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Towards a Stronger, More Equitable and Efficient Tax-Social Security System

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Overview of the Castles Tax and Social Security Roundtable

Introduction

How can the Australian tax system best interact with the social security system to advance the social wellbeing of our national community? Is it also possible to substantially increase the efficiency and/or operational simplicity of the tax and transfer (or social security) systems?

Social equity and systemic efficiency were two of the main themes arising from a joint roundtable held by ANU National Institute for Public Policy, HC Coombs Public Forum, the Academy of Social Sciences and the Australian New Zealand School of Government on 12/13 October 2011. This event brought together policy advisers from Treasury and the Department of Family and Community Services, Housing and Indigenous Affairs (FaCSHIA) and other relevant departments with research experts from academia and elsewhere. The objective was to examine and assess those recommendations of the Henry and Harmer Reports that deal specifically with personal income tax and family assistance; the structure of social security pensions and benefits (eligibility, rates and means tests) and the interaction between these including the impact of effective marginal tax rates; and superannuation.

The participants were asked to identify shorter-term priorities as well as assess whether the proposed architecture would satisfy the objectives of the tax and social security systems and provide a coherent long-term framework. Many of the conclusions arising from the roundtable (and those from the Henry Report), are not expected to be implemented in the short term: their implementation is most likely to take place over several governments. This will require that the strategic direction of reform is widely accepted so that there can be some continuity across governments. Short-term politically based decisions need to be avoided.

This roundtable was held in memory of Ian Castles, who passed away in 2010. As a long time senior member of the public service, including as the Secretary of the Department of Finance and the Australian Statistician and Deputy Secretary at the Department of Prime Minister and Cabinet, Castles dedicated much of his substantial professional career to reforming the tax and transfer system. He was also an active leader within the Academy of Social Sciences for many years. A more richly detailed tribute to Ian Castles' contribution can be found in Professor Andrew Podger's tribute also published as part of this set of papers.

Context: lead up to a roundtable

Between 2009 and now, taxation reform in Australia can be divided into four phases. First, there was the report from the Pension Review led by Dr Jeff Harmer, then Secretary of FaCSHIA, which was published in February 2009. As well as an important input into the Review of 'Australia's Future Tax System', it led to the Government's Secure and Sustainable Pensions Package, a suite of measures affecting age, disability and carer's pensions. Second, there was the report presented to the Treasurer in December 2009 by then-Treasury Secretary Ken Henry on behalf of the Review team, titled 'Australia's Future Tax System' (better known as 'the Henry Report'). This was a comprehensive review of the whole Australian tax and transfer system, the term of reference most relevant to this roundtable being 'improvements to the tax and transfer payment system for individuals and working families, including those for retirees'. The third phase of reform took place sporadically throughout 2010 and 2011, as the Federal Government attempted to implement some of the recommendations and rejected or modified other recommendations contained in the Henry Review. This included a variation on the Henry Review's call for a non-renewable resources tax, and an announced lift in the superannuation contribution rate, from 9 per cent to 12 per cent of salaried income (subject to conditions), which was discussed in the Henry Report but not recommended. The most recent phase came in early October 2011 when a public 'Tax Forum' was convened by the government at Parliament House. With a large number of political, industry, union, NGO and academic leaders present, a public discussion of tax policy was held over two days in a nationally televised event. One session was devoted to the tax and transfer system. While the nature of the forum did not lend itself to detailed study of the issues, it does seem to have succeeded in ensuring more active consideration of outstanding aspects of the Henry Report and several of the recommendations were put back on the policy agenda.

The Castles Roundtable partners consciously tried to complement the Tax Forum by focusing discussion on a particular aspect – the personal income tax and social security system, especially the connection between them – and choosing a format which would encourage freewheeling but expert discussion of trends and challenges. This proved to be very effective.

Some overarching comments

My overall impression from reading the background papers and from discussions at the roundtable is that the Australian tax and transfer system is quite good by OECD standards. That is not a reason for complacency. Indeed the roundtable (and the Henry and Harmer Reports) identified a number of areas for improvement.

The main reasons I make these positive comments about the Australian system are that, compared with other OECD countries, (a) targeting (aided by means testing) is the most effective and 'middle class' welfare is the lowest and (b) the system is far more financially sustainable than those in most OECD countries particularly the European systems as evidenced by some of the current financial problems facing Europe. There is good reason to build on what we have rather than 'start from scratch'. This was essentially the approach of Henry and Harmer. Most of the roundtable's discussion revolved around the Henry Report. The Harmer Report provided excellent background material to support the discussions on pensions and benefits and retirement incomes. Means tests are an important element of the Australian social security system. The Henry Report put forward proposals for revising the means tests, arguing for a more consistent approach to means testing including through the removal of the assets test but inclusion of deemed income from all relevant assets, including superannuation, as part of the assessed means. The recommendations to retain Australia's emphasis on means testing had the strong support of most participants at the roundtable, although some were less positive about means testing family allowances.

The roundtable supported the proposed values (see Box 1) and the guiding principles of equity, simplicity, sustainability, consistency and efficiency for policy reform that were first articulated in the Henry Review. (See Box 2).

Box 1: Proposed values used by the Henry Committee

- a desire to encourage workforce participation;
- the need to promote human capital investment through improved childcare and education opportunities;
- an outward approach to Australia's place in the world;
- pragmatism, recognising the need for an incremental approach to reform;
- an appreciation of the need to balance the standard objectives of the tax-transfer system.

Source: Presentation by John Piggott (a member of the Henry Committee)

Box 2: Design principles for the tax and transfer system

Equity

The tax and transfer system should treat individuals with similar economic capacity in the same way, while those with greater capacity should bear a greater net burden, or benefit less in the case of net transfers. This burden should change more than in proportion to the change in capacity. That is, the overall system should be progressive. Considerations about the equity of the system also need to take into account exposure to complexity and the distribution of compliance costs and risk.

Efficiency

The tax and transfer system should raise and redistribute revenue at the least possible cost to economic efficiency and with minimal administration and compliance costs. All taxes and transfers affect the choices people and businesses make by altering their incentives to work, save, invest or consume things of value to them. The size of these efficiency costs varies from tax to tax (see Chart 1.5 in Box 1.11) and from transfer to transfer, reflecting, in part, the extent to which they affect behaviour. Instability in policy settings can reduce economic efficiency by increasing uncertainty about the expected payoffs to long-term decisions such as investing in education, choosing retirement products, investing in long-lived productive assets and the choice of business structure. These costs represent a net loss to society as a whole, whereas revenue raised through a tax is redistributed among members of society through government expenditure, including transfer payments.

Simplicity

The tax and transfer system should be easy to understand and simple to comply with. A simple and transparent system makes it easier for people to understand their obligations and entitlements. People and businesses will be more likely to make the most beneficial choices for themselves and respond to intended policy signals.

A simple and transparent system may also involve lower compliance costs for taxpayers and transfer recipients.

Sustainability

A principal objective of the tax system is to raise revenue to fund government programs, including transfer payments. The tax system should have the capacity to meet the changing revenue needs of government on an ongoing basis without recourse to inefficient taxes. To be sustainable the tax system, together with the transfer system, must contribute to a fair and equitable society. The cost of the transfer system needs to be predictable and affordable in the light of demographic change. Sustainability also means that the structural features of the system should be durable in a changing policy context, yet flexible enough to allow governments to respond as required. Legal and administrative institutions and frameworks should also be robust to maintain the effectiveness of the system and underpin the legitimacy of the system. Policy settings should also contribute to environmental outcomes that are sustainable.

Policy consistency

Tax and transfer policy should be internally consistent. Rules in one part of the system should not contradict those in another part of the system. To the extent possible, tax and transfer policy should also be consistent with the broader policy objectives of government. However, the primary objectives of the tax and transfer system, to raise revenue and provide assistance to those in need, should not be compromised by other policy objectives.

Source: Henry Review, "Australia's Future Tax System': 17

Data and analysis is extremely important to effective redesign and adjustment of the systems. This became very clear on a number of occasions during the roundtable discussion where evidence challenged popular orthodoxies. For example, analysis demonstrated that there have been some structural reductions in the number of older persons receiving Disability Support Pensions in recent years (i.e. the age specific rates of those receiving DSP at older ages had fallen) largely due to changes in eligibility for related payments such as wife's pensions and age pensions for women aged under 65. On the other hand, adjustment of payment rates (such as the decline in the real rate of Newstart Allowance) had had no demonstrable effect on workforce participation. Retirement behaviour was a further area where better data and analysis might help with the formulation of policy. Another issue discussed in the roundtable concerns the workforce behaviour of mothers of dependent children where data has improved but more is needed. Better data offers the potential to design a more effective and efficient tax and transfer system and so is a good investment.

Key issues in the design of the tax/transfer system

The roundtable identified many issues impacting on the tax/transfer systems. Only some of the more important are discussed here.

First, it is necessary to look holistically at the tax/transfer system including consideration of both horizontal and vertical equity. The connections between the tax and transfer systems are strong. Also, there are connections between the different components of the transfer system. In considering reform, there tends to be too much emphasis on individual components rather than the whole, combined system. This was demonstrated by the narrow terms of reference of the Harmer Review which focused on age and disability pensions, unwittingly perhaps exacerbating inconsistencies with other social security payments and not fully addressing linkages with superannuation arrangements. The Henry Review has gone some way towards addressing these issues.

Second, financial sustainability is a key consideration. Questions were raised about the sustainability of the current system. Two specific concerns are the rapid increase in income tax as a proportion of the total tax take; and the generous superannuation provisions. Both place considerable stress on sustainability. There are many modifications to the current system that might appear 'fair' but their long-term cost may simply not be affordable. Furthermore, future demographic changes are going to put more pressure on the tax/transfer system.

Third, as Henry emphasised, it is important that reforms do not remove work incentives for the working age population. It was also a clear goal of the terms of reference, viz. "The review should take into account the relationship of the tax system with the transfer payments system and other social support payments, rules and concessions, with a view to improving incentives to work, reducing complexity and maintaining cohesion."

However, the roundtable raised questions about whether there was a full understanding of incentives and disincentives. In Henry and elsewhere, there is a lot of emphasis on reducing high effective marginal tax rates because of their impact on work incentives. However, the roundtable suggested that these were not the main issues raised by people when questioned about what was preventing them from working. Rather, the issues raised were the high cost of childcare, lack of public transport, absence of support services and poor health. There needs to be a better understanding of the actual barriers and the impacts of incentives when designing programs. This may be a topic where additional research is justified, as labour market responses of the target group are clearly not based on the incentive impacts alone.

Fourth, and related to this third issue, studies have shown that a most effective way of targeting payments through the social security system is through criteria for eligibility for different forms of income support. Eligibility criteria such as work tests can also be effective in encouraging people of working age (and able to work) to seek and obtain work. Analysis of the effectiveness of eligibility criteria is an important consideration in the design of programs. Some policy makers and public commentators claim that reducing benefit rates in real terms will automatically boost the rate of workforce participation. This rhetoric is not matched by statistical data.

Fifth, while coherence and consistency is essential to good policy, heterogeneity is also an important consideration in the design of programs. Looking at income alone does not recognise the diversity of circumstances of the people who may have the same income level. There may be very good grounds for the system to differentiate between someone who earns a particular income level from 10 hours work and someone who has to work 38 hours to generate the same income. The current system largely treats these situations as the same. For example, some people may only be seeking part-time work because of their particular circumstances (e.g. caring responsibilities). Heterogeneity of personal circumstances is a factor that has to be taken into account when designing programs. Using the analogy of a hole in the ground, it is necessary to distinguish those who simply need a ladder to enable them to climb out of the hole from those who need to be taught how to use the ladder.

Sixth, changing demographics are a consideration for the design of the programs. Some are obvious such as the ageing of the population. Others are less obvious. For example, an increasing proportion of children are being brought up in low socio-economic areas. Programs need to be designed to ensure these children are not caught in a low socio-economic poverty 'trap'. Programs addressing this reality may actually have the greatest long-term benefit.

Seventh, the tax/transfer system is complicated. Few people understand it, including those who are participants in the transfer system (including through superannuation). Given this, it is not surprising that expected changes in behaviour don't always happen. Improved communication with participants may lead to the more desirable behaviours being sought by policy makers.

As a specific example, few Australians are taking advantage of the benefits of annuitising their investments even though a high proportion take out a lump sum on retirement (which is poorly invested in many cases). Voluntary contributions are also low. Yet this is an area of personal investment and income that is taxed lightly when compared with income from other assets.

Greater public understanding of how superannuation works might change behaviour. The public interest may be greatest at present given the impact of the GFC on the retirement savings of many people.

Eighth, the roundtable felt that the Henry Report paid insufficient attention to superannuation benefits, especially how to best manage de-accumulation. The exception was the management of longevity risk although the government initially rejected the recommendations even in this area. The roundtable took the opposite approach to the original position of the Government in that it supported action by the Government to establish a market for annuities to manage longevity risk whereas it did not think the 12 per cent superannuation guarantee was providing much assistance to those employees most in need of a boost to retirement savings. The Henry Report also argued that its recommended changes to superannuation tax would provide a greater benefit to national savings than an increase in the super guarantee to 12 per cent.

Barriers to the redesign of the tax/transfer system

Redesign of the tax/transfer systems will always be difficult. They are complex systems with many vested interests. It is almost inevitable that redesigns will results in 'winners' and 'losers' and, particularly in the current political environment, the 'losers' have many ways of expressing their concerns in a very public way. Some of the main barriers are set out below.

First, lobbying on the tax/transfer system is most often driven by short-term considerations and self-interest. There is insufficient consideration of a longer-term holistic view which is important when so much of the tax/transfer system is so inter-connected. This point was reinforced by the October 2011 Tax Forum. The majority of speakers only addressed their own area of concern rather than the tax/transfer system as a whole.

Second, there is at present a lack of political leadership, or even political courage, to substantially reform the tax/transfer system. The piecemeal treatment of the Henry recommendations, following the partial approach embodied in the earlier Harmer terms of reference, is evidence of this. The Government and Opposition seem to be driven by the election cycle and (not always well informed) public opinion rather than the long term good of the country. This is perhaps not surprising given the relatively short period between elections in Australia.

Third, fiscal considerations are a real and substantial constraint. At present, the Government is putting a lot of emphasis on reducing the size of the deficit while continuing to face modest economic growth, making it hard to compensate 'losers' from any reforms and thus limiting what politically can be undertaken. That will not always be the case. Hopefully, in the future, the economic and fiscal situation will be such that it will not be such a barrier to redesign of systems. Furthermore, is this focus on 'losers' and the use of grandfathering provisions prudent? Although it may be politically difficult to achieve, it may be better policy to withdraw benefits that are no longer warranted.

Fourth, public values and attitudes towards the tax/transfer system can be a significant barrier to reform, especially if they are regarded as politically important. In Australia, there almost seems to be a competition over which party is toughest on working age income support recipients, because that is the electorally popular position, making reconsideration of the size of the benefits more difficult. A recurring theme at the roundtable was the large funding gap between the 'deserving' and the 'undeserving' poor. Many participants expressed their concern over the growing gap in the different rates of support payments received by different categories of welfare recipients. If the purpose of social security payments is to meet the minimum living costs for all those in need, then it is not meeting this purpose for the apparently 'undeserving' poor. Whilst social transfer payments to age pensioners and DSP recipients have, over the past decade, increased faster than cost-of-living price rises, the support rates received by the unemployed (through the Newstart allowance), who are also restricted in their income-earning capacity and in need of assistance to meet basic living expenses, are stagnating and failing to keep up with community living standards. Support for sole parents is also lagging behind that for age and disability pensioners. Fifth, the constraints provided by the Terms of Reference of the Henry Review were not always helpful. Two of the most important are the restriction on taxing superannuation benefits for those over 60, and the restriction on increasing or broadening the base of GST.

The way forward

First, there is a need to agree on the objectives of the social security system, including retirement incomes. Henry has proposed Values and Principles, which were broadly supported by the roundtable, but they need to be complemented by an agreement on Objectives.

There seems to be some implicit agreement on the objectives. Some would argue that the main transfer payments are intended to support a basic quality of living below which no one falls. However, though such a policy position has never been explicitly stated in a government announcement, the logical conclusion to take away from the growing gap is that there is a distinction between different types of income support recipients. There is a decades-long history in the tax and transfers system of distinguishing between pensioners, the unemployed, and students. These same demarcations appear in the Henry Review. Using such efforts at classification does not necessarily call for the hierarchical distinction being made by governments when calculating the level of financial support that each of these groups should receive. The main argument government provides for making this distinction is to provide work incentives but there is little analysis of whether this works or whether the existing gap is necessary to provide those incentives.

It should be recognised that this is a long-term exercise, possibly as long as 15-20 years. As far as possible, political consensus should be reached on the key elements of the tax/transfer system such as the objectives, values and principles. This is more likely if it is treated as a long-term exercise. It can then provide a framework for future government consideration as fiscal and other circumstances change. It should be recognised that it may not be possible to receive sufficient consensus on all proposals and that some will need to be set aside.

It is important to share the problems and proposed directions with the community. They are more likely to accept change if they understand the reasons for change and have been able to contribute to a properly informed public discussion. Their views are often influenced now by perceptions and positions taken by ‘opinion makers’ rather than carefully explained facts.

The roundtable agreed on several changes that should be made. These include:

- Most agreed that increasing and indexing the tax threshold, as proposed by Henry, was a sensible step and could be done in the shorter term.
- The Newstart allowances need upward adjustment especially for the long term unemployed. This could be done in the short term and seems to have broad support apart from the two major political parties. Furthermore, there should be a common approach to indexation so that the gap does not increase in real terms.
- Considerations should be given to a broadening of the tax base including taxes such as the resources rental tax (subsequently implemented) and a financial transactions tax. The roundtable also encouraged consideration of increases in the level of GST. This may be the most efficient way of broadening the tax base, and the financial sustainability of the social security system may depend on it. The alternatives – increasing other forms of tax including income tax, or reducing government-funded programs – may be even less popular electorally than increasing the GST.

- The introduction of a consistent means test, and a revised treatment of assets in the means test, included the deemed income from superannuation assets (but there was no discussion on the level of the deeming rate).
- Programs should recognise that part-time work may be the only possibility (because of constraints on the income support recipient or the lack of availability of full-time work) and be designed accordingly. There would have to be carefully designed conditions to avoid the use of transfer payments to subsidise part-time work where full-time work is an option.
- Eligibility criteria are important and should be carefully considered in the design of programs.
- Support for the Henry Report recommendation for wider reform of housing assistance especially rental assistance for those paying private market rents because of the lack of alternatives.
- There should be investigations of whether all income support payments should be taxed, especially as the move to higher tax thresholds will mean that most income support recipients would not pay tax in any case. It may well considerably simplify the interface between the tax and transfer system.
- Work should start on investigating how the Government can best establish a market for annuities as a form of longevity insurance given the expected demographic changes. This would include the Government possibly selling lifetime annuities themselves to kick-start the market. (Subsequently, the Government has agreed to investigate annuities, and how best to stimulate Superannuation Industry support for them.)
- Whilst the roundtable was able to reach agreement on a number of issues, it could not reach a common view on the best way of treating family assistance. There remained a divergence of views even after a lengthy discussion.

Although the roundtable was somewhat critical of some of the Henry recommendations, the majority of the recommendations dealing with the tax/transfer payments system were either supported or largely supported. The Henry Report has provided a strong base on which to build a much better tax/transfer system and should be considered in that context.

Overall, it was a very worthwhile day but there needs to be continuing dialogue on the issues with increasing focus on the specific details and greater involvement of the most important stakeholders.

Dennis Trewin was the Australian Statistician and head of the Australian Bureau of Statistics from July 2000 until January 2007. He has recently been working as a statistical consultant on assignment with a range of countries and with the UN, OECD and World Bank. Dennis was appointed as a part-time Associate Commissioner at the Productivity Commission for the commissioned study into the Not for Profit Sector. Dennis Trewin has held other senior appointments in Australia, including as a Trustee and Board member for the Australian Reward and Investment Alliance and Chairman of the Advisory Board of the ARC Centre of Excellence for Coral Reef Studies. He is Chairman of the Policy and Advocacy Committee of the Academy of Social Sciences of Australia and the Advisory Board at the Institute for Social Research at Swinburne University. He has been recognised as an Officer in the Order of Australia and received a Centenary Medal for his contribution to statistics.

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[1] http://taxreview.treasury.gov.au/content/FinalReport.aspx?doc=html/publications/papers/Final_Report_Part_1/chapter_1.htm#Chart_1_5

Report on the Proceedings of the Castles Tax and Social Security Roundtable[1]

Introduction

The Henry Report on Australia's tax-transfer system provides a wide-ranging review of the whole framework of taxes by all Australian governments, and of cash transfers by governments to individuals and households. It is pitched to the longer-term, setting out what the Henry Committee considered should be the broad architecture of the system in future, rather than presenting recommendations for specific, early action. The earlier Harmer Report, by contrast, had far narrower terms of reference, focused solely on age and disability pensions and carer payments with particular attention to the adequacy of the single rate of pension. It did not cover pensions and benefits for other categories of people wholly reliant on government for income support nor the broader social security system or related tax arrangements.

The Castles Roundtable, in examining both reports, went well beyond Harmer but not as wide as Henry. It focused on the redistributive elements of the tax-transfer system, in particular the personal income tax system, superannuation tax arrangements and the social security system. While narrower than the whole tax-transfer system, this is still a very wide focus, particularly as current arrangements are extraordinarily complex and full of inconsistencies and confusions.

The challenge for the experts gathered at the roundtable was to find their way through this maze, aided by the Henry and Harmer Reports. They were encouraged to apply a critical eye to the reports, with a view both to identify some priorities for shorter-term reform and to test whether the longer-term architecture proposed would indeed provide the coherence so sorely needed.

Encouragement was provided by Andrew Podger's description of Ian Castles' contribution to policy development and debate in this field from the 1970s to the 1990s. Castles had a unique ability to see the wood from the trees, to appreciate the tax-social security system as a whole and to promote a more coherent approach to meeting the underlying purposes of the government's role in income redistribution.

Principles for a coherent tax-social security system today

Discussion was opened by Jeff Harmer (involved in both the Harmer and Henry Reviews), and John Piggott from the Henry Committee. They drew attention to the key reasons for reviewing the whole tax-transfer system set out in the Henry Report, including the impact of globalisation and the increasing importance of environmental issues. Of particular relevance to the tax-social security elements are:

- the impending demographic changes in Australia, with the proportion of the population aged over 65 expected to nearly double by 2050; and
- technology change, opening up new ways to manage personal tax and transfers.

Another major reason is the complexity of the system and serious doubts that it is effective in meeting its underlying objectives (which are not always entirely clear).

Piggott identified the values the Henry Committee members brought to their task:

- a desire to encourage workforce participation;

- the need to promote human capital investment through improved childcare and education opportunities;
- an outward approach to Australia's place in the world;
- pragmatism, recognising the need for an incremental approach to reform;
- an appreciation of the need to balance the standard objectives of the tax-transfer system.

Harmer and Piggott also identified the principles adopted by the Henry Committee. These included the standard objectives of the tax-transfer system:

- *equity* – which the Committee concluded should be achieved by personal income tax and transfers, not by other parts of the tax system;
- *efficiency* – encompassing economic, administrative and compliance efficiency, leading the Committee to support broadening labour income tax, lowering capital income tax, taxing economic rents and relying more heavily on consumption taxes; and
- *simplicity* – making it easier for people to understand and comply with the law, leading the Committee to propose removing tax filing requirements for many people and making transfers tax-free.

To these were added *sustainability* in terms of raising sufficient revenues and meeting social needs, *predictability* in face of demographic change, and *internal consistency*.

Amongst the key debates within the Henry Committee about trade-offs between these objectives were: whether the tax and social system could be more fully integrated (pragmatism won out, with the Committee focusing more on coherence than integration); the balance between equity and efficiency (the pro-participation emphasis leading to a clear distinction between payments for working age people and those for people not expected to work); and the associated balance between horizontal and vertical equity (the latter being considered more important than the former, even though this would lead to proposals for family assistance that were not as simple as a more universal system which recognised the additional costs of families at all income levels).

In broad terms, Harmer suggested, the Committee was pretty positive about the existing transfer system, its recommendations involving mostly incremental if still important modifications. He commented nonetheless that further work is needed in the area of housing, not only to pursue the Committee's proposals for rent assistance and public housing reform, but also to address problems of housing supply.

Another debate Piggott referred to was about whether the way the system supports the spreading of lifetime earnings through superannuation should involve taxing contributions but exempting benefits, or exempting contributions and taxing benefits. The Committee pursued the first approach (partly because their terms of reference precluded any recommendation to tax superannuation benefits) while also attempting to achieve an outcome broadly similar to that of the more orthodox second approach by proposing a flat rate refundable tax offset. Their recommendations would certainly improve equity, but may leave open problems of sustainability with an ageing population. The associated age pension means test recommendations also represent a pragmatic compromise, being a second-best tax on retirement leisure (by at least restricting access to age pensions for those choosing to retire and having the resources to do so from superannuation or other savings).

There was considerable sympathy amongst roundtable participants for the values and principles set by the Henry Committee, and the discussion corresponded quite closely to the debates the Committee itself had, but not always with the same conclusions. Not surprisingly, there was not always a consensus.

Some were not convinced that the pragmatic approach to balancing equity and efficiency reflected sufficiently the literature on optimal tax strategies by leaving leisure largely untaxed, giving insufficient attention to the costs of caring for children and setting effective marginal tax rates that do not take account of different workforce participation elasticities (i.e. the extent to which people are actually influenced to vary their participation in part-time or full-time work). These participants preferred a more universal approach to family assistance and a more progressive income tax scale.

The Committee's pragmatic approach, of course, reflected continuation of the Australian tradition which gives far more emphasis to means tests than other nations, but also much lower social security budgets and no direct social security contributions. As the background papers from Peter Whiteford demonstrate, this means that Australia's system is the most targeted in the OECD by a long way, though a number of other countries are more redistributive because they spend more.

There was also some unease about the distinction between payments for those of workforce age and those for people not expected to work. While there was universal support to stop the growing gap between the two sets of payments, quite a few participants wanted a common definition of adequacy, thereby setting maximum rates of all the pensions, benefits and allowances concerned at the same rate. This reflected not so much a different view of the right balance between equity and efficiency but a different view of the appropriate means to promote workforce participation – focusing more on work tests and employment and training programs rather than differentiating the payment levels with less-than-adequate minimum income support for some. Some questioned whether the lower rate of payment for the unemployed really reflected the view that they were less deserving than the aged or disabled, rather than the claimed rationale of the need for stronger incentives to work.

