7 The personal tax-transfer system

Outline

This section examines the way in which the personal tax and transfer systems interact to affect the disposable income of individuals and families, and their incentives to work, save and invest (including in skills).

Key points

- The tax and transfer systems combine and interact to be targeted, progressive and redistributive. There are many families and individuals who receive transfers and pay tax in the same year and from one year to the next.
  - Successive tax cuts since 1985 mean that taxpayers at all income levels pay less tax than if the tax thresholds had been indexed for inflation.
- The Australian tax and transfer systems are separate systems. There are different bases of assessment between and within the two systems, including the definition of income, the unit of assessment, the period of assessment and the basis of eligibility. These differences largely exist to achieve a targeted system, but a result is that the system as a whole is complex.
- Significant demographic change, including ageing of the population, will influence the affordability of the transfer system in the future. Participation and productivity increases may offset some of the impact of demographic change.
  - Some workers appear to be more responsive to incentives than others. For example, part-time workers seem to be more responsive than males working full-time hours.
- In combination, the tax and transfer systems determine the disposable income of an individual or family. They also affect their incentives to participate in paid work and to acquire skills, and their decisions about when and how to save.
  - The adequacy of transfers is determined by the sum of income support payments, supplementary payments, in-kind benefits and concessions.

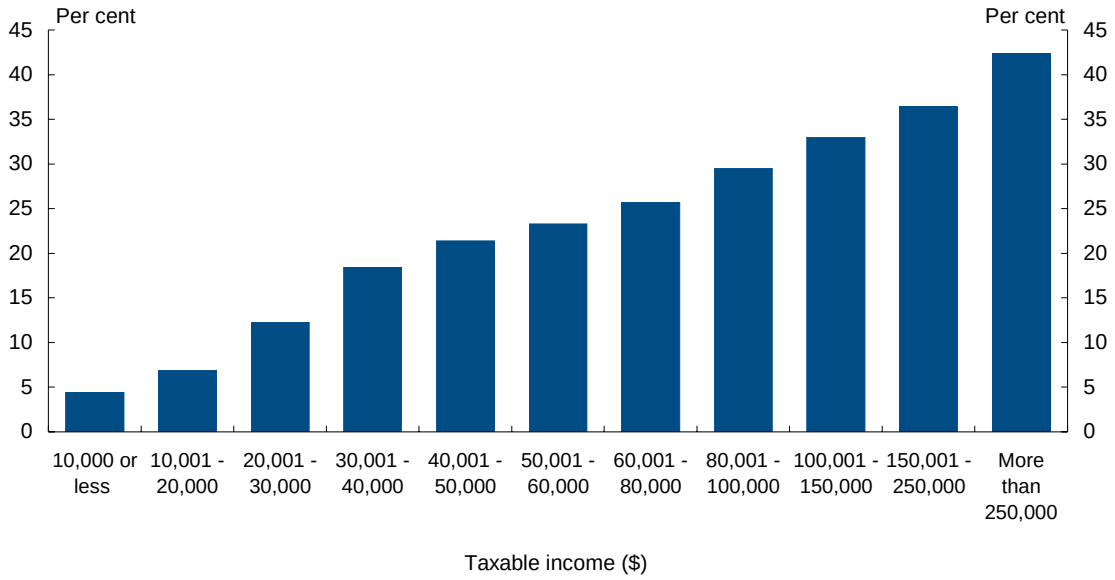
7.1 The role of Australia's personal tax-transfer system

The primary roles of the tax-transfer system are revenue collection and income redistribution. Income is redistributed to Australians through the combination of a progressive tax system and targeted transfers. The personal tax system raised around 45 per cent of total Australian Government revenue in 2006-07. Under Australia's progressive tax system, those with a higher capacity to pay bear a greater than proportional share of the tax burden. Tax offsets and exemptions are also used to target assistance to

individuals and families with lower means or to assist individuals in particular circumstances.

On average, taxpayers with taxable incomes of $10,000 or less in 2005-06 paid 4.4 per cent of their income in income tax (Chart 7.1). Those with taxable incomes over $250,000 paid 42.4 per cent of their income in tax on average.

Chart 7.1: Average tax rates by income range in 2005-06[(a)]

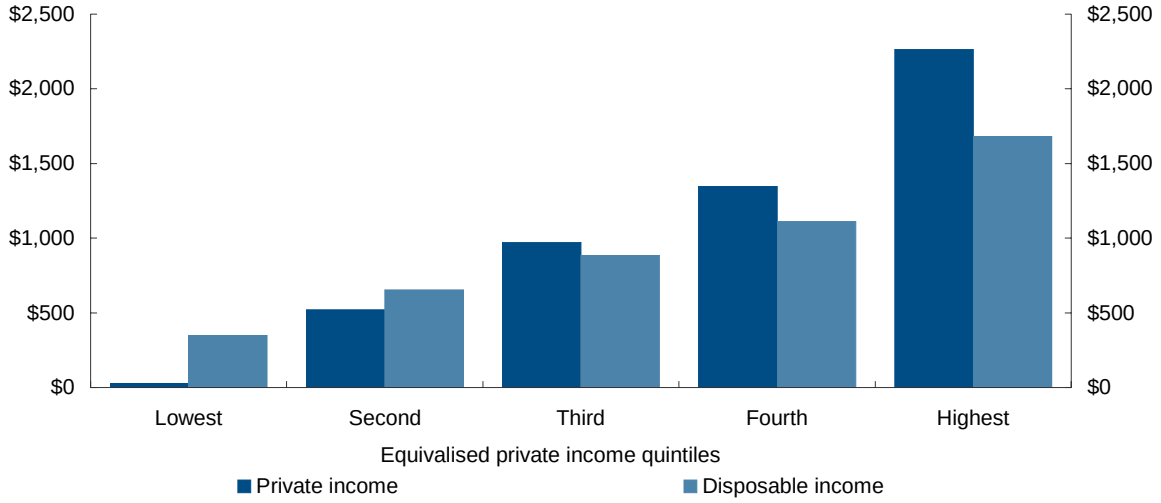


(a) Excludes taxpayers with nil taxable income.
Source: Australian Government administrative data.

Spending on the transfer system by the Australian Government amounted to over 25 per cent of revenue collected in 2006-07. Transfers provide financial assistance to individuals who are unable, or not expected, to fully support themselves, and to families to help meet the costs of raising children.

The net effect of the personal tax-transfer system is to reduce the incomes of higher income households, and increase the incomes of lower income households (see Chart 7.2). The combined effect of taxes and transfers is to make the distribution of income across households more equal. The ABS reports that there was no significant change in income inequality from the mid-1990s to 2005-06 (ABS 2007d). This is despite a more pronounced increase in private incomes at higher income levels than the increases for those on low and middle incomes.

Chart 7.2: Average weekly private and disposable incomes in 2003-04[(a)]



