K The disability support pension

Chapter 6 sets out some options for reform of the DSP given the introduction of the NDIS and NIIS. The desirability and form of change needs to take account of:

- the trends in the uptake of the DSP, why these have occurred and what they might mean for policy
- the current and impending policy environment and their effects.

This appendix examines these issues, as background to the more schematic discussion in the main report.

K.1 Background to the DSP

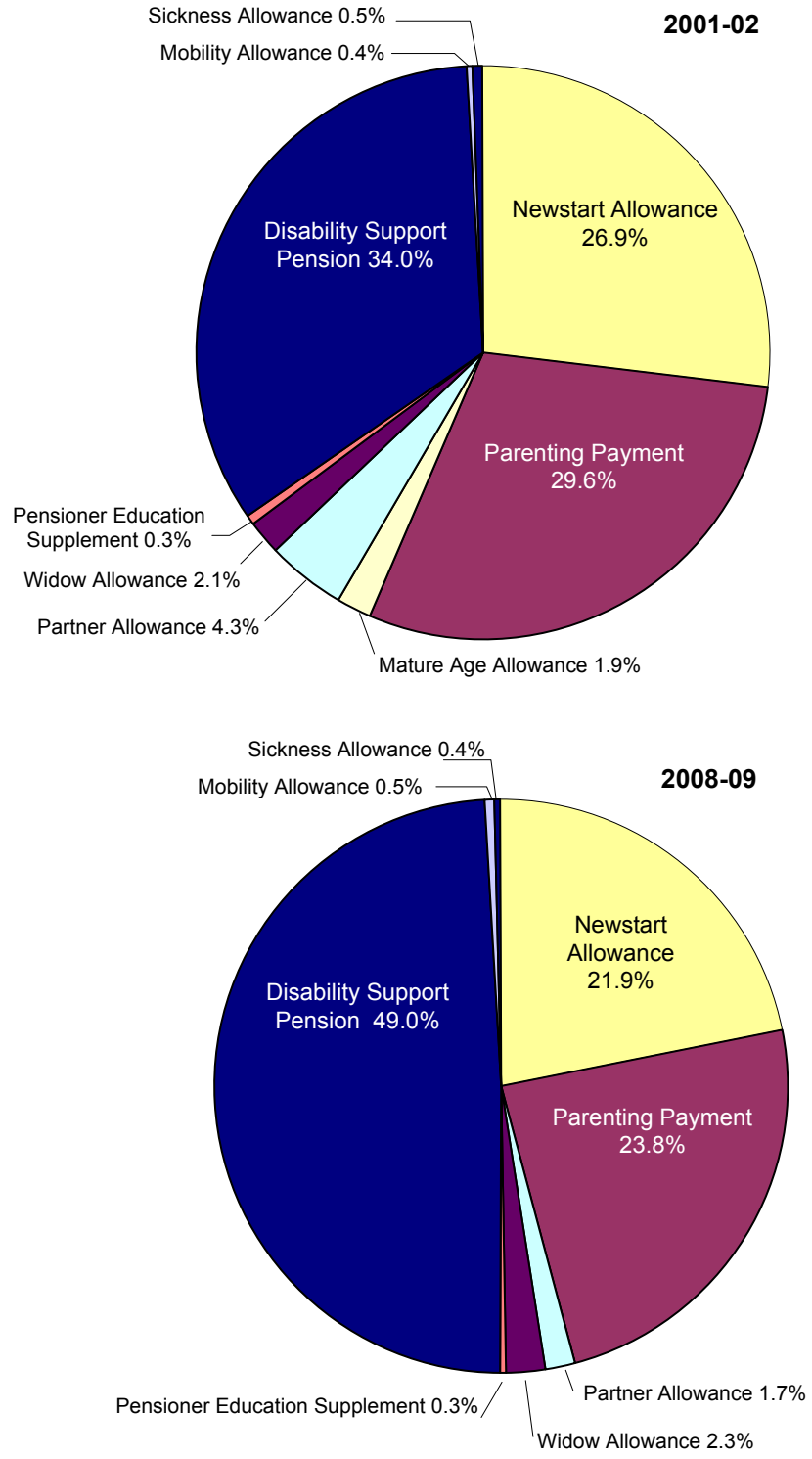
Many people with a disability receive their principal income from income support payments, mainly the DSP. Around 800 000 Australians received the DSP in June 2010 at a cost to taxpayers of $11.6 billion in 2009-10. The projected cost is nearly $13.3 billion in 2010-11 and $13.9 billion in 2011-12 (box K.1). The DSP represents the largest income support payment aimed at working age people in Australia and has shifted from around one third of such payments to one half in the decade from 2001-02 (figure K.1).

People on DSP are highly disengaged from the labour market. While DSP recipients are permitted to work and to retain at least some benefits, around 90 per cent do not get any income from employment. The share searching for a job is even smaller, with 0.8 per cent of the stock of people on the DSP (or around 6600 people) using Job Services Australia in March 2011.[1]

[1] Centrelink and JSA customer populations from the DEEWR website.

Figure K.1 **Disability support pension has grown in relative budgetary importance in working age income support**

Share of income support payments, 2001-02 and 2008-09



Data source: ABS Year Book 2006 and 2010 (Cat. no. 3201.0).

Box K.1 **Some key facts about the DSP**

The number of DSP recipients at the end of June 2010 was 792 581 (which had grown slightly to 793 336 by March 2011).

The growth rate of recipients from end-June 2009 to 2010 was 4.7 per cent. The growth rate in recipients has accelerated since 2007 — the growth in numbers was 2.5 per cent from 2004 to 2007, and 11 per cent from 2007 to 2010. This is likely to reflect the impacts of slower economic growth during this period.

Outlays for the program were $11.86 billion in 2009-10, with projected outlays of $13.3 billion in 2010-11, $13.9 billion in 2011-12, $14.4 billion in 2012-13; $14.9 billion in 2013-14 and $15.5 billion in 2014-15. Accordingly, over a five-year period, costs are estimated to rise by around $3.6 billion or over 30 per cent.

The share of working age population on DSP was around one in every 20 people in 2010, roughly equivalent to enrolment in disability pension programs in other OECD countries (OECD 2010, p. 10). The use of the DSP increases markedly with age, from around 1.5 per cent of 16 to 19 year olds, to around 14 per cent of 60 to 64 year olds.

The share of DSP beneficiaries who are male was 55.8 per cent in 2009 (down from 73.2 per cent in 1991).

In 2010, the most common sources of disability were musculo-skeletal and connective tissue (29.2 per cent), psychological/psychiatric (28.7 per cent), and intellectual/ learning difficulties (11.6 per cent).

9.8 per cent of DSP recipients declared earnings from employment in June 2008. The share of people with earnings was 9.2 and 8.7 per cent in June 2009 and 2010 respectively.

Of the 142 709 new claims for DSP processed in 2009-10, 91 131 (or 64 per cent) were granted. As a share of new claims, the main reasons for rejection were insufficient severity (19 per cent of new claims), having a disability expected to last less than two years (4 per cent of all new claims), and failure to provide requested information (around 6 per cent of all new claims).

Around 80 per cent of DSP recipients were on the full pension (reflecting that few had exceeded income thresholds that reduced benefits).

Source: FaHCSIA (2010), *FaHCSIA Facts and Figures*, October 2010; administrative data from Centrelink; FaHCSIA *Budget Statement 2011-12* (p. 96) and FaHCSIA 2011, *Characteristics of Disability Support Pension Recipients*, June 2010.

It is important to distinguish the stock of people on the DSP from the groups entering and exiting the pension. The stock of people on the DSP is like a large pool of water, with an input and an outlet. The pool grows or falls depending on the magnitude of inflows and outflows. Around 7 per cent of the existing stock leaves each year, matched by a typically somewhat higher inflow (figure K.2).

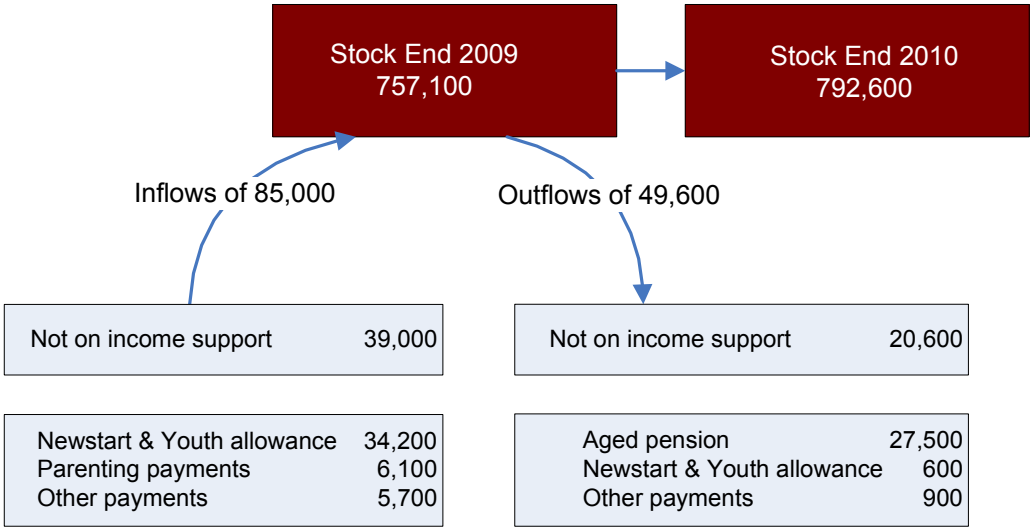
Accordingly, most of the stock stays in place from year to year, so the average durations on the payment are many years (and often until retirement).

Of those people who exit, many do so because they die or go onto the aged pension. Of the remaining group of exiters, most were not unemployed prior to entry and most were on DSP for a short period (Cai et al. 2005).[2] And many come back. Around 50 per cent of people exiting the DSP (other than to death or another income support measure) return to the DSP after two years. As Cai et al. put it:

> ... return to work is … one of the most tenuous exits, in the sense that it is associated with a high propensity to cycle on and off payments. (p. 6)

Accordingly, the average duration data tend not to capture the total amount of time spent on the DSP over a lifetime. People may still have long total spells on the DSP (or other income support measures), punctuated by periods where they receive no income support. Accordingly, policy measures have (so far) faced great difficulties in achieving permanent exits to more positive economic outcomes for people with disabilities.

Figure K.2 **Inflows and outflows in 2009-10**[a]



a The transition to 'Not on income support' includes factors like death; the cessation of eligibility for DSP because of compliance measures and changes in individual circumstances (such as changes in impairment, the application of assets and means tests, and departure overseas). Rounding means that numbers do not add.

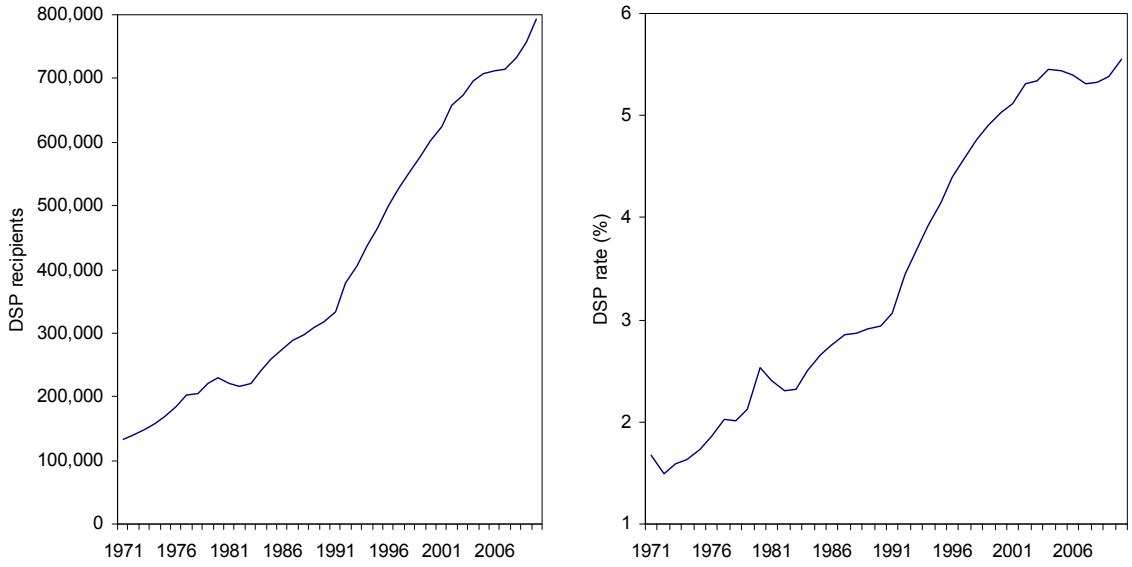
Data source: FaHCSIA 2009, *Characteristics of Disability Support Pension Recipients,* June 2008.

2 Cai, L., Vu, H. and Wilkins, R. 2005, Understanding the nature of and factors behind exits from the Disability Support Pension, Melbourne Institute of Applied Economic and Social Research, Final report (second version) prepared for the Australian Government, 11 August.

