Brotherhood of St Laurence
Working for an Australia free of poverty

Towards a progressive tax system

Submission to the review of Australia's future tax system

Brotherhood of St Laurence
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Summary

The issue of taxation is very important to the Brotherhood of St Laurence for a number of reasons. Governments need tax revenue to enable them to provide essential services such as public infrastructure, health and education. Tax also acts as a redistributive tool, taking money from those that are well off and giving it to those in need. Taxes can also be used to correct for market failure due to 'externalities' (where the social costs/benefits of a particular action are not fully factored into market transactions).

It is also a very complicated area, as there are many types of economic transactions that can potentially be taxed and all in different ways. In addition, taxes can affect on people's behaviour by altering prices and/or incomes.

The Australian tax system has been built in a piecemeal way, responding to different goals of government and to changing social and economic conditions. This has led to a very complex and inefficient system with over 10,000 pages of legislation in the *Income Tax Act* alone.

Major challenges for Australia's tax and transfer system

The participation rate and productivity of the workforce will become increasingly important to the economy as the population ages. The Australian tax and transfer system, and in particular retirement incomes policy, needs to address the revenue challenges of this demographic shift. Despite the signs of economic downturn, an ongoing policy imperative associated with the ageing population will be to significantly improve workforce participation levels of groups such as the mature-aged, prime age women, and the long-term unemployed.

Trends in housing affordability and the growing impact of climate change also pose major challenges for Australians.

A particular challenge that the Australian tax and transfer system must address is to ensure that, while an adequate safety net is provided to protect people from entering poverty, appropriate incentives are in place to encourage workforce participation and savings for all groups so as to prevent the creation of 'poverty traps' over the longer term. Helping low-income households adapt to a post–Carbon Pollution Trading Scheme world is also essential.

Features of an effective tax system

Revenue security, equity, efficiency, transparency, simplicity, and flexibility are all broad principles of an effective tax system.

The priority of the Brotherhood is to ensure that there is equity in the system. Vertical, horizontal and intergenerational equity must be maintained. Poverty traps should as much as possible be avoided, by encouraging and rewarding work and savings and ensuring people have adequate income to manage key labour market transitions and periods out of the workforce for caring, education, unemployment and retirement without being at risk of longer term poverty and social exclusion.

The tax and transfer system should therefore:

- encourage and reward saving across the life course
- acknowledge the importance of supporting early childhood development, particularly when considering intergenerational equity
- encourage and reward human capital development through workforce participation and through education and training
- support people to take time out of the workforce to care for dependants
- support people in other working years transitions (for example, when looking for work or dealing with major personal barriers to employment).

Problems with Australia's tax and transfer system

Current basic levels of government income support are inadequate, particularly for those in receipt of allowances and in the private rental market. Lower income groups entering paid work also continue to face high effective marginal tax rates and little incentive to save and accumulate assets.

Alongside this, the design of Australia's current tax system, with its numerous exemptions, deductions and concessions and varied treatment of income depending on the source, means that people can exploit the system. This promotes a wasteful 'tax minimisation' industry and enables some taxpayers to avoid paying their fair share of tax. Analysis of tax expenditure data compiled by the Australian Treasury (see, for example, Australian Treasury 2007; Allen Consulting Group 2005) show that four of the major tax expenditures (work expenses, capital gains, negative gearing and lump sums) disproportionately benefit higher income groups. The same groups are also better able to exploit the favourable tax treatment of money invested in superannuation.

Recommended reforms

The Henry Review needs to examine options to create a fairer, simpler and more efficient system, including its interaction with the social security system, so that it maximises economic and social participation. A package which eliminates distortionary and unfair tax deductions and concessions to fund more progressive arrangements would result in a tax system that is both more equitable and more efficient. The Brotherhood supports reforms which promote workforce participation and saving for all groups over the life course and which act to prevent poverty, while maintaining an appropriate safety net.

In particular the Brotherhood of St Laurence recommends:

- reform of the income support system, ensuring that an adequate level of support is provided to all eligible recipients. The distinction between pensions and allowances should be removed with a particular focus on increasing support to those on current allowances. Alongside long-term measures to improve housing affordability, rent assistance needs to more accurately reflect private rental costs. Adequate compensation through the tax and transfer system should also be provided to low-income households on the introduction of the government's Carbon Pollution Reduction Scheme.
- examining the implications of introducing the family home into the asset test for government income support payments. This analysis should focus on the effects on asset accumulation and retirement decisions, particularly of low-income households.
- additional measures to assist long-term income support recipients to move into paid work and 'make work pay'. These measures included expanding the principle of the working credit to ensure that long-term income support recipients who move into employment are able to keep a significant proportion of their payment for a period (say 6 months) post-employment. We also suggest that income support recipients entering employment be able to retain their Health Care Card for 12 months after job entry and that for public housing tenants there be a rent

moratorium for 6 months after job entry. This would encourage disadvantaged job seekers to try out employment without fearing that if things do not work out that they will be worse off.

- progressive asset building initiatives, including:
  - abolishing the concessional treatment of capital gains
  - quarantining of negative debt interest deductions to the income earned on the investments it funds
  - including the family home in the capital gains tax base, for homes valued above a reasonable threshold
  - taxing investment in superannuation in line with other savings and investment options
  - investigating progressive lifelong savings accounts for goals including lifelong learning, housing, and retirement incomes
- investigating inheritance taxes as a more progressive and efficient form of taxing wealth
- investment in a national energy efficiency program in order to mitigate the effects of increased utilities costs for disadvantaged Australians arising from the introduction of a Carbon Pollution Reduction Scheme, in addition to adjustments to income support payments to cope with general CPRS-induced price rises. This may avert the need for future increases in the base rate of income support payments over the longer term
- abolishing other tax deductions and concessions such as fringe benefits concessions and deductions for work-related expenses, business tax concessions, the dependent spouse rebate
- reducing other opportunities for income tax avoidance such as income splitting
- either extending income averaging provision to all those with variable annual incomes; or removing the current special provisions for the lucky few.

