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# **The Distributional Impact of the Proposed Welfare-to-Work Reforms Upon Sole Parents**

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**Report to the National Foundation for Australian  
Women  
25 August 2005**

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## **About NATSEM**

The National Centre for Social and Economic Modelling was established on 1 January 1993, and supports its activities through research grants, commissioned research and longer term contracts for model maintenance and development with the federal departments of Family and Community Services, Employment and Workplace Relations, Treasury, and Education, Science and Training.

NATSEM aims to be a key contributor to social and economic policy debate and analysis by developing models of the highest quality, undertaking independent and impartial research, and supplying valued consultancy services.

Policy changes often have to be made without sufficient information about either the current environment or the consequences of change. NATSEM specialises in analysing data and producing models so that decision makers have the best possible quantitative information on which to base their decisions.

NATSEM has an international reputation as a centre of excellence for analysing microdata and constructing microsimulation models. Such data and models commence with the records of real (but unidentifiable) Australians. Analysis typically begins by looking at either the characteristics or the impact of a policy change on an individual household, building up to the bigger picture by looking at many individual cases through the use of large datasets.

It must be emphasised that NATSEM does not have views on policy. All opinions are the authors' own and are not necessarily shared by NATSEM.

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## **Abstract**

In the May 2005 Budget the Federal Government announced a range of proposed welfare to work measures, to take effect from 1 July 2006. Among the numerous measures announced in the Budget were significant changes for sole parents – including that those sole parents claiming income support after 1 July 2006 with a youngest child aged 6 years or more will be placed on Newstart Allowance, rather than Parenting Payment Single. This report analyses the impact of the proposed changes upon the disposable incomes and effective marginal tax rates of sole parents. It shows that the disposable incomes of sole parents can be up to about \$100 a week lower under the proposed new system than under the current system. It also finds that effective marginal tax rates will be sharply increased under the proposed new system, over a reasonably wide range of earned income.

## **Author note**

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## **Acknowledgments**

The authors would like to gratefully acknowledge the funding contribution made to this research by the University of Canberra, via its Collaborative Research Grants Scheme. We would also like to thank our industry partner for funding contribution and support – the National Foundation for Australian Women which has garnered financial contributions from a wide range of generous organisations and individuals.

## **General caveat**

NATSEM research findings are generally based on estimated characteristics of the population. Such estimates are usually derived from the application of microsimulation modelling techniques to microdata based on sample surveys.

These estimates may be different from the actual characteristics of the population because of sampling and nonsampling errors in the microdata and because of the assumptions underlying the modelling techniques.

The microdata do not contain any information that enables identification of the individuals or families to which they refer.

## **Contents**

<b>Abstract</b>	<b>iii</b>
<b>Author note</b>	<b>iii</b>
<b>Acknowledgments</b>	<b>iii</b>
<b>General caveat</b>	<b>iv</b>
<b>1 Introduction</b>	<b>1</b>
<b>2 The PPS and NSA programs</b>	<b>2</b>
<b>3 Impact of proposed changes on disposable incomes</b>	<b>5</b>
<b>4 Impact of proposed changes on EMTRs</b>	<b>11</b>
<b>5 Conclusions</b>	<b>17</b>
<b>References</b>	<b>20</b>



# 1 Introduction

In the May 2005 Budget the Federal Government announced a range of proposed welfare to work measures, to take effect from 1 July 2006. Against the backdrop of projected slower rates of workforce growth in the future due to population ageing (Productivity Commission, 2005), the government is keen to encourage labour force participation. In addition, reducing welfare dependency and increasing employment is seen as likely to improve the lifetime incomes and economic well-being of welfare recipients, as well as boosting economic growth for Australia as a whole. Earlier research by NATSEM and AMP, for example, has shown clearly that many baby boomers have not yet saved sufficient to finance a comfortable retirement – and that this problem is particularly acute for baby boomer women (Kelly and Harding, 2002; Kelly et al, 2002; Kelly, Farbotko and Harding, 2004).

Among the numerous measures announced in the Budget were significant changes for sole parents. Currently, sole parents with a qualifying child aged less than 16 years who meet various income and asset tests can receive Parenting Payment Single, which is subject to the *pension* income test and payment rate rules. Those sole parents who are in receipt of Parenting Payment Single prior to 1 July 2006 will continue to remain on that payment and be subject to the ‘pension’ income test (which is more generous than the ‘allowance’ income test), until their youngest child turns 16. However, new compulsory work obligations will be imposed on this group from the later of 1 July 2007 or when their youngest child turns six. These new obligations will be satisfied by working part time for a minimum of 15 hours a week or by searching for part-time work and participating in Job Network or other services.<sup>1</sup>

The more significant changes are for those sole parents who apply for Parenting Payment Single *after* 1 July 2006. Those sole parents who have a child aged less than six years will still be eligible to receive Parenting Payment Single. However, as soon as their youngest child turns six, they will be transferred to Newstart Allowance and be subject to an obligation to seek part-time work of at least 15 hours per week. Newstart Allowance provides a lower payment rate than Parenting Payment Single and has a much less generous income test. As a result, in the future many sole parents will face large falls in their income when their youngest child turns six. In addition, for those whose youngest child is already aged six to 15 years, the returns from paid work will be much lower than currently. This is because this group will be placed on Newstart Allowance, rather than Parenting Payment Single.

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<sup>1</sup> The Government also announced new spending of \$390 million over four years to help increase employment amongst parents of school aged children, including a new Employment Preparation service.

Section 2 of this paper explains the likely new payment structures applying to this group of sole parents in 2006-07. Section 3 shows the falls in the disposable (after-income-tax) income of affected sole parents, relative to payments under the current program rules. Section 4 examines the impact of the reforms on the effective marginal tax rates of affected sole parents. Section 5 concludes.

## 2 The PPS and NSA programs

There is inevitably some uncertainty about the exact payment rates for Newstart Allowance (NSA) and Parenting Payment Single that will apply in 2006-07, as they depend upon future trends in average weekly earnings and the consumer price index. The following estimates are based on NATSEM's latest projections of these indexes. Using slightly different assumptions about earnings and price changes would slightly change the results. Our modelling is also based on the Government's current statements about the structure of income support after 1 July 2006 (Andrews, 2005a, 2005b). However, as the legislation has not yet been introduced, it is possible that there may be changes to some of the programs and parameters that have fed into our modelling.

Sole parents with one child and no private income receiving Parenting Payment Single are expected to receive about \$257 a week on average in Parenting Payment Single in 2006-07 (Table 1). A crucial factor is the amount of private income that they can receive before their income support payment is reduced. In 2006-07, a sole parent with one child on Parenting Payment Single will be able to earn \$76 a week without any reduction in the income support they receive. For every dollar of income they earn above this threshold, their payment from government is reduced by 40 cents. This is also the payment rate and income test that will face those sole parents who apply for Parenting Payment Single after 1 July 2006 *and* have a youngest child aged less than six years.

