Submission to Senate Select Committee on Economics

This submission is made in a private capacity.

Disclaimer: There may be errors of fact in this submission

Contents

Abbreviations

ANTS .... A New Tax System
ATI .... Adjusted Taxable Income
ATO .... Australian Taxation Office
CCB .... Child Care Benefit
CGT .... Capital Gains Tax
DSR .... Dependent Spouse Rebate
EITC .... Earned Income Tax Credits
EMTR .... Effective Marginal Tax Rate
FBT .... Fringe Benefits Tax
FTB(A, B) .... Family Tax Benefit (Part A, B)
HECS .... Higher Education Contribution Scheme
HIC .... Health Insurance Commission
NSA .... NewStart Allowance
PBS .... Pharmaceutical Benefits Scheme
RFB .... Reportable Fringe Benefits
SATO .... Senior Australian Tax Offset
SG .... Superannuation Guarantee (currently 9%)
YA .... Youth Allowance

Recommendations (not complete – refer text of submission)

1. Absorb Low income tax offset into basic rates
2. Absorb Medicare Levy into basic tax rates
3. Review FTB, CCB, Maternity Leave, Baby Bonus tax offset as a package
4. Change YA, particularly its interaction with FTB
5. Review the $6000 tax free threshold, DSR and FTB(B) as a package
6. Change the basic tax rates and break points
7. Set a target for the top EMTR (excluding situations with mutual obligations or short time frames), preferably equal to the top marginal income tax rate including Medicare Levy
8. Review all tapers on taxes and benefits in light of EMTR target and make changes where necessary
9. Review tax for retirees consistent with other changes
10. Make changes to super taxation consistent with above
11. Review salary sacrifice into super and RFB
12. Consider changes to taxation of goods and services that improve health and environment outcomes, particularly for cars/oil/petrol and cigarettes
13. Reduce conveyancing stamp duties on residential property
14. Consider alternatives to municipal rates for residential property
15. Need bipartisan commitment to a stable policy for funding aged care
16. Reduce joint funding of specific programs with State and/or Local Government
17. In particular, consider absorbing all funding of State public hospitals with changes to State grants (who operates the hospitals is a separate issue)

Introduction

This submission focuses on the individual and the family. It generally ignores the existence of the international community outside Australia. Taxation, tax expenditures, direct expenditure on transfer payments, and a regime of highly targeted means tests interact with each other and are considered as a package in this submission.

If you were creating a tax and transfer payments system from scratch today for Australia, would you create the current system? If the answer is yes, you do not need this submission. If the answer is no, what changes should be made to the current system and how should they be made? The current system has been added to over time with incremental change rather than real structural reform and simplification. I believe significant reform is required for the following reasons:

1. The current system is complex and difficult to understand, even for professionals, and the trend is accelerating. Individuals rely on experts and sometimes do not understand even basic aspects. This implies that some voters may not understand competing policies at elections. There is a need for open and broad debate, which is often focused on the very poor or the very wealthy. Media employees may have a pecuniary interest in policy in this area by virtue of their incomes being above median levels. The Tax Expenditure Statements demonstrate the complexity for both individuals and businesses.

2. Less complexity would mean less employment in the taxation/transfer payment sector. This sector comprises parts of the social welfare and community service groups, lawyers, accountants, financial planners, and most importantly, legislators. The government sector includes Centrelink, the ATO and the HIC. There are also related groups in policy, education and research. I would rather see the nations resources allocated to other sectors of the economy.

3. Objectives are not always transparent and some are not developed. There is a lack of consensus and too much volatility. Long term commitments to superannuation should not be hostage to the numerous changes of government, and the numerous changes in legislation.

4. There are numerous definitions of income and that is a flaw in a system heavily reliant on progressive income tax and subject to so many means tests. Different periods of time are used with various degrees of tolerance. It might be this week, this year, next year, last year, or the FBT year.

5. Workforce participation of older men and women could be much greater. What does the whole community want?

6. Significant differences have emerged between the baby boomers and their children and grandchildren with respect to housing, super and health.

If significant structural changes are implemented, objectives and principles need to be addressed first, particularly with regard to the specific demographic issues discussed below. Some administrative type simplification may help as a precursor. The bundling of payments into FTB and CCB as described in the ANTS package is an example of administrative simplification, rather than structural reform. The behaviour of people is dynamic and this should be allowed for in determining the cost to the budget and impact on the overall economy. If uncertain of the impact, change could be implemented in stages.

