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Tax Reform to Make Work Pay

Peter Saunders & Barry Maley

Perspectives on Tax Reform (3)

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Executive Summary

We are paying more tax than ever before. Australia's tax burden is higher than in the United States and Japan, taxes on incomes are as high as in many European countries, and corporate taxation is higher than anywhere else in the OECD. Higher income earners are taxed more viciously than almost any other country, and workers on the average wage fare no better than in many other developed countries.

These high taxes combine with the steeply means-tested benefits system with disastrous effects. Many families find their benefits phase out at the same time as tax phases in, so as earnings increase they start to lose 60 cents or more in every dollar. One solution that has been widely canvassed is to compensate low income families with a tax credit, but because this is means-tested, it would only displace the disincentives further up the income scale. A tax credit would lock increased numbers of previously self-reliant workers into dependency on government handouts and make even more people vulnerable to the disincentive effects created by means-tested payments.

A better solution is to reduce the amount of means-testing by reforming the system of child payments and raising the tax-free threshold.

Abolishing means-tested child payments in favour of a universal flat rate child credit would ensure that as people work harder and earn more, they do not get caught in a welfare-tax pincer. Combining this with an increase in the tax-free threshold would allow people to retain more of what they earn while relying less on government income support.

The paper makes eight recommendations for changing the tax and family payments system.

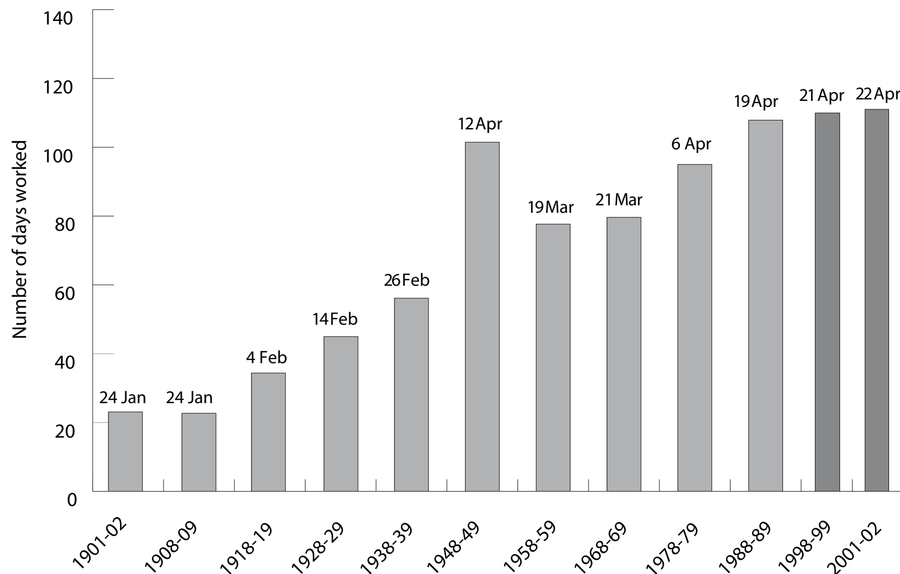
1. The top rate of tax should be reduced to 40 cents in the dollar as the first step towards achieving a flat-rate income tax. The current second-top rate of 42% should be abolished.
2. The top rate threshold should be raised at least to twice the mean level of earnings (approximately $94,000) and should be indexed to rise every year in line with inflation in average wages.
3. Raise the personal zero-rate threshold to $12,500 and index it annually to rise in line with average wages.
4. Where they wish to do so, a couple should be permitted to opt for joint taxation with a shared zero-rate threshold of $19,500. This threshold should be indexed to rise with average wages.
5. All families with dependent children should receive a non-means-tested Child Tax Credit to the value of $3,000 per child per year. This credit should be indexed to rise each year with the average wage.
6. Abolish all existing means-tested family payments.
7. Reform the eligibility rules for Parenting Payment, NewStart Allowance and the Disability Support Pension to reduce the number of claimants and require work where it is appropriate to do so.
8. Consideration should be given to compensating those who lose most net income from these reforms by making a supplementary payment (in the form of additional Parenting Payment or an addition to the Child Tax Credit). This should be limited to parents with children under school age.

Let me tell you how it will be
There's one for you, nineteen for me
Cos I'm the taxman, yeah, I'm the taxman
And you're working for no one but me
The Beatles

Introduction

After seven years in power, and despite its rhetoric about reducing the role of government and allowing people to retain more of the proceeds of their own labour, John Howard's Liberal-National Coalition government today raises as much tax as a proportion of the nation's Gross Domestic Product as any Australian government in history.[1]

Figure 1: Tax Freedom Day 1901-2002



Source: J.Buckingham (ed), *State of the Nation: An Agenda for Change* (Sydney: The Centre for Independent Studies, Sydney, 2004) calculated from ABS *Yearbook 2003,* ABS Cat.1301.0.

Taxation as a proportion of GDP has been rising steadily for the last 100 years. In 1901, total tax revenue per person as a percentage of the per capita GDP was just 6.3%. It reached double figures in the 1920s, crashed through 20% at the time of World War II, and went past 30% during the Howard years.[2] Despite the 2000 reform of the tax system, this is where it has stayed. Tax Freedom Day—the point in the year where Australians collectively generate enough money to cover the government's annual spending so that they can start to earn money for themselves—now falls in late April. We are working nearly four months of every year to pay for the government's programmes before we start to earn money for ourselves.

Is Australia a 'low tax country'?

Despite this dismal history, many members of Australia's social policy establishment think taxes should be higher. For them, taxation is not simply a means to an end—a way of funding desired social programmes—but is an end in itself, a moral good to be pursued irrespective of revenue requirements. They particularly favour increasing tax on higher earners in order to reduce the 'income gap',[3] but there is also a belief that paying taxes is a sign of public morality, and that a high tax country is ethically superior to a low tax one. The Social Policy Research Centre Director, Peter Saunders, asserts that higher taxes would make a 'positive contribution to social justice',[4] and Terry McCarthy and John Wicks of the St Vincent de Paul Society say we should 'debunk the myth that increases in taxes are bad . . . They are not.'[5]

Aware that not everybody shares their enthusiasm for raising taxes, social policy intellectuals try to convince us that Australian tax levels are 'low' when compared with those in many other OECD countries, and that higher earners in particular can therefore easily pay more. The Australian Council of Social Services (ACOSS) describes Australia as 'a low tax country', and it believes we could cope 'reasonably well' with an increase in taxation. Julian Disney, Director of the Social Justice project at the University of NSW and past President of the International Council on Welfare, assures us that Australia is 'a remarkably low-tax country'. Michael Keating, former Secretary of Finance to the Hawke government and Secretary, Department of Prime Minister and Cabinet to the Keating government, thinks we could 'tolerate a significant increase in the ratio of taxation to GDP without great difficulty'.[6]

The two major economies outside of the EU—the United States and Japan—both levy less tax than Australia does. So too do most of our other competitors in the Asia-Pacific region.

Writers like these rest their case on comparisons of the total amount of tax taken by governments in different OECD countries as a proportion of their GDP. These comparisons indicate that the various layers of government in Australia between them soak up less than their counterparts in many other developed countries. The contrast is particularly marked in relation to western Europe, for European Union governments take about 25% more of their GDP in taxes than Australian governments do (the highest is Sweden which absorbs 54% of GDP in taxation compared with Australia's 32%). Because 23 of the 30 OECD countries are in Europe, Australia comes well down the OECD ranking of countries' tax receipts as a percentage of GDP (currently 25th out of 30).

Table 1: Comparative taxation (including social security contributions), 2000

		Proportion of total taxation made up of:				
	Total tax (% of GDP)	*Personal income tax*	*Corporate income tax*	*Social security**	*GST or equivalent*	*Other taxes*
Australia	31.5	36.7	20.6	0.0/ 0.0	27.5	15.2
USA	29.6	42.4	8.5	10.2/11.9	15.7	11.3
Japan	27.1	20.6	13.5	14.2/18.6	18.9	14.2
EU	41.6	25.6	9.2	9.5/15.6	30.0	10.1
OECD average	37.4	26.0	9.7	7.9/14.7	31.6	10.1

*Social Security contributions shown as employee/employer payments
Source: *OECD in Figures*, OECD Observer 2003, Supplement 1.

Advocates of higher taxes often refer to this OECD ranking to support their argument that we are a 'low tax country', but it actually tells us very little, for many of the countries which come above us in the high taxation league table are small European nations which are part of the single EU economic bloc. As Table 1 demonstrates, the two major economies outside of the EU—the United States and Japan—both levy *less* tax than Australia does. So too do most of our other competitors in the Asia-Pacific region (Korea, for example, takes 26% of GDP in tax compared with 32% in Australia).

It is also important to look at the way governments raise their tax revenues. Australia's social policy establishment argued strongly against the GST when it was first introduced, and they remain firmly opposed to any increase in this or other indirect taxes on the grounds that they are 'regressive' (that is, the poor as well as the rich have to pay). When these commentators call for increased taxes, what they have in mind is taxes on personal and company incomes, not GST. But Table 1 shows that tax on corporate and personal incomes in Australia is far from 'low' by international standards.

The proportion of total tax revenues that comes from corporate incomes is actually higher in Australia than in any other OECD country. It accounts for more than one-fifth of all the tax

revenue we generate (double the OECD average). There would seem to be no scope here for further tax rises. Personal income tax is also comparatively high and only three other nations generate a bigger proportion of their total tax revenues from income tax than we do.[7] In short, taxes on incomes (personal as well as corporate) are already stretched tight as a drum.[8]

It is often argued that comparative statistics on income tax are misleading because workers in other OECD countries have to pay compulsory social security contributions as well as income tax, so this should be added to any computation of their total tax levies (employers in those countries also pay a contribution, which is effectively a further deduction from the wage fund, but the Australian equivalent to this is the 9% of wages paid into compulsory superannuation by Australian employers).[9] But even if employee social security contributions in other countries are added to their income tax totals, Australia's total income tax receipts (11.6% of GDP) still do not come out much lower than the OECD average of 12.7%.[10]

There is little evidence to support the myth that Australia is a 'low tax country'. It is true that the total tax burden is lower than in much of western Europe, but it is higher than in the US and Japan, and taxes on incomes are as high here as in many European countries. Australia's corporate taxation is higher than anywhere else in the OECD and taxes higher income earners more viciously than almost anywhere else; even workers on the average wage fare no better than in many other OECD countries. While personal taxes have been cut in many other countries in recent years, they continue to rise in Australia due in no small part to 'bracket creep', the failure to increase tax thresholds in line with the Consumer Price Index.[11]

Should higher income earners pay more tax?