The proposed payment rate and income test for new sole parents whose youngest child is aged six years and over is also summarised in Table 1. They will be placed on Newstart Allowance, which is expected to average \$228 a week in 2006-07. This is \$29 a week less than the PPS payment rate. In addition, they will be able to earn only \$31 a week before their income support payment begins to be reduced. That is, their 'free area' will decline sharply relative to the current rules, by about \$45 a week. The first \$94 of private income above that \$31 a week 'free area' will reduce their Newstart Allowance by 50 cents for every dollar of private income above the free area. Once they reach the second income test threshold of \$125 a week, this withdrawal rate will increase further, with their allowance rate being reduced by 60

cents for every additional dollar of earnings. In other words, once their private incomes reach \$125 a week, they will keep a maximum of 40 cents out of each additional dollar of private income, until they reach the 'cut out point' where they receive no further allowance from government.

The Newstart Allowance income test is thus much more restrictive than the Parenting Payment Single income test, and this is reflected in the very different 'cut out points' shown in Table 1. Sole parents with one child on Parenting Payment Single will be able to earn up to around \$718 per week before their entitlement to income support is extinguished. Sole parents with one child on Newstart Allowance will only be able to earn up to about \$426 a week before their entitlement to income support is extinguished.

This means that income support will cease at a much lower level of earnings for those subject to the new Newstart Allowance test than for those on the existing Parenting Payment Single. For those with more than one child the difference will be even greater, as the 'free area' for Parenting Payment Single is increased by a further \$12.30 per child per week for each child after the first, whereas the 'free area' under Newstart Allowance does not vary with the number of children.

**Table 1 Summary of the Newstart Allowance and Parenting Payment Single Payments for Sole Parents with One Child, 2006-07<sup>a</sup>**

	Parenting Payment Single	Newstart Allowance	Difference
	\$ pw	\$ pw	\$pw
Payment rate for those with one child	\$257	\$228 <sup>b</sup>	-\$29
Amount of income that can be earned before payment is reduced	\$76	\$31	-\$45
Withdrawal rate for each \$ of private income above this threshold	40%	50%	+ 10%
Second income test threshold	na	\$125	
Withdrawal rate for each \$ of private income above this threshold	40%	60%	+20%
Income support cuts out when private income reaches this point (cut-out point)	\$718 <sup>c</sup>	\$426 <sup>c</sup>	\$292

<sup>a</sup> These are the estimated averaged payment rates and thresholds that will apply in 2006-07. The actual payment rates vary at various points throughout the financial year, in line with indexation arrangements. All figures rounded to nearest whole dollar.

<sup>b</sup> This includes \$2.90 a week of Pharmaceutical Allowance, which the government has said will also now be paid to Newstart Allowees who are sole parents.

<sup>c</sup> This includes the effect of the \$2.90 a week of Pharmaceutical Allowance.

Source: Specially created version of STINMOD/05A

Sole parents receiving Newstart Allowance will clearly receive lower payments and face a harsher income test than those on Parenting Payment Single: however there are also other, less obvious, factors that will adversely affect them relative to Parenting Payment Single recipients. One is that pensioners (which includes Parenting Payment Single recipients) qualify for the Pensioner Tax Offset. The aim of the tax offset is to ensure that no tax is payable by a pensioner whose assessable income consists of the pension and around \$144 a week of non-pension income. In 2006-07, some tax reduction will be received by Parenting Payment Single recipients whose taxable income is less than about \$35,000. In contrast, the Allowance Tax Offset ensures that maximum rate allowees with \$31 a week or less of private income are protected from income tax – and effectively begins to be withdrawn when private income is more than \$31 a week. Thus, the reduction in income tax liabilities allowed is much greater for pensioners than for allowees.

A second issue is the receipt of the Pensioner Concession Card. PPS recipients are automatically entitled to a Pensioner Concession Card, which many organisations use as a ‘passport’ to a range of concessional prices for such services as property charges and taxes, energy, water, transport, education, health, car registration, housing and recreation services and so on. While such services are often provided by State and local governments, many private sector businesses also use the possession of a Pensioner Concession Card as the trigger for lower prices for such diverse services as movie tickets and shoe repairs. Similarly, doctors may often bulk bill those with Pensioner Concession Cards, so that they do not have to pay any additional co-payment.

The Government has stated that those sole parents who are shifted to Newstart Allowance under the proposed new arrangements will retain the right to a Pensioner Concession Card. However, as Table 1 makes clear, eligibility for Newstart Allowance for sole parents will cease at a much lower level of private income than eligibility for Parenting Payment Single. As a result, there is a wide range of private income of almost \$300 a week over which those sole parents who would formerly have qualified for the Pensioner Concession Card will apparently not qualify under the new rules.

Most such sole parents will still receive a Health Care Card, via their receipt of maximum rate Family Tax Benefit Part A, but some concessions are provided by State and local governments and other organisations *only* to those with Pensioner Concession Cards and not to those with Health Care Cards. In Victoria, for example, Pensioner Concession Card holders (but *not* Health Care Card holders) qualify for an additional municipal rates concession of up to \$160 a year and an additional transport accident charge concession of up to about \$170 a year. Thus, the loss of these three items alone could reduce the effective income of some sole parents by some \$6 a week.

As well, under the existing Newstart Allowance arrangements sole parents who were shifted and who had been studying would no longer be eligible for the Pensioner Education Supplement. This supplement is currently worth \$31.20 a week.

### 3 Impact of proposed changes on disposable incomes

The figures below trace the impact upon the disposable incomes of sole parents who would qualify for Parenting Payment Single under the current rules but will qualify for Newstart Allowance under the proposed new rules. Thus, the graphs show the impact upon those sole parents whose youngest child is aged six to 15 years and who commence receipt of income support after 1 July 2006. For simplicity, the figures abstract from the precise point in the year at which sole parents become eligible for the payments and simply show the estimated averages for the entire 2006-07 year.

*Disposable income* means the income that sole parents have left in their pockets to spend each week, after the receipt of any income support and/or private income, the payment of income tax and Medicare levy, and the receipt of the various tax allowances such as the pensioner tax offset and the low income tax rebate. The figures below do not take any account of any possible child care costs or rebates or the possible impact of rising private income levels on such factors as consequent increases in public housing rents. The value of the Pensioner Concession Card is also not included.

