Social inclusion, income support and the Australian labour market

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Objectives

The objectives of income support within the Australian labour market must be to: strengthen people’s capabilities to participate fully in the labour market and society; reduce inequalities in the labour market, including inequalities of opportunity; support caring and flexible combinations of caring and workforce participation; and ensure that all attain a decent minimum standard of living. This must happen within a wider framework for reform, which: locates income support within a participation and capacity building framework, including appropriate activity requirements and investment in employment assistance, training and mentoring programs; strengthens mainstream programs and labour market institutions; and better integrates participation support for deeply disadvantaged people.

Reform of publicly-mandated income supports for low income people

The system of publicly-mandated income supports for low income people comprises income support payments, tax concessions and minimum wages. These should be viewed as an integrated system.

Income support: a basis for economic and social participation

It is often wrongly assumed that a robust social security system weakens employment participation or that there is a simple trade off between income adequacy and workforce participation. However, for jobless people of working age, a well functioning social security system supports active engagement with the labour market as well as easing poverty.

In the absence of a robust safety net there is a greater risk that the most disadvantaged jobless people will be excluded from the formal economy. For example, in the United States few unemployed African American young people have social security entitlements because these require a history of employment and generally expire after 6 months. Only 52% of this group had a job in 2000 and in the absence of income support many rely on the informal economy (family, informal employment, and crime), which further distances them from the formal labour market. Those with access to income support (for example sole parents on the Temporary Assistance for Needy Families program) face activity requirements, are connected with employment services, and are therefore more likely to participate in the labour market. This is one of the reasons that employment rates among young African American women rose from 37% in the early 1990s to 52% in 2000 while those of their male counterparts continued to fall.¹

An Australian Minimum Standard of Living

The main purpose of social security payments in Australia should be to prevent poverty. Poverty can be broadly defined in two ways: as an inability to secure socially-defined necessities, or as an inability, due to limited economic means, to participate effectively in society. The former definition is closer to traditional

¹ Offner & Holzer 2002, Left behind in the labour market, Brookings Institution.
conceptions of poverty, while the latter is closer to the concepts of capability deprivation and social exclusion. The common feature is an emphasis on inadequate resources especially, in a market economy, income and assets. Both of these poverty concepts are ‘relative’ in the sense that the living standard or level of functioning required to avoid poverty differs between different societies and at different points of time. For example, Adam Smith argued that people needed decent clothing to avoid poverty, not simply to protect them from the elements but in order to ‘avoid shame’.

To effectively and equitably perform its poverty-reducing function, the social security system should be benchmarked to an Australian minimum standard of living that is grounded in these understandings of poverty and community expectations. We discuss below one way of benchmarking this minimum standard, through the use of budget standards. Other methods should also be applied, including poverty lines and direct measures of living standards such as deprivation indicators, and the results compared.

The present social security rate structure emerged by historical accident as much as conscious planning. Payments are set at very low levels compared with general community incomes, and there are major inconsistencies and anomalies between levels of payment for different payment categories and family types. While pensions are benchmarked to 25% of average male earnings, allowance payments are only indexed to the CPI. As a result the single rate is $55pw lower and the Newstart Allowance will be worth only half the pension rate by 2036. Relativities between singles and couples, and sole parent and married couple families, are also arbitrary. For example a single pensioner receives 60% of the married pension rate (which many argue is inadequate), but a single recipient of Newstart receives only 55% of the married rate.

Table 1 illustrates this by comparing the base rates of key payments with the Low Cost Budget Standards developed by the Social Policy Research Centre at the University of New South Wales. Supplements such as Rent Assistance and Utilities Allowances are not included. These Budget Standards are essentially bare minimum household budgets for people living on a low income – the disposable income needed to buy the essentials of life in Australia today. They are set at different levels for people of working age and mature age to take account of the costs of working or seeking employment. We focus here on the Budget Standards for mature age homeowners since costs such as rents and the costs of job search or work related costs can be addressed through supplements rather than base rates of payment.

