ACOSS Submission | October 2008

Australian
Council of
Social Service

Submission to the Taxation Review Panel

Strong foundations:
Reforming the tax and social security systems

ACOSS, October 2008

Table of Contents

Australian Council of Social Service
Locked Bag 4777, Strawberry Hills, NSW, 2016
Phone: 02 9310 6200
Fax: 02 9310 4822
Email: info@acoss.org.au

Summary

Tax reform

ACOSS has a long standing interest in tax reform. The tax system has a profound impact on the distribution of resources and opportunities across the community. It also affects the strength and character of Australia's economic development well beyond the simple notion that taxes on particular activities, sectors or institutions should be 'competitive'.

Genuine tax reform is not mainly about tax rates. Its purpose is to strengthen the foundations of the system - the tax bases on which revenue is raised – so that Governments have the revenue they need to provide services for the future and that revenue is raised fairly with limited harm to the economy. The guiding principle for progressive tax reform is that by taxing income more comprehensively and consistently - broadening the tax base – Governments can improve equity and efficiency at the same time.

The personal income tax system falls well short of this ideal. Inconsistencies in the way that different forms of income are taxed have distorted saving and investment decisions in economically harmful ways. A recent example is the combined effect of the 50% discount of tax on capital gains and negative gearing on investment at the top end of the housing market, which has contributed to inflation in house prices and excessive household debt levels. These inconsistencies in the tax treatment of different forms of income have opened up opportunities for tax avoidance by high income earners, undermining the fairness and integrity of the system. When individuals can avoid paying tax at their marginal tax rates through devices such as negative gearing, salary sacrifice arrangements, and the use of structures such as private companies and trusts, then the personal income tax is more progressive in form than it is in substance.

It is not always efficient or fair to tax different forms of income at the same rates. For example, tax incentives are desirable to support and encourage long term saving and international tax competition limits the scope for Governments to tax some forms of investment income. This observation underpins a long standing policy debate over whether the incidence of taxation should shift fundamentally from investment income towards consumption or labour income. The problem with such proposals from an equity standpoint is that, all things being equal, low and middle income earners would pay more tax and high income earners would pay less. In any event, it may be more useful to focus policy attention on how to improve the consistency of tax treatment *within* each of these tax bases (for example between different kinds of investment and long term saving, and between wages and earnings sheltered in private companies and trusts) than to search for the ideal balance between the taxation of labour and capital incomes, or income and consumption.

Much public debate over taxation focuses on the personal income tax scale as distinct from whether individuals actually pay tax at these rates. The debate over whether the tax scale should be 'flatter' is often characterised as a tussle between equity and work incentives. However the evidence suggests that tax levels have a greater impact on work incentives among women in low and middle income households than among the (mostly male) top tax rate payers. If this is so then a flatter tax scale could worsen work incentives. Any flattening of the tax scales should be accompanied and paid for by the closure of tax shelters to keep the personal income tax system progressive.

Australia is the eighth lowest taxing country in the OECD. Although a major reason for this is our relatively well targeted social security system, the level of revenue available to Governments is inadequate to meet Australia's present social and economic development needs. This is illustrated by public concern about the adequacy of social security payments and services such as disability services and dental care. For many years Governments, especially at the State and Territory level, have under-invested in the physical and social infrastructure essential to our economic development including school education, public transport and social housing. Over the next 40 years, population ageing will put increasing pressure on both the expenditure and revenue sides of Government budgets. For example, Commonwealth Government expenditure on health care, aged care and pensions alone is expected to rise from 7% to 14% of GDP. Yet only one in five individuals aged 65 years and over pays tax, and under the current tax arrangements for older Australians a mature age couple need not do so until their combined income reaches almost $50,000. In future years, Australians will have to choose between a retreat from public provision and funding of health and community services or higher taxes. Calls for increases in the adequacy of pensions throw this issue into sharp relief.

Tax reform is closely connected to the COAG Reform Agenda (CRA) as the States and Territories have some of the most unstable and economically distorting taxes. The CRA would be strengthened if there was a connection between the allocation of Goods and Services Tax revenues to the States and Territories and improvements in outcomes for the consumers of State funded services.

Social security reform

As with tax reform, reform of social security should build a stronger foundation for the system as a whole, rather than making ad hoc adjustments to particular payments. The main purpose of the social security system is to ensure that people who are unable to fully support themselves with their own incomes have the capacity to secure life's necessities and to participate in the economy and society. To strengthen workforce participation, income support should be balanced where appropriate with reasonable activity requirements, access to employment assistance, and policy action to ease work incentives.

The present social security system is built on shaky foundations. Payments are not fairly and consistently benchmarked to the essential living costs faced by different households. For example, payments for single people do not appear to reflect the diseconomies of scale associated with living alone. The division of payments for people of working age into pensions for those deemed 'unable to work' and allowances for those considered work ready is outdated, unfair and counterproductive. Many disability pensioners are discouraged from seeking employment by the risk that they may eventually be transferred to the Newstart Allowance payment which, at $219 per week for a single adult, is $55 per week less than the pension. The effect of this on work incentives is more powerful than the high 'tax rates' imposed through social security income tests because these pensioners perceive that their economic security as well as their income is jeopardised if they seek employment.

The system should be rebuilt on a firmer foundation. The first element of this new foundation is an Australian Minimum Standard of Living informed by thorough research into the minimum cost living for a single adult, a couple, a sole parent, and children of different ages. Base rates of all payments should reflect this Standard rather than the category of payment that people receive (pensions or allowances). The second element comprises supplements for additional costs such as the costs of disability or caring, rent, and workforce participation or training. The third element is a set of payment categories that determine the participation requirements, if any, that will apply to recipients of working age. These payment categories might not be much different to the present system (including payments for people with disabilities, and parenting and caring responsibilities) but the levels of payment attached to them would no longer vary. In addition, participation requirements would be more graduated and responsive to individual circumstances than in the present system, which divides recipients into one group with no requirements and another with stringent requirements.

The tax and social security systems combine to redistribute income in two ways: from those most able to pay towards those in greater need (the 'safety net' role), and across the life course from people of working age without children to families and mature age people (life cycle redistribution or income smoothing). In theory the two systems could be combined into one. However in practice the safety net role of social security could not be conducted efficiently through the tax system. The administration of activity requirements does not sit well with the goal of simplifying the tax system and the social security system uses the family unit for its income tests in order to target support to those at most risk of poverty. For these reasons, concerns about the efficiency cost of churning household income through the tax and social security systems are misplaced. A single system that attempted to perform both revenue raising and safety net functions across the population would probably be less efficient and more complex than the present arrangements.

Nevertheless, there is a case for simplifying and better integrating the two systems where they combine to redistribute income across the life course towards families with children and mature age people. This has largely been achieved in the Family Tax Benefit system which doubles as an income support payment and tax allowance for children, paid through the social security system. Priorities for reform in this area include improved support for low income families with older children and reform of family income tests to encourage families to move from one to two incomes.

There is much that could be done to simplify and better integrate public assistance for mature age people, clarify its objectives and improve its targeting. Emerging changes to people's retirement pathways – including later retirement and greater reliance on part time earnings and part-pensions, call for a rethink of the role of the social security, superannuation and tax concessions in supporting these transitions. The pension provides inadequate support for those on the lowest incomes, at least for those with the highest costs (especially rents). Those with access to much higher levels of private income receive a complex cocktail of part-pensions and tax concessions whose policy purpose is unclear.

The role of superannuation is also less clear cut than in the past. From a system of saving for retirement that divided neatly between an accumulation phase and a benefits phase it may become a general holding entity for earnings and investment income for people over 55 years. Superannuation tax concessions encourage mature age people, especially those over 60 whose superannuation benefits are tax free, to churn their earnings and investment income through their superannuation accounts without necessarily increasing their saving levels or workforce participation. A more basic problem with the system of tax concessions for superannuation contributions is that they are targeted towards high income earners - who are more likely to save for retirement in the absence of incentives and have less need for public support in retirement. This is due to the tax treatment of employer contributions which take up the lion's share of the $25 billion in superannuation tax concessions. The 15% tax rate on employer contributions has the same effect on equity as replacing the current progressive income tax scale with a flat tax. It delivers a costly tax break to those on the top tax rate, but no benefit to those on the lowest wages.

Directions for reform

1. The separation between social security safety net payments and the tax system should be maintained, while keeping the integrated family payment system (which doubles as a social security payment and tax allowance for children paid through the social security system) and considering options for better integration and simplification of tax and social security for mature age people.

Reform of the tax system

The adequacy of public revenue

2. The Treasury should be asked to model the long-term public revenue impact of population ageing.

3. To address the community's needs for better economic and social infrastructure and to ensure that the costs associated with an ageing population are met in an equitable way, tax reform should strengthen rather than diminish future public revenue:

    - One option is the introduction of an income tax levy (akin to the Medicare Levy) linked but not strictly hypothecated to expenses that are most likely to increase as the population ages.

Economic and revenue efficiency

4. To improve the efficiency of investment and allocation of resources across the economy, the income tax base should be broadened by taxing income from different sources more consistently. Departures from this principle should be based on clear public policy objectives (such as raising household saving levels) or practical considerations (such as the difficulty in taxing capital gains as they accrue).

    - Options for reform of capital income taxes to improve economic efficiency include reducing the concessionality of the tax treatment of capital gains, restricting negative gearing, and improving the scope and targeting of tax concessions for long term saving.

5. Tax reforms to improve work incentives should give priority to the effective tax rates facing low and middle income earners, especially mothers. In many cases this will require adjustments to social security income tests rather than tax rates.

6. Other reforms that should be considered to improve the efficiency and integrity of the income tax system include more consistent tax treatment of income in different holding structures (such as private trusts and companies) the removal of Fringe Benefits Tax concessions for employer-provided cars and reform of the taxation of termination payments.

7. A major review should be conducted of tax expenditures by Treasury and Finance in cooperation with relevant portfolio Departments. This should include a comparison of their cost with those of relevant direct expenditures, identification of their policy objectives and whether these are being met, and their impact on the equity, efficiency

and the integrity of the tax system. Portfolio Departments should subsequently be asked to incorporate a review of relevant tax expenditures into their regular policy review processes, including the annual expenditure review process.

Equity

8. The overall effect of any package of major reforms to the tax system should be to increase its progressivity, by shifting the incidence of tax from low and middle to high income earners.

    - One way to achieve this while meeting economic efficiency goals at the same time is to broaden the personal income tax base by removing economically inefficient tax shelters used by high income earners, as proposed above.

9. Any significant flattening of personal income tax structure should be accompanied by base broadening measures to offset its distributional impact.

10. Any major shift in the overall incidence of taxation from income towards consumption should be avoided on equity grounds.

Simplicity and public acceptance

11. To simplify the tax system and build public support for the system, tax shelters and expenditures that lack strong public policy justification should be closed and tax legislation should be based as far as possible on principles and economic substance rather than ‘black letter law’.

12. Steps should be taken to better inform the community about how Governments spend public revenue. One option is to provide a general break-down of Government expenditure with tax returns.

13. There is also scope to simplify the system by improving the integration between the tax and social security systems, especially for mature age people.

Federal-State financial relationships

14. To improve the efficiency of State tax systems, States and Territories should be encouraged to shift their revenue sources from narrowly based unstable taxes towards less distortionary tax bases; for example from Stamp Duties for property purchases towards more broadly based Land Taxes.

15. The COAG Reform Agenda should incorporate changes to the system of Commonwealth financial support for State and Territory Governments. Generally speaking, federal funding should be linked to broad outcomes rather than being completely open-ended or tied to detailed inputs.

Charitable organisations

16. Modern statutory definitions of charitable purposes and benevolent charities should be introduced along the lines recommended by the Charity Definitions Inquiry.

Reform of the social security system

An Australian minimum standard of living

17. Social security payments should be benchmarked to an Australian Minimum Standard of Living, that is, the minimum income typically needed for households comprising a single adult, a couple, a sole parent, and children of different ages respectively to avoid poverty and live decently in accord with general community standards. This would ultimately replace the separate pension and allowance levels of payment.

