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Forward Liability and Welfare Reform in New Zealand

In November 2012, Gabriel Makhoul, the secretary to the Treasury, gave a wide-ranging speech to the Trans-Tasman Business Circle which discussed, among other things, recent reforms in the welfare system. He described the new 'investment approach' as a significant change to the New Zealand welfare system, which he suggested would effectively get people back into work, reduce poverty and increase living standards. The overarching welfare reforms announced and being implemented by the current government are in large part constructed around this investment approach, which provides a central policy narrative to the reforms. The centrality of the investment approach is expressed via the operational use of a measure of what is variously termed

'forward liability', 'future liability' or 'long-term liability' of the welfare system as the key performance management tool for Work and Income. Forward liability (the term exclusively used here) is basically the total current and future fiscal costs of welfare, appropriately discounted.

Makhoul is correct in his assessment that the investment approach marks a significant departure in terms of performance management for the New Zealand welfare system. The purpose of this article is to critically examine the new model and its likely effectiveness, with a view to better understanding its strengths and its weaknesses. The perspective taken is one of mainstream public economics and labour economics.

The origins of the investment approach

The investment approach has a long genesis. One source is a paper written by Rob Brown and Helene Quilter of the then Department of Social Welfare for the 1997 Beyond Dependency conference (Brown and Quilter, 1997). This paper contains both the strengths and weaknesses of the investment approach as it has more recently emerged. Having identified

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the policy problem as the growth in welfare benefit dependency, Brown and Quilter argued for a forward-looking and intertemporal vision of the welfare system as the basis for finding effective policy solutions. This vision was described as the 'new approach', and was outlined fairly briefly. The approach involved acknowledging the 'fiscal, economic and social costs of long term dependency' and hence concluding that '[policy] initiatives must be seen as investments against the future costs'. Welfare dependency needed to be conceptualised as a future contingent liability on the government: 'We need new models and disciplines', Brown and Quilter write, 'that borrow concepts from finance and accounting, something akin to a balance sheet, to recognise that long-term dependency is a cost which will fall to future tax-payers' (Brown and Quilter, 1997, p.46). Critical to understanding the investment approach is this lineage in accounting rather than economic concepts of costs.

In 2010 the National-led coalition established a Welfare Working Group to undertake a fundamental review of New Zealand's welfare system. The main explicit task of the group was to identify how to reduce long-term welfare dependency, a very similar problem to that addressed by the Beyond Dependency conference. One of the terms of reference of the review was a consideration of 'How welfare should be funded, and whether there are things that can be learned from the insurance industry and ACC in terms of managing Government's forward liability' (Welfare Working Group, 2011, p.36). There is a clear echo here of Brown and Quilter, but also the suggestion that the corporatised ACC forward liability funding model, developed in part to set ACC premiums, had been successful, and had similar applicability to welfare.

The final Welfare Working Group report made a number of recommendations regarding the desirability of an investment-based approach. The report defines forward liability as 'The expected costs associated with an individual being in the welfare system over their working life', and proceeds to argue that 'The welfare system needs to recognise the value of investing early to

reduce the long-term social, economic and fiscal costs of welfare dependency. Adopting an actuarial approach to measuring the forward liability will therefore be an important feature of any reform' (Welfare Working Group, 2011, pp.vii, 2). The report proposed that the welfare agency would 'be held accountable for improving work outcomes for people of working age at risk of long-term welfare dependency and reducing the long-term costs of welfare dependency (as measured by the forward liability)'.

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Thus, forward liability would become a key plank in the performance management system:

The use of forward liability and the independence of the delivery agency are the key mitigation strategies. These ensure the delivery agency is incentivised to focus on investing to reduce long-term cost and has the operational independence to implement the new welfare system. (ibid., pp.17-18)

The Welfare Working Group took the view that there was a one-to-one relationship between enhancing employment and reductions in forward liability, recommending that:

employment support and programmes be rigorously selected on the basis of improving employment outcomes and therefore reducing long-term cost (the forward liability), and expenditure be continually re-directed to programmes that are most effective in meeting this objective. (ibid., p.25)

Of the twin strategic planks of forward liability performance management and independence of operation of the welfare agency along ACC lines, only the former reform was in the end adopted by government.