These comparisons suggest that the present payment levels and relativities among social security payments are inappropriate.²

² These Budget Standards are conservative since the original budgets were developed in 1996 and subsequently indexed using the CPI. The basket of goods and services used for the budgets should be updated from time to time to reflect changes in community standards and expectations.
Table 1: Income support payments and Low Cost Budget Standards (December 2007, $ per week)

<table>
<thead>
<tr>
<th></th>
<th>Budget Standards</th>
<th>Pension base rates</th>
<th>Gap</th>
<th>Allowance base rates</th>
<th>Gap</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single, home owner</td>
<td>$285</td>
<td>$269</td>
<td>$16</td>
<td>$215</td>
<td>$70</td>
</tr>
<tr>
<td>Couple, home owner</td>
<td>$390</td>
<td>$449</td>
<td>-$59*</td>
<td>$388</td>
<td>$2</td>
</tr>
<tr>
<td>Single as a % of couple</td>
<td>73%</td>
<td>60%</td>
<td>55%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>


Note: Budget Standards are for mature age home-owners, so do not include rents or costs of working or job search. They are indexed to Dec 2007 using CPI, Base rates do not include Supplements (such as Rent Assistance of up to $53pw that is paid to a significant minority of recipients). *In this case, income support is higher than the Budget Standard.

**Payment rates structure**

The present income support system for people of working age is based on an historical distinction between one group of recipients (pensioners) who are deemed unable to work and therefore receive higher payments with no activity requirements and limited access to employment assistance; and another group (allowances or beneficiaries) who are considered work ready and therefore receive lower payments, face stringent activity requirements and receive more help to find a job.

The system is inequitable because levels of payment are based on historical views about which groups are more or less ‘deserving’ of support rather than on people’s actual living costs. For example, a person with a disability on Newstart Allowance who faces high medical costs due to their disability receives less than a Disability Support Pensioner (DSP) who does not face such costs. Unemployed people required to search for a job receive less than pensioners without such requirements, despite the extra costs of seeking work.

In the past, separate rates of payment for pensions and allowances were justified on the grounds that people on Allowances typically only needed short term income support. As the profile of Allowance recipients has become more disadvantaged, that assumption no longer holds. As overall unemployment levels have fallen those still out of work are drawn from severely disadvantaged groups in the community. For example, over 60% of Newstart Allowance recipients have lacked substantial employment for over a year, 30% have been out of work for over 2 years, and of these people over 60% have a Year 10 education or less.

Further, the boundaries between pension and allowance payments are not clear cut. Many social security recipients move between the two systems. For example, a sole
parent leaves the pension system and enters the allowance system if she partners with a jobless person, even though she is still the main carer of her children. It is estimated that half of new Age Pension recipients received another social security payment (including Newstart Allowance) at the time of their pension claim. Similarly, one third of new Disability Support Pensioners were on Newstart Allowance when they claimed the pension. Separate levels of payment for pensions and allowances make these transitions between payments more difficult for people.

This two tier system of income support blocks transitions to employment for many people with disabilities and sole parents. Those who test the labour market face the risk of transfer to a lower payment. It is likely that this feature of the social security system has a greater impact on work incentives than the high effective tax rates that have attracted more policy attention. The reason for this is that pensioners put their income security at risk if they seek employment, as well as losing some of their income support. Pensions are widely regarded as more secure payments than allowances. This is one of the reasons that Australia has one of the lowest employment rates among disability pensioners in the OECD - only 12% of the 700,000 DSP recipients have a job.

The system of social security payments for people of working age needs major structural reform. The broad direction for reform is clear – to move away from the present divide between ‘pensions’ and ‘allowances’ towards a payment structure that reflects actual living costs rather than people’s distance from the labour market. This would comprise two tiers: core rates of payment based on the Australian Minimum Standard described above, and supplements for specific needs including costs of children (Family Tax Benefits), costs of disability, costs of workforce participation or training, and rent.

Separate categories of payment (such as disability, caring and parenting) would still be required to determine the activity requirements (if any) that would apply. However, these payment categories would not determine rates of payment. This would free up the rates structure to respond to the needs and living costs of different recipients, and also free up the activity requirements to better respond to people’s labour market circumstances and work capacities.