18. The Australian Minimum Standard of Living should be based on the best available research on the living costs and financial circumstances of low income Australians, including:

    - Budgets developed by experts to reflect the minimum expenditures required to achieve a decent standard of living (Budget Standards).

    - Research on the actual living standards of recipients of the different payments, including access to socially defined 'essentials of life' and financial stress indicators.

    - Poverty lines.

Support for families with children

19. Family Tax Benefit Part A should be maintained as a fully integrated social security and tax allowance for children paid through the social security system, along with the supplement for sole parents in Family Tax Benefit Part B.

20. Options should be explored to redesign the family income test for Family Tax Benefit Part A to shift its incidence from secondary to primary earners, and to reduce the effects of income test 'stacking' where this income test overlaps with those for other payments including the Part B payment, Youth Allowance and Child Care Benefit.

21. Options should be explored to improve the targeting and efficiency of the Part B payment in respect of couples, including targeting this support towards families caring for younger children and integrating it with the Part A payment.

Support for people of working age

22. Options should be developed for fundamental reform of the social security payment structure for people of working age based on:

    - The Australian Minimum Standard of Living described above.
    - Supplements for rent, the extra costs of disability and caring, and the costs of workforce participation or training.
    - A common platform of eligibility requirements (including residence requirements, assets tests and access to supplements, but not activity requirements).
    - Separate payments with the common features described above (including a common rate structure) but with different activity requirements to acknowledge parenting and caring roles, and disabilities.

23. Income tests for payments for people of working age should be reviewed and eased where the evidence suggests that this is a cost effective way to improve work incentives. Options include easing the Newstart Allowance income test for those required to seek part time employment.

Support for mature age people

24. The system of retirement income supports including pensions, tax concessions and superannuation should be reformed in order to:

    - reduce financial hardship and ease future inequality in retirement incomes
    - more efficiently encourage and support saving for retirement
    - encourage workforce participation where appropriate
    - ensure that these supports are sustainable as the population ages
    - encourage retirees to use tax preferred retirement income savings to improve their living standards and reduce their need to rely on the Age Pension, rather than for estate planning purposes
    - simplify these systems and their interaction – for example by treating income and assets more consistently across the pensions and tax systems.

A. Purposes of the tax and transfer systems

Tax

The main purpose of the tax system is to raise sufficient revenue for Governments to provide the economic and social infrastructure that underpins Australia's economic and social development, including services and income supports for the community.

Ideally, this should be achieved in a way that:

- undesirable distortion of economic activity (including incentives to work and invest, and flows of saving and investment to and from Australia) is kept to a minimum;
- the economic resources available to people are redirected from those who can most afford to pay towards those in greater need;
- the economic resources available to people are taxed in a consistent way regardless of their origin (e.g. wages, different forms of investment income and assets, different holding structures); and
- the system is as simple as possible to comply with and broadly perceived as fair.

The tax system also has a number of other purposes, which at times justify departures from the above principles, including:

- encouragement of long term saving
- discouragement of undesirable activity (such as excessive consumption of alcohol and tobacco)
- encouragement of desirable investment (such as products that reduce carbon emissions).

Since tax concessions for special purposes reduce revenue and bias the tax system in favour of some activities over others, the key consideration is whether tax concessions for special purposes or particular sectors benefit the economy or society as a whole. For example, a tax concession for a particular industry may boost investment in that sector, but at the expense of efficient allocation of capital across the economy.

Social security

The main purpose of the transfer (or social security) system is to redistribute resources towards those in greatest financial need. It also facilitates participation in the labour market and society and supports caring.

Its redistributive function has two aspects – providing a safety net for those on inadequate incomes (a vertical equity goal because it involves redistribution from those with more to those with less resources) and redistribution across the life course (a horizontal equity goal since it involves redistribution between households with different needs, for example from smaller to larger households). Since transfers are in effect negative income taxes, the tax and social security systems are two sides of a single coin.

However, the Australian social security system is distinguished by its safety net objective -

to assist individuals and families to achieve a minimum acceptable living standard and the capability to participate in the economy and society.

The safety net role comes into play when people are unable to secure enough income from earnings or other sources to meet socially defined basic needs – that is, to avoid poverty. The safety net role dominates the Australian social security system because Australia lacks a national social insurance scheme. Social security payments are financed from general taxation rather than employer, employee and Government contributions and are paid at low flat rates rather than as a proportion of previous wages. One advantage of the Australian model is that it is cost effective in reducing poverty. However, the low level of payments (when account is taken of overseas social insurance schemes) is one reason that overall poverty levels in Australia are higher than in most of the European Union countries.

For jobless people of working age, a well functioning social security system supports active engagement with the labour market as well as easing poverty. In the absence of a robust safety net there is a greater risk that the most disadvantaged jobless people will become deeply excluded from the formal economy. For example, in the United States few unemployed African American young people have social security entitlements because these require a history of employment and generally expire after 6 months. Only 52% of this group had a job in 2000 and in the absence of income support many rely on the informal economy (family, informal employment and crime), which further distances them from the formal labour market. Those with access to income support (for example sole parents on the Temporary Assistance for Needy families program) are connected with employment services and are generally more likely to participate in the labour market. This is one of the reasons that employment rates among young African American women rose from 37% in the early 1990s to 52% in 2000 while those of their male counterparts continued to fall.[1]

There is nevertheless a tension between the provision of a minimum income and work incentives, which we discuss below in the section of this submission that deals in more detail with reform of the social security system.

The social security system plays a critical role in support of caring. Safety net payments such as Parenting Payment and Carer Payment enable people on low income who have caring responsibilities to achieve an adequate minimum living standard despite their inability to fully participate in the labour market. A well designed system should also facilitate their participation in the paid workforce including combinations of caring and part time employment.

In addition to its safety net role, the social security system redistributes income across the life course from people of working age without children towards families with children and retired people. For this reason, payments for children and mature age people are not as strictly targeted towards jobless people and those on the lowest incomes. For example, Family Tax Benefits play a vital role in supplementing minimum wages for employees with children, a function the wages system alone cannot effectively perform.

Another ‘horizontal equity’ function of the social security system is to compensate people for the additional costs of a disability. This, along with access to community and health services, is necessary to enable people with disabilities to participate fully in society. One advantage of cash payments for this purpose (whether tied to specific services or otherwise) is that people with disabilities have more control over how the resources are

[1] Offner & Holzer 2002*, Left behind in the labour market*, Brookings Institution.

used, and the resources are used more efficiently. Since payments such as Mobility Allowance perform more than a safety net function, they should not be as strictly targeted as safety net payments. For example, from a horizontal equity viewpoint it is appropriate to provide such support to a full time employee with a disability to compensate for their additional costs of employment such as equipment or taxi fares. Carer Allowance performs a parallel function for carers of people with of disabilities.

Integration or separation?

Social security payments are equivalent to negative income taxes and there is much overlap between their role and that of various concessions and allowances in the income tax system. This raises the question of whether it would be simpler or more efficient to combine the two systems.

Three features of an effective income support *safety net* distinguish this role of the social security system from that of the tax system: activity requirements for those able to participate in the labour market, family based income tests, and tighter definitions of income. For these reasons, it is economically efficient and socially beneficial to 'churn' income between taxpayers and low-income social security recipients, even though they are the same people in many cases:

- The administration of activity requirements does not sit well with the other functions of the Australian Taxation Office and would add considerable complexity to the tax system. Much of the difference in administrative cost between the tax and social security systems is due to activity testing so the saving in administrative costs from integrating them into a single system is unlikely to be substantial as long as activity requirements are retained.

- The annual assessment of income adopted in the tax system is simpler than the requirement for many recipients of safety net payments to declare changes in their income on a fortnightly basis. Social security income tests also use broader definitions of income, to target support to those most in need.

- The individual is the primary unit of the Australian tax system of income taxation. This is a desirable feature since it reduces discouragement of employment among second earners within families. However, it conflicts with the need for social security systems to target support to those most at risk of poverty. This is more efficiently achieved using the family as the income unit since low income families tend to pool their expenditures.

These tensions between simplicity and activity testing, between individual and family based taxation, and between simplicity and effective income-testing, will remain whether the tax and social security systems are integrated or kept separate. However, they suggest that the tax-transfer system will operate more efficiently if the safety net function is carried out by a separate social security system. Because their core functions are different, the organisational cultures of Centrelink and the Australian Taxation Office are quite distinct.

The horizontal equity goal of *redistributing income across the life course* from people of working age without children towards families with children and retired people is more readily shared between the social security and tax systems. For example, social security payments for children and retirees do not normally attract activity requirements and (due to their role in redistributing income across the life course) are not as tightly targeted towards people on the lowest incomes.

Consequently, there is more scope for better integration of those elements of the social security and tax systems directed towards *the support of children and retired people*. Although mainly paid through the social security system, Family Tax Benefit is in effect a tax allowance for children as well as a social security payment. As discussed in the section of this submission dealing with social security reform in more detail, this is a simpler and fairer way to help families with the direct costs of children than overseas systems that divide such support between the tax and social security systems. There is also an overlap between the roles of the Age Pension, the superannuation system, and various tax concessions for mature age people with significant levels of private income.

Payment of Family Tax Benefits and Age Pensions through the social security system has distinct advantages, both from an administrative standpoint and from the standpoint of recipients. Although parents have the option to claim family Tax Benefit through the tax system, over 95% opt to receive it as a fortnightly cash payment from Centrelink.

One stumbling block to greater integration of the two systems for children and retired people is their different definitions of income – which is family-based and more sensitive to short term fluctuations in income in the social security system. This tension between the two systems is illustrated by the problems that emerged when a new income test for Family Tax Benefits, based on annual taxable income, was introduced in 2000. The new income test led to a high incidence of overpayments among low income families in unstable employment.

Easing the business cycle

A further economic policy objective of the tax and social security systems is to ease the adverse effects of the business cycle. The tax and social security systems act as automatic stabilizers for the economy. However, because Australian public revenue and social security expenditure are relatively low, our automatic stabilisers have less impact on the economy than in most OECD countries.

In the event of a major economic downturn, it is not sufficient to rely on the automatic stabilisers alone. Policy action is necessary to boost demand for goods and services in a timely way. Increases in social security payments are more effective for this purpose than reductions in income tax because low income households are more likely than high income earners to spend the extra income in times of economic uncertainty. For example, an increase in family payments for low income families was effective in boosting demand during the recession of the early 1990s. Investment incentives introduced at the same time through the tax system were ineffective because the main barrier to investment in a recession is not tax levels but a lack of consumer demand.

The Government's recent package of temporary increases in social security supplements and family payments is consistent with this approach. It will help underpin economic growth in the short term while other measures such as infrastructure projects that take more time to come on stream are planned and developed. Increases in income support and improvements in employment assistance for unemployed people would be particularly well targeted to those regions most affected by an economic downturn and those experiencing the greatest hardship as a direct result of an economic downturn. An economic downturn has a particularly severe impact on employees who lose their jobs and existing unemployed people and new entrants to the labour force who find it more difficult to secure one.

A key issue to be resolved if the tax or social security systems are used to boost demand in an economic downturn is whether any tax reduction or increase in social security payments is temporary or permanent. Generally speaking, it is desirable to withdraw any stimulus once the economy recovers, as the Government's package does. This can be achieved by adding a sunset clause to any tax reductions or concessions, or by paying any social security increase as a once-off lump sum benefit. However, if the change is part of a desirable long term reform of the social security or tax systems, it is best to make it permanent.

Directions for reform

1. The separation between the social security safety net payments and the tax system should be maintained, while keeping the integrated family payment system (which doubles as a social security payment and tax allowance for children paid through the social security system) and considering options for better integration and simplification of tax and social security for mature age people.