Following the recommendations of the Welfare Working Group, Taylor Fry, an Australian actuarial firm, was asked by the Ministry of Social Development (MSD) and the Treasury to assess the feasibility of adopting this long-term investment approach to achieving better employment, social and financial outcomes and to set out how aggregate future liability would be calculated. Rather than considering employment and social gains from moving a person off benefit, Taylor Fry's response to the brief

was to focus on developing a model measuring only future fiscal liability of people being on a benefit (Taylor Fry, 2011). Their discussion proceeds as if reducing the forward fiscal liability and maximising employment and social outcomes were synonymous activities (Taylor Fry, 2011, e.g. pp.3, 8, 13). No discussion is entered into of issues underlying this very strong and indeed critical presumption. The best way of maximising employment and social outcomes is simply taken to be minimisation of the forward liability.

What does forward liability measure?

At the cost of some generalisation, the forward liability defined by Taylor Fry is primarily the discounted expected future value of government benefit payments. But these fiscal accounting costs are not the economic costs of raising money to fund welfare. It is the deadweight costs of taxation, typically in New Zealand taken to be 20 cents in the dollar, that are the true economic costs, a point well made elsewhere by the Treasury (New Zealand Treasury, 2005).

In economic terms, the fiscal costs of welfare benefits are simply distributional transfers from taxpayers to benefit receivers. This redistribution, which may be considered desirable or undesirable partly depending on one's distributional

value judgements, is not an economic cost as conventionally considered.

Thus, the fiscal focus of the forward liability approach amounts to a performance model focused on achieving a particular target for the intertemporal redistribution of income by the benefit system between beneficiaries on one hand, and other taxpayers on the other. Achieving the forward liability target may have positive or negative consequences on other outcomes, such as employment, poverty or living standards, but these outcomes are merely derivative, since the welfare agency is not tasked to improve these outcomes, let alone optimise them.

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Forward liability and consideration of the other balance sheet components

In the standard private sector accounting model, the balance sheet approach equates assets to liabilities plus equity. The aim of a profit-maximising enterprise is generally taken to be managing the enterprise's assets and liabilities so as to maximise equity – the difference between the two. Applying this to the welfare system suggests that the reform has not explicitly addressed measuring the corresponding intertemporal asset in the welfare system. Indeed, what would be the point of New Zealand as a society holding a forward liability in the welfare system if there was not a corresponding asset associated with it?

It is a useful exercise to ask what the components of the asset corresponding to the forward liability might be. Current and future benefit payments are part of that forward asset, since they comprise the income protection which the system is intended to deliver. The question then is how to value these intertemporal benefits. It is generally accepted that on average a dollar paid to a beneficiary will generate

higher marginal utility of income than a dollar to the average taxpayer, since the average beneficiary is poorer than the average taxpayer (Fujiwara, 2010). This declining marginal utility of income would make the forward asset larger than the forward liability. In addition, another part of the intertemporal asset is the psychological gains to those not in the system of knowing that there is a welfare benefit to fall back on should they not find work, fall sick, or separate with responsibility for a child. Finally, there may be utility generally gained from citizens living in a society which they perceive as more socially just. The net

difference between the forward assets and the forward liability might reasonably be described as the forward equity of the welfare system. Given the considerations outlined above, net social equity would likely be positive.

If neither the forward equity nor the assets of the welfare system are measured by a performance management system, any agent (welfare agency) which is set a forward liability target by the principal (government) will be indifferent as to whether this performance goal is achieved via reduction of the forward asset, arguably the undesirable outcome, or an increase in the forward equity, arguably the desirable outcome. For example, policies which reduce the take-up of welfare benefits by those who remain eligible for a payment are likely to reduce the forward asset more than the forward liability. Yet in a system where only forward liability is used for performance management, achievements by the agent in dissuading legitimate benefit claimants by various administrative or other means will be seen as successful business behaviour.