Another issue highlighted in the discussion concerned financial sustainability which, while identified in the Henry Report, was possibly understated. It was suggested at the roundtable that, using domestic consumption as the underlying base for revenue-raising, spending demands seem likely to rise from around 35 per cent of gross domestic consumption to above 40 per cent over the next ten years. If this is to be met primarily by the personal income tax system, marginal rates for most must rise to 45 per cent, or more which, with the current GST, implies effective marginal rates of over 50 per cent. Governments will need to consider how best to handle these pressures, including the options to take selected services out of the tax-funded system and to apply more user charges. Roundtable participants considered that the option to rely more heavily on consumption taxes should also not be dismissed. Such options would have significant equity implications.

There was wide support for addressing the equity objective by increasing and indexing the tax threshold as Henry recommends, this being even more important if consumption taxes need to be increased. It was noted, however, that governments had shown unwillingness to commit to this in the past.

Personal income tax and family assistance

Relevant Henry Committee Recommendations

- A much higher personal tax-free threshold, around $25,000, should replace the complex array of thresholds and offsets.
- A simple two-step tax scale should apply.
- Progressivity of the tax system should be enhanced by including all forms of work remuneration.
- Family assistance should be paid through a single program principally based on the additional costs of children, in general increasing with age, and means tested in accordance with family taxable income on the same basis as for income tax.

Henry's pragmatic approach led understandably to rejection of full integration of the personal income tax and social security. The different income units (individual versus family) and the different time frames (annual versus current with fortnightly payments) reflect the different primary objectives of the two, so integration would not only lead to winners and losers that would be hard to manage politically but could also have undesirable impacts on poverty alleviation and/or workforce participation incentives. The focus on more coherence, rather than integration, was therefore accepted by roundtable participants as the most sensible approach.

Henry's main means of achieving this is through a large increase in the tax threshold and a single system of income-tested family allowances.

While accepting the need for a pragmatic approach, Rob Bray (ANU and previously FAHCSIA) opened discussion by highlighting how small the labour force participation gains and losses would be under the Henry personal income tax scale and hence how small the likely labour market response despite the Committee's pro-participation stance. Modelling by Hielke Buddelmeyer of the Melbourne Institute using its MITTS model suggests very small changes overall in employment and even smaller changes in hours worked. As illustrated in the table he presented, even amongst the group with the highest labour market response (married women) the effective change in hours worked would be minimal, whilst average hours worked by single men and women and sole parents would fall.

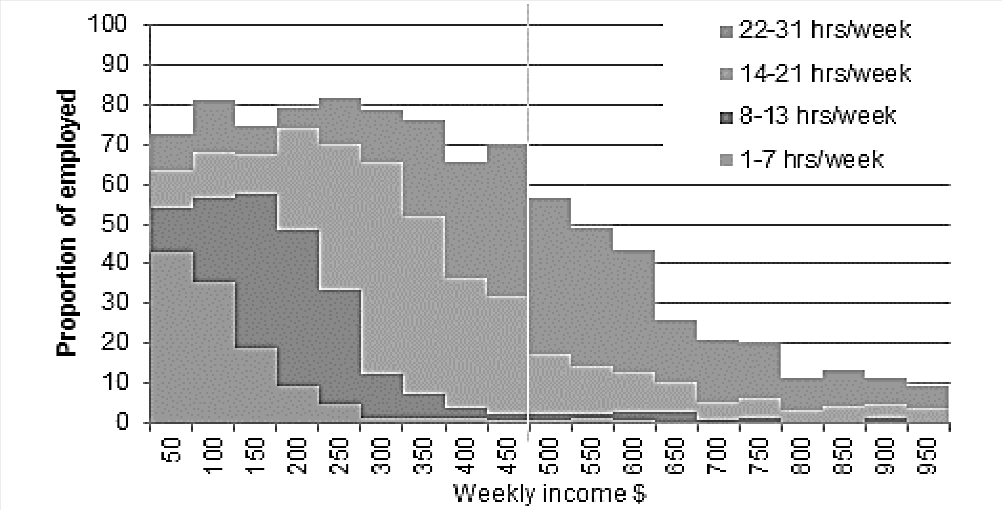
Table 1: Estimated Labour market response

Group	Employ/ pop. Ratio	Jobs	Av hours/ pop.
Married men	+0.04%	1,921	+.01%
Married women	+0.81%	38,896	+0.2%
Single men	+0.01%	300	-0.03%
Single women	+0.05%	1,399	-0.04%
Single parent	-0.82%	-4,730	-0.4%

Australian National University

A second factor identified by Bray was the extent to which the increase in the threshold would substantially exempt most (68 per cent) of part-time workers from paying personal income tax (as the following graph shows, nearly all those working less than 21 hours a week have incomes below the proposed threshold, and a substantial proportion of those working more than 21 hours but less than 31 hours also have incomes below the proposed threshold).

Figure 1: Personal income tax (PIT) threshold and part-time work



Australian National University

He questioned whether this was a desired outcome, although he noted that the GST (along with any expansion of indirect taxes) would still be payable.

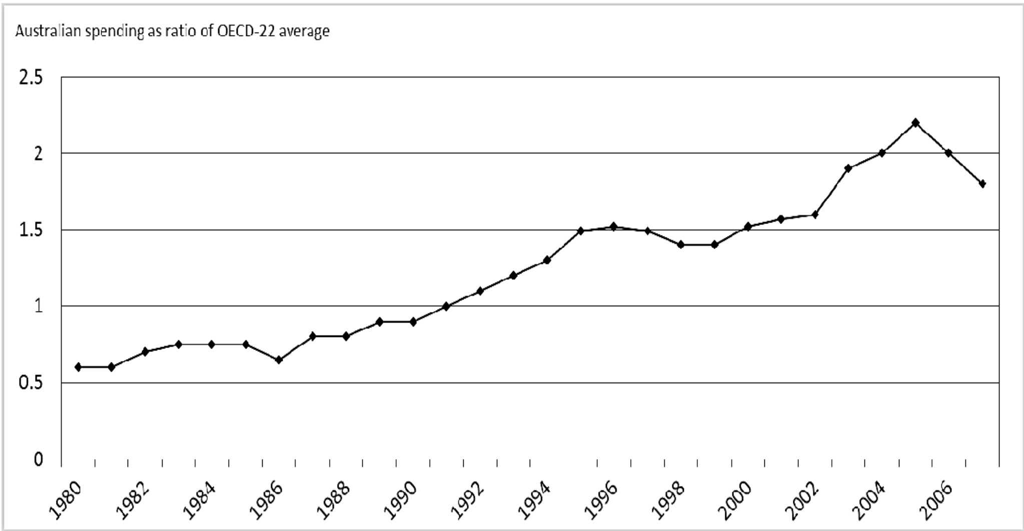
While the story is more complicated when the proposed family allowance changes are taken into account, Bray suggested that Henry had overplayed the role of incentives caused by effective marginal tax rates. For many, including families who make labour supply decisions jointly, considerably greater attention should be paid to income effects more generally and to the value people attach to leisure and home production.

Bray also drew attention to Henry's acceptance of the proposition that family payments should fully cover the direct cost of children in low-income families. While this had been built into the system in the 1980s, it remains a large step to say that this is a state responsibility. Setting such a high maximum payment inevitably raises costs and broadens the impact of the means tests that must be applied.

Accordingly, Bray concluded that Henry's attempt to clean up personal income tax scales had left the transfer system, particularly with respect to family payments, very messy. He saw considerable benefit in some of the tax changes, including the removal of terms such as 'dependent spouse rebate' and 'low income tax offset' which can lead to misleading and counter-productive perceptions of dependency and exclusion (the 'low income tax offset' for example applies up to middle range incomes). He thought that more consideration, however, was needed of Henry's proposed family payments arrangements. Changed banking and credit processes, for example, might provide the opportunity for new payment processes that would rid family payments of its badging problem (as 'Centrelink' or 'welfare' payments), a problem which, like 'dependent spouse' and 'low income tax offset', is much more than simply presentational.

Peter Whiteford, the other discussant in this session of the roundtable, focused on family payments, highlighting Australia's unique arrangements. Over the last 30 years, spending on family allowances has increased from around 60 per cent of the OECD average to around double the average.

Figure 2: Trends in spending on family allowances, 1980 to 2007

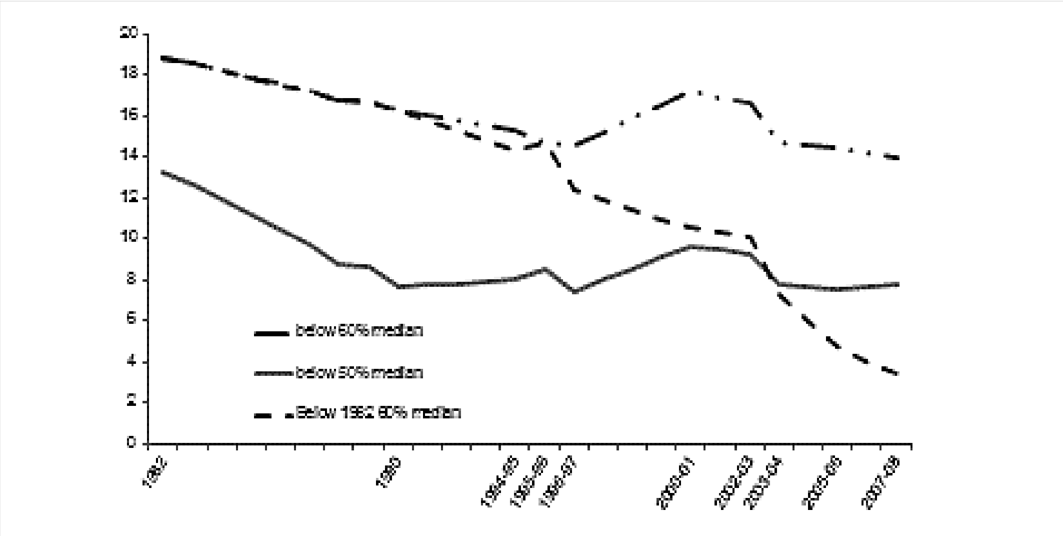


Social Policy Research Centre

Notwithstanding media criticism of Bob Hawke's promise that by 1990 no child would need to live in poverty, the number of children in poverty (as defined relative to median community incomes) did fall dramatically by 1990 (by between 43 and 47 per cent) with the poverty gap also being reduced (by 50 per cent to 55 per cent). That improvement has been largely maintained ever since (despite subsequent increases in family payments, relative poverty has not fallen further but this is a consequence of substantial increases in median incomes since the mid-1990s: if the poverty line was held constant in real 1982 prices, poverty rates would have continued to fall very substantially).

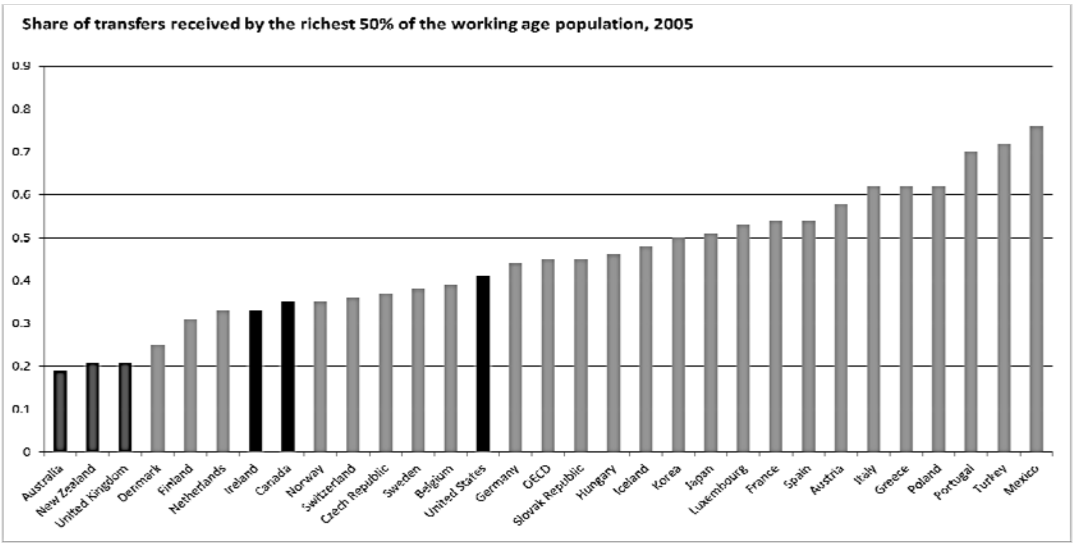
While over this period the payments have become less targeted on the poorest 20 per cent of the working age population, it is still shared predominantly amongst individuals and families with below median income (the shift upwards in incomes covered by family allowances has been driven by more generous payments at low income levels combined with lower rates of income test tapers, raising cut-out points i.e. the income levels where the family allowances payable reduce to zero). Accordingly, as illustrated by Figure 4 (relating to total transfers, not just family payments), Australia's approach still involves the lowest level of 'middle class welfare' in the OECD.

Figure 3: Trends in child poverty in Australia, 1982 to 2007-08



Social Policy Research Centre

Figure 4: Australia, New Zealand and the UK have the lowest 'middle class welfare' in the OECD



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Discussion at the roundtable focused on the balance between horizontal and vertical equity (whether the costs of families should be recognised at all income levels, or whether higher priority should be given to higher payments for families on lower incomes) and the impact of effective marginal tax rates on workforce participation amongst families with children. The Henry recommendation to increase the tax threshold was generally endorsed though there was some debate about other aspects of the personal income tax scale.

Whether there is a tension, at least conceptually, between horizontal and vertical equity was questioned on the basis that horizontal equity (through universal family benefits) is aimed to ensure tax properly reflects capacity to pay at all income levels, after taking into account the costs of children. By doing so, the total revenue collected can be optimised, allowing the government (if it wishes) to allocate more funds towards vertical equity to assist the poor. This line of argument is consistent with Ian Castles' support in the 1970s and 1980s for increased universal family allowances, regarding these as legitimate offsets to tax for taxpaying families with children. On this basis, it was suggested, the real trade-off was between means testing family assistance and having lower (or higher) marginal tax rates at high incomes for taxpayers with or without children.

It was noted that the tension between horizontal and vertical equity became a major issue in practice when family benefits shifted from the revenue side (as deductions or rebates) to the outlays side (as cash payments). The Australian tradition of means testing social security payments then arose in a way that had not applied to tax deductions and rebates. Full integration of social security family benefits and tax-rebated family benefits in the 1990s led to even stronger perceptions of a tension between horizontal and vertical equity. Apart from causing overpayments (as assessable income at the end of the year often exceeded the estimated income during the year), integration locked in the assumption that all low-income families (both pensioner/beneficiary families and other families on low incomes) should receive family assistance covering the total cost of their children. This added greatly to total costs, particularly when income test tapers were reduced to lower effective marginal tax rates, raising questions about whether any family support at high-income levels could be afforded.

The focus amongst many academics and commentators on 'Manhattan sky-lines' of effective marginal tax rates was also seriously questioned by roundtable participants. A more nuanced approach was advocated based on the likely real choices over workforce participation faced by different groups of people. Thus, for example, very high effective marginal tax rates (EMTRs) over narrow ranges of income affecting small numbers of people may not be of particular concern if the workforce choice they face is whether to take up a substantial part-time or full-time job, not to increase participation by an hour or two. For them, the net marginal gain may still be worthwhile despite the high EMTRs over some of the income ranges they jump over. Lowering these EMTRs by extending them over much wider income ranges may well have adverse impacts on the many more people affected, some of whom do face more incremental choices over hours of work. This might suggest an alternative to the Henry approach by having a more modest and more universal payment combined with a generous but more tightly income tested supplement.

Another way of considering the incentive effects of transfers was identified, by classifying them as lump sums (such as payments for the aged and unemployed) in lieu of earned income, or as job subsidies (e.g. the payments for sole parents) supplementing earning from part time work. It was suggested that the Henry approach appears to be to press people into the lump sum group (with full benefits for not working or being able to work) or into full time work. Under this policy, EMTRs are not really the issue as they are not so relevant to the practical choice being forced on to people – whether or not to move from no work to full time work, and how to stay in full time work. Work tests and other eligibility criteria may play a much more important role. More generally, policy makers need to consider more carefully the numbers of people in different categories, the real workforce choices they face and how they might respond to different incentives.

While some participants were uneasy about whether the discussion was dismissing economic theory about marginal rates of return and their effect on workforce incentives, others noted that there are both income and substitution effects to be considered, and emphasised that they were not suggesting EMTRs do not matter but that they need to relate to the real life choices different people face at the margin.

The discussion did not lead to agreement on the best approach to family assistance. Supporters of the Henry approach for a simplified but still fully income-tested family payment conceded that it might not rate particularly well against the criteria of efficiency and simplicity (particularly with the parallel assessments of the income of most taxpayers with children for tax and family allowance purposes), but argued it addressed equity well and was aimed to attract wide public support. Others considered there was an alternative approach based on a modest but universal payment supplemented by a more tightly targeted generous payment, possibly combined with higher taxes at high-income levels (either through higher marginal rates or lower tax points). They suggested such an approach would better meet the efficiency and simplicity criteria, as well as the equity criterion. They recommended that such an approach be developed in more detail and tested against the Henry recommendations in terms of Henry's own criteria.

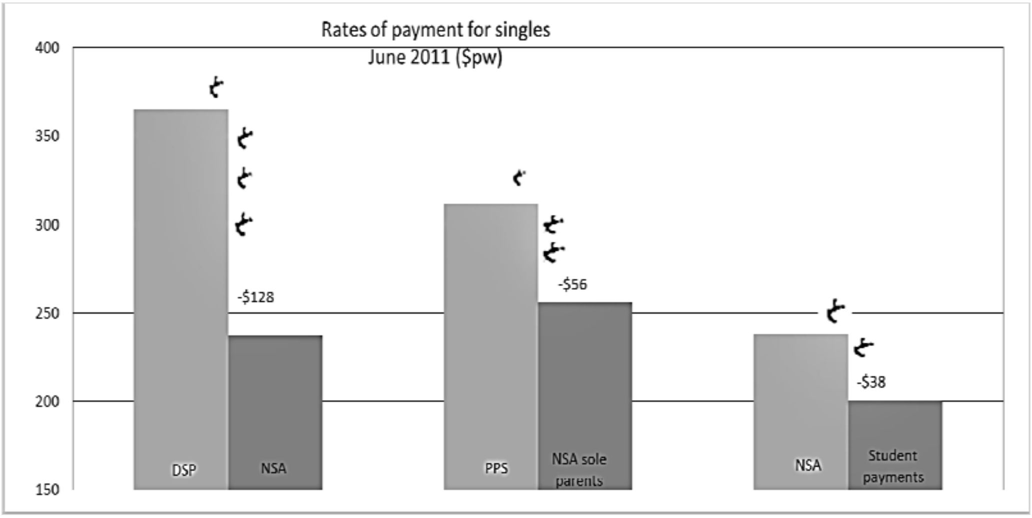
Social security pensions and benefits

Relevant Henry Committee Recommendations

- Three levels of primary support payments should be established – pensions for the aged, disabled and carers; lower-rate participation allowances for those of working age; and assistance payments for young people and students – each with means test withdrawal rates reflecting different work expectations.
- Once adequacy benchmarks are reached, they should be preserved by common indexation arrangements applied to each of the main payment types.
- Following the Pension Review changes, the relativity between the single and couple payments should be improved across the other payment types.
- The assets test should be abolished, and a comprehensive means test base established for the main pension and allowance payments (including for Rent Assistance to prevent additive withdrawal rates). Income from savings would take the form of deemed returns from assets.
- All pensions, allowances and other transfer payments should be tax-free.
- Maximum rates of Rent Assistance should be substantially increased and linked to market rents.
- Subject to transitional arrangements, public housing rent concessions should be replaced by Rent Assistance and a new form of assistance for higher needs tenants, to improve equity and work incentives.

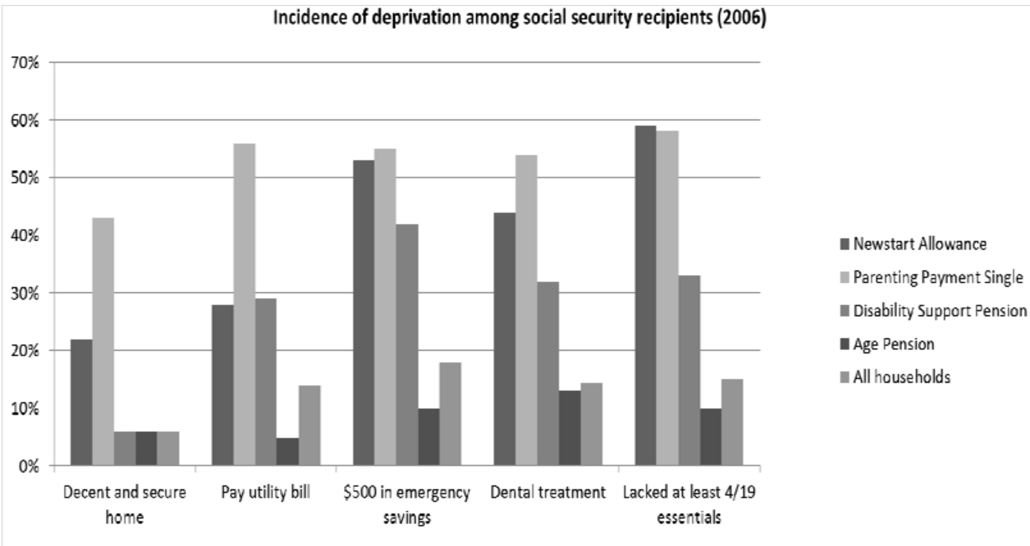
Peter Davidson (ACOSS) opened discussion by highlighting the growing gap between payments for those expected to work (unemployed and sole parents in particular) and payments for those not expected to work (aged, disabled, carers), (see Figure 5). Figure 6 shows the high level of deprivation amongst the former group, despite the fact that reliance on income support amongst those of workforce age has been steadily declining over recent years.

Figure 5: Key payment gaps



Australian Council of Social Service (ACOSS)

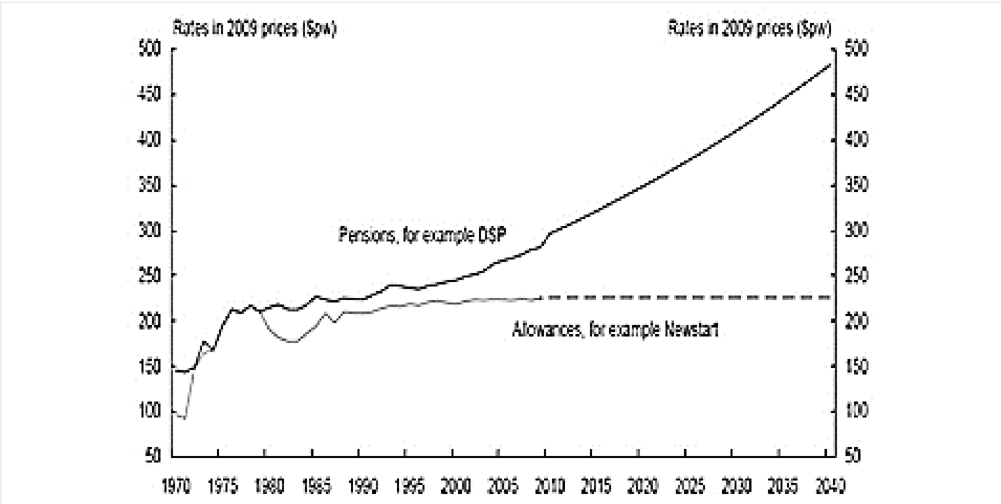
Figure 6: Who's struggling on income support?



Australian Council of Social Service (ACOSS)

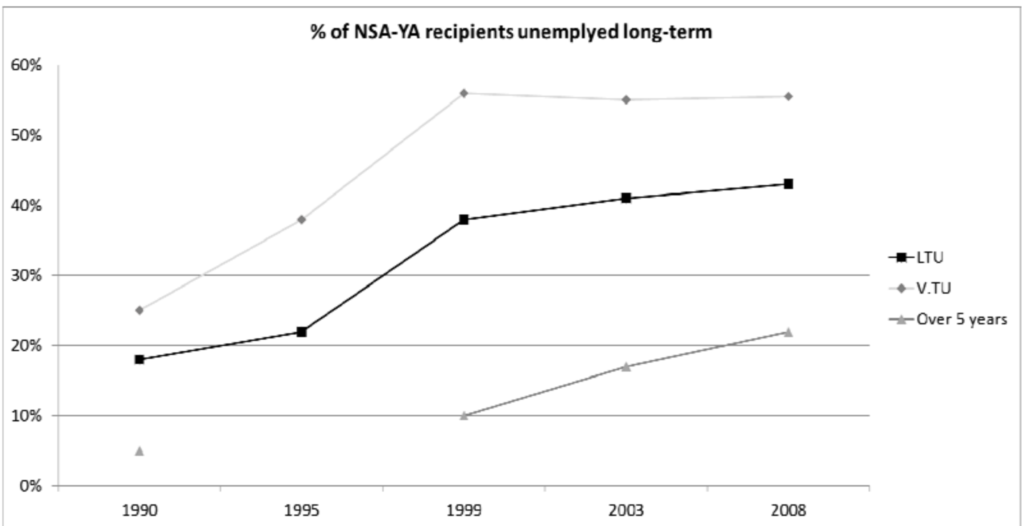
While the Henry Report highlighted the growing gap in payment levels (see Figure 7), and recommended increases in the base rates for single income support recipients in the participation and student categories, the Committee recommended continuing a distinction between payments for working age people and those for people not expected to work, albeit without further widening of the gap by having consistent indexation arrangements.

Figure 7: Real value of pension and allowance payments for a single adult (in 2009 dollars)



Australian Council of Social Service (ACOSS)

Figure 8: The profile of unemployment payments has changed



Australian Council of Social Service (ACOSS)

Davidson strongly questioned the case for such a distinction noting the growing proportion of Newstart recipients who are unemployed long-term (see Figure 8) and their similar needs to and greater lack of personal resources as those on age and disability pensions. One in three are 45 years of older and one in ten are Indigenous.

