Australia's Future Tax System

Submission by Catholic Social Services Australia

October 2008

Contact: **Frank Quinlan**
Executive Director

Catholic Social Services Australia
PO Box 326, Curtin ACT 2605
Telephone: 02-6285 1366
Mobile: 0409-655 460

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EXECUTIVE SUMMARY

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

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

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

The Australian tax system and the distribution of income and wealth

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

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

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

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

Recommendation 1

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

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

Adverse interactions between the tax and transfer systems

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

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

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

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

Recommendation 2

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

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

Conclusions

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

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

1. BACKGROUND AND CONTEXT

Australia's Future Tax System

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

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

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

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

A Workforce participation and skill formation;

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

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

D Reducing tax system complexity and compliance costs.

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

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

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

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

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

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

About Catholic Social Services Australia

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

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

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

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

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

The distribution of disadvantage in Australia

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

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

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

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

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

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

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

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

2. PRINCIPLES AND POLICY FRAMEWORK

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

2.1 CATHOLIC SOCIAL SERVICES AUSTRALIA'S TAX DESIGN PRINCIPLES

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

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

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

1. The Common Good

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

2. Distributive Justice

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

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

[7] *Gaudium et spes. n26.*

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

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

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

3. Preferential option for the poor

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

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

Objectives and priorities

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

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

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

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

2.2 CONSISTENCY OF OBJECTIVES

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

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[10] *Mater et magistra, n132.*

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

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

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

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

3. AUSTRALIA'S TAX AND TRANSFER SYSTEM

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

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

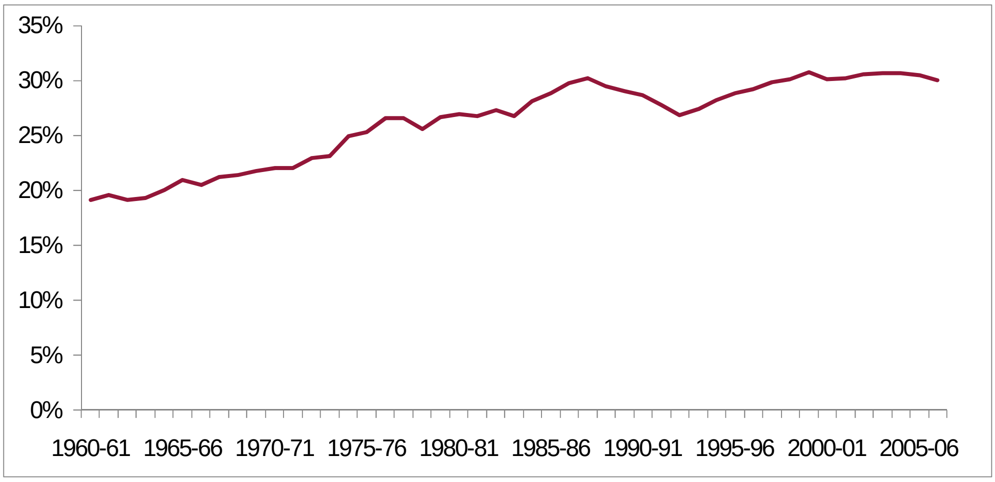
Over the recent years, differences in economic circumstances for different groups in the community have become more pronounced. Australia's so-called 'two-speed economy' has resulted in growing cost of living pressures on many of the most disadvantaged in the community. The higher costs of housing (prices,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

