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19 June 2009

Senator Claire Moore
Chair
Senate Community Affairs Legislation Committee
Parliament House
Canberra ACT 2600

Dear Committee Chair,

Social Security and Other Legislation Amendment (Pension Reform and Other 2009 Budget Measures) Bill 2009

Catholic Social Services Australia welcomes the referral of this Bill to the Senate Community Affairs Legislation Committee to examine the following issues – tapering, indexation, pension age, restrictions on who receives the increase and impact for single parents.

Given the short timeframe afforded to the Committee for this Inquiry, Catholic Social Services Australia wishes to draw the Committee's attention to a number of key issues this organisation has been concerned with for some time. These relate specifically to the manner in which pensions and entitlements are set, restrictions on who receives the increase and the impact for single parents.

Catholic Social Services Australia has proposed a longer term solution to the ad hoc nature of the setting of government pensions and allowances. The separation of Parenting Payment Single from its alignment with other pension payments is a further example of the unsatisfactory nature of the current system.

We have proposed an independent commission be established to inform decisions about the adequacy of pensions and other forms of income support. This proposition was outlined in a discussion paper released by Catholic Social Services Australia on 22 September 2008 entitled, ***An Australian Entitlements Commission***. (See Attachment A).

The paper examines the history of the adequacy of Australia's income support system, exposing the ad hoc nature of decisions and the absence of an enduring set of principles to guide decisions about adequacy. The fact that Parenting Payment Single (as along with other allowances) was excluded from the scope of the Australia's Future Tax System's "Harmer Review" is further evidence of the need for such a body.

An independent entitlements commission would recommend the level of pensions and other income support payments independently of the government of the day in much the same way as the Fair Pay Commission, the Commonwealth Remuneration Tribunal and the Reserve Bank of Australia establish independent benchmarks for decisions that require special expertise and that ought not be politicised. Its terms of reference would be public and its decision making processes transparent.

Catholic Social Services Australia does not support the Government's position that some payments such as Parenting Payment Single, Parenting Payment Partnered, Newstart and Youth Allowance should necessarily be lower than other levels of payment. When setting the rate of pensions and allowances, the Government's paramount consideration should be to ensure those payments can support and maintain a simple life in reasonable comfort, maintain dignity and allow an individual or family to take part in the life of the community.

This Bill widens the gap between the payment levels of the various pensions and payments. According to ACOSS,

- A new gap of $43 per week will open up between the standard pension rate and payments for sole parents
- The gap between pensions and Newstart Allowance will widen to $106 pw
- The gap between pensions and Austudy or Youth Allowances for students aged 18-64 years living independently of their parents will widen to $147 pw[1].

In setting adequacy benchmarks an Independent Entitlements Commission would consider:

- The goods and services necessary to live in reasonable comfort, maintain dignity and take part in the life of the community
- The contribution of in-kind government support provided through measurers such as the Seniors Card, Medicare, Public housing and subsidised rent and transport
- Differences in the cost of living between income support recipients who own their own homes or have access to public housing and those who rely on the private rental market
- Differences in the cost of living for income support recipients in different geographical areas
- Differences in the cost of living for income support recipients living in different family/household types.

The Harmer Pension Review's Report clearly states it does not support an independent entitlement commission approach on the basis that "decisions on the level of support the nation is willing to provide to those with limited or no means, including pensioners, are most appropriately made by the Australian Government and Parliament as the elected representatives of the Australian people, rather than being a function that can, or should be, delegated"[2].

There are two important issues here. Providing for basic standards of living should not depend on what political leaders are "willing" to pay and secondly, establishing 'adequacy benchmarks' such as those outlined in Catholic Social Services Australia's proposal should not be assessed against an 'available budget' prescribed by Government and the bureaucracy, it should be assessed on need.

Encouraging people into employment

One argument sometimes put to rationalise lower payments to some individuals relates to incentives to employment participation. A successful strategy to encourage employment participation will require much more than a focus on the individual motivation of some job seekers. A successful strategy will need to overcome some current systemic disincentives, including but not limited to:

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[1] ACOSS, "The winners and losers from the pension increases", May 2009. p. 1

[2] Harmer, Dr J. "Australia's Future Tax System: Pension Review Report", Department of Families, Housing, Community Services and Indigenous Affairs, February 2009. p. 48.

1: **Labour market and Jobs creation – matching people's skills to jobs**.
Suitability and appropriateness of the job to the individual?
This includes access to appropriate and affordable training.

2: **Labour market and Jobs creation – matching people's circumstances to available jobs**.
Does the job match the individual/family circumstances?
Is it favourably located?
Is it casual or permanent?
Does the employee have access to paid sick leave and annual leave?
Is the job flexible enough to allow the parent to respond to urgent family needs?
What is the adequacy and affordability of child care?
What is the adequacy of the public transport system?
What is the suitability of Housing?

3: **Adverse interactions between Australia's Tax and Transfer system**
As individuals earn greater amounts of private income, they are dually penalised: first, through the personal income tax system, and second, through the withdrawal of means-tested benefits. The combined impact of these two effects is captured in an effective marginal tax rate, or EMTR. High EMTR's remain a significant issue for segments of the working population and some of the highest EMTR's are faced by those in the lower end of the income spectrum. As findings of Modelling undertaken by the National Centre for Social and Economic Modelling (NATSEM) shows that in 2006-07, although low-income earners may only face a marginal income tax rate of 16.5%, together with the withdrawal of welfare entitlements, EMTRs can be as high as 98% (that is, only 2% of privately-earned income is retained by the individual/family)[3]. NATSEMS' modelling also indicates that high EMTRs are faced disproportionately by those with dependent children, especially sole parents.

These issues are explored in greater detail in Catholic Social Services Australia's submission to Australia's Future Tax System, October 2008 (see Attachment B).

Housing

The Harmer Pension Review Report finds that there is "strong evidence that many pensioners in private rental housing face particularly high costs and have poor outcomes. Rent Assistance and social housing have a complementary role to play in addressing the financial security of these pensioners. The review notes that the government has proposed an increased investment in social housing and considers that reforms to Rent Assistance would complement this"[4].

A new review released by the Australian Catholic Council for Employment Relations compares the Melbourne Institute's Poverty Lines, June quarterly reports and the housing assistance section of the ABS's Year Book Australia, 2008. In short, the review finds that for a pensioner couple, the Melbourne Institute underestimates housing costs $42.86 per week and overestimates rental assistance by $8.10 per week. The combined total would reduce the margin over poverty from 18.6% to 5.7% [5].

[3] NATSEM "Trends in effective marginal tax rates 1996-97 to 2006-07 AMP/NATSEM Income and Wealth Report, Issue 14, September 2006.
[4] Harmer, Dr J. "Australia's Future Tax System: Pension Review Report", Department of Families, Housing, Community Services and Indigenous Affairs, February 2009. p. 53.
[5] Australian Catholic Council for Employment Relations "Housing-adjusted Henderson Poverty Lines", 11 May 2009, pp 7-8.

Applying the same principle to analyse the single pension, the difference in housing costs is $8.49 per week and the difference in rental assistance is $12.00 per week. The underestimation of $29.49 per week reduces the margin over the poverty line from 8.4% o 1.4%[6].

There has been no transparency regarding how the newly proposed pension rates have been set. However, ACCER's findings show there is a high probability that housing costs may have been underestimated hence eroding the 'real' value of the proposed increase.

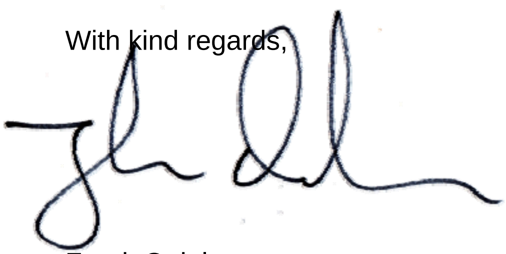
Conclusion

In the light of all of these issues, Catholic Social Services Australia concludes that the way in which pensions and allowances are set fails to justly provide all Australians who find themselves reliant on a Government provided safety net with an adequate level of subsistence.

Catholic Social Services Australia proposes that pensions and allowances should be set within the framework of an enduring set of principles to guide decisions about adequacy. Furthermore, that there is a need for the establishment of an independent commission to inform decisions about the adequacy of pensions and other forms of income support and that the commission's deliberations and decisions need to be open and transparent.

I look forward to appearing before the Committee during the Public Hearing to expand upon or clarify any of the issues raised in this brief submission.

With kind regards,



Frank Quinlan.
Executive Director

Attachment A:
An Australian Entitlements Commission: A proposal for an independent commission to inform decisions about the adequacy of pensions and other income support payments.
A Discussion Paper by Catholic Social Services Australia
22 September 2008.

Attachment B:
Australia's Future Tax System
Submission by Catholic Social Services Australia
October 2008

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6 Ibid, p. 8.

Catholic Social Services
Australia

An Australian Entitlements Commission

A proposal for an independent commission to inform decisions about the adequacy of pensions and other income support payments

22 September 2008

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Summary

This paper puts the case for the establishment of an independent Entitlements Commission to set and review pensions and other income support payments. In the absence of a credible standard of adequacy, decisions are made on an ad hoc basis and are prone to political whim.

The paper argues that despite the fact that Australia's income support system is more progressive than most other countries, it remains inadequate.

Adequacy is not just a problem for age pensioners and carers. It is a problem for anyone who has to rely on income support for extended periods of time.

The Entitlements Commission

An independent Commission would review the adequacy of pensions and other income support payments without political interference and "argy bargy".

An adequate standard of living is one that allows an individual to live in frugal comfort, maintain their dignity, and take part in the life of the community.

The Commission would operate at arms length from government in much the same way as the Fair Pay Commission, the Commonwealth Remuneration Tribunal and the Reserve Bank of Australia.

Its Terms of Reference would be public and its decision making processes transparent.

The Commission would be ongoing and the government would appoint members for a fixed period (for example, 4 years).

Before making each decision the Commission would call for submissions and hold public consultations.

In setting adequacy benchmarks the Commission should consider:

- the goods and services necessary to live in reasonable comfort, maintain dignity and take part in the life of the community;
- the contribution of in-kind government support provided through measures such as the Seniors Card, Medicare, public housing and subsidised transport;
- differences in the cost of living between income support recipients who own their own homes or have access to public housing and those who rely on the private rental market;
- differences in the cost of living for income support recipients in different geographical areas;
- differences in the cost of living for income support recipients living in different family/household types.

The Commission could include:

- Academics with expertise in poverty research and income support policy.
- Representatives of the community sector.
- Representatives of the business community with expertise related to cost of living issues.
- Retired MPs or senior public servants with relevant experience.

Discussion

In support of the call for an independent Entitlements Commission, the paper examines the history of the adequacy of Australia's income support system, exposing the ad hoc nature of decisions and the absence of an enduring set of principles to guide decisions about adequacy.

It paints a picture of a system inspired by short term political considerations.

It exposes a system where "deservedness" has played an important role, excluding people who were not of good character.

Successive Australian governments have avoided making any judgments about what an acceptable living standard for Australians might be.

The closest the Australian Government has come to answering the question was to commission the Social Policy Research Centre to assess the adequacy of income support payments using a budget standards approach.

The paper discusses the Whitlam reforms of the early 70s, noting that in1974 deservingness was no longer a legal requirement for pension eligibility.

But after the change of government in 1975 the principle that payment should be based on need was dropped. The Fraser Government froze single rates of unemployment benefits to allow them to fall behind the pension rate. It was not until the Hawke Government took office that the principle of payment according to need, re-emerged.

The paper discusses the impact of the Social Security Review, commissioned by the then minister for social security, Brian Howe in 1986, in which Bettina Cass argued that there is no evidence that the basic income support needs of the unemployed are less than those of pensioners.

In 1995, Peter Baldwin, then Minister for Social Security, reaffirmed the goal of targeting payments according to need, and he also argued for tighter targeting of those payments.

The paper looks briefly at the key design principles of Australia's income support system, including a basic acceptable standard of living, equity, targeted payments, the promotion of participation and self provision and sustainability, with adequacy as the primary principle.

The paper discusses the historic justifications given by both sides of government for inadequate rates of payment, demonstrating that other objectives have overridden the objective of adequacy.

The paper discusses objections to setting adequacy benchmarks, commenting on the complexities of individual circumstances, the vagueness of adequacy and the arbitrariness of adequacy judgments. It discusses the importance of setting benchmarks for a budget standards approach to adequacy, the cost of a basket of goods and services, citing work by Professor Peter Saunders.

The paper also cites evidence presented to the recent Senate Community Affairs Committee's Inquiry into the Cost of Living Pressures on Older Australians.

Historically income support payments have been set in an arbitrary fashion. Policy makers have rarely taken a structured approach to balancing adequacy, incentive effects, affordability and sustainability. And even though the government has acknowledged that payments should be sufficient to support an adequate standard of living, there is currently no officially recognised standard of adequacy.

The technical issues involved in establishing credible benchmarks of income adequacy are well established. Appropriate methodologies have been developed for use in the Australian context.

The major hurdles are not technical but political.

Unless the community insists that government should meet standards of accountability, the system will not change.

1 Entitlements based on need not politics

Almost everyone recognises that income support payments to age pensioners are inadequate. And if this is true for elderly Australians it is also true for many other people of working age who depend on pensions and allowances to support themselves and their families.

While there is a growing awareness of the inadequacy of income support payments there is no credible standard of adequacy to guide decisions about the amount of support various groups of income support recipients ought to receive. In the absence of such standards, decisions tend to be made in an ad hoc way in response to political pressure.

Catholic Social Services Australia proposes the establishment of an independent Australian Entitlements Commission to set and adjust standards of adequacy. This body would operate at arms length from government in much the same way as the Fair Pay Commission, the Commonwealth Remuneration Tribunal and the Reserve Bank of Australia. Its terms of reference would be public and its decision making processes transparent.

An independent Entitlements Commission would depoliticise decisions about income support adequacy and consider the needs of all recipients regardless of their level of political influence. The current ad hoc process has contributed to the complexity and inconsistency of the income support system and has tended to overlook the needs of vulnerable groups who lack the ability to lobby effectively.

In a country as wealthy as Australia, nobody should be left to survive on an inadequate income. The fact that so many people are, says more about our priorities than our capacity to afford a decent safety net. Inadequacy is the result of trade offs. We sacrifice adequate incomes for the vulnerable when we value other objectives more.

If we value transparency and accountability we should insist that our governments make trade offs explicitly rather than covertly. In a transparent and accountable process, policy makers would provide a definition of adequacy, set benchmarks and — if income support payments are not adjusted to meet them — provide a justification.

2 Current payments are inadequate

There would be little need for an Entitlements Commission if income support payments were paid at an adequate level. Unfortunately, they are not. Australia’s income support system is efficient and highly progressive, but it is not generous. Many recipients (and not just age pensioners and carers) endure years of their lives at a standard of living that, by any reasonable community standard, is not acceptable.

When the Senate Community Affairs References Committee conducted an inquiry into poverty and financial hardship during 2003–04, non-government senators acknowledged that “for many people the assistance provided by the income security system is barely adequate to ensure a reasonable standard of living and that serious gaps persist that need to be addressed.”

As a result, the majority report recommended a substantial increase in all income support payments. The majority report called for a gradual increase in the rate of both pensions and allowances to a rate that is substantially higher than the current benchmark of 25 per cent of Male Total Average Weekly Earnings currently applied to pensions.

Government Senators saw the situation differently at the time. “It is a statement of fact”, they wrote, “that Australia has one of the best and most generous income support systems in the world.” The suggested that if some Australians endure an unacceptably low standard of living, it may well be because they drink too much, gamble too much, or are illiterate, disabled or mentally ill.[1]

As a number of commentators, have pointed out, Australia's income support system is far more generous to those on low incomes than it is to those on middle or high incomes. It is a highly progressive system. Compared with other developed countries a far greater share of the benefits flow to those on the lowest incomes. While many other OECD countries offer social security benefits to medium and high income earners, Australia's system is more tightly targeted, and rightly so.

But, as the OECD's Peter Whiteford[2] argued, it is a mistake to equate relative generosity with adequacy:

> It is essential to note, however, that the fact that Australian benefits for poor families are generous compared to many other countries does not in itself mean that benefit levels are adequate, or that there is not a case for increasing them. Adequacy of benefits can only be defined by reference to the living standards that Australian benefits afford in Australia, and political and social judgments about what is an acceptable living standard for Australians. The fact that benefits for the Australian poor are higher than benefits for the Italian poor does not help anyone in Australia pay the rent or any other bills (Whiteford 2005).

Successive Australian governments have avoided making any judgments about what an acceptable living standard for Australians might be. Some of the arguments used to divert attention have included:

- a job is the most effective solution to the problem of poverty and that they intend to significantly reform the welfare to work system;
- income support adequacy must be balanced against incentives to work and the sustainability of the social security system (especially given the aging of the population);
- the government provides a range of other payments and in-kind benefits that have, or will be, made more generous; or that
- payments have not declined in value because they are automatically indexed to keep pace with increases in the cost of living.

While these are all relevant to the discussion, they are not an answer to the key question of adequacy. The closest the Australian Government has come to answering the question was to commission the Social Policy Research Centre to assess the adequacy of income support payments using a budget standards approach. While the researchers succeeded in developing a

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[1] In their report *Balancing the picture on poverty*, the government senators wrote:

> The problems of those affected by poverty are not easily defined, categorised or resolved. Their problems are not solved by simply throwing more money at them, expanding non-effective approaches or setting up more Government committees.
>
> Issues of poor educational attainment, physical and mental health problems, family breakdown, drugs, alcohol, gambling, smoking, illiteracy, disabilities, and indigenous heritage have all been identified, in one form or another, as important drivers of poor outcomes (Australia Parliament Senate Community Affairs References Committee 2004).