Why have the DSP numbers changed?

Understanding why DSP numbers have changed over time helps to suggest possible policy responses that might increase the employment rates of people with disabilities. The number of people on DSP has increased substantially in Australia over the last four decades (figure K.3), a phenomenon that is common to many other developed economies (Marston et al. 2009 and OECD 2010). Over the period from 1984-85 to 2008-09, DSP numbers increased by around 530 000 (figure K.3). Increasingly, growth in overall DSP numbers reflects the uptake of this payment for women. For example, in the period from 2004-05 to 2009-10, DSP numbers increased by around 96 000, but around 85 per cent of this represented growing numbers of female recipients (for reasons that are discussed below).

Figure K.3 **DSP has become much more prominent over time**
1971 to 2010



a The DSP rate is the number of DSP recipients as a share of the population aged 16 to 64 years.

Data source: Yeend (2010), Department of Families, Housing, Community Services and Indigenous Affairs (FaHCSIA) Annual Report 2009-10, Lattimore (2007) and ABS, *Australian Demographic Statistics*, cat. no. 3101.0.

While there are strong grounds for concerns about the growth of DSP numbers, it is important to break down the contributors to that growth to avoid misinterpretation of the trends (an observation made by FaHCSIA, sub. DR977, p. 1). In particular, it is important to distinguish the potential for a person to enter DSP from the absolute numbers of people in the DSP.

Population growth is one driver

In particular, population growth is a significant contributor to the increase in numbers, but not to DSP prevalence rates. Over the longer run period from 1984-85 to 2009-10, population growth accounts for around one fifth of the growth of female DSP recipients and around one half of the growth for male recipients. In recent years, population growth has become an even more important driver of rising DSP numbers for men, but not women (table K.1).

Table K.1 **Change in DSP recipients due to population change**[a]

	Change due to changing aggregate prevalence rate	Change due to population growth	Total change in DSP numbers
	%	%	Number
Females			
1984-85 to 2009-10	82.6	17.4	288 676
1984-85 to 1990-91	54.2	15.6	19 086
1990-91 to 2000-01	86.2	13.8	142 037
2000-01 to 2009-10	82.9	17.1	127 553
2004-05 to 2009-10	91.3	8.7	72 416
Males			
1984-85 to 2009-10	48.5	51.5	244 743
1984-85 to 1990-91	58.2	41.8	55 986
1990-91 to 2000-01	75.7	24.3	147 655
2000-01 to 2009-10	-62.5	162.5	41 102
2004-05 to 2009-10	-219.2	319.2	13 383

a Commission calculations using the decomposition approach set out in technical paper no. 6 in the Commission's report on the economic implications of ageing (2005). Unlike some simple decomposition approaches, this approach ensures that the sum of the individual effects adds to 100 per cent. A large percentage contribution can occur when there are two counteracting factors at work — as in the most recent period.

Source: PC calculations based on data from Parliamentary Library (Park 2005) and FaHCSIA (various issues) Characteristics of Disability Support Pension Recipients.

The effects of population growth have two important implications for understanding the policy aspects of the DSP:

- Significant increases in DSP numbers do not necessarily indicate policy failure. (Indeed, it is possible for DSP numbers to rise, even if policy or other factors have led to large reductions in the rate of DSP use.) For example, had there been no compensating shift down in the prevalence rate of DSP use among men, population growth for men would have led to an increase in male DSP numbers of about 32 000 between 2004-05 and 2009-10 (instead of the observed increase of around 13 400).
- What matters for the affordability of DSP for governments is the ratio of the costs of income support to tax revenue. As modelled in the Treasury

Intergenerational Report and the Commission's own work, population growth itself does not lead to fiscal pressure because all other things being equal, the economy and tax receipts expand with population. Accordingly, the effects of population growth per se on DSP numbers should not be a major source of policy concern.

The central concern for affordability should be changes in the *rate* at which working age people use the DSP since this is the source of fiscal pressures for government. Two underlying factors influence this rate.

Change partly also reflects an ageing population

First, there is a higher likelihood that older working age people use the DSP, which is consistent with the pattern of disability in the general population (figure K.4). For instance, in 2009-10, around one in six of all males aged 60 to 64 years were on the DSP compared with one in fifty males aged 16 to 19 years. The Australian population has aged over recent decades. This means that a greater share of the working age population is in older age groups where the uptake of DSP is higher. That will increase the overall take-up of DSP, even if there is no inherent change in the likelihood that people of any given age use DSP.

That said, over the period from 1984-85 to 2009-10, changes in the age structure have played a minor role in the overall increase in the take-up of DSP among working age Australians (table K.2), accounting for around 0.6 percentage points of the 2 percentage points increase in the overall prevalence of DSP use by males (and an even lesser role for females). This impact will continue given future trends in population ageing. Ageing of the working age population and the associated uptake of the DSP will create fiscal pressures for government. However, the only way in which these pressures could be moderated would be by lowering the age-specific rates of DSP use, since population ageing is outside government control.[3]

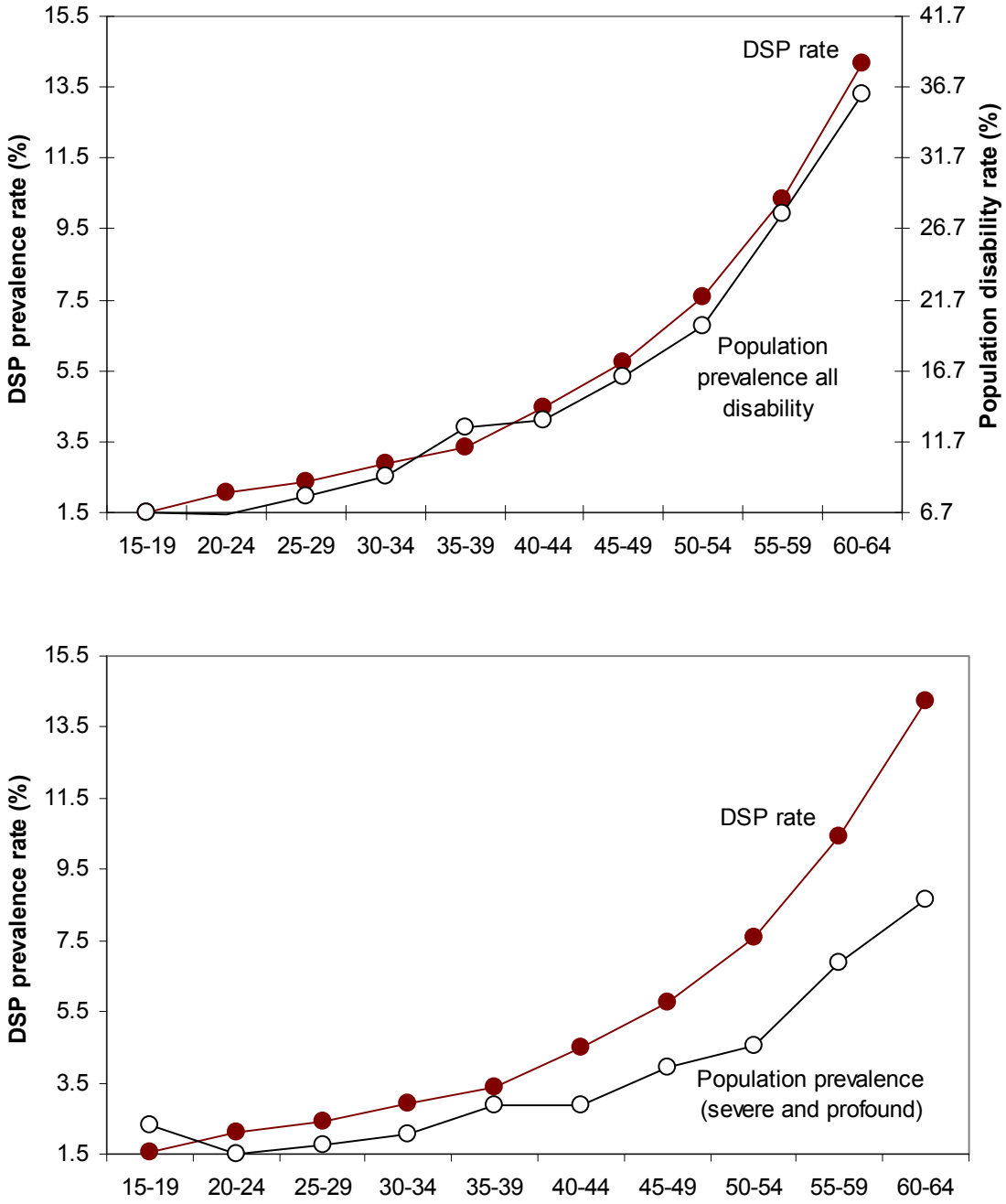
Age specific rates of using the DSP have risen

Second, much of the *long-run* growth of the overall DSP prevalence rate reflects increases in the age-specific prevalence of DSP use. Among female DSP users, this is partly an artefact of welfare policy change — reflecting transfers of people between alternative forms of welfare. For example, many women who would

[3] FaHCSIA (sub. DR977, p. 5) provided some evidence of this occurring, with older men not as prone to claim the DSP as was previously the case. 24 per cent of men born in 1935 were on the DSP by age 60 years (that is by 1995), while less than 13 per cent of the 1950 cohort were on the DSP when aged 60 years (that is, in 2010).

otherwise have used the age pension shifted to the DSP when the age of eligibility for the pension increased.

Figure K.4 **Both DSP rates and population disability prevalence rise steeply with age, 2009**



a The SDAC number refers to either the share of the relevant population with (1) all disability or (2) those with a severe or profound disability. The DSP rate is the share of the relevant population who are DSP recipients.

Data source: Yeend (2010), FaHCSIA (2010f), Lattimore (2007) and ABS, *Australian Demographic Statistics*, cat. no. 3101.0 and ABS SDAC 2009 survey.

Table K.2 **Changes in DSP prevalence is little influenced by population ageing**

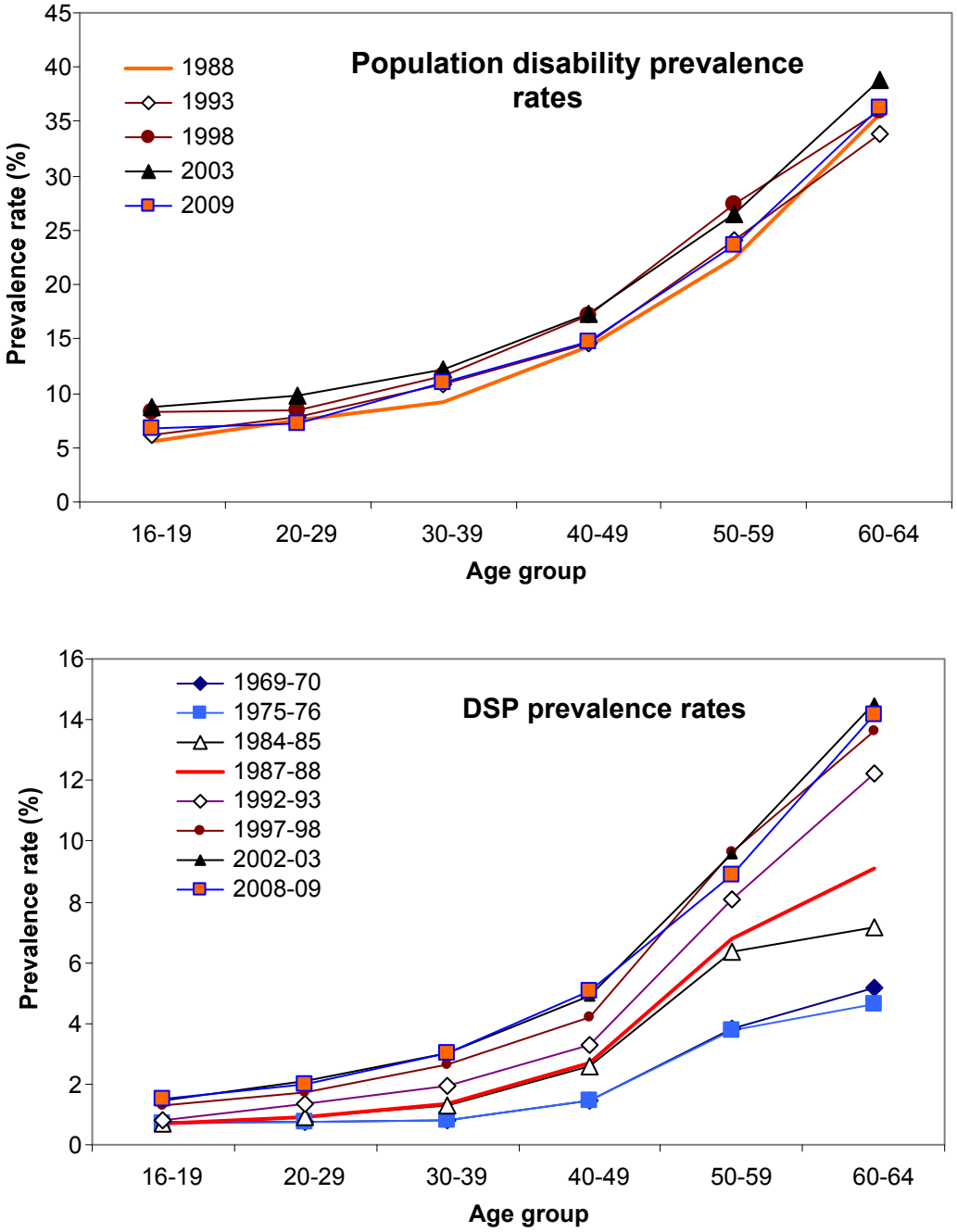
	Growth due to changes in age-specific take-up of the DSP	*Growth due to changing age structure*	*Total increase in DSP rate for the working age population*
	Percentage points	Percentage points	Percentage points
Females			
1984-85 to 2009-10	2.97	0.63	3.59
1984-85 to 1990-91	0.17	0.01	0.18
1990-91 to 2000-01	1.65	0.30	1.95
2000-01 to 2009-10	1.15	0.32	1.46
2004-05 to 2009-10	0.66	0.22	0.88
Males			
1984-85 to 2009-10	1.44	0.58	2.01
1984-85 to 1990-91	0.63	-0.06	0.57
1990-91 to 2000-01	1.36	0.43	1.79
2000-01 to 2009-10	-0.55	0.21	-0.35
2004-05 to 2009-10	-0.47	0.07	-0.40

Source: See table K.1.