Some advocates of higher taxes want to limit tax rises to those on higher incomes. They say higher income earners are not paying their 'fair share'. But recent work by Sinclair Davidson shows that the top quarter of income earners pay a lot more than their 'fair share' and contribute 64% of all income tax revenues. Despite the widespread belief that higher income earners have been 'unfairly' favoured by the Howard government, their share of income tax has actually gone up by 3% since 1996.[12] Indeed, a recent Parliamentary Library paper concludes that 'top taxpayers' have been losing out ever since the late 1980s, and that the 2000 tax cuts 'did not alter the situation significantly'.[13]

It is true that the top rate itself has come down over the last 20 years or so, but failure to index the top-rate threshold to inflation has meant that a much bigger slice of people's incomes is now subject to the top rate of tax than was the case in the past. It also means, of course, that many more people now get taxed at the top marginal rate. In 1980, workers did not start paying the top rate of tax (which was then 60%) until they earned $35,000, which was approximately three times the average income. Today, workers start to pay the top rate (47%) at 1.3 times average earnings. About 1.3 million people are now paying the top rate, and their numbers are growing. It is estimated that 336,000 people moved into the top two tax brackets between 2001/01 and 2003/04, not because their real earnings rose, but because the brackets were not adjusted to take account of inflation.[14]

In 1980, workers did not start paying the top rate of tax until they earned $35,000, which was approximately three times the average income. Today, workers start to pay the top rate (47%) at 1.3 times average earnings.

Higher income earners are taxed more viciously in Australia than in most other OECD countries. Table 2 shows that Australia has one of the highest top rates of tax (47% plus the 1.5% Medicare levy—with another 1% surcharge on top of that for those who do not have private health insurance) *and* one of the lowest income thresholds at which this top marginal rate starts to operate ($62,500). Taking the rate and threshold together, it is clear that Australia penalises higher income earners more than any other 'Anglo' country and more than any other country in the Asia-Pacific region. Even some of the continental European nations (for example, Germany) are more generous than we are to those on higher incomes.

Table 2: Top marginal tax rates and income thresholds comparing Australia with 13 other countries, 2003

Country	*Top Marginal Rate*		*Income Threshold*	
	(%)	*Ranking*	*(A$)*	*Ranking*
Australasia:				
Australia	48.5*	3	62,500	11
New Zealand	39	9	53,000	12
North America:				
Canada	46.8	4	110,000	6
USA	41.5*	7	395,000	1
Asia-Pacific:				
Hong Kong	16	14	365,000	2
Indonesia	35	11	30,000	13
Japan	50	1	217,000	4
Malaysia	28	12	83,000	8
Singapore	22	13	303,000	3
Thailand	37	10	130,000	5
Europe:				
France	49.6	2	77,000	9
Germany	45	5	85,000	7
Ireland	42	6	45,000	13
UK	40	8	73,000	10

Source: KPMG estimates published in *The Australian* (24 February 2004).

The Melbourne Institute estimates that for $1 billion a year we could:

- reduce the top marginal rate of tax by 2% (from 48.5% to 46.5%); or
- raise the top rate tax threshold by $16,000 (from $62,500 to $78,500); or
- cut the second-highest marginal tax rate by 5% (to 38.5%); or
- Raise the second-top threshold by $4,000 (to $56,000).

All four options are attractive, yet none is sufficient. On grounds of fairness as well as efficiency there is a compelling case for reducing the current grossly inflated tax levy on above-average income earners. In the long-run the aim should be a single, flat-rate tax on all incomes equivalent to the current company tax rate of 30%. This can only be achieved in stages, but reform must begin soon and should not be deterred by the argument that the government 'cannot afford it'.

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The tax money we pay is not the government's money, it is ours. Taxes this high indicate that the government is spending too much, not that taxpayers need to pay more. It is the argument of an expenditure junkie to say that taxes must continue to increase because current spending levels are still rising and demands on the government are still mounting. The spiral needs to be put into reverse.

It is a common trap to see government budgets as fixed and static when in reality they are open and fluid. It is possible to cut taxes yet raise total revenues; Geoffrey Walker reminds us how the 1981 Reagan tax cuts ended up generating an increase in revenues when critics had all forecast a deficit, and he notes that Russia's dramatic move to a low 'flat tax' in 2001 has produced 'vastly more revenue' than was collected under the old, steeply progressive tariffs.[15] It is simply not known how much (if at all) actual revenues might fall if taxes on higher income earners were cut, for this would change incentive structures. Not only would people work harder to earn more, but they would devote

less energy to tax-saving schemes if marginal rates were cut. The economy is an open system, and it should not assumed that current patterns of behaviour will persist in a changed tax environment. They will not.

RECOMMENDATION 1:
The top rate of tax should be reduced to 40 cents in the dollar as the first step towards achieving a flat-rate income tax. The current second-top rate of 42% should be abolished.

RECOMMENDATION 2:
The top rate threshold should be raised at least to twice the mean level of earnings (approximately $94,000) and should be indexed to rise every year in line with inflation in average wages.

Are average earners over-taxed?

Workers on average earnings are not generously treated by the Australian tax system either, but judging by international comparisons, the case for reducing their average tax burden is not as urgent as at the upper end. Table 3 calculates the proportion of gross income lost (after paying tax and receiving benefits) by workers in different types of families in Australia, and shows how this compares with the rest of the OECD. In most cases, Australian workers come out around the middle of the rankings.

For example, an Australian worker on the average weekly earnings whose partner stays at home to look after their two young children ends up forfeiting 15% of gross earnings. Our ranking of 13th out of 30 indicates that twelve other OECD countries take even more than this (Denmark in first position takes twice as much), but 21 take less. They include France, Italy, Japan, the US, the UK, Spain, Austria, Switzerland, Portugal and Ireland.

Table 3: Proportion of gross wage lost in income tax and employee contributions (net of cash benefits) by different household types, comparing Australia with 30 OECD countries, 2002

	% of gross wage lost	*OECD tax ranking (out of 30)*
Childless single persons:		
Earning 67% AWE	19.7	17
Earning AWE	23.6	17
Earning 167% AWE	32.0	13
Single parent, 67% AWE, with 2 children	-10.5	25
Married couple, 2 children:		
One earner on AWE	14.7	13
One on AWE, plus partner on 33% AWE	16.8	13=
One on AWE, plus partner on 67% AWE	19.2	14
Married couple, no children, 1 on AWE, other on 33% AWE	20.3	17

Source: OECD, *Taxing Wages 2001-2* (Paris: OECD, 2002), Table 4.

Looking at Table 3, only one household type appears to be very generously treated by the tax system in Australia as compared with elsewhere, and that is the low income single parent family. Only five OECD countries (the Czech Republic, Iceland, Luxembourg, the UK and

Ireland) treat a single parent bringing up two children on two-thirds of Average Weekly Earnings more generously than we do. It should not be of great concern if the net incomes of low-income single parents fall back a little as a result of tax and welfare reform, for this is about the only group in the Australian population which is currently doing better than the international average.

The tax-welfare squeeze and the problem of disincentives

The average amount of tax paid (net of cash benefits received) by ordinary working families may not be excessive by international standards, but the major problem is the *rate* at which earnings are lost to tax as people start to work harder and raise their gross pay. This problem is created by the way the income tax system interacts with the welfare system.

One reason why Australian governments have managed to keep total tax revenues below the OECD average is that less is spent on welfare than in other countries. The social policy establishment thinks this means less generosity is shown to those in need, but this is not the case. Even though less is spent in total on welfare, more money is actually diverted to those on lower incomes than almost any other OECD nation.

Other countries have higher total welfare bills because they channel more money to those on higher incomes. This is because they have contributory, insurance-based, welfare systems whereas we have a non-contributory, means-tested system. The reason Australia's welfare bills are relatively low is because welfare recipients are means-tested much more stringently than in other countries.

Throughout Europe and North America, workers establish entitlements to welfare benefits through the payments they make to a social security fund. When they are unemployed, sick or retired, they draw the benefits to which they are entitled, irrespective of their financial circumstances at the time. This means a lot of people get paid a lot of money even if they do not 'need' it, and the 'surplus' is then clawed back through the tax system (that is, they are taxed on their welfare incomes). Retired people with independent incomes or savings still get paid the state pension, for example, but they have to pay tax on their income from all sources including the pension.

In Australia, by contrast, all benefits (including age pensions) are paid out of general taxation, and eligibility is established purely on the basis of 'need', rather than according to contributions made. The result is that fewer people end up receiving payments, for those who have saved or who have other sources of income get nothing. This means less is spent in total on welfare, but it is targeted to those considered to be in greatest need. The result is that total welfare spending is the third-lowest in the OECD, but the value of net transfers to the poorest 30% of the population is the third-highest, greater even than Sweden[16] and exceeded only by Norway and Finland.

As soon as workers increase their hours or take on more responsibility, they begin to lose their welfare payments as their earnings rise, and in some cases they end up little better off than before.

The Australian system is therefore very efficient at directing money only to those who need it, however, there is a heavy price to pay because strict means-testing creates huge disincentives to people to work and to save. If eligibility for government support is determined by 'need', rather than by past contributions, then neediness is rewarded while self-reliance is penalised.

For example, those who save for their old age are penalised because any income from savings reduces the value of the age pension they can claim. Not surprisingly, many people do not bother to save, or if they do, they blow their superannuation on houses, holidays or gifts to their children rather than forfeiting the means-tested government pension.

Even more disturbing, because targeting benefits for the working-age with little or no other income is so successful, those who do not work are rewarded and those who work harder in an attempt to increase their earnings are penalised. As soon as workers increase their hours or take on more responsibility, they begin to lose their welfare payments as their earnings rise, and in some cases they end up little better off than before.

The problem of high Effective Marginal Tax Rates (EMTRs)

The precise details of how benefits disappear as earnings rise are complex, but the problem can be illustrated by considering a single parent with two young children living on Parenting Payment Single (PPS). As of early 2004,[17] this claimant would receive $452.80 per fortnight in PPS, plus $130.48 in Family Tax Benefit (Part A) and $112 of Family Tax Benefit (Part B), generating a total welfare income of $18,127 per annum (not counting rent assistance). Once he or she starts to work, however, these benefits rapidly fall away.

The PPS rules allow claimants to earn $169.20 per fortnight ($4,411 per annum) before the benefit starts to reduce at the rate of 40 cents in every extra dollar earned. People earning their own income remain eligible for a part pension until their fortnightly earnings exceed $1,315.70 ($34,302 per annum), at which point no more PPS is payable. Any job paying between $4,411 and $34,302 per annum therefore incurs a reduction in PPS of 40 cents in every dollar earned.

Family Tax Benefit also falls as earnings rise. The FTB (Part B) is not means tested for sole parents, but FTB (A) is means tested for all recipients. The maximum rate is paid until claimants exceed $31,755 per year, at which point it starts to taper off at 30 cents in every dollar earned. A sole parent earning between $31,755 (the start of the FTB taper) and $34,302 (the end of the PPS taper) will therefore lose 40 cents in the dollar of PPS plus 30 cents in the dollar of FTB, *in addition to paying income tax*.

A single income family in Australia with two children on average earnings faces an effective marginal tax rate of 61%. Only four other OECD countries have EMTRs this high.

Income tax liability kicks in on all earnings of more than $6,000 per year. Earnings above that attract a marginal tax rate of 17% (although low income earners qualify for a small, means-tested rebate to set against this tax liability).[18] This marginal tax rate then leaps to 30% once earnings pass $21,600, rising to 42% on earnings over $52,000, and reaching the top rate of 47% on all earnings over $62,500.

This combination of a means-tested benefits system (the more you earn, the less you get) and a 'progressive' tax system (the more you earn, the higher the marginal rate) means that people on low to middle incomes lose benefits at the same time as they pay increasing amounts of tax. The work disincentives can be devastating.