[2] Peter Whiteford worked as Principal Administrator in various Divisions of the Directorate for Employment, Labour and Social Affairs at the OECD in Paris. In 2008 rejoined the Social Policy Research Centre (SPRC) at the University of New South Wales.

set of standards (along with a 670 page report), a change of government meant that the project was abandoned.[3]

There is a growing awareness in the community that many age pensioners are struggling to make their incomes stretch to cover the basics of food, transport and accommodation. The pension rate for singles is $546.80 a fortnight. Groups representing pensioners and seniors have highlighted cases of extreme hardship, particularly among single people who do not own their own homes. Evidence presented to the recent senate inquiry into the cost of living pressures on older Australians painted a vivid picture of how difficult life on a pension can be.

With the cost of housing, petrol and groceries rising, many working Australians feel a great amount of empathy for elderly people and carers who are struggling to make ends meet. Even though their incomes may be much higher, they too feel as if they are struggling.

But if seniors, carers and working families are doing it tough what about single parents, people with disabilities and those on allowances such as Youth and Newstart? The single rate of Newstart Allowance is currently $437.10 per fortnight. And while it might come with a modest rate of rent assistance and the Family Tax Benefit (FTB) for those with children, allowees miss out on many of the additional supports available to seniors and pensioners. There are no annual bonuses or allowances for telephones or utilities.

Data from the Household, Income and Labour Dynamics in Australia (HILDA) survey shows that it is not just age pensioners who are ‘doing it tough’. This chart from the Department of Families, Housing, Community Services and Indigenous Affairs, shows that reports of financial stress and hardship are even more common among single parents and working age couples with children.[4]

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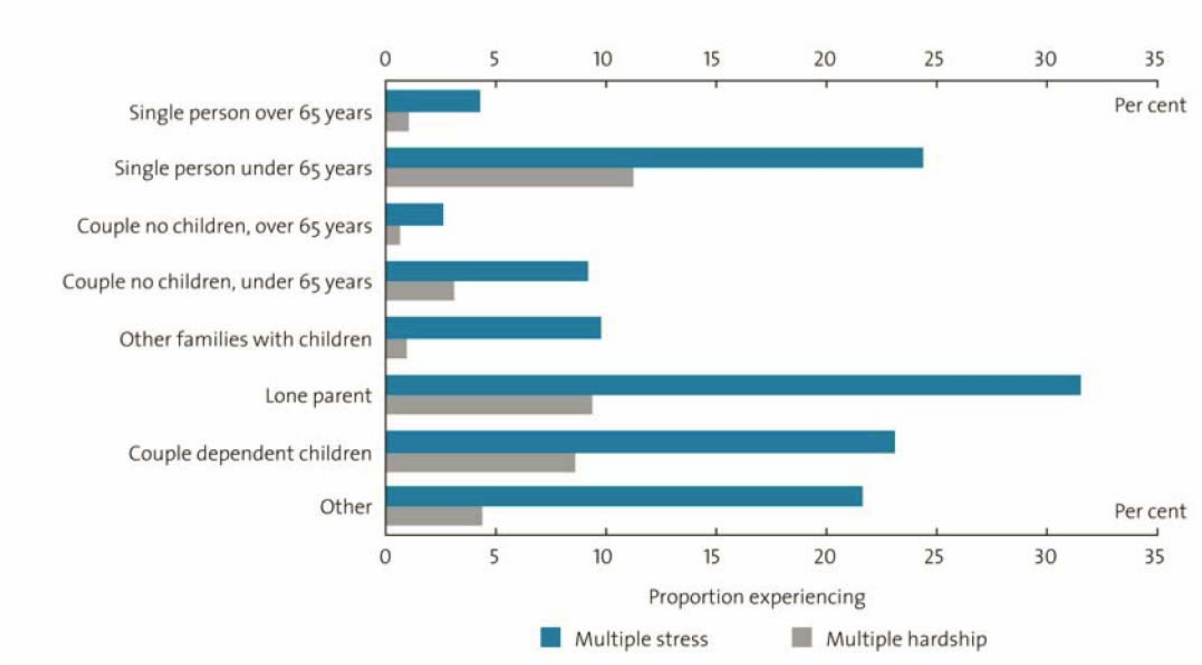
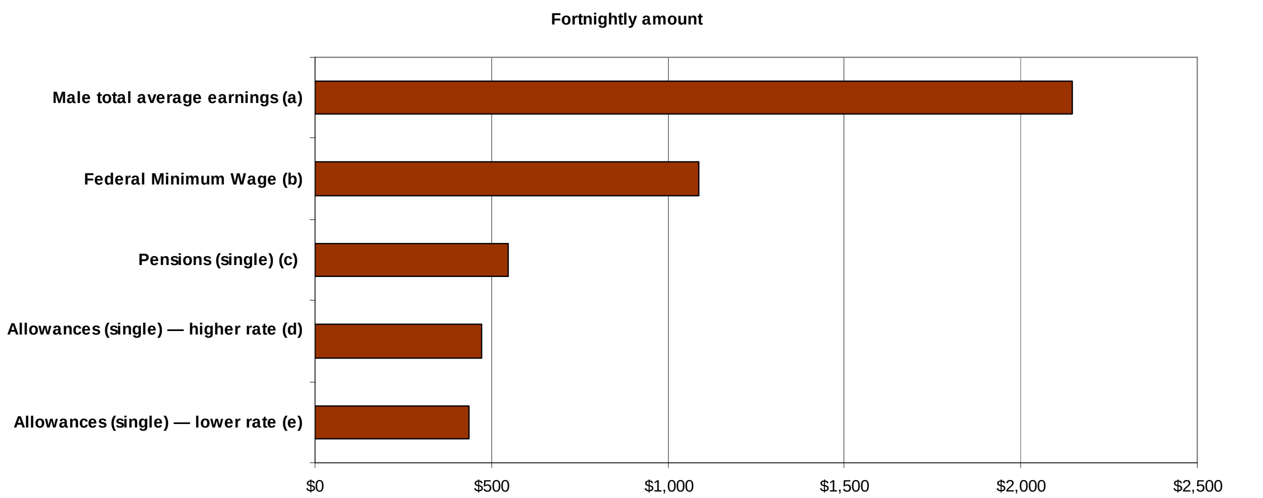
[3] To see how far advanced the project was before the government abandoned it, see the Department of Social Security (DSS) research paper *Development of Indicative Budget Standards for Australia* (Saunders 1998)

[4]According to the departmental paper:

> Hardship relates to the incidence of: missing a meal, going without heating, having to sell or pawn an item, or seeking help from a welfare organisation, because of a shortage of money. Financial stress includes these items as well as being unable to pay electricity, gas or phone bills on time, not being able to pay mortgage or rent on time or asking for financial help from family or friends. Multiple stress or hardship involves a person reporting two or more of these items over the previous 12 months.



Adequacy is not just a problem for age pensioners and carers. It is a problem for anyone who has to rely on income support for extended periods of time. As the chart below shows, income support payments are well below the minimum full time wage for adults.



(a) All employees total earnings for May 2008 (original). Source: ABS Average Weekly Earnings Australia 6302.0.
(b) July 2008 Decision. Source: Australian Fair Pay Commission.
(c) Maximum single adult rate as at 1 July 2008. Includes Age Pension, Disability Support Pension, Carer Payment, Parenting Payment Single, Bereavement Allowance, Wife Pension, Widow B Pension and Service Pension.
(d) Maximum single adult rate as at 1 July 2008. Includes Newstart Allowance, Parenting Payment Partnered, Sickness Allowance, Mature Age Allowance, Widow Allowance and Partner Allowance. Higher single rate applies to: a person with a dependent child; or a person aged 60 or more and on income support for at least 9 months; and to partnered people separated due to ill-health, infirmity or because the partner is in gaol.
(e) Lower single rate applies to singles not covered by the higher rate. Source: Pension Review Background Paper, FaHCSIA.

Because many people suspect that single parents and the unemployed are responsible for their own problems, they prefer to tune out or gloss over their stories. Even people with disabilities are sometimes considered suspect — with musculoskeletal disabilities referred to derogatively as ‘Mediterranean back’ or episodes of major depression dismissed as ‘lack of motivation’. It is common to hear people talking about ‘the dole’ as if it were an addictive drug that perpetuates disadvantage rather than alleviating its symptoms. But logically, it is hard to accept that money takes on special drug-like powers when it is deposited by Centrelink or that joblessness is only psychologically destructive before the age of 65 (or 63 for women born before 30 June 1944).

In reality there is probably more diversity within income support categories as there is between them. Some mature aged Newstart or disability support recipients have worked almost all of their adult lives while some age pensioners have worked only intermittently if at all. It is impossible to generalise about the ‘deservingness’ of entire groups.

The rate of income support payments should be based on need rather than stereotypes about the deservingness of various groups. Judged against this criteria, it is not just pensions that are inadequate.

3 What gets measured gets done

Before the last federal election Peter Garrett confronted the climate change sceptics in the Australian Government attacking them for refusing to set targets on greenhouse gas emissions. “It is perhaps the last line in the sand for the climate sceptics”, he said, “they know that what gets measured gets done and that real targets will lead to real action” (Garrett 2007).

Australia also has a problem with people who are skeptical about the problem of inadequate income support payments. When policy makers do not want to take action on a problem, they refuse to measure it or set targets. Without publicly available performance indicators it is easier to treat the adequacy of income support payments as if it were purely a matter of opinion.

The Australian Government claims that our income support system is designed to support “a basic acceptable standard of living, accounting for prevailing community standards” (Harmer 2008 p 4). But there are no benchmarks for adequacy — no performance indicators.

The lack of adequacy benchmarks is a long standing problem. The Australian Government has had responsibility for income support since the creation of the first Commonwealth pensions for old age and invalidity almost 100 years ago. But in almost a century of policy making, there have been only two occasions that the Australian Government has taken steps to research what it costs income support recipients to live at an acceptable level.

During the early to mid 1970s, the Commission of Inquiry into Poverty (Henderson Commission) established a poverty line and recommended that pensions and benefits should be raised above it. The Commission was not a partisan creation. It was established by the McMahon Government in 1972 and expanded under the Whitlam Government. But by the time the Commission reported, the Fraser Government was attempting to reduce expenditure. The Henderson poverty line was never officially endorsed and was not accepted as a benchmark for policy making.

During the 1990s, the Keating Government looked again at the issue of adequacy. Under Minister Peter Baldwin, the Department of Social Security began a project to develop adequacy benchmarks for income support payments (DSS 1995). As part of the Adequacy Project, the department commissioned a unit at the SPRC to establish benchmarks using a budget standards methodology. But despite successfully establishing a set of benchmarks, these were not endorsed by the government or incorporated into a process for setting and adjusting payment rates. Again, a change of government and a new set of priorities intervened.

3.1 Adequacy as an objective

According to many commentators, support for an adequate standard of living is the *primary* objective of the Australian income support system. For example, Peter Whiteford and Kim Bond have written that:

> The most important objectives of government assistance are to alleviate poverty and to assist individuals to maintain adequate living standards. Other important objectives include encouraging self-provision and avoiding undesirable incentive effects (Whiteford 2000).

This view is occasionally reflected in government publications. For example, in a fact sheet, the former Department of Families and Community Services has defined an income support payment as “a primary payment to ensure an adequate standard of living, such as a pension, allowance or student assistance.” (FaCS 1999).

The government’s background paper for the pension review also endorses this view. The paper claims that the first key design principle underpinning the system is that it “supports a **basic acceptable standard of living**, accounting for prevailing community standards.” (Harmer 2008 p 4).

3.2 Adequacy and the history of Australia’s income support system

Australia’s income support system has developed gradually over time. Beginning with pensions for the aged and disabled, it gradually expanded to include single parents, the unemployed and students. But it would be a mistake to think of its development as some kind of teleological process underpinned by an enduring set of principles.

On some occasions, changes to the system were inspired by short term political considerations. On others they were the first steps towards more sweeping reforms that never took place. For example, since 1954 payments to blind pensioners have been exempted from means testing. This anomaly is a relic from a time when some politicians hoped to abolish means testing for all pensioners.

It is debatable whether the system as a whole has been intended to support people according to their level of need. Judgments about deservingness have often played an important role.

3.2.1 Aid for the deserving: 1908 – 1951

The first income support payments were targeted at the aged and people with disabilities. This was not just because these groups were considered the most in need of assistance, but also because they were considered the most deserving.

By 1908 New South Wales, Victoria and Queensland had all created their own pension schemes. But with the passage of the *Invalid and Old-age Pension Act* of 1908, the Commonwealth took over this responsibility. According to Terry Carney and Peter Hanks:

> Those programmes were heavily infused with the values and philosophy of ‘social deserts’. Need, of itself was seen as an entirely inadequate justification for attracting government support. Public moneys were to be expended only on citizens of long standing who, by their endeavours in years past, had laid the foundations for community well-being. Support was extended to the aged and to invalids on the basis that they had contributed to community prosperity, and were now unable to participate in productive activity, or that, through no fault of their own, they were denied that opportunity to participate (Carney 1994 p 32-33).

Legislation for the Old-age Pension specifically excluded claimants who were not of good character. The rate of the pension was set at an amount that the Commissioner of Pensions determined as “reasonable and sufficient” and a means test was applied.

In practice, political considerations often determined the pension rate. For example, in 1940, the Menzies Government agreed to increase pension rates. The opposition also pushed it to adjust pension rates automatically each quarter to take account of increases in the cost of living. This was an attempt to take the politics out of adjustments to pensions.

After the change of government in 1941 the Labor Government continued the practice of automatic adjustment. But in November 1943 politics returned when the cost of living measure fell and the pension rate was reduced. The government quickly came under pressure from pensioner organisations and was forced to reverse the reduction. After reconsidering the issue the government decided to abandon automatic indexation.

In 1942 the Widow's pension was created, closely followed by unemployment, sickness and special benefits in 1944. As with recipients of the age pension, widows were also required to be "of good character and deserving of a pension". All the new payments included a means test.

3.2.2 Ad hoc adjustments

Pension rates were increased fairly regularly from the end of the Second World War. However, unemployment benefit rates were generally increased only when recessions drove up unemployment and put the government under political pressure. In 1952 the government doubled the rate of the benefit and increased it again in 1957, 1961 and 1962. 1961 had been an election year. Following the election the Menzies Government announced economic measures designed to stimulate the economy. These included increases in unemployment and sickness benefits (Kewley 1965 p 276).

The 1950s also saw the creation of one of the most enduring anomalies of the Australian income support system. For years there had been talk about removing means tests on pensions. In 1952 the government allowed blind pensioners to receive a part pension — £3 — free of the means test. Then in 1954 they removed the means test entirely. In 1952 the Minister for Social Services said:

> … we have planted something that will grow and that the people of the Commonwealth will respond with an expression of their willingness to bring to fruition a complete scheme whereby no man will be debarred from pension because of his thrift or his industry (Townley in Kewley 1965 p 310).

While the seed that Athol Townley planted never grew into anything much larger, it never went away either. Blind pensioners remain exempt from the means test.

During early 1972 the McMahon Government came under increasing pressure to raise pension rates. While noting that pensions had been rising significantly faster than the consumer price index or average weekly earnings, William Wentworth (Minister for Social Services) told cabinet that:

> … there is a general feeling in the community and in the pensioner group that the pension is inadequate, that pensioners are in a state of relative poverty, and that a substantial increase in pensions is not only warranted but, indeed, is expected (Wentworth 1972).

Not surprisingly the minister recommended that pensions should be increased, noting that the amounts he proposed "would be the minimum acceptable to the community and electorate at the present time."

In the same year there was a much more ambitious proposal to link pension rates to movements in per capital Gross National Product to enable pensioners "participate in increasing national prosperity" and remove the issue of rate adjustments from the political arena. This proposal was rejected on advice from Treasury who warned that "Adoption of the Minister's proposal would have very serious budgetary consequences" (Treasury 1972).

It was no secret that Treasury's assessments of affordability were the most significant limit on the growth of income support payments. In a 1973 submission to the Commission of Inquiry into Poverty, the Australian Council of Social Service (ACOSS) argued that:

> There are indications that a subjective judgment of the community's ability to pay has generally been a more significant factor in setting a minimum income level than the amount needed to maintain some acceptable standard of living (ACOSS 1973: 243).

Poverty was becoming a more significant issue as the 1972 election loomed. Mounting public pressure led the McMahon Government to set up a Commission of Inquiry into Poverty headed by Professor Ronald Henderson.

3.2.3 The Whitlam reforms

The election of the Whitlam Government in 1972 saw significant increases in the rates of income support payments. The poverty inquiry was expanded, and there was a discussion about replacing the income support system with a more streamlined and comprehensive guaranteed income scheme. Under Whitlam, the Australian Government replaced the principle of payment according to deservingness with the principle of payment according to need.

In opposition Whitlam had promised to raise the level of pensions to 25 per cent of average weekly earnings. He justified the benchmark by saying that the Chifley Government had set the pension at this level in 1949 (Whitlam 1985: 359). This was a politically advantageous rationale as it suggested that pensions had been adequate under Labor, but that subsequent conservative governments had allowed them to become inadequate.

Whitlam also promised to decouple the objective of adequacy from competing objectives. In a 1972 speech he said that:

> The basic pension rate will no longer be tied to the financial and political considerations of Budgets. All pensions will be immediately raised by $1.50 and thereafter every Spring and Autumn, the basic pension rate will be raised by $1.50 until it reaches 25 per cent of average weekly make earnings. It will never be allowed to fall below that level (Whitlam in Kewley 1980 p 55).