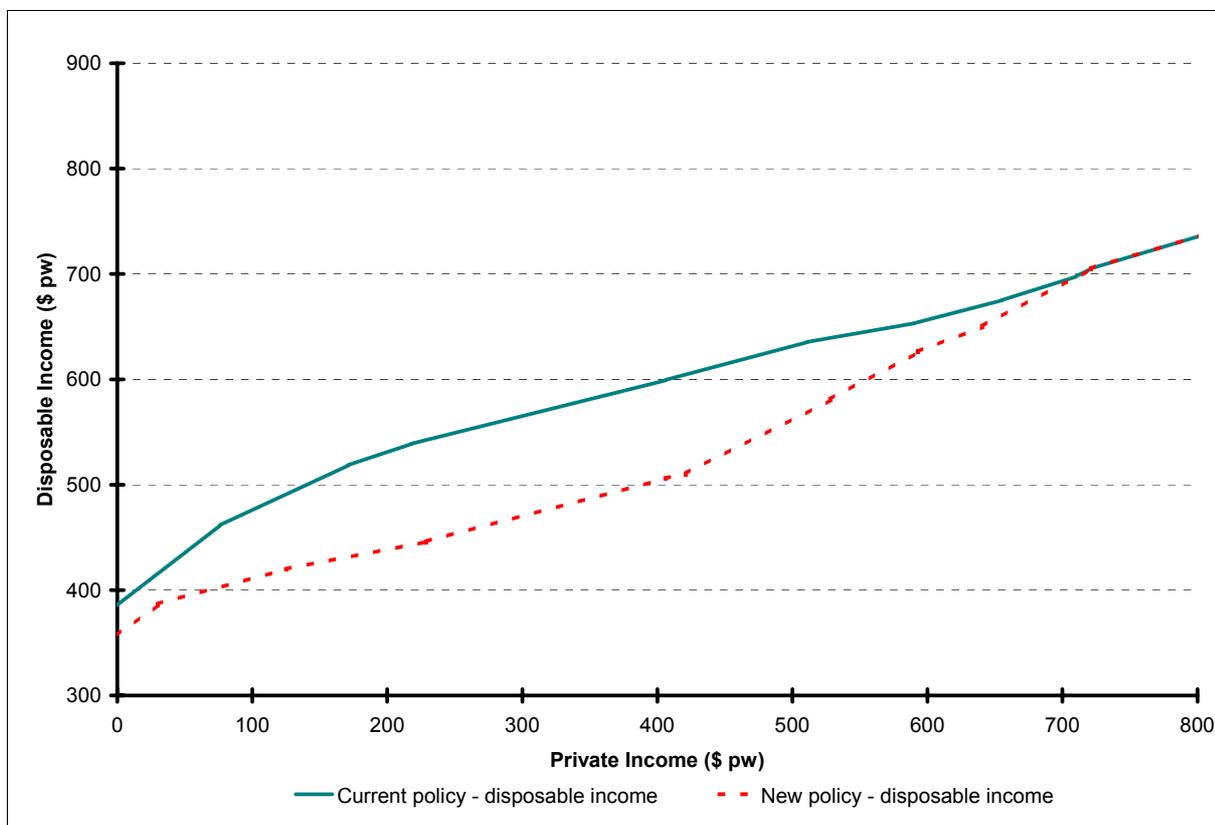
As Figure 1 shows clearly, the disposable incomes of sole parents with one child aged six years and over are much lower under the proposed new system than under the current system over a very broad range of private income. ('Private income' means income from sources other than government cash transfers, such as earnings.) The losses sustained by sole parents amount to almost \$100 a week when earnings are between about \$200 and \$450. As shown in Table 2, for example, the proposed new reforms reduce the 'take-home' incomes of sole parents with one child and earnings of \$200 a week from \$531 under the current system to \$439 under the proposed new system – a cut of \$92 a week. This effectively represents a 17 per cent cut in the living standards of these sole parents and their children. It should perhaps be mentioned again that cuts of this magnitude will be experienced almost overnight by sole parents when their youngest child turns six.<sup>2</sup>

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<sup>2</sup> It should be noted here that under the existing system sole parents are transferred from Parenting Payment Single to Newstart Allowance when their youngest child reaches the

At low levels of private income, there is about a \$30 a week difference between the proposed new and existing systems, due to the difference between the maximum rates of pension and allowance. At the other end of the spectrum, above around \$700 a week, there is no difference in the incomes of sole parents under the proposed new and current systems because, beyond this point, they are not receiving any income support. Between these points, disposable incomes of sole parents are lower under the new system than under the current system, primarily because of the stricter income test applying to Newstart Allowance but also because of the less favourable tax concessions for allowees compared with pensioners.

**Figure 1 Disposable income of sole parents with one child aged 6 years or over under current and proposed systems, 2006-07**



Source: Specially created version of STINMOD/05A. PA excluded from all calculations (see footnote to Table 2)

Sole parents with two and three children have higher disposable incomes than those with only one child, due to the receipt of additional Family Tax Benefit Part A payments (Figures 2 and 3). At most income ranges, the losses that those with two and three children will experience under the new system are slightly higher than for those for one child. This is due to the additional ‘free area’ per child of \$12.30 per

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age of 16 years. Thus, ‘overnight’ cuts in income are also a feature of the current system – but 10 years later than is proposed for the new scheme.

week allowed under the Parenting Payment Single income test. In contrast, the free area allowed under the allowance income test does not vary with the number of children. As a result, a sole parent with three children and \$200 a week of earnings will be \$99 a week worse off under the proposed system compared with the current system. This compares with a \$92 a week loss for a sole parent with the same \$200 of earnings but only one child.

**Table 2 Impact of proposed new system on disposable incomes and EMTRs of sole parents with various levels of earnings, 2006-07**

Private Income	Disposable Income			Effective Marginal Tax Rates		
	Current System	New System	Change	Current System	New System	Change
	\$ pw	\$ pw	\$ pw	%	%	Percentage point
<b>One child aged 6 years and over</b>						
\$0	385	356	-29	0	0	0
\$50	435	394	-41	0	65	65
\$100	476	411	-64*	40	65	25
\$150	506	426	-79*	40	75	35
\$200	531	439	-92	57	75	18
\$300	565	470	-95	68	66	-2
\$400	597	504	-93	68	66	-2
\$500	632	562	-70	66	34	-32
\$600	656	629	-27	66	50	-16
<b>Two children aged 6 years and over</b>						
\$0	468	439	-29	0	0	0
\$50	518	477	-41	0	65	65
\$100	563	494	-69	40	65	25
\$150	593	509	-84	40	75	35
\$200	617	522	-96*	57	75	18
\$300	651	553	-98	68	66	-2
\$400	683	587	-96	66	66	0
\$500	717	645	-72	66	34	-32
\$600	750	714	-36	78	30	-48

