Taxation and Social Security: An Overview

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AN OVERVIEW

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Russell Ross
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Peter Whiteford

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ABSTRACT

This paper provides an overview of the interrelationships between the taxation and social security systems in Australia. The paper describes the interaction between the two systems in terms of the overlaps between income tests and the income tax rate scale and common populations. The paper then discusses objectives common to the taxation and social security system, referring particularly to assistance for families, tax expenditures and assessment of the redistributive impact of current arrangements. The paper reviews two recent suggestions for change - the proposed introduction of a broad-based consumption tax and proposals to income-test the tax threshold - and assesses the compensation packages associated with these reforms. The paper then outlines how possible poverty traps develop because of the interaction of the two systems and canvasses some approaches to alleviating these poverty traps. The paper concludes that the growing interaction of taxation and social security reflects both conscious policy changes and economic and social developments, which mean that the issues identified will remain of concern for some time to come.

1. INTRODUCTION

The past twenty years has seen a very significant growth in the scope, impact and cost of the Australian social security system. This growth has parallelled similar developments in most OECD countries, where the increases in costs and coverage of social insurance provisions were seen for many years as an inevitable effect of the maturation of the welfare state provisions introduced after World War Two. Whether comparable developments in Australia are seen as a necessary and humane public response to changing social and economic pressures or as a sign of an unwelcome increase in dependence upon public support, the current economic significance of social security provisions cannot be denied.

In 1966, for example, social security recipients made up about 7.4 per cent of the total population, with there being 17.5 persons receiving these payments for every 100 persons in the labour force. By 1987, in contrast, these proportions had increased to 17.5 per cent and 37.0 per cent respectively.[1] At the same time as the number of social security recipients has increased, the costs of these provisions have also grown, and they are now the largest single item in the Commonwealth Budget; outlays on social security and welfare being estimated as 28.6 per cent of total outlays in 1987-88 (Australia, Budget Statements, 1987-88, p.74).

These trends, together with increased spending on other areas of social policy, have required substantial increases in taxation revenues. Between 1966 and 1986, total Commonwealth taxation revenues increased from $20,247 million to $58,399 million (in 1984-85 terms), or from around $1,700 per capita to around $3,670 per capita, growing from 20.0 to 25.2 per cent of Gross Domestic Product (Moore and Whiteford, 1987, p.47).

In the context of these developments, the interrelationship between taxation and social security provisions has increasingly become a focus of interest to both researchers and policy makers. It can be argued that taxation and social security are closely linked in a number of ways (Sandford, 1980, pp.1-9; Harding and Whiteford, 1986, pp.3-6):

- **Taxation and social policy provisions overlap** - The populations paying tax and receiving social security payments are not distinct, but share members in

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1 These figures understate the coverage and growth of social security provisions since they do not include the children of recipients, while the total population figures include children. In addition, the proportion of children of social security recipients has grown at a rate faster than has the recipient population.

common. The combined effects of the taxation and social security systems therefore need to be considered together.

- **Taxation is itself an instrument of social policy, but may also negate the effects of other social policies** - The taxation system, together with the social security system, are the two key instruments of redistribution. Alternative forms of income support can be provided through either system (e.g. direct transfers or tax credits), and taxation concessions can be directed towards specific social policy goals (i.e. through tax expenditures). Taxation policies, however, can undercut social policy goals; for example, indirect taxes or increases in direct taxes at low income levels can reduce the adequacy of social security payments. Alternatively, and as a consequence, social security programs can be used to offset the undesirable effects of otherwise desired tax changes.

- **Taxation and social policy provisions may both have effects on economic growth** - The rate of economic growth is relevant to the capacity of the economy to afford improvements in social benefits, while declines in growth leading to higher unemployment place new calls on existing resources. The impact of taxation and social security on economic incentives therefore requires investigation. A particular concern is the overlap between income tax and social security and other income tests which may produce 'poverty traps'.

- **Taxation finances social policy** - As noted by Sandford (1980, p.1), it is a truism that almost all social policy requires expenditure, and that at least in the long term and if taxation is suitably defined, then the main means of financing is taxation. A more specific issue in this regard is what form that financing should take - should social security be financed through social insurance principles (contributions) or from general revenue, as is currently the case in Australia.

This paper provides an overview of certain of these issues. The chapter is organised as follows. Section 2 describes the structure of the relevant parts of the social security and taxation systems and outlines the ways in which the two structures interact, as well as discussing the development of current arrangements. Section 3 deals with some of the social policy objectives sought through the taxation system, in particular the provision of income support for families and the achievement of redistribution through taxation and social outlays. Taxation expenditures are briefly discussed. Section 4 outlines some of the ways in which proposals for change to the taxation system can have a negative impact on the living standards of low and moderate income groups. This section concentrates on the 1985 debate on proposals for a broad-based consumption tax and possible methods of compensation for low income groups, as well as more recent proposals to abolish or income-test the tax threshold. Section 5 deals with high effective marginal tax rates produced by the interaction of the taxation and social security systems, and the resultant possibility of 'poverty traps'; these being circumstances in which social security pensioners or beneficiaries may find that any efforts to increase work effort may result in only a very small increase in disposable income, if any. The paper then discusses a range of proposals that address the concern with poverty traps through some form of integration between the taxation and social security systems. This and the previous section touch in passing on some aspects of the issue of financing.

2. THE INTERACTION OF TAXATION AND SOCIAL SECURITY

2.1 Overlaps

The interaction between taxation and social security is produced by the structural features of the two systems; that is, overlaps occur because of the level of social security payments available to different types of income units, the varying tax treatment of those payments and the nature of the income tests applying to other sources of income, as well as the income tax rate scale, personal tax rebates and Medicare arrangements.

Some of the main effects of social security income tests are shown in Table 1, while Table 2 provides details of income tax arrangements for 1988-89. Table 3 shows how the systems interacted in the case of a sole parent with one dependent child and renting privately for the period July to December 1988.[2] For example, such persons would effectively start paying tax at the 24 per cent rate once private incomes exceed about $40 per week; they would then start to have their pension reduced by 50 cents in the dollar once private incomes are higher than $52 per week, and they would pay tax on the remaining 50 cents; they would enter the 29 cent tax bracket at private incomes of around $191 per week, and at private incomes around $292 per week, the non-taxable payments for children start to be reduced;[3] at private incomes of $349 per week, the Medicare levy becomes payable at the phase-in rate of 20 per cent, and is fully phased-in by around $373 per week, from whence it simply adds 1.25 per cent to the marginal tax rate rate; at $374 per week, the pensioner starts to pay the 40 per cent tax rate, but at around $390 per week all pension entitlements cease, and the individual is subject to the normal tax scale.

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2 This example uses weekly rates of payment in effect between July 1988 and December 1988 together with the 1988-89 tax scale reduced to its weekly equivalent.

3 Because additional pension, mother's guardian's allowance and rental assistance are not taxable income, pensioners with total incomes in this range must pay tax at the 29 per cent rate on the whole dollar of private income, even though they lose 50 cents of (non-taxable) payment. This produces the higher effective marginal tax rates shown in the table.

TABLE 1 : RATES OF PAYMENT AND INCOME LIMITS FOR PENSIONS, AND UNEMPLOYMENT AND SICKNESS BENEFITS - SELECTED CATEGORIES, JULY TO DECEMBER 1988

Status of pensioner or beneficiary	Rate of Payment $ p.w.	Maximum pension or benefit payable if private income does not exceed $ p.w.	No pension/benefit payable when private reaches (1): $ p.w.
Single pensioner without dependents	120.05	40.00	280.10
Sole parent pensioner			
- with one child (2)	154.05 - 160.05	52.00	360.10 - 372.10
- each additional child, add (2)	22.00 - 28.00	12.00	56.00 - 68.00
Pensioner couple without dependents	100.05 each	70.00	470.20 (combined)
Pensioner couple with dependents			
- with one child (2)	222.10 - 228.10	82.00	526.20 - 538.20
- each additonal child, add (2)	22.00 - 28.00	12.00	56.00 - 68.00
Pensioners receiving rental assistance, add	15.00	-	30.00
Single unemployment or sickness beneficiary aged 21 years and over and without dependents	112.10	30.00	162.10
Unemployment or sickness beneficiary couple without dependents	200.10	30.00	250.10
Beneficiary couple with dependents			
- with one child (2)	222.10 - 228.10	30.00	(3)
- for each additional child, add (2)	22.00 - 28.00	-	(3)
Beneficiaries receiving rental assistance, add (4)	10.00 - 15.00	-	10.00 - 15.00

NOTES:

(1) Age and invalid pensions paid to the permanently blind are free of income test, and age pensions for those aged 70 years or more are subject to a special income test.