Once in office the Government moved quickly to put these promises into effect. In March 1973, not only were pensions increased, but unemployment and sickness benefit were also increased to bring them into line with pensions. Payments were increased again in September. Bill Hayden's July 1973 cabinet submission explained the reasoning behind the decision:

> The proposal envisages that the rates of unemployment, sickness and special benefits should be increased by the same amounts as the pension. The principle that common needs deserve common rates of assistance was established when benefit rates were raised to the same level as pension rates under amendments to the Social Services Act made in March last (Hayden 1973).

As Minister for Social Security, Hayden sometimes seemed overwhelmed by the expectations created by Labor's election promises. Before the election Whitlam had promised to remove the means test on age pensions (Whitlam 1972). In office, Hayden was now responsible for implementing this despite the fact that it would be hugely expensive. In a submission to cabinet he wrote:

> … we have the situation that the abolition of the means test during the life of the present Parliament was promised in the Election Policy Speech and there is a widespread public expectation of action in that direction. Although on the basis of need, perhaps other groups have a stronger case for additional Government assistance, the proposals [advanced in the submission] are, I feel, the minimum that could be adopted if we are to maintain the faith of the electorate in our willingness and ability to honour our commitments (Hayden 1973).

In this case, a popular election promise trumped the emerging principle of targeting according to need.

The Whitlam government also removed the requirement that pensioners must be of good character and be "deserving of a pension. " In a cabinet submission, Bill Hayden wrote:

> Although I am informed that these provisions have not been invoked by the Department for a number of years, while they remain in the Act they are anachronisms and reflect undesirable moralising attitudes inherited from the 19th century and which are contrary to the philosophy of the present Government.
>
> <u>It is recommended</u> that these provisions be repealed (Hayden 1974).

And in 1974 they were. Deservingness was no longer a legal requirement for pension eligibility.

3.2.4 The Social Security Review

After the change of government in 1975 the principle that common needs deserve common rates of assistance was dropped. The Fraser Government froze single rates of unemployment benefits to allow them to fall behind the pension rate (Cass 1988).

It was not until the Hawke Government took office that the principle of payment according to need, re-emerged. In 1986 Brian Howe, the Minister for Social Security, commissioned a review of the social security system under the leadership of Professor Bettina Cass.

Cass argued that “There is no evidence that the basic income support needs of the unemployed are less than those of pensioners”. The review’s report on income support for the unemployed concluded that:

> There is absolutely no justification which can be given for providing a lower rate of payment to single individuals, whether short-term or long-term unemployed, who must not only support themselves, but engage in active job search and maintain the mobility and social contacts necessary to ensure against labour market marginality (Cass 1988 p 292).

By the late 1980s, the idea that the age pension should be available without a means test had dropped off the agenda. Even in the mid-1970s, Ronald Henderson was arguing that improving the adequacy of payments was a far more important objective (Henderson 1975 p 47).

3.2.5 Beyond the Safety Net

In 1995, Peter Baldwin, then Minister for Social Security, reaffirmed the goal of targeting payments according to need. In a paper titled *Beyond the Safety Net* Baldwin showed how the Social Security Review had resulted in substantial improvements in payment levels — particularly for low income families with children. But he also argued that these improvements were achieved, in large part, by tighter targeting.

> This process was not without political pain, as anyone who recalls the reintroduction of the pensions assets test in 1985 will attest (I was berated at a meeting of the Pyrmont/Ultimo branch of the ALP over this, despite the fact that not one person in the room would have been within cooee of the assets test threshold!) (Baldwin 1995 p 10).

While Baldwin wanted to ensure that payments were adequate, he was sceptical about the poverty line established by the Henderson Commission. Drawing on the theoretical work of Amartya Sen and empirical work of Australian researchers Peter Travers and Sue Richardson (Travers 1993), he argued that the level of income that was ‘adequate’ could vary significantly depending on a person’s circumstances. For example, elderly people who own their own homes are better off than many other people on similar incomes who do not (Baldwin 1995 p 38).

Constrained by a budget, Baldwin was keen to look for opportunities to help age pensioners make better use of their assets and to help unemployed and disabled people take more advantage of work opportunities and techniques to make their low incomes stretch further.

3.3 Attempts to set adequacy benchmarks

Most changes to payment levels have been the result of automatic indexation or government’s response to political pressure. But in a number of cases, governments have attempted to define benchmarks for adequacy. Currently pensions are indexed to 25 per cent of male total average weekly earnings.

3.3.1 Linking pensions to an index of average earnings

During the last year of the McMahon Government, Cabinet discussed the idea of automatically adjusting pensions in line with movements in per capita gross national product. A Treasury analysis of the proposal was unfavourable and Cabinet rejected the idea (Treasury 1972).

Opposition leader, Gough Whitlam had a different proposal. He pledged to lift age pensions to 25 per cent of average weekly earnings arguing that:

> Under the Chifley Labor Government the single pension was 25% of average weekly earnings. They have now fallen below 20%. The pension for a married couple was half average weekly earnings. Now it is barely one-third. And of course the point about using average weekly earnings as the appropriate bench-mark is that it is the true guide to the increased wealth of the community, the tax resources available to the community and the cost of a decent life in modern times. How can it be argued that we cannot afford to do to-day what we were able to do a quarter of a century ago (Whitlam 1972).

The Henderson Commission adopted a similar approach, arguing that both pensions and benefits should "be updated frequently and regularly by an amount that prevents the beneficiaries from falling behind the rest of the population." The Commission suggested using either an index of average earnings or an index of per capita gross domestic product (Henderson 1975 p 47).

Whitlam never succeeded in lifting pension rates to the target. But the commitment was retained by the Hawke Labor Government and pensions (not just age pensions) reached the benchmark of 25 per cent of male total average weekly earnings (MTAWE) in 1990.

While the Hawke Government made a political commitment to link pensions to MTAWE, this commitment was not entrenched in legislation. In 1997 the Howard Government reaffirmed the commitment and put it into law. Noting that many older Australians were concerned that the cost of living was increasing faster than pensions, the government strengthened its pledge that pensions would be indexed to keep pace with rising community living standards:

> The Government also recognises that many seniors are concerned that their cost of living may rise faster than the consumer price index. To address this, the Government will guarantee that the Age Pension will increase in line with the higher of the consumer price index, increases in male total average weekly earnings or the living cost index for age pensioner households. These arrangements will ensure that the Age Pension keeps pace with increases in prices and improvements in community living standards (Australian Government 2008).

While pensions have increased in value in real terms, allowances have not. The principle of payment according to need appears to have been abandoned.

3.3.2 Benchmarking using a budget standards approach

In 1993 Peter Baldwin announced that the Department of Social Security (DSS) would conduct a study to develop new benchmarks for adequacy. This was a wide ranging study which recognised from the beginning benchmarks must be developed from a combination of normative and empirical judgments. In a 1995 paper the department explained that:

> Statements regarding the adequacy of incomes are, necessarily, influenced by community views and attitudes. They reflect judgements regarding the legitimate aspirations of individuals, the role of the individual within the society, and the relationship between the individual, the community and the state.
>
> As such, there can be no absolute statement regarding adequacy. The notion of adequacy must be placed in context with regard to both subject and purpose (DSS 1995p 5).

While adequacy benchmarks are conceptually distinct from poverty lines, the department realised that there was little hope of maintaining this distinction in public debate. Creating a benchmark would create a strong expectation that payments would not fall below it.

Even in the early stages of the project, it was clear that political considerations were making it difficult to keep the objective of adequacy conceptually distinct from other government objectives. The 1995 paper argued that:

> … assessments of adequacy may be influenced by broader fiscal objectives, labour market incentives or judgements about community goals (DSS 1995: 37).

Conceptually this claim is nonsense. Broader fiscal objectives and labour market incentives are separate but competing objectives that governments must balance against adequacy. Policy making is all about trade-offs.

But perhaps it is unreasonable to expect a department to put their minister in the position of having to admit that income support payments have deliberately been set at a rate that is inadequate.

Interestingly, the recent departmental background for the pension review has updated the SPRC's budget standards and used them to make the point that pension adequacy has improved (Harmer 2008 p 18).

4 The problem of trade-offs

At first glance, Gough Whitlam's promise that "the basic pension rate will no longer be tied to the financial and political considerations of Budgets" might seem reckless and irresponsible. Obviously, no government can ignore budgetary constraints or politics and function effectively. But what the promise represents is the determination to put adequacy first, even if this means trade offs in other areas. And when governments do make trade offs, they should do so explicitly. This is what accountability requires.

4.1 Key design principles of Australia's income support system

According to the government's background paper, Australia's income support system is underpinned by five key principles:

> It supports a **basic acceptable standard of living**, accounting for prevailing community standards. Payments are not related to past earnings and do not compensate for pain, suffering or loss of amenity.
>
> It is **equitable**. It treats people in similar circumstances similarly. Those with additional costs are given greater assistance either through transfer payments or services to help them achieve a similar living standard. In some circumstances, these additional costs are recognised across a range of income levels.
>
> It **targets payments** to those not able to fully support themselves. Those with their own resources and therefore the capacity to support themselves do not have the same need for transfers. Income and assets tests are used to reduce payments for people with private resources.
>
> It **promotes participation and self-provision** through a combination of:
>
> - services and assistance to help people deal with disadvantage (including disability, caring, improving skills and seeking work)
> - incentives to work to provide for current needs and for retirement —for example, through contributions to superannuation
> - obligations to work and to seek suitable work for those who are expected to, and the use of private savings to support themselves for those with savings.

> It is **sustainable**. The broad community accepts that those who receive social security payments are in genuine need and that the overall system is affordable across the economic cycle and in the long run, given the ageing of the population (Harmer 2008).

The government's background paper recognises that "these principles must be balanced against each other, because there are significant tensions between them."

4.2 Adequacy as the primary principle

According to most commentators, support for an adequate standard of living is the *primary* objective of the Australian income support system. For example, Peter Whiteford and Kim Bond write that:

> The most important objectives of government assistance are to alleviate poverty and to assist individuals to maintain adequate living standards. Other important objectives include encouraging self-provision and avoiding undesirable incentive effects (Whiteford 2000).

This view is occasionally reflected in government publications. For example, in a fact sheet, the former Department of Families and Community Services has defined an income support payment as "a primary payment to ensure an adequate standard of living, such as a pension, allowance or student assistance." (FaCS 1999).

4.3 Competing principles

Not all of the five principles conflict with the principle of payment according to need or conflict to the same degree.

Applying the principle of equity (or fairness) complements the principle of payment according to need by ensuring that those whose level of need is the same, receive the same level of assistance. As the background paper explains, the goal is to give each recipient the amount they need in order to "achieve a similar living standard".

Targeting is about applying the needs principle in a cost effective way. By applying means tests and work tests, the income support system can be designed to exclude claimants who are able to support themselves — that is, it attempts to exclude claimants who do not need income support in order to reach a basic acceptable standard of living. So, for example, person who is able to earn a income through paid employment but who *chooses* not to, does not have the same level of need as a person who is unable to work.[5]

In principle there is no conflict between targeting according to need and the application of the needs principle. But in practice, the system will make mistakes. If targeting is tight, it will exclude some people in genuine need. If it is loose it will make payments to people who do not need them. Creating a system which was able to investigate each claimant's individual circumstances and customise payments exactly according to need is unlikely to be cost effective. Giving decision makers a high level of discretion about payment rates would almost certainly lead to inequitable outcomes.

Unlike the principles of targeting and equity, the principle of promoting participation and self-provision can conflict with the needs principle. It may be that reducing income support payments to inadequate levels will encourage some people to save more for retirement or search for work more aggressively. After all, in many third world countries there are no income support programs and people scrape together a living by picking through garbage dumps, searching for scrap metal or

[5] While straightforward in principle, attempts to exclude claimants who are voluntarily unemployed can be difficult in practice. Targeting a small number of voluntarily unemployed is also likely to result in the unnecessary harassment of many more involuntary unemployed.

other forms of subsistence-level self-employment. And in many countries it is common elderly people move in with their adult children when they are unable to afford to feed, clothe and house themselves. The question is whether we want to encourage this kind of self-provision at the expense of denying vulnerable people an income that is enough to enable them to live decently as members of our community.

The principle of sustainability has two components — political and fiscal. Political sustainability is about the public's support for the income support system. Public opinion tends to be more favourable towards the elderly, carers and working couples supporting families than it is to unemployed young people or single women with children. Public attitudes are heavily shaped by stereotypes about different groups of claimants and judgments about deservingness. Governments can increase support for the income support system by biasing assistance towards 'deserving' groups such as age pensioners.

Fiscal sustainability is about the burden today's decisions will have on tomorrow's budgets. For example, if the population is aging, making large increases to the age pension will have significant consequences for future budgets, especially if pensions are indexed against a measure of average male earnings.

Concerns over political sustainability encourage spending on pensions and payments to families with children while discouraging additional spending on payments such as Newstart and Youth Allowance. This makes it more difficult for governments to achieve a system that is equitable and targeted according to need. Concerns about fiscal sustainability tend to work in the opposite direction, strongly discouraging increases to pensions.

4.4 Justifications for inadequate rates of payment

As the background paper to the Pension Review explains, ensuring that recipients have the ability to maintain an adequate standard of living is not the government's only objective. In some circumstances other objectives might override the objective of adequacy. For example:

- ***Maintaining incentives to work:*** Policy makers may decide to set payments to working age recipients at an inadequate level in order to encourage recipients to take up opportunities for paid work.

- ***Affordability:*** Policy makers may decide that adequate income support payments are not affordable within current budget constraints. They may decide to trade off income support adequacy in favour of other objectives such as lower taxes, higher rates of economic growth, or high spending on other programs.

- ***Sustainability:*** Policy makers may decide to set income support payments at an inadequate level now to avoid creating affordability problems in the future. For example, since it is politically more costly to reduce Age Pension rates than to increase them, policy makers may decide to limit increases now in order to avoid having to reduce payment rates as the population ages.

4.4.1 Examples of tradeoffs

For working age payments the most important trade off has been between adequacy and work incentives. According to one very old school of thought, it is *impossible* to preserve work incentives and maintain payments at an adequate rate. The French thinker Alexis de Tocqueville argued this point in 1835:

> Man, like all socially organised beings, has a natural passion for idleness. There are, however, two incentives to work: the need to live and the desire to improve the conditions of life. Experience has proven that the majority of men can be sufficiently motivated to work only by the first of these incentives. The second is only effective with a small minority. Well, a charitable institution indiscriminately open to all those in need, or a law which gives all the poor a right to public aid,

> whatever the origin of their poverty, weakens or destroys the first stimulant and leaves only the second intact (de Tocqueville 1997: 55).

If de Tocqueville was right, then financial incentives alone are not enough to encourage work. Even if jobs are available and wages are substantially higher than income support payments, many people will make no effort to work or save for retirement if income support payments are set at an adequate level. For these people, the only way to preserve work incentives is to threaten them with severe hardship.

Obviously de Tocqueville's fears were exaggerated. Today, even in countries where benefit levels are extremely generous, the majority of people choose to work. Commentators like Clive Hamilton now worry that a desire to "improve the conditions of life" is causing many people to *over*work (Hamilton 2003). However, the idea that adequate income support will undermine incentives to work continued to influence income support policy into the 20th century and is often used to justify the disparity between the rates of pensions and those of unemployment allowances. As a report for the Hawke Government's Social Security Review noted

> … the underlying rationale for keeping the level low was to deter unemployment. No government from the time of the *Social Services Consolidation Act* until 1972 showed any intention of providing benefits which would be sufficient for beneficiaries to live on (Jordan 1975). The fear was expressed that if people could live on unemployment benefit many would choose to so, despite the work test (Cass 1988 p 18).

Up until 1972, governments maintained unemployment and sickness benefits at a lower rate than pensions. After 1972, the Whitlam Government both substantially increased the rate of payments and aligned unemployment and sickness benefits with pensions. But with the next change of government the gap was allowed to reopen.

It is important to recognise that there are a number of ways to address the problem of work incentives. Rather than reducing income support payments to those out of work, policy makers can choose to increase payments available to those in low paid work or increase the job search and training obligations imposed on income support recipients. Unless we accept de Tocqueville's argument that many people lack a strong enough desire to live above a subsistence level, this means that the problem of work incentives is really a problem of affordability.

When income support payments are reduced below adequate levels the negative impacts of motivating recipients who *are* able to find work fall on those who *are not* able to find work. All recipients are made to suffer in order to change the behaviour of a few. When work incentives are increased in other ways the impacts are met by the community as a whole.

4.4.2 Competing objectives and adequacy standards

The presence of competing objectives is sometimes invoked as if it were an argument against establishing adequacy standards. For example, when the UK Select Committee on Work and Pensions rejected a proposal to use budget standards as an adequacy benchmark, they give this rationale:

> One reason for the Department's reluctance to use budget standards is an anxiety that they will in some way be used to fix social assistance and other scale rates, and some advocates believe they can be used for this purpose. However, the Committee recognises that benefit levels cannot be determined by budget standards. Ministers have to have regard to a range of factors in fixing benefit levels including the resources available and incentive effects (Select Committee on Work and Pensions 2004).

However, if it is unreasonable to quantify adequacy because Ministers must take affordability and incentive effects into account then why is not equally unreasonable to quantify incentive effects and affordability? The most powerful motivation for not setting adequacy standards is that they would force governments to acknowledge these trade offs.

If policy makers are committed to transparency and accountability they will make these trade offs explicitly rather than covertly. In a transparent and accountable process, policy makers would provide a definition of adequacy, set benchmarks and — if income support payments are not adjusted to meet them — provide a justification.

5 Objections to setting adequacy benchmarks

5.1 The problem of individual circumstances

In the past, Australia has resisted providing a definition of adequacy or setting benchmarks for adequacy. Under the previous government, the Department of Families, Community Services and Indigenous Affairs gave this rationale:

> The adequacy of Australians' retirement incomes has been the subject of considerable debate over recent years. Much of the debate has centred on setting a benchmark for an adequate retirement income. However, the adequacy of retirement incomes depends on an individual's own circumstances, needs and expectations and accordingly the Australian Government has not set a 'one-size-fits-all' benchmark (FaCSIA 2007).