However, the most important factor behind the long-run growth in the age-specific use of the DSP seems to be the lowered receptiveness of the economy to the employment of people who jointly have a disability and relatively low job skills, especially among older people. That reflects the structural shifts in the economy from an abundance of lower skilled manual jobs to ones that involve more skills and credentials, and greater requirements for flexibility (Lattimore 2007).

These structural shifts mean the age-specific DSP take-up rate has increased over time. In contrast, the evidence suggests that age standardised population disability rates has not changed over time (AIHW 2008b, Davis et al. 2001). The results from the 2009 ABS SDAC preserve this pattern, with no effective change in population disability rates (figures K.5 and K.6).

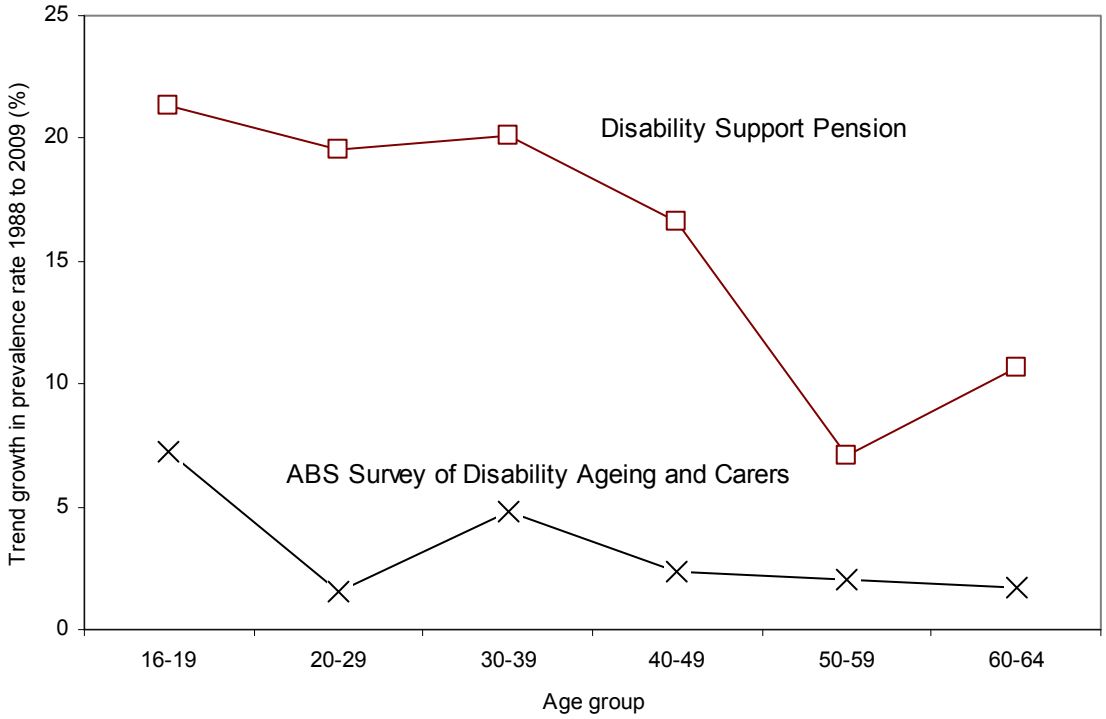
Figure K.5 **Population disability rates are stable over time, while DSP rates have increased significantly**[a]



[a] The population prevalence data use the adjusted data from the ABS (Davis et al. 2001) that tries to correct for some variations in survey questions over time. While there are some variations in rates between successive surveys, much of this will be due to sampling errors and non-sampling bias. The consensus view is that for Australia, disability rates have been stable over time.

Data source: Analysis of the CURFs for SDAC 2003 and 2009; Davis et al. (2001); FaHCSIA (various issues), *Characteristics Of Disability Support Pension Recipients* and ABS, *Australian Demographic Statistics*, Cat. No. 3101.0.

Figure K.6 **Trend growth rates in disability rates from 1988 to 2009**
By age and by DSP and population disability rates[a]



[a] The chart shows the growth rate in the relevant prevalence rates from 1988 to 2009 for each age group. The trend growth rates were calculated by regressing the relevant prevalence rate against a time trend.

Data source: As in figure K.5.

Why has the Australian labour market become more difficult to access for people with disabilities?

The pressures posed by this long-run shift in the economy have been intensified during economic downturns. While inflows into the DSP increase in periods of economic stagnation (Cai and Gregory 2004), there is no substantial link between economic upturns and outflows — which also holds for the OECD as a whole (OECD 2010, pp. 32–34).[4] This inertia is likely to reflect many factors relevant to policy in this area:

- for many people with low re-employment prospects, the DSP has become the means for early retirement. One indicator of this is the gap between the population disability rate and the DSP prevalence rate by age (figure K.5 above

4 In some years, this has been reinforced by taking into account of the state of the labour market, as well as the characteristics of the applicant in determining eligibility to the DSP. This no longer applies.

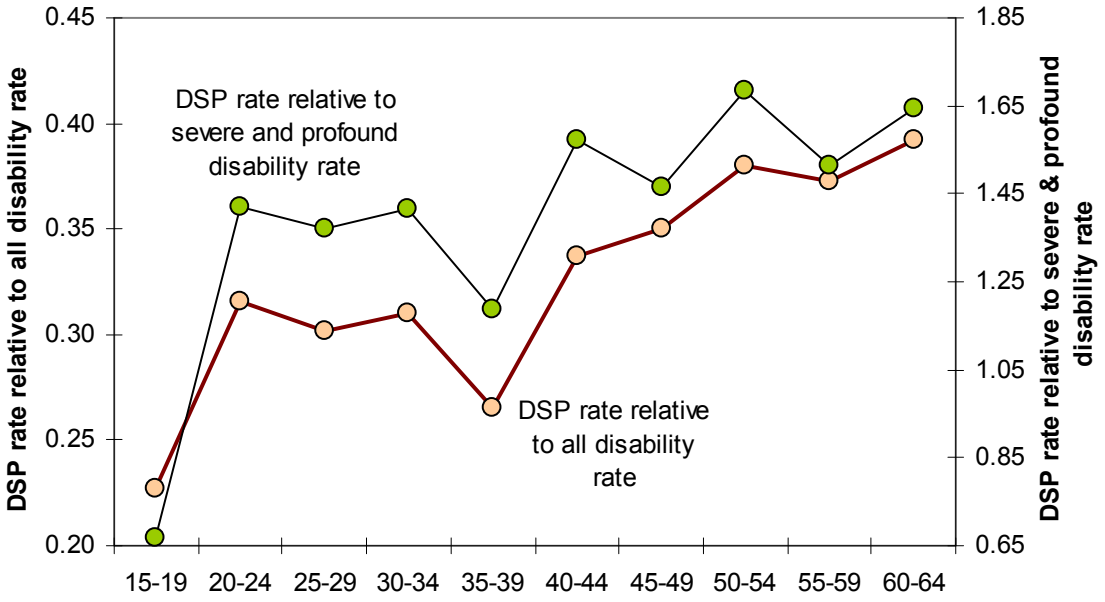
and figure K.7). It shows that the probability of a person with a disability being on DSP rises with age. This growing propensity is consistent with several processes. First, the combination of older age and disability is likely to worsen employment prospects. Second, the adverse effects of previous periodic spells of unemployment on employability increases with the number of such spells, reflecting the progressive erosion of skills acquired when younger. Thirdly, there is likely to be a cohort aspect to the story. People aged 60 years old in 2009 were born in 1949, while those who are 20 years old, were born in 1989. The cohort characteristics, not just age alone, may affect DSP propensity rates (for example, the type of skills of a person born in 1949 would be different from a person born in 1989, as would be their employment experiences. Finally, a young person going onto DSP forgoes a lifetime of potentially better income from working, while an older person does not, especially if they anticipate that much of their future role in the labour force would be unemployment, with low rates of Newstart allowance

- employers sometimes use duration of joblessness as a signal of the quality of the job applicants (which it is for the *average* applicant with long run joblessness), but this means employers may discriminate against particular people in the group who are job ready (so-called 'statistical' discrimination)
- being jobless becomes normalised, and this may be intensified if there is intergenerational joblessness and welfare dependence, or if disadvantage is localised. (In some areas of Australia, 20 per cent of working age people are on the DSP.)
- people lose their job skills and confidence, especially if being on the pension has been preceded by long-term unemployment or other income support arrangements
- the impacts of macroeconomic and labour market factors in creating and entrenching joblessness among people with disabilities has been reinforced by the welfare system, which provides much more substantial (and widening) benefits to people on the DSP than to people actively searching for a job while on Newstart. Whatever the grounds for these variations, they create incentives for people with disabilities to enter and stay on the DSP. Moreover, DSP beneficiaries have (until recent amendments proposed in the 2011-12 budget) been free of any requirements to re-engage in the labour market even if their disability is not likely to be lifelong, and generally have been unencumbered by measures that have encouraged people receiving Newstart and Parenting Payment to search and take jobs. It is notable that many people with disabilities try to get on to the DSP and are rejected during the assessment phase (figure K.8). This is particularly apparent among the young. This indicates the

attractiveness of a higher payment to people who do have an inherent capacity to work

- people with low skills and the likelihood of sporadic casual work with disjointed and changing work rosters, may be economically better off under the DSP. That reflects the fixed costs of working and the high withdrawal rates of benefits as people work
- people are sometimes concerned that getting a job that disqualifies them for the DSP could make it difficult to re-enter the DSP at a later time if their disability intensifies (as can be the case for episodic and unstable conditions). To some extent, this concern has been reduced by allowing people a two year grace period in which they can work ('suspension' of the DSP), while having automatic entitlement to re-entry for the DSP without a new work test in that period. That said, very few people appear to have exercised this option (table K.3)

Figure K.7 **The propensity for people with disabilities to enter the DSP grows with age**
2009

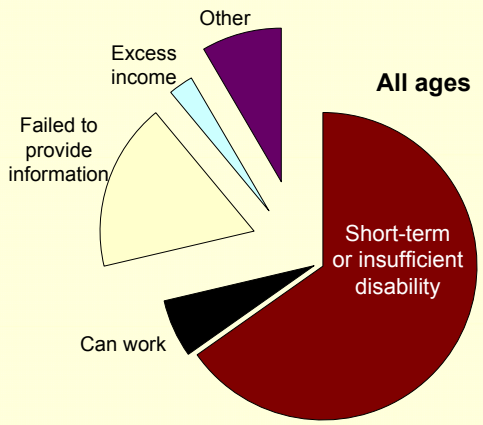


Data source: As for figure K.5.

Figure K.8 Rejections for the DSP

By age and reason, 2009-10

Age	Total rejections	Total claims	Rejection rate
years	No.	No.	%
16-19	3372	11069	30.5
20-24	2929	6062	48.3
25-29	2942	6580	44.7
30-34	3413	8180	41.7
35-39	4783	11670	41.0
40-44	5713	14418	39.6
45-49	6543	17349	37.7
50-54	7060	19574	36.1
55-59	7466	22816	32.7
60+	7357	24991	29.4
Total	51578	142709	36.1



51 578 rejections (all ages)

Data source: FaHCSIA 2011, Characteristics of Disability Support Pension Recipients 2009-10.