Background on the Brotherhood of St Laurence

The Brotherhood of St Laurence is a community organisation that has been working to reduce poverty in Australia since the 1930s. Our vision is 'an Australia free of poverty'. Our work includes direct service provision to people in need, the development of social enterprises to address inequality, research to better understand the causes and effects of poverty in Australia, and the development of policy solutions at both national and local levels. We aim to work with others to create:

- an inclusive society in which everyone is treated with dignity and respect
- a compassionate and just society which challenges inequity
- connected communities in which we share responsibility for each other
- a sustainable society for our generation and future generations.

The Brotherhood of St Laurence works to prevent poverty through focusing on those life transitions where people are particularly at risk of social exclusion.

The issue of taxation is very important to the Brotherhood of St Laurence for a number of reasons. Governments need tax revenue to enable them to provide essential services such as public infrastructure, health and education. Tax also acts as a redistributive tool, taking money from those that are well off and giving it to those in need. Taxes can also be used to correct for market failure due to 'externalities' (where the social costs/benefits of a particular action are not fully factored into market transactions).

Recognising the relevance of tax issues to equity considerations, the Brotherhood of St Laurence has had a long history in the tax reform debate in Australia. The Brotherhood was involved in the ACOSS–ACCI tax summit in the mid 1990s and, in partnership with the Committee for Economic Development of Australia (CEDA) and the Melbourne Institute, conducted a major study on tax reform options later in the 1990s. More recently, the Brotherhood of St Laurence collaborated with Professor John Freebairn from the University of Melbourne to analyse key areas of the federal tax system that are the most unfair and require reform (Freebairn & Scutella 2008).

1 Major challenges facing Australia that need to be addressed through the tax and transfer system

The uncertainty of the effects of the global financial crisis and economic downturn on Australia must be placed in the context of longer term structural trends in our demographic profile and labour market, which in turn will be affected by the growing impact of climate change on all aspects of our lives. Trends in housing ownership and affordability are another complicating factor. These challenges must all be considered and addressed by our tax and transfer system. These are now discussed further.

Demographic change and need for human capital development

Over the next decades, the ageing population will result in a higher proportion of the community becoming dependent on a smaller number of people in the workforce. The participation rate and productivity of the workforce will become increasingly important to the economy as the population ages. In 2007, about two-thirds of Australia's population—slightly more than 14 million people—are of working age (15–64 years). This is a historically high rate that will not be maintained. Over the next 40 years, the proportion of the population that is of working age will decline (to 60 per cent), and they will be called upon to support an increasing group of older people (Australian Treasury 2007, pp.xx–xxi).

Retirement incomes policy needs to address the revenue challenges this demographic shift brings.

An ongoing policy imperative associated with the ageing population, despite the short-term possible economic downturn, will be to significantly improve workforce participation levels of groups including the mature aged, prime age women, and the long-term unemployed. The Australian tax and transfer system must ensure that while an adequate safety net is provided to protect people from poverty, appropriate incentives are in place to encourage workforce participation and savings for all groups to prevent the creation of 'poverty traps' in the longer term.

Even with record low unemployment, in September 2008 the Australian Bureau of Statistics estimated that there were still over 450,000 unemployed Australians. The underutilisation rate is about 9 per cent—double the official unemployment rate in any given month. Added to this, a significant proportion of the people with disabilities (715,000) and on parenting payments (500,000) could be gainfully employed if given the right support. The employment rate of those with a disability is about half that of those without disabilities. Australia also has a relatively low employment rate of women with children—about 10 percentage points lower than in the UK.

Australia will need to raise the quality of its potential pool of workers so that as many as possible are participating in the labour force and working productively. A report to the Council of Australian Governments recognised that 'enhancing workforce participation and productivity will require the development of the capabilities of the Australian people – our "human capital" ' (COAG 2006, p.2).

Compared with other OECD countries, Australia has a relatively high rate of low skilled workers, with over one-third (35%) of the working age population (25–64 years) not having achieved formal school qualifications (Year 12 or equivalent). Younger workers (25–34 years) have a 21% non-attainment rate. However, demand for low-skilled labour has declined both in Australia and overseas: nearly three-quarters of new jobs in the period 1990–2003 were taken up by university graduates. Only one in eight of the jobs went to job seekers without post-school qualifications.

Despite these employment trends, Australia has lagged behind global best practice in investment in people's access to education, skills building and active labour market programs.

It is therefore imperative that Australia's tax and transfer system recognises the important contribution of education and training to human capital development and that it supports education and skills building, particularly for those with the lowest participation rates and those facing the toughest barriers. Supporting early childhood development is of particular importance for the nation's future, and ensuring access to affordable quality child-care is an immediate challenge.