However, the same departmental submission asserts that the Age Pension "is meant to support a modest but adequate standard of living in retirement …". Taken together these two assertions suggest that, ideally, pension rates should be set on a case by case basis according to "an individual's own circumstances, needs and expectations".

It is unlikely that policy makers ever intended to pay pensioners different rates depending on their different expectations. So if the Age Pension really is intended to support an adequate standard of living, this standard of living needs to be defined independently of individual expectations. It is up to policy makers to establish what this standard of living is.

The problem of individual circumstances arises because different individuals may need different incomes in order to reach the same standard of living. For example, recipients who own their own home will need less income than those who rent privately. Similarly, recipients who are physically unable to drive may need a higher income in order to achieve the same level of mobility as those who are able to drive their own car.

While it is not possible to adjust payment rates to take account of all these factors, it *is* possible to estimate what proportion of the recipient population are unlikely to be able to achieve an adequate standard of living at prevailing rates of payment.

In some cases it may be more efficient to help recipients with special needs using targeted interventions to supplement income support payments. For example, income support recipients who face extra costs as a result of participation in intensive job search, education, training or voluntary work could be eligible for a participation supplement. This idea was canvassed by the Reference Group on Welfare Reform headed by Patrick McClure (McClure 2000 p 29)

5.2 The vagueness of 'adequacy'

Critics of benchmarks rightly point out that the concept of adequacy is inherently vague. While it might be possible to say that $1000 per week is more than adequate and that $10 per week is inadequate, this does not imply that there must be some specific dollar figure which marks the line between adequacy and inadequacy.

According to the critics it is reasonable to hold governments accountable for improving the adequacy of payments but it is not reasonable to set a benchmark and then say that policy makers have failed if payments are set a few cents a week below it.

While it is true that adequacy is a matter of degree so too is disability. The vagueness of the concept of disability does not prevent policy makers from setting a benchmark (using impairment tables), gathering statistics on the number of people with a disability and establishing a Disability Support Payment which requires that recipients be disabled in order to be eligible.

Setting a benchmark involves making judgments. What is most important is not that the judgment is beyond reasonable dispute, but that it is made on the basis of relevant considerations (eg cost of housing, cost of transport) and not on the basis of irrelevant considerations (eg policy makers willingness to allocate resources, effect on work incentives).

5.3 The arbitrariness of adequacy judgments

Judgments about the adequacy of a standard of living involve value judgments. However this does not make them entirely arbitrary or undermine their legitimacy. John Veit-Wilson argues that:

> There cannot be a free-floating and universally acceptable criterion of 'adequacy'; it can be argued only in terms of answers to real-life questions such as *adequacy for what?, adequacy for how long?, adequacy for whom? and who says?* (Veit-Wilson 1998 p 21).

Once these kinds of questions are answered, the task of setting income benchmarks is largely a technical one. But *until* they are answered, any benchmarks that are set will be arbitrary.

Adequacy judgments are less arbitrary when they are made in a structured and transparent way and normative judgments are clearly distinguished from positive judgments.

One approach to bolstering the legitimacy of normative judgments is for policy makers to rely on the judgments prevailing in the general community rather than their own personal views. Some researchers have attempted to do this for poverty measures (for example, see Hallerod 1994).

Professor Peter Saunders of the Social Policy Research Centre (SPRC) studied the history of the 'budget standards' approach to setting adequacy levels and argues that budget standards are unlikely to be as arbitrary as many critics allege:

> The results suggest, for example, that the budget standard developed in the 1920s to guide the setting of a basic wage, when updated by movements in prices and real incomes, is virtually identical to that developed by SPRC almost 80 years later.
>
> Some will argue that this similarity is nothing more than a coincidence, given the differences in how the budgets were originally constructed and what items were included. It is nonetheless remarkable that the results produced by a methodology that has been widely condemned for being arbitrary should turn out to be even remotely consistent over such a long period. At the very least, this suggests that the claims that budget standards are necessarily arbitrary should be treated with a degree of caution. The fact that two studies separated by eight decades of substantial economic development and massive social and attitudinal change produce such similar results suggests that, in practice, the use of normative judgements does not automatically make a budget standard inherently arbitrary, as many critics have argued (Saunders 2006).

5.4 What if income support payments are already adequate

If the current levels of income support payments were obviously adequate then there would be little to be gained from establishing a more precise benchmark. However the evidence suggests that this may not be the case.

The Social Policy Research Centre recently reported on research into poverty, deprivation and social exclusion. The concluded that:

> Improvements are needed in existing income support provisions, which are currently at levels where deprivation is high, indicating that they fail to provide adequate levels of support (Saunders, Naidoo, and Griffiths 2007).

This study did not rely on the researchers' personal judgments about adequacy but on judgments made by a sample of the general public.

6 Creating benchmarks for income adequacy

It is difficult to evaluate the success of a government program if its objectives are not measurable. So if the objective of income support payments is to ensure that recipients are able to enjoy an adequate standard of living, policy makers cannot be held accountable unless they define what adequacy means and establish benchmarks.

6.1 Adequacy — a budget standards approach

A considerable amount of research has already been undertaken on adequacy benchmarks. In Australia the SPRC has applied the budget standards approach to the Australian context. This work originated with DSS' 1990s Adequacy Project. As Peter Saunders explains:

> The budget standards method begins by articulating a standard of living in terms of its consumption and activity patterns, and specifies the needs that must be met in order to maintain that standard. It then goes on to identify and price the basket of goods and services required to meet these needs, and adds up the resulting expenditures to produce the total family budget needed to achieve the presumed standard of living. If a family was provided with this level of resources (either as cash or as access to the identified services free of charge), it would have the opportunity through consumption of goods and services, to achieve the standard of living to which the budget standard corresponds. Whether the family actually chooses to purchase this bundle of consumption items will depend upon the tastes and preferences of family members. However, if the family does not have access to all of the resources implied by a particular budget standard, then it will not be able to meet all of the needs on which that standard is based (Saunders 2006).

The methodology for this approach is well established and Australian research on budget standards is well regarded internationally (for example see Fisher 2007).

Despite commissioning work on budget standards the government did not end up applying the approach to the setting of income support payment rates. The SPRC's Peter Saunders has argued that, under the previous government, attention shifted away from adequacy and towards issues such as the factors that drive dependence on income support (Saunders 2004).

6.2 A question of political will

The technical issues involved in establishing credible benchmarks of income adequacy are well established. Appropriate methodologies have been developed for use in the Australian context. The major hurdles are not technical but political. Unless the community insists that that government should meet standards of accountability, the system will not change.

7 Creating an Entitlements Commission — a proposal

7.1 Purpose of the Commission

The purpose of the Entitlements Commission would be to set and adjust benchmarks for the adequacy of income support payments.

7.2 Why establish an independent commission?

If the government is to be held accountable for maintaining income support payments at an adequate level, standards of adequacy should be set independently and transparently.

The Fair Pay Commission, Commonwealth Remuneration Tribual and the Reserve Bank of Australia are examples of decision making bodies that operate at arms length from the political process. Their independence allows them to focus on the relevant technical considerations and ignore the pressures of electoral politics and public opinion. At the same time, the values that underpin their decision making are set by government. While their autonomy allows them to consider technical issues dispassionately it does not allow them to impose their own vision.

Establishing an Australian Commission for Entitlements as an independent body would give the commissioners a license to disregard political considerations and focus on issues relevant to income support adequacy. This would enhance public confidence in the resulting adequacy benchmarks.

7.3 Proposed terms of reference

1. In keeping with this objective the Commission's role would be to establish adequacy benchmarks for income support payments. In setting these benchmarks the commission should consider:

    1.1. the goods and services necessary to live in reasonable comfort, maintain dignity and take part in the life of the community;

    1.2. the contribution of in-kind government support provided through measures such as the Seniors Card, Medicare, public housing and subsidised transport;

    1.3. differences in the cost of living between income support recipients who own their own homes or have access to public housing and those who rely on the private rental market;

    1.4. differences in the cost of living for income support recipients in different geographical areas;

    1.5. differences in the cost of living for income support recipients living in different family/household types.

2. The objective of the income support system is to create a safety net to support a standard of living below which no member of the community should have to fall. The safety net is *not* designed to:

    2.1. reduce inequality of income (although it may have that effect);

    2.2. enable working aged individuals to voluntarily withdraw from paid employment or social participation.

3. An adequate standard of living is one that allows an individual to live in frugal comfort, maintain their dignity, and take part in the life of the community. An adequate income is a necessary but not sufficient requirement for attaining an adequate standard of living.

4. The Commission will operate transparently and publicly explain and report on the evidence and reasoning behind its decisions.

7.4 Composition of the commission

The commission could include:

- Academics with expertise in poverty research and income support policy.
- Representatives of the community sector.
- Representatives of the business community with expertise related to cost of living issues.
- Retired MPs or senior public servants with relevant experience.

The commission would be ongoing and the government would appoint members for a fixed period (for example, 4 years).

7.5 Operation of the commission

The commission would make determinations annually according to a predetermined methodology. To ensure transparency the commission would publish a written justification of each decision.

The commission's first task would be to produce a discussion paper outlining the methodology it proposes to use. In preparing this paper it should consult widely and call for submissions from government departments and interested parties.

After a process of consultation the commission would finalise and publish its methodology. This methodology will include operationalised definitions of terms such as 'frugal comfort', a list of the data the commission will draw on to make its decision and an outline of any analytical procedures it will use (eg determining the composition of a 'basket of goods', equivalence scales, geographical categories).

Before making each decision the commission will call for submissions and hold public consultations.

8 Conclusion

Historically income support payments have been set in an arbitrary and politicised fashion. Policy makers have rarely taken a structured approach to balancing adequacy, incentive effects, affordability and sustainability. And even though the government has acknowledged that payments should be sufficient to support an adequate standard of living, there is currently no standard of adequacy.

There are two major reasons for establishing an Australian Entitlements Commission. First, if standards are not set, adequacy is likely to lose out to other more easily measured objectives. And second the current ad hoc, politicised process has contributed to the lack of fairness, complexity and inconsistency of the income support system and has tended to overlook the needs of vulnerable groups who lack the ability to lobby effectively. An independent commission could help turn this around.

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Catholic Social Services
Australia

Australia's Future Tax System

Submission by Catholic Social Services Australia

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EXECUTIVE SUMMARY

On 13 May 2008 the Australian Government announced a review of Australia's taxation system. The purpose of the review, entitled *Australia's Future Tax System,* is to analyse the current tax system and make recommendations to position Australia to deal with the demographic, social, economic and environmental challenges of the 21st century and enhance Australia's economic and social outcomes.[1]

Catholic Social Services Australia, the Catholic Church's peak national body for social services, represents 66 social service organisations providing diverse services to over a million Australians each year from over 500 sites in metropolitan, regional and remote Australia. It has the mission of promoting a fairer, more inclusive society that gives preference to helping people most in need and therefore has direct interest in Australia's tax and transfer system. The Catholic Bishops of Australia have previously articulated their belief that tax reform is needed in Australia in order to maintain the principle of the common good of society and to enhance the prosperity for the Australian community, and in particular, poorer sections of the community.[2]

Catholic Social Services Australia therefore takes this opportunity to make a submission to the Australian Government's review of the taxation system, to continue to draw attention to characteristics of the tax and transfer system which adversely impact on poorer sections of the community, and to outline some possible policy responses.

The Australian tax system and the distribution of income and wealth

The last few decades have seen Australia's tax and transfer system undergo significant reform – on both the tax, and the welfare front. While welfare reform has helped to meet the needs of society's lowest income households, tax reform – particularly reforms to the taxation of superannuation – has largely benefited those on higher incomes. At the same time, market forces have tended to widen differences in pre-tax incomes in many developed economies, including Australia where a 'two speed' economy has led to significant divergences across sectors of the community and elements and segments of the community. Offsetting these developments, targeted welfare to those most in need meant that there was little change in final (after tax and transfer) measures of income inequality in the decade to 2005-06 but pressures have built on the less well-off in recent times.

In particular, cost of living pressures on low-income families have increasingly mounted. As the price of essential items such as food, transport and accommodation has increased, the financial pressure – in some cases the financial distress – facing the most disadvantaged elements of the community has heightened. Evidently, not all have benefited from Australia's recent extended period of economic prosperity.

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[1] See http://taxreview.treasury.gov.au/Content/Content.aspx?doc=html/home.htm for a full discussion of the scope of the review.

[2] Australian Catholic Bishops, *A position paper of the central commission of the Australian Catholic Bishops on the moral reference points for tax reform.* 27 July 1998.

Recommendation 1

Given the significant cost of living increases witnessed over the last few years – the impacts of which are felt disproportionately by low income households – relief through the tax and transfer system for low income families is emerging as a high priority for the tax system reform agenda in Australia. Distributive justice and preferential option for the poor suggest a need for a renewed focus on society's most disadvantaged.

Strong consideration should be given to measures which address the pressures facing low-income households, either through taxation reform such as an increase in the tax-free threshold, or a reduction in personal tax rates for low-income earners (noting that such measures would apply to all, not simply low-income earners), or through targeted welfare provisions such as rent assistance (appropriately integrated to avoid effective marginal tax rate increases).

Adverse interactions between the tax and transfer systems

The financial pressures facing segments of the Australian community are compounded by characteristics of the tax and transfer system which diminish the rewards to those reliant on welfare from transitioning into paid employment. This limits their ability to attain higher income levels and in some instances confines them to welfare-dependency and the relatively lower standards of living associated with this. Such barriers can, over time, accentuate income inequalities and, from an economic efficiency perspective, contribute to an under-utilisation of Australia's labour force.

Means-testing of welfare programs results in tapered withdrawal of entitlements as the income of the individual or family increases beyond certain levels. The combined effects of welfare-withdrawal and personal income tax – captured in an effective marginal tax rate (EMTR) – can impose severe penalties on low-income households as they enter the workforce or increase their work hours. Other family costs associated with entering the workforce, such as those associated with childcare, accentuate these effects.

Modelling undertaken by the National Centre for Social and Economic Modelling shows that in 2006-07, 7.1% of Australia's working age population, or around 900,000 Australians, faced EMTRs in excess of 50% – a significant increase from the 4.8% recorded a decade prior. Overwhelmingly, these households are families. In fact, couples with children are nearly six times more likely to face high EMTRs greater than 50% than those without, while singles with children are more than 16 times more likely than those without.

Along the income spectrum, the prevalence of high EMTRs is greatest in the lower-middle income deciles. Around one in seven workers in the fourth, fifth and sixth deciles – a gross income range that spans from $40,000 to $75,000 – faced EMTRs greater than 50% in 2006-07 (NATSEM, 2006).

Recommendation 2

Alleviating the impacts of high EMTRs is a challenging assignment, but one of great significance to the prospects of a large segment of the Australian community. Policymakers must balance the need to provide adequate assistance to society's most disadvantaged, with ensuring that those who seek to enter the workforce, or increase their workforce participation, achieve adequate reward from doing so.

This requires a significantly greater level of integration between the tax and transfer systems than exists at present. Given Australia's complex, interrelated tax and transfer system, this will only effectively be achieved through a fully integrated, whole-of-system approach to reform. Some specific measures which should be considered as effective options for addressing high EMTRs and their adverse impacts include: (i) negative income taxes; (ii) reduced taper rates; and (iii) integrated income tests.

Conclusions

While the Government's review of Australia's tax system will no doubt canvas a large number of issues relating to the operation of Australia's tax and transfer system, the ability of the system to effectively address the circumstances of low-income earners and Australia's most disadvantaged must be a high priority. Financial pressures created by increasing costs of living, coupled with barriers to workforce participation generated through high EMTRs, are diminishing the living standards of certain segments of the community and restricting their ability to overcome this by earning additional private income.

Australia's Future Tax System has both a direct and an indirect role to play in improving outcomes for the community's most disadvantaged. Strong consideration should be given to measures which alleviate the burdens on low-income households, either through taxation reform or through targeted welfare provisions, while integrative measures should be sought to diminish the impact of high EMTRs and reward, not discourage, the transition from welfare to employment. Alleviating high EMTRs produces benefits not only from an equity perspective – through improving opportunities for low-income households – but efficiency also – through enhancing the utilisation of Australia's labour force.

1. BACKGROUND AND CONTEXT

Australia's Future Tax System

On 13 May 2008 the Australian Government announced a review of Australia's taxation system. The purpose of the review, entitled *Australia's Future Tax System,* is to look at the current tax system and make recommendations to position Australia to deal with the demographic, social, economic and environmental challenges of the 21st century and enhance Australia's economic and social outcomes.

As outlined in its terms of reference[3], the review will consider:

- the appropriate balance between taxation of the returns from work, investment and savings, consumption (excluding the GST) and the role to be played by environmental taxes;
- improvements to the tax and transfer payment system for individuals and working families, including those for retirees;
- enhancing the taxation of savings, assets and investments, including the role and structure of company taxation;
- enhancing the taxation arrangements on consumption (including excise taxes), property (including housing), and other forms of taxation collected primarily by the States;
- simplifying the tax system, including consideration of appropriate administrative arrangements across the Australian Federation; and
- the interrelationships between these systems as well as the proposed emissions trading system (ETS).

The objective of the review is to ensure the tax system is equitable as well as economically efficient. The terms of reference emphasise that any recommendations must enhance overall economic, social and environmental well-being and the review is tasked with ensuring there are appropriate incentives for:

A Workforce participation and skill formation;

B Individuals to save and provide for their future, including access to affordable housing;

C Investment and the promotion of efficient resource allocation to enhance productivity and international competitiveness; and

D Reducing tax system complexity and compliance costs.