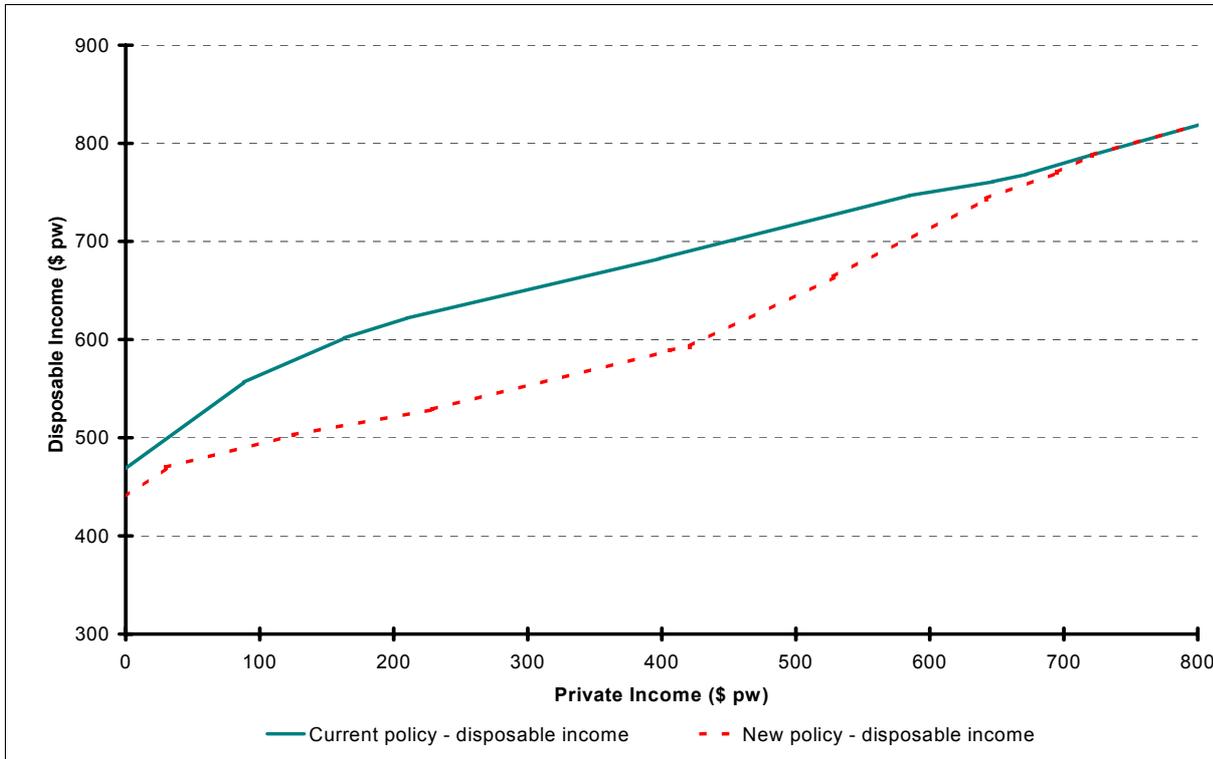
*Note:* Averaged 2006-07 payment levels have been used. All dollar figures rounded to nearest dollar. All EMTRs rounded to nearest one per cent. Note that we have been unable to simulate the receipt by sole parent Newstart Allowees of Pharmaceutical Allowance within the time frame allowed for this project. Pharmaceutical Allowance (PA) has a particularly complicated income test and is also non-taxable. To make a fair comparison between the current and proposed systems, we have excluded Pharmaceutical Allowance from the calculations in both the current and proposed new world. However, this exclusion makes little difference, as the payment is only worth \$2.90 a week and is received by sole parents in both the current and proposed new systems if they are in receipt of income support. Thus, the *difference* between the two systems is in most cases not affected by this exclusion. It should be noted that Pharmaceutical Allowance is also excluded in Figures 1 to 6.

For simplicity, in this Table and in Figures 1 to 6, it is assumed that the sole parents are not receiving any child support. As such child support is received in both the existing and proposed new systems, and affects only Family Tax Benefit Part A entitlement rather than income support payments, this makes no difference to the results.

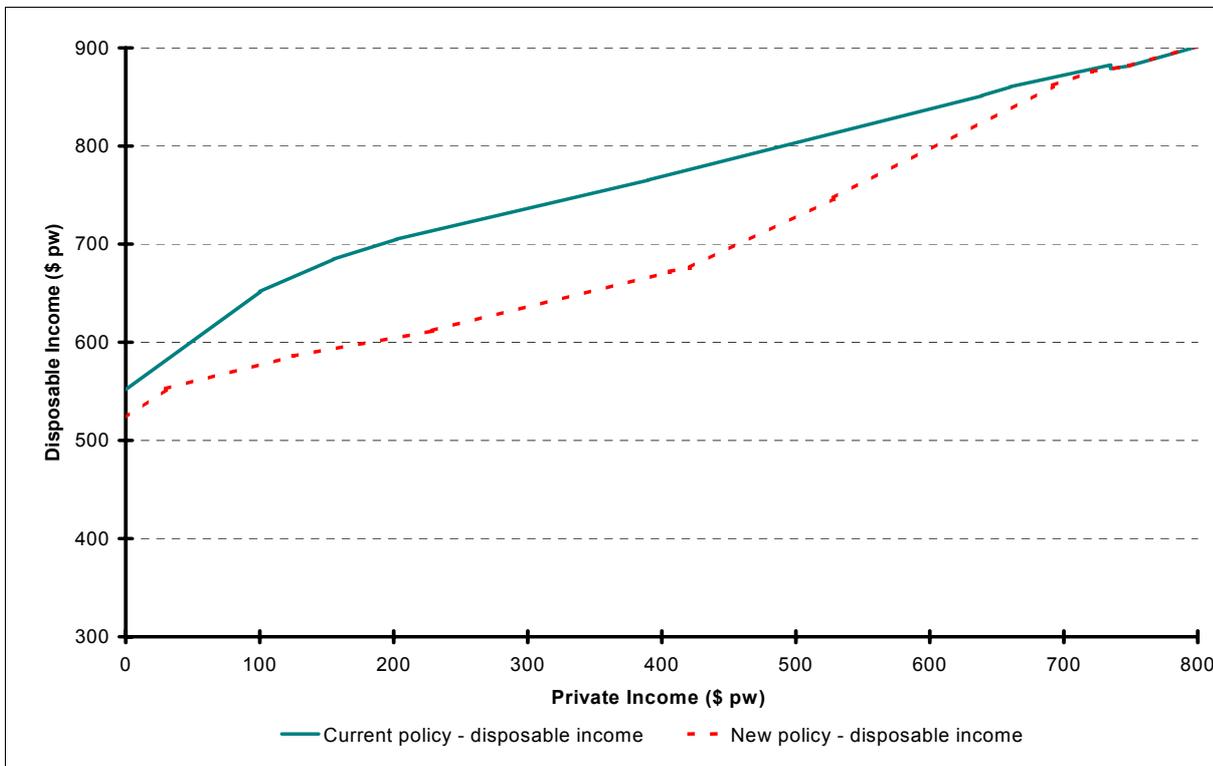
\* Due to rounding, this value is not the same as the difference in disposable income between current system and new system.

*Source:* Specially created version of STINMOD/05A

**Figure 2 Disposable income of sole parents with two children aged 6 years or over under current and proposed systems, 2006-07**



**Figure 3 Disposable income of sole parents with three children aged 6 years or over under current and proposed systems, 2006-07**



Source for Figures 2 and 3: Specially created version of STINMOD/05A. PA excluded from all calculations.