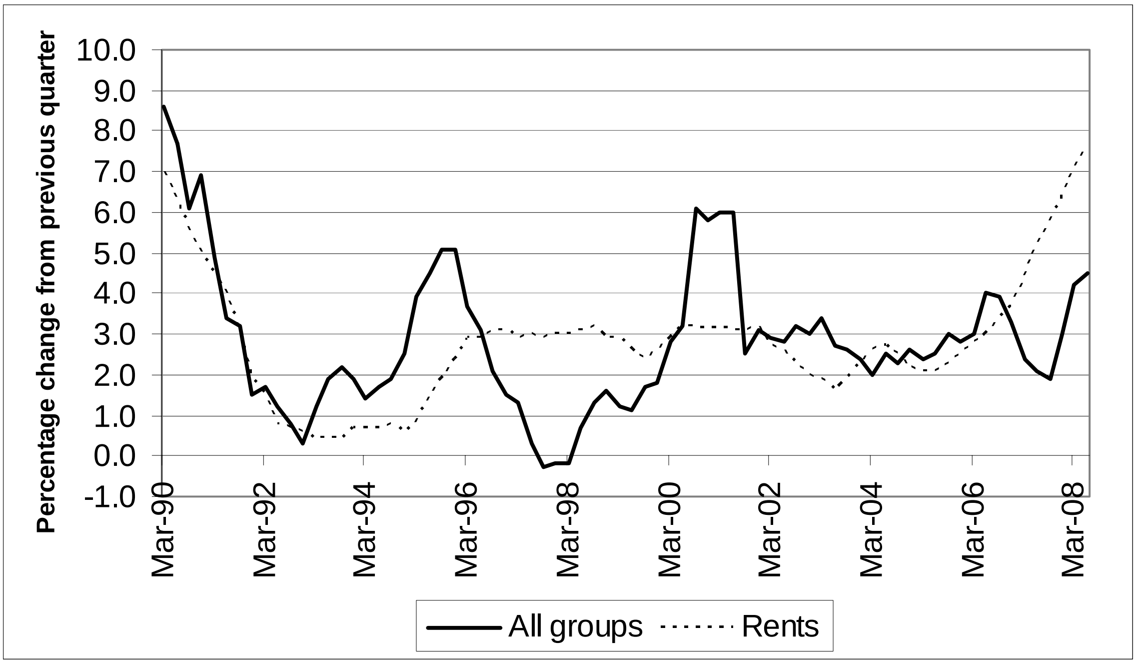
Housing affordability

A range of demand and supply side factors have contributed to the rapid increase in real house prices in Australia since 2000 (Productivity Commission 2004), an underlying trend that is likely to continue into the future (Yates 2008b). This trend is making home ownership out of reach for many and increasing the pressures on the private rental market.

The main mechanism of short-term assistance to low-income renters in Australia is the Commonwealth Rent Assistance (CRA) Scheme. CRA is indexed to the CPI, but increases in private rental costs since 2007 have been significantly greater than CPI increases (see Figure 1.1). Quarterly changes in rents have been 3.5 to 4 per cent above the changes in the CPI (All Groups). Thus Rent Assistance has not kept pace with actual rent increases, adversely affecting many low-income private renters. Yates (2008b) highlights that higher income households have displaced lower income households from more affordable housing in the private rental market, and cites evidence that lower income households are being driven to outer suburbs or to non-metropolitan areas.

The long-term effects of people being excluded from home ownership are also considerable, with implications for retirement incomes policy and intergenerational equity (see, for example, Yates 2008a).

Figure 1.1 Comparison of rent increases with CPI (All Groups) increase, percentage change from previous quarter, 1990–2008



Data source: ABS 2008, Table 7.

The National Housing Affordability Agreement and the National Rental Affordability Scheme (NRAS) are two important mechanisms in addressing housing supply issues for those on low incomes. Indeed it is estimated that NRAS will reduce the rents on properties involved in the scheme by 20 per cent. Further housing and tax initiatives, as well as the adequacy of the

Commonwealth Rent Assistance scheme, need to be examined so that through supply and demand strategies, low-income households have access to affordability housing.

Climate change

Climate change and responses to it will have important implications for Australians over the coming decades. The Garnaut Climate Change Review (2008) identified the financial costs of unmitigated climate change. It found that modelling results for middle of the road outcomes on temperatures and decline in rainfall 'indicate that climate change would wipe off around 4.8 per cent of Australia's projected GDP, around 5.4 per cent of projected household consumption, and 7.8 per cent from real wages by 2100'. The impacts will be particularly pronounced for low-income and vulnerable households who have limited capacity to adapt to changing climatic and economic circumstances and already face other stressors such as housing costs. The predicted costs of unmitigated climate change provide a compelling case for decisive national and international action to reduce greenhouse gas emissions.

The current review of the Australian taxation system should consider the likely implications of various reforms on the nation's efforts to reduce greenhouse gas emissions.

In this submission we focus our comments on the Australian Government's most significant current response to climate change, the national Carbon Pollution Reduction Scheme (CPRS) (Australian Government 2008) which is scheduled to commence in 2010. The Brotherhood welcomes the introduction of the CPRS as a responsible policy to reduce greenhouse gas emissions. It is, however, essential that the scheme is designed to minimise impacts on disadvantaged households. Research commissioned by the Brotherhood of St Laurence and undertaken by the National Institute for Economic and Industry Research (NIEIR 2007) has shown that low-income households will be disproportionately affected by a CPRS.

2 Features of an effective tax system

Progressive reform of Australia's taxation and transfer taxation arrangements is central to the Brotherhood's mission of working to reduce poverty. The Henry Review provides a generational opportunity to consider the fairness of the existing income transfer, benefits, tax and superannuation savings arrangements in order to develop an integrated system for Australia in the twenty-first century.

An important element of the tax and transfer system is what Nicholas Barr refers to as the 'piggy bank' function. This function involves government smoothing of individual consumption over the life cycle and over a range of risky outcomes: this refers to events such as unemployment, education and training, parenting and caring for young children and retirement. The review should consider the impact of taxes and transfers over the life cycle, and their effect on labour market transitions.

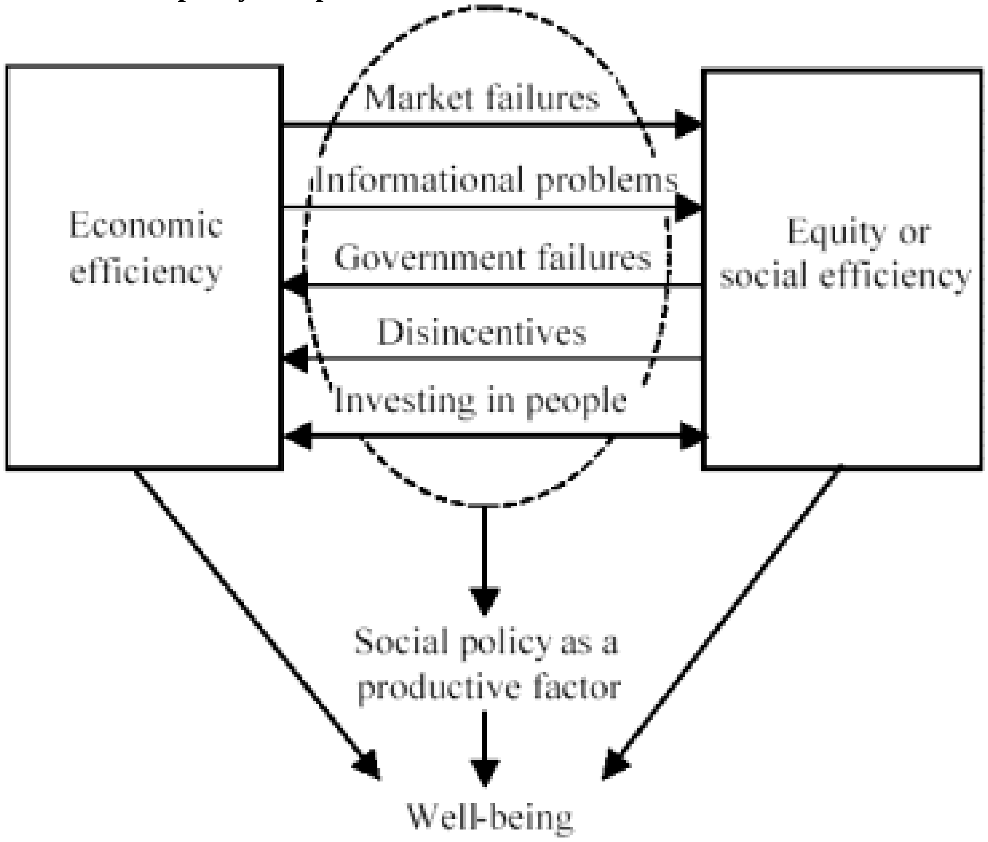
Keeping these elements of the tax and transfer system in mind and the importance of assessing the impact of reform over the life cycle, key principles of tax reform options should include:

- revenue security
- equity
- efficiency
- transparency
- simplicity
- flexibility.

Revenue security

According to the review's terms of reference, any reforms proposed should maintain a similar size of government. Therefore tax revenue collected should be no less than current levels. The Brotherhood agrees that public provision of goods and services is important. Figure 2.1 summarises how social policy can be a productive factor, as governments can use more inclusive and equitable social policy measures to ensure more economically efficient outcomes to counterbalance market failures and informational problems. Investing in building people's capabilities to participate in society can be a win–win situation which can produce both social and economic gains and improved overall wellbeing.

Figure 2.1 Social policy as a productive factor



Source: Fouarge 2003, Figure 1, p.10

Security of future revenue is also important, particularly with an ageing population. Tax bases therefore need to be broad enough to ensure future revenue security.

Equity

A key feature of a tax and transfer system is that it should be fair. There is a need to ensure that there is vertical equity in the system—people who are more able to pay (having higher incomes or higher assets) pay more than those less able to pay—and that there is horizontal equity—those with the same capacity to pay have the same tax liability. Ideally this means that incomes from various sources (wages and savings, asset and investment income and in-kind remuneration), receive similar tax treatment and that no subgroup with the same capacity to pay is taxed more or less favourably than others.

One aspect of horizontal equity is intergenerational equity. People of various generations should be treated fairly and no generation should be treated more favourably than others.

Poverty traps should as much as possible be avoided, by encouraging and rewarding work and savings and ensuring people have adequate income to manage key labour market transitions and periods out of the workforce for caring, education, unemployment and retirement without putting them at risk of longer term poverty and social exclusion.

Without adequate assets, people on low incomes find it difficult to provide a buffer for fluctuations in income as they cannot draw on savings and cannot borrow due to a lack of collateral. A gap in employment or some other crisis can plunge people into poverty, or undermine their efforts to build financial security. This can make it difficult to break the poverty cycle. Ownership of assets also provides benefits beyond financial stability. Asset building policies targeted to those with limited means are thus an important way of improving the longer term wellbeing of the poor.

The tax and transfer system should therefore:

- encourage and reward saving across the life course and income distribution
- acknowledge the importance of supporting early childhood development, particularly when considering intergenerational equity
- encourage and reward human capital development through workforce participation and through education and training
- support people to take time out of the workforce to care for dependants
- support people in other working years transitions (for example, when looking for work or dealing with major personal barriers to employment)

Efficiency

A tax and transfer system should also as efficient as possible. If inefficiencies are not taken into consideration, under quite reasonable assumptions, taxing the better off can actually lead to a reduction in the amount of income available for the poor. Okun's leaky bucket analogy summarises this best: 'The money must be carried from the rich to the poor in a leaky bucket. Some of it will simply disappear in transit, so the poor will not receive all the money that is taken from the rich.' (Okun 1975).

To achieve efficiency in the tax system it is usually desirable to minimise distorting people's behaviour. Thus allowing tax deductions for certain goods and services is typically not desirable in efficiency terms. Administrative and compliance costs also need to be considered, as reducing them releases scarce resources for more productive uses. That is why simpler, broader based taxes are usually favoured on efficiency grounds, and in some cases universal transfer payments may be desirable. Another consideration is the potential stigma associated with targeted payments.

Where there are externalities (a difference between social and private costs or benefits) it is desirable on efficiency grounds for governments to try to influence people's behaviour. An example of this is the government's proposed emissions trading scheme, which will attempt to correct for the negative environmental costs associated with CO2 emissions, by change people's energy use.

Thus, when assessing the benefits of tax reform we need to consider the likely behavioural responses, and whether these responses will have desirable effects. For example tightly targeting income transfer payments by means-testing (on income or savings) can cause people to fall into poverty traps.

These efficiency considerations mean that in some cases it may be desirable to have universal payments as opposed to more targeted payments (which may be better at addressing equity considerations). Thus there is merit in combining some universal element to payments such as family payments, child care benefits and the age pension with a more targeted top-up payment to those on lower incomes to protect them from entering poverty.

Transparency

It is important that people are aware of the taxes that they are paying so they can make informed consumption, investment and labour decisions. Some flexibility may be desirable to change tax rates as economic circumstances change, particularly for clear and marked swings over the economic cycle.

Simplicity

As noted in the Treasury's background paper (Australian Treasury 2008), complexities in the tax system make it harder for people to understand their obligations and entitlements and lead to increasing compliance costs due to the need to obtain professional advice. This has the greatest impact on those with the least capacity to meet these extra costs. It is therefore desirable to ensure that a tax and transfer system is as simple as possible. This goal is linked with that of transparency.