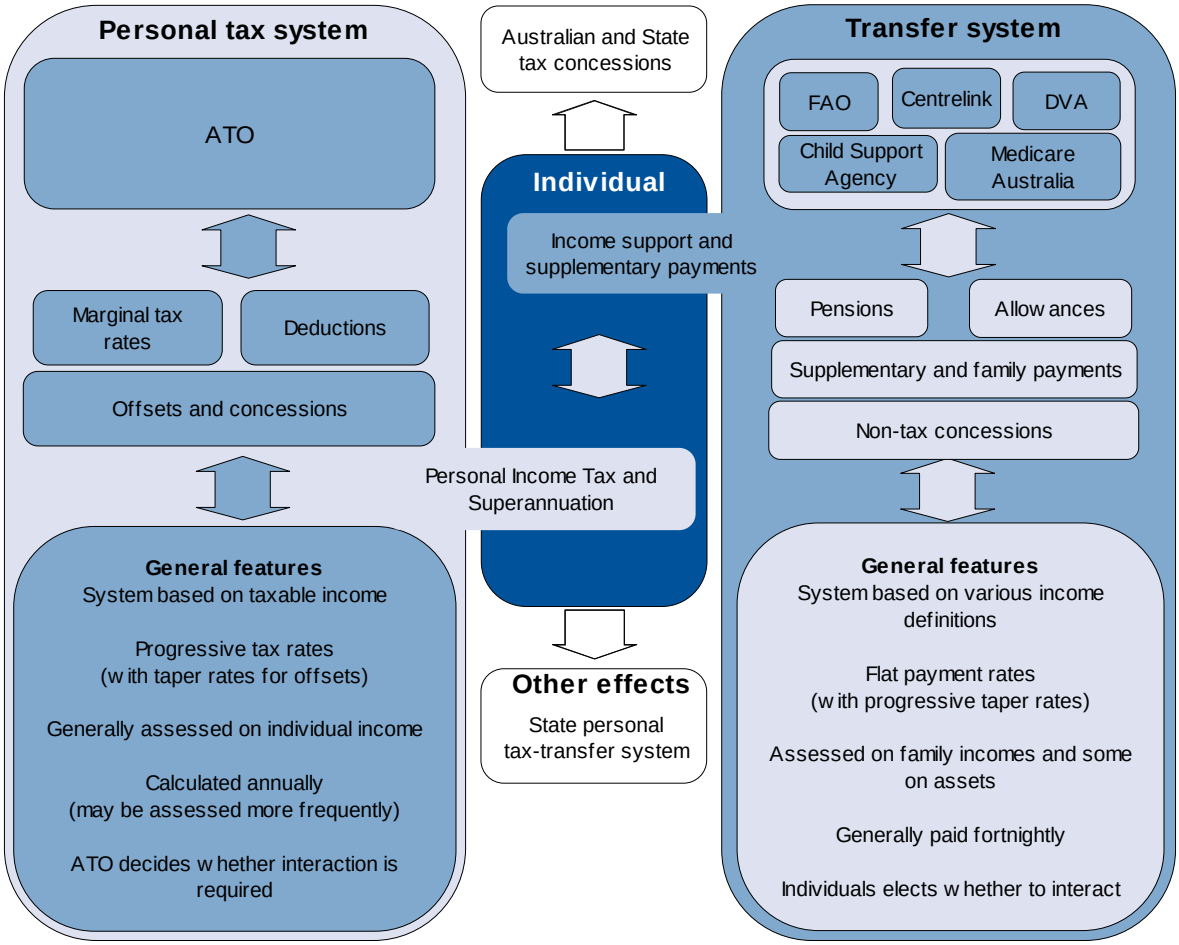
(a) Household equivalised incomes. Equivalised incomes take account of different household sizes and structures by identifying the amount needed to provide an equivalent standard of living to that of a single person.
Source: ABS (2007b).

7.2 How individuals interact with the personal tax-transfer system

The components of the personal tax–transfer system affect a household's disposable income and impact on incentives to work, save and develop skills. Marginal tax rates and means test tapers affect the financial return from additional work and the return from savings and investments. Transfers, tax exemptions for some forms of income, and tax offsets add to disposable income and can reduce incentives to work. Superannuation is facilitated through a mixture of compulsory saving and tax concessions which are designed to improve retirement income.

Chart 7.3 shows the elements of the personal tax-transfer system and how it interacts with an individual or family unit. Other effects outside the Australian Government tax-transfer system, such as the state tax-transfer systems, also impact on the individual or family unit but are not included in this chart.

Chart 7.3: Personal tax-transfer system



Individuals interact with different agencies depending on whether they pay tax or they are eligible for transfers (the left and right sections respectively of Chart 7.3). The type of interactions can also differ between the agencies. This can lead to increased compliance costs for individuals depending on how many agencies they must deal with during a year.

The tax and transfer systems have different objectives which influence how the agencies administer their part of the system. Differences between the tax and transfer systems include: the financial basis of assessment (income versus income and assets); the income unit (individual versus family); and frequency (annual assessment versus fortnightly assessment) as outlined in Box 7.1.

The measurement of income is a particular area of difference (Table 7.1). Income support (pensions and allowances) are assessed on a social security definition of income, while only taxable income is used to assess the senior Australians tax offset and the low income phase-in of the Medicare levy. Differences in what is assessed can also relate to the calculation period — fortnightly for income support and annually for tax assessment and family assistance. Another way in which income definitions vary is whether they are applied to an individual or a couple.

Box 7.1: Different characteristics of the personal tax-transfer system

Individual versus family

The individual is generally the unit of assessment for the taxation system. However, there are exceptions where income tested programs are applied to individuals taking into account their spouse's income and/or family circumstances, such as the senior Australians tax offset and the Medicare levy surcharge.

The unit of assessment in the transfer system is the couple or family, based on the principle that the provision of targeted support should take into account other sources of financial support, including from close family members (spouse, parents of dependent children). The type of household also determines eligibility for assistance.

Income and assets tests

The income definitions used to assess the appropriate level of taxation and transfers differ within and between the two systems (see Table 7.1). 'Taxable income' in the tax system permits a range of deductions, while 'ordinary income' used for income support payments is a far more comprehensive definition of income.

Eligibility for most transfers is subject to means tests that target assistance based on an assessment of need. Income support payments are subject to both income and assets testing, with more generous assets test limits for those who do not own a home. Family assistance and the Commonwealth Seniors Health Card are tested on income but not assets.

Assessment periods

Tax is assessed on annual financial year income[1], though amounts are withheld and remitted to the ATO on a regular basis through the pay as you go (PAYG) withholding arrangements.[2] The effect of these arrangements is to remove employees from the majority of transactions occurring in the tax system. Income support payments are assessed and paid on a fortnightly basis, to provide timely support to recipients. Income support means tests are therefore highly responsive to short–term changes to an individual's or family's circumstances. Family assistance is provided to the majority of recipients on a fortnightly basis, with the income test based on annual income.

Agency assessment versus self-assessment

The personal taxation system is generally based on self-assessment — particularly in relation to deductions and non-salary income sources. The transfer system is based on self-identification — an individual needs to apply for most payments and allowances. Eligibility is assessed by an agency based on information provided by the individual.

1 Primary producers, artists and composers can average their income over a number of years.
2 Some people pay quarterly instalments, such as sole traders and people with investment and business income.

Table 7.1: Selected definitions of income in the tax-transfer system

	Income base	Key components of the income base			
		Employer fringe benefits	Salary sacrifice-superannuation contributions[a]	Net losses (rental property and financial)[b]	Tax exempt income (including superannuation, foreign, defence income)
Pensions	Ordinary income	Non-grossed fringe benefits included	Not included, except when over age pension age	Losses cannot reduce other assessable income	Some forms included
Allowances	Ordinary income	Non-grossed fringe benefits included	Not included, except when over age pension age	Losses cannot reduce other assessable income	Some forms included
Family Assistance	Adjusted taxable income	Non-grossed reportable fringe benefits included	Not included	Net rental property losses added back	Some forms included
Commonwealth Seniors Health Card	Taxable income with adjustments	Assessable fringe benefits included	Not included	Net rental property losses added back	Some forms included
Child support	Taxable income with adjustments	Grossed-up reportable fringe benefits included	Not included	Net rental property losses added back	Some forms included
Superannuation co-contribution	Assessable income with adjustments	Grossed-up reportable fringe benefits included	Not included	Losses not deducted from assessable income	Not included
Personal income tax	Taxable income	Not included	Not included	Losses included in taxable income	Not included
Higher Education Loan Program	Taxable income with adjustments	Grossed-up reportable fringe benefits included	Not included	Net rental property losses added back	Some forms included
Medicare levy surcharge	Taxable income with adjustments	Grossed-up reportable fringe benefits included	Not included	Losses included in taxable income	Not included
Senior Australians tax offset	Taxable income	Not included[c]	Not included	Losses included in taxable income	Not included

(a) To be included in most programs from 1 July 2009.
(b) To be included in some programs from 1 July 2009.
(c) To be included from 1 July 2009.

Definitions
'Ordinary income' for social security purposes includes salary, wages, net business income, rent and deemed income on financial investments. It also includes certain periodic payments such as some gifts and allowances, and payments to employees for particular purposes such as relocation or travel, where the employee has the discretion whether to spend the money on that purpose. Exceptions to ordinary income include emergency or like assistance, payments by States or Territories to assist a person to purchase or build their own home, payments made to a person for a dependent child, or insurance or compensation payments made for the loss or damage to buildings, plant or personal effects.
'Adjusted taxable income' is taxable income, adjusted fringe benefits, target foreign income, net rental property losses, tax free pensions or benefits, less any deductible child support paid.
'Assessable income' is ordinary income plus statutory income (provided it is neither exempt nor non-assessable non-exempt).

Interactions within the year

As people's circumstances change, their interactions with the personal tax-transfer system also change. In some cases only the tax system will affect income, while in others it is the transfer system. There will also be times when people are paying tax as well as receiving transfers or paying tax on a transfer. This is referred to as 'churning', as the total payments received offset part or all of the tax they pay.