**Cameo 1: Alison's story**

Alison and Jack have been married for six years and have a five year old daughter Sienna. In August 2006 they decide to separate and Alison remains in the family home and applies for Parenting Payment Single. Alison works for four hours on Saturday at a local shop and receives \$60 a week in wages. Her mother lives close by and looks after Sienna on Saturdays, so she incurs no child care costs.

Alison receives \$385 a week from the government through Parenting Payment Single and Family Tax Benefit Parts A and B, plus another \$2.90 in Pharmaceutical Allowance. When this is added to her \$60 of wages, she receives \$448 a week, as she does not have to pay income tax. Jack runs his own small business and is paying the minimum child support rate of \$5 per week. Her disposable income to support herself and Sienna is thus \$453 a week.

In November 2006 Sienna celebrates her sixth birthday and, under the government's proposed new rules, Alison is then shifted to Newstart Allowance. She now receives \$344 a week in Newstart Allowance, Family Tax Benefit Parts A and B and Pharmaceutical Allowance. However, she now has to pay \$4.48 tax a week. When this is added to her \$60 of wages and \$5 of child support, her after-tax income drops sharply to only \$405 a week.

Alison is thus \$48 a week worse off under the Government's proposed new scheme. This amounts to an 11 per cent cut in the amount of income that Alison and Sienna have to live on each week.

In the longer term, Alison will be subject to the new work requirements and will have to find at least another 11 hours of work each week.

**Cameo 2: Brian's story**

Brian and Paola have been happily married for 10 years and have two six year old twins, Jessica and Zac, and an eight year old daughter Alissa. Brian works full-time in a medium level clerical position in a large organisation and earns \$750 a week for a 37.5 hour week. In September 2006 Paola is fatally injured in a car crash, leaving Brian with sole responsibility for the three children. Brian finds it impossible to keep working full-time now that he has sole care of three such young children. Fortunately his employer is very understanding and renegotiates his hours so that he can work 5 hours each working day between the hours of 9am and 3pm, thus allowing him to take the children to and from school. Brian's earnings fall commensurately to \$500 a week.

Under the current system, Brian would be eligible for \$394 in Parenting Payment Single, Family Tax Benefit Part A and B and Pharmaceutical Allowance. His take-home pay to support himself and the three children would be \$806 per week, after paying \$88 in tax. He would also receive a Pensioner Concession Card, worth perhaps \$20 to \$30 a week in effective income.

Under the government's proposed system, Brian's earnings are too high to allow him to receive any Newstart Allowance. He does receive Family Tax Benefit Part A and B, but not the Pharmaceutical Allowance or the Pensioner Concession Card. His take-home income to support his family of four is \$728 a week.

Brian is thus \$78 a week worse off under the Government's proposed new scheme (\$806 minus \$728). His disposable income is 10 per cent less than under the current system.

He may also lose other valuable State and local government concessions, as a result of losing the Pensioner Concession Card.

### **Cameo 3: Leila's story**

Ali and Leila were together for 10 years and have two children aged seven and nine. They separated in 2005 and Leila went onto Parenting Payment Single. In August 2006 they reconcile but, in February 2007, they decide to split up again. During this whole period Leila has been lucky enough to find and keep a part-time job during school hours with an employer who is understanding about her sometimes having to change her hours when the children are sick. She earns \$200 a week from this job.

Because Leila has been off Parenting Payment Single for more than 12 weeks, she is regarded as a new applicant under the government's proposed new rules. She receives \$350 a week in Newstart Allowance, Family Tax Benefit Parts A and B and Pharmaceutical Allowance. Ali is unemployed and pays her \$5 a week in child support. After paying income tax, her total after-tax income to support herself and the two children is \$529 a week.

Had the existing Parenting Payment Single rules remained unchanged, Leila would have received \$426 a week in Parenting Payment Single, Family Tax Benefit Parts A and B and Pharmaceutical Allowance. When added to her \$200 a week earnings and the child support from Ali, Leila's after-tax income would have been \$625 a week to support herself and the two children.

Leila is \$96 a week worse off under the Government's proposed new scheme. The income that she has available to support her family of three is 15 per cent lower under the proposed new rules than under the current rules.

## **4 Impact of proposed changes on EMTRs**

When announcing the Welfare to Work Budget changes, Minister Kevin Andrews noted that 'these changes are designed to assist, support and encourage parents to return to work when their children are old enough to go to school' (Andrews 2005a). One of the factors affecting the workforce incentives of sole parents is the effective marginal tax rate that they face. An effective marginal tax rate (EMTR) measures how much of an additional dollar of earnings sole parents actually keep, after taking account of the various income tests associated with social security and family

payments, the payment of income tax and the receipt of various tax allowances and rebates. An EMTR of 70 per cent means that the 'disposable' or 'take-home' income of a sole parent will increase by only 30 cents when earnings increase by \$1.

The EMTR graphs shown below take no account of the possible *increased costs* associated with rising earnings, such as increased transport or child care costs. They also take no account of possible 'knock on' effects to programs or services not administered by the Federal Government, such as rent payments for public housing tenants or State and local government concessions. As a result, the EMTRs shown below can probably be regarded as being somewhat lower than those that will face sole parents in the real world. As explained above, this is because we have at this stage probably over-estimated how much of each additional dollar of earnings many sole parents will actually retain to improve the welfare of themselves and their children, primarily by taking no account of any increased costs associated with working.

For sole parents with one child aged six years and over, the EMTRs faced at lower levels of private income (that is, earnings) are generally higher under the new system than under the existing system. Sole parents with weekly private incomes between around \$31 and \$76 a week face an EMTR of 65 per cent under the new system, compared with a zero EMTR under the current system. That is, for each additional dollar of earnings in this range, sole parents will keep only 35 cents under the new system, compared with 100 cents under the existing system.

Sole parents with one child with private incomes between \$76 a week and \$125 a week will also face substantially higher EMTRs under the proposed new system – 65 per cent under the new system compared with only 40 per cent under the current system. That is, each additional dollar of earnings in this range net sole parents 25 cents less under the new system than under the existing system.

Why do sole parents face a 65 per cent EMTR when their private income ranges between \$31 and \$125 a week under the proposed new system (compared with either a 0 or 40 per cent EMTR under the current system)? This effect is due to 'income test stacking', with sole parents facing a 50 per cent EMTR due to the allowance income test plus a 15 per cent EMTR due to a combination of the effective withdrawal of the 'allowance tax offset' and the payment of income tax. The 'pensioner tax offset', in contrast, is withdrawn at the lesser rate of 12.5 per cent and only from a private income level which is almost five times higher than that for the beneficiary tax offset (\$31 of private income per week for allowees versus \$144 of private income per week for sole parent pensioners). Thus, one of the less obvious implications for sole parents of the proposed changes is that they will be subject to the harsher allowance tax offset under the new system rather than the more generous pensioner tax offset which applies under the current system.