Specifically, the review is asked to consider the relationships between the tax system and the transfer payment system and other social support payments, rules and concessions in order to improve incentives to work, reduce complexity and maintain cohesion.

In accordance with the review's terms of reference, Treasury released a discussion paper on 6 August 2008 entitled *Architecture of Australia's tax and transfer system.* The paper provides a comprehensive review of the tax and transfer systems in Australia, and was produced in collaboration with the Department of Families, Housing, Community Services and Indigenous Affairs, the Department of Employment, Education and Workplace Relations and the Australian Taxation Office.

[3] http://taxreview.treasury.gov.au/Content/Content.aspx?doc=html/home.htm

The discussion paper provides a detailed overview of the tax-transfer system, including the mix of taxes on work, investment and consumption, the personal tax-transfer system and the complexity and operating costs of the tax-transfer system.

Following the publication of the discussion paper, on 19 August 2008 the review panel invited submissions from the public. These submissions, as well as initial discussions with major representative organisations on tax policy review priorities, will be released by the panel before the end of 2008 in the form of a consultation paper. The consultation paper will outline the key issues to have emerged and provide a basis for further review processes conducted by the panel during 2009.

This paper constitutes Catholic Social Services Australia's submission to *Australia's Future Tax System.*

About Catholic Social Services Australia

Representing 66 member organisations, Catholic Social Services Australia is the Catholic Church's peak national body for social services. It advises the Australian Catholic Bishops Conference on social policy issues as well as supporting the delivery of a wide range of social service programs and is the Church's public voice on social policy and social services issues.

For 50 years, Catholic Social Services Australia has assisted and promoted better social policy for the most disadvantaged people in Australian society. This continues a much longer tradition of such engagement by the Catholic Church in Australia.

Catholic Social Services Australia promotes a fairer, more inclusive society that gives preference to helping people most in need. It is committed to an Australian society that reflects and supports the dignity, equality and participation of all people. To this end, Catholic Social Services Australia works with Catholic organisations, governments, other churches and all people of goodwill to develop social welfare policies and other strategic responses that work towards the economic, social and spiritual well-being of the Australian community.

Our 66 members employ over 6,500 people and provide 500 different services to over a million people each year from sites in metropolitan, regional and rural Australia.

Services provided by our members include but are not limited to: aged care, children's services, drug, alcohol and/or other addiction services, disability services, employment services, employee assistance programs, family services, housing and homelessness services, Indigenous services, mental health programs, migrant and refugee services, pregnancy counselling and support, pastoral ministries, policy and research, youth services.

The distribution of disadvantage in Australia

A 2007 report by University of Sydney Professor Tony Vinson, which was jointly commissioned by Jesuit Social Services Australia and Catholic Social Services Australia, found that despite the nation's strong economic growth, some communities remain caught in a spiral of low school attainment, high unemployment, poor health, high imprisonment rates and child abuse.[4]

The report finds that pockets of concentrated and severe social disadvantage have become entrenched across rural and remote as well as suburban Australia.

[4] Vinson, T (2007) "Dropping off the edge – the distribution of disadvantage in Australia" *Report for Catholic Social Services Australia and Jesuit Social Services*.

It finds that just 1.7 per cent of postcodes and communities across Australia account for more than seven times their share of top rank positions of the major factors that cause intergenerational poverty, including: low income, limited computer and internet access, early school leaving, physical and mental disabilities, long-term unemployment, prison admissions and confirmed child maltreatment.

The report estimates that in Victoria, where adequate surveys have been conducted, nearly one-third (33.1%) of all communities suffer from 'low social cohesion' - where inadequate levels of community reciprocity, trust and resources make it more difficult for individuals and families to overcome the individual and family problems that lead to poverty.

The report highlights the particularly strong link between intergenerational poverty and low educational attainment. By detaching individuals, families and whole communities from the modern economy in this way, the report argues that disadvantage is holding back the nation's economic potential. Concentrated disadvantage of the kind demonstrated in the report robs the nation of needed skilled workers, adds to labour shortages and, by inflating welfare expenditure, reduces government expenditure for other purposes. The report also suggests that there is 'return on investment' for the community if it overcomes long term disadvantage because it is associated with such high costs.

The report complements other recent studies based on OECD data[5] showing Australia to be (1) near the bottom of OECD rankings on child poverty and (2) experiencing widening gaps in income, wealth and opportunity between the rich and the poor.

[5] UNICEF, *An overview of child well-being in rich countries*, February 2007; (2) A B Atkinson and A Leigh, *The distribution of top incomes in Australia*, ANU, February 2007.

2. PRINCIPLES AND POLICY FRAMEWORK

An evaluation of Australia's tax and transfer system and the identification of key areas for reform must be underpinned by an appropriate policy framework; that is, a certain set of principles adopted to inform the analysis. As a precursor to the analysis that follows, this section briefly sets out the policy position of Catholic Social Services Australia – as articulated by the Catholic Bishops of Australia – on tax reform and contrasts this with criteria commonly adopted by tax experts and policymakers.

2.1 CATHOLIC SOCIAL SERVICES AUSTRALIA'S TAX DESIGN PRINCIPLES

The Catholic Bishops of Australia set out what they regard as moral reference points for tax reform in Australia in a 1998 position paper released by the Central Commission of the Australian Catholic Bishops.[6] In the decade since this paper was released, the Australian tax and transfer system has undergone significant reform (see discussion in Section 3), however the principles underpinning the paper, and hence the Catholic Social Services Australia position, remain entirely relevant today. Drawing on this paper, the following discussion summarises the position of Catholic Social Services Australia on tax reform in Australia.

Tax reform is needed in order to maintain the principle of the common good of society and the enhancement of prosperity for the Australian community. While the Bishops seek increases in prosperity overall, they have a special concern for the poorer sections of the community and for reducing the differences between rich and poor.

Underpinning the views of the Catholic Social Services Australia on tax reform are three fundamental principles that are held as essential to achieving a just society.

1. The Common Good

The principle of the common good refers to "the sum total of social conditions which allow people, either as groups or as individuals, to reach their fulfilment more fully and more easily".[7] It concerns the life of all and must take account of the needs and aspirations of all members of the community. The Catholic Church argues that "it is the proper function of the public authorities to arbitrate, in the name of the common good, between various particular interests but it should make accessible to each what is needed to lead a truly human life: food clothing, health, work, education and culture, suitable information, the right to establish a family, and so on".[8] Citizens therefore have an obligation to pay tax in order that the common good is promoted and the welfare of the community is maintained.

2. Distributive Justice

Catholic tradition holds that the goods and the burdens of a community are to be distributed on the basis that not all persons can contribute in the same way.[9] While the value of individual merit, effort and utility are recognised, society's burden should be distributed

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[6] Australian Catholic Bishops, *A position paper of the central commission of the Australian Catholic Bishops on the moral reference points for tax reform.* 27 July 1998.

[7] *Gaudium et spes. n26.*

[8] *Catechism of the Catholic Church, (English translation) 1994.* Homebush: St. Paul para 1906.

[9] Pope Leo XIII, 1891, *Rerum novarum ('*On the Condition of the working Classes'). Encyclical Letter. Reprinted 1942, St Paul Editions. N27.

equitably with due emphasis on a person's capacity to contribute. In a system of taxation based on justice and equity, it is fundamental that the burdens be proportioned to the capacity of the people contributing.[10] This is an example of what is known as the principle of distributive justice.

3. Preferential option for the poor

The Catholic Church has a primary commitment to be at the service of the poor, the disadvantaged and the marginalised members of our community, holding that the greater the needs of people, the greater the responsibility of authorities and of those with capacity to meet those needs. As the US Catholic Bishops have noted, "the prime purpose of this special commitment to the poor is to enable them to become active participants in the life of society. It is to enable all persons to share in and contribute to the common good. The 'option for the poor', therefore, is not an adversarial slogan that pits one group or class against another, rather it states that the deprivation and powerlessness of the poor wounds the whole community. The extent of their suffering is a measure of how far we are from being a true community of persons."[11]

The Church therefore seeks to encourage civil authorities to also share this commitment, for the common good of society. As Pope John XXIII articulated, "consideration of justice and equity can at times demand that those in power pay more attention to the weaker members of society, since these are at a disadvantage when it comes to defending their own rights and asserting their legitimate interests"[12].

Objectives and priorities

In light of these principles, tax reform in Australia should aim to achieve three things:

- improvement in the prosperity and life circumstances of low-income families and individuals ensuring that each citizen contributes tax according to the capacity to pay;
- a robust tax revenue base; and
- the encouragement of employment generating investment.

On this basis, two main priorities are seen for tax reform in Australia.

- First, it should aim to remove 'poverty traps' and 'work traps' that are created by the way the income tax system relates to the social security system.
- Secondly, the income tax system needs to be reformed to deliver a fairer deal to low-income households and families with dependants and to minimise opportunities for the affluent to avoid paying their fare share of tax.

2.2 CONSISTENCY OF OBJECTIVES

In conceiving tax system reform, and in evaluating alternative tax reform options, tax experts generally draw on three core principles which are widely held to underpin optimal tax system design: economic efficiency, equity and simplicity. While these may be supplemented with additional considerations such as cross-border competitiveness, revenue sustainability and

[10] *Mater et magistra, n132.*

[11] US Catholic Bishops, 1986, Economic Justice for All, Pastoral Letter on Catholic Social Teaching and the US Economy *http://www.usccb.org/sdwp/international/EconomicJusticeforAll.pdf*

[12] Pope John XXIII, 1963, *Pacem in terries (*'Peace on Earth'). Encyclical Letter. Homebush: St. Paul Publications n56.

competitive neutrality, it is these three key criteria which are the essential guides for tax system reform.

In light of this, there is a strong accord between the principles that Catholic Social Services Australia hold as essential considerations in tax reform and conventional criteria adopted by economists and policymakers to evaluate various tax reform options. Both recognise the importance of pursuing efficiency in order to maximise prosperity and both identify equity as important to maintaining a 'fair' system.

In practice, of course, there may be differences in emphasis. However, the suggestions presented in the following sections are consistent with aims to improve economic efficiency as well as strengthening the social safety net underpinning the tax system in Australia, which recognises society's concern for the poorest elements of the community.

3. AUSTRALIA'S TAX AND TRANSFER SYSTEM

Successive Australian Governments have employed progressive income tax scales and targeted transfer payments to meet their social welfare objectives. Around 30% of GDP is collected in taxation at some level of government with around 8% of GDP redistributed through various transfers (welfare payments).

Over the past few decades, market forces have tended to widen differences in before-tax incomes in many developed economies including Australia. Despite this, at least up until the middle of this decade, Australia has seen little change in final (after tax and transfer) measures of income inequality largely as a result of targeted welfare payments for those most in need. At the same time however, there has been growing inequality in the ownership of assets. Significant increases in the value of several asset classes including property and shares (the financial turmoil of the last few months aside) has enabled those with existing assets, in particular those with superannuation, to accumulate greater amounts of wealth.

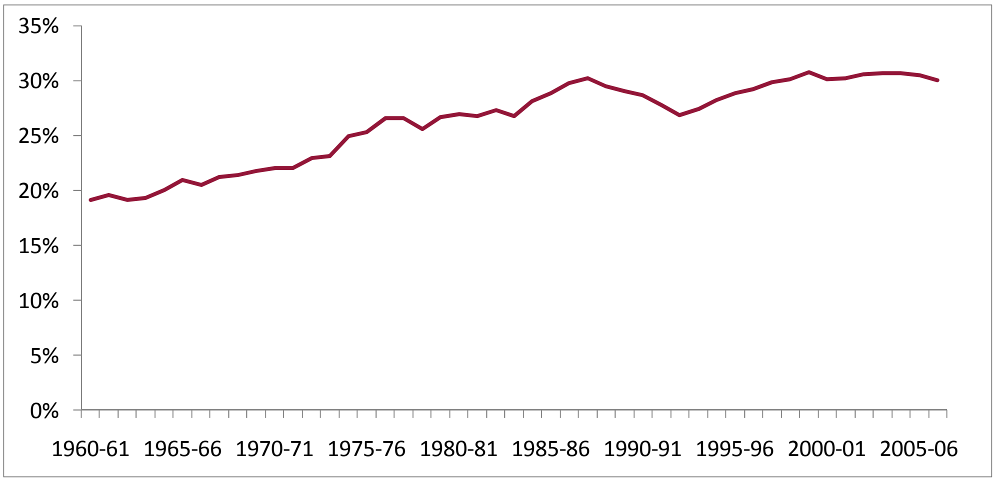
Over the recent years, differences in economic circumstances for different groups in the community have become more pronounced. Australia's so-called 'two-speed economy' has resulted in growing cost of living pressures on many of the most disadvantaged in the community. The higher costs of housing (prices, interest rates and especially rents), food, utilities and petrol tend to fall disproportionately on households on lower incomes. The result has been a worryingly increasing trend in the incidence of financial distress.

These pressures are not expected to quickly abate. In these circumstances, it is important that the tax and transfer system is used to address the impact of the pressures on those most severely affected.

3.1 RECENT TRENDS IN TAXATION AND WELFARE

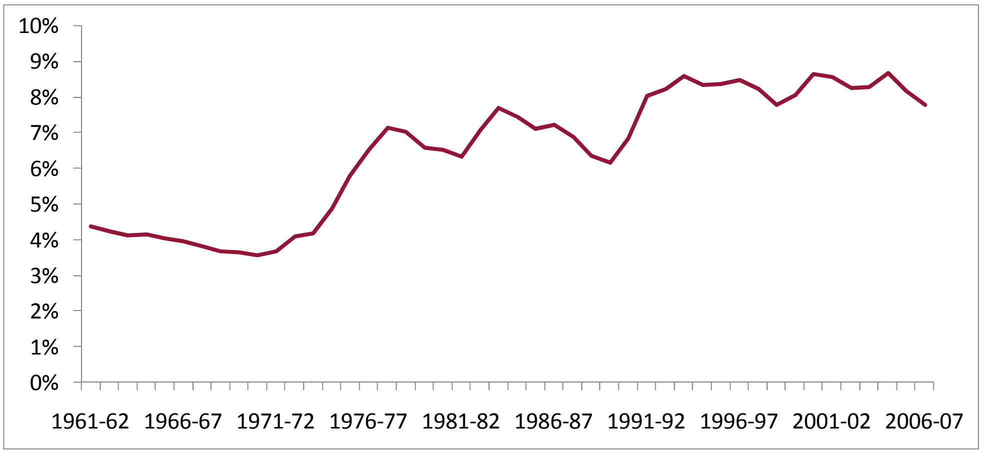
A significant share of Australia's income is tied up in the tax and transfer system. As shown in Figure 3.1 and Figure 3.2, around 30 % of Australia's gross domestic product is collected in taxation by some level of government, and around 8% of GDP is distributed in transfers.

FIGURE 3.1: TAXATION (% OF NOMINAL GDP)



Source: ABS 5206.0 Table 1 and Table 18

FIGURE 3.2: SOCIAL ASSISTANCE BENEFITS PAYMENTS (% OF NOMINAL GDP)



Source: ABS 5206.0 Table 1 and Table 19

3.1.1 LINKS BETWEEN TAXATION, WELFARE AND CATHOLIC SOCIAL SERVICES AUSTRALIA'S TAX DESIGN PRINCIPLES

The design of the tax and transfer system has a major bearing on prosperity, equality and the plight of those least well-off in society. It has major impacts on the efficiency with which the economy operates – and hence economic growth – and, as the fundamental mechanism through which income is redistributed, is the Government's primary tool for achieving distributive justice, or equity.

The common good

Revenue raised through taxation allows government to further national prosperity and contribute to the common good through the provision of goods and services that are in the interests of the community as a whole, be that, for example, through investment in infrastructure projects, or in the health and education of Australians.

Distributive justice

One of the main goals of the taxation and welfare system is the redistribution of income to achieve a more equitable outcome than that produced by market forces alone. Among other things, this is undertaken in the belief that income equality promotes social cohesion.

Elements of both the taxation and welfare systems are progressive, meaning that people with higher incomes pay proportionally more income tax than those with lower incomes and have proportionally less access to welfare payments.

Equality of opportunity, or income mobility, is also affected by the tax and transfer system. The welfare system plays an important role in providing support to individuals when they are unable to work for a period of time (for example, while obtaining education, raising children, or due to sickness), but who may later return to work and move up the income distribution. The creation of poverty traps as a result of high effective marginal tax rates (discussed in detail in Section 4) is an outcome of the tax and transfer system that can negate income mobility.

Preferential option for the poor

The core purpose of the welfare system is to ensure all members of society are given access to a reasonable standard of living. The success of the social safety net is determined by the degree to which the system identifies those in need, the degree to which the system provides sufficient resources to avert poverty, and the opportunity the system provides to those who are able to improve their situation through work.

3.1.2 THE HISTORY OF TAXATION AND WELFARE REFORM IN AUSTRALIA

Australia's tax and transfer system has undergone marked change over the last two decades. The tax base has shifted considerably, with indirect taxation assuming a larger component of the nation's total tax take - most notably through the introduction of the Goods and Services Tax in 2000. Welfare reforms have led to an increase in the amount of support going to families with children, and increased obligations for welfare recipients to look for work if they are able to.

This section presents a summary of major changes to the taxation and welfare systems, focusing on the reforms that have impacted on income inequality and poverty. The history of reforms highlights the way various objectives have come to prominence and the piecemeal nature of changes to the system of transfers in particular.

The current review into *Australia's Future Tax System* represents an opportunity to correct the whole system.

Taxation

Taxes are levied by three levels of government in Australia, however the focus here is on changes in Australian Government taxes because they collect the largest share of taxes and also because the types of taxes the federal government collect have the biggest impact on income distribution and the burden of taxation on people with low incomes.