(2) The lower rate is payable to those with dependents aged under 13 years and the higher rate is payable to those with dependents 13, 14 or 15 years of age. These figures do not include family allowances.

(3) Beneficiaries with children and with incomes above $250.00 per week would receive higher rates of assistance from the family allowance supplement (FAS), which is reduced by 50 cents in the dollar of joint income over $300.00 per week (plus $12.00 per week for each of the second and subsequent children).

(4) Rent assistance of up to $10.00 per week is payable to single beneficiaries over 24 years of age or married or aged 18 to 24 years and not living with parents or guardians and who have been in receipt of benefit for 26 weeks or more. Rent assistance of up to $15.00 per week is payable to beneficiaries with dependent children under 16 years of age.

TABLE 2 : PERSONAL INCOME TAX ARRANGEMENTS 1988-89

1. **Tax Scale**

Range of taxable income ($ per annum)	Marginal Rate (Cents per $)
0 - 5,100	0
5,100 - 12,600	24
12,600 - 19,500	29
19,500 - 35,000	40
35,000 and over	49

2. **Personal Tax Rebates**

Rebate	Level ($ p.a.)	Income Tests
Dependent Spouse		Reduced by $1 for every $4 by which dependent spouse's income exceeds $282 p.a. The higher rate is paid only to those with a 'dependent' child whose income must be less than $1,786 p.a.
- with children	1,030	
- without children	830	
Sole parent	780	Income test on child's income, as above.
Pensioner (single and each of couple)	430	Reduced by 12.5 cents for every $1 by which taxable income exceeds $6,892.
Beneficiary		Reduced by 12.5 cents for every $1 by which taxable income exceeds $6,184 for single beneficiaries and $11,059 for couples (married or de facto).
- single	260	
- couple	600	

Medicare

Levy Rate	1.25 per cent
Threshold	
- Singles	$9,560
- Couples and sole parents	$16,110
- Addition per child	$2,100
Shade-in rate	20.0 per cent
Maximum Levy	No limit

TABLE 3 : EFFECTIVE MARGINAL TAX RATE SCHEDULE - SUPPORTING PARENT BENEFICIARY, (ONE CHILD UNDER 13) RECEIVING RENT ASSISTANCE - JULY TO DECEMBER 1988

	Non-DSS Income ($p.w.)	Taxable Pension ($p.w.)	Taxable Income ($p.w.)	Gross Tax ($p.w.)	Sole Parent Rebate ($p.w.)	Net Tax ($p.w.)	Medicare Levy ($p.w.)	Untaxed Pension MGA ($p.w.)	Untaxed Pension FAS ($p.w.)	Rent Assistance ($p.w.)	Family Allowance ($p.w.)	Disposable Income ($p.w.)	Effective Marginal Tax Rate (%)
1.	0.00	120.05	120.05	5.34	14.96	0.00	0.00	12.00	22.00	15.00	5.25	174.30	
													0
2.	40.11	120.05	160.16	14.96	14.96	0.00	0.00	12.00	22.00	15.00	5.25	214.41	
													24
3.	52.00	120.05	172.05	17.82	14.96	2.86	0.00	12.00	22.00	15.00	5.25	223.44	
4.	101.00												62
5.	191.22	50.44	241.66	34.52	14.96	19.56	0.00	12.00	22.00	15.00	5.25	276.35	
													64.5
6.	292.10	0.00	292.10	49.15	14.96	34.19	0.00	12.00	22.00	15.00	5.25	312.16	
													79
7.	316.10	0.00	316.10	56.11	14.96	41.15	0.00	0.00	22.00	15.00	5.25	317.20	
													79
8.	349.25	0.00	349.25	65.72	14.96	50.76	0.00	0.00	5.43	15.00	5.25	324.17	
													99
9.	360.10	0.00	360.10	68.87	14.96	53.91	2.17	0.00	0.00	15.00	5.25	324.27	
													99
10.	372.53	0.00	372.53	72.47	14.96	57.51	4.66	0.00	0.00	8.79	5.25	324.40	
													80.25
11.	374.00	0.00	374.00	72.90	14.96	57.94	4.68	0.00	0.00	8.05	5.25	324.68	
													91.25
12.	390.10	0.00	390.10	79.34	14.96	64.38	4.88	0.00	0.00	0.00	5.25	326.09	
													41.25
13.	671.27	0.00	671.27	191.81	14.96	176.85	8.39	0.00	0.00	0.00	5.25	491.28	
													50.25
14.	958.96	0.00	958.96	332.78	14.96	317.82	11.99	0.00	0.00	0.00	5.25	634.40	
													75.25
15.	979.96	0.00	979.96	343.07	14.96	328.11	12.25	0.00	0.00	0.00	0.00	639.60	
													50.25

Table 3: Key

1. Earnings commence; effective marginal tax rate (EMTR) on next dollar is zero.
2. Tax liabilities equal to tax rebate; EMTR equals 24 per cent.
3. Pension starts to be reduced, and tax is payable on the change in taxable income; EMTR is 62 per cent (ie 50 plus 24 per cent of 50).
4. Pensioner fringe benefits lost.
5. Twenty nine cent tax bracket commences; EMTR is 64.5 per cent.
6. Taxable pension is extinguished; withdrawal of non-taxable pension does not include taxable income which reduces by $1 for each $1 of earnings; EMTR is 79 per cent (ie 50 plus 29).
7. Non-taxable mother's/guardian's allowance equals zero, and non-taxable family allowance supplement starts to be reduced; EMTR remains 79 per cent.
8. Medicare levy becomes payable at phase-in rate of 20 cents in the dollar; EMTR equals 99 per cent.
9. Family allowance supplement reduces to zero, non-taxable rent assistance starts to taper away; EMTR remains 99 per cent.
10. Medicare levy fully phased-in, and its rate reduces to 1.25 per cent; EMTR is 80.25 per cent.
11. Forty cent income tax step commences; EMTR equals 91.25 per cent.
12. Rent assistance extinguished; EMTR is 41.25 per cent.
13. Forty-nine cent step commences; EMTR is 50.25 per cent.
14. Family allowance starts to be income-tested at rate of 25 cents in the dollar; EMTR is 75.25 per cent.
15. Family allowance reduced to zero; EMTR is 50.25 per cent.

These interactions differ for each type of income unit (Raymond and Whiteford, 1984, pp.42-49; Brownlee, 1985, pp.61-72), but the general features of the overlaps are similar, irrespective of family type. A number of points can be made about these effects. The system is obviously complex and can produce very high effective marginal tax rates (EMTRs) through the combination of increased tax and reduced social security entitlements. In addition, further income tests can heighten these EMTRs - pensioner fringe benefits, for example, are also withdrawn once income exceeds a set point, while other levels of government may also reduce their own assistance over parts of these income ranges. These high EMTRs may result in 'poverty traps' through disincentives to increased work effort - a possibility discussed in Section 5, below. It is also clear that the pension system can extend quite deeply into the income distribution, sole parent pensioners being entitled to some social security payment up to private incomes of nearly $400 per week. For pensioner couples with children, the cut-out points can be even higher and can exceed average weekly earnings.

2.2 Common populations

As a consequence of these high cut-out points, large numbers of individuals and families have entitlements and liabilities in both systems. Thus the two systems do not have discrete populations. A further result is that social security initiatives affect many taxpayers while tax initiatives can have direct impacts on the living standards of many social security recipients. In 1980-81, for example, around 580 thousand taxpayers, or more than 10 per cent of total taxpayers, received an Australian Government pension or benefit at some time during the year. They paid more than $800 million in tax or about 5 per cent of all revenue collected from income tax (Harding and Whiteford, 1985a, p.4). By 1983-84, the proportion of total taxpayers receiving some pension or benefit had increased to 13.5 per cent (Harding and Whiteford, 1985b, p.2).

One major reason for the increasing number of taxpayers receiving social security payments has been the rapid growth in the number of unemployment beneficiaries since the mid 1970s. In contrast with pensioners, and the aged in particular, the unemployed are likely to spend part of the year as social security recipients and the remainder in work. In 1984-85, for example, of the 393 thousand taxpayers who had received some unemployment and sickness benefit during the year, it appears that around 70 per cent had either been on benefit for only part of the year or had other income while receiving benefit (Australian Taxation Office, 1986).

