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**Towards a Stronger, More Equitable and  
Efficient Tax-Social Security System:  
Overview of the Castles Tax and Social  
Security Roundtable**

***Dennis Trewin***

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## **Towards a Stronger, More Equitable and Efficient Tax-Social Security System Overview of the Castles Tax and Social Security Roundtable**

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### **Introduction**

**H**ow can the Australian tax system best interact with the social security system to advance the social wellbeing of our national community? Is it also possible to substantially increase the efficiency and/or operational simplicity of the tax and transfer (or social security) systems?

Social equity and systemic efficiency were two of the main themes arising from a joint roundtable held by ANU National Institute for Public Policy, HC Coombs Public Forum, the Academy of Social Sciences and the Australian New Zealand School of Government on 12/13 October 2011. This event brought together policy advisers from Treasury and the Department of Family and Community Services, Housing and Indigenous Affairs (FaCSHIA) and other relevant departments with research experts from academia and elsewhere. The objective was to examine and assess those recommendations of the Henry and Harmer Reports that deal specifically with personal income tax and family assistance; the structure of social security pensions and benefits (eligibility, rates and means tests) and the interaction between these including the impact of effective marginal tax rates; and superannuation.

The participants were asked to identify shorter-term priorities as well as assess whether the proposed architecture would satisfy the objectives of the tax and social security systems and provide a coherent long-term framework. Many of the conclusions arising from the roundtable (and those from the Henry Report) are not expected to be implemented in the short term: their implementation is most likely to take place over several governments. This will require that the strategic direction of reform is widely accepted so that there can be some continuity across governments. Short term politically based decisions need to be avoided.

This roundtable was held in memory of Ian Castles, who passed away in 2010. As a long time senior member of the public service, including as the Secretary of the Department of Finance and the Australian Statistician and Deputy Secretary at the Department of Prime Minister and Cabinet, Castles dedicated much of his substantial professional career to reforming the tax and transfer system. He was also an active leader within the Academy of Social Sciences for many years. A more richly detailed tribute to Ian Castles' contribution can be found in Professor Andrew Podger's tribute also published as part of this set of papers.

### **Context: lead up to a roundtable**

Between 2009 and now, taxation reform in Australia can be divided into four phases. First, there was the report from the Pension Review led by Dr Jeff Harmer, then Secretary of FaCSHIA, which was published in February 2009. As well as an important input into the Review of 'Australia's Future Tax System', it led to the Government's Secure and Sustainable Pensions Package, a suite of measures affecting age, disability and carer's pensions. Second, there was the report presented to the Treasurer in December 2009 by then-Treasury Secretary Ken Henry on behalf of the Review team, titled 'Australia's Future Tax System' (better known as 'the Henry Report'). This was a



comprehensive review of the whole Australian tax and transfer system, the term of reference most relevant to this roundtable being 'improvements to the tax and transfer payment system for individuals and working families, including those for retirees'. The third phase of reform took place sporadically throughout 2010 and 2011, as the Federal Government attempted to implement some of the recommendations and rejected or modified other recommendations contained in the Henry Review. This included a variation on the Henry Review's call for a non-renewable resources tax, and an announced lift in the superannuation contribution rate, from 9 per cent to 12 per cent of salaried income (subject to conditions) which was discussed in the Henry Report but not recommended. The most recent phase came in early October 2011, when a public 'Tax Forum' was convened by the Government at Parliament House. With a large number of political, industry, union, NGO and academic leaders present, a public discussion of tax policy was held over two days in a nationally televised event. One session was devoted to the tax and transfer system. While the nature of the forum did not lend itself to detailed study of the issues, it does seem to have succeeded in ensuring more active consideration of outstanding aspects of the Henry Report and several of the recommendations were put back on the policy agenda.

The Castles Roundtable partners consciously tried to complement the Tax Forum by focusing discussion on a particular aspect – the personal income tax and social security system, especially the connection between them – and choosing a format which would encourage freewheeling but expert discussion of trends and challenges. This proved to be very effective.

#### **Some overarching comments**

My overall impression from reading the background papers and from discussions at the roundtable is that the Australian tax and transfer system is quite good by OECD standards. That is not a reason for complacency. Indeed the roundtable (and the Henry and Harmer Reports) identified a number of areas for improvement.