B. Reform of the tax system

1. The adequacy of public revenue

Commonwealth and State and Territory Government taxes raise 31% of Gross Domestic Product in public revenue compared with an OECD average of 36%. Australia is the eighth lowest taxing country among the 30 OECD nations.[2]

The main reason for Australia's low tax status is that we spend much less on social security in the absence of a national social insurance scheme. This is due in part to our system of income testing, but also due to the relatively low level of payments - Newstart Allowance for a single unemployed adult is $219 per week and the single pension is $275 per week, and both are below internationally recognised poverty lines.

Australia spends around the OECD average in total on health education and social welfare services (though we spend slightly more than average on health and less than average on education). Nevertheless there is considerable scope for improvement in these services, including in the quality of schooling in disadvantaged areas, access to disability services, and access to basic health care such as dental services. Further, State and Territory Governments have under-invested in public infrastructure such as social housing and public transport in outer urban areas and regional cities.

As the population ages, more pressure will be placed on public spending. For example, expenditure on health care, aged care and pensions alone is expected to rise from 7% to 14% of GDP over the next 40 years. Overall, Commonwealth Government spending per person is projected to increase by 2% a year in real terms over this period. The main contributing factor is higher expenditures on health and aged care, rather than income support. As a result of these trends, by 2046 Commonwealth expenditure is projected to exceed revenue by around 3½% of GDP.

Unfortunately the Intergenerational Report does not model the impact of population ageing on taxation revenues, and assumes instead that tax to GDP ratios remain constant over this period. Given that only one in five people over 65 pay income tax, and the range of tax concessions that reduce the level of tax paid by this sector of the community, this may not be a realistic assumption in the absence of major tax reform. Another factor that may depress future public revenues is the increased weighting of health expenditures in the economy as the population ages. This may curb growth in future GST revenues due to the exemption for health care.[3]

Directions for reform

2. The Treasury should be asked to model the long-term public revenue impact of population ageing.

3. To address the community's needs for better economic and social infrastructure and to ensure that the costs associated with an ageing population are met in an equitable way, tax reform should strengthen rather than diminish future public revenue:

[2] OECD 2008, *Revenue Statistics*.
[3] Australian Taxation Office 2008, *Taxation Statistics*; Treasury 2007, *Intergenerational Report*; Productivity Commission 2005, *Economic effects of an ageing population*.

- One option is the introduction of an income tax levy (akin to the Medicare Levy) linked but not strictly hypothecated to expenses that are most likely to increase as the population ages.

2. The balance between different tax bases

Taxes are levied on labour income, capital income, consumption, and assets such as land.

By comparison with other OECD countries, Australia's reliance on consumption taxes is about average. Australian Governments rely relatively strongly on land taxes, due largely to the system of Local Government rates. Our Governments' overall reliance on taxes on income is about average. Superficial differences in the incidence of tax on *labour* income between Australia and other OECD countries are due largely to the absence of social security taxes in Australia. When those taxes in other OECD countries are added to their personal income tax revenues, Australia also comes close to the OECD average on this score.

Reliance on corporate income tax is relatively high in Australia. To a significant extent this is a by-product of strong growth in corporate profits during the recent boom conditions. Factors contributing to higher reliance on corporate income taxes over the longer term include an increase in the profits share of national income (which is common to most OECD countries), Australia's relatively broad corporate income tax base, improvements in tax compliance, and the system of dividend imputation which encourages companies to pay tax so that their shareholders benefit from imputation credits.

It is widely acknowledged that taxes on land have a relatively low impact on economic efficiency because land is immobile and economic decision making is less likely to be distorted by these taxes. Beyond this there is considerable debate among tax policy experts over the relative efficiency and equity of different tax bases.

Advocates of a shift in the overall incidence of taxation from income to consumption argue that this would encourage saving and investment. However, any beneficial economic effect of such a shift is limited by existing tax concessions for important forms of saving and investment. Further, any economic benefits would be offset to a significant degree by the effect of higher taxes on labour income on work incentives. Higher taxes on labour income would be needed to collect the same overall revenues in the absence of taxes on saving.

The effect of such a shift in the tax mix on equity is also disputed. Advocates of this policy argue that there is no difference in the incidence of taxation over the life course between income and consumption taxes, provided inheritances are fully taxed. However, a shift towards consumption taxation would confer substantial tax deferral benefits for those taxpayers who have the greatest capacity to save for the long-term – that is, high income earners. The benefits of long-term tax deferral can be considerable. On the other hand, many low income earners have little choice but to draw down their savings to maintain consumption levels. At least in the short term, consumption taxes fall more heavily on these low income earners.

Advocates of lower corporate taxes argue that this would encourage investment and boost productivity levels and economic growth. Most of the difference between levels of reliance on corporate tax revenues between Australia and other OECD countries appears to be due to factors (identified above) other than statutory rates of tax or the tax base on which these are levied. Over the past few decades, Australia has followed an international trend to reduce corporate income taxes and recoup the revenue losses by broadening the business tax base. Setting aside the effects of economic downturns, corporate tax revenues were robust in most countries throughout this period. Australia's corporate tax rate is currently slightly higher than the OECD average, though company tax rates are declining across Europe. This could affect levels of foreign investment in Australian companies. On the other hand, if Australian corporate tax rates were to fall significantly below those in countries from which we attract investment, some of the benefits of lower tax rates for those investors may be clawed back by overseas revenue authorities through the operation of our tax treaties with those countries. The major problem with any reductions in the corporate tax rate is that this would reduce the very substantial public revenue gains from corporate income derived from mining exports. A further problem that would have to be addressed is the sheltering of personal income in private companies by high income earners, which is discussed further below.

The equity implications of higher or lower corporate tax rates depend on who ultimately pays this tax. Company income tax is likely to fall mainly on local and overseas shareholders (most shares are held by high income earners though many low income retirees also have small shareholdings), and to a lesser extent on employees and consumers (who are more likely to be low or middle income earners). If the system of dividend imputation remains in place, local investors would not generally benefit from a reduction in the corporate tax rate as they would lose imputation credits. Overseas investors would be the main direct beneficiaries.

Advocates of lower tax rates on capital incomes relative to labour incomes argue that this would be economically efficient because capital is more mobile than labour. They argue that a medium sized open economy such as Australia's would therefore benefit more from lower taxes on capital than from lower taxes on labour. An example of an income system along these lines is the 'dual income tax' system in place in a number of relatively high-taxing northern European countries such as Sweden. In these tax systems, capital incomes are taxed at a low flat rate while a progressive rate scale still applies to labour incomes. The primary motivation for introduction of dual income tax systems was to stem the leakage of tax revenue from investment income to lower taxing jurisdictions elsewhere in Europe, as barriers to investment flows between European countries fell away. One advantage of these systems from a revenue standpoint is that losses from investments can not be offset against individual earnings (since these two forms of income are taxed separately). Thus, negative gearing is prohibited. The main disadvantage from an equity perspective is that these systems shift the incidence of income tax onto labour incomes, and therefore at least nominally from high income earners towards low and middle income earners. A further weakness of dual income tax systems is the difficulty in drawing a clear boundary between capital and labour incomes. For example, self employed people may be able to shelter their earnings from the higher tax rates applying to labour incomes by using private companies and other structures.

In Australia, the benefits of a dual income tax system, or lower tax rates on capital income generally, are not clear cut. Since our overall tax and expenditure levels are low by OECD standards, there is greater scope to reform the Australian tax system by broadening tax bases and lowering rates generally. Further, many forms of investment income (for example superannuation) are already taxed below personal income tax levels. One of the biggest changes in the incidence of taxation arising from a dual income tax system is likely to be lower tax rates on interest in savings accounts. Since these accounts are generally used by taxpayers to hold savings for short periods rather than for long term saving purposes, the economic benefits of such a tax reduction are not clear. Although there has been some leakage of public revenue in recent years due to the failure of taxpayers to declare income in overseas savings accounts, a marginal reduction in tax rates on interest payments from local savings accounts may not have a big impact on this problem because many of these taxpayers aim to avoid tax altogether.

From the standpoint of economic efficiency, better targeting of existing tax concessions for long term saving, and the removal of distortions within the system of taxation of investment income (especially between investments yielding capital gains and other long term investments) may be more beneficial than a blanket reduction in capital income taxes. If capital income taxes were cut across the board, then the cost to revenue would be high and the benefits to investors would be spread thinly. This was the case with the former Government's savings rebate which reduced effective tax rates only slightly despite its high cost to revenue.

As discussed below, the consistency of the tax treatment of income or consumption *within* each of the above tax bases may be more important for economic efficiency and the integrity of the tax system than the balance of taxes *between* different tax bases.

3. Economic and revenue efficiency

The way in which taxes are raised affects Australia's economic development. By changing incentives to work, invest and save, the tax system can either contribute to future economic growth or detract from it. Another way of assessing the efficiency of the tax system is its capacity to raise revenue while minimising tax avoidance. Generally speaking, taxes with a broad base – that is, those that tax different activities in a consistent way - are more likely to be economically efficient as well as efficient in raising revenue. By broadening tax bases and lowering tax rates, efficiency and equity can be improved at the same time. Over time, reforms of this kind also strengthen public revenue by restoring the integrity of the system and stemming large-scale tax avoidance.

The present income tax system treats different forms of investment inconsistently, often without a clear policy basis. Capital gains are taxed at much lower rates than income from other investments such as long term savings accounts or profits from direct investment in a business enterprise. This is due to the deferral of tax on capital gains until assets are sold, together with the 50% discount of tax on capital gains received by individual tax payers, trusts and partnerships. This concessional tax treatment of capital gains has led to over-investment in some assets that appreciate in value. In Australia, it particularly encourages over-investment at the top end of the real estate market in economic booms. This has led to inflation in house prices, disadvantaging first home buyers. It also exaggerates the cycle of investment in rental property to the disadvantage of tenants, who have been severely affected by the sharp decline in rental vacancies in recent years. The broader economic effects of lower taxes on capital gains include diversion of investment from other activities that would contribute to Australia's long term economic development, and the fuelling of asset price booms. The recent boom in real estate prices in Australia and other wealthy countries was a key factor in the demise of the longest period of economic growth since the early 1970s. Inflation in these and other asset prices made it more difficult for the authorities to sustain the low levels of inflation that underpinned sustained economic growth.

The adverse economic effects of the special tax treatment of capital gains are compounded by the unlimited deductability of losses associated with investment in assets such as property and shares against other forms of income such as wages, or negative gearing. Rental property investment advisers recommend an investment strategy to their clients that is designed to sustain investment losses over the long term so that these can be deducted against their wages. For example, their clients are advised to borrow to invest in a succession of rental properties in order to keep interest expenses above rental income. The key to these strategies is to limit investment income to capital gains, which are not taxed until the properties are sold many years later and then at a lower rate. In this way, the tax system has contributed to the excessive accumulation of household debt over the past five years, which will become a drag on economic growth in future years.

Tax incentives for long term saving are largely restricted to saving for retirement through superannuation. This leaves a gap in taxation support for long term saving which is only partly filled by the new first home savings accounts, further adding to the tax bias in favour of housing investment. Another key weakness of the tax treatment of saving is that superannuation tax concessions are mainly targeted towards high income earners. The most important tax concession for superannuation is the flat 15% tax rate for employer contributions that applies to superannuation guarantee and salary sacrifice arrangements. Together with the similar flat tax rate on superannuation fund income, his represents over 90% of the total annual cost of superannuation tax concessions. The distributional effect of this tax concession is identical to replacing the progressive marginal tax rate scale with a flat tax rate of 15%, since employees would otherwise pay tax on these earnings at their marginal tax rate. As a result high income earners save more tax for every dollar transferred by employers into their superannuation accounts. Although the co-contribution for employee contributions is better targeted, it is a much smaller concession overall than the tax concession for employer contributions.

As a result superannuation tax concessions are much less effective than they could be in boosting overall saving levels, since high income earners are more likely to save in the absence of incentives than are low or middle income earners. Further, the targeting of tax concessions to high income earners means that the superannuation system is less effective than it would otherwise be in reducing reliance on the Age Pension and promoting equity in future retirement incomes.