Analysis of churning is highly sensitive to the time period in question. Income support payments are targeted on the basis of an immediate current need, such as unemployment, and are mostly assessed fortnightly. In such cases, the transfer system is responsive to an immediate set of circumstances for which people typically cannot cover their costs. The tax system has an annual basis, with some expectation that individuals can manage variations in income over the period. As an individual's or couple's earnings increase, transfers are recouped through payment withdrawal. Tax liabilities also increase.

While churning is a consequence of a targeted redistributive system, it can be costly. One set of costs relates to the separate administration of the tax-transfer system, to the extent that a similar outcome could be achieved with less churn. Another set of costs relates to the compliance costs on individuals, who are subject to different information and compliance requirements from the combined effects of the two systems.

At an aggregate level, Australia has a low level of churn by international standards, as the personal tax-transfer system is tightly targeted, highly progressive and substantially redistributive. OECD estimates (Whiteford 2005) indicate that Australia has the lowest level of churn of any OECD country, on the basis of direct taxes and transfers. Widening the assessment to include indirect taxes and non-cash benefits does not significantly change this analysis (Harding et al, 2006).

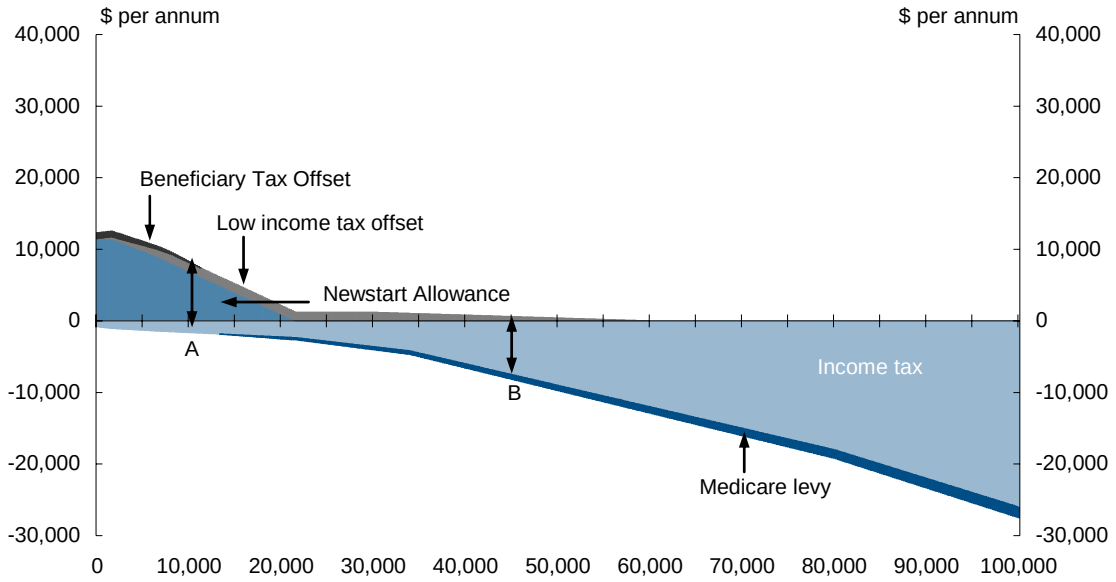
Individuals experience churn in two main ways. Many families who receive family assistance (Family Tax Benefit (FTB) or child care assistance) also pay income tax. Families can choose whether to receive FTB after their taxable income has been assessed at the end of the year. However, fewer than 10 per cent of families choose this option, instead preferring fortnightly payments despite the associated churn. Historically, redistribution of family assistance from breadwinners to primary carers within couples has been an important reason why governments have supported direct payments rather than delivery of assistance for children through the tax system.

Individuals and families also experience churn when they receive income support and have low to moderate levels of private income. For example, a person on a part–rate Newstart Allowance with an ongoing part-time job is in both systems at the same time. If they move off Newstart into full-time work, they would still be in both the tax and transfer systems over the course of the income year. Similarly, older Australians with savings may also receive the Age Pension and still pay tax even after the operation of the low income tax offset (LITO) and the senior Australians tax offset. Churning of income support recipients with private income has increased since the 1980s, as income support payments have risen from below the tax free threshold to well above it. While a relatively low tax free threshold increases this form of churn, a higher tax free threshold would have the disadvantage of increasing opportunities for tax planning.

Interactions over time

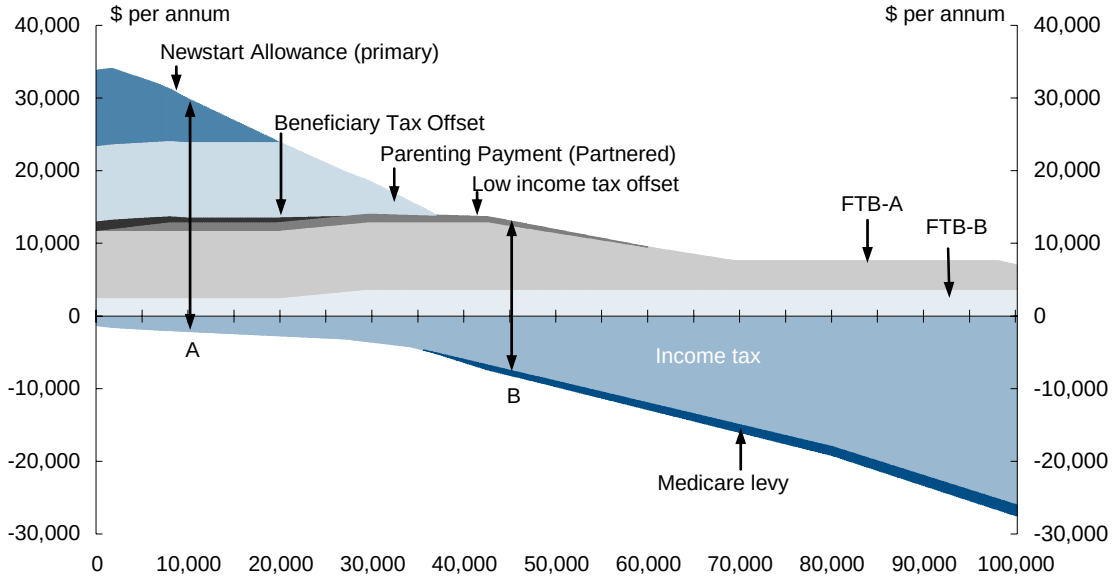
Charts 7.4 and 7.5 show how the personal tax-transfer system interacts to determine an individual's disposable income for two single income family types — one with no children and one with a partner and two children aged three and eight. Point A shows the effect of the tax-transfer system at an income of $10,000. Point B shows the effect where the level of earned income is $45,000. They also show the extent of 'churn' which can occur in the system.

Chart 7.4: Transfers and taxes, by level of income
Single income no children (2008-09)



Source: Australian Treasury estimates.

Chart 7.5: Transfers and taxes, by level of income
Single income family, two children aged 3 and 8 (2008-09)



Source: Australian Treasury estimates.

The amounts above zero show the components of the personal tax-transfer system which have a positive effect on disposable income. These are Newstart Allowance,

Parenting Payment (Partnered), LITO and Family Tax Benefit A and B. The items below zero reflect the individual's tax and Medicare levy liability. As the individual earns more income they start to lose their payments and offsets and pay more tax. The effect on disposable income is shown in Tables 7.2 and 7.3.

Table 7.2: Disposable income based on family type — $10,000 earned income (2008-09)

	Individual — no children	Single income couple — children 3 and 8
Earned income	$10,000	$10,000
Newstart	$6,946	$5,825
Parenting Payment (Partnered)	-	$10,369
Gross income	$16,946	$26,194
Gross tax (Medicare levy threshold not reached)	$1,642	$2,129
- less beneficiary tax offsets	$142	$655
- less LITO	$1,200	$1,200
Net tax payable	$300	$274
Family Tax Benefit Part A + B (tax exempt income)	-	$11,789
Total disposable income	$16,646	$37,709

Table 7.3: Disposable income based on family type — $45,000 earned income (2008-09)

	Individual — no children	Single income couple — children 3 and 8
Earned income	$45,000	$45,000
Gross taxable income	$45,000	$45,000
Gross tax on gross income (including Medicare levy)	$8,175	$8,175
- less LITO	$600	$600
Net tax payable	$7,575	$7,575
Family Tax Benefit Part A + B (tax exempt income)	-	$12,469
Total disposable income	$37,425	$49,894

The interactions between the components of the personal tax-transfer system mean that some individuals and families will not become net taxpayers until their private income is well above the tax–free threshold of $6,000. This point is sometimes called the 'net tax threshold' and represents the point where cash transfers equal tax paid. After this point the individual or family will become net taxpayers. As shown in Table 7.4, the net tax threshold differs for different family types.

