989**

| Type of Benefit | New Zealand | Australia |
|---|---|---|
| Aged | | |
| - Married | 73 | 58 |
| - Single | 44 | 35 |
| Sole Parent (One Child) | 64 | 47 |
| Sick or Unemployed | | |
| - Couple (One Child) | 73 | 67 |
| - Single | 37 | 33 |

Notes:

1 Treasury calculations. See footnote 1 earlier for caveats to New Zealand Australian welfare comparisons. These figures exclude indirect taxes which raised New Zealand benefit rates (via GST compensation) and take no account of non-cash assistance such as health care subsidies.

In summary, two conclusions are apparent from the discussion of whether enough support is being given to the right people:

- Many people who are not in need receive benefit support of various sorts.
- Compared with average earnings, the levels of benefits in New Zealand are higher than is considered sufficient by some measures in other countries, such as Australia.

The more effective eligibility rules are in identifying those in need and without opportunity for self-improvement, the less concern would arise over the effects of given benefit levels. Weak eligibility tests require lower benefit levels in order to reduce adverse impacts on people's behaviour, and fiscal costs.

In determining benefit levels and eligibility criteria, difficult judgements are unavoidable. Tradeoffs must be made between fiscal and social objectives, between short-run adequacy concerns and long-run effects on participation and growth. From our examinations of both eligibility criteria and benefit levels, there seems to be some room to lower the fiscal cost of benefits without undermining the goal of providing adequate support to those in need. The next question is the social effect of the benefit system, and in particular the incentives on people to provide for themselves.

## Benefits, Work and Other Choices

Estimating the effect that the benefit system has on people's behaviour is difficult: since we cannot accurately determine the options people face, we cannot be sure what they would have done in the absence of benefits. There are many factors behind a decision to take on paid work, to make savings, to divorce or to remarry. Obviously, it is naive to think that cash benefits will always dominate such choices. Social issues such as work enjoyment, self-betterment or even family violence are intimately involved. Similarly, many beneficiaries may have little choice since, try as they might, no job is available. However, the rise in the numbers and duration of benefits is large, and if only one in 10 beneficiaries has been influenced in their decisions to accept or remain on the benefit, by the benefits available, then the cost is substantial.

### *Forms of Assistance*

One important issue in the consideration of incentives is the link between the test for eligibility and the form of assistance. For example, there is usually little incentive to fake an illness if the assistance that is offered to those who are ill is treatment for their disease. However, where cash is provided the incentive to fake eligibility is more severe. Methods which require the beneficiary to absorb some of the cost will encourage some self-selection and therefore assist in identifying those in real need. For example, the use of a waiting period before payments begin may deter people from leaving a job for a short spell of voluntary unemployment, or discourage trivial claims for accident compensation.

One means of reducing the pressure on eligibility tests is to split the benefit, so that a proportion is only available for those facing special circumstances. This approach is already followed with the Accommodation Benefit, and in the discretionary Special Benefit and the Special Needs Grant. A system of a basic rate and some add-ons has the advantage of drawing on local information available to welfare officers. However, the effectiveness of a discretionary approach depends critically on the quality of the administrative systems that are in place, since it is clear that the individual has a strong incentive to make a case for assistance, and the official has little incentive to decline it. Thus, major questions of control and administration need to be resolved to ensure that discretion is being exercised by the right people, for the right purpose, and at the right level. The record is not reassuring. Around 98% of all applications for Special Needs Grants are approved, with many application forms failing even to record the reason for the application. This suggests a lack of tight monitoring.

In addition to the form and method of payment, two aspects of a benefit regime are likely to be very influential in determining the number of beneficiaries. The first is the relationship between the level of benefit that an individual can expect and the level of income that could be received from other sources (generally paid work). This relationship is usually called the "replacement rate". The second issue is the "effective marginal tax rate", which determines the net gain to a beneficiary from an extra hour of work, after taxes and benefit abatement (reduction or withdrawal) are taken into account. These two aspects of the relationship between benefits and earnings are discussed in turn.

***The Ratio of Benefits to Wages: the "Welfare Trap"***

The higher the level of benefits in relation to earnings (that is, the higher the replacement rate), the less financial gain from taking paid employment. The following table presents estimated average replacement rates for some groups of typical beneficiaries in New Zealand, based on the wages that job applicants with similar education and experience might expect. It is likely that these overestimate the true expected wages of the unemployed and therefore that true replacement rates may be even higher, as the unemployed often have to accept a reduction in their wage expectations before finding a job.