The main reason Henry maintained the distinction was to retain incentives for those in the participation categories to seek work. Instead, Davidson suggested Australia draw on initiatives in the UK and NZ to introduce a more standard level of minimum income payment but with varying approaches to income tests and conditionality related to expectations of workforce participation.

Bob Gregory (ANU), the second discussant, noted how his views of how people respond to the welfare system have changed dramatically in recent years. Formerly he thought there was a high degree of substitutability, people shifting from one payment to another whenever eligibility rules changed, so that he was pessimistic about the likelihood of moving people off welfare and into jobs by changing eligibility criteria. But it is clear now that eligibility conditions do matter, and can increase the number of people seeking and finding employment. As grandfathering provisions have phased out, the removal of wife's pensions, widows pensions for those without children, and the removal of age pensions for women under 65, have corresponded with a one third reduction in the numbers of older female *and male* recipients of pensions. The changed behaviour of women, for example, has impacted on their husbands' eligibility for disability pensions.

On the other hand, Gregory noted, there is little evidence that rates of payment or EMTRs matter much. Income support for the unemployed is now one third lower than a decade ago, but there is no evidence that this has affected numbers of recipients. Nor do income test changes seem to have had much impact. But eligibility conditions and threats do have an impact. Active programs to help people into work also have an effect, though not greatly for long-term welfare recipients.

Other data mentioned by participants supported Gregory's conclusions. The proportion of older women (aged 60 to 64) on income support has dropped from 68 per cent to 39 per cent over the last decade. The proportion of older men and women on the disability support pension has also dropped with the removal of wife's pensions in particular.

There was considerable support for a single definition of adequacy for those reliant on pensions or benefits. While Henry would stop the gap from growing, many at the roundtable considered that there should be no gap. The increase in age and disability pensions following the Harmer Review had only exacerbated the problem, with the Henry Report's apparent justification of a gap on the grounds of work incentives possibly disguising a political judgement that the unemployed are less deserving than the aged and disabled. Evidence suggested that work incentives could be maintained in other ways.

Maintaining relativities will, of course, require the use of a single indexation factor rather than the current search for indexes related to specific groups' expenditure patterns. While it may not be possible politically to revisit the generosity of the pension indexation factor (based on male average earnings), a strong theoretical case could be made to apply a common price indexation factor to all forms of income support and to provide ad hoc increases to reflect changes in community living standards when this is considered appropriate and as budget circumstances permit. The alternative to apply the current pension indexation factor to all pensions and benefits (in addition to an increase in Newstart Allowance and Single Parenting Payments to reduce or remove the existing gap) may be no less challenging politically (and financially).

One option for reducing the gap is to increase the rent allowance substantially. This was unfortunately not pursued by the government following the Harmer Review despite it being a less costly and less discriminatory approach (addressing the needs of the most vulnerable of all pensioners and beneficiaries, those in private rental accommodation and paying market rates).

The Henry Review, however, supports such action as part of a wider reform of housing assistance. This would not replace the need to reduce or remove the gap between different pensions and benefits (and might raise its own challenges such as the risk of facilitating higher rents), but it could ameliorate the most urgent of concerns.

Discussion turned again to the role of EMTRs on work incentives. Some questioned the need for concern about high EMTRs when work tests provide the necessary incentive.

Further, income tests, which promote part time work amongst Newstart recipients, might seem counterproductive to incentives for full time work. A preferable approach might be to ensure incentives for part time work amongst parents of young children, including those on single parenting payments, and to test disabled people for their capacity to undertake part time work, and then to design the relevant income tests and associated active work programs accordingly.

Discussion of the Henry Committee's recommendations that all transfer payments be exempt from tax led to broad agreement that it be re-considered as it may well be inappropriate and unnecessarily expensive. The case for exemption was based on simplicity – many transfers are already exempt so the suggestion would lead to more consistency, and it would also take many more people out of the tax system.

Those questioning the recommendation noted that the proposed major increase in the tax threshold would ensure people fully or largely reliant on pensions or benefits did not have to pay tax anyway, without exempting the payments themselves. Exemptions would only benefit higher income groups, adding to the privileged status of those already having tax-exempt superannuation benefits. For those receiving pensions or benefits for only some of the year, exemptions would have the curious impact of allowing them to gain a substantial tax refund at the end of the year, without providing any help while in receipt of the pension or benefit. Taxing the pensions and benefits would also claw back a little of the moneys paid without the recipients being put into any income difficulty.

In terms of EMTRs, tax exemption reduces the extent to which tax and income tests overlap but, at the point they still do overlap, the EMTR is higher (the sum of the taper and the marginal tax rate). Taxing pensions smooths EMTRs, increasing some because the overlap is wider but reducing others as the EMTR is equal to the taper plus the marginal tax rate's application to the net taxable income remaining.

While the case for pensions and benefits to be taxed is strong, however, there is also a good case for exempting those payments aimed at horizontal equity whether in the tax or transfer systems, in particular, payments for children. (Current arrangements broadly follow this approach, with most social security pensions and benefits being taxable and family payments being exempt.)

Relevant Henry Committee Recommendations

- The tax on superannuation contributions in the fund should be abolished, increasing saving from currently taxed contributions by 17.5 per cent.
- Instead, employer superannuation contributions in the fund should be included in employee taxable income. Subject to annual limits, all contributions would attract a tax offset payable to contributors.
- All income and gains of superannuation funds should be taxed at a rate of 7.5 per cent, further increasing savings.
- The $50,000 transitional cap for contributors aged 50 or older should be continued indefinitely.
- Superannuation balances should be included in Age Pension means tests on the same basis as other savings.
- The development of longevity insurance products should be encouraged and the government should consider offering such products itself.
- Care services for the aged should in general be separated from accommodation choices and provided on a means tested basis – preferably any future compulsory levies should apply to all personal taxpayers and not be linked only to the superannuation guarantee.

Hazel Bateman (UNSW) opened the discussion, marking the relevant Henry Report recommendations in terms of how well they address the current horrendously complicated and inequitable system of support for superannuation. Henry's superannuation tax proposals deserve three stars (out of three) particularly for addressing equity concerns; there are no stars for action on the demand side and few for the proposals on the supply side; and two stars for Henry's means test proposals, including the treatment of income from superannuation. The Government's response deserves a negative three stars, particularly its decision to increase compulsory contributions to 12 per cent as lobbied by the superannuation industry without addressing the current dysfunctional tax arrangements.

Bateman noted the history of confusing superannuation tax changes, from exempting contributions and fund income while taxing benefits (an EET system), to taxing all three components (TTT), though some concessionally, and then to taxing contributions and fund income only and not benefits (TTE). The tax applying under this last approach is at a flat rate. Henry's proposals would impose progressivity to the system and, while retaining its basic TTE design (as effectively required by the Review's terms of reference as they precluded taxing superannuation benefits), would very broadly replicate an EET system, the more orthodox approach to facilitating the spread of lifetime earnings.

Bateman's main concern is that Henry did not pay enough attention to superannuation benefits, though the Report does identify options for the Government to facilitate the development of a longevity insurance market and recommends consideration be given to the Government selling lifetime annuities (a recommendation initially rejected by the Government). She suggested that the Government's decision to introduce the default My Super fund, because managing investments was too difficult for many people, should be effectively extended to support people to manage their benefits. They need a retirement income plan and, perhaps, some benefits should be required to be in the form of retirement income. She highlighted that, in the first six months of 2011, less than 30 lifetime annuities were sold in the whole of Australia, demonstrating how weak current arrangements for ensuring retirement incomes are. The issues are complex but there is evidently some market failure, exacerbated perhaps by regulatory arrangements prohibiting deferred and variable annuities. The result is that the age pension has become the basis for longevity insurance; it also provides, at taxpayer expense, insurance against poor investment decisions by those who dissipate their lump sum benefits too quickly.

Deborah Ralston (Monash University) described the Melbourne Mercer Global Pension Index, published by the Australian Centre for Financial Studies, which is a comparative international study of retirement systems. In its 2011 report, Australia's retirement system was rated second only to the Netherlands. Australia's system reflects the World Banks' preferred four or five pillar approach which includes public pensions, mandated and voluntary privately funded pensions, such as superannuation, and private savings. We rate particularly highly on *sustainability* (because of our reliance on defined contributions and funding, and with only the age pension safety net reliant on tax revenues, and because of our private savings through home ownership)) but have also improved our position on *adequacy* with the recent increases in the age pension; we also rate reasonably on *integrity*. Using this analytical framework, the Index suggests Australia could improve its rating (and reach "A grade") by increasing the compulsory contribution rate to 12 per cent (as agreed by the Government), improving labour force participation rates of older workers, improving communications by providing better projections of benefits, and encouraging benefits to be taken as an income stream through the use of annuity-like products.

Ralston's positive portrayal of Australia's arrangements did not sit comfortably with many around the table concerned about the cost, inequities and poor retirement income outcomes of the current superannuation system. There was a danger that the Mercer index would provide an excuse for complacency about the serious weaknesses of current arrangements.

The main concern was the one highlighted by Bateman about de-accumulation, or the form of superannuation benefits. This had occupied much of the time of the Henry Committee and initially, apparently, there were signs of Government interest in better management of longevity risk so as to improve sustainability of the superannuation system. Subsequently, the view that self-funded retirees should manage longevity risk on their own seemed to prevail, with the Government taking responsibility only for age pensions. (However, following the Tax Summit, the Government indicated that it would look again at its possible involvement in annuities.) It was also suggested that the problem had fallen between the responsibilities of different government agencies and was not given priority by any of them. Self-interest of funds and investment advisers has also got in the way of good policy to promote retirement incomes particularly via any sale of government annuities or mandating that part of the benefits be in the form of annuities. The views of potential consumers of these products do not seem to have gained much attention.

There was a strong view around the table that the issue of lifetime annuities needs to be put back on the Government's agenda. Options such as the sale of annuities by the government should not be rejected on the basis of the contingent liability involved, as government is already bearing much of this risk, if not more, through age pensions. The issue is about ensuring better adequacy of income over the whole of retirement.

There was also general support for addressing the inequities of current superannuation tax arrangements. Some highlighted the total costs of superannuation tax concessions (estimated by Treasury in its Tax Expenditures publication at over $25 billion), which are of a similar order to the direct cost of age pensions. Others considered that this grossly exaggerates the costs involved because it applies, as the benchmark for neutral taxation, the full marginal tax rate to all contributions and to all fund earnings, as would apply now to money people might put into bank accounts. As Henry highlights, this approach to taxing savings amounts to a substantial tax on assets, not just income and, in any case, a more appropriate benchmark might be one attuned to the objective of spreading lifetime earnings, i.e. a tax on final consumption rather than on income. Using this as a benchmark, superannuation tax expenditures would probably be a small fraction of the figure currently quoted. It would, however, be even more skewed towards higher income groups, with lower income groups actually being penalised, demonstrating even more clearly the inequities of current arrangements.

The Henry Committee addressed the equity problem by proposing that the tax on contributions be based on individuals' marginal income tax rates less a standard offset (using a 20 per cent offset to illustrate the approach). Thus higher income contributors would pay around 30 per cent tax on contributions (50 less 20), most would continue to pay 15 per cent (35 less 20) and low income contributors would receive a 20 per cent co-contribution (replacing the existing co-contribution system). The Committee also recommended halving the tax on fund earnings from 15 per cent to 7.5 per cent.

These recommendations were based upon the requirement in the terms of reference that superannuation benefits not be taxed. While some considered that requirement to be politically immutable (and administratively difficult to reverse), others expressed concern about the long-term impact. The move away from a more orthodox EET system began when Paul Keating (as Treasurer) introduced the 15 per cent tax on contributions and fund earnings. The effect was to bring forward tax revenues from future benefits to address immediate budgetary pressures. Completion of the move to a TTE system came when Peter Costello announced that benefits from taxed schemes would in future be fully exempt. Notwithstanding rhetoric from both major parties that the superannuation reforms were intended to improve sustainability and address the ageing population, these measures have exacerbated future fiscal problems by reducing future revenues from benefits and using the moneys brought forward for immediate budgetary purposes.

That said, there is no easy way to return to an EET arrangement. In the meantime, however, there is also no evident political support yet for the Committee's proposals.

The Henry Committee's means test proposals, however, including the treatment of superannuation savings, could be seen to provide a partial solution to the absence of an EET tax arrangement. The proposed comprehensive income test would ensure access to age pensions is reduced on account of superannuation savings however these are drawn down.

This somewhat messy approach will still allow most superannuation beneficiaries to receive a full or part age pension given the still relatively low retirement incomes available from their superannuation savings, adding to the adequacy of their total retirement incomes. As some roundtable participants noted, the two components of the retirement incomes system should not be presented as conflicting – one aimed primarily at reducing the other – but mostly as complementary, together meeting the twin objectives of poverty alleviation amongst the aged and income maintenance at, and through, retirement.

There was little support for the Government's decision to increase compulsory superannuation contributions to 12 per cent, given that the increased employer contributions would be borne effectively by the employees. Concern was expressed about the effective burden on lower income groups with more pressing needs in their working age years particularly when the higher contributions would only yield marginally better retirement incomes given their likely dependence upon age pensions. There was also concern about possible gender imbalance as the higher contribution could impact more adversely on women with intermittent and part time workforce participation. A higher priority might be warranted to extend the existing superannuation guarantee to the 20 per cent not now covered.

On the other hand, some consumer organisations are more favourably disposed towards the decision to increase the guarantee so long as it is part of a broader strategy to address the needs of older Australians including improved aged care, health services, transport and housing.

That package might involve bringing the personal home into the financing requirements for aged care as recommended by the Productivity Commission, but only if the trade-offs in terms of increased security and quality of care can be demonstrated. Groups such as Seniors Australia are looking for a stronger consumer focus, with better understanding of the need to address the complexities of current arrangements and the burden of worry placed on people as to how best to manage their finances. Clearer rules on levels of contributions, and forms of retirement benefits would add to their security and peace of mind if combined with firmer guarantees of access to quality services.

The Henry Committee's recommendation to increase the preservation age to the age pension age by 2024 also received mixed views. Apart from the political difficulties involved, many people may find it difficult to continue in full time work to age pension age given their lack of relevant skills and mobility. The ability to draw on superannuation during a more gradual transition to retirement might be more sensible than some artificial approach to try to force people onto Newstart, etc. at older ages pending their access to their own-funded superannuation. So long as the system does not encourage excessive draw down of benefits before age pension age (for example, by requiring some to be used to purchase deferred annuities), a less stringent approach to the preservation age might be appropriate.

Conclusions

Dennis Trewin presented an initial overview of the roundtable discussion, identifying areas of broad agreement, the key issues identified and debated and the barriers to genuine reform; he also suggested a way forward including some priorities for early action (see separate paper).

Subsequent discussion confirmed broad agreement with the values and principles adopted by the Henry Committee, and widespread support for much of the direction for long-term reform set out in the Henry Report. This recognised the strengths of Australia's current approach to social security transfers, while giving more emphasis to its sustainability and the importance of promoting workforce participation for both equity and efficiency reasons.

Particular priorities for early action include addressing the growing gap between Newstart and other pensions and benefits, increasing rent assistance, further action to increase the tax threshold and simplify the personal income tax scale, and ensuring more superannuation benefits are in the form of lifetime annuities. There was also support for some early action to address the inequities involved in current superannuation tax arrangements.

The lack of agreement on two issues in particular suggests there is room for more analysis, including through development of clearer alternatives that might be compared. Regarding family assistance, an alternative to Henry's single income-tested payment involving a modest universal payment with a tightly income-tested supplement might facilitate more careful study of the trade-offs in equity, efficiency and simplicity. Regarding superannuation, while bipartisan commitment to tax-free benefits might preclude any return to an EET regime, more research might be conducted to compare the effect of the Henry approach, including the comprehensive income test on age pensions, with a more orthodox EET regime, to test longer-term revenue/expenditure implications and the incidence of these tax/transfer alternatives.

The discussion also revealed some interesting new insights into the issue of work incentives and the role of EMTRs in the tax/transfer system. A much more nuanced appreciation of the role of EMTRs emerged together with a better understanding of the importance of other design elements, particularly the conditions applying for eligibility for pensions and benefits, to incentives for full and part-time employment. The roundtable also confirmed the value and continuing relevance of the work done by Ian Castles, emphasising the tax/transfer arrangements as a system, and coming to grips with the underlying issues and the combined impact of its different elements. He would have enjoyed the discussion.

Andrew Podger is Professor of Public Policy at ANU, and Adjunct Professor at Xi'an Jiao-tong University in China. He was Secretary of the Australian Department of Health and Aged Care from 1996 to 2002, and previously headed the Departments of Housing and Regional Development and Administrative Services. He was Public Service Commissioner from 2002 to 2004. Since retiring, Andrew Podger has advised governments in Australia and Asia on aspects of public administration, particularly on social policies and public sector management.

John Wanna is the ANZSOG Foundation Professor for the Sir John Bunting Chair of Public Administration based at the Australian National University. Professor Wanna's research interests include Australian and comparative politics, public expenditure and budgeting, and government-business relations. He also writes on state politics and has been a regular state political commentator for the Australian Broadcasting Corporation (ABC), The Courier-Mail, The Australian and other media outlets.

[1] The Castles Roundtable was held on 12-13 October 2011 at the Australian National University. Participants included some members of the Henry Committee, practitioners from the relevant Commonwealth agencies along with academic experts and several former public servants with considerable experience and expertise in the field. The Chatham House Rule applied. Those mentioned in this report by name have all agreed to the references made.

Ian Castles and the Henry Tax/Transfers Review

Ian Castles passed away in September 2010. A number of us here attended the service at University House, Australian National University, where we celebrated Ian's many contributions and achievements. He was a man of extraordinary intellect, whose advice to government was always based upon the most careful analysis of the evidence, while also reflecting an amazing sense of political opportunities for reform. We are honoured tonight to have Glenice Castles join us, along with two of Ian and Glenice's children, Richie and Simon.

When Dennis Trewin first suggested to me that we have a roundtable on the social security and personal income tax elements of the Henry Report, I immediately thought of the continuing relevance of Ian Castles' work in this field in the 1970s and 1980s. Dennis, who like me worked closely with Ian (in his case in the Australian Bureau of Statistics (ABS) in the 1980s and 1990s), quickly agreed that such a roundtable should be used to highlight Ian's contribution as well as to explore in some detail these elements of the Henry Report and priorities for action now and in the years ahead.

My involvement with Castles' work on income security

My involvement with Ian began in 1975 when Gough Whitlam established the Income Security Review under Ian's chairmanship. I was seconded to the ISR secretariat from the Social Welfare Commission along with Helen Williams from Treasury, Steve Spooner from Social Security and Michael Goonrey from Repatriation and Compensation. Ian was then a deputy secretary in Prime Minister and Cabinet (PM&C). He was appointed chair of the ISR because he was seen to have some independence, but also because he had been on the Swan Committee that led to Bill Hayden's reforms of personal income tax in the 1975 Budget.

The Fraser Government decided to continue the Income Security Review with Castles in the chair: I remained in the secretariat and Mike Keating and Col McAlister became deputy chairs in 1976 and 1977 respectively. Sometime later in a song written for Col's 40th birthday, we referred unkindly to the ISR as "an exercise that didn't take us very far", but, as I will explain shortly, much of its work still resonates. I continued working with Ian in PM&C before he moved to head Finance and I moved to Social Security. Ian kept close contact with this group, seconding me at one point for a policy review of aspects of the tax system by Finance and Treasury. I later joined Ian in Finance in 1982, working with him on social security, tax and superannuation reform before Ian moved on to the ABS in 1986.

The income security review

The context of the ISR, established more than 35 years ago, was somewhat different to the context in which we are examining the Henry Report, but both exercises focused on tax and transfers as a 'system'. Our initial reference points were a series of major independent reviews during the 1970s: the Asprey Report on the tax system, the Henderson Report on poverty, the Hancock Report on national superannuation and the Woodhouse Report on national compensation (also the Toose report on the repatriation system for veterans). The ISR was established by Whitlam in part to help sort out the contrasting approaches recommended in these reports, the emphasis on insurance and income maintenance by Hancock and

Woodhouse and the emphasis on poverty alleviation and guaranteed minimum income by Henderson and, to a degree, also by Asprey (influenced by the Treasury Paper on Guaranteed Minimum Income prepared mostly by Daryl Dixon, one of a series of excellent submissions by Treasury to the Asprey Review).

The ISR was a fundamental review though it was conducted wholly within government and its reports and papers kept confidential (the earlier major inquiries having been published after wide consultative processes). It examined in some detail all income security programs and policies across departments, also addressing the role of the minimum wage and labour market programs. It focused in particular on the interaction between cash transfers and personal income tax. Over two years it presented half a dozen reports to Cabinet, drawing on over 30 background papers.

Whitlam was in favour of the grand, national insurance proposals but his original national Woodhouse-inspired compensation legislation had been stymied in the Senate; the ISR was required to take into account a revised proposal then before the Parliament based only on injury compensation. Much to his ire, the Social Welfare Commission had contributed to the Senate's rejection of the original legislation through its evidence to the committee, which criticised the costs and the lack of priority given to poverty alleviation. But others in the bureaucracy, including the Priorities Review Staff, had offered similar advice to the Government confidentially. The Government later authorised publication of the Priorities Review Staff's report, which advocated a Guaranteed Minimum Income along similar lines to that proposed by Henderson.

I met Ian for the first time at the first meeting of the Inter Departmental Committee (IDC) established to oversee the ISR, before its secretariat in PM&C was set up. Gough Whitlam himself chaired the meeting in the Cabinet Room, Ian sitting at his right hand and officials from Treasury, Social Security, Repatriation and Compensation, Labour and Industrial Relations, the Priorities Review Staff and the Social Welfare Commission seated around the table. The Prime Minister opened with a very pointed criticism of the Commission and the Priorities Review Staff, before the IDC began to discuss how the work of the ISR might be pursued. Towards the end of the meeting, Aussie Holmes from the Priorities Review Staff and EE Payne (then deputy chair of the Social Welfare Commission) asked for the opportunity to respond to the Prime Minister's opening criticisms. I recall this particularly well as the Prime Minister told my boss that he did not know he was from the Social Welfare Commission: he thought his bearded young colleague beside him was the Social Welfare Commission. That was me, the equivalent of an EL1 today, aged 26, in my first ever meeting with a Prime Minister. I nearly slid under the table as I realised Whitlam had personally followed my evidence given at a hearing of the Senate Committee.

While then accepting perhaps that his criticism of the PRS and the Commission might have been a little too harsh, Whitlam turned to Ian Castles and said something like: "But I have full confidence in you, Mr Castles, in chairing this Income Security Review and your ability to properly advise the Government in confidence".

The Income Security Review's first report to Cabinet was lodged with the Cabinet Office on the morning of 11 November 1975 (the day the Whitlam Government was dismissed) with a short covering Submission from the Prime Minister. Obviously the Whitlam Cabinet never had an opportunity to consider its work. But that first report did set a broad framework for the Income Security Review's subsequent work for the Fraser Government.

It suggested a two-pronged approach by identifying the qualifications that would necessarily introduce a degree of complexity into any guaranteed minimum income scheme, and the scope for simplifying and rationalising existing and proposed programs. It noted that earnings related schemes could operate in conjunction with either approach or stand alone. Thus the ideas of Henderson, and the PRS, formed a broad benchmark, but the ISR also highlighted the extent to which the existing social security system provided guaranteed income support for those considered to need assistance with the minimum wage and government family assistance providing protection for others. The report identified a long list of papers under preparation including a tome on 'Inadequacies, Overlaps and Inefficiencies in the Existing Income Security System', known to us as 'Gaps and Craps', which – sadly – I strongly suspect would now be many times the size if updated to 2011.

This practical approach, linked explicitly to a theoretically attractive benchmark such as the Henderson Guaranteed Minimum Income, was quintessentially the Castles' style: it facilitated consideration of principles and exposed the inherent tensions between objectives such as concentrating assistance on those most in need and encouraging self-help, while also ensuring the identification of politically feasible options.

Subsequent ISR reports to the Fraser Government on family allowances, social security income tests, sole parents' pensions and taxation treatment all related in some way to the general idea of a more coherent Guaranteed Minimum Income, but without the naive suggestion that cash assistance should be available without any test of need. While it is best remembered for advising the 1976 family allowances reform, the ISR contributed to many other reforms including the establishment of the sole parents' pension, quite unique internationally, moves to a simpler social security income test and indexation arrangements across social security and tax.

The ISR also confirmed with the Fraser Government its view that the national insurance schemes should not proceed, with the clear implication that further action was needed to reform occupational superannuation and existing workers' and other compensation schemes, to supplement or complement social security. I suspect that was always Ian's preference.

Let me turn now to the three aspects of the tax and social security system to be explored at this roundtable, and Castles' contributions in each area.

Personal income tax and family assistance

The ISR report on family allowances in 1976 was in response to a Treasury proposal to means test child endowment, one of many Treasury savings papers aimed to help the Fraser Government reduce the very rapid growth in outlays under Whitlam. The report included a minor variation of the Treasury proposal as one option, but clearly favoured the alternative option of cashing out tax rebates for dependent children, adding these to universal child endowment, set at rates that achieved the same net budgetary savings as the first option. As Hayden later acknowledged, this proposal was a natural extension of his reform – recommended by the Swan Committee on which Ian had served – to replace tax concessions for dependent children with tax rebates. Castles highlighted its consistency with Henderson's Guaranteed Minimum Income, which necessarily involved universal payments in respect of dependants. He also tellingly demonstrated in a highly influential graph how the cashing out provided increased assistance to families with incomes at or below the tax threshold, including nearly all pensioners and beneficiaries with children. Other benefits of this option included the transfer "from wallet to purse", the avoidance of high effective marginal tax rates and their impact on women's employment, and the ease of administration.

Of course, the budgetary savings had to come from somewhere: they came from freezing the new rates of family allowances so that, over the ensuing years taxpaying families with children were disadvantaged compared to those without children. This was of increasing concern to ministers like Margaret Guilfoyle as well as to Castles and others of us who contributed to the 1976 reform despite our understanding at the time that some such effect was implicit in the 1976 measure, at least in the short term.

What none of us appreciated sufficiently was the powerful effect of taking out an integral part of the tax system and placing it in the social security system, turning it from a tax offset into an outlay. Notwithstanding the similar net impact, the presentational difference continues to affect policy attitudes of many politicians, officials and public commentators.