Table 7.4: Net tax threshold for different family types (2008-09)

Family types	Net tax threshold
Single person, no children	$19,448
Single income couple, no children	$33,864
Dual income couple (75-25 split), no children	$35,579
Sole parent, two children aged 3 and 8	$53,819
Single income couple, two children aged 3 and 8	$53,819
Dual income couple (75-25 split), two children aged 3 and 8	$59,367

Over a lifecycle, people receive greater subsidies at times of higher need, such as when they have young children and in old age, and pay higher levels of tax at times when they can better afford to do so, such as in later working years when their children have left home. In

this way, the tax-transfer system 'smooths' income through more difficult periods and bears some of the risks associated with unemployment, illness and other life contingencies.

Inflation and the personal tax-transfer system

The personal income tax settings affect a person's real disposable income (income adjusted for changes in inflation). Where a progressive tax scale is not adjusted over time, wage increases can result in an individual paying a higher average tax rate on the same level of real income. This can reduce the progressivity of the tax system and is known as bracket creep or fiscal drag.

Australia has returned fiscal drag through regular (though unscheduled) tax cuts in the form of changes to rates, thresholds and adjustments to LITO. Compared to 1985, successive tax cuts have meant that taxpayers at all income levels pay less tax than they would have if the thresholds had been indexed to the consumer price index (CPI) or even to wages growth.

Table 7.5 shows the effect on average tax rates of the return of fiscal drag since 1985 for a single person earning half average weekly earnings (AWE), AWE, and twice AWE. For example, if the tax thresholds had only been indexed to CPI or wages, an individual earning AWE would have an average tax rate today of 22.8 per cent and 21.4 per cent, respectively. The changes to personal tax thresholds since 1985 have meant that this individual has an average tax rate of 18.1 per cent.

Table 7.5: Fiscal drag has been more than returned since 1985

		Average tax rate in 2008-09 if the 1985-86 personal tax thresholds had been indexed to:	
Earnings	Actual average tax rate in 2008-09	Inflation	Wage growth
Half AWE ($24,070)	7.8	14.7	13.5
AWE ($48,140)	18.1	22.8	21.4
Twice AWE ($96,280)	27.0	37.2	34.8

Assumes CPI/AWE indexation applies to personal tax thresholds, LITO amount and threshold, and the Medicare low-income threshold.
Source: Australian Treasury estimates.

Inflation can also affect the purchasing power of transfers through the effects on payment rates and thresholds. The combination of the indexation to CPI and benchmarking of Age and Service Pensions to male total average weekly earnings (MTAWE) has resulted in increased purchasing power over time, while the indexation of allowances to CPI has sought to ensure that the value of these payments is not eroded by changes in consumer prices. The indexation of income support payments is discussed in more detail in the next section.

7.3 Important impacts of the personal tax-transfer system

Adequacy of support

The personal tax–transfer system plays a key role in the social support of individuals. The primary source of income for the majority of Australians is earnings from work. The tax system provides concessions to reduce the tax paid by lower income earners, particularly those receiving transfers. The transfer system plays the societal function of providing

support for people who are transitioning into the workforce or are unable to work, or not expected to work (due to age, disability, study or carer responsibilities).

A central issue for the personal tax-transfer system is the level of support that it should provide to people with lower resources. This is usually expressed in terms of the 'adequacy' of the rate of assistance.

There are many views on what constitutes adequacy, and how it should be measured. Common adequacy measures include the use of fixed and relative benchmarks, such as replacement rates, budget standards, wellbeing outcomes and poverty lines (see Box 7.2). Measuring the adequacy of income support against these benchmarks can give different results.

Adequacy measurements that look solely at the base level of income support can misrepresent the total level of support provided to individuals and families. Supplementary payments, other sources of income and in-kind benefits are also important determinants of the overall level of support.

The issue of adequacy of income support payments is dealt with in more detail in the companion document to be issued by FaHCSIA.

Box 7.2: Types of adequacy benchmarks

Common measurements of adequacy of income support payments include: replacement rates; budget standards; wellbeing outcomes and poverty lines.

Replacement rates

There are two main types of replacement rates. The first compares an individual's post-retirement spending power with their spending power before retirement. The other compares the income of an individual with that of a particular group (for example, a comparison of the income of an Age Pensioner to a person who earns the average wage). An increase in the proportion of income support to wage income suggests an income support recipient has become relatively better off.

Budget standards

Budget standards are used to estimate the budget to fund the goods and services a person or family needs to achieve a particular standard of living. The Social Policy Research Centre at the University of New South Wales has developed budget standards for two levels, a 'median living standard', for households somewhere around the median standard of living in Australia, and a 'low-cost' budget which requires frugal management but still allows social and economic participation consistent with community standards.

Financial stress indicators

These are determined by survey responses to questions on financial wellbeing. The responses enable comparisons of income support recipients to the community as a whole. A series of financial stress indicators has been included in the ABS's Household Expenditure Survey.

Poverty lines

Poverty lines set a benchmark income below which a person or household is considered to be living in poverty. A commonly used line is 50 per cent of average or median household income. An equivalence scale is often used to adjust the income of different household types to that of a standard household type used for the poverty line.

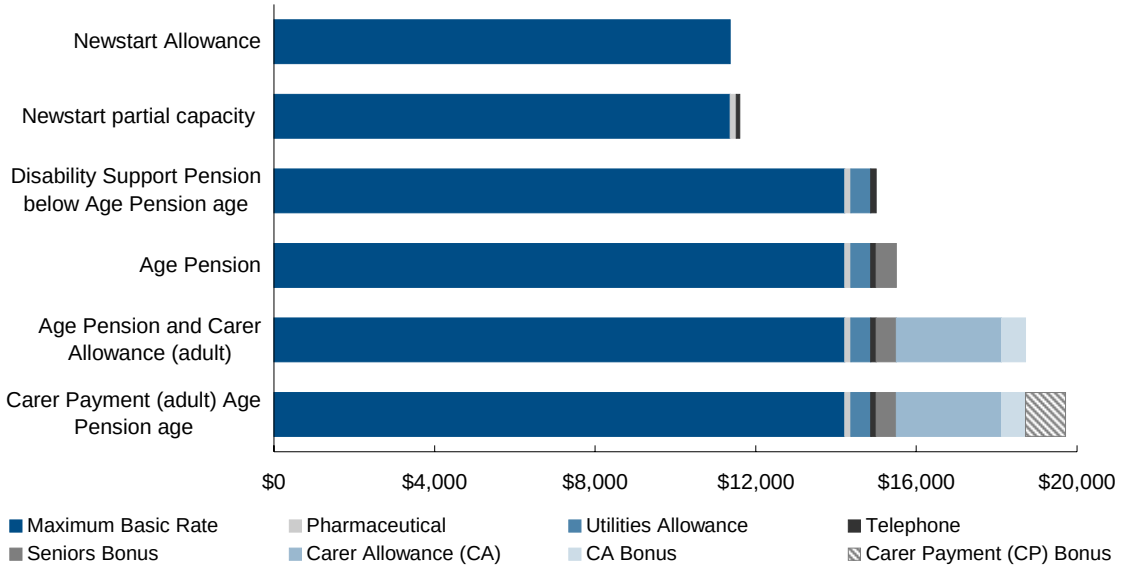
Adequacy benchmarks are dealt with in more detail in the companion document to be issued by FaHCSIA.

Measuring the level of support

Many transfer recipients receive an amount which is greater than the base rate of payment. The total income support package received depends on both the type of payment and the supplementary amounts available with that payment. The recent introduction of Utilities Allowance and 'one-off' lump sums, in addition to Telephone and Pharmaceutical Allowance and support for carers, has increased the total cash benefits well above the base rate of payment for carers and pensioners. These supplements have also significantly altered the relationship between various income support packages. Chart 7.6 illustrates the different levels of support given to recipients, which for a single person can range from $11,364 per annum for a Newstart allowee to $19,715 for a Carer pensioner of Age Pension

age. Further support of up to $2,782 a year is available for private renters through Rent Assistance.

