THE IMPLICATIONS OF INCOME TESTING FAMILY ALLOWANCES

Australia presently operates one of the most tightly means-tested income security systems in the western industrialised world. In addition to relatively strict income tests, almost all pension and benefit payments are subject to income tax. As a result the personal income tax system has the broad effect of relating a recipient's net benefits from (and payments to) the Government to their incomes. In other words the taxation and income security systems operate as different sides of the same income redistribution coin. While it is possible to assess separately the effects on income distribution of the taxation and income security systems, the final distribution of disposable incomes will generally be determined by the interaction of the two systems.

For approximately 2.5 million Australians presently receiving some form of pension or benefit, the major factors determining their disposable income are:

(a) the maximum levels of income security payments;
(b) the social security income tests, including such factors as whether an income test is applied, the level of 'free income' under the income test, whether certain income is excluded from the income test, and the income test rate of withdrawal (usually 50 cents in the dollar); and
(c) the personal income tax system, including such factors as when income security payments and/or allowances are taxed, the tax threshold and the income tax rate scale.

The interaction of these factors is extremely complex and not always obvious. For example, because some income transfers are subject to an income test and some are not, some are liable to income tax and some are not, the complicated system can result in what are, in effect, extremely high marginal tax rates on poorer people.
By earning more a part-time worker drawing some social security pension or benefit may add little or nothing to their disposable income. Indeed, in certain cases, they may actually reduce their disposable income when they earn more.

Most of the present debate on the role of income tests in Australia's income security system has focussed on social security expenditure. Less attention has been paid to taxation expenditure, which is the various concessions that reduce or delay collection of taxation revenue, and as such are as much a call on the Federal Government's Budget as direct payments. Recent Budget statements published by the Federal Government have attempted to estimate the costs to revenue of concessional income tax rebates, deductions and other relief provided to particular groups of individuals. Rebates including the dependent spouse rebate, sole parent rebates, zone rebates, contributions to medical insurance funds and home loan interest rebates will reduce Government revenue by well over $1500 million in 1982-83. Allowable deductions from assessable income such as gifts to charities and superannuation costs are estimated to cost government revenue a further $2000 in 1982-83. All of these rebates or deductions are available free of any income test: suggestions are now being made, however, that taxation expenditure should be subjected in the same way to income testing.

At present family allowances are paid to all Australian families without income tests and free of taxation. Over the past few years, frequent calls have been made to either income test or tax them. Detailed consideration of the implications of these proposals requires examination of the combined effects of both the income security and taxation systems.

When the Commonwealth Government began making cash payments to families with children in 1941 it was one element of overall Government policy for raising taxation, controlling inflation, restraining wage increases and maintaining the essential purchasing
power of families. Since that time, Governments have through a variety of different measures attempted to continue Government financial support to families with children. This support attempts to recognise that the presence of children in a family increases that family's living costs and reduces its capacity to pay tax in comparison to families with fewer or no children.

Since 1941, Government support to families with children has been provided through a variety of devices:

1. concessional deductions from income,
2. tax rebates,
3. cash payments and
4. concessional deductions for expenses associated with dependents.

Particularly during the past eight years major changes have occurred in the way the Government provides financial assistance. Until 1974-75 assistance for dependent children was provided through the taxation system in the form of concessional deductions, and, for 1975-76 alone, through tax rebates. Cash assistance has been provided through child endowment or, since the abolition of tax rebates for children in 1976, through family allowances. As the then Treasurer, Philip Lynch, observed in his 1976 Budget speech: the main advantage of providing assistance through cash payments rather than through the tax system was that families with incomes too low to benefit from tax rebates would now be helped. In addition, the assistance could be directed to mothers rather than the principal income earner who, in the majority of cases, was the father.

The fourth alternative mechanism for assisting families with dependents - concessional deductions or rebates for expenses associated with dependents - has also changed significantly. In 1975-76, concessional deductions or rebates were absorbed for most taxpayers by the introduction of the general rebate.

Subsequently, concessional rebates have been confined to expenditure on selected items which in total exceed a certain prescribed amount, currently $1,590 a year.

In the light of this forty-two year commitment by the Commonwealth
Government to provide income support to all families, introduction of an income test on taxation of family allowances would represent a major change in Government policy. Such changes would mean that Government no longer accepted that all families faced additional costs in raising children which warranted Government support. Support would be concentrated on low-income families.