Arguably, many of the recent problems bedevilling the ACC system have involved reductions in long-term liability – the performance target – achieved by the agent running down the unobserved long-term asset of ACC income-related payments. The political and media voice exercised by aggrieved former ACC clients who have suffered from the removal of this asset has ultimately reflected asset erosion information back to the centre, creating a significant political scandal. It is worth noting that these feedback loops regarding asset erosion resulting from simply managing forward liability are likely to be weaker for the welfare system than in ACC, since an informed middle-class voice is likely to be stronger for ACC payments than for welfare beneficiaries.

Forward liability and measurement error

There are further problems with forward liability as a performance management tool. These problems revolve around the noise-to-signal ratio in the forward liability measure. Changes in forward liability are measured with significant uncertainty and error. They are primarily affected, but to an uncertain extent, by social and economic factors outside the control of the welfare agency, and are dependent on a wide variety of debatable accounting assumptions. These inherent uncertainties around the measure of forward liability create a signal extraction problem for the principal (in this case the newly-created Welfare Board supervising Work and Income). To what extent is any given change in forward liability a consequence of the actions of the welfare agency, of measurement error, or of the broader social and economic context which drives the bulk of observed changes in forward liability? There is no experimental counterfactual available regarding the forward liability effects of an alternative pattern of actions by the welfare agency.

As an additional consequence of this fundamental uncertainty, there are strong incentives on the part of the agent – in this case Work and Income – to devote considerable resources to litigating changes in forward liability, claiming credit for the gains and distributing blame for the increases outside the system.

The principal will then need to devote significant resources to this litigation process. These problems seriously weaken the utility of the forward liability measure as a central tool for performance management, even on its own terms.

Forward liability and employment

If welfare reform is intended to generate additional transitions from benefits into employment, the question needs to be addressed of whether reductions in forward liability will lead to not simply enhanced but optimal employment outcomes, as Taylor Fry's report believes. Is a reduction in forward liability a good proxy for a positive employment outcome? The answer is no.

Movement by people off a welfare benefit may occur for non-employment reasons, including to re-partner, emigrate, move into further education, go to prison, or move into the black or grey economy (employment transitions into the grey or black economy are considered here, realistically, to be undesirable outcomes). Equally, people may not enter the benefit system, despite becoming eligible through a lack of employment, because of stigmatisation, lack of information regarding entitlement, dissuasion by high transactions costs and system complexity, or through mental health difficulties or cognitive problems.

Finally, even if gaining employment and moving off benefit could be mapped onto each other in a one-on-one fashion, the proposed forward liability model values all employment gains as equal to the dollar reduction in benefit payments arising from benefit exit. That is to say, the forward liability model values the additional earnings that people make, and any other positive (or negative) consequences of these earnings and work, including for their families and children, at zero. If positive employment outcomes are valued at zero, then the agent has a strong incentive to rationally under-invest in positive outcomes, compared to all the other reasons for a reduction in the number of people on a benefit.

International experience of policy changes which have been evaluated as raising the exit rate from unemployment benefits, hence involving reduction in

forward liability, in the New Zealand context, have been shown to not generate a positive employment outcome. For example, in the United Kingdom, both Manning (2009) and Petronglo (2009) show that the introduction of the 1996 job seeker allowance reform involved higher unemployment benefit exit, but at the same time failed to move those people into employment.

Long-term benefit dependency and forward liability

The stated policy problem addressed by the 2010 Welfare Working Group was long-term benefit dependency; their report was actually entitled Reducing Long-Term Benefit Dependency. There is consequently a huge puzzle at the heart of

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the group's performance management and welfare reform recommendations. Long-term benefit dependency can be directly measured from current welfare records in almost real time, with great accuracy and at minimal additional cost. Forward liability, on the other hand, requires considerable expensive actuarial resources to produce millions of dollars, cannot be measured in anything like real time (the proposal is to produce it annually) and contains a high and uncertain amount of noise in relation to the ultimate measure, long-term benefit dependency.

