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**RATIONALISING THE INTERACTION OF TAX AND SOCIAL
SECURITY: PART II: FUNDAMENTAL REFORM OPTIONS**

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ABSTRACT

Discussion Paper 423 described current problems in the interaction of the tax and social security systems, analysed the impact of the new tax system reforms, and proposed a number of reforms aimed at further addressing problems of high effective tax rates and associated work disincentives.

This paper takes the analysis a step further by considering more major structural reforms which could address such problems in a systematic manner, and allow the implementation of a designed set of effective tax rates (ETRs) for social security clients and taxpayers.

There are four main classes of reform options, namely:

Negative Income Tax (NIT) or Guaranteed Minimum Income (GMI)

integration of tax and social security, abolishing separate social security means tests and using a system of income tax surcharges and/or special rates to recoup benefits as income rises

full separation of the two systems, using special tax scales or tax rebates to avoid tax cutting in until benefit entitlements are fully exhausted; and

full (integrated) coexistence, such that the combined tax and social security tax rates approached a desired configuration.

1 INTRODUCTION

The notion that the tax and social security systems should be more closely integrated has had considerable currency in Australia and overseas. In Australia, it reflects current concerns about high ETRs, with consequent disincentives to earn additional income or to save for retirement. While a number of *ad hoc* rebates have been introduced (and increased) in order to exempt basic rate pensioners and beneficiaries from liability to income tax, this approach falls short of providing long term solutions and can create new problems of its own. For example, withdrawal of such tax rebates increases effective tax rates over the income range from which it is withdrawn.

With 4 million welfare clients at any one time (and more over the course of a year) as compared with some eight million taxpayers, it might be questioned whether it is appropriate to maintain two separate administrative systems, each with their own rules, definitions and procedures, and both charged with essentially the same role: reducing net disposable income according to some measure of need. If the net value of social security benefits could be withdrawn through the positive tax system, administrative burdens on Centrelink could be reduced, compliance facilitated, and ease of understanding greatly improved. This is the reasoning behind advocacy of the NIT and similar reform proposals.

2 THE NEGATIVE INCOME TAX (NIT) OR GUARANTEED MINIMUM INCOME (GMI)

The current system provides benefits to the poorest in our society in a manner not too far removed from a NIT or GMI scheme, albeit of the categorical (and conditional) type. The main condition is that a person who is assessed as being able to work – that is not aged, disabled, a carer or parent, or sick – is expected to actively seek work. However it is a GMI characterised by poor design, excessive complexity, and unwanted overlaps with the tax system and other income transfers. It must be said, however, the Australian system is very redistributive and manages to be significantly more generous to the poorest than the OECD average, when the purchasing power of basic benefits is compared rather than replacement rates (Whiteford 1997, p48).

Admittedly, the current system's ability to help the poorest is achieved by something of a subterfuge: clients often do not understand the extent of the very high effective tax rates they face, and these are in part the secret of the scheme's ability to redistribute. However they are also one of its major weaknesses. There are also social and political difficulties created by helping the very poorest, while doing relatively little for those just outside this group. These difficulties are manifested in recent proposals to provide extra assistance, such as earned income tax credits (EITCs), to low wage earners: see Ingles 2000 and Ingles and Oliver 1999. But the EITC proposal does not sit easily with Australia's system which is essentially based on the GMI approach, and which already provides substantial in-work assistance to low-income families.

There are several radical NIT or guaranteed minimum income (GMI) options that have been proposed to address design problems. The most recent is the NIT proposal of Dawkins *et al* (1997, 1998a), although this is one in a long list of similar proposals stretching back to the Poverty Inquiry (Henderson, 1975) and beyond. One of the important contentions of this paper is

that it is not necessary to so radically overhaul the whole structure of the tax/transfer system in order to achieve many of the benefits being sought.

The basic philosophy underlying the GMI approach involves rejecting categorisation (by age, disability etc.) as a criterion for assistance in favour of using low income as the sole indicator of need. But the NIT in its pure (ie non-categorical)¹ form has a number of significant problems. These include:

- the very high tax rates required across the whole population if the basic income guarantee level is to be at the same rate as existing categorical payments (this is estimated as 57 per cent by Dawkins *et al* - 1997 p2),
- the consequent possibility of a significant general work and saving and/or tax avoidance response
- the apparent extension of assistance to those whose need may not be great, such as those voluntarily not in the workforce
- if the tax definition of income is adopted in the unified system, as proposed by Dawkins *et al*, the social security system loses the ability to distinguish those with substantial assets.