Chart 7.6: Income support packages for selected single recipients — March 2008



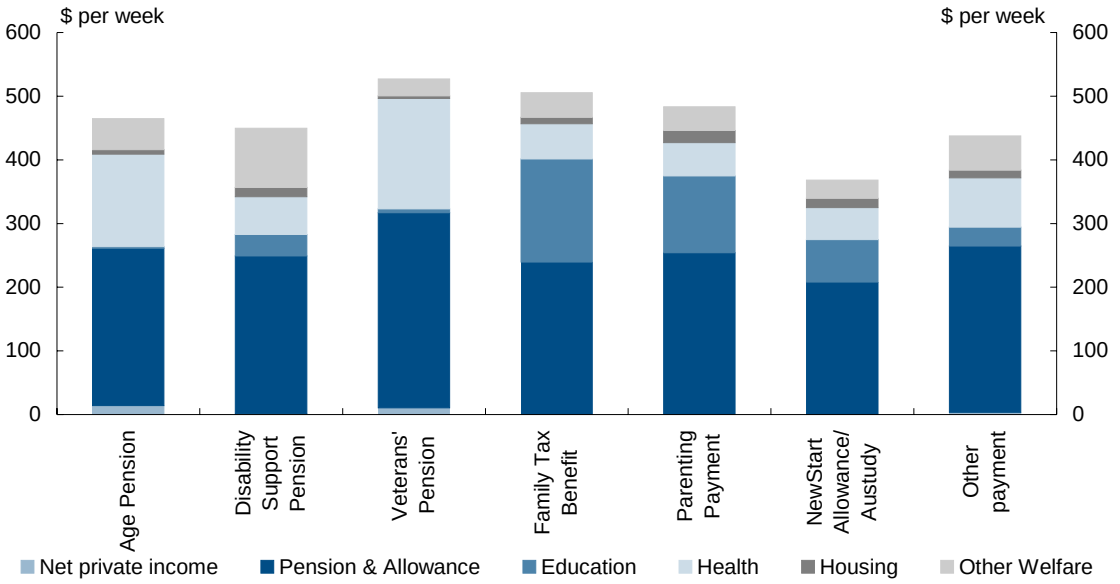
Excludes non-cash benefits and tax expenditures.
Source: FaHCSIA estimates, rates as at 20 March 2008.

Beyond cash payments

The support provided by governments to individuals and families also includes government services, concessions and in–kind benefits. ABS estimates show that, for welfare dependent households receiving the Age Pension, the average equivalised[1] value of these benefits is $203 per week. This is almost equal to the average value of income support cash payment ($247 in 2003-04 dollars). These in-kind benefits therefore are an important part of the total support provided to households and individuals (Chart 7.7).

1 Equivalised incomes seek to identify the equivalent level of income households need to achieve a comparable level or pattern of consumption to a single person.

Chart 7.7: Components of final income of income support dependent households
Classified by main type of payment in 2003-04[(a)]



(a) Households reliant upon income support for 90 per cent or more of disposable income classified by main income support payment, equivalised components of final income.
Source: FaHCSIA estimates derived from ABS (2006a).

Many households that receive income support have private sources of income and wealth. This is particularly the case for Age pensioners where a growing number of recipients are retiring with increasing levels of wealth, including superannuation savings. This trend is expected to continue as more people retire with higher levels of superannuation. However, the proportion of people receiving the Age Pension is not expected to decrease significantly. Projections prepared for the second Intergenerational Report (Australian Government 2007b) indicate that even with the maturation of the superannuation guarantee (SG), there will only be a modest increase in the proportion of older Australians who will not receive at least a partial Age Pension. However, the proportion of retirees on full-rate pensions will fall from over two thirds to less than half.

Replacement rates

One approach to measuring adequacy is to consider the value of income support as a replacement for earnings — defined as the level of income that payments provide relative to the take-home pay of an employed person. Using this approach, the replacement rate for a single allowee, such as a person on Newstart Allowance, is currently 46 per cent of the net earnings of a minimum wage earner, while a single Age pensioner receives 60 per cent. In comparison with a male on average wages, a single allowee receives 25 per cent, while an Age pensioner receives 33 per cent.[2]

Further discussion of benchmarks of adequacy can be found in the companion document prepared by FaHCSIA.

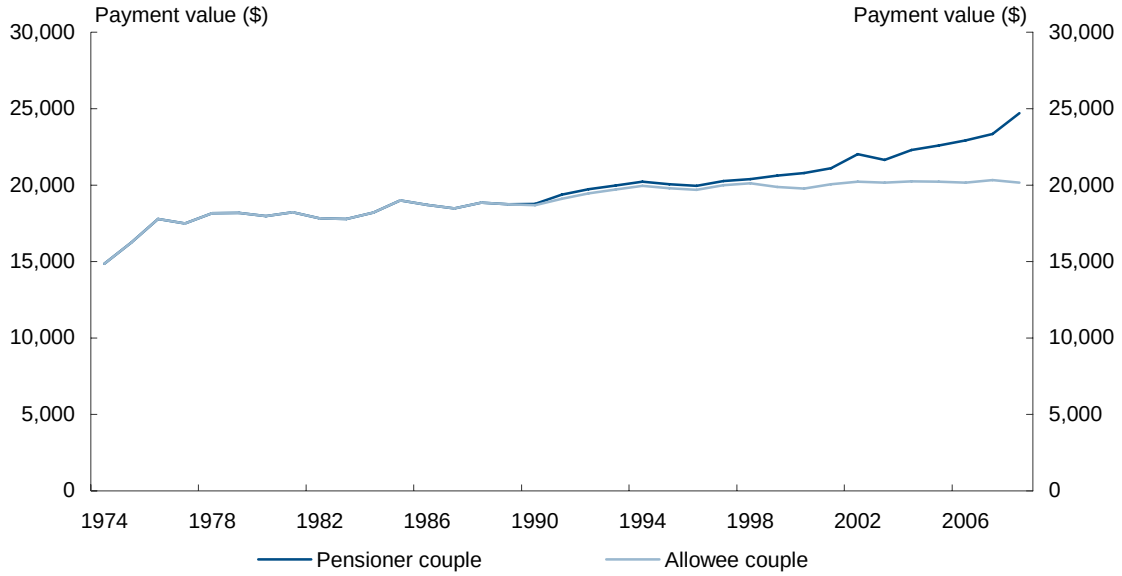
2 'Net earnings' are after-tax earnings of a single adult who receives this rate over the entire tax year. The average wage comparison is based on net MTAWE. Pension rates include Telephone, Pharmaceutical and Utilities allowances, but exclude bonuses. Pension and allowance rates both exclude Rent Assistance.

Changes to the real value of basic income support over time

Both pensions and allowances are indexed by the CPI to maintain their purchasing power in the face of price increases. In addition, pensions are benchmarked to earnings as measured by MTAWE. This means that pension recipients benefit from productivity growth in the economy.

The rate and indexation of pensions and allowances has changed over time (Chart 7.8). In the past 10 years, the real value of the pension has increased. Over the same period, allowances have remained flat in real terms, being linked to the CPI. The difference in real value partly reflects the different rationale for allowances which have historically been designed to provide temporary assistance and pensions which are for longer-term assistance. Chart 7.8 illustrates this divergence for the case of couples. Allowances such as Newstart are estimated to be 50 per cent of the pension by 2035 under current indexation arrangements if real wages continue to grow at their long term average rate.

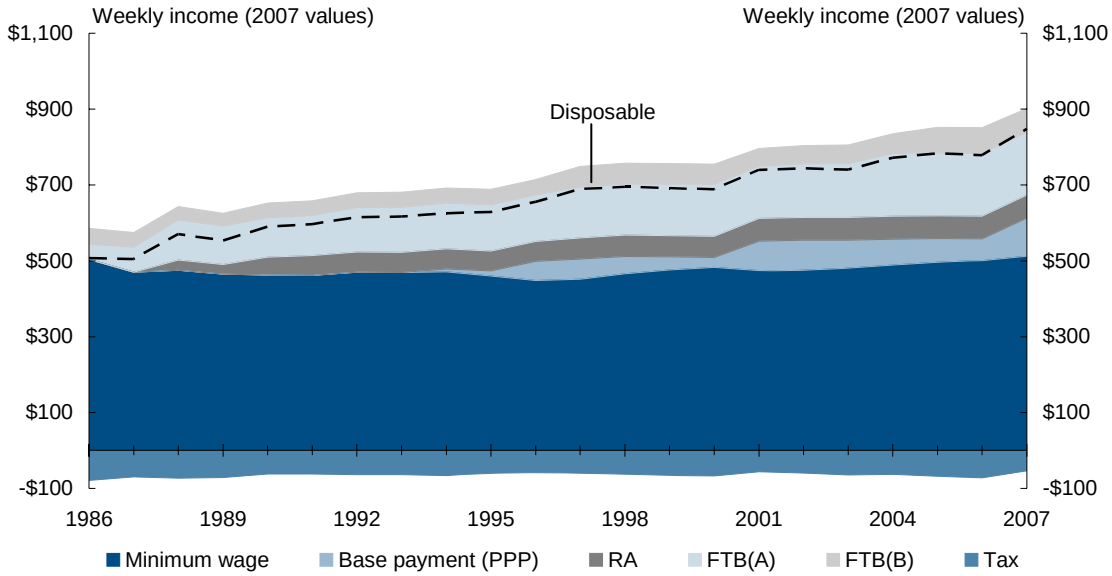
Chart 7.8: Real rates of selected pensions and allowances 1970-2008[(a)(b)]



(a) Annualised rates of assistance applying as at 1 January, adjusted by the All Groups Consumer Price Index.
(b) Rates include Telephone, Pharmaceutical and Utilities allowances, but exclude bonuses.
Source: FaHCSIA estimates.