**TABLE 8D - ESTIMATED REPLACEMENT RATES FOR BENEFICIARIES IN NEW ZEALAND[1]**

| Group of Beneficiaries | Average Replacement Rates[2] % | Average Dollar Margin Between Benefits and Earnings |
|---|---|---|
| Single (20+) | 57.3 | 155 |
| Sole Parents | 83.8 | 65 |
| Married (principal earner) | | |
| - No children | 71.9 | 128 |
| - With children | 85.2 | 70 |

Notes:

1 Treasury estimates for 1990/91, calculated using the 1987/88 Household Expenditure and Income Survey. All figures are net of tax and take account of benefits and housing assistance.

2 A higher replacement rate indicates smaller net gains from accepting employment.

For many people on benefits it is clear that the benefit level is substantially lower than the wages that could be earned. However, among all groups of beneficiaries there are significant numbers for whom employment offers an after-tax gain of only $2 or less per hour, or about $70 extra in exchange for 40 hours per week time and effort put in to paid employment. Once the costs of work are taken into account, including childcare and travel costs, the net gains may be sufficiently small to discourage many would-be workers, or at least to delay them taking on a job. It is likely that long-term beneficiaries are particularly affected by high replacement rates, as they are known to find it difficult to maintain contact with the labour market and they tend to be offered less-attractive and lower-paid jobs. The replacement rates shown above may be compared with estimates[4] in Australia of around 37%-66%, which are substantially less than the figures for New Zealand.

***Effective Marginal Tax Rates: the "Poverty Trap"***

Effective marginal tax rates measure the amount that extra gross income is reduced by the abatement (withdrawal) of income-tested benefits and by the payment of income tax. The consequences of any particular set of rates are also hard to assess with precision. However, it is likely that for most people the higher the effective marginal tax, and therefore the less the net gain from an extra hour of work, the less will be the amount of time worked. Statistical studies in other countries suggest that these effects are particularly significant among women. As a general rule, the more people facing higher effective marginal tax rates over longer ranges of potential income, the greater the cost to society and the greater the probable loss of output.

However, it is not clear that reducing the rate of withdrawal for benefits or Family Support, which acts to spread the abated benefit over a wider income scale, would represent an improvement. The fiscal cost would probably increase, because more people would be eligible for assistance. In addition, there would be an increase in the number of people facing the effect of the abatement of assistance (though at a more moderate rate).

The effective marginal tax rates faced by sole parents are shown in Figure 8.3.

It is clear that the effective marginal tax rates for sole parents are high and variable. Similar charts, showing similar or even more severe effective marginal tax rates, can be drawn for other groups. Many beneficiaries face rates that approach 100% for a significant range of potential earnings. An indication of the effect of such scales is the fact that very few people are in jobs with an income at the level where the maximum rate of benefit abatement applies; instead they tend to have no job at all, rather than work for little gain. This is worrying since it discourages part-time work, which may be the most appropriate employment for some beneficiaries.

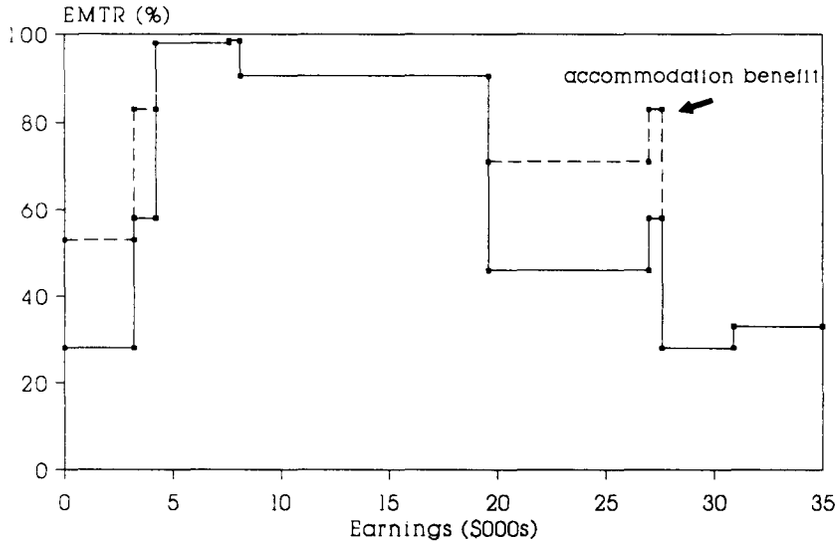
Figure 8.4 shows the combined effects of high replacement rates and high effective marginal tax rates for sole parents. Again, the picture is similar for other groups.