Given the problems of taxpayer resistance already being encountered in income tax and the likely efficiency implications of placing further weight on this tax, this seems unlikely to be generally acceptable. On equity grounds alone one could question the appropriateness of placing further weight on a definition of income already widely regarded as deficient in measuring real command over resources (unless there is a thoroughgoing reform of the tax base towards a more comprehensive income definition, possibly including the inclusion of imputed asset income).²

There is also the issue of the likely public reaction if benefits were payable without any test on work intentions. The Commission of Inquiry into Poverty felt that its proposed GMI would not damage work incentives because 'Australians have no respect for the bludger' (Henderson 1975, p.391). In contrast, the Taxation Review Committee argued that GMI schemes seemed likely to have 'consequences for incentives to work and save which make it impossible to consider such a scheme seriously' (Asprey 1975, p. 180).

The Committee of Inquiry into Poverty (Henderson 1975) and the Priorities Review Staff (1975) both recommended a shift toward a GMI system integrating benefit withdrawal into the positive tax system. Neither the Poverty Inquiry nor the Priorities Review Staff actually went so far as to advocate the removal of all forms of categorisation, as implied by the pure form of GMI. Rather, they would have applied one level of income guarantee to existing categorical groups and a lower level to others. The effect would have been to diminish, but certainly not eliminate, the effects of categorisation. Since for many taxpayers the effect of the low guarantee would be broadly similar to that of the existing tax threshold, the overall distributional impact would be broadly similar to the existing system.

1 'Non-categorical' implies that the full negative income guarantee would be available to all those with sufficiently low incomes, without reference to their eligibility under categories such as the aged, invalid, unemployed etc.

2 As proposed, for example, by D Dixon (1985).

Similarly, Dawkins *et al* proposed a number of modifications that allow the required linear tax rate to be reduced:³

- The first sub-option (1b) involves lowering the guaranteed minimum income (GMI) level by 25 per cent to reduce the required tax rate to 45 per cent. Dawkins *et al* correctly note that this approach is ‘unlikely to be acceptable’ (p19).
- The second Option (2) tapers out the tax credits on middle incomes, defined as between \$30,000 and \$80,000. Basic benefits must be cut by 19 per cent in order to achieve the target 45 per cent nominal tax rate, and the tapering out of credit causes the effective tax rate to rise over the taper range.
- Option (3) is similar to (2), but with an initially higher tax rate of 60 per cent, a nominal rate of 30 per cent on middle incomes (but a higher effective rate due to the tax credit taper) and a nominal and effective tax rate on incomes over \$80,000 of 50 per cent.
- Option (4a) proposes the continuation of some degree of categorisation. Current categorically eligible groups would receive a full GMI; the remainder of the population would be eligible for a GMI equal to 25 per cent of the maximum. In this ‘two tiered’ GMI system (which is quite similar to Henderson’s original proposal), the flat tax is computed to be 52 per cent (p23).
- Further sub-options (4b and 4c) might allow the flat tax to be reduced to 50 per cent, but all involve a higher effective rate at some point in the income distribution (pp24-25).

What this illustrates is very simple. That is, it is very difficult for a NIT to avoid most of the issues that underlie difficulties in the existing system — principally categorisation and high tax rates on low-income earners — if any new system is to be socially and politically acceptable. (This is quite aside from any questions as to its economic credibility).

Given this, and all the problems that will therefore remain — proving eligibility, definition of the income unit, the time period for assessment, etc — it might seem preferable to stick with the current system for the moment and adopt a more incremental approach, albeit paying particular attention to low income earners.

It is interesting to note the differences between Dawkins *et al*’s costing and those of the Poverty Inquiry. The Poverty Inquiry thought that a pure GMI would involve a financing tax rate of 50 per cent (Henderson 1975 p74); Dawkins *et al* suggest 57 per cent. The Poverty Inquiry’s two-tier GMI involved a 35 or 40 per cent general tax rate; Dawkins *et al* suggest 52 per cent. While there are some differences of detail, the main differences between now and 1975 are the greater coverage of the social security system, and the higher real and relative rates of benefit for some groups, such as children. These have made a GMI an even more difficult proposition than it was in 1975. However the introduction of a GST has eased EMTR problems for some groups (see Discussion Paper 423 in this series), and should lower the required NIT tax rate.

3 These options are drawn from Dawkins et al 1997. Dawkins et al 1998a provides an essentially similar proposal, but with some modifications.

Some specific issues with the GMI are:

- Is it desirable to avoid categorising the population into various eligible groups,
- Is a linear benefit withdrawal-cum-tax rate optimal?
- Should additional assistance needs to be directed to low wage earners (Dawkins 1996)?

These are discussed below.

2.1 To categorise or not?

There is no doubt that the present categorical system is complicated, cumbersome and arbitrary (see eg Perry 1995). There are apparent attractions in moving to a system where the only criterion for assistance is low income. However, there are also major problems:

- such a system cannot discriminate between those whose low income is voluntary, and those for whom it is not - ie, there would be no work test for the able-bodied unemployed; and
- some individuals, notably the self-employed and those with substantial asset incomes, are able to manipulate their affairs so as to declare an apparently low income when in fact their full (comprehensive) income may be quite adequate.

