F — The transfer system

F. The transfer system

The primary purpose of government assistance payments to individuals is to provide them with a minimum adequate standard of living. In seeking to meet this goal, Australia has traditionally placed a higher weight on poverty alleviation than on income maintenance compared with many other countries. Most OECD countries have systems that provide both social insurance related to previous earnings and tightly targeted social assistance for poverty alleviation.

Australia's emphasis on poverty alleviation means that it has one of the most targeted and redistributive transfer systems in the OECD. This is largely because of the unique nature of the income support system. Australia has a 'flat' rate structure that does not take into account previous earnings and is financed from general government revenue. Assistance is not time-limited and is targeted to 'need' using means tests that are relatively generous compared to other social assistance schemes.

Principles

The primary purpose of government assistance payments is to ensure a minimum adequate standard of living, taking into account individual circumstances and prevailing community standards.

The design of the income support system, including amounts of payments and means test withdrawal rates, should take into account how the income support system and the personal income tax system together affect incentives to work and save. Design of the income support system should also take into account overall budget sustainability.

The main features of the Australian system should be retained. These are its targeted and category-based income support payments and family assistance, paid to income support recipients as well as working families.

Public spending on cash benefits in Australia is lower than in many other countries and is only 70 per cent of the OECD average. Australia has the most progressive benefit system in the OECD. Because of the design of assistance payments and taxes, Australia's system of redistribution is also very efficient in that there is minimal churning,[1] and most money is transferred to low-income households (Whiteford 2009).

The combined redistributive effects of the personal tax and transfer system are substantial at the aggregate level compared to overseas systems. However, payment adequacy, structure and incentives could be improved.

Government assistance payments comprise cash payments to individuals for income support, payments to families to help with the costs of raising children, and subsidies for

1 Tax–welfare churning occurs when governments tax individuals and then spend tax revenues on providing income and services 'back' to those same individuals.

specific goods and services such as housing rent and child care. Access to these forms of assistance is means tested to target assistance to those with the greatest need. Government also provides assistance to individuals through subsidies to providers — public and private — for goods and services such as health care, education, training and housing.

There were around 40 Australian government assistance payments amounting to outlays of over $85 billion in 2008-09 and representing more than a quarter of Australian government spending. This Review has focused on the main income support payments for the aged, people with disability, the unemployed, parents and full-time students. It has also considered family assistance paid to income support recipients and working families, rent assistance and child care subsidies.

The income support system assists a large number of people — more than 4.8 million people, excluding children — and family assistance is paid to parents (receiving income support or working) in respect of more than 3.4 million children (see Chart F-1). The scope of the income support system is very broad and the Review Panel has not undertaken a detailed review of adequacy or reviewed individual payments. Instead this Report has focused on the broad architecture of the system — such as the relationships between payment categories — and its interactions with the personal tax system. In considering payment adequacy, the Review has taken the policy settings established by the Australian Government following the 2009 Pension Review as establishing the highest level of income support payment. The primary focus of this Report is the structure and relationship of working-age income support — for the unemployed, parents, people with a disability and students (see Section F1 Income support) — to the pension. The way in which assistance is targeted to individuals and families by means tests is examined in Section F2 Means testing.

Chart F-1: Income support recipients, and children for whom Family Tax Benefit Part A is paid

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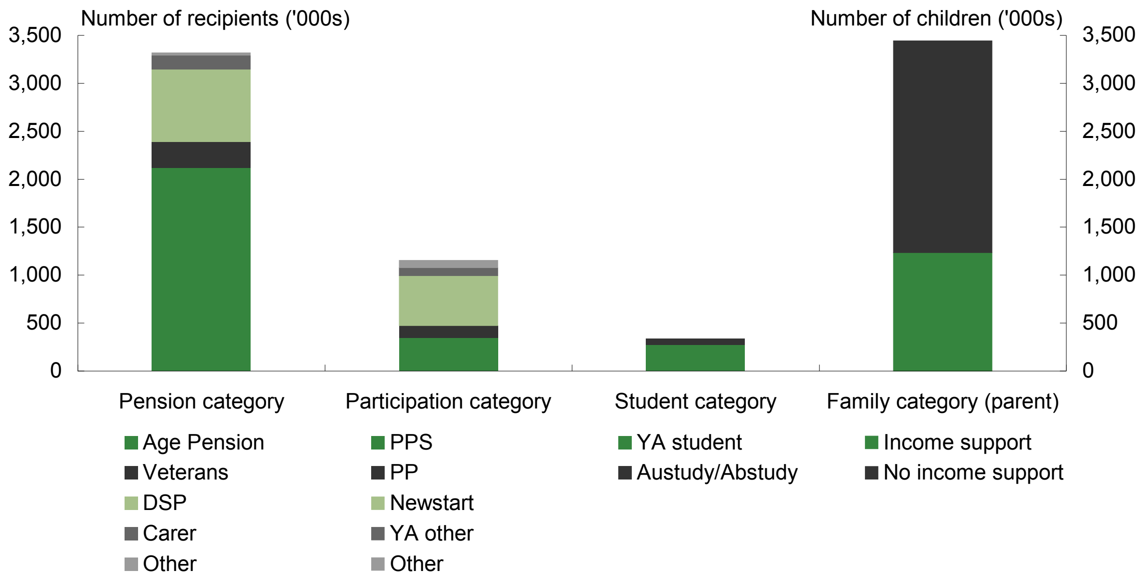


Source: Australian government administrative statistics.

While overlap between the tax system and the transfer system has increased in recent decades, full integration to achieve a single system would involve common treatment for income definitions, the unit of assessment (for example, individual or family) and the period of assessment. While full integration may be technically possible in the future, it is considered that assessment of need in the Australian transfer system and capacity to pay in the tax system are sufficiently different to warrant retention of a categorical means tested income support system based on joint assessment of need for couples. This differs from the tax system, where capacity to pay is assessed on an individual basis, on an annual rather than fortnightly basis.

An important reason to improve the income support system is to make it more work-focused for more people. Structural ageing of the Australian population makes it particularly important that people in the community who wish to and have some capacity to work should not be discouraged from doing so by the personal tax and transfer system. But structure of income support alone is not sufficient, as Whiteford (2009) has concluded:

> Among the most disadvantaged and long-term jobless the problems appear to include very low levels of educational attainment (around 60 per cent having Year 10 qualifications or below), lack of access to reliable transport, relatively unsafe neighbourhoods for families with children, and complex personal problems including poor health and disabilities among adults and children. While it is possible that poorly designed tax and transfer systems might exacerbate these problems, it is difficult to see that transfer reform can resolve them. Instead, what seems more promising for these groups is a more effective mix of services that support participation generally (for example, better child care) plus targeted employment support programmes and activation policies (p. 30).

As stated earlier, the primary purpose of government assistance payments to individuals is to provide a minimum adequate standard of living. Poverty alleviation is a central feature of this purpose, but if poverty has dimensions beyond income then an income support system will not be sufficient to eliminate it. In the absence of measures that address these other dimensions there are limits to what the income support system can achieve. It may in fact entrench poverty if income support creates a barrier to employment.

In an influential work, Sen (1992) proposed that poverty is a function of capability — in effect, the choices people have in life. In this view, income is only one dimension of poverty — depending on the social surroundings, such things as poor health, poor education, poor family life or poor political voice can all be seen as valid measures of poverty because they limit individual capability and hence autonomy and happiness.

Significantly, these different dimensions can vary over time and across societies, which means that the importance and nature of instruments to address these dimensions — such as through the income support system — can also vary over time. It is difficult to predict the evolution of future social attitudes and arrangements, so policy choices will primarily reflect current Australian society.

Viewed in this way, alleviating poverty also involves reducing disincentives to work created by the tax and transfer system. This could include changes to payment rates, income withdrawal rates, activity tests, and access to child care, rental subsidies and other services.

Therefore the impact of all aspects of the tax and transfer system should be considered — including cash transfers, subsidies for housing, child care, concessions and other social services. While some of these areas are outside the Review's terms of reference, parallel reforms in aged care, disability and employment services will be crucial to managing the pressures of an ageing population. These pressures include the growing unmet need for aged care, and the need to ensure a high level of employment and a productive workforce.

The current disability service system is fragmented, insufficient to meet current needs, difficult for people to access, and has no incentives to promote increased efficiency or effectiveness. This system will face considerable challenges in the future in meeting the demand for accommodation, care and respite services for people with a severe disability. Despite increased spending, the rate of growth in demand is around 7.5 per cent. In this context the Productivity Commission will explore the merits of a national disability insurance scheme and review the efficiency, effectiveness; sustainability; case for increased investment (including the private sector); consistency of access; and planning for lifelong care in the provision of disability services.

There are two particular demographic groups — single parents and people with a disability — for whom increases in employment rates could substantially improve outcomes.

Income support

The income support system is a crucial social institution. As in the past, it will need to continue to be adapted to changing social and economic needs (see Section F1 Income support).

The primary focus of the income support system has been and should continue to be the provision of a minimum adequate level of income to people who are unable to support themselves through work or their savings. This focus on payment adequacy, however, has to be balanced with incentives to work. And payments need to be seen as affordable, sustainable and fair by the community at large.

There are large differences in rates and conditions of payment for people of working age. These differences produce very different outcomes for people with similar capacity to work. They can create disincentives to work or incentives to move to non-activity tested payments.

There should be three primary payment categories that reflect societal expectations about the level of work that can reasonably expected to be undertaken by an individual — a pension category where there is no expectation of work; a participation category for those who are expected to work now or in the near future; and a student category for those undertaking full-time study in an approved course. Rates of payment for those in the pension category should generally provide a higher level of adequacy than rates in either the participation or student categories.

To improve equity, the current differences in rates of payment should be reduced through increases in the single person's rates of payment in the participation and student categories. These single rates of payment would be lower than in the pension category; however, increases over time in the rates of payment should establish a consistent treatment of households of different size and composition based on the current relativities between the single and combined couple rates of payment in the pension system.

Under present indexation and benchmarking arrangements, the relative adequacy of allowances diminishes over time relative to pensions because different indexation methods apply. The last adjustment to the single rate of allowance — apart from normal price indexation and compensation for the goods and services tax — was in 1994. Similarly, youth rates of allowance have not been increased since 1987 when Austudy was introduced. Once established, relative levels of adequacy should be maintained over time. This could be achieved by a consistent approach to indexation across the three payment categories. But it should be noted that developing a consistent indexation regime that meets community expectations and is fiscally sustainable is challenging.

Means testing

Means testing is an important tool for targeting government payments to those with most need and for managing the sustainability of the transfer system (see Section F2 Means testing).

The transfer system should have a broader assessment of means than the tax system, which is focused on a person's ability to pay. The concept of means for income support payments should include not only income but also a person's ability to generate an income from their assets.

Means test arrangements should ensure that people on the same payment with similar means, including their income and their assets, receive an equivalent level of income support or other assistance.

As means testing has similar economic impacts as taxation, the settings for a means test should have regard to its impact on a person's decision to work and save as well as its primary objective of targeting government payments.

The current means test for income support payments is not as equitable as it could be because it results in people with similar need for support and the same level of means receiving different rates of income support. This reduces the fairness of the system and creates incentives to hold wealth in particular types of assets. In its strategic report on the retirement income system (AFTS 2009) the Review Panel foreshadowed that there should be a comprehensive means test that replaces the assets test by extending the income test by deeming returns on a greater range of assets.

Assistance for families and youth

Family assistance (including payments for dependent youth) is the part of the transfer system that has the greatest overlap with the tax system because it is paid to many households with children where parents are not receiving income support. Because family payments can be substantial and are means tested, they raise effective tax rates for both recipient and non-recipient households. Consequently, family assistance has considerable potential to affect incentives to work.

Because family assistance and income support for dependent young people are similar in nature, these forms of assistance are considered together in the report in Section F3 (Family and youth assistance). Rates of payment for income support recipients aged under 21 (22 for full-time students), including rates of Disability Support Pension and Carer Payment, need to be considered in the context of the principles underlying family assistance rates and in the context of the principles underlying income support rates for adults. These issues are also discussed in Section F3. Australian families are increasingly balancing work and family responsibilities. The workforce participation rate of secondary earners, who in most cases are women, has risen steadily over the past few decades. The design of the system needs to be responsive to that.

The tax and transfer system can impact on the benefits of working relative to the benefits of not working. This can include the choice to work or to take care of children at home. It is therefore a major influence on some parents' ability to participate in the workforce. The system is inherently biased against paid work because of the taxation of wage income (but not home production), the removal of benefits as earned income increases and the availability of government payments as a substitute for paid work.

The current system of family assistance can be rationalised and remodelled to create a family assistance program that is simpler, more transparent and provides greater support where needed. Support provided through family payments should be designed to assist with the direct cost of children, while support for adults (including parents) should be provided through income support payments.

The family assistance system includes a number of payments with overlapping objectives. This increases the compliance costs for parents and increases the challenge of designing a system that is fair to families in different circumstances. The existence of multiple payments also results in overlapping withdrawal rates, which increases effective rates of tax.

Family payments should be the main form of assistance for children up to the age of 18 or until the completion of secondary school. Beyond these points, youth payments alone should be available and should be focused on encouraging study, training or workforce engagement. There should be a seamless transition from family payments to youth payments. Youth payments should be the main form of income support from the age of 18 until the age of independence.

The rates of youth payment should reflect that youths generally have lower needs than adults, but should be sufficient to support investment in education, training and other capability-building activities. Youth rates should not favour unemployment over education and training. Youths in different living arrangements and personal circumstances have different needs, for example young people living away from home have higher costs than those living at home.

Access to high-quality and affordable child care is important to facilitate the workforce participation of parents, particularly secondary-earner parents and single parents with the primary care of children. For parents who use child care in order to participate in paid employment, child care is a cost of employment. The costs of child care may mean that in the short term parents receive minimal financial benefit from returning to work, even though the long-term gains from working are much greater for parents and their children, and for the broader community when this lowers reliance on income support. Helping parents to access good quality and affordable child care can help overcome these barriers to workforce participation.

The level of child care assistance currently provided to families is broadly adequate. However, the current payment structure could be simpler and more transparent (see Section F4 Child care assistance).

Rent assistance

The purpose of rent assistance should be to ensure that adults with limited means can afford to live in an adequate standard of rental housing (see Section F5 Housing assistance).

Rent Assistance payment rates should be increased so that assistance is sufficient to support access to an adequate level of housing. Maximum assistance should be indexed to move in line with market rents. Rent Assistance should be extended to public housing tenants, with recipients generally paying rents that reflect market rates, subject to transitional arrangements.

A new source of funding should be made available in respect of the tenants who have high housing needs, such as those with high costs due to disability or people likely to face discrimination in the private market. The payment would be based on the needs of recipients and where practical directed by them to providers of their choice.

The Australian government and the States should retain the option of providing capital for housing construction.

Transfers tied to goods and services

While transfers are usually thought of as cash payments, governments also provide transfers such as concessions and payments that are tied to the purchase, or supply, of a particular good or service. These transfers are often provided to encourage the consumption of goods and services that help people improve their capabilities (see Section F6 Transfers tied to goods and services).

All three levels of government are involved in the funding and provision of transfers tied to goods and services; however, the approach across the federation is not always coherent with other aspects of the tax and transfer system.

Transfers tied to goods and services can be tailored to people with high need. A person may have high health or support needs due to illness or disability, or their costs may vary depending on where they live. Determining a rate of payment based on what an average person requires can result in some people receiving less support than they need, and others receiving more. In cases where levels of need vary considerably across the population, a transfer provided as a concession may entail less risk than a cash payment of under-compensating those with high needs and over-compensating those with low needs. It can also allow people to manage their risks better by giving them access to goods and services at times when their needs are higher.

F1. Income support payments

Key points

Current income support policy settings do not adequately reflect changing employment patterns and changes in the composition of the working-age population.

Large differences in payment rates and conditions create incentives to switch to high payment categories that carry greater risk of long-term welfare dependency. Restructuring income support can reduce this risk, but only if it is clear that income support recipients are expected to find work and there is adequate investment in employment-related services.

Restructuring income support within three categories — a pension category, a participation category and a student category — would more appropriately balance payment adequacy and incentives to work and study for people in different circumstances. Pensions would be paid at the highest rate in recognition that people eligible for them are likely to rely on them fully for a long time. Participation payments would be paid at a lower rate to maintain incentives to work. Student assistance for adults would continue to be paid below the participation rate on the basis that it is intended to be supplemented by other means.

The difference in rates between the three categories of payment should be reduced, particularly for singles. To achieve this, rates of payment for the participation and student categories need to be increased to establish appropriate payment relativities. To maintain these relativities over time there should be a consistent approach to indexation across the three payment categories, although achieving this while balancing incentives to work and fiscal sustainability will be a challenge. There should also be a consistent treatment of households of different size and composition based on the current relativities between the single and couple rates of pension.

F1-1 Striking the balance between payment adequacy and incentives to work

The primary focus of the income support system is poverty alleviation through the provision of a minimum adequate standard of living to people unable to support themselves through work, savings or other means.

Societies can choose to meet this objective in a number of ways. They include negative income taxes, social insurance and category-based mean-tested approaches. A negative income tax system could be based on a single basic level of income paid to everybody and taxed at a single rate. Alternatively there could be a number of category-based minimum-income payments with different tax rates. A pure negative income tax system with an adequate basic income would involve a very high tax rate as every individual would be paid a transfer. This would be unlikely to gain public acceptance in the face of perceptions that people are being paid regardless of need, obligations or behaviour. To date, no country has instituted a pure negative income tax based scheme.

Most countries provide assistance to people's category-based life circumstances or contingencies such as old age, disability, sickness and unemployment. The two main models are social insurance and general revenue-financed means tested assistance payments. Many countries combine both approaches; however, Australia has opted for category-based means-tested assistance payments supplemented by private superannuation (including a mandatory component — the superannuation guarantee), industrial entitlements (including sick leave) and State government workers' compensation schemes.

Social insurance is based on income-related contributions and pays income-related benefits. History has shown that there is unlikely to be support for a major shift in Australia to social insurance as there is an underlying social preference for payments targeted to poverty alleviation rather than to income maintenance. Also, the transition costs of moving to a social insurance scheme could be particularly high. This would be the case even if payment levels were not increased because more people would receive a payment, or an increase in payment, which would have to be funded by higher taxes on those already in the workforce. While history and revealed preferences should not rule out major policy changes, current approaches are widely supported. For those who wish to make additional provision for possible risks, insurance arrangements are generally available.

While there is currently no strong case for a shift away from a categorical approach, the number and structure of categories — including differences in rates of payment, means tests and activity requirements — can and should reflect changing social expectations such as attitudes to work (and retirement), parenthood and disability.

Targeting support to categories of need

Categorical distinctions — such as single parenthood, disability or unemployment — assist in targeting support to those with varying need and capacity to support themselves. Such distinctions also give effect to various social judgements about who should receive assistance.

Within a categorical means tested system of income support, the most important design elements — aside from the eligibility criteria for different payments — are the adequacy or rate of the payment, means tests (how assistance is withdrawn as income rises and need falls), and participation or activity requirements. Participation requirements primarily define who is and who is not expected to undertake an approved activity in return for assistance. Requirements are based on social expectations of particular groups to undertake paid work in order to support themselves. For unemployed adults, the primary activity requirement is to look for full-time work, while primary carers are subject to part-time activity requirements when their youngest child is aged six. Disability Support Pension and Carer Payment are not subject to participation requirements, as recipients are either unable or unavailable to participate in significant part-time work in the open labour market.

Another argument in favour of categorisation is that different groups of people respond differently to the incentives they face, particularly in relation to work. Total costs and disincentives to work may be minimised if rates of payment and means tests reflect group differences (Akerlof 1978). However, there can also be significant differences within groups, and this may impact on the effectiveness of incentives targeted to a particular group (Viard 2001).The practical effect of varying the incentives faced by different groups of people is to maximise the number of hours worked in the economy — maximising full-time work by those able and available to work full-time and maximising part-time work by those who are not able, not available or not expected to work full-time (Saez 2001; Kaplow 2006).

A disadvantage of categorical income support systems is that they are complex. There is also a tendency to increase complexity by creating new categories of payment and additional means tests in an attempt to target the payments ever more tightly to need, while ensuring that no deserving group is left out. There is certainly an optimal level of categorisation[2], though determining this would be difficult in practice. The level would in any event vary with social, economic and labour market conditions. However, one factor to take into account in determining the effectiveness of existing categories is the extent to which differences in rates and conditions of payment give people an incentive to change their category.

To the extent that it is possible for the same person to be eligible for different payment categories, or to experience large changes in assistance without commensurate change in circumstance, there will inevitably be concerns with horizontal equity (that is, treating people in similar economic circumstances similarly). For example, a person with disability who is assessed as being able to work 14 hours a week rather than 15 hours a week can receive a higher level of assistance and lower rate of withdrawal of income support. Another example occurs for single parents on their youngest child's eighth birthday. Even if the single parent was already working 20 hours a week, their disposable income would fall significantly on the birthday of their child.

Principles

Income support payment categories should be limited in number and reflect current social expectations about the responsibilities that individuals in different circumstances have to look for work.

Differences in the treatment of individuals in similar circumstances on different payments should be limited to minimise horizontal inequities and disincentives to work created by categorical differences. This means that minor changes in personal or family circumstances should lead to only minor changes in payment conditions.

Payment adequacy, poverty and incentives to work

There is no single agreed definition of income poverty, nor is there an agreed way to measure the adequacy of support rates. What would have been seen as an adequate level of payment according to 'community standards' in 1950 might not be seen as adequate today, and what might be seen as adequate today might not be seen as adequate in 2020. Aside from changes in living standards and the distribution of work and income, views about the best way to avoid or alleviate poverty can also change.

2 This can be defined as 'the point where the marginal social benefit equals the marginal social cost in terms of distortions in decisions of what group to belong to' (Moffitt 2008, p. 11).

The level of payment has to be balanced with incentives to work. It also needs to be seen as affordable, sustainable and fair by the community. These considerations would support a lower level of payment for those expected to work full-time compared to those not expected to work and likely to be reliant on income support for a long time. For all those not expected to work, maintaining incentives to work is not as crucial. Social expectations that individuals would be able to share resources such as income or accommodation — with parents or a partner — may also justify different rates of payment.

While there is no clear principle for establishing the level of payment for those who are expected to work, the rate once determined should be maintained against some measure of community living standards. One measure that has been used for pensions is a wages benchmark. Alternatively, there could be indexation to some other measure with regular review of whether this was continuing to meet community standards. Indexation of the payment solely to prices can reduce adequacy relative to members of the community who work.

Principles

The highest level of payment — pensions — should be paid to those who are not able or expected to work and who are likely to be reliant on income support for a long time. Rates of payment for those who are able and expected to undertake significant levels of work — allowances — should be lower in order to maintain incentives to work.

Relativities between pension and allowance rates of payment should be maintained by indexing all rates by the same measure of community standards.

The higher the level of income support for people of working age, the more likely it is a disincentive to work. The point at which an individual will choose to work will vary with individual characteristics (such as skills, experience and capability reflected in a person's potential wage rate), work preferences (for example, to work full-time, part-time or not at all), and the design of the tax and transfer system (such as income support participation requirements and withdrawal rates as income from work increases).

Participation requirements ensure that income support recipients with the capacity to undertake paid work actively seek such work. Participation requirements also provide assurance to the broader society ('taxpayers') that those experiencing a period without sufficient means are not only provided with an adequate level of income but are obliged to make appropriate efforts to reduce their reliance on government assistance.

Another consideration is the level of income support relative to minimum wages, and minimum wages relative to median earnings, as this will determine the number of people whose workforce incentives may be affected.

These factors interact. For example, where there is a high minimum wage and a moderate payment rate, it is possible to have a high income support withdrawal rate with little impact on incentives to work. This would occur where individuals wish to work full-time and income support is withdrawn well before the minimum wage. This conclusion would be less clear if there were limited labour demand for low-paid full-time work, but some demand for low-paid part-time work.

In addition, some people prefer part-time work to non-employment but prefer non-employment to full-time work, such as some people with caring responsibilities or primary care of young children. Others may not be able to work full-time (due, say, to disability) and would be adversely affected by an incentive structure that favoured full-time work.

If income support is withdrawn beyond the minimum wage there would be limited impact on incentives to work for individuals who prefer part-time work. This is likely to be the case for many primary carers of young children. However, such a design may create disincentives to work if individuals prefer full-time work.

In considering the effect of any incentives to work, it is important to consider both *substitution effects* and *income effects*. A substitution effect is where an improvement in the return from work, for example due to either a withdrawal rate or marginal tax rate reduction, leads to an increase in the hours worked, with a reduction in the return from work leading to a fall in the hours worked. Income effects occur when additional income — for example, from an income support rate increase or an effective tax rate reduction — reduces hours worked, as the person can achieve a similar standard of living with less work. Conversely, the income effect could mean that a rate reduction or withdrawal rate increase would lead to an increase in hours worked.

These effects are present together in almost any change to the financial arrangements of income support. It is important to consider both effects at the same time. For example, a reduction in the withdrawal rate of Parenting Payment Single (PPS) may have the effect of increasing the return from working. But it may also increase disposable income for those on PPS, thereby reducing or negating the positive effect of the reduction in the withdrawal rate. Put another way, if people can achieve an adequate standard of living by only a limited amount of work they are more likely to do so. In any given change, which of these effects dominates is a matter of empirical evidence — theory will not tell us which is more important. However, in most circumstances the substitution effect tends to dominate the income effect where income levels are low, in which case higher taxes and tighter means tests will reduce the amount of work by those who face them. This is less of an issue where a person is highly motivated to work and can attain enough work to get off payment altogether.

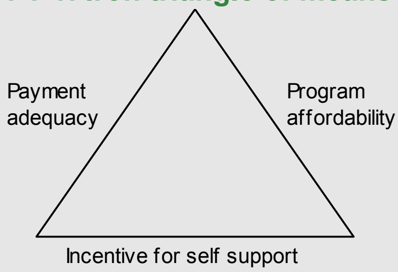
Ideally, the rate of payment to people expected to take up full-time work should remain well below the minimum wage and cut out before the minimum wage. This would help to ensure that people can see a clear benefit from work. The effectiveness of this minimum wage constraint depends on a number of factors, including how easy it is for people to qualify for higher-rate payments such as the Disability Support Pension or Parenting Payment Single, and the structure of payments for children as parents increase their work effort. It will also depend on the overall need to ensure that recipients take up part-time or intermittent work where it is the only work available to them.

The trade-off between payment adequacy and program affordability or sustainability is outlined in Box F1-1. To reduce disincentives to work without reducing payments for income support recipients would involve either relaxing (or removing) means tests or targeting payments to people according to characteristics such as age or duration on payment. The income support system uses both of these strategies.

Box F1-1: Balancing adequacy, incentives and affordability

With any income support payment, there is an 'iron triangle' associated with means testing (see Chart F1-1). The generosity of the payment (including the breadth of its coverage) needs to be balanced by how much it costs taxpayers, and the incentive for people to get off the payment by earning income. Improving one of these worsens one or both of the others.

Chart F1-1: Iron triangle of means testing



To improve incentives without reducing the payment level there are only two possible strategies:

- relax or remove some means tests — apart from raising inevitable questions of 'middle class welfare' and 'churning', this would greatly increase the cost to taxpayers and jeopardise affordability; or
- reduce or remove the payments to some people on grounds other than income, such as age or an expectation that duration on income support will be short — this would reduce the total income of those people and may compromise adequacy.

Whether the pattern of incentives is changed by adjusting the means test or using a tax instrument such as an earned income tax credit does not affect this trade-off; it simply changes it from a question of welfare design to a question of tax design. Which is the better approach depends on other issues such as administrative practicalities, signalling effects (such as the weight given to work), and tax churning.

F1-2 Arrangements need to reflect changing realities

The income support system is a crucial social institution. In the future as in the past it will need to continue to be adapted to changing social and economic needs. Changes in workforce participation, the level of unemployment, and the mix of full-time and part-time work all have an influence on the numbers receiving income support.

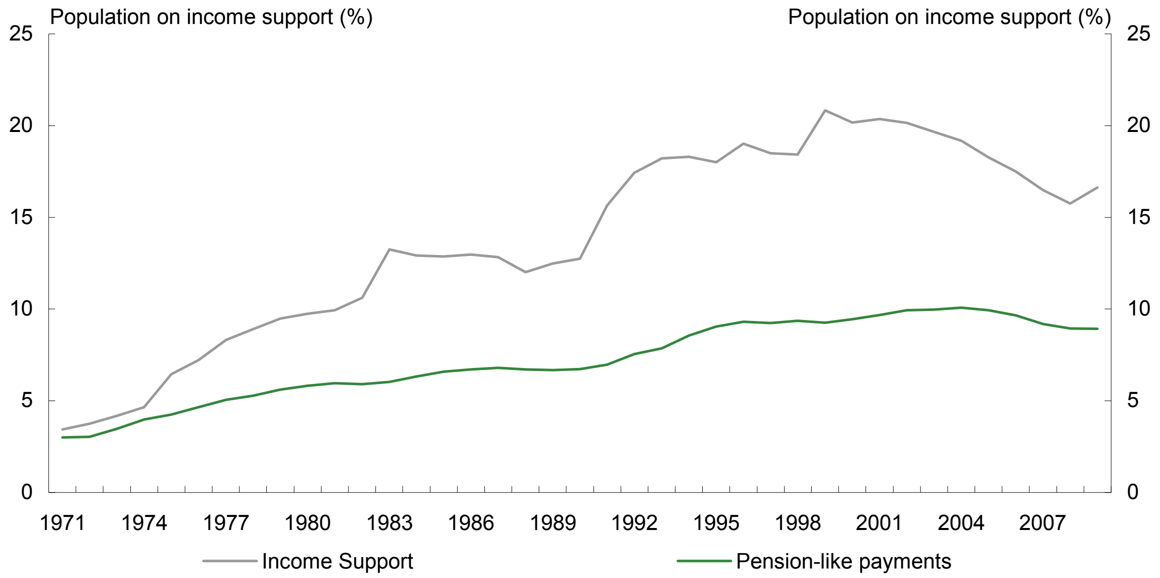
Working-age income support receipt and employment trends

From 1970 the percentage of the working-age population receiving income support increased steadily for nearly 30 years (see Chart F1-2). There are many reasons for this growth, such as the ageing of the baby-boom cohort, recessions, industry restructuring, the growth of female workforce participation, and increasing rates of single parenthood. Policy has also contributed to this growth, in some cases by allowing people to receive income support while working. In other cases decisions to target payment increases to particular groups has increased incentives for some people to remain on and for others to seek to qualify for higher-rate, non-activity tested payments, such as Disability Support Pension (DSP).

The nature of work has changed considerably over the past 40 years, as have attitudes to women depending on their partners' income. This has been reflected in continued changes to the tax and transfer system. Partners of the unemployed have been required to claim income support payments in their own right. Payments made to women because they were wives of age or disability pensioners or partners of allowance recipients have been closed to new entrants. Payments to single parents, introduced in response to the rising incidence of single parenthood and concerns about poverty in that group, have been adjusted in line with increasing rates of workforce participation of mothers and women more generally. The employment rate of women has increased considerably since the 1970s (from 39 per cent in 1971 to 55 per cent in 2008). The number of people working part-time has also substantially increased — from 15 per cent of total employment in 1978 to 28 per cent in 2008. Women accounted for 70 per cent of part-time employment in 2008.

In the early 1970s, unemployment was very low. Working-age income support largely comprised pensions for war veterans, people with disability, women who were eligible for the Age Pension at age 60, wives of age and disability pensioners, and widows. The proportion of the working-age population on pensions was around 3 per cent. Today the proportion is about 9 per cent, which is over half of all working-age income support recipients.

Chart F1-2: Percentage of working-age population receiving income support and pension payments (1971–2009)[(a)]



(a) Pension payments include: Age Pension; Disability Support Pension; Parenting Payment Single; and Carer Payment.
Source: Annual ABS population figures for people aged 15 to 64 and Australian government administrative data.

After nearly 30 years of growth in working-age income support receipt, the favourable labour market conditions from the late 1990s to 2008 led to a consistent downward trend in the proportion of the population receiving working-age income support. This was largely due to falling unemployment, but in the fours years preceding the global financial crisis the proportion of the working-age population on working-age pensions (particularly DSP and Parenting Payment Single) also started to fall as a result in part of welfare to work measures. This lag between falling unemployment and a fall in the proportion receiving working-age pensions is a result of two factors: first, the small number of people who move off payments such as DSP to full-time work and, second the fact that lower skilled and more marginal workers are among the first to lose their jobs in economic downturns and the last to regain jobs in the recovery phase. The key to preventing people who have a reasonable capacity to work from becoming dependent on income support is to reduce inflows to pension payments. Favourable economic conditions are a pre-requisite, but income support settings can also assist by reductions in disincentives to work, including by making payments conditional on job search for more people.

Payment adequacy and categories

Category-based systems of income support can provide different rates of payment, and conditions, to people in different circumstances. While theory cannot tell us what the rates should be for the different payments, a number of factors can be considered. These include '*community standards*', expected *duration* on payment, *incentives* to work and the overall *coherence* of the income support system.

Payments are currently paid at two main rates, with a higher rate for pensions and a lower rate for allowances.[3] Student and youth payments are paid at a rate below the general allowance rate unless children are present. Pensions are paid to eligible aged and people with disability, carers and single parents whose youngest child is less than eight years.

Newstart Allowance is paid on the basis that a person is expected to actively seek and accept suitable work, consistent with their ability and availability for work. For most recipients the expectation is for full-time work; however, part-time requirements apply for a person with disability who has a partial capacity to work and primary carers of dependent children aged under 16. Other groups of people are exempted from requirements — for example, they have a temporary incapacity for work, are attending rehabilitation or are in the period of confinement prior to childbirth. Other allowance payments with the same rate structure and means-testing arrangements provide for specific contingencies that limit a person's ability to work, such as short-term sickness or illness, or that limit their availability for work, such as the primary care of a young child. As with single parents with a young child, partnered parents with young children are not expected to actively seek and accept suitable work. This decision is left up to the individual.

The Pension Review considered the adequacy of the Age Pension, Carer Payment and Disability Support Pension. It was not required, however, to comment on the relationship between these pensions and other payments (such as Parenting Payment Single) and allowances (such as Newstart Allowance). In establishing a rate it ' … considered that the full rate of pension should provide a basic acceptable standard of living for those who are wholly reliant on it, often for extended periods, without any assumptions about access to private income or assets' (FaHCSIA 2009, p. xii). The Pension Review considered that the level of assistance should move in line with community standards.

3 Since September 2009 Parenting Payment Single, although a pension, is paid at a lower rate. Also Austudy is paid at a lower rate than the main Newstart Allowance rate.

The single rate of allowance is currently $228 a week whereas the single rate of Disability Support Pension (including Pension Supplement) is $336 a week, a difference of $108 a week. The difference is $89 a week where a single person receives the higher allowance rate.[4]

The size of this difference is due to historical differences in policy settings that have allowed this gap to increase over time, but some difference in the level of payments can be justified on the basis of differing needs and presenting different incentives to different groups. If a person is expected to take immediate full-time work whenever they can, it is important that they are much better off taking that work. If a person is never expected to work at all, then incentives for them to do so are irrelevant and the rate of assistance should be sufficient to meet the minimum community living standard. If a person is also receiving family assistance or youth payments for dependent children it is important that the adult's rate of income support provide for a similar standard of living so as to not compromise the assistance for children.

Harder to justify is the fact that rates of pension and allowances are not merely different, but the gap between them is widening. Since 1997 pensions have been increased in line with the greater of indexation to prices and benchmarking to Male Total Average Weekly Earnings — a measure of community standards — and allowances to prices. This has resulted in a growing gap between allowance rates such as Newstart Allowance and Parenting Payment Partnered and pension rates such as DSP and PPS. As economic growth causes real wages to increase, the gap between the two will continue to grow. If the current indexation arrangements remain in place, it is likely that by 2040 a single pensioner would be paid more than twice as much as a single unemployed person (see Table F1-1). A continuous decline in Newstart Allowance against community standards would have major implications for payment adequacy and the coherence — in terms of horizontal equity — of the income support system.

Table F1-1: Single adult Newstart Allowance compared to single adult pension
$ per fortnight

	1980	2010	2040 (projected)(a)
A Single allowance rate	$51.45	$456.00	$902.05
B Single pension rate	$57.90	$671.90	$1,945.40
A/B	89%	68%	46%

(a) Assumes 2.3 per cent per annum CPI growth, 4 per cent per annum MTAWE growth.
Source: Australian government administrative data.

Another measure of community standards — apart from the pension, which is benchmarked to Male Total Average Weekly Earnings — is net (after personal income tax) median income. The OECD considers that a person is in poverty if their income falls below 50 per cent of equivalised median disposable incomes. Using this measure a single person who received Newstart Allowance for the full year in 2007–08 had an income of 31 per cent of net median income.

Measuring poverty by a relative financial measure is always problematic and there is no accepted measure of poverty for policy purposes (FAHCSIA 2008, p. 15). However, poverty analysis can be used with other analyses to identify areas of concern.

4 The higher single rate of allowance is paid to recipients aged 60 and over, after nine months of continuous income support receipt; and to other singles with the care of children, including those with greater than 14 per cent of the care of a child aged under 16 or a Youth Allowance recipient aged under 18.

Using the OECD poverty measure, the Melbourne Institute estimated that around 12 per cent of Australians were in poverty in 2006 (Melbourne Institute 2009). It is important to note that much of this poverty is not persistent. While in any given year 12 per cent of Australians may be living in poverty according to this measure, most only experience poverty for short spells. Only 7.9 per cent of Australians were below this poverty line for four or more years of the survey. Only 2.6 per cent of the population were below this poverty line in all six years. Among the working-age population the Melbourne Institute analysis indicates that the household types most likely to be in income poverty are single parents (19.4 per cent) and single people (19.5 per cent). The rate of children living in poverty is significantly higher (28 per cent) for those living with one parent, compared with those living with both parents (6 per cent).

Duration on income support

While expected duration is a reason for differences in payment rates, there is the question of whether actual durations on income support are different enough to expected durations to justify large differences in payment rates. It needs to be borne in mind when interpreting actual duration data that it is an outcome of underlying economic conditions, payment conditions, and personal characteristics. The data used in the following analysis cover a period of favourable labour market conditions. Payment conditions also changed during the period, particularly for single parents, which led to transfers to other payments such as Newstart Allowance, Disability Support Pension and Carer Payment.

Age and Disability Support Pension recipients have the longest durations. In the ten years to 2007 Age Pension recipients spent 8.9 years on average on income support and DSP recipients spent 8.2 years (FaHCSIA 2008, p. 33).

Between July 1999 and July 2008 — a nine-year period — an average of 4.5 years was spent on working-age income support by single parents who became eligible for Parenting Payment Single in 1998–99. This compares with 3.2 years for Parenting Payment Partnered recipients and 2.6 years for Newstart Allowance recipients. Average durations are considerably higher for those who were already on income support at the beginning of 1998-99. Parenting Payment Single recipients spent an average of 6 years compared to an overall average for all working-age income support recipients of 4.8 years (see Table F1-2).

Newstart Allowance recipients have the lowest average durations on income support because a large number get work and exit income support within a year. However, differences in average durations between those on Newstart Allowance and PPS and DSP could reduce in coming years because of increased numbers of single parents and people with a partial work capacity who will receive Newstart Allowance following *Welfare to Work* policy changes in 2006.

About a quarter of current Newstart Allowance recipients have been continuously on income support for over two years, even in the very strong labour market of recent years.

Table F1-2: Average time on working-age income support in the period July 1999 to July 2008

For new recipients in 1998–99 or existing recipients at the beginning of 1998–99[a]

Recipient type	Average number of years in receipt of income support	Average years as a percentage of the whole period (%)
New Newstart recipients	2.6	29.2
All Newstart recipients	4.4	49.2
New Parenting Payment Partnered	3.2	35.2
All Parenting Payment Partnered	4.9	54.4
New Parenting Payment Single	4.5	50.0
All Parenting Payment Single	6.0	67.3
All New recipients	3.1	34.2
All recipients	4.8	53.0

(a) Excludes time spent on the Age Pension. New recipients are individuals who had previously had at least a 6 week period without income support, or 13 weeks where a previous period of income support was greater than 46 weeks.
Source: Australian government administrative data.

A substantial number of working-age people, including some on Newstart Allowance, spend comparatively long periods on one or more working-age income support payments. These long durations are consistent with the large number of movements between payment categories while on income support, often as the result of commonplace life events such as a change in partner status, a birthday for the recipient or their children, or a move into study or employment.

Table F1-3 shows the payment-to-payment moves of working-age people during 2008. It shows that around 307,500 people transferred between categories in the working-age income support system in 2008 (compared to about 682,100 who exited income support and 870,900 who moved to these payments from outside the income support system). There are a great variety of moves. A large number of people become unemployed and access Newstart Allowance and then move off payment relatively quickly (about 60 per cent have been on Newstart Allowance for less than one year and 24 per cent, or 135,000 people, have been on for more than two years).

More people move to Carer Payment and DSP from another income support payment than from outside the transfer system. A similar number move from other payments to Parenting Payment Partnered (29,800) and Parenting Payment Single (34,700) as move from outside income support (32,300 and 39,700 respectively).

Table F1-3: Working-age payment transfers, rounded to the nearest 100 (2008)

	Transfer from(a)											
Transfer to	ABY	AUS	CAR	DSP	NSA	OTH	PPP	PPS	YAO	YAS	Total	Inflow(b)
ABY	0	0	0	0	1,400	500	100	100	700	400	3,100	6,746
AUS	0	0	100	0	8,100	200	500	600	0	500	10,000	16,000
CAR	100	200	0	600	10,700	1,500	3,100	3,400	700	400	20,500	16,300
DSP	100	100	1,500	0	34,900	3,400	1,800	4,600	1,300	800	48,400	38,500
NSA	1,300	8,400	6,300	1,300	0	5,500	5,900	17,700	13,800	11,500	71,800	375,500
OTH	0	100	1,300	100	1,900	0	100	400	2,900	2,000	8,900	37,400
PPP	100	300	300	0	8,000	500	0	17,600	2,800	300	29,800	32,300
PPS	100	200	900	100	11,800	300	16,200	0	4,700	400	34,700	39,700
YAO	2,600	0	200	100	0	1,900	200	600	0	48,500	54,200	75,900
YAS	100	0	100	0	3,700	500	100	100	21,600	0	26,200	135,800
Sub total	**4,400**	**9,200**	**10,700**	**2,300**	**80,400**	**14,400**	**27,800**	**45,100**	**48,400**	**64,800**	**307,500**	
AGE	0	0	3,500	34,500	8,600	20,800	100	200	0	0	67,600	96,900
OFF	5,000	14,700	9,400	30,800	322,000	38,100	43,300	51,900	74,000	92,900	682,100	
Total	9,400	24,000	23,500	67,700	411,000	73,300	71,100	97,100	122,400	157,700	1,057,200	870,900

Recipient loses income | Recipient gains income | Recipient income faces little change

(a) ABY: ABSTUDY; AUS: Austudy; CAR: Carer Payment; DSP: Disability Support Pension; NSA: Newstart Allowance; OTH: Other payments (including Sickness Allowance and Special Benefit); PPP: Parenting Payment Partnered; PPS: Parenting Payment Single; YAO: Youth Allowance Other; YAS: Youth Allowance Student; AGE: Age Pension; OFF: off payment.
(b) Excluding transfers from other payments and people who had not previously been on a payment.
Source: Australian government administrative data.

In 2008, some 57,000 people transferred from Newstart Allowance to a higher-rate pension payment with no requirement to look for work (mostly DSP, Carer Payment or PPS). There were also 17,600 movements from PPS to PPP (a reduction in payment associated with changed partner status, resulting in a drop to an allowance rate and means test) and 16,200 moves in the opposite direction involving a potentially large increase in income support for the primary carer.

There were about 8,000 moves from PPS to a higher payment than Newstart Allowance (DSP and Carer Payment) and about 18,000 from PPS to Newstart Allowance (which can involve a large drop in income). The latter is continuing to increase as a result of the 2006 *Welfare to Work* policy changes. The death of the person being cared for can result in a large drop in income. For example, in 2008 some 6,300 people (or nearly 5 per cent of people on Carer Payment) moved from Carer Payment to Newstart Allowance. Relatively few people move off DSP. Most people who do move to the Age Pension.

There are also significant numbers of movements between youth (Youth Allowance Other) and student payments (Youth Allowance Student and Austudy), and other higher-rate working-age payments such as Newstart Allowance and Parenting Payments. This most likely reflects movements due to the cessation or commencement of full-time study, for example, (movements between YAS and YAO and between Austudy and Newstart), birthdays (for example; YAO to Newstart Allowance), or the birth of a child (YA to PPS).

From one point of view the large number of transfers between working-age payments shows that the income support system is responsive to changing personal circumstances. However, it also suggests there is a large group of people with a similar capacity to work who receive very different levels of income support.

Finding

Existing categorical differences between pension and allowance rates reflect a range of decisions, including expected duration of payment. However, actual durations for some working-age recipients, even for those on allowances, can be substantial.

The large number of working-age payment-to-payment transfers indicates that large differences in rates of payment can have a large impact on many individuals.

Incentives to work

Paying income support can reduce incentives to work. The higher the payment the higher the potential impact, although this will also depend on differences in responsiveness of individuals to financial incentives.

Labour supply research would support the application of high withdrawal rates to unemployed people without the primary care of dependent children because they are more likely to prefer full-time work and respond less to changes in financial incentives. Research also supports low withdrawal rates for primary carers of young children with a preference for part-time work and for people with disability unable to work full-time because they are more likely to respond to incentives (Dandie & Mercante 2007). Current policy settings largely reflect these findings. The major exceptions are single parents with a youngest child eight or older and people with a partial capacity to work.