A sole parent with a part-time job paying, say, $24,000 per annum will find that each extra dollar earned reduces the PPS by 40 cents, and that each extra dollar is also taxed at 30 cents (with a further 4 cents lost in the reduction in the low income rebate). The combined effect is that 74 cents in every additional dollar earned disappears in tax and lost benefits (what economists refer to as an 'effective marginal tax rate' of 74%).

It is not only sole parents on low incomes who experience the frustrations of very high EMTRs like this. Many people living on benefits find that moving into low-paid or part-time employment produces disappointingly small improvements in their living standards as sharp income tests begin to bite and the value of payments declines at the same time as they have to start paying tax.[19] Full-time working parents earning anything between the minimum wage and the average wage also see much of their additional earnings disappear if they work more hours or take a better-paid job, and because eligibility for income support is assessed on the combined family income while income tax is levied on an individual basis, many part-time second earners find it hardly pays to work at all.

Although low-to-average income groups in Australia do not appear to be harshly treated as compared with equivalent groups in other countries when it comes to their net deductions or benefits, they do face much tougher disincentives if they want to improve their take-home earnings. A single income family in Australia with two children on average earnings faces an effective marginal tax rate of 61%. Only four other OECD countries have EMTRs this high.[20] The unique nature of our benefits system and the steeply progressive structure of our income tax system means that we have a much bigger problem of tax/welfare disincentives than most other countries.

Almost one million people, or 8% of the working-age population, face EMTRs of 60% or more.[21] These high EMTRs are caused mainly by the withdrawal of Family Tax Benefit (A) as

family earnings rise. This is why three-quarters of those facing high EMTRs live in families with children under the age of 16. Only 3% of single people, and just 1% of those in couples without children, face high EMTRs, but 15% of individuals in couples with children and nearly one-quarter of sole parents are caught by EMTRs of 60% or more.

If cutting top rates of tax is one priority, then another must be to reduce the high EMTRs faced by working families earning between the minimum and the average wage. The prospect of giving up 60% or more of one's earnings must inevitably lead many people to decide that it is simply not worthwhile making the effort to work. This is a devastating indictment of the tax and welfare system.

Problems in making work pay

Almost everyone agrees that high EMTRs are destructive of personal incentives and that they need to be reduced so that it pays people to work. As a recent editorial in *The Australian* suggested:

> The existing tax structures sap initiative and cripple the incentive to work harder and make more money, for high- and low-income earners alike. And the insidious combination of tax and welfare systems punishes people who try to reduce their reliance on the public purse by earning additional income. Getting the tax mix—and the rates we all pay—right is the central policy problem in Australian politics.[22]

There is, however, little agreement about how this might best be done.

Logically, there are only three possible solutions.

(i) Change the welfare rules so that people do not lose so much in benefits as their earnings rise;

(ii) Change the tax rules so they do not pay so much tax as their earnings rise; or

(iii) Change both the welfare and the tax rules so that workers (especially workers with families) do not lose benefits as they pay more tax.

(i) Changing the welfare rules

The first possible solution is to reduce the rate at which welfare benefits are withdrawn as incomes rise. This could certainly help to increase work incentives, for quite small adjustments have in the past produced quite impressive results. When the government reduced the PPS taper from 50% to 40% in 2000, for example, work participation of single parent households rose by around 2.5%, and because more people were working, this halved the net cost to the government of making the concession in the first place. There was also a positive (though less dramatic) employment effect from the reduction of the FTB taper from 50% to 30%.[23]

Almost everyone agrees that EMTRs are destructive of personal incentives and that they need to be reduced so that it pays people to work.

The problem, however, is that reducing the taper rate on welfare payments means increasing the income range over which the benefits are payable. Currently, for example, PPS is withdrawn at 40 cents in the dollar on earnings over $4,411 p.a. and it phases out altogether once people earn around $34,000. If the taper rate were reduced to 20 cents in the dollar, this would ease the problem of high EMTRs experienced by single parents, but it would mean the benefit would still be payable to single parents earning as much as $60,000 per year. And if the current 70% taper on NewStart allowance were reduced to 45%, it would mean having to pay an unemployment benefit to people working full time at the minimum wage.[24]

Not only is it very expensive to reduce the taper rate on benefits but it is also inefficient. As affluent households become eligible for welfare payments they do not 'need', the tax and welfare bureaucracies become increasingly entangled with each other as one pays people the benefits to which they are entitled while the other tries to claw them back again in increased taxes. This increases bureaucratic costs (so-called 'churning'), but more importantly, it also undermines work incentives as workers end up paying more tax at the same time as they become more reliant on handouts from the government.

We saw earlier that the strength of the Australian welfare system is that it targets aid on those 'in need' much more effectively than other countries do. Despite our tightly-targeted, means-tested system, we do still have a 'churning' problem, but it is nowhere near as bad as in Europe. It would be a mistake to ease our problem of high EMTRs by increasing our problem with churning.

(ii) Changing the tax rules by introducing an 'Earnings Credit'

The second possible solution to the problem of high EMTRs is to reduce the amount of tax lower income working households have to pay. This could be achieved by across-the-board tax cuts, but those who prefer to target low-to-middle income groups (who currently face the highest EMTRs and hence the greatest work disincentives)[25] often argue instead for a new 'earnings credit' (EC) to be paid solely to low income working families.

In essence, an earnings credit would involve an additional cash transfer financed by the government but paid through the wage packet to lower income earners to compensate them for the increased taxes they pay and the reduced benefits they receive as their income rises. In other words, workers would continue to claim their benefits and pay their taxes, but a new payment would be laid on top of this existing system to reduce the net amount they end up losing.

The Americans have had an earnings credit ('Earned Income Tax Credit') in place for more than 30 years. Low income Americans complete a tax return at the end of the year and claim a lump sum reimbursement from the federal government. In the UK, the Blair government has also introduced a series of tax credits since it was first elected in 1997, and these now cover low income families with children, low income workers without children, and age pensioners with savings.

An earnings credit is just another means-tested government payment which would phase out as people's earnings rise and create work disincentives at the point in the income scale where it starts to fall away.

In Australia, a proposal to introduce an earnings credit (EC) was first outlined by five leading economists in an open letter to the Prime Minister in 1998.[26] In the latest version of this proposal,[27] the EC would be superimposed on the existing FTB (Part A) payment which we saw earlier is currently payable in full to parents earning up to $31,755. A new EC would increase in value as people increase their earnings up to the $31,755 FTB threshold, at which point it would taper off at a rate of 30% (the current FTB taper rate) until earnings hit the FTB base payment level, when the EC would disappear. Those who developed this proposal estimate that it would reduce the EMTR faced by a jobless couple with two children who move into low-paid employment from 69% to 65%.

The main aim of a tax credit is to encourage more non-employed people into paid employment by topping up the take-home pay of workers with dependent children who earn relatively low wages. Its supporters claim that, even though a reduction of 4 percentage points in the EMTR does not sound much, it would be enough to encourage another 72,000 people into paid employment at a cost to the Treasury of around $2.5 billion per annum.[28]

The numbers are modest, but it looks like a move in the right direction. There are, however, some serious drawbacks with this proposal.

The main problem is that it would improve work incentives for some people while reducing them for others. Despite its name, an earnings credit is just another means-tested government payment which would phase out as people's earnings rise and create work disincentives at the point in the income scale where it starts to fall away.

The 'Five Economists' try to minimise this disincentive effect by linking the new EC to the existing FTB payment. This means that people in households with incomes over $31,755 would lose their combined FTB/EC payments at a rate of 30 cents in every extra dollar earned (as well as paying income tax at a marginal rate of at least 30%), but this is no worse than the existing system of phase-out of FTB alone. There would therefore be no increase in the *EMTRs* faced by these workers. There would, however, be an increase in the *number of people* affected by the taper, for the payments would now stretch across a broader band of incomes than before.

While encouraging some people living on welfare to take on part-time or low-paid employment (because the EMTRs on very low incomes would fall), this means that a new earnings credit would create a new set of work disincentives for those with household incomes of around $45,000 to $50,000 who would be dragged into the FTB/EC taper for the first time. As in the US and the UK, we would find that helping those on lower incomes creates new problems for those on middle incomes.[29] The effect on part-time second earners in these middle income households would be particularly sharp, and the architects of the EC proposal admit that the number of partnered women going out to work would actually fall as a result of the change.[30]

The basic problem with tax credits is that they lock increased numbers of previously self-reliant workers into dependency on government handouts and therefore make even more people vulnerable to the perverse disincentive effects created by all means-tested welfare systems. In Britain, introduction of tax credits increased the number of households claiming means-tested payments by more than 40% in six years,[31] and *85%* of families with children are now eligible for a tax credit.[32] Blair's former Minister for Welfare Reform, Frank Field, points out that it is now impossible for many people to escape dependency on government payments by working harder or getting better qualified.[33] People who had never before been part of the social security system are now caught up in the welfare dependency net.[34]

Tax credits can encourage fraud as employers collude with their employees to pay a proportion of the wage 'off the books' so as to maximise tax credit eligibility.

There are other problems too. Both ACOSS and the recent Senate Inquiry into poverty point out that tax credits can end up subsidising low-paying employers who rely on the government to supplement the wages paid to their employees. The British experience has also been that tax credits encourage fraud as employers collude with their employees to pay a proportion of the wage 'off the books' so as to maximise tax credit eligibility.[35]

If we were to go down this road, more would be spend on income support than currently is the case. The Five Economists suggest that the cost of their proposal would be no more than $2.2 billion per annum, and they speculate that the increased work incentives generated by an EC could mean that the scheme would be revenue-neutral (or even revenue-generating) within ten years.[36] International experience suggests otherwise, for like every other government payment that has ever been introduced, tax credits get extended after they have been running for a few years and the cost keeps going up. In the UK, the Labour government's spending on its various tax credits has grown alarmingly since the Working Families Tax Credit was first introduced in 1997. Reaching 0.6% of GDP by 2001, the total cost is anticipated to rise to 1.2% of GDP (£14 billion) by 2005/6.[37] In the US, the cost of the Earned Income Tax Credit was estimated to have reached $27 billion in 1996.[38]

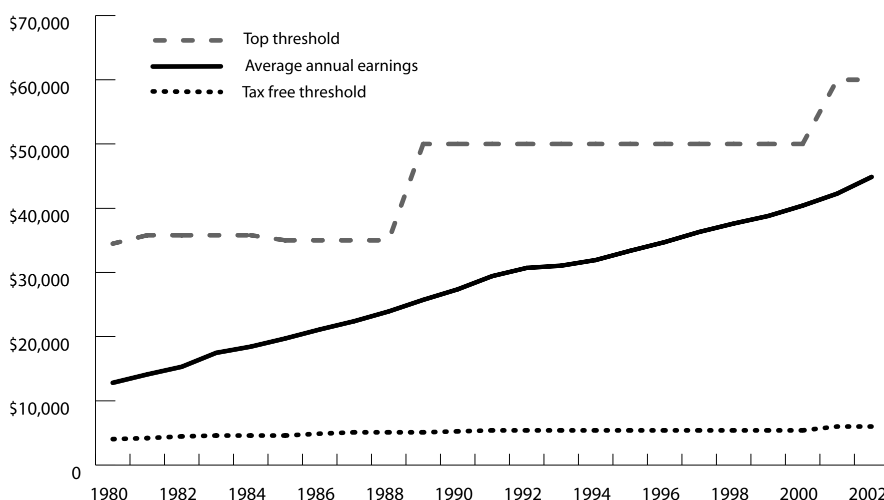
Once introduced, it would be almost politically impossible to reverse the policy and claw the money back, for too many people would come to rely on the handout. Continuing concern about high EMTRs (remember the current proposal only reduces the EMTR of a low income family by 4%) would result in pressure to ease the taper, thereby pushing the coverage of tax credits ever higher up the income range. From being targeted at the lowest earners, tax credits would thus swiftly be extended to cover middle earners as well. As the political parties compete with each other to woo the median voter, the temptation would grow to introduce new kinds of tax credits to boost the take-home incomes of other sections of the population not currently covered, just as has happened in the UK. This would not only result in escalating costs but it would also ensnare ever greater proportions of the working-age population in dependency on government income transfers—which is exactly what we are trying to avoid.