The declared objective in income testing or taxing family allowances is not to increase support for low income families, but to reduce government expenditure. The argument appears to assume that higher income families with children, rather than say single taxpayers, or beneficiaries of gifts or estates, are the group best able to suffer income loses to reduce government deficits.

If the objective is to reduce the income of some families with children, the broad options are to either tax family allowance payments or income test them.

Proposals for income testing family allowances raise a number of special problems. The most serious is the difficulty, and the consequent administrative costs, of monitoring individual or family income. Income for many individuals and families varies from week to week, and regular reporting would be required to ensure family allowance payments were at the appropriate level. Presumably additional government officers would be required to monitor and detect under-reporting of income. On the other side of the coin, advertising and information strategies would need to be developed to ensure that families actually received their entitlements. Other problems with proposals to income test family allowances include such issues as the treatment of de-facto spouse income with all the consequent problems of determining whether or not a de-facto marriage exists.

Leaving aside these difficulties, the most common proposal is to income test family allowances on the basis of the combined income of parents. Full payments could be made until combined income reached say, average weekly earnings, after which payments might be reduced by say, 10 cents for every dollar of combined income in excess of average weekly earnings. The effect of such a proposal would be to increase effective marginal tax rates for families
with children by 10 cents in the dollar over the ranges of income when allowances were being reduced. In single income families, if the woman considered taking up paid employment, she would be effectively taxed at the rate of 10 per cent in the first dollar earned; further, over the range in which the dependent spouse rebate is withdrawn, the effective marginal tax for the family would rise from 25 per cent to 35 per cent. On the other hand, if the father were to increase his income, he would pay additional tax at the appropriate marginal rate, while the mother would lose 10 cents in the dollar also. The overall effect would be to increase the effective tax rates facing families with children.

If we turn to the various suggestions for taxing family allowances we face a slightly different set of problems and outcomes. A serious problem facing the broad proposal is that Australia's income tax system operates on the basis of individual taxpayers. Without changing this basis to family units the options for taxing family allowances are:

* taxing them in the hands of the recipient, in which case they might also be treated as income for the purpose of the separate net income test for the dependent spouse rebate, or

* taxing them in the hands of the higher income earner.

The likely winners and losers of each of the alternatives are as follows:

* the effects on disposable income of taxing family allowances in the hands of the recipients but not treating them as income for purposes of the separate net income test for the dependent spouse rebate would be:
  (1) generally to make no change for single income two parent families, regardless of their income;
  (2) generally to reduce the net assistance for children in two income families who would be liable for tax on the payments, and

(1) Arguments against such options are developed by M. Edwards in Taxation and the Family Unit. Taxation Institute. Sydney. 1979. Such a change would also raise issues such as the definition of a family for income tax purposes. The income tax system presently does not recognise de-facto marriages for the purposes of tax concessions.
(3) to reduce the net assistance for children of sole parents whose total taxable income was above the tax threshold;

* if family allowances were both taxed and treated as income for purposes of the dependent spouse rebate, single income two parent families with two or more children would have their entitlements to the dependent spouse rebate reduced, even if the mother had no private income. While families with no children or one child would continue to receive the full benefit of the dependent spouse rebate, the value of the rebate would be reduced as family size increased. The vast majority of non-pensioner/beneficiary families would have their net assistance reduced. The main exception would be single income, two parent families with one child;

* the effects of taxing family allowances in the hands of the higher income tax earner would be to cause most families to pay tax on their allowances. The main exception would be pensioners and beneficiaries with little or no other income and few children. The amount of assistance for children would be effectively cut by 30 per cent for most families.

In addition, this option may cause some problems under existing family allowance payment and income tax collection arrangements. Income tax laws would either have to be changed to allow the taxation of income received by other than the taxpayer or family allowances would have to be paid to the liable taxpayer. In this second case family allowances would generally cease to be paid to the mother.

In summary, none of the options for taxing or income testing family allowances is without quite serious implementation or equity problems. If, however, the government did decide to increase tax on some families with children, the most equitable option would appear to be to income test family allowance on the basis of the higher income earner, while maintaining the payments to the mother. The total cost of family allowances could also be reduced by targeting increases to families with children under school age who, currently, are the least assisted by government welfare and education programs.