Additionally, achieving a forward liability target may or may not involve reducing long-term benefit dependence. The low-hanging fruit for achieving a forward liability reduction are those which offer the biggest net fiscal saving. Long-term beneficiaries offer a gross fiscal saving. While benefit savings from moving them off benefit are considerable, the fiscal cost is also very high. It is quite conceivable that the optimal strategy for reducing forward liability and generating

intertemporal net fiscal savings is to place more resources into choking off benefit inflows, thus leading to a rise in both relative and absolute long-term benefit dependency.

So why spend a lot of money and time developing a forward liability performance measure which bears an uncertain and sometimes perverse relationship to the asserted, readily- and cheaply-observed ultimate target of long-term beneficiaries? The first best option, surely, is to manage performance via a long-term benefit dependency reduction target.

There are two plausible explanations for the failure to develop a performance management system around the share of long-term beneficiaries: a lack of

analytical rigour on the part of the working group, or pursuit of an agenda which actually has little to do with aiding long-term beneficiaries.

Cost-benefit analysis: the alternative investment model

If an intertemporal approach to effective resource allocation in the welfare system is taken to be relevant, the most obvious investment model is not the accountants' or actuaries' forward liability model. Rather, it is the very standard economists' cost-benefit approach. Such an approach is laid out in the Treasury's cost-benefit primer (New Zealand Treasury, 2005) and in terms of social cost-benefit analysis of employment programmes by Fujiwara (2010). A similar approach is deployed empirically in the context of optimal investment in active labour market programmes in Denmark by Jespersen, Munch and Skipper (2004). Such an approach allows a coherent, rational consideration of economic and social gains from placing people off-benefit and into work.

If such a cost-benefit analysis approach is taken, then the discounted stream of forward employment benefits, incorporating all benefits (and costs) to the person and to society from getting someone working, from each available labour market programme should be compared with a specified cost, again appropriately discounted if it has an intertemporal dimension. Each person on a benefit will have the active employment programme allocated to them which leads to the highest discounted stream of net benefits.¹ Each person on welfare would then be ranked from those generating the highest to those generating the lowest net

enables examination of post-programme monthly PAYE earnings over time, with information currently available on a lag of about one year (this lag may feasibly be shortened to about three months). In addition, the IDI provides information on programmes and a means of assessing whether benefit payments decline as a consequence of such programmes. Treasury work on the efficiency costs of taxation allows an estimation of the efficiency gains from reductions in benefit payments. Future developments in the IDI will allow integration of justice and health data, so these outcomes can be factored into the cost-benefit calculation.

is on the programme (\$15,000), being \$35,000 in total. Since liability is \$5,000 higher if the programme is undertaken, no investment will take place.

Now consider the same decision under a cost-benefit analysis. The cost of the programme is the cost of the training programme plus the deadweight tax costs of funding it. Thus total costs are \$24,000. The benefits from the programme are the \$30,000 gross earnings in year two plus the reduction in taxation deadweight from not having to pay welfare in year two (20% of \$15,000). Total benefits are \$33,000. Consequently, net benefits from the programme are \$9,000, meaning, contrary to the forward liability model, investing in the training is efficient.

The forward liability model values a reduction in welfare benefits of one dollar at a dollar, while the cost-benefit analysis values it at 20 cents. The cost-benefit model values one dollar of earnings at a dollar, while the forward liability model values earnings at zero. Consequently, the forward liability model means a greater investment in reducing benefit payments and less investment in obtaining positive employment outcomes. It is scarcely necessary to point out this oddity in a model which is supposed to have an employment focus. Of course, there will be cases where both models draw the same conclusion about investment, but, generally, an optimal investment decision will differ considerably due to valuation differences.

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benefits from the particular programme which is most beneficial to them. Total funding available for active employment programmes would then be allocated according to this ranking, starting by funding investment in the person with the highest net benefit. Funding would be allocated until the prior allocated fund runs out, or all programmes giving positive benefits are funded, whichever is the first. If the allocated fund still leaves a margin of people on welfare for whom net benefits are positive, then funding can be increased in the following budget round. Equity weights can readily be included.