(iii) Tackling tax and welfare together by raising the zero-rate threshold

Any means-tested payment aimed at working households *must* create work disincentives because it reduces as earnings rise. The only way of avoiding this is to move away from means-tested in-work benefits altogether. This is the logic behind the third possible solution to high

EMTRs, which is to disengage the tax and welfare systems so that (as far as possible) they no longer overlap. The key to achieving this is to raise the zero-rate (tax-free) threshold.

Figure 2: Average earnings and tax thresholds, 1980-2002



Source: Based on table in Bendzulla Actuarial Pty Ltd website (www.bendzulla.com.au)

The amount of tax we pay on any given income depends on two things—marginal tax rates and tax thresholds. Although nominal marginal tax rates have declined in Australia over the last 20 years, we have seen that most of us are losing a bigger slice of our incomes in tax than ever before. This is because tax thresholds have not kept up with inflation (Figure 2). This has affected taxpayers at all levels of income, but its effect on the basic rate of tax has been particularly devastating.

In 1980, a worker did not pay any tax at all until he or she earned $4,041 per year (one-third of average earnings). Wages have gone up by 350% since then, but the tax-free earnings threshold has only risen by around 50%, to $6,000 (less than one-seventh of today's average earnings). Every worker now therefore pays tax on a much bigger proportion of their earnings than they used to. Had the 1980 personal threshold of $4,041 kept pace with earnings, it would now be over $14,000.

There is a strong case for restoring the value of the tax-free threshold to something close to its 1980 level, and pegging it to rises in wages so that it cannot be eroded again.

RECOMMENDATION 3:
Raise the personal zero-rate threshold to $12,500 and index it annually to rise in line with average wages.

The principled case for raising the threshold is that workers should be allowed to earn and retain enough money to meet their own subsistence needs before any tax is taken away from them. We can define a 'subsistence income' as the minimum amount somebody would receive if they were unemployed and living on welfare benefits. At the time of writing, a single person on the lowest level of welfare payments would receive $12,567, so it follows that the tax-free threshold for a single person should be raised beyond this level.

The pragmatic argument for raising the threshold is that it is the only practical way to overcome the problem of high EMTRs arising from the interaction of the tax and welfare systems.

Since the value of the personal tax-free threshold has slipped to less than half what a single unemployed person gets in income support and rent assistance, the government now takes

money away from us long before we have secured our own basic subsistence. Inevitably, this means it then has to give much of this money back again in welfare payments so those on lower incomes can maintain themselves and their families. It is this 'churning' that adds to the high EMTRs faced by people caught in the tax/welfare pincer, for as they increase their earnings, they pay more tax at the same time as their means-tested benefits are reduced.

It makes no sense to tax low income earners into poverty, and then to pull them out of it by giving them welfare benefits and/or tax credits. It makes a lot more sense to allow people to keep more of what they earn so that they are not enmeshed in the welfare transfer system. Raising the threshold above the welfare floor would allow them to remain self-reliant through their own efforts without having to depend on the whims of politicians in Canberra tweaking this benefit or fiddling with that credit.

The main argument against raising the zero-rate threshold is that it benefits all income tax payers, not just those on the lowest incomes. Because everybody benefits from an increased threshold, the cost to the Treasury is substantial while the pay-off in terms of inducements to lower income groups are necessarily diluted. It has been suggested, for example, that raising the tax-free threshold to $10,000 (while leaving all other welfare payments unchanged) would cost twice as much as the EC proposal but would achieve only half of the increase in labour market participation.[39]

But the fact that an increased threshold benefits all taxpayers is the strength of the proposal, not its weakness. It is precisely because everybody receives the tax-free threshold (that is, it is not means-tested) that it overcomes the disincentive problem that is inherent to all other strategies for raising people's take-home incomes above subsistence level. It therefore avoids persecuting those who better themselves, for the threshold is never taken away, no matter how much extra they manage to earn.

Raising the zero-rate threshold above the welfare floor is thus an essential step in restoring incentives and the principle of self-reliance to the income tax system. A tax-free income of $12,500 is only sufficient to maintain one person, so where a worker is earning a wage or salary which has to support a second, non-earning, adult, they clearly need a more generous tax-free (or zero-rate) threshold if the couple is to achieve a subsistence income and thereby maintain self-reliance.

RECOMMENDATION 4:
Where they wish to do so, a couple should be permitted to opt for joint taxation with a shared zero-rate threshold of $19,500. This threshold should be indexed to rise with average wages.

The fact that a couple has a higher subsistence level than a single person is recognised in the welfare system where an unemployed couple with no children is currently given a total income in benefits worth $20,169—61% more than a single claimant receives. Although the welfare system assesses needs at a family or household level, the tax system currently treats individuals as distinct income units and they are taxed separately on their own earnings, irrespective of how many other people might eventually share that income.

Terry Dwyer argues that the tax system should come into line with the welfare system by taking account of the number of people who have to be supported from any one individual's earnings.[40] This can best be done by allowing a second partner in a couple to transfer part of his/her zero-tax threshold to the first (assuming this is what they both choose to do).[41] We should not allow the whole of a second threshold to be transferred because household living costs are reduced by economies of scale (two people can live cheaper than one). If one person needs, say, $12,500 for subsistence (the current welfare minimum), two people living together do not need (2 x $12,500 = $25,000) to achieve the equivalent standard of living. Most 'equivalence scales' suggest they need about one and a half times what a single person needs (which would give them a joint threshold of $18,750), and as we have seen, the welfare system thinks they need around $20,000. This suggests that the shared zero-tax threshold for a couple who choose to pool their tax liability should be in the region of $19,000 or $20,000.[42]

Universal, non-means-tested tax credits for dependent children

Dwyer recommends that the principle of family tax pooling could be extended to children as well as operating between partnered adults. This would mean giving dependent children their own thresholds, recognising that they too must achieve a subsistence income in order to live. Part or all of these thresholds could then be transferred to one of both working parents to compensate them for that portion of their income that is consumed by their children.

The problem with this idea, however, is that it would soon take the total threshold for a family above the minimum wage level. For example, if children were each allowed to transfer, say, one-third of the full adult threshold to their parents, a two-adult, two-child family with just one earner could earn around $27,000 before becoming liable for tax. If the single earner were on the federal minimum wage (currently worth $23,316),[43] he or she would be earning $3,684 per year less than the family's pooled threshold. In this event, the family would fail to get the full benefit of their pooled allowance and would end up with an income below what the tax/welfare system was defining as a subsistence level for this family type.

The best way to overcome this problem is to support the cost of children through non-means-tested child tax credits, rather than through additional zero-rate thresholds. This is a policy that has long been recommended by Barry Maley.[44]

RECOMMENDATION 5:
All families with dependent children should receive a non-means-tested Child Tax Credit to the value of $3,000 per child per year. This credit should be indexed to rise each year with the average wage.

The welfare system defines the subsistence income for a family of two adults and two children as $27,335. Such a family should be allowed to earn something close to $27,000 before starting to lose tax. This could be achieved by allowing them two single person thresholds of $12,500 (or a shared couple tax-free allowance of $19,500), and adding to this a refundable tax credit of, say, $3,000 per child. This credit would be claimed against any income tax paid on income over the $19,500 couple (or $25,000 two-singles) threshold, and if the total value of the child tax credit/s exceeded the total tax liability for the year, the balance could be claimed back as a refund.

For example, a couple with one full-time earner and two dependent children might between them earn $50,000. If they opt to pool their tax-free threshold, they would start to pay tax at $19,500 (alternatively, if both are earning and they opt for separate taxation, they would between them earn $25,000 before paying tax). At current tax rates, they would pay 17% on earnings between $19,501 and $21,600 and 30% on the remainder—a total tax liability of $8,877. Two $3,000 child tax credits would however allow them to recoup $6,000 of this,[45] so they would only end up paying $2,877 in tax.

Why should taxpayers subsidise the cost of other people's children in this way? And why should even wealthy parents benefit from a Child Tax Credit?

There are at least three reasons. First, if 'horizontal equity' is to be achieved (that is, people on similar earnings end up with similar disposable incomes), then taxes levied on income earners must take account of the number of people who are supported on their income. Secondly, income should only be taxed once, and the person who pays it should be the ultimate beneficiary (not necessarily the one who initially earns it). This means that children (the beneficiaries) should be recognised as income-receivers in the tax system. Thirdly, every citizen needs to ensure a subsistence income, which means every citizen should be entitled to a tax-free income up to subsistence level. If children are recognised as income receivers for tax purposes, it follows that they should also be given their own tax-free income allowance.

All parents are obliged by law to maintain and care for their children. Children therefore have a legal claim on at least a subsistence income from their parents. In effect, the law forces parents to transfer income-in-kind to their dependent children in order that they may subsist.

Yet under existing arrangements, means-testing of family support payments excludes about one family in four from receiving Family Tax Benefit (Part A) and children in these families are being denied a subsistence-level tax-free income allowance. However, like adults, even the richest children should be entitled to a tax-free allowance on the (imputed) subsistence 'income' they receive from their parents and so the subsistence income of children should not be taxed (which means, in effect, that it should not be taxed in the hands of the parent-trustees of that income). The current means testing of family support payments is illegitimate, and it creates substantial horizontal inequity between couples who choose to have children and those who do not.

It is sometimes argued that favouring children in this way creates inequity between taxpayers with children and those without. However there is no inequity if policy is kept stable over the life-cycle, because every individual as a child would already have benefited from the taxation relief enjoyed by his or her parents. Besides, there is a strong case for arguing that children are to some extent a 'public good' from which we all benefit, and therefore we should all contribute towards them. A tax and welfare system which did not compensate parents for some of their lost income consequent upon transferring some of their earnings to the subsistence of their children would effectively allow those who remain childless to 'free-ride' on those who invest in producing the next generation of citizens.

It is important that any system of tax allowances for children should not be conditional upon a mother or father either working or staying at home. There is no sound economic or social argument for privileging particular family choices in these matters, and their choices in any case are highly variable and oscillate over the family life cycle. Contributing to the growth of the human capital of a child who will regenerate the labour market is no less an economic contribution than market work itself.

How much would it 'cost' and can Treasury 'afford' it?