Castles highlighted this in the early 1980s, noting that the tax rebates for children still existed for the purposes of zone allowances for those living in remote areas. These had been indexed every year since 1976 while family allowances were frozen. He once suggested that perhaps family allowances could be presented in government accounts as an offset to tax rather than as an outlay, as had been done for a somewhat similar payment in Canada, noting also that tax refunds are treated that way even though they are paid out and appropriated.

Castles' frustration with the presentational problem became most apparent in 1983 when the Hawke Government was looking for budgetary savings and Finance chaired an Inter Departmental Committee reviewing family allowances. Much to the anger of Treasury and PM&C, we in Finance did not support means testing the payments but joined with Social Security in defending their universality. On hearing of (Treasury deputy secretary) David Morgan's advice to Cabinet that he and his wife (Ros Kelly, a Government minister) should not be receiving family allowances, Castles sent a note to the Finance Minister showing that, in a revenue neutral approach, the Morgan family would almost certainly have a net gain from means-testing family allowances if the moneys saved were redistributed via a tax cut. The issue was not whether high-income families like the Morgans should benefit from family allowances, but whether the presence of dependent children affected capacity to pay tax at all income levels.

What was, and remains, frustrating, is the 'topsy-turvy' nature of the arguments caused by this presentational challenge. It was the welfare lobby and the Social Security Department that were left to argue the tax equity argument despite the axiomatic truth that, in terms of their primary interest in poverty alleviation, universal family allowances were inefficient and wasted money that could be better spent on pensions and benefits and means tested family payments. Meanwhile Treasury (along with PM&C) was pressing Finance to argue the poverty alleviation line albeit with some reduction in spending, when their purpose was to find savings to protect taxpayers. At some point, it was inevitable that the welfare lobby, and probably Social Security, would trade-in universal family allowances in order to gain an increase in more targeted welfare spending even if this was at a cost to taxpayers with children.

Under Castles, the Finance view was that our role to promote economy (as well as efficiency and effectiveness) meant we should be questioning and helping governments to contain what I would term 'real welfare' spending, along with other public spending, in order to minimise pressure to increase taxes and, preferably, to facilitate reductions in tax – and increases in family allowances. (Not that Castles was blindly in favour of containing welfare or reducing taxes: he was always looking to identify a tax-transfers system that was fair and promoted the wellbeing of all.)

Some of this will resonate with those involved in the Social Security Review in the 1980s for the then minister, Brian Howe, as the income-testing of family allowances in 1987 came in spite of that Review arguing for universal payments on the grounds of horizontal equity.

The Henry Report identifies the trade-off between horizontal and vertical equity in discussing family payments. While recognising the tension, I am not sure Castles would have approached the issue the same way. I suspect he would argue that recognising that capacity to pay tax is affected by the presence of dependent children is central to optimising revenue from personal income tax, and hence the funds available for poverty alleviation measures. In other words, some form of universal support should be an integral component of the tax and social security system.

I have told before the story of Castles' 1977 advice to Fraser on personal income tax reform. It began with Doug Anthony, as Acting Prime Minister, giving a speech to a rural constituency advocating a proportional tax system (or a 'flat tax'). Castles called me into his office to discuss what advice we should give, in light of the widespread press criticism of Anthony's speech. We noted that the various Guaranteed Minimum Income schemes all had standard rates of tax over most income levels, but also all involved a high tax threshold where any negative income tax ran out or a demogrand payment was fully offset by tax. We agreed it would be feasible to have a standard tax rate for the vast majority of taxpayers so long as there was a sufficiently high threshold to protect the poor; excessive tax cuts at high income levels could be avoided by surcharges affecting a small minority of taxpayers. Such a scale would, like the original Hayden tax scale, marry well with social security payments if the threshold was significantly higher than those payments.

We set to work on developing such a scale, costing it and testing for winners and losers, using our new Texas Instruments calculator. Within about 24 hours, Castles sent a telex to the Prime Minister who was stopping in Singapore on his way home, advising him not to reject Anthony's idea out of hand when meeting the press at Sydney Airport in the morning, but to agree to officials working further on the matter. Castles included in the telex an illustrative option of a possible scale. Several months later after acrimonious arguments with Treasury, the Government announced the new tax scale to commence in February 1978. It had exactly the same threshold ($3750) and standard rate (32 per cent) as Castles proposed in his telex. Castles' proposed surcharges (14 per cent and 28 per cent) were taken up, starting at high-income levels almost exactly as Castles suggested.

Importantly, the new tax threshold was well above the pension level, and the standard tax rate applied all the way to incomes well above Average Weekly Earnings, ensuring coherence between tax and social security and appropriate work incentives for most people of working age.

I should mention that that threshold is equivalent to over $24,000 today (comparable to Henry's recommended $25,000), though the first surcharge came in at the equivalent of just over $100,000, not the $180,000 proposed by Henry.

Over subsequent years, Treasury successfully advised against adjusting the tax threshold, failing in my view to appreciate the role of personal income tax, together with transfers, in achieving a fair distribution of income. This policy also brought more and more pensioners back into the tax system causing them to face high effective marginal tax rates. Complicating matters, governments then reduced marginal tax rates at lower income levels rather than increase the threshold in order to protect middle-income earners. Whenever the opportunity arose, Castles argued for increasing the threshold, retaining the integrity of the 1978 reform.

An even more serious attack on the threshold came in 1986 from Michael Porter from Monash University who presented an influential but essentially nonsensical proposal to "means test" the tax threshold. Castles was, I think, stunned by the proposal and its wide support despite what he thought was its transparently obvious sleight of hand. He provided forceful advice to the minister, Peter Walsh, highlighting the fact that the proposal did not abolish the threshold for high income earners at all, but merely offset an increased threshold (via a new "low income tax offset") with higher effective marginal tax rates at moderate income levels; these applied precisely where efficiency losses were most likely to occur. He also warned that the Porter approach would in time require a replication of the social security system within the tax system if full-rate pensioners and beneficiaries were not to pay tax on their minimum income payments, and involved a very substantial redistribution to the rich.

Notwithstanding this advice, and Walsh's acceptance of it, there has been a steady increase in the level and array of income-tested tax rebates to ensure the effective tax threshold increased in line with social security payments. Our $6,000 threshold is in reality now over $16,000 (the recent claim by the Treasurer that his latest proposals will "triple the tax threshold" are almost as misleading as Porter's original suggestion that his proposal would abolish the threshold); moreover, the rebate income tests now involve high effective marginal tax rates over wide ranges of modest incomes.

(Porter also proposed the abolition of family allowances, restricting child payments to pensioner and beneficiary families only. Castles was as scathing about this as he was about the so-called abolition of the tax threshold. He noted Porter's claim was that this would allow marginal tax rates to be reduced, enhancing incentives to work; this of course totally ignored the inevitable increase in effective marginal tax rates for pensioner families. Castles then drew attention to the fact that the much higher workforce participation of sole parents in other developed countries at the time was associated with more universal family assistance, not more means-tested assistance.)

I have no doubt Castles would welcome the Henry personal income tax recommendations which would remove the nonsense-on-stilts that has built up since the mid-1980s and return to a simpler and more sensible scale similar to the one he recommended over 30 years ago.

Pensions and benefits

Henry proposes distinctions between payments for age and disability pensioners and carers, those for people of workforce age, and students. The ISR 35 years ago supported the Henderson Poverty Inquiry's approach to distinguish between those for whom provision needs to be made on a long-term basis (pensioners) and those who are experiencing a loss of income as a result of a short-term contingency such as unemployment or sickness (beneficiaries). It did not address student assistance.

Looking back at the ISR reports, it is clear that the ISR approach has some similarity to Henry's, the differences relating mostly to changes in our society and workforce since the 1970s. The ISR began the questioning of the need for pensions for certain people of workforce age (wife's pensions and age pensions for women under 65) and whether sole parents' pensions should have work tests.

Importantly, however, the ISR did not suggest different levels of payment for pensioners to that for beneficiaries. The implied assumption was that 'adequacy' required the same rates of minimum income support, as Henderson had recommended and the Whitlam Government had effected. The first step to favour pensioners over beneficiaries came after the ISR when the Fraser Government decided to freeze the single rate of unemployment benefit against the advice from those of us in PM&C. One cannot help but suspect that this reflected an unstated distinction between the 'deserving' and 'undeserving' poor rather than any more objective assessment of need. As Henry highlights, the differences in rates are now very substantial and still growing, and now affect sole parent pensioners as well as the unemployed; this urgently needs to be addressed, and ideally by a single definition of adequacy, not Henry's apparent compromise with unstated notions of 'deserving' and 'less deserving' categories.

I do not know for certain Castles' view on whether pension and benefit payment levels should be exactly the same, but I am not aware he ever suggested varying maximum rates of pensions and benefits to encourage people to work (other than young unemployed); rather, he focused on effective marginal tax rates and also gave more attention to the role of work tests than Henry seems to have done. Work tests play a critical role in promoting genuine workforce participation, offsetting the risk that the welfare payments become a lifestyle. They can also remove much of the need for concern about the impact of high effective marginal tax rates on work incentives. And they have some advantages in their flexibility according to labour market conditions. Castles recommended strengthening the tests firmly as the economy recovered after recessions, expressing less concern when the economy was weak.

The ISR recommended removing the former property test element of the pension means test and applying tests on income only, including income from assets. Ian was also opposed to reintroducing an assets test in the 1980s, preferring to keep closer similarity between tax and social security treatment of income and means. Interestingly Henry proposes returning to an income test, though his 'comprehensive income' definition involves deeming income from assets whether or not interest is earned. Henry does not apply this approach to personal income tax but he does propose other measures to tax income from savings more consistently and appropriately.

The ISR triggered decisions to widen the taxation of social security pensions and benefits. The initial argument was related to the then policy in favour of universal age pensions, taxing them being seen as a reasonable offset to abolishing the means test. The ISR demonstrated that taxing means-tested pensions did not affect those wholly reliant on them because of the tax threshold; others paid additional tax, with their effective marginal tax rates being “smoothed” through the closer interaction between the means test and the tax system. Taxing unemployment and sickness benefits had the added advantage of seamlessly clawing back some of the government assistance if the person was only unemployed or sick for part of the financial year. Castles did not support taxing family allowances and related payments which would detract from their horizontal equity role.

I suspect Castles was still comparing the net impacts of these different tax and social security instruments to what a theoretically ideal system might deliver. Against a Henderson-style Guaranteed Minimum Income, an outcome that smoothed effective marginal tax rates while ensuring maximum rate pensioners and beneficiaries received adequate total support made considerable sense. He was even sympathetic to the idea of universal age pensions as he saw that this was more likely to facilitate coherence between superannuation and social security.

Henry surprisingly proposes exempting all social security payments from tax. Given the major increase proposed to the tax threshold, this seems to me unnecessarily generous while still leaving some overlaps between tax and income tests causing very high effective marginal tax rates.

Superannuation

While the Fraser Government was never supportive of a government-run, national superannuation scheme, I suspect the work of the ISR and the passage of time following the Hancock Report contributed to a bipartisan view that there was another, better approach to addressing the objective of income maintenance in conjunction with the objective of poverty alleviation.

Castles began to focus on reform of occupational superannuation when he moved to Finance, which had direct responsibility for the Commonwealth’s own superannuation schemes. He was particularly annoyed by frequent claims that these unfunded schemes offering indexed lifetime annuities were unaffordable, when they presented far better models for the direction occupational superannuation should take than the schemes more commonly available in the private sector, and provided income replacement rates no more generous than those provided by government schemes in most other developed countries. His advice to successive Finance ministers demonstrated how state governments replacing their public sector schemes’ indexed annuities with lump sums were merely cost-shifting to the Commonwealth because of its excessive lump sum tax concessions, and that most individuals’ demonstrated preference for lump sums when they had the option only proved that indexed annuities were indeed affordable. He was not particularly concerned about the unfunded nature of the public sector schemes, so long as their liabilities were properly reported and managed, and notional contribution rates included in any assessment of remuneration. He noted the changing fashions over the previous twenty years within the accounting profession about funding, and focused his attention on the fundamental issues of transparency and management of liabilities, as well as the most sensible form of genuine retirement income.

The opportunity to address the lump sum problem came in 1983 when, initially, Hawke gave the Finance Minister, John Dawkins, responsibility for tax. This brief window of opportunity allowed Castles to advise a major savings measure through removal of this tax concession and replacing it with taxes set consistent with the tax applying to annuities. Treasury, influenced by the Campbell Committee Report, initially favoured taxing superannuation contributions. But Ian successfully argued in favour of the more orthodox policy of continuing exemptions for contributions but with a much firmer approach to taxing benefits, attacking directly the then bias in favour of lump sums and against annuities. He also strongly supported Treasury proposals to strengthen vesting and preservation arrangements, and enhance portability.

Castles also argued successfully in favour of issuing indexed bonds, an argument he had been having with Treasury for a decade or more. Treasury's view was that such bonds would cause complacency about inflation. Castles argued that it would do no such thing, only addressing a market failure to offer indexed annuities by facilitating market trade of the risk of inflation; he also noted the extent to which government was already giving away indexed annuities through social security pensions, and the extent to which the absence of indexed annuities was causing many old people to rely on social security to manage their longevity risk at an unnecessary cost to taxpayers.

The period since Castles left Finance has seen many more superannuation initiatives, many rightly regarded as major reforms building on the 1983 changes. The steady shift to funded superannuation schemes and the introduction of the superannuation guarantee have not only lifted the level of support available for retirees in the future, but also enhanced portability and increased national savings, and contributed to better inter-generational equity. Castles would certainly have supported a move to mandated contributions, as he always favoured compulsion in the public sector schemes and recognised the damage community short-sightedness caused to the welfare of people when they reached old age.

The move to funded schemes has also made possible the former Treasury preference for taxing contributions, but I doubt Castles would have supported the abolition of tax on superannuation benefits. Henry's proposals to change the tax on contributions would reduce the most severe inequities associated with that decision (and the earlier Keating decision to tax contributions), but we are yet to see any sign of political support for these proposals and, in the meantime, the inequities are being locked in together with the associated exacerbation of the costs of an ageing population and the undermining of intergenerational equity gains from the earlier reforms.

The orthodox approach to equitable spreading of lifetime earnings – exempting contributions for genuine superannuation purposes and taxing all benefits – is still the more obvious benchmark approach. How we now get something that more closely reflects that remains a huge challenge.

One priority Castles would strongly support is Henry's advocacy of more effort to promote benefits in the form of lifetime annuities. Inexplicably, at least to me, the Government rejected the option identified by Henry to sell such annuities. Recent reports suggest the NSW Government is contemplating offering some form of lifetime annuities, hopefully encouraging the Commonwealth to reconsider its position. Given the extent to which the Government already gives away lifetime annuities, indexed more generously than in line with the CPI, I do not understand the opposition to sale, at an appropriate price, of lifetime annuities indexed to the CPI, possibly capped at the level of the pension or the pension income test free area, or in the form of deferred annuities from age 75 or 80.

This is a particularly sore point for me. David Knox and I proposed four years ago the replacement of the only remaining open, unfunded Commonwealth superannuation scheme, the Military Superannuation Benefits Scheme, by a fully funded scheme at no more cost to the taxpayer, so long as it allowed longer-term ADF members to buy indexed lifetime annuities at a price set regularly by the Actuary. Our proposals, agreed by the Defence Chiefs and Defence Department, would have stopped all new unfunded liabilities and indeed sharply reduced them, and would also have limited access to government-guaranteed indexed pensions to longer-term ADF members who would be required to pay a full and fair price for them. To my amazement, Finance opposed the idea because of the remaining contingent liability! Four years later, unfunded liabilities continue to grow rapidly, and no price is attached at all to the government-guaranteed lifetime annuities available to all MSBS members. It was not advice a Castles Finance Department would provide.

Final comments

Ian Castles always considered tax and social security as an integrated system, from a time when this was most rare. The Henry Review therefore would surely have been a welcome initiative.

Castles' approach was pragmatic, but also meticulously analytical and always linked to a theoretically attractive benchmark model. There is much to commend the Henry Review, but I suggest its series of figures of building blocks of payments for different groups lacks the elegance of Castles' graphs of the distributional impact of tax and social security options for different categories of individuals and families, compared both to existing arrangements and to a Guaranteed Minimum Income or other theoretically attractive model.

Henry rejected the idea of a fully integrated tax and transfer system, as indeed did Castles, but there is something unsatisfactory in not showing how the Henry proposals compare to a theoretically attractive integrated approach, nor even to current arrangements to highlight the likely winners and losers.

Much has happened since Ian Castles' main contribution to the study and practice of tax and social security policy. Many others have made major contributions over that time, including a number at this roundtable.

But tonight I want to celebrate the unique contribution Ian Castles made. Much of it remains highly relevant. It provides a most useful set of tests to assess the recommendations in the Henry Report. There are other approaches to reviewing Henry's proposals and we shall no doubt hear some of them tomorrow; moreover, the context has changed a great deal over the last 25 years, for example in terms of workforce participation, a less regulated wage system, and increased appreciation of the importance of 'active' welfare to complement social security entitlements and taxation obligations.

Mine is of course a very personal perspective and no doubt my presentation is coloured by my own views on tax and social security. I may even have overstated Castles' likely attitude towards current policy options.

But what I can say with absolute certainty is how much Ian Castles influenced me, and I am sure virtually everyone at this roundtable, either directly or indirectly. For that we should all be enormously grateful.

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Distributional Outcomes and the Architecture of the Australian Tax-Transfer System

Targeting and progressivity

The design features of welfare states differ in important respects. Two of the most important features relate to the way benefits are *funded* – i.e. the different ways in which programs are financed – and *structured* – i.e. the relationship between benefits received and the past or current income of beneficiaries.

The social welfare systems of OECD countries are often characterised as either ‘Bismarckian’ or ‘Beveridgean’[1]. In the Bismarckian approach, social programs are based on social insurance principles, with earnings-related benefits, entitlement based on contribution records and funding through employer and employee social security contributions. In the Beveridge approach, policies are generally characterised by universal provision, with entitlement based on residence and in some cases need, and with benefits that are flat-rate and financed through general taxation.

A related way of classifying and evaluating alternative welfare state arrangements is on the basis of the forms of redistribution emphasised in different institutional arrangements. Barr[2] points out that the main objective of transfer systems in most OECD countries is to provide *insurance* in the face of adverse risks (unemployment, disability, sickness) and to *redistribute across the lifecycle*, either to periods when individuals have greater needs (for example, when there are children in the household) or would otherwise have lower incomes (such as in retirement). Barr[3] describes this as the ‘piggy-bank objective’[4].

The second main objective of the welfare state can be described as *‘taking from the rich to give to the poor’* (what Barr calls the ‘Robin Hood’ motive). Targeting of benefits is usually justified as a means of achieving the ‘Robin Hood’ objective. Bismarckian-type welfare states give priority to the ‘piggy-bank’ objective, while Beveridgean-type welfare states give priority to the ‘Robin Hood’ objective.

Australia is the strongest example of a country emphasising the ‘Robin Hood’ objective both in the design of the system and in much of the public debate about transfer reforms. It is important to note, however, that programs can aim to achieve both objectives simultaneously. For example, the main objective of family assistance in Australia is to redistribute across the life course, but at the same time Australia also provides much higher levels of assistance to low income families than to higher income families.

The differing designs of social programs influence the distribution of household incomes in different ways. In assessing these impacts it is important to distinguish between *targeting, progressivity*, and *redistribution*.

- *Targeting* is a means of determining either eligibility for benefits or the level of entitlements for those eligible. In a sense, all benefit systems – apart from a universal ‘basic income’ or ‘guaranteed minimum income’ scheme – are targeted to specific categories of people, such as the unemployed, people with disabilities or those over retirement age. Income- and asset-testing is a further form of targeting that can be applied once people satisfy categorical eligibility criteria.

- *Progressivity* refers to the profile of benefits when compared to market or disposable incomes – how large a share of benefits is received by different income groups? – e.g. do the poor receive more than the rich from the transfer system?
- Finally, *redistribution* refers to the outcomes of different tax and benefit systems – how much does the benefit system actually *change* the distribution of household income?

Income-testing and targeting

Table 1 shows the level of spending on income-tested cash benefits as a share of GDP, and as a share of total cash benefit spending between 1990 and 2005[5]. Australia stands out from all other OECD countries, spending more than six per cent of GDP on income-tested programs, or close to 80 per cent of its total spending on cash benefits. Canada and New Zealand come next, but spend a little more than half this level on income-tested payments. The United States spends somewhat less than the OECD average; spending on income-tested programs is particularly low – under five per cent of total spending – in Hungary, Italy, Japan and Sweden.

Table 1: Extent of income testing in cash benefit programs, OECD countries, 1990 to 2005

	% of GDP				% of public cash benefits			
	1990	1995	2000	2005	1990	1995	2000	2005
Australia	6.5	7.4	7.5	6.3	89.1	81.1	80.9	77.8
Austria	1.0	1.2	0.9	1.1	5.6	6.1	5.1	5.8
Belgium	0.9	1.2	0.8	0.9	5.4	6.7	5.4	5.7
Canada	*3.2*	3.8	3.6	3.3	*35.6*	45.4	51.3	48.8
Czech Rep	2.9	2.1	1.9	1.6	27.0	19.0	15.9	14.1
Denmark		1.4	1.0	1.0		8.3	7.9	7.3
Finland		3.4	3.0	2.6		17.0	20.1	17.2
France	1.6	1.8	1.8	1.9	10.1	10.3	10.5	10.6
Germany	0.9	1.2	1.3	1.5	6.7	7.9	8.3	9.7
Greece	0.2	0.2	1.1	1.3	2.0	2.0	8.7	9.8
Hungary			0.7	0.6			5.9	4.2
Iceland	1.8	1.6	1.0	1.0	32.6	26.0	19.0	18.2
Ireland	3.3	3.8	2.4	2.6	37.9	44.1	34.3	30.6
Italy	0.7	0.7	0.6	0.7	5.1	4.7	3.7	4.0
Japan	0.2	0.3	0.3	0.5	4.0	3.8	3.7	4.8
Korea	0.2	0.1	0.3	0.7	15.0	7.0	13.9	25.3
Luxembourg				0.5	..	..	..	3.3
Mexico	0.3	0.7	0.5	0.5	50.9	51.4	35.0	25.9
Netherlands		1.7	1.1	1.1		11.4	10.1	9.8
New Zealand	3.7	3.3	3.6	3.4	27.7	31.1	34.9	37.2
Norway	1.5	1.4	1.1	1.1	11.7	10.9	9.8	9.8

Poland			0.8	1.1			5.0	7.0
Portugal	0.4	0.5	0.7		5.4	4.3	5.4	
Slovak Rep		2.7	2.4	0.6		23.3	20.2	5.5
Spain	2.0	2.2	1.8	1.6	15.0	14.9	13.6	12.3
Sweden		1.4	1.0	0.6		8.7	7.1	4.3
Switzerland	0.6	1.0	1.0	1.1	7.2	8.6	9.6	8.9
Turkey	0.0	0.0			0.0	0.2		
UK	2.0	2.8	1.9	1.7	21.6	26.0	19.4	16.5
USA	1.3	1.6	1.2	1.2	16.3	19.5	15.6	15.6
OECD-20	**1.4**	**1.6**	**1.5**	**1.6**	**17.9**	**17.1**	**16.8**	**17.3**

Note: The following income-tested spending items are included: spending on 'other contingencies – other social policy areas' as in the OECD Social Expenditure Database (SOCX), income-tested spending on the unemployed (e.g. unemployment assistance payments for Germany), income-tested support payments to the elderly and disabled (e.g. Belgium, and the UK), other income tested payments (family cash transfers) but do not include specific housing subsidies, spending on active labour market policies, or income-tested medical support. Source: OECD Secretariat calculations based on OECD (2009), Social Expenditure database (www.oecd.org/els/social/expenditure).

Overall, Table 1 shows that low levels of spending on income-tested programs tend to be the rule in OECD countries, with the exception of the English-speaking countries – but not including the United States – and with Finland apparently being closer to the English-speaking countries than other Nordic welfare states. There also does not appear to be any consistent trend between 1990 and 2005 in spending on income-tested benefits. In a number of countries this spending peaked around 1993, probably reflecting the impact of the recession in the first part of the 1990s. A few countries have seen relatively large increases but from low bases – Germany, Greece, Korea and Portugal, while a number have seen declines – Denmark, Norway, Spain and Sweden.

The extent of income testing, however, is not a comprehensive indicator of the redistributive profile of different social security systems, as it is possible to redistribute between rich and poor through means other than direct income testing. For example, all OECD countries have safety nets to prevent old-age poverty, but there are four generic types: social assistance; separate, targeted retirement income programs; basic pensions; and minimum pensions within earnings-related plans.

Table 2 provides a range of measures of the overall progressivity of transfers in OECD countries between the mid-1990s and 2005. The first measure shown is the 'ratio of transfers' – the share of transfers received by the poorest population quintile compared to the share received by the richest quintile[6], with results disaggregated by age of household head. It is readily apparent that overall, and for people of working age, Australia has the most progressive benefit structures in the OECD – and by an extremely wide margin. In 2005, the average OECD value for the total population was 2.1, but the Australian ratio was 12.4, with the next most targeted being New Zealand, where the ratio was roughly two-thirds of Australia's level.