3 Problems with the current system

Australia's current tax system, with its numerous exemptions, deductions and concessions and varied treatment of income depending on its source falls short of the basic principles of good tax design. People can exploit the system and avoid paying their fair share of tax, and inefficiencies mean that there is a large cost to governments in collecting their tax revenue. By removing many special deductions and exemptions, many of them costed in the annual *Tax expenditure statement* (Australian Treasury 2007), the base could be expanded to collect in excess of another $10 billion a year in foregone revenue, and up to another $30 billion a year altogether. While the deductions are claimed by many taxpayers, they tend to be of more value to higher income earners. Thus a reform package could be designed to eliminate many of these deductions/concessions and reduce overall marginal tax rates. Broadening the tax base would secure Australia's future revenue and allow a focus on major inequities and inefficiencies within the current system.

Particular problems with the current system include:

- There is an inadequate safety net for many groups of people unable to work, particularly for allowance recipients and income support recipients in private rental accommodation.
- Interaction of taxes and transfer payments acts as a disincentive for those entering/re-entering the labour market.
- Current measures to promote asset building are grossly inequitable and arguably inefficient.
- Other inequitable tax deductions and concessions include those relating to motor vehicles.
- The impact of the government's proposed Carbon Pollution Reductions Scheme will be regressive.

These are now discussed in greater detail.

Inadequate income support payments

As noted by FaHCSIA (2008), income support payment rates for some groups are below generally accepted basic living standards. In particular, allowance payments and rent assistance have not changed in real terms even though costs of essentials, including food, energy and rent, have been rising more than the overall CPI (FaHCSIA 2008; Australian Treasury 2008). Groups that require the most attention include the unemployed, single parents and income support recipients renting privately.

A range of leading researchers have identified that people who are paying more than 30 per cent of their income on rent for private housing are experiencing financial stress and related social exclusion (see, for example, Morris 2007; Temple 2008; Yates 2007). As noted earlier, Rent Assistance has not kept pace with actual rent increases. Housing policy and the Commonwealth Rent Assistance scheme both need to be examined so that through supply and demand strategies, additional housing assistance is provided for those in the private rental market.

By contrast Family Tax Benefit Part A seems to be a relatively effective instrument at alleviating both family and child poverty (Whiteford & Adema 2007). It provides financial support for most families on low incomes. Its availability to families on middle incomes ensures its popularity, making it less vulnerable to political cycles and ensuring little or no stigma associated with the payment.

Interaction of tax and transfer system making it difficult for those entering the labour market

The apparent simplicity and progressivity of the personal income tax rate schedule hides the complications of a number of tax offsets and rebates. These include the phasing-in of the Medicare levy, the phasing out of the Low Income Tax Offset (LITO) and the Senior Australians Tax Offset (SATO), and the interactions of the tax and benefit systems and their effects on workforce participation and decisions about hours of work. A significant proportion of income support recipients face effective marginal tax rates (EMTRs) of over 50 per cent if they gain some paid employment, due to the interaction of the tax system (including the phasing in of the Medicare levy and the withdrawal of LITO) with the withdrawal of social security benefits (Harding, 2008).

Added complexity is apparent in the differential indexation of pensions and allowances, with pensions such as the Disability Support Pension and Parenting Payment Single indexed to average weekly earnings (AWE), while allowances such as Newstart Allowance are indexed to the consumer price index (CPI). As wages typically grow faster than prices, rates of payment diverge over time. This is an even greater disincentive for those on the higher pension payments to re-enter the workforce, for fear of losing their eligibility for a pension and having to claim the lower allowance if things do not work out in their job.

Individuals and families moving from income support into employment not only have their benefits withdrawn but also face the prospect of no longer being eligible for their Pensioner Concession Card or Health Care Card, which entitles them to cheaper medicines and a range of concessions (varying across states) relating to utilities, health, transport and education.

Individuals and families in public housing also face an increase in their rent until their rent reaches market rates. The combined effects of very high effective marginal tax rates with the withdrawal of the Health Care Card and other concessions can act as a powerful disincentive for a job seeker moving from welfare to work. This is particularly true where a job may be short-term or where a person has been out of work for some time and is not sure whether their foray into the labour market will result in long-term employment.

In the existing system, people can potentially be worse off if they accept employment that does not work out. Accepting a job can seem to be a risk that is just not worth taking.

The generosity of the senior Australians' tax offset (SATO) relative to the low income tax offset (LITO) available to other Australians is a problem for horizontal equity. There is no evidence that the employment or savings decisions of the low-income seniors are more elastic than those for the young to warrant such tax rate differences between the SATO and LITO on efficiency grounds.

In addition, means-tested assistance is available to families with children through Family Tax Benefit A (FTB-A). This is paid per child, with around 70 per cent of families with children eligible for some benefit. Single parent and single income earner partnered families are also able to claim Family Tax Benefit B (FTB-B). The Baby Bonus is an additional means-tested payment ($5000 at 1 July 2008) at the birth of each child. A complex array of benefits are available for child care through the Child Care Benefit, the Child Care Tax Rebate and JET Child Care Fee Assistance and other tax deductions. As all of these payments are means-tested, their withdrawal adds to effective marginal tax rates of families. Efforts to reduce taper rates over recent years have reduced this effect, but at the cost of providing higher rates of assistance to families higher up the income distribution who may not need support. Also, means-testing assistance on family income discourages secondary earners (generally women) from re-entering the labour market.

The Family Tax Benefit B (FTB-B) income test on secondary earners discourages mothers from re-entering the workforce. The Brotherhood believes a better structured maternity/parental leave system, such as that proposed by the Productivity Commission (2008), is a more effective form of assistance to women than the current Baby Bonus, with an additional positive impact on female labour force participation.

Our overarching concern is that high EMTRs for some income support recipients, particularly in combination with the loss of other benefits such as Health Care Cards, are likely to have an adverse effect on workforce participation.

Weaknesses of current asset building incentives

Tax incentives in the form of deductions, exemptions or concessions are very common instruments used to encourage savings and asset accumulation. These policies however are generally only accessible to middle and high income individuals and families. By contrast, support for lower income groups is provided instead through income transfers (pensions or allowances) with associated assets tests, which may act as a disincentive to save and accumulate assets.