There will also be compliance and administration issues. I can not offer much comment on compliance, but I believe there is scope for significant reduction in administration. A large proportion of the population are clients of both Centrelink and the ATO. Several pay no tax so have negligible interaction with the ATO. Several have no connection with Centrelink other than the FTB where they can deal with the ATO or Medicare Offices as alternatives. There needs to be a balanced perspective of compliance, administration and ideology. The Government sometimes shifts the cost and responsibility of administration and compliance onto others, and this may not always be in the national interest.

Demographic issues.

People will exercise freedom of choice and make trade offs between work, leisure, savings, family and household formation, and increasingly do some of these things overseas. The tax/benefit treatment varies with these demographics and is sometimes very complex.

1. The major demographic difference is the family or household status, ie single, married, parent, dependent, or carer.

2. There are significant differences in the treatment of children, those of workforce age and those beyond. The transition from dependent child to independent adult is unnecessarily complex and change is sought by some in the community. The transition from work to retirement also needs a clear strategy that addresses both short term and long term issues.

3. Earned and unearned income is sometimes treated differently. This applies to minors and potentially applies to EITC. I believe this is generally undesirable, in that individuals should have the choice to save from earned income and then live off the capital saved or the unearned income generated from the capital. This applies to people combining work and education, it applies to people taking long service leave, and it applies to retirees.

4. There are instances where income of a couple is combined, with no choice. In other instances, they are treated separately. The differing treatment adds to complexity and appears to be haphazard. Couples are sometimes better off if their income and assets are distributed evenly, but this is not always the case. Some couples have more flexibility in changing the distribution than others. In some instances children impact tax or benefits depending on the number, their age or their income.

5. Single parenting, divorce/separation and child support arrangements are complex, particularly with respect to maintenance payments. The incidence is too significant for the issues not to be considered.

6. De facto relationships and other forms of shared households such as students, relatives, older people, carer/dependent, and couples separated by sickness are treated differently in some cases, sometimes due to targeted means testing.

7. A proportion of the community has a citizen/resident status that is treated differently.

Specific issues

1. Basic tax rates (1)

The basic tax rates have not changed much since around 1978 or earlier. Extracts from the 1977-1878 Budget Speech and Budget Statements are attached as an Appendix to this submission. Your attention is drawn to the introduction of 4 tax rates, ie nil, 32%, 46% and 60%, the following statements.

"Some 90 per cent of taxpayers will pay no more than the standard marginal rate of 32 per cent."

Under Social Security and Welfare
"These outlays now account for 27 cents in every $1 spent from the Budget, or 56 cents in every $1 raised in personal income tax."

Family assistance has had many forms over the years including non-means tested family payments. FTB and CCB are now larger and are means tested. They account for a significant part of the increase in "Social Security" spending and the high EMTRs faced by low to middle income families.

Other significant changes since 1978 include the reductions in the company tax rate and the top income tax rate for individuals, the changed demographics, and the role of super.

Most of the personal income tax is collected from the small number of taxpayers with taxable incomes over $52000. The situation is more complex for couples. Super is concessionally taxed, and some retirees then pay no tax and get the pension while others face high EMTRs up to 80% in retirement. Some people have argued that only taxing super on exit is expenditure-based taxation. I consider it to be deferred income tax. It may be more productive to move to a nominally less progressive system. The net redistribution may be less than imagined, and the other effects, including less complexity and associated costs and more transparency and flexibility may be desirable.

2. Low income tax offset

Is there any reason why the $235 low income tax offset could not be absorbed into the basic tax rates? They would become nil tax to $7382, 17% to $21600, 34% to $27475, 30% to $52000, 42% to $62500 and 47% above that, all excluding Medicare Levy.

3. Medicare Levy

A small number of taxpayers are exempt from paying the Medicare Levy primarily because they are not eligible for benefits. Others are exempt because their taxable income is below a certain threshold. There are numerous thresholds for singles and families (varies with number of children) in three different categories, normal, pensioners, and those eligible for the SATO. They all have a phase in with a taper of 20% adding to the EMTR and sometimes they overlap other tapers.

The Medicare Levy only covers some of the Medicare expenditure. Why not absorb the Medicare Levy into the basic tax rates? The tax rates above would then become 0%, 18.5%, 35.5%, 31.5%, 43.5% and 48.5%. The Medicare Surcharge could still remain. It is a separate issue discussed below in section 10 (Health, aged care, education).