A more important factor in this growing interaction, however, has been a series of deliberate policy initiatives which have had the effect of extending social security entitlements through relaxations in income and means tests. Until 1969, pensions were like benefits in being subject to a 100 per cent withdrawal rate over the 'free area' of income.[4] In 1969, this rate was reduced to 50 per cent. Between 1973 and 1975 the means test on pensions was successively abolished for those aged 70 years and over, and in 1976 the means test was replaced with a test on income alone.

Since 1978 some of these initiatives have been reversed, through the effects of inflation, through the imposition of the special income test on pensioners aged 70 years and over, and through the introduction of the assets test. Nevertheless, the cut-out points for pensions are still significantly higher than in 1969, with the cut-out point for a single pensioner without dependents now being about 2.36 times the basic pension rate, compared with 1.67 times the basic rate in 1969.

The relaxation of income tests required complementary changes to the tax treatment of pensions. In 1973, in conjunction with the abolition of the means test for those aged 75 years and over, pensions paid to people of age pension age were made taxable. In 1976 most other basic pensions and benefits payable to persons below age pension age were also made taxable. This was done in order to reduce the extent to which pensioners and beneficiaries, including those with private incomes, could have a higher disposable income than those in employment and with similar total levels of (completely taxable) income.

In this sense, the horizontal equity case for making pensions and benefits taxable is quite strong. If pensions and benefits were not taxable, then people with the same level of total annual resources could face quite different tax liabilities depending upon the source of their income. This issue was made more salient by the increases in unemployment referred to previously, as a consequence of which many more people could be expected to spend some time on benefit during the year.

A contrasting and strong concern is that pensioners and beneficiaries with no income apart from their social security payments should not have the adequacy of these payments reduced by taxes. If these payments are taxable, this suggests that the basic tax threshold should be set a level high enough to effectively exempt pensions and benefits from tax liabilities.

In fact, at no time in the past twenty years have pensioners with little or no income apart from their basic payments been liable for tax. At first, this was achieved through the tax

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4 The free area for pensions was substantially higher than that then applying to benefits, and relative to the basic level of pension was much higher than the current pension free area - in 1969 the free area was equal to 67 per cent the standard rate of pension, while it is now about 33 per cent of the standard pension rate. This means that while the current income test extends assistance further into the income distribution, current arrangements may not necessarily cost more than an alternative of a 100 per cent taper with a higher free area. The costs or savings from any change would depend on the distribution of pensioners' private incomes.

exempt status of the payments and was complemented by a special age allowance in the tax system. When basic payments became taxable, the allowance was replaced by an income-tested rebate. This special age rebate was subsumed by the general concessional rebate in 1975 and by the tax threshold in 1978. Further protection was offered by the continued exemption from tax of additional pension payments for children and those renting. In addition, in 1982-83 a special pensioner rebate of $250 per year was introduced, because the real value of the basic tax threshold had been declining since 1978-79 (Whiteford, 1986, p.13).

In contrast with the circumstances of pensioners, many beneficiaries had their basic payments reduced by tax in the late 1970s and early 1980s. This was because the corresponding additional payments for children of beneficiaries were taxable until 1983-84, and because of the declines in the real value of the tax threshold and the dependent spouse rebate[5] - the threshold falling by 34 per cent and the dependent spouse rebate by 16 per cent in real terms between 1978-79 and 1985-86. This situation was addressed by a number of initiatives - the exemption of additional benefit from tax in 1983-84, the introduction of a special beneficiary rebate in 1984-85, and the extension of the dependent spouse rebate to de facto couples in 1984-85 (Moore and Whiteford, 1986, pp.6-8).

This discussion of the structural interaction of taxation and social security arrangements suggests that the current system has evolved over time in a rather haphazard way. This in turn emphasises the importance of considering the **combined** impact of taxation and social security provisions (Podger, Raymond and Jackson, 1980a, 1980b), particularly when examining the effects of the two systems on the distribution of income.

3. TAXES, TRANSFERS AND REDISTRIBUTION

3.1 Parallel features and objectives

The previous description of the overlaps between the income taxation and social security systems should make it apparent that there are a number of structural features of the two systems which parallel each other. First, the income tests on pensions and benefits are analogous to the income tax rate scale, in that both reduce the benefit to an individual of additional income. Both the tax rate scale and income tests contain a zero rate step - the tax threshold, under which tax liabilities do not accumulate, and the pension/benefit free areas, under which social security payments are not reduced. Further, these zero rate steps are varied for different family types - the tax threshold by the operation of the

5 Because pension entitlements for couples are shared between husbands and wives, pensioners generally take no advantage of the dependent spouse rebate. For beneficiary couples, in contrast, payments are made entirely to one spouse, who is therefore generally entitled to the spouse rebate.

rebates, and the pension free areas by the higher free area for couples and the income disregard for children.

This sort of parallel arises because both income tests and the tax rate scale are generally designed to promote progressivity - income tests by reducing social security entitlements as other income rises, and the rate scale by increasing tax liabilities as taxable income rises. The variation of taxes and social security entitlements according to income is designed to achieve vertical equity objectives - so that the more well-to-do should shoulder greater tax burdens than the less well-off, while those less fortunately placed should receive greater assistance than higher income groups (Jackson, 1982, p.15).

The second important aspect of the parallels between the taxation and social security systems is the way in which the entitlements and liabilities of different types of family units are determined within the systems. For example, the standard rate pension available to a sole parent pensioner can be considered to parallel the standard tax threshold available to a non-pensioner sole parent. Just as a sole parent pensioner receives a special allowance (the mother's/guardian's allowance), so too does a sole parent taxpayer receive a special sole parent rebate. Just as a pensioner can be eligible for an income-tested additional payment for children, a non-pensioner can be eligible for an income-tested income supplement for children. Both pensioners and non-pensioners are entitled to family allowances for their children.

This is not to argue that these parallel features are in themselves necessarily similar in all their important characteristics. Rather, when comparing one type of pensioner/beneficiary with another type of pensioner/beneficiary family and one type of non-pensioner/beneficiary family with other types, it is apparent that there is a concern common to both systems, in that both provide what can be thought of as a basic entitlement for individuals and then add supplements in respect of persons in specified family situations. This of course is the horizontal equity objective shared by the two systems.

3.2 Assistance for families

The importance of looking at the taxation and social security systems together is also illustrated by the recent history of general assistance for children in Australia. Assistance through the personal income tax system for each child was provided in the form of concessional deductions (which were of greater benefit to high income earners) up to 1974-75. The crucial step towards the current system was made in 1975-76, when tax rebates (which were of equal money value to all but very low income taxpayers with dependent children) were introduced. Throughout this period, cash assistance for families with children was also provided through child endowment paid by the

Department of Social Security. In 1976, both cash rebates and child endowment were replaced with the current system of family allowances.

The two main advantages of providing assistance through cash payments instead of through tax reductions were that payments could be made to **all** families with children, not just to those with incomes high enough to benefit from the tax rebates, and assistance could be directed to mothers. Because of the change from tax rebates to family allowances, both taxation revenues and government outlays increased by some $700 million in 1976-77. While most taxpayers with children continued to receive about the same amount of assistance as they had prior to the family allowances reform, it was estimated at the time that some 300,000 families (with 800,000 children) whose incomes had been insufficient to take full or any advantage of the tax rebates, received greatly increased assistance for their children.

Since their introduction, family allowances have been criticised as 'middle class welfare' because they are a cash payment from the Department of Social Security, but until recently they have not been income-tested and they are not taxed.[6] Indeed, around 80 per cent of the recipients of family allowances are not in receipt of any other payment from the Department of Social Security. This could indicate either that family allowances are not well targeted to the poor, or that they are not intended to be reserved for the poor. In fact, while family allowances are counted as expenditures by the Department of Social Security, they can still properly be viewed as serving equity objectives basic to the income taxation system. This view is supported both by the history of family allowances and arguments in taxation literature that exemptions for family composition are essential to the structure of any tax which bases itself on the principle of ability-to-pay and by the practice of most other countries. The Australian income tax system itself still recognises this principle of horizontal equity through the dependent spouse rebate and the sole parent rebate.

Family allowances still provide a major instrument for reducing the effective income tax burden on many families with children, in recognition of the fact that at any income level families with children have a lower capacity to pay tax than similar families or individuals without children. In addition, family allowances also offer a means of providing greater assistance according to the number of children in the family. In contrast with other tax measures, they also provide equal assistance to families with low incomes who pay little or no tax. Thus, rather than being a poorly targeted 'welfare'

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6 In the Economic Statement of 13 May 1987, it was announced that an income test on family allowances would come into effect in October 1987. Families with joint parental taxable incomes exceeding $50,000 in the previous financial year now have family allowances reduced by 25 cents for every dollar above the threshold applicable to that family. (The threshold is increased by $2,500 for the second and each subsequent child).

measure, family allowances can be considered as a general taxation measure which also provides additional assistance to the neediest families.