[4] Saunders, Bradbury and Whiteford (1989), "Unemployment Benefit Replacement Rates", Australian Bulletin of Labour, Vol. 15 (3), 233-244. The estimates are on a similar but not identical basis to our calculations.

*Figure 8.3*

## Effective Marginal Tax Rates

Sole Parent, 1 Child

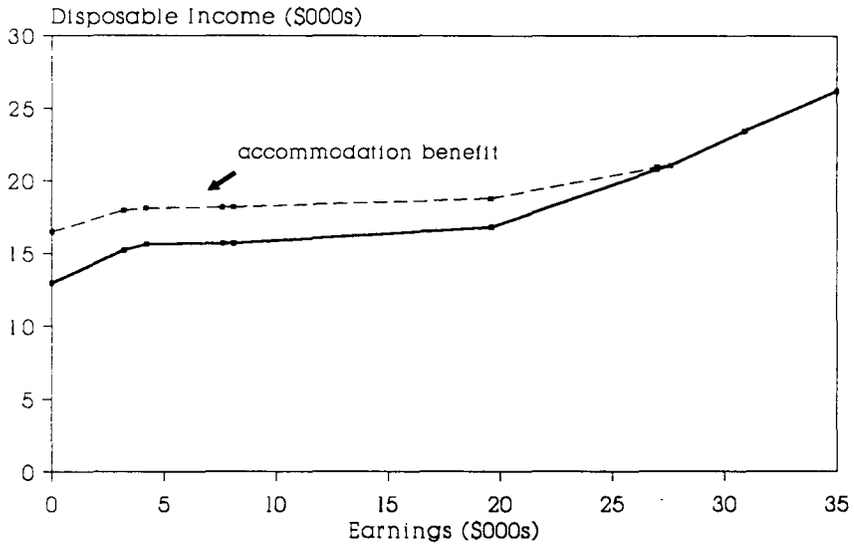



Source: Treasury estimates

*Figure 8.4*

## Disposable Income vs Earnings

Sole Parent, 1 Child




Source: Treasury estimates

Many beneficiaries could be said to be trapped on welfare: they are unable to improve their disposable income by very much unless they can find full-time work at close to the average wage. For example, a married couple with two children earning a gross wage of $25,000 only receives about $3,000 net more per annum than they would on full-time benefit supplemented by the accommodation benefit.

Overall, the design of an equitable and efficient benefit system depends on the interaction between the rules on who is eligible, how their income is supplemented, how much is paid to them, and how support is withdrawn as their income rises. High levels of benefits are a major cause of pressure on the whole system:

- They increase the incentive to accept benefits.
- They reduce the room to ease the poverty trap by lowering abatement and effective marginal tax rates. This is because a combination of high benefits and low abatement rates spreads the abated benefit over a very wide income scale, affecting more people and raising fiscal costs.

Reduced real benefit levels, combined with more active eligibility tests for all benefits, are central to addressing the negative social consequences and high fiscal costs of benefit dependency. A quick consideration of the major welfare programmes suggests the types of reform that are likely to be most worthy of consideration in each area.

## Guaranteed Retirement Income (GRI)

GRI is paid to about 515,000 New Zealanders over the age of 60. The net annual cost of GRI is over $4100 million, although the surcharge recoups about $250 million of this sum. Even with the increase in the age of eligibility to 65 over the period 2006 to 2026, the burden placed by GRI on the tax base will remain roughly at its present level - equivalent to a tax rate of about 6.0% on all income.

The sheer size of the GRI programme demands that it contribute to fiscal savings, and its entitlements be limited. However, superannuation policies tend to reflect historical conditions rather than current realities. In the 1930s an age of 65 was regarded as the standard retirement age, with income-tested assistance available from 60. In today's service-based economy, with much greater life expectancy and working and savings capacity, a case can be made for a later age. For example, the 1988 Royal Commission on Social Policy weighed social and economic concerns, and suggested that age 68 would be more justified.

Key reform issues include:

- Benefit level: GRI rates are higher than standard benefit rates. For example, a single person on GRI gets about $550 more a year, after tax, than a sickness or invalids beneficiary, and about $1,500 more than an unemployment beneficiary. Since there is a higher rate of debt-free home ownership among the elderly, this margin is hard to justify, even given some increased costs of household operations such as home heating.