The income tax system also treats income differently according to the holding structures used by different taxpayers, such as private companies and trusts. This opens up considerable opportunities for high income earners to avoid tax. The company income tax acts as a form of withholding tax to capture income that might otherwise evade taxation by the time it is transferred to shareholders. It is also a simpler way to tax corporate income than attributing income each year to every shareholder. However, the corporate tax rate is lower than the top marginal rate of personal income tax, providing opportunities for high income earners to defer tax by retaining income in a private company which they control. Given the downward pressure on company tax rates from international tax competition, this gap between corporate and personal tax rates is likely to remain.

Unlike companies, discretionary trusts allow their beneficiaries to take full advantage of any tax concessions (such as building depreciation allowances) to which the entity is entitled. Discretionary trusts are also well suited for tax avoidance purposes because the income of these trusts can be re-directed each year among its beneficiaries at the trustee’s discretion. For this reason, these trusts are often used to facilitate income splitting between family members. The most sophisticated avoidance strategies use multiple linked private trusts and companies. This makes it more difficult for the tax authorities to trace income and identify its ‘owners’, and easier for taxpayers to redirect income into those structures where the greatest advantage can be taken of tax concessions and loopholes in the system.

The tax system, combined with social security income tests, also affects incentives to work. Although discussion of this problem often focuses on the top marginal tax rate faced by high income earners, it is low and middle income families that face the highest effective tax rates, and mothers in low and middle income families who are most sensitive to these disincentives. High income earners are much less sensitive to the disincentive effects of marginal income tax rates despite their higher marginal tax rates. Since most mothers work part time their marginal tax rate is more likely to be 15% than 40 or 45%. A flatter tax scale may therefore be less rather than more efficient from the standpoint of promoting labour force participation.[4]

There are fewer opportunities for wage earners to avoid tax, compared with those available to investors. However, income tax on earnings can be avoided by taxpayers on the top marginal rates through salary packaging (especially by taking advantage of the concessional treatment of superannuation, company cars and share options and rights). Further, termination payments for purposes other than retirement are taxed at low flat rates, which disproportionately benefits high income earners.

A useful way to assess the effects of departures from a comprehensive tax base is to compare these tax concessions with direct government expenditures, as the Treasury does in its annual Tax Expenditures Statement. In many cases, the distinction between tax and direct expenditures is an arbitrary one. For example, assistance with the costs of dependent children is mainly paid as a direct expense through Family Tax Benefits, while assistance for a dependent spouse is paid through the tax system.

Once tax expenditures are itemised and costed, it is useful to ask whether they would survive the rigorous policy review process that applies to direct expenditures, and whether they are compatible with direct expenditures that serve similar public policy objectives. Tax expenditures are not subjected to the same expenditure review process as direct expenditures. As a result they often lack policy logic. Many have been expanded well beyond their original purposes through judicial interpretation of tax law. One example of a tax concession that lacks logic from a public policy standpoint is the deduction for educational expenses, which is restricted to employees participating in courses that are likely to improve their incomes in their current job. This tax concession is therefore biased towards skilled employees. For example, a teacher or solicitor undertaking mid career training would qualify but a cleaner studying for a career in child care would not. This tax concession has evolved from judicial interpretation of tax law rather than a education or human capital development policy objectives. If this tax concession was reviewed regularly along with other education expenditures, it is likely that the tax law would be changed or it would be converted into a more broadly accessible direct expenditure program that is more consistent with education policy objectives.

The number and cost of tax concessions has risen substantially in the last 10 years, with 100 new expenditures added and only 30 removed. This reflects the lack of regular review and the technical and other difficulties in removing a tax concession once it is in place. The estimated annual cost of tax concessions doubled from $24 billion to $50 billion over the decade from 1996 to 2006. The most expensive tax concessions are those for superannuation, which were estimated to cost $25 billion in 2006, more than the Age Pension.

[4] Dandie & Mercante 2007, *Australian labour supply elasticities*, Treasury Working paper 2007-04.

Directions for reform

4. To improve the efficiency of investment and allocation of resources across the economy, the income tax base should be broadened by taxing income from different sources more consistently. Departures from this principle should be based on clear public policy objectives (such as raising household saving levels) or practical considerations (such as the difficulty in taxing capital gains as they accrue).

    - Options for reform of capital income taxes to improve economic efficiency include reducing the concessionality of the tax treatment of capital gains, restricting negative gearing, and improving the scope and targeting of tax concessions for long term saving.

5. Tax reforms to improve work incentives should give priority to the effective tax rates facing low and middle income earners, especially mothers. In many cases this will require adjustments to social security income tests rather than tax rates.

6. Other reforms that should be considered to improve the efficiency and integrity of the income tax system include more consistent tax treatment of income in different holding structures (such as private trusts and companies) the removal of Fringe Benefits Tax concessions for employer-provided cars and reform of the taxation of termination payments.

7. A major review should be conducted of tax expenditures by Treasury and Finance in cooperation with relevant portfolio Departments. This should include a comparison of their cost with those of relevant direct expenditures, identification of their policy objectives and whether these are being met, and their impact on the equity, efficiency and the integrity of the tax system. Portfolio Departments should subsequently be asked to incorporate a review of relevant tax expenditures into their regular policy review processes, including the annual expenditure review process.

4. Equity

Income and wealth are distributed unequally in Australia. In 2006, the top 20% of households received 39% of all household income, while low income earners received 11% and the middle 20% received 18% of all income. Since 1994, household income inequality has increased. The real disposable incomes of low income households rose by 31%, those of middle income earners rose by 32% and those of the top 20% of income earners rose by 36%.

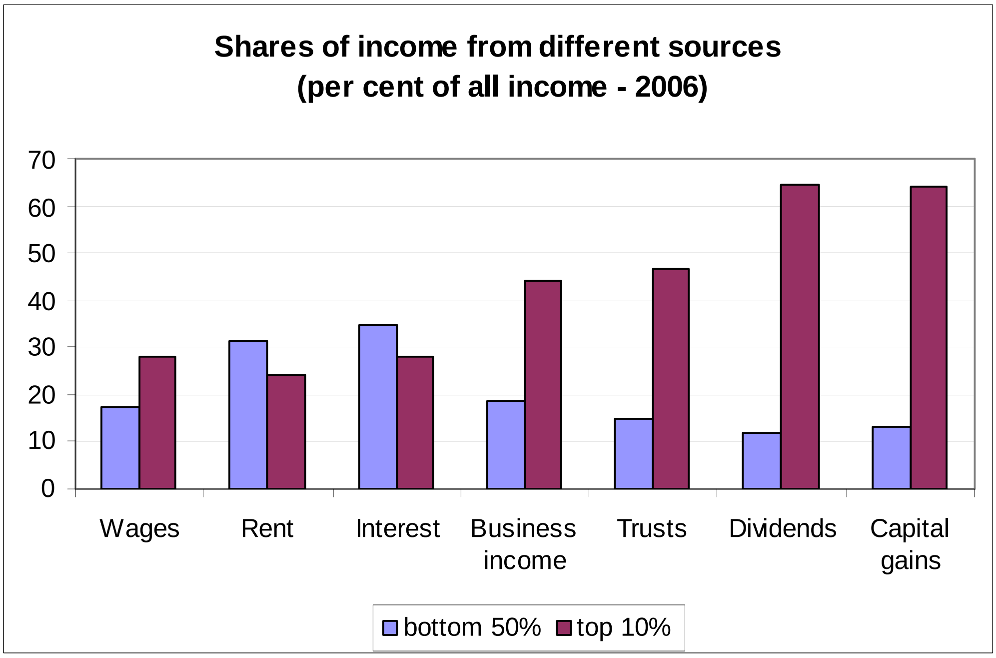
The distribution of wealth is more concentrated, with over 60% being held by the top 20% of households and just 1% held by the bottom 20%. To a large extent, these inequalities arise from unequal opportunities or inheritances rather than differences in individual talents or effort, indicating a case for Government action to reduce them.[5]

The pattern of distribution of income varies considerably among different forms of income.

[5] ABS 2006, *Household income and income distribution*.

This has important implications for any assessment of the effects of tax reform proposals on equity. As the graph below illustrates, capital incomes, especially from investment in shares, are very strongly concentrated among high income earners despite widespread share ownership. Income from trusts and partnerships is also relatively concentrated among high income earners. Among individual tax payers, the top 10% receive 28% of all wages, 47% of all partnership and trust income, and 64% of all capital gains. In contrast the bottom 50% receives just 18% of all wages, 15% of partnership and trust income, and 13% of capital gains. [6]

Graph 1



Source: Treasury 2008, *Architecture of the Australian tax transfer system*. Note that 'trusts' includes partnerships.

The tax system along with the social security system plays a key role in improving 'vertical equity', by redistributing income from high to low income earners. Its effectiveness in this regard depends on:

- The mix of taxes – about 64% of tax revenue is collected from taxes on income while 36% is collected from indirect taxes that mainly fall on consumption.

- The income tax rate structure – this is progressive due to the tax free threshold, the Low Income Tax Offset, and higher tax rates for those on higher incomes.

- The income tax base – especially the extent to which high income earners can avoid paying tax at their marginal tax rate.

- The other tax bases – for example whether the Goods and Services Tax includes items such as food and whether Land Tax includes owner occupied properties.

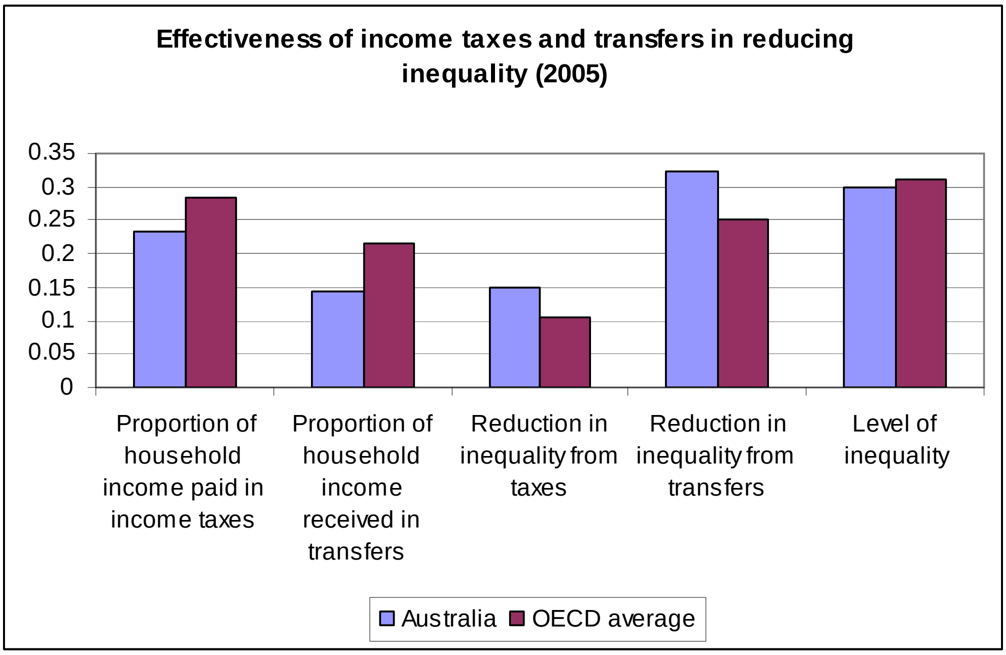
[6] Treasury 2008, *Architecture of Australia's tax and transfer system*.

Taking account of the mix of taxes between broadly progressive taxes on income and broadly regressive taxes on consumption, and the opportunities for high income earners to reduce their effective tax rates through tax shelters, it is possible that the overall tax system is roughly proportional – that is, tax-payers on different incomes pay roughly the same average rate of tax. On the other hand the social security system is strongly progressive because it is targeted towards low income households and payments are made at flat rates.