In relation to the first point, current policy is moving dramatically away from the concept of a social security payment as an unconditional entitlement for those of working age, and current rhetoric focuses instead on the idea of ‘mutual obligations’ (see eg. Reference Group on Welfare Reform, 2000a and b).

On the second point, it is interesting to note that the Youth Allowance means test attempts to better assess the real income of the self-employed by using the so-called ‘actual means test’, which involves a mixture of wealth and consumption measures. However there are major difficulties with this test. When applied to the pension system in the late 1970s the test on income only gave rise to widespread ‘income rigging’ practices, resulting in the re-imposition of the asset test. Until such issues are resolved, using low income as the only criterion of need for assistance, while theoretically attractive, is probably not workable.

For these reasons I will assume that some form of categorical system will continue to operate. However some of the options discussed in this paper have the effect of sizeably reducing differences in the treatment of those categorically eligible and those not, and this will generally be a desirable direction for reform. Low income earners might be best assisted by measures such as raising the tax threshold, since this involves much reduced measurement and incentive problems (see the discussion on ‘convergence’ later in this paper).

2.2 The optimal tax/taper rate

Dawkins *et al* estimate that even if categorisation were retained, the linear tax/taper rate required to finance existing maximum benefits would need to be 50 per cent, if it were uniform across income classes (1998a p251).

Raising the benefit withdrawal rate can reduce the general tax rate; the appropriate trade-off between these two is a difficult issue. ‘Optimal tax’ theory has tended to suggest that a linear rate is optimal, but this conclusion is by no means universally accepted and depends on the limitations inherent in optimal tax analysis. There may in fact be good economic reasons for a

higher initial marginal rate (Ingles 1998b).

Suffice to say that the precise way this question is answered probably does not matter too much, if considered purely in terms of economic efficiency. From a horizontal and vertical equity perspective, however, it is highly desirable that ETRs do not exceed, say, 75 per cent over any substantial income range. Otherwise, because of childcare, travel and other costs, there is no effective gain from working — and for the retired, little incentive to invest in assets subject to asset test or deeming provisions.

The previous paper in this set (Discussion paper 423) showed in Table 3 that ETRs for some of our payments are in fact in excess of the 75 per cent figure, although implementation of the NTS has reduced ETR problems for families. It is mainly in the allowance area (Newstart Allowance and Parenting Payment (Partnered)) that high ETRs now arise. There can be disincentives to move from part-time to full-time employment, and/or for a spouse to take up employment, if a couple is in receipt of these payments.

Discussion Paper 423 argued that high ETRs for allowees are best addressed by action on the tax side, rather than further lowering tapers. Reducing tapers exacerbates horizontal inequities between those categorically eligible for payment and those not, and there is already a substantial group of low income earners not eligible for any categorical payment. The size of this group is indicated by the \$3 billion estimated cost of extending eligibility for Newstart allowance to full-time earners.⁴

2.3 Low wage earners

Low wage earners are a policy concern partly because of the increasing dispersion of earnings in Australia (see eg Gregory 1993), a problem we share with a number of other OECD countries, and partly because a number of economists have argued for pursuing increased earnings dispersion in order to allow the creation of more jobs (Dawkins *et al* 1998b). Dawkins (1996) and Dawkins and Freebairn (1997) have argued the economic benefits of moving towards a more decentralised (ie market oriented) wage system, while using the social security system — either through a NIT or an EITC - to prop up the incomes of those who would otherwise be disadvantaged — notably the low-skilled.

The NIT proposal is not without adverse consequences for work.⁵ Low wage earners can be helped in many different ways. If we wish to direct additional assistance to those not in the

4 Many of these would be self-employed people currently excluded by the activity test – ie, they are not regarded as ‘available for work’.

5 Dawkins et al suggest that a NIT would ‘provide a safety net for all families without dulling incentives to enter paid work. Indeed, it could be expected to improve the incentive to work [by virtue of reducing poverty traps and low income traps]’ (1997 p413). While it cannot be ruled out that reform of low-income traps may improve work incentives for those now subject to them, it is wrong to imply that a NIT would necessarily improve aggregate incentives to enter paid work. In the US NIT experiments conducted during the 1970s, an aggregate loss of labour supply of around 10 percent among recipients was found (see Burtless 1987).

While this would vary in the Australian situation depending on a number of parameters, the predicted effect on work effort by low wage earners currently outside of the current social security system is certainly negative. This is because income and substitution effects are both operating in the same direction below the NIT breakeven point, to depress labour supply. This must be counted as a cost to be offset against the hoped-for benefits of moving towards a more deregulated wage environment.

social security system but with earnings below the existing tax threshold, then the NIT or refundable tax credit approach may be required. But it seems more likely to me that our main concern should be the deteriorating position of those on low full- or nearly full-time earnings - ie, with incomes well above the current tax threshold (Ingles and Oliver 1999).