The main reasons I make these positive comments about the Australian system are that, compared with other OECD countries, (a) targeting (aided by means testing) is the most effective and 'middle class' welfare is the lowest and (b) the system is far more financially sustainable than those in most OECD countries particularly the European systems as evidenced by some of the current financial problems facing Europe. There is good reason to build on what we have rather than 'start from scratch'. This was essentially the approach of Henry and Harmer. Most of the roundtable's discussion revolved around the Henry Report. The Harmer Report provided excellent background material to support the discussions on pensions and benefits and retirement incomes. Means tests are an important element of the Australian social security system. The Henry Report put forward proposals for revising the means tests, arguing for a more consistent approach to means testing including through the removal of the assets test but inclusion of deemed income from all relevant assets, including superannuation, as part of the assessed means. The recommendations to retain Australia's emphasis on means testing had the strong support of most participants at the roundtable, although some were less positive about means testing family allowances.

The roundtable supported the proposed values (see Box 1) and the guiding principles of equity, simplicity, sustainability, consistency and efficiency for policy reform that were first articulated in the Henry Review. (See Box 2).

**Box 1: Proposed values used by the Henry Committee**

- a desire to encourage workforce participation;
- the need to promote human capital investment through improved childcare and education opportunities;
- an outward approach to Australia's place in the world;
- pragmatism, recognising the need for an incremental approach to reform;
- an appreciation of the need to balance the standard objectives of the tax-transfer system.

*Source: Presentation by John Piggott (a member of the Henry Committee)*

**Box 2: Design principles for the tax and transfer system**

**Equity**

The tax and transfer system should treat individuals with similar economic capacity in the same way, while those with greater capacity should bear a greater net burden, or benefit less in the case of net transfers. This burden should change more than in proportion to the change in capacity. That is, the overall system should be progressive. Considerations about the equity of the system also need to take into account exposure to complexity and the distribution of compliance costs and risk.

**Efficiency**

The tax and transfer system should raise and redistribute revenue at the least possible cost to economic efficiency and with minimal administration and compliance costs. All taxes and transfers affect the choices people and businesses make by altering their incentives to work, save, invest or consume things of value to them. The size of these efficiency costs varies from tax to tax (see Chart 1.5 in Box 1.1<sup>1</sup>) and from transfer to transfer, reflecting, in part, the extent to which they affect behaviour. Instability in policy settings can reduce economic efficiency by increasing uncertainty about the expected payoffs to long-term decisions such as investing in education, choosing retirement products, investing in long-lived productive assets and the choice of business structure. These costs represent a net loss to society as a whole, whereas revenue raised through a tax is redistributed among members of society through government expenditure, including transfer payments.

**Simplicity**

The tax and transfer system should be easy to understand and simple to comply with. A simple and transparent system makes it easier for people to understand their obligations and entitlements. People and businesses will be more likely to make the most beneficial choices for themselves and respond to intended policy signals.



A simple and transparent system may also involve lower compliance costs for taxpayers and transfer recipients.

**Sustainability**

A principal objective of the tax system is to raise revenue to fund government programs, including transfer payments. The tax system should have the capacity to meet the changing revenue needs of government on an ongoing basis without recourse to inefficient taxes. To be sustainable the tax system, together with the transfer system, must contribute to a fair and equitable society. The cost of the transfer system needs to be predictable and affordable in the light of demographic change. Sustainability also means that the structural features of the system should be durable in a changing policy context, yet flexible enough to allow governments to respond as required. Legal and administrative institutions and frameworks should also be robust to maintain the effectiveness of the system and underpin the legitimacy of the system. Policy settings should also contribute to environmental outcomes that are sustainable.

**Policy consistency**

Tax and transfer policy should be internally consistent. Rules in one part of the system should not contradict those in another part of the system. To the extent possible, tax and transfer policy should also be consistent with the broader policy objectives of government. However, the primary objectives of the tax and transfer system, to raise revenue and provide assistance to those in need, should not be compromised by other policy objectives.