Single parents with a youngest child under eight face a 40 per cent withdrawal rate**.** Age pensioners, people with a disability receiving DSP and Carer Payment recipients face a 50 per cent withdrawal rate. Unemployed people, partnered primary carers, single primary carers with a youngest child aged eight or more, people with disability with a partial capacity to work as a result of a disability, and students face an income test with both a 50 and 60 per cent withdrawal rate.

Single primary carers of young children face participation requirements when their youngest child turns six but remain on a higher pension rate of payment until the child turns eight. Single primary carers with a youngest child aged eight and over with a part-time work requirement face the same income test as a single unemployed person who is expected to look for full-time work. On the other hand, a single parent with a youngest child between six and eight who is also expected to look for work faces the lowest income support withdrawal rate (40 per cent).

There are limits on the extent to which incentives to work can be improved by adjusting income support withdrawal rates. One limit is the policy trade-off between designing means tests to target payments to those expected to either work full-time or part-time. The trade-off between the two would be easy if people with different labour force responses fitted into discrete payment categories, for example, if all single parents are paid Parenting Payment Single or all people with disability are paid DSP.

Another limit is the relationship between rates of income support and withdrawal rates on the one hand, and the minimum wage on the other hand. This is important because the potential for impacting on the incentives of large numbers of people increases significantly beyond this point in the income distribution.

Current maximum single rates of payment vary as a proportion of the net minimum wage. The net replacement rate (NRR) compares the after-tax value of income support payments to the amount of after-tax income the person could receive if they worked full-time in a minimum wage job. For example, the NRR of the lower rate of Newstart Allowance compared to the net minimum wage is 46 per cent. By comparison the NRR for the standard single rate of Austudy is 37 per cent, and for DSP it is 56 per cent (see Table F1-4).

The net replacement rates increase if rent assistance or family payments are included. For example, the NRR increases from 50 to 59 per cent for a person on the higher single rate of Newstart Allowance who also receives rent assistance and pharmaceutical allowance.

While all maximum rates of income support are significantly below the minimum wage, the addition of supplements and differences in rates of income withdrawal can mean that some people receive income support while working significant hours. For a single parent with one child receiving PPS, income support (excluding family assistance) is payable up to 149 per cent of the minimum wage. This compares to 78 per cent for the lower rate of Newstart Allowance (see Table F1-4).

Table F1-4: Comparison of working-age income support and Federal Minimum Wage (FMW) ($543.78 a week)

September 20, 2009

Payment	Net income no private income ($ per week)	Net income at FMW ($ per week)	Net replacement rate(a) (%)	Transfer Payment cut-out(b) ($ per week)	Cut-out (% of FMW)
Single person					
Newstart (lower)	228	497	46	427	78
Newstart (higher)	247	497	50	458	84
Newstart, (higher with rent assistance and pharmaceutical allowance)	306	514	59	556	102
Austudy (standard rate)	186	497	37	434	80
Austudy (long-term transferee, with rent assistance)	281	527	53	594	109
Disability Support Pension (DSP)	336	597	56	743	137
Single parent					
Parenting Payment, one child (excludes family payments)	290	615	47	809	149
Couples					
Newstart single income :					
Primary earner (P1)	412	629	65	390 (P1)	72 (P1)
Partner (P2)				733 (combined)	135 (combined)
DSP/Carer (one earns FMW income)	518	824	63	1137	209

(a) Net replacement rate is income support payment after tax as a proportion of the post tax minimum wage.
(b) Payment cut-out is the point at which the last dollar of income support is paid.
Source: Australian government administrative data.

The eligibility of people at incomes above the minimum wage for income support has been a longstanding concern that has impacted on the structure of the transfer system. However, in recent decades a number of policy changes have sought to extend assistance to some people in work. These include the separation of child income support from the income support system (starting with Family Income Supplement in 1983 and culminating in the present-day Family Tax Benefit) and the introduction of sequential income testing.[5] Parenting Payment Single is paid beyond the minimum wage because it is intended to allow some level of part-time work.

It is not clear what effect these differences in relativities to the minimum wage have on employment outcomes — for example, whether they would lead to reduced or increased hours of work. For single parents and people with a limited capacity to work they may lead to increased hours of work, especially if the choice is between no work and some work. For those who are expected to work full-time they may lead to reduced hours of work. There has been no definitive quantitative analysis of this issue in Australia, largely because sufficiently detailed data to support such studies have not been available until recently. Available data on the numbers of people on Newstart Allowance who also receive income from employment show that the proportion with earnings has remained very stable over the past six years at around 20 per cent.

The majority of people who work part-time do so in response to life-cycle events (Productivity Commission 2008a, p. xxii). For these individuals, targeted tax and welfare changes may have only small effects on preferences for full-time work. It is more likely that transition to full-time employment occurs when the family circumstances change — for example, as a child gets older a parent may increase the hours they work. Also, for a substantial number of employees actual hours worked depend on the state of the labour market. At least 10 per cent of young people and working-age males working part-time said they were unable to find full-time work or they accepted part-time work because they liked the job (Productivity Commission 2008a, p. xxiii).

Trends in employment suggest that part-time work has become increasingly important in its own right, irrespective of whether or not it provides a 'stepping stone' to full-time employment.

Finding

There is a case for applying a low taper rate to single parents with primary care of young children. There is scope to improve the rewards for work for people with disability who have a partial capacity to work. As the cut-out points for income support already extend beyond the minimum wage for several groups of income support recipients, increases in rates of assistance or reductions in withdrawal rates would extend these further.

System coherence

The increasing difference in payment rates between pensions available to people of working age, and allowances, will also increase the impact on individuals of such common events as a birthday or relationship change. It also increases the cost to the individual of administrative decisions such as the Job Capacity Assessment (which determines access to Disability Support Pension by judging whether an individual can work more or less than 15 hours a week).

5 In sequential income testing, once a person's income has reduced their own payment to zero, any excess over that point ('partner income excess') is applied to the other partner. This is achieved by an income test on partner income excess.

In September 2009 a person receiving Newstart Allowance and working 15 hours at the minimum wage had a disposable income of $338.62 a week. A person receiving the maximum rate of DSP had a disposable income of $335.95 — only $2.67 a week lower — and would not be expected to work. If they worked for 15 hours a week, they had a disposable income $143.16 a week higher than the Newstart Allowance recipient and $140.16 more than the Newstart recipient with a partial capacity to work (see Table F1-5).

Once a person receives a higher payment, there are strong reasons to avoid jeopardising it, and the evidence indicates that few people leave DSP other than to move to the Age Pension. The greater the difference between the high and low payment rates, the more critical it is to ensure that categories reflect real differences between individuals.

Table F1-5: Disposable income of income support recipients working 15 and 20 hours a week at Federal Minimum Wage ($14.31 an hour)
$ Per week, 20 September 2009

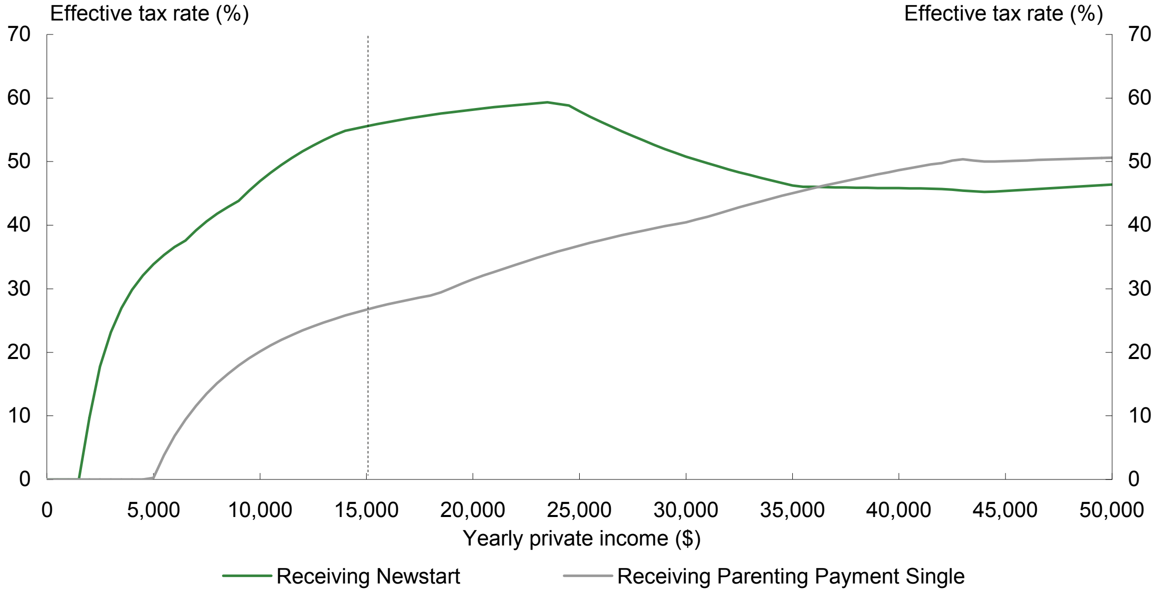
Gross earnings	No work (0)	15 hours a week (214.65)	20 hours a week (286.20)
DSP	335.95	478.78	514.55
Newstart	228.00	335.62	355.35
Newstart PCW(a)	231.00	338.62	358.35

(a) Partial work capacity greater than 15 hours a week.
Source: Australian government administrative data.

A similar issue arises for single parents at the boundary of Parenting Payment Single and Newstart Allowance when their youngest child turns eight. For example, a single parent receiving PPS and working 20 hours a week at the minimum wage (about $14,900 a year) would have a participation tax rate of 27 per cent. On the birthday of their child, this would increase to over 50 per cent (see Chart F1-3). Even though they may be working to the expected level of 20 hours a week, their income would fall by $118 a week or $6,136 a year.[6]

6 20 September 2009 rates.

Chart F1-3: Single parent[a] participation tax rates[b]
20 September 2009



(a) A single parent receiving Parenting Payment Single has a youngest child less than eight years of age. A single parent receiving Newstart Allowance has a youngest child eight or older. In this example the parent has two children.
(b) The participation tax rate is the average effective tax rate from no work to the level of yearly private income.
Source: Australian government administrative data.

Finding

Large differences in rates of payment and means test taper rates across categories can currently produce very different outcomes for working-age people with similar capacity to work. These differences can create disincentives to work or incentives to move to non-activity tested payments.

Another aspect of the current structure of income support that creates horizontal inequities is the large variation in the ratio of single to couple income support payments. Chart F1-4 compares levels of income support for singles and couples without children for various payment types. For students on Austudy without dependent children it is 50 per cent, whereas for allowance recipients the ratio is 55 per cent for those without dependent children. It is 66.33 per cent for pensioners (excluding PPS). Rates of payment for those on Youth Allowance and Austudy without children are considerably less than the adult allowance rate.

The Pension Review found that the relativity of the rate of pension for singles living by themselves and couples is too low. For single pensioners who share accommodation the existing relativity was found to be broadly adequate. A relativity of between 64 to 67 per cent was seen as more appropriate than the current relativity. A relativity approaching 67 per cent was found to be appropriate for singles living by themselves with 64 per cent reflecting the average needs of single pensioners.[7]

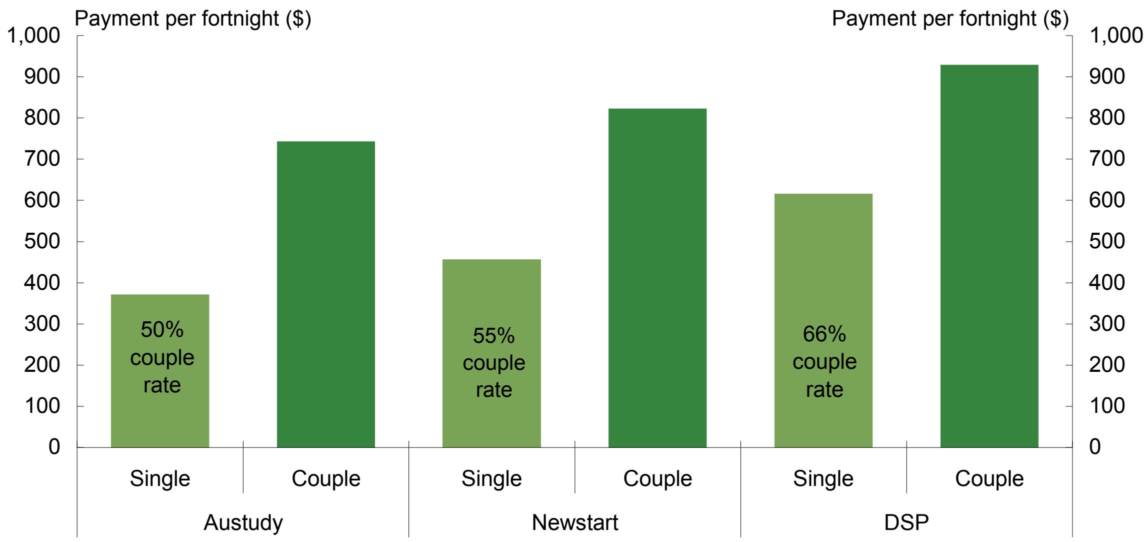
7 FaHCSIA 2009, pages 50–51. In the 2009–10 Budget the Australian Government announced that it would establish the new relativity at 66.33 per cent from 20 September 2009.

Following the recommendations of the Pension Review, on 20 September 2009 the Government increased the single rate of pension and established a new ratio between single and partnered pension rates. The new ratio sets the single pension at 66.33 per cent of the combined couple pension rate. This is consistent with the modified OECD equivalence scale,[8] which suggests that a ratio of around 67 is appropriate where the policy goal is to provide a single person with a standard of living equivalent to a member of a couple. The new ratio was applied to the base rate of pension and the new pension supplement, but not to rent assistance.

Renting privately (and receiving rent assistance) is the predominant housing tenure for Parenting Payment Single recipients (45 per cent) and Newstart Allowance recipients (37 per cent). Given that renting involves higher costs, the level of rent assistance is particularly important in achieving adequate levels of after-housing income (that is, after rent costs) for working age recipients reliant on income support (see Section F5 Housing assistance). There are also significant proportions that own or are purchasing a home. Therefore the adequacy of rates of income support with and without rent assistance is very important.

Chart F1-4: Adult single and couple relativities (no children): primary income support payments (20 September 2009)[(a)]

Per fortnight



(a) The same base payment is payable for Austudy singles and members of a couple, ABSTUDY (for students 16–20 years who are living away from home or independent with no children and couples with no children) and Youth Allowance (for singles with no children not living at home and couples with no children). The rate of Newstart is the lower rate paid for single people under age 60.
Source: Australian government administrative data.

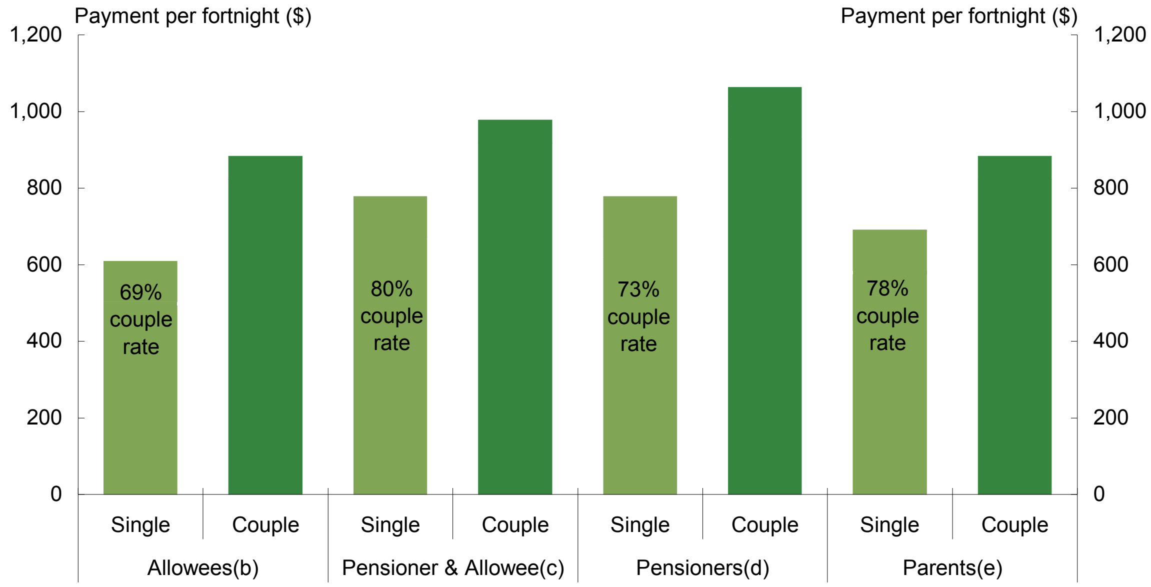
Working-age households may also include children. Chart F1-5 includes Family Tax Benefit B (FTB B) as a payment for parents not children. FTB B significantly increases the amount of assistance provided to parents (single and couple) and also the amount provided to single parents relative to couples. Having a child increases adequacy of payments for single parents compared to partnered parents to 69 per cent for both Austudy and Newstart Allowance recipients (see Chart F1-5). Rates of payment for Youth Allowance, Austudy and

8 The OECD modified scale assigns a value of 1 to the household head, 0.5 to each additional adult and 0.3 to each child. So a single person would receive 66.7 per cent of the combined couple rate.

Newstart Allowance recipients with children are broadly equivalent, with point in time differences due to bi-annual rather than annual indexation. However, rates of payment for people on Youth Allowance and Austudy without children are considerably less than the adult Newstart Allowance rate. The relativities between single and couple parents also vary considerably; from 69 per cent of allowees to 80 per cent for a single parent pensioner (such as DSP) compared to a DSP and Newstart allowee couple. The relativity for a single parent (PPS) compared to an allowee couple is 78 per cent.

Chart F1-5: Adult single and couple parent relativities: Primary income support payments and Family Tax Benefit Part B (20 September 2009)[(a)]

Per fortnight



(a) Excludes FTB A, but includes FTB B as a payment for a parent (in respect of child aged less than 5).
(b) Either Austudy or Newstart parents.
(c) Single DSP recipient and DSP-Newstart couple.
(d) Pensioner single and pensioner couple.
(e) Single parent (PPS) and PP-Newstart couple.
Source: Australian government administrative data.

The increase in assistance for parents through payments such as FTB B since 1997 reflects a priority to target assistance to families with children.

Among other things, these differences reflect the higher pension levels of assistance for single parents with a young child compared to the amounts available under other payments, and the availability of FTB B in addition to primary income support.

Expenditure data are not sufficiently disaggregated to enable reliable estimates of what singles in a variety of circumstances need to spend to achieve equivalent living standards to members of a couple in the same circumstances. The evidence base available to make these judgements is therefore not strong.

However, budget standards research using normative judgements of expenditure needs implies that working-age income support recipients have broadly similar economies of scale in consumption as age pensioners. That is, a single working-age recipient living alone needs much the same proportion of working age recipient couple's payment as a single age pensioner does of an age pensioner couple's payment. For example, using after-housing cost budget standards to remove sensitivities around housing cost assumptions, a single 35 year old renter would need 66 per cent of the income of a private renter couple. This compares to a single 70 year old homeowner requiring 68 per cent of the income of an aged couple who are homeowners (DSS 1998, p. 491). Given these sensitivities, and also the contestable normative judgements needed to construct budget standards, these results cannot be treated as definitive. They are, however, broadly in line with overseas research that uses alternative approaches to derive equivalences.

Equivalence research cannot indicate whether couple rates of payment are adequate or not in themselves; rather, it indicates whether current single rates are likely to be inadequate compared to couple rates.

Given the new single-to-couple ratio for pensions (and the consistency of that ratio with comparable overseas measures like the OECD modified scale) there is a case for making similar changes to the single-to-couple ratios for working-age payments, particularly for singles living by themselves. A lower relativity can be justified where it is expected that single people will share housing, as might be the case for students or some other singles without children.

Finding

There are large variations in the relativities between single and couple rates of payment in the working-age income support system. These are not based on analysis of the amounts of income that single people need to achieve the same standard of living as members of a couple. Available evidence supports the same relativity for working-age income support payment rates as is applied to pension rates.

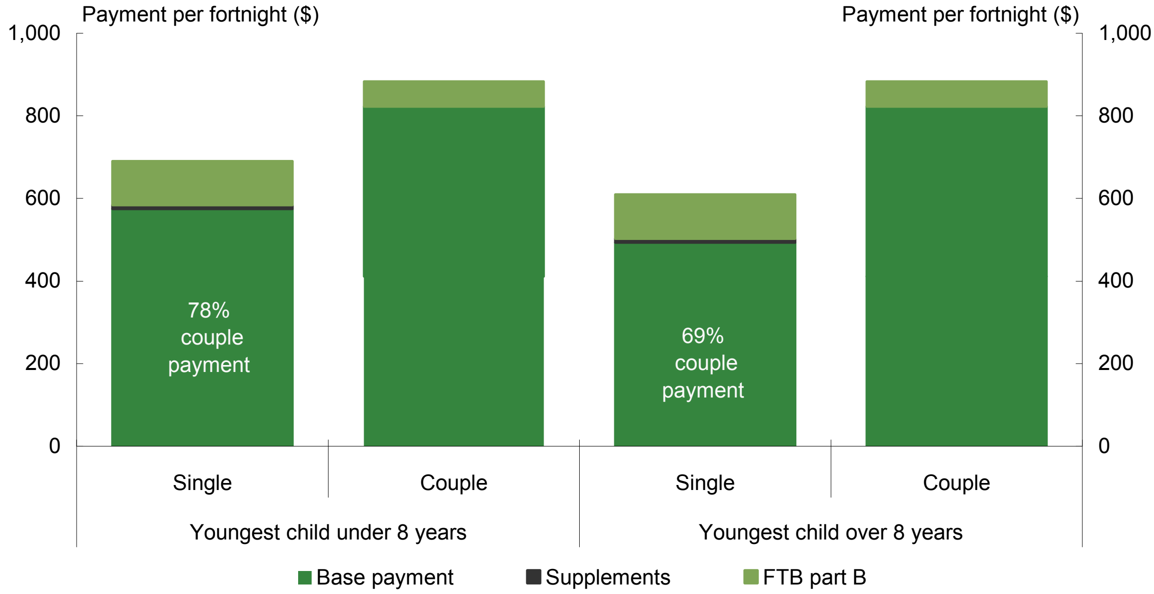
Single and partnered parents

Single and partnered parents are significant groups within the income support system. Parenting Payment consists of two different rates and conditions of payment. In part this is because income support for single and partnered parents has evolved from different payments.

Until September 2009, PPS was paid at the same rate as other pensions (Age and Disability Support Pension and Carer Payment), with the same income test. PPS recipients did not receive the 20 September 2009 pension increase, and nor was the income withdrawal rate increased from 40 to 50 per cent. As a consequence PPS is now a different category of income support payment. PPS has payment rates that are less than other pensions, and the lowest income test withdrawal rate in the income support system. Along with other pensions it is benchmarked to wages, although it is benchmarked to 25 per cent of Male Total Average Weekly Earnings (MTAWE) rather than 27.7 per cent that applies to other pensions.

These differences in payment conditions combine to produce large differences between the payment outcomes for PPS and PPP recipients, and also between PPS recipients and single parents with older children, who do not qualify for PPS but instead must claim another income support payment, generally Newstart Allowance.

Chart F1-6: Single/couple parent relativity (20 September 2009)[a]
Per fortnight



(a) Single to couple relativity including: income support payments, FTB Part B and relevant supplements such as Pharmaceutical allowance. The base payment of a single parent with a child less than 8 years is 70 per cent of total couple base payments (or 60 per cent of total couple base payments if the child is over 8 years).
Source: Australian government administrative data.

Chart F1-6 shows the relativity between income support payments for single parents (who receive PPS with a child aged between five to seven years of age, and Newstart Allowance when their child is eight to 15 years) and for couples. The relativity between assistance for these two categories (including primary payment, supplements for pharmaceuticals and telephone concessions, and Family Tax Benefit Part B) falls from 78 per cent to 69 per cent when the child turns eight.

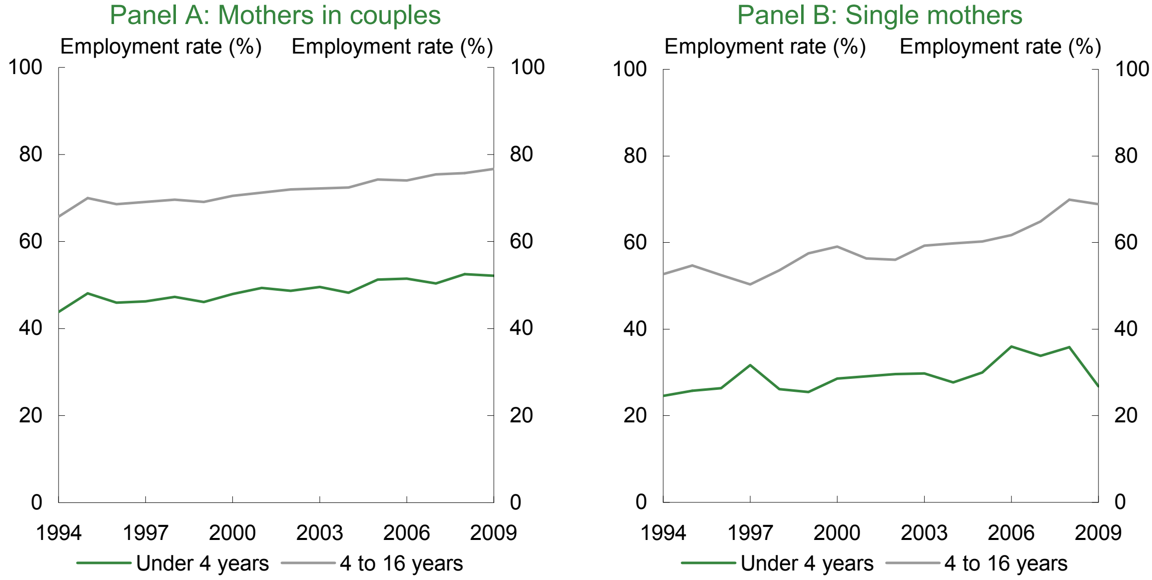
One reason for providing a relatively high level of income support for single parents is because they have a higher risk of poverty. This argument is supported by a range of evidence including self-reported measures of financial stress (for example, could not pay bills or rent on time) and hardship (for example, pawned or sold something, went without meals or were unable to heat the home). Single parents had a higher rate of financial stress than couples with dependent children and single people under 65. However, they had lower rates of multiple hardship than single people under 65 and a similar, albeit slightly higher, rate than couples with dependent children (FaHCSIA 2008, pp. 16–17).

Another argument for a higher level of income support is that single parents face higher direct and indirect costs because they have no partner in the household to help with child rearing and other household tasks. The argument for a higher payment for single parents is strongest when they are caring for young children.

The direction of recent policy for single parents has been two-pronged: to increase their employment through limiting access to the more generous pension package of assistance to single parents with young children, and to introduce participation requirements for parents (both single and partnered) with school-age children . These changes, introduced in 2006, have contributed to significant reductions in the number of parents with school-age children who receive income support. There has also been a small reduction in the number of single parents of pre-school-age children receiving income support.

While the employment rate of single parents has increased, there is still a sizeable gap between their employment participation rate and that of partnered mothers, especially while the children are young (see Chart F1-7). Where there is a child younger than four there is a 25 percentage point gap; for a child aged over four and up to sixteen the gap is 8 percentage points. There is no gap between employment rates of single parents and partnered mothers when the youngest child reaches 16 years of age.[9] These differences may to some extent reflect selection biases (as indicated by lower average wage rates and education levels for single compared to partnered women). When single parents do work they have higher median hours of work than secondary earners in couple families. However, it is also the case that Australia's assistance to single parents is among the most generous in the OECD (Whiteford 2009, p. 49). Also, Australia has the fourth-highest joblessness rate in the OECD for households with children, and this joblessness is concentrated among single-parent families (Whiteford 2009, p. 57). Another policy consideration is the growing evidence that long periods out of the workforce reduce the probability of eventual employment and harm both single parents and their children.

Chart F1-7: Employment rate of mothers in couples and single parents

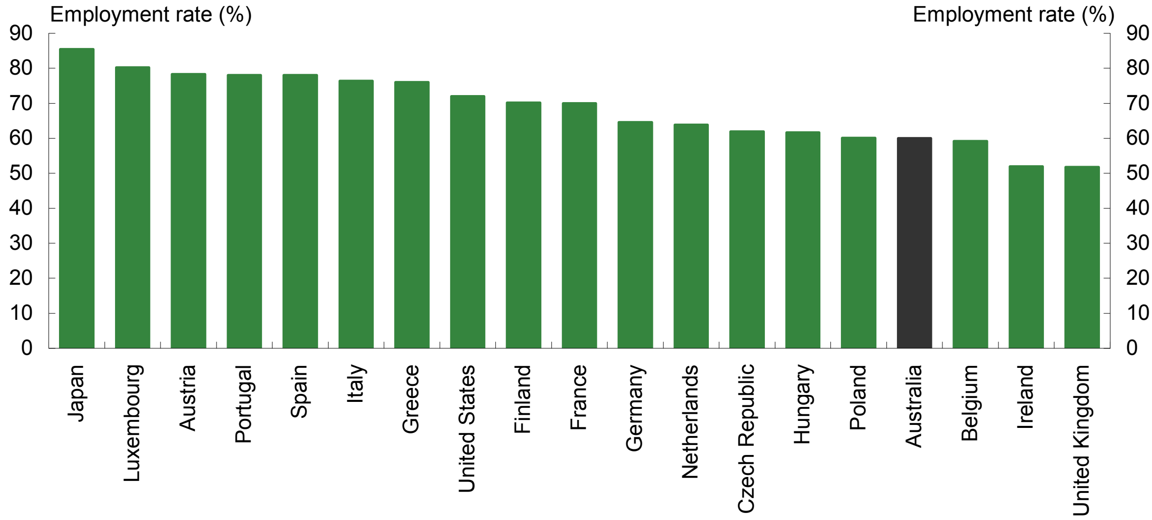


Source: ABS (2009g).

Despite the increasing workforce participation rate of single parents, Australia still has one of the lowest levels in the OECD (see Chart F1-8).

9 ABS 2006b, 5 per cent sample.

Chart F1-8: Employment rates of single mothers in OECD countries
2007



Source: OECD 2007, OECD Family database, LMF3 Maternal employment by family status.

Finding

Single-parent employment is increasing but it still falls well short of rates for partnered women and is low compared to most other OECD countries.

People with disability

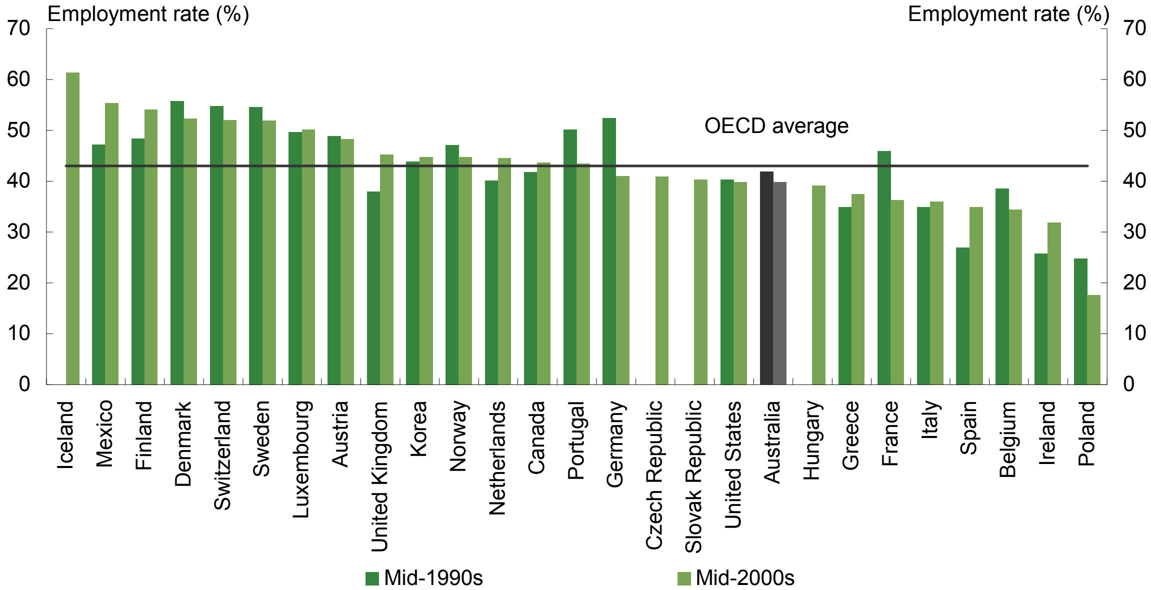
Working-age people with disability can receive a number of different income support payments. The largest number — 757,000 — receive the Disability Support Pension, with a smaller number on Newstart Allowance.

The employment rate of people with a disability in Australia was 39.8 per cent in 2003. Australia is ranked 19th of 27 countries in an OECD comparison and is below the OECD average of 43.0 per cent. No country has high employment rates for people with a disability, although a number of OECD countries — such as Finland, Denmark and Switzerland — have achieved rates above 50 per cent (see Chart F1-9).

The employment rate in Australia fell by 2.1 per cent between the mid-1990s and mid-2000s, while 15 of the 23 countries as defined by the OECD over the same period either increased or remained steady. The employment rate of people on DSP is even lower, with less than 2 per cent leaving DSP each year to return to work, and only 9.1 per cent reporting earnings (September 2009). Of these, a quarter is in supported employment through Australian Disability Enterprises.

Chart F1-9: Employment rates of the working-age population with disability in OECD countries

Mid-1990s[(a)] and mid-2000s



(a) Data not available for the mid 1990s for four countries.
Source: OECD (2009c), 'Sickness, disability and work: keeping on track in the economic downturn', Background paper, p. 12.

There are many possible reasons for Australia's relatively poor performance for people with disability, including lack of employer demand, labour market restructuring, and the absence of work requirements associated with income support for most people with a disability.

A person can remain on DSP for a very long time. Of the 740,000 people on DSP in December 2008, 53 per cent had been on it for more than 10 years. Also, although disability increases with age, there are large numbers of younger people receiving DSP. Sixteen per cent of recipients are under 35 years of age, 16 per cent are 35–44, 26 per cent are aged 45–54 and 42 per cent are 55 and over.

The proportion of the Australian working-age population on DSP in 2007 was 5.4 per cent. Australia is ranked 14th of 28 countries in an OECD comparison (based on 2007 or latest available year). While Australia is currently lower than the OECD average of 5.8 per cent, our position is likely to deteriorate further with the increased flow of women onto DSP as other payment options with similar rates of payment become less available.

The largest source of growth in the DSP in the past decade has been by women. In that period, the number of women receiving DSP increased by 63 per cent, while the number of working-age women rose by only 17 per cent. Women now make up 44.2 per cent of DSP recipients, up from 35.4 per cent 10 years ago. A major reason for the growth is the increase in the Age Pension age for women and the closure of alternative dependency-based payments, including wife and widows' pensions and Partner Allowance. There is also evidence of significant flows of single parents onto DSP when eligibility to PPS is lost; however, this effect is expected to lessen over time as the Welfare to Work changes to PPS eligibility and take effect. Women are claiming DSP at an earlier age and remaining on payment longer.

To be eligible for DSP, which is paid at a higher rate and with a more generous income test than Newstart Allowance, a person must satisfy two tests administered by a job capacity assessor. The impairment test requires that a person's condition is diagnosed, treated and stabilised. It uses evidence from a health professional on the level of a person's impairment against a set of tables. The test for continuing inability to work requires that a person's impairment must prevent them from achieving at least 15 hours a week of work at full award wages within two years after rehabilitation and/or retraining.

As pointed out by the OECD (2009c, p. 17):

> The inherent problem with most public disability schemes is that entitlement is not determined according to a reliable and valid assessment of a person's labour market competitiveness. Instead, a medical practitioner with minimal or no training in the complex task of assessing how various injuries and ailments reduce labour market competitiveness, is required to estimate globally whether a person is unfit for work, including into the future … The result being that significant numbers of people with partial work capacity and who are not wholly uncompetitive in the labour market, become deemed unable to work.

Australia has sought to address this problem by moving away from a purely medical model of assessment, replacing medical officers with allied health professionals under the Better Assessment changes of the early 2000s, and by introducing Job Capacity Assessments under the *Welfare to Work* program introduced in 2006. It was thought that allied health professionals who have experience in finding employment for people with disabilities would have a better insight into work capacity. There is some evidence, however, that decisions about DSP eligibility decisions continue to give greater weight to impairment than ability to work.

Previous efforts to address deficiencies in the test for continuing inability to work have failed. Changes in 1995–96 to require decision-makers to think more broadly about 'any' work and on-the-job training had no impact on DSP inflows. Similarly, the expected reduction to the DSP inflow under *Welfare to Work* was not realised.

A key deficiency of the DSP claiming process is that the continuing inability to work test is assessed before most claimants have had any retraining or rehabilitation. Around half of people granted DSP come onto payment from employment without having tested their capacity to be retrained for work, and many of those who were on activity-tested payments had a medical exemption from activity test requirements. The job capacity assessment therefore requires a prospective assessment or prediction about a person's future capacity to work, with little information about the likely benefits of an employment intervention.

Finding

Employment rates of people with disability are relatively low and few people on Disability Support Pension (DSP) report earnings or leave DSP for work. DSP should continue to be an important part of the income support system for people whose disability precludes substantial work. However, it is important for the wellbeing of people with moderate disabilities that the work test associated with access to DSP is effective in identifying people who could be assisted into substantial part-time or full-time employment.

Indexation

Indexation is used to maintain the real value of policy settings — such as rates of payment — over time. This can also include maintaining the value of assistance relative to broader community standards, rather than just the purchasing power of payments.

The choice of indexation arrangements has important consequences for the sustainability of the income support system, in terms of community acceptance, in terms of incentives to work, and in fiscal sustainability.

Prior to 1997, income support rates automatically increased in line with price increases. Governments provided additional ad hoc increases to improve the real value of payments either in pursuit of a policy goal, to align assistance between groups or to improve relativities between groups of recipients. For example, ad hoc increases were made in order to achieve and maintain the single rate of pension at 25 per cent of Male Total Average Weekly Earnings, with these increases also being paid as ad hoc increases to partnered allowance and single allowance recipients with children. Other ad hoc increases improved the single rate of allowance.

Since 1997, pension rates, but not allowance rates, have also benefited from legislated benchmarking of rates to community living standards, as measured by increases in the a wages measure (Male Total Average Weekly Earnings).[10] Given budgetary pressures as a consequence of population ageing there is a need to ensure that the measure used for indexation appropriately reflects changes to community living standards. A measure that overstates such change will not be fiscally sustainable and could compromise the integrity of the tax and transfer system.

For those recipients expected to work, applying this factor could change the relationship between rates of income support and the minimum wage if the minimum wage grows slower than wages in the broader community. The Pension Review report (FaHCSIA 2009, p. 68) notes that faster payment growth for pensioners:

> may raise questions about the rewards for work as the incomes available to those on income support grow relative to earnings … pensioners receiving a part rate of pension can already have a higher disposable income than low-income taxpayers who are funding pension spending through their taxes.

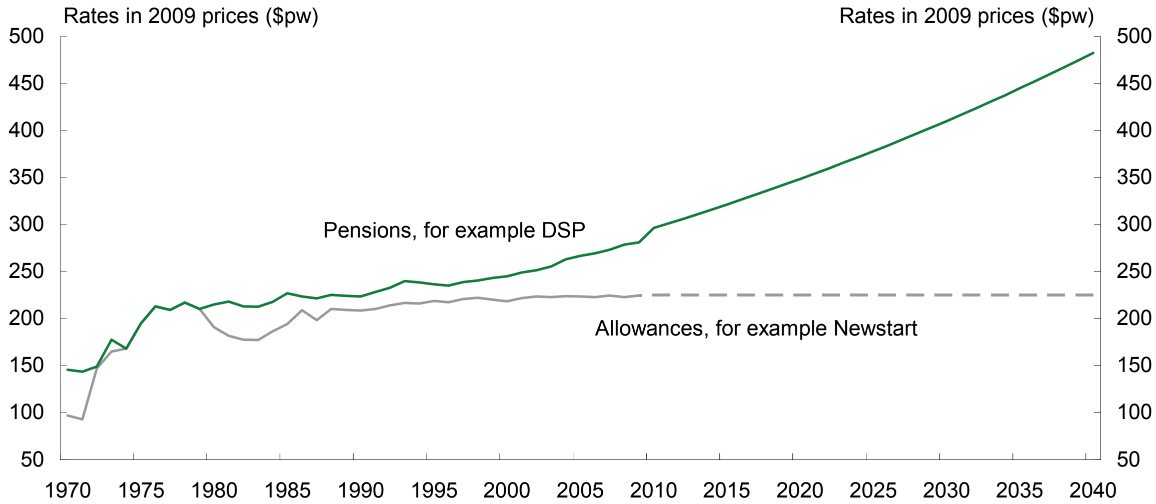
Reflecting changes in community standards is important but cannot be achieved solely through automatic adjustments. For example, changes in community living standards as measured by wages are relatively easy to reflect with automatic adjustments. Slower shifts, such as changes in the composition of households and the nature of workforce participation, can be more appropriately dealt with through separate government decisions. As the Pension Review report noted (p. 66), 'it is hard to see a rationale for such changes to impact on the rate of the pension'.

10 Prior to 1997 pensions and partnered rates of allowance and the higher rate of Newstart were increased periodically by ad hoc decisions against a benchmark of 25 per cent of MTAWE. Legislation introduced to provide for automatic indexation against this benchmark in 1997 did not link increases for partnered rates or the higher single rate of Newstart allowance.

A regular review of payment amounts, for example at five-yearly intervals, would enable these non-wage drivers of community standards to be reflected in income support payments. Such a process may of course alter the relativity between pension and allowance rates of payment. The last adjustment to Newstart Allowance, apart from increases related to price indexation and compensation associated with the GST, was an increase of $2.95 (or 2 per cent) in 1994.

When different components of the tax and transfer system are indexed differently, the relationship between them can change over time. An important example is the widening disparity between pension and allowance rates, resulting from the additional benchmarking of pensions to wages while allowances are indexed solely to price changes. Chart F1-10 compares the real rates of these payment types over time, including projections of future growth. It shows that the gap between these payment types is larger today than it has ever been, and will continue to widen if current settings are maintained.

Chart F1-10: Pension and allowances over time[a]
2009 prices

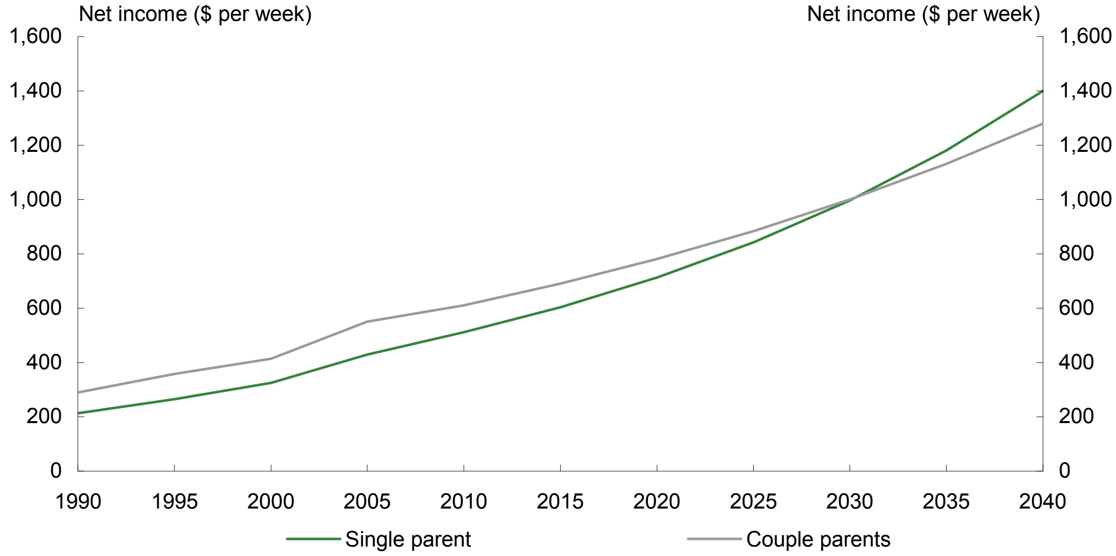


(a) Projected values assume no policy change.
Source: Treasury estimates.

The gap presents people with strong incentives to test their eligibility for a pension, and not to jeopardise their pension entitlements by taking up work. It also places increasing pressure on the assessment process for DSP, particularly from people with weaker employment prospects.

Differences in indexation are also producing changes in the relativity between income support for single parents and couples. Chart F1-11 shows that if current indexation arrangements continue, by 2030 a single parent with a youngest child aged five to seven will receive the same amount of assistance (income support and FTB-B) as an unemployed couple with a child of the same age. The ratio was 65 per cent in 1990 when automatic indexation was extended to family payments, 67 per cent in 1997 prior to MTAWE applying to PPS rates and not partnered allowance rates and 78 per cent in 2009.

Chart F1-11: Disposable income of single parent with one child compared with a couple with one child[(a)]
$ Per week, 1990 prices[(b)]



(a) Single parent receiving maximum rates of Parenting Payment Single and a couple receiving maximum rates of Parenting Payment Partnered and Newstart Allowance.
(b) Projected values assume no policy change.
Source: Australian government administrative data and Treasury estimates.

Indexation arrangements have also brought about a decline in the real value of the free area for allowances — the amount of income that a person can have before payment is withdrawn. In 1986 the allowance free area — the amount that a person can have before their payment is reduced — was 31 per cent of the lower single rate of allowance. By 1995 this had fallen to 20 per cent and is currently 14 per cent. This is because the free area has not been indexed. It is difficult to see a rationale for these outcomes, other than that the cut-out point for Newstart Allowance is higher in real terms in 2009 than in 1986 and 1995 following reductions in the income withdrawal rate in 1995, with a further reduction and an increase in the income level at which the higher withdrawal rate applies in 2006.[11]

Finding

Different indexation for pensions and allowances is creating an ever-widening gap between pensions and allowances that can create inequities between assistance for individuals in similar circumstances as well as disincentives to work.