The proposal for raising zero-rate thresholds above the welfare subsistence floor and supplementing them with flat rate tax credits for dependent children would allow families with at least one full-time worker to be taken out of the means tested welfare system altogether. This would overcome the high EMTRs that arise under the present system as benefits are withdrawn because the only government payments they would be receiving would be non-means-tested child credits whose value would remain constant even if their earnings started to rise.

This, then, is the prize. Working families would retain more of what they earn, would become more self-reliant, and would escape the 'poverty trap' produced by the interaction of the tax and welfare systems. But is it financially possible to do it?

If the proposals were adopted, the existing battery of welfare payments propping up the incomes of people in employment who have dependent children would no longer be needed. Family Tax Benefit (Part A), Family Tax Benefit (Part B), Child Care Benefit and Maternity Allowance would be completely eliminated, generating an estimated saving of $13.2 billion per annum.[46]

RECOMMENDATION 6:
Abolish all existing means-tested family payments.

Against these savings, this proposal incurs new 'costs' to the Treasury of $10.3 billion to cover the higher tax-free thresholds, plus nearly $12 billion for the child credits.[47] Setting these against the savings from eliminating existing welfare payments leaves a net shortfall of just over $9 billion. If the cost of cutting the top rate taxes (Recommendations 1 and 2) were added, the shortfall would be closer to $15 billion. Does this mean the proposal is impractical?

It was not very long ago that Australia enjoyed a system not unlike the one proposed here. As recently as 1980, the zero-rate tax threshold was worth around $14,000 in today's money (although tax rates were somewhat higher then), and up until 1986 there was a universal family

allowance for families with children which was not means-tested or taxed. A single earner family with three dependent children living on an income one and a half times average earnings (equivalent to about $65,000 today) paid no tax. Indeed, after receiving child allowances, this family's final disposable income was 3% *higher* than its earned income.[48]

Since then, however, the tax burden on middle and upper income families has grown much heavier and changes in the tax and welfare system have redistributed income away from couples with children and towards single people, sole parents, and the elderly.[49] However, these trends are not inevitable and irreversible.

One of the problems that bedevils debates over tax and welfare reform is that bureaucrats and politicians think proposals for change should be 'revenue-neutral' (that is, governments must be allowed to continue to raise as much tax revenue under new arrangements as is currently raised under existing ones), and they want to ensure that no one loses out. These two conditions, if accepted, mean that nothing of any substance can ever change. Things can be changed at the margins (for example, the proposal for $2.5 billion of tax credits to reduce EMTRs by 4%), but anything more radical is ruled out in advance. If tax changes that would necessitate substantial expenditure reductions are ruled out, or if all reforms must ensure nobody is worse off than before, then the result can only be a continuation of the century-long escalation in tax and spending noted at the start of this paper.

Governments have for too long been absorbing too much tax and spending must be cut back. Rather than starting from the previous year's expenditure pattern and adding incrementally to it, they should be limited in what they spend by a prior judgement of what it is reasonable for them to raise in tax. In the 1940s, Keynes famously held that it would be counterproductive if governments were ever allowed to absorb more than 25% of GDP in tax.[50] In Australia, governments are now absorbing well over 30%, and it has indeed proved counterproductive. It is time to require our politicians to trim their spending to a budget rather than budgeting according to their spending plans.

A $9 billion revenue shortfall predicted under these proposals would require government spending to be cut back to make way for a fairer and less punitive tax regime. Elsewhere it has been shown how significant expenditure savings are possible from making desirable reforms to the welfare benefits system. Reforms to the Disability Support Pension designed to limit the pension to those who really are disabled would, for example, save between $500 million and $1.5 billion per year.[51] Time limits on unemployment benefits linked to an extension of Work for the Dole for those claiming for more than six months could generate in excess of $1 billion in annual savings.[52] And bringing Australia into line with most other OECD countries by expecting welfare parents to find part-time employment once their youngest child starts school would save around $1 billion on Parenting Payment (Single) and another $0.5 billion on Parenting Payment (Partnered).[53] Taken together, these three reforms, each designed to reduce dependency levels to something approaching 1980 levels, could save $3 or $4 billion, and that takes no account of the additional revenues which would accrue as former claimants move into employment and start to pay tax.

RECOMMENDATION 7:
Reform the eligibility rules for Parenting Payment, NewStart Allowance and the Disability Support Pension to reduce the number of claimants and require work where it is appropriate to do so.

Other significant savings are almost certainly possible in other areas of the federal Budget. Some $3.8 billion is calculated to have accrued between 2000 and 2005 simply as a result of 'bracket creep', and putting this together with our proposed welfare savings would bring us closer to the $9 billion savings target.[54] If still more revenue were needed to make up the difference, there is scope for so-called 'tax broadening',[55] or for raising GST. However, the emphasis should be on limiting spending, not raising new taxes.

Who gains and who loses?

Raising tax thresholds creates only winners. Nobody loses out if the zero-rate threshold is raised from $6,000 to $12,500 (for singles) or $19,500 (for couples), and anybody earning more than $6,000 per annum obviously gains. In absolute terms, everybody makes the same money gain (at a 17% tax rate, this works out at $1,105 per annum for singles and $2,295 for couples opting for shared taxation), but in relative terms, lower income earners gain more, because an increase in the threshold lowers their average tax rate more than it does that of higher earners. A single person on the minimum wage ends up paying 35% less tax ($2,061 as against $3,166), compared with just a 3% tax saving for the equivalent person earning twice the average wage ($31,755 against $32,859).

Table 4: Gains and Losses: Net income of selected household types before and after proposed reforms (not including rent assistance and Medicare Levy)

Household Type	*Gross Earnings*	*Welfare Benefits**		*Tax Paid**		*Net Income*	
		Before	*After*	*Before*	*After*	*Before*	*After*
Childless single person:							
No Income	0	10,147	10,147	0	0	10,147	10,147
Part-time, ½ Min Wage	11,658	3,512	3,512	962	0	14,209	15,160
Full-time, Min Wage	23,316	0	0	3,166	2,061	20,150	21,255
Mean Wage	48,993	0	0	10,869	9,765	38,124	39,228
2x mean wage	97,986	0	0	32,859	31,755	65,127	66,231
Single parent 2 children, 5-13:							
No Income	0	21,383	12,543	0	-6,000	21,383	18,543
Part-time, ½ Min Wage	11,658	18,228	9,388	962	-6,000	28,924	27,046
Full-time, Min Wage (w/ 50hrs childcare)	23,316 (19,529)	12,385	4,725	3,166	-3,938 (40,858)	33,714	31,979
Mean Wage (w/ 50hrs childcare)	48,993 (10,275)	3,132	0	10,869	3,765	41,256 (48,399)	45,228
2x mean wage (w/ 50hrs childcare)	97,986 (9,180)	2,037	0	32,859	25,755	67,164 (74,307)	72,231
Couple,2 children aged 5-13:							
No Income	0	27,148	18,302	0	-6,000	27,148	24,302
1 part-time on ½ Min Wage	11,658	20,536	11,696	962	-6,000	31,232	29,354
1 full-time on Min Wage (w/ 50hrs childcare)	23,316 (19,529)	12,385	3,545	3,166	-5,280	32,535 (39,679)	32,141
1 Mean Wage (w/ 50 hrs childcare)	48,993	3132 (10,275)	0	10,869	2,575	41,256	46,418 (48,399)
1 on twice mean wage	97,986	2,037 (9,180)	0	32,859	24,565	67,164	73,421 (74,307)

*Does not take account of rent assistance or Medicare Levy/Surcharge.

It should prove a major political attraction of our proposal that every working family in the country will be allowed to keep more than $20 per week more of their earnings.

Similarly, nobody is worse off if children are given a $3,000 per head non-means-tested tax credit. Again, in relative terms this is worth more to low income families than to those on higher incomes. In this case, however, the change is linked to the abolition of a raft of in-work means-tested benefits including Family Tax Benefit Parts A and B and Child care Benefit. This will inevitably create net losers as well as net winners.

Estimates using the Centrelink Customer Data Base for May 2002 suggest that replacing FTB and Child Care Benefit with a single $3,000 payment for all children up to 15 years would create almost as many families who are worse off (nearly one million whose incomes on average would fall by $3,337 per year) as families who are better off (nearly 1.2 million would on average gain $2,191 per year).[56]

Those who lose the most are the 613,000 recipient households on income support who lose an average of $3,756 per year. There is also a major effect on low income families earning less than $40,000 per annum—over 800,000 of them lose an average of $3,600. Almost half of those who are worse off are lone parent families relying on family payments—they lose an average of $4,143—although there are 60,000 lone parent families in the family assistance system who gain an average gain of $1,430.

It should prove a major political attraction of our proposal that every working family in the country will be allowed to keep more than $20 per week more of their earnings.

Most working families gain from the change. One million families with incomes over $40,000 per year see their net incomes go up by an average of $2,900. There are also three-quarters of a million couples with children who currently receive family payments but who still win from this change (average gain = $2,850).

These calculations do not take account of the proposed increase in tax thresholds. Table 4 compares looks at what single earners, single parents and coupled parents at different levels of income receive under current arrangements and compares this with what they would receive if means-tested family payments were replaced with a Child Tax Credit *and* the zero-rate thresholds were raised. For the sake of simplicity, rent assistance has been ignored, which is worth between $2,326 and $3,267 to low income families, depending on the number of children they have, and the Medicare Levy and Surcharge. Although we have suggested there is a strong case for reducing top tax rates and for reforming eligibility for various welfare benefits, we also assume for the purposes of this table that all current tax rates and welfare payment rates remain the same. All that changes is the zero-rate threshold and the system of child payments.

It is clear that the proposals tend to benefit working families at the expense of welfare families. This is hardly surprising given that the intention is to increase the rewards from working so as to strengthen the incentives that generate self-reliance.

Full-time workers

The principal objective driving our proposals has been to reduce the cripplingly high EMTRs experienced by low-to-middle income workers as they seek to improve their incomes. Table 4 shows this can be achieved with success.

The effect of our proposals on the EMTRs experienced by low-to-middle income earners can be seen by comparing the 'before' and 'after' net incomes of workers earning the minimum wage with those of workers earning the average (mean) wage. There is not much difference for single, childless workers, for they do not receive means-tested benefits under existing arrangements and therefore do not suffer from high EMTRs. The increased tax-free threshold delivers them a small increase in take-home pay at both the minium and the average wage, but the relativities do not shift.

For workers with dependent children, however, the effect of these proposals is huge. A single parent with two school-age children who increases his/her gross earnings from the minimum wage of $23,316 to the average wage of $48,993 currently retains just 29% ($7,542) of this increase. Under our proposals, he or she would retain 52% ($13,249) of it.

A couple with two children who opt for joint taxation make a similarly significant gain. Under existing arrangements, they keep just 34% of the increase in earnings; under these proposals, they keep 56% of it. If they are both working and opt for separate taxation, their total gain would be even greater as they would receive an additional $5,500 of tax-free earnings, most of it at 30% tax rate.