The value of assistance provided to families has increased substantially, as has its role in complementing the earnings of low income working families. Over the last 21 years, transfers have increased the disposable income of a single income family earning the minimum wage by 67 per cent (Chart 7.9). In contrast, there has been little change in the real value of the minimum wage over that period.

Chart 7.9: Real income components — minimum wage single income family[(a)]



(a) Couple family with a single income earner on the minimum wage with two children aged 3 and 8 and receiving full Rent Assistance.
Source: FaHCSIA estimates.

Maintaining value over time

The effect of the SG on future retirees' income will be significant. The SG commenced in 1992 and did not reach the maximum rate of 9 per cent until 2002. The influence of the SG on an individual's retirement income will depend on when they retire, whether the individual has made voluntary contributions and how long they are in paid employment.

Under a fully mature SG system, an individual who earns 75 per cent of Average Weekly Ordinary Time Earnings (AWOTE) (approximately $43,000) is estimated to have a replacement rate[3] of 78.4 per cent. The same individual earning AWOTE (approximately $58,000) will have a replacement rate of 68.5 per cent. Although the replacement rate is lower for the individual earning AWOTE, their actual retirement income will be higher. If there was no SG and these individuals retired only on a full-rate Age Pension, the replacement rates would be 48.5 per cent and 38.1 per cent respectively.

Affordability

In 2007-08, transfers constituted approximately $70 billion or over a quarter of total Australian Government expenditure.

The affordability and sustainability of the personal tax-transfer system is influenced by a range of factors, including: workforce patterns, such as shifting patterns of part-time, full-time and unpaid household employment; the levels of different payments; and other non-financial policy settings. In addition, the size of the budget (now and in the future) and competing priorities for government expenditure will affect overall policy settings.

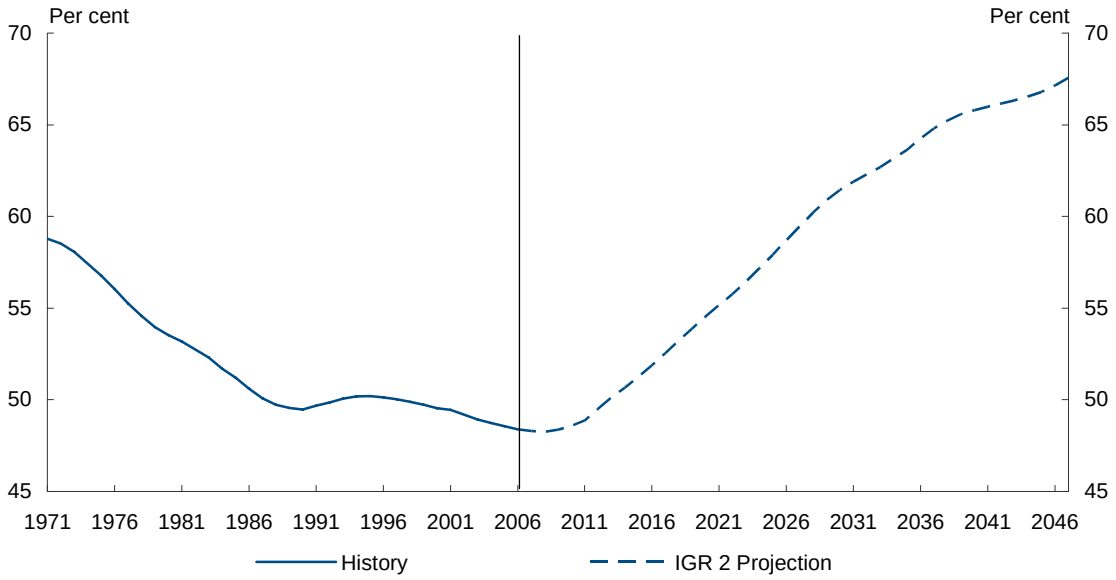
3 This includes income from the Age Pension and superannuation and assumes a male who works for 35 years and retires at age 65, income indexed at 4 per cent per annum, net earnings of 7 per cent per annum and inflation of 2.5 per cent per annum.

Demographic trends will play a significant role through their impact on the aggregate level of income support payments and the number of people in the workforce who will support these payments through the tax system.

The second Intergenerational Report (Australian Government 2007b) estimates that the ageing of Australia's population, coupled with higher life expectancies, will drive a net increase in payments to individuals from 6.7 per cent to 7.1 per cent of GDP over the next 40 years. Notwithstanding the maturation of the SG arrangements and the expected reduction in the proportion of individuals receiving a full-rate Age Pension, Age Pension outlays are expected to increase from 2.5 to 4.4 per cent of GDP.

Non-working age people as a proportion of working age people will increase as the population ages. This is reflected in the dependency ratios illustrated in Chart 7.10.

Chart 7.10: Past and projected total dependency ratios in Australia



Note: The dependency ratio is the ratio of the dependent population (those aged less than 15 or 65 or more) to the working age population.
Source: Australian Treasury projections for Australian Government (2007b).

7.4 Workforce participation

Taxes on earned income are a significant source of government revenue. An increasing dependency ratio will affect the ability of the working age population to support government programs. This gap can be filled by increased participation of people in the workforce and increased productivity.

The personal tax-transfer system can affect workforce participation decisions by altering the financial rewards of working — that is, disposable incomes. Where transfers are high enough to meet an individual's needs, their incentives to work longer hours are reduced. Tax, together with reductions in transfers as people earn more income, reduces the financial rewards from work, making it less attractive. Policy settings thus need to consider participation goals alongside other concerns such as adequacy and affordability.

Workforce participation is an important driver of economic growth and has benefits for broader social inclusion. While the proportion of the population in paid work is currently at an all time high, the increased prevalence of part-time work and employment of female workers have increased the importance of personal tax-transfer settings that encourage participation. These groups seem more responsive to incentives than are males working full-time hours, as they tend to have more flexible patterns of participation and are more affected by interactions with the personal tax-transfer system.

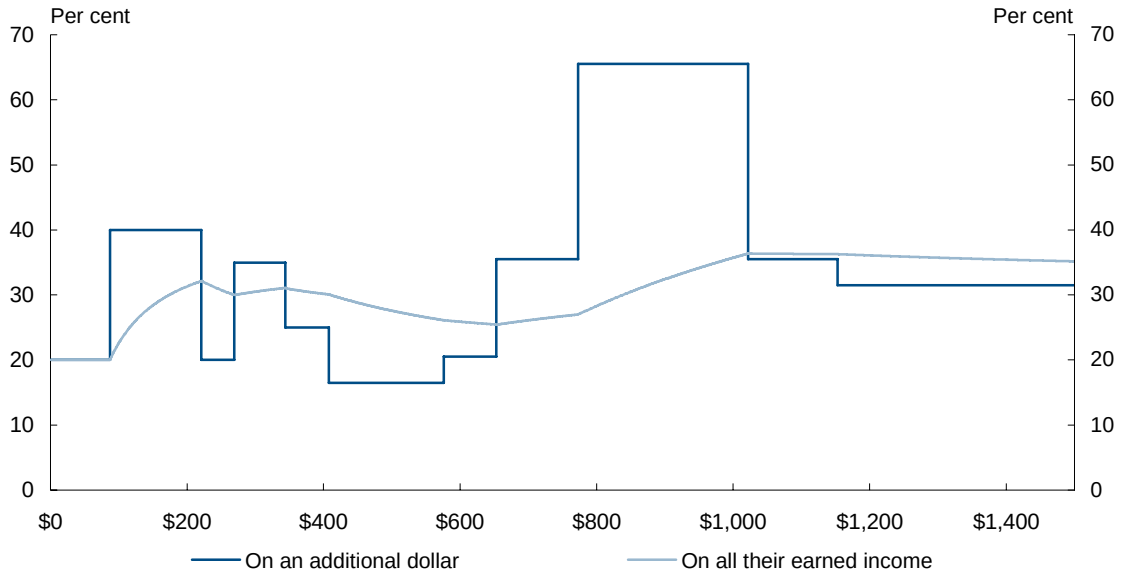
Another reason incentives are becoming more important is population ageing, which will drive down the participation rate in the future.