11 Prior to 1980 unemployment benefit was withdrawn dollar for dollar over a permissible earnings limit. From 1980 onwards income was first withdrawn at 50 per cent and then at 100 per cent. In 1995 the 100 per cent withdrawal rate was reduced to 70 per cent, and in 2006 it was reduced to 60 per cent.

F1-3 A restructured income support system

Recommendation 82:

There should be three categories of income support payments:

(a) A **pension category** for people who are not expected to support themselves through paid work, whether because of their age, disability or because they are providing full-time care for a person with disability (or frail aged). This pension would be paid at a rate that provides a basic acceptable standard of living, having regard to prevailing community standards.

(b) A **participation category** for people of working age who are expected to support themselves through paid work now or in the near future. This would cover the unemployed including youth (both under and over 18), those who are temporarily incapacitated, people with a partial capacity to work and primary carers of dependent children. The rate of payment, for those who are expected to work, should provide a basic level of adequacy while maintaining incentives to work. This would be less than the pension rate. Parents on income support would receive a higher total level of payment. Unemployed youth aged less than 21 would be paid no more than full-time students to avoid creating incentives to leave full-time study for unemployment.[12]

(c) A **student assistance category** for people engaged in full-time study. Students aged 21 and over would continue to be paid at a lower rate than the unemployed and at the same rate as younger students in similar circumstances. Some students have the capacity to work part-time to supplement their income support. Other students could be given the ability to borrow against future income to supplement their student assistance.[13]

Recommendation 83:

There should be a more consistent approach to payment relativities within each of the three categories of payment based on the single to couple pension relativity. A more consistent approach would mean an increase to base rates for single income support recipients in the participation and student assistance categories. However, a lower relativity for singles in these categories without children may be warranted given their greater capacity to share accommodation.

12 Rates of payment for participation category customers aged less than 21 are discussed in Section F3 Family and youth assistance.

13 Rates of payment for student assistance category customers aged less than 21 are discussed in Section F3 Family and youth assistance.

Recommendation 84:

Payments and income test parameters should be indexed in a consistent way to maintain relativities across the three payment categories and to reflect changes in community standards. Governments should regularly review indexation as community standards are likely to be affected by significant changes in the composition of the workforce and household incomes in coming decades. The current community standard for pensions is set by reference to Male Total Average Weekly Earnings. Indexing all payments to this standard has been projected to involve a significant increase in budgetary outlays over the coming decades so it will be necessary for governments to regularly review the appropriateness of this measure and the level of the benchmark.

Recommendation 85:

Income support arrangements for parents should support and encourage participation in work while maintaining adequate levels of assistance to families. As a condition of payment parents should be required to look for part-time work once their youngest child turns four. Parents would receive supplements as follows:

(a) For couples and single parents with a youngest child under six years, the amount of the supplement should be set such that the total support for single parents on income support will be equivalent to the maximum rate of pension. The supplement would be paid through the family payment system.

(b) For single parents with a youngest child aged six or older, the supplement should be paid at a substantially lower rate through the family payment system.

(c) For couples with a youngest child aged six years or older, the lower rate supplement should be paid through the income support system.

Recommendation 86:

People with disability who have a partial capacity to work, excluding people receiving Disability Support Pension (DSP), should have a part-time work requirement. They should be subject to a means test or payment arrangements that provide an incentive to work part-time and that recognise that they face higher average costs of work. This could also be achieved by an in-work supplement and/or an earnings disregard in the means test.

Recommendation 87:

Students should have access to an income test that facilitates significant part-time work at a level that does not compromise educational outcomes. Adults requiring additional income should be able to borrow to top up their student rate of income support to the level of the participation payment rate. The feasibility of using the existing income-contingent loans scheme and the potential impact of it on access to higher education of students from a low socioeconomic background should be examined.

The system should do more to encourage employment

The ageing of the population and a policy focus on individual wellbeing imply that the structure of income support should do more to encourage employment. This goal applies to all income support recipients. Two groups — single parents and people with disability with the capacity for substantial part-time work — have particularly low workforce employment rates. Improving employment rates for these groups should be a policy priority.

There are now considerable differences between pensions and allowances in terms of payment rates and conditions. This significantly affects the simplicity, equity and efficiency of the tax and transfer system. Again, two groups are particularly affected — the differences are most stark at payment boundaries for single parents and people with disabilities. Building a system that supports people's efforts to work entails a three-way trade off. While higher transfer payment rates provide recipients with a better standard of living, they can compromise incentives to work and are more expensive for the general community of taxpayers to support. This is why participation requirements are necessary. On the other hand, low rates that do not facilitate looking for work or participating in society can compromise employment outcomes (reducing tax revenues and increasing income support outlays) and social cohesion (crime levels, a more unequal distribution of income), which is also more expensive for the community to support.

The policy challenge is to ensure that those on income support have an adequate standard of living, and at the same time to give those with the capacity to work incentives that make work attractive. Maintaining category-based differences as proposed in Recommendation 82 will continue to be a way to meet this challenge. However, the boundaries between categories can be adjusted to ensure that an individual's capabilities are increased through employment. This is particularly needed for single parents and people with disability with significant capacity to work. Differences in payment relativities across the three categories and between payments within the categories should also be reduced to create a more coherent and simpler income support system (see Recommendation 83).

There are limits to the extent to which effective marginal tax rates can be reduced to improve incentives to work. This is particularly the case for parents, because at some point the total level of assistance — comprising income support, family and rent assistance — has to be withdrawn.

Within a categorical approach to income support it is possible to target incentives to work through participation requirements: continued eligibility for payment is conditional on job search. Further extension of activity testing is warranted in the case of parents — single and partnered — as a clear signal not to stay out of the workforce for too long and as a reflection of community norms and expectations.

Paying the same basic rate of income support to all people in the participation category — Newstart Allowance — with supplements for parents, children and rent costs, would reinforce the participation focus of income support for people of working age. Disability Support Pension and Carer Payment would continue to be separate categories of payment in the pension category.

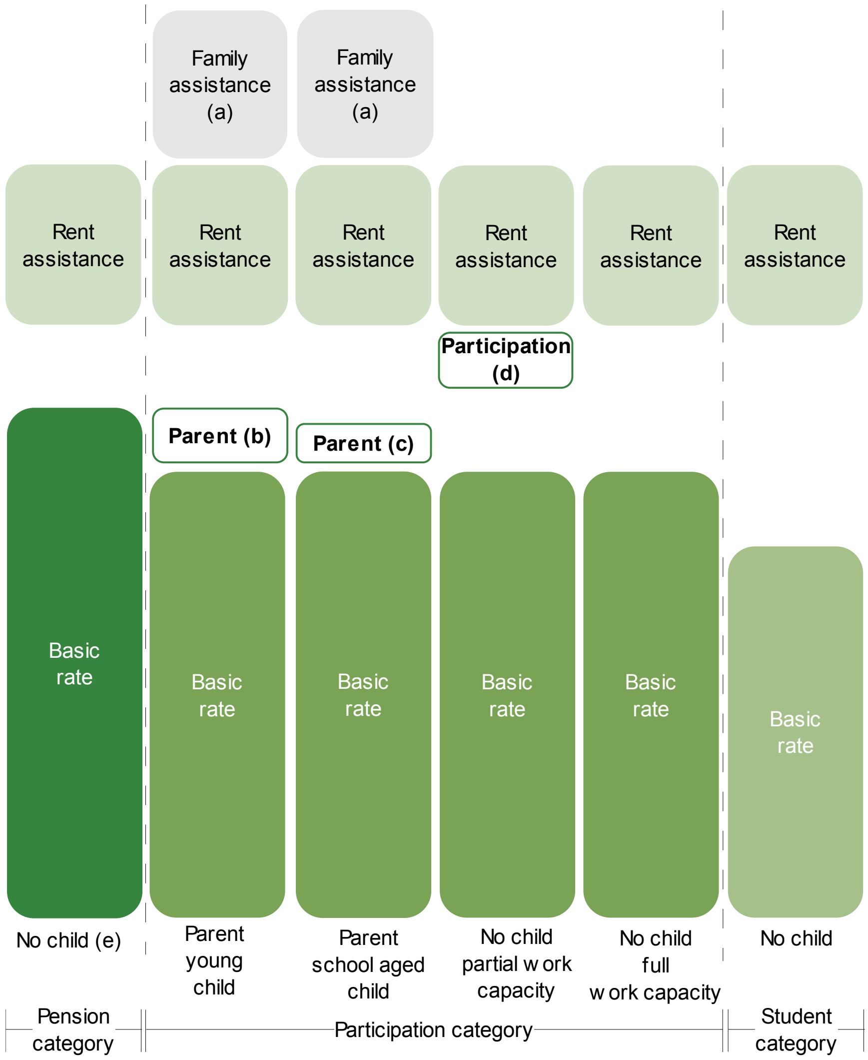
The level of assistance for those who are expected to work is a trade-off between adequacy, work incentives and other priorities and is ultimately a matter for governments to decide. There is a case, however, for increasing the level of assistance for single unemployed and students, particularly for singles not sharing with another adult. This is based on a range of analysis, including appropriate single and couple payment relativities and the disincentives to work caused by large differences in rates of payment for people in similar circumstances. There is also a case for indexing payments on a common basis, and/or for conducting regular reviews of adequacy against community standards, so that differences between rates of payment do not increase too much.

Restructuring the income support system will be costly. It will have to deal with the difference in payment rates at the same time as providing strong incentives to work and adequate support services to ensure that new entrants to the labour market or people increasing their work effort succeed in getting jobs. The cost of indexing allowances to male total average weekly earnings is projected to increase from 0.08 per cent of GDP in 2019–20 to 0.35 per cent of GDP in 2049–50. Reforms will therefore have to be prioritised and phased in over the longer term.

Some differences between rates of assistance for people neither expected nor likely to work again and for those expected to look for work are justified to preserve incentives to work. However, the differences in the current system are growing and too large. They should be addressed.

A new structure for income support is outlined in Chart F1-12.

Chart F1-12: Indicative structure of adult working-age income support
Single person



(a) Family assistance for the direct costs of children.
(b) Parent supplement for families with a youngest child aged under six would be paid through family assistance and be available to working families.
(c) Parent supplement for single parents with a youngest child six and older would be paid through family assistance. For partnered parents it would be paid as part of income support.
(d) Participation supplement could be delivered through the means test.
(e) Age, Disability and Carer pensioners would be eligible for the parent supplements.

The broad architecture of the system is based on three payment categories: a pension category, participation category and student assistance (see Chart F1-12). In addition there would be supplements in respect of the direct costs of children (see Section F3 Family and youth assistance), significant rent costs (see Section F5 Housing assistance), and a parenting supplement. There would also be a per family participation supplement in respect of the costs of work for people whose disability means they only have a partial work capacity.

Carers providing constant care and people assessed as having disability that precludes any level of workforce participation would receive the highest rate of payment, as they are more likely to be reliant on income support for a long and indeterminate time. The rate of payment for those aged 21 and over or aged under 21 with dependent children would be as established by the Australian government following the Pension Review.[14]

The participation category

In the longer run, the direction of policy should be to simplify working-age income support by reducing the number of payment categories and reducing differences between current categories. The UK government has committed to consult on such reform through a single income-replacement benefit for people of working age (UK Department of Work and Pensions 2008, p. 32).

For most people unemployment lasts for only a short time, which is one reason why rates of payment for Newstart Allowance can be less than pension rates. However, the unemployed population is becoming much more diverse as a result of changes to eligibility for Parenting Payment and Disability Support Pension access. Also, a sizeable proportion of unemployed people, even under favourable labour market conditions, spend more than two years on payment.

Australian unemployment assistance is based on the notion of 'reciprocal obligation' — that the taxpayer will support a person in return for the person actively pursuing ways to avoid the need for further support. Most jobseekers are expected to seek full-time work. Government policy since the mid-1980s has typically aimed at improving the rewards for part-time work to avoid poverty traps and to improve financial outcomes for those in work, while at the same time continuing to ensure that jobseekers seek further work or improve their employment prospects via the application of full-time activity tests.

In recent years this policy has been made more flexible. There are now substantial groups, such as people with partial work capacity and single parents with school-age children, who are expected to look only for part-time work. Activities other than job search are sometimes taken as satisfying recipients' obligations.

Under the Review's proposals (see Recommendation 82), the participation category would consist of those who are looking for work — the unemployed — and those who are working to their 'required level' but who are not income-tested off payment (such as those with part-time requirements). It would also include people expected to look for work in the future, such as primary carer parents whose youngest child is below age six and people with a temporary sickness or impairment that precludes work.

Single people and couples expected to look for work would face a full-time work requirement. Parents and people with disability with the capacity to work significant part-time hours who are expected to look for work would face a part-time work requirement.

Participation payments should focus on capability not disability, as many people with disability or another barrier to work still have a substantial capacity to work. A focus on capability would increase individual wellbeing. While this Review focuses primarily on the architecture of the tax and transfer system, it recognises that many people require tailored

14 Rates of payment for pensioners aged less than 21 without dependent children are discussed in Section F3 Family and youth assistance.

services to ensure a successful entry into work. These services are provided through the employment services system. Further development of this system may be required.

Unemployed people with full-time job search requirement

Jobseekers with a full-time work requirement would receive a minimally adequate base rate of payment and have access to employment services according to their individual needs. Assistance for singles would increase relative to the couple rate, to be more consistent with the relativity for the pension.

Increasing payments for the unemployed to a higher proportion of the pension, or indexing them to the same wages index as pensions, may mean that more people will be able to combine substantial part-time work with income support. However, this effect will be countered by participation requirements to continue to pursue full-time employment.

If participation requirements are considered insufficient and it is considered undesirable to assist those in low-paid work through the income support system, it may be necessary to consider other approaches. For example, the income test on payments could be tightened (through a low free area and a high withdrawal rate). If this were not considered sufficient, a 100 per cent withdrawal rate could be applied and earned income tax credits could be used to achieve a desired pattern of effective marginal tax rates. For example, single parents could be given a different set of work incentives compared to single people without children. Alternatively, the conditions for receipt of income support could be progressively modified — by reducing income withdrawal rates — to allow people to more easily combine work and benefits simultaneously.

Parents

Recommendation 85 focuses on workforce participation and income support for parents.

In moving to a participation-focused income support system, there should be a more coherent structure of assistance for parents who are primary carers and for other people who are expected to work in the future.

One possible approach for reform is a system like those of Scandinavian countries, where parents (including single parents) have high rates of workforce participation. Both parents, even of quite young children, are expected to work, just as any other capable adult is, but very extensive support is provided in the form of high-quality child care and early education. Further, there are extensive provisions in labour law to ensure 'family-friendly' workplaces.

While there is some movement in Australia in this direction — such as through child care subsidies, extension of early childhood education, and parental leave — fully implementing the Scandinavian approach would be very expensive in the short run.

Instead of enforcing an expectation that both parents work full-time when their children are young, current policy is explicitly aimed at keeping primary carers in touch with the labour market. That usually means some form of part-time work. The future direction of policy should involve requiring parents on income support to look for work when their children are younger. A first step would be to align the age of the youngest child at which single parents are expected to look for work with the reduction in income support. This should be the same age for partnered primary carer parents. In the short term, this should be at age six. In the longer term, this should be reduced in line with significant changes in the availability of early childhood education and affordable child care (including after school care). Such a shift should also be contingent on an adequate and affordable supply of child care and 'family-friendly' conditions of work.

Policy should be directed at increasing the workforce participation of single parents, as single-parent households constitute a significant proportion of all jobless households. A priority for income support policy should be to introduce a means test structure that provides a more seamless transition to work when the youngest child turns six.

Parents in the income support system would receive a supplement where there is a youngest child aged less than six to provide a higher level of adequacy for those likely to be outside the workforce. Single parents with a young child would receive the same rate of income support as a single pensioner (including the pension supplement). This would be achieved through the combination of the participation payment and the parent supplement. In addition there would be family assistance to reflect the direct costs of children (see Section F3 Family and youth assistance).

The additional assistance for single and partnered parents of children aged less than six would be paid as a separate per-family supplement — whether or not they receive income support — through the family assistance system. A single parent would receive the same amount as a couple.

Where the youngest child of a single parent is six or older a lower rate supplement would also be paid through family assistance and single parents receiving income support would be subject to a part-time work requirement.

Partnered income support recipients with a youngest child six or older would receive the lower parent supplement as part of their basic rate of income support and be income tested as part of the basic rate of income support to avoid stacking of income tests.

The parenting supplement would continue to be paid until the youngest child turns 18 or while there are children in the household receiving at home rates of payment.

Workers with partial capacity for work

Recommendation 86 proposes that people with a disability who have a partial capacity to work, excluding those receiving DSP, should have a part-time work requirement.

Many people with disability already work, and others would like to work. A system that supports work for people with a disability would enable them to increase their lifetime income and contribute to society in a wider range of ways.

Some OECD countries are applying activity test requirements to their disability payments, but these countries generally have much higher proportions of their working-age population on payment than Australia has.

If it is accepted that the current DSP qualification settings are appropriate — that is, that people who cannot work 15 or more hours a week due to a permanent disability require long-term income support because they are unable to support themselves through significant employment — there is little point in introducing requirements for people with such limited capacity to work. However, there should be better satisfaction that this is actually the case before a person gains entry to DSP.

It is inherently difficult to forecast the long-term employment prospects of many people with a disability, and errors in both directions will inevitably be made in the assessment. On the one hand, not paying DSP to someone who genuinely can never support themselves through work may seriously reduce their wellbeing. On the other, paying DSP to someone who may be able to find some work could also reduce their long-term wellbeing as well as incurring higher public outlays.

The risks and costs of these errors can be managed by reducing the differences in treatment (such as payment rates) between those assessed as being able to undertake significant part-time work, those deemed marginally able to work and those deemed unable to work, and by changes to the work test that determines eligibility for DSP.

The introduction of an expectation that people applying for DSP (except those who are manifestly eligible) should first test their ability to be assisted back to work would establish a greater level of objectivity and should lead to greater levels of workforce participation.

Previous attempts to tighten access to DSP have had limited success. Not only is it a matter of the disabled person's incentives, but also assessors are likely to be aware that refusing entry of marginal cases to DSP can have a high cost for individuals. Addressing the prospective nature of the current work test may be a way of ensuring that those who have a substantial capacity to work are assisted to find employment. Those who demonstrate capacity to work reasonable part-time hours without ongoing support in the workplace would not gain entry to DSP. In this way the focus of the payment would shift toward capability and away from disability.

Limited availability of employment services program places has in the past hampered the requirement for DSP claimants without a manifest entitlement to participate. However, recent increases in the availability of places will make it feasible to assess a person's capacity for work in this way. Strict safeguards would need to be in place to ensure exemptions form assessment for people who will clearly never be able to work.

People with disability who are limited to part-time work have similar workforce participation costs to those of full-time workers (such as the costs of transport to and from work for a person with the capacity to work five short days in a week), yet because part-time workers earn less, these costs can account for a greater proportion of their take-home earnings.

People with an assessed partial capacity to work more than 15 hours a week should be subject to an income test that provides a reasonable return to part-time work. This could be achieved through a higher income test free area, a lower withdrawal rate, or something similar to the work bonus for age pensioners. Alternatively a supplement could be paid, although this would be more complex to administer. This would also assist with the ongoing cost of workforce participation, reduce the incentives to seek DSP and recognise that this group is likely to have a longer duration on payment than other income support recipients.

The student assistance category

Recommendation 87 focuses on students' ability to work part-time while studying.

The decision whether to study beyond school leaving age is discretionary. For that reason, adult student income support differs from most other forms of income support, which are required because of circumstances over which the claimant has little control — they are unable to find paid work, they are aged or have a disability that limits their capacity for work (see Box F1-2).

Box F1-2: Rationale for student income support

The rationale for adult student income support is different from that for people who are not expected to work, are unable to work or are temporarily unemployed. There are two distinct arguments for student support:

1. Efficiency**:** It is in society's interest to subsidise education because it benefits society as well as the individual.
2. Equity**:** Because there are limits to the ability of students to borrow against their likely future income, those without the means to support themselves while studying can get an education only if the government provides support. This argument also has a substantial efficiency aspect — if talented people of lesser means are unable to get a tertiary education then this represents a cost to society.

Policy in Australia has dealt with the efficiency and equity arguments for student support by treating the **direct** costs of higher education (tuition fees, textbooks, etc) quite differently from the larger but more **indirect costs,** predominantly in income forgone by not working. The Higher Education Loan Program (HELP), which replaced the former Higher Education Contribution Scheme (HECS), is explicitly aimed at sharing the direct costs with the student through income-contingent loans. Around 92 per cent of domestic university students are in places supported by the Australian government and are therefore eligible for HELP.

For direct costs the efficiency argument has held sway — through HELP the student covers part of these costs, while other costs are covered by a system of grants to the States and to tertiary institutions.

However, student income support — which can be seen as either support to mitigate the indirect costs of education or income support to a person undertaking an approved course of study to improve their long-term employment prospects and self-reliance — has always focused on and been justified by the second argument; without this support, access and equity in higher education would be compromised.

Income support for students is spread across several programs with varying conditions and rates — Youth Allowance, Austudy and ABSTUDY. In addition, the parents of many full-time students receive the base rate of Family Tax Benefit Part A — an arrangement that can continue until the student is aged 25 (see Section F3 Family and youth assistance).

The Government announced that the age of independence for students (the age to which the parental income test is applied) will be lowered to 22 by 2012. Young people become eligible for Newstart Allowance at 21. Aligning the age of independence with the age at which young people become eligible for adult rates of unemployment payments would create a simpler system and avoid favouring unemployment over studies.

The single without child rate of Austudy and Youth Allowance are lower than both the single and partnered rates of Newstart Allowance. Student income support has been the focus of recent major reforms, following the Bradley Review of Higher Education, which found that higher education is becoming less affordable. It concluded that 'the contributions made by students themselves through the income-contingent loans scheme are currently appropriate and should not be increased any further' (DEEWR 2008, p. 58). It went on to recommend some changes to income support for students relating to the extent and the circumstances in which students should be considered dependants of their parents, such that the parents, rather than the taxpayer, should be called on where they are able to partly or fully support them. It also recommended a relaxation of the income test free area for student assistance to allow students to keep a higher proportion of what they earn. The Australian Government has accepted this last recommendation. In addition, the Bradley Review made two findings of relevance to this Review:

- The level of income support paid to eligible students should be considered in the context of the findings of the Pension Review.
- Further work should be undertaken on the feasibility, and impact on students, of introducing a loans supplement scheme or using FEE-HELP as an instrument for income support (p. xxvii).

The Review Panel is in favour of further analysis of an optional income support top-up through the existing income-contingent loans scheme.

The basic structure of student income support is Youth Allowance for those under 25, Austudy for those 25 and over, and ABSTUDY for full-time Indigenous students (for whom there is additional support). These payments differ from other income support payments in several ways.

- Payment rates are the lowest in the income support system for those without children, although, subject to the passage of enabling legislation, relatively generous lump-sum scholarships will now be paid by the Australian government yearly to university students, especially if the student has to move away from home.
- Personal income tests are more generous than for most other income support payments. An income bank effectively allows work over long holidays to be averaged over a longer period.
- The notion of 'dependency' on parents will be reorganised, subject to the passage of enabling legislation. On the one hand, more students are considered dependent for income support purposes. On the other hand, the taxpayer's contribution to middle-income families with dependent students has been greatly increased through changes to the parental income test.

This structure is based on the idea that full-time students can supplement their income with paid work, either part-time or in holidays, or both. As a consequence, Australia now has the highest rate in the OECD of tertiary students who are also doing paid work. There are good arguments that people's study years and labour supply years should be separated, particularly where there is a risk that the need to work compromises study choices and achievement. But there are also good arguments that combining work and study can improve both. Even if it is considered generally desirable for post-school students to work part-time, some of them may risk hardship under the current system, such as those unable to supplement their student income support with paid work because of where they live, their choice of course or study load, the unavailability of suitable employment, caring obligations or disability.

The rates of Newstart Allowance for single adults are sometimes compared with the rate of Austudy and student Youth Allowance for those over 21. That Newstart Allowance is paid at a higher rate may present adults with an incentive to abandon full-time study for unemployment. However, the loss of future income in abandoning full-time study is so large relative to any short-run differences in income support rates, and the number of students affected so relatively small, that this may not be a significant practical problem.

F2. Means testing

Key points

Means testing is an important tool for targeting government payments to those with most need and for managing the sustainability of the transfer system. It should continue to be used in the transfer system, but could be improved so that income and assets are more fairly assessed and incentives to work and save are strengthened.

Means testing is a key characteristic of Australia's unique transfer system, which is more highly targeted than other OECD countries. This high level of targeting is a strength of Australia's approach to income support that should be maintained. The concept of means for income support payments should include not only income but also the ability of a person to generate an income from their assets.

However, means testing can increase the level of complexity a person faces in interacting with the tax and transfer systems and can affect their incentives to work and save. Striking an appropriate balance between targeting based on need and maintaining incentives to work and save is a significant challenge in designing a means test.

Within the current two-part means test — the income test and the assets test — some assets are assessed under both tests, while other assets are assessed only under the assets test. This results in people receiving different levels of government payments even though they have the same level of wealth. This reduces the fairness of the means testing system.

A more uniform treatment of assets in the means test would reduce these outcomes and be more equitable. This could be achieved by having a comprehensive means test that determines access to all income support payments, including Newstart Allowance and the Age Pension. This means test would include deeming an income on most assets. The deeming rates would be based on the returns expected from a portfolio of assets that would be held by a prudent investor.

The comprehensive means test would provide a platform for tailoring the means test parameters such as free areas, withdrawal rates and earnings disregards to the circumstances of particular groups.

Family payments are in part paid to reduce the tax burden on those supporting dependent children, so it is more appropriate that the income base on which they are assessed is aligned with the taxation base. Taxable income on a family basis should therefore continue to be the sole means of determining a person's eligibility for these payments.

F2-1 Designing equitable means tests to reduce impacts on work and saving

The tax system and the transfer systems often use different concepts of means to determine a person's tax liability and their eligibility for income support. Under a progressive tax system the more income a person has the higher is their tax liability. Under a means tested transfer system, the level of income support decreases as the means a person has at their disposal increase. Another difference between the systems is that the transfer system includes all means available to a person, including those of their spouse or partner, while the tax system only considers the means belonging to the individual.

Both the tax system and the transfer system include employment income as means, although the transfer system does not generally reduce a person's income by their work expenses when determining their level of means. Apart from the treatment of the means of a partner, another difference between the two systems in calculating a person's means is the treatment of assets.

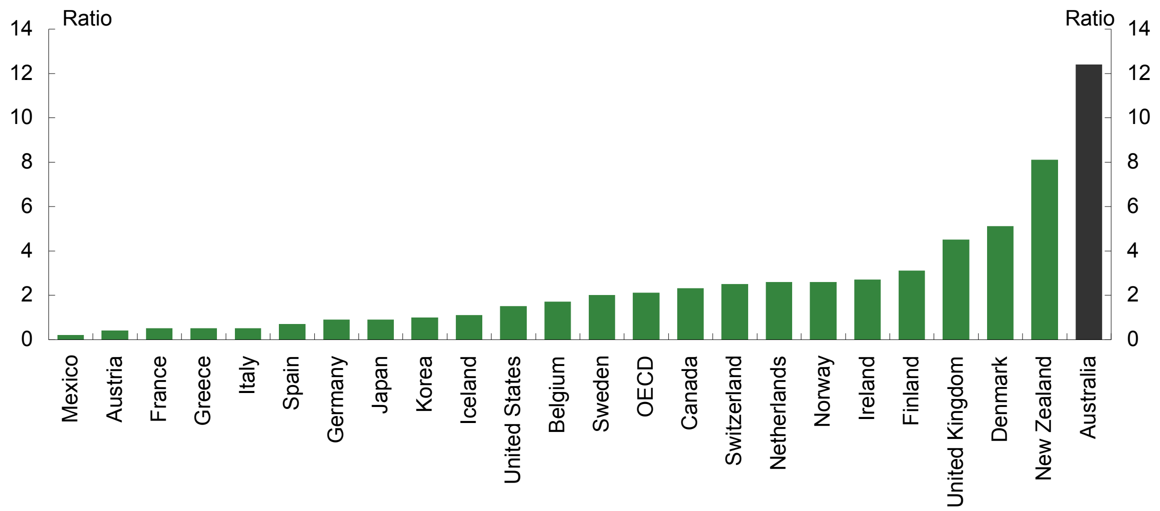
The tax system includes only the income generated from assets, such as rent, dividends and interest. A change in the value of assets does not have an immediate effect in the tax system. Changes in asset values only affect a person's income when there is a disposal or other realisation event in relation to the asset.

The transfer system, however, looks beyond whether an asset actually generates an income to consider the amount of assets at a person's disposal. It assumes that a person can use their assets to generate an income to support themselves. This includes their non- or low-income earning assets. Changes in means, such as increases in assets values, are therefore tested more frequently in the transfer system.

The different treatment of assets in the transfer system is a reflection that targeting on the basis of need requires a broader view of a person's ability to maintain themselves than that which is implied by testing income only. Without an effective assessment of assets, income support would enable greater transfer of assets to younger generations through bequests, rather than targeting assistance to people in need.

Means testing can be an effective mechanism for targeting assistance to people in need. Australia relies more on means tested payments than many other countries, with the result that its transfer system is more progressive than those of other OECD countries. Chart F2-1 shows the ratio of benefits received by the poorest 20 per cent of people to the benefits received by the richest 20 per cent of people in OECD countries (Whiteford 2009). Whiteford finds that within the OECD, Australia has the most progressive distribution of disability benefits and unemployment benefits, ranks second in the distribution of Age Pension benefits and ranks fifth in the distribution of family benefits.

Chart F2-1: Progressivity of cash benefits
Ratio of benefits received by households in the poorest to the richest quintiles, total population 2005



Source: Whiteford 2009.

The targeted nature of Australia's income support system has a number of benefits. It contributes substantially to the progressive effect of the tax and transfer systems on income distribution. Means testing is important to the sustainability of the income support system. By focusing spending on a smaller group, the level of benefits provided to those most in need can be kept higher.

While means tests and taxes have a different conceptual basis, they can have a similar economic impact. Empirical research shows that means testing affects decisions to work as strongly as tax does (Meghir & Philips 2009). Means testing raise effective tax rates which reduce the return people get from work and saving. For example, a person who earns an additional $100 of income may not only pay tax on that amount but also lose some of their income support.

It is therefore essential to limit means testing to the core transfer payments, in particular income support and family payments. Payments and supplements should be withdrawn so that the cumulative effective tax is not excessive.

The existence of multiple separately means tested payments results in overlapping withdrawal rates, which raise effective rates of tax. This can be particularly problematic where services and concessions are linked to payments and create 'sudden-death' loss of assistance once a particular income level is crossed.

The level of efficiency of taxes and means tests as ways of raising revenue (or limiting outlays) has been a crucial question in the Review's deliberations. Although means tests reduce the returns from work or saving, they can be designed in ways that reduce this impact. Indeed, some features of means tests may make them a more efficient instrument than direct taxes. For some working-age transfer payments, means tests are accompanied by activity-testing that directly requires recipients to look for, or undertake, employment.

Principles

The transfer system should have a broader assessment of means than the tax system. The concept of means for income support payments should include not only income but also the ability of a person to generate an income from their assets.

Means test arrangements should ensure that people on the same type of payment with similar means, including their income and their assets, receive an equivalent level of income support or other assistance.

The settings for a means test should pay attention to its impact on a person's decision to work and save as well as its primary objective of targeting government payments.

Means testing should be limited to essential payments, in particular income support and family assistance payments, to avoid an unnecessarily high effective rate of tax created by the cumulative nature of means test and tax.

While the targeted nature of Australia's income support system is on balance a strength of the system, there are areas where means testing could be improved. In particular, people who are receiving the same type of payment and have similar means should be treated consistently. It is also important to maintain incentives to work and save.

F2-2 The current system treats income and assets differently

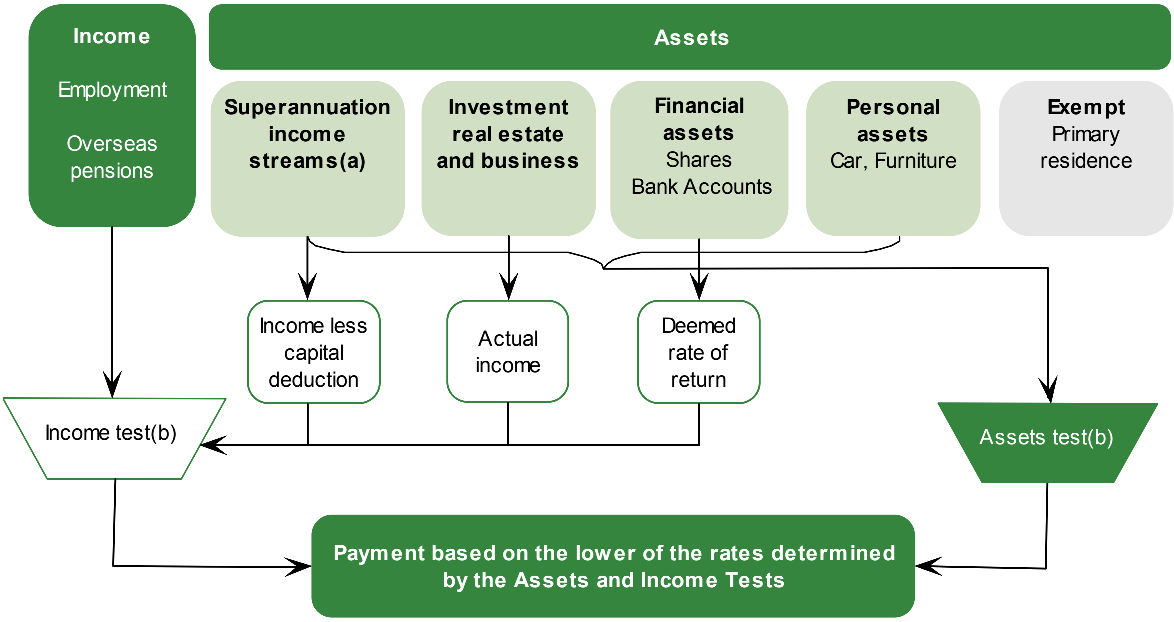
Means testing is used to determine the rate at which transfer payments are made. Transfer payments subject to means testing include: allowances (for example, Newstart Allowance, Youth Allowance and Parenting Payment (Partnered)); pensions (for example, Disability Support Pension, Carer Payment, Parenting Payment (Single) and the Age Pension); and family assistance (for example, Family Tax Benefits Part A and Part B, and Child Care Benefit).

The means test for allowances and pensions has two parts: an income test and an assets test (see Chart F2-2). A person's payment is calculated by applying the test that results in the least amount of payment.

- The income test reduces payments at a specified withdrawal rate per dollar of income above a free area. The withdrawal rate is 50 cents for all pension recipients (except Parenting Payment (Single) where it is 40 cents), and 50 and 60 cents for Newstart Allowance recipients. It applies directly to earned income (with certain concessions), but uses a variety of methods to assess income from assets. Actual income from real estate and trusts is used, while deemed income is used for financial assets (see *Deeming rate* in Section F2-4).
- The assets test includes most assets, and reduces pensions (other than Parenting Payment (Single)) by $1.50 per fortnight (or $39 per year) for every $1,000 of assets above the free area. Allowance and Parenting Payment (Single) recipients lose their payment entirely if they have assets above the free area. The principal home is exempt from the assets test (although there is a higher asset free area for non-homeowners).

The assets test has a similar effect as deeming a rate of return on assets for those people affected by it.

Chart F2-2: The existing means test base for income support payments



(a) Accumulated superannuation benefits which are not being drawn down through an income stream are treated as financial assets for people over Age Pension age. They are not included in the means test for people under Age Pension age unless they are being drawn down.
(b) Free areas and withdrawal rates apply to determine the amount of income support payment.

No asset test applies to family assistance payments (Family Tax Benefit Part A, Family Tax Benefit Part B, Baby Bonus) and Child Care Benefit. Eligibility for these payments is determined by adjusted taxable income. Adjusted taxable income comprises taxable income with adjustments made to improve the fairness of the system and move the means test for these payments closer to that for income support payments. For example, net investment property losses, salary sacrificed superannuation contributions and the adjusted or 'cash' value of fringe benefits are added back to taxable income.

Eligibility for Family Tax Benefit Part A is based on an estimate, made in advance, of the family's annual adjusted taxable income. The payment is reduced by 20 cents for each dollar above a threshold (currently $44,165) until it reaches the base rate of payment (this depends on the number and age of children and whether the family is receiving Rent Assistance). The base rate is then withdrawn from $94,316 (plus $3,796 for each child after the first child) by 30 cents for every dollar over that amount until the payment reaches nil.

Family Tax Benefit Part B has a two-stage test for couple households, such that it is only payable if the higher-income earner has an income of less than $150,000. If this test is satisfied, eligibility is based on the income of the lower earner. The full rate of assistance is payable where the lower earner earns less than the threshold (currently $4,672 a year). The payment is reduced by 20 cents for each dollar earned above this threshold. Full phase-out of the payment depends on the age of the child, with a higher payment and therefore higher phase-out level for children aged less than five years.

Single parents qualify for the full rate of Family Tax Benefit Part B if they have income of less than $150,000 a year and receive no payment when income exceeds this amount.

The income thresholds for receipt of Family Tax Benefit do not apply where people receive an income support payment from Centrelink or the Department of Veterans' Affairs. Rather, in situations where the income cut-out point for receipt of a part-rate of income support is above Family Tax Benefit income thresholds, income support recipients with qualifying children receive the maximum rate of Family Tax Benefit.

In the current system, multiple family payments create overlapping withdrawal rates and increase barriers to participation. Each payment withdrawal taper can be added to other taxes and withdrawal tapers and can contribute to higher effective rates of tax.

Additive tapers for family payments affect secondary earners in particular. The simultaneous withdrawal of Family Tax Benefit Part A and Part B add to effective marginal tax rates of secondary earners. Given other costs associated with working, this may deter secondary earners from entering or re-entering the workforce.

The full rate of Child Care Benefit is paid to families with combined incomes less than $37,960. Above this threshold, assistance is tapered away at various rates, depending on the number of children using approved care. The income cut-out points for Child Care Benefit are around $131,560 for families with one child using approved care, $136,375 (two children) and $153,995 (three children) plus an additional $29,077 for each child after the third.[15]

The Child Care Rebate is a payment in lieu of providing a tax deduction for child care, in recognition that this is a cost of employment. It is therefore appropriately not means tested, but should have a participation requirement attached (see Section F4 Child care).

Separate means testing arrangements apply to aged care and are considered in Section F7 Funding aged care.

F2-3 The current means tests treat people with the same means differently

The current approach to the means testing of income support payments is not as equitable as it could be, particularly in the assessment of assets and its effects on people with similar means. Some assets are assessed under both the assets and income test, while non-income-producing assets are only assessed under the former. For example, a holiday house is assessed only under the assets test, while financial assets, such as term deposits, are assessed under both tests (with the test that results in the least amount of payment applying).

Table F2-1 shows the reduction in pension payments due to an additional $1,000 of assets above the asset test free area, held in different forms, and assessed in different ways.

15 These figures are as at 20 September 2009.

Table F2-1: Pension reduction due to an extra $1,000 of assets above the free area[(a)]

Asset class	Means test treatment	Current pension reduction ($ per annum)
Own home	Exempt	0
Land	Asset test	39
Land (non-income producing)	Income test	0(b)
Term deposit	Income test — lower deeming rate(c)	10(d)
Term deposit	Income test — higher deeming rate(c)	15(d)
Term deposit	Asset test	39
Allocated pension	Income test	Varies(e)
Allocated pension	Asset test	39

(a) Shows the pension reduction due to the income and assets test assessment of these assets. Free areas are set out in Table F2-2.
(b) Income from income producing land is assessed under the income test.
(c) Different deeming rates apply depending on the person's overall level of financial assets.
(d) Based on current deeming rate of 2 and 3 per cent. Deeming rates have varied in the past (see Chart F2-5).
(e) Actual amount can vary depending on factors such as when the pension was taken and a person's drawdown choices. These factors can lead to no income being included in the income test.
Source: Treasury estimates.

Because income from some, but not all, assets is included in the income test, people can receive different levels of government payments even though they have the same aggregate level of wealth. It can also result in people receiving the same level of payment even though they have considerably different aggregate levels of assets. For example, a person earning $3,000 a year (an amount marginally below the current income test free area) can have around $170,000 of non-financial assets and receive the same pension as someone earning the same amount without any assets. This is because non-financial assets that do not produce income are not counted under the income test.

Findings

Means testing as it applies in Australia is a strength of the transfer system because it targets government payments to those with the most need and assists in managing the system's sustainability.

The current means test for income support payments is not as equitable as it could be because it results in people with different assets of the same value receiving different rates of income support. This reduces the fairness of the system and creates incentives to hold wealth in particular types of assets.

This can affect a person's choice on how to hold their assets. For example, a person in the example above may choose to invest their $170,000 in land instead of term deposits because it would have less effect on their income support payments. This reduces the fairness of the means testing system and the allocation of resources in the economy. A more uniform treatment of assets in the means test would promote a more equitable outcome.

F2-4 A new system would treat assets more consistently

Recommendation 88:

The current income and asset tests for income support payments should be replaced with a comprehensive means test based on a combined measure of employment income, business income and deemed income on assets. The comprehensive means test would:

(a) extend deemed income on assets in addition to other financial assets, including superannuation income streams, rental housing and other asset classes (whether income-producing or not). Superannuation income streams where deeming income would be difficult to apply would be tested on gross income but with an actuarially fair deduction for capital;

(b) have low and high deeming rates based on the returns expected from a portfolio of assets held by a prudent investor. These rates should be set by reference to an appropriate benchmark;

(c) continue the means test exemption for owner-occupied housing up to a high indexed threshold;

(d) set a high capped exemption for personal-use assets;

(e) retain the current concessional treatment of employment income for certain allowances and pensions;

(f) have different free areas for pensions and allowances; and

(g) remove the liquid assets waiting period and the sudden-death cut-out that applies to people on certain payments.

Means testing should continue to be part of the transfer system. However, the inequitable treatment of assets under the current means test highlights the need for reform. The objectives of reforming the means test would be to:

- ensure that the full range of a person's assets is effectively and fairly assessed;
- achieve greater neutrality in the treatment of different forms of savings;
- ensure people have appropriate incentives to use their savings effectively; and
- provide appropriate incentives for people, particularly for older Australians, to undertake paid work.

A comprehensive means test

The Review Panel foreshadowed in its report on strategic issues in the retirement income system that there should be a comprehensive means test that removes the assets test and extends the income test by deeming returns on a greater range of assets (AFTS 2009). While that report focused on retirement income payments, the same holds for other income support payments, such as Disability Support Pension, Parenting Payment and Newstart Allowance.

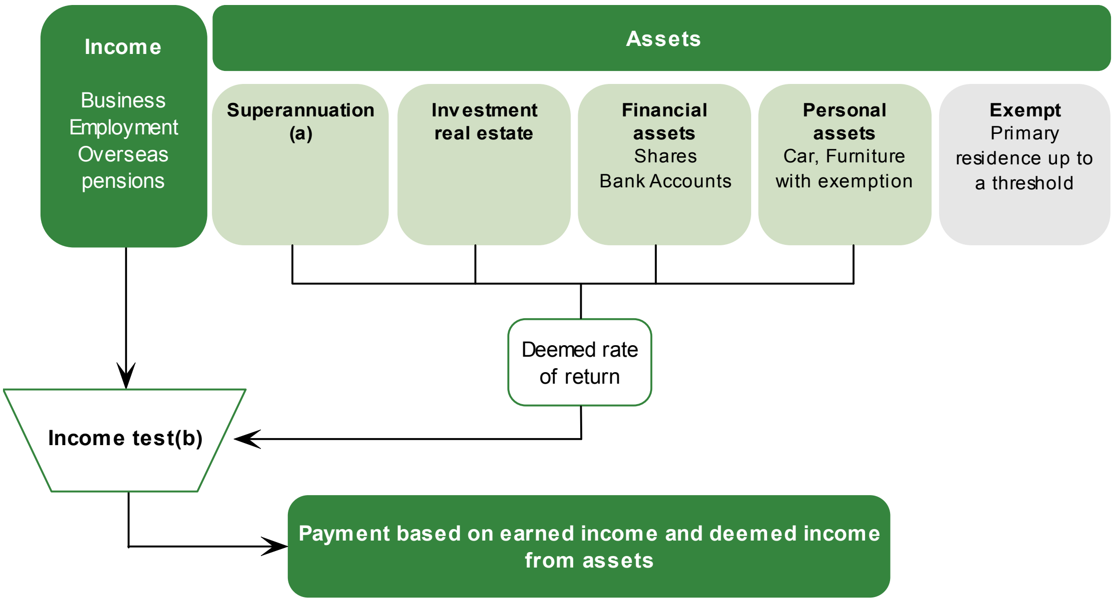
The removal of the assets test would make income the sole test of a person's means. However, removing the assets test without capturing non-income-producing assets would worsen the inequities evident in the current means test between these assets and financial assets. Therefore, to protect equity, an income would need to be deemed on non-income-producing assets to ensure they are incorporated into the means test.

Extending deemed returns to a broader range of assets would target the first three objectives for a comprehensive means test outlined above. It would include a broad range of a person's private means (income and assets) in the means test. It would be fairer than the current means test arrangements, as it would treat most assets in the same way when determining a person's eligibility for income support. It would also encourage a person to use their assets to generate an income to support themselves while they are accessing income support.