The information requirements for doing cost-benefit analysis perfectly are in excess of what is currently feasible. However, it is useful to set out this ideal, in order to examine the extent to which the forward liability actuarial approach is a step in the right direction towards such a model, and how that model might be amended or supplemented to push it further in the right direction.

Can a cost-benefit approach be employed in practice which approaches more closely over time the ideal outlined above? The answer is yes. Statistics New Zealand's integrated data initiative (IDI)

A cost-benefit analysis is the economists' preferred investment model. As is well known, economic costs and benefits are not equal to an accountant's costs and benefits, which underpin the forward liability model. But does the difference actually matter in practice for decision making?

Consider a simple example where there is a successful training intervention which takes one year to complete and costs \$20,000. People then go off benefit for annual earnings of \$30,000. Assume, for illustrative ease, that there are only two years to be considered and there is no discount rate. The annual welfare benefit is \$15,000. The deadweight cost of taxation is 20%.

In this simple example, an agent making an investment allocation under a forward liability performance measure would not invest in the training programme. On the other hand, a rational resource allocation made using a cost-benefit analysis would lead one to invest in the programme. The forward liability without the programme spending is the sum of benefits paid in the two years, or \$30,000. If the programme goes ahead, the new liability is the cost of the programme (\$20,000) plus the benefit paid in year one when the beneficiary

Arguments defending the forward liability approach

One argument which has been offered in support of the liability model is that while acknowledging that the model is imperfect, as indeed all approaches to performance management are, the performance of Work and Income has been so poor for long-term beneficiaries that the new model will bring huge improvements. A variation on this thesis is that MSD has overly focused on easier-to-place unemployment beneficiaries, ignoring other beneficiaries because they need higher investment to shift them off benefit. It is worth noting, however, that the recent State Services Commission performance improvement framework

(PIF) assessment is glowing in its praise for the performance of the ministry, and does not criticise it on these dimensions.

The responses to those arguments are fairly straightforward. First, there is no need for an actuarial model of liability to shift the focus onto long-term or non-unemployment beneficiaries. As already pointed out, these groups are easily observed in the existing data. Second, the actuarial model will in any case produce the wrong set of interventions and for the wrong people since it fails to value employment and social outcomes of interventions in a rational fashion. Third, there is a current, well-developed mechanism for ministers to set priorities for MSD in the standard statement of intent system. There is no suggestion anywhere in the State Services Commission's PIF assessment of any fundamental problems here as regards MSD. On the face of it, the liability solution is being offered up to address a non-existent problem.

An alternative performance management framework

It is worth sketching out an alternative performance management framework to forward liability, one which could readily be incorporated into the existing MSD statement of intent. The starting point for consideration of the welfare system must be that it has multiple strategic performance objectives, and that it seeks both equity and efficiency goals. Consequently, it is not a system which can be readily managed by an overriding, unitary performance framework like forward liability.

The two main strategic objectives of welfare are paying adequate benefits to those eligible for them and supporting transitions off benefit into sustainable employment. Assignment theory suggests that two performance goals means that at least two broad performance measures should be imposed on the agent by the principal. In terms of paying benefits to those eligible, there is a need for performance measures based on non-take-up of benefits. In this regard, it is noteworthy that the Department of Work and Pensions in the United Kingdom has published take-up by person and

by expenditure amounts by benefit type since 1997. Overseas evidence suggests that non-take-up is a major issue for welfare systems (Hernanz et al., 2004). It is unfortunate that no regular non-take-up tax-benefit information is produced in New Zealand.

There is also a need to judge systemic performance by measures of over- and underpayments, as well as compliance with benefit conditions such as job search requirements and not living with a partner if on a sole-parent benefit. New Zealand evidence shows that overpayments and underpayments to those on benefit and non-compliance with benefit eligibility

people who welfare records showed were receiving a domestic purposes benefit self-reported that they were partnered or living as married (Chapple and Crichton, 2012). Again, these numbers are suggestive of considerable systemic underperformance.

Thus, the key performance measurement areas should be underpayments, overpayments and benefit take-up, with the performance aim being to minimise the first two and maximise the last.