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

3.1 RECENT TRENDS IN TAXATION AND WELFARE

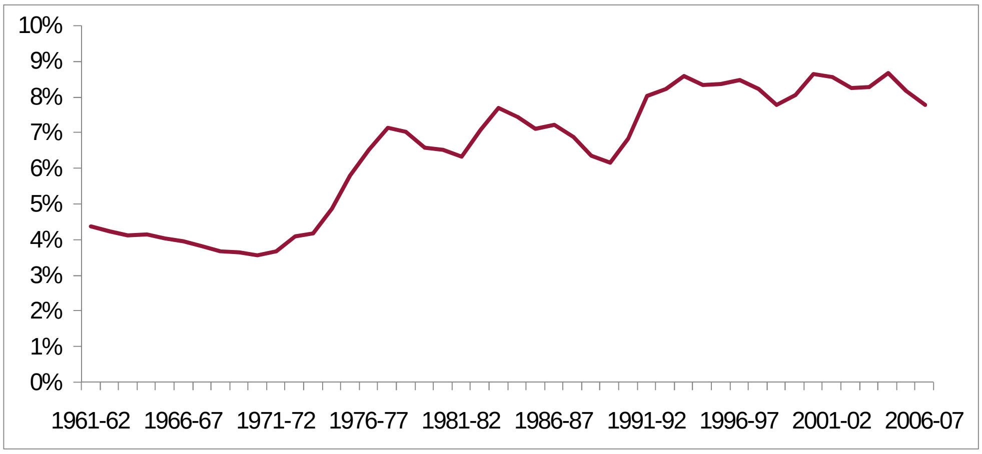
A significant share of Australia's income is tied up in the tax and transfer system. As shown in Figure 3.1 and Figure 3.2, around 30 % of Australia's gross domestic product is collected in taxation by some level of government, and around 8% of GDP is distributed in transfers.

FIGURE 3.1: TAXATION (% OF NOMINAL GDP)



Source: ABS 5206.0 Table 1 and Table 18

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



Source: ABS 5206.0 Table 1 and Table 19

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

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

The common good

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

Distributive justice

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

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

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

Preferential option for the poor

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

3.1.2 THE HISTORY OF TAXATION AND WELFARE REFORM IN AUSTRALIA

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

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

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

Taxation

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

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

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

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

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

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

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

Welfare[13]

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

Government payments to individuals fall across three broad groups:

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

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

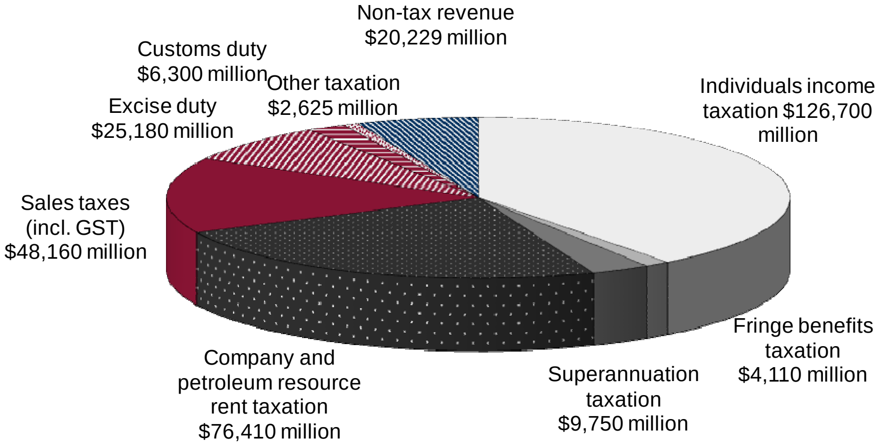
[13] Parliamentary Library of Australia, e-brief (2000) *Welfare review*, http://www.aph.gov.au/library/INTGUIDE/sp/welfarebrief.htm#3.%C2%A0%20Welfare%20reviews%20and%20reforms%20-%20history