Reforms along these lines were considered by the previous Labor Government in the early 1990s and by the Coalition Government in 2003, but were not pursued. Two countries with broadly similar social security systems to Australia’s - the UK and New Zealand - are considering similar reforms to simplify their social security systems to remove distinctions between ‘pension’ and ‘allowance’ payments. A key motive for these reforms is to encourage employment participation among people with

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3 FaHCSIA 2008, Pension Review background paper; FaHCSIA 2004, Characteristics of DSP customers.

disabilities. The OECD has also recommended payment simplification in Australia on this ground.5

**Work incentives**

In Australia, incentives to move from unemployment to a low paid full time job are relatively strong, especially for single people who double their disposable income if they work fulltime on the minimum wage. The reasons for this include the low level of social security payments, the high level of in-work payments for low paid working families (Family Tax Benefits), and the activity requirements linked to receipt of unemployment payments. Graph 1 compares maximum levels of income support with minimum wages across different family types. In all cases modelled, jobless people on income support significantly increase their disposable income by moving to a full time job at minimum wages.

**Graph 1: Disposable incomes out of work and on the federal minimum wages, July 2007**

Research evidence suggests that benefit replacement rates (the ratio of disposable income on Newstart Allowance compared with disposable income when employed) have had a minimal impact on the level of structural employment in Australia over the past three decades. A much more important factor was the rise and fall of long term unemployment over that period. This suggests that lack of capability (for example,

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5 Freud 2007, Reducing dependency, increasing opportunity, Department for Work and pensions; Minister for Social Development and Employment 2005, Extending opportunities to work, New Zealand Cabinet Submission; OECD 2007, Sickness, disability and work.
skills and recent work experience) was a more important contributor to structural unemployment over this period than lack of incentive. It also reflects our relatively low benefit replacement rates.6

However, incentives to move into part time jobs, and from part time jobs to full time jobs, are relatively weak. Newstart Allowance recipients have little incentive to undertake part time work because the payment is withdrawn at the rate of 60 cents in the dollar across a wide range of earnings. This is a major problem for those expected to seek part time work since the Welfare to Work changes: parents and people with disabilities. The pension income test (which has a 40% taper rate) facilitates transitions to part time employment at a cost of much looser targeting of income support. For example a pensioner couple can earn almost $70,000 between them before losing access to a part pension. Another difficulty with the pension income test is that recipients may be discouraged from moving from part time to full time employment, though this may be less important issue for people with barriers to work such as disabilities.

Role and adequacy of minimum wages
Along with income support payment rates, minimum wages anchor the living standards of low skilled and disadvantaged Australians.

The appropriate benchmark for minimum wages is an income that is sufficient to enable a single adult to live in a modest level of comfort, at a standard of living well above poverty.

Traditionally, Australian minimum wages were set at levels designed to keep families out of poverty. The Harvester Standard or Basic Wage (itself based on ‘Budget Standards’ research at the turn of the last century) was pitched towards a couple and three children. Since then, family allowances have emerged to assist low income households with the costs of children, and the Equal Pay decision of the early 1970s broke with the assumption that women were dependent on their partners. The appropriate ‘target’ for a minimum wage benchmark is therefore a single adult.

Also, living standards and expectations have changed dramatically over the last century, especially during the long boom following the war. By the time Professor Henderson benchmarked his poverty measure to the Basic Wage plus child endowment in the late 1960s, the Basic Wage itself was surpassed by minimum award rates set at well above poverty levels. This reflects the role of minimum wages in setting a floor for the broader wages structure as distinct from attaining a minimum living standard for low paid workers. One of the reasons minimum wages are set well above poverty levels is a strong community expectation that workers should be paid enough to work in dignity and to live decently. As a result, Australian minimum wages are high by international standards.

For these reasons, a more appropriate Budget Standard for setting minimum wages would be the SPRC’s *Modest but Adequate* standard, which is pitched at a living standard of ‘modest comfort’ and an income level close to median household incomes (including social security recipients as well as wage earners), rather than poverty levels.