The big improvement in incentives for families with workers earning between the minimum and the average wage is achieved mainly by boosting take-home pay higher up rather than by depressing it at the minimum wage level. The one-earner couple with two children on an average wage enjoys a 13% increase in net earnings, while the same couple on the minimum wage suffers just a 1% decrease. For the single parent with two children earning the average wage, there is an increase in take-home earnings of 10%, although the decrease for the same parent earning the minimum wage is rather greater (5%).

The absolute gains achieved as workers approach the average wage are retained at higher income levels, but the relativities do not grow any bigger—indeed, the relative gain starts to fall back. At twice the average wage, for example, the net earnings of a single-earner couple with two children are 9% higher than at present (as compared with a 13% gain at the average wage), and the gains achieved by a single parent with two children are 8% higher (compared with 10% at the average wage).

Nearly all families with a least one worker in full-time employment therefore appear to benefit from the changes proposed. There are some small net losses at the very bottom of the earnings distribution at and around the minimum wage level, but these soon translate into gains as gross earnings start to rise. This is because the highest marginal tax rate levied on any worker in this income range is just 30% (as compared with 60%, 70% or even 80% under current arrangements). The effect of this incentives boost on activity levels (and hence on additional tax revenues) is likely to be substantial.

Raising the zero-rate threshold and replacing means-tested child payments with a flat-rate tax credit helps overcome the problem of high EMTRs for full-time workers.

Workers who are also on benefits

Raising the zero-rate threshold and replacing means-tested child payments with a flat-rate tax credit helps overcome the problem of high EMTRs for full-time workers because the only 'top-up' most of them will receive under these proposals is the non-means-tested child credit, and the only deduction they suffer as their wages rise is therefore the additional tax for which they become liable.

Potential 'poverty trap' problems remain, however, in the case of part-time workers (and, indeed, some low-income full-time workers) who are currently eligible for income support top-ups. In recent years there has been an increase in the number of welfare recipients who are also working—about one in eight of those claiming unemployment benefits have some income from paid work, and this mixed pattern of working and claiming is even more prevalent among those receiving Parenting Payment (Single). In the late 1990s it was estimated that 18% of income support recipients were receiving a part payment, almost all of them because they were also working in paid employment.[57]

Any part-time workers earning between $6,000 and $12,500 per year will see their EMTR reduced by 17% as a result of raising the zero-rate threshold, for they will no longer have to pay tax on each new dollar earned. But where people are earning over $12,500 and are still receiving benefits, our proposals will fail to reduce their EMTR.

Consider, for example, a single person on NewStart who undertakes some part-time work. They receive an allowance of $10,147 per annum, plus rent assistance, and are allowed to earn up to $1,616 without any loss of benefit. Beyond that, payments taper at 50 cents in the dollar for the next $2,086 of earnings, and at 70 cents in the dollar thereafter until the allowance eventually disappears altogether at $16,708. This is substantially more than the welfare floor which has been taken as the tax-free threshold cut-off, so under this proposal, this person still starts to pay tax at $12,500 even though they still also receive a small NewStart payment right up to $16,708. Despite raising the threshold, this claimant will still face an EMTR of 70% (the NewStart taper) plus 17% (the base rate tax)—a total of 87 cents lost in every extra dollar earned.[58]

For single parents, the problem extends across a much wider range of earnings. A sole parent with two children can earn up to $4,411 before Parenting Payment (Single) begins to taper at 40 cents in the dollar. Eligibility for a part payment continues until earnings reach $35,045 per annum. Raising the zero rate threshold to $12,500 would allow them to retain an additional $1,105 per year of earned income but once they get beyond $21,601 (the 30% tax rate threshold), sole parents would still be facing an EMTR of 70% or more.

If single parents are to be allowed to continue combining work with welfare (and this seems appropriate and sensible for those with children of school age), then it is inevitable that they will face high EMTRs as they increase the earned part of their income, for their eligibility for income support must taper out at some point. Only if the welfare payments were capped at the zero-tax threshold, or set the tax-free threshold at the maximum welfare level, could it be ensured that welfare tapers are not exacerbated by the onset of tax liability. Neither option is feasible. Workers earning above the welfare floor but below the welfare ceiling are therefore destined to live with high EMTRs.

This means that any effort to encourage greater work participation among this particular group of claimants would have to focus on changing the eligibility rules rather than improving the financial inducements. Oddly, very little of the extensive discussion that has been going on about how to get more sole parents into the labour force has thought about any strategy other than changing the inducements.

Elsewhere we have argued that full Parenting Payment should only be payable to families with at least one child under school-age, for once all children are at school it is reasonable to expect a principal carer to return to work part-time.[59] If this were written into the eligibility rules for Parenting Payment, we would not have to worry so much about the high EMTRs faced by sole parents as they combine work with welfare, for contributing towards their own living costs by finding part-time work once their children go off to school would become more a matter of personal responsibility than of financial calculation. For claimants with children over five, part-time work would be a condition of accessing Parenting Payment, and for those with children under five, there would be no need to create employment inducements since the system would expect to support them in their role as full-time carers.

If it is appropriate that some welfare claimants should work, then this should be a requirement irrespective of whether it 'pays' them to do so.

What this indicates is that the debate over EMTRs and work incentives cannot be separated from the debate over what levels of participation in paid employment we expect of different categories of welfare claimants. If it is appropriate that some welfare claimants should work, then this should be a requirement irrespective of whether it 'pays' them to do so. Improved financial inducements are not the only way of achieving greater workforce participation.

Welfare claimants with no other source of income

Those who lose the most net income from the changes outlined here would be people on welfare who do no paid work. Single jobless claimants would not be affected, but the net income (excluding rent assistance) of a jobless single parent with two children would fall from $21,383 to $18,543 (a 13% drop), and that of an inactive couple with two children would fall from $27,148 to $24,302 (a 10% cut). Part-time workers who supplement their incomes with welfare payments and who make extensive use of childcare would also be worse off as result of scrapping the Child Care Benefit (currently, parents on income support and those with earned incomes below $31,755 can claim a maximum Child Care Benefit of $2.74 per hour for up to 50 hours per week).[60]

While the net incomes of some welfare recipients would fall under these proposals, this does not necessarily mean that the proposals are flawed. While our total welfare spending is the third-lowest in the OECD, the value of net transfers to the poorest 30% of the population is the third-highest. There may therefore be some scope for adjustments to welfare-wage relativities without putting Australia out of line with other countries, and if these changes were phased in over, say, three years, the effect on those with net income losses could be softened.

Politically, however, it would be difficult to resist making some concessions to the those who lose the most. The simplest concession would be to reinstate the Child Care Benefit. But this would reactivate the problem of high EMTRs (because the benefit is means-tested), and it would add $1.7 billion to the cost of the reforms.

A slightly better alternative might be a means-tested 'Supplementary Child Allowance' targeted at very low income families. If this were valued at say, $2,500 per child (in addition to the flat-rate $3,000 child credit), it could make up the losses at the bottom end of the distribution. Like reintroducing Child Care Benefit, however, this is far from desirable, because it means recreating high EMTRs further up the income distribution as people start to increase their earned incomes.

A better compensation might be to limit supplementary payments to those parents whom are not expected to participate in paid employment (that is, those with children under school age) to avoid creating new work disincentives. This could be done by topping up the Child Credit, or by supplementing the Parenting Payment.

Raising the value of the Child Tax Credit for the under-fives from $3,000 to, say, $5,000 would help compensate as well as directing resources into the 'early years' where many commentators now believe extra help should be targeted.[61] Jobless families with two young children would gain $1,160, rather than losing $2,840, and families with two young children where a parent works part-time at a minimum wage job would go from losing $1,878 to gaining $1,122. But with about 1,230,000 children in the 0 to 4 age group, this option would be expensive, incurring an additional cost to the Treasury of just under $2.5 billion.

Alternatively, if the quarter of a million or so Parenting Payment claimants with children under school age were each given a supplement worth, say, $3,000, this would ameliorate many of the most severe losses incurred by parents of young children, be they coupled or single, at a cost of less than $1 billion. Rather than losing nearly $3,000, a single parent or couple living on benefits with two children would come out $162 ahead. Those combining benefits with part-time work would also be fully compensated.

RECOMMENDATION 8:
Consideration should be given to compensating those who lose most net income from these reforms by making a supplementary payment (in the form of additional Parenting Payment or an addition to the Child Tax Credit). This should be limited to parents with children under school age.

Would voters support the reforms?

Most voters support raising the tax-free threshold. A recent poll carried out by ACNielsen on behalf of The Centre for Independent Studies asked at what level of earnings people thought income tax should begin. The results (Table 5) reveal strong support for raising the personal tax threshold above the minimum welfare floor. More than four out of every five respondents believed that there should be a zero rate on all earnings below the welfare subsistence level.

Table 5: Public opinion and the personal tax-free threshold

At what level of earnings do you believe people should start to pay income tax?

	No	%
On every dollar they earn right from the first dollar	217	4
On earnings above $6000 per year (as now)	764	13
Not until they earn above basic welfare benefits level	2,445	43
Not until they earn above minimum award wage	2,014	35
People should not have to pay income tax	230	4
Don't know/No opinion	51	1
Total	5,721	100

Source: First CIS ACNielsen survey[62]

There are also important indications that the electorate would support cutting tax rates on higher earners, once they are informed how much tax people are currently paying. In another survey, we told respondents how much income tax is paid by people earning gross annual incomes of $30,000, $60,000 and $120,000 and asked whether or not they considered such tax levels to be 'fair'. Table 6 shows that substantial numbers of people think the current levels of income tax are unfairly high. Even when considering the tax levied on high income earners, fewer than 10% of the public think it is too low, while 45% think it is too high.

In a later paper in this series, Andrew Norton will examine public opinion data on tax issues in more depth, but it does seem from these results that there would be substantial voter support for cutting the top rate as well as raising the zero-rate threshold.

Table 6: Fairness and unfairness of current income tax levies on single person's annual income

	$30,000	*$60,000*	*$120,000*
Tax paid is unfair (too high)	41	46	45
Tax paid is fair & reasonable	58	51	45
Tax paid is unfair (too low)	1	3	9

Notes: Q.1: A single person with no dependents who earns $30,000 a year loses about 20% of this ($5,830) in taxes and levies. In your view is this tax deduction (a) Unfair (they should pay less); (b) Fair and reasonable; (c) Unfair (they should pay more)?
Q.2: A single person with no dependents who earns $60,000 a year loses about 30% of this ($17,080) in taxes and levies. In your view is this tax deduction (a) Unfair (they should pay less); (b) Fair and reasonable; (c) Unfair (they should pay more)?
Q.3: A single person with no dependents who earns $120,000 a year loses about 40% of this ($46,780) in taxes and levies. In your view is this tax deduction (a) Unfair (they should pay less); (b) Fair and reasonable; (c) Unfair (they should pay more)?
Source: Second CIS/ACNielsen opinion survey.[63] N=466 (questions 1 and 3), 464 (question 2).

Conclusion

Everybody accepts that something needs to be done to reduce the crippling disincentives in the Australian income tax system. The main ones are the high top tax rates that cut in at very modest levels of income, and the high EMTRs that penalise initiative and effort in the low-to-middle income range. Leaving things as they are should not be an option.

People's incomes are taxed too highly, and this is combined with one of the most targeted system of means-tested income support in the western world. The result is that working families get hit by high tax levies at the same time as they lose eligibility for welfare benefits. If you are earning between $25,000 and $45,000, it can sometimes feel as if the government simply does not want you to work harder and raise your income.