The effectiveness of a comprehensive means test would depend on having the broadest possible asset and income base with minimal exclusions. If there were significant exclusions, there may still be a need for a residual assets test. There is a case for special arrangements to apply to owner-occupied housing and to personal-use assets (that is, assets that do not generate an income but may have sentimental value). These arrangements are discussed in the section titled 'Value of assessable assets' below.

The structure of the base for a comprehensive means test is illustrated in Chart F2-3.

Chart F2-3: A comprehensive means test base



(a) Deeming on account-based superannuation assets would apply from Age Pension age. Special arrangements would apply to income streams where deeming is difficult. Superannuation assets would not be deemed for people under Age Pension age unless they are being drawn down.
(b) Free areas and withdrawal rates would apply to determine the amount of income support payment.

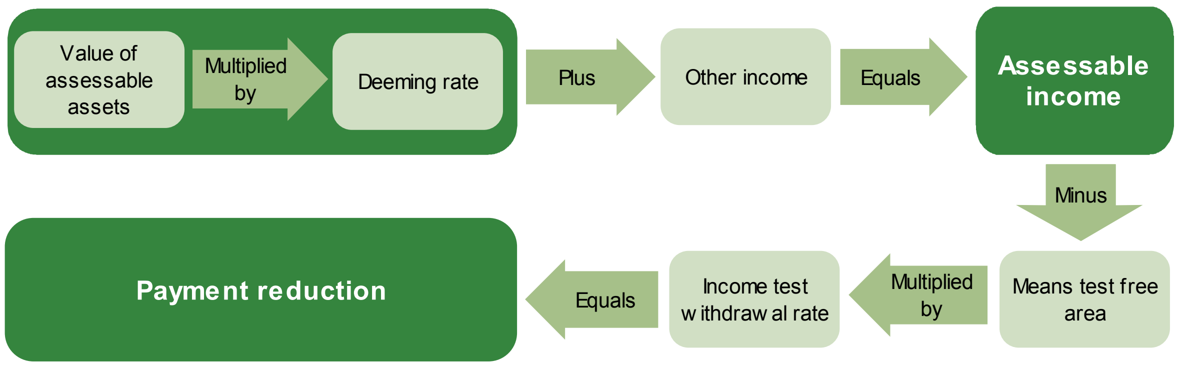
Under the means test, a person's income would depend on the value of their assets and the deeming rates that apply to these, in addition to their other income (income from employment, overseas pensions and other non-asset backed sources). Income for means testing purposes would continue to be based on a person's ordinary income — that is, income from employment, savings and other sources before deductions — as it better reflects a person's capacity to support themselves. However, payments should not be reduced as a result of the inclusion of compulsory superannuation contributions in taxable income (see

Effect on government payments and child support in Section A2-2 Taxing retirement incomes).

The current income and assets tests treat income-producing assets in different ways. Under the income test, deeming is generally applied to the gross value of financial assets. By contrast, the assets test generally includes only the net value of assets. Under the comprehensive means test, deeming would be based on the net value of assets (that is, the market value of the assets less any encumbrances, such as loans, secured against them). The net value of assets provides a more accurate reflection of the amount of assets a person has at their disposal. Arrangements would need to be put in place to ensure that the allowance for encumbrances was not abused.

The amount of income support payments would also depend on the free area (the level of income a person can have before it affects their payment) and the withdrawal rate (how quickly payments are reduced as income increases). Chart F2-4 outlines the key components of a comprehensive means test.

Chart F2-4: How the means test would work



There may be circumstances where these parameters are adjusted to achieve particular participation or distribution goals. For example, for single parents and people with a disability, the means test arrangements should provide an incentive to work part-time and recognise the higher costs of work they may face (see Recommendations 85 and 86).

Value of assessable assets

Deeming is a device to establish an income from an asset. The principle underlying deeming is that where an asset value can be simply and effectively determined, deeming would result in a fairer and straightforward means test assessment.

Deeming an income on more assets would involve more frequent assessment of their value. This would make the means test more responsive to changes in people's circumstances, including changes in market conditions. As with deeming on financial assets, this does not mean that income support recipients would need to report the value of their assets fortnightly.

Extending deeming would also change the means testing arrangements for many assets, including investment properties and some pensions paid from superannuation funds and life insurance companies.

Rental income from an investment property is currently included in the income test. Under the base for a comprehensive means test, income would be deemed on the value of the property. Other properties such as holiday homes would be treated in a similar way. The value of properties would be determined, and reviewed, using the approach currently adopted under the assets test, with properties valued at their net market value.

Account-based superannuation pensions, such as allocated pensions, would be included in the extended deeming arrangements. Such pensions are similar to other financial assets as there is an easily determined account value. Under the base for a comprehensive means test, an income would be deemed on the account value like other financial assets. The current rules for the assessment of these products (gross income minus a deduction for capital) would no longer apply.

However, there are some assets where deeming may be difficult to apply. In these cases other arrangements may be appropriate. Some examples of these assets are set out below.

Some people may receive a guaranteed income for life that commences when they retire. This may be paid from a defined benefit superannuation fund or purchased from a life insurance company. The Review has also identified the role that deferred annuities can play in an ageing society (see Section A2-3 Responding to increasing life expectancies). These products commence from a specified age and are a type of insurance against running out of income in retirement. When a person dies their premium can be used to support other people who have purchased this insurance. Deeming an income on these products would be difficult because an underlying asset value cannot be easily identified.

Where deeming cannot be simply and accurately applied, the gross income received may be the simplest measure of the asset's value to the person. However, as part of the gross income of these products is a repayment of the person's own capital, the income should be reduced by an actuarially fair deduction for capital.

The base of the comprehensive means test would include income received from private companies, sole proprietors, partnerships and trusts. Under the current system, income received from these arrangements is included in the income test (less deductions for expenses necessary to operate the business), and the value of the trust or company assets is included in the assets test. Income from these arrangements would be included in the base, but further work would need to be undertaken on the appropriate method for assessing assets in these entities.

Personal-use assets such as furniture, cars and clothing are usually purchased for reasons other than to generate a return. People may also have assets that have sentimental value, such as small collections. These assets are included under the current means test via the assets test, which effectively deems an income on them once a pensioner has total assets above the assets test free area. However, the base of the comprehensive means test would result in more of these assets being assessed. To help address sensitivities about reductions to payments due to the assessment of income from these assets, there would be a capped exemption from the means test for these assets. This would particularly assist people with moderate asset holdings.

The definition of personal-use assets would need to be considered carefully — in particular, whether it would extend beyond personal effects, household contents and cars to include boats and caravans. Such assets could be assessed at their market value, as they are currently, with the owner's estimate of market value accepted in some cases.

Deeming rate

Deeming is a device to establish an income from an asset. An appropriate deeming rate would be set with reference to the returns likely to be generated on a portfolio of assets a prudent investor is likely to hold. Actual income above the level of deemed income is not included in the means test.

Currently there are low and high deeming rates on financial assets that are set by agreement between the Minister for Families, Housing, Community Services and Indigenous Affairs and the Minister for Education, Employment and Workplace Relations. Financial assets include investments such as bank deposits, shares and managed investments.

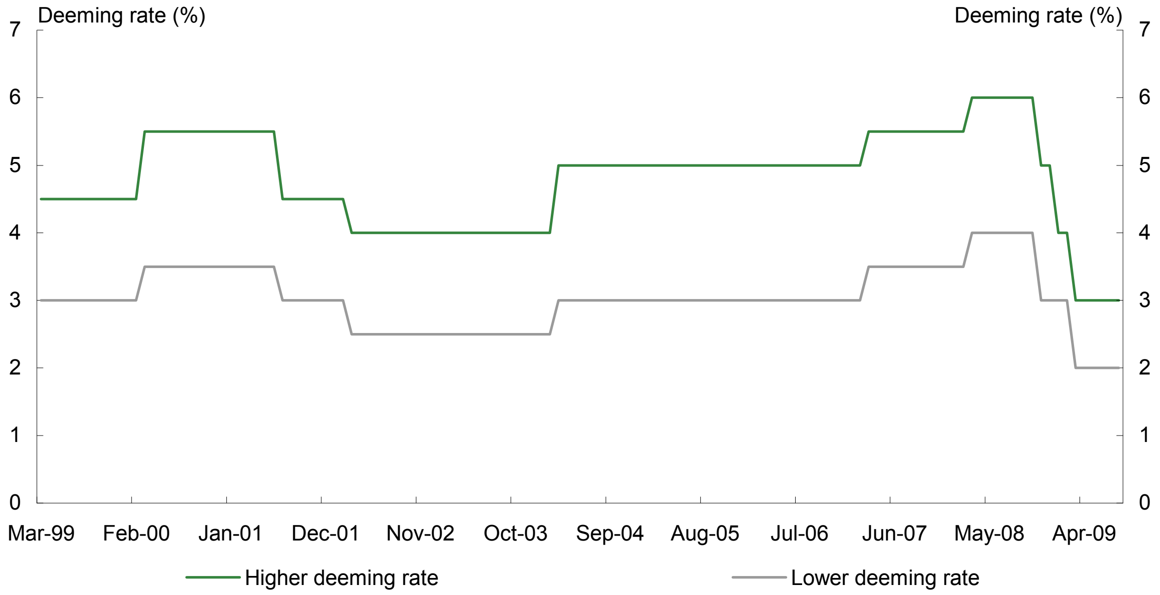
The low deeming rate is set at a rate of return that people with relatively few savings are likely to receive. It also reflects the returns on highly liquid and safe assets, such as bank deposits, which are likely to be preferred by people with few savings. This rate applies to the amount of financial assets a person has below a prescribed threshold. The high deeming rate reflects an expectation that people with more savings can obtain, and should seek, higher returns on some of their savings. This rate applies to the value of financial assets above the threshold.[16]

The deeming rate applied is likely to vary between different classes of income support recipients because of the level of assets they hold. Few young people, for example, will have sufficient assets to incur the higher deeming rate, while many retirees will.

Chart F2-5 shows how these deeming rates have changed over time. Given the likely risk preferences of income support recipients with low asset balances, retaining both low and high deeming rates remains appropriate.

16 The low deeming rate applies to: the first $42,000 of total financial assets for a single allowee (a person receiving an allowance) or pensioner; the first $70,000 of a pensioner couple's total financial assets; and the first $35,000 of total financial assets for each member of an allowee couple. These amounts are indexed yearly to the consumer price index (CPI).

Chart F2-5: Deeming rates — March 1999-August 2009



Source: Department of Family, Housing, Community Services and Indigenous Affairs.

However, it would be more transparent if these rates were set with reference to a benchmark rather than by the relevant ministers. The low and high rates could be set at a discount or premium to a relevant benchmark, such as the cash rate or Treasury bond rate, at least twice a year. A mechanism would also be put in place to allow for changes to the deeming rates to occur more regularly in case of sudden movements in the market.

Other income

The actual value of employment income and overseas pensions would be included in the means test, subject to any disregards or discounts applied to particular groups (see below).

One of the objectives of reforming the means test is to provide appropriate incentives to work, particularly to older Australians. For this reason the existing concessional treatment of employment income for some income support recipients should be retained. For example, under the Work Bonus, only half of the first $500 of fortnightly employment income is included in the means test for pensioners over Age Pension age.[17]

The Working Credit scheme, which applies to other income support recipients,[18] and the Student Income Bank[19] should also be retained. Working Credit allows a person to accrue up to $1,000 of credits they can use to offset employment income once they commence work.[20] Student Income Bank allows a person to accumulate up to $6,000 of any unused portion of their fortnightly income free area that can later be used to offset income above the free area.

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17 This commenced from 20 September 2009. For example, a person over Age Pension age who has $400 of employment income per fortnight will only have $200 included in the means test for that fortnight.

18 Working Credit applies to Newstart Allowance, Youth Allowance (Job Seeker), Partner Allowance, Mature Age Allowance, Sickness Allowance, Widow Allowance, Parenting Payment (Partnered), Parenting Payment (Single), Wife Pension, Widow B Pension, Carer Payment, Disability Support Pension and Bereavement Allowance.

19 Student Income Bank applies to full-time students who receive Youth Allowance, Austudy or ABSTUDY.

20 A person accumulates credits if their income from all sources is less than $48 a fortnight.

This recognises that students generally earn much of their income during their holidays, rather than throughout the year.

Means test free area

Currently there are separate free areas for the income and assets tests. These free areas set the level of income or assets a person can have before they start to lose some of their payment. Tables F2-2 and F2-3 following set out the current free areas and cut-out points for pensions and allowances.

Table F2-2: Pension income and assets tests free areas and cut-out points[a]

Income test (per fortnight)		Assets test	
Free Area:	$142 (single) $248 (couple)	***Cut-out points for full pension***	
		Homeowners:	
Cut-out points:	$1,485.80 (single) $2,274.00 (couple)	Single Partnered (combined):	$178,000 $252,500
		Non-Homeowners:	
Pensions are withdrawn at 50 per cent for every dollar above the free area.(b)		Single: Partnered (combined):	$307,000 $381,500
The income test does not apply to a permanently blind person receiving an Age, Service or Disability Support Pension.		***Cut-out points for part pension***	
		Homeowners:	
Cut-out points for part pension may be higher if receiving Rent Assistance or if separated due to illness.		Single: Partnered (combined):	$626,000 $928,500
		Non-Homeowners:	
		Single: Partnered (combined):	$755,000 $1,057,000
		Pensions are withdrawn at a rate of $1.50 per fortnight for every $1,000 above the threshold.	
		Cut-out points for part pension may be higher if receiving Rent Assistance or if separated due to illness.	
		The assets test does not apply to a permanently blind person receiving an Age, Service or Disability Support Pension.	

(a) Cut-out points as at 20 September 2009. Free areas are indexed in line with CPI and increase from 1 July each year.
(b) Parenting Payment (Single) recipients have a withdrawal rate of 40 per cent. They have a free area of $166.60 per fortnight, plus $24.60 for each additional child.
Source: Australian government administrative data.

Table F2-3: Allowance income and assets tests free areas and cut-out points[(a)]

Income test (per fortnight)		Assets test	
Free Area:	$62	*Homeowners:*	
Withdrawals:	50 per cent on income between $62-$250 60 per cent on income above $250	Single	$178,000
		Partnered (combined):	$252,500
		Non-Homeowners:	
Cut-out points:	$853.34 (single) $1,558.34 (couple)	Single:	$307,000
		Partnered (combined):	$381,500
Partner income test:		If assets are assessed as being above the free area by any amount entitlement to payment is zero. The free area and cut-out points are therefore identical.	
Free Area:	$780		
Withdrawal:	60 per cent		
If the recipient's partner is a pensioner, a joint income test applies. Individual income is calculated as half the combined income of the couple. This amount is then subject to the person's individual income test.			
If the recipient's partner is not a pensioner, a sequential income test applies. Individual income test is applied to own income. Partner income over the partner income free area is subject to a 60 per cent withdrawal.			
Cut-out points for part pension may be higher if receiving Rent Assistance or if separated due to illness.			

(a) Cut-out points as at 20 September 2009. Free areas are indexed in line with CPI and increase from 1 July each year. Allowances include Newstart Allowance, Parenting Payment Partnered, Sickness Allowance, Mature Age Allowance, Widow Allowance and Partner Allowance and exclude student and youth payments. Allowance assets test limits also apply to Parenting Payment (Single). Cut-out points for student and youth payments vary based on age, whether the person is living at home or not, and whether they are partnered. A single person aged 18 or over living at home can earn up to $236 a fortnight and still receive full student payments, with the benefits cutting out at $656. If they were living away from home, these limits are $236 and $868 respectively. The personal income threshold is proposed to increase to $400 from 1 July 2012. The withdrawal rates are set out in the Withdrawal rates section below.
Source: Australian government administrative data.

Free areas serve a range of purposes, including to:

- avoid reducing payments on the basis of small levels of income and assets;
- reduce the administrative burden associated with reporting on small levels of income and assets;
- provide some recognition of the costs associated with obtaining income (whether through employment or investment); and
- provide incentives for people to take up paid work.

These objectives must be balanced against the broader objectives of maintaining a targeted and sustainable income support system. There are different free areas depending on the type of income support payment. The pension free areas are currently more generous than those for allowances. The different free areas for pensions and allowances should be maintained under the proposal.

The free areas for pensions are designed to protect the adequacy of the income of pensioners with small amounts of non-pension income. Many pensioners are not able, or expected, to support themselves through paid work. This means that pensioners have a heavier reliance on their savings to provide their non-pension income. A higher free area ensures they are not forced to dissipate these savings too quickly. At the same time the higher free area provides an incentive for pensioners to supplement their income where they are able to do so.

The free areas for allowances are set at a level that ensures that targeting is met and workforce incentives are maintained. This recognises that people on allowances generally have more opportunity to support themselves through paid work.

There are also free areas for family payments and child care assistance. These operate to ensure that family payment and child care assistance withdrawal do not coincide with income support payments for those likely to be able to take up employment (for example, allowance recipients).

Withdrawal rates

A person's income support payment is reduced by a set amount for every dollar of income, or $1,000 of assets, in the case of asset tested pensions, above the respective free areas. The withdrawal rates vary between the various payments. For example, the income test withdrawal rate for the Age Pension is 50 per cent while for Newstart Allowance there are two withdrawal rates: 50 per cent applies for income over $62 per fortnight up to $250 per fortnight and 60 per cent applies from that point.

The design of withdrawal rates seeks to balance a range of objectives, including workforce incentives and targeting assistance to those most in need. In general, a steeper withdrawal rate would reduce incentives to work and save (although this impact can be reduced by the use of activity requirements). A shallow withdrawal rate would not reduce incentives by as much but, as more people would receive some payment, it would increase the number of people exposed to reduced incentives to work and save. In the case of Newstart Allowance, the stepped withdrawal rate of the income test seeks to balance these two effects.

Arrangements for couples

The means test for members of a couple currently operates differently depending on the type of payments the couple receives. If neither member of the couple receives a pension, a person's income first reduces their own payment. If their income completely withdraws their payment, their remaining income then reduces their partner's payment. This arrangement does not apply to couples who are both pensioners, or where one receives an allowance and the other receives a pension. In these cases, a person's income is split 50:50 with their partner and therefore reduces both payments at the same time.

Requiring pensioner couples to split their income in this way can weaken their incentives to participate in the workforce. It also means that a person's payment is reduced at a low level of partner income, which may not reflect an increase in the resources available to them. The option of having a consistent treatment of income for all couples on income support should be further explored. However, this should take into consideration the potential increase in complexity these people would face in how they manage their affairs. This complexity would arise due to the distribution of assets between a pensioner couple affecting the total pension payment to the couple.

Arrangements for payments to young people

A parental income test applies to people receiving Youth Allowance and ABSTUDY who are regarded as being dependent on their parents. Currently, Youth Allowance and ABSTUDY are withdrawn at a rate of $1 for every $4 above the parental income threshold (currently $32,800), which is based on the previous year's taxable income. [21]

A family assets test also applies to Youth Allowance and ABSTUDY. Under this test, a person is not eligible for a payment once their family's assets exceed a threshold (currently $571,500).[22]

Given the need for a means test to consider most of the resources available to an individual, the parental income test and family means test should remain until the individual is assessed as being independent.

Interactions with taxation settings

Making transfer payments non-taxable will lead to simpler interactions between the tax and transfer systems (see Section A1 Personal income tax). When payments are withdrawn at the same time as tax is paid, the stacking of the means test and tax scale can result in high effective tax rates. This can harm participation incentives. Where appropriate, means tests could be adjusted to take account of the underlying tax scales to deliver a desired effective tax rate. Given the different treatment of income and period of assessment in the two systems, this may be difficult to achieve precisely.

Transitions to a new system

A more equal treatment of assets under the comprehensive means test base may reduce a person's entitlement to income support if they have assets not currently captured by the income test. Transitional arrangements could be put in place to reduce the impact of this change. This could include freezing the current level of payment a person receives but not indexing that amount until their income support is equivalent to that which would apply under the new arrangements.

If such arrangements were considered too complex, an alternative would be to announce that the comprehensive means test would be introduced some years in the future. This would give people time to make adjustments. This approach has been adopted for the increase in superannuation preservation age from 55 to 60 and increases in Age Pension age.

Owner-occupied housing

Owner-occupied housing plays an important role in Australian society. In the strategic report on the retirement income system (AFTS 2009), the Panel supported continuing the exemption of owner-occupied housing from the means test. However, the report highlights that an uncapped exemption provides for very high levels of wealth to be sheltered from means testing.

Owner-occupied housing would continue to be exempt from the proposed comprehensive means test base. However, to increase the fairness of the means test, a cap should be applied to the exemption. Only the amount above the cap would be included in the means test and

21 The threshold increases for each additional child in the parent/s care. The parental income test does not apply if the parent/s gets an income support payment or has a low-income Health Care Card. In determining a person's payment the parental income test applies before the personal income test.

22 A 75 per cent discount applies for farm/business assets.

subject to deeming. This would ensure that the means test exemption applies to housing that meets the primary role of providing shelter and other support. Beyond this point, housing can be considered like any other asset a person purchases with an expectation of generating a future return.

The cap would ensure that the means test targets only housing of significant value. For example, it is estimated that a cap of $1.2 million would currently mean that around 10,000 age pensioners' homes would be partially assessed under the means test. In setting a threshold, consideration should be given to the effect on regional areas.

The design of a comprehensive means test also needs to deal with housing transitions. Neutrality between housing choices is an important public policy goal. These choices include whether to be a homeowner or renter, and different home ownership options, for example, downsizing from a three-bedroom family home to a smaller unit.

Currently, a number of aspects of the tax and transfer systems may deter people from downsizing. A person must pay stamp duties when choosing to sell their home and purchase a new one. The Review is recommending that stamp duty be reduced or removed (see Section C2 Land tax and conveyance stamp duty). Selling a home can also result in a person losing part of the income support payment. For example, a person who sells their home for $600,000 and purchases a new one for $400,000 would have the $200,000 difference included in the means test.

In the existing means test arrangements, the difference in the assets test free areas for homeowners and non-homeowners reduces the disincentives for a pensioner to sell their home and become a renter. While the assessable assets of a pensioner who has sold their home and becomes a renter increase, they benefit from a higher free area.

The removal of the assets test and assets test free areas under a comprehensive means test would remove any difference in the treatment of homeowners and non-homeowners. The reforms to Rent Assistance recommended in Section F5 (Housing assistance) would mean that homeowners and renters would be treated equitably in the income support system. There would therefore be no reason to maintain different free areas for homeowners and non-homeowners under the comprehensive means test. However, consideration would need to be given to how retirement village entry contributions and eligibility to Rent Assistance for those in retirement villages might be assessed.

The proposed comprehensive means test would have less impact than the current dual means tests on income support payments for people who move from owner-occupied housing to renting. This is due to the combination of the proposed reforms to Rent Assistance and the lower pension withdrawal rates that would apply under a comprehensive means test. The lower effective withdrawal rate would also reduce disincentives to move from larger to smaller houses. A pensioner who moves from a large to a small house would still be moving assets from an exempt to an assessable environment but the lower withdrawal rate in the new comprehensive means test would result in an increase in their total income.

In addition, the Review is recommending that the comprehensive means test base incorporate rules that create flexibility for homeowners who experience temporary changes in their circumstances, or who are moving from one housing arrangement to another. These rules would generally be based on the assets test rules that currently operate in these circumstances:

- Where an income support recipient temporarily vacates their principal home, the home continues to be considered as their principal home and remains exempt under the assets test for up to 12 months. The exemption applies even when the person expects to be absent for more than 12 months. Where the home is lost or damaged the temporary absence can be extended to up to 24 months if certain criteria are met.
- The value of an accommodation bond of unlimited value paid on entry to residential aged care is an exempt asset. A pensioner's former principal home is generally exempt from the assets test for up to two years from the time they move into residential aged care.
- The proceeds from the sale of a pensioner's principal home they intend to use to purchase another home are an exempt asset, generally for up to 12 months.

Liquid assets waiting period and sudden-death cut-outs

The liquid assets waiting period applies to Newstart Allowance, Youth Allowance, Sickness Allowance and Austudy. If a person would otherwise be eligible for one of these allowances but has more than $5,500 in liquid assets ($11,000 for a couple or single with dependents) they have to wait for a period before they can access a payment. This period can range from one week to 13 weeks depending upon the level of liquid assets. The purpose of the waiting period is to ensure that people rely on their readily accessible assets such as bank deposits before becoming eligible for income support.

However, the liquid assets waiting period can result in inconsistent and inequitable treatment of some people with relatively small levels of savings. It can act as a disincentive to save, especially for people who expect to need income support in the near future. It can also encourage people to run down their savings more quickly in order to qualify for income support.

A more consistent treatment of assets for means testing purposes would provide a better measure of means for people applying for allowances, removing the need for the liquid assets waiting period.

A sudden-death assets test exists for Newstart Allowance, Widow Allowance, Partner Allowance, Sickness Allowance, Special Benefit, Parenting Payment, Youth Allowance and Austudy. This means that once a person's assets (not including the family home) are $1 above the threshold they lose 100 per cent of their payment. The Review is not recommending that this aspect of the current means test arrangements be retained in the comprehensive means test. A sudden-death threshold can result in an inequitable situation where people with assets marginally below the threshold receive full income support while people with assets marginally above the threshold receive no support.

How the comprehensive means test affects pensioners and allowees

Table F2-4 sets out some indicative means test parameters for a single age pensioner and Newstart Allowance recipient that may apply under a comprehensive means test. The actual impact of the proposals on payments will depend on the setting of parameters such as the precise treatment of particular assets (for example, personal-use assets and assets in trusts), withdrawal rates, free areas and transition arrangements.

Table F2-4: Indicative parameters of a comprehensive means test (single person)

	Age pensioner	Newstart allowee
Free area (per fortnight)	$142	$62
Withdrawal rate (on income above the free area)	50 per cent	65 per cent
Employment income	The means test only includes 50 per cent of the first $500 of fortnightly income. Amounts above $500 are fully included in the means test.	100 per cent from first dollar of income is included in the means test.
Treatment of assets	First $42,000 of assets deemed at low rate Assets above $42,000 deemed at high rate Exemptions: Owner-occupied housing up to a threshold of $1.2 million First $75,000 of personal-use assets	Same as for pensioners

The comprehensive means test would reduce the effect assets have on a person's payment relative to the effect from the current assets test. Under the indicative comprehensive means test the withdrawal rate on a pension would reduce to 50 per cent until the payment phases out completely. Under the current assets test, the effective withdrawal rate of a pension can be higher than 50 per cent. For example, a pensioner loses $1.50 of payment per fortnight (or $39 a year) for every $1,000 of assets over the free area. This equates to an effective marginal withdrawal rate on income of 78 per cent, assuming a 5 per cent annual return on those assets. This rate will vary depending on asset holdings and the assumed rate of return.

The indicative comprehensive means test would increase the assets people could hold before their payment is phased out completely. It would also increase the effective 'cut-out' point for allowees who rely solely on income from their assets.

F2-5 Means testing family assistance payments

Recommendation 89:

Means testing for family assistance payments should be based on the same measure of taxable income as for income tax, including fringe benefits. However, payments should not be reduced as a result of the inclusion of compulsory superannuation contributions in taxable income. Consideration should be given to aligning the definitions of income and periods of assessment for family assistance payments more closely to those that apply to income support payments. However, this should not include deeming income on assets.

Family payments should continue to be means tested by reference to an estimate in advance of the family's annual adjusted taxable income. Family assistance payments are to assist in the financial support of children. Actual income, rather than deemed income, is a more appropriate basis to means test these payments as it reflects the income readily available to families to support their children. Deeming an income on assets may also discourage families from saving while they have children, which may affect their future wellbeing. Family assistance payments are described in more detail in Section F3 Family and youth assistance.

Currently, taxable income is adjusted to include amounts such as the 'cash' or adjusted value of fringe benefits and salary sacrificed superannuation contributions. The Review is recommending that fringe benefits and superannuation contributions be included in a person's taxable income (see Section A1 Personal income tax) so these adjustments would no longer need to be made. However, including compulsory superannuation contributions in taxable income should not affect family assistance payments (see Taxing retirement incomes in Section A2-2). This could be achieved by increasing the thresholds for family payments. Taxable income would be reduced by the proposal for a 40 per cent savings income discount to individuals for non-business related net interest income, net rental income and capital gains (and losses). See Section A1 Personal income tax.

In the longer term, basing entitlement to family assistance on a test of current actual income using the same definitions and periods of assessment as income support should be explored. This would be more responsive to changes in people's circumstances because fortnightly payments would reflect the current circumstances of the family and not an estimate of its income over a 12-month period. It would also end the current situation where a family can incur a debt at the end of the income year because of unforeseen changes in their circumstances.

Child care assistance is provided to encourage participation in employment or training for low-income families and to recognise that child care is a cost of employment for all families. For this reason, child care should be means tested from a high rate of assistance for low-income families down to a base rate of assistance for all families that use child care in order to engage in the workforce. See Section F4 for more detail on child care assistance.

The means testing arrangements for child care need to operate coherently with other means tested payments received by parents. Because families are potentially eligible for a number of payments and services, it is essential that child care withdrawal rates are considered in conjunction with other withdrawal rates (see Recommendation 100).

F3. Family and youth assistance

Key points

Family payments should be sufficient to ensure that children have access to a basic acceptable standard of living. The rate of family payments should reflect the direct costs of children in low-income families. Current rates of assistance do not adequately reflect the direct costs of older children, but are more than adequate for very young children and for larger families.

Family payments provide a degree of horizontal equity between taxpayers with and without dependent children. For a given amount of funding, this horizontal equity role must be balanced with the need to ensure vertical equity.

Family payments should also assist parents who are nurturing young children to balance work and family responsibilities. Assistance could continue beyond the early years for single parents and families in specific circumstances, such as parents caring for disabled children and foster care children with higher needs.

The total amount of family assistance should be withdrawn using a single means test based on family income which avoids cumulative withdrawal rates that create unnecessarily high disincentives for working.

Current arrangements for family payments are complex in terms of the number of payments, the design of individual payments and their interaction with the rest of the tax and transfer system.

Family payments should be provided in a simple and transparent form coherent with other parts of the tax and transfer system. A single, simple family payment should be provided to cover the direct costs of children. Because these costs increase as children grow older, assistance should be higher for older children. The payment should be means tested based on family income and should be designed to minimise the impact on workforce incentives.

Family payments should be the main form of assistance for children up to the age of 18 or until the completion of secondary school. Beyond these points, youth payments alone should be available and should be focused on encouraging study, training or workforce engagement. There should be a seamless transition from family payments to youth payments. Youth payments should be the main form of income support from the age of 18 until the age of independence.

The rates of youth payment should reflect the fact that young people generally have lower needs than adults, but should be sufficient to support investment in education, training and other capability-building activities (including combining part-time work and part-time study). Youth payment rates should not favour unemployment over education and training and should reflect the fact that young people in different living arrangements and personal circumstances have different needs. Those living away from home have higher costs than those living at home.

F3-1 What is the role of family and youth assistance?

Ensuring children have access to a basic acceptable standard of living

Parents have primary responsibility for the financial support of their children. However, some families do not have a level of private income sufficient to adequately support their children. As income support payments are designed to be adequate only for their recipients, these families need additional income to adequately support their dependent children.

The primary role of family payments, as distinct from income support payments, is to ensure all children have access to a basic acceptable standard of living. To achieve this goal, family payments must work hand in hand with income support payments so that parents have the means to provide themselves and their children with a basic acceptable standard of living. The provision of a basic acceptable standard of living encompasses both poverty alleviation and social inclusion objectives.

Access to services such as education and health is also fundamental to ensuring access to a basic acceptable standard of living for children and to facilitating their social inclusion. Children's access to these services is as relevant as the role that family payments play in addressing the objectives of poverty alleviation and social inclusion. From early childhood onwards full access to health services and participation in education should not be restricted by a family's financial circumstances.

Poverty alleviation and social inclusion should not be considered in a static sense. While it may be necessary to provide financial assistance to families when their available income is low, social inclusion is not likely to be sustainable if families continue to rely on transfer payments as a primary source of income. It can be difficult to find the right balance between providing an adequate level of support and not providing government transfers at a level where these payments become a substitute for employment.

A general principle is that the rate of family payments should reflect the direct costs of children in low-income families — that is, the out-of-pocket expenses parents must incur to provide a basic but adequate standard of food, clothing, housing and other items necessary for the development of children. Family payments should combine with income support payments to provide an adequate level of support for both parents and children.

Principle

Family payments should be sufficient to ensure that children have access to a basic acceptable standard of living. The rate of family payments should reflect the direct costs of children in low-income families.

Horizontal equity

The principle of horizontal equity is that individuals with a similar ability to pay taxes should pay the same amount. For family payments, this involves acknowledging that people with children have greater costs and greater needs than people without children at the same level of income, and recognising that children are a valued social resource on which future living standards and the wellbeing of society as a whole depend. This suggests that taxpayers supporting dependent children should have a lower net tax burden than those without dependent children. This lower net tax burden could be achieved through tax offsets or family payments.

Applying the horizontal equity principle in pure terms would mean a universal family payment; that is, families with similar characteristics (such as, age and number of children) would receive the same amount of assistance irrespective of income. However, because family payments in Australia are paid at relatively high rates to achieve adequate levels of support for low-income families, it would be extremely costly to provide universal payments. Phasing out payments using a low withdrawal rate can provide some level of assistance to most families without the full cost of a universal family payment.

Horizontal equity can also refer to providing similar tax treatment to couples that receive their income primarily through one earner, relative to couples where both members undertake significant work. Because of the progressivity in the tax and transfer system, the couple where both members work pay lower net tax. The current system provides assistance to dependent spouses through Family Tax Benefit (FTB) Part B for those with children and through the Dependent Spouse Tax Offset, where the primary earner pays sufficient tax, for those without children.

Historically, assistance for families has addressed vertical and horizontal equity for families with dependent children in different ways. Vertical equity — the concept that people with low means should receive greater assistance than those with higher means and that those with greater economic capacity should have a higher tax burden — has been addressed by the provision of additional assistance or higher rates of family assistance to low-income families.

Although family payments in Australia have generally provided a degree of horizontal equity, since the late 1980s governments have also tended to identify points on the income spectrum where assistance has no longer been considered necessary. In the current system, this occurs through the provision of a base rate of assistance for middle-income families (though not fully horizontal, as this is also means tested).

Principle

Family payments provide a degree of horizontal equity between taxpayers with dependent children and taxpayers without dependent children. For a given amount of funding, this horizontal equity role must be balanced with the need to ensure vertical equity.

Supporting parents with young children

Families may also experience indirect costs (such as loss of income) when parents need to care for their children and have limited capacity to work. The Paid Parental Leave (PPL) program scheduled to begin in 2011 will encourage time out from the workforce after the birth of a child and provide an alternative source of income for primary carers who satisfy the employment requirements before their child is born.

Supporting the role of parents is particularly important in the period immediately following the birth of a child. OECD studies and the Productivity Commission's report on PPL identify a period after the birth of a child when it is significantly advantageous for both the child and the mother to be at home (around 0 to 6 months), with a reasonable prospect that longer periods of parental care (9–12 months) are also beneficial (OECD 2007c; Productivity Commission 2009b).

The literature also identifies a period (beyond five months) over which absences from the workforce become more critical to parents' longer-term employment prospects (Jaumotte 2003; Ruhm 1998). Maternal participation is in turn important for longer-term outcomes for mothers and their children (OECD 2007c; Jaumotte 2003).

In Australia, most primary carers (who are usually mothers) who choose to return to work after the birth of a child do so between one and three years of the birth (see also *S*ection F1 Income support).

Family payments have a role in ensuring that the choice to spend a reasonable length of time out of the workforce to care for young children is not constrained by financial need. PPL provides a strong signal that an absence from employment is appropriate and provides an alternative source of income for primary carers after the birth of a child.

Beyond the immediate post-birth period covered by PPL, many parents continue to stay out of the workforce or reduce their hours of participation to provide care to young children. Low- to middle-income families should continue to be supported in the interests of the welfare of children, while still fostering increasing workforce attachment. For some families, one parent remains out of the workforce or works reduced hours; for other families, both parents reduce their hours of employment or forgo employment opportunities. The family payments system should support families with young children through this period, while minimising disincentives to participate in paid work, and acknowledge that families balance their work and family responsibilities in different ways.

The income support system also provides a safety net of support for parents, to ensure that both parents and children have a basic acceptable standard of living if they are unable to earn sufficient income to support themselves. Paying an additional amount for parents with young children assists in improving the adequacy of payments for this group.

Supporting parents with children six years and older

For all parents with a youngest child aged six years and over, supplementary parental support should be provided to raise the level of adult income support payments above the rate of those without children, reflecting the need to ensure that the total support provided to families is adequate.

For couples, the supplement should be provided through the income support system and withdrawn with income support payments. This recognises that the combined withdrawal of two income support payments occurs well above the minimum wage and close to the average wage.

For single parents, the supplement should be provided through the family payment system and withdrawn with family payments. Applying the income support method (used for couples) to single parents would result in assistance cutting out at relatively low levels of income, which is not desirable.

Section F1 (Income support) provides detail on the payment rates for partnered parents with youngest children aged six years and older.

Principles

A degree of assistance with income replacement for a parent after the birth of a child (to recognise their reduced capacity to participate in the labour market) should be provided through paid parental leave, and through higher rates of family assistance in the pre-school years.

Income support for low-income parents with children should, in combination with family payments, provide a higher rate than standard income support payments.

Some additional assistance (over and above the direct cost of children) should continue to be provided to single-parent families with youngest children aged six years and older.

Supporting educational attainment

Family payments should also support older children to continue with education and training. Changes to technology and the labour market have increased the need for all workers to develop their skills. It is well established that higher levels of educational attainment are associated with higher levels of workforce participation. The participation rates of both men and women in Australia with no post-school qualifications are around 10 percentage points lower than those with post-school qualifications (Kennedy et al. 2009).

Decisions to undertake post-compulsory education will be determined by a number of influences throughout a young person's life, but important decisions are often made at the point when they reach school-leaving age. For many older children and their families, access to financial support plays an important role in decisions about Year 12 completion and post-secondary school training and study.

Beyond the age of compulsory education, older children have the option of participating in the workforce on either a part-time or full-time basis. Assistance for older children should recognise that there may be pressure on them to earn income from work, in addition to or instead of full-time study, because of the financial circumstances of their family. If adequate support is not available, some people (particularly from low-income families) may be forced to compromise their educational performance or discontinue their education.

Within Australia, Year 12 completion rates vary according to socioeconomic status, location and Indigenous status. For example, James et al. (2008) found that in 2006, while the Year 12 completion rate[23] was 67 per cent across Australia, for low socioeconomic status students it was 59 per cent compared with 78 per cent for high socioeconomic status students. The corresponding figures were 52 per cent for remote students and 69 per cent for metropolitan students. The rate for Indigenous students was 40 per cent. As the completion of secondary education can have a significant impact on a person's ability to find and retain employment,

23 In this case, the Year 12 completion rate was measured as the number of Year 12 completions (Year 12 certificates issued by State/Territory education authorities) as a proportion of the estimated population that could attend Year 12 in that calendar year.

and is usually a pre-requisite for further education, the failure to complete Year 12 can have a large impact on an individual's future workforce participation.

Recent Council of Australian Governments (COAG) reforms aim to guarantee that young people have access to education and training opportunities. The reforms also impose a requirement that they participate in education, training or employment.[24] These reforms need to be complemented by ensuring that young people have access to appropriate financial support when they do participate in appropriate education or training.

Principle

Assistance for older children and youth should support young people to continue with education and training. This requires the provision of adequate support accompanied by appropriate conditions so that payments do not favour unemployment over education and training.

Recognising diverse youth transition paths

As children grow older and become more financially and socially independent, it becomes less appropriate for parents to receive payments for their direct costs. While family payments can generally be provided without conditions on what children do (other than the requirement that they attend school), beyond the age of compulsory education, older children make more choices independently. As older children transition into early adulthood, it is more appropriate that assistance should be contingent on the circumstances of the young person, and less on the circumstances of their parents.

The transition paths of older children into early adulthood are diverse and involve many dimensions, including:

- living arrangements — some older children will need to move away from home in order to complete their secondary or post-secondary education;
- participation in education and training — different career paths require different levels of education and training, which take varying amounts of time to complete; and
- participation in the workforce — different career paths imply different ages at which young people move into full-time work. Young people will also have varying capacities to combine education and training with work.

It is therefore difficult to design assistance for young people in a 'one size fits all' model. Assistance needs to be flexible enough to accommodate diverse transition paths. This may require different types of payments to people in different circumstances.

Assistance to young people should also take into account the expected availability of financial support from their parents. Although this will require imposing somewhat arbitrary distinctions between dependent and independent older children, if independence

24 These reforms are detailed in the COAG communiqué of 2 July 2009 and the National Partnership Agreement on Youth Attainment and Transitions.

tests are designed effectively they can be a useful way to ensure that appropriate levels of assistance are available for different circumstances.

While assistance for young people should be flexible, there should also be a seamless transition from family payments to youth payments. Youths and families should be able to understand the assistance available to them and what they are required to do to receive it. There should be a single clear mechanism for assistance based on circumstances, rather than a complex choice between a number of different forms of assistance.

Principles

There should be a seamless transition from family payments to income support for young people based on a young person's circumstances.

Youth payment rates should reflect the fact that young people generally have lower needs than adults, but should be sufficient to support investment in education, training and other capability-building activities. To accommodate diverse transition paths, assistance should be flexible and should recognise that the financial needs of young people vary depending on their age, living arrangements and availability of financial support from parents.

Trade-offs and interactions with other parts of the system

The design of family payments will be a function of how objectives are prioritised. Although the objectives may be complementary to some degree, for a given aggregate level of family payments they involve trade-offs with other parts of the tax and transfer system.

Adequacy of family payments and workforce participation

The objective of family payments in relation to participation should be the same as that of the broader tax and transfer system — that is, payments should not discourage participation beyond the level that is unavoidable when providing any safety net support. There are two aspects to this. The first is ensuring that the withdrawal of family payments does not significantly add to effective marginal tax rates (EMTRs) for a large number of people. The second is ensuring that government assistance does not become a substitute for income earned from working.

In the current system, the withdrawal of income support payments can result in relatively high EMTRs. FTB Part A has therefore been designed so that it is not withdrawn at the same time as income support payments. The FTB Part A income test begins to withdraw benefits beyond the cut-out points for allowance payments and the single pension, but operates over the same income range as the income test for a partnered pensioner. The degree to which these payments can be tightly targeted at low-income families is limited by the withdrawal of income support payments.

While means testing payments keeps assistance targeted and affordable, it also necessarily imposes higher EMTRs over the withdrawal range. While the payment may achieve a poverty alleviation goal in immediate financial terms, a poorly designed means test can have a detrimental impact on participation, leading to lower family income in the longer term. The more that means tested payments are provided to families, the more significant is the compounding effect of these withdrawal rates on EMTRs.

Child care assistance also plays a role in assisting parents (particularly secondary earners and single parents) to balance paid employment with parental caring responsibilities. Child care assistance is discussed in detail in Section F4.

Principle

Family payments should be designed so as to limit the participation disincentives inherent in all targeted transfer payments. In particular, where families are eligible for more than one means tested payment or concession, the means tests need to be designed to operate in a coordinated way to avoid means test stacking resulting in high EMTRs.

Relationship of horizontal equity to poverty alleviation and workforce participation

If family payments are designed to provide for poverty alleviation for families with low incomes and pure horizontal equity between all parents of dependent children and taxpayers without dependent children, then disincentives to workforce participation for a broader range of people will be introduced. This happens because an alternative to earned income is available to a larger number of people — as family payments would be extended to families with higher incomes currently affected by the means test, and because other taxpayers would incur a larger tax burden to fund a larger total amount of family payments.

On the other hand, fully universal payments (without means tests) would reduce the EMTRs for some families, which could increase workforce participation incentives.

The degree to which payments impact on participation depends on the rate of assistance (which reduces incentives through an income effect), the withdrawal of payments (which reduces the amount of each dollar of earned income that the family keeps after tax and transfer withdrawal), and the distribution of families affected by the withdrawal of payments.

Within a given budget constraint for family payments, 'pure' horizontal equity would necessitate a reduction in the adequacy of the payment available to low-income families. If a government's budget constraint is less binding, payments could be set high enough to meet the adequacy objective, but tax rates across the population would need to be higher to support the higher cost of universal family payments.

As the primary goal of family assistance is to ensure adequacy, this objective should not be traded off against horizontal equity. Similarly, parents have primary responsibility for the financial support of their children and should not be discouraged from working due to the provision of horizontal equity payments.

Horizontal equity payments for dependent spouses (either with or without children) are payments or tax allowances intended to provide support to couples where one partner does not participate in paid employment. To ensure that this assistance is restricted to spouses who are dependent, an income test on the secondary earner's income is necessary, and this can create a disincentive to participating in paid employment. The withdrawal rate and the interaction with other income support and family payments, as well as the number of people affected by the assistance, will determine how significant the participation impact is.

Providing payments simply

Like all areas of the tax and transfer system, family payments should be easy to understand, both in how the payments operate and in the way they interact with other parts of the system. Families should be able to understand their entitlements and navigate the system without difficulty and without incurring debts. This can also build greater community support for family payments.

Simpler payments can make it easier for assistance to respond to changes in family circumstances in a timely way. The birth of a child and other events — such as returning to work, separation, re-partnering and the birth of subsequent children — impact on the family and its finances. If payments are unnecessarily complex, it can be difficult for a family to understand what is required when circumstances change.

The interaction of family payments with other parts of the tax and transfer system can be a significant source of complexity. If family payments are withdrawn at an income level where other tax and transfer rates are also changing, this can complicate decisions related to workforce participation.

Principle

Family payments should be provided in a simple and transparent form that is coherent with other parts of the tax and transfer systems.