3.2 OVERVIEW OF THE CURRENT SYSTEM

3.2.1 TAXATION

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

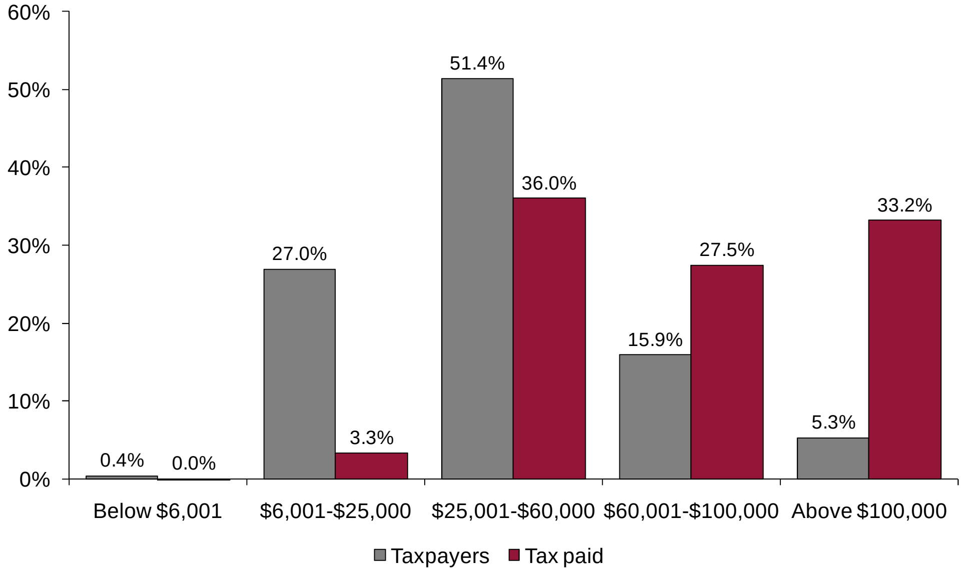
FIGURE 3.3: AUSTRALIAN GOVERNMENT TAX MIX, 2008-09



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

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

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



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

3.2.2 WELFARE

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

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

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

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

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

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

n.e.c. not elsewhere classified

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

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

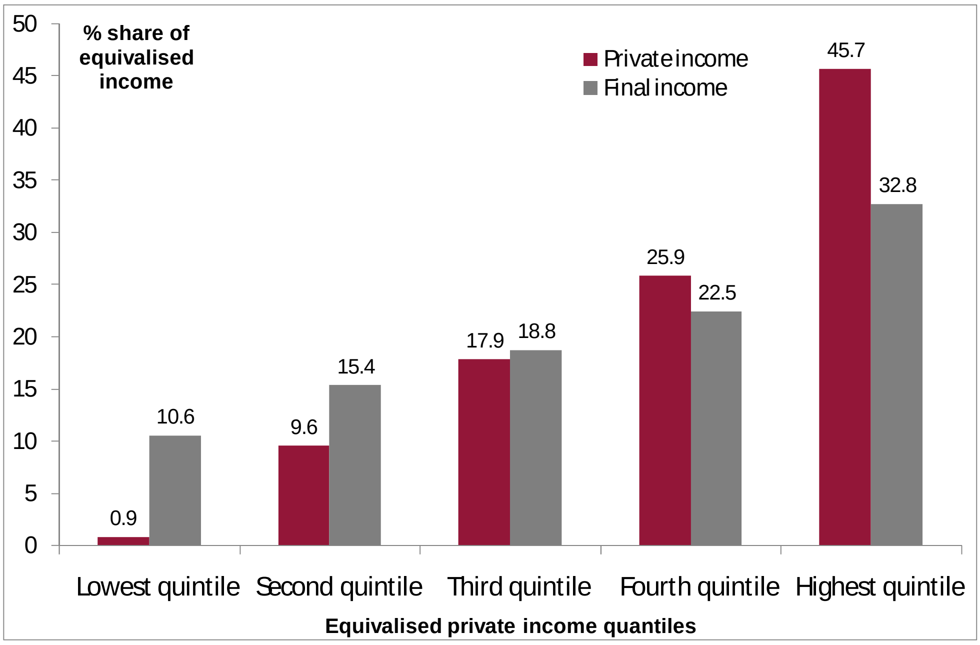
A key difference between the welfare system in Australia and the taxation system is the units (individuals versus families) against which income (or in the case of welfare, assets) is assessed. While taxation is levied against individual income, eligibility for many welfare payments is dependent on family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