Table K.3 Few people on DSP move off to get jobs and exit rates have been falling

	Number of DSP recipients 'suspended' due to returning to work	*DSP stock at **start***	*Ratio*
	Number	Number	%
2003-04	11 751	673 334	1.75
2004-05	9 347	696 742	1.34
2005-06	10 509	706 782	1.49
2006-07	10 273	712 163	1.44
2007-08	11 784	714 156	1.65
2008-09	9 451	732 367	1.29
2009-10	7 725	757 118	1.02
2010-11*	7 157	792 581	0.90

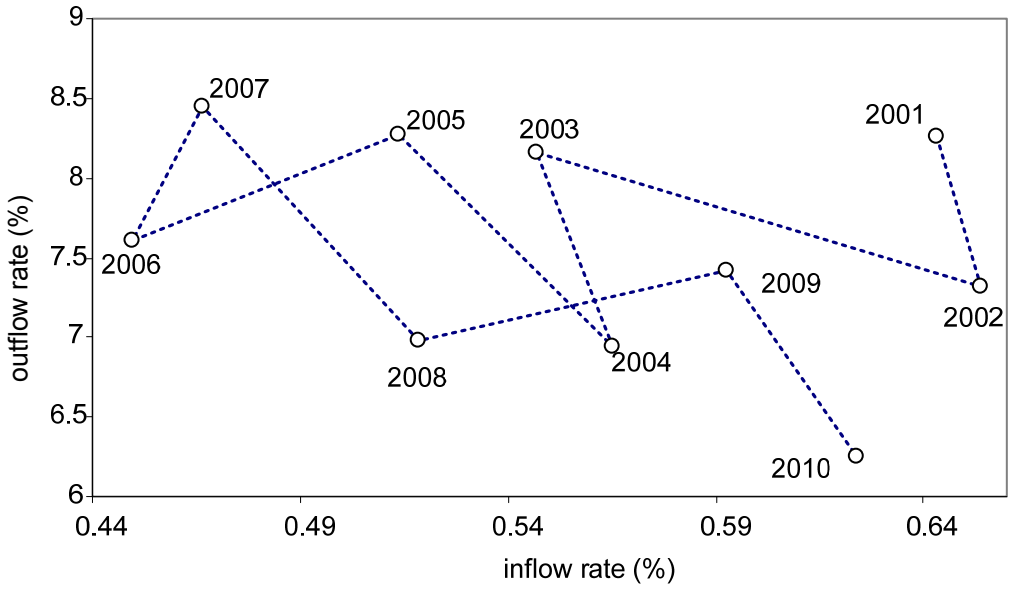
Source: Senate Community Affairs Committee, question 251 (FaHCSIA) and as for figure K.3.

Accordingly, people who enter the DSP tend to stay there unless they die or transition to the age pension or other benefits (the experience in several other countries, such as the United States — Mitra 2006). Major changes in policy settings and resourcing for job readiness would be required to reduce the stock significantly.

Inflows are much more responsive to improved economic conditions and to policy change than outflows. The inflow rate fell markedly from 2002 to 2006. However, following slower economic growth, the rate has risen back to roughly the same rate as in 2001 (figure K.9).

Figure K.9 **Outflow rates have not been responsive to better economic circumstances**

2001 to 2010



a The inflow rate is measured as the number of people entering the DSP as a share of the population (aged 16-64 years) that are not already on DSP. The outflow rate is the share of the stock of DSP recipients that exit each year.

Data source: FaHCSIA (various issues), *Characteristics Of Disability Support Pension Recipients* and ABS, *Australian Demographic Statistics*, Cat. No. 3101.0.

Implications

The above analysis suggests that (buttressed by stable macroeconomic policy) the greatest social policy scope for reducing DSP rates would be:

- using the DSP more as a 'last resort' income support measure for people with intractable severe disabilities preventing employment, with others supported to get employment. (One participant in the inquiry — the CWA, sub. DR927 — noted that the DSP can be a destination point for people having to move off other benefits, but who do not have the same obstacles to work as those with severe disabilities.)
- improvements in the support for people seeking employment

- attempting to re-engage unemployed people with disabilities early after the onset of unemployment
- increasing people's work capacity and motivation (for example, through education, training and mentoring)
- incentives to search for work and to stay in employment
- a strong emphasis on preventing long durations on DSP where there was a realistic option for a job in the future (early job intervention).

In a different social, economic and policy context, more people on DSP could be employed or actively engaged in other ways. This is suggested by the fact that some other countries have (much) higher employment rates for people with disabilities than Australia (OECD 2010, p. 51, table K.4, figure K.10 and chapter 6), and that in the past many people with disabilities were in the workforce.

The social model of disability (chapter 1) has strong application to the low levels of employment of people with disabilities. In considering various policy options for higher employment for people with disabilities, the OECD noted that:

> The annual number of disability benefit claims responds swiftly to comprehensive system change, as seen from reform in countries such as Hungary, Italy, the Netherlands and Poland. Moreover, it appears that roughly half of those no longer coming onto the disability benefit rolls stay in work even without, or with only very limited, employment support. (2010, p. 12)

It is sometimes suggested that many people on the DSP do not have genuine disabilities, implying a much greater role for active compliance measures in the program. However, Centrelink has put in place increasingly sophisticated measures for detecting fraud and undisclosed changes of circumstances for all welfare benefits (Prenzler 2010 and 2011). There have been relatively few cases of convictions for fraud involving the DSP[5] (though it is a difficult task if impairments have no easily observable physical manifestations). People may also exit DSP because of non-compliance (which may not involve fraud), but this represents around 3 per cent of total exits and 0.2 per cent of the total stock of beneficiaries in the latest year of data provided by Cai et al. (2005). It therefore appears that most people on DSP have significant impairments that genuinely affect their employment prospects. That suggests that changes to policy should primarily not take a compliance approach beyond standard Centrelink risk and fraud management processes. Instead, assessment should ensure that only people with few long-run employment prospects should be on the DSP and that the obstacles to employment

5 There were 301 in 2008-09 or about 10 per cent of all cases of social security fraud according to Prenzler (2011).

should be addressed (whether these are posed by the incentives present in the current arrangements, employment support or the attitudes of both the community and people with disabilities).

Table K.4 **Employment performance for selective countries**[a]

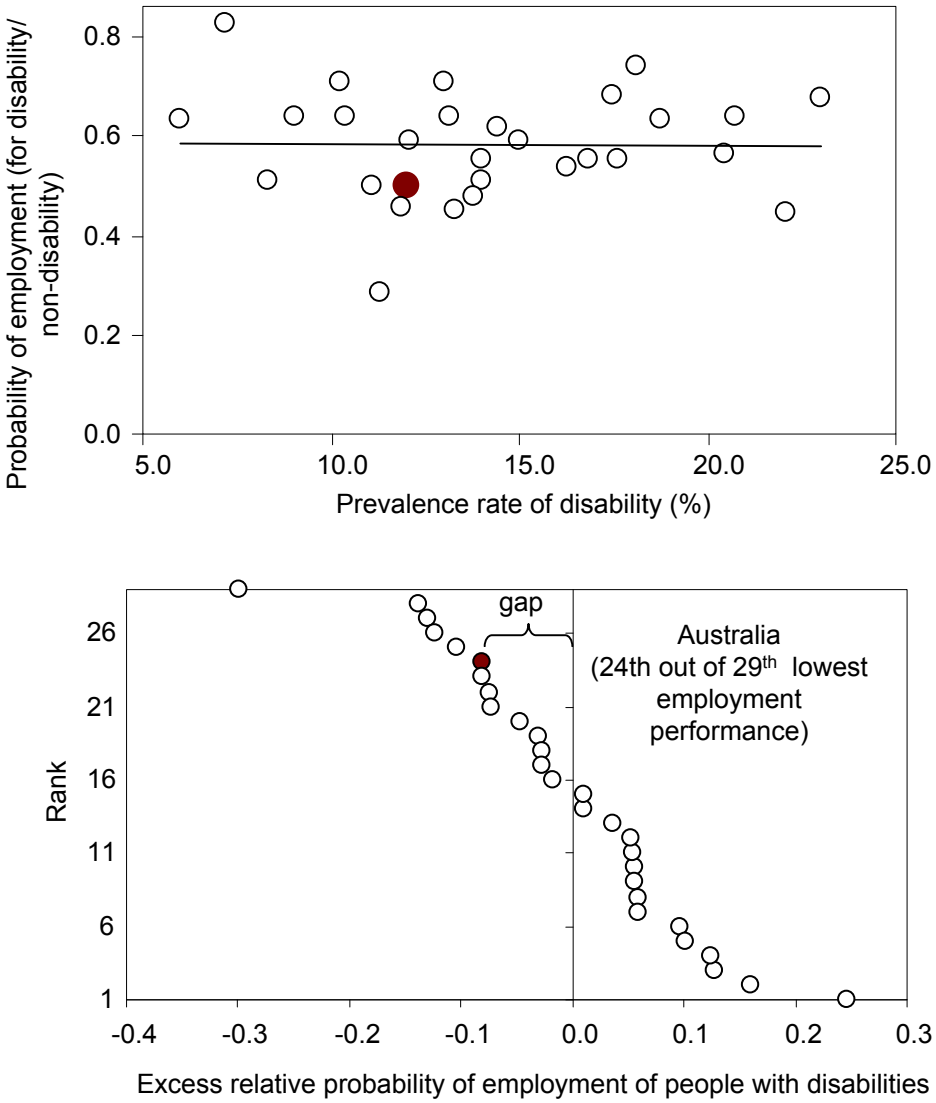
	People with disabilities	*People without a disability*	*Performance ('worst'=29, 'best'=1)*
	%	%	Rank out of 29
Australia	39.8	79.4	21
Austria	43.9	70.8	16
Belgium	36.3	71.5	23
Canada	46.9	79.0	10
Czech Republic	35.0	73.1	25
Denmark	52.3	81.6	6
Estonia	55.8	82.2	3
Finland	43.5	76.8	17
France	45.8	71.8	11
Germany	50.4	73.7	8
Greece	34.2	67.0	26
Hungary	31.7	71.3	28
Iceland	61.3	86.4	2
Ireland	32.9	72.7	27
Italy	40.7	63.7	20
Korea	44.7	70.3	13
Luxembourg	50.4	71.3	7
Mexico	55.4	66.8	4
Netherlands	44.5	80.5	15
Norway	44.7	83.4	14
Poland	17.6	62.1	29
Portugal	47.9	75.4	9
Slovak Republic	41.1	74.0	19
Slovenia	41.3	69.7	18
Spain	35.7	71.1	24
Sweden	62.3	83.9	1
Switzerland	54.9	85.5	5
United Kingdom	45.3	81.4	12
United States	38.5	83.9	22

a The data were derived from various surveys. In Australia's case, disability is defined as the sum of the profound, severe, moderate and mild groups, but the definitions vary for other countries. For example, for most European countries, disability is defined as having a chronic health problem for at least six months that limits daily activities. In Norway, disability is defined as having 'a long-standing health problem or disability'. Other, roughly similar definitions apply to other countries listed. The variations in definitions mean that care should be taken in comparisons between employment rates by country, although figure K.10 below may correct for these problems.

Source: OECD 2010, *Sickness, Disability and Work: Breaking the Barriers - A Synthesis of Findings across OECD Countries.*

Figure K.10 **Australia has poor relative employment rates for people with disabilities**

OECD mid 2000s[a]



a The top graph shows the relative likelihood of employment for people with a disability compared with those without a disability, based on data for the mid 2000s (E_D/E_{ND}). The benefit of this measure is it that it corrects for any economic factor (such as poor economic growth) that affects employment generally. Australia has one of the lower probabilities of employment (as measured by its position on the vertical axis). It is potentially important to control for countries' varying prevalence rates because the estimated relative probabilities are based on different surveys and disability definitions. It could be expected that countries with high disability rates would be using a wider definition of disability than ones with low rates — with effects on employment rates. In fact, no significant relationship holds. In that case, a useful measure of country's comparative performance can be estimated as $Gap_j = (E_D/E_{ND})_j - AV$, where AV is the average value of (E_D/E_{ND}) across all countries, and $(E_D/E_{ND})_j$ is the relative employment ratio for the jth country. This gap (for Australia of -0.08) is shown in the bottom chart. That implies that Australia should have a disability employment rate of $AV \times E_{ND}$. In chapter 6, the calculation of the deficit in the disability employment rate is shown (that is, $E_D - AV \times E_{ND}$). It reveals that just by achieving the average, Australia could aspire to a disability employment rate that would be 6.4 percentage points above the current level.

Data source: As in table K.4.

K.2 The current and impending policy framework for the DSP

Eligibility for the DSP

The DSP is paid to people who are unable to work due to a significant physical, intellectual or psychiatric disability expected to last for two years or more (a 'permanent' condition[6]) and which has been fully diagnosed and subject to any practical treatment. To be eligible a person must be aged 16 years or over and be under the age pension age at the time of claiming, must meet certain Australian residency requirements, and must pass income and asset tests. In addition, under current arrangements, new applicants must meet one of the following two conditions (though other arrangements apply for people who qualified for the DSP in the past — box K.2). They must:

- not be able to work for 15 hours or more per week at or above the relevant minimum wage or be re-skilled for such work for at least the next two years because of illness, injury or disability (the 'continuing inability to work' or CITW test) *or*
- be working under the Supported Wage System (SWS)

People who are permanently blind are currently exempt from any work test and from asset and income tests, which preserves a unique historical entitlement for this group. (The degree to which employed blind people use the entitlement is uncertain.)