*Source: Henry Review, "Australia's Future Tax System": 17*

Data and analysis is extremely important to effective redesign and adjustment of the systems. This became very clear on a number of occasions during the roundtable discussion where evidence challenged popular orthodoxies. For example, analysis demonstrated that there have been some structural reductions in the number of older persons receiving Disability Support Pensions in recent years (i.e. the age specific rates of those receiving DSP at older ages had fallen) largely due to changes in eligibility for related payments such as wife's pensions and age pensions for women aged under 65. On the other hand, adjustment of payment rates (such as the decline in the real rate of Newstart Allowance) had had no demonstrable effect on workforce participation. Retirement behaviour was a further area where better data and analysis might help with the formulation of policy. Another issue discussed in the roundtable concerns the workforce behaviour of mothers of dependent children where data has improved but more is needed. Better data offers the potential to design a more effective and efficient tax and transfer system and so is a good investment.

**Key issues in the design of the tax/transfer system**

The roundtable identified many issues impacting on the tax/transfer systems. Only some of the more important are discussed here.

First, it is necessary to look holistically at the tax/transfer system including consideration of both horizontal and vertical equity. The connections between the tax and transfer systems are strong. Also, there are connections between the different components of the transfer system. In considering reform, there tends to be too much emphasis on



individual components rather than the whole, combined system. This was demonstrated by the narrow terms of reference of the Harmer Review which focused on age and disability pensions, unwittingly perhaps exacerbating inconsistencies with other social security payments and not fully addressing linkages with superannuation arrangements. The Henry Review has gone some way towards addressing these issues.

Second, financial sustainability is a key consideration. Questions were raised about the sustainability of the current system. Two specific concerns are the rapid increase in income tax as a proportion of the total tax take; and the generous superannuation provisions. Both place considerable stress on sustainability. There are many modifications to the current system that might appear 'fair' but their long-term cost may simply not be affordable. Furthermore, future demographic changes are going to put more pressure on the tax/transfer system.

Third, as Henry emphasised, it is important that reforms do not remove work incentives for the working age population. It was also a clear goal of the terms of reference, viz "The review should take into account the relationship of the tax system with the transfer payments system and other social support payments, rules and concessions, with a view to improving incentives to work, reducing complexity and maintaining cohesion."

However, the roundtable raised questions about whether there was a full understanding of incentives and disincentives. In Henry and elsewhere, there is a lot of emphasis on reducing high effective marginal tax rates because of their impact on work incentives. However, the roundtable suggested that these were not the main issues raised by people when questioned about what was preventing them from working. Rather, the issues raised were the high cost of childcare, lack of public transport, absence of support services and poor health. There needs to be a better understanding of the actual barriers and the impacts of incentives when designing programs. This may be a topic where additional research is justified as labour market responses of the target group are clearly not based on the incentive impacts alone.

Fourth, and related to this third issue, studies have shown that a most effective way of targeting payments through the social security system is through criteria for eligibility for different forms of income support. Eligibility criteria such as work tests can also be an effective way of encouraging people of working age (and able to work) to seek and obtain work. Analysis of the effectiveness of eligibility criteria is an important consideration in the design of programs. There is a mantra by some policy makers and public commentators that reducing benefit rates in real terms will automatically boost the rate of workforce participation. This rhetoric is not matched by statistical data.

Fifth, while coherence and consistency is essential to good policy, heterogeneity is also an important consideration in the design of programs. Looking at income alone does not recognise the diversity of circumstances of the people who may have the same income level. There may be very good grounds for the system to differentiate between someone who earns a particular income level from 10 hours work and someone who has to work 38 hours to generate the same income. The current system largely treats these situations as the same. For example, some people may only be seeking part-time work because of their particular circumstances (e.g. caring responsibilities). Heterogeneity of personal circumstances is a factor that has to be taken into account when designing programs. Using the analogy of a hole in the ground, it is necessary to distinguish those who simply need a ladder to enable them to climb out of the hole from those who need to be taught how to use the ladder.



Sixth, changing demographics are a consideration for the design of the programs. Some are obvious such as the ageing of the population. Others are less obvious. For example, an increasing proportion of children are being brought up in low socio-economic areas. Programs need to be designed to ensure these children are not caught in a low socio-economic poverty 'trap'. Programs addressing this reality may actually have the greatest long-term benefit.

Seventh, the tax/transfer system is complicated. Few people understand it, including those who are participants in the transfer system (including through superannuation). Given this, it is not surprising that expected changes in behaviour don't always happen. Improved communication with participants may lead to the more desirable behaviours being sought by policy makers.

As a specific example, few Australians are taking advantage of the benefits of annuitising their investments even though a high proportion take out a lump sum on retirement (which is poorly invested in many cases). Voluntary contributions are also low. Yet this is an area of personal investment and income that is taxed lightly when compared with income from other assets. Greater public understanding of how superannuation works might change behaviour. The public interest may be greatest at present given the impact of the GFC on the retirement savings of many people.