Private incomes between \$125 a week and \$171 a week are again subject to much higher EMTRs under the proposed new system – 75 per cent under the new system compared with only 40 per cent under the existing system. Thus, the current system allows sole parents to keep an extra 35 cents out of every additional dollar of income that they earn in this range, relative to the proposed new system.

Put another way, over this income range the rewards to sole parents for working are almost twice as high under the existing system as under the proposed new system. The particularly high EMTRs under the new system are due to the allowance withdrawal rate rising from 50 to 60 per cent, with this being stacked on top of the effective withdrawal of the allowance tax offset and the payment of income tax.

At just above \$420 a week of private income sole parents under the new Newstart Allowance regime cease receiving any allowance, so that their EMTRs fall to those facing standard taxpayers. Their EMTRs of 34 per cent consist of the 30 per cent payable through the standard income tax schedules plus the 4 per cent withdrawal of the Low Income Tax Offset (LITO). Once the LITO withdrawal finishes, their EMTRs remain at 30 per cent until they reach the shade in range for the Medicare levy, at \$721 of private income. Where private incomes range from about \$230 to just over \$400, those sole parents under the existing system face higher EMTRs than those under the proposed new system, as sole parents under the existing system face one or more of the 40 per cent pension income test withdrawal, the 30 per cent tax rate, and the withdrawal of the LITO and the pensioner tax offset.

What do the higher EMTRs facing sole parents with one child under the proposed new regime mean in practical terms? Those sole parents receiving Newstart Allowance with private incomes ranging between \$31 a week and \$420 a week face EMTRs of 65 per cent or more. This is substantially higher than the top marginal income tax rate of 48.5 per cent (including Medicare levy) paid by the most affluent taxpayers in 2006-07 – that is, those whose taxable incomes exceed \$125,000 a year. As shown below, the impact of these high EMTRs is to ensure that the financial benefits from work are very low for sole parents receiving Newstart Allowance.

The recently announced minimum wage is \$484 for a 38 hour week, or \$12.74 an hour. It is difficult to predict what a likely minimum wage will be in 2006-07, given the proposed changes in industrial relations legislation. But suppose we assume that by 2006-07 the minimum wage will have risen to \$13 an hour. Suppose further that a sole parent with one child on Newstart Allowance manages to find a 15 hour a week job that thus satisfies the proposed new work obligations and for which the pay is \$195 a week (\$13 an hour multiplied by 15 hours). Under the current system, this sole parent will keep \$144 of this \$195, thus substantially increasing the amount of income they have to support themselves and their child after moving from no paid

work to the 15 hours of paid work.<sup>3</sup> Under the proposed new system, this sole parent will experience only an \$81 a week increase in their take-home income.<sup>4</sup>

In effect, the Federal government will be the major beneficiary of this sole parent being required to undertake 15 hours of paid work a week. Thus, while the sole parent will keep \$81 a week of their \$195 a week of earnings, the government will take the other \$114, via reduced Newstart Allowance and increased income tax payments.

And making the assumption that the sole parent on Newstart Allowance will have all of this additional \$81 a week to support themselves and their child after their earnings rise to \$195 a week assumes that the costs of work are zero. If additional transport, clothing, lunch and other costs were actually, say, \$30 a week when moving from zero to 15 hours paid work a week, then the gains to this sole parent family would fall further to \$51 a week.

In addition, as noted earlier, there may be 'knock on' effects to other income-tested programs. For example, using the 1996 Census data, Burke et al showed that 16 per cent of sole parent families lived in public housing (2001). They also noted the work disincentives faced by public housing tenants, who lose 25 per cent of their earnings through increases in the rent that they have to pay (that is, there is an effective 25 per cent taper in the public housing rent rebate formulas). In the example above, therefore, if the sole parent was in public housing, they could lose a further \$20 of the \$81 increase in their disposable income through the higher rent due, reducing their net gain from the 15 hours of work to \$61. Again, if the costs of work amounted to, say, \$30 a week, then the net gain for this sole parent from moving from zero to 15 hours of work would fall to \$31 a week.

### *Sole parents with two or three children*

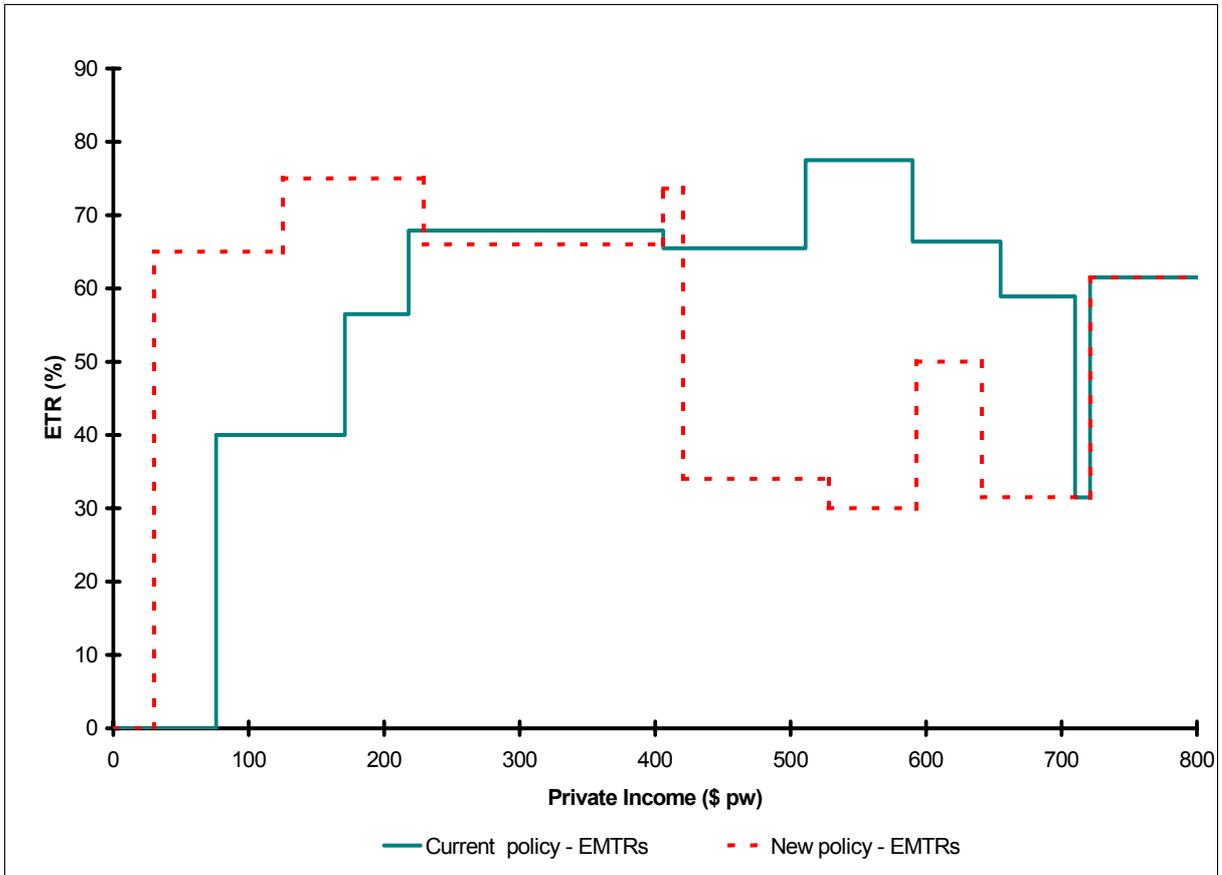
The results for sole parents with two or three children are very similar. The only key change is that under the existing pension income test, an additional \$12.30 a week of earnings is disregarded for each additional child after the first. This slightly extends the zone of private income in which these sole parents face a zero EMTR, relative to sole parent pensioners with one child. In contrast, the point at which sole parents on Newstart Allowance start facing EMTRs of 65 per cent does not vary with the