3.3 INCOME DISTRIBUTION AND FINANCIAL STRESS

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

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

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



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

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

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

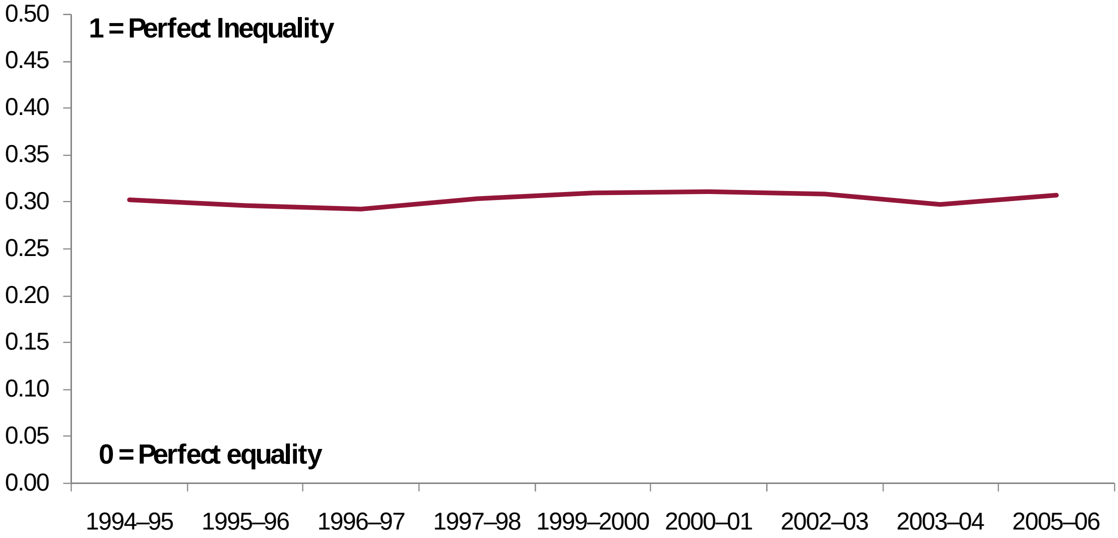
The most widely used summary measure of income inequality is the Gini coefficient.[16] In brief:

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

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

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

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



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

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

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

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

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

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

3.4 POLICY IMPLICATIONS

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

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

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

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

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

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

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

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

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

4.1 THE NATURE OF THE PROBLEMS

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

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

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

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

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

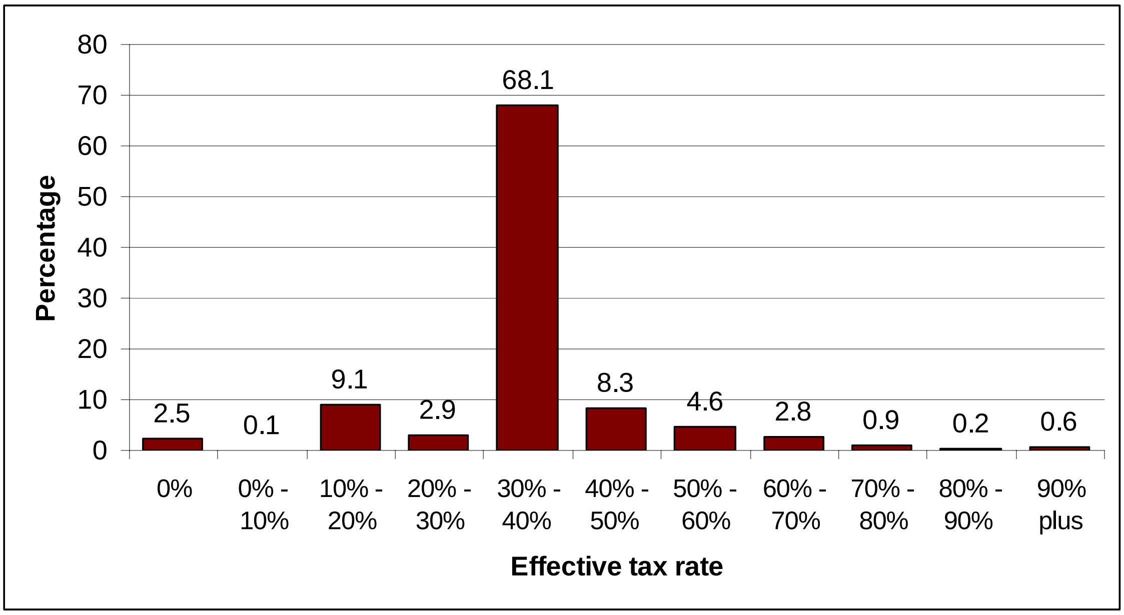
4.2 EMTRS IN THE AUSTRALIAN TAX AND TRANSFER SYSTEM