The recent Treasury report *Architecture of Australia's tax and transfer system* characterised the history of Australian Government tax reform as falling into two periods. From federation to the middle of the 1970s the focus of reform was on increasing tax revenue (by expanding the revenue base) to cover increasing expenditure. Since the mid-1970s the objectives of tax reform have been focused on improving the equity, efficiency and simplicity of the tax system.

Among the significant changes to the tax system introduced over recent decades have been:

- base broadening of income taxes, especially with the introduction of the capital gains taxes and comprehensive fringe benefit taxes in the late 1980s;
- the introduction of dividend imputation for dividends paid to Australian shareholders;
- the tax-preferred treatment of superannuation including, most recently, with the exemption of benefits paid from a taxed fund to people aged over 60 as introduced in the 2007-08 Budget; and
- the introduction of the Goods and Services Tax (GST) that was accompanied by the abolition of the multi-rate wholesale sales taxes and a range of state taxes. Rates for personal income tax were reduced, meaning there was an overall shift in the tax mix towards indirect taxation and away from income taxation, with adverse implications for the progressivity of the system overall.

Changes in the tax mix, the share of total tax revenue collected from different types of taxes, affects the overall level of progressivity in the tax system. This is because not all taxes have the same level of progressivity.

Personal income tax has always been taxed progressively (that is, rates increase with income). Consumption taxes, such as the GST, are usually regressive as they are charged at a flat rate but people on lower incomes tend to spend a greater share of their income on consumption (rather than savings and investment). Likewise the favourable tax treatment of superannuation favours people on higher incomes.

The combination of the introduction of the GST and the 2007-08 changes to superannuation indicates that the taxation system has become more regressive over the past decade.

Welfare[13]

The 2008 report *An Australian Entitlements Commission* that was prepared for Catholic Social Services Australia provided a detailed summary of the history of Australia's income support system. This document highlighted that while in the beginning the goal was clearly to provide aid for the deserving, there have since been adjustments of a more ad hoc nature, often inspired by short term political considerations.

Government payments to individuals fall across three broad groups:

- assistance to the aged;
- assistance to those of workforce age (including to people with a disability, to the unemployed, and parents); and
- assistance to families with children.

1908	Old age and invalid pensions introduced.
1941	Child endowment introduced.
1942	Widows pension introduced.
1944	Unemployment and sickness benefit payments introduced.
1972	Commission of Inquiry into Poverty.
1970s	Whitlam Government significantly increased rates for income support payments.
1988	Social Security Review – resulted in a number of new programs and the modification of many existing welfare programs to: • increase targeting of payments, and • provide incentives to work, and reduce dependence.
1994	Beginning of process to increase the eligibility age for the age pension for women from 60 to 65 years (this reflected a desire to remove gender based eligibility conditions for payments).
1997-2000	Mutual obligation and work-for-the dole.
2006	Welfare-to-work reforms.

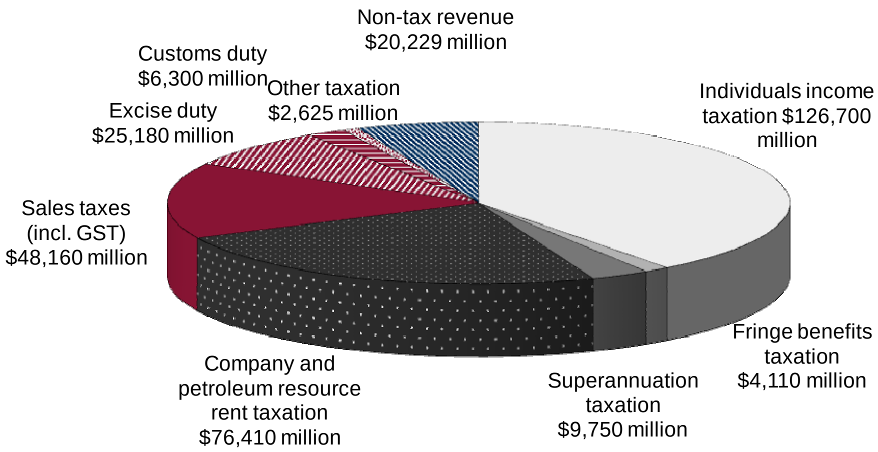
[13] Parliamentary Library of Australia, e-brief (2000) *Welfare review*, http://www.aph.gov.au/library/INTGUIDE/sp/welfarebrief.htm#3.%C2%A0%20Welfare%20reviews%20and%20reforms%20-%20history

3.2 OVERVIEW OF THE CURRENT SYSTEM

3.2.1 TAXATION

As discussed above, the design of the tax system has important impacts on the distribution of income in Australia. Figure 3.3 shows the estimated mix of revenue sources for the Australian Government for 2008-09. In addition to personal income tax and the GST (included in Sales Taxes in the chart below), the other significant source of tax revenue is company income tax and petroleum resource rent taxation which accounts for 24% of Australian Government tax revenue.

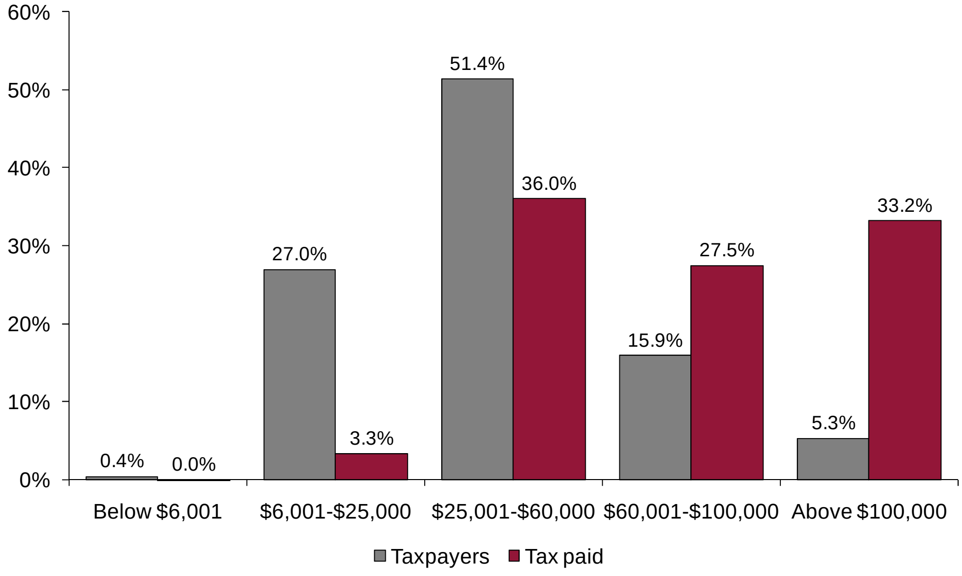
FIGURE 3.3: AUSTRALIAN GOVERNMENT TAX MIX, 2008-09



Source: Budget Paper No. 1, Budget Strategy and Outlook 2008-09

As noted, a feature of Australia's personal income tax system is its progressivity. Above a tax-free threshold of (currently) $6,000, the marginal tax rate an individual faces increases as their income level passes certain thresholds, and hence, additional amounts of income are taxed at a higher rate. Figure 3.4 demonstrates the impacts of this progressivity showing that, in 2005-06, the top 5.3% of income earners contributed 33.2% of the total personal income tax, while the bottom 27.4% contributed 3.3%.

FIGURE 3.4: NET PERSONAL INCOME TAX PAYABLE BY TAXABLE INCOME LEVEL[14], 2005-06



Source: Australian Taxation Office (2008), Taxation statistics 2005-06

3.2.2 WELFARE

The social safety net is intended to ensure society's most disadvantaged are provided with an appropriate level of financial support. It provides income to live on for those who, for a variety of reasons, do not have sufficient income and/or assets to maintain a basic standard of living.

Although the provision of in-kind services, such as education and health care, is a central element of the social safety net provided by government, the focus in this section is on the role of welfare payments (pensions and allowances). In relation to the problem of poverty traps (discussed in Section 4, below), it is means-tested welfare payments that create high EMTRs and reduce the rewards to people from working.

Table 3.1 lists the major categories of welfare payments along with their share of total Australian Government welfare provisions in 2006-07. As is evident from the table, the majority of welfare payments – around two-thirds – are received by the aged and by families with children. People with disabilities (14%) and veterans and dependents (7%) are also significant sources of welfare expenditure.

[14] Only includes individuals with a net tax payable greater than $0.

TABLE 3.1: AUSTRALIAN GOVERNMENT WELFARE PAYMENTS, SHARE OF TOTAL EXPENDITURE ON WELFARE 2006-07

Nature of welfare payment	%
Assistance to the aged	35.2%
Assistance to families with children	30.2%
Assistance to people with disabilities	13.9%
Assistance to veterans and dependants	6.8%
Assistance to the unemployed	5.1%
Common youth allowance	2.3%
Aboriginal advancement n.e.c.	1.4%
Assistance to the sick	0.1%
Other welfare programmes	2.4%
General administration	2.6%
Total social security and welfare	**100.0%**

n.e.c. not elsewhere classified

Source: Commonwealth of Australia (2008), Budget: Budget strategy and outlook, Budget Paper No.1 2008-09, Table A1

Given the resources of Government are limited, welfare is largely targeted at those most in need. This is achieved by assessing the individual's (or family's) access to other sources of income and assets. The means-testing of welfare payments results in the rate at which payments are made decreasing with the means (income and assets) of the welfare recipient.

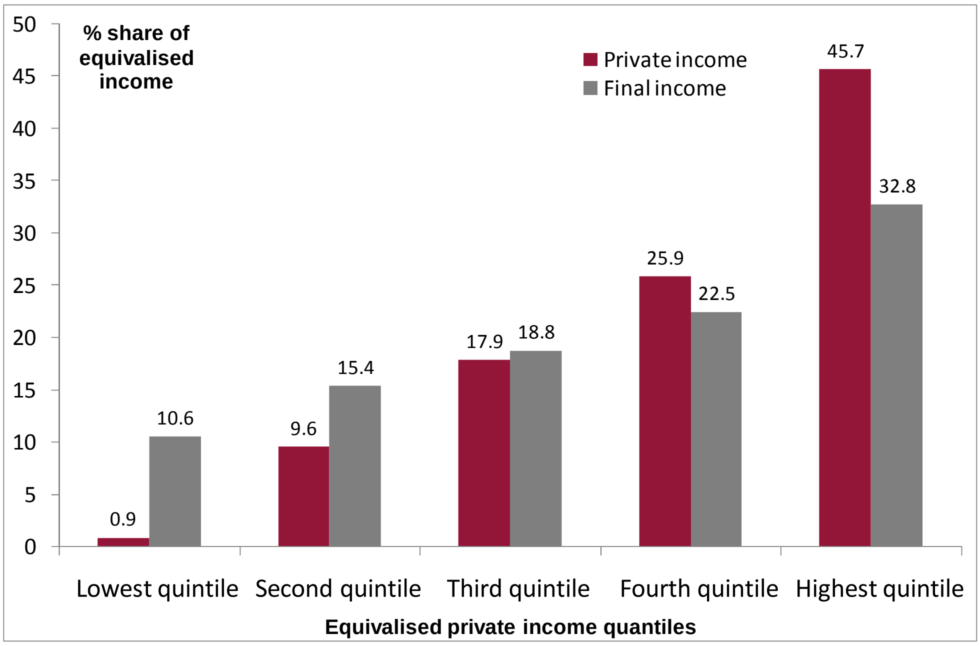
A key difference between the welfare system in Australia and the taxation system is the units (individuals versus families) against which income (or in the case of welfare, assets) is assessed. While taxation is levied against individual income, eligibility for many welfare payments is dependent on family structure and on the financial circumstances of the family.

3.3 INCOME DISTRIBUTION AND FINANCIAL STRESS

The distribution of income across the community can be, and indeed regularly is, measured and reported in a variety of ways. Unadjusted, pre-tax income provides an indication of the equality of income distribution in the absence of Government intervention. The distribution of final income on the other hand (income after accounting for taxes and transfers), demonstrates the Government's effectiveness in redistributing this income in a way that satisfies society's equity objectives.

Figure 3.5 shows the equalising effect of the tax and transfer system on the distribution of income in 2003-04. Final income is spread more evenly than private income, with, for example, the highest 20% of income earners share of total income reduced from 48% to 33% through the tax and transfer system.

FIGURE 3.5: EFFECT OF TAXES AND BENEFITS ON HOUSEHOLD INCOME, 2003-04



Source: ABS 6537.0 2003-04 Government Benefits, Taxes and Household Income, Australia

If incomes were completely equitable then each quintile would account for 20% of equivalised income[15]. While perfect income equality is not necessarily the desired outcome, there are important questions as to what degree of inequality is excessive and what degree of equality we should strive for.

Figure 3.6 provides evidence of the recent situation for income inequality in Australia. The focus here is on the distribution of final incomes (i.e. after taxes and welfare benefits). While there appears to be evidence that inequality of earnings (wages) has been increasing, this is only an issue for the design of the taxation and welfare system to the extent that changes in inequality are occurring in final incomes.

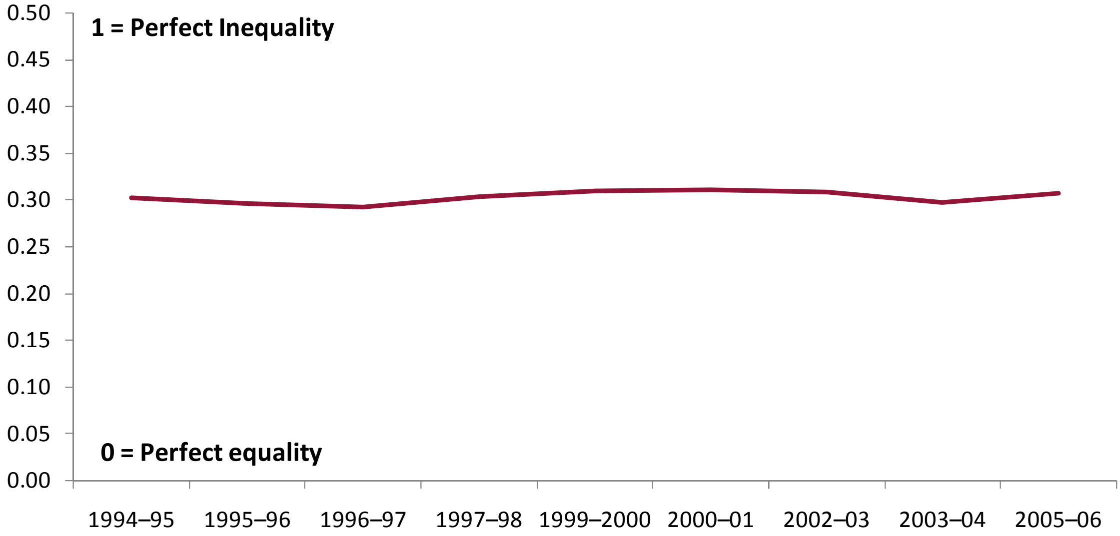
The most widely used summary measure of income inequality is the Gini coefficient.[16] In brief:

- if we all had the same income, then the Gini measure would be equal to zero;
- if all the income in Australia was earned by one person, then the Gini would be one.

[15] Equivalised income refers to the level of income after adjustment is made to account for differences in household sizes and structures.

[16] Gini, Corrado (1921). "Measurement of Inequality and Incomes". *The Economic Journal* 31: 124-126. The Gini coefficient is one of many possible measures of inequality.

FIGURE 3.6: GINI COEFFICIENT, SUMMARY MEASURE OF INCOME INEQUALITY, 1994-95 TO 2005-06



Source: ABS 6523.0, Household income and income distribution, Australia, 2005-06.

Between 1994-95 and 2005-06, there has been no significant change in Australia's Gini coefficient.[17] This period coincided with a period of strong economic growth for Australia, where there were gains at all points on the income distribution. After allowing for inflation, the incomes per head of the poorest 20% of Australian households increased 34% over the past eleven years, almost exactly matching the gain in the community as a whole.

In part, the stability of the Gini measure of income inequality reflects the fact that, countering growing disparity in before-tax earnings, changes to taxes and, especially, benefits have tended to favour lower income households.

The observation that the Gini measure of inequality displayed little change in the decade to 2005-06 suggests that there had been no progress in improving redistributive justice over this period. Furthermore, and very significantly, there is considerable on-the-ground evidence that the financial circumstances of society's most disadvantaged have deteriorated since 2005-06.

In particular, Australia's pronounced 'two-speed' economy has seen cost of living pressures for many Australians progressively worsen. The increases seen in interest rates, rents and prices for petrol, electricity and basic food items have fallen most heavily on lower income households (especially outside the resource-intensive States).

As evidence mounts of this rising costs-of-living and incidence of financial distress in the community, it is an important time to refocus on the needs of poorest in the community and objective of redistributive justice.

3.4 POLICY IMPLICATIONS

The last few decades have seen Australia's tax and transfer system undergo significant reform – on both the tax, and the welfare front. Total taxation revenue has continued to rise, as has welfare expenditure, albeit at a lower rate and moderating in recent years. At the

[17] Some alternative measures of income inequality to the Gini coefficient, such as percentile ratios (e.g. ratio of total income of people in the 90th percentile to the income of those in the 10th percentile) show a small scale increase in inequality.

same time, market forces have tended to widen differences in pre-tax incomes in many developed economies, including Australia.

Given the significant cost of living increases witnessed over the last few years – the impacts of which are felt disproportionately by low income households – relief through the tax and transfer system for low income families is emerging as a high priority in Australia. While the performance of the Australian economy over the current decade has, in aggregate, been strong, the headline trends mask a growing divide across different segments of the economy, and indeed the community. The much-publicised 'two speed economy' has seen certain sectors, and those employed within these (and related) sectors, enjoy strong financial gains and commensurate increases in living standards.