In the following discussion we outline the main areas of inequity and inefficiency in current Australian asset building incentives: capital gains concessions and negative gearing, tax treatment of the family home, and the favourable treatment of income invested in superannuation.

Capital gains tax and negative gearing

The current concessional treatment of income earned from capital gains on assets (other than the primary home) held by individuals or trusts for over 12 months amounts to an estimated revenue cost of over $7.4 billion in 2007–08 (Australian Treasury 2007). In addition debt interest in investments that earn capital gains is tax deductible (negative gearing). Small businesses receive a number of additional capital gains tax concessions for no good efficiency reason. Special concessions not available to others apply if the assets are used for retirement, or have been held for more than 15 years, or if the assets are sold as part of an active business decision. In total, the Australian Treasury estimates these small business capital gains tax concessions to have a tax revenue cost of over $800 million in 2007–08.

The concessional treatment of capital gains are inequitable as capital gains are mainly enjoyed by higher income individuals, as shown in ATO data on the distribution of declared realised capital gains by level of taxable income (ATO 2008). The concessions also involve an important element of horizontal inequity (that is, individuals or households using other savings and investment options receive less favourable tax treatment).

The combination of the CGT discount and negative gearing means that investors are able to arbitrage early period deduction of the expenses against concessional taxation of the capital gains (both the half rate and the deferral benefits). This encourages speculators to enter the property market, and as a result there is overinvestment in residential property, and underinvestment in other socially more productive investments in plant and equipment, human capital and research and development.

Treatment of owner-occupied housing

The exemption of owner-occupied housing from capital gains tax and from the pension assets test is inequitable. Headey, Marks and Wooden (2005) present data from the HILDA survey for 2002 showing that the distribution of household wealth in the form of owner occupied homes, like other forms of wealth, is more unequal than the distribution of income . Thus, wealthier individuals or households benefit from the favourable tax treatment of both owner-occupied and other housing. Also, the favourable tax treatment of owner-occupied housing distorts behaviour. People invest more in housing, particularly in their own home, than other investment alternatives that might have a higher social and economic return to Australians.

Superannuation

Most superannuation from July 2007, including that funded by the compulsory 9 per cent levy on wages and salaries, attracts a flat rate of tax of 15 per cent on funds at entry and 15 per cent on the annual income earned[1]. It is important to note that these contributions are from pre-tax income. In aggregate, Treasury estimates a tax expenditure of over $20 billion for 2007–08 (Australian Treasury 2007).

Many individuals on higher incomes make additional pre-tax contributions to superannuation, and certainly much more relative to those on lower incomes. This inequity is unlikely to have an efficiency trade-off either as the background paper notes: as income and substitution effects offset each other, the concessions are likely to have a limited effect on aggregate domestic saving, and little effect on aggregate investment because Australia is a small net capital borrower. Thus, the super tax concessions are mainly an unfair redistribution in favour of those with a tax rate above 15 per cent, and the more so the higher the income.

Regressive impact of proposed Carbon Pollution Reduction Scheme

The introduction of the Carbon Pollution Reduction Scheme (CPRS) in 2010 is expected to increase energy costs as well as the costs of general goods and services. The Green Paper (Australian Government 2008, p.282) estimated that, at a $20 per tonne carbon price, electricity prices will rise by 16 per cent and prices of gas and other household fuels by 9 per cent; while the all groups consumer price index (CPI) is predicted to increase by 0.9 per cent. Analysis by KPMG (2008, p.15), conducted in partnership with the Brotherhood of St Laurence, suggests that these price increases would result in $494 per year additional expenditure for very low income (below $500 week gross income), high energy using households[2]; and $478.40 for low-income (below $1000 per week gross income), high energy using households (see Table 3.1).

[1] But note that the capital gains component is taxed at a 10 per cent rate.

[2] This estimate can be considered somewhat conservative compared with other studies such as that of the National Institute of Economic and Industry Research (NIEIR 2007) which finds that the impact on 'poor family households' is $557.70 per annum, assuming a carbon price of $25/t CO2-e.

Table 3.1Impact of the CPRS on low-income households without compensatory measures

Income group (see below for explanation)	**Increase in expenditure due to the CPRS p/a**			
	$20/t CO2-e	**$30/t** CO2-e	**$40/t** CO2-e	**$60/t** CO2-e
Very low income[a]/ high energy consumption	$494.00	$624.00	$764.40	$910.00
Very low income[a]/ medium energy consumption	$390.00	$564.20	$657.80	$780.00
Low income[b]/ high energy consumption	$478.40	$592.80	$715.00	$865.00

Notes: [a] Very low income households are defined here as receiving gross income less than $500 per week.
[b] Low income households are defined here as receiving gross income between $500 and $1000 per week.
Source: KPMG 2008

Such CPRS-induced price increases will exacerbate existing price pressures on low-income households including increasing housing, food and electricity costs.

Separate research conducted by the National Institute of Economic and Industry Research (NIEIR 2007) for the Brotherhood of St Laurence showed that the price impact of the CPRS will be regressive, that is it will disproportionately affect low-income households. The Garnaut Review (2008) broadly agreed, as did the Green Paper (Australian Government 2008, p.282), albeit to a lesser extent, finding that the impacts would be 'mildly regressive'. Low-income households will be particularly adversely affected by the CPRS because they:

- incur the greatest energy costs (expressed as a proportion of weekly expenditure), even though most low-income households consume less energy than average
- have very little capacity to raise the money required to purchase appliances that will change their energy consumption; and often have to restrict the number of appliances they own due to cost
- are more likely to live in substandard housing which rates poorly in terms of energy efficiency
- cannot pass price impact to others, as they represent the end of the supply chain.

Other areas

Artificial income splitting

Australia's income tax system is based on the individual as the tax unit. However, through the use of family trusts, partnerships and companies, income splitting between family members occurs. This tax-minimising strategy is used predominantly by high-income earners and small business people, and not available to the majority of wage-earners. It thus violates both principles of vertical and horizontal equity.