Another important consideration is that the gap between this income level and poverty levels creates space for the income support system to prevent poverty without weakening work incentives.

One criticism of minimum wages in Australia and other countries is that they are a poorly targeted mechanism to alleviate poverty. If minimum wages were benchmarked to enable wage earners to live in ‘a modest level of comfort’ rather than simply to avoid poverty, this criticism would miss the point.

Nevertheless, minimum wages also play a role in reducing poverty among people of working age. They do so indirectly rather than directly. The direct impact of minimum wages on poverty in Australia is modest because poverty is measured on the basis of household incomes and minimum wage earners are not concentrated in the lowest income households (many of whom are jobless). Rather, they are usually found in households that sit between the third and sixth deciles of the distribution of working age households.  

**Graph 2: International comparisons of proportions of workers on low pay and children in poverty**

![Graph 2](image_url)


Note: "Workers on low pay" refers to the % of full-time workers on wages less than 2/3 of the median. "Children in poverty" refers to the % of all children living in poor households, with the poverty line based on half median equivalent household disposable income.

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Despite their modest direct impact on poverty levels, minimum wages are a key plank in the wider system of publicly mandated income supports for low income earners. To maintain work incentives, countries with low minimum wages usually keep income support payments low as well. Thus, a lower minimum wage can shift the entire structure of income supports for those at risk of poverty downwards. This is one explanation for the relationship between low pay and child poverty (the incidence of which is mainly determined by parental income) observed in international comparisons (see Graph 2).

In-work payments

In addition to adequate minimum wages, in-work payments (including income support payments or refundable tax credits) can be used to underpin incomes for low paid workers and work incentives for jobless people. Along with adequate minimum wages, they also make room for income support payments to be raised above poverty levels by widening the gap between people’s disposable incomes when jobless and when employed on low wages.

From its inception the Australian system of family payments has supplemented minimum wages for families, on the grounds that wages cannot fully and accurately take account of the costs of children. Family Tax Benefits now offer a higher level of income support for minimum wage-earning families than in-work payments (including tax credits) in any other OECD country (see Graph 3).\(^8\)

Policy makers face two critical choices in designing in-work payments:
- Whether these should be paid separately to income support for jobless people or combined into a single system of support for low income people.
- How widely available a low wage subsidy should be – should it extend to all low paid workers or only those facing particular costs such as those of raising children.

Australia’s Family Tax Benefit Part A provides integrated support for the costs of children in low income families, regardless of the parent’s workforce status. Since the ground-breaking ‘child poverty’ reforms introduced by the Hawke Government in 1988, the same level of family payments has been paid to jobless families and those on a low full time wage (see Graph 4, which shows the level of payment for a typical family according to family income levels). This reduces poverty among both types of family, while at the same time preserving incentives for families to move from joblessness to at least one low paid full time job.

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\(^8\) Whiteford & Adema 2007.
Graph 3: Net family assistance for families working at the minimum wage, USD PPPs


Graph 4: Family Tax Benefits for Australian families (vertical axis) relative to family income (horizontal axis)

An alternative approach is to provide a separate tax credit or income support payment to families in paid employment and assist jobless families separately through the
income support system. This is the approach pursued in the United States, which provides an Earned Income Tax Credit (EITC) to low paid ‘working’ families. As shown in Graph 5, this is not available to parents without earnings. Like Family Tax Benefit (Part A), it is also income tested on family income.

Graph 5: Earned Income Tax Credits (EITC) for American sole parents (vertical axis) relative to family income (horizontal axis).

Although incentives to move from joblessness to a low paid fulltime job are stronger in the US, this is due to lower levels of support to jobless families rather than more support for those in low paid employment (refer to Graph 5). The essential difference between Family Tax Benefit and the EITC is not the level of generosity of income support for working families. Rather, it lies in their different treatment of jobless families. Those families receive the maximum level of support in Australia but are not entitled to the EITC. Jobless families in the US must rely instead on child supplements paid along with the Temporary Assistance for Needy Families (TANF) payment for jobless parents. These are paid at very low (and declining) levels. For example, a typical TANF payment for a sole parent and two children has about the same purchasing power as Newstart Allowance for a single adult (which is just over $200 per week). The main reason for the low level of income support for jobless families in the US is that they have failed to attract the same level of Government and Congressional support as the EITC. By contrast, Australia’s Family Tax Benefit (which extends to both jobless and low paid ‘working’ families) has broad public and political support and expenditure on this payment increased substantially over the past decade.