Setting aside the effects of other taxes, the income tax and social security systems alone are relatively progressive in Australia compared with other OECD countries. This is mainly due to our higher tax free thresholds for low income earners and the targeting of social security payments towards low income earners. However, although the income tax and transfer systems are relatively well *targeted* for redistribution, they are *smaller in size* than in most OECD countries – a lower overall proportion of Gross Domestic Product is collected in taxation and expended on social security payments in Australia - due to the lack of a social insurance system. This is illustrated by the graph below. Note that this does not take into account the broadly regressive effects of indirect taxes such as taxes on consumption.

Because our income tax and social security systems are 'small' by OECD standards they have to work harder to achieve the same distributional outcomes. In OECD countries with much less progressive tax systems (for example the Scandinavian countries that rely more heavily on consumption taxes) the adverse effect of this on income distribution is usually offset by generous social insurance payments.

Graph 2



Source: OECD 2008, *Growing unequal*? 'Level of inequality' is measured using the Gini Coefficient. 'Reduction in inequality' from taxes and transfers is the percentage reduction in the Gini Coefficient.

Another important equity principle is 'horizontal equity' - that people in similar circumstances should be taxed in a consistent way. As detailed above, the personal income tax system departs from this principle by taxing different forms of income at different effective rates. For example, although wage earners usually pay tax at the appropriate marginal rate of tax, there are many more opportunities for investors to reduce their effective tax rates well below their marginal rate. Where they occur, these departures from horizontal equity should be clearly justified on economic efficiency or social policy grounds. As identified above, some major tax shelters are economically inefficient as well as unfair.

Directions for reform

8. The overall effect of any package of major reforms to the tax system should be to increase its progressivity, by shifting the incidence of tax from low and middle to high income earners.

   - One way to achieve this while meeting economic efficiency goals at the same time is to broaden the personal income tax base by removing economically inefficient tax shelters used by high income earners, as proposed above.

9. Any significant flattening of personal income tax structure should be accompanied by base broadening measures to offset its distributional impact.

10. Any major shift in the overall incidence of taxation from income towards consumption should be avoided on equity grounds.

5. Simplicity and public acceptance

The Australian tax system is very complex. A major reason for this is the different treatment of different forms of income, assets and consumption, and the various exemptions and special concessions that have accumulated over the years in response to political lobbying. This problem is exacerbated by the way in which tax payers take advantage of these inconsistencies and concessions – often well beyond their original policy objectives - to avoid paying tax. Further legislation is then passed to close off these loopholes, creating a spiral of complexity.

A complex tax system is difficult to comply with, and requires the majority of people to use tax agents. Since it is widely known that tax is often avoided, public support for the tax system is also undermined. This problem is exacerbated by a lack of knowledge about how Governments spend their revenue.

Directions for reform

11. To simplify the tax system and build public support for the system, tax shelters and expenditures that lack strong public policy justification should be closed and tax legislation should be based as far as possible on principles and economic substance rather than 'black letter law'.

12. Steps should be taken to better inform the community about how Governments spend public revenue. One option is to provide a general break-down of

Government expenditure with tax returns.

13. There is also scope to simplify the system by improving the integration between the tax and social security systems, especially for mature age people.

6. Federal-State financial relationships

The Commonwealth Government collects most of Australia's tax revenue and controls the most important tax bases including personal and company income tax and the Goods and Services Tax (GST). It distributes a portion of the revenue collected (including all of the GST revenues) to the States and Territories to assist them to provide economic and social infrastructure to the community. The States also levy their own taxes but these are usually narrowly based (for example taxes on insurance) or unstable (for example Stamp Duty on home purchases).

A strong Commonwealth role in tax collection has important public policy benefits including a robust income tax system with consistent tax rates applying across the country, improved capacity for the Commonwealth Government to manage the economy, a stable revenue base to finance the social security system, and the leverage it gives the Commonwealth Government to ensure that services funded by the States are provided on an equitable basis across the country.

Problems with the present system of Federal-State financial relations include the adverse economic effects of narrowly-based State taxes, and a lack of a clear division of responsibilities between the different levels of Government. It is generally acknowledged among tax policy experts that land taxes and payroll taxes are among the least distortionary States taxes (although exemptions reduce their efficiency) and that stamp duties are among the least stable and most distortionary taxes.

The States and Territories lack robust tax bases of their own to finance all of their services and must rely heavily on Commonwealth taxes, especially the Goods and Services Tax (GST). One advantage of the GST arrangements is that the States have greater revenue certainty than was the case when Commonwealth Financial Assistance Grants were allocated annually at the discretion of the Federal Government. However, the potential for these arrangements to boost effective long term investment in health, community and other services has not yet been realised. This is partly due to the complex and confused system of overlapping responsibilities for these services and their financing – from Specific Purpose Payments that are tied to the provision of very specific service inputs to the open ended distributions from GST revenues.

Directions for reform

14. To improve the efficiency of State tax systems, States and Territories should be encouraged to shift their revenue sources from narrowly based unstable taxes towards less distortionary tax bases; for example from Stamp Duties for property purchases towards more broadly based Land Taxes.

15. The COAG Reform Agenda should incorporate changes to the system of Commonwealth financial support for State and Territory Governments. Generally speaking, federal funding should be linked to broad outcomes rather than being completely open-ended or tied to detailed inputs.

7. Charitable organisations

An aspect of the tax system that is of particular concern to the community sector is the tax treatment of charitable institutions and gift deductible recipients. These organisations have a special tax status that is designed to encourage charitable donations and strengthen the capacity of non government community services to meet social needs.

The present system is inefficient and inequitable, due mainly to the outdated definitions used to determine which organisations qualify for charitable and Public Benevolent Institution status. For example, there is an overemphasis on the provision of direct services to individuals and public advocacy activities may disqualify organisations from charitable status. This reflects a lack of development of the common law definition of charity through the courts over the past 30 years. To address a similar problem in the United Kingdom, a Charities Commission was established to both regulate charities and to modernise the definition of charitable purposes. In Australia in 1999 a Charity Definitions Inquiry was established for the latter purpose. It consulted widely with the community sector and advanced recommendations for modern statutory definitions of charitable purposes and benevolent charities. However, these recommendations have not been implemented.[7]

Directions for reform

16. Modern statutory definitions of charitable purposes and benevolent charities should be introduced along the lines recommended by the Charity Definitions Inquiry.

[7] Treasury 1999, *Report of the Charity Definitions Inquiry*.

C. Reform of the social security system

We focus here on the adequacy of social security payments generally, on safety net payments for low income people, and on redistribution across three stages of the life course - children, people of working age and mature age people. The discussion of social security payments for mature age people includes taxation concessions and the superannuation system, as there is a case for better integration of these three systems of support for mature age people.

Further discussion of these issues can be found in our submission to the Pension Review.

1. An Australian minimum standard of living

The main purpose of social security payments in Australia is to prevent poverty. Poverty can be broadly defined in two ways: as an inability to secure socially-defined necessities, or as an inability, due to limited economic means, to participate effectively in society. The former definition is closer to traditional conceptions of poverty, while the latter is closer to the concepts of capability deprivation and social exclusion. In a market economy, families with very limited economic resources (particularly income and housing and financial assets) are likely to face a much higher risk of poverty, however defined. Both of these poverty concepts are ‘relative’ in the sense that the living standard or level of functioning required to avoid poverty differs between different societies and at different points of time. For example, the economist Adam Smith argued that people needed decent clothing to avoid poverty, not simply to protect them from the elements but in order to ‘avoid shame’.

To effectively and equitably discharge its poverty-reducing function, the social security system should be benchmarked to an Australian minimum standard of living that is grounded in these understandings of poverty and community expectations.

Unlike many OECD countries, Australia lacks a national social insurance scheme funded jointly by employers, employees and Government which pays pensions and unemployment benefits to replace lost earnings on retirement or unemployment. Our closest equivalent to these payments is compulsory superannuation, which does not guarantee a minimum level of retirement income. As a result, Australian social security payments are generally lower than those in most OECD countries, at least compared with social insurance entitlements.
Social security payments are set at low levels relative to community incomes, especially for single people without children (see table below).

Table 1: Base rates of social security payments (September 2008)

Payments	Eligible groups	Base rates excluding supplements (single) ($pw)	Base rates excluding supplements (couple) ($pw)	Ratio of single: couple base rates (%)
Pensions	Retirees, people with disabilities, carers, sole parents	$274	$457	60%
Newstart Allowance	Unemployed people, including many people with disabilities, carers and sole parents	$219	$394	56%
Austudy Payment/ Youth Allowance	Students 18-65 yrs, living independently, unemployed young people	$178	$355	50%

These payments are all below, or close to, poverty lines commonly used in international poverty research. For example, recent research commissioned by ACOSS found that 41% of people who mainly rely on social security for their income lived below a standard poverty line set at half median family income.[8]

A further problem with levels of social security payments is that they are not benchmarked in any consistent way to basic living costs or to other community income levels. The maximum single rate of pension is pegged to 25% of Male Total Average Weekly Earnings and the single rate is equal to 60% of the partnered rate. These are arbitrary benchmarks. For example, there is evidence to suggest that minimum living costs are higher for singles relative to couples than these benchmarks allow (see Table 2).

There is no adequacy benchmark for Allowances such as Newstart Allowance. Allowance rates were equal to pension levels in the 1970s, were subsequently eroded by lack of indexation, and then increased in the early 1980s in an attempt to close the gap. The gap between pensions and allowances is growing each year since Allowances are only indexed to the CPI. The Pension Review estimates that by 2038 the Newstart Allowance will be paid at just half the adult pension rate. Young people over 18 years living independently of their parents receive $41 per week less than an adult on Newstart Allowance, yet there is no evidence to suggest that their average living costs are lower. Adult students on Austudy Payment also receive this lower amount.

Family Tax Benefit Part A was originally benchmarked to a proportion of the married pension rate (16% for children under 13 and 22% for those aged 13 to 15 years), but levels of payment have subsequently been raised above those levels, suggesting that the original benchmarks may have been inadequate. On the other hand, the maximum rates of Youth Allowance for dependent young people aged 16 to 17 years living at home have only been increased in line with the CPI. As a result, the level of family assistance available for a

[8] Social Policy Research Centre 2007, *Poverty in Australia*.

dependent child in a low income family now falls following the child's 16th birthday. This is despite expert evidence from the Parkinson Review of the child support system that the direct costs of children rise substantially as they grow older.[9]

The present social security rate structure emerged by historical accident as much as conscious planning. Payments are set at very low levels compared with general community incomes, and there are major inconsistencies and anomalies between levels of payment for different payment categories and family types. The table below illustrates this by comparing maximum rates of key payments with the Low Cost Budget Standards developed by the Social Policy Research Centre at the University of New South Wales. These Budget Standards are essentially minimum household budgets for people living on a low income. At the least, these comparisons suggest that the present relativities between social security payments are inappropriate.

Table 2: Income support payments and Low Cost Budget Standards (December 2007, $pw)

	Budget Standards	Income support (base rates)	Gap
Single, mature age home owner (Age pension)	$285	$269	$16
Couple, mature age home owner (Age Pension)	$390	$449	-$59*
Single, mature age as a % of couple	73%	60%	
Single, working age renter (Newstart Allowance)	$399	$215	$184
Couple, working age renter (Newstart Allowance)	$523	$388	$135
Single, working age as a % of couple	76%	55%	

Sources: Saunders 2004, *Updating and extending indicative budget standards for older Australians*, SPRC; Saunders 2004, *Updating budget standards for Australia*; Note: Budget Standards indexed to Dec 2007 using CPI, 'Income support' is base rate of Age Pension and Newstart Allowance respectively and does not include Supplements (such as Rent Assistance of up to $53pw that is paid to a significant minority of recipients). *In this case, income support is higher than the Budget Standard.