4. Basic tax rates (2)

The 35.5% could be merged with the rate above or below into a single rate. It depends on possible changes to the nil tax rate, the relation between taxation of singles and families, and FTB etc as discussed below. The budgetary impact would be manageable.

The 43.5% rate could be absorbed into the rate above or below, but the budgetary impact would be larger. Two rates for middle and upper incomes of 35%and 45% may be feasible. Such a change depends on the future of the top rate, taxation of superannuation, together with overall revenue requirements, particularly for families. A simpler scale was feasible in 1978, so why not now? Some relevant issues are discussed below.

5. Retirees

There are several issues including the so called tax free threshold, the high EMTR for several retirees on income or assets, which has some logical relationship with risk/return decisions on investments, and intergenerational issues.

6. High EMTRs

High EMTRs distort behaviour and give rise to inefficiencies for the person, their family and the broader community. Some people do not know what their EMTR is and some do not consider it when making relevant decisions. Some will consider it, and modify their behaviour as a result. Impacts include workforce participation, investment choices, family formation and childcare. Workforce participation includes weekly hours at the margin, new job, extra job, promotion, leave at half pay, or timing of entry or exit from the workforce. We often seek to remove such distortions in the world of domestic or international business, why not in personal taxation? In fact, some individuals see themselves as a business, even if they are only hiring their own labour.

High EMTRs may be acceptable in some instances, eg where mutual obligation applies, or where a time limit applies. Otherwise, EMTRs should not exceed the top tax rate, ie 48.5% at present. Higher rates are inequitable and the impacts of higher rates are probably substantial. Some of these might suggest that there is an onus on the individual or family to lift their income, even though there is no mutual obligation. Alternatively, the means test could be relaxed subject to budgetary constraints, and/or the benefit could be reduced in some way. FTB/YA is an example that is discussed below. Some high EMTRs arise from means testing of social security or tax benefits and many are additive. Some means tests have two tapers, eg one around $30000 to $40000 another around $80000 for FTB. Some tax offsets are refundable and some are not. Tax offsets do not reduce taxable income, so tax may be reduced, even to nil, yet the affect of the taxable income on a means tested benefit or another tax offset is unchanged. An example is the withdrawal of taxable super below the low rate threshold, commonly referred to as tax free. Tax is reduced to nil, but the withdrawal will be included in taxable income and may reduce the SATO for an eligible person. Some means tests are based on family income, meaning the two parents, and affect both of them at the margin. Some tapers maybe transferred to the other partner, eg unused SATO. Some tapers only operate on the other partner, eg DSR where a person with low income affects the DSR claimed by their spouse. Couples may or may not be aware or consider the consequences.

Tapers affecting EMTR include:

FTB(A)-30%
FTB(B)-30%
DSR-25%
YA-25% per person
Baby bonus tax offset-? (complex and benefits high income earners)
Low income tax offset-4%
Medicare Levy-20%
SATO-12.5% (unused part may transfer to spouse along with taper)
Other offset for pensioner not eligible for SATO-12.5%?
Beneficiary offset for some Social Security recipients-?
Spouse super contribution-18%
Low income personal contribution-10% to be replaced by->
Proposed low income co-contribution to super by Government-8%
Super surcharge- nominally 15% but varies with ATI and proportion of super to ATI, and may be much higher
HECS-varies
Child Support payments-varies with number of children and is based on gross income?
Other factors include Rent Assistance, Health Care and related Cards (benefits include concessions on PBS, utilities, travel, and reduced prices from doctors and others, plus other benefits such as Education Maintenance Allowance)

7. Super

Super contributions are really income that is deferred and as such it is bit like long service leave. There are options that could be considered for taxing super at the front end, possibly with offsets. One problem with taxation on exit is the averaging affect on the notional income tax that is only an issue because of the progressive tax scales and the deferment. The surcharge addresses this in an expensive and clumsy manner, and also in effect acknowledges that it is income in the year it is earned and contributed.

The range of ATI where surcharge phases in ($94,691 to $119,924) is also much higher than the top income tax points of $52000 and $62500 plus SG of 9%, ie about $57000 and $69000. This reflects less indexation of the top tax rates relative to the AWOTE indexation of the ATI limits for surcharge. Tax relief by changes to the top income tax rates or breakpoints is needed before surcharge relief if parity is to be restored with the situation prevailing when surcharge first operated. The surcharge, or surtax, was introduced when no new taxes were promised, and now may be reduced by the same people.