3.3 Perceptions of the tax-transfer system

In the senses discussed above, the taxation and social security systems can be seen to be linked by the common objectives of promoting both vertical and horizontal equity. The links, however, are far greater than indicated just by the existence of parallel features to achieve similar goals. Indeed, many tax and social security measures can be regarded as interchangeable mechanisms for achieving policy objectives. Assistance to families with children can be provided through tax rebates or deductions for taxpayers with children, or through cash transfers such as family allowances. Social security cash transfers can thus be thought of as equivalent to 'tax credits' or 'negative income taxes' (Musgrave, 1959, p.18).

This issue is important because just as many may perceive taxpayers and social security recipients as being discrete populations, many see taxation and social security instruments as being inherently different in their nature. Social security outlays are generally seen as representing a cost to taxpayers and as contributing to the size of the government sector. In contrast, similar measures in the tax system (e.g. the dependent spouse rebate, the sole parent rebate) are often not regarded as a cost to anyone and tend to be seen as reducing the size of government. But both cash transfers and assistance through reductions in tax liabilities involve calls on revenue and have similar implications for the budget deficit or surplus. Except for administrative costs, neither cash transfers nor tax assistance add to or detract from the size of the public sector in the sense of involving the government itself in using up real resources (in the same way that building roads, hospitals or ships does). Rather, the two systems simply redistribute disposable income between individuals and families. Social security expenditures ultimately are spent by private individuals for private purposes, in the same way allowed for by tax concessions.[7]

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7 It should be emphasised, however, that while cash transfers and tax concessions do not strictly add to the size of the public sector, they do represent a constraint on government choices. The revenues not collected or rebated because of tax concessions and the moneys redistributed through cash transfers are (generally) not available for the government's other objectives. Whether family allowances, for example, are paid as a cash transfer or a tax rebate or whether the DSR is cashed-out or unchanged does not affect the size of the budget deficit - it is still money forgone. If governments wish to increase assistance for certain groups, then whether that assistance is provided in the form of cash payments or tax rebates will make little difference, to its budgetary impact. If the budget deficit is not to be increased it would still be necessary to either increase taxes elsewhere or reduce other expenditures.

Perceptions of social security outlays as a cost, while tax concessions are perceived as costless, are misleading and may mean that tax concessions are subject to less scrutiny than social security outlays, irrespective of the actual merits and efficiency of direct expenditures in comparison with taxation instruments.

3.4 Taxation expenditures

Concern with these and similar issues has grown in recent years and as a consequence there has been considerable effort to identify and cost those areas of taxation policy whose objectives are analogous to direct programs of assistance (House of Representatives, 1982; Ingles, Podger, Raymond and Jackson, 1982). As noted by Treasury (1986, p.1):

> A number of provisions of ... taxation law provide preferential treatment to certain classes of taxpayers or to particular types of activity. These provisions may take the form of tax exemptions, deductions, deferrals, rebates or special rate reliefs. In some cases the intention may be to ensure equitable tax treatment for taxpayers in particular circumstances. In other cases, however, the clear intention of the provision is to grant a subsidy or provide an incentive to those engaging in a specific activity or to those in particular circumstances.
>
> ... Such concessions reduce or delay the receipt of taxation revenue and in that respect represent a call on the Budget similar to direct outlays. Because their effects on the Budget and on beneficiaries are comparable in many respects with the effects of direct outlays, and because the benefits provided by many of the concessions could conceivably be provided alternatively by direct expenditures, such concessions have come to be referred to as 'tax expenditures'.
>
> ... A full understanding of government programs requires that information be available on the extent, nature and cost of tax expenditures.

The most recent estimates of aggregate tax expenditures costed them at $8,354 million in 1985-86, (Treasury, 1987, p.10). Tax expenditures in the social security and welfare category provided the largest revenue cost, being valued at $5,144 million or 62 per cent of the total estimated cost of all tax expenditures. These 'concessions' in the social security and welfare category are equivalent to roughly one quarter of the cost of direct government outlays, and are thus a very significant component of the Government's total social welfare effort.

The definition of a taxation expenditure does, however, involve a number of important conceptual issues. As noted by Ingles et al. (1982, p.6), current definitions are essentially pragmatic and beg a number of questions; the most important being what constitutes a concession rather than being a normal feature of the tax structure. The tax expenditures listed under social security and welfare provide a good example of these conceptual difficulties.

Table 4 provides some details of tax expenditures listed by Treasury as concessions for social security of welfare purposes. Initially, it is important to note that a positive tax expenditure arises where an activity or class of taxpayer is taxed preferentially with respect to the chosen benchmark structure. In particular, the legislated income tax scale, including the tax threshold, is taken as part of the benchmark structure. This immediately raises questions over the treatment of the personal tax rebates for sole parents and persons with dependent spouses. These rebates increase the tax threshold for persons eligible, and their usual rationale is that such exemptions are a necessary component of an income tax structure based on ability to pay.

The **Tax Expenditures Statement** recognises that it is a matter of judgement whether these dependent rebates are classed as elements of the benchmark structure or as tax expenditures. Treasury argues that the decision to cash out the previous child rebates as family allowances justifies the inclusion of the remaining provisions in a listing of tax expenditures. On this basis, it would seem reasonable to think of family allowances itself as a form of tax expenditure, but in fact the Treasury Statement only treats the tax exempt status of family allowances as a tax expenditure. This seems problematic.

These comments should not be taken as suggesting that the costs of the personal tax rebates should not be clearly identified. It would seem nevertheless that there is some inconsistency remaining between the treatment of these rebates and of family allowances. Alternatives that may provide greater consistency would be to treat all offsets for dependents (both rebates and family allowances) as integral parts of the tax structure or treat them all as tax expenditures (Ingles et al., 1982, pp.17-19).

3.5 The redistributive impact of taxation and social security

While governments may use a wide range of measures to influence the distribution of economic well-being, the taxation and social security systems are the two key instruments of distributional policy. As noted by Treasury (1984), 'the fiscal policies in the area of taxation and social security provide a direct means of altering the distribution of income'. Taxation and transfer policies are often framed with explicit distributional objectives and because of the scope of the two systems these effects can be significant.

Australian studies of the impact of government on income distribution have generally been of two sorts. One approach involves analysing the combined effects of trends in the taxation and social security systems as they affect different types of model families (Saunders, 1982; Moore and Whiteford, 1986).

TABLE 4 : SELECTED TAX EXPENDITURES - SOCIAL SECURITY AND WELFARE

Description	1985-86 Revenue Cost ($m)
Sole parent rebate	103
Rebates for dependent Spouse, daughter-housekeeper, housekeeper, parent and parent-in-law	883
Rebates for taxable social security and repatriation pensions and taxable social security benefits	186
Exemption from tax of repatriation and related pensions	210
Exemption from tax of certain social security payments (including family allowance)	680
Concessional treatment of superannuation contributions, fund income and benefits paid	3,060

Source: Treasury 1987, pp. 15-17.

For example, the analysis in Moore and Whiteford shows how changes in wages, prices and in tax-transfer arrangements between 1964-65 and 1985-86 affected the real disposable incomes of families of differing compositions at different, set levels of pre-tax income - maximum pension and benefit rates, and 50, 100 and 200 per cent of average weekly earnings (AWE). The main conclusion of this study is that all types of model income units would have experienced substantial real increases in disposable incomes over the period 1964-65 to 1985-86. These real increases were of the order of 30 per cent for those with gross incomes equal to 200 per cent of AWE to between 50 and 60 per cent for pensioner and beneficiary families, and 70 per cent for those families around half AWE who received the benefits of the Family Income Supplement (FIS). This suggests that during the past twenty years there should have been some narrowing of the gap between the poorest families and the rest of the community.

These conclusions were modified by the observation that most of these changes were results of initiatives between 1964-65 and 1976-77, while after 1976-77 the position of families with children, particularly the poorest families with children, declined substantially relative to individuals and couples without children.