Determining eligibility for the DSP is based on several processes. Treating doctors provide evidence about a person's medical state (including a judgment about the permanence of a condition), but no longer provide information about a person's work ability. Instead, using these medical reports and other evidence, Job Capacity Assessment (JCA) providers assess people's capacity to work. Currently, these are a mix of government and private providers, but from 1 July 2011, Centrelink (with the assistance of the Commonwealth Rehabilitation Service Australia) will undertake all assessments.

6 For social security purposes, a permanent impairment is defined as 'fully diagnosed, treated and stabilised and likely to last for at least 2 years without significant functional improvement that would lead to a capacity to work within the next 2 years'. (Australian Government, Guide to Social Security Law, March 2011, version 1.176).

Box K.2 **A potted history of recent reforms to the DSP**

Apart from the changes announced in the 2010-11 Australian Government budget, successive governments have sought to reform the DSP, reflecting contemporary attitudes to the value of economic and social participation by people with disabilities and the significant costs to taxpayers of the payment.

In 1991, the Invalid Pension was changed to the DSP, with greater access to employment programs and an emphasis on rehabilitation and a return to work where practical. People could not get the DSP if they could work 30 hours or more per week. Labour market conditions were no longer relevant to qualification for the DSP, except for those aged over 55 years. The reform did little to affect inflows or outflows from the pension.

In 2006, under the Welfare to Work changes, people with disabilities who were able to undertake significant part-time work (of 15 hours or more) were shifted to Newstart Allowance with a part-time work requirement. Increased rehabilitation and employment assistance was provided. Labour market conditions were no longer taken into account in the work test for any person. The arrangements did not affect people qualifying for the DSP prior to May 2005, and only affected those qualifying between May 2005 and June 2006 after their first review. An evaluation of the Welfare to Work program found evidence that the new processes encouraged people to seek employment support and that people became less reliant on income support (DEEWR 2008).

Governments have undertaken various trials to encourage employment for people on the DSP.

The Job Network Disability Support Pension Pilot commenced in 2003 for a year. Pilot providers used a range of tailored strategies to actively engage DSP recipients who did not have ongoing support requirements.

The Employment Incentive Pilot commenced in March 2010 to assist 1000 people receiving the DSP (to run for two years and with an initial budget of $6.8 million). Under the pilot, employers are supported through wage subsidies of up to $3000 after the job seeker where they have remained in work for at least eight hours a week for 26 weeks. Normal income taper rates apply to DSP recipients who participate in the pilot. Employers will not be able to receive the subsidy if they employ someone as part of Job Services Australia, as they would already be able to use the Employment Pathway Fund for this purpose.

A Disability Support Pension workforce re-engagement contact strategy commenced in a pilot program in mid-2010 in various regions around Australia. It is a three year trial that involves contacting 16 000 new DSP entrants who have an assessed current or future work capacity of some kind. An Area Project Customer Service Adviser contacts new DSP customers at the time DSP is granted, and then three months and 12 months after qualification for the DSP. The aim of the contact is to provide advice on support services available to the DSP customers if they choose to take part in work, study, training or volunteer activities, in line with their current or future ability. Enrolment and continued participation in the pilot is entirely voluntary.

There is also a change to the impairment tables currently under way.

Source: Daniels (2011).

Allied health professionals (such as registered psychologists and rehabilitation consultants) undertake medical and CITW assessments for the DSP. The medical assessment takes into account the evidence from the treating doctor, and is used by the JCA assessor to determine whether the person meets the required impairment severity test (a score of 20 points or more using so-called 'impairment tables'). JCA assessors may consult with treating doctors or seek independent specialist reports if

they require further medical evidence for a JCA. In 2008, around 5 per cent of assessments involved independent specialist reports (Commonwealth Ombudsman, 2008, p. 14). No extensive assessments need to be undertaken in cases in which eligibility is manifest (such as a terminal illness, evident intellectual disability, or where a person needs nursing home level care).

The CITW assessment recognises that a person may have a significant impairment, but still have a sufficient capacity to work or train, in which case they would not qualify for the DSP. The CITW takes into account the medical assessment, but also considers the capacity of a person to undertake training or obtain a job of 15 hours or more over the two years following the application for the DSP. In determining a claimant's current work capacity, JCA assessors will take into account a person's prior work history and their previous access to employment services. The CITW assessment does not take account of whether vacancies exist or not or whether suitable work is available. A JCA is not just an instrument for determining eligibility for the DSP, but also a referral tool for people facing obstacles to working that might be addressed through interventions. Where this is the case, people are referred to employment and training supports from Disability Employment Services or Job Services Australia.

People are entitled to work while on the DSP as long as they meet income and hours tests. Moreover, if a person ceases to receive DSP because they exceed the working hour limit (15 hours currently) or income test, then Centrelink suspends rather than cancels their DSP for two years. People can also keep their Pensioner Concession Card for 12 months if they go off payment due to working. What happens after the two year period depends on the person's income and working hours:

- If a person works above the working hour limit (or gains sufficient income so they get a nil DSP benefit) for more than two years, they have their DSP cancelled, and any future eligibility for the DSP would be based on criteria used for any first-time DSP applicant.
- If after two years, the person works below the working hour limit and has at least a partial pension payment, then Centrelink will restore a person's DSP (and other associated entitlements). For example, someone who worked for 17 hours a week (two hours in excess of the hourly threshold under the current provisions) for 23 months, before their work hours dropped to 10 hours a week, would have their payment suspended over the 23 month period, but would have their DSP restored when they reduced their hours. (An important issue is the review process that may ensue later, which is discussed below.)

The two year grace period is intended to resolve the uncertainty about re-qualification for DSP after a period of employment. People's uncertainty about re-

qualification reflects the fact that the JCA is not a gold standard test of impairment and the capacity to work, but will include false negatives (failing to provide the DSP when it should be) and false positives (providing the DSP when it should not be). Notably, Disability Employment Service providers' biggest complaint about JCA providers was that they did not accurately assess people's work capacity.[7] Accordingly, without a grace period, people with a periodic capacity for working longer hours would be reluctant to do so because of uncertainty about whether they would requalify if they legitimately needed to cut back on their hours. Accordingly, in principle, the two year grace period allows people to work more hours without concern that they are putting at risk their subsequent eligibility for DSP. As discussed later, the Australian Government has proposed further changes to the two year grace period to further encourage people on the pension to work (subject to income tests).

What benefits does the DSP provide?

There is a complex suite of benefits for DSP beneficiaries, depending on age, location, disability needs and the extent to which they engage in employment, education or training. The full rate of DSP for a single pensioner aged over 21 years was $670.90 a fortnight in March 2011, though recipients also receive the Pension Supplement of $58.40 per fortnight (which incorporates allowances to cover partly the costs of the GST, utilities, telephone bills and pharmaceuticals). DSP recipients also automatically get a Pensioner Concession Card, which provides various discounts (such as reduced cost PBS drugs, assistance with hearing services and, depending on the state or territory, benefits such as reduced property and water rates, lower energy bills and motor vehicle registration costs, reduced public transport fares and, in some cases, free rail travel). Its estimated value is around $60 a fortnight (Baker 2010 and FaHCSIA 2008, p. 9). DSP recipients may also be eligible for a Mobility Allowance of up to $116.20 per fortnight if they have difficulties accessing public transport, and are required to travel for work, education or volunteering purposes. People studying an approved subject at an approved educational institution for at least 25 per cent of the usual study load are eligible for $62.40 a fortnight (the Pensioner Education Supplement), while they would also be eligible for a one-off Education Entry Payment of $208. Rent assistance of a maximum of $116.40 per fortnight is also payable. Persons in remote areas are eligible for a Remote Area Allowance of $18.20 per fortnight.

Typically, a person on DSP engaging in at least part-time study could earn around $28 000 annually. This is significantly below average weekly earnings, but

7 50 per cent of DES providers indicated this (DEEWR 2011, p. 51).

significantly more than unemployed people and some low-paid workers. In particular, benefits on the DSP are much greater than those available on Newstart (unemployment benefits) and the gap between these payments have been widening over time (table K.5). Were current indexation arrangements to continue, benefits for unemployed people would be less than half of those accessing the DSP by 2040. The widening gap has several impacts. First, it raises equity issues (as discussed in the Henry Tax Review). Second, it encourages people with a disability who have a work capacity below the threshold 15 hours a week to attempt to qualify for the DSP, even if there is a chance that they could work more hours than this by searching for a job while on Newstart. Finally, it reduces people's incentives for, or disclosure of, improved functioning and work capacity. Flows from DSP to Newstart are close to zero, while flows from Newstart to DSP are very large (figure K.2).[8]

Table K.5 **The gap between Newstart and DSP payments is widening**

Year	*DSP*	*Newstart*	*Newstart payment as share of DSP*
	$ per fortnight	$ per fortnight	%
1980	116	116	100.0
2011	729	475	65.1
Projected 2020[a]	1036	593	57.2
Projected 2040[a]	2271	972	42.8

[a] Following the 2010 IGR, it is assumed that inflation is 2.5 per cent annually (the basis for indexation of Newstart allowance) and that real productivity growth is 1.6 per cent per annum. It is assumed that real wages, which is the basis for indexation of the pension, rise by the 4.1 per cent annually (the sum of the inflation and productivity growth rates). The analysis includes the pension supplement (which further widens the gap between the two payments, though it should be noted that the supplement is indexed to the CPI, which reduces its importance as a contributor to that gap over time). The figures provided above are similar to those of the Henry Tax Review (2010, p. 501), but use the Guide to Social Security for current and historical rates, only include CPI indexation of the supplement and use IGR assumptions for real wage growth and inflation.

Source: Henry Tax Review (2010, p. 501), Payment rates from Centrelink for 20 March 2011, and Treasury (2010).

People can add to their income by working while on DSP, though only around 10 per cent of DSP beneficiaries work in any job. Once a person earns over $146 a fortnight, the DSP payment is reduced at a rate of fifty cents for every dollar earned

8 In general, very few people on DSP move to lower value income transfer payments, while many people move from lower value transfer payments to DSP. For instance, administrative data for 2008 showed that just under 50 000 people transferred to DSP from other working age income support measures (97 per cent of them from income support measures with lower payment rates), and only 2000 people exited to other working age income support measures (Henry Tax Review (2010, p. 504).

(in effect, a 'tax' rate of 50 per cent), providing quite weak incentives to work.[9] At existing minimum wages, the $146 limit would represent less than 5 hours of work per week. The (usually defined) incremental effective tax rate from working is higher than this because of the withdrawal of other benefits as income rises (figure K.11 for person without a partner or children). The result is that there is a kink in the relationship between DSP beneficiaries' gross earnings and their take-home pay. As discussed below, taking into account thresholds on hours worked means that implicit tax rates on working are even higher than these already high amounts, an issue that underlies some recent reforms.[10]

New policy approaches

As part of a long lineage or arrangements intended to promote the social and economic participation of people with disabilities (and to save money), the Australian Government announced various new DSP policies in the 2011-12 Budget.

The '30 hour concession' — people can still get the DSP and work up to 30 hours a week

On 1 July 2012, the Australian Government will allow DSP recipients to work up to 30 hours a week continuously for up to two years without having their payment suspended or cancelled. These people would be able to receive a part pension if they were working up to 30 hours a week, subject to usual means testing arrangements.

The current 15 hour threshold is at odds with the income taper applying to the DSP (see below for details on the income tests applying to the DSP). Under that taper, people would be able to retain at least part of their DSP until they earned around $42 000 of gross labour income. At minimum wages (of $15 an hour in mid 2011), the comparable hours would well exceed 15 hours. In effect, taper rates and income thresholds are largely redundant for many people under the old rules because the binding constraint was hours, not income. Under the old rules, this shows up as effective marginal tax rates of well over 100 per cent on a dollar earned just above $11 730 (figure K.12 below).

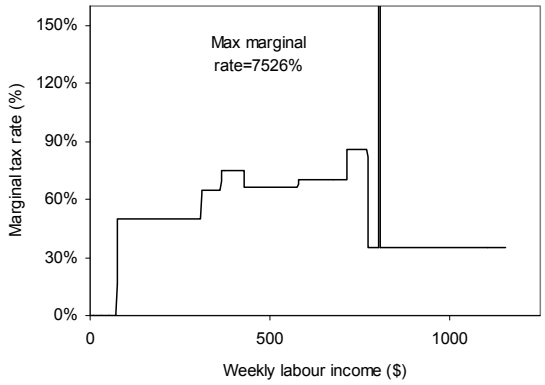
9 The same income threshold and 'taper' rate applies to many other income support arrangements (such as the Age Pension and Carer Payment).