Table 2: Progressivity measures for transfers by household group, 1990s to 2005

	Ratio of transfers paid to poorest quintile to those paid to richest quintile									Ratio of transfers to taxes for lowest quintile		
	Working age			Retirement age			Total					
	1995	2000	2005	1995	2000	2005	1995	2000	2005	1995	2000	2005
Australia	6.8	12.7	15.1	1.2	1.4	1.7	6.4	10.4	12.4	36	55.5	31.7
Austria	0.9	1.1	0.5	1.1	0.4	0.3	1	0.7	0.4	..	..	2.8
Belgium	1.1	1.1	1.9	0.3	0.3	0.4	1	1	1.7	..	..	4.9
Canada	1.5	1.7	2.5	0.9	*1*	1	1.5	1.7	2.3	4.5	3.7	5.9
Czech Republic	3.2	2.7	2.2	0.8	0.9	0.9	3.2	2.8	2.1	4.5	3.7	5.9
Denmark	3.4	4.8	4.9	1.2	1.3	1.4	3.7	4.9	5.1	2.8	2.9	2.9
Finland	3.1	4	3.6	1	1.7	1.9	2.7	3.3	3.1	3.9	3.9	3.9
France	..	..	0.6	..	..	0.2	..	..	0.5	..	..	3.6
Germany	1.9	1.4	1.4	0.3	0.4	0.4	1.1	1	0.9	3.5	4.7	6.7
Greece	0.5	0.3	0.4	0.2	0.3	0.3	0.5	0.4	0.5	..	..	..
Hungary	1	1.3	1	0.6	0.6	0.5	1	1.2	0.9	..	..	..
Iceland			0.8			0.8	..	..	1.1	..	..	0.9
Ireland	3.6	3.4	2.7	0.8	0.8	1	3.2	3.1	2.7	29.4	24.2	32.9
Italy	0.4	0.4	0.4	0.3	0.3	0.3	0.4	0.5	0.5	3.9	5.3	6.6
Japan	0.9	0.8	0.8	0.6	0.5	0.5	0.9	0.8	0.9	2	2	2.7
Korea	..	..	0.9	..	..	0.2	..	..	1	..	..	1.8
Luxembourg	1.1	1.1	0.7	0.6	0.5	0.5	0.9	1	0.6	..	..	3.1
Mexico	0.2	0.1	0.2	0.1	0	0	0.2	0.1	0.2	..	..	..
Netherlands	3.1	3.2	3	1	1	1	2.6	2.7	2.6	3.4	4.9	6.5
New Zealand	7.9	6.9	7.6	1	1	1	6.4	5	8.1	21.9	19.1	8.3
Norway	2.8	2.6	2.7	0.7	0.7	0.7	2.8	2.9	2.6	5.6	4.4	3.9
Poland	..	0.7	0.4	..	0.4	0.4	..	0.6	0.3	..	..	1.9
Portugal	0.4	0.4	0.2	0.3	0.2	0.2	0.5	0.5	0.3	9.1	5.4	4.5
Slovak Republic	..	..	1	..	..	0.6	..	..	1.1	..	..	4.8
Spain	0.7	0.6	0.6	0.5	0.5	0.4	0.6	0.7	0.7	..	..	..
Sweden	1.9	2.2	2.3	0.5	0.5	0.6	1.6	2	2	3.3	3.3	3
Switzerland	..	2.1	2.5	..	0.9	0.9	..	2.3	2.5	..	1	1
Turkey	0.3	..	0.1	0.1	..	0.1	0.2	0	0.1	..	..	..
United Kingdom	6.2	7.2	6.2	0.9	0.9	0.9	4.1	5.3	4.5	12.3	15.7	11.1
United States	1.9	1.8	1.7	0.6	0.5	0.5	1.6	1.4	1.5	8	5.3	5.8
OECD	**2.3**	**2.6**	**2.3**	**0.7**	**0.7**	**0.7**	**2**	**2.2**	**2.1**	**10**	**10.1**	**6.7**
Australian/ Mean	3	4.9	6.6	1.8	2.1	2.7	3.2	4.8	5.9	3.6	5.5	4.7

Notes: data not available. Source: Calculated from various waves of OECD income distribution study.

In general, the most targeted systems are the English-speaking countries of Australia, New Zealand, Ireland and the United Kingdom (but not Canada and the United States, where the ratio is only average or below), together with the Czech Republic, and Denmark, Finland and Norway (but not Sweden), and the Netherlands[7].

Transfers to people of working age are even more targeted with the Australian ratio at 15.2 being roughly twice as progressive as the next ranked country, New Zealand. There also appears to have been a significant increase in targeting of payments in Australia over the decade shown. Payments to households with a retirement age head are generally less targeted, because they go to a majority of the relevant population group rather than a minority as is the case with payments to people of working age. The Australian pension system is the second most progressive in the OECD after Finland.

This 'ratio of transfers' measure, however, suffers from the limitation that it is strongly influenced by how much goes to the richest 20 per cent of the population and ignores how much goes to the middle of the income distribution. What is unusual about Australia is the smallness of the share going to the richest 20 per cent of the population, this being only three per cent of all transfer spending. The only other countries where the well-off benefit nearly as little from the transfer system are New Zealand (four per cent), Denmark and the United Kingdom (where they receive between six and 10 per cent of all transfer spending), and Canada, the Czech Republic, Finland, Ireland, the Netherlands and Norway where they receive a little over 10 per cent.

The final panel of Table 2 shows the ratio of the transfers received by the poorest quintile of the population to the taxes they pay – a measure of how much the poor pay for their own benefits. Australia and Ireland stand out – in 2005 in both countries the poorest quintile received more than 30 times as much in cash transfers as they paid in direct taxes, followed at a considerable distance by New Zealand, the United Kingdom and the Czech Republic. This ratio apparently rose significantly in Australia between 1995 and 2000 and then fell back to its earlier level by 2005; however, this large swing reflects the fact that the taxes paid by the poorest 20 per cent of Australian households are extremely low so that small changes in this denominator can change the ratio of transfers to taxes significantly.

In summary, these results show that Australia plays 'Robin Hood' and targets assistance to the poor in two ways – first through income and means-tests so that payments to better-off households are minimised, and second through extremely low levels of direct taxes on poor households, so that very little of the assistance directed to lower income-groups is clawed back. The combination of these two mechanisms has a strong effect on how much redistribution to the poor is achieved.

Redistribution across the life course – the 'piggy bank' objective

The degree of targeting that characterises the Australian transfer system is highly unusual. In practice, transfer systems in all OECD countries – also including Australia – involve a mix of redistribution between rich and poor and risk insurance or lifecycle redistribution, although the mix of elements differs between countries.

An indication of the importance of lifecycle redistribution is the extent to which social protection systems emphasise support for older people. Spending data show that social protection systems in most OECD countries have as their primary focus the wellbeing of pensioners or those over retirement age. It can be estimated that on average roughly two- thirds of social spending in OECD countries is directed towards pensioner households, as much as 80 per cent in Italy and Greece and close to 90 per cent in Turkey; at roughly 55 per cent Australia is towards the lower end of the OECD range, but spending on pensioners through cash benefits, health care and other services remains a major part of social spending.

The precise nature of the mix between redistribution to the poor and redistribution across the lifecycle cannot be observed directly in annual data on incomes or social spending, since annual data cannot identify the extent to which households have already paid for their benefits in past years, or the extent to which they will do so in the future or the extent to which current taxpayers will be future beneficiaries.

As a result, various ways of modelling the lifetime distribution of benefits and taxes are required. In the United States, for example, many studies of social security evaluate the extent to which the system provides 'value for money', i.e. the extent to which individuals with different characteristics receive back in retirement more or less than they contributed during their working lives[8].

In a comparative study, Falk Ingham and Harding[9] compared Australia and the United Kingdom and estimated that in Australia, 38 per cent of lifetime benefits received by individuals, on average, were financed through taxes they paid at another stage in their lifecycle, and the remaining 62 per cent of lifetime benefits involved redistribution between rich and poor; in the United Kingdom these shares were reversed, with 38 per cent of lifetime benefits involving redistribution between individuals and 62 per cent involving redistribution over different phases of the lifecycle of the same individual.

A survey by Ståhlberg[10] compares a wider range of countries and shows that the degree of redistribution across the lifecycle is negatively correlated with the level of targeting, that is, systems that target low-income households at a point in time are more redistributive between rich and poor, but achieve less life cycle redistribution[11].

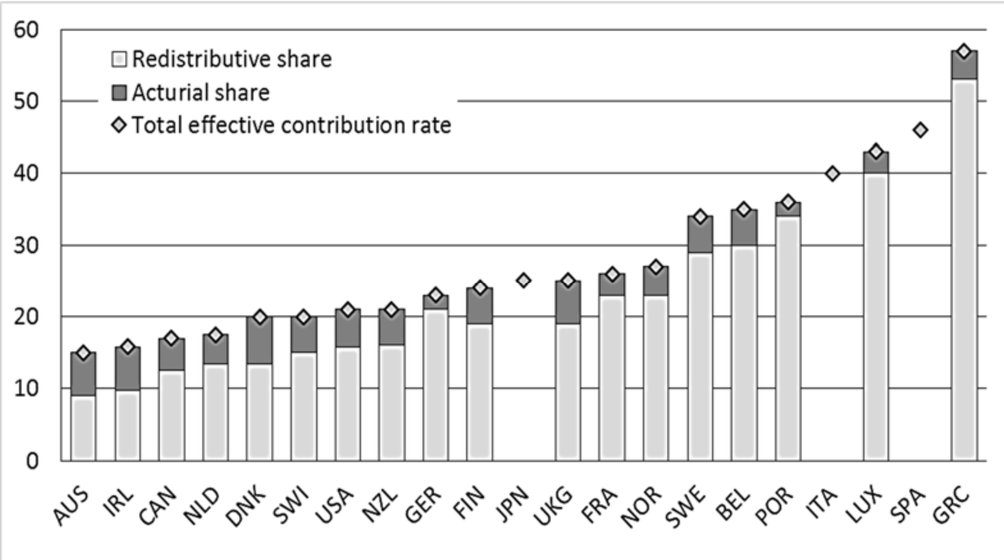
Ståhlberg[12] distinguishes between the 'yearly give and take' and the 'life cycle give and take' and cites a study for Sweden that finds that just over eight out of every 10 Swedish kronor which the average individual receives in transfers and subsidies over the life course have been financed by the individual himself. Only 18 per cent of the redistribution, which takes place via taxes, transfers and public consumption, is genuine redistribution between individuals. Another study cited by Ståhlberg finds that in Italy the corresponding figure is around 24 per cent. Overall, she concludes that countries like Australia, the United Kingdom and Ireland achieve a higher component of spending that is genuinely between rich and poor, but a lack of truly comparable studies makes it difficult to conclude whether the overall level of interpersonal redistribution is higher in more targeted welfare states (since spending is lower).

The actual distribution of benefits across the life cycle for individuals, however, is likely to differ from calculations of this sort, since both money's worth calculations and micro-simulations usually look at hypothetical lifetimes and calculate the extent of lifetime redistribution on the basis of the tax and benefit system at a specific point in time. In practice, taxation and benefit systems can be changed many times during an individual's lifetime. Some studies, therefore, attempt to estimate to what extent different generations are net beneficiaries or net contributors to social security systems[13].

A further complication relates to the unit assumed to pay taxes and receive transfers in these models. Falkingham and Harding[14] find for example that the family in Australia redistributes as much lifetime income as does the tax system. An individualistic approach to estimating the extent of redistribution across the life course also does not deal with the issue of whether working age individuals benefit from transfers to other households to whom they are related – for example, in the absence of government transfers individuals may have to make private monetary or in-kind transfers to support retired, ill or unemployed relatives.

Another measure of the balance between these two types of redistribution is shown in Chart 1 derived from Disney[15]. This shows the effective contribution rates to public pensions as a percentage of earnings (with countries ranked by the level of contributions required) as well as the part that redistributes between individuals, on one side, and across the individual's lifetime, on the other[16]. In an actuarially fair system, individual pension entitlements would exactly match individual earnings. In contrast, in a redistributive system there is little or no relationship between lifetime earnings and individual entitlements, and rates of return on contributions differ significantly between generations.

Chart 1: Contribution rates to public pensions, redistributive and actuarial components, 1995



Notes: The effective contribution rate is the average rate of contributions as a percentage of earnings required to finance current spending on public pensions without budgetary transfers or accumulation or de-accumulation of pension funds. The redistributive share of contributions is calculated as the coefficient of variation of replacement rates at different points in the earnings distribution, with the actuarial share being the extent to which entitlements are proportional to lifetime earnings[17].

A number of points should be emphasised. First, on this measure the share of redistribution between rich and poor varies widely across countries. Second, in all countries, including Australia, the larger part of pension contributions goes towards redistribution across the lifecycle. However, there is greater cross-country variability in the level of contributions going towards lifecycle redistribution than towards redistribution between rich and poor. Lastly, there tends to be an inverse relationship between the degree of redistribution between rich and poor and the level of contributions – countries that spend the most tend to concentrate more on redistribution across the lifecycle, while those that focus more on redistribution between rich and poor spend less. Thus while Australia has the lowest effective total contribution rate of any of these countries, in absolute terms it has the third highest redistribution tax rate (with implications for the generosity of payments and for incentives).

Redistribution across the lifecycle cannot reduce lifetime inequality between individuals, since it is simply a way of smoothing consumption for the same person, whose total lifetime income remains unchanged; it can, however, reduce inequality at a point in time, and lower both lifetime poverty (for those whose average lifetime incomes are above the poverty line) and poverty at a point in time[18].

Lifecycle redistribution can also occur – and in some countries may be most common – through instruments that fall outside the traditional boundaries of the welfare state. For example, home ownership is strongly redistributive across the lifecycle, as families usually face higher expenses for home purchase while they are working and then benefit from lower housing costs when in retirement. Similarly, private health insurance, personal savings, individual pension plans and endowment insurance involve either self-insurance or redistribution across an individual's or family's own lifecycle, while usually providing no redistribution between income groups. A crucial difference between private and government redistribution across the lifecycle is that private redistribution does not normally involve the pooling of risks (except in the case of insurance policies).

Levels and distributions of cash transfers and household taxes

It is often taken for granted in Australia that because we have a targeted benefit system that is flat-rate and means-tested, that by definition it must be more redistributive than other systems. Indeed, Table 5 shows that in some OECD countries the top half of the income distribution receives more than half of all transfers, raising the question of how such systems can possibly reduce inequality and poverty. However, this is to misinterpret the potential impact of the welfare state and to confuse progressivity with redistribution. The only prerequisite for (static) redistribution to occur is that the distribution of cash transfers (and that of household taxation) be more progressive than the distribution of market income. So long as inequality of transfer receipt is less unequal than inequality of market incomes, then transfers will reduce inequality. In fact, the transfer systems in all OECD countries are less unequal than the market income distribution, so that all social protection systems, no matter how regressive they appear to be, do reduce inequality.

The degree of redistribution achieved by the tax-benefit system[19], however, depends on both the progressivity of taxes and benefits and their size, i.e. the level of spending and of revenue collected[20]. By definition, in a means-tested system, benefits provided to the poorest are greater than the average benefits paid. Conversely, a universal, flat-rate system provides benefits that are of equal value to all recipients, while under an earnings- related system average benefits are greater than minimum benefits. It follows that, *for a given amount of spending*, benefits paid to those with fewer economic resources will be greater under a means-tested system than under a universal benefit system, which in turn will provide more generous payments to the poor than an earnings-related system.

On the other hand, these characteristics of welfare systems may also impact on the overall size of spending, as the middle class may be more supportive of welfare programs when benefits are universally provided[21]. Indeed, in much of the social policy literature, Australia (along with the other English-speaking countries) is viewed as a residual welfare state, providing the lowest level of 'decommodification' of any OECD country[22]. Similarly, a Dutch study of 'the worlds of welfare' concluded that, 'Australia has no collective social insurance schemes and is thus a textbook example of a liberal or residual system'[23]. The critical question, therefore, relates to the impact of different program designs or distributional profiles when levels of spending and taxes differ across countries.

Table 3 shows the level of public cash transfers and of household taxes expressed as a share of household disposable income; also shown is how these shares have changed since the mid-1990s. Cash benefits are lowest in Korea and Mexico, at four per cent and six per cent of household disposable income, respectively, while they account for around nine per cent of household income in the United States. Cash benefits are between 13 and 20 per cent of household disposable income in Australia (the sixth lowest level in the OECD), Canada, Finland, Iceland, Ireland, Japan, the Netherlands, New Zealand, Switzerland, Turkey and the United Kingdom; between 20 and 30 per cent in the Czech Republic, Denmark, Germany, Greece, Italy, Norway, Portugal, Spain and the Slovak Republic; and they exceed 30 per cent of household income in Austria, Belgium, France, Hungary, Luxembourg, Poland and Sweden.

Cash benefits are most significant for the population of retirement age, amounting on average to two-thirds of their incomes, and to more than 90 per cent in Belgium, France, Italy, Luxembourg and Sweden, and for over 100 per cent in Austria. Cash transfers account for only around half of the household income of older people in Australia (the fifth lowest level in the OECD), Canada, Ireland, Japan, the Netherlands, Turkey, the United Kingdom and the United States, and are least significant in Korea, Mexico, and apparently Finland[24]. For households with a working-age head, benefits are much less significant, averaging around 15 per cent of household income, but ranging from three to six per cent in Korea, Mexico and the United States to 30 per cent in Poland, with Australia, at 10 per cent, being seventh lowest.

Table 3: Shares of cash benefits and household taxes in household disposable income

	Public cash benefits				Household taxes			
	Working age	Retirement age	Total		Working age	Retirement age	Total	
	Levels in mid-2000s			Change since mid-1990s	Levels in mid-2000s			Change since mid-1990s
Australia	10.1	48.7	14.3	-0.6	24.8	9.7	23.4	-1.4
Austria[3]	27.4	101.3	36.6	..	35.0	27.5	33.4	..
Belgium[3]	22.3	96.9	30.5	-2.1	42.1	19.6	38.3	..
Canada	9.3	46.7	13.6	-4.4	27.0	15.0	25.8	-3.5
Czech	17.0	79.1	24.3	3.2	23.9	6.1	21.6	0.9
Denmark	19.9	81.1	25.6	-5.6	53.8	44.2	52.5	-0.7
Finland	12.4	18.1	14.4	-8.9	31.0	24.8	30.1	-3.7
France[4]	22.6	96.4	32.9	-0.1	28.8	11.1	26.0	0.5
Germany	16.4	82.2	28.2	4.9	41.1	12.5	35.5	-3.5
Greece[1]	16.7	66.4	22.7	3.3	..	..	..	..
Hungary[1]	27.5	85.6	35.1	1.1	..	..	..	..
Iceland	12.3	79.7	19.2	..	54.1	34.2	53.1	..
Ireland[2]	13.3	55.8	17.7	-6.7	20.7	5.4	19.4	-3.6
Italy	21.1	87.4	29.2	0.6	32.0	21.1	30.2	1.2
Japan	11.0	55.8	19.7	8.2	21.0	15.4	19.7	-0.1
Korea	3.0	15.7	3.6	..	8.1	5.0	8.0	..
Luxembourg	22.4	91.0	30.6	..	26.3	14.8	23.8	..
Mexico[1]	5.4	21.3	5.8	2.2	..	..	..	..

Netherlands	12.7	53.0	17.1	-3.5	26.9	10.0	24.7	-6.0
New	13.1	76.8	13.0	-2.8	29.1	19.8	29.0	-1.5
Norway	15.4	72.7	21.7	0.4	35.0	22.7	33.2	1.3
Poland[1,2]	30.4	92.6	35.8	..	28.8	17.9	27.7	..
Portugal[1,2]	20.3	74.2	25.5	-1.5	..	..	..	..

	Public cash benefits				Household taxes			
	Working age	Retirement age	Total		Working age	Retirement age	Total	
	Levels in mid-2000s			Change since mid-1990s	Levels in mid-2000s			Change since mid-1990s
Slovak	22.0	86.0	26.0	..	22.0	5.0	20.0	..
Spain[1,2]	15.0	70.4	21.3	-2.3	..	..	..	..
Sweden	21.4	96.3	32.7	-5.7	44.2	40.2	43.2	1.2
Switzerland[2]	9.7	63.6	16.0	..	36.6	32.9	36.0	..
Turkey[1]	18.6	46.0	16.9	10.6	..	..	..	..
United	8.7	54.3	14.5	-0.5	26.2	10.0	24.1	0.4
United	5.6	42.1	9.4	-1.5	27.7	16.4	25.6	-1.6
OECD-24[5]	**15.8**	**69.7**	**21.9**	**-1.5**	**31.1**	**18.4**	**29.3**	**-1.3**

1. Data on public cash benefits are reported net of taxes (i.e. household taxes not separately identified).
2. Changes refer to the period from the mid-1990s to around 2000.
3. Data for the mid-1990s only available net of household taxes.
4. Data on levels and changes are based on two different sources.
5. Average of the 24 OECD countries with data on both gross public cash transfers and household taxes (i.e. all countries shown in the table except Greece, Hungary, Mexico, Portugal, Spain and Turkey).

Source: Computations based on OECD income distribution questionnaire.

Measured household taxes also vary widely. They are low in Korea but account for more than 40 per cent of household disposable income in Sweden and more than 50 per cent in Denmark and Iceland[25]. The level of household taxes – as measured in household surveys – has decreased on average by about one percentage point since the middle of the 1990s, matching the decline recorded on the transfer side, with larger declines in the Netherlands, Canada, Germany, Ireland and Finland. It is clear, however, that the relationship between measured taxes and transfers differs across countries. For example, in the United States- based on the household survey data used there – household taxes (at 26 per cent of household income) are nearly three times higher than cash transfers. At the other extreme, in the Czech Republic, France, Luxembourg and the Slovak Republic, measured transfers account for a larger share of household disposable income than measured taxes. A major factor behind these discrepancies is the fact that employer social security contributions – which finance a large part of the welfare state in these and some other countries – are paid by employers directly to the government, and since they do not pass through the household sector they are not recorded in household income surveys.

Table 4 compares OECD countries in terms of how public transfers and household taxes are distributed across income groups. The measure shown is the concentration coefficient, which is calculated in the same way as the Gini coefficient, except that households are ranked by their disposable incomes. Because individuals are ranked according to their disposable income, rather than by the public transfers they receive, the concentration coefficient of transfers ranges between plus one and minus one, with zero implying that transfers are flat rate; negative values occur in the case where poorer income groups receive a higher share of transfers than their share of disposable income, so that lower and more negative values imply greater progressivity.

As noted earlier, cash benefits are more progressively distributed than market incomes in all countries, thus reducing inequality. The distribution of cash benefits for the entire population is most progressive, by a wide margin, in Australia, followed by New Zealand, Denmark, the United Kingdom, Finland and Ireland, while it is least progressive in Mexico, Turkey, Portugal, and Poland. With the exceptions of Portugal and Turkey, transfers to people of working age are more progressively distributed than those to people of retirement age, and again Australia has the most progressive distribution by a wide margin. The ranking of countries is broadly similar for transfers to people of retirement age and of working age, although Finland has the most progressive distribution of transfers to people of retirement age.

The progressivity of transfers varies significantly also across different types of benefits, with the highest progressivity being for housing benefits (because they tend to be income-related), 'other benefits' (which include social assistance), unemployment payments and family cash benefits (Table 5). Housing benefits are most progressively distributed in the Nordic countries, while family benefits are most progressive in the United States and other English-speaking countries, where income testing is more common. Australia has the most progressive distributions of disability benefits, unemployment benefits and survivor benefits, the second most progressive distribution of age pensions and the fifth most progressive distribution of family payments. It should be noted, however, that while the United States and Italy have the most progressive distributions of family benefits, this does not include tax rebates or deductions for children, which would substantially change measured progressivity if included.

Table 4: Progressivity of cash benefits and household taxes

Concentration coefficients for cash benefits and direct taxes, mid-2000s

	Public cash benefits			Household taxes		
	Working age	Retirement age	Total	Working age	Retirement age	Total
Australia	-0.431	-0.080	-0.400	0.492	0.816	0.533
Austria	0.130	0.256	0.157	0.365	0.464	0.381
Belgium	-0.141	0.169	-0.120	0.363	0.420	0.398
Canada	-0.173	-0.006	-0.152	0.472	0.586	0.492
Czech	-0.151	0.037	-0.154	0.424	0.789	0.471
Denmark	-0.303	-0.054	-0.316	0.332	0.336	0.349
Finland	-0.258	-0.138	-0.219	0.419	0.444	0.428
France	0.098	0.285	0.136	0.354	0.474	0.374
Germany	-0.066	0.175	0.013	0.439	0.485	0.468
Greece[1]	0.176	0.202	0.115	..	..	..
Hungary[1]	-0.025	0.119	-0.016	..	..	..
Iceland	0.018	0.037	-0.041	0.257	0.296	0.267
Ireland	-0.205	-0.001	-0.214	0.531	0.782	0.570
Italy	0.158	0.225	0.135	0.512	0.623	0.546
Japan	0.020	0.121	0.010	0.356	0.429	0.378
Korea	0.040	0.282	-0.012	0.363	0.462	0.380
Luxembourg	0.075	0.145	0.085	0.404	0.430	0.420
Mexico[1]	0.407	0.518	0.373	..	..	..
Netherlands	-0.223	-0.014	-0.198	0.436	0.705	0.471
New Zealand	-0.331	-0.011	-0.345	0.485	0.249	0.498
Norway	-0.177	0.074	-0.183	0.355	0.433	0.376
Poland[1]	0.173	0.198	0.185	0.382	0.325	0.379
Portugal[1]	0.315	0.295	0.247	..	..	..
Slovak	-0.030	0.104	-0.056	0.388	0.726	0.422
Spain[1]	0.102	0.175	0.063	..	..	..
Sweden	-0.153	0.090	-0.145	0.330	0.312	0.337
Switzerland	-0.176	0.015	-0.170	0.211	0.202	0.223
Turkey[1]	0.320	0.288	0.347	..	..	..
UK	-0.347	0.035	-0.275	0.486	0.614	0.533
USA	-0.115	0.105	-0.089	0.549	0.658	0.586
OECD-24	**-0.107**	**0.085**	**-0.099**	**0.404**	**0.502**	**0.428**

Note: The concentration coefficient is computed in the same way as the Gini coefficient of household income, so that a value of zero means that all income groups receive an equal share of household transfers or pay an equal share of taxes. However, individuals are ranked by their equivalised household disposable incomes.

1. Data on public cash benefits are reported net of taxes (i.e. household taxes are not separately identified).
2. Average of the 24 OECD countries with data on both gross public cash transfers and household taxes (i.e. all countries shown in the table except Greece, Hungary, Mexico, Portugal, Spain and Turkey).

Source: Computations based on OECD income distribution questionnaire.