These trends in the disposable incomes of families with children vis a vis families without children can be directly traced to policy changes in the social security and taxation areas since 1976-77. While there have been regular changes to the tax scale providing general tax cuts to taxpayers irrespective of the number of their dependents (if any), tax rebates for dependents have not been increased since 1982-83, rates of family allowances have effectively been increased only once and until 1983-84 additional pension/benefit and mothers/guardians were only increased once. This had had the effect, over the period since 1976-77, of widening the relative gap between families with and without children and in particular between the poorest families and other members of the community.

These sorts of studies can be criticised since they do not take account of actual changes in the labour force or the population, for example, increasing unemployment or sole parenthood, the increasing prevalence of two-income families, or growing numbers of persons receiving social security payments. This approach should therefore be thought of as providing a basis for assessing the **nominal** redistributive effects of government policies that are changing either purposefully or through oversight. Unless it can be shown that other social or economic trends are likely to produce countervailing distributional changes, however, then analyses of this sort are likely to provide a good indication of the direction of redistribution. Moreover, the direction of government distributional policies are of concern in their own right.

The other approach involves the analysis of household survey data to determine the effects of the benefits of government programs and the taxes required to fund them on the distribution of income between different classes of households.[8] Related research has been carried out to assess the impact of government social security programs on the incidence of poverty. This type of research is more comprehensive than the first approach, although it also is not without major problems (Piggott, 1987).

Contrary to the claims of some critics of the Australian social security system, these sorts of studies generally find that expenditures on social security cash transfers are highly redistributive. Using 1975-76 data, Harding (1984), for example, found that social security payments increased the income of the lowest decile by 85 per cent, with the effect declining rapidly to only 2 per cent of the income of the highest group.

A more recent ABS study using 1984 data shows similar results, which are summarised in Table 5. The table shows that direct cash benefits are distributed in a very progressive manner, declining from 86 per cent of gross income in the lowest decile to only 1.7 per cent in the highest income group. Direct taxes also appear to have a progressive impact, rising from 0.4 per cent of gross income to 28.6 per cent. Indirect benefits are also very progressive, while only indirect taxes would act to redistribute resource away from low income groups. Overall, low income groups receive far more in all forms of government benefits than they pay in direct and indirect taxes - the bottom two deciles receiving about ten times as much in benefits as they pay, and the top income group receiving benefits equivalent to about one third of the taxes they pay. The turning point is in the seventh decile, where taxes begin to exceed benefits.

A more disaggregated analysis of these figures reveals that even the apparently less progressive aspects of government policies may be more redistributive than is often considered. For example, the average weekly value of total education benefits increases from $6.70 for the lowest decile to $61.22 for the highest decile, or from 5.4 to 7.1 per cent of final income. This, however, does not take account of the fact that the bottom two deciles contain very large numbers of age pensioners, who in a point in time analysis like this, not unexpectedly benefit little from education spending. If the distribution of education spending across income quintiles is assessed for married couples with dependent children only, then a very different picture emerges. Among those for whom education spending is predominantly intended, the average weekly value of total education benefits increases from $64.36 to $88.27, thus declining from 23.2 per cent of final income to 11.8 per cent.

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8 Examples of studies of this sort include Bentley, Collins and Drane (1974), Kakwani (1983), Warren (1979, 1986), Harding (1984), Australian Bureau of Statistics (1987) and Castles (1987). Some international comparisons are provided in Saunders (1987) and Castles (1987).

Table 5 also suggests that direct taxes have a significant impact on the incomes of the highest income group, amounting to nearly 30 per cent of gross income. Government policies, however, may not be as effective in redistributing income as suggested either by studies of trends over time in their nominal impact or point in time analyses of the incidence of taxes and benefits. The progressivity of the overall tax system can be undermined if the tax base is narrow or if tax avoidance and evasion are widespread. In addition, as noted by Saunders (1987, p.45) the **redistributive** impact of social security spending depends not only on how progressive is the **distribution** of expenditures, but also on the **level** of expenditures available for redistribution. Saunders compared Australia in 1981-82 with Norway, Sweden and the United Kingdom in 1982 and found that while social security transfers in Australia were the most heavily concentrated on low income groups, income inequality, whether measured by the relative income share of the lowest 20 or 40 per cent, was greater in Australia than in the other three countries. The explanation for this was the overall level of social security spending is lower, and 'it is this lower level of transfer spending which dampens the redistributive impact in Australia, despite the greater degree of income targeting in the Australian system' (Saunders, 1987, p.48).

On the basis of these and similar findings (Castles, 1987), it can be concluded that while taxation and social security policies are the most important instruments of redistribution, the progressivity of their structure may not be sufficient in itself to achieve whatever degree of redistribution is required. A more broadly-based tax system with less avoidance and evasion, even in combination with apparently less progressive social security payments, may achieve greater poverty alleviation or income redistribution than the current system.

4. TAX REFORM AND LOW INCOME GROUPS

The Draft White Paper on **Reform of the Australian Tax System** published in June 1985 and the National Taxation Summit held in July 1985 represent the most comprehensive appraisal undertaken of the Australian taxation system since that of the Asprey Committee a decade before. A very wide range of changes resulted from this process, including the introduction of the fringe benefits tax and the capital gains tax, as well as very significant changes to the personal income tax rate structure (Keating, 1985). Two particular sets of proposals not implemented - one put forward by the Government and the other supported by the Centre of Policy Studies (COPS) at Monash University - would have had very major implications for social security recipients and other low income groups. The debate around these options - the Government's then preferred broad-based consumption tax (BBCT) on goods and services and the COPS

TABLE 5 : RELATIONSHIP BETWEEN BENEFITS, TAXES AND INCOME BY GROSS HOUSEHOLD INCOME DECILE, 1984 HOUSEHOLD EXPENDITURE SURVEY

	Lowest 10%	Second Decile	Third Decile	Fourth Decile	Fifth Decile	Sixth Decile	Seventh Decile	Eighth Decile	Ninth Decile	Highest 10%	All Households
Direct benefits as per cent of gross income	86.1	80.1	59.7	20.4	9.9	7.1	5.1	3.9	2.5	1.7	11.5
Direct tax as per cent of gross income	0.4	1.7	3.8	11.6	15.0	17.8	20.2	21.6	23.2	28.6	20.2
Indirect benefits as per cent of gross income	61.5	50.8	43.3	29.1	22.9	20.0	16.7	14.1	11.9	9.0	18.2
Indirect taxes as per cent of gross income	14.2	11.7	12.0	10.7	9.7	9.3	8.6	7.7	7.5	6.3	8.3
Private income as per cent of final income	9.5	14.5	31.6	74.5	91.8	99.9	108.0	113.4	120.1	132.5	98.6
Ratio of total benefits to total taxes	10.2	9.8	6.5	2.2	1.3	1.0	0.76	0.61	0.47	0.31	1.04

Source: Calculated from Australian Bureau of Statistics, Catalogue No. 6537.0, 1987, p.22.

proposal to 'income-test' the tax threshold illustrate and emphasise the complementary nature of taxation and social security provisions.

4.1 Compensation for indirect taxes

As noted at the conclusion of Section 3, the degree of redistribution achieved by the tax system depends not only on the progressivity of the income tax rate scale but also, and perhaps more importantly, on the breadth of the tax base and the level of tax avoidance and evasion. Overall progressivity should also be assessed in relation to the entire tax system, including the effects of social security transfers.

The view that it is essential to consider the overall effects of a set of changes to the tax system has been emphasised since the Report of the Asprey Committee in 1975. As part of its own recommendations, the Committee favoured the introduction of Value Added Tax (VAT), although noting that 'VAT on goods and services puts those on low incomes at a disadvantage and some countervailing measures would have to be taken' (p.520). It was recommended that a VAT be introduced at initially low rates, but that thereafter it be increased steadily with concomitant upward adjustments to social security payments and downward adjustments to income tax.

The basic approach adopted by the Taxation Review Committee has proved influential. Since that time, it has virtually become the conventional wisdom that the undesirable distributional effects of a shift towards broad-based consumption taxes can be alleviated by the appropriate combination of income tax cuts and increases in transfers, and that the desired degree of progression in the overall tax system should be addressed through widening of the income tax base, the introduction of progressive annual wealth taxes, say, as well as greater reliance on progressive expenditure policies.

Australian advocates of such a shift to broad-based indirect taxes have included Gates (1969) and Groenewegen (1971), prior to the Report of the Taxation Review Committee (1975), and Warren (1977) and Mathews (1983a, 1983b) since. In nearly all these cases, mention has been made of possible means of offsetting the effects of indirect taxes, e.g. a tax credit system (Warren, 1977), but there has been no detailed specification of proposals and their overall effects. This is understandable, since specific proposals for compensation necessarily require specific proposals for a change in the tax mix. Thus the Draft White Paper of June 1985 provided the first case in which it is possible to inquire in detail whether low income groups could feasibly be compensated for the regressive effects of a major shift to broad-based indirect taxes.

