A fairer, more efficient tax and social security system

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1 Introduction

The Australian Council of Social Service (ACOSS) has a long history of involvement in tax and social security reform in Australia. Founded in 1956, ACOSS is the peak body of the community services and welfare sector and the national voice for the needs of people affected by poverty and inequality. With a network of national and state and territory councils of social service, and a membership of over two thousand organisations around the country, ACOSS has a depth of expertise and community experience that is unique in the area of taxation reform.

ACOSS was a strong contributor to the Henry Review process. ACOSS has also pushed for strong community representation in the upcoming Tax Forum, which is to continue the tax reform dialogue started with the Henry Review. ACOSS sees the Tax Forum is an opportunity for Government to gain the views of a broad cross-section of the community regarding the priorities and directions for further reform of Australia's tax and transfer system.

2 What principles should guide tax and social security reform?

2.1 Revenue adequacy

Community organisations have long advocated investment in community services and poverty alleviation. An essential part of this advocacy is to answer the question of from where that money would come. Based on current trends, there will be a shortfall of federal public revenue compared with expenditure of around 3% of GDP in 40 years due to the ageing trend of the Australian population.

This can, to some extent, be met by improving spending efficiency and to some extent by charging service users. However, there is a limit to how far these strategies can stretch while maintaining social inclusion and good quality universal services. The danger with user pays arrangements is that people on the lowest incomes would be left with second rate services, such as shared rooms with no windows in nursing homes.

As the population ages it is appropriate that governments spend a higher proportion of GDP on health, aged care and pensions. The question remains: how will this be funded?

2.2 Fairness

Tax and social security distribute resources across the community. They are important tools in combating poverty and social exclusion. The basic principle of a good tax system is that tax is levied according to the ability to pay. Income taxes come closest to this principle because they include both employment and investment income. Unlike consumption taxes, income tax is not levied on those with little or no earning capacity.

Fairness is also improved if those on higher incomes pay a higher rate of tax and different income is taxed consistently, irrespective of the form it takes.

2.3 Economic efficiency

Tax and social security also affect the way in which people earn a living and how they invest their savings. This, in turn, affects the operation of markets, including the housing and labour markets. Thus, tax and social security reform can improve employment opportunities and housing affordability.

The present tax system undermines efficiency as different forms of labour or investment income are taxed at different rates. This distorts investment, often without a sound reason. An example of this is the lower tax rate on capital gains compared to other investment incomes (such as bank interest). This has contributed to overinvestment in housing at the top end of the market, and to Australia's high housing costs.

2.4 Poverty and participation

The social security system should ensure a minimum adequate level of income for all, based on need rather than outdated ideas about who is more or less 'deserving'. It should be linked to reasonable requirements to seek decent paid work and to services to assist people in that process.

The system should be targeted on the basis of need without undermining incentives for paid work.

3 Framing the public debate: deciding what needs to be fixed

The 'Australia's Future Tax System' (Henry) Report's proposals provide a sound framework for tax reform in the medium to long term. Although the Panel could have been bolder in its proposals for social secuity reform, the Review presents a good blend of vision and pragmatism, equity and efficiency. The proposals provide a good starting point for debate over the next steps in tax reform and it would be pointless and wasteful to start the tax reform discussion all over again with a 'clean slate'.

ACOSS does not expect announcements of major tax reforms immediately following the Tax Forum on October 4-5. However, we hope that the Government will set cleargoals and priorities for the next phase of tax reform, and a dialogue will be started with the community on these issues.

The 'Australia's Future Tax System' Review engaged experts over a two year period in a process to develop a framework for tax reform. However, before we can decide on the policy solutions the community must agree on the the problems to be resolved. That essential first step has not been taken.

Tax reform is more likely to attract broad supprt if, instead of announcing 'one big tax package', policy makers first engage with the community to identify problems that concern them which tax and social security reform might help resolve. In our view, those include:

- How to pay for the health and aged care services needed as the population ages and ensure that our retirement income system is both fair and suatainable.
- How to improve housing affordability for low and mdidle income people.
- How to improve the fairness and economic efficiency of the personal income tax system by closing tax shelters and lowering rates of tax.
- How to reduce poverty and improve workforce participation.

There are many myths and misconceptions about our tax system. If we allow the discussion to be distracted by these issues, experience suggests that it will be difficult to reach agreement on the basic problems and facts, let alone necessary reforms.

These misconceptions include that:

- Australia has high overall tax levels by international standards.
- Thetop marginal tax rates are the main disincentive to workforce participation.
- That there is a shortage of investment in Australia due to an 'uncompetitive' tax system.
- That by international standards Australia relies too much on income taxes and too little on consumption taxes and this undermines economic efficiency.

We discuss these four misconceptions first before moving on to deal with problems that tax and social security reform could help resolve.

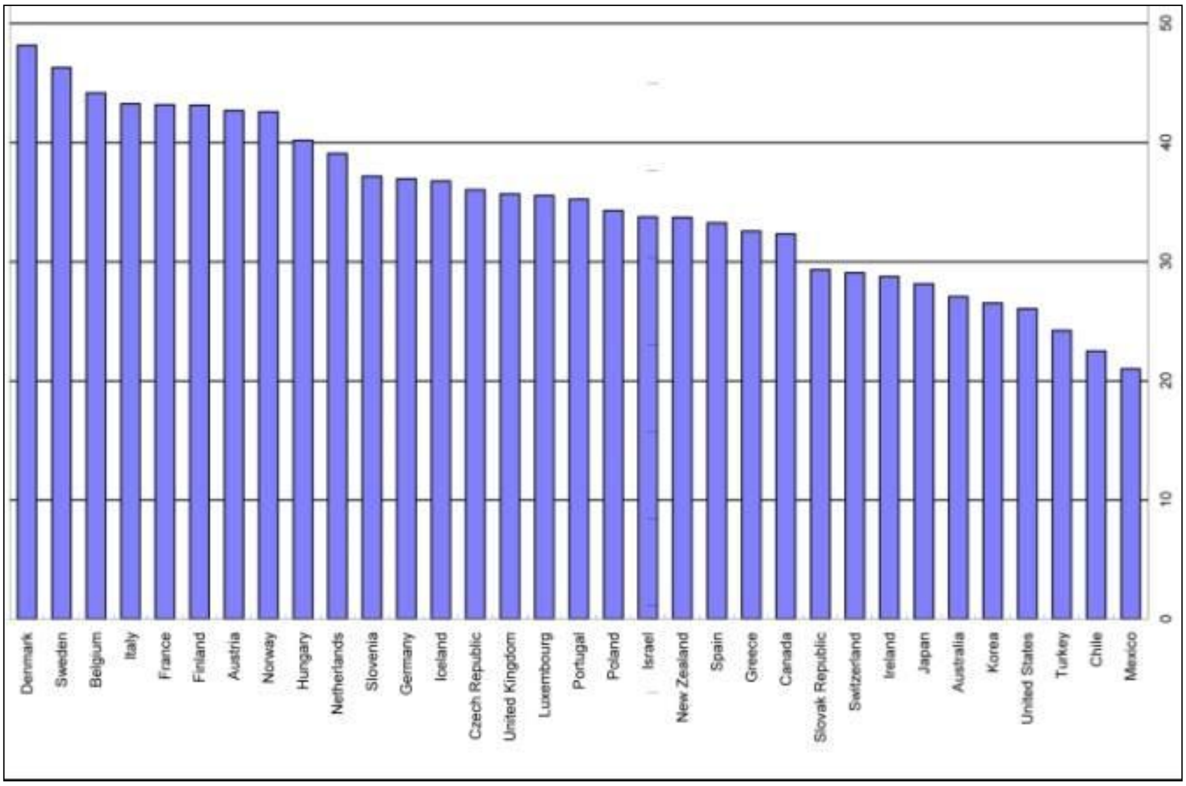
3.1 Australia does not have high overall tax levels

According to data from the Organisation for Economic Cooperation and Development (OECD), Australia is the 6th lowest of the 33 OECD countries in 2008 for tax levels.[1] Only Mexico, Chile, Turkey, the US and Korea have lower tax levels than Australia, as can be seen in Figure 1.

Even if we include our own superannuation guarantee (something not added by the OECD because the funds are private funds) our ratio between tax and GDP is increased by only a few percentage points.

[1] Organisation for Economic Cooperation and Development (2010): Revenue Statistics, 2010.

Figure 1: Revenue as a % of GDP, 2008



Source: OECD (2011), *Revenue statistics 2008*.

3.2 Top marginal rates are not the most important work disincentive

Top marginal tax rates are not the main disincentive to workforce participation. The people whose labour supply is most sensitive to tax rates are women on low incomes who have dependent children, not high income earners (most of whom are men).

The key work disincentives for low and middle income women with children include the lack of quality affordable child care and social security income tests, as much as income tax rates.