Broadening the corporate tax base

The 1999 Ralph Committee Review of business taxation proposed a broad comprehensive tax base with no special exemptions and deductions, with the additional revenue to fund the lower corporate tax rate. While this general theme was accepted, a few special exemptions were retained for no good efficiency reason, just to respond to well-targeted lobbying. These included accelerated depreciation provisions for forestry, some horticultural crops, some water infrastructure and some transport infrastructure (but with economic depreciation for the vast majority of plant and equipment and building investments); concessional valuation of livestock; and an exemption for off-shore banking income. Together, these special exemptions have an estimated revenue cost of around $400 million a year (Australian Treasury 2007). The concessions provide a subsidy for the selected investments relative to the numerous other business investments in equipment, buildings, new product development and marketing, workforce skills, etc. They also add complexity, with businesses collecting one set of records for tax purposes and another for sensible business investment decisions. Even those primary producer concessions largely go not to family farms, but to large corporate investors. The deductions are worth more the higher the taxpayer's income.

Fringe benefits and other work-related deductions

Special tax exemptions and deductions exist for remuneration in the form of fringe benefits and lump sums (other than superannuation, which we consider elsewhere). In addition a range of work-related expenses are tax-deductible.

The concessional taxation of labour remuneration taken as fringe benefits rather than as wages is estimated to cost over $3 billion in tax revenue in 2007–08, with the largest item associated with motor vehicles ($1.5 billion) (Australian Treasury 2007).

Some lump sum payments to employees (including termination payments other than superannuation, and payments for unused recreation and long service leave accrued before 1993) also receive concessional treatment. In aggregate, these concessions have an estimated tax revenue cost of over $1.5 billion in 2007–08 (Australian Treasury 2007).

It is likely that fringe benefit tax concessions on motor vehicles are skewed in favour of middle and high income earners. Also, they involve an element of horizontal inequity between people who receive their remuneration as wages and those whose remuneration includes a motor vehicle. While some people earning low incomes receive lump sum payments, most lump sum payments are received by people at the end of their career and on higher incomes. Data from the ATO, for example, shows that almost half of the concessions on unused accumulated leave prior to 1978 go to the three per cent of taxpayers earning more than $100,000 a year.

The FBT concessional treatment, while representing a dollar-for-dollar labour cost to the employers, can distort employee expenditure decisions as well as reducing the income tax base. It is likely that the consumption patterns of many not-for-profit sector employees have been distorted by the provision of an important share of their remuneration as fringe benefits rather than as wages. There is no efficiency argument to favour lump sum payments over wages and salaries.

Individual taxpayers can claim as a deduction some, but far from all, work-related expenses, with the allowable items varying by industry and occupation. There is a confusing array of partial subsidies and tax deductions for child care while working (and also during non-work periods). Taxpayers at all income levels claim deductions for work-related expenses, but the distribution of claims is skewed towards those on higher incomes (ATO 2008).

Income averaging

A select group of taxpayers, including primary producers, artists and authors, are able to average their income over a five-year period in determining their tax rate. Primary producers also have access to farm management deposit bonds which allow for deferral of tax from relatively high to relatively low income years. In 2007–08 these two special allowances are estimated to cost tax revenue of $150 million each (Australian Treasury 2007). Such options are not available to other taxpayers with variable incomes, including other small businesses, female employees with broken careers, the 30 per cent of the workforce who are part-time employees, and workers with spells of unemployment. It should be noted that low-skilled and low-paid people are overrepresented in the last two categories.

Highlighting the inequities

The gross inequities in the tax system are well illustrated by looking at the tax liabilities of two hypothetical individuals; a 55-year-old executive earning $120,000 per annum and a 55-year-old cleaner working full-time at $15 an hour—just above the minimum wage. As Table 1 highlights, the high-income executive can manipulate the superannuation tax arrangements to significantly reduce their tax burden. By investing $90,000 of their pre-tax annual income in superannuation, they end up paying only $329 a week in tax, or 14.3 per cent of their earnings.

Table 3.2 Contrasts in tax liabilities

Scenario	Gross weekly earnings	Weekly impact of tax paid	Effective average tax rate*
55-year-old executive From salary of $120,000 p.a., sacrifices $90,000 into super	$2308	$329	14.3%
55-year-old cleaner After being unemployed, starts full-time job with wages $31,200 p.a. ($15 per hour)	$600	$332[#]	55%

* This takes into account the tax-free threshold, LITO and the Medicare levy.
[#] Includes the loss of Newstart Allowance.

In start contrast is the tax impact for a person moving from welfare to a low-paid job. If the 55-year-old in this example moved into a full-time $15-an-hour cleaning job, earning $31,200 a year, they would lose their Newstart Allowance and start paying tax and the Medicare levy. They would therefore effectively pay $332 a week in tax and lost benefits, or 55 per cent of their earnings. They might also lose other benefits such as a Health Care Card.

4 What reforms do we need to address these problems?

Providing an adequate safety net for all

The government must reform the current income support system to improve the adequacy of basic income support payments. The current distinction between pensions and allowances should be removed and the array of income support payments replaced with a basic income support payment provided to all those eligible, with add-ons for groups with higher needs—for instance people with a disability, carers, and people with dependent children. Particular attention needs to be made to private renters on income support, with reform of Rent Assistance to ensure that the payment is more in line with market rents.

The Brotherhood of St Laurence recognises that while all families should be supported with the costs of raising children, poverty prevention should be a key goal of Australia's system of family assistance. The review panel should consider restructuring the current system of Family Assistance (including Family Tax Benefit Parts A and B), by creating a small universal child-related payment and then combining this with a more targeted top-up payment similar in structure to FTB-A to make sure that the most in need are getting the most assistance. This should also involve replacing the universal Baby Bonus with a well-designed paid maternity/parental leave system, to which government contributes, to ensure that low-income families are protected. We also recommend abolishing the Dependent Spouse Rebate.

The Brotherhood recognises that with limited resources it is difficult to find the right balance between targeting to ensure that those in most need receive assistance, and ensuring that there remain incentives to work and save. We therefore recommend that the review panel examines a range of options to improve the adequacy of income support payments.