Solving the problem at the upper end is easy, and it may not even cost much in foregone revenue. The top tax rate should be no higher than 40%, and the threshold should be significantly higher than it is currently.

Solving the problems of EMTRs lower down is extremely difficult. We can introduce marginal improvements like the earned income tax credit, but even marginal measures create new disincentives elsewhere, and they leave the core of the problem little changed. In this paper, we have shown how we could make a much bigger impact on the problem by raising tax-free thresholds and replacing means-tested child payments with a flat rate child tax credit. This would benefit almost every full-time worker in Australia, and it would dramatically improve incentives and rewards for those earning between the minimum wage and the average wage. However it cannot be done without some people being worse off (although there are ways of compensating them without compromising the spirit of the reforms).

The temptation for politicians will always be to support reforms that only create winners. This is precisely how 'Tax Freedom Day' came to shift in the course of 100 years from 24 January to 22 April, for buying support from one section of voters while avoiding unpopularity

among all others inevitably drives total government spending, and hence the total tax burden, ever further upwards. The time has come to reverse this trend.

Reducing the punitive taxes on higher income earners, and changing the way the tax and welfare systems interact lower down the income scale, cannot be achieved without significant reductions in overall government spending to get us back to where we were 20, 30 or 40 years ago. Some sceptics might look at the revenue implications of our proposals, or at the politics of reform, and conclude that it cannot be done. But inaction is no longer an option, and only radical reform can deliver. To paraphrase Sherlock Holmes, when you have ruled out every other possibility bar the least likely, then the least likely is the only solution.

Endnotes

[1] Income tax and company tax together accounted for 17.1% of GDP in 2002-3 (*The Australian,* 3 November 2003).

[2] 'Taxation' ABS*, Year Book* (Canberra: ABS, 2003), Table 27.19.

[3] According to the SPRC's Peter Saunders, for example, we need to 'bring the rich back within the sight of the rest of society'. See P. G. Saunders, 'Welfare Reform, Work and The Labour Market', *Economic and Labour Relations Review* 12 (2001), p.153. The recent Senate Inquiry into poverty heard many comments like this from academics and the welfare lobby, and it too ended up arguing that higher income earners must 'surrender' more of their wealth. See Senate Community Affairs References Committee, *A Hand Up Not a Hand Out* (Commonwealth of Australia, March 2004), Para 18.54.

[4] Peter Saunders, *The Ends and Means of Welfare* (Melbourne: Cambridge University Press, 2002), p.248.

[5] 'Greed, Poverty and Compassion', Paper to the ALP Round Table on Poverty (Canberra, 18 October 2002), p.7. The British Labour MP, Frank Field, has noted how support for high taxes in that country 'became a proud badge for the Left to wear'. See F. Field, *Welfare Titans* (London: Civitas, 2002), p.64. Much the same appears to be true here.

[6] ACOSS, *Taxation in Australia,* ACOSS Info 347 (June 2003), pp.3,15. Julian Disney, 'Some Future Directions for Australia', in P. Duncan & R. Maddock (eds), *Aspire Australia* (Melbourne: Business Council of Australia, 2002), p.52. Michael Keating, 'The Case for Increased Taxation' *Policy Paper.1* (Canberra: Academy of the Social Sciences, 2004), p.6.

[7] Despite promising that the 'new tax system' introduced in 2000 would reduce personal taxes to compensate for the GST which was imposed on the goods and services people buy, income taxes have climbed back above where they were before the GST was introduced. Personal income tax was 11.9% of GDP in 1995/6, when the Howard government was first elected, and was 12.3% of GDP in 2002/3, despite the cuts at the time GST was introduced (Brian Toohey, 'What Costello Won't Tell You About Your Tax', *The Australian Financial Review,* 1-2 February 2003). Income tax and company tax together accounted for 17.1% of GDP in 2002-3 (George Megalogenis, 'Public Investment Off Costello Menu in Taxing Times', *The Australian,* 3 November 2003). When it entered office, the Howard government inherited income tax legislation running to an indigestible 3,500 pages. Six years later, this had expanded to 8,500 pages (Fleur Anderson, 'Our Taxes are Like a War on the People', *Daily Telegraph,* 18 November 2002)

[8] 'While total tax revenue in Australia is 20% below the OECD average, income taxes as a percentage of GDP are about 30% above the OECD average. The income tax structure is also very progressive, making it difficult to raise revenues further without exacerbating problems of avoidance or evasion. Alternatively, across the board income tax increases are likely to be politically unpopular'. See P. Whiteford and D. Stanton, *Targeting, Adequacy and Incentives* paper given at the 9th International Research seminar on Issues in Social Security (Sigtuna, Sweden, 15-18 June 2002), p.45.

[9] This is paid by employers but is obviously a deduction from the wage fund available for remuneration of employees.

[10] Australia and New Zealand are unique in the OECD for having no contributory social security scheme. Logically, employee contributions should be added to income tax when calculating personal tax levels, for they are compulsory and revenue from them is pooled. There is an argument that the 9% superannuation levy in Australia should also count as 'taxation', although these payments go into people's personal funds and might therefore better be seen as 'compulsory savings' than as taxes. The figures for combined income tax and employee social security contributions are derived from Table 12.1 by adding them together and expressing them as a proportion of the total tax receipts given in the first column. For Australia, 36.7% of the 31.5% of GDP raised in taxes = 11.56% of GDP taken in income tax; for the OECD average, (26.0+7.9) = 33.9% of the 37.4% of GDP raised in taxes = 12.68% of GDP in income tax and employee contributions.

[11] It is estimated that failure to index tax brackets to CPI means that the federal government will collect $3.8 billion more in tax in 2005/6 than in 2000/01. See H. Buddelmeyer et al, 'Bracket Creep, Effective Marginal Tax Rates and Alternative Tax Packages' (Melbourne: Melbourne Institute/*The Australian*, 2004), p.17.

[12] When it came to power in 1996, the top quarter of income earners paid 60.8% of all income tax; by 2001 this had risen to 64.1%. See Sinclair Davidson, 'Lies and Statistics' (*AFR,* 21-22 February 2004). See also S. Davidson, *Some Hard Truths About Personal Income Tax* (Sydney: The Centre for Independent Studies [CIS], forthcoming).

[13] S. Barber, 'Taxpayers in the Top Tax Bracket', *Research Note* 47 (Canberra: Parliamentary Library, 29 March 2004).

[14] *The Weekend Australian,* (21-22 February 2004); H. Buddelmeyer, P. Dawkins, J. Freebairn and G. Kalb, 'Bracket Creep, Effective Marginal Tax Rates and Alternative Tax Packages', *Melbourne Institute Quarterly Bulletin* 1.04, 17-28.

[15] G. Walker, *The Tax Wilderness*, Policy Monograph 62 (Sydney: CIS, 2004), p.10.

[16] P. Whiteford and G. Angenent, *The Australian System of Social Protection* (Canberra: FaCS, 2001) p.50.

[17] The following figures are derived from Centrelink, *Parenting Payment Rates 1 January—19 March 2004* (C0032.0401), Chart C. Sole parents can also claim Family Tax Benefit, Part B (worth between $2,037 and $2,920 per annum depending on age of youngest child), which is not means tested.

[18] As of early 2004, those earning less than $21,600 (the 17% marginal tax rate ceiling) were eligible for a rebate of $235, which then reduces by 4 cents for every dollar earned, phasing out completely at $27,475.

[19] The Australians Working Together package has tried to ameliorate this problem by introducing the new Working Credit which allows benefits to be phased out over a period of time when people begin work. This does not solve the problem—it simply delays its impact.

[20] Lauchlan Chipman, 'A Just Society Repays Effort', *The Australian (*6 January 2004).

[21] G. Beer, ''Work Incentives Under a New Tax System', *The Economic Record* 79 (Canberra: NATSEM, 2003), pp.S14-S25. A report prepared by the Office of Status of Women in 2003 estimated that almost 1 million people were losing at least 60 cents in the dollar of additional earnings. See Sid Marris and Michael McKinnon, 'Howard Battler Tax Slog Revealed', *The Australian (*18 September 2003). Although recent reforms have ameliorated the worst problems, some extreme cases remain where people can actually end up worse off if they increase their earnings. See Bettina Arndt, 'Not Just Small Change' *The Sydney Morning Herald* (11 December 2002).

[22] *Weekend Australian (*21-22 February 2004).

[23] A. Duncan and M. Harris, 'Simulating the Behavioural Effects of Welfare Reforms Among Sole Parents In Australia', *The Economic Record* 78 (2002), pp. 264-76.

[24] H.Buddelmeyer et al, 'Bracket Creep', p.20.

[25] '21% of those in the first income decile have EMTRs in excess of 50%, 19% have EMTRs in excess of 70%. The situation in the second income decile is even worse with 31% having EMTRs over 50% and 27% facing EMTRs in excess of 70%. Across all deciles about 16% have EMTRs in excess of 50% and only 8% are on EMTRs over 70%'. See H. Buddelmeyer et al, 'Bracket Creep', p.18.

[26] For the original proposal, see Peter Dawkins, 'A Plan To Cut Unemployment in Australia', *Mercer-Melbourne Institute Quarterly Bulletin of Economic Trends* 1/99 (1999) pp. 48-59.

[27] P. Dawkins, A. Duncan and J. Freebairn, *Modifying Income Support in The Australian Tax and Transfer System,* Paper to the 'Pursuing Opportunity and Prosperity' conference (University of Melbourne, November 2003)

[28] H. Buddelmeyer et al, 'Bracket Creep', p.22.

[29] The same effect of increasing disincentives higher up the income scale has been noted of both the American and UK tax credit systems. See Gary Burtless, 'Can Supply-Side Policies Reduce Unemployment?' *Australian Economic Review* 35 (2002), pp. 3-28, suggests that the number of discouraged middle earners in the US far outweighs the number of welfare recipients who are encouraged to move into work. Philip Collins and Roger Wicks, 'Special Report on Means Tests and Tax Credits', *Prospect* (May 2003), 50-55 talk of a new 'middle income trap' in Britain, showing how a couple with two children earning $250 per week now gain only a 6% increase in net income from a 20% rise in earnings.

[30] Supporters of the EC have acknowledged that it would impact on second earners but argue that this is a price worth paying in order to encourage more people from wholly welfare-dependent households into work. See, for example, Peter Dawkins, 'A Tax System for Workers', *The Australian Financial Review* (29 January 2003).

[31] In Britain, the proportion of households eligible for means tested government support rose from 17% in 1997 to 29% in 2003 due largely to the introduction of tax credits. See Philip Collins and Roger Wicks, 'Special Report on Means Tests and Tax Credits', p.54.