Table 1: Summary of Australian studies of the sensitivity of employment decisions to tax levels

		Married men	Married women	Lone parents	Singles
Evidence on variation between population groups					
Responsiveness		Least responsive.	Fairly responsive, and a wider variation in responsiveness.	Possibly the highest responsiveness and widest range.	Likely to be more responsive than married men and less responsive than married women. Single women are likely to be a little more responsive than single men.
Uncompensated wage elasticity		Mostly in the range between 0 (or slightly negative) to around 0.3 with average around 0.	Mostly in the range 0 to 0.8 with an average around 0.3.	Around 0.5 on average, but probably higher than this (could be as high as 1.5).	Insufficient data, however an average around 0.3 is possible.
Evidence on variation within population groups					
Source of variability within the population group	**Lifecycle stage/children**	Slightly more responsiveness from those without children than those with young children, however the difference is fairly small.	Higher wage elasticity for those with dependent children compared to those without children or where children have left home. Those with older children (school-aged) generally have higher elasticities than those with younger (pre school-aged) children.		
	Wage level	Some evidence of slightly reduced responsiveness for those in families with both partners with higher wages compared to those with lower wages.	Generally those in families with both partners with lower wage levels have higher elasticities than those with higher wage levels.		
	Hours of work/employment status		Those on lower hours (part-time work) have higher elasticities than those working higher hours (full-time work).	Generally higher elasticities for those not working or working part-time hours.	
	Education	Generally higher responsiveness for those with lower educational attainment.	Generally higher responsiveness for those with lower educational attainment.		
	Foreign status		Australian-born women have higher elasticities than foreign-born women. Of the foreign-born, those from NESB backgrounds have the lowest elasticities.		
	Welfare dependency			Lower elasticities for lone mothers with some degree of welfare dependency.	

Source: Dandie & Mercante (2007), *Australian wage and labour supply elasticities, a critical review*, Treasury Working paper 2007-04

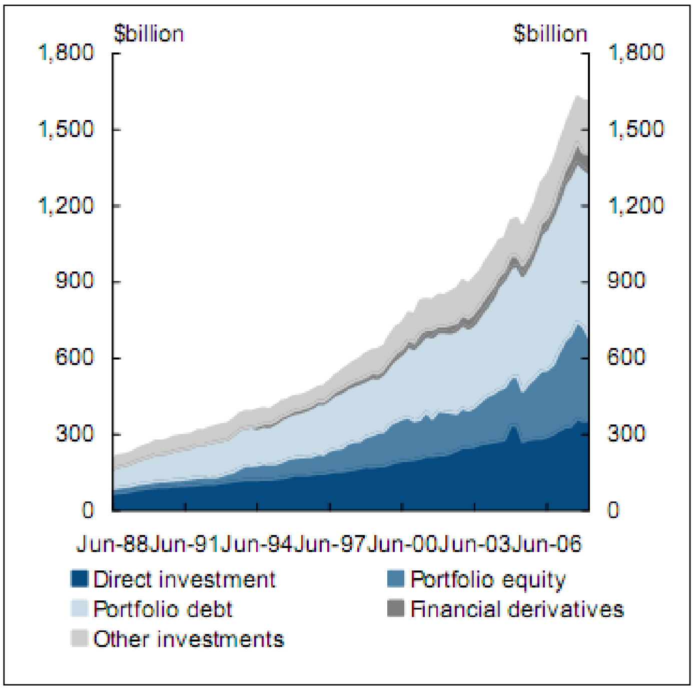
3.3 There is no overall shortage of investment in Australia

There is no overall shortage of investment in Australia. Foreign investment in Australia has grown dramatically over the last decade, particularly in the mining industry.

It would be possible to make changes to the tax system to increase overall investment in the short term. However, investments attracted through such changes are not likely to be of high quality. The countries most affected by the Global Financial Crisis, including Ireland and the US, had a surplus of economically harmful investment during the recent economic boom, especially speculative investment in property finnaced by high levels of household debt.

The main problem with Australia's tax system from this standpoint is not that the system discourages investment generally, but that as discussed later in this report, it encourages poor investment choices of this kind.

Figure 2: Foreign investment in Australia



Source: Australia's Future Tax System (2008), *Architecture of the Tax and Transfer System*.

3.4 Our tax mix between income and consumption is not much different to the OECD average and the economic benefits of taxing consumption more and income less are not proven.

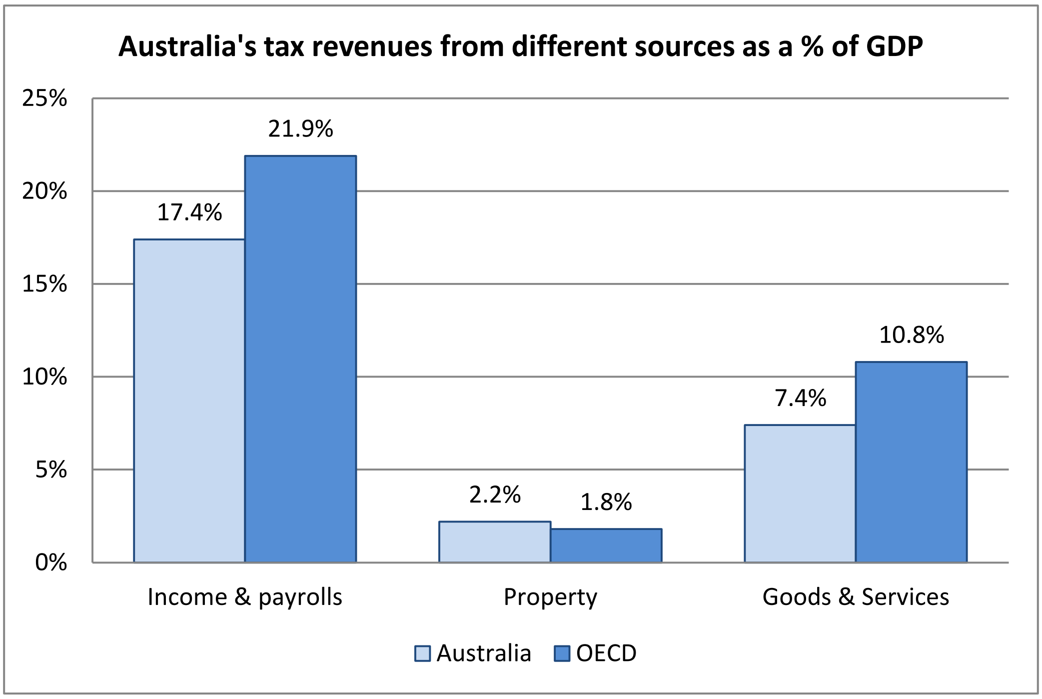
The basic difference between income taxes and consumption taxes is that saving and investment are taxed with an income tax but they are not taxed with a consumption tax.

Some argue that Australia's tax mix is economically inefficient: that we rely too much on income taxes and not enough on taxes on consumption to raise public revenue. This is based on the view that it is economically efficient to tax less mobile factors such as land and labour more and more mobile factors such as financial investments less. For example, it is harder for people to shift their investments in land and the minerals beneath it in response to high tax rates, or for workers to move overseas, than it is for investors to shift their savings into overseas back accounts.

While this is true in theory, Australia already taxes most forms of income from investments – including superannuation and housing - at lower rates than wages. Once again, the main problem for the economic efficiency is that different investments are taxed at different rates. The claimed economic benefit of reducing our overall reliance on income taxes are unproven.

A related argument is that we raise a higher proportion of public revenue from taxes on income than the average wealthy nation, and that this makes Australia 'uncompetitive' as an investment destination. While Australian Governments do raise a slightly higher percentage of their revenue from income and payroll taxes (64% compared with the OECD average of 62%), the point is that we raise much less revenue overall (27% of GDP compared with an average for OECD nations of 35%), so our income tax 'take' is still below average.

Figure 3: Australia's Tax Mix



Source: OECD (2011), Revenue statistics 2008.

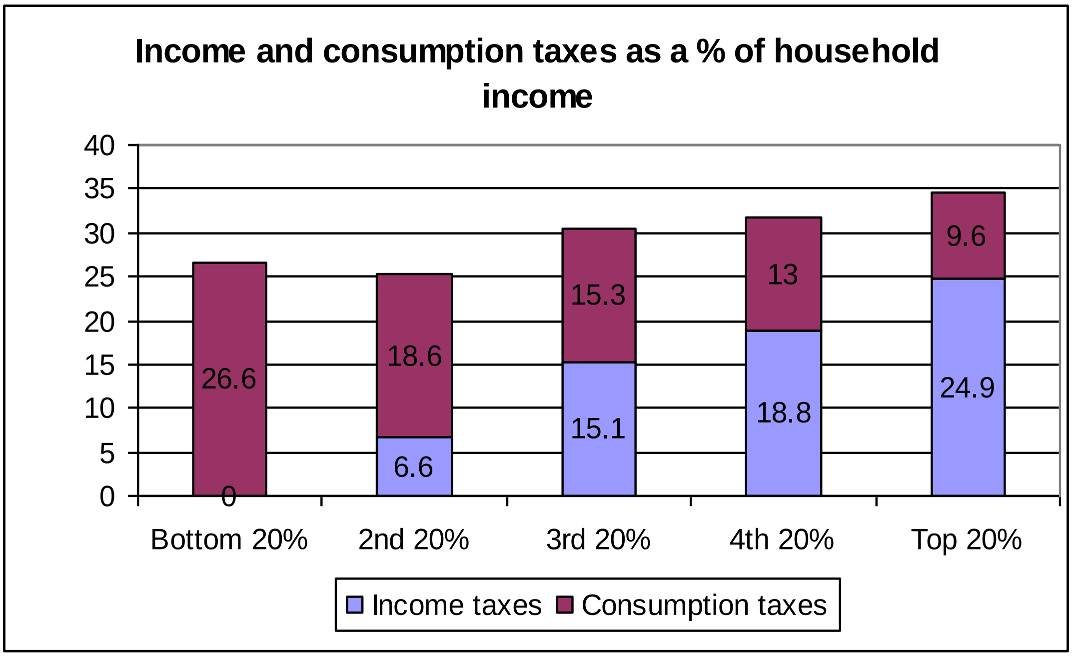
A great deal of time could be wasted debating the'ideal' tax mix. Such debates are unresolvable. They are also divisive as they pit 'fairness' against 'efficiency'. For example, people on low and fixed incomes generally oppose increases in consumption tax because they are the worst affected by higher taxes on consumption. There are three reasons for this:

- Those on the lowest incomes do not pay any income tax, but they do pay taxes such as the GST whenever they shop.
- If consumption taxes are increased the value of the savings of retired people is eroded because goods and services become more expensive.
- The top 20% of households by income are the biggest savers. Since income from investments is taxed under an income tax but not under a consumption tax, a shift from taxing income to taxing consumption is a windfall gain for these households.