10 Two other factors that affect implicit tax rates on working have been ignored in this appendix. Working credits allow a jobless person to acquire credits (up to a limit) based on time not in a job that can be used to extend the period of eligibility for income support when they do get a job. This encourages work. On the other hand, the costs of working (such as clothes and transport costs) are also ignored, further eroding employment incentives.

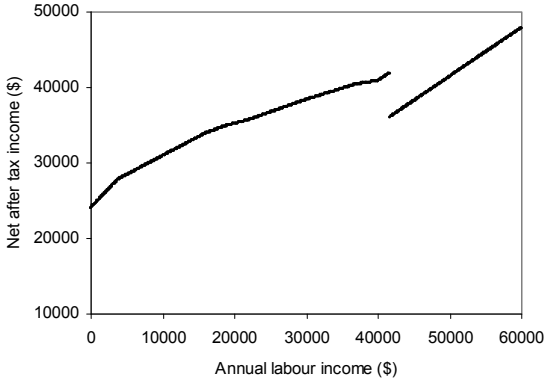
Figure K.11 **Incentives to work are low**[a]

The impacts of income support ignoring the work test

Standard measure of effective incremental tax rates



Link between net after tax income and earned income

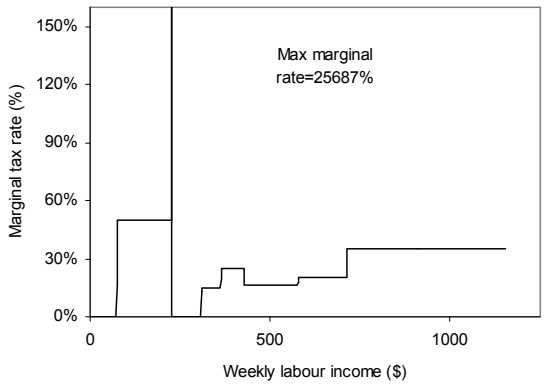


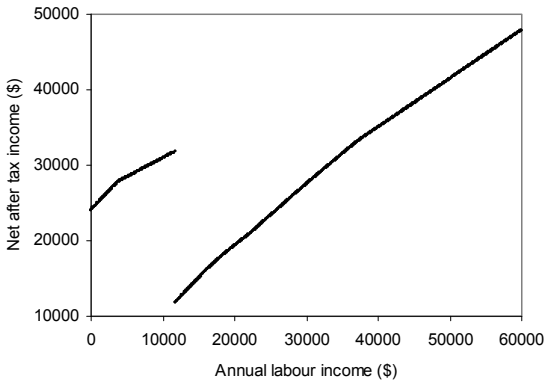
a The effective incremental tax rate differs from the usual effective marginal tax rate (EMTR) in that it is calculated as 100*(1-ΔNATY/ΔGY) where ΔGY is the gross labour income from a person working an additional tenth of an hour a week at $15 an hour (the minimum wage in early 2011) and ΔNATY is the change in net after tax income associated with that change in gross earnings. The advantage of this approach is that it is similar to the EMTR, but allows alternative effective tax rates to be estimated (see below) if the calculations take into account social security rules also apply thresholds on hours worked in addition to the standard income test. The graph is based on arrangements in 2010–11 for a single DSP beneficiary with no dependents. It takes account of all DSP benefits, including the pension concession card, pensioner supplement and rent assistance (with private rent of $400 a fortnight assumed). It takes into account the existing income tax thresholds, the low income tax offset, Medicare levy arrangements for people on low incomes and the surcharge. The chart above does NOT take account of the impact of the DSP thresholds on maximum working hours. The effective marginal tax rates are very high at certain points because people can lose a large share of their entitlements by working or earning just a little more. For example, increasing hours of work from 30 hours a week to just over 30 hours at the minimum wage rate reduces a person's income from around $36 000 annually to around $22 000. The graph's scale does not reflect the full extent of these high marginal rates because to do so would lose all the information about tax rates at other points.

Data source: Commission calculations.

Figure K.12 **When the work limit is taken into account, incentives are even lower than usually implied**[a]

Under the current 15 hour work test





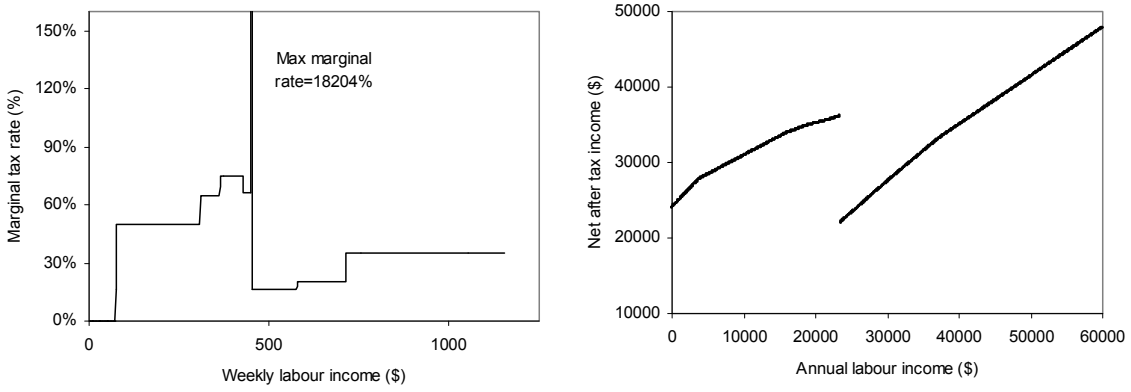
a The difference between this chart and figure K.11 is that it takes the impact of the current 15 hourly threshold for *continued* eligibility for the DSP into account.

Data source: Commission calculations.

Changing to a 30 hour ceiling (at the minimum wage) shifts the point at which this high tax rate applies to annual labour income of around $18 500, encouraging people to work longer, and providing them with a better standard of living (figure K.13).

Figure K.13 **The proposed new arrangements have improved incentives to work**[a]

Under the proposed 30 hour work test



a The difference between this chart and figure K.12 is that it takes the impact of the proposed 30 hourly threshold for *continued* eligibility for the DSP into account (as compared with the 15 hour *entry* test to the DSP).

Data source: Commission calculations.

More accurate assessments

The Australian Government has brought forward the use of a significantly revised set of impairment tables in the JCA to September 2011, rather than January 2012 (Australian Government 2011b, p. 181). The modified JCA will focus more on ability, rather than inability. All DSP claimants (excepting manifest cases) will need to provide evidence that they have tested their future work capacity by participating in training or work-related activities. The latter measure is expected to save $196 million in gross terms from 2011-12 to 2014-15, but requires around $145 million of costs to achieve that saving, with a net budgetary saving of around $50 million. (This is beyond the savings anticipated in the 2010-11 Budget.) Daniels et al. (2011, p. 8) suggest that most of the savings will arise because DSP claimants will move to another lower-value income support measure, such as Newstart. However, the research by Cai et al. (2005, 2007) suggests that the outcomes may be more positive for people who have not had a long period of prior unemployment before applying for the DSP.

The Government will also audit a sample of DSP claims (Australian Government 2011b, pp. 178–179). Health Professional Advice Units located in Centrelink offices help DSP assessors to make a fully informed assessment by providing specialist medical and rehabilitation advice. This measure will draw on the expertise of the units to audit one per cent (some 1,612 claims) of recent DSP claim assessments over a 12 month period in 2012-13. The audit will help identify any deficiencies or inconsistencies in the current process.

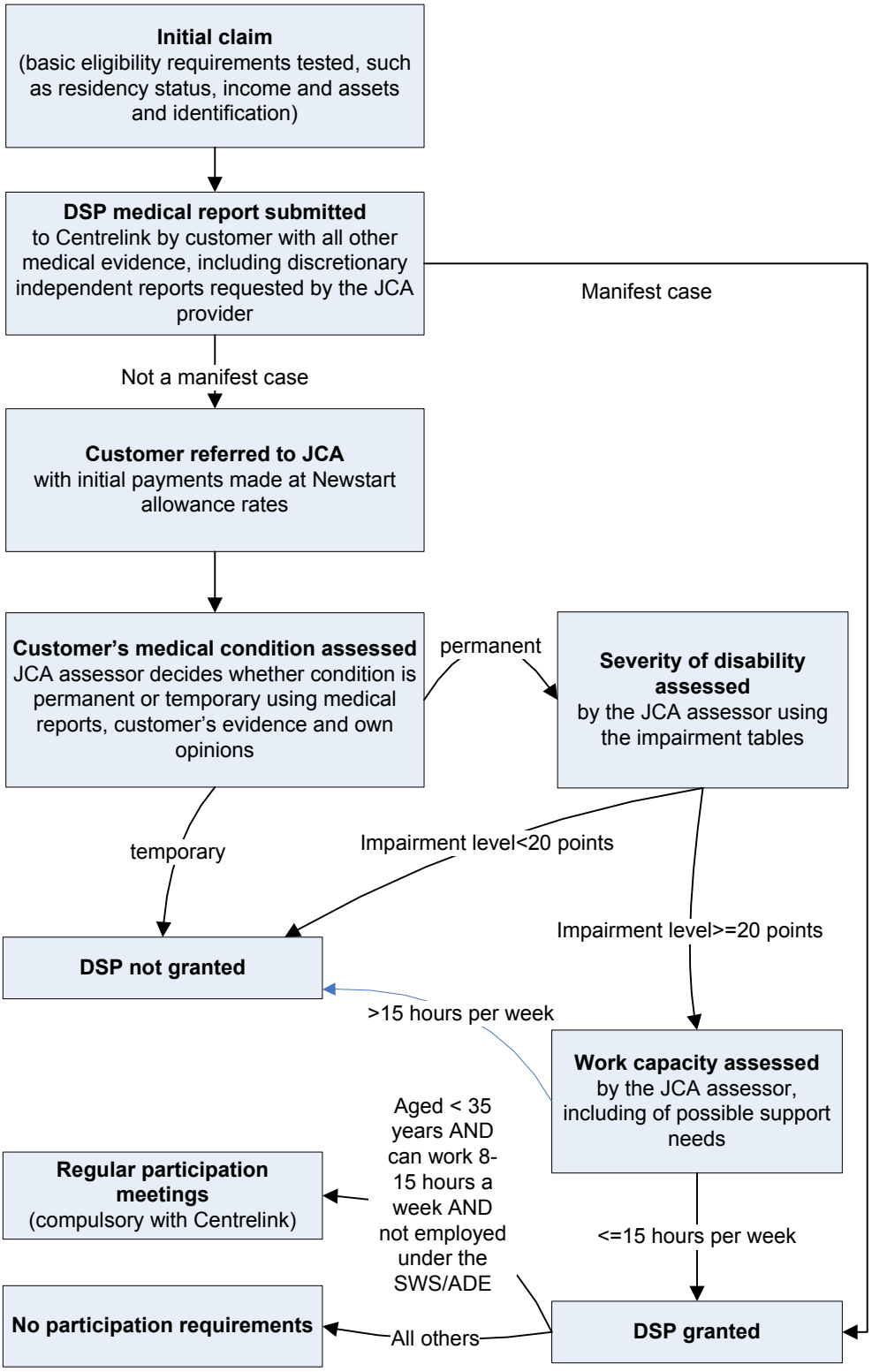
One of the lessons from the work of the Commission on the NDIS is the critical need for a valid instrument with high test-retest reliability and good inter-rater reliability (an issue explored for test instruments more generally in chapter 7). Of the above three requirements for a good assessment tool, inter-rater reliability is as much an outcome of the training and supervision of assessors, as it is the nature of the assessment instrument. The Commission has proposed tight controls on the assessment arrangements in the NDIS, recognising that this can be a source of cost blowouts. The same principles apply to the implementation of the JCA. There would be significant benefits from monitoring the decisions of people determining eligibility for the DSP (and of the distribution of outcomes for any given Centrelink office) to ensure that inter-rater reliability is high. For example, a Centrelink decision-maker with a consistently higher approval rate for DSP that was not explained by the nature of the local disability population and applicant types would be re-trained or mentored. This would prevent assessors/decision makers from overlaying the assessment tool with their own implicit criteria and avoid outcomes such as a assessors who are consistently overly harsh or generous in their assessments. A tool is only as good as its assessors and the governance arrangements that supervise them.

Participation requirements for some DSP recipients

The pathways to DSP have become more nuanced (figure K.14). From 1 July 2012, new and existing DSP recipients aged less than 35 years who have an assessed work capacity of eight or more hours a week will be required to attend periodic participation interviews with Centrelink to develop participation plans (Australian Government 2011b, 2011c).

Figure K.14 **The DSP assessment process**

Post 1 July 2012 arrangements



[a] SWS is the supported wage system, while ADE are Australian Disability Enterprises.

These plans are intended to 'help them build their capacity and, potentially, lead to employment'.[11] Interviews with Centrelink will be held on a quarterly basis for the first 18 months after recipients receive the payment and then twice a year. Participation interviews will continue while the recipient is under the age of 35 and maintains a partial work capacity. This approach has large similarities with the UK Pathways-to-Work program, which requires that participants must see a personal adviser regularly.