Table 5: Progressivity of cash transfers by program
Concentration coefficients for cash transfers, mid-2000s

	Old age pensions	Disability benefits	Compensation for occupation injury and diseases	Survivor benefits	Family cash benefits	Unemployment benefits	Housing benefits	Other benefits
Australia	-0.47	-0.35	..	-0.30	-0.33	-0.44	..	-0.40
Austria	0.25	0.14	0.16	0.00	-0.09	-0.17	-0.48	-0.05
Belgium	-0.09	-0.27	-0.13	-0.14	0.03	-0.22	-0.15	-0.50
Canada	-0.11	..	..	..	-0.46	-0.06	..	-0.22
Czech Rep	-0.11	-0.06	..	0.19	-0.26	-0.28	-0.66	-0.36
Denmark	-0.49	-0.18	..	..	-0.04	-0.22	-0.58	-0.37
Finland	-0.44	0.07	0.12	0.02	-0.07	-0.24	-0.61	-0.39
Germany	0.10	..	0.07	-0.04	-0.04	-0.28	0.00	-0.24
Greece	0.15	0.06	0.25	0.02	-0.02	0.04	-0.17	-0.11
Hungary	0.01	..	..	..	-0.06	-0.25	..	-0.17
Ireland	-0.32	-0.27	0.27	0.08	-0.21	-0.07	-0.46	0.02
Italy	0.22	0.90	..	..	-0.52	-0.04	..	-0.05
Japan	0.02	..	..	..	..	-0.11	..	-0.33
Luxembourg	0.17	0.00	..	0.13	-0.02	-0.09	-0.41	-0.52
Netherlands	-0.16	-0.11	..	-0.14	-0.36	0.03	-0.65	-0.37
New Zealand	-0.32	-0.35	-0.41	0.02	-0.43	-0.38	-0.37	-0.14
Norway	-0.27	-0.06	..	-0.18	-0.06	-0.12	-0.65	-0.24
Poland	0.26	0.04	0.40	0.15	-0.22	0.13	-0.26	-0.13
Portugal	0.33	0.03	..	0.03	..	0.20	0.13	-0.77
Slovak Rep	0.00	-0.19	-0.01	0.24	-0.01	-0.07	0.84	-0.59
Spain	0.04	0.11	0.14	0.05	0.35	0.02	0.48	0.02
Sweden	-0.19	0.25	0.25	..	-0.07	-0.10	-0.66	-0.16
Switzerland	-0.19	..	..	..	-0.02	-0.15	..	-0.29
Turkey	0.37	0.07	..	0.25	0.17	0.08	..	0.52
UK	-0.21	-0.20	..	..	..	..	..	-0.37
USA	-0.04	..	..	..	-0.56	0.07	..	-0.10
OECD-27	**-0.05**	**-0.01**	**0.10**	**0.02**	**-0.14**	**-0.10**	**-0.29**	**-0.24**

Note: Data refer to the mid-2000s for all countries. Data refer to 'gross' public cash transfers (i.e. before taxes) for all countries except Greece, Hungary, Ireland, Mexico, Poland, Portugal, Spain and Turkey (where survey data on transfers are reported net of taxes). OECD-27 is the average across all countries with data available. *Source*: Computations based on OECD income distribution questionnaire.

Tables 6 to 9 show trends in the concentration coefficient for transfers from the 1980s to 2000. Overall, Australia has always over this period had the most progressive distribution of transfers, and progressivity has also increased in Australia. Transfers have become somewhat less progressive in the United States and Canada, and more progressively distributed in the Nordic countries apart from Norway, and in the Netherlands and New Zealand. Similar broad trends apply in the case of transfers to working-age households. Family cash benefits have become significantly more progressive in Australia, Canada, New Zealand and the UK.

Table 6: Progressivity of transfers, entire population, OECD Countries, 1980s to 2000

Concentration coefficient

	1980s	1990s	2000
Australia	-34.1	-38.1	-38.3
Austria	-4.1	-0.5	-6.0
Belgium	-5.9	-7.4	-7.4
Canada	-16.2	-13.2	-12.0
Czech Republic	..	-22.9	-18.9
Denmark	-18.3	-24.6	-29.2
Finland	-18.8	-16.9	-23.0
France	2.1	4.3	-3.0
Germany	-2.1	-5.0	-1.3
Greece	21.7	14.1	17.2
Hungary	..	-1.3	-6.0
Ireland	-19.3	-23.2	-22.6
Italy	1.5	18.1	14.8
Japan	7.9	1.0	3.2
Luxembourg	1.4	1.8	-8.2
Mexico	67.9	37.7	37.1
Netherlands	-14.1	-19.1	-22.1
New Zealand	-22.3	-29.7	-30.7
Norway	-22.3	-21.3	-20.6
Poland	..	7.6	5.9
Portugal	..	12.7	15.1
Spain	5.7	6.5	5.4
Sweden	-5.3	-9.8	-14.3
Switzerland	..	4.4	5.9
Turkey	26.7	26.4	21.3
United Kingdom	-29.1	-27.1	-28.6
United States	-13.1	-10.2	-8.8
OECD	**-4.1**	**-5.0**	**-6.5**

Source: Calculated from various waves of OECD Income Distribution Study.

Table 7: Progressivity of transfers to people of working age, OECD countries, 1980s to 2000

Concentration coefficient

	1980s	1990s	2000
Australia	-36.4	-41.6	-42.4
Austria	8.0	3.4	-1.6
Belgium	..	-9.5	-9.5
Canada	-16.8	-16.5	-11.2
Czech Republic	..	-22.1	-18.6
Denmark	-13.9	-22.9	-28.1
Finland	-16.1	-20.6	-27.2
France	-3.5	-7.8	-7.1
Germany	-1.8	-12.8	-6.5
Greece	24.3	16.2	21.8
Hungary	..	-0.6	-6.4
Ireland	-20.0	-26.2	-24.1
Italy	4.8	20.6	19.6
Japan	8.8	2.2	3.3
Luxembourg	0.7	-2.2	-3.4
Mexico	62.9	37.6	43.8
Netherlands	-15.8	-21.6	-26.3
New Zealand	-24.9	-35.3	-37.1
Norway	-17.3	-20.3	-18.3
Poland	..	6.4	4.5
Portugal	..	19.2	18.4
Spain	6.6	6.4	8.4
Sweden	-2.2	-12.0	-15.2
Switzerland	..	2.5	-5
Turkey	24.8	23.5	21.3
United Kingdom	-32.1	-32.7	-35.4
United States	-19.3	-14.0	-12.6
OECD 27	**-3.8**	**-6.7**	**-7.2**

Source: Calculated from various waves of OECD Income Distribution Study.

Table 8: Progressivity of family cash benefits and unemployment benefits, OECD countries

Concentration coefficient

	Family cash benefits			Unemployment benefits		
	80s	90s	2000	80s	90s	2000
Australia	-20.9	-48.4	-47.3	-46.5	-39.0	-44.9
Austria	-1.4	-2.5	-14.0	-5.7	-23.4	-33.0
Belgium	..	5.2	..	..	-38.5	..
Canada	-24.3	-41.6	-53.6	-4.4	0.5	-6.0
Czech Republic	..	-27.0	-33.4	..	-32.9	-22.4
Denmark	-23.3	-12.2	-13.0	-5.9	-17.4	-23.7
Finland	-11.7	-5.3	-12.6	-22.6	-24.0	-30.4
France	-44.1	-53.9	-19.2	-0.8	7.4	-6.7
Germany	-9.0	-13.5	-6.0	-26.9	-26.4	-19.8
Greece	-7.5	-1.4	-2.9	2.4	6.2	21.8
Hungary	..	-10.3	-13.5		-34.2	-35.9
Ireland	-15.0	-22.8	-24.4	-28.5	-38.3	-36.1
Italy	..	..	..	..	..	..
Japan	..	..	..	..	..	..
Luxembourg	-16.2	-11.5	-11.9	-1.6	-31.7	-5.3
Mexico	..	..	..	..	..	..
Netherlands	-20.7	-19.1	-20.3	-7.5	-2.8	-9.3
New Zealand	-35.5	-52.4	-52.2	-39.0	-35.8	-40.8
Norway	-15.4	-12.2	-11.8	..	-12.8	-21.0
Poland	..	-11.2	-10.8	..	-19.9	-17.7
Portugal	..	..	-7.9	..	..	15.6
Spain	..	..	..	-5.9	-4.4	-10.0
Sweden	-3.4	-13.7	-15.1	-13.7	-17.2	-20.1
Switzerland	..	-7.2	-8.9	..	-19.4	-24.7
Turkey	..	..	..	..	..	-7.6
United Kingdom	-26.7	-20.6	-51.8	-67.7	-58.9	-60.8
United States	-58.5	-53.5	-59.5	0.3	7.2	0.6
OECD 27	**-20.8**	**-21.7**	**-23.3**	**-17.1**	**-20.1**	**-19.0**

Source: Calculated from various waves of OECD Income Distribution Study.

Table 9: Progressivity of transfers to pensioners, OECD Countries, 1980s to 2000

Concentration coefficient

	1980s	1990s	2000
Australia	-7.0	-1.8	-6.1
Austria	-12.6	-2.0	17.3
Belgium	..	22.2	22.2
Canada	0.0	1.2	-0.6
Czech Republic	..	4.1	3.7
Denmark	-1.1	-2.9	-5.6
Finland	-5.8	-1.2	-11.9
France	26.9	25.6	23.9
Germany	21.3	19.8	18.0
Greece	26.4	27.2	23.6
Hungary	..	8.8	9.2
Ireland	-4.9	3.9	2.9
Italy	8.6	21.4	20.7
Japan	8.4	8.7	11.0
Luxembourg	12.6	10.8	12.5
Mexico	65.1	44.3	44.6
Netherlands	1.1	0.3	-0.9
New Zealand	1.9	-0.2	-0.1
Norway	6.6	7.8	6.9
Poland	..	10.7	10.6
Portugal	..	21.2	28.5
Spain	13.4	14.1	13.0
Sweden	19.5	13.2	12.5
Switzerland	..	19.4	19.2
Turkey	36.0	32.4	21.5
United Kingdom	-0.5	2.1	2.6
United States	6.9	9.5	11.5
OECD 27	10.6	11.9	12.0

Notes: Data for Switzerland refer to ODSB, which is old-age cash benefits, disability benefits and survivors' benefits. *Source:* Calculated from various waves of OECD Income Distribution Study.

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[3] Barr (2001) op. cit..
[4] Other forms of redistribution can occur as well: for example, between generations, between men and women, or across geographical regions, but these are usually a by-product of the two main objectives rather than being primary goals in their own right.
[5] These programs have been identified through analysis of the OECD Social Expenditure database, and, in addition to social assistance payments, they include income-tested spending on the unemployed, separate income-tested payments for older people and people with disabilities, and income-tested family cash benefits, but do not include housing benefits.
[6] Individuals are ranked on the basis of equivalised household disposable income; for details, see Förster, M and Mira D'Ercole, M (2005). Income distribution and poverty in OECD countries in the second half of the 1990s, OECD social, employment and migration working paper, no. 22, OECD, Paris.
[7] Analysis of trends over time shows that targeting – using this measure – has increased in Australia, Denmark, the Czech Republic, the United Kingdom and the Netherlands (and Mexico and Turkey from extremely low bases), and has gone up and then down in New Zealand, and to a lesser extent in Finland and Sweden. In the case of the US, targeting appears to have declined since the 1970s. However, in the US assistance provided through the tax system has become more generous to low income families with children, particularly the Earned Income Tax Credit and more recently, the Child Tax Credit.
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[11] Ståhlberg (2007) notes that about 30 dynamic microsimulation models have been constructed internationally, with approximately 10 models in active use at present. Studies which have used dynamic microsimulation models, to investigate lifetime income and intra-personal redistribution, include countries like Australia, Ireland, Italy, the Netherlands, Sweden, the UK and the USA.
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[15] Disney, R (2004). 'Are contributions to public pension programs a tax on employment?', *Economic Policy*, July.
[16] While total lifetime income for an individual is unchanged by redistribution across the lifecycle, income smoothing can reduce the share of time that might otherwise be spent below the poverty line by

those whose average incomes are above the poverty line. However, while people whose lifetime incomes are below the poverty line can theoretically have their incomes raised above the poverty line at different points in time, this could only be achieved at the cost of more severe poverty (i.e. a larger poverty gap) in other periods.

[17] The effective contribution rate is the average rate of contributions required to finance current spending on public pensions without budgetary transfers or accumulation or de-accumulation of pension funds. Disney (2004) op. cit.

[18] Åberg, R (1989). 'Distributive mechanisms of the welfare state—a formal analysis and an empirical application', *European Sociological Review*, no. 5.

[19] A simple example (which disregards the impact of taxes) illustrates the impact of different welfare state arrangements on the distribution of household income. Imagine two countries with the same distribution of market incomes and a concentration coefficient of 0.40. In country A transfers account for 20 per cent of household gross income and the concentration coefficient for transfers is 0.30 (i.e. the system is earnings-related, but not as unequal as market income); in this country, market income provides 80 per cent of gross household income and the Gini coefficient for income after transfers is 0.38 (0.40*0.8 plus 0.30*0.2). In country B transfers account for only five per cent of gross income, but the concentration coefficient for transfers is zero (i.e. benefits are flat-rate) so that the Gini coefficient for income after transfers is also 0.38 (0.40*0.95 plus 0.00*0.05). In this example, the transfer systems of these two countries reduce income inequality by the same degree even though the level of spending and the distribution of benefits were very different between the two.

[20] Barr (1992) op. cit ; There are other influences, as well, including the incidence of unemployment by income class and differences in life expectancy and disability by income; other important factors include the take-up of benefits (low take-up reduces effective progressivity) and the coverage of the social security system – as shown below, Mexico and Turkey have the least redistributive social security systems in the OECD, with the main explanation for this being their lower level of coverage of the population.

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[24] The apparently low level of public cash benefits to the retirement age population in Finland reflects the fact that, in the income questionnaire used by the OECD, mandatory occupational pensions are counted as a private transfer (hence included in capital incomes) rather than as government cash transfers.

[25] Taxes paid by people of retirement age are by far the highest in Denmark, taking 44 per cent of their household disposable income, followed by Sweden, Iceland and Switzerland.

Middle Class Welfare and Churning

Despite the highly targeted nature of Australia's benefit system, it is sometimes argued that the system is not targeted enough. Two related concerns are that there is unnecessary 'churning' of benefits and taxes and that Australia has too much 'middle class welfare'.

Defining 'middle class welfare' is difficult because there is no consensus on who exactly is middle class[1]. Table 1 uses a broad approach and shows the share of transfers going to the richest 50 per cebt of households. On average the richest half of the population in OECD countries receives 45 per cent of all cash transfers, and on this measure Australia has by far the lowest level of middle-class welfare at 19 per cent of transfers paid; other countries with limited middle-class welfare include New Zealand, Denmark and the United Kingdom. Middle class welfare is most extensive in Austria, France, southern European countries and Poland, and particularly in Mexico and Turkey where the richest half of the population receives nearly three-quarters of all transfers.

Table 1: Middle class welfare: Share of transfers received by richest half of the population

	1995	2000	2005
Australia	22.9	18.6	18.6
Austria	49.2	..	60.0
Belgium	46.6	37.9	39.3
Canada	42.9	43.2	38.0
Czech Republic	31.2	32.5	35.5
Denmark	28.8	25.7	24.3
Finland	36.1	35.2	34.2
France	..	..	58.5
Germany	47.0	47.0	49.6
Greece	59.1	58.4	57.6
Hungary	48.2	44.3	48.0
Iceland	..	..	44.6
Ireland	30.2	29.6	32.5
Italy	61.5	56.4	58.5
Japan	50.3	41.7	49.1
Korea	..	..	46.7
Luxembourg	51.0	39.1	54.5
Mexico	73.1	70.4	73.9
Netherlands	35.8	34.0	34.7
New Zealand	25.3	27.7	21.5
Norway	32.7	32.1	35.3

Poland	..	48.9	63.6
Portugal	57.3	45.5	64.7
Slovak Republic	..	..	46.2
Spain	54.7	53.1	53.9
Sweden	41.9	37.5	37.9
Switzerland	..	38.9	38.0
Turkey	67.2	..	75.0
United Kingdom	27.7	24.7	26.8
United States	41.2	26.7	42.2
OECD	**44.2**	**39.5**	**45.4**
Australia/Mean	**0.52**	**0.47**	**0.41**

Source: Calculated from various waves of OECD income distribution study.

Concern with churning is related to the possibility that households can be both recipients of welfare and taxpayers simultaneously, or that individuals pay taxes at some stages of their life-course that they recoup in benefits at other times[2] – what Ståhlberg[3] calls the 'yearly give and take' and the 'life cycle give and take' respectively. It is argued that this flow of transfers into households and taxes out of the same households may involve unnecessary administrative duplication, impose compliance costs on households, and reduce choice. Saunders[4] has argued that the efficiency of welfare arrangements could be significantly enhanced without compromising poverty alleviation by reducing the 'churning' of taxes and benefits, both at a point in time and over the life cycle.

The OECD (1998) provided early estimates of the level of simultaneous 'churning' of direct taxes and transfers, covering ten OECD countries in the mid-1990s. This analysis showed that Australia had lower 'churning' than any of the other countries included, including Japan and the USA, with lower levels of social security expenditure than Australia[5]. This is likely to be the result of the very low share of transfers going to the rich in Australia, and the very low share of direct taxes paid by the poorest quintile.

Table 2 provides updated (and corrected) estimates of simultaneous churning for 2000 and 2005. Churning is calculated as the difference between direct taxes paid and cash transfers received by decile groups. First, each income decile is identified as either net transfer recipients or net taxpayers. Then, for net transfer recipients, the direct taxes paid are calculated as a percentage of disposable income; where deciles are net taxpayers, transfers are calculated as a percentage of disposable income. The level of churning is the average of these amounts across all decile groups, weighted by the decile shares of disposable income.

The implication of this is that where deciles are net transfer recipients it would theoretically be possible to reduce direct taxes paid and then reduce transfers correspondingly, without making them financially worse-off. At the other end of the income scale, it would be possible to reduce transfers received by net taxpayers, and then equally offset their direct taxes, also without making them worse-off. In theory, both taxes and transfers could be scaled back by the amount of 'churning' without any change to the net redistributive impact of the two systems, and the same net redistribution could be achieved with a lower level of both transfers and taxes, making the system more 'efficient'.

Table 2 shows that Australia had the lowest level of churning of any country in 2000, at around 5.6 per cent of disposable income, and in 2005 the level of churning was almost exactly the same, but with new data for Korea for the first time, Korea now had the lowest level of churning – mainly reflecting the fact that the level of transfers in Korea is about half that of Australia's. Other countries with low levels of churning in both years are New Zealand, Ireland, Canada, Japan, and apparently France in 2000 but not in 2005, while the countries with the highest level of churning are Germany, Italy, Sweden and Switzerland in both years and Denmark and Poland in 2005.

Table 2: Churning of transfers and taxes, OECD countries, 2000 and 2005

	2000		2005	
	Disposable income	Direct taxes	Disposable income	Direct taxes
Australia	5.6	22.7	5.5	23.3
Austria	..	..	27.5	80.5
Belgium	18.0	48.1	19.8	51.9
Canada	13.0	44.4	9.2	35.6
Czech Republic	10.3	52.7	11.8	54.8
Denmark	18.0	70.7	23.7	49.2
Finland	11.1	34.0	10.3	34.2
France	9.2	100.0	24.6	94.9
Germany	20.4	53.3	20.0	56.3
Iceland	..	..	19.2	36.1
Ireland	7.5	43.8	7.7	39.5
Italy	21.1	73.0	20.0	66.0
Japan	9.9	51.0	13.8	70.0
Korea	..	..	3.0	36.4
Luxembourg	..	..	19.4	81.4
Netherlands	13.4	39.0	10.2	41.4
New Zealand	7.5	27.1	6.8	23.5
Norway	14.2	41.5	15.3	45.9
Poland	..	..	24.7	89.1
Portugal	13.5	78	19.9	68.6
Slovak Republic	..	..	14.7	73.6
Sweden	23.6	51	24.0	55.6
Switzerland	20.2	59.5	15.6	43.3
United Kingdom	12	56	7.1	29.3
United States	12.7	39.7	6.4	25.1
Average	**13.7**	**51.9**	**14.6**	**52.2**

1. Churning is calculated by comparing the level of transfers received by each decile with the level of direct taxes (income taxes and employee social security contributions) paid by each decile. Where transfers exceed taxes, then churning is the level of taxes, and where taxes exceed transfers, churning is the level of transfers. The results are then expressed as a percentage of household disposable income and also as a percentage of direct taxes.

2. The ratio of transfers to taxes is the sum of all transfers to households as a percentage of direct taxes paid by households. Taxation data not available. *Source:* Calculated from various waves of OECD income distribution study.

It should be noted that the volume of churning would differ markedly if expressed as a percentage either of direct taxes paid in each country – also shown in Table 2 – or of transfers received[6]. This is because the countries with the highest level of churning also tend to have the highest level of spending and taxing. Table 2 shows that churning in Australia was equivalent to around 23 per cent of direct taxes in both 2000 and 2005 – now considerably lower than the figure for Korea; while this is the lowest level of any of these countries, there is some convergence – for example, using this alternative base, the estimate of churning doubles for Sweden, but rises four-fold for Australia.

It could be argued that the problem of churning is in fact much worse than suggested by these figures[7], if one were to include services such as health and education and take account of indirect taxes. Indeed, for Australia, churning defined to include indirect taxes and non-cash benefits as well as direct taxes and benefits would be more than three times higher, or around 18 per cent of final income[8]. The main factors associated with this higher churning are the weight of indirect taxes paid by lower income groups and the receipt of health and education benefits by higher income households. While comparable data are available for only a few OECD countries, it is likely even on this broader definition that Australia would still have comparatively low churning, because of the relatively low level of indirect taxes.

Is churning a useful concept in assessing the efficiency or effectiveness of tax-transfer systems? In fact, there are reasons for thinking that the concept or at least the way it is measured may be misleading in important respects. For example, Table 2 shows that in 2000 churning as a percentage of disposable income was relatively low in France, but as a percentage of direct taxes it was higher than any other country. Indeed, these figures imply that France could have completely abolished its income tax and employee social security contributions if it was able to reduce churning to zero (and it was thought this was a sensible policy). The explanation for this unusual result is that France relies heavily on indirect taxes – particularly employer social security contributions and VAT – rather than direct taxes, and indirect taxes are not measured in household surveys. As a result, on average, households in France, Austria, the Czech Republic and Slovak Republics, Luxembourg and Poland receive more in benefits than they pay in direct taxes, while at the other extreme, households in the United States pay nearly three times as much in direct taxes as they receive in transfers. A more complete accounting for the taxes that finance welfare state provisions suggests that, in these countries, churning would actually be higher than the levels shown here. These results suggest that estimates of churning restricted to direct taxes and cash benefits should be treated with caution.

A further measurement issue is that these estimates are calculated by comparing average benefits received and taxes paid by decile groups; but it is theoretically possible that half the households in a decile pay all the taxes and the other half receives all the benefits, without any overlap between them. While this is not particularly likely, it means that the level of churning estimated above is probably an upper limit. Comparisons across household types, rather than deciles, have similar problems.

A further issue is that estimates of churning are based on analysis of household incomes, but the income tests in the Australian transfer system are generally based on 'income units', the nuclear family. A greater prevalence of families sharing households will increase the level of churning – for example, a retiree living with adult children or an unemployed youth living at home count as transfer recipients in households of net taxpayers. From a purely measurement perspective, it would be possible to reduce churning if these beneficiaries moved to separate households. Policies to encourage this would probably neither be economically efficient nor socially desirable. In this context, some cross-country differences in churning levels are due to differences in household living arrangements rather than in the efficiency of social security systems. For example, a relatively high proportion of Japanese retirees live with adult children, and high proportions of households in Southern Europe contain youth still living at home[9].

The term 'churning' itself is an example of persuasive labeling; it gives the impression that what is happening is haphazard or unplanned, or is the result of badly designed or irrational policies. But churning may result from intentional policy changes designed to reduce poverty or promote economic efficiency. For example, the July 2000 reforms to the Australian taxation system involved the introduction of the goods and services tax and a compensation package of increased benefits and family payments. Since one of the major components of 'churning', more broadly defined, relates to the indirect taxes paid by the lowest 60 per cent of households, these reforms undoubtedly increased churning. However, the objective of reform was to increase economic efficiency while protecting low-income groups from the adverse effects of higher prices. Correspondingly, any future compensation for the carbon pollution reduction scheme may increase measured churning.

A similar example arises in the case of New Zealand, where measured churning is higher than Australia because most benefits are 'grossed-up' before payment and then subject to withholding of income tax. This procedure increases measured churning, but it imposes no administrative burdens on households, and it promotes horizontal equity.

Churning is not a measure of economic efficiency. In the case of family payments, it would be possible to replace the present cash payments with refundable tax credits, reducing both the level of transfers and taxation. But if the income-testing parameters of the tax credit were the same as the cash transfer, it would simply reproduce the pre-reform pattern of effective marginal tax rates. It is difficult to see that there would be significant efficiency gains in such a change, even if there were presentational advantages. This would also add very significant additional complexity to the tax system, at a time when simplification is being sought, as experience in the United Kingdom demonstrates[10].

It is also important to note that churning is a measure of potential waste only if it is possible to reduce churning and keep the distribution of income unchanged. A policy change that reduces churning but simultaneously changes the distribution of income may or may not be welfare-enhancing. In this context, the OECD (1998) points out that while some policy changes could reduce churning they would not leave households unaffected. An example is publicly funded medical care, access to which depends on health status rather than income. In such cases, reducing the level of churning would change the distribution of income. Assessment of the desirability of these policy changes would need to take account of these distributional effects, and not simply whether the system appeared to be more efficient. More broadly, what critics describe as churning is from another perspective one of the main objectives of welfare state provision – the 'piggy bank' objective.

This discussion should not be taken to imply that it is not important to assess whether specific transfer policies and taxation policies are efficient or could not be improved. Undoubtedly, it would be possible to improve the efficiency and effectiveness of the tax- transfer system. In addition, it is possible that people may view the source of household income as important – for example, it is possible that support provided through the tax system might encourage greater work effort compared to support provided through cash transfers – but the extent to which this is the case is not captured by the conventional measures of churning described above. The point of the discussion is that the apparent level of 'churning' by itself is a very limited measure of the scope for reform. Such an assessment needs to be based on a detailed assessment of individual programs, not broad and potentially misleading statistical measures.

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[1] One approach is to consider the best-off 10 per cent or 20 per cent to be rich, but inspection of the incomes of those in these broad groupings suggests that most of these groups are upper-middle income at best, with the truly rich being a minority in the top income decile.