For these reasons, ACOSS opposes an overall increase in consumption taxes such as the Goods and Services Tax.

Most people think that Australia's tax system is 'progressive', due to the fact that high income earners face higher rates of personal income tax. Yet when we take account of both income and consumption taxes and both federal and state taxes, Australia's tax system is not strongly progressive. Taxing consumption more and income less could lead us to a 'flat tax system' where tax overall levels on income and spending no longer rise along with people's capacity to pay.

Figure 4



Source: ABS, *Government benefits taxes and household income 2003-04*, table 9F (includes State and Local taxes)

Previous attempts to increase the level of taxes on consumption have failed, including the Hawke Government's 'Option C' in 1985, and the Howard Government's attempt to levy the GST on food and use the proceeds to cut income tax in 2000. While it is true that many European countries have much higher consumption taxes than Australia, the reason this is accepted in those countries is that their Governments use the additional revenue to pay for generous social insurance payments and quality universal community services such as free child care. Australia, by comparison, has very a very 'lean' welfare system. Swedish consumption taxes are unlikely to be accepted here without Swedish benefits and services.

Tax reform is more likely to succeed if, instead of an unproductive and divisive debate over the ideal tax mix between income and consumption, we focus on improving the fairness and efficiency of each of the tax bases we have, as proposed in the Henry Report.

4 Four problems that tax and social security reform could help resolve

We identify four key objectives that tax and social security reform could help achieve:

1) An fairer and more efficient personal income tax.
2) An adequate and sustainable system of retirement incomes and services.
3) Affordable housing.
4) A simpler and fairer social security system for people of working age that reduces poverty and encourages employment.

4.1 A fairer and more efficient personal income tax system

Australia's personal income tax system is unfair. Different income types are taxed inconsistently. This creates opportunities for some people to avoid tax, leaving the rest to pay more than they would otherwise have to. One of the most common complaints about the income tax system is that, while for most people tax is automatically deducted from their incomes at the marginal rate, others who are well off and well advised can in effect choose their own tax rate. The reason for this is that different kinds of income are taxed at different rates, as shown in Table 2.

Table 2

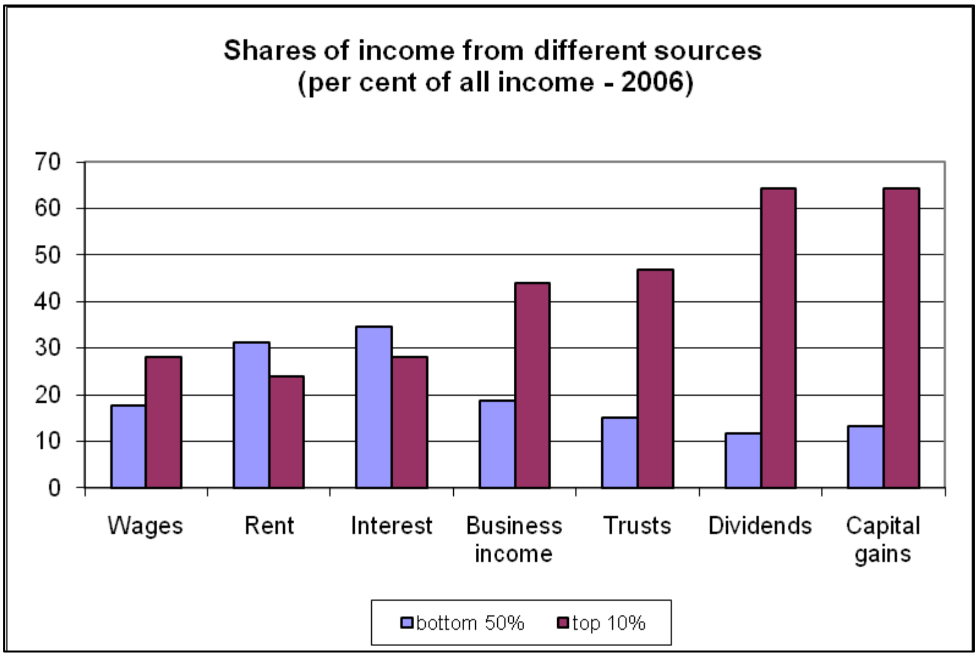
Effective tax rates for a high earner (income over $180,000 per year)
45% on personal earnings or bank interest
22.5% on capital gains
15% on employer superannuation contributions
15-30% on 'golden handshakes'
30% on income retained in a private company
15% on discretionary trust income split with a family member employed part-time
Negative tax rate on loss-making investments that yield future capital gains

This is both unfair and economically inefficient.

Fixing this problem by taxing income more consistently fits neatly with tax theory - that a more efficient and equitable tax system has a 'broad base' (that is, different forms of income are taxed consistently) that reduces opportunities to avoid tax, and low tax rates. This insight has given rise to successful tax reform packages in the past including the Hawke Government's 'Option 1' package in 1986 and the Howard Government's corporate income tax reforms in 2000.

Income from different sources is very unevenly distributed across the community. Many of the lowest-taxed investments (such as shares and property yielding capital gains) are heavily concentrated at the top end, as evidenced in Figure 5.

Figure 5



Source: Australia's Future Tax System (2008), *Architecture of the Tax and Transfer System*.

The Government has already moved to close a number of tax shelters in its 2011-12 Budget, for example by reforming the Fringe Benefits Tax on 'company cars' and removing tax breaks for distributions through trusts to minors. However, there is a limit to the gains in fairness and efficiency that can achieved politically through such 'base broadening' without packaging it with tax cuts and service guarantees. The Henry Report proposes that Governments should tax different types of income in a more consistent manner by:

- Removing poorly targeted tax offsets, for example those for 'golden handshakes' and self education expenses;
- Reducing the tax advantages of diverting personal income into private companies and trusts;
- Introducing a standard deduction and tightening substantiation requirements for large work-related expense claims;
- Tightening the formula for Fringe Benefit Tax concessions for company cars (implemented in the last Budget); and
- Using these savings to raise income tax thresholds and reduce tax rates.

These recommendations would substantially improve the fairness and efficiency of the personal income tax system, with the important exception of the Report's illustrative option to 'flatten' the tax scales by removing the 15% and 37% tax rates.

'Flattening' tax rates in this way (as distinct from lowering them generally) reduces the progressivity of income tax, without any clear benefits for economic efficiency. For example, abolition of the 15% tax rate would reduce incentives for many low income earners to seek part time employment and would particularly disadvantage taxpayers earning between around $30-$80,000. Removing the 37% tax rate would provide a windfall gain for those on $80,000 and above. These two elements of an otherwise sensible option to reform tax scales and the interaction between the tax and social security systems are the main reason that Treasury modelling finds that this reform option would increaseoverall tax levels for middle income earners and reduce them for high income earners.

Flattening the tax scales does not simplify the tax system for taxpayers, since for most people tax is withdrawn from pay packets by the employer and there are 'tax calculators' available to help people work out their overall level of tax. A tax scale with five levels is no more complex in practice than one with three.

Since they have no clear efficiency benefits and they would reduce fairness, ACOSS opposes proposals to flatten the personal income tax scales.

4.2 An adequate and sustainable system of retirement incomes and services

Many mature age people, especially those on low incomes with limited superannuation, are worried whether future governments will continue to provide age pensions and the necessary health and aged care services. Future budgets will be affected greatly by the ageing population due to higher expenditures and less revenue. The latest Treasury Intergenerational Report estimates that by 2046 Federal Budget expenditure will rise by almost 5% of GDP and the Federal Budget will be in deficit by almost 3% of GDP due to higher health, aged care and social security spending caused in large part by population ageing. State Government expenditures will also be affected.

If public revenue is not strengthened, future governments will have to rely to a much larger extent upon the users of services to pay for health and aged care, which could result in a two-tier system of service delivery akin to public health services in the United States, which provide a second-rate service for the poorest.