The DSP plans could involve undertaking programs with employment services, training, rehabilitation or volunteering. The assessment resources and supports required for this measure is predicted to cost the Australian Government just over $90 million over the four years from 2011-12 to 2014-15. The Budget papers do not take account of any savings in DSP payments associated with increased participation by DSP beneficiaries.

Assessing the possible impacts of these reforms

The 30 hour concession

As shown by the differences between figures K.12 and K.13, the capacity to work up to 30 hours a week and retain the DSP represents a significant shift in the incentive to work. However, there are some wrinkles in this story.

It may result in cyclical working

People only get a two-year window in which they can work between 15 and 30 hours a week and retain a part pension (subject to the income test). After the two-year period has elapsed, people would need to drop back to less than 15 hours a week to satisfy the CITW test. Accordingly, while the details of the policy are not yet fully developed, applying the current CITW after a period when someone has worked above between 15 and 30 hours may encourage people to cycle between jobs with less than 15 hours and jobs between 15 and 30 hours with a two-year frequency.

11 FaHCSIA (2011b) *Budget Statement, 2011-12*, p. 18.

People may worry about 'review risk'

Among other factors, the effectiveness of the 30 hour concession depends on the extent to which a person's chance of passing re-assessment reviews of future DSP eligibility is affected by a previous period of working while on the DSP.

To understand people's perceptions about 'review risk', it is important to understand how assessment reviews are undertaken. Centrelink reviews people's eligibility for DSP (Australian Government 2011c) when:

- statistical profiling identifies them as having the greatest risk of no longer being eligible for DSP
- Centrelink considers a person may not be qualified for DSP for reasons other than those disclosed by profiling. For example, that might occur if a third party provided information about doubtful eligibility.
- where the person indicates that they are interested in being assisted back to work.

On the positive side, the review process is important because it can (in principle) enable Centrelink to identify people whose medical conditions or/and capacity to work has improved. That might lead to cancellation of payments and direction to job-oriented supports. The targeted nature of the process means that not all DSP beneficiaries are reviewed, which is appropriate for many manifest cases (for example, someone with terminal cancer or a very severe permanent cognitive impairment).

On the other hand, while there are strong grounds for a review process, certain types of review arrangements can undermine people's willingness to work. People on DSP may often worry that working beyond a certain number of hours *during* the two year grace period would increase the likelihood of a work test review (and its failure) after that period had elapsed (with loss of the DSP and of some of its related benefits). The calculation of effective marginal tax rates should reflect people's uncertainty about the likelihood of failing future reviews.

For example, suppose that someone gains entry to the DSP and can work 14 hours a week. Under the policy changes proposed for 2012, they could obtain a 28 hour a week job at $15 an hour for two years and retain a part pension while working (but could not do so currently). However, they may well be reluctant to take such a job if it 'revealed' a capacity to work 15 or more hours a week and therefore ineligibility for the DSP after the two-year period. If this is how assessments were undertaken (or if people *believed* that was how they would be done), then working 15 hours or more per week in the two year period would, in effect, be playing dice with future

income security, with the dice increasingly loaded against the person the closer they got to the 30 hour limit.

Figures K.15 to K.18 (based on the methodology described in box K.3) illustrates the effects of uncertainty.

They show that once the risk of losing the DSP is factored into the analysis, it is easily possible to have very high marginal taxes on income derived from working at 15 hours or more per week for periods up to two years. The impact on people's total take home pay depends on how they achieve given labour earnings. This reflects the fact that for given labour earnings in the two year grace period, different combinations of hours worked and job duration are likely to have differing impacts on the probability of subsequent review failure (with its loss of DSP entitlement).

Currently, FaHCSIA have not made a decision about the exact nature of the processes that would apply after introduction of the new policy proposals. Even though it would be inconsistent with the original criteria for entry (<15 hours), there are grounds for choosing a different work test for people who are *already* on the DSP (chapter 6). Once uncertainty is taken into account, a 30 hour work test or indeed no work test for those already on the DSP would provide a greater encouragement to work.

The Commission considers the possible policy responses to the above concerns in chapter 6.

Changed assessment and participation requirements

Tightening of the assessment requirements and the introduction of some participation requirements (with some additional job supports) are likely to increase employment for some people with disabilities. However, some have expressed scepticism about the likely size of the effect given past attempts to constrain entry into the DSP.

Analysis by the Parliamentary Library expressed scepticism about the likely effectiveness of this strategy noting that:

> Given that 34 per cent of DSP grants are actually transfers from NSA [Newstart], it appears that members of this group would already have been exposed to a period of work search and work related activities. … It remains to be seen how effective this new 'severely impaired' classification will be. The, then, tough DSP changes under the WtW [Welfare to Work] programs of 2006, and their limited impact post 2006, suggest that where you set a test or a higher hurdle, DSP claimants will rise to meet the new test. (Daniels 2011, p. 13)

Box K.3 How uncertainty can act as a work disincentive

Several factors influence people's employment decisions, but monetary gain is one of them. Depending on the severity of his or her disability and the receptiveness of the local labour market, a DSP beneficiary seeking to work faces some choices about the hours of work and the duration of a job. The calculus for this decision has altered with the policy changes to be implemented in 2012. Given the policy change, there are two important choices for people with some capacity to work that influences the likelihood of future welfare benefits:

(a) A person could work more than 30 hours, but that would usually make the person worse off in monetary terms, unless she or he secured a full-time or/and highly paid job. This is because working above 30 hours would result in cancellation of a partial DSP benefit and the removal of other welfare benefits.

(b) A person could choose to work some amount of hours up to 30 hours for some of the two year period. *If* the entry work test of 15 hours applies after the two year period, then the closer a person got to 30 hours and the longer the duration of the job, the more likely that, after a person reduced their hours back to less than 15 hours after the two year grace period, they would get and fail a review (or perceive such as risk). This reflects that work tests typically take account of a person's past employment history. In effect, they would have revealed a work capacity of 15 hours or more. For instance, it would raise doubts that a person was unable to work 15 hours or more if they worked at 30 hours a week for 103 weeks and then reduced their work hours to 14.5 hours. It may be that their disability had increased in severity, but many people would be concerned that their work history would affect the result of any JCA review.

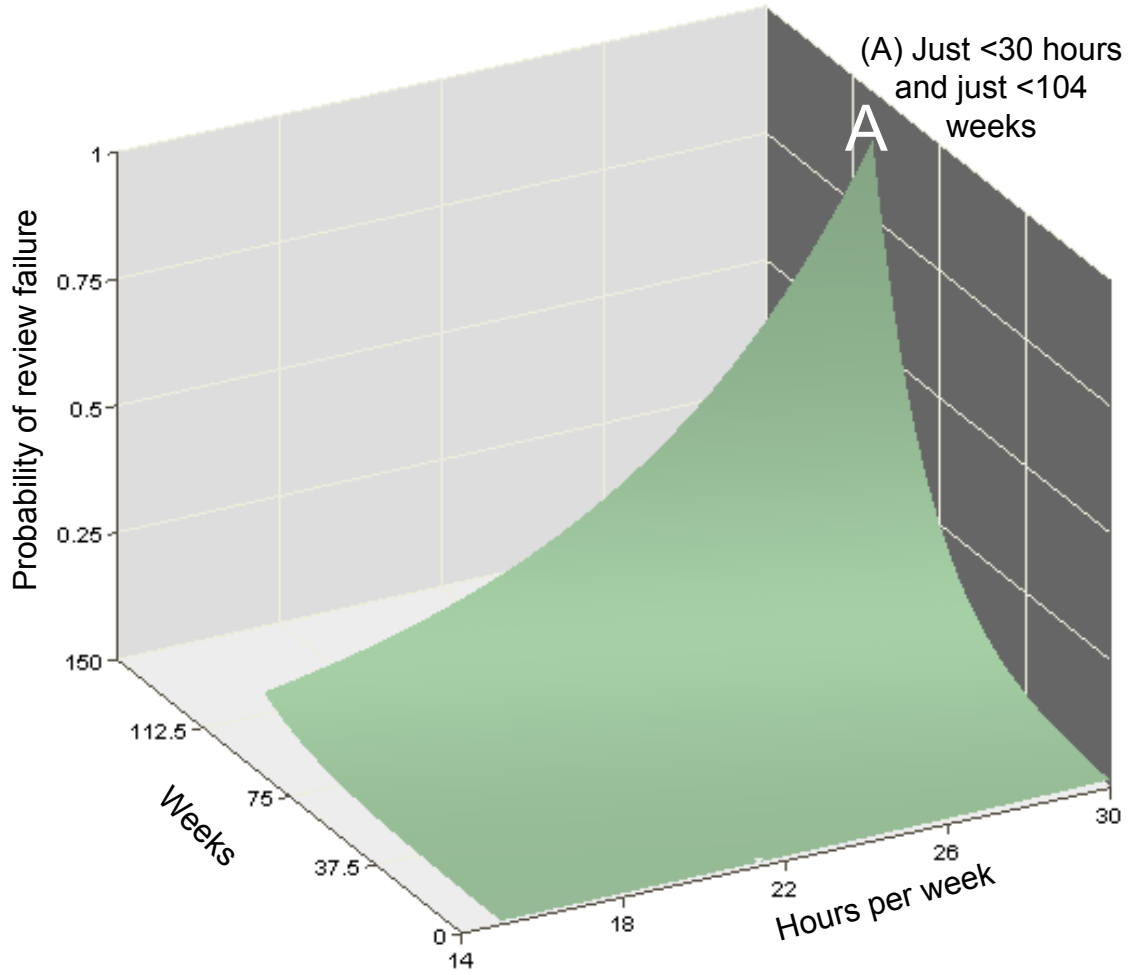
Modelling the effects of the uncertainty associated with the impacts of future reviews is complex. This reflects a variety of problems. We do not know how choices of hours and the duration of work up to the two year grace period jointly affect the probability of subsequent review failure. Finally, the time of any review after the two year period is also likely to be a function of the person's choices about hours and period worked within the two year period. So, for instance, it would be more likely that a person working 29 hours for close to two years would be reviewed soon after the 2 year grace period than someone working 16 hours for one year — and that affects the people's expected duration on benefits after the two year period.

Given this and other complexities, the Commission has constructed a (relatively simple) illustrative model that highlights the problems potentially posed by a two-year limit combined with a 15 hour work test after the two years. The Commission:

- examines the income consequences for various choices of working hours per week (above the 15 hour level) and weeks worked (up to the two year limit). We assume that no one works 15 hours or more after two years, given the penalties involved. The wage rate is $15 an hour
- assumes that the two year period starts on 1 July (to make tax issues more simple)
- assumes that the probability of failing a post two-year review is an exponential function of the hours worked and job duration during the two year period, with the probability of failure for any given combinations, a multiple of the two exponential functions (we assume 'independence'). So, for example, Prob(hours) = $\alpha \times \exp(\text{hours}/\beta)$ measures the probability of failing a post-two year review as a function of hours worked. α and β are worked out by assuming that Prob(30)=0.9 and assumptions about the probability of review failure when a person works at the midpoint of the available hours (22.5 hours). A similar assumption applies to the exponential function as a function of job duration.
- assumes that people are on benefits for five years after the two years has elapsed. In the event that a person does not fail a review, it is assumed that they retain a partial DSP and work just less than 15 hours a week for the five years. In the event that they fail a review, they give up their job and get Newstart allowance for the five years (since working for just under 15 hours a week without the DSP would make them poorer than being on Newstart) and that while on Newstart they work for 15 hours (under the partial capacity rules). All income values are in present value terms.
- estimates the expected total take home income (EY) of people as a function of their choices of hours and job duration, also taking into account the probabilities above, tax rates, and the various tapers and provisions of the welfare system. We also estimate the gross labour income (LY) as a function of hours and job duration. Then it is possible to examine the effective incremental tax rate as $100 \times (1-\Delta EY/\Delta LY)$ where ΔEY relates to any change in income due to changes in hours or job duration.

The model is only illustrative and has some unrealistic elements, but it serves to show that marginal tax rates on current labour income can be much higher when people take account of the risk of the withdrawal of future welfare entitlements.