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

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

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

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



Source: Harding et al (2006)

4.3 IMPACTS OF HIGH EMTRS

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

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

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

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

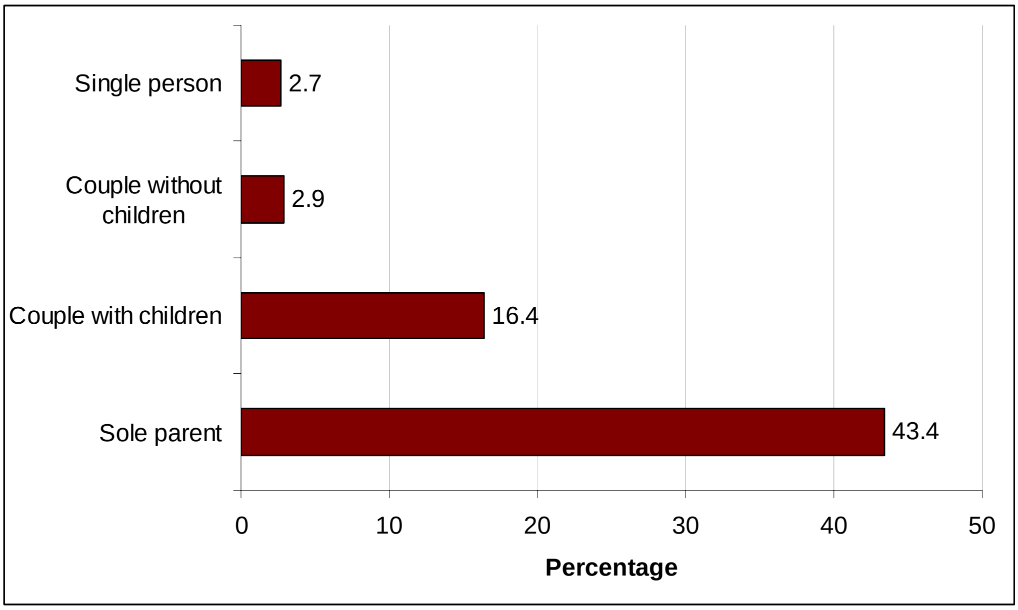
4.4 INCIDENCE OF HIGH EMTRS

High EMTRs and family type

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

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

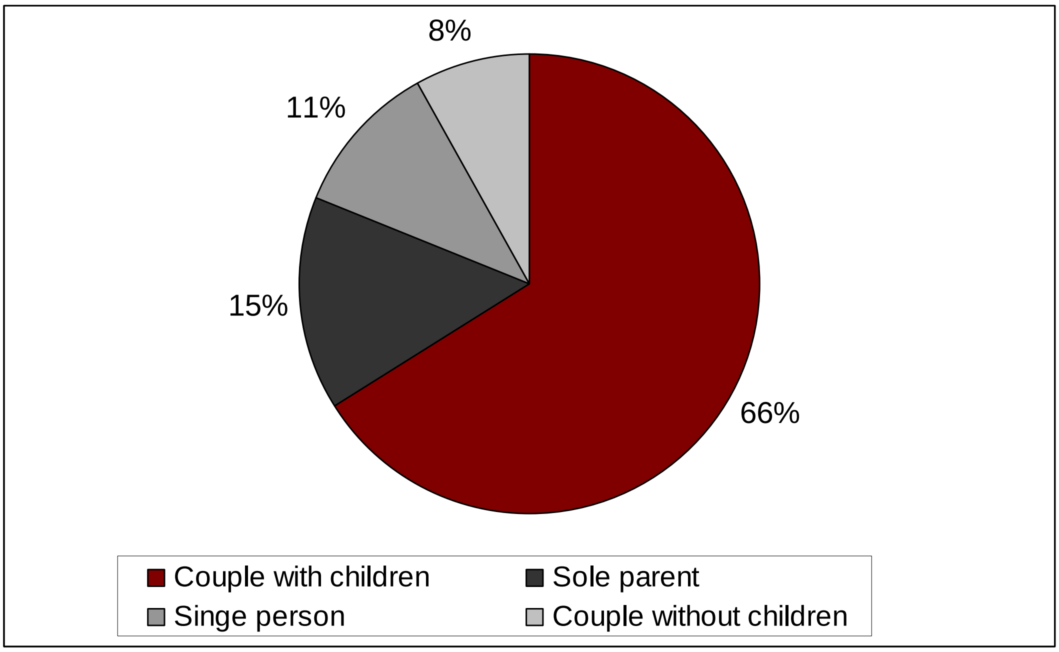
FIGURE 4.2: PROPORTION OF EMPLOYEES FACING HIGH EMTRS BY FAMILY TYPE, 2006-07



Source: Harding et al (2006)

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

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



Source: Harding et al (2006)