[2] Saunders, P (2005). *The $85 Billion Tax/Welfare Churn*, Issue Analysis 57, Centre for Independent Studies, Sydney; Saunders, P (2007). *A Welfare State for Those Who Want One, Opts-outs for Those Who Don't*, Issue Analysis 79, Centre for Independent Studies, Sydney.

[3] Ståhlberg, A-C (2007). 'Redistribution across the Life Course in Social Protection Systems', in *Modernising Social Policy for the New Life Course*, OECD, Paris.

[4] Saunders, P (2005). *Op cit.*

[5] The 1998 OECD estimates contain a measurement error, because churning was calculated as the simple average of the level of 'unnecessary' taxes or transfers, but it is necessary to weight the average to reflect differences in the proportion of private income in different income deciles. When this is done, the calculated level of churning for Australia fell from 6.5 per cent of income before taxes and transfers to 4.25 per cent.

[6] The choice of the appropriate denominator – disposable income or taxes or transfers themselves – depends on one's view of why churning is a problem. If churning is seen as a problem of broader economic efficiency, then disposable income could be regarded as the appropriate basis for comparison. If it is seen as a problem of tax inefficiency then taxes are likely to be the appropriate denominator.

[7] Saunders, (2005), *Op cit*; Saunders, (2007). *Op cit.*

[8] Estimates derived from Harding, A, Lloyd, R and Warren, N (2004). The Distribution of Taxes and Government Benefits in Australia, Online Conference Paper - CP63, NATSEM, University of Canberra.

[9] Such differences in household composition are also likely to affect measures of progressivity so that the distribution of transfers will be less progressive in countries where recipients share households with other adult family members.

[10] Whiteford, P, Millar, J and Mendelson, M (2003). Timing it right? Tax credits and how to respond to income changes, Joseph Rowntree Foundation, London.

The development of family assistance in Australia

The level and means by which assistance is provided to Australian families has developed since the early 20th century, reflecting changes in social structures, the labour market, and attitudes and priorities, as well as the capacity of Australians to afford the support being provided to families[1]. At different times these objectives have included contributing to the cost of bearing and raising children and redistributing resources over the lifecycle, alleviating child poverty and boosting low family earnings, promoting equity within the tax system, redistributing within families, and relieving unemployment and low income traps. Overall, the Australian system has gone further than many other countries in emphasising redistribution to low- income families and in particular to mothers within families.

Taxation support for families with children was first introduced in 1915. A national system of cash assistance for children was introduced in 1941, with Child Endowment, a system of non-means-tested cash payments for the second and subsequent child in all families. There were also payments for pensioner and beneficiary families with children introduced in this period. Whilst there were a number of important policy changes over succeeding decades, the underlying structure of the system of family payments was not altered. The most important change affecting family payments was the introduction of Family Allowance from 1976. This involved the cashing-out of the then income tax rebates for children, so that assistance was redirected from taxpayers (usually fathers) to mothers. Low- income families whose incomes had not been high enough to benefit from the tax rebates also received significantly increased assistance.

In the period between 1976 and 1982, Family Allowances and the additional payments for pensioner and beneficiary children were not indexed and as this was a period of high inflation, low-income families in particular were adversely affected. In addition, the number of low-income families had increased significantly as the result of increasing unemployment and growing lone parenthood. In 1982 the Coalition government announced the introduction for the first time of an income-tested supplement for low-income working families. When the program came into effect after the Federal election in 1983, this Family Income Supplement was paid to about 1.2 per cent of Australian children. However, also in the 1982-83 period the number of children in unemployed and jobless families increased significantly as a result of the recession[2].

After 1983, payments for children became much more targeted, but targeting was achieved through two processes – reducing assistance to high-income families, and extending more generous assistance to an increasing proportion of low-income families. Coverage of Family Allowances for children under 16 years of age was universal until 1987. The introduction of means testing in 1987 and tighter income and assets tests from 1994 reduced coverage to around 79 per cent of all children by the late 1990s.

On the other hand, payments to lower income families expanded considerably between the mid-1980s and the mid-2000s, particularly following Prime Minister Bob Hawke's pledge in 1987 to eliminate by 1990 the need for any child to live in poverty. In December 1987, the Family Income Supplement was subsumed by the Family Allowance Supplement (FAS) at higher rates and a more generous income test. Rates of Additional Pension and Benefit for children were increased correspondingly, and effectively indexed to inflation for the first time. Rates were further increased in 1989 and formal indexation provisions were introduced in 1990.

One of the most important changes was in 1993, when all the payments for low- income families in work and on benefits were integrated into a single payment called the Additional Family Payment. This was then one of the few systems of family assistance that provided integrated support for low- income families in and outside the workforce, as in most other countries with systems of in-work support payments are made separately (e.g. the Earned Income Tax Credit in the USA, and working tax credits in the United Kingdom.) In addition, this meant that the principal carer in couple families – usually the mother – became entitled to payments rather than the primary benefit recipient, usually the father.

In response to the recession in the early 1990s, the Keating government further increased the generosity of family payments, and expanded access to families in the middle of the income distribution through a relaxation of the income test for unemployment payments, and the partial individualisation of payments for unemployed couples, which had the effect of increasing the number of families eligible for Additional Family Payment. In addition, the last specific support in the tax system for families with children – the dependent spouse rebate for families with children – was gradually moved into the benefit system. Once again, the partial individualisation of the benefit system shifted support to women, as previously the benefit entitlement for the couple had been payable to the primary beneficiary.

In summary, in the period of the Labor government between 1983 and 1996 there was both a reduction in coverage of universal assistance for all families with children on the one hand, accompanied by increased coverage of assistance for low- income families and increases on the real level of child payments for these families, on the other hand. Overall, the real level of assistance for low- income children roughly doubled between 1983 and 1990, with even higher real increases for those with older children and those renting privately. The number of children in families receiving income-tested payments increased from around three per cent of all children under the age of 16 years in 1965 to 43 per cent of all children by the late 1990s. About one-third of these families receiving income-tested payments were in employment (14 per cent of all families with children) and two-thirds were in families receiving income support benefits.

From 1996, Prime Minister John Howard followed a policy of further expanding payments to families whom he described as 'battlers'. The first stage was the introduction of the Family Tax Initiative in 1996-97. This provided benefits payable in cash to lower income families or through the tax system to middle to higher income families. The assistance through the tax system was provided as an increase in the tax threshold (the level of taxable income at which the first positive tax rate becomes payable), so that the assistance provided was the same for all families irrespective of their incomes. The cash assistance was the same amount of money, paid to those in receipt of the higher rate of Family Allowances. The Family Tax Payment/Assistance had two components: Part A was a small payment per child in all families, and thus similar to the Family Allowance, although the income test parameters differed. Part B was a higher payment for single income families, including sole parents, with a youngest child under five years of age. Providing payments through the tax system represented a partial reversal of policy trends since 1976, and also introduced a degree of increased complexity since the Family Tax Payments to some extent duplicated existing benefits.

In July 2000 the Australian system of assistance for families with children was again reformed as part of a broader program of reform of the taxation system, including the introduction of a Goods and Services Tax, which had a significant one- off impact on consumer price inflation in 2000. As well as increases in payment rates, these reforms alleviated the high effective marginal tax rates (EMTRs) facing many low-income families with children and simplified the system in some important respects (although the GST itself ensured that the impact of the tax system extended further into the pockets of very-low-income families).

Part of the reforms involved giving families the choice of whether assistance was received through cash payments or through the tax system, thus further partially reversing the direction of reforms since 1976. These changes to family assistance were also intended to simplify payments, by amalgamating a number of different forms of assistance, and also provided higher levels of assistance, with reductions in income test withdrawal rates. The new structure was also simpler, combining 12 of the pre-existing types of assistance into three new programs: Family Tax Benefit Part A to assist with the general costs of raising children; Family Tax Benefit Part B directed to single income and sole parent families; and Child Care Benefit to assist with the costs of child care.

Payment through the tax system introduced a new level of complexity, because the income tax system is subject to end of year reconciliation. As a result families were required to estimate their incomes in advance, with payments made on the basis of these estimates, and overpayments being raised following the submission of end-of-year tax returns and underpayments being made up. As a result, the number of families with family payment debts increased from just over 50,000 in 1999-2000 to 670,000 in the year after the introduction of the new system[3]. A range of subsequent initiatives attempted to deal with this problem of overpayments, including the introduction of an end of year lump sum payment of $600 per child in 2004, with the lump sum being used to offset any debts accrued during the year. Regular payment rates were also increased in the same year, and new Maternity Payment was also introduced (popularly known as the Baby Bonus). Unusually, these increases in family benefits were made as part of a broader package of income tax reductions, so that the overall package involved increases in disposable income of families at the same time as the tax cuts increased the disposable incomes of taxpayers without children[4].

Apart from increases in benefit rates, the generosity of family assistance has been enhanced by changes to income tests. Up until 1987, additional pensions and additional benefits for children were withdrawn once basic benefit entitlements were extinguished, at either 50 per cent for pensioners or 100 per cent for beneficiaries. The Family Income Supplement was withdrawn at 50 cents in the dollar, from incomes a little over the cut-out point where families no longer received unemployment benefits. With the introduction of Family Allowance Supplement in 1987, the cut-out point for payments for one child increased by about 20 per cent. There were further increases in thresholds in subsequent years. In 2000 the income test withdrawal rate was reduced from 50 to 30 per cent, and in 2004, the 30 per cent rate was reduced to 20 per cent between the maximum and base rates.

Chart 1 shows the overall effects of these changes on spending on family assistance in Australia in the period from 1988-89 to 2008-09. The figure separately identifies the total level of spending on families – which includes spending on child care assistance and income support payments for low-income families – and spending on family allowances (including the higher rates of payments for low-income families), that is what are now called Family Tax Benefits Part A and B. It is evident that spending on Family Tax Benefits and its earlier equivalents doubled from around 0.5 to 1.0 of GDP between the late 1980s and the early to middle 1990s, this was followed by a period of stability (at least as a percentage of GDP), but there was another large increase in 2000 as a consequence of the compensation package for the GST. A shorter period of stability was followed by another significant increase in spending from 1.5 to two per cent of GDP as an effect of the 2004 increases in family benefits. Since 2005, spending has fallen consistently as a percentage of GDP, probably reflecting the strong increase in GDP and in household incomes over most of this period.

Chart 1: Spending on assistance for families, Australia 1988-89 to 2008-09, % of GDP

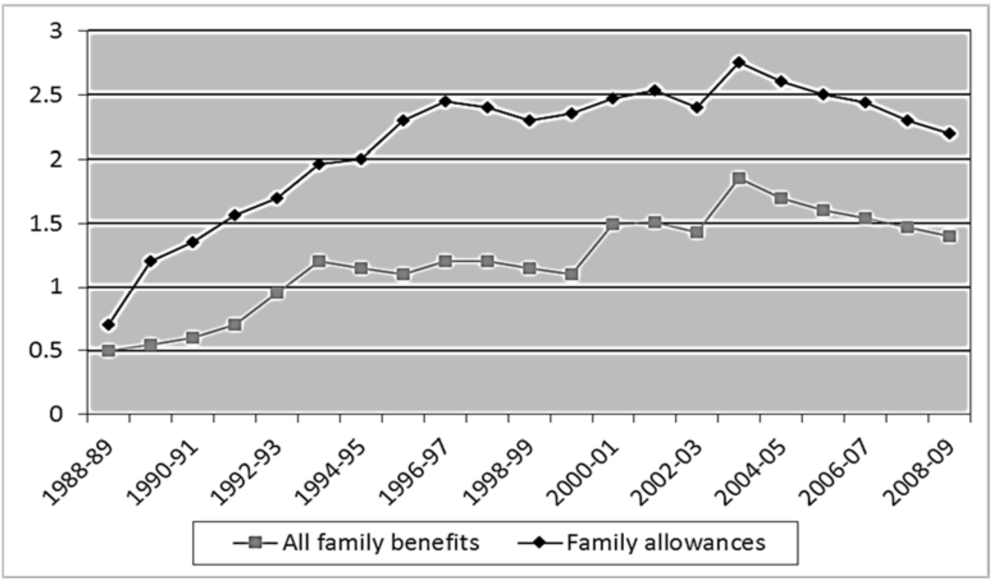


Chart 2 shows trends in the real maximum value of different family payments for a family with one child from 1975 to 2010. The figures for 'Family Allowances' include Child Endowment initially, then Family Allowances, and after the payment was income-tested, the basic rate of family payment and then the lower rate of Family Tax Benefit Part A; 'additional family payment' refers to additional pension and benefit for children (which was paid at the same rate as Family Income Supplement), and then Family Allowance Supplement, and then the higher rate of Family Tax Benefit Part A; FTBB initially refers to Mothers/Guardians Allowance, until it was superseded by the Family Tax Benefit.

Chart 2: Real maximum value of family payments for a family with one child, 1975 to 2010 (2010 $pw)

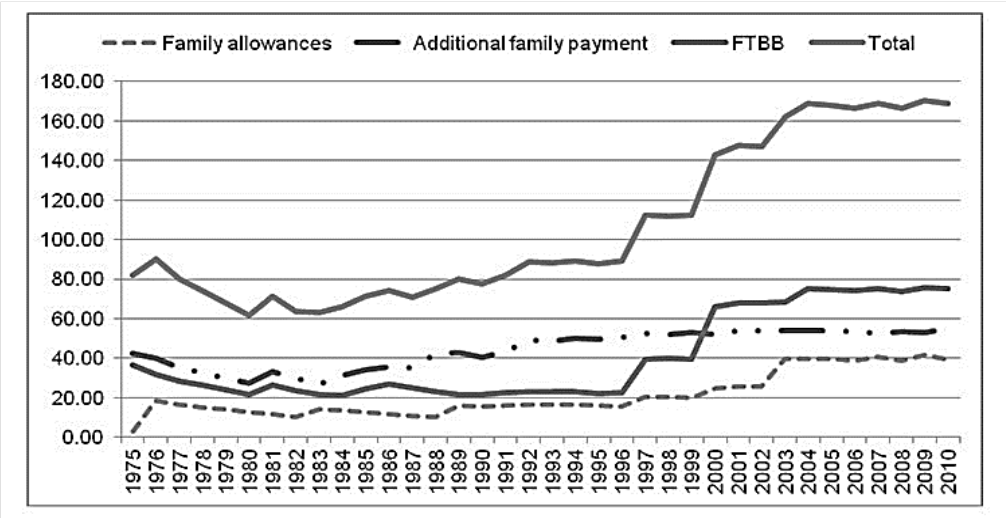


Chart 2 shows that after an initial increase in payment levels following the introduction of Family Allowances the total value of payments fell substantially in the late 1970s and early 1980s. Real payment levels were increased steadily from 1983 onwards, with particularly large increases in payments in 1997 with the Family Tax Initiative, again in 2000 as part of the ANTS package, and again in 2003. Overall, the real value of payments for a family with one child was at its lowest in 1979 at around $60 per week, but since 2003 maximum payment rates exceed $160 per week.

Spending in comparative perspective

Table 1 compares Australian spending on support for families with OECD and EU countries in 2007. Spending includes cash benefits such as family allowances and payments for lone parents, as well as parental and maternity leave, services such as childcare, and tax support for families with children. In terms of total spending, Australia ranks thirteenth in the OECD or 27 per cent above the OECD average, but in terms of spending on cash benefits, Australia ranks seventh or about 50 per cent above the OECD average. Spending on services is below the OECD average.

Table 1: Public spending on family benefits in cash, services and tax measures, % of GDP, 2007

	Cash	Services	Tax breaks towards families	Total
France	1.33	1.66	0.72	3.71
United Kingdom	2.13	1.11	0.33	3.58
Sweden	1.49	1.86	0.00	3.35
Hungary	2.24	1.10	-	3.34
Denmark	1.48	1.80	0.00	3.28
Belgium	1.60	0.95	0.58	3.13
Luxembourg	2.66	0.47	0.00	3.13
New Zealand	2.26	0.79	0.02	3.07
Norway	1.36	1.45	0.10	2.91
Iceland	1.41	1.45	0.00	2.86
Netherlands	0.61	1.38	0.85	2.84
Finland	1.48	1.34	0.00	2.83
Australia	**1.80**	**0.65**	**0.36**	**2.81**
Germany	1.09	0.75	0.88	2.71
Ireland	2.32	0.28	0.11	2.70
Austria	2.15	0.45	0.04	2.64
Czech Republic	1.49	0.50	0.47	2.46
Slovak Republic	1.40	0.38	0.41	2.19
Israel	1.02	0.97	-	1.99
Cyprus	1.63	0.26	-	1.89
Slovenia	1.29	0.51	-	1.80
Estonia	1.34	0.33	-	1.67
Romania	1.03	0.63	-	1.66
Poland	0.79	0.28	0.50	1.58
Spain	0.52	0.71	0.24	1.47
Switzerland	0.94	0.32	0.14	1.40
Italy	0.65	0.75	0.00	1.40
Canada	0.80	0.16	0.42	1.38
Portugal	0.71	0.44	0.17	1.32

	Cash	Services	Tax breaks towards families	Total
Japan	0.43	0.36	0.51	1.30
Bulgaria	0.89	0.36	-	1.26
United States	0.10	0.55	0.53	1.19
Lithuania	0.84	0.35	-	1.19
Latvia	0.97	0.20	-	1.17
Greece	0.69	0.39	-	1.09
Malta	0.93	0.09	-	1.02
Mexico	0.32	0.66	0.00	0.99
Chile	0.37	0.44	-	0.81
Korea	0.02	0.48	0.17	0.66
OECD 33-average	**1.22**	**0.78**	**0.25**	**2.20**

Source: Social Expenditure Database (www.oecd.org/els/social/expenditure), 2010, and ESSPROS, 2010.

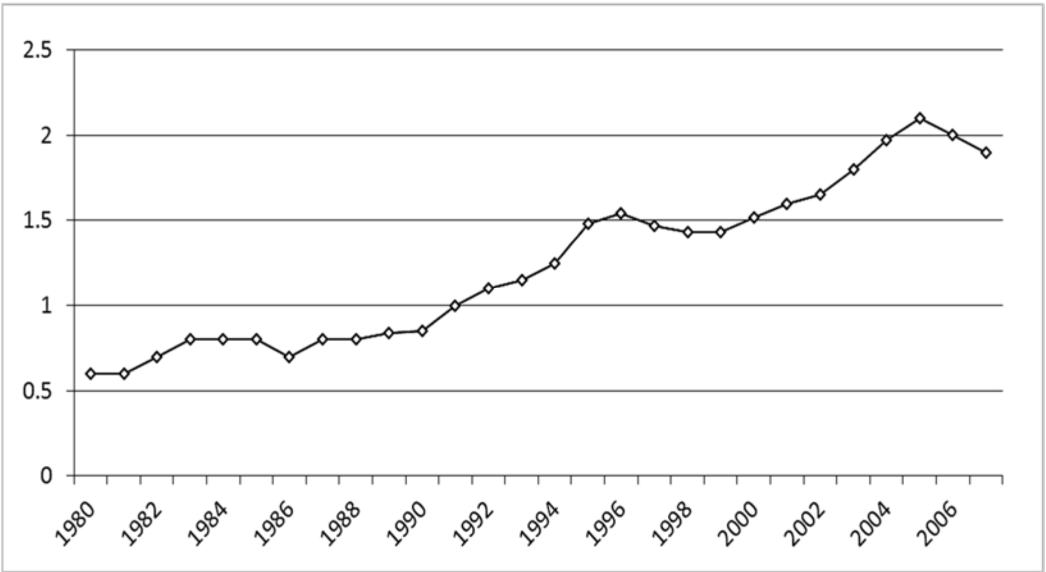
As noted, however, spending on cash benefits includes spending on universal and income-tested payments similar to Family Tax Benefits, spending on low- income families such as Parenting Payment Single, and spending on maternity, paternity and parental leaves. Australian spending on maternity and parental leave was the third lowest in the OECD in 2007. Correspondingly, spending on Family Allowances is amongst the highest in the OECD.

Since 2000, the system of family allowance payments (FTB-A and FTB-B combined) has been among the most generous in the OECD, although also still among the most targeted, in that nearly all payments were means-tested, albeit at a high level. Payments per child (FTBA) are the second highest in the OECD after Luxembourg (in terms of purchasing power), and Luxembourg's payments are not income-tested, and second after New Zealand as a percentage of the average wage.

As shown in Chart 3, Australian spending on family payments was around 60 per cent of the OECD average in the early 1980s, rising to around the OECD average in the early 1990s, then to around 1.5 times the average by 1996 and increasing to more than twice the average since 2000. In 1980 Australian spending on family payments ranked sixteenth in the OECD, but in 2007 it was the third highest in the OECD[5].

Chart 3: Trends in spending on family allowances, 1980 to 2007

Australian spending as ratio of OECD-22 average



Australia's rise in spending up the OECD ranking was during the period when income-testing restricted payments to higher income groups, so this relative increase mainly reflects the increase in assistance for lower-income families and the extension of this higher assistance to a greater share of families in the bottom half of the family income distribution.

Family assistance and child poverty

To a large extent, this increased spending was the result of initiatives following Bob Hawke's famous 1987 pledge that by 1990 no Australian child would need to live in poverty. This promise is now widely seen as either a broken political promise or an example of hyperbole, including by Hawke himself[6]. In fact, early assessment of the Family Package (Brownlee and King, 1989) estimated that the initial impact of these reforms in 1987 was to reduce the number of children in poverty by between 43 per cent and 47 per cent, with the poverty gap being reduced by 50 per cent to 55 per cent.

Subsequent analysis by the OECD[7] found that by 2003, benefit levels for Australian families receiving income support payments were the second highest in the OECD for lone parents and the highest for couples with children, both in absolute terms and relative to median incomes. Benefits paid to low-income working families (at the minimum wage) were the highest in the OECD. Between 1985 and 2000, child poverty fell by more than any other OECD country, and Australia moved from having the sixth highest rate of child poverty to sixteenth. By 2005 Australia was the second most effective country in the OECD in reducing child poverty[8]. In summary, the family assistance changes outlined here had a very significant impact on child poverty, as they were designed to.

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[1] see Peter Whiteford, David Stanton and Matthew Gray (2001). "Families and income security: changing patterns of social security and related policy issues", *Family Matters*, Issue 60, Spring/Summer: 24-35, Australian Institute of Family Studies, Melbourne; Morehead, A (2004). A review of new Australian Government initiatives for families with children, *Family Matters*, no. 69, Spring/Summer: 94-99.

[2] Peter Whiteford, (1987). 'Unemployment and Families', *Australian Bulletin of Labour*, 14, 1, December 1987: 338-357.

[3] Peter Whiteford, Jane Millar and Michael Mendelson (2003). Timing it right? Tax credits and how to respond to income changes, Joseph Rowntree Foundation, London. ISBN: 1-85935-109-3.

[4] Taxpayers with children also benefited from the income tax cuts of course, but since income tax cuts do not have a family dimension, the relative disposable incomes of families with children would fall compared to those without children in the absence of increases in family payments.

[5] (OECD (2011). Social Expenditure Database (www.oecd.org/els/social/expenditure), OECD, Paris.

[6] 'Twenty years after pledging no Australian child would live in poverty, former Prime Minister Bob Hawke has said the comment was one of the biggest regrets of his career...' John Masanauskas and Martin Philip, "Bob Hawke's biggest regret", *Herald Sun,* June 16 2007. http://www.heraldsun.com.au/news/national/bob-hawkes-biggest-regret/story-e6frf7l6-1111113759999

[7] Peter Whiteford and Willem Adema (2006). 'Combating Child Poverty in OECD Countries: Is Work the Answer? *European Journal of Social Security*, Vol. 8, no. 3: 235-256. ISSN: 1388-2627.

[8] Effectiveness is calculated as percentage point difference in the child poverty rate before and after taxes and transfers. Peter Whiteford (2009). *Family Joblessness in Australia,* Social Inclusion Unit, Canberra. ISBN: 978-1-921385-44-5.

Trends in Receipt of Income Support Among People of Working Age

The proportion of the Australian population dependent on the social security system for their livelihood is an issue of ongoing policy concern, as it is one of the major determinants of the cost of the system. In addition, to the extent that receipt of benefits is associated with poverty and social exclusion, rising numbers on benefits can be taken as an indicator of increasing social disadvantage.

Receipt of social security payments can be measured in a number of ways. The most straightforward approach is to compare the number of people receiving payments from Centrelink with the number of people in the population or in specific sub-groups of the population (e.g. men or women or people in specified age groups or locations). This calculation involves using administrative data on the numbers receiving payments as the numerator and using ABS data on the estimated resident population as the denominator.

While this method is the most commonly used, it suffers from the limitation that part- rate beneficiary recipients are given the same weight as those who have no other source of income apart from their pension or benefit; in the context of a rising share of people combining work and receipt of welfare payments this could be viewed as giving a misleading impression of trends in reliance on welfare payments.

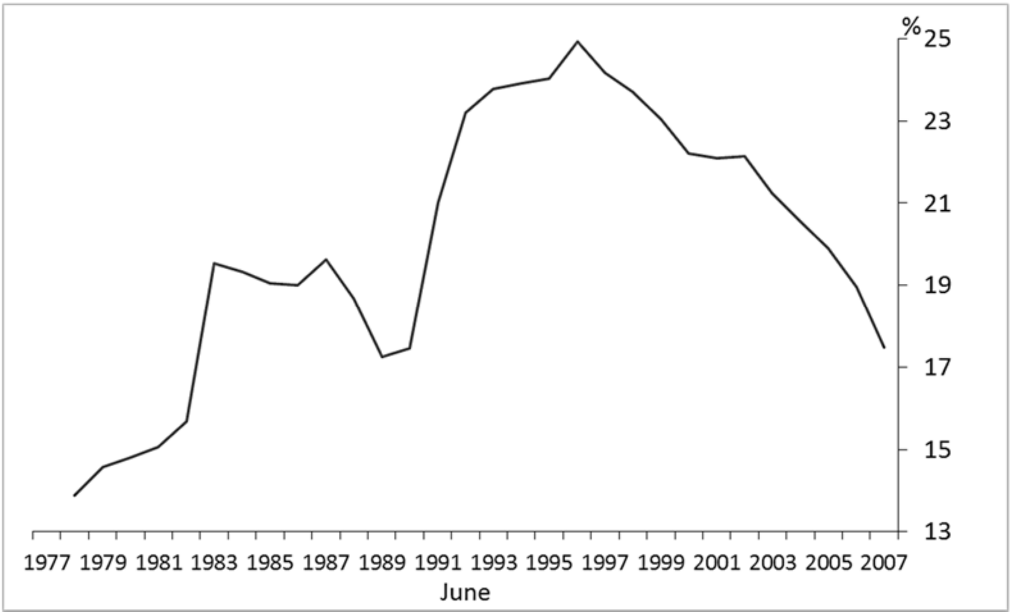
The alternative approach is to use ABS income surveys and estimate the proportion of households or families receiving either all or a substantial proportion of their income from social security payments. The ABS regularly publishes these estimates, and it is possible from this source to provide alternative estimates of rates of reliance on income support. While this approach can potentially deal with the issue of changes in the combination of work and welfare, the ABS income surveys can suffer from sampling errors and there are pension and benefit recipients outside the scope of income surveys (for example, people in nursing homes or hospitals or boarding houses, and homeless people).