Eighth, the roundtable felt that the Henry Report paid insufficient attention to superannuation benefits, especially how to best manage de-accumulation. The exception was the management of longevity risk although the government initially rejected the recommendations even in this area. The roundtable took the opposite approach to the original position of the Government in that it supported action by the Government to establish a market for annuities to manage longevity risk whereas it did not think the 12 per cent superannuation guarantee was providing much assistance to those employees most in need of a boost to retirement savings. The Henry Report also argued that its recommended changes to superannuation tax would provide a greater benefit to national savings than an increase in the super guarantee to 12 per cent.

### **Barriers to the redesign of the tax/transfer system**

Redesign of the tax/transfer systems will always be difficult. They are complex systems with many vested interests. It is almost inevitable that redesigns will result in 'winners' and 'losers' and, particularly in the current political environment, the 'losers' have many ways of expressing their concerns in a very public way. Some of the main barriers are set out below.

First, lobbying on the tax/transfer system is most often driven by short-term considerations and self-interest. There is insufficient consideration of a longer-term holistic view which is important when so much of the tax/transfer system is so interconnected. This point was reinforced by the October 2011 Tax Forum. The majority of speakers only addressed their own area of concern rather than the tax/transfer system as a whole.

Second, there is at present a lack of political leadership, or even political courage, to substantially reform the tax/transfer system. The piecemeal treatment of the Henry recommendations, following the partial approach embodied in the earlier Harmer terms of reference, is evidence of this. The Government and Opposition seem to be driven by the election cycle and (not always well informed) public opinion rather than the long term



good of the country. This is perhaps not surprising given the relatively short period between elections in Australia.

Third, fiscal considerations are a real and substantial constraint. At present, the Government is putting a lot of emphasis on reducing the size of the deficit while continuing to face modest economic growth, making it hard to compensate 'losers' from any reforms and thus limiting what politically can be undertaken. That will not always be the case. Hopefully, in the future, the economic and fiscal situation will be such that it will not be such a barrier to redesign of systems. Furthermore, is this focus on 'losers' and the use of grandfathering provisions prudent? Although it may be politically difficult to achieve, it may be better policy to withdraw benefits that are no longer warranted.

Fourth, public values and attitudes towards the tax/transfer system can be a significant barrier to reform, especially if they are regarded as politically important. In Australia, there almost seems to be a competition over which party is toughest on working age income support recipients, because that is the electorally popular position, making reconsideration of the size of the benefits more difficult. A recurring theme at the roundtable was the large funding gap between the 'deserving' and the 'undeserving' poor. Many participants expressed their concern over the growing gap in the different rates of support payments received by different categories of welfare recipients. If the purpose of social security payments is to meet the minimum living costs for all those in need, then it is not meeting this purpose for the apparently 'undeserving' poor. Whilst social transfer payments to age pensioners and DSP recipients have, over the past decade, increased faster than cost-of-living price rises, the support rates received by the unemployed (through the Newstart allowance), who are also restricted in their income-earning capacity and in need of assistance to meet basic living expenses, are stagnating and failing to keep up with community living standards. Support for sole parents is also lagging behind that for age and disability pensioners. Fifth, the constraints provided by the Terms of Reference of the Henry Review were not always helpful. Two of the most important are the restriction on taxing superannuation benefits for those over 60, and the restriction on increasing or broadening the base of GST.

### **The way forward**

First, there is a need to agree on the objectives of the social security system, including retirement incomes. Henry has proposed Values and Principles, which were broadly supported by the roundtable, but they need to be complemented by an agreement on Objectives.

There seems to be some implicit agreement on the objectives. Some would argue that the main transfer payments are intended to support a basic quality of living below which no one falls. However, though such a policy position has never been explicitly stated in a government announcement, the logical conclusion to take away from the growing gap is that there is a distinction between different types of income support recipients. There is a decades-long history in the tax and transfers system of distinguishing between pensioners, the unemployed, and students. These same demarcations appear in the Henry Review. Using such efforts at classification does not necessarily call for the hierarchical distinction being made by governments when calculating the level of financial support that each of these groups should receive. The main argument government provides for making this distinction is to provide work incentives but there is little analysis of whether this works or whether the existing gap is necessary to provide those incentives.