Financial incentives, however, are only part of the story. An individual's responsiveness to them will depend on the role played by other factors that influence participation. There are also non-financial incentives such as activity tests for certain income support payments which can play a significant role for some. Individuals take into account many other considerations, such as: meeting basic financial needs; their work ethic; caring responsibilities; their health and disability status; level of wealth; social expectations; the availability of child care; working conditions; and the benefits of remaining attached to the labour market as it affects career prospects and expected future earnings.

One way of assessing financial incentives to work is to measure the amount by which an individual's gross pay is reduced by the personal tax-transfer system. The proportion of an individual's gross pay that is taken as tax or is offset by a reduction in payments is called their effective tax rate (ETR). There are various types of ETRs. An individual who moves into the workforce will keep only part of their gross pay after tax is taken out and transfers are reduced. These are often called participation tax rates. If an individual takes on some extra work, they will only keep a proportion of their extra gross pay. These are called effective marginal tax rates for an additional dollar earned and effective average tax rates for a larger increase in earnings (for example, another day's work). If ETRs are too high, some people may decide it is not worth their while to take a job, or work extra hours. Other people in certain circumstances might decide to increase hours of work to ensure their ongoing commitments are met. See Section 3.5 for a discussion of participation tax rates and ETRs.

Chart 7.11 provides an example of the ETRs faced by a secondary earner with two school-aged children. The chart considers ETRs when moving into work, and also when earning an additional dollar. It is important to consider ETRs on a range of different increases in income, as people generally can only increase (or decrease) their hours in blocks.

Chart 7.11: Effective tax rates faced by a secondary earner
With a partner earning average weekly earnings with children aged 6 and 7



ETRs for 2008-09. Children are aged 6 and 7, partner is earning $57,900.
Source: Australian Treasury estimates.

A secondary earner who enters the workforce in a job paying $280 a week (about three days at the Federal Minimum Wage) loses 30 per cent of their pay (the light blue line). Once they are in the workforce the impact of the tax-transfer system on an additional dollar of earnings can be significant. For example, if they move from gross earnings of $900 a week to $901 a week, the tax-transfer system takes 65.5 cents of this increase.

Some households face high ETRs on earning an additional dollar of private income. Research for AMP (AMP.NATSEM 2006) found that over the decade to 2006-07 there had been a reduction in the number of working age Australians facing very high ETRs of over 80 per cent. However, it found there had been a pronounced increase in the overall number of people facing ETRs of greater than 50 per cent (from 4.8 to 7.1 per cent). Almost two-thirds of these people were members of couples with dependent children. This was due to the extension of eligibility for family assistance to a greater proportion of people.

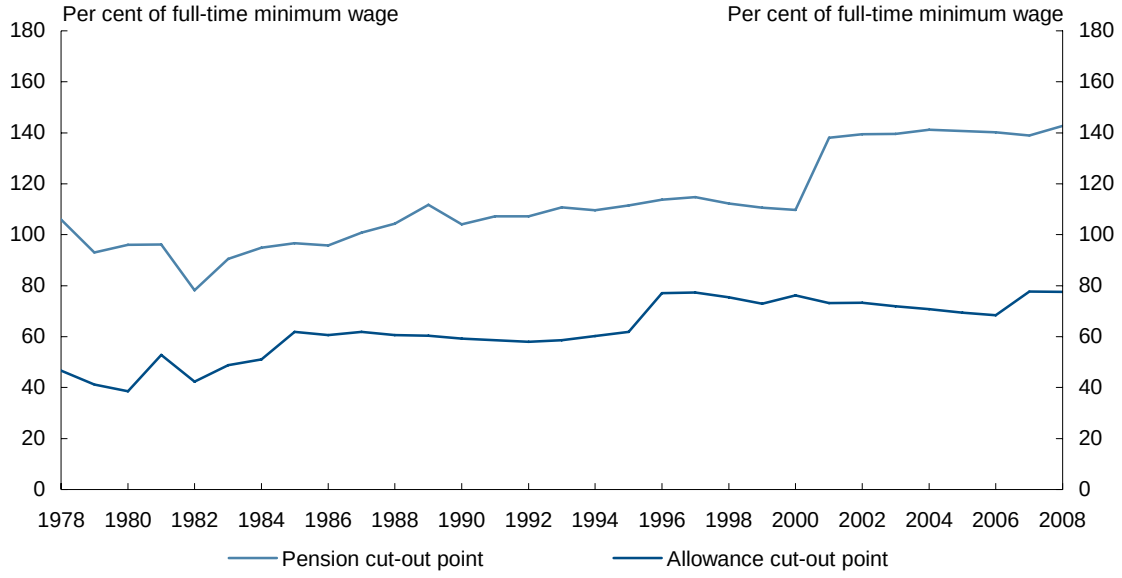
Calculating rewards for working can be complex. They can be influenced by the cost of getting to work, purchasing appropriate clothing and equipment and the costs of child care. While elements of the personal tax-transfer system assist with the cost of child care, child care tends to be relatively 'lumpy' — it is generally purchased in blocks of days per week, rather than in amounts corresponding to additional hours worked. Similarly, people can lose various concessions as their earnings increase. These have different values to different people depending upon their circumstances and consumption patterns.

There are also questions about the importance of financial incentives that do not have an immediate effect on an individual's disposable income. For example, the net return from working is reduced by the withdrawal of LITO. However, half of this withdrawal is not calculated until the end of the year when the individual submits their tax return. As the full effect of the withdrawal is not seen in an individual's regular pay packets it may play less of a role in affecting their decision to do additional work.

A targeted social security system, which reduces payments as incomes increase, necessarily reduces financial incentives. Lower taper rates can be used to improve incentives by reducing the amount of a payment that is lost for a given increase in income. However, this means that access to some of the payment is provided to people on higher incomes as the taper range will be longer. This can then affect the new recipients' incentives, as additional work will reduce the payments they would receive under the lower tax rate. Attempts to increase participation at certain incomes can therefore adversely affect the incentives of other income earners.

Chart 7.12 shows how lower taper rates have affected payment cut-outs over time. For example, in 1978 an unemployment benefit recipient would lose all their payment working only 18 hours a week at the minimum wage. In 2008 they can work 29 hours a week before losing their payment. The cut-out point for pensions has increased even more dramatically.

Chart 7.12: Pension and allowance cut-out points as a percentage of the minimum wage[(a)]



(a) Excludes supplementary payments such as Rent Assistance.
Source: DEEWR estimates.

The position of ETRs along the income scale is also important. High ETRs lower down the income scale can act as a disincentive to move into paid work. High ETRs further up the income scale can make it less attractive to take on full-time or better paid work or invest in education. Disincentives at certain income levels, such as around the Federal Minimum Wage, are of particular interest since they may impact on people whose decision to participate in the workforce is sensitive to the financial return.

While participation is important, some parts of the personal tax-transfer system are designed to enable people to stay out of the paid workforce. The provision of Age, Carer and Disability Support pensions and Carer Payment reflects a community decision that certain people should not or cannot be expected to rely on paid work for income. There are also measures to support people taking time out of paid work for shorter periods, such as students or carers of young children. In recognition of the longer term value of these activities, the community bears some of the short term costs.

7.5 Savings and investment incentives

Australia's total savings (or national savings) is made up of the private savings of households and businesses (retained earnings) plus public savings (government budget surpluses or deficits).

The savings of individuals and households fulfil three important functions:

- to provide a means for them to smooth their income over time — in particular, between the individual's working life and their retirement;
- to meet transitory adverse shocks such as sickness and unemployment; and
- to finance investment in capital that can be used to improve productivity, leading to higher incomes.