The broad-based consumption tax proposed in the Draft White Paper would have been set at 12.5 per cent, and was estimated to have a 6.5 per cent price effect, i.e. for each dollar of expenditure that a household made prior to the tax change, an additional 6.5 cents would be paid in indirect taxes following the introduction of the BBCT.

The Draft White Paper adopted an approach designed to compensate **precisely** for this price effect. The first step in the compensation proposals of the Treasury would be to determine for each broad type of household an **effective compensation threshold**, which would be the point at which current income tax liabilities equalled the estimated price effect of the new tax. Taxpayers with incomes at this level could be compensated by an increase in the tax threshold to this point, and those with higher incomes could receive an exactly compensating cut in marginal rates.

For those with incomes below their effective compensation thresholds, the situation was potentially more complex, except for those entirely dependent on social security payments. Pensioners, beneficiaries and other recipients of Government income support and who had zero private income could have been compensated simply by a 6.5 per cent increase in all their income security payments at the time of introduction of a BBCT. Thus, they would be in precisely the same financial situation after any new indirect tax as before. In addition, the proposed increase in the basic tax threshold would have been sufficient to protect these increased payments from tax and also obviate the need for the current special pensioner and beneficiary rebates.

Low income, non-pensioner or beneficiary taxpayers would pose a problem since their current income tax liabilities would be insufficient to make good the price effect on their disposable incomes, and they do not receive any current payments that could be increased. The maximum detriment for this group would arise at the point when their incomes were just below their respective effective tax thresholds, since above these levels they would start to pay tax and would therefore derive some, albeit insufficient, benefit from increases in the tax threshold. To protect these groups, it would therefore have been necessary to introduce a new payment equivalent to 6.5 per cent of their effective tax thresholds, tapered away at some rate appropriate to the reduction in their income tax liabilities and designed not to produce over-high effective marginal tax rates. This could be provided either in the form of a refundable tax credit, a cash payment analogous to the Family Income Supplement (FIS) scheme, or perhaps some form of subsidy paid through employers and refunded by the government.

Pensioners and beneficiaries whose private incomes from investments or part-time work carry their total income up towards their effective compensation thresholds without exceeding them would require an extra payment equal to 6.5 per cent of the difference between their social security or other payment and their effective compensation threshold. This could be in the form either of the compensation provided to other low income earners such as a tax credit or through a further increase in the base rate of pension.

The first point to note about this theoretical approach to compensation is that there are a considerable number of further complications to deal with in practice. Price effects would actually have been higher than the average 6.5 per cent for low income households and for those with dependent children. For distributionally neutral compensation to be achieved for these groups, it would be necessary that increases in thresholds and cash transfers be greater than the average.

Available data from the 1984 Household Expenditure Survey also show that for many low income households, their expenditures apparently exceed their disposable incomes. There are a number of reasons for this phenomenon, including inherent difficulties in measuring incomes and expenditures and relating them to meaningful time periods, as well as expected rundowns in assets in later parts of the life cycle. However, some of this dissaving will arise as low income groups borrow from relatives or friends or go into debt or draw on savings for what they hope will be a short period of unemployment or sickness. In these sorts of circumstances, it may be considered desirable to provide further compensation so that these groups will not be additionally disadvantaged.

Complications would also arise because of the differing tax treatment of certain transfer payments. Invalid pensions as well as war widow and war disability pensions are not taxable, and persons receiving these payments can therefore have higher private incomes than other social security recipients before they become liable for income tax (up to $88 per week in the case of a single person). Correspondingly, such groups would not receive the benefit of income tax cuts provided through threshold increases. Unless it was explicitly considered desirable to reduce this relative advantage, it would be necessary to provide some extra form of compensation targeted directly to those with non-taxable income support payments.

A final complication lies in the instruments or mechanisms of compensation for those with low incomes and who do not receive a transfer payment. If a tax credit or a new social security payment were to have a low rate of take-up, the compensation would not be effective. It could reasonably be expected that payments involving low levels of compensatory assistance and/or that were tightly income-tested would be likely to experience take-up problems.

Whiteford (1986b) assesses the detailed compensation package put forward in the Draft White Paper. The package would in general terms have been adequate to offset most of the regressive impact of a large scale switch in the tax mix. Nevertheless, the compensation proposals had a number of problems for different groups. Certain categories of social security recipients would not have been fully compensated by the proposed package, while a small number would have received very large over-compensation. Although large numbers of welfare recipients would have received moderate over-compensation, even after taking into account higher price effects for low income groups and assumed dissaving, the overall package does not appear to have been significantly redistributive, because of much higher income tax cuts directed to higher income taxpayers.

In addition, two income families in certain low income ranges might not have been adequately compensated for the effects of a BBCT, depending upon the pattern of income receipt between primary and secondary earners. Compensation for some secondary earners would have been provided in the form of tax cuts to primary earners, and consequently there would have been a shift in purchasing power within some family units. More generally, there would have been a shift in relative tax burdens for middle and higher income earners, with taxpayers without dependents benefiting to a greater degree than those with dependents from the income tax cuts.

The proposed package shows that compensation would be an extremely complex matter, and not a simple exercise of bringing forward indexation increases in pensions and benefits. It would have involved further complication of the already complex system of income support, and brought fairly large numbers of low income persons into the welfare system. While the inter-relationship between tax and transfer policies would have been highlighted by such a change, recipients of current transfers might feel that over time these arrangements would increase pressures on other parts of the social security system.

4.2 Taxing the threshold

In addition to the debate about the proposed broad-based consumption tax, considerable attention was given at the Taxation Summit to the tax rate scale, the desired degree of progressivity in the scale, and various proposals for the 'abolition' of the tax threshold, with or without offsetting measures such as the introduction of tax rebates to protect low income groups.

Differing options were put forward, the best known being that of the Centre of Policy Studies (COPS) at Monash University. Academic economists at the Summit (Head, Sieper, Apps, Groenewegen), were generally very negative about proposals to income test or abolish the tax thresholds (National Taxation Summit, 1985). Despite this, others were not convinced that raising the threshold was necessarily the most equitable way of providing tax cuts (McBean, in National Taxation Summit, 1985, p.173). Following this, the Prime Minister in summing up stated that it was 'appropriate for government, in the process now of discharging its obligation to move to the creation of a final package, to look at whether it may not be appropriate to look at the abolition of the threshold and, at the whole question of dependent spouse rebates and family allowances' (National Taxation Summit, 1985, p.227). In the event, the Statement on **Reform of the Australian Taxation System** made by the Treasurer in September 1985 foreshadowed an increase in the tax threshold, its limitation to a pro-rata basis for persons entering the Australian workforce for the first time or leaving the workforce permanently, and no changes at all to family allowances or the dependent rebates (Keating, 1985, p.54).

These developments have not reduced interest in the role of the tax threshold. Further refinements of the original proposals continue to be made (Porter, Cox and Bascand, 1985; Dixon, Foster and Gallagher, 1985; Freebairn, Porter and Walsh, 1987), while other commentators have also suggested either income-testing of the threshold (Grbich, 1986) or its complete abolition (Tingle, 1986).

In assessing options of this sort, it should be noted that the tax threshold has two main effects. The first is to contribute to the overall progressivity of the rate scale, and the second is to protect low income earners from paying tax. The threshold is in itself a progressive measure, since the provision of a zero rate step followed by positive tax rates results in an increasing proportion of income being paid in tax as taxable income rises, or alternatively, the marginal rate of tax must always exceed the average rate, given a zero step. With respect to the second objective, it can be argued from an ability-to-pay perspective that only discretionary income should be subject to tax and that therefore whatever the level of income required for the provision of the necessities of life as well as the basic costs of earning that income should be effectively free from tax. This approach also suggests that provisions should be made for family circumstances within the basic tax structure. Given that the Australian social security system is designed to provide a minimally adequate level of income support, it has generally appeared reasonable to argue that pensioners and beneficiaries should not bear tax if they have no other resources but their income support payments. As previously discussed, this objective is substantially met through the tax threshold, supplemented by the dependent rebates and the income-tested social security rebates.

Apart from these equity considerations, the provision of a zero rate step has the effect of simplifying tax administration by removing large numbers of persons who would otherwise have low tax liabilities from the requirement to submit returns, unless tax has already been withheld through PAYE or other arrangements. The provision of a zero rate step can also be considered to promote efficiency goals since low income earners can participate in the labour force and earn nearly $100 per week before they are required to pay tax.