Recent tax reforms – both to personal income tax and especially to the taxation of superannuation – have tended to provide relatively greater benefits to those higher up the income distribution. In light of these pressures, and reflecting the principles of distributive justice and preferential option for the poor, there is a strong case for the provision of greater levels of welfare assistance to low-income households, particularly the most disadvantaged.

High priority should be given to measures which address the pressures facing low-income households at present and into the future, either through taxation reform such as an increase in the tax-free threshold, or a reduction in personal tax rates for low-income earners (noting that such measures would apply to all, not simply low-income earners, and do not assist those not paying income tax), or through targeted welfare provisions (appropriately integrated to avoid EMTR increases).

4. ADVERSE INTERACTIONS BETWEEN AUSTRALIA'S TAX AND TRANSFER SYSTEMS

The financial pressures facing segments of the Australian community are compounded by characteristics of the tax and transfer system which diminish the rewards to those reliant on welfare from transitioning into paid employment. This restricts their ability to attain higher income levels and in some instances confines them to welfare-dependency, and the relatively lower standards of living associated with this. Such barriers can, over time, accentuate income inequalities and from a national economy prospective, contribute to an inefficient utilisation of Australia's labour force.

This section outlines the nature and origins of these issues, analysing their impacts and discussing the benefits of reform. Some possible policy responses are discussed in Section 5.

4.1 THE NATURE OF THE PROBLEMS

Australia's personal income tax system is based primarily on the individual, with tax rates invariant to family circumstances, including family income. The progressivity of the personal income tax scale, including an initial tax free income range, introduces a degree of equity to the personal tax system. As individuals earn higher amounts of private income, they pay a greater proportion of that income in tax (that is, their marginal tax rate increases).

Australia's welfare system is characterised by a range of payments and allowances targeted at individuals and families in certain circumstances and with a defined level of financial need. Unlike the tax system, the welfare system installs the family as the unit of welfare eligibility, with the circumstances of the entire household taken into account in welfare provision determinations.

Such a system invariably results in some individuals paying tax, while at the same time receiving welfare payments – a phenomenon known as 'churning'. As individuals in such circumstances earn greater amounts of private income, they are dually penalised: first, through the personal income tax system, and second, through the withdrawal of means-tested benefits. The combined impact of these two effects is captured in an effective marginal tax rate, or EMTR. In effect, an EMTR defines the proportion of an additional dollar of private income earned which is retained by the income earner: that is, the reward that can be achieved for additional effort in paid employment.

Australia's social safety net, which, by international standards, is relatively targeted, allows comparatively greater levels of assistance to be provided to those most in need. However this characteristic means that welfare withdrawal rates, and hence EMTRs, tend to be relatively high among those affected. Where the eligibility criteria and withdrawal ranges of different welfare measures overlap, this tendency is accentuated.

Narrowly defined, EMTRs capture the combined impact of personal income tax and welfare withdrawal, however broader definitions also incorporate additional costs faced by families in entering the workforce (child care, for example). The research in this area varies in which of these measures is reported and, as such, the discussion in the following sections refers to both definitions, depending on which is most pertinent to the discussion.

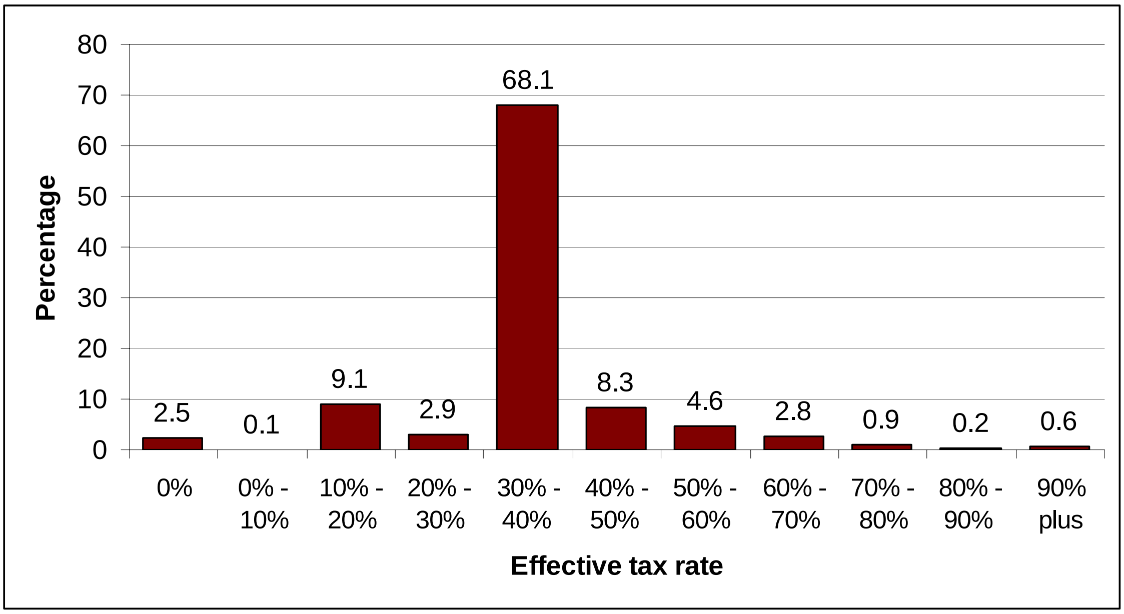
4.2 EMTRS IN THE AUSTRALIAN TAX AND TRANSFER SYSTEM

Despite a concerted effort by policy makers to lessen the impacts of high EMTRs on Australian working families, increasing workforce participation, particularly by women, coupled with extensions to the welfare support offered to families, has meant that high EMTRs (defined here, consistent with the literature, as greater than 50%) remain a significant issue for segments of the working population. Modelling undertaken by the National Centre for Social and Economic Modelling (NATSEM) shows that in 2006-07, 7.1% of working age population, or around 900,000 Australians faced high EMTRs (NATSEM, 2006).

Figure 4.1 provides a detailed breakdown of the EMTRs facing working age employees in Australia in 2006-07, based on the NATSEM research undertaken by Harding et al (2006). Reflecting the breadth of the fourth income tax band ($75,000 to $150,000; 40%), around two-thirds of employees – some 68% – face EMTRs of between 30 and 40%.

For around 100,000 working Australians in 2006-07, the effective tax rate faced as they earn an additional dollar of private income was more than 80%. That is, for every additional dollar of private income they earned, the combination of personal income tax together with the withdrawal of welfare entitlements meant they retained less than twenty cents of this dollar.

FIGURE 4.1: DISTRIBUTION OF EMTRS AMONG WORKING AGE EMPLOYEES IN 2006-07



Source: Harding et al (2006)

4.3 IMPACTS OF HIGH EMTRS

Taxes invariably affect behaviour. Indeed some taxes are designed to affect behaviour (carbon taxes, for example). Personal incomes taxes affect behaviour by reducing work incentives – to a greater or lesser extent – thereby impacting on an individual's decisions regarding whether, and how much, they work. The progressive nature of the personal income tax scale means that the work disincentives increase with the individual's income, however this is deemed a reasonable trade-off in the pursuit of equity objectives.

Interactions between the tax and transfer system accentuate these impacts, particularly at the lower end of the income spectrum where some of the highest EMTRs are faced. As the findings of Harding et al (2006) demonstrate, although low-income earners may only face a marginal income tax rate of 16.5%, together with the withdrawal of welfare entitlements, EMTRs can be as high as 98% (that is, only 2% of privately-earned income is retained by the individual/family). Under such circumstances, the rewards from entering the workforce or increase working hours are significantly reduced, as households are only marginally better off from having an individual employed than when they remain entirely dependent on welfare entitlements.

Such disincentives to enter the labour force can trap long term welfare-reliance, potentially locking families into a cycle of poverty. While welfare entitlements are an essential component of protecting the living standards of society's most disadvantaged, to the extent the EMTRs associated with these welfare entitlements dissuade individuals from entering the workforce, they can negate a family's ability to achieve a sustained higher standard of living.

High EMTRs have adverse impacts not simply for the individuals and families affected, but for Governments and economies as well. Where high EMTRs prevent individuals from entering the workforce when they would otherwise do so, clear inefficiencies result – both through the continued need for government assistance and by constraining the supply of labour.

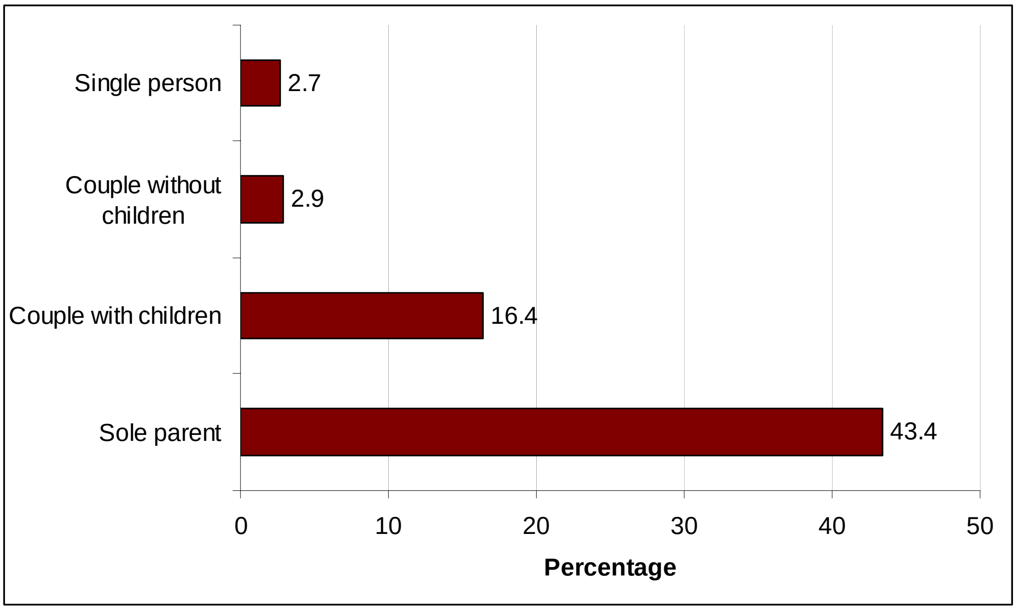
4.4 INCIDENCE OF HIGH EMTRS

High EMTRs and family type

Modelling by NATSEM indicates that among Australian employees, high EMTRs are faced disproportionately by those with dependent children (Harding et al, 2006). In 2006-07, couples with children were nearly six times more likely to face high EMTRs than those without, while singles with children were more than 16 times more likely than those without (Figure 4.2). Furthermore, the likelihood of facing high EMTRs rises at an increasing rate with the number of children, from 16.3% for families with one child, to 38% for families with four or more children.

Overall, female employees are more likely to face high EMTRs than males, with some 10.5% of female workers facing EMTRS of 50% or greater compared with 7.7% of males.

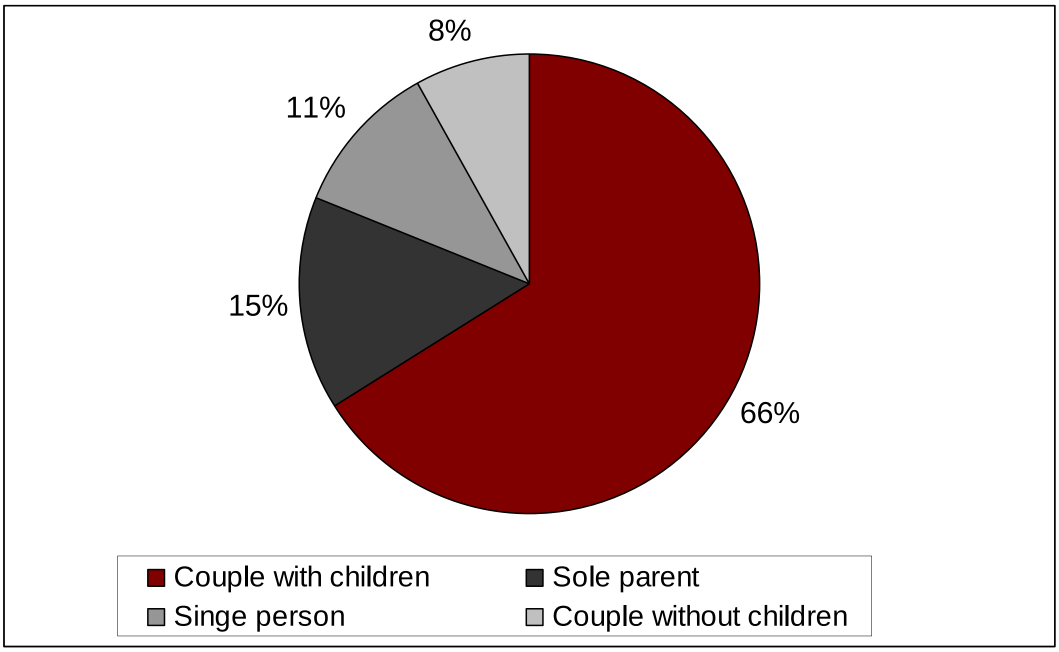
FIGURE 4.2: PROPORTION OF EMPLOYEES FACING HIGH EMTRS BY FAMILY TYPE, 2006-07



Source: Harding et al (2006)

The contention that the incidence of high EMTRs falls heavily on working families is re-iterated by Figure 4.3 below, which shows that employees facing high EMTRs are overwhelming those with children. NATSEM modelling indicates that 81% of all employees facing high EMTRs have children, including 66% who are couples with children (Harding et al, 2006).

FIGURE 4.3: DISTRIBUTION OF EMPLOYEES FACING HIGH EMTRS, BY FAMILY TYPE, 2006-07



Source: Harding et al (2006)

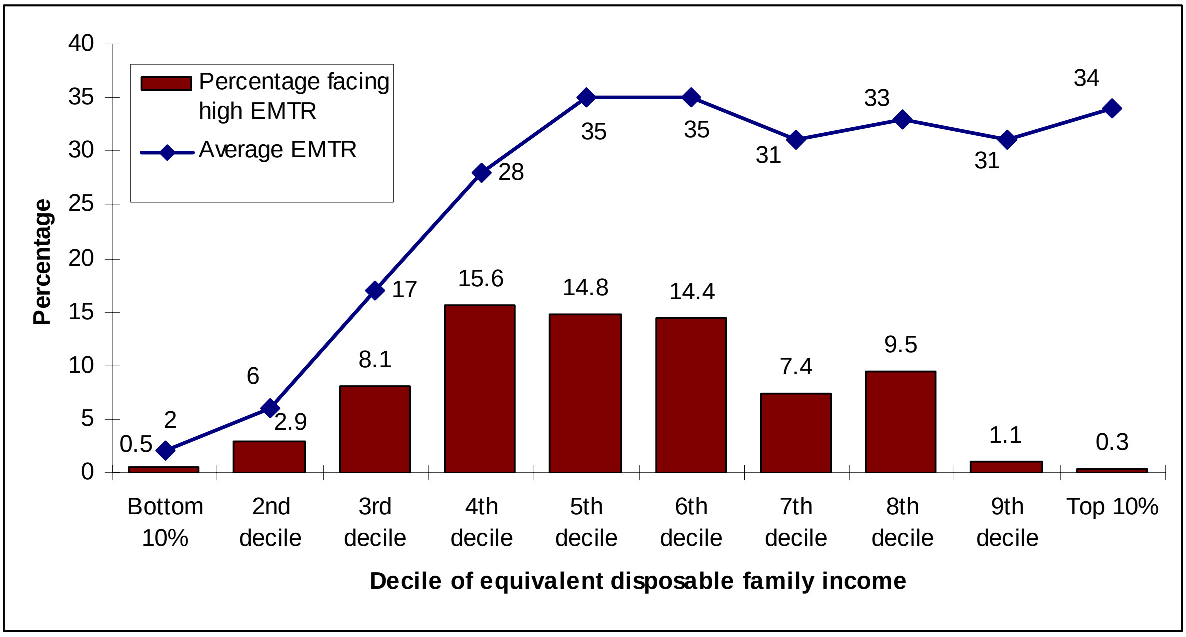
High EMTRs and income level

Another important dimension to the incidence of high EMTRs is the income level of the individual facing them. Once again drawing on modelling from NATSEM (NATSEM, 2006), Figure 4.4 shows that the prevalence of high EMTRs is greatest in the lower-middle income deciles, with around one in seven workers in the fourth, fifth and sixth deciles facing EMTRs greater than 50% in 2006-07. In 2006-07, the average gross incomes of the families (or singles) in these deciles ranged from about $40,000 to $75,000. Among other things, the high EMTRs facing these workers is reflective of the withdrawal of family tax benefits over this income range.

Only a very small proportion (less than 3%) of employees in the top two and bottom two incomes deciles face very high EMTRs. For the lowest income earners, this reflects the fact that they pay little tax and do not face significant welfare benefit withdrawals, while for the highest income earners, it reflects the fact that they do not qualify for welfare entitlements and hence their EMTR is effectively the top personal income tax rate.

The blue line in the chart shows the average EMTR in each income decile, indicating that despite the nature of the personal income tax scale, interactions with welfare provisions generate some of the highest EMTRs in the mid-range of the income distribution - the average EMTR of 35% in the fifth and sixth decile is indeed greater than that in the ninth and tenth.