It should be recognised that this is a long-term exercise, possibly as long as 15-20 years. As far as possible, political consensus should be reached on the key elements of the tax/transfer system such as the objectives, values and principles. This is more likely if it is treated as a long-term exercise. It can then provide a framework for future government consideration as fiscal and other circumstances change. It should be recognised that it may not be possible to receive sufficient consensus on all proposals and that some will need to be set aside.

It is important to share the problems and proposed directions with the community. They are more likely to accept change if they understand the reasons for change and have been able to contribute to a properly informed public discussion. Their views are often influenced now by perceptions and positions taken by 'opinion makers' rather than carefully explained facts.

The roundtable agreed on several changes that should be made. These include:

- Most agreed that increasing and indexing the tax threshold, as proposed by Henry, was a sensible step and could be done in the shorter term.
- The Newstart allowances need upward adjustment especially for the long term unemployed. This could be done in the short term and seems to have broad support apart from the two major political parties. Furthermore, there should be a common approach to indexation so that the gap does not increase in real terms.
- Considerations should be given to a broadening of the tax base including taxes such as the resources rental tax (subsequently implemented) and a financial transactions tax. The roundtable also encouraged consideration of increases in the level of GST. This may be the most efficient way of broadening the tax base, and the financial sustainability of the social security system may depend on it. The alternatives – increasing other forms of tax including income tax, or reducing government-funded programs – may be even less popular electorally than increasing the GST.
- The introduction of a consistent means test, and a revised treatment of assets in the means test, included the deemed income from superannuation assets (but there was no discussion on the level of the deeming rate).
- Programs should recognise the reality that part-time work may be the only possibility (because of constraints on the income support recipient or the lack of availability of full-time work) and be designed accordingly. There would have to be carefully designed conditions to avoid the use of transfer payments to subsidise part-time work where full-time work is an option.
- Eligibility criteria are important and should be carefully considered in the design of programs.
- Support for the Henry Report recommendation for wider reform of housing assistance especially rental assistance for those paying private market rents because of the lack of alternatives.
- There should be investigations of whether all income support payments should be taxed, especially as the move to higher tax thresholds will mean that most income support recipients would not pay tax in any case. It may well considerably simplify the interface between the tax and transfer system.
- Work should start on investigating how the Government can best establish a market for annuities as a form of longevity insurance given the expected demographic

changes. This would include the Government possibly selling lifetime annuities themselves to kick-start the market. (Subsequently, the Government has agreed to investigate annuities, and how best to stimulate Superannuation Industry support for them.)

- Whilst the roundtable was able to reach agreement on a number of issues, it could not reach a common view on the best way of treating family assistance. There remained a divergence of views even after a lengthy discussion.

Although the roundtable was somewhat critical of some of the Henry recommendations, the majority of the recommendations dealing with the tax/transfer payments system were either supported or largely supported. The Henry Report has provided a strong base on which to build a much better tax/transfer system and should be considered in that context.

Overall, it was a very worthwhile day but there needs to be continuing dialogue on the issues with increasing focus on the specific details and greater involvement of the most important stakeholders.



***Dennis Trewin was the Australian Statistician and head of the Australian Bureau of Statistics from July 2000 until January 2007. He has recently been working as a statistical consultant on assignment with a range of countries and with the UN, OECD and World Bank. Dennis was appointed as a part-time Associate Commissioner at the Productivity Commission for the commissioned study into the Not for Profit Sector. Dennis Trewin has held other senior appointments in Australia, including as a Trustee and Board member for the Australian Reward and Investment Alliance and Chairman of the Advisory Board of the ARC Centre of Excellence for Coral Reef Studies. He is Chairman of the Policy and Advocacy Committee of the Academy of Social Sciences of Australia and the Advisory Board at the Institute for***

***Social Research at Swinburne University. He has been recognised as an Officer in the Order of Australia and received a Centenary Medal for his contribution to statistics.***

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<sup>1</sup> [http://taxreview.treasury.gov.au/content/FinalReport.aspx?doc=html/publications/papers/Final\\_Report\\_Part\\_1/chapter\\_1.htm#Chart\\_1\\_5](http://taxreview.treasury.gov.au/content/FinalReport.aspx?doc=html/publications/papers/Final_Report_Part_1/chapter_1.htm#Chart_1_5)