It follows that the most direct way to help the relevant target group is by reform of the tax rate structure. One option is an EITC; another is to substantially raise the tax threshold and, if necessary, finance this by imposing a higher initial marginal rate (currently 17 per cent). The effect of the higher initial rate is to quarantine the benefits of the threshold increase to low income earners.⁶ As described later, however, there are problems in a policy of raising both thresholds and the first marginal rate; it can actually exacerbate the EMTR problems described above. Hence the preferred policy approach canvassed later in this paper is to apply a partial family basis to the tax structure, extending the lowest (17 per cent) tax bracket from \$20,000 pa to \$29,000 pa for couples.

The New Tax System (NTS) increased the tax threshold to \$6,000, or effectively \$6,882 inclusive of low-income rebate. Single income families with a young child are claimed⁷ to have an effective tax threshold of \$13,882, made up of the new \$6,000 threshold plus \$2,000 for one dependent child and a further \$5,000 for single income families with a child under 5 years of age under FTB(B), plus \$882 from the low income rebate.

There is a dubious logic in paying a *refundable* tax credit — in fact a cash benefit — such as the FTB(B) and calculating a tax threshold as if that were a conventional tax rebate. It is true that the family are at least as well off in cash terms. But families in receipt of FTB(B) in fact face positive tax rates at income levels well below \$13,882, particularly if some of that income is earned by the spouse.

Hence individuals, couples and families on quite low incomes are presently required to pay income tax. One reason for wishing to reduce their tax burden is both to decrease interactions between means tests and income tax, and to increase the rate at which the incomes of social security beneficiaries ‘converge’ with the incomes of those who have no categorical eligibility. The issue of convergence is discussed later in this paper. In that section I conclude that one option for full tax-social security integration requires that tax thresholds be set at the cutout points for receipt of basic benefits, and that – as a matter of financial necessity - beyond those points quite high tax rates should apply.

3 INTEGRATION OF TAX AND SOCIAL SECURITY

Integration has great theoretical attraction, as stressed, for example, in the Report of the Taxation Review Committee (Asprey, 1975). It is based on the question of whether it necessary to maintain two separate administrative systems, each with their own rules, definitions, and

6 One objection to raising the tax threshold is that this is not target-efficient, because it benefits high-income earners, secondary earners, income splitters and the like. This objection is partly addressed by the claw-back proposal in the text. Moreover, the usual remedy proposed - to means test the threshold - can involve a structure of effective marginal rates which is rather strange, involving a middle income zone where such rates are higher than at high incomes.

7 In the New Tax System literature.

procedures, and each charged with a very similar function: ie, to supplement or reduce net disposable income according to some measure of need.

‘If the net value of social security benefits could be withdrawn through the positive tax system, administrative burdens on the DSS could be reduced, compliance facilitated, and ease of understanding greatly improved’ (Ingles 1985). In a like manner, Dawkins *et al* argue that ‘Part of the complexity of the tax transfer system arises simply because taxes and transfers are administered separately’ (1998a p240).

While the NIT is one approach to integration, there are others. Ingles (1985) showed how integration broadly based on the current system might proceed. Separate social security means test would be abolished and replaced by special tax scales for those in receipt of a social security payment. The scales, which could be designed to broadly replicate the effective tax rates now applicable, would be applied to the joint income of pensioner and allowee couples, as under the current system.

The Asprey Committee was favourably disposed to eliminating social security means tests in favour of relying on the positive tax system to modulate net benefits according to need. The report envisaged the use of a separate rate scale superimposed on the standard rate structure, noting that while such an arrangement would be a ‘...complicating element in the administration of the normal tax system ...it would allow a simplification of the public finances as a whole by the abolition of the existing complicated means tests’ (Asprey 1975, p.179).

The Meade Committee, which studied options for taxation reform in the United Kingdom, was similarly attracted to the possibility of dispensing with separate social security means tests in favour of reliance on the general tax system, suitably modified, to claw back net benefits as private incomes rose (Meade 1978, pp.269-307). A member of that Committee subsequently collaborated in a book proposing a wholesale reform of the United Kingdom social security system based on use of the refundable tax credit mechanism. That proposal also involved amalgamation of taxation and benefits payment administrative systems through combined local offices (Dilnot *et al.* 1984), similar to the new Family Assistance Office set up to administer the FTB in Australia.

The Poverty Inquiry had argued that, short of a full GMI, taxation and means test arrangements should at least be consistent. While they felt that capital gains should be taken into account for pension purposes, ‘pension practice should seek to follow changing income tax definitions in this matter’.