Currently, only one in five people over 65 pays income tax. Most cannot afford to pay yet a growing minority of mature age people can afford to pay more. NATSEM has estimated the proportion of all household wealth held by people over 65 years will rise from 22% in 2001 to 47% by 2031, and that wealth will in future be distributed much more unequally among mature age households.[2] Relatively wealthy mature age people who are well advised can easily avoid paying income tax at their normal marginal through special tax breaks such as the Senior Australians Tax Offset (SATO), the zero tax rate on the earnings of their superannuation funds in the 'benefits phase', and the way in which the tax rules allow people to collect capital gains tax free in self managed superannuation funds. This is unfair to younger people (who have to pay more tax to compensate for the public revenue loss)

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[2] Kelly (2003), *Self Provision In Retirement? Forecasting Future Household Wealth*, NATSEM, University of Canberra.

and to mature age people on lower incomes (who miss out on the publicly funded services they need though lack of public resources).

An increasingly common tax avoidance strategy among people over 55 years of age is to 'churn' part of their wages through their superannuation accounts and then pay themslves an equivalent superannuation benefit. This can result in that part of their earnings that is 'salary sacrificed' into superannuation being taxed at 15% instead of their marginal rate. Yet this income 'churn' might not increase their level of personal saving at all, so there is no public benefit in allowing people to reduce tax in this way.

Table 3: Example of 'Transition to retirement' strategy

	Salary	
	$50,000 $	**$100,000 $**
Without transition to retirement		
Income tax and Medicare	8,850	27,500
Net income	41,150	72,500
With transition to retirement		
Salary sacrifice	25,000	50,000
Superannuation income	16,525	31,350
Income tax and Medicare on remaining $25,000/$50,000	375	8,850
Tax on super contributions	3,750	7,500
Net income	41,150	72,500
Reduction in total tax	4,725	11,150

Source: Treasury (2008), *Architecture of the Tax-transfer system*. Note that the levels of salary sacrifice illustrated here are designed to maintain the same level of after-tax income.

To resolve these problems, the Henry Report proposes that:

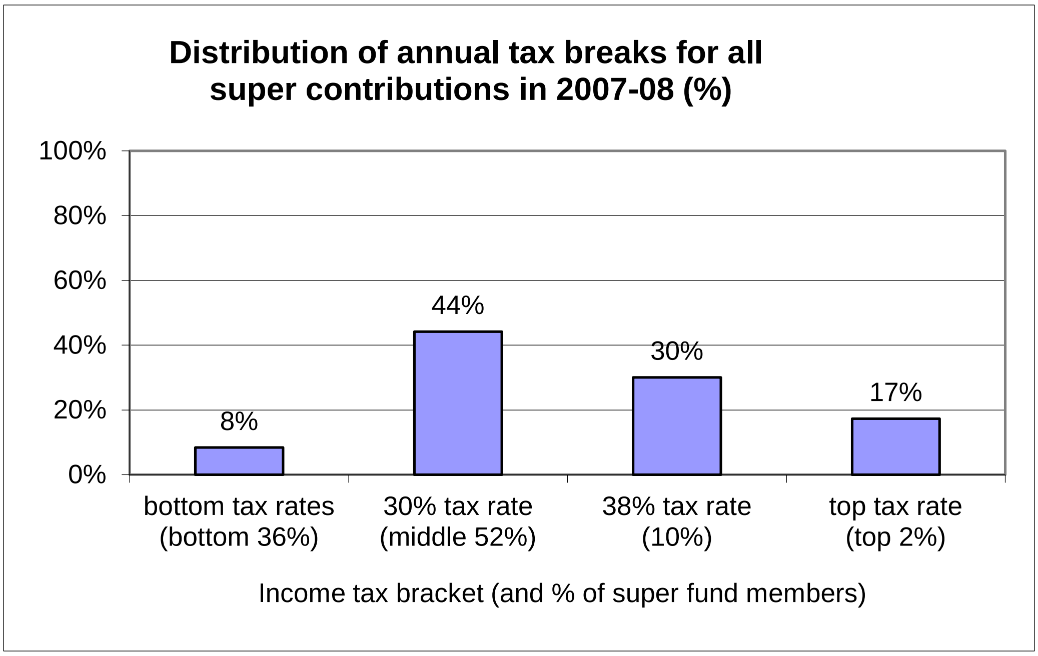
- Tax breaks for superannuation contributions should only apply to the extent that contributions made exceed benefits paid (that is, the fund member is actually saving income through superannuation).
- The same tax rate should apply to superannuation fund investment income in the so-called 'benefits phase' as in the so called 'accumulation phase'.[3]
- Age-specific tax breaks such as the Senior Australians Tax Offset should be abolished.

ACOSS suggests that savings gained from reducing these tax shelters be earmarked for future public expenditures on aged care and health services as the population ages. This idea is similar to the earmarking of increased income tax revenues, via a 'National Welfare Fund', to fund the major improvements in social security introduced in 1944. Alternately, they could be deposited into a 'sovereign wealth fund' by the Government to finance both these services and the proposed National Disability Insurance Scheme.

A related issue is the inequity of tax breaks for superannuation contributions. Australia has almost universal superannuation coverage. However, this is superimposed on a tax treatment that grew from the time when superannuation was a perk for those on the highest incomes. Of the $15 billion in tax breaks on superannuation contributions in 2008, almost 20% went to the top 2% of income earners (those over $150,000) and almost 50% went to the top 12%.

[3] Currently, the interest income of super funds is taxed at 15% while the fund accumulates savings (before retirement) but it is not taxed in the 'benefits phase' (once the fund starts to pay benefits). In recent years, the distinction between these two stages has been blurred since fund members over 55 years of age can stay employed and contribute to super while their super fund pays them a benefit.

Figure 6



ACOSS estimates based on Gallagher (2011), Treasury Measurement of Retirement Income Adequacy and Tellis (2009), Projecting the Distributions Of Certain Superannuation Tax Expenditures On Contributions, Paper delivered to 17th Colloquium of Superannuation Researchers, University of NSW, July 2009.

This inequity especially disadvantages women, many of whom are employed part time on low wages. It contributes to their low levels of retirement savings and high levels of reliance on age pensions.

The gender differences point to ongoing flaws in a system that relies on the model of being in continous paid work until retirement as its basis. Women's lifetime earnings are generally less than men's because of the time demands of higher domestic and care responsibilities and the generally lower pay rates for many jobs, identified as primarily female. The current hourly wage gap hovers around 17% and has remained more or less static over many years and discrimination is a factor as found in a recent Fair Work Australia judgement on the community services industry. They are also more likely to be casual workers as the only way that they can achieve family need flexibility, and fewer casuals are also covered.

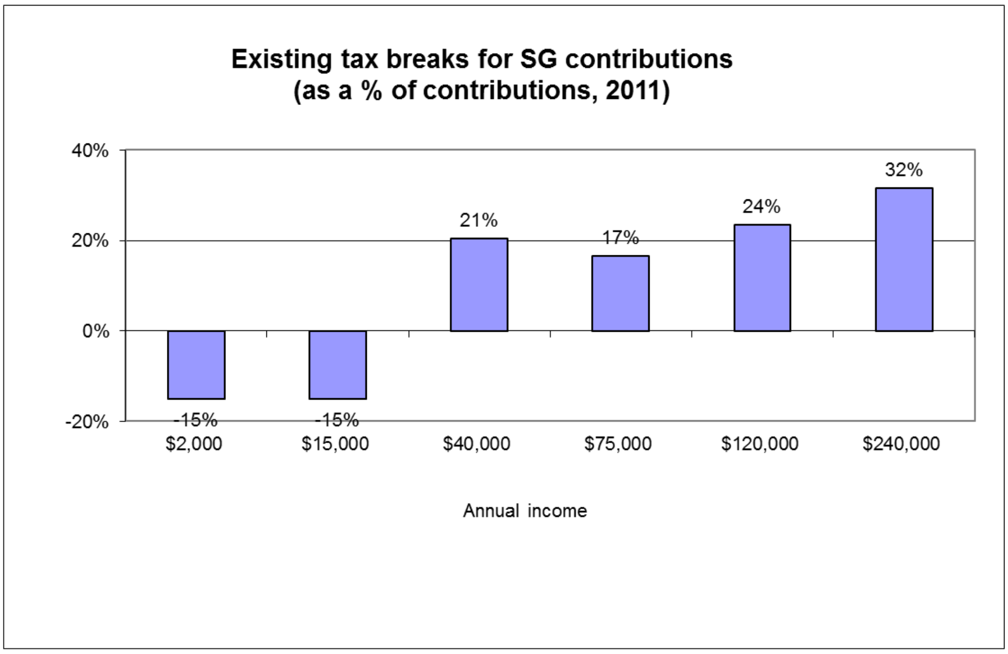
There is a lack of recent data on the differences in benefit accumulation which should be addressed by ABS. The latest data from 2007 showed that working age women have just over half the retirement savings that men have. In 2004, half of all women aged between 45 and 59 had $8,000 or less in superannuation, while men had $31,000[4]. Statistics also show that more women (38%) than men (26%) do not have superannuation and more women than men have dormant accounts.

While this is mainly in older age groups, the differences will increase as younger women workers take on unpaid family responsibilities, via part time work and fewer possible promotions. This tension shows in the 2007 data, with lone females aged 35-44 years having 89% of male balances versus coupled females with only 60% of the male mean, This raises questions on what is the public obligation to contribute to an adequate retirement income for those whose social contributions reduce their time in paid work.