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<sup>3</sup> Under the current system their disposable income increases from \$385 a week when they have no paid work to \$529 a week when they work 15 hours for \$195 of pay (excluding Pharmaceutical Allowance in both cases).

<sup>4</sup> Under the proposed new system, their disposable income increases from \$356 a week when they have no paid work to \$437 a week when they work 15 hours a week for \$195 of pay (excluding Pharmaceutical Allowance in both cases).

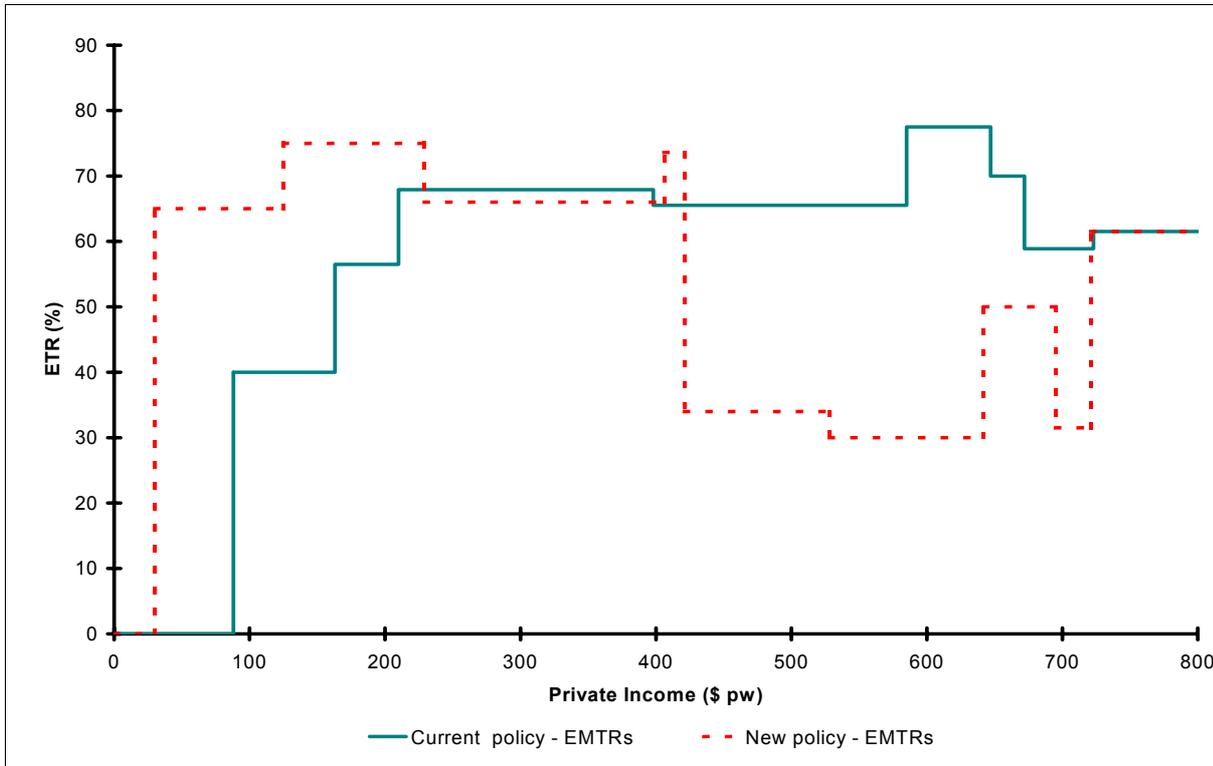
**Figure 4 EMTRs facing sole parents with one child aged 6 years or over under current and proposed systems, 2006-07**



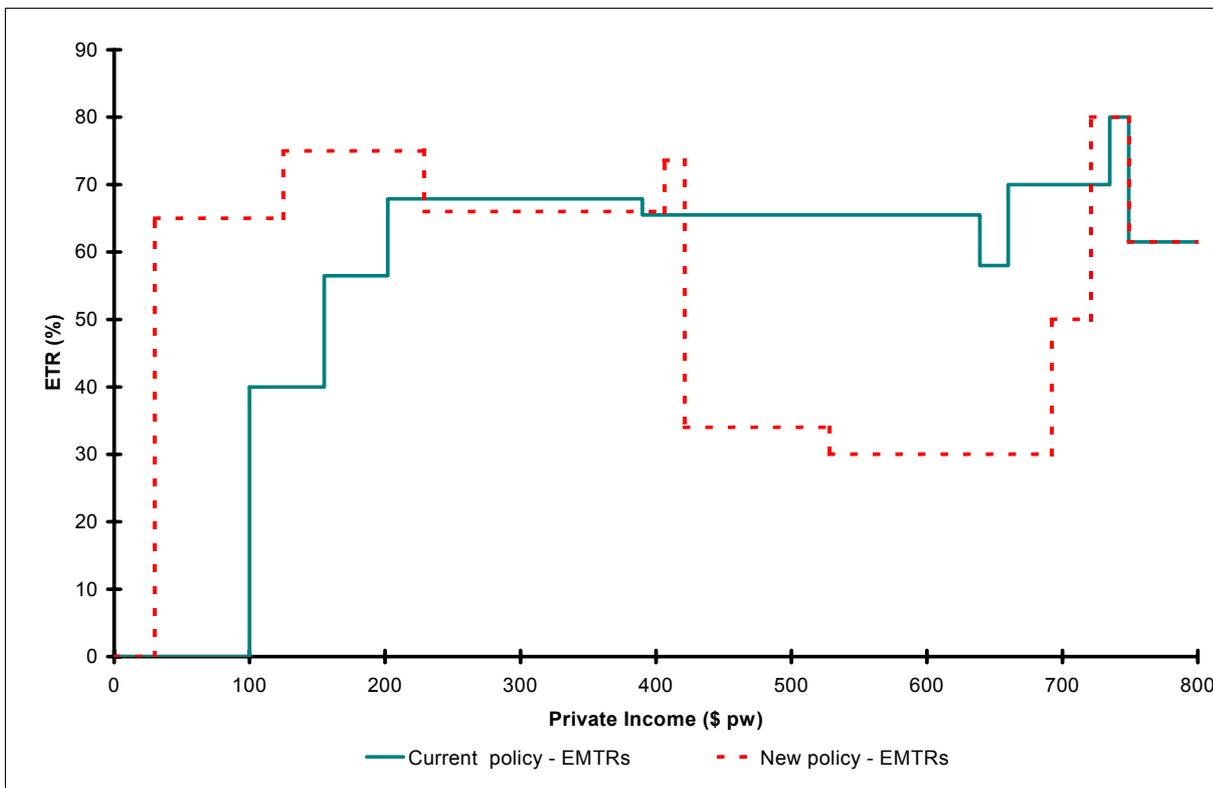
Source for Figures 3 to 6: Specially created version of STINMOD/05A. PA excluded from all calculations (see footnote to Table 2).