A significant reduction or complete removal of the surcharge would lead to an incentive to salary sacrifice into super or make deductible contributions for self-employed people. The only obvious limitations are the RBLs, the age based limits for deductions on contributions, and peoples' need for cashflow. The tax on fund earnings is also a concession to high income earners. Very few people receive excess benefits in the retirement phase and most people cannot reach the pension RBL ($1,176,106). The few who can would control their level of contributions. Many people subject to means tests and tapers based on taxable income also gain by excluding super contributions and fund earnings from current taxable income. At exit, super is attractive for small sums and large sums. It is less attractive in the middle where the pension income or assets test, and the operation of SATO lead to very high EMTRs.

A less progressive income tax or even removal of the top rates would negate most of the above. Super is there to provide for retirement. It also replaces the age pension. There is no reason why it cannot be mandated to a level that negates the need for the age pension, or to a level (probably higher) that provides a balance between the standard of living in retirement with that during working life. Mandated super does not require concessions. Voluntary super does not necessarily require concessions either. Making changes may not be politically or practically desirable. What is required depends on future changes to the basic tax rates and the retirement environment. A change to a relatively flat income tax environment, and corresponding changes in the retirement environment, would make the point of super taxation more neutral in income tax terms.

8. YA, FTB, CCB, DSR, Maternity leave, baby bonus tax offset, tax free threshold

These, including proposals for paid maternity leave should be restructured. What is the interaction between the high EMTR from FTB and workforce participation rates? There an emphasis on mutual obligation for parents on Parenting Payment when their youngest child turns 13. Why is there is no similar obligation with FTB?

If a parent is receiving additional FTB(A) for a dependent child living at home who is full time student, payment ceases when the child turns 16 which may be in Years 9,10 or 11 in Victoria. The child can then apply for YA that is a few dollars more. It is subject to a means test that can lead to the YA being similar to the previous FTB. The YA is normally paid into a parent's bank account. The YA is taxable income in the child's name, but if there is no other income, there is usually no tax, and a beneficiary tax offset may be applicable if there is some other income. The child may feel that they have the right as to how it is spent, but the money is deliberately directed to the parent so that the parent can make those decisions. Families can elect to claim basic FTB(A) instead of YA because YA is subject to a continuous taper to nil payment. Families with income around $40,000 to $50,000 would consider this. However, the parent and child make separate claims as individuals for YA and FTB, and this can be a problem. When the child turns 18 an increased rate of YA applies, and the student might be in Year 11, 12 or beyond in Victoria. There is also a push in Victoria for students to finish Year 12 of school or its equivalent. YA has different provisions for young people who are not full time students. For many people, it would seem more logical for the FTB regime to apply to the end of year 12 for full time students. School or equivalent training is the mutual obligation. For young people who are considered independent or who do not meet this obligation, there is employment and income support. This could be provided by NSA or a modified YA that recognises the education and training issues.

FTB extends in a modified way to age 24. This should be reviewed in light of proposed changes to tertiary education policy.

Nearly all low income earners of workforce participation age have an EMTR of at least 25% when the impact on the whole family is considered. Why does a person with no dependents except for a spouse, get DSR because their spouse chooses not to work? Should there be mutual obligation? The existence of a tax free threshold causes some of the complexity in the current system. The provision of a non-refundable tax offset for a household, that could be different for singles and couples, would allow a flat tax rate for the first $21600.

A flat rate of 18.5% up to $21,600 ($3996) would suggest a single person household would need an offset of about $1271 to give the current tax of $2725 including Medicare Levy and allowing Low income tax offset. Alternatively, if there was no offset, a flat rate of 12.6% would be required for tax of $2725. Again, if there was a flat rate of 31.5% ($6804), an offset of $4079 would be required. The Government would have or should have the income profile for individuals and for households to consider the impacts of these options assuming no change in behaviour. Somewhat more difficult is the assessment of the dynamics in response to these sorts of changes.

DSR would be abolished and FTB(A) and FTB(B) could be combined into a single tax free payment based on the number and age of children. The baby bonus tax offset and maternity leave could be absorbed into FTB or paid as a non means tested lump sum.

The EMTR due to the means test on FTB implies that it is income support, although the Government specifically avoids reference to FTB when it refers to income support. If families earn more, they get less FTB and need less. Isn't this income support? Why is there no mutual obligation on families, including the primary wage earner, to earn more? If this is seen as an entitlement for children that is subject to means testing because of budgetary constraints, that is different.