The tax threshold has been subject to criticisms of two main types. The first arises from the nexus between average and marginal rates of tax. To produce any given level of revenue, the availability of a zero rate step must require a higher marginal rate for taxpayers with incomes above the threshold.

The second argument is the closely related proposition that the provision of a threshold for everyone is not necessarily the most target-efficient means of ensuring that low income earners do not pay tax. A related concern is that the provision of a threshold may facilitate income splitting, and thus undermine horizontal equity, since families who can avail themselves of income splitting will have significantly lower tax liabilities than those who cannot.

The efficiency arguments against the threshold have been developed and elaborated primarily by the Centre of Policy Studies at Monash University. COPS also appear to suggest that abolition of the threshold would be equivalent to a widening of the income tax base (Bascand, Boyd et al., 1985, pp.2-3), as does Grbich (1986, pp.107-108) who suggests, however, that this impression is 'merely a heuristic, an imperfect means of quantifying the impact of particular shifts which depend on a suspension or disbelief'.

The precise proposals put forward by COPS and by Grbich differ markedly in their parameters[9], but all share features in common. In general, they involve the replacement of the zero rate step with a first step of the order of 20 to 25 per cent. In order to protect low income earners from facing much higher tax rates, special tax rebates could be introduced, but these would in turn be income-tested over low to middle income ranges.

As a consequence, these proposals involve a substantial redistribution of taxation liabilities. While those receiving the full value of the rebates would generally (but not always) not pay higher taxes, both average and marginal tax rates increase significantly for those in the rebate reduction range, and average tax rates also increase for some groups above the rebate cut-out point. The various sets of proposals also involve a **relative** shift in tax liabilities on to single income families with children, among those with incomes above the rebate cut-out point. This is because the dependent spouse rebate would no longer be available, and the average tax rates of single income families vis-a-vis individuals would be modified only by the provision of family allowances. In a somewhat contradictory manner, the COPS schemes, however, would tend to favour single income families over two income families in the income ranges over which the rebate is available either in full or part, because the rebate would be reduced according to joint income. The proposals also generally provide protection for low income taxpayers and social security recipients, as well as redistribution to those with very low incomes,

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9 All of these proposals, as well as those of Dixon, Foster and Gallagher (1985) are reviewed in detail in Whiteford (1986c).

although in some cases, the results would exacerbate rather than reduce possible 'poverty traps'.

The primary argument put forward by COPS and Grbich in favour of their proposals is that they would have positive effects on economic efficiency. These improvements would occur because of the reductions in marginal tax rates on high income earners. For example, the 1985 COPS proposal and the Grbich proposal would have reduced the top marginal rate (then 60 per cent on incomes over $35,000 p.a.) to 40 and 45 per cent respectively.

If reductions of this sort would have a positive effect on economic behaviour then the increases in marginal rates consequent upon the income-tested credits must have a negative impact. In this context, the effect of the Grbich proposals, for example, is to shift the then top 60 per cent marginal rate on to differing groups of taxpayers with incomes between $12,500 and $27,500 p.a. The various COPS proposals also increase marginal tax rates on lower to middle income earners by roughly the same orders of magnitude. The range of incomes over which these high marginal rates apply would be less than under Grbich, but because the average tax rates would be higher, i.e. in general, those with even lower incomes would be paying more tax than under the Grbich proposal.

These proposed tax scales in fact reinforce the argument that there is a nexus between marginal and average rates of tax. That is, in revenue neutral circumstances, reductions in average and marginal rates of tax on high income earners can only be achieved by increasing average and marginal rates on some groups of lower income earners.

COPS support their proposals by arguing that the reductions in marginal tax rates on higher income earners have a positive effect on work behaviour that outweighs the negative effects of income-testing. In contrast, Apps and Savage argue that labour supply studies indicate that tax disincentive effects for secondary earners and lower income groups such as female-headed families are substantially greater than those for prime age males. Apps (1987) further explores this issue and argues that 'the studies must demonstrate that the social welfare losses associated with switching to less progressive marginal tax rates and higher rates for lower income earners and working married women are outweighed by the efficiency gains from reduced disincentive effects' (1987, p.43).

In essence this is what COPS argue - the disincentive effects of the increases in marginal rates for some groups of taxpayers are more than offset by the positive effects of marginal rate reductions over broader range of incomes.

While resolution of this debate is beyond the scope of this chapter, the arguments advanced in Apps and Savage (1986) and Apps (1987) suggest that it must be doubted whether proposed cuts in marginal rates on high income groups would in fact offset the disincentive effects of increases in marginal rates on lower income earners.

In summary, the most important point to note about the threshold is that it is a step in the rate scale and not an exclusion of income from tax. It is therefore not accurate to describe proposals to reduce or to income-test the threshold as a means of broadening the income tax base. The income below the threshold is already taxable income and any effective taxation of this income simply involves a shift in existing tax liabilities. Income-testing options expand the tax base only to the extent that the abolition of the threshold facilitates the introduction of more general withholding tax arrangements. It would of course be possible to strengthen and extend existing withholding arrangements, such as the prescribed payments system (PPS), without any changes at all to the threshold.

Perhaps the most misleading aspect of threshold abolition proposals is the claim that they actually involve the abolition of the threshold, when in fact the effects of the threshold are provided for many taxpayers through rebates or credits. This point has been made by the Taxation Review Committee (Asprey) in discussing tax allowances and rebates:

> ... these are in fact exactly equivalent to making the first step a zero-rate one; and they mostly serve to conceal the abrupt rise in the effective marginal rate when, at the point of exhaustion of the allowance or the rebate, the marginal rate of the tax scale begins to be effective. Universal tax allowances or non-reimbursable tax rebates are merely techniques for altering the actual progressivity of the tax scale. The issue of the amount of tax to be levied on low incomes should not be obscured by artificialities. (1975, p.189)

In this sense, it is irrelevant to suggest that the current threshold is an 'inefficient' means of protecting the poor. The threshold is an important component of the current level of progressivity achieved in the personal income tax structure. The case for changes to the threshold must therefore involve judgements that either a more or less progressive distribution of tax liabilities is desirable.

5. TAXATION, SOCIAL SECURITY AND INCENTIVES

One of the most important issues raised in current debates about tax reform has been the perceived desirability of reducing marginal rates of income tax in order to promote work incentives. As discussed in Section 4, this has been a focus of the Centre of Policy Studies proposals, as well as the Government's changes to the tax rate scale implemented in July 1987.

The issue of work incentives is just as salient in analysing the effects of the social security system. The overlaps between the taxation and social security systems may heighten this concern, because both income tax and income tests reduce the benefit to individuals of additional effort to earn income. Studies in the US of the work incentive effects of income-tested transfer payments found that primary wage earners reduced their hours of work only slightly, but secondary earners' and sole parents' hours of work fell significantly in response to such payments. It was also found that the level of the withdrawal rate in the income test had stronger effects than the level of the payment itself (Whiteford, 1981). That is, the substitution effect appeared more important than the income effect.

5.1 Poverty traps

In this context, some results of the interactive effect of taxation and social security are of particular concern. Once pensioners' and beneficiaries' incomes enter the taxable range, the combined effect of liability for income tax and the reduction of pension or benefit through social security income tests can produce 'effective marginal tax rates' far higher than the current top rate of 50.25 per cent (including Medicare) applied to taxpayers on the highest incomes. 'Effective marginal tax rates' refer to the amount of income lost, through withdrawal of assistance by income test and/or the payment of tax out of each additional dollar of private income. Pensioners and beneficiaries can face effective marginal tax rates (EMTRs) of 100 per cent or more over certain private income ranges, and attempts to increase their disposable incomes, e.g. through part-time work, can leave them no better off or even worse off. These situations are often known as 'poverty traps', in recognition of the possibility that people in these situations may have the desire to improve their financial circumstances through work, but the rationality of doing so may not be evident, and that consequently people may feel 'trapped' into dependency on financial support.