FIGURE 4.4: PROPORTION OF WORKING AGE POPULATION FACING HIGH EMTRS, BY INCOME DECILE, 2006-07



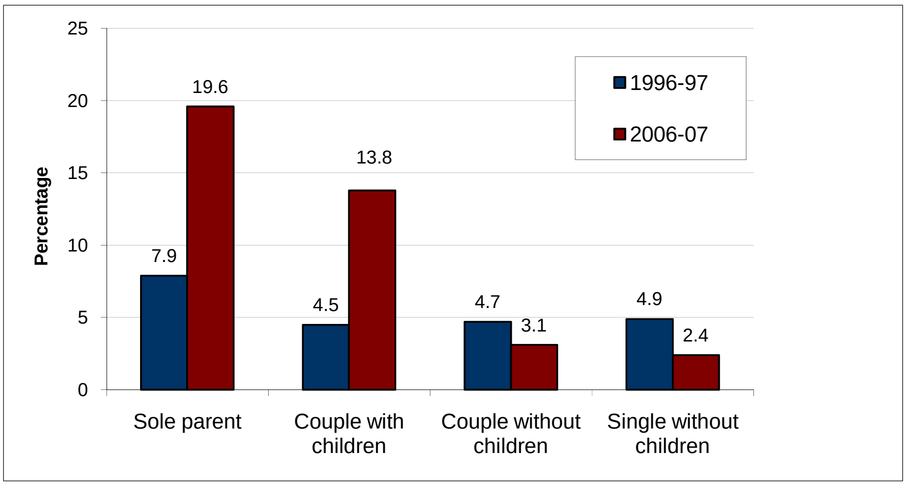
Source: NATSEM (2006)

4.5 TRENDS OVER TIME

The prevalence of high EMTRs in the Australian tax and transfer system has been increasing. Over the decade to 2006-07, the proportion of Australia's working age population facing high EMTRs increased from 4.8 to 7.1% (NATSEM, 2006). That said, the proportion facing EMTRs greater than 80% has fallen.

Reflecting the significant changes to Australia's tax and transfer system over the last decade, together with changes in workforce participation and employment patterns, significant changes in the incidence of high EMTRs have occurred. As Figure 4.5 below depicts, while for both singles and couples *without* children, the likelihood of facing high EMTRs fell between 1996-97 and 2006-07, for those *with* children, it increased considerably (NATSEM, 2006). Couples with children were three times more likely to have high EMTRs in 2006-07 than a decade prior and sole parents around two-and-a-half times more likely. This can be explained at least partially by the expansion of welfare entitlements to families (in particular, the Family Tax Benefit) and continued increases in employment levels, however it is nonetheless cause for concern.

FIGURE 4.5: PROPORTION OF EACH FAMILY TYPE FACING HIGH EMTRS, 1996-07 AND 2006-07^

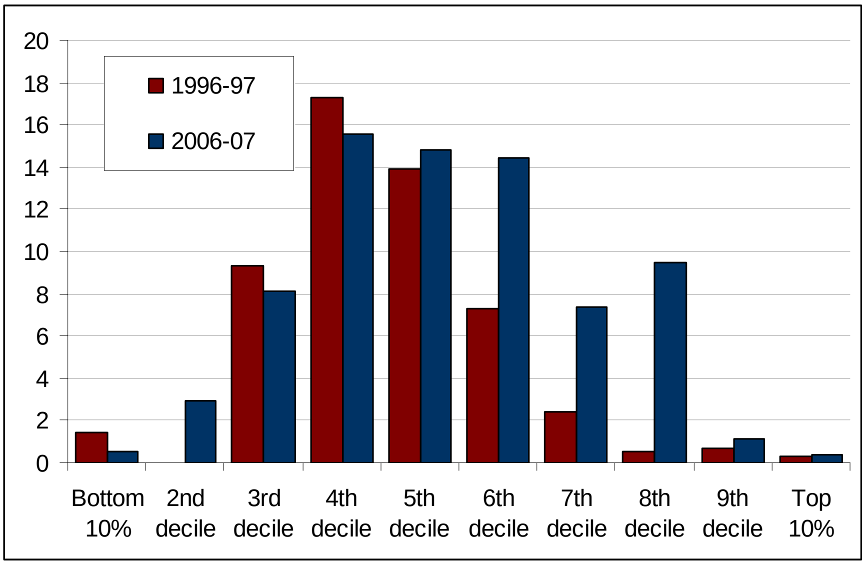


Source: NATSEM (2006)

^Note differences between these results, based on the working age population, and those reported above in Figure 4.2, based on employees only.

In terms of the incidence of high EMTRs along the income spectrum, NATSEM modelling indicates that over the decade to 2006-07, high EMTRs have shifted up the income scale (Figure 4.6). The introduction and extension of means-tested welfare entitlements for families on higher incomes has resulted in a notable increase in the rate of high EMTRs in the upper-middle income deciles. The seventh and eighth decile have been particularly affected, with the proportion of the working age population in these groups facing high EMTRs increasing from 2.4% to 7.4% and 0.5% to 9.5%, respectively (NATSEM, 2006).

FIGURE 4.6: PROPORTION OF WORKING AGE POPULATION FACING HIGH EMTRS, BY INCOME DECILE, 1996-97 AND 2006-07



Source: NATSEM (2006)

The scorecard for society's lowest income earners is mixed. While the rate of high EMTRs in the bottom income decile fell from 1.4 to 0.5% between 1996-97 and 2006-07, the rate of high EMTRs in the second decile actually *increased,* from 0 to 2.9%.

4.6 BENEFITS FROM ALLEVIATING HIGH EMTRS

By redressing barriers individuals face to entering the workforce or increasing working hours, alleviating high EMTRs can enhance the rewards from working and create earning, training and career-development opportunities for low-income households. Particularly over the longer term, the financial and social benefits to individuals and their families from entering the workforce, or working additional hours, can be a significant factor in enabling them to overcome poverty traps and enhance their standard of living. In addition, generating higher levels of earnings also increases the capacity to save, and thereby increases the capacity of low-income households to achieve other objectives in life, such as asset ownership.

The benefits of alleviating high EMTRs and increasing the rewards from work accrue not only to the individual and their family, but to the economy as a whole. From the Government's perspective, given the pending fiscal pressures foreshadowed in the Federal Treasury's Intergenerational Report, increasing workforce participation and reducing welfare-reliance will be central to ensuring the sustainability of Government finances over the coming years. In addition, demands on welfare are reduced by those who are willing and able to enter the workforce doing so, and the Government's ability to provide greater levels of assistance to those genuinely in need is increased.

At a macroeconomic level, labour force participation has long been regarded as one of the pillars of economic growth. Indeed, it is one of the oft-touted 'three Ps' of economic growth (the others being productivity and population). In recent times especially, with unemployment levels at historical lows and several industries experiencing labour shortages, achieving optimal utilisation of Australia's labour force has become a major Government focus. Successive Federal Budgets have cut personal income tax rates on the grounds of increasing labourforce participation. Alleviating high EMTRs and in so doing increasing the rewards individuals derive from working additional hours, and in particular, from entering the workforce where they would otherwise abstain, can increase workforce participation and thereby have a positive influence on the nation's economic growth.

The labour supply of low income earners is generally more responsive to changes in net earnings than that of high income earners (the elasticity of supply of labour is greater), suggesting a proportional increase in net earnings (via an EMTR reduction) will have a greater impact on aggregate labour supply if targeted at low income earners. In addition, the greatest labour supply gains come not from encouraging those in the workforce to increase their work effort, but rather, from rewarding additional workers who enter employment (Heckman, 1993). There are strong grounds therefore, for encouraging workforce participation from low income earners – particularly those presently outside the workforce – through reduced EMTRs, not only for the welfare of these households, but from a macroeconomic standpoint as well.

Addressing the adverse impacts of EMTRs is therefore beneficial both from the perspective of equity – through improving the opportunities for low-income households – *and* efficiency – through enhancing the utilisation of Australia's labour force.

4.7 SOME POLICY OPTIONS

The extent of high EMTRs in the Australian economy and their impacts, in particular on low-income households, are widely recognised and broadly acknowledged by researchers and policymakers alike. However they remain pervasive. While some success has been achieved recently in redressing extremely high EMTRs, in many cases, gains to certain groups have only been achieved at the expense of others (that is, shifting, rather than eliminating, the impacts).

As noted previously, in order to ensure welfare measures are restricted to those with genuine financial need, means-testing of government benefits remains a key element of any effective welfare system. As individuals earn increasing amounts of private income, their need for welfare assistance diminishes, and welfare entitlements are rightly withdrawn, or tapered. The key challenge in alleviating high EMTRs is implementing taper rates on individual welfare measures which, when combined with taper rates on other welfare measures and with the tax system, do not generate high EMTRs. History shows this is no easy assignment.

Policymakers must balance the need to provide assistance to society's most disadvantaged, with ensuring that those who seek to enter the workforce, or increase their workforce participation, achieve adequate reward from doing so. Reform should therefore aim to ensure that those who seek to escape welfare-dependency are not constrained by the tax and transfer system in their ability to do so.

This requires a significantly greater level of integration between the tax and transfer systems than exists at present, which, given Australia's complex, interrelated tax and transfer system, will only effectively be achieved through a fully integrated, whole-of-system approach to reform.

Some specific options

Over the last decade, there has been extensive discussion in the academic literature of the merits of specific proposals aimed at addressing high EMTRs, increasing the system's simplicity and improving work incentives. Drawing on the findings of this research, this section analyses several possible avenues for alleviating high EMTRs in Australia's tax and transfer system: negative income taxes, a single income test on cash transfers and reduced taper rates.

1. A negative income tax/earnings tax credits

One option supported by the literature (for example, Keating and Lambert, 1998; Dawkins and Freebairn, 1997) to counter the impact of high EMTRs is a negative income tax. A negative income tax is a system under which, rather than paying tax, individuals or families on low incomes receive entitlements from the tax system. These entitlements can be regular payments, provided as a steady stream of income support to low-income households. As incomes increase, the household then moves from being a net tax recipient to being a net tax payer.

Several variants of negative income taxation have been proposed for the Australian system, including the extreme model, under which a negative income tax is introduced as a substitute to the welfare system. While in its simplest and purest form, a negative income tax tends to be prohibitively expensive (Keating and Lambert, 1998), more moderate alternatives whereby a negative income tax supplements other welfare measures can be both affordable and effective.

One of the most promising alternatives to the introduction of a wholesale negative income tax is a system of tax credits. Tax credits allow greater targeting towards low income earners, and can increase work incentives by rewarding additional private income and ensuring the individual/household is sufficiently better off from earning additional private income than continuing to rely on welfare.

The introduction of a tax credit in Australia was advocated more than a decade ago by Keating and Lambert (1998). Under their specific proposal, a tax-free credit of two per cent would be paid as a supplement to the wage of low wage earners in low-income families[18], with

[18] Under this model, tax credits were introduced as an alternative to minimum wage increases.

withdrawal undertaken in such a way to mitigate, as much as possible, any increases in EMTRs further up the income distribution. Analysis of a variant of this proposal by Lambert (2000) indicated that, combined with a wage-tax trade-off[19], the policy is likely to cause a redistribution of income away from the top part of the income distribution and towards the lower part, boosting the incomes of low- to middle-income families.

A system of tax credits operates in the United States, forming a key component of the welfare system. Dependent on the number of children and the level of family income, earned income tax credits, or EITCs, increase proportionally with income, plateau and are then tapered out. Tax credits of this nature reduce EMTRs at low levels of family income, but increase them further up the income distribution where tax credits are tapered out (Dawkins, 1998).

The tendency for tax credits, particularly the EITC model, to increase EMTRs further up the income tax scale has been observed by other researchers, including Buddlemeyer et al (2006). The authors' analysis, undertaken using the Melbourne Institute Tax and Transfer simulator, finds that the introduction of a hypothetical EITC of $47 in 2006 reduces EMTRs by 7.3 percentage points on average for almost a third of all working-age individuals, however this comes at the expense of 14.4 per cent of working age individuals who experience an increase in EMTR of more than 17 percentage points on average.

From a macroeconomic standpoint, among a series of policy initiatives considered by Lateral Economics (2006), the introduction of an EITC was found to result in the greatest increase in labour participation, particularly in lower-income families. The EITC was also found to be more effective than the other policy options considered in inducing labour supply from currently jobless households.

Variants of a negative income tax have long been on the reform agenda, however the persistence of high EMTRs facing low-income earners coupled with increasing cost of living pressures, intensifies the impetus for closely considering the merits of such a model. While the fiscal impacts may be significant, these can be moderated, and at any rate, the costs must be viewed in the context of the benefits to low-income households, and to the economy more generally through increased labour force participation.

2. A single income test on cash transfers

Overlapping means tests generate some of the economy's highest EMTRs. As multiple welfare measures are withdrawn simultaneously, the penalties from earning additional private income can be severe. Reducing or ideally eliminating overlap in income tests is therefore a key priority for effectively redressing high EMTRs and their adverse impacts.

Where a large number of welfare measures are involved, one option proposed for eliminating overlap is a single income test (Keating and Lambert, 1998). If current means tests on welfare entitlements cannot be refashioned in such a way that concurrent withdrawal is avoided, then a single income test should be considered as a way of comprehensively integrating the welfare system (McClure Report, 1999).

3. Reductions in taper rates

Taper rates (that is, the rate of welfare withdrawal as additional private income is earned) are one of the primary sources of high EMTRs, hence reducing EMTRs through taper rate reductions has intuitive appeal. In general however, reducing taper rates can result in significant falls in EMTRs *for certain groups*, though often at the expense of others.

[19] Providing workers with tax credits in exchange for minimum wage increases.

Reducing taper rates increases the range over which welfare entitlements are withdrawn, and as such, tends to shift the impacts of welfare withdrawal higher up the income distribution. While conceivably this may be seen as part of a progressive tax/transfer system, in effect, the shifts are often not great enough to have any equity-enhancing impacts.

Buddelmeyer et al (2006) highlighted such impacts with modelling undertaken using the Melbourne Institute Tax and Transfer Simulator (MITTS). Reducing taper rates on several common income support payments (NewStart Allowances, Partner Allowances, Youth Allowances and Parenting Payments) to 32% resulted in a fall in the EMTR facing some low-income households by as much as 38 percentage points. However at the same time, those earning incomes marginally above this level faced an increase in their EMTR of 32 percentage points. Indeed the authors found that reducing selected taper rates reduced EMTRs by around 22 percentage points for seven per cent of all working-age individuals, but almost twice as many experienced an increase in their EMTR of similar magnitude.

Gregory (2008) has also highlighted the potential adverse consequence of reduced taper rates, suggesting that reduced taper rates are an ineffective way to reduce high EMTRs facing low income earners. He finds that the combined impact of cut-off (the income level at which the welfare recipient is no longer eligible) and knock-on (increasing the private income level at which additional welfare program tapers start) effects will usually deliver the largest income gains to those with lower EMTRs and higher incomes.

Furthermore, from a macroeconomic standpoint, Lateral Economics (2006) finds that among a series of comparable hypothetical policy initiatives aimed at increasing labour supply, the option of reducing taper rates performs worst, with gains being outweighed by losses as taper rates fall.

5. CONCLUSIONS

The Australian Government's review of Australia's tax system will invariably canvas a broad range of issues relating to the system's effectiveness, its efficiency and its impacts on the wider economy. In light of the trends discussed in this paper, there is a strong case that among the top priorities for consideration should be the combined impacts of the tax and transfer system on low-income households – both on equity *and* efficiency grounds.

On the basis of the preceding analysis, this section makes a number of broad policy recommendations regarding the direction for tax reform in Australia, highlighting priority areas to be addressed in the interests of increasing the living standards and opportunities of low-income Australians.

Reinforcing the social safety net

Given the significant cost of living increases witnessed over the last few years – the impacts of which are felt disproportionately by low income households – relief through the tax and transfer system for low income families is emerging as a high priority in Australia. While the performance of the Australian economy over the current decade has, in aggregate, been strong, the headline trends mask a growing divide across different segments of the economy, and indeed the community. The much-publicised 'two speed economy' has seen certain sectors, and those employed within these (and related) sectors, enjoy strong financial gains and commensurate increases in living standards. Despite measures of income inequality remaining relatively stable over recent years, there is evidence to suggest that those unable to harness these gains however have, to some extent, been left behind. Combined with significant increases in the cost of living, this has placed considerable financial stress on low-income households.

Recent tax reforms – both to personal income tax and to the taxation of superannuation – have tended to provide relatively greater benefits to those higher up the income distribution. Reform to the taxation of superannuation has increased the concessionary tax treatment afforded to income deferred to superannuation, as well as the earnings generated on superannuation investments. With high-income households disproportionately represented in the pool of superannuation, and an absence of differentiation on the basis of means, elements of the taxation of superannuation are inherently regressive.

In light of cost of living pressures as well as recent trends in tax reform, and reflecting the principles of distributive justice and preferential option for the poor, there is now a strong case for the provision of greater levels of welfare assistance to low-income households, particularly the most disadvantaged.

High priority should be given to measures which address the pressures facing low-income households at present and into the future, either through taxation reform such as an increase in the tax-free threshold, or a reduction in personal tax rates for low-income earners (noting that such measures would apply to all, not simply low-income earners), or through targeted welfare provisions (appropriately integrated to avoid EMTR increases).

Addressing the impacts of high EMTRs

Interactions between the tax and transfer system can create circumstances which provide limited rewards for those on welfare who seek additional levels of employment, limiting their ability to achieve a higher standard of living potentially locking families into a cycle of poverty.

High EMTRs have adverse impacts not simply for the individuals and families affected though, but for Governments and economies as well. Where high EMTRs prevent individuals from entering the workforce when they would otherwise do so, clear inefficiencies result – both through the continued need for government assistance and by constraining the supply of labour.

Addressing the adverse impacts of EMTRs is therefore beneficial both from the perspective of equity – through improving the opportunities for low-income households – *and* efficiency – through enhancing the utilisation of Australia's labour force. The Government must closely consider the impacts of alternative mechanisms for more seamlessly integrating the tax and transfer system in ways that provide low income families with opportunity to enhance their standard of living through workforce participation. Several distinct options are identified in this paper as potentially effective mechanisms for achieving these goals, however the list is not an exhaustive one, and as part of this review, Government should consider all options available for addressing this high priority issue.

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