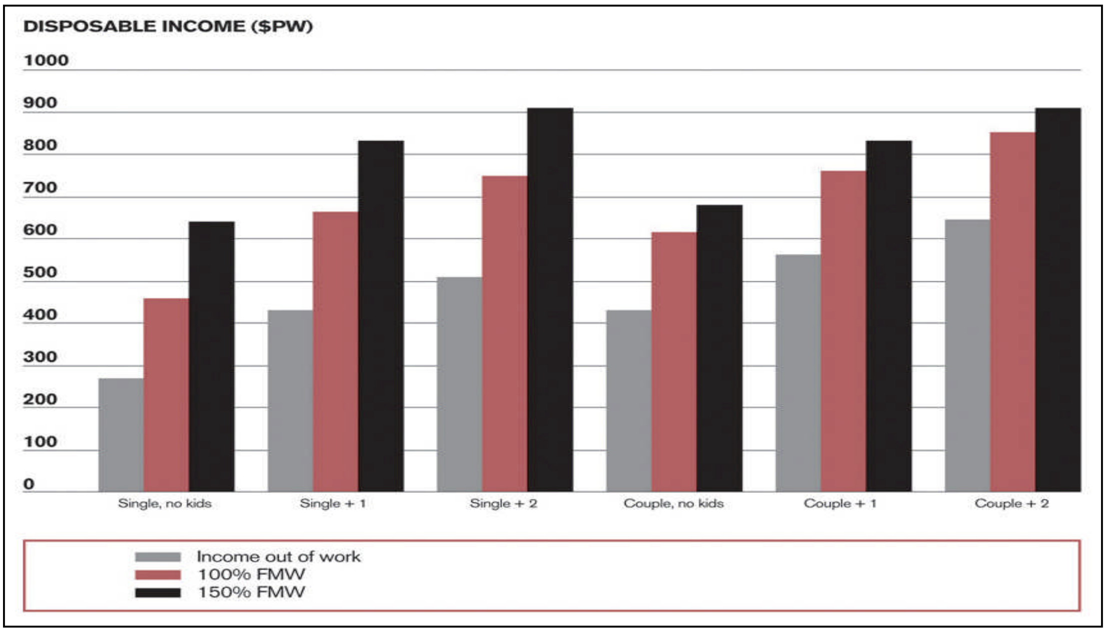
[9] FaCSIA 2007, *Costs of children*: research commissioned by the Ministerial Taskforce on Child Support

ACOSS' Pension Review submission includes more detailed analysis of the adequacy of payments for different groups. ACOSS is also preparing a separate research report on hardship among social security recipients that will examine aspects of their actual living standards.

One concern that is raised about substantial increases in social security payments for unemployed people is the risk that social security income would become a substitute for wages. This risk should not be overstated. Jobless people on social security are likely to value 'free time' less than those with jobs and are well aware of the wider social benefits of employment.

In Australia, the risk that recipients will choose to rely on social security instead of wages is relatively low due to the low level of social security payments (especially for single people who double their disposable income if they work fulltime on the minimum wage), in-work payments for low paid working families (Family Tax Benefits), and the activity requirements and employment programs linked to receipt of unemployment payments. The graph below compares maximum levels of income support with minimum wages across different family types. In all cases modelled jobless people on income support significantly increase their disposable income by moving to a full time job at minimum wages – though as we argue below, this does not always apply to transitions from joblessness to part time employment.

Graph 3: Disposable incomes out of work and on the federal minimum wages, July 2007



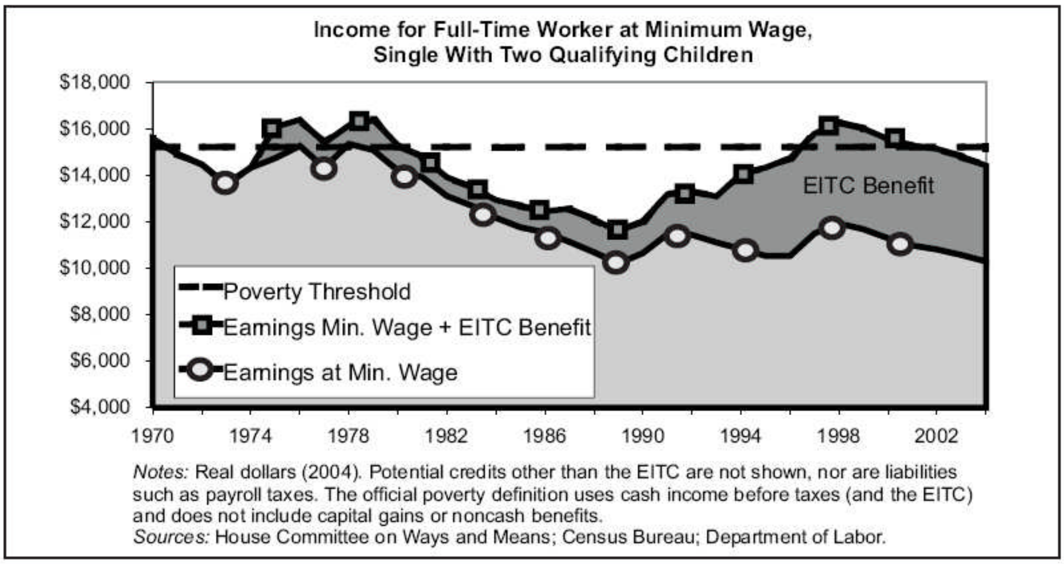
Source: Australian Fair Pay Commission 2007, *Wage setting decisions.*

Research evidence suggests that benefit replacement rates (the ratio of incomes on Newstart Allowance compared with wages) have had a minimal impact on the level of structural employment in Australia over the past three decades, much less than the effect of changes in the level of long term unemployment over that period. This suggests that a lack of capability (for example, skills and recent work experience) was a more important contributor to structural unemployment over this period than a lack of incentive.[10]

An adequate level of minimum wages is needed to 'make room' for social security payments that are high enough to prevent poverty, while preserving work incentives. ACOSS has argued that minimum wages should be benchmarked to a 'decent' adequate living standard, well above poverty levels, that allows a single adult to live in modest comfort. An example of such as benchmark is the 'Modest But Adequate' Budget Standard developed by the SPRC, which is significantly higher than the Low Cost Standard referred to above. When indexed to December 2006 using the CPI, the 'Modest but Adequate' Budget Standard for a single adult was $512 per week, after tax. This is consistent with the Australian tradition of setting minimum wages well above subsistence levels, and it allows for social security payments to be set above poverty levels. Benchmarking minimum wages to the needs of a single adult is appropriate because wages cannot effectively take account the cost of dependents. [11]

In the absence of a significant gap between safety net payments and minimum full time wages, work incentives would be weakened. One way to address this problem is to extend 'in-work payments' through the tax or social security systems to low paid workers. Australian Governments do so for low paid working families though Family Tax Benefit Part A. However, if in-work payments extended to minimum wage earners generally (not only to families), there is a greater risk that costs would be shifted from employers to Governments because any across the board reduction in minimum wages would be offset by the in-work payments. The costs to Government can be substantial. For example, in the United States, where hourly minimum wages are much lower and these are subsidised by an Earned Income Tax Credit, the cost of the tax credit exceeds expenditure on social security payments for jobless families. Despite this, typical incomes for families on the minimum wage in the US are below poverty levels, as shown in the graph below. The main reason for this is that the minimum wage is only around three fifths of that paid in Australia.[12]

Graph 4



Source: Kravitz T 2005, *Minimum wage, earned income tax credit, and inflation,* Urban Institute Brookings Institution Tax Policy Centre.

[10] Kennedy et al 2008, *Inflation and full employment*, Australian Economic Review V41 No 3.
[11] ACOSS 2008, *Submission to Fair Pay Commission on minimum wages*.
[12] ACOSS 2008, ibid. Note that the poverty measure used in the US is lower than poverty lines typically used in Australia.

International evidence suggests that activity requirements and employment assistance programs for unemployed people can offset the work disincentive effects of social security payments for unemployed people, even where payments are significantly higher than in Australia. For example, although Dutch social security payments are typically about 50% higher than ours and their benefit replacement rates are also much higher, their level of structural unemployment is well below the OECD average and probably lower than Australia's. OECD research suggests that the disincentive effects of Dutch unemployment benefits are almost completely offset by activity requirements and investment in employment assistance programs.[13] Activity requirements for unemployed people in Australia are among the most stringent in the OECD, including a default requirement to apply for 10 jobs a fortnight at all skill levels, and to fully participate in employment and training programs.

Directions for reform

17. Social security payments should be benchmarked to an Australian Minimum Standard of Living, that is, the minimum income typically needed for households comprising a single adult, a couple, a sole parent, and children of different ages respectively to avoid poverty and live decently in accord with general community standards. This would ultimately replace the separate pension and allowance levels of payment.

18. The Australian Minimum Standard of Living should be based on the best available research on the living costs and financial circumstances of low income Australians, including:

    - Budgets developed by experts to reflect the minimum expenditures required to achieve a decent standard of living (Budget Standards)
    - Research on the actual living standards of recipients of the different payments, including access to socially defined 'essentials of life' and financial stress indicators
    - Poverty lines.

2. Support for families with children

Family Tax Benefit performs a dual function. It is designed to both reduce child poverty and to compensate the majority of tax-payers who are parents for the direct costs of raising children. In this way, it doubles as a social security payment and a child tax allowance. Although this dual function was only formalised in 2000 when parents were given the option of payment through Centrelink or the Australian Taxation Office, it is a long standing feature of the Australian system of family payments. The original system of Child Endowment introduced in New South Wales in the 1920s was designed both to ease child poverty and to assist mothers generally with the extra costs of raising a family. Another key long-

[13] ACOSS 2008, *Employment participation policies, an international snapshot,* ACOSS Paper 155; OECD 2006, *Employment Outlook*.

standing role of the Australian system of family payments is to supplement minimum wages.

Family Tax Benefit Part A is well structured to perform these roles:

- It is benchmarked to a proportion of the married couple rate of pension, based on an assessment of relative costs of children and adults in low income households (though the original benchmarks were inadequate and have since been surpassed).
- There is an additional allowance for sole parent families to acknowledge the extra costs of raising a child alone (this is incorporated into the 'Part B' payment).
- The maximum rate is targeted towards low income families, who are most at risk of poverty. This means that increases in the maximum rate to alleviate child poverty are more affordable than they would have been if the payment were universal.
- The maximum rate extends to families on a modest full time wage (up to approximately $40,000), easing any disincentive for jobless families to move from income support to at least one fulltime job.
- A lower 'minimum rate' extends to middle income families, enabling the payment to function as a defacto tax allowance for families with children generally, without unnecessarily supporting high income families.
- It is paid at the same rates and by the same mechanism regardless of the recipient's workforce status, thereby simplifying the system for parents who move in and out of unstable jobs.[14]
- It is paid fortnightly to the primary carer of the child (usually the mother), which provides timely help with the costs of children. This is the preference of the vast majority of parents.
- It is widely supported, especially by mothers, and does not attract the stigma of a 'welfare' payment. This is especially important for jobless families.

Some countries, including the United States, divide their income support for children in low income families into two parts: a social security payment for those in jobless families and a tax credit for those whose parents are employed. The main justification for separate tax credits for low income families in employment is to encourage transitions from income support to paid employment.

Australia's Family Tax Benefit Part A provides the same level of support to both jobless and low paid working families. As such it offers a higher average level of income support to families in low paid employment than most, if not all, OECD countries including the United States. Although incentives to move from joblessness to low paid employment are generally stronger in the United States, the reason for this is the very low level of income support for jobless families rather than higher levels of support for parents in low paid jobs. For example, in purchasing parity terms, a typical income support payment in the US for a sole parent family of three is less than Australia's Newstart Allowance for a single adult without children. As a result, the stronger work incentives in the United States come at the expense

[14] The need to transition from a social security payment to a tax allowance when a parent's labour force status changes is a major problem with the British system of family assistance. Once the parent works for 16 hours a week or more (regardless of wage levels) their child tax credit is paid through the tax system rather than the social security system.

of high child poverty levels among jobless families.[15]

Notwithstanding the strengths of the Family Tax Benefit system noted above, there are two major problems with the present system of family payments.