The main reason for the inequitable distribution of superannuation tax breaks is that employer contributions attract a flat tax rate of 15%. Compared with the marginal tax rate an employee pays on their wages, this means that earnings contributed to superannuation by their employer are taxed 30 cents per dollar less in the case of a high income earner, but 15 cents per dollar *more* for an employee below the tax free threshold (currently $16,000 taking account of the Low Income Tax Offset). That is, a low income earner is *penalised* by the tax system for employer superannuation contributions. The proposed 15% Government Contribution would remove this tax penalty for those on the lowest incomes but still leave them with zero tax support for contributions from their employer, compared with a tax break of 32 cents per dollar contributed on behalf of a high income earner.

[4] Figure quoted in speech by Elizabeth Broderick, Sex Discrimination Commissioner and Commissioner responsible for Age Discrimination, Australian Human Rights Commission (15 September 2009): *Accumulating poverty: Women's experiences of inequality over the lifecycle*, from: Simon Kelly, *Entering Retirement: the Financial Aspects* (Paper presented at the Communicating the Gendered Impact of Economic Policies: The Case of Women's Retirement Incomes, Perth, 12-13 December 2006) p 12.

Figure 7



Note: 'SG' refers to Superannuation Guarantee contributions of 9% of wages. The graph takes account of the Low Income Tax Offset, so that an individual earning $15,000 does not normally pay income tax on their wages.

The effect is the same as replacing the current progressive income tax scale with a flat 15% tax. This system of tax concessions is inefficient as well as inequitable, since high income earners are likely to save for their retirement with or without tax breaks, and they are unlikely to rely the age pension in any event. Treasury research estimates that on average, high income earners receive a public subsidy for their retirement incomes (through tax breaks) over their lifetimes that exceeds the cost of paying them the age pension.[5]

If taxation subsidies were more fairly distributed – if each dollar of contributions attracted the same rebate of tax up to an annual limit - the savings obtained by reducing tax breaks for high income earners could be used to substantially increase after-tax contributions for those on low and middle incomes. A reform of this kind, as proposed in the Henry Report, could raise annual after-tax contributions for workers on average wages or less by at least 3% of their wages, even if revenue neutral. This would greatly increase their retirement incomes at no extra cost to them, their employers, or the public revenue.

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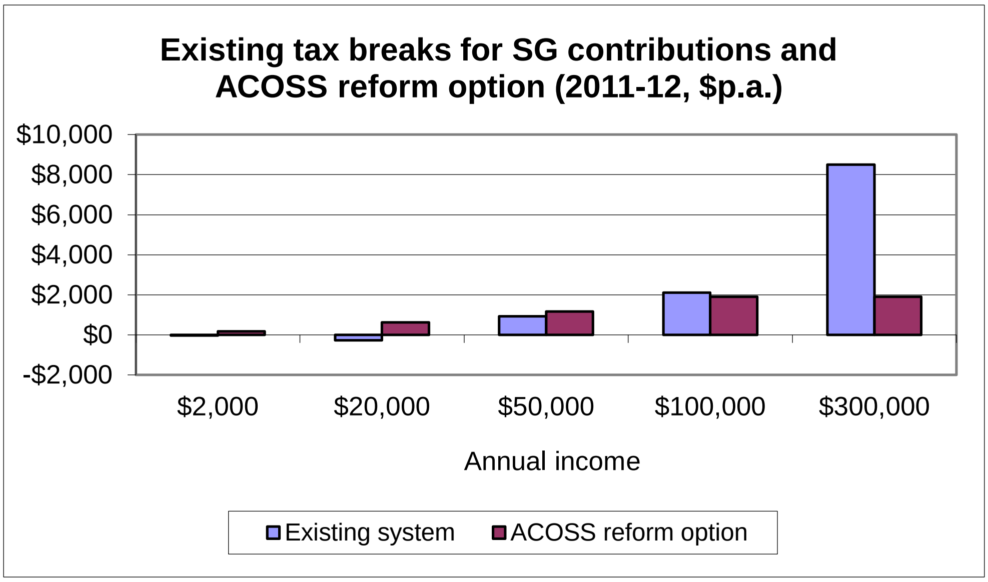
[5] Rothman (2009), *Assessing the equity of Australia's retirement income system*, 17th Colloquium of superannuation researchers, UNSW July 2009.

The Henry Report proposes that:

- employer contributions be taxed at the employee's marginal tax rate and that existing tax breaks for superannuation contributions be replaced by an annual capped rebate.

For example, if all tax breaks for superannuation contributions were replaced by an annual rebate on all contributions equal to 100% for contributions of up to 0.5% of average earnings (to replace the present Government co-contribution) and 20% for additional contributions up to 12% of average earnings (i.e. around $7,200 in annual contributions), then annual tax breaks for superannuation guarantee contributions for low and middle income earners would be significantly increased (see graph below) at no cost to revenue or low and middle income employees.

Figure 8



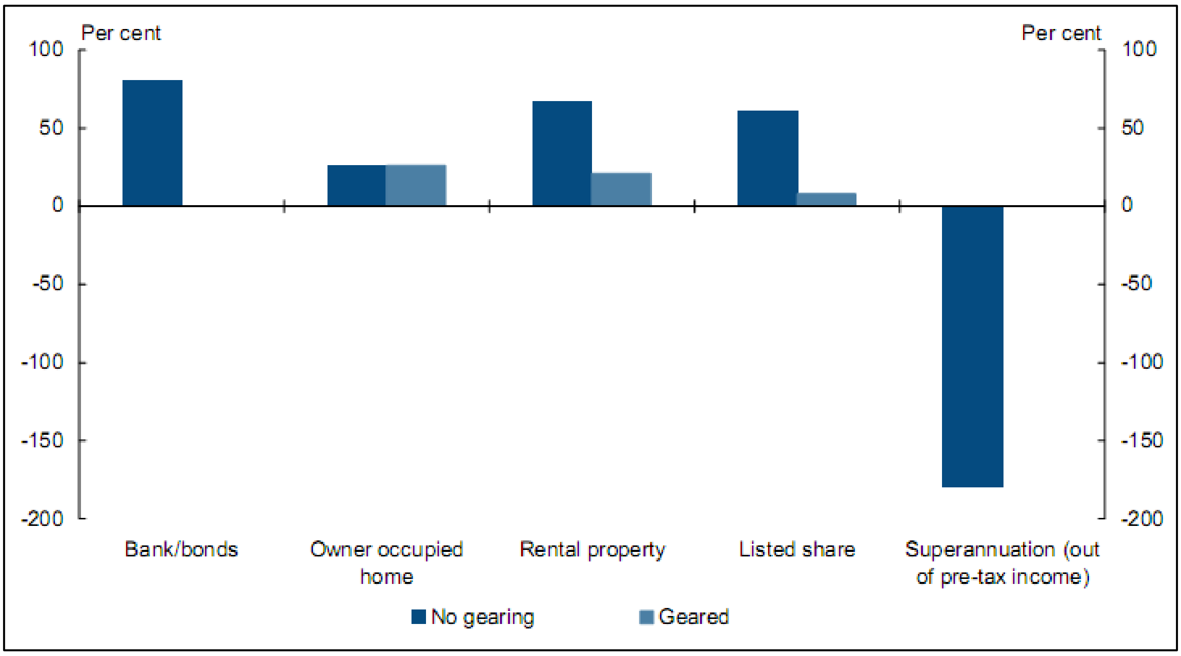
In this reform option, a super fund member on up to average fulltime earnings (around $70,000) would have a stronger financial incentive than now to contribute to superannuation over and above Superannuation Guarantee contributions. In the case of an individual on average earnings, additional contributions of up to 3% of earnings (around $2,000) would attract the proposed rebate. This 3% margin over and above superannuation Guarantee Contributions could be maintained for an average earner if the Superannuation Guarantee is increased from 9% to 12% of earnings by increasing the proposed 'cap' on deductable superannuation contributions to 15% of average eanings .

ACOSS does not, however, support the Report's proposal that its 'marginal rate contributions tax' be deducted from wages. That would reduce workers' disposable incomes. Instead, it should be deducted from the contributions made to the superannuation fund by the employer (and then offset in full or in part by the proposed annual rebate paid into the fund by the Australian Taxation Office).

4.3 Affordable housing

ACOSS is not only concerned about the fairness or otherwise of the tax system. Inconsistent treatment of income also undermines economic efficiency. The inconsistent tax treatment of investment income contributes to Australia's high housing costs, and also makes economic booms more difficult to manage.