The performance of the employment service in generating work can follow the approach outlined in Nunn, Bickerstaffe and Mitchell (2009) and use long-term

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conditions may be significant systemic issues. In path-breaking work based on representative surveys of beneficiaries, Meimand (1997) reported that 13% of beneficiaries were overpaid and 3% were underpaid during the 1996-1997 year. The annual net overpayment was \$195-219 million. Updating this figure for consumer price inflation and the 2012 number of beneficiaries gives a rough current annual figure for benefit overpayment of between \$275 and \$300 million. Extraordinarily, this pioneering study was never updated to regularly assess changes in welfare system performance. Work undertaken by the Department of Labour and based on matching Household Labour Force Survey and administrative welfare records showed that in 2011: 1) about 10% of people who welfare records showed receiving an unemployment benefit reported to the Household Labour Force Survey that they were actually in full-time employment (30 plus hours per week), and hence were ineligible for the benefit; 2) more than a third of people on an unemployment benefit self-reported that they were not actively seeking work, and one in five expressed no intention to seek work in the coming year; 3) about 10% of

measures of monthly PAYE earnings as a measure of welfare attributable to employment services, increasingly augmenting this with a consideration of impacts on broader social outcomes, within a cost-benefit framework.

The policy process behind the liability model

That major welfare reforms have been undertaken which include basic flaws in problem identification, design of performance management indicators, and in understanding of core economic concepts is concerning. One would have expected these issues to have been picked up by senior Treasury and State Services Commission officials as part of a robust internal policy advice process. Equally, the Taylor Fry actuarial report does not seem to have been sent out by the Treasury to external peer reviewers, including people with a public economics and labour market economics background, which seems a significant oversight. It is difficult to see how someone with an understanding of Treasury's cost-benefit primer or the mainstream public economics which underpins that document would have arrived at the forward liability performance model.

Equally, the interdepartmental policy process must also bear some of the responsibility. Despite the (then) Department of Labour being the government's primary adviser on employment policy, and the fact that welfare reform was generally and explicitly understood to be about getting beneficiaries into work, the political arm of government decided that the Department of Labour had no central role to play in the policy development and advice process on welfare reform. Despite this exclusion, the Department of Labour had an independent opportunity to offer free and frank advice and point out known weaknesses in the forward liability model in their 2011 briefing to the incoming minister. They did not take the opportunity to offer their advice on this issue at that point.

Finally, significant questions must be asked of the problem identification through the PIF process managed through the State Services Commission, the Treasury and the Department of the Prime Minister and Cabinet. When that process fails to identify any significant performance management issues with MSD at the same time as the same arms of government implement radical changes to MSD's performance management system,

this further suggests some substantial within-agency issues.

Conclusion

There are many problematic aspects of the forward liability investment model which is being applied in the welfare system. The problem definition surrounding welfare reform and the performance management approach of MSD has been poor, the forward liability solution has not been carefully unpicked, and reasonable alternatives to this model have not been acknowledged, let alone examined in detail.

Arguably, the welfare system does need much better, independent and regularly-collected indicators of performance in terms of benefit take-up, underpayments and overpayments, and compliance with benefit conditions, as well as cost-benefit indicators of the effectiveness of programmes in generating better employment and earnings outcomes. But forward liability – fundamentally a measure of intertemporal income redistribution – is neither a relevant nor reliable indicator in that context. At best, it is no more than an expensive and partial cul-de-sac.

In the long term, policy makers need to set their sights higher than simply

incentivising employment programme performance in terms of earnings outcomes. They need to value, measure and reward operational solutions which directly involve better social outcomes for getting people off benefits and into work – better outcomes not simply for parents, but for their children also, as well as wider society. Again, only if these broader outcomes are explicitly measured and valued will an intertemporal investment approach have any chance to deliver these better outcomes. Only then will Makhlouf's claims that an investment approach will reduce poverty and improve living standards have operational, as opposed to rhetorical, content.

¹ See Behncke, Frölich and Lechner (2009), Mitnik (2007) and Frölich (2008) for models of allocation of programmes to those with socio-demographic characteristics predicting programme effectiveness. Such allocation models have been used in practice in the employment programme area.

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