First, as noted above social security payments for low income families do not increase sufficiently as a child grows older to take account of the higher direct costs involved. Once a child in a low income family reaches the age of 16 years, the level of family payments falls as they transfer to the lower Youth Allowance. This is due to a failure of Governments over the long term to improve support for families with teenage dependent children, at the same time when payments for younger children have increased significantly.

Second, the income tests for both Part A and Part B of the Family Tax Benefit discourage employment, especially part time employment, among second income-earners in low and middle income families. Although the income test for Part A facilitates movements from joblessness to employment on a single low full-time wage, it discourages second earners in low and middle income families where the primary income earner is employed full time on a modest wage. Due to easing of the taper rate for this income test from 30 cents in the dollar to 20 cents, the effective marginal tax rates facing second earners in families affected by this income test are now lower, but more families are affected by this income test. A family with two children can now earn up to around $70,000 and still be affected by this income test. Thus the effect of this easing of income tests was to displace effective marginal tax rates further up the family income scale. The income test for Family Tax Benefit Part A particularly affects the part time earnings of parents on modest hourly wages whose partners are paid around $40,000 per year.[16]

The effect of the FTB Part A income test alone on work incentives is likely to be modest (because it is only withdrawn at the rate of 20 cents in the dollar). However, this is compounded by the impact of other income tests that may apply to the same family, including the income tests for FTB Part B, Child Care Benefit, and Youth Allowance. In many cases, the ‘stacking’ of these income tests results in effective marginal tax rates that exceed 50%.

The income test for second earners in the Part B payment claws back an extra 20 cents in the dollar from part time earnings over a wide range of earnings. This is a deliberate design feature of this payment. The original justification for this feature of the Part B payments was to target parents caring for a young child at home. This confuses the purpose of Family Tax Benefits, whose main function is to help with direct costs of children (for example, food) rather than the indirect costs (for example, support for the living costs of the principal carer while they are absent from the paid workforce). The latter role is already performed by Parenting Payment. In any event, Part B extends to children aged up to 18 years, at which stage the case for at-home care is weak. By contrast, Parenting Payment is now limited to the principal carers of children up to 8 years old.

Directions for reform

19. Family Tax Benefit Part A should be maintained as a fully integrated social security and tax allowance for children paid through the social security system, along with the supplement for sole parents in Family Tax Benefit Part B.

[15] Whiteford 2008, *Child poverty*, presentation to Brotherhood of St Laurence seminar. ACOSS 2008, op cit.
[16] Payne et al 2007, *Another day another dollar*, NATSEM.

20. Options should be explored to redesign the family income test for Family Tax Benefit Part A to shift its incidence from secondary to primary earners, and to reduce the effects of income test 'stacking' where this income test overlaps with those for other payments including the Part B payment, Youth Allowance and Child Care Benefit

21. Options should be explored to improve the targeting and efficiency of the Part B payment in respect of couples, including targeting this support towards families caring for younger children and integrating it with the Part A payment.

3. Support for people of working age

The present income support system for people of working age is based on an historical distinction between one group of payments (pensions) for people who are deemed unable to work and another (allowances) for people who are considered work ready. As discussed above, the different levels of payment reflect this distinction.

The system is inequitable because levels of payment are based on historical views about which groups are more or less deserving of support rather than on people's actual living costs. For example, a person with a disability on Newstart Allowance who faces high medical costs due to their disability receives less than a Disability Support Pensioner (DSP) who does not face such costs. Unemployed people required to search for a job receive less than pensioners without such requirements, despite the extra costs of seeking work.

The present payment structure also fails to take into account the extra costs faced by many people with disabilities. Apart from Mobility Allowance, there is no supplementary payment that recognises these costs. Research commissioned by the Department of Family and Community Services in 1998 found that 91% of DSP recipients faced additional costs due to their disability. These included travel costs, prescriptions, consumables (e.g. ointments and pads), medical and related treatments, housing modifications, furniture, assistance with home tasks, aids and appliances, and care costs. The costs faced by individuals with different impairments and circumstances are diverse.[17] Nevertheless other countries including the UK and New Zealand have comprehensive payments to assist with the costs of disability.

One justification used in the past for separate rates of payment for pensions and allowances was that people on Allowances typically only needed short term income support, but as the profile of Allowance recipients has become more disadvantaged, that assumption no longer holds. As overall unemployment levels have fallen those still out of work are drawn from severely disadvantaged groups in the community. For example over 60% of Newstart Allowance recipients have lacked substantial employment for over a year and over 60% of this group have a Year 10 education or less.

Further, the boundaries between pension and allowance payments are not clear cut. Many social security recipients move between the two systems. For example, a sole parent leaves the pension system if they re-partners even though they may still be the main carer of their

[17] FACS 1999, *Cost of disability survey*. See also Tibble 2005, *Review of existing research on the extra costs of disability*. UK Department for Work and Pensions.

children. It is estimated that half of new Age Pension recipients were previously on another social security payment (including Newstart Allowance) at the time of their pension claim. Similarly, one third of new Disability Support Pensioners were on Newstart Allowance when they claimed the pension.[18] Separate levels of payment for pensions and allowances make these transitions between payments more difficult for people.

As a result of the Welfare to Work policy changes introduced in 2006, many sole parents and people with disabilities now receive Newstart Allowance rather than a pension. Although one of the policy objectives of Welfare to Work was to improve employment outcomes by engaging more people with employment assistance services, the outcome for many was simply a lower level of payment. In the new social security system for parents, an unemployed sole parent whose youngest child is over 8 years old receives at least $37 per week less (on Newstart Allowance) than a sole parent in the same circumstances whose youngest child is 7 years of age (and receives Parenting Payment). Similarly, a jobless single adult with a disability who is able to work part time and applied for social security before July 2006 is likely to receive at least $55 per week less (on Newstart Allowance) than a person in the same circumstances who applied two years previously (and receives Disability Support Pension).

The effect of these changes on work incentives is ambiguous. Although each year around 10,000 people with disabilities who claim social security now receive Newstart Allowance instead of a pension and are required to seek part time work, many of the 700,000 existing disability pensioners are more reluctant to voluntarily seek employment for fear that they too will end up on Newstart Allowance. Parents on income support must now generally seek part time work once their youngest child reaches 6 years of age, but this activity requirement could have been applied (and is applied to ‘grandfathered’ Parenting Payment recipients) without re-directing new applicants for social security onto the lower Newstart Allowance.

This two tier system of income support – pensions and allowances - blocks transitions to employment for many people with disabilities and sole parents. This occurs because those who test the labour market face the risk of transfer to a lower payment. It is likely that this feature of the social security system has a greater impact on work incentives than the high effective tax rates arising from income tests that have attracted more policy attention. The reason for this is that pensioners put their income security at risk if they seek employment, as well as losing some of their income support. Pensions are widely regarded as more secure payments than allowances. This is a key reason that Australia has one of the lowest employment rates among disability pensioners in the OECD - only 12% of the 700,000 DSP recipients have a job.

The social security system also discourages participation by jobless people in further education and training. Since Austudy Payment for full time adult students is substantially less than Newstart Allowance, and there is no supplement (like the Pensioner Education Supplement) to assist with the costs of books and fees, unemployed people who enrol in educational courses to improve their future job prospects are financially disadvantaged. This is contrary to the spirit of the Government’s initiatives to lift skill levels and productivity.

[18] FaHCSIA 2008, op cit; FaCSIA 2004, *Characteristics of DSP customers*.

To complicate matters further, a range of conditions of payment including residency requirements and assets tests are different for working-age pensioners and those on allowance payments. There is no logical basis for these distinctions. They make the system harder for recipients to understand and sharply increase the costs of administration. They also increase the difficulty of transitions between the pension and allowance systems, for example when a sole parent's youngest child reaches the age of 8 years.

It makes more sense for activity requirements to vary between different categories of payment. People with disabilities and caring responsibilities are more constrained in their ability to participate in the labour market, and activity requirements should reflect this. This gives the recipients a degree of certainty about the range of requirements that will (or will not) apply to them. It also brings an element of equity into the system by ensuring that people in similar circumstances in different parts of the country face similar requirements.

However, the present system of activity requirements is too inflexible. People on pension payments generally have no requirements at all whereas many people with barriers to work on the Newstart Allowance (for example a mental health problem) often face the same requirements as those with none. A more graduated system of activity requirements that takes account of individual circumstances is needed. For example, the system should take into account the circumstances of people who have a disability in addition to caring responsibilities. There is also a case for broad-banding activity requirements to enhance flexibility. For example, it would be easier for income support recipients to combine job search with education and training if Newstart Allowance and Austudy Payment were merged, rather than being administered as two separate payments.

The social security system also has two different sets of income tests for pensioners and those on allowance payments. The pension income test is less stringent, with a higher free area that takes account of the number of dependents in a family, and a lower taper rate (40%). This is designed to encourage part time work. The Allowance income test has a much lower free area that takes no account of the number of dependents and higher taper rates of 50% and 60%. The effect of this income test is to discourage part time work and instead encourage recipients to seek a full time job. Effective marginal tax rates for Newstart recipients exceed 70% across a wide range of part time earnings. It is counterproductive to discourage part time employment since most of the growth in low skilled jobs in the last two decades has been in part time jobs. Over half of all low skilled jobs in Australia are now part time.[19] The Allowance income test is particularly inappropriate for those sole parents and people with disabilities affected by the Welfare to Work policy, who are required to seek part time rather than full time jobs.

The benefits of easing social security income tests are not clear cut. Any changes to income tests to improve work incentives should strike a careful balance between incentives to work part time, incentives to move from part to full-time employment, the risk that work incentives might be reduced for people higher up the income scale, and the cost effectiveness of changes to income tests compared with other options to improve the job prospects of unemployed people, such as investment in employment and training programs. As noted above, a lack of capacity rather than a lack of incentive is the main barrier to work for most jobless people on income support.

[19] ACOSS 2008, *Submission to Fair Pay Commission on minimum wages*.

Two countries with broadly similar social security systems to Australia's - the UK and New Zealand - are now considering reforms to simplify their social security systems to remove distinctions between 'pension' and 'allowance' payments. A key motive for these reforms is to encourage employment participation among people with disabilities. The OECD has also recommended payment simplification in Australia for this reason. [20]

The system of social security payments for people of working age needs major structural reform. The broad direction for reform is clear – to move away from the present divide between 'pensions' and 'allowances' towards a payment structure that reflects actual living costs rather than people's distance from the labour market. Reforms along these lines were considered by the previous Labor Government in the early 1990s and by the Coalition Government in 2003, but were not fully pursued.[21] Due to the complexity of the system, the vulnerability of social security recipients and the need to ensure that no group of recipients is worse off, these reforms require careful consultation with organisations representing income support recipients, the community sector more broadly, and policy experts. They should not be rushed. ACOSS plans to consult with its members to further develop these ideas.

Directions for reform

22. Options should be developed for fundamental reform of the social security payment structure for people of working age based on:

    - The Australian Minimum Standard of Living described above
    - Supplements for rent, the extra costs of disability and caring, sole parenthood, and the costs of workforce participation or training
    - A common platform of eligibility requirements (including residence requirements, assets tests and access to supplements, but not activity requirements)
    - Separate payments with the common features described above (including a common rate structure) but with different activity requirements to acknowledge parenting and caring roles, and disabilities.

23. Income tests for payments for people of working age should be reviewed and eased where the evidence suggests that this is a cost effective way to improve work incentives. Options include easing the Newstart Allowance income test for those required to seek part time employment.