Figure 9: Effective tax rates on different investments

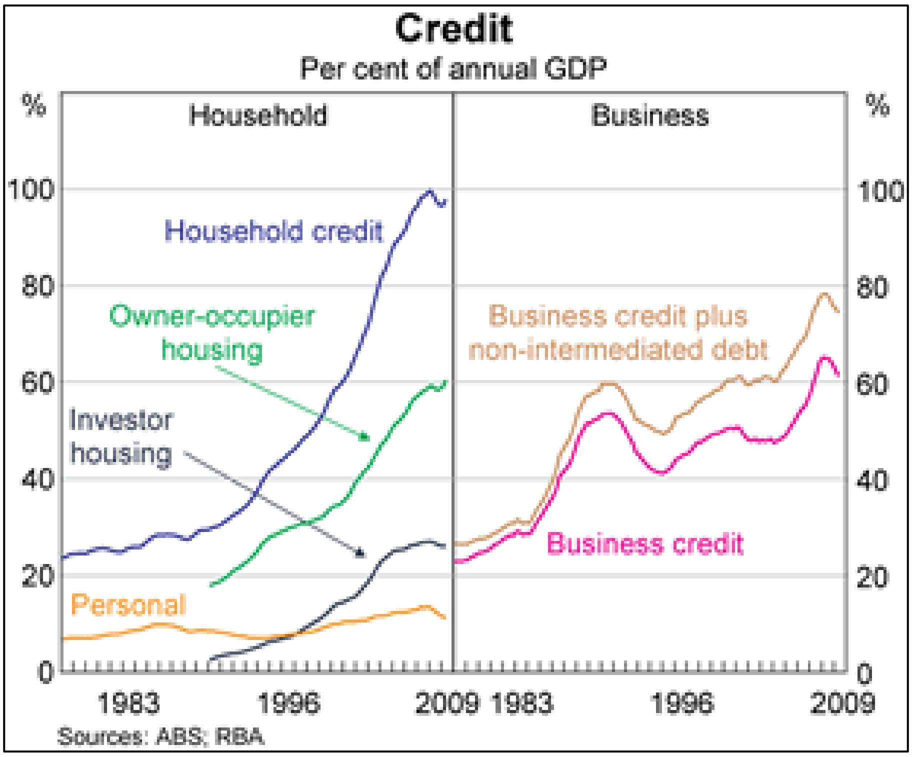


Source: Treasury (2008), Architecture of the Tax-transfer system.

In the past, wage inflation was regarded as a key constraint to economic growth. The Global Financial Crisis, however, reminded us of the risk to growth from inflation in asset prices such as real estate and shares. The US and Irish economies were among the worst affected by a rash of property speculation financed by high levels of household debt. Real estate speculation is also a weak point in Australia's economy. We are fortunate that our banking systems were more robust than those of the US or Ireland; and that we benefited from strong public investment and steady growth in exports throughout the crisis.

Prior to the GFC, Australia experienced almost a decade of over-investment in housing, including in rental property, during the last boom. This was financed by households greatly increasing their debt levels in the anticipation that property values would to continue to rise. The main reasons for this included ready access to credit and a drop in inflation, but the tax system played a part by encouraging debt-financed investment in property. Since demand outpaced supply, the result was escalating home prices.

Figure 10: The rise of property investment and household debt in the last boom

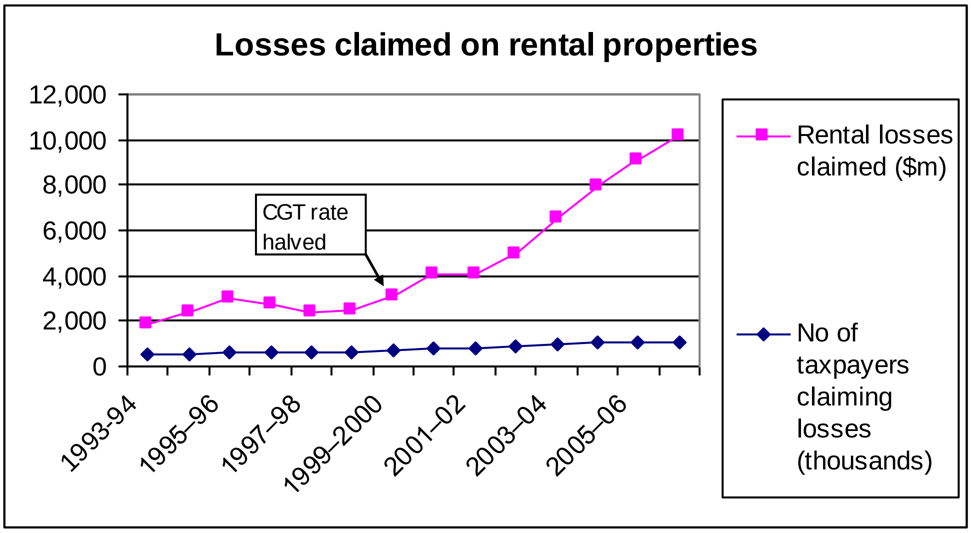


Source: RBA (2009), *Bulletin*.

A key contributor to home price inflation is Australia's unique combination of low tax rates on capital gains from sale of property, shares and other investment assets and the unlimited deductability of investment expenses against income from other sources, including wages. This uneven tax treatment of income and expenses sustains 'negative gearing' strategies where investors deliberately incur losses in order to claim larger tax deductions. Many people are lured into inefficient investments ands risky levels of debt by the promise of tax savings. The outcome is not more affordable housing for tenants because in most cases investors buy existing properties rather than increasing the supply of housing for rent. On the contrary, the resulting over-investment in rental property during economic booms inflates house prices and rents.

The previous Government's decision to halve the rate of Capital Gains Tax, combined with the retention of unlimited deductability of investment costs against wages, contributed to a very large increase in rental property investment loses claimed from the ATO during the first half of the 2000s.

Figure 11: The tax system contributed to over-investment in housing funded by debt



Source: ATO (2009), *Taxation statistics* ['CGT rate' refers to rates of tax on capital gains for individual taxpayers]

Australia's house prices are now among the highest among wealthy nations. This applies equally to rental properties.

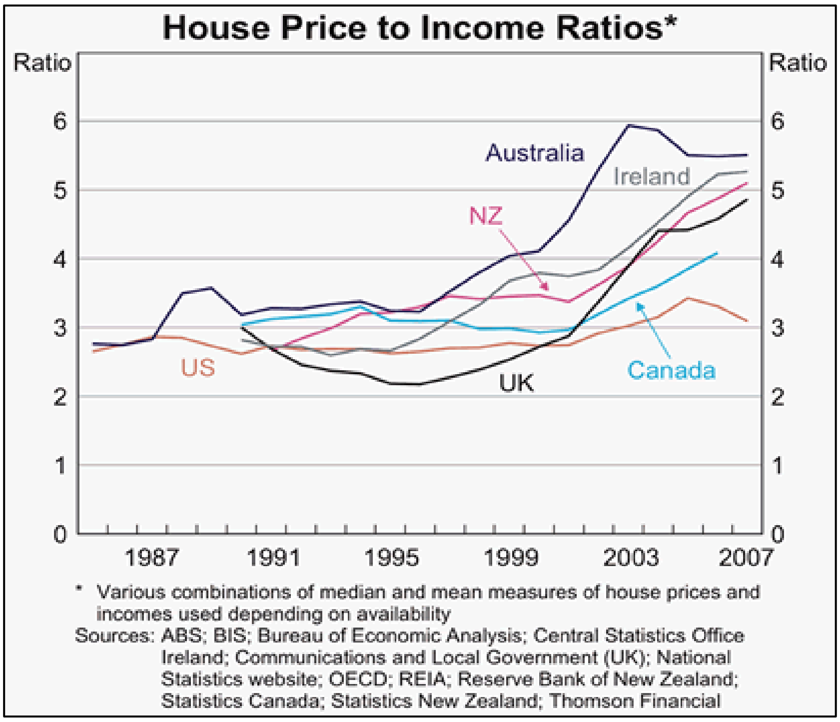
Each year, Anglicare conducts a snapshot into rental affordability. This report studies what properties are on the market, and which ones would be affordable for somebody living on a social security payment, paying no more than 30% of their weekly income on accommodation costs.

The findings for 2011 were particularly disturbing. For example, in Sydney, there were 10,200 properties available for private rental in Sydney and the Illawarra between Friday 8 and Sunday 10 April. However, only 123 of these properties were affordable for a household solely reliant upon Government benefits. Peter Kell, Anglicare Sydney's Chief Executive Officer, noted: "Many commentators focus on affordable housing for middle and upper income earners. For the one million households nationally who rely nearly entirely on Government benefits though, their capacity to get by day to day is already at breaking point."[6]

This short supply of affordable rental properties forces households reliant upon Government benefits to spend over 30% of their income on rent, placing them in 'housing stress'. This also makes low income housholds more vulnerable to social and economic exclusion.

[6] Anglicare Sydney (2011): Housing Affordability Snapshot. Available: http://www.anglicare.org.au/news-research-events/latest-news/rental-affordability-snapshot

Figure 12: Australia’s housing is among the least affordable



Source: RBA (2008), *Bulletin* April 2008.

Tax reform in this area is difficult, but public support for well crafted policies to improve housing affordability could be secured, especially if reforms were linked to incentives to invest in low cost housing; and they if were introduced at a time when the housing market was strengthening.