- Benefit incidence: Targeting GRI on those who are most in need of it could be accomplished through some form of means test, as well as an increased age-of-eligibility test, along the lines recommended by the Royal Commission on Social Policy. It should be realised that much of the benefit of a universal approach is in fact enjoyed by the children of the wealthy elderly, whose bequests are increased.

- More rapid adjustment: Increasing the age of eligibility more rapidly is possible. Apart from the fiscal advantage, this measure has the virtue of encouraging workforce participation and private savings.

## Domestic Purposes Benefit

There are nearly 100,000 Domestic Purposes beneficiaries, supporting about 155,000 children, up from 9234 beneficiaries in 1973. During the 1980s, the average number of beneficiaries has grown by nearly 10% per annum. The Domestic Purposes Benefit is expected to cost about $1210 million in 1990/91.

There are two key issues in this area. The first is the need to ensure that parents do not evade their liability for the support of their children. The second is the need to encourage beneficiaries into paid work where that is a practical and desirable option.

Many non-custodial parents avoid responsibility for their children. The liability assessed under the Liable Parent Contribution Scheme averages only $31 per week, and only 42% of the due payments are collected. Current reforms to the child-support system aim to increase the amount paid by non-custodial parents, and to improve the collection rate, by using the powers and information of the tax system to collect payment. The formula that determines the level of payments will be very important in achieving increased parental and reduced state responsibilities. A full consideration of the liabilities and needs of both parents is closely linked to matrimonial property laws and the ownership of household assets.

Eligibility rules are central to encouraging some sole parents back into paid employment. The current benefit structure does not differentiate between, say, a person caring for a two-year-old child and one caring for a 13-year-old, even though the parental care and time required by these children differs substantially. The Universal Benefit reforms will introduce a requirement for a person whose youngest child is 13 to be available for part-time work, but there appears to be room for more-stringent requirements without imposing social costs.

## Unemployment Benefit

The cost of the Unemployment Benefit has grown sharply in recent years, and is now forecast to total $1,310 million in 1990/91. This growth is a result of two main factors: the number of benefits granted has grown overall, and the average duration on the Unemployment Benefit has been steadily increasing over time.

The key issues in this area revolve around the work test. It is important to assemble adequate evidence of attempts to find work, otherwise there is no test of the opportunities (or lack of them) faced by the individual. This issue is particularly

important for the long-term unemployed, and for those Domestic Purposes beneficiaries who could take on paid work. There are grounds for making the continued receipt of benefits dependent on participation in training, organised job search or work experience. Such an approach would enable special efforts on behalf of those who genuinely have difficulty finding work, in order to improve their prospects and to help them overcome the personal stresses of unemployment.

## Family Assistance

Over the last decade, family-assistance policy has focused on support to low-income families. Various income measures have been used, sometimes in combination with measures of workforce participation. However, not all the money spent on family assistance goes to families in need. About $140 million of the total cost of $750 million is spent on the universal Family Benefit for families beyond the income-tested Family Support thresholds.

While there is no "right" answer to the question of how tightly to target family assistance, the current regime supports many who clearly do not need it. Because there is currently a very limited income gain from working compared with benefit receipt, re-orienting family benefit to low-income families could improve both replacement rates and equity. The proposed changes to the rates of Family and Universal Benefits included in the Social Welfare Amendment Bill take some minor steps in this direction.

## Compensation for Incapacity

The Accident Compensation Corporation's monopoly on the administration of the accident compensation scheme has reduced incentives to control payments. This weak management incentive is combined with a strong incentive for applicants to claim for the relatively high levels of income support available. On top of this, the removal of tort liability (on those responsible for accidents) or any effective experience-rating on contributions to the ACC (which would adjust premiums in line with past accident history) has cut the incentives on employers, owners of property, and drivers to guard against accidents. The rapid growth that has occurred in the number of long-term ACC beneficiaries, and in the overall cost of the scheme, are the consequences that would be expected from such a system.

It is now proposed to extend this regime to all forms of incapacity, including sickness. Though this change would remove an apparent anomaly, it would compound the difficulties inherent in the current scheme and add greatly to the cost. The "steady state" gross cost of the incapacity scheme is forecast to be around $2070 million (1992/93 dollars). This is around $260 million above the combined sum of existing income compensation via the ACC and the total for sickness, invalids and disability benefits. The scheme would pose significant implications for funding, as its costs far exceed employers' levies. If government met the costs of illness compensation, fiscal costs would be very high.