The approach adopted in this paper is to use both approaches to trace trends in welfare receipt over time. The analysis is restricted to people of working age.

Welfare receipt among individuals: administrative data

The proportion of working age people receiving income support grew significantly between the late 1970s and the mid- 1990s. The reasons for the increase in this proportion between June 1978 (about 14 per cent) and June 1996 (around 25 per cent) include declines in full-time employment, an increase in the proportion of people without partners, and higher levels of education participation among young people. Since 1996, however, the share of working-age people receiving income support has fallen significantly. Chart 1 shows these trends up to 2007.

Chart 1: Proportion of working age people receiving income support [(a)] – 1978- 2007

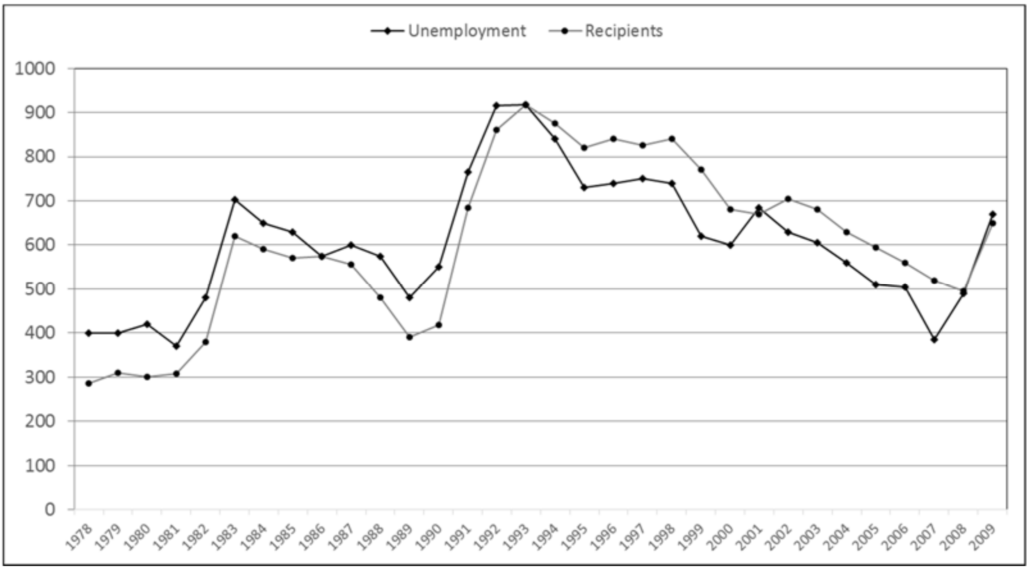


Excluding DVA Income Support Supplement, Exceptional Circumstances Relief Payment, and Farm Family Restart. Source: Parliament of Australia Parliamentary Library 2008, Trends in the receipt of income support by workforce age people 1978 to 2007;

Factors contributing to the decrease in benefit receipt since 1996 include: strong jobs growth; the closure or phasing out of some payments; and tightening of eligibility criteria for other payments. Offsetting these trends has been the ageing of the baby boom generation, which has contributed to ongoing growth in the number of people receiving Disability Support Pension.

A sustained increase in employment opportunities saw the proportion of working age people receiving an unemployment payment fall from 6.9 per cent in June 1996 to 3.3 per cent in June 2008 before rising to 4.2 per cent in June 2009. These movements closely mirror changes in the unemployment rate, as illustrated in Chart 2.

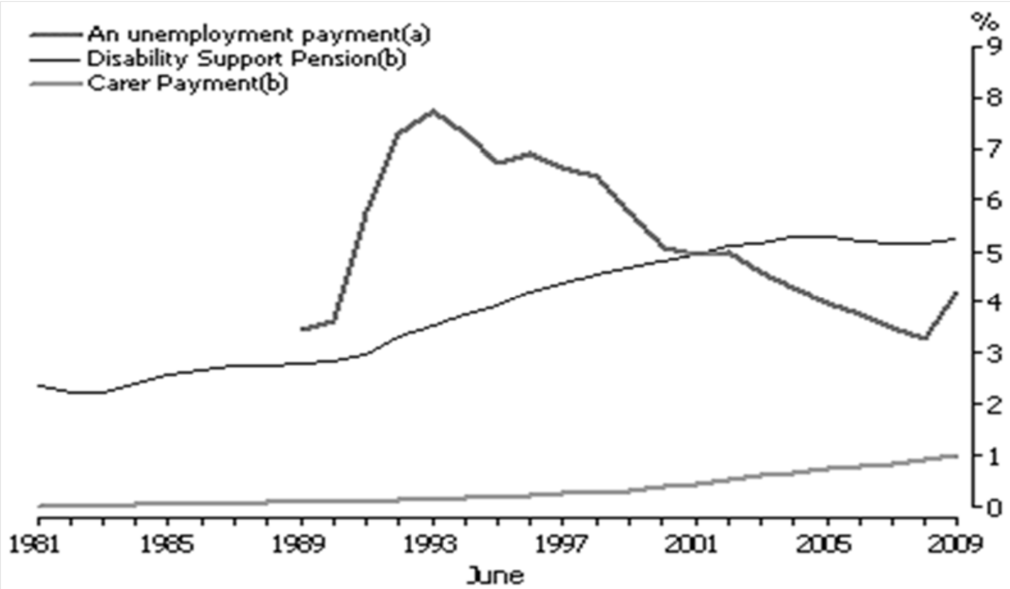
Chart 2: Trends in the number (000s) of unemployed and unemployment benefit recipients, 1978 to 2009



Sources: Australian Bureau of Statistics, *Labour Force Survey*; FaHCSIA and DEEWR, *Labour market and related payments* series.

The lower rate of receipt of unemployment payments, however, accounts for less than half the 7.5 percentage point fall in the proportion of working age people receiving income support between June 1996 and June 2007. Given that the proportions of working age people receiving Disability Support Pension and Carer Payment increased over the same period (Chart 3), factors other than lower unemployment also contributed to the fall in income support receipt among people of working age – although it is possible that stronger labour market circumstances contributed indirectly.

Chart 3: Proportion of working age people receiving selected income support payments

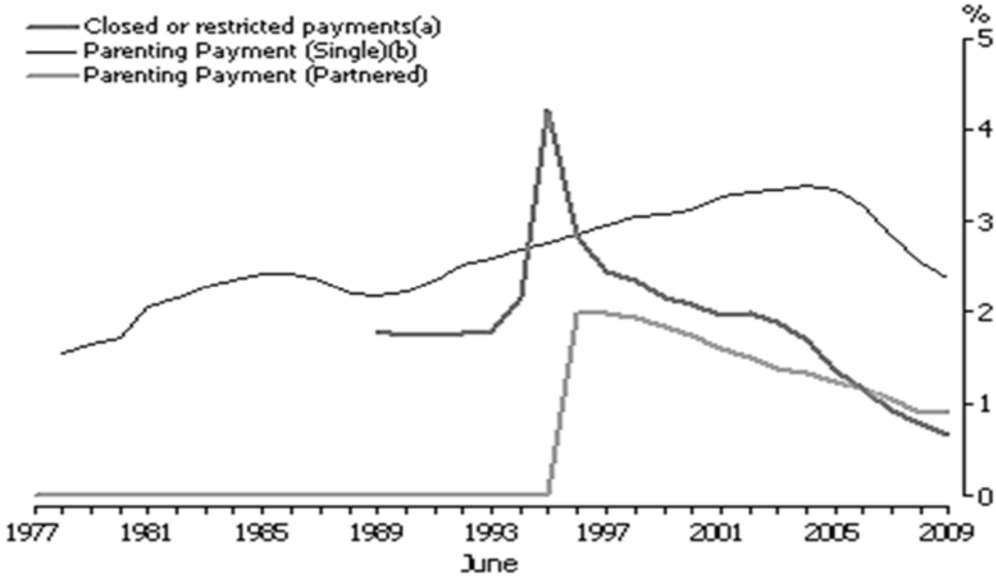


(a) Currently comprises Newstart Allowance and Youth Allowance (Other). Some recipients of Youth Allowance (Other) are under 16. These recipients are in the numerator but not the denominator of the proportion. (b) Some recipients are 65 or over, and some live overseas. These recipients are in the numerator but not the denominator of the proportion.

Source: Australian Government Department of Families, Housing, Community Services and Indigenous Affairs Occasional Paper No.1 Income support and related statistics: a 10-year compendium, 1989-1999; Occasional Paper No.7 Income support customers: A statistical overview 2001; Statistical Paper No. 1 Income support customers: a statistical overview 2002; Statistical Paper No. 4 Income support customers: a statistical overview 2005; Annual Report 2005-06, 2006-07, 2007-08, 2008-09; Australian Government Department of Education, Employment and Workplace Relations Annual Report 2005-06, 2006-07, 2008-09; Population by Age and Sex, Australian States and Territories, June 2009 (ABS cat. no. 3201.0).

A major reason for the decrease in the rate of income support receipt among working age people between June 1996 and June 2007 has been the closure and/or phasing out of a number of income support payments (Chart 4). Wife Pension was closed to new entrants in 1995. Access to Widow B Pension was limited in 1987, and closed to new entrants in 1997. Partner Allowance and Mature Age Allowance were both closed to new claimants in 2003, and by 2008 there were no longer any recipients of Mature Age Allowance. Since 2005, new grants of Widow Allowance have been limited to women born on or before 1 July 1955. The proportion of working age people receiving Wife Pension, Widow B Pension, Partner Allowance, Mature Age Allowance or Widow Allowance decreased from 4.2 per cent in June 1995 to 0.6 per cent in June 2009. None of these closed or restricted income support payments have participation or activity requirements such as studying, training or searching for work. When introduced, payments like Wife Pension and Widow B pension reflected attitudes and policies about which groups of working age people could not reasonably be expected to find paid work. Other payments were introduced in conjunction with individualisation and included restrictions to ensure they would gradually phase out.

Chart 4: Proportion of working age people receiving selected income support payments



(a) Comprises Mature Age Allowances, Partner Allowance, Wife Pension, Widow B Pension and Widow Allowance. Some recipients are 65 or over, and some live overseas. These recipients are in the numerator but not the denominator of the proportion.

(b) Recipients living overseas are in the numerator but not the denominator of the proportion.

(c) Note that the spikes in *Closed or restricted payments* in 1995 and *Parenting Payment (Partnered)* in 1996 reflect the individualisation of payments to couples: the partner supplements previously paid to heads of households, which they replaced, are not included in the data series shown.

Source: Australian Government Department of Families, Housing, Community Services and Indigenous Affairs Occasional Paper No. 1 Income support and related statistics: a 10-year compendium, 1989-1999; Statistical Paper No. 1 Income support customers: a statistical overview2002; Statistical Paper No. 4 Income support customers: a statistical overview 2005; Annual Report 2005-06, 2006-07, 2007-08, 2008-09: Australian Government Department of Education, Employment and Workplace Relations Annual Report 2005-06, 2006-07, 2007-08, 2008-09; Labour Market and Related Payments, January 2010; Parliament of Australia Parliamentary Library Trends in the receipt of income support by workforce age people 1978 to 2007; Population by Age and Sex, Australian States and Territories, June 2009 (ABS cat. no. 3201.0)

Another reason for the decrease in the rate of income support receipt among 16-64 year olds has been the gradual raising of the age at which women qualify for receipt of a pension for having reached retirement age. In June 1996, women needed to be aged 60.5 years to qualify for receipt of the Age Pension and 55.5 years to qualify for an equivalent retirement pension from the Department of Veteran's Affairs. By June 2007, these qualifying ages had risen to 63 years and 58 years respectively. This has resulted in progressively fewer working age people receiving the Age Pension. In June 1995 there were 211,685 women under 65 receiving the Age Pension (representing 1.8 per cent of all working age people). By June 2009 the number of women under 65 receiving the Age Pension had fallen to around 81,000.

Until 10 May 2005, people qualified for the Disability Support Pension if they had an impairment that prevented them from working (or being re-skilled to work) for 30 hours a week at or above the minimum wage for at least the next two years. This changed from 30 hours a week to 15 hours a week for some working age people applying for this income support payment between 11 May 2005 and 30 June 2006, and for all new claimants from 1 July 2006. After rising from 1.7 per cent in June 1972 to 5.3 per cent in June 2004, the proportion of working age people receiving the Disability Support Pension changed little to June 2009 (5.2 per cent).

Chart 4 also shows declines in rates of receipt of Parenting Payments. Until July 2006, Parenting Payment was available (subject to means testing and residence rules) to the principal carer of a child aged under 16 years. Since 1 July 2006, new recipients need to have a child under six (if partnered) or eight (if single). New recipients were required to look for at least 15 hours work per week when their youngest child turned six, and existing recipients were required to do so on 1 July 2007 or when their youngest turned seven (whichever was later). The proportion of working age people receiving Parenting Payment (Single) increased from under 1.6 per cent in June 1978 to 3.4 per cent in June 2005. Over the next four years it steadily fell to 2.4 per cent. The rate of receipt of Parenting Payment (Partnered) has also declined; from 2.0 per cent in June 1996 to 0.9 per cent in June 2009.

Chart 5 shows the breakdown of working age recipients in 2009 by type of payment received. The largest group is DSP recipients (then 750,000), followed by Newstart recipients (520,000) and Parenting Payment Single recipients (340,000), then Carers and Parenting Payment Partnered.

Chart 5: Working-age recipients of selected social security payments, Australia, 2009

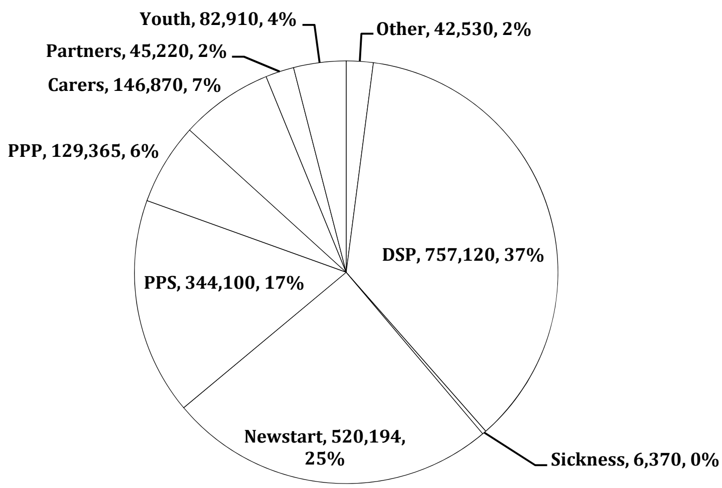


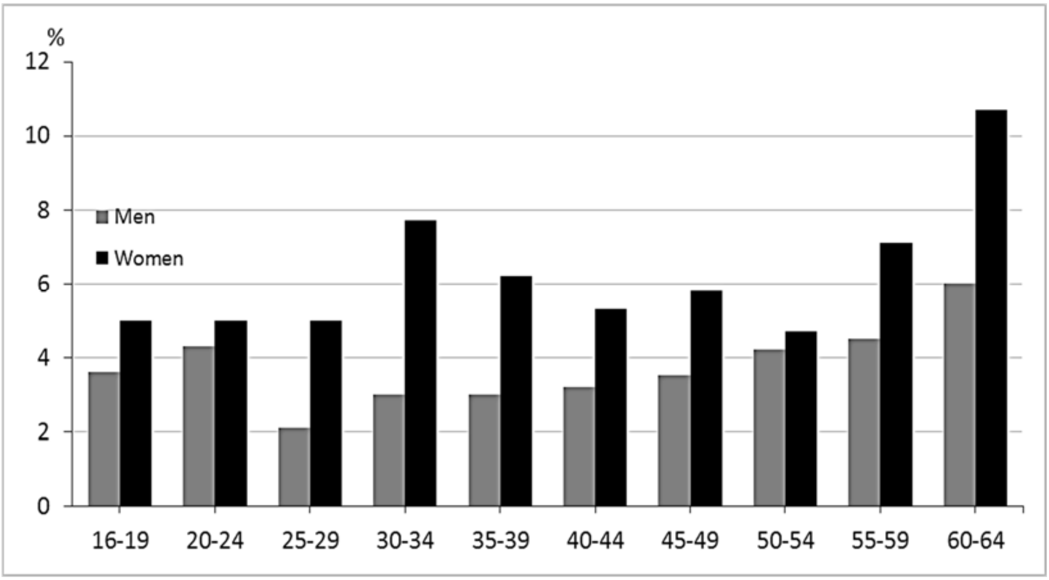
Chart 6 shows the age and sex distribution of working-age income support recipients in 2007-08. In all age groups, women are more likely to receive payments than men. The age/sex distribution of working age income support recipients is shaped by factors such as the incidence of disability (which rises with age) and parenting activity (which increases for women when they have children then decreases as their children age).

In 2007-08, for example, women represented nearly two-thirds (63 per cent) of all working-age income support recipients living in private dwellings. Men are more likely than women to receive certain types of payments. In June 2007, men comprised 63 per cent of Newstart Allowees and 58 per cent of Disability Support Pensioners.

Some payments to people of working age (i.e. Wife Pension, Widow B Pension, Widow Allowance and the Age Pension), were received by women only, while some others (e.g. Carer Payment, Partner Allowance and Bereavement Allowance) were mainly received by women. These payments also partly explain the relatively high proportion of working-age income support recipients who are 55-64 year-old women.

High proportions of people receiving Parenting Payment (Single) (93 per cent) and Parenting Payment (Partnered) (91 per cent) were women, as were more than half (54 per cent) of all students receiving either Youth Allowance (Full-time study), Austudy or Abstudy.

Chart 6: Age/sex distribution of working age income support recipients [(a)] – 2007-08



(a) Some income support recipients are excluded from this distribution because of the scope of the survey, and some are excluded because the survey did not determine that they were receiving an income support payment.

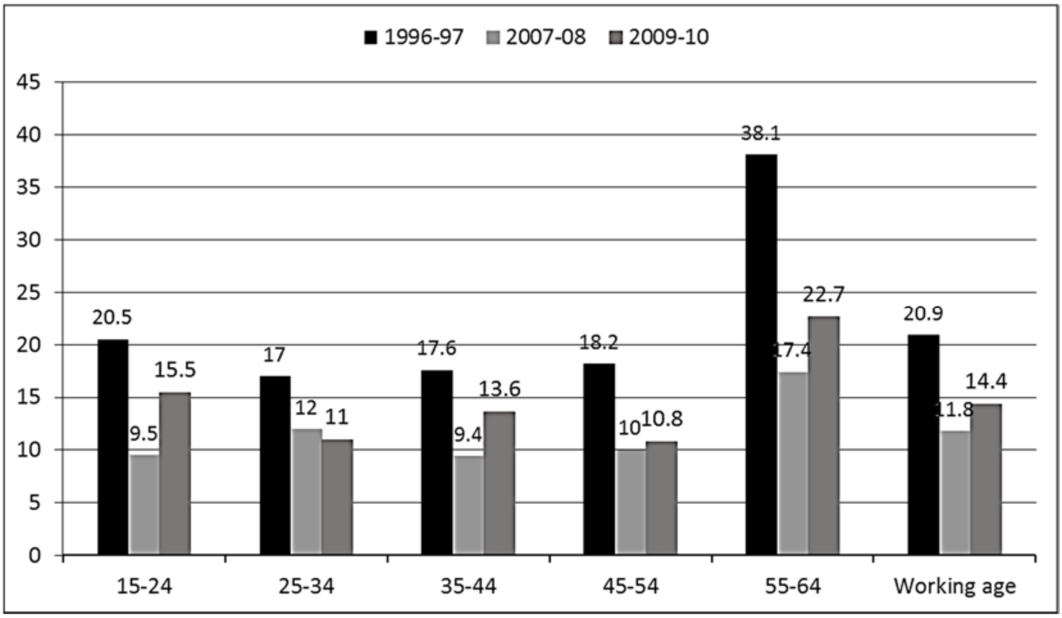
Source: ABS 2007-08 Survey of Income and Housing.

Rates of receipt of the Disability Support Pension rise with age for both men and women, which partly explains the relatively high proportion of working-age income support recipients who are aged 55-64 years.

Welfare receipt among households

Chart 7 shows overall changes in the proportion of working age households whose principal source of income[1] was government cash benefits between 1996-97 and 2007-08 and 2009-10. Rates of receipt fell significantly up to 2007-08. Reductions in rates of receipt of income support were most marked for those aged less than 25 years and those aged 55 to 64 years, where reliance on benefits more than halved. Other age groups saw smaller but still very substantial declines.

Chart 7: Change in working age income support recipients, 1996-97 to 2009-10



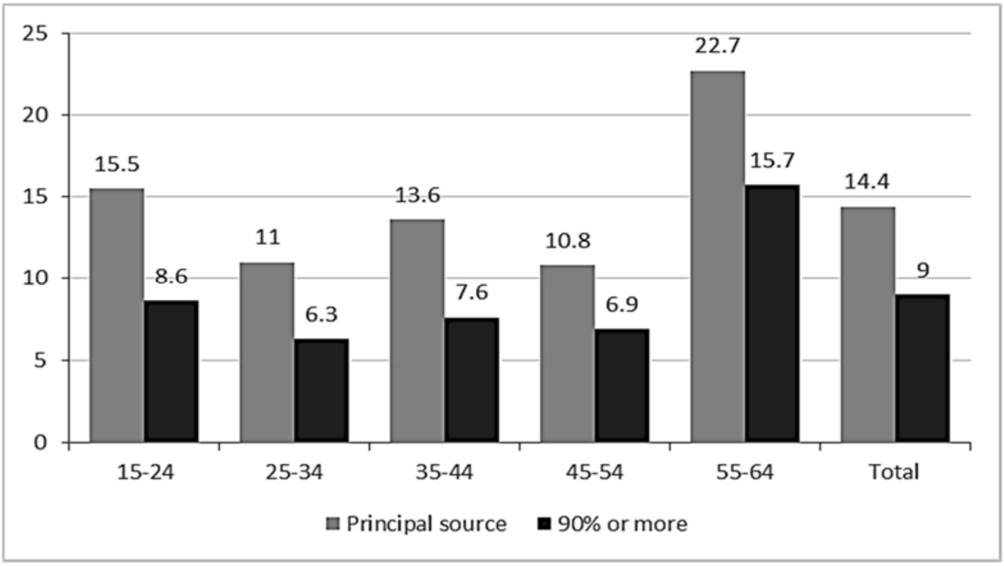
Source: ABS Survey of Household Income and Income Distribution, various years.

For most age groups – except those aged 25 to 34 years – rates of receipt rose following the GFC, most strongly for those aged 15 to 24 years (from 9.5 per cent to 15.5 per cent of these households) as well as for those aged 55 to 64 years (from 17.4 per cent to 22.7 per cent). Overall, the proportion of working-age households whose main income source was government benefits increased from 11.8 per cent to 14.4 per cent, although this is still the second lowest level in the period.

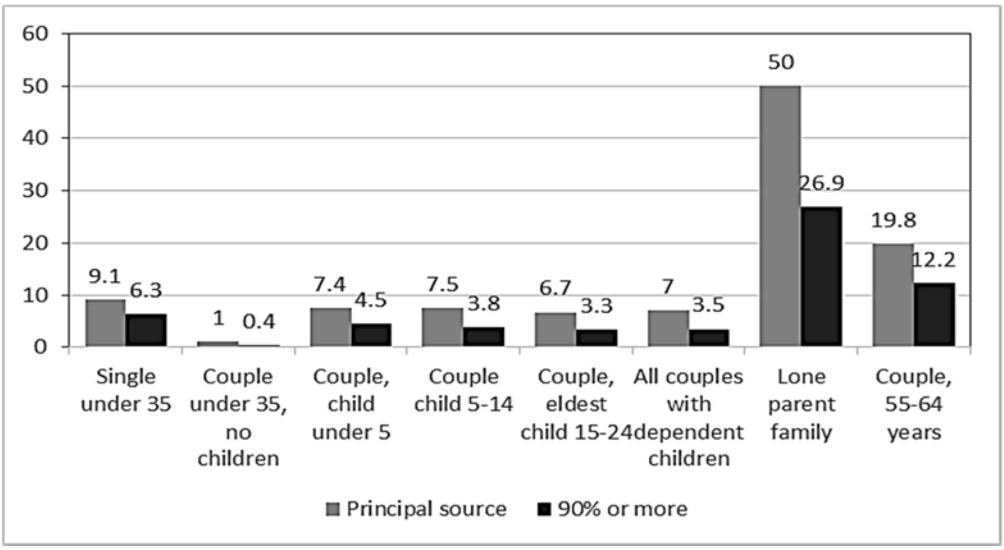
Finally, Chart 8 provides a profile of the extent of welfare receipt among different types of households of working age, distinguishing between those for whom benefits are the largest single source and those for whom it is 90 per cent or more of their income.

Chart 8: Working age income support recipients, 2009-10, by household characteristics

A. Age of reference person



B. Selected life cycle groups



Source: ABS Survey of Household Income and Income Distribution, 2009-10.

The first part of the chart shows patterns by age – generally speaking, roughly two-thirds of those whose main income source is government cash benefits receive more than 90 per cent of their income from this source. The second part of the chart shows that there are much greater differences by household life cycle group. Receipt of payments and deep reliance are uncommon for younger households and couples with children. However, close to 50 per cent of lone parents have benefits as their main income source, and more than one quarter derive 90 per cent or more of their income from benefits. Couples aged between 55 and 64 years also have much higher rates of benefit receipt.

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[1] This covers households for whom social security cash benefits were their largest single source of household income. Given multiple income sources, this may be less than 50 per cent.

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