The Henry Report proposals relating to housing and other assets included to:

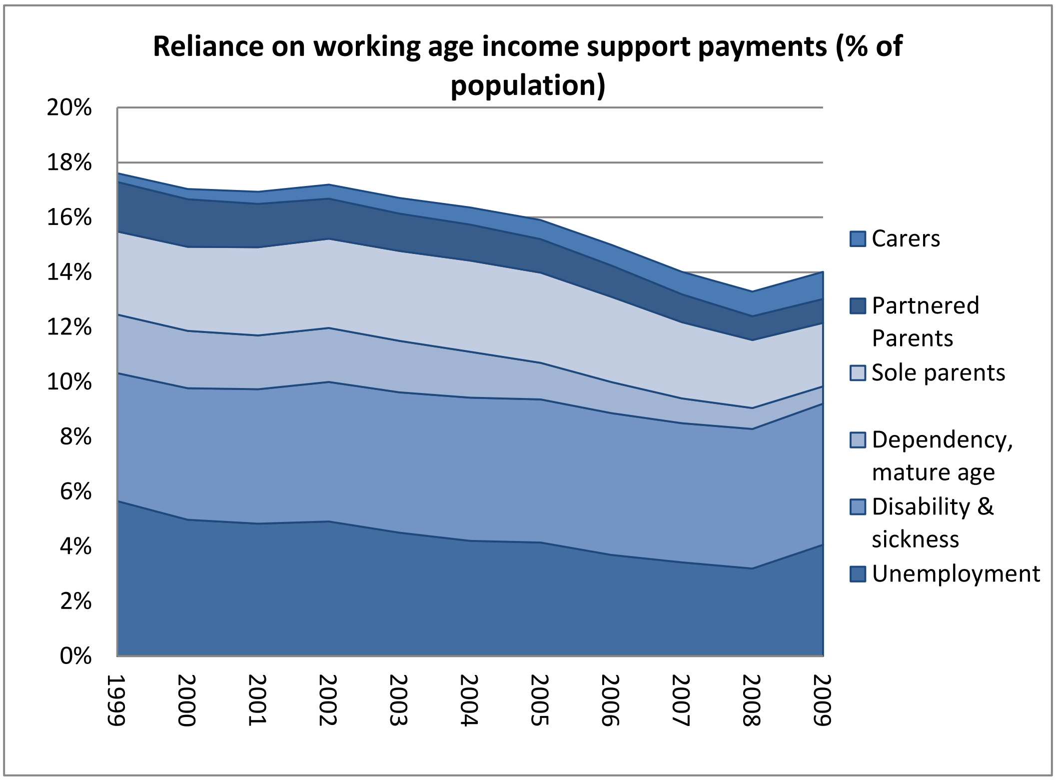
- Broaden Land Tax to owner occupied housing and cut Stamp Duties.
- Tax capital gains, interest and rents at a consistent 40% discount from personal tax rates.
- This 40% discount would also apply to deductions for investment expenses and losses for investments in property and shares.
- A significant increase in Rent Assistance for low income private tenants.

ACOSS proposes that part of the revenue gained from this limitation of ‘negative gearing’ be used to encourage new investment in affordable housing, for example through expansion of the National Rental Affordability Scheme.

4.4 A simpler and fairer social security system for people of working age

Contrary to concerns about growth in so-called ‘welfare dependency’, the proportion of people of working age on income support has fallen over the last decade, to levels significantly below the OECD average.

Figure 13



Source: FaHCSIA (various years), *Income Support Customers, a statistical overview*. Available: http://www.fahcsia.gov.au/about/publicationsarticles/research/statistical/Pages/default.aspx

The downside of this welcome development is that most of those still reliant on income support are drawn from groups that are disadvantaged in the labour market.

4.4.1 The arbitrary boundary between pensions and allowances

Australia's social security system divides benefit recipients into two main groups – those deemed 'unable' and those deemed 'able' to work. The former group receives higher 'pension' payments and have no requirement to work; the latter group receives lower 'allowance' payments and face work requirements.

There is a growing gap between pension and allowance rates of payments due to different indexation systems. Indeed, the Treasury estimates that, with the current system of different base rates and indexation methods, the allowance payment for people who are unemployed (Newstart Allowance) will be worth just half of the pension rate by 2040.

Currently, the single allowance rate is $243 a week or $35 a day. This is $131 a week less than the pension.

There are a number of problems with the current payment structure, including the difficulty of dividing people into those 'able' and 'unable' to work, the entrenchment of poverty among those on allowance payments, and discouragement of paid work among people who qualifyfor pension payments.

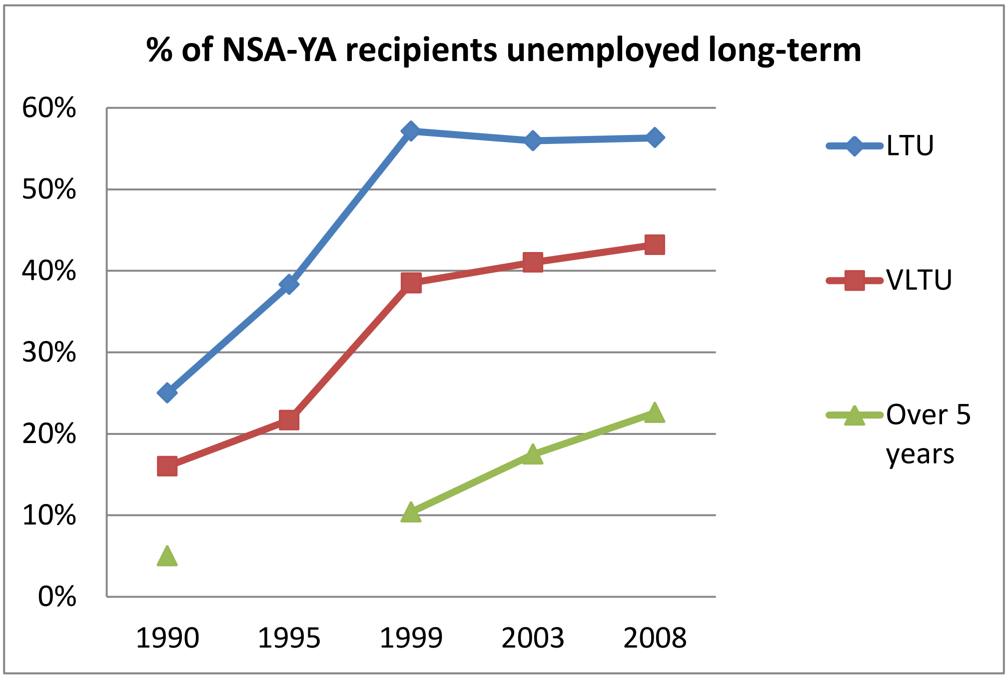
The line between those 'able' and 'unable' to work is not as clear cut as previously. People with disabilities can often work if the necessary workplace and labour market adjustments were made. Parents and carers can undertake paid work if the job is flexible and decent childcare is available.

As unemployment has fallen, those reliant on the Newstart Allowance increasingly resemble the pension recipients of yesteryear:

- One out of three receipients of the Newstart Allowance is aged over 44;
- One out of six recipients has a 'partial work capacity' (disability);
- One out of every 15 recipients is a sole parent; and
- One out of every two recipients has received the payment for over 12 months.

The days when unemployment payments provided a short term income support for young people between jobs are long gone.

Figure 14: Changing profile of Newstart Allowance recipients



Source: FaHCSIA (various years), *Income Support Customers, a statistical overview*. Available: http://www.fahcsia.gov.au/about/publicationsarticles/research/statistical/Pages/default.aspx

4.4.2 Impoverishment of allowance recipients

Currently, single Newstart Allowance recipients receive $35 a day. This is not enough to provide a basic standard of living, thus increasing the numbers of people living in poverty.

The Queensland Council of Social Service (QCOSS) recently released details of the budget of an unemployed single person trying to live on the Newstart Allowance:

Table 4: Expenditure and income, unemployed single receiving Newstart Allowance

Total weekly expenses	
Food & drink	$78
Clothing & footware	$10
Rent (including water)^	$105
Electricity	$10
Household contents & other services*	$15
Health	$14 (no insurance)
Transport	$18 (3 trips bus/train)
Phone/Internet	$12
Recreation/entertainment#	$23
Annual holiday/travel	$6
Education and training fees	$0
Fees/charges/insurance	$0
Emergency savings	$10
Total expenditure	**$301**
Total weekly income	
Income	$237 (Newstart Allowance)
Rent assistance	$39
Other income	$0
Tax	$0
Total income	$276
Weekly difference	**-$25**

^Rent is shared accommodation, costs based on sharing a 3 bedroom house with 2 other adults. Source: QCOSS (2011), *Cost of Living* Report. Available: http://www.qcoss.org.au/content/cost-living-report-2011