Another key policy choice is whether an in-work payment should be generally available to low paid workers or restricted to those with particular costs (such as the
costs of children). One risk of a generic in-work payment is that its benefits may be captured by employers through lower increases in minimum and market wages. Australia’s ‘five economists’ regarded this as a desirable outcome because they considered lower minimum wages were needed to encourage employment of low skilled unemployed workers. This issue is beyond the scope of this presentation.

Nevertheless, a widely available low wage subsidy can become costly to Governments if real minimum wages fall. This has been the US experience (see Graph 6). As a result of a long term decline in real minimum wages together with policy decisions to increase the EITC, the United States Government now spends more on this tax credit than it does on traditional income support payments for jobless families. Yet minimum wages together with the tax credit are still insufficient to prevent poverty among working families in the US.

Graph 6: Low wage supplements can become costly if minimum wages fall – USA example

The risk of cost shifting from employers to Government can be minimised to some extent by limiting in-work payments to supplements for specific needs or costs such as the costs of children, rent and the costs of a disability or caring. Another approach pursued in recent years in Australia is a general tax offset for low income earners. The Low Income Tax Offset, which has increased substantially in recent years, can be regarded as a low wage subsidy. However, a common problem with all low income supplements is that they may discourage movement from low paid employment to higher paid jobs, especially among ‘second income earners’ if a family income test applies.

Source: Kravitz 2005, Minimum wage, earned income tax credit, and inflation, Urban Institute Brookings Institution Tax Policy Centre.

A system of publicly-mandated income supports for low income people
The basic structure of a reformed system of publicly mandated income supports for low income earners is presented Graph 7.

Graph 7: Schematic illustration of reformed system of public income supports

Note: Compares public income supports for a jobless family with those for a family on a single minimum wage. ‘Australian Minimum Standard’ of Living and ‘Modest but Adequate Standard’ of Living refer to income benchmarks for a single adult. ‘Supplements’ refer to such payments as Rent Assistance, a Costs of Disability Supplement, Carer Allowance, and supplements for jobless people engaged in job search or training. Some of these supplements would be confined to jobless people but most would extend to low paid workers. ‘Family Payments’ refers to Family Tax Benefit (for those with dependent children).

The ‘floor’ at the bottom of this structure is an adequate base rate of income support payments, benchmarked to an Australian Minimum Standard of Living for a single adult and a couple, respectively. This would be a poverty standard. The base rate could then be linked to a measure of average or median community incomes (for example, the pension is currently linked to average fulltime male earnings).

Another income ‘floor’ would be constructed well above this level, comprising a minimum wage for a full time worker benchmarked to a ‘modest but adequate’ standard of living for a single adult of working age. Since income adequacy is not the only factor that the wage setting body would take into consideration (for example, the effect of minimum wages on work incentives, employment opportunities, and inflation would also be considered) this benchmark would not be binding.

A significant income gap would be maintained between base rates of income support and minimum wages, to assist in maintaining incentives for people to move from income support to a full time job at the minimum wage.

Base rates of income support and minimum wages would be supplemented by payments for people with particular needs or costs above and beyond the minimum requirements of a single adult. These would include, for example: Family Tax Benefit
for those with dependent children; Rent Assistance; a Costs of Disability Supplement; Carer Allowance; and Job Search and Training Supplements for jobless people seeking work or participating in training.

Most, though not necessarily all, of these supplements would extend on an equal basis to low paid workers, as is the case with family Tax Benefit now. This is an equitable way to assist low income people with additional costs without undermining incentives to seek a low paid full time job. As the graph indicates, a significant gap between the overall level of publicly mandated income supports for jobless people and those on the full time minimum wage would thus be maintained.