[20] FaCSIA & DEWR 2002, *A simpler system*; Freud 2007, *Reducing dependency, increasing opportunity*, Department for Work and Pensions; Minister for Social Development and Employment 2005, *Extending Opportunities to Work*, New Zealand Cabinet submission; OECD 2007, *Sickness, Disability and work*.
[21] Perry 1995, *A single Payment*, Department of Social Security; FaCSIA & DEWR 2002, ibid.

4. Support for mature age people

The three components of public support for retirement incomes are:

- The Age Pension, which provides a minimum income 'floor'.
- Compulsory superannuation, which replaces previous earnings up to a higher standard of income adequacy.
- Tax concessions for voluntary saving through superannuation and for other forms of retirement income.

Together, these components support higher levels of retirement income than the pension alone. Each needs reform in order to ensure adequate incomes in retirement, to improve their fiscal sustainability as the population ages, to improve the efficiency and equity of incentives to save, invest and work, and to simplify support for mature age people.[22] For these purposes, it makes sense to consider these three components of income support for mature age people as a package. This provides more scope for desirable policy trade-offs (for example more support in one area may be more fiscally sustainable if the cost can be offset by changes in other areas) and to simplify the system (for example by rationalising the different treatments of income in the social security and tax systems).

Another driver for reform of income supports for mature age people is the changing nature of transitions to retirement and the role of superannuation in this process. Until recently, most recipients of superannuation benefits in their 50s and 60s obtained a small lump sum payment and retired to live predominantly on the Age Pension. Future cohorts of mature age people in this age group are more likely to participate in the labour market on a part time or intermittent basis and to receive a part-pension. Changes to the superannuation arrangements mean that they can contribute to and draw down from their superannuation accounts at the same time, and that benefits are tax free if received after age 60.

These developments fundamentally change both the character of retirement and the role of superannuation within it. For the most part, there will no longer be a single point at which people leave the paid workforce. Also, the superannuation system is likely to take on the role of a general holding entity for the earnings and investment incomes of mature age people rather than a system of saving for 'retirement'. For example, there are strong tax incentives for employees over 60 years of age to churn their earnings and investment income through their superannuation accounts to the extent they are able to do so. This reduces their effective tax rates, but the impact of this practice on workforce participation and saving levels is unclear.

Fiscal sustainability

There are currently five people of working age for every mature age person, but in 40 years this will fall to two. The latest official estimates suggest that in the absence of policy changes, by 2046 Budget expenditure will rise by 4.8% and the Federal Budget will be in deficit by 3.5% of GDP due to higher health, aged care and social security spending mainly caused by population ageing.[23]

[22] Here we refer principally to those aged 65 years or more, though the discussion includes superannuation and tax arrangements affecting people aged 55 to 65 years.
[23] Treasurer 2007, *Intergenerational Report*.

Australia's expenditure on pensions is modest by OECD standards and most of the projected increase in costs is in health expenses rather than social security. Nevertheless, it will be difficult for future Governments to sustain improvements in Age Pensions unless more retirees pay income tax. Currently, only one in five individuals over 65 do so. On the face of it, tax revenue from retirees should increase in proportion to Gross Domestic Product as the population ages and superannuation account balances increase. However, for the following reasons, this is not assured:

For retirees over 60 years old, superannuation benefits are no longer taxed in most cases. Retirees can substantially reduce the income tax they pay on their other incomes (earnings and investments) by churning that income through superannuation, for example using salary sacrifice arrangements.

Special tax offsets applying to retirement incomes raise the effective tax free thresholds of retired people. The effective tax free threshold for a mature age couple is almost $50,000 compared with approximately $30,000 to $35,000 for a typical dual income couple of working age.

If pensions were increased to improve the income support available to retired Australians, consideration could be given to reducing the scope for retirees to use these concessions to reduce their tax. This would improve the sustainability of the overall system of retirement income support. For example, superannuation tax concessions are estimated by the Treasury to cost $25 billion in 2006-07, which already exceeds the cost of the Age Pension.

Careful consideration should also be given to the scope under the new superannuation arrangements for mature age people to use superannuation for estate planning purposes. Tax-preferred superannuation benefits should be progressively drawn down to finance retirement, not to boost inheritances.

New retirement pathways

Another option under consideration in a number of overseas countries to improve the sustainability of pension systems is to raise the age of eligibility for pensions. The justification for these policies is that in future many people in their late 60s will still be healthy enough to work. A major problem with this option in Australia that it would disadvantage people in a financially vulnerable position, and may have only a limited impact on workforce participation. Many people who retire before age 65 have done so for reasons beyond their immediate control such as redundancy, illness or disability, or caring responsibilities.[24] Since people in these circumstances are likely to have low private incomes and assets, they would be particularly disadvantaged by having to wait longer to receive the Age Pension. Currently, around half of all new Age Pension recipients were previously on another income support payments, including Disability Support Pension, Carer Payment, and Newstart Allowance.[25] These payments are less secure than the Age Pension. Further, as indicated above, those on Newstart Allowance receive much lower payments than pensioners.

[24] AMP-NATSEM 2004, *The lump sum, here today gone tomorrow*.
[25] FaHCSIA 2008, *Pension Review background paper*.

An alternative approach to supporting low income people over 65 years old would be to continue to keep the Age Pension as a minimum income ‘floor’ for this age group, and encourage people to combine a part-pension with part time employment. The present income test facilitates this.

There is a stronger case for raising the preservation age for superannuation, which at 55 years is well below the pension age. Consideration could be given to increasing the preservation age more rapidly than currently legislated. To the extent that this discourages early retirement it would significantly improve retirement incomes and reduce the cost to Government of income support. Those who have little option but to retire early are less likely to be adversely affected by this change because their superannuation assets are typically low. In 2003, 60% of those who retired before 55 years and 50% of those who retired between 55 and 59 years had an average superannuation account balance of less than $10,000.[26] Although this would limit options for people in their late 50s and early 60s to use superannuation to financially support a gradual transition to retirement, it is likely that this transition process will (or should) occur later among future cohorts of mature age people in any event.

A higher standard of income adequacy

There has been much public debate recently about the adequacy of pensions and superannuation. At times this fails to consider their combined impact on the living standards of mature age people. The main purpose of compulsory superannuation is to improve the adequacy of retirement incomes beyond the level achievable through the Age Pension alone. For example as outlined below, in future most retired people are likely to achieve a living standard equivalent to at least the ‘Modest But Adequate’ Budget Standard – a benchmark equivalent to a living standard of ‘modest comfort’ that is well above the ‘Low Cost’ Budget Standard we discussed previously.[27]

Compulsory superannuation also allows wage earners to replace a much higher proportion of their previous incomes in retirement. This is a different way of measuring the adequacy of incomes from applying a single minimum standard to all.

Research by NATSEM indicates that, when account is taken of Age Pension entitlements, taxation, and some of the extra costs facing working households (including paying off a mortgage), the Superannuation Guarantee enables most wage earners employed for 40 years to achieve a living standard after retirement at least equal to 70-80% of their average living standard while they were working. Those who raised children during working life would generally achieve a higher living standard in retirement than they had while working. Treasury research using a different methodology arrives at broadly similar conclusions.[28]

Further, the NATSEM research also suggests that most retired people who have worked for 40 years and receive superannuation contributions equal to 9% of their earnings will attain a living standard equal to or better than the Modest But Adequate Budget Standard.[29]

[26] AMP-NATSEM 2004, op cit.
[27] Saunders 2004, op cit.
[28] CPA Australia 2007, *The right balance?* Rothman 2007, *The adequacy of Australian retirement incomes.*
[29] CPA 2004, op cit.

The main problem with reliance on the Superannuation Guarantee alone is that many people, especially women, are not employed for 40 years or more. Further, few of the present cohort of people in their 50s and 60s have benefited from employer superannuation contributions equal to 9% or more of their earnings throughout their working lives. However, increasing the level of compulsory superannuation contributions is unlikely to substantially boost their retirement incomes. Extending superannuation and its related tax concessions to individuals outside the paid workforce is also an inefficient (and possibly unfair) way to boost retirement incomes. The reason for this is that few could afford to contribute to superannuation in the absence of either a high-income partner or substantial public subsidies, which may not be as well targeted as the Age Pension. The most effective way for these groups to improve their retirement incomes through superannuation is to retire later (where possible) because this increases their superannuation contributions and reduces the number of years they have to rely on superannuation benefits. An adequate Age Pension is especially important in these cases. This reflects its role is to provide a safety net for those with inadequate private income.[30]

Equity in public support for retirement incomes

By 2031, it is estimated that people aged 65 years or more will hold 47% of Australia's household wealth compared with around 22% today.[31] The expansion of superannuation and other retirement assets should greatly improve the overall living standards of future retirees. However, wealth and income will be more unequally distributed in retirement due to the unequal distribution of earnings on which superannuation contributions are based. People on higher wages generally work longer on a full time basis, receive higher compulsory contributions from their employers, and can afford more voluntary contributions.

The current tax concessions for superannuation contributions and investment income will exacerbate future inequality of wealth and incomes. Superannuation contributions made by employers, and the investment income of the funds, attract a flat tax rate of 15% instead of the marginal rates of tax that would normally apply. As noted previously this provides a greater reduction in tax for every dollar invested on behalf of a high wage earner than for a low or middle wage earner. For example, the tax saving for an individual on the top marginal tax rate is 31.5 cents per dollar invested compared with just 1.5 cents per dollar invested on behalf of an individual on the lowest marginal tax rate. Of the estimated $25 billion annual cost of tax concessions for superannuation in 2006-07, around 40% was due to the 15% tax rate on employer contributions and around 50% was due to the equivalent 15% tax rate on fund earnings. This dwarfs the annual cost of other superannuation tax concessions and the co-contribution for low and middle income earners.[32]

There is no policy logic to the system of tax concessions for superannuation. Before the reforms of the 1980s, superannuation was virtually untaxed and it was widely used by high income earners as a tax shelter. To reduce the cost of this tax shelter to the Federal Budget, contributions, fund earnings and large lump sum benefits were taxed at 15% from the 1980s. In 2006, the tax on lump sums was removed for most individuals over 60 years old.

[30] CPA Australia, op cit.
[31] Kelly 2004, *Self provision for retirement?* NATSEM.
[32] Treasury 2007, *Tax Expenditure Statement*.

An efficient system of tax concessions to encourage long term saving would target low and middle income earners rather than high income earners, because high income earners are more likely to save for retirement regardless of the taxation benefits. Generous tax concessions for one form of retirement saving (superannuation) encourage high income earners to switch their investments from other savings vehicles (such as direct investment in shares and property), rather than substantially raising their overall level of saving. Tax concessions should also be capped at a level of contributions or benefits that is sufficient to fund a comfortable retirement income. There is no public benefit in supporting luxurious living standards or estate planning through the tax system.

The Government co-contribution for employees is more consistent with this approach. However, because it is confined to voluntary employee contributions it is of limited benefit to the majority of low and middle income earners who can only afford to rely on compulsory employer contributions. It is likely that the co-contribution mainly supports the superannuation contributions of the partners of high income earners rather than the intended target group of low wage earners from low to middle income families.

Other tax concessions for retirees also contribute to inequality of retirement incomes. For example, the Senior Australians Tax Offset, which currently costs around $1 billion per year, is targeted towards a minority of retirees with incomes well in excess of the Age Pension. When combined with other widely available tax concessions, it raises the effective tax free threshold for a retired couple to almost $50,000.[33]

Directions for reform

24. The system of retirement income supports including pensions, tax concessions and superannuation should be reformed in order to:

    - reduce financial hardship and ease future inequality in retirement incomes
    - more efficiently encourage and support saving for retirement
    - encourage workforce participation where appropriate
    - ensure that these supports are sustainable as the population ages
    - encourage retirees to use tax preferred retirement income savings to improve their living standards and reduce their need to rely on the Age Pension, rather than for estate planning purposes
    - simplify these systems and their interaction – for example by treating income and assets more consistently across the pensions and tax systems.

[33] $49,700 in 2008-09 - See Treasury 2008, *Architecture of Australia's tax and transfer system*.