The first is to examine funding an increased level of base support by tighter targeting of payments through including the family home in the asset test. However, the implications of tightly targeting payments to those with few assets need to be further examined. Questions to be answered include (1) Do the current assets tests discourage low-income households from saving? and (2) Would including the family home in the asset test exacerbate this effect? An alternative option is to examine whether the savings from abolishing concessional treatment of investments generating a capital gain or put into superannuation could be used to fund a universal pension. Again, long-run impacts on savings and retirement decisions need to be examined further.

Making work pay

To further encourage income support recipients to re-enter the workforce, we suggest that the principle of the working credit be expanded to ensure that long-term income support recipients who move into employment can keep a significant proportion of their payment for a period (say 6 months) post-employment. We also suggest that income support recipients entering employment be able to retain their Health Care Card for 12 months after job entry and that for public housing tenants there be a rent moratorium for 6 months after job entry. This would encourage disadvantaged job seekers to try out employment without fearing that if things do not work out that they will be worse off.

Providing progressive asset building initiatives

Reform taxation of capital gains

A more neutral tax system of capital gains tax on different investment and savings options is required. First and foremost this requires removing the concessional half-tax rate on capital gains from the sale of assets other than the family home. This would provide revenue savings of at least $8 billion.

Removing the concessional half-tax rate on capital gains will reduce a large proportion of the current arbitrage opportunities and associated efficiency losses. Some commentators have proposed that the unrestricted deductibility of debt interest expenses be removed, or at least restricted. Debt interest represents a cost of doing business, and under a comprehensive income tax system the debt interest is a deduction for the investor and is taxed as income of the lender of the funds. The real problem is the interaction of concessional taxation of capital gains (including the 50% rate and deferral to realisation) with the deductibility of debt interest (at 100% and on accrual). To remove the CGT concession goes a long way, but not all the way, to closing down the arbitrage game. Disallowing debt interest as a deductible business expense seems to be going too far. Therefore we propose secondly the quarantining of negative debt interest deductions to the income earned on investments it funds, with carry-forward provisions.

A third proposed reform includes bringing capital gains on owner-occupied homes, at least above a minimum threshold, into the tax net. Taxing some (or all) of the capital gains earned on owner-occupied housing would increase vertical as well as horizontal equity.

Further analysis of the implications (including the likely effect on savings and retirement decisions) of including the family home in the asset test for pensions should also be conducted.

Reform taxation of superannuation

The current flat tax treatment of income invested in superannuation needs to be reformed. There are broadly two options here. Taxing superannuation withdrawals is preferable, as this would discourage the withdrawal of lump sums and encourage consumption smoothing over retirement. This option also allows for a future revenue source for governments dealing with an ageing population. However, the terms of reference for the present review rule this option out. The alternative is to tax investment into superannuation, at least above some lower threshold, at the relevant personal income tax rate on entry. This presents a saving to government of up to $20 billion, which could be used to fund more progressive retirement income savings policies.

Invest in progressive lifelong savings measures

We also recommend that the review panel and the government examine the use of lifelong savings accounts to aid in more progressive asset building initiatives. Such accounts could build on the concept of the Super Co-contribution scheme for a broader range of savings goals other than just retirement incomes.

Investigate use of inheritance taxes

We also encourage the review panel to investigate the use of inheritance taxes as a more progressive form of taxing wealth.

Helping those on low incomes respond to climate change

The Australian Government has identified a mix of direct financial compensation through the tax/transfer system and energy efficiency initiatives to mitigate the impact of the CPRS on living standards in low-income households (Australian Government 2008). In relation to direct financial compensation for low-income households the government has committed ‘to meet the overall increase in the cost of living flowing from the scheme’ (p.278). The Brotherhood welcomes the direct financial compensation and believes this will provide an essential buffer to the price rises, particularly at the introduction of the scheme. It will however be important and necessary to combine this direct financial compensation with large-scale national energy efficiency initiatives targeting low-income households.

Recently the Brotherhood, working with KPMG and ECOS, released a proposal for a National Energy Efficiency Program to audit and retrofit 3.5 million low-income households (KPMG 2008). The program would overcome many of the barriers low-income households face to improving their energy efficiency, which include a lack of capital, information barriers and the split incentive between landlord and tenant. This would enable low-income households to become more energy efficient and in most cases offset the increased costs from the CPRS. The biggest benefits would occur in low-income households with the highest energy consumption. Importantly the up-front investment in energy efficiency proposed in the program would provide a hedge against future electricity price rises and the associated drain on household budgets, and benefits would continue even after the program is complete.

For government, such a program has the potential to manage the medium to longer term risk of increasing demands for direct financial compensation as energy prices continue to rise. After 7 years, when the national energy efficiency program is completed, it is foreseeable that government will be able to limit any further increases to the base rate of pensions and benefits for the purpose of compensation against further energy price rises. Automatic indexation to CPI/MTAWE will, of course, continue to provide a buffer against some indirect price increases.

A funded national energy efficiency program targeting low-income households would complement existing programs such as the Green Loans scheme, and the forthcoming Victorian Energy Efficiency Target Scheme which will primarily appeal to medium and high-income households.

Other reforms

The Brotherhood also urges the review to consider:

- reducing opportunities for income tax avoidance by income splitting through family trusts, partnerships and private companies
- broadening the corporate tax base by removing the remaining special business tax concessions

- abolishing fringe benefits tax (FBT) concessions and deductions and removing the assorted allowed deductions for work-related expenses, and using the revenue saved to lower overall marginal tax rates. This would simplify the tax system and reduce compliance costs for a large number of wage and salary earners. In 2005–06, 45 per cent of individual taxpayers claimed a total of $1.3 billion in payments for professional services to manage their tax affairs (Australian Treasury 2007)

  Note that FBT concessions are utilised by the not-for-profit sector to offer competitive salary packaging to attract and retain staff. If these were to be removed they would have to be replaced with other forms of compensation so that the sector could afford to offer higher remuneration to staff and remain competitive.

- introducing a general income averaging provision, for all whose current year income is more than an agreed percentage (say 20 per cent) below the average of previous years). If this idea is not accepted, removing the selective income averaging concessions for the lucky few might be appropriate.

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