number of children, remaining at \$31 a week of private income. Sole parents with two or more children are therefore somewhat more disadvantaged than those with only one child by the proposed move from the pension to the allowance income test regime. The extent of relative disadvantage increases with the number of children: sole parent pensioners with five children can earn \$125 a week of private income before facing the 40 per cent EMTR caused by the pension income test, whereas sole parent allowees with five children can earn only \$31 a week of private income before facing the 65 per cent EMTR caused by the allowance income test and increased taxes.

**Figure 5 EMTRs facing sole parents with two children aged 6 years or over under current and proposed systems, 2006-07**



**Figure 6 EMTRs facing sole parents with three children aged 6 years or over under current and proposed systems, 2006-07**



## 5 Conclusions

The Government's proposed welfare to work reforms will not directly affect the distributional income or effective marginal tax rates (EMTRs) of those sole parents who are already in receipt of Parenting Payment Single on 1 July 2006 and who remain on that payment. Such sole parents will face new work obligations if their youngest child is aged six years or more, but they will not be placed on Newstart Allowance until their youngest child reaches the age of 16 years.

However, sole parents who begin receiving income support after 1 July 2006 will be placed on Parenting Payment Single if their youngest child is aged less than six years – but on Newstart Allowance if (or as soon as) their youngest child reaches the age of six years.

The Newstart Allowance *maximum payment rate* is about \$29 a week lower than that of Parenting Payment Single, resulting in an immediate loss of this amount of income for those transferred from Parenting Payment Single to Newstart Allowance when their youngest child turns six. (Incidentally, it is worth noting here that the gap between Parenting Payment Single and Newstart Allowance will increase further in future years, as Parenting Payment Single is indexed to movement in average weekly earnings, while Newstart Allowance is indexed to the (generally lower) Consumer Price Index. As a result, by 2008-9, for example, the maximum payment rate for Newstart Allowance will be about \$42 a week lower than that for Parenting Payment Single (rather than the \$29 a week apparent for 2006-07.)

The Newstart Allowance *income test* is also much less generous than the Parenting Payment Single income test and the tax treatment of allowees is much less generous than the income tax treatment of pensioners. Taken together, these mean that the losses in take-home income can be as high as \$96.50 a week for sole parents with one child and around \$230 per week of private earnings who are transferred to Newstart Allowance.

For example, a sole parent with one child who is working 15 hours a week for a pay rate of \$13 an hour will have a take-home income each week of \$437 under the Newstart Allowance rules. In contrast, the same sole parent would take home \$529 a week under the current Parenting Payment Single rules. This sole parent, with one child and earnings of \$195 a week, will thus be \$91 a week worse off under the proposed new system than under the current system.

Under the proposed new system, the Federal government will be the major beneficiary of such a sole parent moving from zero to 15 hours a week of paid work, with the sole parent keeping \$81 a week of their \$195 a week of earnings, and the

government taking the other \$114, via reduced Newstart Allowance and increased income tax payments.

The maximum losses experienced by sole parents under the proposed new system relative to the current system increase with the number of children. For example, for sole parents with five children, the maximum losses could reach \$107 a week for those with private incomes ranging from about \$215 to \$290 a week.

The other consequence of the more restrictive Newstart Allowance income test and harsher income tax treatment is to create much higher effective marginal tax rates for sole parents than they face under the current Parenting Payment Single income test. Sole parents with one child aged 6 to 12 years will face EMTRs of 65 per cent or more over a broad band of private income ranging from \$31 to about \$229 a week under the proposed new system. In contrast, under the current system, such sole parents face a zero EMTR for private incomes between \$31 and \$76 a week, and only a 40 per cent EMTR for private incomes between \$76 and \$171 a week. The effect of these income test and tax changes is thus to reduce the attractiveness of paid work to sole parents – and to reduce the amount of income that they have available to support themselves and their children after they undertake paid work.

The need to increase the number of workers as our population ages and the long-term improvements in economic well-being that occur with ongoing workforce participation are some of the factors that lie behind the Federal Government's proposed changes. Many policy analysts will not object to the goal of increasing the labour force participation of sole parents, although they may wish to debate specific aspects of the proposed policies, such as:

- whether the 'age of youngest child' that triggers the compulsory work requirements should be higher than six years;
- whether there should be special measures for those sole parents trying to raise large families by themselves; or
- whether there should be exemptions for sole parents raising disabled children.

However, perhaps of more concern is that our analysis suggests that sole parents will be required to undertake paid work while also being placed on an income support regime that will ensure that many receive minimal improvements in the financial position of their family from that paid work. In addition, the dramatic drop in income that will occur almost overnight for many sole parents when their youngest child turns six would seem likely to have an adverse effect on the wellbeing of the children, as well as their parents. While it is to be hoped that in the longer term many children will be living in sole parent families whose incomes are higher as a result of

the expected increases in paid work, in the shorter term many children will be living in sole parent families whose incomes are much lower than under the current income support rules. These concerns could be overcome by allowing sole parents to remain on the existing Parenting Payment Single, rather than transferring them to Newstart Allowance when their youngest child turns six. Thus, the government's key goal of encouraging sole parents to work could still be achieved via some form of paid work obligation, but sole parents could remain on an income support payment regime that ensured that they and their children were financially much better off after undertaking paid work.

While the particular focus of this paper has been sole parents, others on Newstart Allowance also face the high effective marginal tax rates discussed in this paper. Indeed, the proposed Newstart Allowance income test analysed in this paper is more liberal than the current Newstart Allowance income test (which has a 70 cents in the dollar taper for each dollar of private income over \$71 a week, versus a 60 cents in the dollar taper for each dollar of private income above \$125 a week in the proposed new system). Thus, the Government has responded to the continuing concerns about the impact of high effective marginal tax rates on work incentives by liberalising the income test for Newstart Allowancees from 1 July 2006. Nonetheless, poverty traps remain an on-going issue for many income support recipients. However, until now sole parents have benefited from being placed on the more liberal 'pension' regime, in recognition of the longer-term responsibilities associated with being the primary and sole carer of children.

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