While the practice of ‘income rigging’ eventually moved the Government to re-impose an asset component in the means test, it could well be argued that the problem being encountered in the pensions area were only a reflection of more general problems in the tax treatment of capital incomes. It is far from obvious that the test of ‘ability to pay’ in the tax system should differ from the test of ‘need’ in the pension system, when in fact the different tests apply to so many of the same people, and interact over the same ranges of income.

Different definitions of resources are thus one obstacle to integration of tax and means tests. Other problems are the different assessment units (the social security system generally combines income of spouses) and differences in the time period to which assessments apply — whether that be the financial year (tax), the anniversary of take-up (pensions), or the fortnight (unemployment and sickness benefit). Clearly, these differences are major obstacles to integration. That is not to say that they are insuperable.

In early papers on this issue, Dixon and Foster of the then Social Welfare Policy Secretariat (1983a and b) argued that full integration was not then feasible and may in fact be undesirable because of the different redistributive objectives of the tax and social security systems. Also, there would be objections to changing the tax system from an individual to a family unit basis and the alternative — changing the social security system to an individual basis — is not likely to be feasible in terms of cost. It would imply, for example, access to unemployment benefits for many married women presently precluded by their husbands' income. Dixon and Foster concluded that it was more feasible to consider arrangements under which pensioners who are subject to means tests are not also subject to personal income tax.

3.1 The case for full integration

While the Dixon-Foster proposal does achieve significant reduction in administrative overlap and effective tax rates, it is not intended to achieve full integration with the tax system. Indeed, its basic logic is to achieve full separation. While this may ultimately prove to be a suitable direction for reform (see next section), it would seem desirable that the possibilities for full integration at least be explored, since the attractions, at least in theory, are considerable. The social security and taxation systems can easily be seen as two sides of the same coin — we seek to support those who need it, and to finance that support from those who have the capacity to pay. Withdrawing benefits as incomes rise is similar in its incentive and distributional effects to taxation. There may be good reason, therefore, to standardise our tests of 'need' and 'ability to pay' in a single coherent system.

In considering similar proposals for reform in the United Kingdom, Dilnot et al (1984) suggest: 'In Britain and elsewhere, the two systems grew up separately because they operated for two essentially distinct groups of people. One class of people paid taxes, and another received benefits. The two administrations developed in different buildings and in different styles. If it had been envisaged that one day most people would be both taxpayers and benefit recipients, it is inconceivable that things would have developed this way . . . The school-leaver obtaining his first job, the newly redundant worker, the person planning to retire, the newly bereaved widow, will provide the same information and answer rather similar questions for both the Inland Revenue and the DHSS...'⁸ (p.86).

The situation in Australia is not very different. In relative terms tax liability now extends much further into the income distribution than it did in the formative years of social security. The extent of overlap between taxpayers and social security recipients is considerable and will continue growing under the impact of the NTS measures. Quite apart from it being cumbersome, many find onerous the necessity to pay even small amounts of income tax when their benefits are already being means tested.

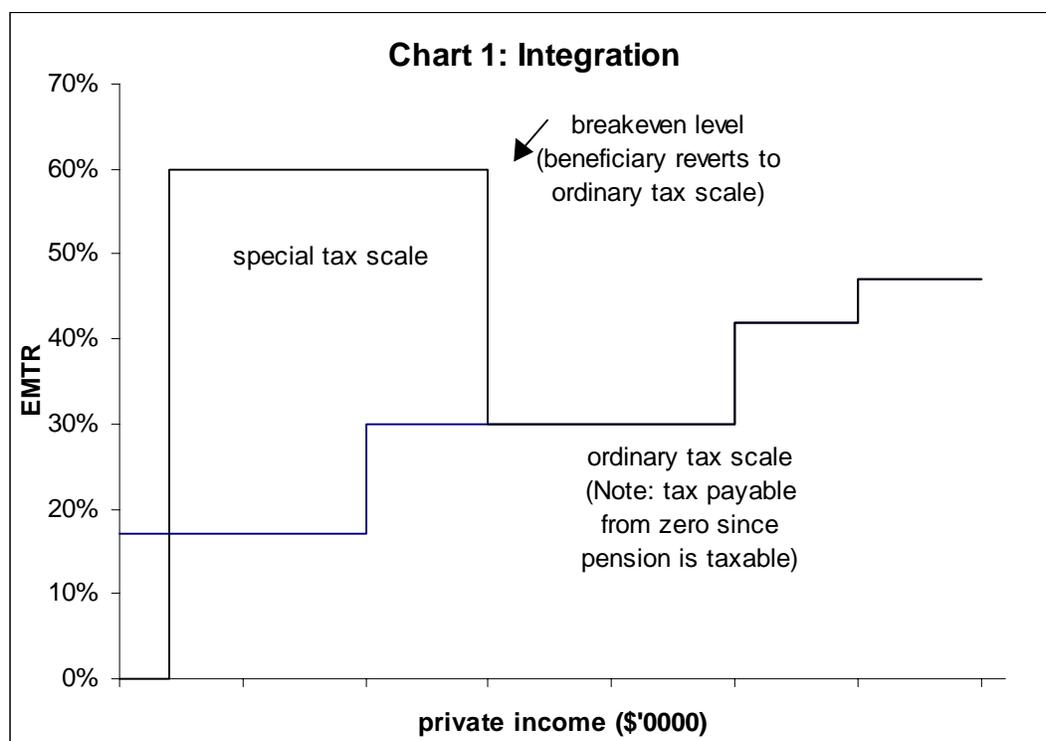
The case for some degree of integration would appear therefore to be strong:

- administrative duplication could be eliminated in payments and assessment systems;
- compliance costs could be eased for clients of the system;
- enforcement would be facilitated by concentrating the resources of the two systems;
- ease of understanding would be facilitated; and

⁸ The UK Dept of Health and Social Security

- current difficulties in defining the period of income assessment might be reduced or even eliminated.

Overall, a much cleaner and fairer system could be expected to eventuate (see Chart 1).



In the proposal that follows, emphasis has been placed on more or less replicating the main incentive and distributional features of the existing system, not because these are necessarily appropriate but so that the issues of administrative reform can be clearly separated from the substantive policy issues of the appropriate means test structure. Nonetheless, some changes are incorporated into the proposed system simply because it would be almost impossible, administratively, to structure a sensible integrated system around all the diverse characteristics of the present system. Where possible, current schedules of effective tax rates have been ‘smoothed’ to iron out the worst of current inconsistencies.

3.2 Details of the full integration proposal

3.2.1 Pensioners

Separate social security income tests would be abolished and replaced by special tax scales applicable to those in receipt of a social security pension. For those on pension for less than the full financial year, a special part-year tax system would be adopted, along the lines of Dixon and Foster’s (1983b) proposal. The normal tax system would apply on a pro-rata basis for that part of the year when not in receipt of pension; the special pensioner rate would apply, also on a pro-rata basis, for the remainder of the year. These scales would be applicable to the joint income of pensioner couples, as under the present income test.

Pensions would be entirely freed from tax. This is not essential to the proposal but is administratively convenient, since it means that the special scales need not be altered each time there is a general rate increase.

The special pensioner tax scale is as follows. For each dollar of non-pension income above \$2,756 a year, a tax rate of 60 cents would apply. For couples, the first step would be \$4,880. These limits correspond to the current pension 'free areas'. The tax rate of 60 cents in the dollar is higher than the 40 per cent pension taper and, indeed, than the top marginal rate of personal income tax. But as Discussion Paper 423 showed, it is in fact reflective of the rates applicable over wide ranges of pensioner incomes, under the NTS.

These withdrawal rates would result in break-even points, where there is no further advantage in remaining on the pension, at levels of income broadly similar to the pension cutouts now applying. At these points, the pensioner would be automatically transferred back to the normal taxation system. There would be end-of-year tax reconciliation, so no pensioner would be advantaged or disadvantaged by failure to transfer back to the tax system at the appropriate time. Most pensioners, once on the system, would simply remain on the special rate scale over the full financial year.

Centrelink would act as a withholding agent for the Tax Office, by deducting appropriate amounts from the pension on the basis of compulsory income declarations. (This is in fact possible under the present system, but declaration is not compulsory and few pensioners do declare.) The Tax Office would be responsible for end-of-year reconciliation, enforcement and compliance.

There will clearly be occasions where pensioners under- or over-declare income, or simply do not know what their taxable income is likely to be. (This also occurs under the current system.) In order to avoid large end-of-year reconciliations, withholding should be based on cumulative adjustments, in a similar manner to the present pension system.

3.2.2 Possible problems

For FaCS/Centrelink the administrative task would not be all that different to the current one, except for the need to liaise with the tax office to effect end-of-year reconciliations. In general, these would not be large. For full-year pensioners, the system should have withheld appropriate amounts on the basis of the cumulative assessment procedure.

There will be a problem in allocating income between periods on and off pension. In general, income subject to PAYE withholding will be allocated to the pay periods over which it was earned. Other income (eg. from capital) will need to be spread over the special and normal tax periods on a pro-rata basis.

This may appear to be an unnecessary complication. An alternative procedure would be simply to apportion total annual income between the special and normal tax periods on a pro-rata basis. This would have the considerable advantage of being even-handed as between part-year and part-time earnings — the latter being discriminated against under the current system. But there would also be important problems. Those coming onto pension after being in the workforce for part of the year might find themselves with little residual entitlement. Those leaving pension to take up work would find themselves having, in effect, to pay back part of the pension already received, since many in this position would find themselves with a large end-of-year tax liability. Hence the use of only the financial year basis of assessment may not be feasible.