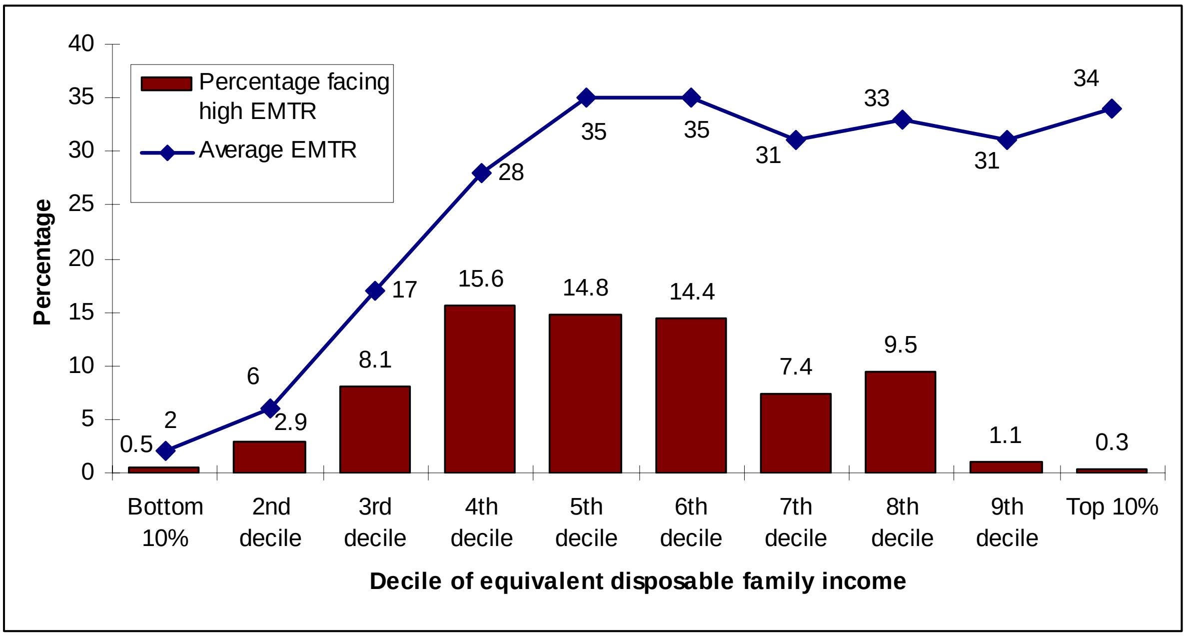
High EMTRs and income level

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

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

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

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



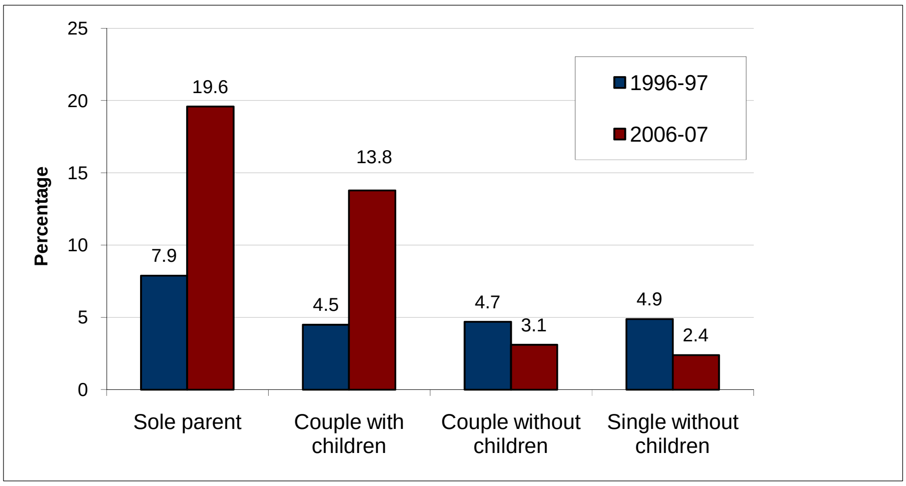
Source: NATSEM (2006)

4.5 TRENDS OVER TIME

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

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

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

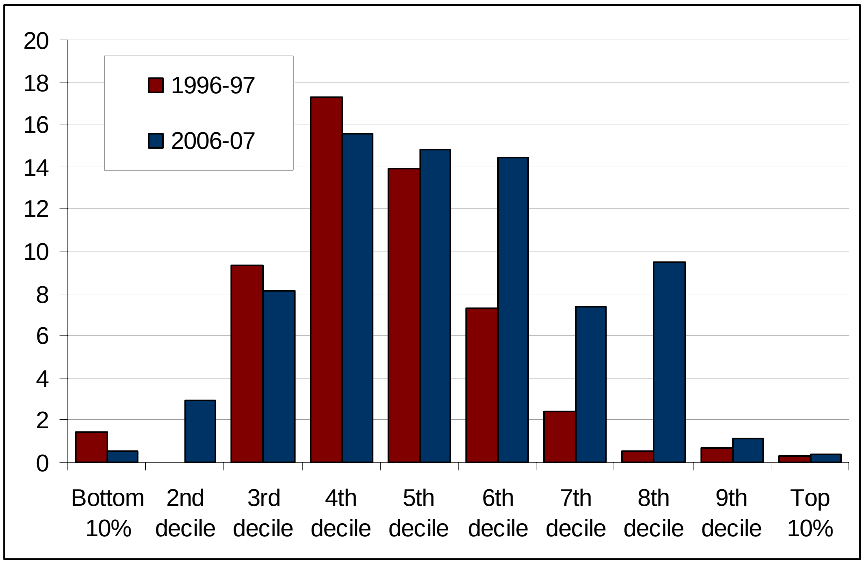


Source: NATSEM (2006)

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

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

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



Source: NATSEM (2006)

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

4.6 BENEFITS FROM ALLEVIATING HIGH EMTRS

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

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

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

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

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

4.7 SOME POLICY OPTIONS

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

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

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

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

Some specific options

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

1. A negative income tax/earnings tax credits

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

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

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

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

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

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

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

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

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

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

2. A single income test on cash transfers

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

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

3. Reductions in taper rates

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

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

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

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

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

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

5. CONCLUSIONS

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

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

Reinforcing the social safety net

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

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

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

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

Addressing the impacts of high EMTRs

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

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

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

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