Some of the issues to be considered here are:

- If illness and injury are to be treated alike, a needs-based approach may be more appropriate, and the level of assistance would most appropriately be set in line with other income-tested benefits.

- A greater role for private insurance in accident protection might allow individuals to purchase the type and extent of income protection that they wished, subject perhaps to some minimum requirements and supported by assistance for low-paid and high-risk people to buy insurance.

- The mechanisms for sheeting home the costs of accidents to the individuals and employers responsible should be examined.

## Welfare Administration

The basic purpose of welfare administration is to use available information to identify and alleviate relative need. This involves collecting information, assessing it to determine eligibility, and making payments. It is questionable whether the existing set of institutions, and the balance of public and private responsibility, is the most effective and efficient option.

Many delivery mechanisms are involved in redistribution. They include public agencies like the Department of Social Welfare, the Inland Revenue Department, the Accident Compensation Corporation and the Housing Corporation. They also include some major voluntary agencies, as well as the important informal processes that occur within families and between neighbours.

Any overview of the administration of redistribution should compare the performance of these alternative distributive mechanisms; yet no-one is explicitly charged with making such comparisons. It is also worrying that the present standard of management information in many of those agencies (including Social Welfare) makes the possibility of making any such comparisons uncertain at best.

Some points are clear:

- There is little overall coherence in the allocation of responsibilities among agencies for the administration of income assistance. The Inland Revenue Department (IRD) has the best and most comprehensive information on income, and other agencies are unable to assemble similar data. Accordingly, there are clear benefits from having IRD assess liabilities for child support. Similarly, the decision to move the assessment of Family Support eligibility from IRD to Social Welfare may not be the most effective approach, because Inland Revenue has better and more comprehensive data.

- Some agencies, notably Social Welfare and the Housing Corporation, combine responsibilities for redistribution with other functions. These roles involve the management in a wide span of control for very different types of activity. In particular, linking social work and benefit administration combines diverse activities, producing weak management for both activities. A fundamental lesson from the reform experience with government trading enterprises is that poorly defined objectives and conflicting roles tend to result in very poor performance.

- There are problems with the management systems in the Department of Social Welfare. Late last year, Coopers and Lybrand reported to the Department that there were effectively no proper internal control mechanisms and that duplicate systems were evolving in the districts. Controls on expenditure were weak, and opportunities for abuse rife. The introduction of Financial Management Reform has helped to clarify financial reporting and accountability lines, but has also highlighted the many gaps in information about performance. For instance, the Department keeps no reliable data on spending on discretionary benefits and there appear to be extensive errors in both the recording and reporting of expenditure on the major benefits.

Options for policy must be considered in the light of the current system, but need not be constrained by an assumption that the present set of departments should continue to enjoy their historical monopoly on the delivery of benefits, or that welfare administration should be the sole preserve of public agencies.

Questions of funding and provision are often best considered separately. Thus, even if distribution is best funded by taxes, private agencies may still be able to be used to help determine eligibility and provide this assistance (as is already done, for example, by the Intellectually Handicapped Children's Society). Two issues are immediately apparent:

- None of the institutions involved in redistribution has sufficient incentive to take an overview of redistribution policies or their efficient administration.

- There is very little information available to assess current performance, and no process currently available to collect information on alternatives.

This could be addressed a number of ways, including explicitly charging a disinterested body with advising the Government on alternative delivery mechanisms. This may involve both the assessment of the efficiency of existing systems, and also appraisal of issues such as the interface between Social Welfare and the New Zealand Employment Service or the Inland Revenue Department. It may even involve the consideration of competing tenders for administering aspects of the redistribution system. However, under the present system there is no specialist agency in a position to consider such alternatives and to advise Ministers on the best approach.

## Conclusion

The basic issues in redistribution are simple but daunting. The scale of the Government's involvement is huge and growing. The number of people dependent on the state is very large. The systems used to identify those in need are weak, and do not use all the available information. The agents used by the state to administer this system have limited information and face weak incentives to control costs or prevent continuing dependence. Many beneficiaries face little incentive to reduce their dependence on the state, and the state has assumed liability for much of the controllable risk in their lives.

If these issues are to be addressed so that the social costs of benefits are reduced and fiscal savings made, then it will be necessary to consider the form, level and structure of benefits, eligibility criteria and benefit administration.