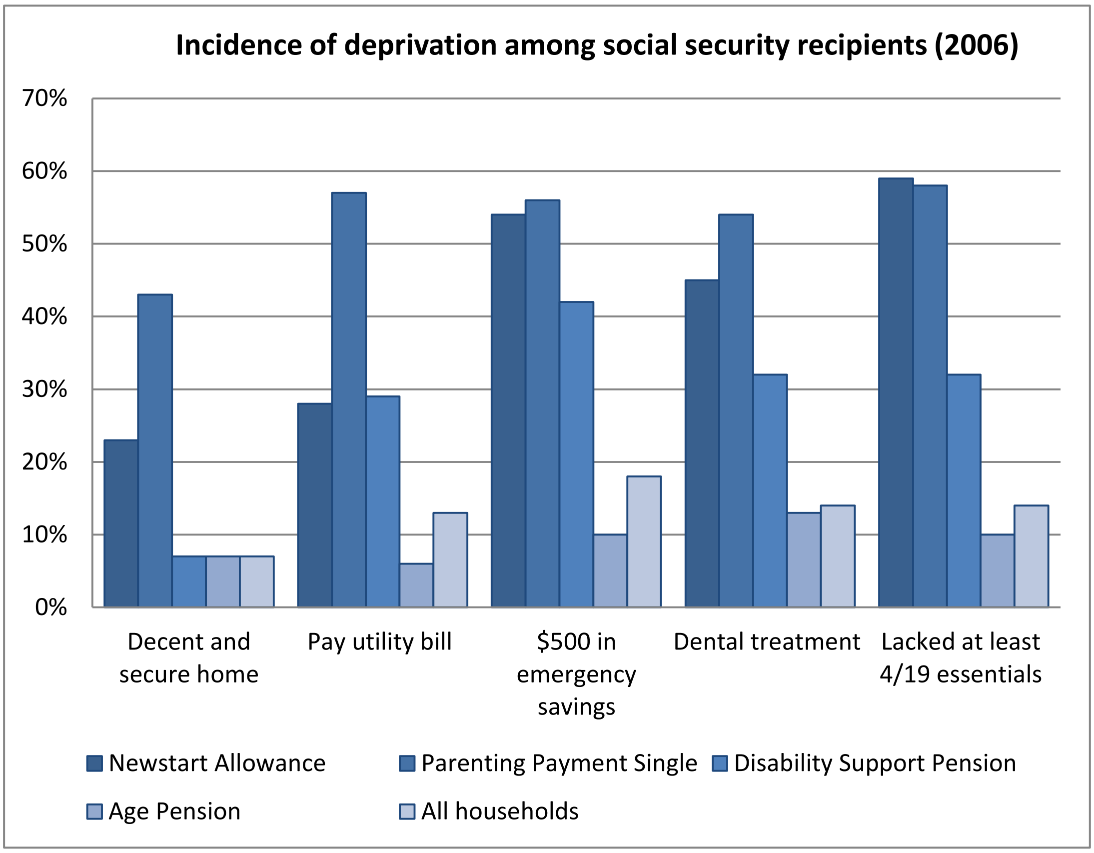
The Newstart Allowance is now so low that the OECD has raised concerns regarding its adequacy. Economic theory might suggest that the lower the payment rate of Newstart, the greater the incentive to find employment. However, it is now so low compared with other payments that a more powerful incentive is to leave it for a more decent benefit. Half of all entrants to the Disability Support Pension move to this payment from the Newstart Allowance. Once there, few leave the Disability Support Pension for employment.

Newstart Allowance was once at a comparable level with pension payments, but, whereas the pension was boosted by $32 per week above normal indexation in 2009, Newstart and its predecessors have not received a boost since 1994 (with the exception of the GST compensation package).

One of the main disconnects between the Newstart Allowance and pensions is the fact that Newstart is indexed in line with the Consumer Price Index (CPI), while pensions increase in line with average male earnings, recently around 4% per annum.

ACOSS is mainly concerned with how those on the lowest incomes are faring. The Social Policy Research Centre conducted research into deprivation in 2006, which is now being updated. These and other data show that deprivation of life's essentials varies across different types of income support payment, as can be seen in Figure .

Figure 15



Source: ACOSS (2009), *Who is worst off?* Data from Social Policy Research Centre

Figure shows that those on the lowest payments – the Newstart Allowance and sole parent payments (Parenting Payment Single) – face the greatest risk of deprivation. While the research is somewhat dated, if conducted again a greater gap between those on the pensions and those on allowances would be evident. This is due to the 2009 increase of $32 a week for the Age, Disability and Carer Pensions, which was denied those on Newstart Allowance and Parenting Payment. As a result of the previous Governmnet's Welfare to Work policy, around 30,000 sole parents are no longer entitled to Parenting Payment and must raise their children on Newstart Allowance.

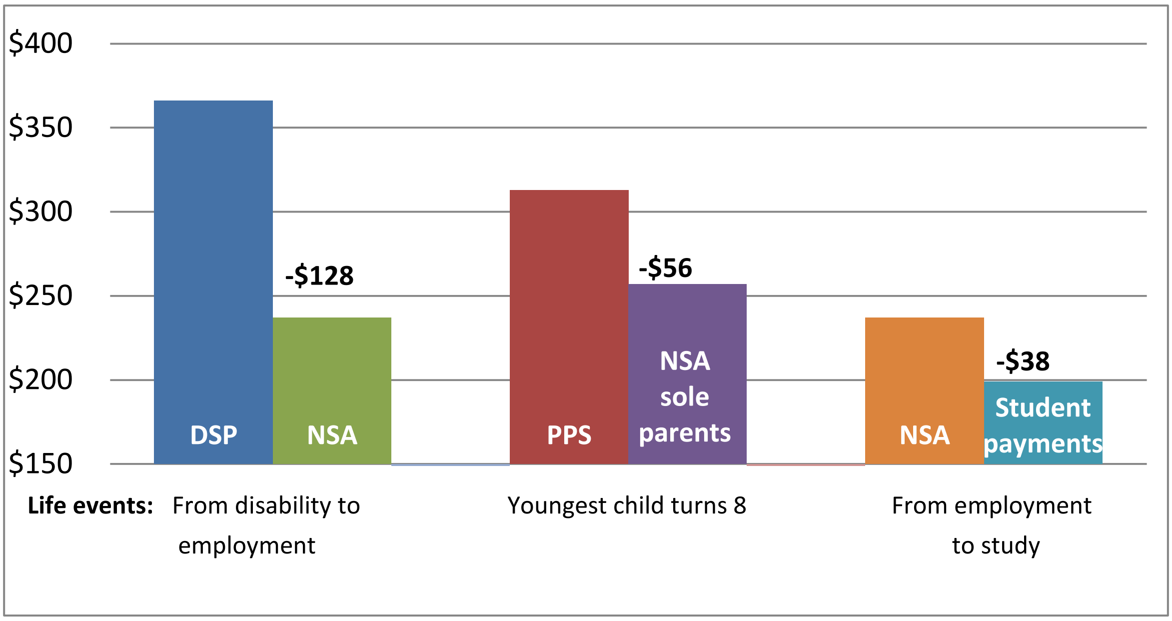
This helps explain the disturbing fact that in March 2011 the OECD found that two thirds of children living in households relying on social security for their sole income were living in poverty.

ACOSS' Australian Community Sector Survey 2011 found that, in the 2009-10 financial year, services reported an increase of 55% in those seeking financial assistance and a 49% increase in those seeking Emergency Relief – in just one year[7].

4.4.3 The payment system makes life transitions more difficult

The differences in payment levels makes labour market and other life transitions difficult for social security recipients. For example, in July 2011 a person who transitioned from the Disability Support Pension to employment, and then lost that job, could potentially lose $128 a week if they then moved on to the Newstart Allowance. Similarly, when the youngest child of a sole parent reached their 8th birthday, the family lost $56 a week as the parent was moved from Parenting Payment to Newstart Allowance. When an unemployed early school leaver undertook fulltime study to improve their prospects in the labour market, they lost $38 a week as they were shifted to a student payment. The difference between the payments can be seen in Figure 16.

Figure 16: Rates of payment for singles July 2011 ($w)



[7] ACOSS (2011): Australian Community Sector Survey, 2011. Available: http://acoss.org.au/images/uploads/ACSS_2011_Report_Volume_1_National.pdf

4.4.4 Recommendations for improving the social security system

The Henry Report recommends:

- that the gap between pension and allowance payments for be reduced by extending to single allowance recipients (including sole parents on Newstart Allowance) the same increases received by pensioners in 2009 (currrently equivalent to approximately a $50pw increase).
- the introduction of a common indexation formula for working age payments based on wage movements.
- An easing of the stringent 'allowance' income test for those parents and people with disabilities required to seek pat time employment (partly implemented in this years Federal Budget)
- Abolition of the Liquid Assets Test waiting period, which requires unemployed people to reduce their savings to almost zero to qualify for income support.

ACOSS believes that the Henry Report should have gone further and advocated replacement of the pension and allowance systems with a single base rate of payment for people of working age, sufficient to buy life's essentials. Supplements should be paid for extra costs, such as the costs associated with a disability, private rents, caring, and the extra costs of raising a child alone. These supplements would improve 'horizntal equity' in the system. For example, it is unfair that the level of Family Tax Benefits paid to a sole parent falls when the youngest child reaches 6 years of age given that the costs of raising a child increase with age.

Proposals to replace the present structure with a common base payment and supplements were considered by the Keating and Howard Governments, and are being introduced in the United Kingdom and New Zealand. Australia is lagging behind.

Conclusion

ACOSS supports building tax reform on the Henry Report, recognising that it is a vital, long-term process in which we all have a vested interest. We believe that it is time to tackle the waste and the loopholes in the tax system that erode public revenue, reduce fairness and encourage inefficient investment. ACOSS calls for a fairer, more efficient tax and social security system that will place Australia on strong ground to deliver the kind of collective outcomes as a country we believe we need.

It is important that planning begin now for securing more equitable and sustainable retirement futures. We must also meet the now daunting challenge to expand the supply of affordable housing. Clearly, we need to modernise our social security system in order to encourage transitions to paid work and ensure that those of us not in paid work have an income that is sufficient to buy essentials.

Importantly, the revenue base to achieve these aims must be strengthened.