The need to administer a joint tax unit may cause some problems for the Tax Office. However, it is not a complete departure from previous practice, since such a unit now applies for assessing eligibility for the dependent spouse rebate and the Medicare levy.

Some of these difficulties might be resolved by a more thoroughgoing integration of the respective roles of social security and the tax office. Dilnot *et al.*(1984) propose, for the United Kingdom, that the tax office be integrated with benefits administration so that the local office of the joint organisation would be the normal point of contact with the tax or benefit system for the average person. In Australia a similar system has been established for the new body (the Family Assistance Office — FAO) which now administers family payments. It may be, however, that this degree of integration is not necessary to substantially achieve the potential administrative advantages.

While the administrative obstacles appear to be superable, a significant obstacle to integration is the differences in the tax and social security income definitions. In general, it would appear to be desirable to standardise to the tax definitions, although widening of the tax base would clearly improve the equity and effectiveness of the joint system.⁹ The desire to maintain a separate assets component in the social security system is an important reason for preferring the full separation option described in the next section.

3.2.3 Allowances

Unemployment (Newstart) and Sickness Allowance would be subject to essentially the same system as pensioners, the only difference being that the 60 per cent tax rate would apply beyond \$31 a week of private income for both single and married beneficiaries, and an 80 per cent per cent rate beyond \$71 a week.¹⁰ These tax rates broadly preserve the existing structure of net benefits, although there might be a case for some easing of the 80 per cent rate in the light of the other features of the system (see below).

As in the case of pensioners, it would be inappropriate for Centrelink to pay benefits on the basis of cumulative income over the financial year to date of application, since needs are likely to be immediate when the event giving rise is unexpected. Rather, entitlement will need, as now, to be based on a fortnightly income assessment, and a part-year tax scale would apply for period on and off benefit.

As Dixon and Foster (1983b) have shown, adoption of the part-year tax assessment basis can imply an offset to the value of unemployment benefit received if the recipient returns to work. In the extreme case where a high rate of income is earned over a short period of time - as in the case of some seasonal workers — the full value of the benefit would be progressively withdrawn so that it became more akin to a loan.

This feature may not be unattractive, and is in part replicated in current eligibility rules for seasonal workers. Dixon and Foster note that under the current system an individual can receive both the value of the tax threshold and the progressive rate structure, as well as any person or

9 Some problems also attach to the different treatment of maintenance payments and compensation payments in the social security system.

10 The system could be designed to replicate the partial individual basis of the current system.

benefit received in the year. Under this alternative treatment, they can access only one of these forms of ‘income support’ at any one time.

These arguments are similar to those put forward in the report of the Taxation Review Committee: ‘in the cases of those social service payments that are normally of a short-term character, especially sickness, retraining and unemployment benefits . . . needs may be urgent and substantial, the poverty very great but essentially temporary. The recipient may well be out of it again before very long. Over a year in which he had months of acute need, fully meriting assistance on equity grounds, he may prove retrospectively to have had an acceptable total income. The community might be prepared to give temporary assistance more promptly and with a less sparing hand if, when the recipient is subsequently restored to financial comfort, he repays via the tax system some or even all the help.’ (Asprey 1975, p. 179)

As in the case of pensions, this procedure should not give rise to large end-of-year reconciliations. The current system tends to result in tax refunds for those who are unemployed for part of the year, since the PAYE procedures tend to over-deduct for part-year income earners. By contrast the part-year tax system would result in more exact deductions. However, some form of compensation might be justified for the harsher treatment of part-year earnings, along the lines of Asprey’s argument that the community can be more generous if the ‘loan’ is repayable. Such compensation could take the form of higher basic rates, or an eased income test, or both.

The current system treats part-week earnings while on benefit rather harshly, part-year earnings (while off benefit) much more liberally. There would appear to be much to be said for a more even compromise between these two extremes, even if that is a perhaps unintentional side effect of the desire to achieve greater administrative integration with the tax system.

3.2.4 Family payments

Under the NTS, family payments have been integrated into the tax system. There would appear to be a number of potential benefits: the relationship of benefits to income will become more certain and more immediate, and the extensive resources of the tax system can be used to check and facilitate compliance. Entitlement to family payment is based on the estimated joint income of the parents for the current financial year, using such information as pay notices and previous year tax returns.

Assessment based on income over the full financial year is more feasible in the family payment system because it is meant only to be an income supplement; it is not designed to provide full support for a family. However there will still be cases where a family, previously on a high income, suddenly has need of a benefit and where it may not be desirable to reduce supplements for family needs on the basis of previous high income. For these sorts of reasons the current situation in which a family on an allowance receives the full rate of FTB(A) automatically will continue.