The decisions made by individuals and households in apportioning income between consumption and saving affect their wellbeing now and in the future. The tax–transfer system impacts on these consumption/saving decisions in three ways:

- through marginal tax rates and access to transfers (including the means testing of savings);
- by providing tax concessions to some savings vehicles; and
- through compulsory savings for retirement (the SG).

These mechanisms can have a complex set of behavioural outcomes:

- the existence of income support as a guarantee of income may reduce the incentive to save for periods when earned income is expected to be lower (for example, unemployment and old age);
- incentives associated with different savings vehicles may lead to a change in saving preferences rather than a change in the level of aggregate saving; and
- incentive effects may differ at different income levels.

The empirical literature on the effectiveness of tax-preferred retirement savings plans in encouraging savings is mixed, with researchers finding effects ranging from significant impacts on savings to little or no effect (OECD 2004). If the concession results mainly in a switching of savings from one vehicle to another there may be no increase in overall household savings. Indeed, national savings may decrease if the value of additional savings is less than the cost of the concession to governments.

The OECD (OECD 2007d) considers that the distribution of concessions is an important indicator of the success of such savings vehicles. In this regard, the success of a policy in encouraging new savings depends on the level of take-up by moderate-income households. Higher income households are more likely to respond by switching their existing savings.

Means testing of income support payments can also affect the incentives to save or dissave by reducing existing savings. These effects are likely to be stronger where the level of savings

results in a reduction in income support entitlements. As a result, they tend to be more significant for low to middle income earners.

Means testing is also likely to affect the savings decisions of individuals who have more frequent contact with the income support system — for example, an individual with an intermittent attachment to the workforce. For these individuals, the decision to save may be influenced by a tighter assets test and a liquid assets waiting period which forces some allowees to run down their savings before accessing income support. Overall, the effects on saving need to be considered in the context of Australia's targeted income support system.

Australia's tax-preferred savings vehicles

Australia's principal tax–preferred savings vehicles are owner-occupied housing and superannuation. Owner–occupied housing is generally exempt from capital gains tax and taxation on the value of rent saved from owning a home. Consistent with this treatment, expenses such as interest costs and maintenance costs are not deductible. In the transfer system, the owner-occupied home is exempt from asset testing.

Unlike the returns on most other taxable savings, savings invested in superannuation are generally not taxed according to the individual investors' personal tax rates. Benefits from a taxed superannuation fund are paid tax free from age 60. Superannuation contributions and earnings are generally concessionally taxed. The value of superannuation tax concessions provided to contributions and earnings is estimated to be over $27 billion in 2008-09, increasing to over $31 billion in 2010-11 (Australian Government 2007a).

The changes to personal income tax rates since 2000 have had a significant impact on the concessions received by low-income and middle-income earners. Based on the 2008-09 tax rates, it is estimated that around 1.2 million individuals do not receive a personal income tax benefit[4] from the tax rate applied to their concessional superannuation contributions. In addition to the number without any concession on contributions, an estimated 1.2 million individuals only have a concession equivalent to 1.5 percentage points (the Medicare levy) in 2008-09.

Chart 7.13 shows the effective marginal concession on superannuation contributions for a single income earner with no children at different levels of income. The higher the effective rate, the higher is the value of the concession. Concessions for higher income earners have been relatively stable since contributions were first taxed in 1988. However, the effective concession for people earning lower incomes has fluctuated over this time.

4 The number of individuals where the net tax paid on their contribution and other taxable income is greater than or equal to the amount that would have been due had the contribution been taxed at their personal marginal income tax rate.

Chart 7.13: Effective marginal concession on superannuation contributions

Assumptions: Single income earner with no children. The value of the concession at lower incomes would be higher for an individual with children, who would be affected by the phase-out of transfers. Rates may change depending on family type.
Source: Australian Treasury estimates.

These fluctuations reflect changes in the arrangements for the phase-out of the LITO and the phase-in of the Medicare levy. From 2010-11 a person earning a third of AWOTE will receive a concession of 1.5 percentage points on their concessional superannuation contributions. This compares to a concession of 16.5 percentage points for a person earning AWOTE and 31.5 percentage points for someone earning three times AWOTE.

The government superannuation co-contribution is intended to provide access to more concessions for low and middle income earners. Under this scheme, post-tax contributions are matched at $1.50 for every dollar up to a maximum contribution of $1,500. The maximum contribution is available for individuals with total income below $30,342 and phases out at the upper threshold of $60,342 (2008-09).

It is estimated that around $1.1 billion of co-contributions will be paid in 2008-09 in respect of post-tax contributions made in 2007-08. Approximately 1.4 million individuals will receive a co-contribution, which represents around 20 per cent of those individuals who would be eligible if they contributed.

7.6 Incentives to improve skills

In the same way the personal tax-transfer system can influence an individual's decision to work, it can also influence the decision as to the type of work an individual undertakes. Skills and education are a major determinant of the hourly rate of earnings. Acquiring these skills and education is costly, both in terms of forgone income while learning and in direct costs of tuition. Improving skills is therefore an investment decision, and the tax transfer system acts both to subsidise the cost of this investment (directly and indirectly) and to reduce the after-tax return from it.

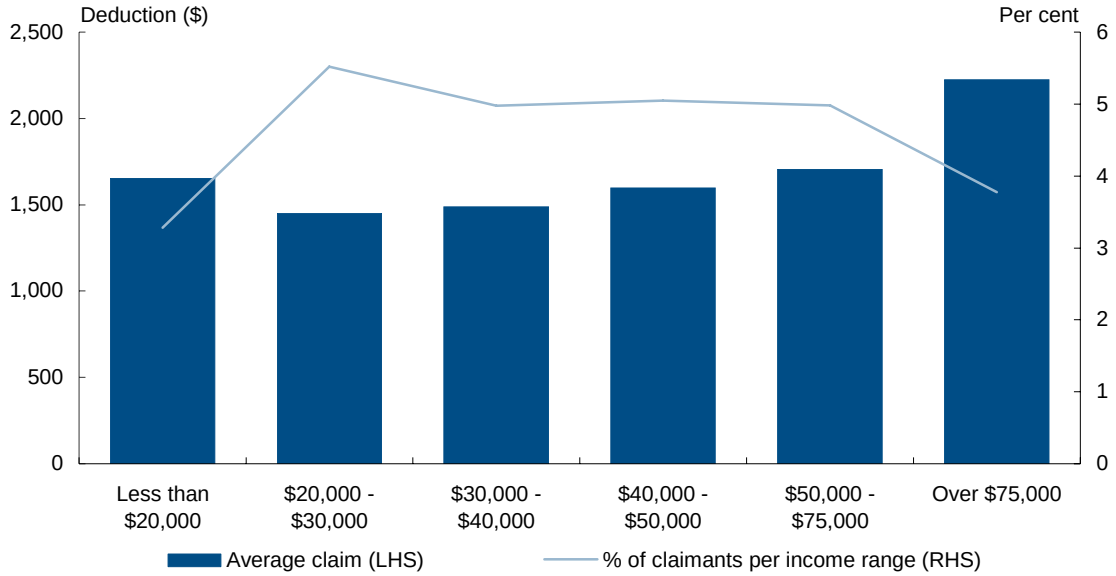
Youth Allowance, Austudy and ABSTUDY are the main means of supporting an individual's participation in education and training. Youth Allowance, Austudy and ABSTUDY are

means tested payments that provide some $2 billion annually and support 320,000 students (as at June 2008). There are many other ways in which both the States and the Australian Government subsidise the more direct costs of education and skill acquisition. In the 2006-07 financial year, the Australian Government provided the university sector alone $5.86 billion while the States provided $508 million (ABS 2008b). The Higher Education Loan Program is also important for many people choosing to undertake further study.

As noted in Section 2, self-education expenses that are directly linked to the individual's existing career are deductible. In 2005–06 over $834 million was claimed as self–education expenses (Chart 7.14). These costs are not deductible if the new skills are for a new career direction.

Loss of income can be seen as a form of personal investment, the cost of which is in effect deductible (equivalent to a post-paid expenditure tax — see Box 6.1) and so treated concessionally relative to other forms of capital investment, especially when subsidies are included.

Chart 7.14: Total self-education expenses
(average claim and percentage of claimants per income range in 2005-06)[(a)]



(a) Average deduction does not include taxpayers who do not claim self-education expenses.
Source: Australian Government administrative data.

The net effect of the personal tax-transfer system on the return to the individual from improving their skills and hence the incentive to invest in skill formation is very difficult to determine.