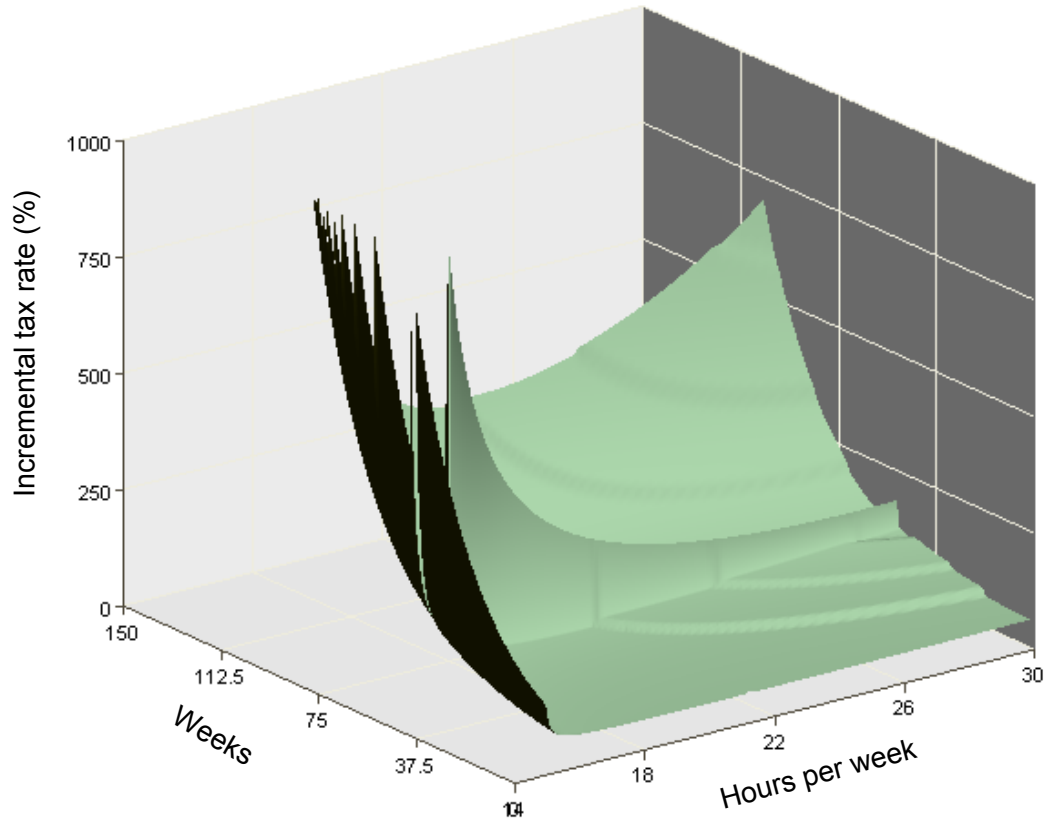
Figure K.15 **Probability of failing a CITW review**[a]



a This shows that as people work more hours per week or more weeks over the 104 week 'grace' period, the probability of a subsequent CITW review (based on 15 hours) finding them able to work increases — or people believe that is so. The probability distribution is assumed, since there is no actual information yet on review findings as a function of past work history. Box K.3 describes the distributional assumptions. The point A is close to 1 — that is, someone working at close to the maximum hours per week for just up to two years is assumed to face a close to 100 per cent probability of a review and then failing it.

Data source: Commission calculations.

Figure K.16 **Incremental tax rates by choice of working intensity**[a]

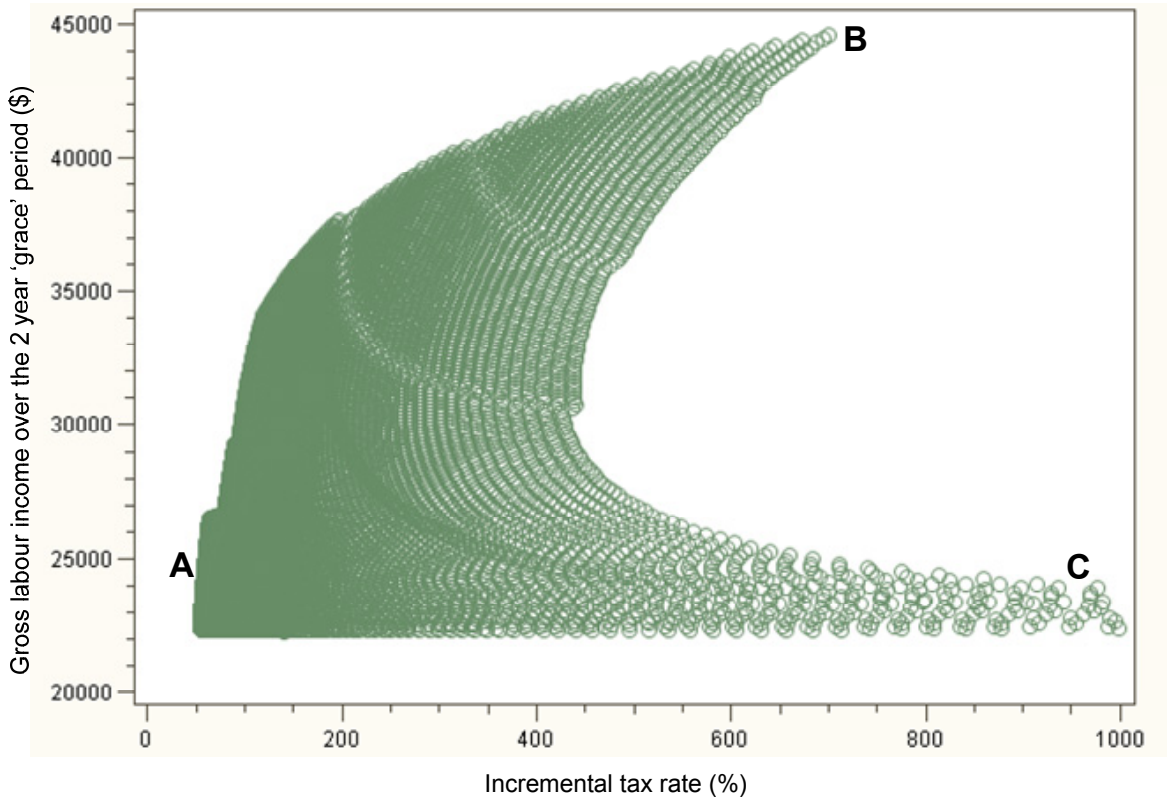


[a]This shows the incremental tax rates at various combinations of hours per week (15 to just under 30 hours) and weeks worked (from 0 to 104 weeks). Box K.3 describes how the tax rate is calculated. The overall picture reflects figure K.15 above. As people work many weeks or many hours per week, they face an increased probability of failing the test, and therefore losing access to the DSP after the two year grace period. So the benefits from working in the grace period are offset by the *expected* costs of losing access to the DSP in later years, and then relying on a lower value payment. The various 'spikes' reflect the impacts of taper rates.

Data source: Productivity Commission calculations.

Figure K.17 **Effective tax rates on labour income when people think about the future risks of losing the DSP**[a]

When people can work up to 30 hours for a two year grace period

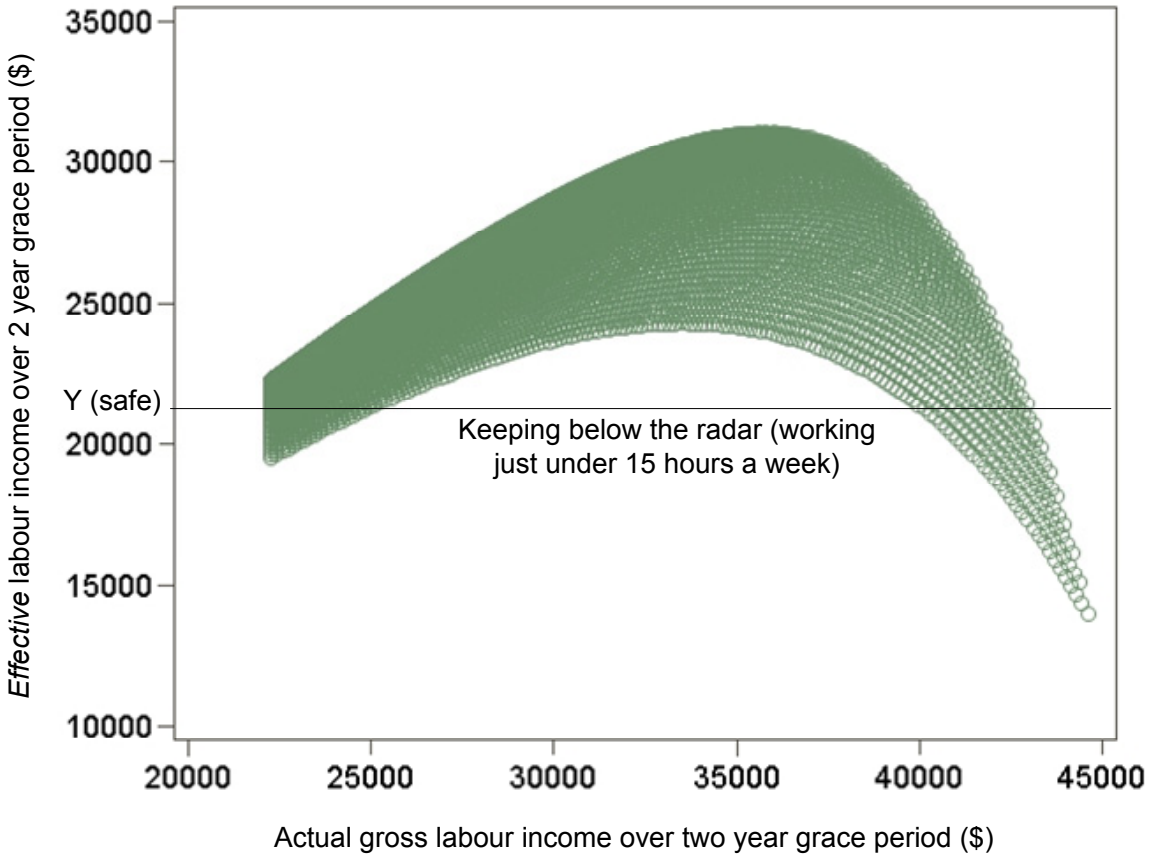


a The calculations are based on the methodology spelt out in box K.3. The graph shows the relationship between the labour income of people over the two year grace period (based on their choices of hours and job duration) and the effective tax rates they face on that income (depending on the various choices they make on hours and job duration to earn that labour income). Someone at point A earns as much gross labour income as person C. However, for someone at A, every new dollar of labour income is taxed at a much lower amount that someone at B. The reason for this is that a person working just above 15 hours a week for one week, and below 15 hours a week for 103 weeks (like person A) earns much the same in gross terms as a person working at just over 15 hours a week for 103 weeks and for only one week at less than 15 hours (person B). Yet B faces a higher probability of failing any CITW review than A. Failing the CITW test after 104 weeks means that a person's subsequent income falls (with the estimated loss implicit in the above calculations based on lost income over the five years after the two year grace period.) In other words, working in the grace period *does* increase earnings in that period, but can involve greater losses in the subsequent five years. Someone working at B has a 'high' gross income in the two year period because they work long hours and for many weeks, but they do poorly in the subsequent five years, leading to high incremental tax rates.

Data source: Commission calculations.

Figure K.18 **The gap between actual gross labour earnings and expected effective labour earnings when people think about the future risks of losing the DSP**[a]

When people can work up to 30 hours for a two year grace period



a The calculations are based on the methodology spelt out in box K.3. Once the probabilities of losing future access to the DSP is taken into account, the effective labour income during the two year grace period can be less than the income the person would have earned had they stayed below the original 15 hour limit (Y safe). These calculations are based on a situation in which a person needs to cut their working hours below 15 hours at the end of the grace period, or thinks they may need to do so. The outcomes would be better if people were confident of working longer hours into the future, but that certainty does not exist for many people with disabilities, because the work-debilitating aspects of disability can be episodic.

Data source: Commission calculations.

Certainly, the evaluation of the past WtW changes (DEEWR 2008) found relatively small changes in inflows into the DSP from, what at that time, was seen as a significant toughening of entry requirements (changing the CITW from 30 hours to 15 hours). In part, that reflected the parallel introduction of activity requirements for parenting payments, which led to more applications for the DSP, some of which were successful. Moreover, the use of the new screening instrument, the Job Capacity Assessment, identified more people with a permanent condition, again swelling claimant numbers.

Nevertheless, DEEWR (p. 49ff) found that, under WtW, people who would previously have qualified for the DSP, but were now on Newstart or Youth Allowance, had a higher chance of securing a job because of the participation requirements of the latter income support categories. (They tended to get part-time jobs paid just above the minimum wage.)

Accordingly, while it is important not to overstate the likelihood of large changes in inflows (and particularly outflows), the experience with WtW suggests that the recent reforms will produce some outcomes. The combination of more accurate assessments, some targeted participation requirements, and additional employment supports associated with the forthcoming DSP reforms is likely to produce some positive employment outcomes (with some economic and fiscal benefits) and lower transition rates from lower paid income support payments (which would mostly be fiscal gains).

This is supported by various reviews of the UK Pathways to Work program — the UK 'sister' program to the new Australian participation approach (Dorsett 2008 and Adam et al. 2010). These studies found employment benefits for some, but not all, groups.[12] For example, one study concluded:

> Using a cost-benefit analysis based on simulating the effect of the policy on incapacity benefit recipients and micro-simulating the tax and benefit system, we find that the programme exhibits positive financial gains for both the individuals and the government, even under conservative assumptions. (Adam et al. 2010).

Further reforms of the kind mooted in chapter 6 are likely to reinforce the gains from the Australian initiatives already in train.

[12] These were mainly women who would have left the benefit anyway, but who then returned to a job rather than to no job. Adam et al. (2010) generally found low program impacts for men, people suffering from a mental health illness or those with long-duration claims (which collectively constituted the largest share of incapacity benefit claimants).