F3-2 The current system could be simpler, more transparent and better targeted

Table F3-1 summarises the main forms of assistance now available for families and youth.

Table F3-1: Family and youth assistance[a]

Payment description	Maximum rates of payment	Income test(b)	Number of recipients and expenditure(c)
FTB Part A Per-child payments for dependent children aged under 16; and dependent young people aged 16-20; and 21-24 year old full-time students not in receipt of an income support payment. To be eligible, a parent must have care of a dependent child for 35 per cent or more of the time. Can include Large Family Supplement and Multiple Birth Allowance. Can include Rent Assistance (children aged under 16) where a parent has care of a dependent child for 14 per cent of the time.	Maximum rates (annual)(d) 0-12: $4,803.40 13-15: $6,033.45 16-17: $2,018.45 18-24: $2,467.40 Base rates 0-17: $2,018.45 18-24: $2,467.40	Families are paid the higher of the maximum or base rate after the operation of the following income tests: The maximum rate is available until family income reaches $44,165 a year, after which a withdrawal rate of 20 per cent applies. The base rate is available until family income is $94,316 a year (plus $3,796 for each FTB child after the first) after which a withdrawal rate of 30 per cent applies.	1.77 million families paid in respect of 3.44 million children Expenditure: $12.576 billion
FTB Part B Per-family payment to single income families (including single parents) and to couple families where the secondary earner's income is low.	Maximum rates based on age of youngest child(e) (annual) 0-4: $3,828.85 5-15*: $2,774.00 (*Or 16-18 if full-time student not in receipt of an income support payment).	Limited to families where the higher-income earner in a couple, or a single parent, has an income of $150,000 a year or less. When the income of the lower earner is over $4,672 a year, the payment is withdrawn at a rate of 20 per cent.	1.36 million families comprising 770,000 couple families and 590,000 single-parent families Expenditure: $4.360 billion
Baby Bonus Payment on the birth of a child or the adoption of a child.	$5,185 per eligible child paid in 13 fortnightly instalments.	Payable to families whose estimate of combined adjusted taxable income is $75,000 or less in the six months following the birth of a child or the child's entry into care.	278,000 recipients in respect of 283,000 children Expenditure: $1.411 billion
Paid Parental Leave (PPL) Payment to help parents spend time with newborns and adopted children. Recipients must fulfil employment criteria in months before birth or adoption to be eligible. Parents receiving PPL cannot receive the Baby Bonus (except in cases of multiple births) or FTB Part B for the time they receive PPL.	Allows eligible parents up to 18 weeks of leave at the Federal Minimum Wage (currently $543.78 per week).	Primary carers will be eligible if they earned less than $150,000 in the full financial year prior to the birth or adoption of a child.	Introduced from 1 January 2011
Youth Allowance (YA) YA (Student): Income support for full-time students aged 16-24 in secondary or tertiary education or training and full-time apprentices. YA (Other): Income support for young people aged 16-20 seeking or preparing for work or temporarily unable to work.	At home rates (annual equivalent) Under 18: $5,285.80 18 and over: $6,354.40 Away from home and partnered rate: $9,656.40 (Higher rates are available in some circumstances — for example, parents).	Following a recommendation of the Bradley Review, the Government introduced legislation in late 2009 to improve the YA personal income threshold (PIT). The changes will increase the PIT threshold to align it with the income test threshold applying to the maximum rate of FTB Part A and replaced the YA per child 25 per cent taper rate with a 20 per cent family taper rate.	YA (Student): 273,100 YA (Other): 82,900 Expenditure YA (Student): $1.829 billion YA (Other): $0.539 billion

(a) Payment rates and income tests are current as at 20 September 2009, except where noted.
(b) The income tests refer to the relevant family or parental income test. Youth Allowance recipients are also subject to a personal income test with separate income tests applying for students and non-students. For FTB Part A, a limit on the income earned by children may also apply.
(c) Recipient numbers as at June 2009. Expenditure is for 2008-09.
(d) FTB Part A amounts include the FTB Part A supplement of $711.75 per-child for 2009-10.
(e) FTB Part B amounts include the FTB Part B supplement of $346.75 per-family for 2009-10.

In addition to the payments listed in Table F3-1, income support recipients may receive a higher rate of payment if they have dependent children and will have adjusted activity requirements.

Source: Australian government administrative data; FaHCSIA and DEEWR 2008–09 annual reports.

The current system could be rationalised and remodelled to create a family assistance program that would be simpler, more transparent and provide greater support where it is needed. Support provided through family payments should be designed to better reflect the direct cost of children, including older children in secondary school, while support for young people and adults (including parents) should be provided through income support payments.

Unnecessarily complex, with multiple payments

The family payments system has a number of payments with overlapping, and in some case, competing, objectives. This increases the compliance costs borne by parents and increases the challenge of designing a system that is fair to families in different circumstances. The existence of multiple payments can also result in overlapping withdrawal rates, which raises EMTRs at certain income levels above the levels that would otherwise be achieved with a single family payment.

For families with inconsistent and unpredictable income flows, the need to estimate taxable income ahead of actual earnings can be problematic. This may not only contribute to over- or underpayments through the year, but may also lead to families adjusting their participation due to concern about accruing family payment debts.

Finding

Current arrangements for family payments are made unnecessarily complex by the number of payments, the design of individual payments, and their interaction with the rest of the tax and transfer system.

Payments are not consistent with supporting workforce participation

Workforce disincentives are inherent in any safety net support system; in this way family payments can be seen to contribute to workforce disincentives (both because they provide an alternative to earned employment income and because they withdraw as earned income increases, raising the effective rate of tax paid by parents in the withdrawal range).

Given the objective of providing a basic acceptable standard of living for all Australians, particularly for children in low-income families, conceding the participation objective to some degree is unavoidable. Where assistance is provided in addition to that required to meet safety net objectives, impacts on workforce incentives are a major concern.

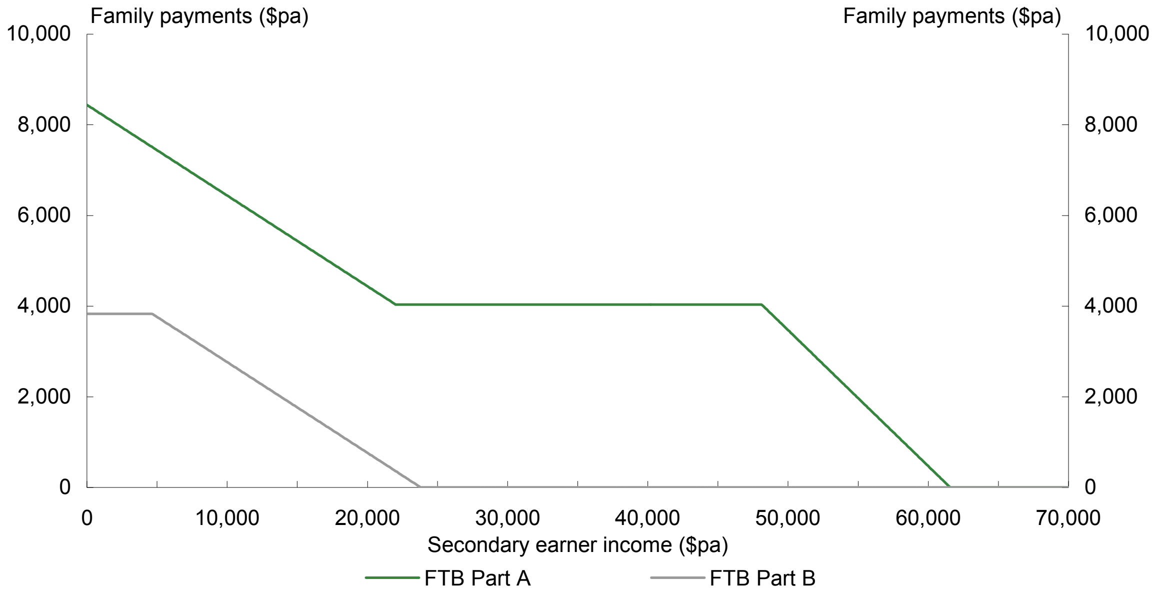
However, assistance can be delivered in ways that have different impacts on the incentives people have for workforce participation. In the current system, multiple family payments create overlapping withdrawal rates and increase barriers to participation. Each payment withdrawal rate can add to other taxes and withdrawal rates and can contribute to higher EMTRs.

Cumulative withdrawal rates for family payments affect secondary earners in particular. The simultaneous withdrawal of FTB Part A and FTB Part B add to the EMTRs for secondary earners, as shown in Charts F3-1 and F3-2. These charts show the situation for a secondary earner with a partner who earns $50,000. As the family has two young children, FTB Part A (which begins to be withdrawn when family income reaches $44,165) continues to be withdrawn at a rate of 20 per cent as the secondary earner begins to earn income. Further, FTB Part B begins to be withdrawn at a rate of 20 per cent when the secondary earner's income reaches $4,672.

The combination of FTB Part A and FTB Part B withdrawal rates, together with income tax rates, can lead to high EMTRs for secondary earners. In combination with the other costs associated with working, this may deter secondary earners from entering or re-entering the workforce or increasing their hours of work, particularly when children are young and out-of-pocket child care costs are incurred.

Chart F3-1: Withdrawal of FTB Part A and FTB Part B, 2009-10

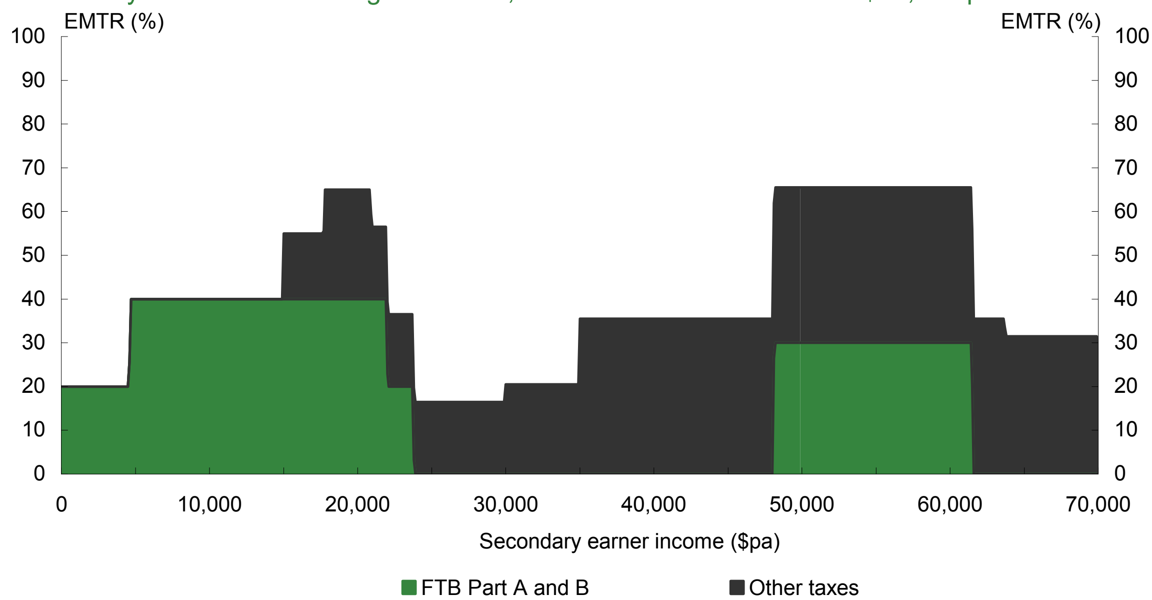
Family with two children aged 4 and 6, first earner's income fixed at $50,000 per annum



Source: Treasury estimates.

Chart F3-2: Effect of withdrawal of family payments on secondary earner's effective marginal tax rates, 2009-10

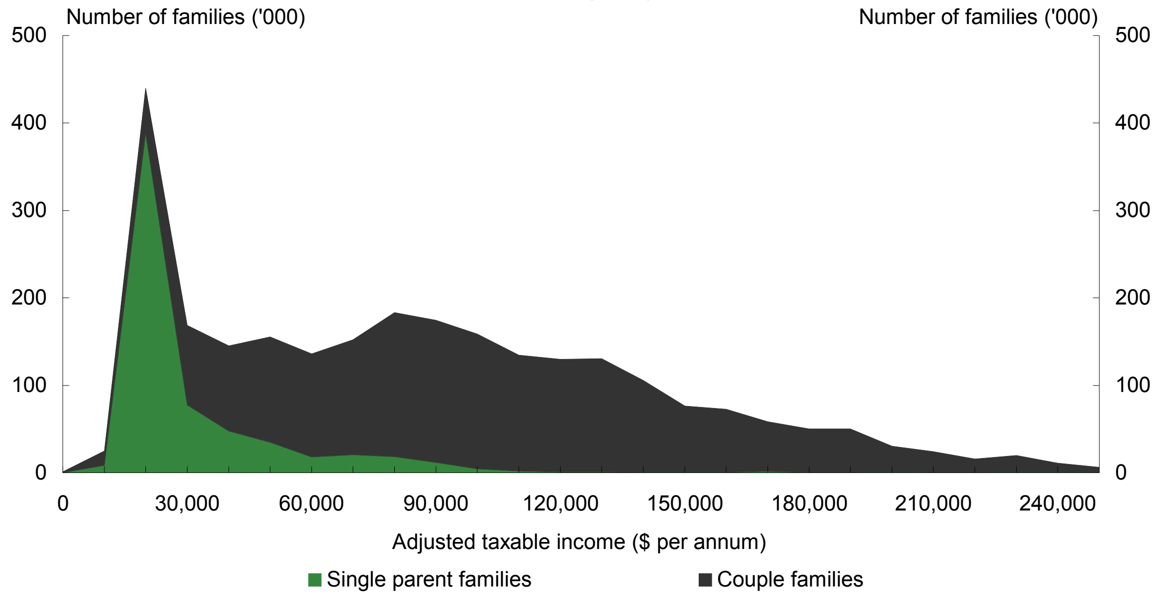
Family with two children aged 4 and 6, first earner's income fixed at $50,000 per annum



Notes: Family Tax Benefit Part A begins to withdraw at a rate of 20 per cent when family income is $44,165, while Family Tax Benefit Part B begins to withdraw at a rate of 20 per cent when the second earner's income is $4,672. The combination of these withdrawal rates, together with income tax rates, can lead to high effective marginal tax rates (EMTRs). Other taxes include the marginal tax rate, the low income tax offset and its withdrawal, and the Medicare levy shade in. Source: Treasury estimates.

While high EMTRs can be a disincentive to work, it is also important to consider the number of people actually affected by them. Chart F3-3 shows a distribution of families by income and provides an indication of the number of families who would be affected by means tests at different levels of family income.

Chart F3-3: Distribution of families by adjusted taxable income, 2009-10



Note: The chart shows an estimated distribution of families with dependent children by combined adjusted taxable income for 2009-10. The distribution of families by combined adjusted taxable income is by $10,000 increments up to the income band of $240,000 to $250,000. Adjusted taxable income includes income support.
Source: Treasury estimates.

Finding

Overlapping withdrawal rates from different family payments can increase the workforce disincentives inherent in means tested payments.

Transfer payments need to be designed in a way that supports participation, but that also recognises that some parents are participation-constrained and may still require support. For example, low-income families (including single parents), where parents are working at full capacity (though not necessarily full-time), may still require in-work assistance where their earned income is insufficient. In other families, participation of one or both parents will be limited by circumstances such as foster caring, child or adult disability.

Finding

Transfer payments need to be designed in a way that supports participation, but that also recognises that some parents are participation-constrained and may still require support.

Payments could be better targeted at the cost of children

There is much research on the direct costs of children and different ways to estimate these costs. Research generally indicates that the costs of children increase as they get older. This reflects older children's food consumption, clothing needs, the cost of other school-related items and increasing social needs.

Research also suggests that current FTB Part A rates are broadly adequate for 5–15 year olds and are more than adequate for 0–4 year olds. For 16–17 year olds, FTB Part A is significantly below the cost of children, and Youth Allowance (which offers a higher rate of assistance, with a tighter means test) also falls short of the direct cost of children.

The costs of children increase markedly at the following points in the lifecycle: starting primary school, starting secondary school and entering the final two years of secondary school. The current FTB Part A rate structure is poorly aligned to these points. Rates of assistance are unchanged on starting primary school. The higher 13–15 year old rate only begins to be paid well after most children have started secondary school. Assistance for 16-17 year olds has eroded relative to rates for younger children over the past 20 years.

While less research has been carried out on the cost of older teenage children, the research available does indicate that older teenage children cost more than younger teenage children. For example, Percival et al. (2007) found that in single-child low-income couple families a child aged 16 to 17 cost 43 per cent more than a child aged 13 to 15. These percentages are consistent with major overseas findings (Henderson et al. 1970; McClements 1978).

Table F3-2 provides estimates of the cost of children based on the cost of children research.

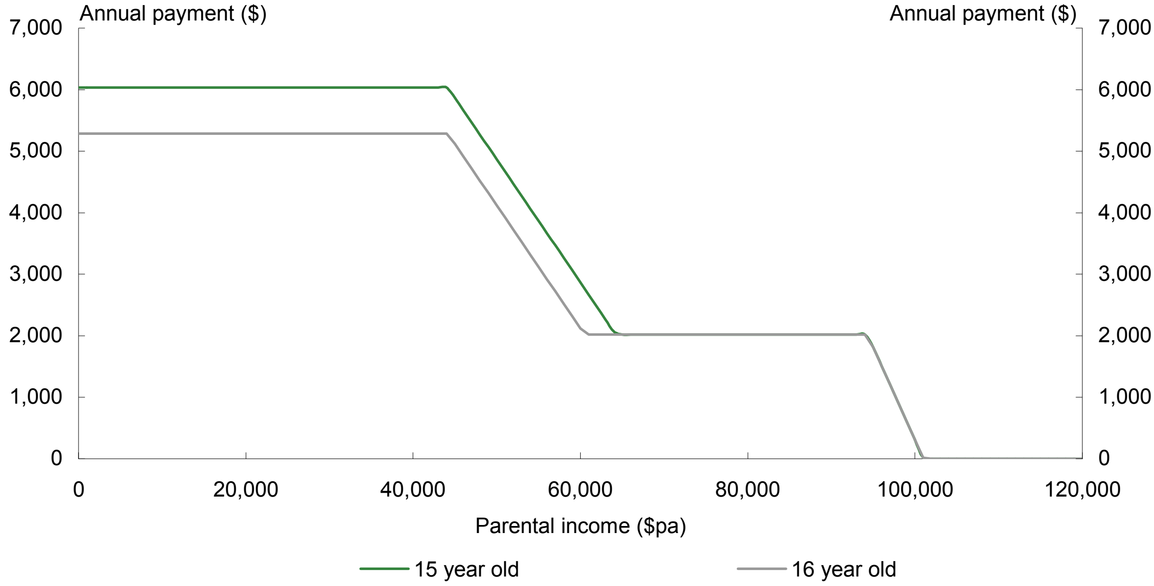
Table F3-2: Direct cost of children estimates 2008–09

Age band	Average cost in a low income family ($ per annum)
0–4	3,842.72
5–11	4,803.40
12–15	6,033.45
16–18	7,541.81

Source: FaHCSIA modelling.

The current rates of payment can result in drops in assistance as children grow older. For example, as Chart F3-4 shows, there can be a drop in payment for some families when children turn 16. This is of particular concern as the fall in payment affects low- to middle-income families where there is a greater likelihood of pressure for older children to earn money to support themselves or contribute to the family budget, rather than continuing with education.

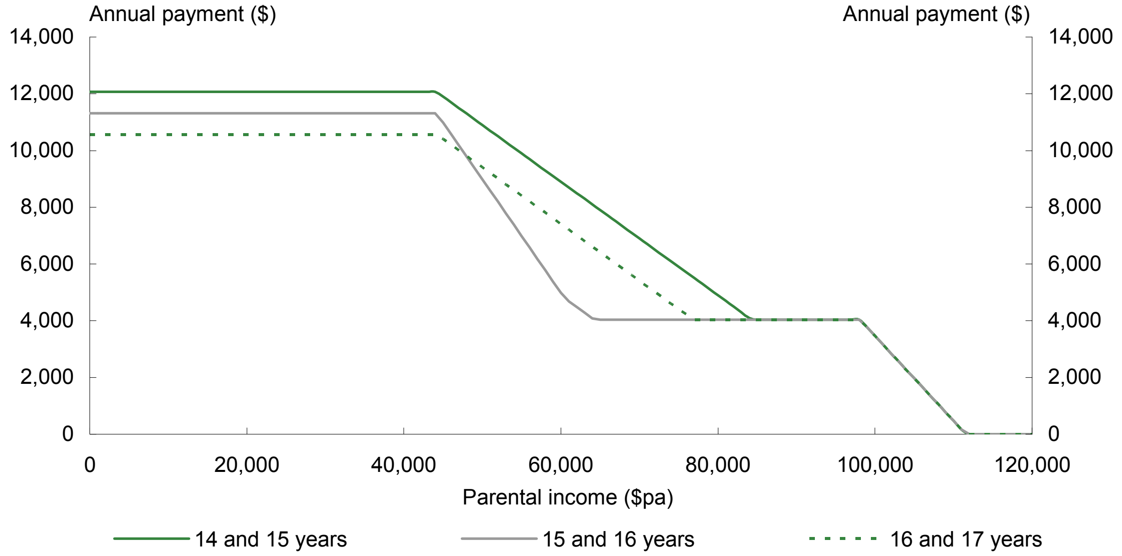
Chart F3-4: Comparison of payments for 15 and 16 year olds at home



Note: Assumes that the threshold for the Youth Allowance parental income test has been aligned with the income test threshold applying to the maximum rate of FTB Part A and that a 20 per cent family withdrawal rate applies to Youth Allowance. The rate of payment for a 16 year old in the chart is the higher of Youth Allowance and FTB Part A at different levels of parental income.
Source: Treasury estimates.

For families with dependent children receiving FTB Part A and Youth Allowance, the reductions in assistance can be larger when the oldest child turns 16, as the family experiences simultaneous reductions from the operation of two 20 per cent withdrawal rates (the FTB Part A family income test and the Youth Allowance parental income test) rather than a single 20 per cent rate. This can compromise not only the effectiveness of Youth Allowance for the older child, but also FTB Part A for younger children. Chart F3-5 provides an example of how assistance for a two-child family can change as the children become older.

Chart F3-5: Assistance to a two-child family at different ages



Note: Assumes that the threshold for the Youth Allowance parental income test has been aligned with the income test threshold applying to the maximum rate of FTB Part A and that a 20 per cent family withdrawal rate applies to Youth Allowance. The rate of payment for 16 and 17 year olds in the chart is the higher of Youth Allowance and FTB Part A at different levels of parental income.
Source: Treasury estimates.

It is easier for parents to work as children grow older, so it is reasonable that the activity requirements involve greater expectations of workforce participation on adult income support recipients as children grow older. However, the maximum rate of per-child family payment should be set so as to ensure that where parents are unable to find employment, or to earn enough to support their children, the payments are sufficient to provide for the direct costs of the child.

Infants

In addition to FTB payments, families may receive the Baby Bonus, which is provided to assist with the costs arising from the birth or adoption of a child. The Baby Bonus in effect covers more than the additional direct costs around the birth or adoption of a child and can be considered to assist with forgone income as well. The latter objective will in effect become redundant from January 2011 with the introduction of PPL.

At its current rate of $5,185 per eligible child (paid in 13 fortnightly instalments), the Baby Bonus provides a higher rate of assistance than is necessary to cover the direct costs associated with a new child.

Budget standards work and qualitative research undertaken by the Department of Families, Housing, Community Services and Indigenous Affairs (FaHCSIA) indicate that actual direct costs at birth for low-income families are around $2,000 for a first child and $1,000 for a second child. The direct costs of the second child are lower as some items acquired for the first child can be reused for the second child (although this would not always be the case depending on gender and the age gap between children).

Multiple children

In addition to FTB payments, families may receive the Large Family Supplement to compensate for additional direct costs of third and subsequent children and the Multiple Birth Allowance up to age 18 years for families that have three or more children born on the same day. However, evidence does not support the proposition that on average each additional child costs the same or more than the last.

Costs of children generally decline with the number of children in a family. A recent study found that in low-income families, the average marginal cost of the second child is around 83 per cent of those of the first. The average marginal cost of the third and fourth children were estimated to be 71 per cent and 63 per cent of the cost of the first child (Percival & Harding 2007[25]).

Other research finds that any economies achieved by families relate primarily to the additional housing cost associated with children (Henman 2005). If a child shares a bedroom, the economies are significant, but if a child is assumed to require an additional bedroom, the economies are small.

While research identifies varying degrees of economies of scale with additional children, there is no indication that the costs of additional children rise, even where housing economies are not achieved. Aspects of the current system, such as higher thresholds for

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25 These figures are based on Table 2: Estimated average costs of children in couple families, by number of children and family income, 2005–06, page 12 (Percival & Harding 2007).

larger families, Multiple Birth Allowance for children born on the same day up to 18 years of age and the Large Family Supplement are not justified by evidence of the cost of children.

Shared-care families

Children raised in shared-care families (that is, living in more than one household) generally cost more than children living only in one household. For example, the two households face similar housing costs (such as furniture) and often face additional transport costs. Family assistance does not currently recognise the additional costs of children who spend time in two households.

For families with shared-care arrangements, the financial resources available for children involve both family payments and child support transfers. Any changes to family payments, including shared-care rates, would need to be considered in the context of child support calculations.

Single parent families

FTB Part B assists single parent families with additional direct costs of managing a family as a single parent. For the most part, these additional costs relate to costs of housing. While this may be able to be dealt with in part through improvements to Rent Assistance, this does not assist single parents with additional housing costs across all tenures.

Assistance with the additional direct cost faced by single parents is warranted. The current level of FTB Part B is, however, higher than the average additional direct cost of single parents and delivers assistance to single parents up to very high incomes.

FTB Part B for single parents is less detrimental to workforce incentives than for secondary earners (given the means testing arrangements). However, it does raise issues of equity, given that the full rate of assistance is provided up to $150,000, whilst dual-income families lose FTB Part B at much lower income levels.

Housing costs and children

One of the major components of the cost of children is the housing costs parents face for each additional child. Some families achieve economies of scale through shared bedrooms, particularly for younger children and children of the same gender. However, where family payments are made on a per-child basis, not related to sibling gender or sibling ages, it is more appropriate to factor in a consistent per-child additional cost of housing per child.

Under the current arrangements, the per-child family payments are sufficient to cover the additional housing costs associated with each child. In addition, higher maximum rates of Rent Assistance apply to parents with children, which provide a more adequate level of assistance for families than the low level provided to singles and couples without children.

Housing costs associated with children are best taken account of through a per-child family payment, rather than through a housing assistance payment. However, housing assistance payments for parents in rental housing would need to be sufficient to ensure that child payments are not required to cross-subsidise assistance for parents with housing costs (see Section F5 Housing assistance).

Using family payments to assist with the cost of housing associated with children has a number of advantages. Child-related housing assistance is paid to parents irrespective of their housing tenure, that is, whether they rent privately or publicly, and whether they own or are purchasing their own home. Providing housing assistance in this way ensures that the marginal cost of housing associated with children is also provided to those with mortgage costs. The simplest way to do this is through the family payments system.

Findings

Current rates of assistance generally reflect the direct costs of children, but not in all circumstances, and particularly not for older children. FTB Part A rates are broadly adequate for 5–15 year olds and are more than adequate for 0–4 year olds. For 16–17 year olds, FTB Part A is significantly below the cost of children, and Youth Allowance also falls short of the direct cost of children.

Payments that provide additional assistance to larger families are inconsistent with evidence that suggests that the incremental cost of each additional child in a family is not on average more than the cost of the first child.

Shared-care families face higher per-child costs than couple families.

Housing costs associated with children are best taken account of through a per-child family payment, rather than through a housing assistance payment.

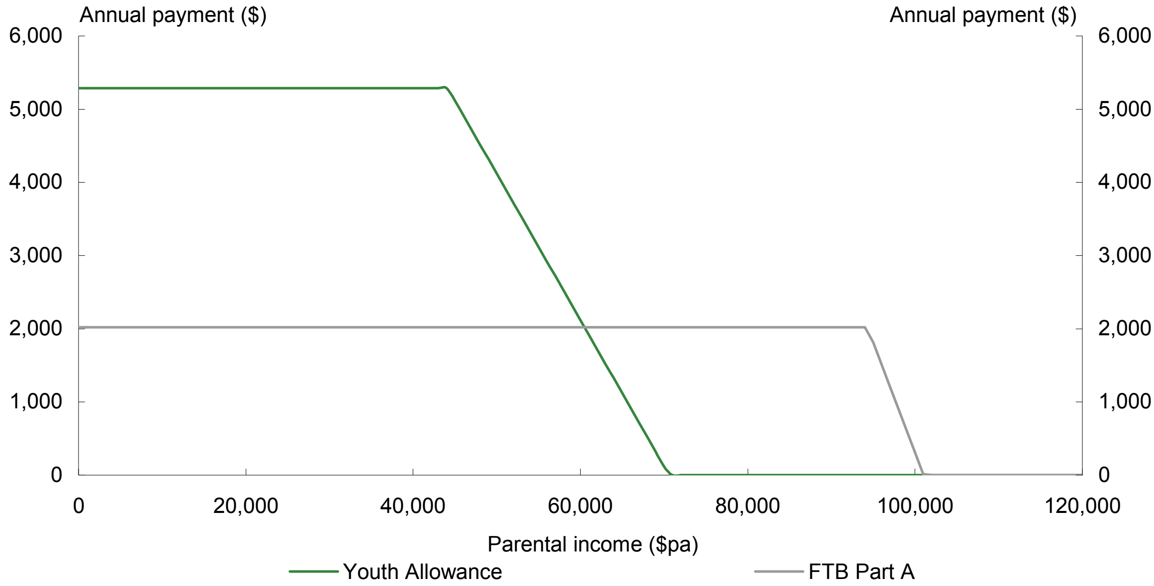
Older children and their families face complex choices

When a dependent child reaches 16 years, income support — generally in the form of Youth Allowance, ABSTUDY living allowance, or Disability Support Pension — becomes available. Significant changes to the assistance available to older children and youths were announced by the Australian Government in the 2009–10 Budget. Participation requirements will be introduced for FTB Part A children aged 16–20 from 1 January 2010.

There are still areas of concern, particularly relating to the interaction of FTB Part A and Youth Allowance. Youth Allowance is the primary form of government assistance for young people who are independent or who come from low- to middle-income families. While FTB Part A remains available to parents of dependent 16–20 year olds and full-time students aged 21–24, the maximum rates of assistance are significantly lower.

Differences in payment rates and the existence of the more generous income test on the base rate for FTB Part A, means that there is a point on the income spectrum where one payment becomes more attractive than the other. Chart F3-6 illustrates this for a family with a 16 year old at home.

Chart F3-6: Comparison of FTB Part A and Youth Allowance for a 16 year old dependent child at home



Note: Assumes that the threshold for the Youth Allowance parental income test has been aligned with the income test threshold applying to the maximum rate of FTB Part A and that a 20 per cent family withdrawal rate applies to Youth Allowance.
Source: Treasury estimates.

The existence of two payments for youths in identical circumstances but different parental income levels creates complexity. FTB Part A and Youth Allowance are not only paid at different rates but also have different parental means testing and personal income testing arrangements that use different periods of assessment and definitions of income. For many families, the payment that provides them with greater assistance will change over time as children age, parental income fluctuates or payment parameters and assessment periods change.

The choice families make is complicated further because of additional forms of assistance related to the receipt of FTB Part A and Youth Allowance. For example, families receiving FTB Part A may also be eligible for FTB Part B[26], whereas FTB Part B cannot be received for similarly aged Youth Allowance children in full-time study. To ensure that they receive the maximum amount of available assistance, people must know a great deal about the payment system and must be able to accurately predict family, second earner and child income.

The choice between payments is a concern for all age groups where both FTB Part A and Youth Allowance are available, although the complexity involved in this choice can vary. For example, at most income levels, Youth Allowance will provide a higher payment for families with multiple children eligible for Youth Allowance.[27] The lowering of the age of independence to 22 by 2012 will result in FTB Part A for 22-24 year olds becoming irrelevant.

26 FTB-B is available (subject to the income tests) for families with a child aged under 16. If the child is aged over 16, it is available until the end of the calendar year the child turns 18.

27 This assumes that the changes to the Youth Allowance parental income test occur and that families are not affected by the family assets test or Family Actual Means Test (FAMT). The FAMT applies where a parent's income used for the Youth Allowance parental income test is deemed to be an insufficient measure of the means available to the family. The FAMT can apply even where a parent receives an income support payment.

Finding

For 16–24 year olds, there can be a complex choice between payments with the higher rate of support dependent on a number of factors. This can be confusing for those making choices about which payment to apply for.

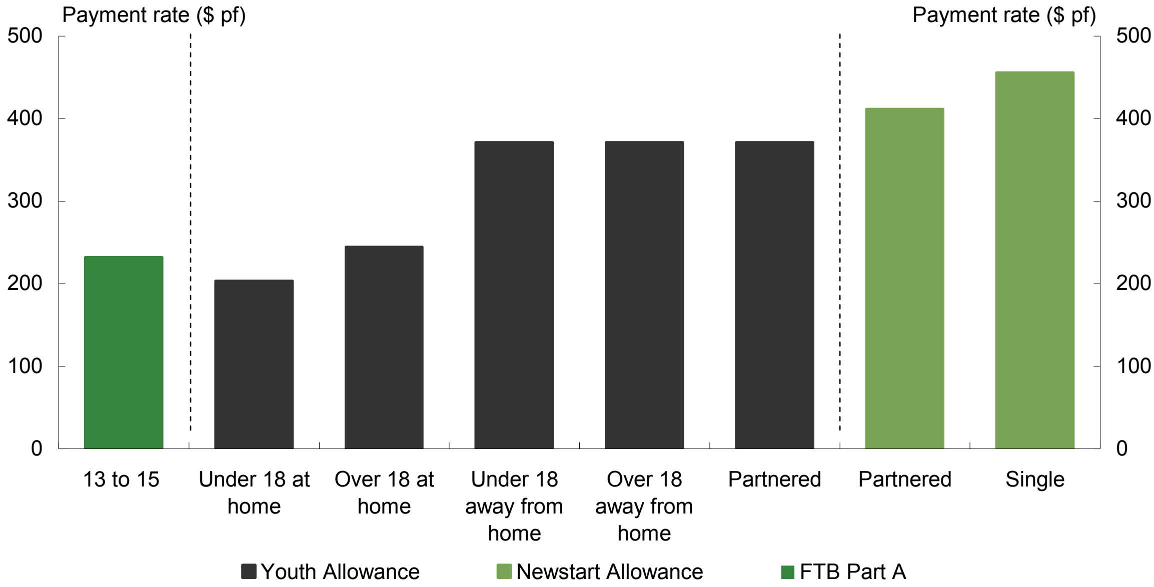
Youth payments are not always coherent with the system

The rates of payments to young people reflect the fact that those people have lesser needs than adults. Chart F3-7 shows that the current rates for Youth Allowance can vary to account for differences in age and living circumstances, but they are not always coherent with other parts of the tax and transfer system. For example, the rate of Youth Allowance for those 18 and over at home is slightly higher than the FTB Part A rate for 13–15 year olds, but the Youth Allowance rate for those under 18 at home is lower.

The higher rate for youths living away from home reflects the fact that youths living at home have lower accommodation costs. For recipients without dependent children, the current rates of Youth Allowance are also lower than the rates of Newstart Allowance. The rate for single young people living away from home is the same as the rate for partnered young people.

Chart F3-7: Youth rates of payment

Maximum fortnightly rates of Youth Allowance compared to Newstart Allowance and FTB Part A



Note: Payment rates are current as at 20 September 2009. The rates of payment shown in the chart are for recipients without dependent children. The fortnightly rate for FTB Part A for 13 to 15 year olds includes the FTB Part A supplement.
Source: Australian government administrative data.

Higher rates of Youth Allowance are available to recipients with dependent children. In contrast to those without dependent children, for both single and partnered people with dependent children, the rates of Youth Allowance are similar to equivalent Newstart Allowance rates.

Youths with a disability may be eligible for Disability Support Pension (DSP) paid at rates equivalent to Youth Allowance plus a Youth Disability Supplement. Young disability support pensioners with children receive adult rates of DSP. Young people with a partial capacity to work who live away from home are paid at adult Newstart Allowance rates, while those living at home are paid youth DSP rates.

While the maximum rates of payment do not depend on the independence of the recipient, non-independent youths are subject to a parental income test. A person is regarded as independent if they are unable to live at home, have a partial capacity to work, are married or in a marriage-type relationship, have a dependent child, have satisfied workforce participation criteria or have reached the 'age of independence'. The age of independence for a non-full-time student is 21. For a full-time student it is 25, but the Australian Government has announced that this will be progressively reduced until it reaches 22.

Findings

Youth payment rates should reflect the fact that young people in different living arrangements and personal circumstances have different needs. Young people living away from home have higher costs than those living at home.

Current youth payments could be made more coherent with other parts of the tax and transfer system.

F3-3 Reform directions — a single family payment and refined youth support

Recommendation 90:

Current family payments, including Family Tax Benefit Parts A and B, should be replaced by a single family payment. The new family payment should:

(a) cover the direct costs of children in a low-income family (that is, the costs associated with food, clothing, housing, education expenses); and

(b) assist parents nurturing young children to balance work and family responsibilities.

Recommendation 91:

The direct cost of children component of family assistance should be a per child payment.

(a) Rates of payment should increase with the age of the children to recognise the higher costs of older children. Three rates of payment should apply: for 0–11 year olds; 12–15 year olds; and 16–18 year olds while in secondary school. These age bands would appropriately accommodate the increasing costs of children (this would require higher payments rates for 12, 16 and 17 year olds). The Baby Bonus should be abolished and a small supplementary payment, reflecting the direct costs of a new-born baby, should be paid over the first three months.

(b) A shared-care rate to recognise the higher costs of separated families should be considered, taking into account interactions with child support as well as other income support payments.

(c) Additional payments for larger families, including the Large Family Supplement, the Multiple Birth Allowance for children over one year, and higher thresholds for larger families should be reconsidered as the case for these payments is not strong.

Recommendation 92:

A supplement for parents nurturing young children (aged under six years) should be provided as a per-family payment, means tested on family income in addition to the recently announced Paid Parental Leave arrangements.

(a) The maximum rate of the supplement should be set such that the total support for single parents wholly reliant on income support is equivalent to the maximum rate of pension.

Recommendation 93:

For single parents with children aged six or older, a parental supplement (which should be considerably smaller than under Recommendation 92), should be paid through the family payment system.

Recommendation 94:

For couples with children aged six or older, a parental supplement at the same rate as for single parents should be paid through the income support system (see Section A1 Personal income tax).

Recommendation 95:

Assistance for families should also recognise that there are specific circumstances, such as parents caring for disabled children and foster care children with higher needs, for which additional support beyond the early years is appropriate.

Recommendation 96:

The total amount of family assistance should be withdrawn with a single means test to avoid cumulative withdrawal rates which create unnecessarily high disincentives for working. A single low taper rate of 15–20 per cent would be appropriate to minimise workforce disincentives.

Recommendation 97:

While family payments should be the main form of assistance for families with children up to the end of secondary school, or the school year in which they turn 18 (the earlier of the two), youth payments should be available to older children in some circumstances.

(a) Dependent older children for whom a suitable pathway may be leaving school and looking for work or combining part-time work and part-time study should have access to a youth payment, governed by strict participation requirements.

(b) Children without access to financial support from their families should continue to have access to a youth payment, governed by strict criteria.

Recommendation 98:

Youth payments should be the main form of income support from the age of 18 until the age of independence.

(a) Family payments should not be provided for those aged 18 and over unless they are completing secondary school in the year they turn 18.

(b) Youth payment rates should reflect the fact that most young people have lower needs than adults but need adequate assistance to participate in education and training.

(c) Dependent youth payment recipients should be subject to a parental income test consistent with that applying to family payments. Family means tests should be designed so that families with dependent children in both the family payments and youth payments system are not disadvantaged.

(d) The age of independence should be aligned for full-time students and non full-time students.

A single family payment for the direct costs of children

Age of child and rate

Rates of assistance for family payments should be guided by evidence of the direct costs of children; that is, the out-of-pocket expenses that parents incur in providing food, clothing, housing and other items necessary for the development of their children. These costs are distinct from the indirect costs that parents incur as a result of being responsible for children, such as income forgone because their availability to work is reduced by the need to care for children.

A three-tiered approach with increasing rates for 0–11 year olds, 12–15 year olds and 16–17 year olds (including 18 year olds in secondary school) would appropriately and simply reflect the changing costs of children as they grow older. These ages also broadly reflect the ages of transition in the education system. While the cost of 0–4 year olds is generally below the cost of 5–11 year olds, the difference may not be sufficient to warrant a separate rate.

The Baby Bonus does not reflect the additional direct costs of children at birth, because in effect it includes an element of income replacement. With the introduction of PPL, the Baby Bonus should be abolished and a small supplementary payment, reflecting the average direct costs of a new born, should be paid over the first three months as part of the per child family payment (including to those receiving PPL).

Abolition of multiple child add-ons

While costs of children studies indicate varying degrees of economies of scale, additional children do not cost more than the first child. It is therefore more appropriate to provide per-child assistance that does not increase with additional children.

Shared-care rates

The costs of children in shared-care families are higher than for those in families where parents cohabit. To provide the same level of support for children in shared-care households, it would be necessary to provide a slightly higher rate of family assistance.

Child support arrangements are built around the current family payments arrangement. As such, any change to family payments would need to be considered in the context of child support calculations.

Higher rate of assistance for parents with young children

Government payments have a role in ensuring that the choice to spend time out of the workforce to care for young children is not unduly constrained by financial need. PPL provides a strong signal that an absence from employment at this time is an appropriate choice and provides an alternative source of income for primary carers after the birth of a child.

Beyond the immediate post-birth period covered by PPL, up to when the youngest child turns six years of age, low- to middle-income families should be paid a supplement as part of family assistance, subject to the family payment means test in order to assist parents to balance work and family responsibilities.

The maximum pension rate is the appropriate benchmark payment rate for single parents with young children. The parental supplement should be set to ensure that a single parent with young children on the participation payment receives a combined amount equivalent to the maximum pension rate. The couple rate should be set at the same rate as that for single parents.

Supporting parents with children six years and over

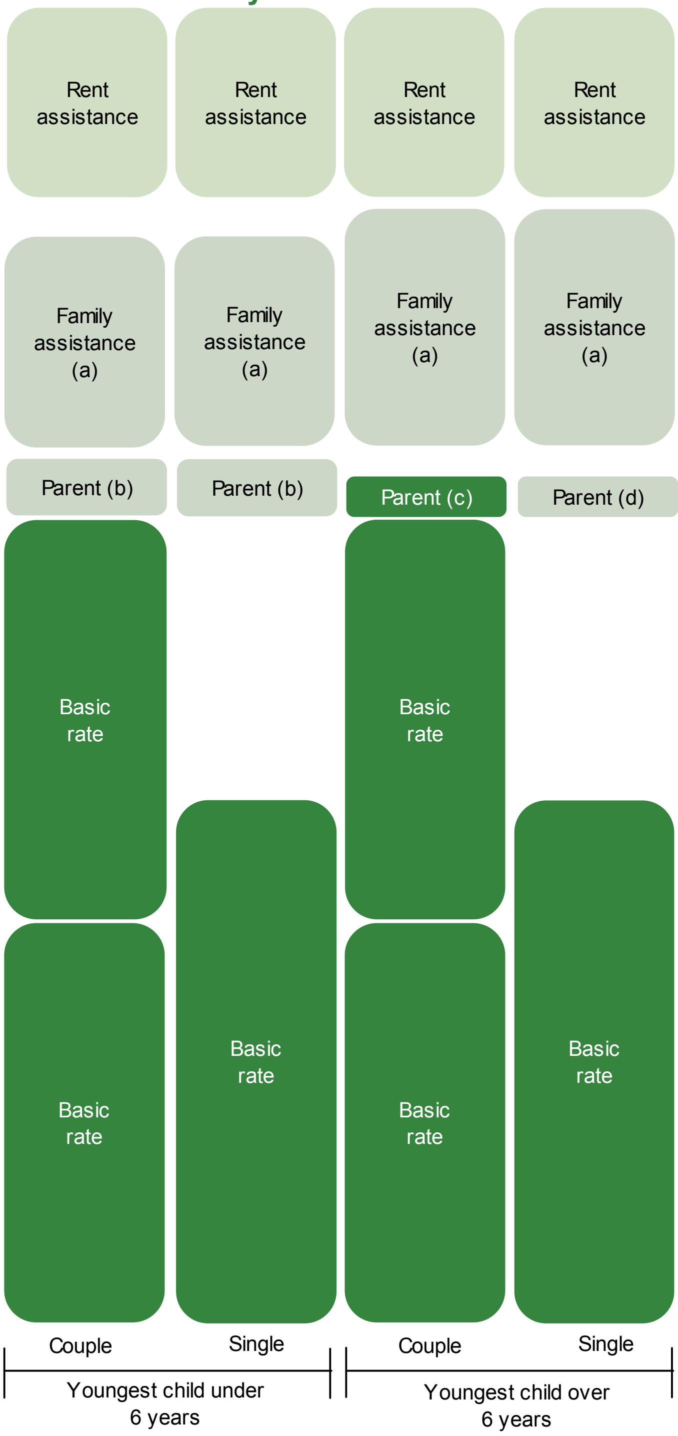
Supplementary parental support should be provided to parents with youngest children aged six years and over, to raise the level of adult income support payments above the rate of those without children. This reflects the need to ensure that the total support provided to families delivers a higher rate of adequacy, but at a lower rate to that provided for parents with younger children.