[32] In the UK, the credits originally introduced by the Blair government—the Working Families Tax Credit and Child Care Tax Credit—were replaced in April 2003 by a more generous and more extensive Child Tax Credit, and a new Working Tax Credit (for low earners with no children) was also introduced for the first time. See M. Brewer, T. Clark, M. Wakefield, 'Social Security in the UK Under New Labour', *Fiscal Studies* 23 (2002), pp. 505-37. The Institute for Fiscal Studies (quoted in Frank Field, *Welfare Titans,* pp. 5, 54) put the proportion of families with children eligible for the old Working Families Tax Credit at 83%. Donald Hirsch, 'Poverty: The Uphill Struggle', *New Statesman* 16-30 (December 2002), p. 26, puts the proportion eligible for the newly introduced Child Tax Credit at 85%. All families with a household income under UK$50,000 get at least $10 per week in addition to $26.50 child benefit.

[33] Frank Field, *Welfare Titans*, p. 5.

[34] David Smith, 'Welfare and Work' in D.Smith (ed), *Welfare Work and Poverty* (London: Civitas, 2000): 'Families… who had never been near the social security system, apart from receiving child benefit, could qualify for the new credit… it is extending dependency to those on higher incomes', p.31.

[35] See F. Field, *Welfare Titans*; P. Collins and R. Wicks, Special Report on Means Tests and Tax Credits', *Prospect* (May 2003), pp. 50-55; Department of Family & Community Services, *International Comparisons and the International Experience With Welfare Reform,* FaCS Paper (6 September 2002).

[36] See P. Dawkins et al, *Modifying Income*; C. Richardson, 'Reducing Unemployment', in Business Council of Australia, *Rebuilding the Safety Net* (Melbourne: BCA, Melbourne, 2000), pp.44-46.

[37] M.Brewer et al, 'Social Security in the UK', p. 510.

[38] FaCS, *International Comparisons*.

[39] H.Buddelmeyer et al, 'Bracket creep', p.22.

[40] T.Dwyer, *The Taxation of Shared Family Incomes,* Policy Monograph 61 (Sydney: CIS, 2004).

[41] Under Dwyer's proposals, it would be for each family to choose how it wants to be assessed. Many working couples would probably prefer to continue filing separate tax returns so that each can retain their own tax-free

threshold. They would be free to do so. Couples where there is only one earner, however (and especially those who also have dependent children) might prefer to transfer part of the threshold of the non-working partner to the working partner.

[42] In recent years, the Federal government has tried to counter some of the inequity in the tax treatment of individuals and couples by giving certain categories of families a welfare top-up. Family Tax Benefit, Part B, for example, is paid to families where there is only one earner to try to compensate them for the disadvantages they suffer through the tax system. The result, however, is a tangle of money transfers in which people get tax taken from them only to have some or all of the cash returned in the form of welfare payments. This is not only costly—it is also wrong in principle. We should not be taxing families until they have secured their own subsistence—and a family's subsistence level will be higher than it is for single people or couples without dependent children.

[43] ACTU, *2004 Minimum Wages Case Fact Sheet* www.actu.asn.au

[44] For example: B. Maley, *Family and Marriage in Australia* (Sydney: CIS, 2001).

[45] Reimbursement could be through an annual rebate or by adjusting weekly PAYG calculations.

[46] Total spending on Family Tax Benefits is $10,912,110,000. Maternity Allowance costs $216,634,000 and childcare support is another $1,692,371,000. We would also scrap the low income tax offset (a means-tested rebate aimed at raising the tax-free threshold for low income earners to $7,382) which costs another $392,020,884. Sources: 'Actual expenses 2002-03' *Budget and Additional Estimates 2003-04*; *2003-04 Budget paper No.1*, Part 3, Statement 5; Australian Taxation Office, *Taxation Statistics 2000-2001*. We are grateful to Caspar Conde for his work in producing these and subsequent calculations.

[47] The cost of raising the threshold assumes current tax rates of 17% up to $21,600. There are 8,343,000 income tax payers. We estimate that 967,681 of these would opt for the shared couple threshold of $19,500 (this includes all the 621,681 taxpayers currently receiving FTB (Part B), plus 346,000 couples where there is a single earner but no children). The remainder are assumed to opt for the individual threshold of $12,500. The total cost is therefore: (12,500-6,000) * 0.17 * (8343000-967681) + (19,500-6,000) * 0.17 * 967681 = $10,370,555,390.

There are 3,984,178 children under the age of 15. A tax credit worth $3,000 would therefore cost $11,952,534,000 per year.

[48] L. Sullivan, *Taxing the Family,* Policy Monograph 50 (Sydney: CIS, 2001).

[49] As above.

[50] G. Walker, *The Tax Wilderness,* Policy Monograph 60 (Sydney: CIS, 2004), p.9.

[51] P. Saunders, 'Why We Must Reform the Disability Support Pension' *Issue Analysis* 47 (Sydney: CIS, April 2004). It is estimated that at least 300,000 current DSP claimants are not 'disabled' in the sense oif being incapable of working. If they were transferred from DSP onto Newstart, the saving would be $500m per year. If just one-third of these transferees subsequently found employment or exited NewStart for some other reason, this would save at least another $1 billion.

[52] The estimate is based on evidence of the compliance effect of the existing Work for the Dole scheme. If a work programme similar to WFD were put in place for all claimants who had been unemployed for six months, and if full-time and continuing participation was required in return for a dole-level wage, we could probably expect the long-term unemployment rate as recorded by the Department of Family and Community Services to fall by more than 100,000. Of course, this scheme would incur some increase in total administration costs--the total additional cost of extending WFD to all those on benefits beyond 6 months could be around half a billion dollars. However, the savings from people leaving welfare would easily out-weigh these additional costs, and the total net saving should be well in excess of $1 billion per year. See P. Saunders, *Welfare Isn't Working* (Sydney: CIS, forthcoming), which revises estimates originally outlined in P. Saunders, 'How to Reduce Long-Term Unemployment' *Issue Analysis* 40 (Sydney: CIS, September 2003).

[53] Requiring all PPS and PPP claimants whose youngest child is at school to seek part-time work would enable their current Parenting Payment entitlement to be halved. This would affect about 110,000 sole parents and over 60,000 partnered parents whose children are all above school age but who are nevertheless still living full-time on welfare. If these people found part-time work, and their Parenting Payment were halved, over one billion dollars would be saved each year on PPS payments plus as much as half a billion on PPP outlays. We estimate 111,000 sole parents are currently claiming full PPS even though their children are all over 5 years of age. The savings would accrue from these claimants going on to half rate. See P. Saunders, *Welfare Isn't* Working, and P. Saunders and K. Tsumori, 'The Tender Trap', *Issue Analysis* 36 (Sydney: CIS, June 2003).

[54] The $3.8 billion is estimated in H. Buddelmeyer et al, 'Bracket Creep'.

[55] H. Buddelmeyer et al, 'Bracket Creep', estimate that as much as $10 billion could be saved every year by removing special tax deductions and exemptions, and while much of this should be devoted to reducing top tax rates. Every $1 billion saving could fund a 2% reduction in the top marginal rate or a $16,000 increase in the top rate threshold. One or $2 billion could be syphoned off if necessary to meet any remaining shortfall resulting from the raising of the zero-rate threshold.

[56] Figures computed by Department of Family & Community Services.

[57] J. Pech and J. Landt, 'Work and Welfare', *Family Matters* 58 (Autumn 2001), pp. 22-27.

[58] The new 'Working Credit,' introduced in September 2003, can ameliorate this problem but cannot solve it.

The Working Credit allows claimants to build up a maximum of $1,000 of credits to offset against earnings. Credits accumulate at a rate of $48 per fortnight for those with no earned income. But while this is useful in smoothing lumpy transitions between welfare and work (e.g. when claimants take on short-term employment), it would do nothing to prevent high EMTRs for those who combine welfare with employment over an extended period. See FaCS Fact Sheet, *Australians Working Together: Programmes and Services* http://www.together.gov.au/programmesAndServices/workingCredit/default.asp

[59] Saunders & Tsumori, 'The Tender Trap'.

[60] The minimum rate is payable on incomes over $91,035 (for 1 child in child care), $98,709 (for 2 children) and $112,136 (for 3 children), see www.centrelink.gov.au/internet/interbet.nsf/payments

[61] The principle of targeting extra help on families with pre-school children (the 'early years') has widespread support. Peter McDonald, 'Reforming Family Support Policy In Australia', *People and Place* 2:11 (2003) recently proposed a cash payment for all children aged nought, one, and two, of $6,500 per annum; a cash payment for all children aged three and four of $2,500 per annum; allocation by the Commonwealth of $4,000 per child aged three to four years to a new jointly-funded Commonwealth-States early childhood scheme education and care scheme. These payments would start to be means-tested at a family income of 'around $100,000'. Low income families (under about $30,000) would receive higher payments through receipt of the maximum payment rates of Family Tax Benefit A, but sorting out the intersection between Benefit Part A and the Parenting Payment is not discussed, nor is the possibility of high EMTRs in means-testing these benefits considered. McDonald gives no overall costings of his scheme. He admits that there will be losers, but they are not identified.

McDonald's scheme seems to envisage no child support beyond ages 0-4, except for low income families below about $30,000 p.a. who would continue to receive the full benefits of Family Tax Benefit Part A plus parenting payment or some part thereof. He recommends (as we do) that Family Tax Benefit Part B, the Maternity Allowance, and the Child Care Benefit, be scrapped. His scheme has the virtue of reducing some of the complexity and incoherence of present arrangements, but it would leave parents other than low income parents bereft of child allowances after the first five years; that is, for two-thirds of the minimum period of dependency. The proposal mandates early childhood education as a condition of getting a public benefit even though many parents would not want their children to participate and would therefore be penalised.

[62] The survey was based on a sample of 5,721 Australian residents linked to the ACNielsen Australian Internet User Survey. Between 12 and 27 March 2003, people completing the internet user survey were also invited to do the CIS survey (4,369 people did so); in addition, a random sample of 4,369 respondents who had completed the user survey before 12 March were recontacted, and 1,352 agreed to participate in the CIS survey. This is not a probability sample design, for it is based on self-selection, so inferential statistics (including standard errors) are inappropriate. There are reasons to believe that people who use the internet are a peculiar and specific section of the whole population—not a cross-section of it—and there is the normal survey bias problem that those in the target population who agree to participate in the survey may be quite unlike those who refuse.

These problems can be rectified to some extent by weighting. The final sample was weighted by gender, age, state of residence and annual income to bring it into line with population estimates by the Australian Bureau of Statistics. This is a standard survey procedure for correcting sample biases, but it is not ideal, for there is no guarantee that the sample will turn out to be representative on other, uncontrolled, characteristics. To check for this, we ran two tests of 'external validity'. The first compares our respondents' stated voting intentions and reported past voting behaviour with opinion poll data for the same period. This suggests there may be a small skew against Labor supporters in our final, weighted sample. The second compared our data on marital status with that recorded in the first wave of the Household Income and Labour Dynamics (HILDA) survey. The two surveys appear broadly consistent, although ours slightly overestimates those who had never been married and those who had been divorced/separated, and slightly underestimates those who are married. Overall, the weighted survey appears to generate reasonably valid population estimates, but the results should still be treated with some caution, for this is not as valid a survey as a more conventional probability sample would have been.

[63] Unlike the first survey, this second survey was carried out according to a probability sampling design. The target population was 1,850 internet users, of whom 467 (25%) responded. The sample appears representative of the Australian population as a whole when checked against national data on age, gender, income, state and region, and has not therefore been weighted. The survey was conducted in early August 2003.

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