Table 3 showed how these high marginal tax rates arise in the case of a sole parent with one dependent child. For other pensioners without children, the social security income tests cut in at a lower level of private income, and income tax may also become payable at lower levels of total income. In summary:

- For the majority of pensioners whose payments are both income-tested and taxed, EMTRs are at least 62 per cent over the range of private income where tax and the income test overlap. Where the special pensioner rebate is being withdrawn, the EMTR rises to 68.25 per cent. Where non-taxable payments are being withdrawn (e.g. assistance for children or renters), the effective withdrawal rate rises to either 79 per cent or 90 per cent, with the Medicare levy further heightening the effect;

- For those whose payments are income-tested but not taxed - invalid pensioners and family income supplement recipients - effective marginal tax rates are at least 74 per cent, rising to 79 per cent or higher; and

- For unemployment or sickness beneficiaries, effective marginal tax rates are at least 62 per cent in the 50 per cent withdrawal range, and rise to 68.25 per cent when the beneficiary rebate is being reduced. EMTRs rise to 100 per cent when the $1 for $1 rate is applied above $70 per week. This is a deliberate design feature, but beneficiaries with children can face a 124 per cent EMTR over those ranges where the non-taxable payment reduces. This is because private income reduces additional benefit dollar for dollar, but taxable income is increasing. Thus, these groups pay tax on money from which they get no benefit.

Whether high effective marginal tax rates have a significant impact on the actual labour force behaviour of social security recipients is not known, since there are no large scale, empirical studies of the effects of these poverty traps. Nevertheless, if the work incentives of average income earners facing a marginal rate of 41.25 per cent at $19,500 is thought to be a significant issue, then consistency suggests that the 62.5 per cent marginal rate facing a sole parent at $9,200 is also significant.

5.2 Alternative policy approaches

As part of its tax reform initiatives, the Government announced a range of measures to address poverty traps that came into effect from 1 July 1987. These initiatives were:

- an increase in the free area for pensioners from $30 to $40 p.w. for singles and from $50 to $70 for couples;

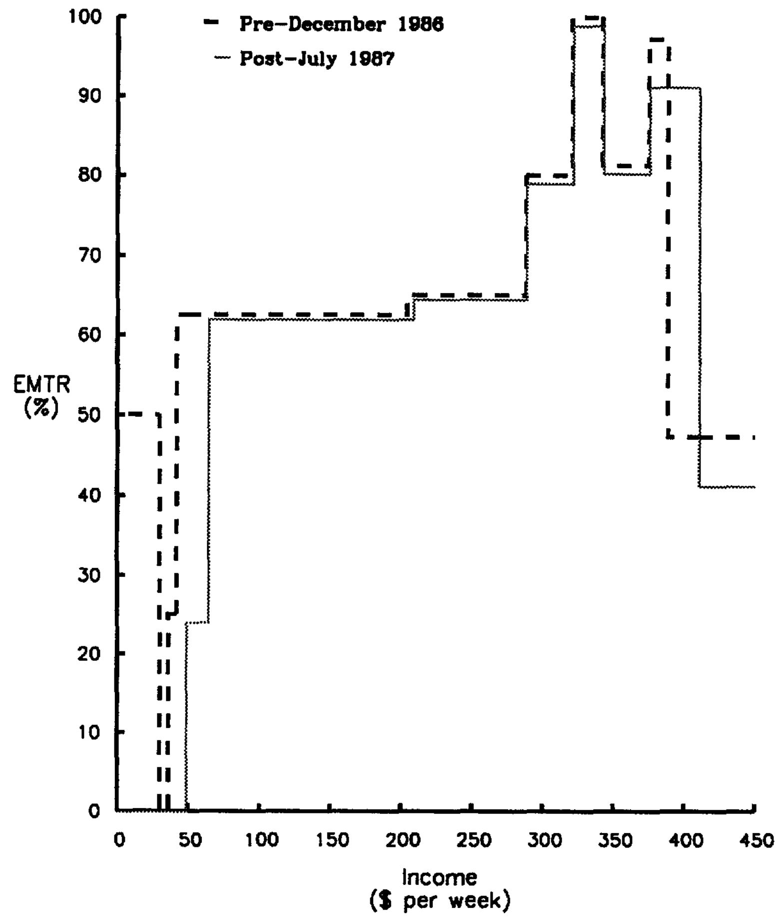
- an increase in the additional disregard for children from $6 to $12 p.w.; and

- the abolition of the separate income test on rental assistance, so that rather than being withdrawn from the first dollar of private income, it is reduced after other social security entitlements are extinguished.

The effects of these poverty trap initiatives on a sole parent who is renting and has two children are shown in Figure 1, which also illustrates some of the problematic features of poverty traps. The largest reduction in EMTRs is caused by the abolition of the separate income test on rent assistance. The other elements of the poverty traps package simply move high EMTRs slightly further out into the income distribution, while cuts in marginal tax rates also reduce EMTRs by a small amount. The transfer of the rental assistance income test to the point at which other pensions are zero actually increases marginal tax rates by 50 per cent over the income range where this payment is now

Figure 1: Illustration of Effective Marginal Tax Rates (EMTR) Before and After Poverty Trap Initiatives:

Sole Parent Pensioner With Two Children Renting Privately



reduced. The actual effects of these initiatives will depend on the distribution of social security recipients over these income ranges, together with the opportunities that they will have to vary their hours of work.

In summary, there are a range of options available to governments who wish to address these issues. These include:

(i) **Taxation changes** - The first option is increases in the basic tax threshold, which would reduce the overlap between the two systems. Such increases, however, are very expensive, costing about $770 million a year in revenue forgone for a $500 increase in the threshold (Collins 1986, p.195). This alternative would probably only be contemplated in the context of broader changes, but if the increase was large enough, then reductions of the special pensioner and beneficiary rebates could be made or they could be abolished, which would reduce EMTRs quite significantly (by 6.25 per cent over some ranges). Cuts in the first tax rates also reduce EMTRs for social security recipients, but feasible reductions could not reduce EMTRs to any great extent. A third tax option to address the specific problem of those receiving non-taxable additional payments, would be to 'gross-up' these payments and subject them to tax. This option would also be comparatively expensive but, compared to the previous two, has the advantage that the benefits of the approach would be directed most to those with the lowest incomes. (Increases in the threshold would benefit all taxpayers equally, while cuts in marginal rates benefit those below the top of that rate less than those above.)

(ii) **Social security changes** - An alternative to the approach adopted by the government of increasing free areas would be to reduce the taper in the income test, say to 40 per cent or 25 per cent. Reductions in the taper would have a larger effect on EMTRs, which it would lower, whereas increases in the free areas simply shifts the high EMTRs out. However, taper reductions like increases in the free area, increase EMTRs for persons who become newly eligible for payments. In addition the highest cash benefits from any such change go to those with higher private incomes, e.g. a taper reduction to 25 per cent would increase pension entitlements by $5 per week for a single person with a private income of $60 per week, but the pension increase for someone with a private income of $200 per week would be $40 per week. In contrast, increasing free areas, like an increase in the tax threshold, would give the same collar benefit to all those above the new free level.

(iii) **Integration of taxation and social security** - The problem of poverty traps arises because the provision of cash assistance requires higher marginal rates to face recipients over the range of incomes over which assistance is to be withdrawn. Once again there is a nexus between average and marginal tax rates. For a uniform marginal rate to face all recipients and taxpayers, it would be necessary to introduce some form of guaranteed minimum income along the lines of that proposed by the Commission of Inquiry into Poverty (1975), which would effectively integrate taxation and social security and impose a uniform marginal rate over all income ranges. To finance the costs involved in such a proposal, the uniform marginal rate would have to be of the order of 40 to 50 per cent, which would be much higher than the marginal rates currently facing low income earners currently not receiving social security payments. For these and other reasons, a number of alternative approaches to integration have been proposed. The Taxation Review Committee (1975) and Ingles (1985) have proposed an approach to integration that would involve the abolition and replacement of the income tests on pensions and benefits with a separate tax scale, that would impose a higher tax rate on pensioners' private incomes (say 60 per cent), but which would still be lower than the combined effect of current tax and social security provisions. An alternative approach has been proposed by Dixon and Foster (1983a, 1983b) which would involve the exemption of social security payments from tax, together with the imposition of a new, higher rate of income test, but which would also be lower than that produced by the current system. In effect, both these approaches involve the separation of the taxation and social security systems, rather than their integration. In addition, major integration issues relating to the definition of the income unit remain to be resolved (Edwards 1983, 1984).

6. CONCLUSION

This discussion has shown that the degree of interaction between the taxation and social security systems has increased markedly over the past twenty years. This increasing interaction has been due to both deliberate policy decisions and to social and economic changes that have caused a substantial growth in the number of persons receiving government income support. As a consequence it is difficult to envisage any major reduction in the overlap between taxation and social security. The issues discussed in this paper are likely to remain of concern for some time, as taxation and social security arrangements continue to be adapted to changing social and economic circumstances.

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