For partnered parents, the supplement should be provided through the income support system and withdrawn with income support payments. This recognises that the combined withdrawal of two income support payments occurs well above the minimum wage and close to the average wage.

For single parents, the supplement should be provided through the family payment system and withdrawn with family payments to extend the income range over which the supplement is available.

The proposed payment structure for families, including the arrangements for the Parent Supplement are outlined in Chart F3-8 and Table F3-3.

Chart F3-8: Payment structure for families



(a) Assistance with the direct costs of children.
(b) Additional parental supplement where the youngest child is under six years, paid as part of the family payment and means tests with the family payment.
(c) Smaller parental supplement for couple parents where the youngest child is over six years, paid as part of income support.
(d) Smaller parental supplement for single parents where the youngest child is over six years, paid as part of the family payment and means tests with the family payment.

Table F3-3: Parent Supplement arrangements

	Youngest child under aged six years	Youngest child aged six years or older
Single parent family	Higher rate of supplement (equivalent to gap between allowance and pension rates) Paid as part of family assistance Means tested on family income.	Lower rate of supplement (set at, for example, half the higher rate) Paid as part of family assistance Means tested on family income
Couple family	Higher rate of supplement (equal to single parent rate) Paid as part of family assistance Means tested on family income.	Lower rate of supplement (equal to single parent rate) Paid as part of income support Means tested on personal and partner income.

Parents with older children in special circumstances

Assistance should also be provided in other specific circumstances, such as parents caring for children at older ages with high needs, including some children with disability, and foster care children (taking into account interactions with existing support for these groups).

Education Tax Refund

The Education Tax Refund (ETR) was introduced as a refundable offset to assist certain prescribed education expenses. (See Annex A1 Concessional offsets in detail).

As with any payment that is linked to receipt of other payments (in this case FTB Part A), the ETR creates a sudden death cut out and results in very high (over 100 per cent) effective tax rates at the point at which the main payment (FTB Part A) is extinguished. In addition, as a tax refund, there is a time lag for payment.

Recommendation 6c (see Section A1 Personal income tax) is that the ETR should be removed from the personal tax system and replaced with automatic advance payments through the family payment system at the beginning of each school semester.

Assistance for youth

Family payments should apply when children are under the primary care of their parents; that is, both financially dependent and reliant on their parents for day-to-day needs. As the majority of children progress through secondary education and go on to complete Year 12, it is appropriate that family payments continue to be the primary form of assistance for children up to the end of secondary school or the school year in which they turn 18 (the earlier of the two). Youth income support payments (including Disability Support Pension for young people) should generally become available from this time.

There are older dependent children for whom a suitable pathway may be leaving school before Year 12 and looking for work or combining part-time work and part-time study. In these circumstances, it would be appropriate for a youth payment to be available, with eligibility governed by strict participation requirements. There are also older children who do not have access to support from their family. Youth payments, governed by strict independence criteria, should also be available for these older children. Although this would mean having two payments for older children, there would be no need to make a choice between payments, as the applicable payment would be determined by the activities of the child.

Youth payment rates should reflect the fact that young people generally have lower needs than adults, but should be sufficient to support investment in education, training and other capability-building activities (including combining part-time work and part-time study). Youth rates should not create inappropriate incentives for young people to leave full-time study prematurely and should not favour unemployment over education and training. The rates of payment must make further study practical for those from disadvantaged backgrounds.

The future arrangements for youth payments should build on aspects of the current system, but with some changes that would improve coherence with other aspects of the tax and transfer system:

- Assistance for youths should have an 'at home' rate and an 'away from home' rate. The at home rate for youth payment recipients under 18 should be aligned with family payment rates to avoid providing incentives to leave education or training. The at home rate should be higher for youths 18 and over. Away from home rates should not create inappropriate incentives for young people to leave home prematurely. Consistent with adult rates of income support, away from home rates should reflect the fact that that partnered youths have lower costs than single youths.

- The same rate should be paid to dependent and independent young people with similar living arrangements. While all youth payment recipients should be subject to a personal income test, dependent young people should also be subject to a parental income test. This parental income test should be broadly consistent with that which applies to family payments. To avoid reductions in assistance for families with both family payment and youth payment recipients, one option is to operate the two means tests consecutively, with the youth payment parental income test operating after the family payment income test.

- Young pensioners (including Disability Support Pensioners) have a greater need for assistance than other young people, but have lower needs than adult pensioners. A youth rate structure for pensions minimises inappropriate incentives for young people to claim these payments. To maintain system coherence, the relativity between adult rates of pension and participation payments should be reflected in the youth rate structure.

- While young people generally have lower needs than adults, some young people have adult responsibilities and face similar costs as adults. The payment of lower youth rates to young parents would result in these families having a lower standard of living than other families. Assistance for young parents should therefore be aligned with that for adults to avoid compromising the welfare of dependent children.

- Youth payments should be the main form of income support from the age of 18 until the age of independence. The current age of independence for a non-full-time student is 21 while the Australian Government has announced that the age of independence for full-time students will be progressively reduced to 22. The age of independence should be aligned in the future at 21.

F4. Child care assistance

Key points

Child care assistance should facilitate workforce participation of parents and support the development of children, particularly those from disadvantaged backgrounds.

Child care assistance should in most cases be provided as transfers to parents rather than subsidies to child care providers. The current child care payment structure could be simpler and more transparent.

Child Care Benefit and Child Care Rebate should be combined into a single payment to parents (or to child care centres in respect of each child) based on a percentage of out-of-pocket costs. This payment should be structured so that low-income families would be required to make a small co-payment. The payment should be means tested, but a base rate of assistance should be available to all families. The base rate of assistance should be linked to the marginal rate of tax faced by the majority of taxpayers.

F4-1 What is the role of child care assistance?

Assistance to access high-quality and affordable child care is important to the workforce participation of parents, providing them with the means to support and provide opportunities for their children. This is particularly important given the expected large increase in the dependency ratio — the number of people aged 65 and over per 100 workers — due to population ageing. All societies will need to ensure that the tax and transfer system does not unduly discourage workforce participation, particularly for parents returning to work after the birth of a child. The availability of affordable child care is more significant for women's than men's participation, given that women still undertake a greater role in caring for children in the home.

Access to quality child care also plays a role in early childhood development, particularly of children from families experiencing, or at risk of experiencing, social exclusion.

Child care and workforce participation

Australian families are increasingly balancing work and family responsibilities. The workforce participation rate of secondary earners, who in most cases are women, has risen steadily over the past few decades. Between 1982 and 2007 the participation rate of mothers with a youngest child aged 0 to 4 years increased from 29 per cent to 51 per cent. For mothers with a youngest child aged 5 to 9 years the rate increased from 51 per cent to 75 per cent. Of mothers in paid work prior to childbirth, 74 per cent return to work within 18 months of the birth, although mothers on lower wages are less likely to return to work within 18 months than those returning to average or higher-paying employment. Many mothers returning to work do so through part-time employment (Productivity Commission 2009b). These trends are broadly consistent with experience in other OECD countries.

As noted in the discussion on family assistance (see Section F3 Family and youth assistance), the value of parental care of children relative to the value of parental attachment to the workforce varies with the age of the child. Parental care is particularly important when the child is very young. The Productivity Commission's report on paid parental leave found that for the first six months it is significantly beneficial for the child and the mother to be together at home, with a reasonable prospect that longer periods (of up to 9 to 12 months) are also beneficial (Productivity Commission 2009b).

The OECD (2007c) notes that longer absences from the workforce can influence a mother's longer-term employment prospects. In this period, connection (or reconnection) with the workforce can become important. A system that supports parents to balance caring responsibilities with participation is important to social and economic outcomes for parents and their children.

For parents who need to use child care in order to work, child care is a cost of employment. The costs of child care may mean that parents receive minimal financial returns from returning to work in the short term — even though the long-term gains for parents, children and society more broadly from continued engagement with the workforce are much greater. Providing assistance so that parents can access good quality and affordable child care can help overcome these barriers to workforce participation.

Child care and early childhood development

The role of child care in early childhood development is a contested area of research and public policy debate. Much of the evidence is drawn from studies conducted in North America that focus on extensive interventions targeted at specific groups, including children from families with very low incomes.

While noting these caveats, the broad conclusions from the literature are that the quality of care makes a significant difference to outcomes and that children aged over two years experience positive outcomes from quality child care (although very long hours in care may be detrimental). For younger children, the outcomes are mixed and depend heavily on quality of care, hours in care and the home environment (that is, poor home environments mean better comparative outcomes for those children in child care).

Access to quality child care is particularly important in supporting the development of children from families experiencing, or at risk of experiencing, social exclusion. This can include children from jobless or low-income families, Indigenous children, children from minority cultural or linguistic backgrounds and children with a disability. For such children, evidence suggests that quality child care can lead to significantly better outcomes than no child care (COAG 2009). Making child care available to these children can not only assist their development and help them adjust to school, it can also help their parents take advantage of opportunities for economic and social participation.

Principle

Child care assistance should aim to facilitate workforce participation of parents and to support the development of children, particularly those from disadvantaged backgrounds.

How should assistance for child care be provided?

Funding parents versus funding providers

Government assistance with the costs of formal child care could be delivered by directly subsidising child care providers (including government-owned providers) or by providing payments directly to parents (consumers of child care). In the current system, the majority of assistance is provided to parents (or on behalf of parents) through a voucher-like payment.

There are a number of advantages to this approach. Providing parents with the resources to access child care services allows parental needs to drive where child care centres are established and the type of care available. The government does not have to determine where child care centres should be located or which ones should receive additional funding. Providing funding directly to parents allows for better targeting of assistance to particular groups of parents and children based on their individual characteristics.

Subsidising child care providers directly can be appropriate where the costs of establishing and running centres are so high that even after assistance to parents has been provided, a market does not emerge; or where there are strong social benefits to children or parents. For example, providing subsidies to providers may be appropriate in geographically remote areas.

While parents are usually best placed to decide how much and what type of child care is best for their children, there are some aspects of the quality of child care and its impacts on child development that parents may not be able to assess as well as government regulators. The choices parents make about child care therefore need to be combined with appropriate quality standards. Governments are best placed to make decisions about mandatory qualifications for child care staff and about health and safety standards for centres. They are best able to gather, assess and distribute information on service provision and, where necessary, adjust standards.

Higher-quality standards increase the costs of child care and consequently the participation choices of parents. It is therefore important that the benefits of setting standards are clear and outweigh the impact that higher costs will have on the ability of families to access child care.

Principle

Child care assistance generally should be provided as transfers to parents (or on behalf of parents) rather than subsidies to child care providers. Governments have a role in setting quality standards and ensuring that good information on child care services is available to parents.

Targeting assistance

To facilitate workforce participation and improve early childhood development, parents and children in different circumstances will require different amounts of assistance.

For low-income families, assistance with the cost of child care plays a significant role in facilitating workforce participation, a key factor for some families in breaking out of the cycle of poverty. This suggests that relatively more assistance should be provided to families with lower incomes.

Even at higher income levels, however, the tax and transfer system impacts on the benefits of working relative to the benefits of not working (including the choice to care for children at home). The current system includes a number of biases against paid work because of the taxation of wage income, the removal of benefits as income increases and the availability of government payments as a substitute for paid work.

The combination of these objectives suggests that the amount of child care assistance should be higher at low income levels and means tested as income increases, but that a base level of assistance should be provided across the income spectrum to facilitate participation. Given the policy rationale of providing assistance to facilitate participation, the base level of assistance should be provided with a participation requirement — that is, on the condition that single parents or both parents in couple families are participating in work, education or training.

For low-income families in particular, there is an additional objective of enhancing child development, and some child care assistance should be provided without a participation requirement. The number of hours of assistance available without a participation requirement should be limited. This could, for example, be set with regard to the number of hours available of universal pre-school that are available.

Assistance to parents could be provided as a transfer or as a tax deduction — recognising that child care is a cost of employment. Providing assistance as a tax deduction would not always assist low-income families, as many are not taxpayers and, where they are, the delay in assistance would significantly reduce the benefit of the assistance. For low-income families, assistance therefore needs to be provided as a transfer payment.

In terms of administration and compliance costs, it is likely to be simpler to provide assistance through a single mechanism in the transfer system, rather than through a tax deduction and transfer payment — although the rates of payment should be set with reference to the value that a tax deduction would provide.

A separate question is whose income should be used as the basis of the means test: should it be the combined family income or the income of the secondary earner? While the combined family income is a better proxy for a child's social circumstances, it is the secondary earner's work decisions that are likely to be impacted to a greater extent by child care costs.

Application of a family income is consistent with means testing arrangements for family payments and could be applied for child care. If a base rate of assistance was provided, a family income means test would still ensure that low-income secondary earners could receive some level of assistance, regardless of primary earner income. A measure of taxable income should be used as the basis for assessment (consistent with family payments).

While it is important for low-income families to be able to access quality and affordable child care, it is appropriate that they make at least a small co-payment towards the cost of child care. The existence of a price signal reduces the risk of parents taking up child care places when they are not needed.

In some circumstances, particularly for at-risk or vulnerable children with multiple disadvantages, it will be appropriate to cover the full costs of care to actively encourage the use of child care. It would not be appropriate to provide this rate of assistance based on family income alone: better measures of disadvantage may come from the health, community services or child protection systems. Other special circumstances (including grandparents caring for children and children in foster care) will also warrant non-means tested support.

Principles

Higher levels of child care assistance should be provided to low-income families. To recognise that child care costs are a cost of producing income, a minimum universal level of assistance should be available.

Child care assistance is more effectively provided through the payments system rather than through a tax deduction. Assistance should be means tested using a measure of family taxable income.

Requiring at least a small co-payment for low-income families reduces the risk of parents taking up child care places when they are not needed. In some cases, particularly for at-risk or vulnerable children with multiple disadvantages, it may be appropriate to cover the full costs of care.

F4-2 Current arrangements are complex and could be better balanced

The majority of child care assistance currently provided by the Australian government is in the form of payments to (or through) families to assist with the cost of care. There are two main child care payments: Child Care Benefit (CCB) and Child Care Rebate (CCR).

- CCB is a means tested payment per hour rate of assistance. The CCB rate for an hour of care is determined by a combination of factors including family income, the number of children in care, the number of hours used, whether the children attend school and the type of child care used.
- CCR covers 50 per cent of out-of-pocket expenses for approved child care; that is, 50 per cent of the amount of the fee *less* any entitlement to CCB and Jobs, Education and Training Child Care Fee Assistance. CCR is paid quarterly and has a maximum annual value of $7,778 per child in 2009–10.

Other child care assistance is provided through payments such as Jobs, Education and Training Child Care Fee Assistance, which provides help for parents undertaking job search, work, study or rehabilitation; and the Child Care Services Support Program, which provides payments to child care services to meet a number of objectives, including the provision of services to children with ongoing high support needs.

There is also a fringe benefits tax (FBT) exemption for child care facilities provided on an employer's business premises for the benefit of employees. Salary sacrificed payments for child care (from pre-tax income) or employer subsidised child care are not subject to tax in the hands of the employee or the employer.

Employers can allow employees to salary sacrifice the cost of their child care, or child care may be provided as part of a remuneration package. This is equivalent to providing a tax deduction, but only to a narrow group of parents given the condition that the child care facilities are provided on the employer's business premises for the benefit of employees.

Given that CCR provides a rebate for 50 per cent of out-of-pocket expenses up to a maximum of $7,778 per child for 2009–10, the FBT exemption provides a greater level of assistance only for families with very high child care costs on either the top marginal tax rate or second top marginal tax rate.

The FBT exemption for child care provides a higher rate of assistance for taxpayers earning over $180,000 and incurring child care costs over $16,727 ($64.33 per day in full-time care). Taxpayers with incomes lower than $180,000 would need to be incurring costs in excess of $19,691 to receive a higher rate of assistance from the FBT exemption, although that figure is accurate only for those taxpayers with incomes close to $180,000 because as a taxpayer's income begins to fall below $180,000, any benefit from the FBT exemption falls exponentially due to lower marginal tax rates and higher entitlement to the means tested CCB.

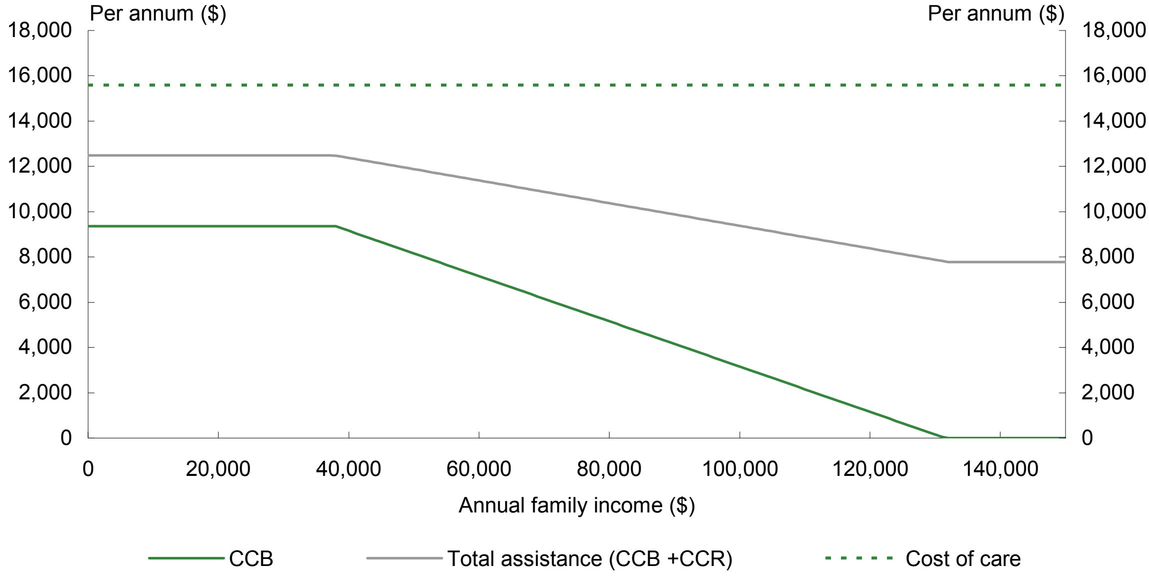
Further, while CCB and CCR are conditional on child care being provided by regulated providers for quality assurance purposes, these important conditions do not apply to the FBT exemption.

Australian government expenditure on child care has risen from around $2.6 billion in 2007-08 to a projected $3.6 billion in 2009–10. This reflects an increasing demand for child care services and policy changes that increase the level of assistance, most notably the increase in the CCR from 30 per cent to 50 per cent in 2008–09.

Chart F4-1 shows how assistance for child care changes as family income increases. For a given weekly fee, out-of-pocket costs increase as CCB is withdrawn. As CCR covers 50 per cent of out-of-pocket expenses, it provides relatively more assistance as CCB is withdrawn.

Chart F4-1: Child care assistance, 2009–10

One child in full-time care (50 hours per week) assuming a weekly fee of $300 per week



Note: Assumes that the child is in approved care and not of school age and that the child care fee is constant across all income levels.
Source: Treasury estimates.

The example presented in Chart F4-1 shows that, in combination, CCB and CCR cover the majority of child care fees for a low-income family. This result, however, depends on the child care fees: out-of-pocket costs will be higher if child care fees are higher. There is wide variation in child care fees across Australia, with fees in metropolitan areas significantly higher than fees in regional and remote areas (Australian Government 2009a).

Complexity in the calculation and delivery of payments

Current arrangements for child care assistance can be complex for parents, providers and administrators. The calculation of CCB is particularly complicated as the standard hourly rate can differ based on the type of care, whether the care is part-time or full-time, the number and ages of children a family has in care and whether the care is work-related. While tailoring assistance to particular groups is important, it comes at the cost of additional complexity. This can make it difficult for parents and providers to interact with the system and may deter them from doing so.

The existence of two child care payments and the way they interact can also add to complexity. The current system of child care assistance includes a payment that provides a dollar amount per hour of care (CCB) and a fixed proportional out-of-pocket child care expenses (CCR). The 'hourly rate' payment is means tested while the 'out-of-pocket assistance' payment is not, so that the former provides relatively more assistance to low-income earners and the latter provides relatively more assistance to high-income earners.

Sustainability of current payments

Although the maximum rates of CCB are indexed to CPI, in recent years child care fees have generally increased at a faster rate than CPI. If this trend were to continue, the proportion of child care costs covered by CCB would decline over time. In contrast, an out-of-pocket assistance payment, such as CCR, automatically adjusts to cover price increases (up to the maximum rate of CCR). Over time, this would shift the relative weight of child care assistance away from low-income families and create a flatter rate of child care assistance across the income spectrum.

The use of a pure hourly rate payment can result in the rate of assistance not automatically moving with increases in the cost of child care from year to year, particularly where child care prices rise at a faster rate than CPI. In addition, an hourly rate payment is not responsive to fee differences across service types and locations, which is a feature of the Australian system. As higher-quality care may also come at a higher cost, a flat hourly rate may constrain the use of high-quality care by low-income families.

While assistance provided as a proportion of out-of-pocket costs can help overcome these issues, it may put more pressure on child care fees and government expenditure, particularly if the supply of child care providers is constrained. Putting a dollar amount cap on the out-of-pocket assistance — as is currently done with CCR — can ameliorate these effects.

The sustainability of current payments also needs to be considered in the context of the proposed Council of Australian Governments (COAG) reforms that aim to improve quality standards in child care through the National Quality Agenda by introducing a new National Quality Standard and a new unified national regulatory environment. Over time, these reforms will increase staff qualification requirements and staff-to-child ratios, and these changes are expected to flow through to higher prices for child care.

In the absence of these reforms, child care prices would be likely to rise as a result of State-based changes to child care standards. Victoria has recently legislated improved quality standards. New South Wales, South Australia and the Northern Territory have announced similar intentions. Streamlining the regulation of the sector by moving to a national system will also result in savings for some service providers.

Payment delivery

The way payments are delivered impacts on the experiences of parents and providers. In the current system, CCB can be paid to child care providers who then deduct the relevant amounts from child care fees, or they can be made direct to families. Providing payments to providers as fee reductions (in respect of each family using care) reduces the number of payment points, but may place greater upward pressure on child care prices if the full rate of assistance were provided in this form.

While CCB is generally provided fortnightly, CCR is paid quarterly, so there is some disconnect between when this assistance is provided and the decisions parents make about the purchase of child care. This may affect low-income families, particularly in high-fee areas, who have difficulty paying in advance and may not take the full value of the assistance into account when making decisions about work and child care. It does, however, reduce the pressure on prices by ensuring that parents are subject to a larger proportion of the up-front cost.

Findings

The current child care payment structure could be simpler and more transparent, and could provide greater levels of assistance to lower-income families.

- The formula for calculating Child Care Benefit (CCB) is overly complex. The existence of two different payments with different types of assistance can add to complexity.
- CCB makes up the largest proportion of assistance to low-income earners. This assistance has not kept pace with increases in child care prices.
- Although providing assistance that covers a proportion of out-of-pocket costs can put higher pressure on child care fees and government expenditure, it is more responsive to changes in child care prices and to differences in prices across Australia.

Fringe benefits concessions are not an effective way of targeting child care assistance.

F4-3 Reform directions — a streamlined child care payment

Recommendation 99:

Child Care Benefit and Child Care Rebate should be combined into a single payment to parents (or to child care centres) in respect of each child based on a percentage of child care costs. The payment should have the following features:

(a) a high rate of subsidy for low-income families that covers most of the costs of child care (up to 90 per cent). This would involve a small co-payment for low-income families;

(b) a base rate of assistance for all families that use child care to facilitate parental engagement in the workforce. The base rate of assistance should be set as a proportion of child care costs, with reference to the marginal tax rate faced by the majority of taxpayers. (Based on the indicative personal income tax rates scale in Section A1, this would indicate a rate of assistance of 35 per cent);

(c) access to the base rate of assistance subject to a requirement that parents participate in work, education or training. Where parents are not participating, the maximum rate of assistance should be available for a limited number of hours. The number of hours subsidised without a participation requirement should be the same as the number of hours of universal access to pre-school (15 hours by 2013); and

(d) coverage of the full costs of child care for at-risk children and children facing multiple disadvantages, without participation requirements on parents.

Recommendation 100:

The child care payment should be means tested down to the base rate of assistance based on family income and should have regard to the interaction with other means tested payments (income support and family payments) and marginal tax rates, to ensure that effective marginal rates of tax are not excessive.

Recommendation 101:

The fringe benefits tax exemption for child care facilities provided on an employer's business premises for the benefit of employees should be removed.

Designing a single child care payment

A key element in simplifying the delivery of child care assistance would be to combine CCB and CCR into a single payment. To maintain rates of assistance over time and to accommodate the wide distribution of child care prices in Australia, the assistance (maximum and base rates) should be set as a percentage of out-of-pocket expenses.

Low-income families should receive a high rate of assistance to facilitate workforce participation and support the use of child care for early learning and development. It is envisaged that, in the long term, up to 90 per cent of out-of-pocket expenses would be covered.

Assistance would be means tested on family income (consistent with the family payment arrangements) and would provide a base rate of assistance for all secondary earners (regardless of primary-earner income) and all single parent families.

Because the means test adds to the effective rates of tax faced by the parent whose employment decisions depend on the cost and availability of child care, the threshold for means testing of child care will need to interact coherently with income support means testing. It is particularly important that child care means testing be coherent with the effective rates of tax from the withdrawal of other transfer payments faced by secondary earners and single parents. If assistance is based on a percentage of out-of-pocket costs, the means test would need to take into account families who have multiple children in child care.

To recognise that child care costs can be a cost of employment for single parents and secondary earners, the payment should have a base rate of assistance for all families. Using the marginal rate of tax faced by the majority of taxpayers may be an appropriate proxy for this, as some secondary earners will face lower rates of tax and some will face high rates. Under the illustrative rates scale (see Section A1 Personal income tax), this would imply a base rate of 35 per cent of out-of-pocket costs. For families receiving the base rate of assistance, an annual cap on assistance should be retained (but indexed), to limit assistance to a standard level of child care services for high-income families.

To link child care assistance with workforce participation (or activities that support future workforce participation), access to the base rate of assistance should be subject to a requirement that parents be participating in work, education or training. Where parents are not participating, the maximum rate of assistance should be available for a limited number of hours. The number of hours of child care that are subsidised without a participation requirement should be the same as the number of hours of universal access to pre-school. The Early Childhood Education National Partnership specifies that this will be 15 hours by 2013 (COAG 2008).

For children 'at risk' or facing multiple disadvantage, assistance for the full cost of care to encourage use of child care is envisaged. Access to quality child care is particularly important in supporting the development of children from families experiencing, or at risk of experiencing, social exclusion. This can include children from jobless or low-income families, Indigenous children, children from minority cultural or linguistic backgrounds and children with a disability.

To ensure the child care payment is sustainable and maintains cohesion with other aspects of the tax and transfer system, the parameters underlying the payment and the means test would need to be reviewed over time. This includes the timing of how assistance is delivered; that is, the proportion of assistance delivered up-front compared to the proportion of assistance delivered each quarter (or other time period). While the majority of assistance (at least for low-income families) should be delivered on a regular basis, the quarterly payment approach could be retained for the base rate of assistance, or some portion of the base rate of assistance, for all families. This could help to balance the objectives of maintaining a meaningful price signal to parents and providers and ensuring that child care remains affordable for low-income families.

Fringe benefits tax exemption is not appropriate

The fringe benefits tax (FBT) exemption for child care facilities provided on an employer's business premises was intended to encourage the creation of additional child care places. However, only higher-income employees working for larger businesses able to establish a child care centre can benefit from the concession.

Even if the exemption were to be broadened to remove the restriction on the employer providing the child care, an FBT exemption is not an appropriate vehicle for providing child care assistance because it adds complexity, relies on employers being prepared to put in place salary sacrifice arrangements and does not operate coherently with the other child care payments (CCB and CCR).

The FBT exemption cannot be used to assist low-income families with child care. While it is possible to provide this assistance separately, it would remain difficult to provide the two forms of assistance in a coherent way.

CCB and CCR are intended to be the primary form of child care assistance. The FBT exemption is now a remnant of an older system of support largely overtaken by an alternative system of direct support.

F5. Housing assistance

Key points

Adequate housing is integral to a decent life. As well as providing basic services, such as shelter, it enables people to participate fully in society. Ensuring access to adequate housing should be a key part of the social safety net by providing assistance based on the means and needs of individual recipients.

Including rent assistance as part of the income support system allows the assistance to be targeted to need and delivered in a way that does not discourage workforce participation. However, the current maximum levels of assistance for private tenants are too low, cutting out below a level that would ensure access to an adequate standard of housing. Indexation of assistance to the Consumer Price Index means that assistance is not well-targeted over time, exposing recipients to the risk of rent fluctuations.

The higher average level of assistance to public tenants is not well-targeted to need. As a majority of public tenants have similar means to recipients of the government's Rent Assistance payment, the large difference in assistance levels is inequitable. The gap in assistance leads to rationing through queuing and can lead to poor outcomes for tenants in the long term.

In public housing, the use of queues to ration assistance and income-based rent setting discourage workforce participation. Current public housing funding neither effectively targets assistance nor encourages use of the housing stock in ways that reflect the needs of clients.

Rent Assistance should be increased so that assistance is sufficient to support access to an adequate level of housing. Assistance should be more appropriately indexed to reflect the growth in line with market rents. Rent Assistance should be extended to public housing tenants, with recipients paying rents that reflect market rates, subject to gradual transitional arrangements.

Social housing providers should receive a new source of funding in respect of tenants with high housing needs, such as those with high costs due to disability or people likely to face discrimination in the private market. The payment would be based on the needs of recipients and could in many cases be directed by them to providers of their choice. In combination with Rent Assistance, this assistance will encourage the formation of a more dynamic social housing market that would reduce reliance on the current system of block grants.

The Australian government and the States should retain the option of providing capital for housing construction.

F5-1 Housing assistance — why is it needed and what form should it take?

Why does government provide housing assistance?

A key function of national government is the prevention of capability deprivation — that is, the absence of fundamental capabilities that enable people to participate fully in society. Income support is a major mechanism for achieving this end. It provides people with resources to maintain an adequate standard of living and supports their participation in the community, including the workforce (see Section F1 Income support). There is a further need for specific housing assistance in recognition of the special role it plays in supporting wellbeing.

Access to adequate housing is necessary for both a decent standard of living at a point in time and for development of capability over the long term. Housing is a complex good that performs a range of valuable functions. As well as providing basic shelter, it is a key factor in health, child development and workforce participation, and a platform for broader social cohesion. Poorer households need to dedicate a greater proportion of their incomes to achieving an adequate standard of housing. In 2007–08, renters with household incomes in the bottom 20 per cent of the income distribution spent 36 per cent of their income on rent, compared to 19 per cent for renters in the middle 20 per cent. Poorer households also devote a large share of their income toward housing if they do not have the option of occupying social housing where rents are charged proportional to incomes. Their access to affordable housing is affected by a range of supply constraints, such as requirements for Australian housing to meet a minimum standard of quality, which are discussed in greater detail in Section E4 Housing affordability.

A further role of government assistance is to ensure access to adequate housing for people with high needs who would be unlikely to access it in the private market. The private market is likely to fail people with a range of needs — for example, people with mental or physical disabilities or substance-abuse problems — either through discrimination, lack of suitable housing or excessive premiums for risk. The key role of assistance for people with high needs is to enable their access to housing by funding social housing provided by State housing authorities (public housing) or non-government organisations (community housing). Housing assistance should also reflect the difficulty Indigenous Australians can face in accessing mainstream housing markets. In addition, the particular housing needs of Indigenous Australians in remote areas should be addressed through specific measures, such as the provision of capital for house building.

This focus on people with special needs and the broader role of social housing in the current Australian housing market means that some supply side measures are also a critical element of a comprehensive social housing system. Projected population growth will require that supply of social housing keeps pace to ensure that homelessness is prevented.

How should assistance be provided?

Housing assistance should be provided in a way that is equitable, does minimum harm to participation incentives and gives recipients choice in the housing they occupy.

Housing assistance for people with limited means is best provided as an integrated component of the income support system. The comprehensive assessment of income and assets undertaken through the income support system is the most effective way of targeting housing support to people with limited means. It also ensures that people of similar means receive the same level of support.

As a part of the income support system, housing assistance can be designed to minimise disincentives to work. With a person's total income support reflecting assistance for housing and other costs of living, the total amount of assistance can be reduced consistently as their means increase. This enables the impact of all taxes and transfer withdrawal to be considered together, with the total effective marginal tax rate set to minimise harm to participation while a person receives income support.

Housing assistance for people with high needs is most effective when targeted to their needs directly, rather than indirectly through providers. Recipients being able to direct the assistance to providers of their choice enables competition, which can help ensure the housing they receive meets their needs. Funding that is directed by recipients can also be scalable to enable successful housing providers to expand their provision.

The overall system of housing assistance and funding should support the viable provision of social housing for people with low incomes and high housing need. There is a particular need for the provision of capital funding in some circumstances, such as Indigenous Australians in remote areas. To ensure that housing assistance is effective, the roles and responsibilities of different levels of government in its provision should be made clear.

The form of housing assistance

Housing assistance should be designed to enable recipients to access an adequate standard of housing. Further, housing assistance should be set with reference to base rates of assistance to ensure that income after housing costs is sufficient for consumption of an adequate standard of other goods and services.

As the cost of housing can fluctuate significantly with changing market conditions, housing assistance should be structured to remain adequate over time and not expose its recipients to undue risk posed by large increases in housing costs. As housing constitutes a large share of expenses for people with limited means, market fluctuations can affect them significantly.

Housing assistance should aim to treat people in the same circumstances in the same way. In general, a person's housing tenure is only a rough proxy for their means or needs and is therefore a poor mechanism for targeting assistance. Where possible, assistance should be based on means and needs because it allows people greater choice and is fairer. A system that is tenure-neutral — that is, it provides assistance independent of a particular form of tenancy — would allow recipients of housing assistance to move more easily between types of tenure. This would be most important for long-term recipients of income support.

Balancing tenure neutrality with targeting need

A system that follows strictly the principle of tenure neutrality would take no account of how people spend assistance, including the amount or type of housing they consume.

However, it is important that tenure neutrality be balanced by consideration of a person's housing costs, as this affects their need for assistance.

Information used to determine people's eligibility for housing assistance should include information about their housing costs so that those who face higher costs can receive higher levels of assistance. This approach differs from that used more generally in income support for several important reasons.

Housing costs are readily observable, which enables assistance to be better targeted. Tighter targeting of assistance means that for the same fiscal cost, greater assistance can be provided to people with high housing costs.

Further, high housing needs are likely to be associated with financial stress. People enter the income support system — perhaps because of loss of work or marriage breakdown — with differing levels of housing costs, reflecting earlier choices. Providing additional assistance to people with higher housing costs minimises the financial stress of moving in and out of income support.

Principles

To ensure it is effectively targeted, assistance for housing should be an integrated component of an income support system designed to alleviate poverty that:

- ensures people requiring assistance can access an adequate standard of housing;
- is based on a comprehensive assessment of individual means and the costs of housing; and
- minimises harm to workforce participation.

Additional assistance should be provided to ensure access to adequate housing for people whose high needs would otherwise make it unlikely they could find adequate housing in the private sector. This assistance would be most effective when it is based on recipients' needs and directed by them to providers of their choice.

The overall system of housing assistance and funding should also include funding for capital costs to support the viable provision of social housing for people with low incomes and high housing need.

F5-2 Assessment of the current system

Overview of housing assistance

Two major forms of housing assistance are available to low-income earners: Rent Assistance and public housing. A person can access only one or the other.

Rent Assistance is a component of the Australian government's income and family support systems. Eligibility for Rent Assistance requires eligibility for income support or more than the base rate of Family Tax Benefit Part A and rental costs that exceed a minimum level. Assistance is paid for rents above this level at 75 cents per dollar of rent up to a maximum cap (details at Table F5-1). In 2007–08, Rent Assistance was provided to around 940,000 recipients at a cost of $2.3 billion.

Table F5-1: Rent Assistance per fortnight

Rates and proportions as at September 2009

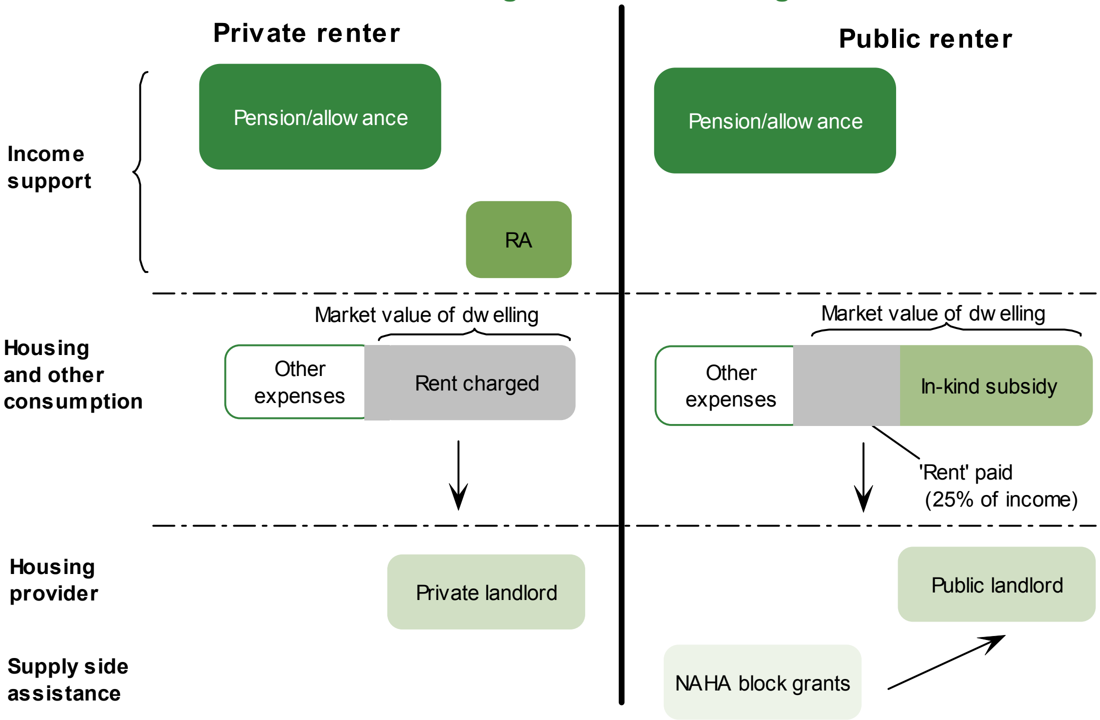
Recipient type		Minimum rent for eligibility for assistance	Rent at which maximum asistance received	Maximum amount of assistance	Proportion of all recipients (%)
Single	sharer with no children	$99	$199	$75	15
	alone with no children	$99	$248	$112	38
	with one or two children	$131	$306	$131	18
	with three or more children	$131	$329	$148	4
Couple	with no children	$162	$303	$105	9
	with one or two children	$194	$369	$131	11
	with three or more children	$194	$391	$148	5

Source: Centrelink 2009 and FaHCSIA unpublished.

Public housing is an in-kind benefit that operates independently of the income support system. Eligibility is determined by State housing authorities and based on income combined with other criteria indicative of housing need. Rents are typically set at a maximum of 25 per cent of tenant income, with the assistance equal to the difference between the charged rent and market rent. At 30 June 2008, there were around 330,000 households in public housing, who received an aggregate subsidy of around $1.6 billion. Through the National Affordable Housing Agreement, the Australian and State governments provide around $1.3 billion in annual funding, including for both ongoing and some capital costs, to public housing authorities.

These arrangements are depicted in Chart F5-1 for a recipient with no private income.

Chart F5-1: Current arrangements for housing assistance



Community housing is also a form of housing assistance for around 30,000 low-income households. Community housing organisations are non-government organisations that provide subsidised housing funded through government grants and private donations. Eligibility for community housing is determined by the provider, but is generally based on criteria similar to those for accessing public housing. Community housing tenants can receive Rent Assistance. In general, providers set rents at 25 per cent of their income. Increasingly, community housing providers set rents to include all the Rent Assistance their tenants receive. In 2007–08, the Australian Government provided grants of around $68 million to a range of not-for-profit providers of housing to disadvantaged people.

As set out in Table F5-2, a number of other housing assistance programs focus on different aspects of housing need. The Review has assessed neither these programs in detail nor alternative supply- or demand-side policies.

Table F5-2: Housing assistance programs

Program	Provider	Purpose	Cost
National Affordable Housing Agreement	Australian Government	In addition to providing funding for public housing, the National Affordable Housing Agreement provides untied funding to states and territories for housing and homelessness services. It replaced the Commonwealth State Housing Agreement (including identified programs such as the Crisis Accommodation Program and the Aboriginal Rental Housing Program) and the Supported Accommodation Assistance Program. It is supported by National Partnership Agreements on social housing, homelessness and remote Indigenous housing.	NAHA — $6.2 billion over five years. National Partnerships — $7.1 billion over 10 years.
Nation Building — Economic Stimulus Plan Social Housing Initiative	Australian Government	Provides funding to states and territories for the construction of new social housing and repair and maintenance to existing public housing dwellings.	$5.638 billion over three and a half years, including $400 million for repairs and maintenance.
First Home Owners Grants	States (ongoing) and Australian Government (one-off supplements)	The First Home Owners Grant was introduced with the introduction of the GST to compensate non-home owners for the increase in the cost of housing arising from higher construction costs of new homes. To provide short-term assistance to the housing sector, the Grant has been increased temporarily in 2001–02 and through the First Home Owners Boost introduced in October 2008.	First Home Owners Grant — $1.3 billion in 2008–09. First Home Owners Boost — $934 million in 2008–09.
National Rental Affordability Scheme	Australian Government with States	Assistance to housing providers to encourage supply of housing that is rented out to low- to moderate-income earners at below market rents.	$72 million in 2008-09 (growing to $357 million in 2011-12)
Housing Affordability Fund	Australian Government	To reduce the cost of charges levied by State and Territory and Local Governments on homebuyers, by providing an incentive for reform of inefficient processes and a contribution towards infrastructure costs.	$512 million over five years.
First Home Saver Accounts	Australian Government	To assist young Australians save over a number of years for their first home, through low tax savings accounts that the Government contributes to each year.	$245 million over five years from 2008-09.
Home purchase assistance for Indigenous Australians	Australian Government	The Home Ownership Program (HOP) and the Home Ownership on Indigenous Land Program (HOIL) assist low income Indigenous households to purchase their own homes.	HOP — $552 million in outstanding loans at 30 June 2009. HOIL — $1.3 billion in approved loans in 2008-09
Home purchase assistance	States	To assist low- to moderate-income households with the costs of home purchase, including direct lending, deposit assistance and mortgage relief.	$22 million of interest rate assistance and mortgage relief and $1.1 billion of direct lending in 2007–08.
Private rental assistance	States	To assist low-income households who have difficulty securing and maintaining rental accommodation.	$25 million in rental grants, subsidies and relief payments and $47 million in bond loans in 2007–08.

As the current system provides assistance according to tenure, the following assessment of assistance considers Rent Assistance, public assistance and assistance for low-income mortgagors.

Rent Assistance

The structure of Rent Assistance is appropriate

In a number of ways, Rent Assistance aligns with the principles for delivering housing assistance.

Basing Rent Assistance on the recipients' rent levels means the payment can be well-targeted to need. By paying assistance above a rent threshold, around 40 per cent of income support recipients who could otherwise be eligible for Rent Assistance do not receive the payment because they pay low or no rent. Further, paying assistance at 75 cents per dollar of rent in excess of the threshold means the recipient faces a co-payment of 25 per cent for their rent.

Around 30 per cent of people receiving Rent Assistance are paid less than the maximum rate, which suggests that the co-payment provides recipients with some incentive to economise on their rental costs.

The maximum rates of Rent Assistance are different depending on whether a person is single, in a couple or sharing with others. This approach allows maximum Rent Assistance to be reduced in line with the economies of scale that can be achieved through sharing or living with a partner. Reducing assistance in these circumstances is consistent with the principles of a targeted system and lowers the overall cost of assistance.

For adults without children, Rent Assistance is included as an integrated component of income support. In terms of means testing, Rent Assistance is added to a recipient's base payment so that, as recipients' private means increase, their base income support is withdrawn before Rent Assistance is reduced. Though this extends the income range over which Rent Assistance recipients face payment withdrawal, it results in withdrawal rates determined by base payments alone. This means status as a renter does not influence withdrawal rates, which are set to reflect workforce participation objectives. Further, the alternative of 'stacking' — withdrawing base payment and Rent Assistance simultaneously — would create higher withdrawal rates and deter people from entering the workforce. This is particularly important because a substantial proportion of housing assistance recipients are single parents. When surveying empirical results, Wood et al. (forthcoming) state that 'the weight of evidence suggests that Rent Assistance has only small, negative impacts on employment outcomes'.

However, the maximum level of assistance is low and indexed inappropriately

The rent caps where maximum Rent Assistance is paid are set at low levels of rent. For singles, the cap of $124 per week represents the bottom 10 per cent of one-bedroom dwellings rented in capital cities. Across the country, around 220,000 dwellings rent for less than the couple rent cap of $151 per week, well below the number of childless households who receive Rent Assistance. At June 2009, the average rents of Rent Assistance recipients are $147 per week for a childless single (non-sharer) and $198 per week for a childless couple.

Because the maximum rate of Rent Assistance is reached at relatively low levels of rent, many recipients divert their base income support payment from other expenses in order to acquire an adequate level of housing. As an indicative example, renting a dwelling for $165 per week[28] leaves a single pensioner with around 68 per cent of their base payment and a single Newstart Allowance recipient with 52 per cent of their base payment for other living expenses.

28 This is broadly equivalent to the 25th percentile of one-bedroom dwellings and the 5th percentile of two-bedroom dwellings.

The minimum rent thresholds below which Rent Assistance is paid are the same for each payment type, irrespective of the recipient's base payment. This means that people on allowances must use more of their base payment to get an adequate standard of housing than recipients of pensions.