This new FTB could be restructured within budgetary constraints to reduce EMTR, address the workforce participation issue when children get older, and the education and YA issues discussed above. If a substantial EMTR is to remain, separation of the implied income support and mutual obligation should be considered. Please note the concern about defacto education vouchers expressed below in section 11 (Health, aged care, education).

The CCB is a separate issue that I have not examined. However it is related in a strategic sense to the other issues discussed in this submission.

9. Income, FBT, RFB and salary sacrifice

Fringe benefits and salary sacrificed income really ought to be part of normal personal income. The FBT year is different to the individuals tax year. Salary sacrificing leads to RFB, but is added back to taxable income for various purposes. For some reason, salary sacrifice into super is treated differently. In a similar vein, deductions on a negatively geared property are added back for some purposes, but not deductions for borrowing to buy shares. The States add various items when assessing income for payroll tax purposes. Deductible super contributions are added back for ATI. This list of anomalies is endless.

10. Property

Conveyancing stamp duties on residential property distort behaviour because they are large in both absolute and relative terms. They should be reduced. Rates on residential property require ongoing valuations to track what can be volatile prices. Consider alternatives to municipal rates for residential property.

11. Health, aged care, education

Major areas of expenditure by all levels of Government in total are health and aged care, education and transfer payments. Health and education (primary/secondary) have parallel systems. These are inherently unstable and will be subject to ongoing political debate. They are half pregnant to use the Telstra terminology.

The "Industry Commission's Report on Private Health Insurance in Australia" by Gary Banks (conference paper on 28 May 1998, file cs19980528.pdf) on the Productivity Commission website is a reasonable statement of the current position. I am concerned about the voluntary nature of community rating, and the ongoing rise in costs of Private Health Insurance because of adverse selection. I expect the current Medicare proposals for insurance outside hospitals, if passed, will follow the pattern of gap insurance for services inside hospitals. I also expect that if current policy settings are not changed, then real health insurance premiums may double within twenty years, and coverage will fall back to the 30% mark or less. The change maybe less if the threat contained in Lifetime Health Cover makes a permanent change.

If the Government wants to shift from Medicare to the private sector, it should either mandate Private Health Insurance (with possible exemptions), or lower the Medicare Surcharge to be consistent with income support levels providing health care cards, eg around $32, 000 for a family. If this seems too low, are health care card limits are too low? The current Surcharge limit is around $50,000 for a single and $100,000 for a couple. Most singles and couples earn considerably less, and data on this issue is available in the Taxation Statistics from the ATO.

The tax and benefit arrangements vary markedly in the health and aged care sector. The logic, other than historic incremental development, escapes me. Compare the PBS, hospital usage, dentists and purchase of glasses as example. One step forward would be for State funding of Public Hospitals to move to the Federal Government. It is hard to see why Federal and State Governments contribute in roughly equal proportions. The State contribution is a small part of overall health expenditure, and is their primary expenditure. The public are confused and there is no practical transparency and accountability on the adequacy of funding. The operation of the hospitals is a separate issue.

Some of the debate on health policy is also applicable to the public and private educations systems at the primary and secondary level. However the adverse selection in health does not apply to education, and I suspect the situation is more stable. A major concern with FTB, both now and in the future, is the possibility for FTB to flow though to education costs, and become a defacto education voucher, in conjunction with funding of private schools. It is also debatable that current funding of private schools, particularly the non-Catholic sector, is directed to low income/low wealth families. It could be achieved by more direct means, without loss of privacy. The current arrangements using postcode data distort behaviour and lack practical transparency. Try getting the relevant data such as the socio-economic indexes for your local community. It is complex and requires a lot of money and effort compared with similar data in other policy areas.

There are many areas of risk that are met by various combinations of insurance or savings (ie funded) in either the Government or Business sectors or by the individual. Areas the Committee could examine include House and Contents Insurance, and income support and disability. In particular, there is a need for a bipartisan commitment to a stable policy for funding aged care, because of the substantial cost involved for high care over several years for dementia patients.

12. Health and environment issues

The primary objective should be a focus on community outcomes, eg health, rather than financial outcomes. Cigarettes are a major health issue. Other concerns are cars and petrol in relation to the environment and to their impact on urban planning, regional planning and infrastructure issues, and water and soil conservation. Federal Government policies, including taxation in particular, have a significant impact on other levels of Government, and other sectors of the community.