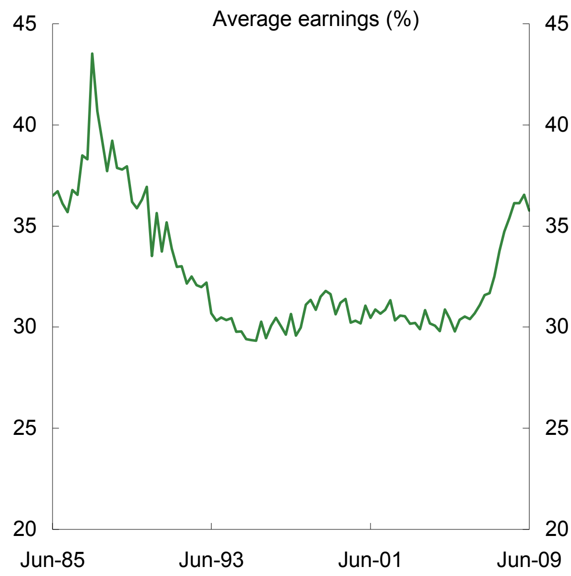
One reason that the maximum Rent Assistance is reached at a low rent level is that it is indexed by consumer price index (CPI) changes. Significant short-term fluctuations in real rents do occur. Over the past three years, average rents have grown at an annual rate of around 10 per cent, outstripping growth in the maximum rate of Rent Assistance at 2.7 per cent per year as well as average wages (Chart F5-2 Panel A). The yield obtained by rental property investors is determined by combination of a range of factors in addition to rent, such as expected capital gain and potential tax advantages. This combination is not stable over time, as shown by the movement in rental yield over the past 25 years (see Chart F5-2 Panel B). Not indexing assistance to rents exposes recipients to the risk of structural shifts in yield that can be driven by market forces and policy changes. Recipients of housing assistance are less likely to be able to bear the risk of large changes in housing costs than others in the community.

The composition of the CPI basket also means that it is a poor reflection of the housing costs of low-income renters. Around 6 per cent of the CPI basket is rent, while rent represents around 35 per cent of income for Rent Assistance recipients.

Inadequate indexation leaves fewer resources available for other expenditure and harms the overall wellbeing of recipients. From 2004 to 2009, overall real income support for Rent Assistance recipients (after rent) has fallen by around 23 per cent for Parenting Payment Single recipients and 36 per cent for recipients of Newstart Allowance.

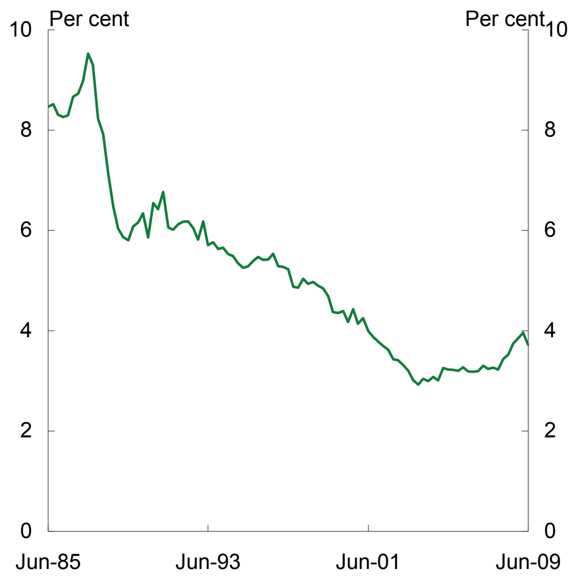
Chart F5-2: Variation of rents over time

Panel A: Rent to average weekly earnings



Source: REIA (2009) and ABS 6302.0.

Panel B: Rental yields of three bedroom houses



Source: REIA (2009).

Rent Assistance in respect of children and for families

For families who rent, the housing assistance paid in respect of their children is not coherently designed. The number of children in a household is taken into account when determining the maximum level of Rent Assistance. For example, the maximum rate for a single person with one or two children is $131 per fortnight, $20 per fortnight more than a childless single. In addition, all parents receiving income support also receive the Family Tax Benefit (FTB) Part A family payment. FTB Part A recognises the direct costs of children, including housing costs, and is paid at the same rate to all parents regardless of tenure. As it is not clear that income support recipients who rent face greater marginal housing costs from children than non-renters, there is no obvious rationale for providing additional assistance to renters in respect of these costs.

The current approach for providing Rent Assistance to families blurs the roles of income support and family payments. As set out in Section F1, income support reflects the needs of adults with limited means, while family payments should assist with the direct cost of children (discussed in Section F3 Family and youth assistance). Families whose income makes them ineligible for income support still receive Rent Assistance as long as they receive more than the base rate of FTB Part A (which has a higher income cut-off). For these parents, their continued eligibility for Rent Assistance is effectively due to their status as a parent. This structure involves a trade-off between the coverage of low-to-middle income families and the adequacy of assistance.

Public housing

Public housing is a significant mechanism for providing housing to disadvantaged groups. It has become the primary source of housing for people who cannot access appropriate or adequate housing in the private market such as people with a mental illness and Indigenous Australians who still too often face discrimination in the housing market. Social housing (public housing and community housing) provides a valuable stock of houses in the context of Australia's housing supply difficulties, and in some areas such as remote Indigenous communities is the only viable source of housing.

However, there are a number of areas where social housing is not adequately supporting the Australian households that rely upon it for adequate housing.

Differences in assistance do not target need well

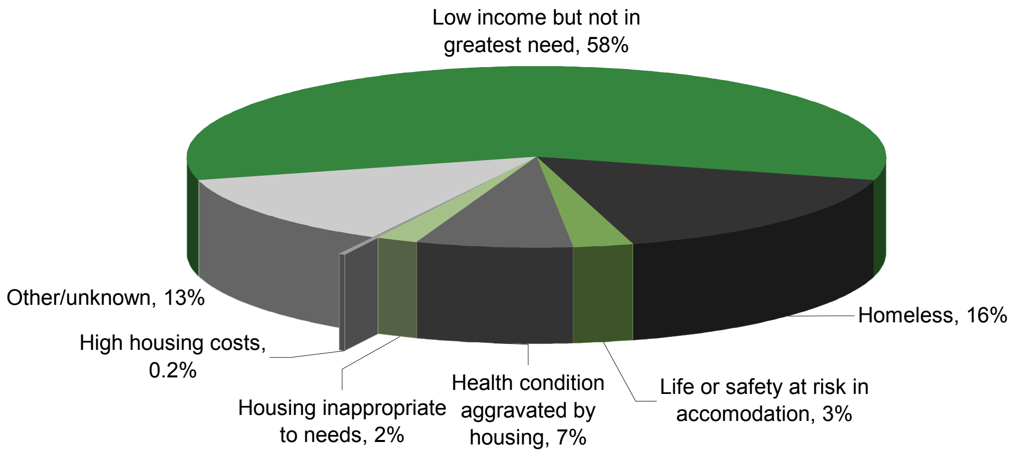
Public housing confers a greater average level of assistance to recipients than Rent Assistance. This is inequitable but can also lead to poor long-term outcomes for recipients.

Setting public housing rents as a proportion of incomes results in the average level of support being around $220 per fortnight, while average assistance is only around $90 per fortnight for Rent Assistance recipients. Rationing of public housing through queues is a key indicator of the difference in levels of assistance between the two types of tenure. At 30 June 2007, around 176,000 applicants were on waiting lists for public housing (that is, current demand exceeded supply by around half). In 2006–07, around 30 per cent of tenants allocated to public housing had waited for two years or more. There is also significant variation in assistance within public housing, as the level of assistance depends on market value of the dwelling to which a recipient is assigned.

Public housing also provides greater tenure security than is available to many people in the private market. Tenure security can be important for tenants[29] as it provides greater certainty in their lives and saves on moving costs, which may be significant for some recipients (such as those with disabilities). Around 75 per cent of public housing tenants have been with their provider for five years or more. Long levels of occupancy reflect the fact that tenure is for life in most States, although this may also be influenced by public housing eligibility rules.

As indicated in Chart F5-3, a significant minority of new entrants to public housing are assessed as having high housing needs, such as being homeless or having their health at risk. However, the variation in public subsidy is not directly targeted to tenants with assessed as in 'greatest need'[30], who instead receive preferential placement, which results in shorter average wait times for access to housing. Tenants assessed as not being in 'greatest need' and who are eligible for public housing based on their low income alone, generally receive higher levels of assistance than people with similar means who rent privately.

Chart F5-3: New allocations to public housing by need category (2006–07)



Source: AIHW 2008.

The existence of large differences in the size and nature of assistance can also lead to poor outcomes for recipients. As public housing entitlements generally are not portable, the large gap with Rent Assistance discourages people from moving out of public housing. This has the potential to lock people in to depressed areas and to discourage moving for work. People may modify their behaviour to gain access to the immediate financial benefit of public housing in ways that have negative long-term consequences. To remain eligible for public housing, the incomes of prospective tenants must stay low while they are on the waiting list. Dockery et al. (2008) suggested that this was a significant reason why unemployment rates are 11 percentage points higher for prospective male tenants on public housing waiting lists, and 5 percentage points higher for females.

29 In the 2007 National Housing Survey, around one-quarter of respondents nominate tenure security as a reason for moving into public housing (AIHW 2007a).

30 The greatest need standard includes households that at time of allocation were: homeless; their life or safety was at risk in their accommodation; their health condition was aggravated by their housing; their housing was inappropriate to their needs; or they had very high rental costs.

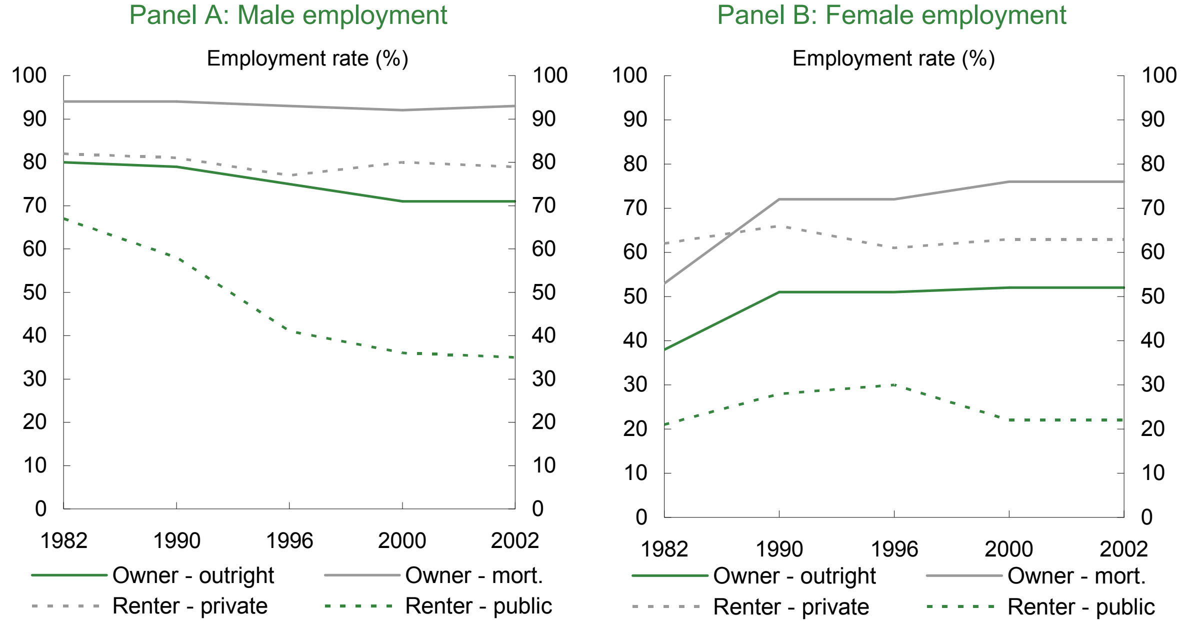
Barriers to workforce participation

Ensuring that the transfer system supports long-term capability development by doing minimum harm to workforce participation is of particular importance for housing assistance. The characteristics associated with high housing need — such as disability or addiction problems — are also likely to affect the participation prospects of housing assistance recipients. This heightens the need to ensure that the system does not fail vulnerable recipients by giving them incentives that fail to enhance, or even reduce, their self-reliance.

Employment rates among public housing tenants are low and have been declining over time (see Chart F5-4). While this reflects the fact that public housing is targeted toward people with poor participation prospects, public housing rent-setting also reduces incentives to work.

Public housing rents are generally set at 25 per cent of income. As this rent stacks on top of income support withdrawal rates, public housing tenants face an effective marginal tax rate that is 25 percentage points higher than if they privately rented or owned. Public housing rent-setting policies can also contribute to intergenerational poverty traps, as children of public housing tenants may also have to contribute 25 per cent of their income for rent.

Chart F5-4: Employment rates by tenure[(a)]



(a) Employment rates over this time period would have been affected by a range of factors including economic conditions, the increase in participation by females and the ageing of the population.
Source: Wood et al. (forthcoming).

There is strong evidence of the impact that public housing has on employment incentives. Modelling by Dockery et al. (2008) estimated that around 110,000 recipients are in 'employment traps' where high effective marginal tax rates discourage entry to the workforce. Wood et al. (2007) found employment by female public tenants (64 per cent of primary earners in public housing) was lower than that of equivalently skilled private renters.

State housing authorities use a range of programs to promote employment, perhaps in recognition of these incentives. For example, the Australian Capital Territory provides the Employment Rent Rebate Extension, which preserves below-market rents for the first six months of employment. In Victoria, the Public Tenant Employment Program provides tenants with training and advises them of job vacancies. While such programs may promote participation where they are used, they are unlikely to counteract the negative incentive effects inherent in the system.

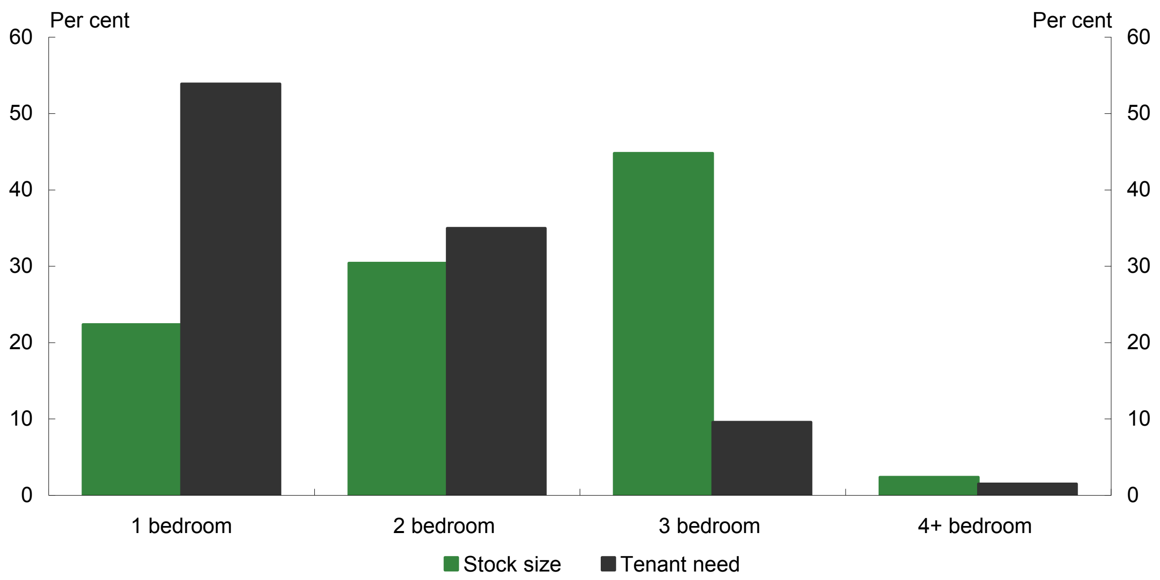
Funding arrangements create poor incentives for effective use of the housing stock

Public housing has two sources of funding: rents from tenants and grants from governments. This system provides poor incentives to both recipients and providers of public housing and may not be sustainable.

Setting rents with reference to tenant income means there are no effective price signals governing the allocation of public housing. The rents providers receive give them no information about the type or location of housing their tenants prefer, which ideally should be reflected in their housing stock. Tenants with the same income pay the same rent regardless of the size, location, condition or general amenity of the house they occupy. This means they have an incentive to maximise their 'in-kind subsidy' — that is, they try to stay in larger and better houses than they would normally occupy if they had to pay directly for their housing. Whelan (2009) found that recipients of dwellings with higher market rent tended to have longer tenancies than equivalently sized households occupying cheaper dwellings. Many would use the value of the subsidy differently if they had the choice.

However, many public housing recipients have little real choice about the particular dwelling they occupy. Facing significant wait times and movement to the back of the queue if an offer of housing is declined, recipients have an incentive to accept whatever housing they are offered. Further, the type of housing available can be incompatible with a recipient's need. The public housing stock is dominated by three bedroom houses, yet most recipients are singles or couples without children, as illustrated by the Tasmanian stock in Chart F5-5.

Chart F5-5: Tasmanian housing stock
Public house sizes compared to room needs of tenants (2006–07)



Source: FaHCSIA 2009.

Public housing providers are financed through a combination of government grants — the Commonwealth State Housing Agreement to 2007–08 and the National Affordable Housing

Agreement from 2008–09 — and the rents that public housing authorities charge recipients. For funding to be sustainable, it must at least meet the cost of providing the housing services.

Assistance being provided through grants enables housing services to be delivered at below market rents. Until the new funding agreement in 2008–09, grants had been declining over time in real terms, falling by around 25 per cent in the ten years to 2006–07. The lack of clarity in the roles and responsibilities of the Australian government and State governments may have affected funding levels, with each tier of government seeking to transfer the fiscal cost to the other.

Public housing has increasingly been rationed to recipients with high needs. However, the grants are not based on the likely need or number of such clients, nor on the overall quantity or quality of housing provided. The current grants are provided through block funding, based on the population in each State. This funding mechanism provides an incentive for States to transfer management of public housing to community providers. The tenants transferred to community housing become eligible for Rent Assistance and, with fewer tenants, the effective per-dwelling funding in the public housing stock increase.

The scope for use of tenant rental charges has declined in line with levels of employment in public housing. At 30 June 2008, around 88 per cent of recipients paid below market rents, with the remainder having their rent capped at the market level. With low private income, recipients pay their rents out of income support, the indexation and level of which affects the viability of providers. Providers receive a larger payment from pensioners than recipients of allowances (like Newstart Allowance) for providing the same dwelling. While growth in pensions through wage benchmarking generally outpaces CPI-indexed allowances, neither payment type is likely to move systematically with private market rents.

In aggregate, public housing rent setting and funding policies have led to a declining level of funding over time. From 1997–98 to 2007–08, public dwellings have decreased from 6 per cent to 5 per cent of the overall housing stock. Lower supply further contributes to unmet demand for public housing.

Low-income mortgagors

In 2005–06, around 300,000 (or 11 per cent) of income support recipients were repaying a mortgage.[31] How mortgaged borrowers are affected through the tax and transfer system is not straightforward to assess.

Unlike renters, they do not receive assistance with their ongoing housing costs. The only direct assistance available to low-income earners with mortgages is provided through small direct lending and temporary mortgage assistance, which is available in only some States.

However, comparing means of mortgagors and renters is complicated by the fact that home equity earns a tax-free return and is not included in the means testing of income support. Depending on the level of equity in their home, this may confer greater assistance than Rent Assistance. For example, a single mortgagor on a part-pension with less than $116,000 of

31 The proportion with a mortgage varies considerably by type of recipient. It is 6 per cent for Age Pension; 21 per cent for single parent pensioners or 16 per cent for those receiving Newstart Allowance.

equity in their home would receive less assistance from the transfer system than if they were a renter.

Findings

The different levels of subsidy between tenants in different tenures, such as social housing and private rental, are inequitable and not well-targeted to need.

The current rent caps for Rent Assistance are too low and do not reflect an adequate level of housing for many recipients. Indexation of Rent Assistance to CPI means that assistance is less well targeted over time and exposes renters to housing cost risks.

In public housing, the use of queues to ration assistance and income-based rent setting discourage workforce participation. There is a need to reform public housing funding to better target assistance and encourage use of the housing stock in ways that reflect the needs of clients, and to make the funding model sustainable in the long term.

F5-3 Reforms for adequacy, targeting and participation support

The Panel proposes reforms to housing assistance to ensure that assistance is adequate, targets need and supports participation incentives.

Recommendation 102:

The maximum rate of Rent Assistance should be increased to assist renters to afford an adequate standard of dwelling. To ensure that Rent Assistance can be maintained at an adequate level over time, the rent maximum should be indexed by movements in national rents, which could be measured by an index of rents paid by income support recipients.

Recommendation 103:

To better target an increase in the maximum rate, Rent Assistance should be part of the income support system, with eligibility based on rent paid and the income support means test, rather than on eligibility for another payment (for example, Family Assistance).

Recommendation 104:

Mechanisms should be developed to extend Rent Assistance equitably to public housing tenants along with removing income-linked rent setting in public housing.

Recommendation 105:

A high-need housing payment should be paid to social housing providers for their tenants who have high or special housing needs or who may face discrimination in the private market. This payment should be funded by the Australian government. The Commonwealth and the States should retain the option of providing capital for social housing construction.

Recommendation 106:

Income-linked rents should be phased out in social housing, with providers charging their tenants rents linked to the market rate, with existing rent-setting for current tenants phased out using grandfathering or other transitional arrangements. However, continued use of income-limited rents is appropriate in some circumstances, such as in remote Indigenous communities.

Rent Assistance to better target adequacy

The rent caps for Rent Assistance should be raised. They should be set to ensure assistance is paid up to an adequate level of housing and does not compromise an income support recipient's consumption of non-housing goods and services.

While the Review has not conducted a detailed survey of adequacy or of the rental market, it appears that setting the upper cap of rent with reference to rental costs of one- and two-bedroom dwellings in the 25th percentile of rents across capital cities is a reasonable benchmark for determining adequacy (Recommendation 102). Dwellings of this size are consistent with the need for housing in assessments such as the Budget Standards (Saunders et al. 1998). One- to two-bedroom dwellings should be adequate for households without children — assistance for the housing costs of children in families is discussed below. Setting the rent cap rents with reference to the capital cities should ensure access to job markets and reflect the housing costs where the majority of Australians live. Set with reference to rents at the 25th percentile, there should be a reasonable standard of housing and number of dwellings available. However, this benchmark should be reviewed over time to take into account future developments in rental markets.

A cap set with reference to this level should also be consistent with ensuring an adequate level of non-housing consumption. Rent Assistance involves a co-payment, without which there would be no incentive to economise on housing costs. As such, it is not possible for income after housing expenses to be the same across renters with different costs, between renters and non-renters, or between pensioners and allowees. Adequacy should focus on the remaining base payment of pensioners receiving maximum rate of assistance.

Providing additional assistance to low-income renters is likely to increase their demand for housing. Where supply is restricted or slow to respond, this may place some upward pressure on rents. However, several factors will limit the potential for more adequate Rent Assistance to increase rents. The co-payment associated with Rent Assistance will limit this potential, as not all recipients will choose to demand more housing. The increased assistance for recipients who currently pay more than the existing caps would accrue to them, and the scope for their landlords to further raise rent is limited by its level being tied to the term of the tenancy agreement. Though they are a significant proportion of the rental market, Rent Assistance recipients will represent a minority of that market, which, along with their modest means, limits the potential impact on overall rent setting.

Importantly, the potential for increases in rents is not a reason to deny an increase in Rent Assistance caps. Such increases in rents would result from greater spending power and choices for low-income earners. This provides a market signal to suppliers of rental housing to shift toward provision of the type of housing demanded by Rent Assistance recipients. Suppressing price signals is not conducive to promoting increasing supply over the long term. There are, however, constraints to supply in the housing market overall, which reflect a range of factors including tax and, especially, non-tax policies, which are discussed at Section E4 Housing affordability.

Rent Assistance should continue to include single, couple and sharer rates, with the rent caps set to reflect economies of scale in housing. Budget Standards found the relative housing needs for singles and couples to be the same in terms of bedroom numbers, suggesting that couples can achieve large economies of scale through the sharing of a room. However, assessments of housing need for a couple should recognise that some additional floor space, such as for storage or living areas, may be required with a second person. As such, it would be appropriate to set the rent cap for couples at a slightly higher level than for singles. A sharer rate should continue to be used. It should ensure that sharers have an incentive to occupy housing of a similar quality to the adequate standard used for singles and couples. However, unlike the desire to live with a partner, the decision to share is predominantly motivated by achieving cost savings. If the sharer cap were set too low and discouraged sharing, this would be counterproductive as sharing is beneficial both recipients and taxpayers, through lower costs of subsidies. To ensure Rent Assistance is applied consistently across all income support types, the sharer rate should be extended to recipients of Disability Support Pension and Carer Payment.

To ensure assistance continues to target an adequate level over time, the maximum caps threshold should be indexed to move in line with national rents (Recommendation 102). While the rental component of the CPI is a readily available and transparent measure, use of an index of rents paid by Rent Assistance recipients would provide a more accurate assessment of their rental costs.

The minimum rent thresholds are currently set as a flat amount, which means recipients of allowances pay a greater share of their base payment in rent before Rent Assistance starts than pensioners. Setting assistance as a percentage of a recipient's base rate of payment, such as 20 per cent of the base payment, would result in a more consistent recognition of rent costs for income support recipients and be consistent with targeting assistance toward those facing high housing costs.

Eligibility for Rent Assistance

The purpose of Rent Assistance should be to ensure that adults with limited means can afford to live in an adequate standard of rental housing. As such, Rent Assistance eligibility should be based on a person's means and rental costs. This is best done by paying Rent Assistance as part of the income support system. Eligibility for Rent Assistance will therefore be set by the interaction of the maximum rates of payment, rates of Rent Assistance, and the taper rate. An increase in the maximum rate of Rent Assistance may mean that some Newstart Allowance recipients with high rents receive a portion of their payment even when engaging in full-time work at the minimum wage.[32] Though the Review's position is that participation payments should generally be withdrawn before this point, providing Rent Assistance in these circumstances is consistent with minimising disincentives for taking on work.

Rent Assistance should be paid to tenants in public housing to provide more equitable and effective assistance. The interaction of eligibility for Rent Assistance and overall funding for social housing is discussed below.

In line with reforms that ensure family payments cover the housing costs of children, Rent Assistance caps should no longer be increased based on the number of children in a household. This will ensure clear functions for both payments, with Rent Assistance contributing to the income support for adults and family assistance providing for the direct costs of children (see Section F3 Family and youth assistance).

Equally, eligibility for Rent Assistance should no longer be attached to receipt of more than the base rate of FTB Part A. The means testing of the income support system determines when people have sufficient incomes (or assets) to support themselves. The proposed increase in the maximum amount of Rent Assistance will have the effect of increasing this income level at which people who have high rent costs can access Rent Assistance. This increase will mean more families will be eligible for Rent Assistance on the basis of their income. Removing eligibility for parents whose income exceeds income support cut-offs is consistent with the greater targeting of Rent Assistance to need. However, grandfathering arrangements should accompany the introduction of such a change to prevent income shocks for people currently eligible for Rent Assistance only through FTB Part A. In addition, consideration will need to be given for single parents whose income may be affected due to reforms to FTB Part B (see Section F3 Family and youth assistance).

32 This currently occurs for recipients of higher rate Newstart (such as long-term recipients aged over 60) who receives maximum rate Rent Assistance. For example, the remaining income support, after income testing, for a person in this position earning the minimum wage ($28,276) would be around $9 per fortnight.

Not extending an equivalent of Rent Assistance to mortgagors

While homeowners with a mortgage may face cash flow pressures similar to those faced by renters, the Review does not recommend extending the general scheme of rental assistance.

Mortgagors have access to mechanisms to smooth cash-flow difficulties — including repayment deferral or restructuring options through their banks, or through accessing equity in their homes — that are not available to renters. Further, assistance for mortgagors based on the cost of their mortgages would in effect be an interest rate subsidy. This poses a significant moral hazard problem of encouraging greater borrowing, which does not apply to Rent Assistance for renters. Though not well-targeted to housing stress, the non-taxation of the equity in their home, and its exclusion from income support means tests, benefit mortgagors.

While mortgage stress is a real issue, it would be very difficult to design a fair and simple assistance arrangement that addresses these issues, and the Review does not recommend it at this time.

A high-need housing payment to assist recipients with special needs

Housing assistance would be incomplete if it did not provide a mechanism for assisting people likely to have high housing costs or unlikely to be well served in the private market. Recipients of such assistance should include people who, for behavioural or cognitive reasons, find it difficult to sustain a private tenancy, or are likely to face discrimination in accessing the private rental market. Funding should ensure that social housing providers have an incentive to provide such recipients with an adequate standard of housing.

High-need tenants should be assisted with a new form of funding. A high-need housing payment would provide assistance for the higher costs of housing people with special needs. The level of assistance would be based on the high-need category to which a recipient belongs, such as having a disability or being homeless. The payment would reflect the potential costs associated with housing high-need clients, such as modifications to housing or the greater need for maintenance and repair.

The high-need housing payment would depend on the assessed needs of an individual recipient and would be portable across different eligible social housing providers. This would ensure competition among providers, which should encourage the delivery of housing that best meets the needs of their tenants. The assistance would also be scalable, allowing providers who meet the needs of their clients to expand their provision. This would encourage development of a more dynamic social housing sector.

The high-needs housing payment should be tied to housing, as it is an entitlement to enable recipients to access social housing that reflects their needs. As such, while directed by individual recipients, it should be paid to the provider of their choice. However, the high-needs housing payment reflects only housing costs, so it is not intended to replace funding that providers can also receive for delivering other support services to their tenants.

Though the majority of high-need renters will receive Rent Assistance, eligibility for the payment would best be governed by assessment of a person's high-need characteristics, rather than their income. Ongoing eligibility assessed by periodic review would mean that recipients would not have a disincentive to take on work, which may occur if eligibility were also linked to income.

The high-need housing payment should be provided by the Australian government. As noted in Section F1 Income support, preventing capability deprivation is a public good, best provided by a national level of government. The high-need housing payment would supplement the redistributive nature of Australian government income support. Further, having the Australian government pay all providers through the same mechanism is consistent with ensuring competition among community providers and State housing authorities.

As the majority of high-need recipients are currently likely to live in social housing, the reform should focus on that sector when introduced. Once established, however, the scope for extending the high-need housing payment to private providers should be explored.

A national assistance program

The Review does not recommend that Rent Assistance or the high-need housing payment vary geographically. Higher rents based on locations are generally associated with access to better services or lower costs of travel of those areas. It can also be difficult to set meaningful rent boundaries as there can often be as much variation in rents within a major city as there is between the average rent in that city and the average rent in a regional area. Setting Rent Assistance with reference to all capital cities should enable recipients to live in those areas or move to them to find employment.

Further, the responsibility for providing assistance to people with limited means and high needs is a Commonwealth responsibility, with assistance responsive to movements in national rents. Where regional rents vary significantly from national averages this is likely to be due to forces beyond the control of a national government. State and local governments have responsibility for aspects of policy that overlap with housing — such as infrastructure provision and planning regulation — and are likely to affect the rental costs of particular regions. High rents in a specific region can only be sustained where supply restrictions constrain the addition of supply. Policies that address the source of regional variations in rents would be more effective in the long term.

Rent setting and funding of social housing

Income-related rents generally should be phased out in social housing, with providers charging their tenants rents linked to the market rate (see Recommendation 106). Carefully targeted transition arrangements will be necessary to ensure households are not forced into housing-related stress or dislocation from social networks.

As recipients of social housing would receive Rent Assistance, the amount they pay to their landlord should reflect the market rent of a dwelling. A dwelling's rent reflects the range of benefits it provides, such as the building's size and quality and the location's proximity to employment, services or nearby amenities. Charging market rents would allow recipients to make trade-offs between these aspects of housing and other elements of their consumption. It would also provide signals to social housing providers about the housing that is valued by their clients. In combination, Rent Assistance based on market rents should encourage the provision of social housing that is of value to tenants.

There will, however, be some circumstances where the use of market rents will be neither possible nor appropriate. For example, in some remote Indigenous communities there is no effective market for rental housing. It may not be possible for market rents to be used in these areas. In a limited number of areas — such as in mining towns facing supply constraints in the provision of rental housing— market rents may reach a level where even the enhanced Rent Assistance program envisaged by the Review will not provide assistance that makes social housing affordable by low income households. A short-term departure from setting market-based rents may be the most effective way of addressing such cost pressures on tenants. In such cases, there may be a need for social housing to limit rents with reference to tenant incomes.

The Review Panel considers that combining access to Rent Assistance with market rents would improve the equity of housing assistance. However, this approach would be a significant departure from the existing approach of charging income-based rents. Transitional arrangements would need to be considered as part of any changes to rental subsidy arrangements (see Box F5-1).

Box F5-1: Transition mechanisms in social housing

The proposed approach for rent-setting and funding in social housing is a substantial shift from current practices.

Even with access to increased Rent Assistance, tenants who occupy dwellings of high market value would be exposed to a reduction in income if these reforms were introduced suddenly. The move to market rents should be phased in gradually. A potential approach could be for tenants to receive Rent Assistance based on the market value of their social housing dwelling, but have their providers charge them a rent at a discount to the market value to ensure that they are not initially worse off. This discount could be reduced at an annual proportion, enabling a very gradual transition toward market rents over a number of years. A gradual approach would enable tenants time to find alternative housing if they find it better value than the dwelling they currently occupy. In some cases, grandfathering of existing tenants may be necessary.

The National Affordable Housing Agreement would require renegotiation to facilitate reform, which should take into account transitional arrangements for tenants.

The high-need housing payment would involve very substantial reform to the current National Affordable Housing Agreement. In combination, the Rent Assistance and high-need housing payment would direct assistance to recipients on the basis of their means and needs and would also be a reliable and transparent form of funding for housing providers. Through Rent Assistance and the high-need housing payment, the Australian government would become the main funding provider for housing assistance. Housing for low-income and disadvantaged households would be delivered by State housing authorities and community organisations, as well as private providers. This approach would effectively create a user-directed funding model for the provision of public and community housing. Allowing assistance to be directed by recipients gives them greater choice and places pressure on providers to deliver housing that recipients want to live in. Housing support that is neutral between public and private rental tenures would encourage more responsive provision of social housing. The 2007 National Housing Survey indicates that 63 per cent of public housing tenants are satisfied with their dwelling, while 78 per cent of community housing recipients are satisfied with theirs (AIHW 2007a and AIHW 2007b).

However, the Rent Assistance reforms and the high-need housing payment will not replace the need for governments to provide capital funding for social housing. This is particularly the case for Indigenous housing in remote areas, where the Australian government has already assumed responsibility for the provision of capital funding. As the social housing sector will need to continue to provide a significant part of the stock of housing in Australia, capital funding can also enable a more immediate increase in supply when the housing market is constrained.

Tenure security and housing assistance

Tenure security is an important aspect of social housing for some recipients. Because many renters are unable to purchase long-term secure leases at a reasonable cost in the private market in Australia, social housing has tended to become the default provider of long-term secure rental properties. However, under the current arrangements, security of tenure comes at a large cost to providers, as the rent they receive from tenants generally moves in line with income support (indexed to CPI or wages), which is unrelated to the market rent of the dwelling. Further, while they receive tenure security, it is only for one dwelling, which can lock recipients in to particular housing.

The proposed funding model for social housing should enable security of tenure for recipients. By providing assistance in line with the likely costs of tenants, the high-need housing payment provides an incentive for social housing providers to house tenants with special needs. As Rent Assistance is proposed to move in line with rents, this reduces risks to clients and enables social housing providers to charge market rents. This should facilitate the use of long-term leases that are valuable for both recipient and provider.

In addition, the Review's proposed reforms to land tax (see Section C2 Land tax and conveyance stamp duty) and income taxation (see Section A1 Personal income tax) should facilitate improved tenure security in the private market over time. These reforms would reduce barriers for larger investors, such as superannuation funds, to invest in the housing market. Institutional investors are more likely to invest over long-term horizons.

F6. Transfers tied to goods and services

Key points

While transfers are usually thought of as cash payments, governments also provide transfers such as concessions and payments that are 'tied' to the purchase, or supply, of a particular good or service. These transfers are often provided to encourage the consumption of goods and services that help people improve their capabilities.

All three levels of government provide concessions. The approach across the federation is not always coherent and the interaction of concessions with other types of transfers provided by different levels of government makes it difficult to determine whether concessions provide value for money. The Productivity Commission should review concessions across all levels of government and provide recommendations for consideration by the Council of Australian Governments (COAG).

Governments also support people to improve their capabilities through the direct provision of public services such as health and education. The capacity of the tax and transfer system to deliver improvements to people's wellbeing is highly dependent on how governments fund and deliver these services. The Productivity Commission should also examine the principles of public service delivery and the mechanisms that are available to governments to deliver public services.

F6-1 The relative merits of 'tied' and 'untied' transfers

Transfers help individuals and families improve their wellbeing by helping them purchase goods and services. Transfers are normally thought of as cash payments made directly to people. They include pensions, allowances and family payments. While the recipients of these payments may need to have certain characteristics (such as being unemployed or having a disability) or undertake certain activities (such as looking for a job) to be eligible, they can generally use these payments to purchase goods and services according to their own preferences. That is, the payments are not 'tied' to any specified use.

Another group of transfers are specifically linked, or tied, to the consumption of certain goods and services. The adequacy, equity and efficiency effects of cash transfers cannot be fully assessed without considering tied transfers. For this reason, the Review has considered some major tied cash transfers such as child care assistance (Section F4) and rental housing assistance (Section F5). This section discusses the issues related to tied transfers, since they arise across a wide range of other government programs and assistance.

Tied transfers can be provided by way of:

- discounted prices at the point of purchase available in specified circumstances and for specified goods and services, such as lower public transport prices for concession card holders; and

- entitlements that can be used at the point of purchase or cash rebates available some time after the purchase of specified goods and services. For example, the Child Care Benefit provides eligible families with funding to reduce their child care fees.

Recently, the tying of some income support has also been trialled in parts of Australia. A proportion of cash transfers are directed to priority needs of individuals, families and children. The central idea of these transfers is that government support should be conditional upon personal and socially responsible behaviour.[33]

Governments provide a mix of untied cash transfers and tied transfers — either to encourage some types of consumption or to limit or prevent other types of consumption. The purpose, design and relative merits of these different types of transfers are discussed below.

Cash transfers can provide freedom and choice

In general, united cash transfers allow people to make the best use of available resources to meet their particular needs. For example, people in rural areas may pay less on rent but more on transport than people living in the city. Providing a cash transfer means they can allocate their resources as they wish, rather than having to spend some minimum amount on rent or transport.

It is also easier to integrate cash transfers with other aspects of the tax and transfer system. Cash transfers can be targeted to people with different incomes by withdrawing the value of the transfer payment as their private income increases. Some transfers tied to goods and services can be withdrawn in a similar way; for example, the value of an entitlement could be based on income. If there are many entitlements for different goods and services, however, simultaneous withdrawal as income increases can create high effective marginal tax rates. In contrast, a cash transfer that helps people access a range of goods and services can be withdrawn as a single payment with a single withdrawal rate.

Transfers provided in the form of discounted prices can be particularly difficult to integrate with other aspects of the tax and transfer system. Because of the complexity of providing individualised discounts to people based on their income and other characteristics, these transfers are typically provided as a set discount to a wide group of people. For example, access to a concession card may be given to all recipients of income support payments. Although this is simpler than providing differentiated discounts, it can result in people with large differences in financial capacity receiving the same amount of assistance. It can also result in 'sudden death' drops in the value of transfers when people lose eligibility for the discount. In some areas, particularly the health system, this risk is removed by providing universal transfers without means testing.

Tied transfers can encourage consumption of merit goods

While cash transfers have advantages, there are circumstances where they will not be the most effective way of delivering assistance. Sometimes people may spend cash in a way that is inconsistent with the community's reasons for providing the assistance. For example,

33 Examples of this type of approach include aspects of the Northern Territory Emergency Response and Cape York Welfare Reform Trials.

many people might object to people spending cash transfers on alcohol rather than their child's education. In such cases, education is a merit good — that is, a good that people should consume regardless of their preferences for other things. At other times, governments may want to limit access to certain goods that may be detrimental to society or a person's development. For example, alcohol may be considered a 'demerit good' for someone who is attempting to escape addiction and poverty. Linking transfers to certain goods and services can encourage the consumption of merit goods and limit the consumption of demerit goods (provided that the transfer cannot be easily exchanged for cash). This can be particularly beneficial for people who have trouble managing their income.

Tying a transfer to a good or service can also ensure that the transfer goes to those in most need. Since cash is of benefit to anyone, people will have incentives to present themselves as being in need (Akerlof 1978). However, by tying a transfer to a particular good or service, the government can ration the good or service to those who actually need it. For example, few people would be interested in having access to disability support services unless they have a disability, but many more would be interested in a (similarly valued) cash transfer. Tied transfers are more likely to be of direct value only to the targeted recipients.

Transfers tied to goods and services can also be tailored to those with high need. A person may have high health or support needs due to illness or disability, or their costs may vary depending on where they live. Determining a rate of payment based on what an average person requires can result in some people receiving less support than they need, and others receiving more. In cases where levels of need vary considerably across the population, a transfer provided as a concession may entail less risk of under-compensating those with high needs and over-compensating those with low needs. It can also allow people to manage their risks better by giving them access to goods and services at times when they need them most. For example, it can be difficult for someone to predict when their health expenses will be high. Providing low-income earners with a guarantee of a discount on their health expenses rather than an ongoing cash payment can be a better way of managing their risk (although for some insurance can also serve this function).

The design of a transfer should take into account whether it will affect how much of a good or service people will consume and how much (and what quality) providers will supply. A transfer tied to a particular good or service can mean that the consumer does not respond to price signals. For example, if the price of water increases, people who receive a discount on their water bill may not reduce their consumption by as much as they would have done if they had they been paying the full price. Capping the value of the transfer can help reduce this effect.

On the supply side, transfers can be delivered by governments requiring providers to charge lower prices or to supply fixed quantities. If providers do not receive the full price from a high proportion of consumers (and they are not compensated for having to provide their good or service at a lower price), they have less incentive to increase supply, or improve the quality of their product. For example, if a large proportion of commuters on a rail service are travelling for free, the rail company has less incentive to invest in the service. While governments have a role in ensuring that quality standards are adequate and can be trusted by all users, regulatory obligations on providers should generally not be used to provide transfers to particular groups. That is, community service obligations should be funded by governments, not by cross-subsidies between consumers. This does not mean, of course, that businesses should not engage voluntarily in social responsibility programs or pricing policies that assist particular groups.

Providing tied funding to people (potentially tailored to their characteristics) and allowing them to choose between providers can often be the best way for governments to encourage the consumption of certain goods and services while also supporting efficient service provision.

Principles

Cash transfers are generally a better way to provide general living assistance because they can be provided simply, allow recipients more choice and are more easily integrated with the rest of the tax and transfer system.

Transfers attached to specific goods and services can be effective in encouraging the consumption of merit goods (especially for people with income-management problems) and delivering assistance to people with diverse needs. These transfers should be provided by assisting people so they have the resources to access goods and services — not by regulating providers or through imposing cross subsidies. These transfers can be provided in a manner that supports efficient service provision, consumer choice and equitable outcomes.

Providing transfers in the federation

Many, if not most, Australians are concerned about other Australians living in poverty. Poverty alleviation can therefore be viewed as a national goal. If the best approach to poverty alleviation is providing a mix of untied and tied transfers, then the national government is best placed to undertake this role as competition between sub-national governments can lead to a sub-optimal level of transfers. For example, if one jurisdiction had higher rates of payments, it may encourage the poor to relocate to that jurisdiction. To prevent this response, sub-national governments may reduce the transfers they provide (Wellisch 2000).

This suggests that the Australian government should fund transfers that are aimed at poverty alleviation to ensure that all Australians have access to a basic standard of living. This includes cash transfers and some transfers tied to goods and services (which may be explicitly linked with the receipt of a cash transfer). State and local governments may choose to provide additional funding to reflect their different priorities, the different needs of their population or the different ways that goods and services are provided in their jurisdiction.

It would be necessary for governments to reach agreement on which transfers tied to goods and services are necessary for poverty alleviation.

Principle

Poverty alleviation is a national goal that should be financed by the national government. The Australian government should be responsible for funding those transfers that ensure that all Australians have access to a basic standard of living. State and local governments may choose to provide additional funding, reflecting area-specific concerns.

F6-2 Concessions — their scope and role in the transfer system

Concessions are generally provided as reductions in prices or bills and are used to provide low income groups with more affordable access to commonly used goods and services such as water, energy and transport. Concessions are also provided for government taxes and user charges. For example, certain groups of taxpayers receive concessions on local government rates (see Section G3 Local government).

Concessions play a large role in the transfer system and all levels of government in Australia deliver them. It is difficult, however, to determine the total expenditure on concessions because the value of the concession used in some transactions may not be recorded.

The Australian government's concession card system acts as a gateway to a number of concessions throughout Australia. Concession cards are broadly available to people receiving a pension or allowance, as well as people and families with low incomes and seniors. Over 5.2 million Australians (around one quarter of Australia's total population) hold one of many concession cards, principally Pensioner Concession Cards and Health Care Cards.[34] Around 85 per cent of people over Age Pension age hold an Australian government concession card, either a Pensioner Concession Card, or its equivalent in Veterans' Affairs, or a Commonwealth Seniors Health Card (FaHCSIA 2009).

The Australian government plays a central role in the provision of health and related concessions, including through the Pharmaceutical Benefits Scheme, and Medicare co-payments and safety nets. There are substantial price subsidies for Pharmaceutical Benefits Scheme medicines as well as the Pharmaceutical Benefits Scheme safety net, which has a lower threshold for concession card holders. For medical costs, the Medicare safety nets limit out-of-pocket costs for medical services provided out-of-hospital — again there are lower thresholds for concession card holders.

State and local governments fund and administer a number of concessions and generally make decisions on the type and level of concessions they offer. State and local government concessions include discounts for council and other property based rates; utilities, including energy, water and sewerage; public transport; and motor vehicle registration. The forms of concessions include fixed amount discounts; percentage discounts that may also be capped at a maximum dollar amount; and rebates on or exemptions from charges. While similar concessions are available in each of the States, there is variation in the value of concessions available in each State.[35]

The Australian government contributes some funding towards selected State-based concessions through a national partnership payment. The partnership specifies a number of concessions the States must provide to all Pensioner Concession Card holders, and requires the States to provide public transport concessions for all Seniors Card holders, irrespective of their State of residence.

34 There are also approximately 2 million dependants listed on concession cards who have access to some concessions.

35 Tables 2.27 to 2.34 of the Australia's Future Tax System Architecture Paper provides information on the range of concessions available in each State.

Concerns with the current approach to concessions

Current concession arrangements raise concerns in terms of incentives to work, equity and complexity.

Work disincentives

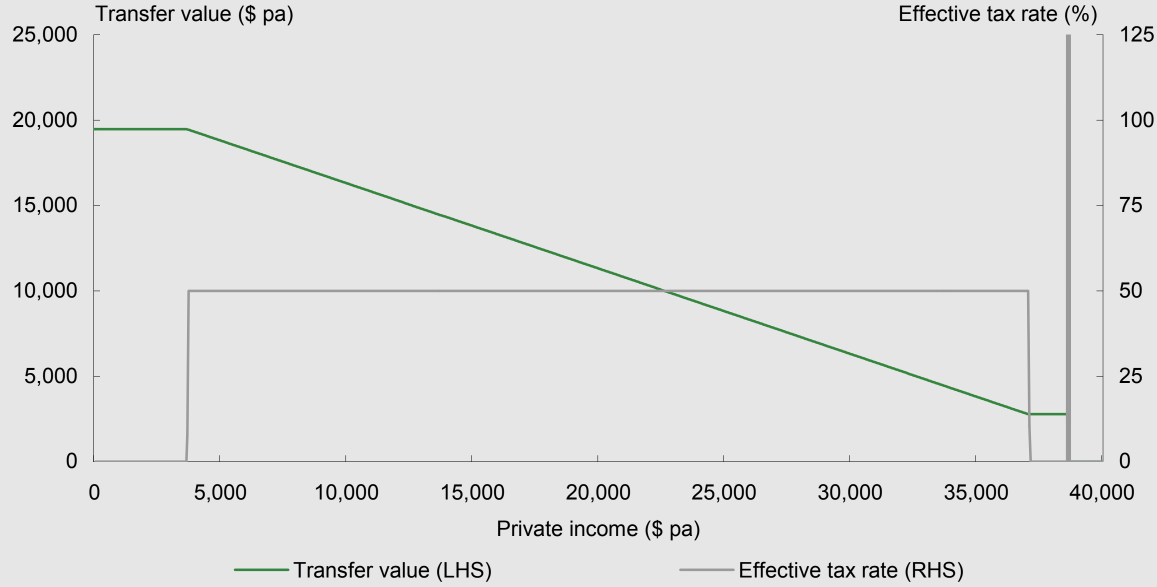
Eligibility for many concessions depends on whether a person holds a concession card. Concessions and concession cards are not withdrawn gradually like income support payments — all individuals who have the same concession card get the same concessions regardless of differences in their personal income. That is, a person receiving the maximum amount of income support will generally have the same access to concessions as a person who qualifies for only one dollar of payment. This creates a high effective tax rate on the last dollar of payment and provides strong incentives for people to gain or retain eligibility for payments (see Box F6-1).[36] This is particularly relevant for people who are heavy users of their concession cards or who value their concession card highly because of the insurance it provides. Disability Support Pension recipients, for instance, may be reluctant to jeopardise the concessions they receive for health and disability goods and services by testing their ability to work.

36 Once people no longer qualify for relevant payments, they must generally stop using their concession cards. However, in some circumstances, people can retain their concession cards for a short period of time after returning to work. These provisions are designed to assist people to make the transition from income support to work.

Box F6-1: Concession cards and effective marginal tax rates

Chart F6-1 illustrates how linking eligibility for concession cards to the receipt of any amount of transfer payment can contribute to high effective marginal tax rates. The chart shows the value of transfers that a single pensioner receives from their pension (including pension supplement) as well as their pensioner concession card, assuming that the concession card provides $2,000 worth of value each year. The chart shows the total value of the transfers (pension, supplement and concessions) on the left-hand axis and the contribution to effective tax rates on the right-hand axis.

Chart F6-1: Concessions and effective tax rates



At income levels above the free area ($3,692 per annum), the pension payment for single pensioners is withdrawn at a rate of 50 per cent. The minimum rate of the pension supplement is kept until income reaches a level that would otherwise reduce total payments to zero. At this income, eligibility for the pensioner concession card is also lost. For the last dollar of payment, both the minimum rate of pension supplement and the value of the concession card are lost. While the chart shows the effective tax rate rising above 100 per cent, if the concession card provides $2,000 worth of value (and an alternative concession card is not available), the effective tax rate on the last dollar will be over 200,000 per cent.

Equity

If a concession card is widely available, its value as an indicator of financial need can be diminished. In particular, as the number of card holders rises, the need for a concession card may lose acceptance among service providers and the general population. For example, the Pension Review's consultation process found that some general practitioners have become less willing to bulk bill concession card holders, as not only do they represent a very high proportion of their patients but some card holders have significant private income (FaHCSIA 2009).

In some cases concessions may operate regressively. For example, concessions for local government rates can be regressive with respect to wealth holdings because the dollar value of the concession is often greater for people with higher-value properties. Additionally, renters may effectively pay rates in the form of higher rental payments and get no assistance. Although the value of concessions for local government rates is generally capped, these concessions can still be worth significant amounts of money over time.

Further inequities can arise if higher-income concession card holders live in areas where there is better access to services (such as transport), so they benefit more from their concession card.

Complexity

All three levels of government are involved in the delivery of concessions and there are a large number of concessions available. It can therefore be difficult for people to determine what concessions are available, the level of government responsible for the delivery of the concession and how much governments are spending on concessions. For governments, it can be difficult to identify the outcomes from providing concessions and hence whether they give value for money. This is further complicated when there are other types of transfers with similar policy objectives (see Box F6-2).

Box F6-2: Different forms of assistance provided by different governments — but with a similar purpose

The Australian government and State governments provide different forms of assistance for accessing transport services. The Australian government provides assistance through Mobility Allowance — a payment available to people with a disability aged 16 and over who are unable to use public transport without substantial assistance and are required to undertake work, training or job seeking activities. A number of State governments also provide taxi subsidies to people who cannot use public transport. For example, in NSW, the Taxi Transport Subsidy Scheme allows eligible applicants with a permanent disability to travel by taxi at half fare up to a maximum of $30 per trip. A similar scheme operates in Victoria (the Multi-purpose taxi program) where the maximum per trip subsidy is $60. For both programs, the subsidy may be used for taxi travel in other States.

Differences in concessions for local government rates may also be seen as a source of complexity. The current arrangements allow the States to set their own levels of concessions: some provide concessions as a flat amount, while others provide a percentage reduction. Further, some States increase the value of the concession on an annual basis, while in other States the value of the concession has not changed for many years.

Findings

The use of concession cards as a gateway to a number of concessions provided by the Australian, State and local governments creates strong incentives for people to gain eligibility for concession cards.

While eligibility for concession cards is targeted, some concessions are regressive because they provide higher value transfers to people with higher means.

The interaction of concessions with other types of transfers provided by different levels of government makes it difficult to determine whether concessions provide value for money.

Reform directions

Recommendation 107:

The Productivity Commission, constituted to include an appropriately qualified and experienced member, should review concessions across all levels of government and provide recommendations for consideration by COAG.

While some concessions complement other forms of assistance in the tax and transfer system, a number of current concessions have questionable objectives and equity outcomes. Further, continuing to provide concessions under the existing arrangements may not be sustainable as the population ages, particularly considering the number of people who have access to concession cards at the moment.

There is a strong case for rationalising a number of concessions as well as converting some into cash transfers or tax reductions. Concessions that provide relatively more value to people with greater means should be priorities for reform. There is also a case for greater coordination across the federation to ensure equity and consistency in the way concessions are funded and delivered.

Because of the number of concessions in the current system and because reform to concessions would affect funding across all levels of government, the Productivity Commission should review concessions across all levels of government and provide recommendations for consideration by COAG. To assist the Productivity Commission, an Associate Commissioner with appropriate knowledge and expertise should be appointed to the review. Reforms could then be implemented through an intergovernmental agreement (for more detail, see Section G2 State tax reform).

In the long term, technology may also allow for alternative ways to deliver assistance currently provided as concessions. This could come from a combination of a single customer account that could be viewed and managed online, and the use of smart card technology that would allow concessions to be granted at the point of sale. Point-of-sale information could be brought together to help governments determine the particular needs of different people, based on their characteristics (for example, disability, age or location).

Such a system offers the potential to facilitate better income management, as the assistance provided by governments would be more transparent. It may also allow governments to tailor assistance to those with diverse needs, rather than issuing a concession card that gives all holders access to the same level of assistance.

F6-3 Differing mechanisms to deliver government-supported goods and services

The use of transfers tied to goods and services to support the consumption of merit goods raises the broader question of how governments provide support for merit goods in general. Governments support a range of goods and services in Australia, such as public hospitals and public schools. For these services, governments generally provide funding to a limited number of suppliers (usually government-operated) in a block grant type arrangement.

While this funding is not provided directly to people in the same way as other transfers are provided, it also helps people access goods and services to improve their wellbeing.

Current arrangements appear to have largely historical origins rather than to result from comprehensive assessments of the best ways to fund or deliver services. For example, there is a strong presence of direct public sector provision in schools and hospitals, but not in child care or aged care where large increases in demand have emerged relatively more recently. Changes are slowly evolving — in recent years there has been a shift to greater private provision in schools and a decline in the role of public housing. There has also been a growing reliance on contracting services to non-government organisations. But in these and other cases it is not clear whether developments are following changes in demand or assessed needs, or whether other forces are shaping funding and supply policies.

One result of current arrangements is that there are substantial differences in the ways in which the same or similar services are funded and delivered through public and private mechanisms. It is not clear that these differences ensure that public objectives such as equity are being met, nor that the full potential benefits of user-directed choice are being obtained. These differences are further complicated by the fact that the different levels of government take different levels of responsibility for providing funding. In general, the Australian government often provides funds for private sector provided services, usually requiring or allowing private co-payments, and often providing a degree of user choice. The States, on the other hand, assisted by grant funding, usually provide public services free of charge on a universal access basis (hence often also generating waiting lists). The combination of these arrangements may or may not produce equitable outcomes, and may or may not produce efficient service delivery. In many areas, there is considerable concern about various aspects of these outcomes. The different roles of the different levels of government also raise issues about transparency and accountability for outcomes.

The assistance governments deliver through direct service provision often interacts with parts of the tax and transfer system that aim to deliver similar outcomes. For example, the need for the medical expenses offset or the private health insurance rebate is influenced by how governments fund (and how people are able to access) hospitals and health services. Another example arises in the housing sector, where access to affordable housing is supported by three broad mechanisms:

- housing funded and provided directly by governments at rental rates below market rates, such as public housing;
- housing provided by non-government or private providers who are funded under government contracts, such as grants to community housing providers; and
- housing provided by non-government providers where renters are given government funding, such as rent assistance, directly.

The mechanism that governments choose to deliver assistance is to a large degree dependent on the objectives governments want to achieve. For example, if the government's goal is that all household rubbish is collected, it may be more effective to provide the service directly or contract a single provider, rather than providing individualised assistance to households and compelling them to contract a service provider.

However, as cost pressures grow in the future, governments need to make sure the mechanisms they use are as efficient and equitable as possible. Governments also need to ensure that the mechanisms they use do not lead to unintended outcomes. For example, while governments may choose to subsidise public transport with the aim of reducing traffic congestion and carbon emissions, such subsidies may provide greater benefit to those with higher incomes. IPART (2004) found that over 60 per cent of full-fare paying trips on Sydney ferries (which are subsidised and priced below actual cost) are taken by residents with household incomes over $100,000 a year. Further, in 2001 and 2002, CityRail's subsidy per passenger kilometre was significantly lower than subsidies provided by Sydney Ferries, despite the fact that users of CityRail services come from lower-income households than users of Sydney Ferries.

Governments and the public should be aware of such outcomes, but the manner in which these subsidies are provided often makes it difficult to identify and quantify them.

Reform directions

Recommendation 108:

The Productivity Commission should examine the principles of public service delivery and the mechanisms that are available to governments to deliver public services and their implications for financial arrangements in the federation. The findings of this study should be considered by COAG.

While the size and range of government-supported services is outside the terms of reference of the Review, it is clear that the capacity of the tax and transfer system to deliver improvements to people's wellbeing is highly dependent on how governments fund and deliver public services such as health and education. Governments should explore the potential for different mechanisms to deliver government-supported services in more effective ways. This is particularly so because governments in Australia have moved to a much more complex environment for service delivery. In this environment, the same or similar services are provided via a range of mechanisms.

While the overall provision of government-supported services in Australia (compared to 22 other OECD countries) has been found to be relatively efficient (Afonso et al. 2003), other studies that have focused on specific services in Australia have revealed many areas where better outcomes could be achieved. Population ageing is likely to put greater pressure on the need to achieve value for money in public service delivery.

A useful starting point would be for the Productivity Commission to examine the principles of public service delivery; that is, what governments should be seeking to achieve in funding public services. This study should also examine the mechanisms that are available to governments to deliver public services and how appropriate they are for different types of public services.

The outcome of any review of these issues would potentially have significant implications for the tax and transfer system, including the best assignment of taxing powers between the levels of government. It is possible that they would lead to a stronger funding (as opposed to service delivery) role for the Australian government. It would be unfortunate if tax and transfer decisions were made in isolation of the consideration of these related issues by all governments.

As all three levels of government in Australia are closely involved in public service delivery, the findings of the Productivity Commission study should therefore be considered by COAG.

F7. Funding aged care

Key points

The priorities for governments are to determine what an adequate level of aged care should be to ensure a decent quality of life for older people, the necessary pricing and regulatory arrangements to deliver it, and the most sustainable funding arrangement to ensure access by those who cannot afford it.

Recent reviews of the aged care system have called for increased choice for consumers and reduced regulation on aged care providers. Limiting the number of subsidised aged care places and associated price controls impedes competition between providers, undermining both their capacity to respond to the needs of older people and their incentive and ability to plan for future growth in an industry driven by an increasingly ageing population.

Responsive and sustainable aged care services are particularly important because many people requiring the services are vulnerable, and the fiscal costs to the economy are increasing.

The Australian Government has announced a Productivity Commission inquiry into aged care to be conducted in 2010. This inquiry will examine all aspects of aged care and make recommendations on options for redesigning Australia's aged care system to ensure it can meet the challenges facing it in coming decades.

Australia's aged care sector is complex in both its regulatory system and its funding arrangements. It is beyond the scope of this Review to examine aged care in detail and, given the Productivity Commission inquiry, it would clearly be premature. However, a range of issues related to the tax and transfer system should be considered alongside the Productivity Commission's recommendations, including changes to the current funding arrangements to improve equity across aged care programs and support for structural reforms aimed at improving consumer choice in aged care services.

F7-1 Funding and charging for access, equity and efficiency

Access to adequate aged care services is a key component of the wellbeing of older Australians. A key reason for government funding of aged care is to ensure that older people of limited means can access these services.[37]

Aged care spending is projected to grow rapidly — from 0.8 per cent of GDP in 2008–09 to 1.9 per cent of GDP in 2048–49 — and was the fastest-growing component of government expenditure identified in the Intergenerational Report 2007 (Australian Government 2007a). This growth is driven largely by demographic changes, with the number of people aged 85

37 The government also has a role in other aspects of the aged care sector, including addressing failures likely to occur in market provision, such as exploitation arising from lack of information by care users.

and over projected to increase from 378,000 at 30 June 2009 to 1.8 million by 2049 — a more than four-fold increase. The life expectancies of older Australians are also projected to rise, and care needs tend to increase with age. In 2003, 32 per cent of those aged 65 to 74 required assistance, while this number increased to 86 per cent of those aged 85 and above (Productivity Commission 2008b).

Demand for aged care services is also expected to become more varied in the future. Aged care recipients are likely to have a wider range of complex or high-level care needs, as advances in treatment enable people with chronic diseases to live longer. Increasing affluence and ethnic diversity are also expected to lead to a wider range of client preferences. In particular, demand for care provided at home will increase, due to strong preferences for independent living among the baby boomer generation. Common to all these factors is recipients' desire to exercise greater choice about the care they receive, greater capacity to 'age in place' and better continuity of care.

Features of the current aged care sector are significant regulation of supply and pricing, together with limited choice for recipients. These features restrict the delivery of care consistent with recipients' preferences. The Productivity Commission is expected to examine the aged care sector in detail in its inquiry during 2010. Accordingly, this Review focuses on the funding and charging arrangements for aged care. Charges for aged care affect the incentive for people to save for retirement and the adequacy of their income during retirement. Public financing of the sector represents a growing pressure on the taxation system. While funding from the public purse is necessary for some older Australians, those with sufficient means should be responsible for contributing to the costs of their own care.

What is aged care?

Aged care services are actually one or more of a number of different services that can be used by older Australians, including personal care, health care, assistance with everyday living and, in residential aged care, accommodation.[38]

Personal care

Personal care services include assistance in eating and drinking, personal hygiene, managing bodily functions and minor medical treatments. Many older Australians have diminished capacity to perform such functions by themselves because of frailty or disability.

Personal care services are generally the most expensive of the range of services provided in aged care, accounting for half to three-quarters of total residential aged care costs (Productivity Commission 2003). There is a wide spectrum of personal care depending on individual needs, ranging from low levels of episodic assistance to high levels of ongoing assistance. The variation in care costs is substantial. For example, care costs can range from less than $1000 a year for occasional assistance to perhaps more than $50,000 a year for a people with dementia, whose care need can continue for a number of years.

Addressing personal care needs provides the major rationale for government intervention in aged care. For an aged care system to provide an adequate level of personal care, this care must reflect the particular needs of individuals, which can be highly variable. As the cost of

38 Considering aged care in its various components is common to most studies, such as Hogan (2003).

these services can also be very large, it would not be effective to fund them through regular transfer payments to recipients. Instead, specific assistance for personal care should be targeted to the needs of individuals.

Adequacy depends not only on the degree of financial support, but also on aged care services reflecting the needs and preferences of recipients (see Section F6 Transfers tied to goods and services). Facilitating consumer choice ensures that the services people use are the ones they value most, leading to greater satisfaction and sense of autonomy among users. Choice can also improve the efficiency of provision, as providers will receive funding only when they deliver services that are valued by users. And choice puts competitive pressure on providers to reduce unnecessary costs.

Health care

Aged care can involve a range of health services similar to those provided through the health care system. These include access to nurses to administer injections, or to allied health professionals such as physiotherapists. Providing health care services through the aged care system can reflect the overlap in skills needed by providers of personal care services and allows coordination of recipients' care needs.

Assistance with everyday living

Aged care services can include assistance with a range of 'everyday living' expenses, including food or laundry expenses.

Accommodation

'Residential aged care' facilities can provide personal care, health care and assistance with everyday living, along with accommodation. When these services are instead provided in a recipient's house, they are referred to as 'community care'.

'Unbundling' aged care to assign funding responsibilities

For each of the different services available through the aged care system, the provision of assistance and the assignment of funding responsibilities are best considered separately, as these services can be provided both inside and outside the system. By 'unbundling' services and responsibilities in each component, assistance for aged care can be targeted most effectively. In particular, unbundling funding for care (both personal and health care) reduces the potential for cross-subsidies across different care types or between different users. Cross-subsidies in funding arrangements can lead to inefficient provision, encouraging people to use one type of service just to gain access to the service they really want. Care assistance that is not linked to accommodation can enable people to 'age in place' in their homes, which can improve their wellbeing by providing care where they are comfortable and allowing them to maintain their links with the community.

A system that involves cross-subsidies is also likely to be inequitable. For example, people whose means enable them to cross-subsidise other aspects of their own care (or even others' care) may receive preferential treatment from aged care providers. To prevent this, the prices received by providers should reflect the cost of providing care, rather than the means of recipients. Unbundling allows providers to charge prices in line with costs, while recipients' means determine their level of financial support.

Individuals should finance the costs of everyday living and accommodation, just as they do outside the aged care system. Assistance for these services is provided on a means tested basis through the income support system. Accommodation and everyday living costs are fairly predictable expenses and not exclusively associated with increasing frailty or disability. As such, these costs should be a private responsibility inside the aged care system, with the recipient paying the full cost of their provision. This would remove incentives for people to change their living arrangements to access aged care, potentially harming living standards in retirement.

To ensure that all Australians can access aged care, people with limited private means should be provided with assistance so they can receive an adequate level of care at no financial cost to them. Ensuring access to an adequate level of care irrespective of means is a 'public good' similar to other aspects of the redistributive system, such as income support, and should be funded by the community through general taxation. Where people do have means, they should be user charged for the services they receive. A particular personal care service is a 'private good' in that the greatest benefit from its use accrues to the care recipient, rather than the community as a whole. Charges for care should be set with reference to both a person's means and the cost of their care. Means testing should have regard to the impact of means testing undertaken in the broader income support system (see Section F2 Means testing).

It is an underlying principle of Australia's transfer system that the Australian government helps to support those with limited means while the remainder of the community supports itself. Reliance solely on taxpayer funding would most likely undermine the sustainability of the aged care system. The absence of any price signals could also reduce the efficiency and raise the cost of providing the service.

Governments need to finance the health care-related elements of aged care. Health care provided through aged care should be subject to similar charging arrangements as occurs in the health care system. This means that the health care component should generally be free or accompanied by modest co-payments. However, this general approach would need to be balanced by practical considerations, as the distinction between health care and personal care can be difficult to draw in aged care.

Ensuring access to an adequate standard of services should not preclude people from purchasing a higher standard of service, provided they pay the full additional cost. The existence of additional services does not, of itself, reduce the standard of care for those who receive no more than the adequate level. Preventing the purchase of a high standard not only denies access to care that people value, but is also likely to stifle the delivery of higher-quality care. Access to higher-quality services would also provide an additional reason for potential recipients to retain their assets into retirement.

Principles

Equitable provision of assistance for aged care would ensure that recipients of limited means can access an adequate standard of care. To ensure that aged care services meet the needs and preferences of users, funding should be tailored to the needs of users and directed in line with choices. As care may often be delivered effectively in both recipients' homes and aged care facilities, assistance for care should generally not be tied to a particular care setting.

Recipients should generally pay for accommodation and living costs provided through aged care with user charges equal to the cost of their provision, as these costs are personal responsibilities outside the aged care system.

Recipients with sufficient means should contribute to the cost of their care, which should result in more efficient provision of care and reduced cost on taxpayers. Means testing of aged care assistance should be consistent between residential and community care options while taking into account other taxes and means tests applying to older Australians.

The provision of means tested care should not preclude the provision of aged care beyond the adequate standard of service. Recipients should be fully user-charged for such care.

F7-2 Current funding and charging arrangements have weaknesses

Overview of the system

A range of government-subsidised aged care services are available through either residential or community care programs. Table F7-1 summarises features of the available programs.

The majority of recipients of aged care services receive relatively low levels of support in the community through the Home and Community Care (HACC) program. This care is funded by both the Australian and State governments, with access to programs governed by providers who follow guidelines established by States.

The other care programs are funded by the Australian government. Access to subsidised aged care services are regulated in two ways:

- Potential recipients are assessed by Aged Care Assessment Teams (ACATs), who act as gatekeepers to subsidised care. ACATs determine a person's eligibility for a type of care (residential or community, high or low needs, permanent/respite).
- Subsidised care must be delivered by an approved provider, whose supply is regulated according to needs-based planning arrangements, which limit the number of providers in the following ways:
  - Across the country, 113 aged care places are provided for every 1000 people aged 70 years or over. The total number of places is divided between 44 high-level residential care places, 44 low-level residential care places, 21 low-level community care packages and 4 high-level community care packages.

– These places are allocated geographically within regions of a State in line with the proportions of elderly in each area. Once an allocation to a particular area is made, it is not generally subject to subsequent review. The ability to become a care provider is tied to a particular area and allocated through a (non-price-based) competitive tender.

Table F7-1: Current aged care programs

	Health and Community Care (HACC)	Community Aged Care Packages (CACP)	Extended Aged Care at Home (EACH)	Extended Aged Care at Home — Dementia (EACH-D)	Residential (Low level care)	Residential (High level care)
Number of recipients	831,500	61,740			160,000	
Government funding	$1.7 billion(a)	$729 million			$6.7 billion	
Source of government funding	Commonwealth (60%) and States (40%)	Commonwealth			Commonwealth	
Total cost per recipient ($)	2,086	15,100	43,630	49,150	39,550	63,300
Private contribution	5	16	5	5	53	26

(a) Excludes additional funds from state and territory governments over the matching requirement (estimated to be $119 million in 2006–07).
Note: These figures overstate the private contribution towards the cost of residential aged care services compared to community care. These private contributions for residential aged care reflect payments toward accommodation and daily living expenses, which are paid for by recipients of community care services.
Source: Department of Health and Ageing (2009a).

Residential aged care

The following sections discuss the funding and charging arrangements for the different services provided in residential aged care.

Personal and health care

In residential aged care, the Aged Care Funding Instrument (ACFI) is used to determine the level of assistance for both personal care and some health care costs. The ACFI divides the type of care a resident requires into three domains and each domain has three funded levels (see Table F7-2). The higher the level a resident is assessed at in each domain, the higher the cost of their care and the larger the payment received by the aged care facility to provide their care. For example, the cost of care for a resident assessed as low on activities of daily living, medium on behavioural supplement and high on complex health care supplement would be $99.01 per day or $36,139 for a year.

Table F7-2: Daily ACFI subsidy rates (at 30 June 2009)

Level	Activities of daily living	Behavioural Supplement	Complex Health Care Supplement
Nil	0	0	0
Low	$29.78	$6.81	$13.40
Medium	$64.86	$14.11	$38.17
High	$89.85	$29.72	$55.12

Source: Department of Health and Ageing (2009b).

This funding arrangement is essentially 'user-directed' funding, as the assistance goes to recipient's choice of provider. However, the benefit of this funding model is limited by the supply restrictions enforced through the needs-based planning ratios, which operate as a second gatekeeper on care (Productivity Commission 2009).

Supply restrictions can lead to high occupancy rates in care facilities and the use of waiting lists for access to care. As noted by the National Health and Hospitals Reform Commission (2009), limited availability of places can lead people to choose the first available place, rather than choosing their preferred facility. When this occurs, providers have little incentive to attract clients by delivering better-quality care. The restrictions also act to prevent popular providers expanding their share of the market. While funding through ACFI (with 64 different levels of assistance) provides scope for significant tailoring of assistance to assessed need, recipients are allocated to a care entitlement in either a low-level or high-level facility. The use of these broad categories can affect access to care because providers are able to charge recipients differently for non-care costs depending on these categories, which will be discussed in greater detail below.

The means tested fees paid to providers reduce the government subsidy, which ensures that providers receive the same payment for each recipient to whom they provide care. The resident's fee is equal to 41.67 per cent of their income in excess of $20,376, a figure set equal to a full rate single Age Pension (including supplement) plus the income-free area of the income test. The maximum fee a resident can be charged can not be greater than the cost of their care, as determined by the ACFI, or greater than $21,674, set as 150 per cent of the annual single basic Age Pension (see Table F7-3). The effect of care fees is considered below in combination with other means tested fees in residential aged care.

Table F7-3: Funding of health and personal care in a residential aged care facility (annual)

	Income	Care cost	Resident fee	Government subsidy	Provider revenue
Full pensioner	$19,000	$36,139	0	$36,139	$36,139
Part pensioner	$40,000	$36,139	$8,177	$27,962	$36,139
Self-funded retiree	$60,000	$36,139	$16,510	$19,629	$36,139

Source: Department of Health and Ageing (2009c) and Treasury calculations.

Assistance with every day living costs

Residential aged care provides people with food and other living costs, such as laundry. These services can be provided at a standard quality or a higher 'extra service' level.

All residents who receive standard service pay a fee equivalent to 84 per cent of the single Aged Pension, currently equal to $36.94 per day or $13,483 per year. This fee is notionally allocated to the funding of activities of daily living.

'Extra service' can include a range of additional services such as better food or pay TV, hairdressing, newspaper delivery or a larger room (interacting with accommodation, which is discussed below). Providers must be approved to provide a place offering extra services, and the number of extra service places in a region is capped to ensure that residential care remains available to people who cannot afford the additional charges.

Providers may charge an additional 'extra service daily amount' for providing these services. As well as cost recovery, the use of extra service fees affects other aspects of aged care funding and charging. Regulations reduce a provider's residential care subsidy by 25 per cent of the extra service fees they charge clients. A further regulatory implication is that if a high-care resident uses extra services their provider can charge them differently (often more) for their accommodation than they could otherwise. These funding arrangements give both suppliers and users a disincentive for the use of extra service places.

Accommodation

Residents can be charged for the accommodation they receive through either a charge or a bond. Charges are used for residents entering high-care facilities, unless they chose to receive 'extra service' which allows providers to charge them bonds. Providers can ask all low-care residents to pay a bond.

The level of an accommodation charge is determined by residents' asset levels. No charge is paid for residents whose assets are below $36,000, with the charge increasing to a maximum of $26.88 per day at an asset level of $91,910.40. The Australian government provides an 'accommodation supplement' in respect of residents who do not pay the full charge. This is an effective accommodation subsidy for those residents, which ensures providers receive the same payment for accommodation irrespective of recipient means. Access to an accommodation subsidy of some form is appropriate in aged care, as outside the system older people who face high housing costs are eligible for Rent Assistance on top of their pension.

Residents entering low-care or high-care 'extra service' places can be asked to pay an accommodation bond whose value is agreed between the resident and the provider. The only limit on the size of the bond is that it must not leave the resident with less than $36,000 in assets. Providers retain any earnings on the bond for as long as the resident uses their service. In addition, for or up to a maximum of five years providers can retain 10 per cent of the bond each year, with the amount capped at $3,588 per annum (for bonds over $35,880).

Table F7-4: Funding of accommodation services in residential aged care

	Assets	Charge	Government subsidy(d)	Bond income	Provider revenue (charge)	Provider revenue (bond)
Full pensioner	0	0	$9,811	na	$9,811	na
Full pensioner	$80,000(a)	$7,195	$2,616	$6,388	$9,811	$6,388
Part pensioner	$200,000(b)	$9,143	$668	$14,088	$9,811	$14,088
Self funded retiree	$400,000(c)	$9,811	0	$24,588	$9,811	$24,588

(a) Pays a bond of $40,000.
(b) Pays a bond of $150,000.
(c) Pays a bond of $300,000.
(d) Only if resident pays a charge not a bond. The provider revenue from the bond assumes a return of 7 per cent.
Source: Department of Health and Ageing (2009c) and Treasury calculations.

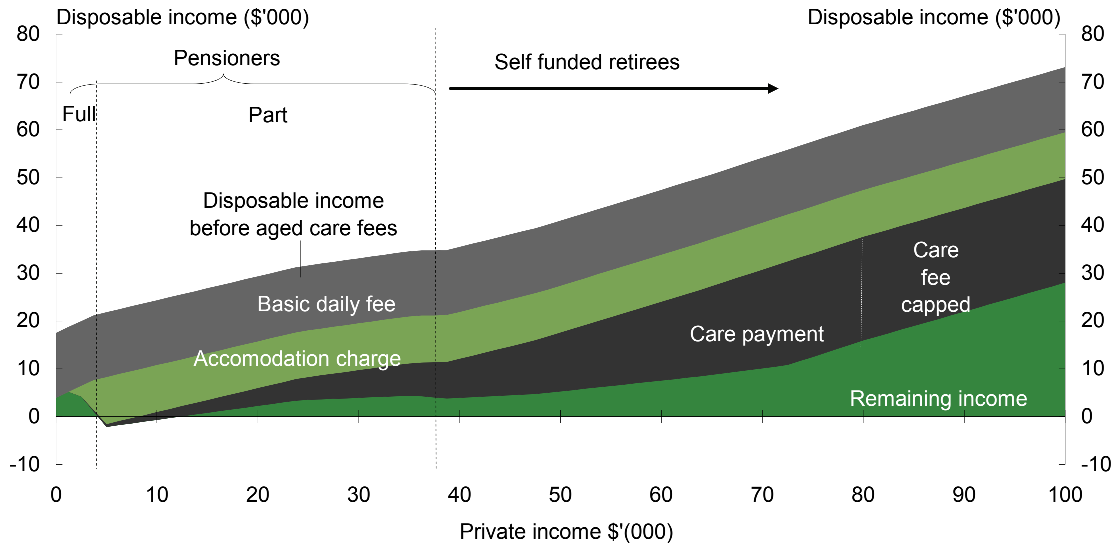
The design of a bond is more like a tax, limited by people's capacity to pay, rather than a user charge, which would be limited by the costs of their accommodation. As noted by the Productivity Commission (2009), supply restrictions result in providers gaining monopoly pricing power in local regions. Bonds are the only aspect of the market where providers have pricing flexibility and the amount they receive does not offset other government subsidies. This has led to substantial growth in bonds providers can charge, with the average accommodation bond agreed with new residents rising from $58,400 in 1997–98 to $212,958 in 2007–08. Where bonds exceed around $90,000, they result in people paying more for their accommodation than those levied with a charge.

This difference is inequitable. It leads to substantial difference in the accommodation payments based on care need. In addition, bonds mean that high-wealth clients are more financially lucrative to providers than low-wealth clients, even though the service they are provided with is the same. This provides an incentive for providers to 'cherry pick' their clients according to wealth, which was suggested by Ergas (2008) to be a reason why wait times were higher for low-income recipients.

Total effect of means testing

The total effect of means testing on aged care residents who pay an accommodation charge is set out in Chart F7-1.

Chart F7-1: Total effect of means testing



Note: Disposable income includes private income plus pension less tax. Private income is assumed to be derived from assets earning a 5 per cent rate of return.
Source: Department of Health and Ageing (2009c) and Treasury calculations.

Means tested charges for the costs of care should be set so they do not harm income adequacy in retirement and are consistent with pension means testing. As the Age Pension is designed to ensure access to an adequate basic standard of living that does not include significant personal care costs, these costs should generally not be levied on recipients of a full Age Pension. Following the approach in the income support system, means testing should not be designed to force the drawdown of assets, but instead target the income from assets. The charge should also take into account the effective tax rate already applied to private income through the pension means test and income taxes, with the total effective marginal tax rate being less than 100 per cent of income. These features are necessary to provide an incentive for people not to draw down their assets excessively to avoid means testing. These combined parameters — starting means testing from a level of income adequate to cover other expenses, ensuring the total taper on private means does not remove all incentive to maintain savings, and limiting the charge to the cost of care — should allow means testing to target assistance tightly. This ensures that users with sufficient means are able to reduce the funding pressure on the wider community through higher taxes.

The current approach to means testing appears inconsistent with this approach in two ways. For a reasonable estimate of the earning capacity of assets, the rate at which the accommodation supplement is withdrawn creates effective marginal tax rates in excess of

100 per cent on asset earnings. For example, if the assets subject to the test ($55,910) earned a 5 per cent rate of return, they would generate only around $2,800 of income, compared to the $9,784 annual charge. As such, this test results in depletion of asset values.

For higher income ranges, however, the total effective marginal tax rate can fall. Further, the cap on means testing charges for personal care provides a benefit to wealthy recipients of aged care, as it takes effect from incomes of around $72,000. This results in taxpayer funding for the costs of care that, given the income levels of the recipients, are a personal responsibility. A more consistent approach to means testing would be to target a consistent effective marginal tax rate until these costs are covered.

Community aged care

Community aged care services provide personal care services and some assistance with standard living costs, such as provision of food. Access to community aged care is governed through a combination of State-managed assessment and the ACAT assessment teams for Australian government programs. Recipients are allocated to their providers, who determine the level of care based on their assessment of the recipients' needs. The funding a provider receives for their care is not tightly matched by recipients' care needs and is governed by a different mechanism than used in residential care. The approach to means testing also varies between these services, and compared to residential aged care.

Funding care levels

The Home and Community Care (HACC) program funds a range of personal care, health care and assistance with standard living costs set out in Box F7-1. Eligibility for HACC is determined by service providers in each State, with care funding delivered to providers through block grants. Most HACC clients (97 per cent) receive, on average, services worth about $1,200 per year (in 2007–08 prices), although this includes non-care services. About 3 per cent of HACC clients receive services worth more than $16,000 per year (Department of Health and Ageing 2008). Expenditure on these clients accounts for about 30 per cent of all HACC expenditure.

Three community aged care programs are funded entirely by the Australian government: the Community Aged Care Program (CACP) and the Extended Aged Care at Home (EACH) program and the EACH — Dementia (EACH-D) program. CACP does not fund health care services but does include personal care. EACH and EACH-D both fund specialist nursing care as well as personal care. The cost of a CACP package is $15,100 per person, $43,630 for an EACH package and $49,150 for an EACH-D package.

Box F7-1: Services provided through community care

The services provided through a Home and Community Care (HACC) package vary by State. For example, in Victoria, services include personal care, respite home care, property maintenance, nursing, allied health, delivered meals and planned group activities.

A Community Aged Care Program (CACP) package includes personal care, such as bathing and dressing, and domestic assistance, such as housework and shopping, as well as help in participating in social activities. Examples of services may include:

- meal preparation;
- laundry;
- assistance with continence management;
- transport;
- personal care;
- social support;
- home help;
- gardening; and
- temporary in-home respite care.

An Extended Aged Care at Home (EACH) package provides a range of assistance, including nursing input, and services such as:

- care by an allied health professional such as a physiotherapist or podiatrist;
- personal care;
- domestic assistance;
- in-home respite;
- transport;
- social support;
- home help; and
- assistance with continence management.

An EACH — Dementia (EACH-D) package includes:

- linkages to services to meet the specific needs of recipients with dementia;
- care by an allied health professional such as a physiotherapist or podiatrist;
- personal care;
- home help; and
- assistance with continence management.

Source: Victorian Department of Health Services (2009); Department of Health and Ageing (2009).

Eligibility for the three levels of Commonwealth-funded community aged care is determined by ACATs. Based on their entitlement, recipients are allocated to a provider, who receives the funding for the care. Providers receive an amount per client based on the average care cost in the relevant broad category of community care — CACP, EACH and EACH-D — rather than the individual's specific needs. Providers supply care across recipients with differential needs so that their average level of servicing equates to what they are paid by government.

This funding for community care can constrain care and choice by recipients in several ways. Recipients are allocated to specific providers in a given region that hold the contract to provide the care to which they are entitled. This reduces the competitive pressure on providers to deliver high standards of care and means recipients may have to leave trusted providers when moving to a higher level of care. In addition, providers receive care based on an average level of assistance, rather than an individual's particular need, which can lead to recipients 'falling through the gaps' of care levels, as noted by NHHRC (2009). The restrictions on the numbers of Australian government care packages can limit the choice of recipients. In addition, many recipients would be eligible for a higher level of care subsidy if they moved into residential aged care.

Fee setting

Though underpinned by broad national program guidelines, fee policies for HACC services vary across States. The Department of Health and Ageing (2008) noted that the fees are generally lower than in Australian government packaged care programs. For example, in both Victoria and Western Australia, there is no distinction between the charge levied on full- and part-pensioners. Fees can be set such that they are discounted for multiple use. Further, some living expenses, such as meals, are provided below user cost. However, as HACC is often provided by small providers with assistance occurring on an infrequent basis, some variation in fee-setting policy is expected, given the compliance cost of undertaking more comprehensive means tests.

In Australian government aged care programs, fees for full Age Pension recipients cannot exceed 17.5 per cent of income. While some services provided through CAC-P packages can include living costs for which it would be appropriate to user-charge, the flat 17.5 per cent payment is unlikely to reflect these. Where this amount is for personal care, it reduces the income adequacy for full-rate pensioner. This is most likely to occur for recipients of EACH or EACH-Dementia, as the majority of this care reflects personal care.

Clients with income above the full rate pensioner income can be charged up to 50 per cent of this income (see Table F7-5). This amount is uncapped by the costs of care and does not offset the government subsidy. Providers therefore have an incentive to 'cherry pick' wealthier clients, which undermines the equity of the system. Further, if recipients pay more than the cost of their care, they are effectively cross-subsidising the care of less wealthy recipients. Ensuring that people with limited means can access care would be more appropriately financed through broad-based taxes, rather than through an effective tax on care users. For recipients facing a means tested payment, the effective marginal tax rate is slightly higher than what is expected from residential aged care recipients.

Table F7-5: Funding of Commonwealth community aged care programs (annual)

	Income	Av care cost	Resident fee	Government subsidy	Provider revenue
CACP					
Full pensioner	$19,000	15,100	$3,325	$12,684	$16,009
Part pensioner	$40,000	15,100	$13,378	$12,684	$26,062
Self-funded retiree	$60,000	15,100	$23,378	$12,684	$36,062
EACH					
Full pensioner	$19,000	$43,630	$3,325	$41,449	$44,774
Part pensioner	$40,000	$43,630	$13,378	$41,449	$54,827
Self-funded retiree	$60,000	$43,630	$23,378	$41,449	$64,827

Source: Department of Health and Ageing (2009a) and Treasury calculations.

Findings

The current aged care system is complex, and the funding arrangements have several poorly performing features that affect the wellbeing of older people at a vulnerable time in their lives.

Means testing of charges is not applied consistently. The difference in charging for accommodation in low-level and high-level residential care appears particularly inequitable. The difference in the provision of assistance across aged care in residential and community settings limits the choice of recipients. Where funding sourced from wealthier recipients cross-subsidises the care of others, as occurs in community aged care, providers have poor incentives to deliver care efficiently and less well-off recipients' access to care can be harmed.

F7-3 Reform directions

Recommendation 109:

There is considerable scope to align aged care assistance with the principles of user-directed funding to provide assistance in line with recipients' needs, enable their choice of care and support the fiscal sustainability of the aged care sector. However, effective user-directed funding is significantly limited by regulations that govern supply and price, reforms to which would have complex sequencing and transition issues. The Productivity Commission should consider this potential reform direction in its upcoming inquiry into aged care.

Recommendation 110:

It is important for governments to determine what an adequate level of aged care should be, the necessary pricing and regulatory arrangements to deliver it, and the most sustainable funding arrangement to ensure access by those who cannot afford it. Given this, and noting that the Productivity Commission will be inquiring into the disability insurance scheme, its consideration of aged care should include the potential for insurance to play a role in helping to fund aged care as Australia's population ages.

Potential reform to financing arrangements

The Review has considered the funding and means testing arrangements for aged care in the context of growing need for high-quality care and fiscal pressure that flow from satisfying the needs of an ageing population. There is some potential for reforms to financing arrangements, particular user-directed funding, to further these objectives.

The Review supports the recommendations in the final report of the National Health and Hospitals Reform Commission that:

- government subsidies for aged care should be directly linked to people rather than places;
- there should be a more flexible range of care subsidies for people receiving community care packages, determined in a way that is compatible with care subsidies for residential care;
- people supported to receive care in the community should be given the option to determine how the resources allocated for their care and support are used; and
- care subsidies and user payments should be aligned across community care packages and residential care, and older people should be given greater scope to choose for themselves between using their care subsidy for community or for residential care.

The application of consistent means testing arrangements across aged care programs would also support choice for consumers of aged care services. In line with unbundling of care funding, there is some scope for more targeted means testing of care, which would improve the fiscal sustainability of the care system.

However, in light of the existing supply and price regulations, the benefits of reform to the financing arrangements of aged care would be limited. Further, changes to the financing and regulatory framework of aged care would require careful sequencing to ensure that access to care is not harmed during any transition. The potential for user-directed and consistent means testing should be considered as part of the Productivity Commission's inquiry into the aged care sector (see Recommendation 109).

Long-term sustainability of funding arrangements

Reforms to facilitate user-directed funding and ensure recipients with sufficient means finance their own care costs would improve the fiscal sustainability of aged care. However, several factors limit the scope for greater user funding of the system through means tested user charges.

As the superannuation guarantee scheme matures, cohorts of older people should have larger assets balances available to them at retirement. However, these assets will need to provide an adequate stream of income over a person's retirement, the duration of which is uncertain for individuals. The expected increase in average life expectancy is likely to add to this risk. Further, the use of aged care services is particularly intensive for people aged 85 and upwards, once many have been retirement for 20 years or more.

As is discussed in greater detail in Section A2 (Retirement incomes), wider availability of products that can insure against longevity risk would give greater certainty around income over a long retirement. This would facilitate a more dependable income stream on which users of aged care services could draw to pay for the costs of their care. It is also possible that moves towards a universal levy on taxable income could be used to offset future fiscal risks of government financing aged care.

The uncertain and potentially high costs of aged care mean that many people would not be able to provide for their care costs out of their savings. When insufficient provision for the costs of aged care results in inadequate access to care, the wellbeing of older Australians is significantly harmed. The introduction of a compulsory insurance scheme should be considered as a way to deliver a funding source to ensure that all individuals can access an adequate standard of care.

Currently, insurance companies are prohibited from offering voluntary insurance products for aged care costs. Further, the current restrictions on the supply of aged care would likely limit the use of insurance, even if it were available.

The Review supports consideration by the Productivity Commission of the potential for insurance, whether compulsory or voluntary, to assist in the task of funding aged care as Australia's population ages (see Recommendation 110). Further, aged care insurance would have many of the social insurance attributes of broader disability insurance, which is also the subject of a Productivity Commission inquiry.