Such income support recipients are quarantined from the full end-year reconciliation. Otherwise, they could find themselves not only with high EMTRs on moving into the workforce — which would be dependent on what point of the financial year they made the move — but also (depending on income while in work) a potential liability to pay back some and perhaps all the family payment they had received while on income support. It would be easy to incur a net tax debt in these circumstances, even taking into account the over-withholding of PAYE tax that occurs for part-year earners.

While this could be regarded as horizontally inequitable as between part-year income support receipt and part wages, versus low full-year wages, the alternative of full reconciliation would likely lead to even worse problems.

The most radical option is application of the full ‘tax credit’ principle whereby benefit entitlement would offset any tax liability so that only the appropriate net benefit would be paid to, or tax be paid by, the recipient unit. This is the approach adopted in the new UK Working Family Tax Credit (WFTC) system. The obvious advantage is that running adjustment as incomes change will be made by employers through the PAYE system. A major disadvantage, however, is that it becomes more difficult to direct assistance to mothers if they are not working. There could also be high compliance costs for employers, a problem in the UK.

The full separation proposal in the next section deals with this issue in neat manner by ensuring that people are either in the benefit system — in which case they receive the appropriate amount as a direct payment — or in the tax system, but not both. Problems only arise in the case where a family is close to the edge of one system, and crosses over to the other from time to time. This problem is addressed by the imposition of a special part-year tax rate.

3.3 Conclusion – integration

The proposal demonstrates that the obstacles to integration of pension and tax are not as great as have sometimes been thought. In particular, differences in the period of assessment and the income unit need not stand in the way of reform. However the compromises necessary in order to achieve full integration might reduce the apparent attraction of going down this road and Centrelink, in taking over the function of withholding the correct cumulative amount of tax, may be embarking on a task not all that different from that it now undertakes in administering pension and allowance means tests.

A particular problem, not so apparent at the time of writing the Ingles 1985 article, is the very different income definitions prevailing in the two systems. It can be questioned whether such definitions have now diverged so greatly that the integration option is no longer practicable.

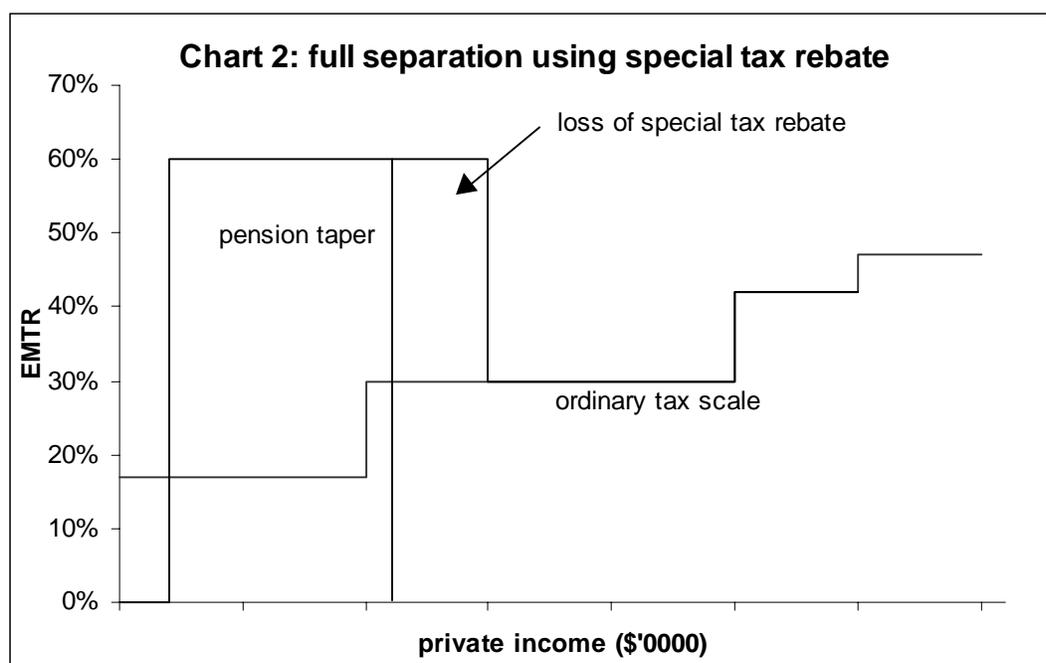
These differences include the inclusion of imputed asset income in the social security means test, the disallowing of negative property incomes, and the inclusion of certain work-related fringe benefits. Returning to a tax definition would amount to the abolition of the asset test and the income deeming provisions resulting, in effect, in a test of income only. This proved completely unviable in the late 1970s and early 1980s. If the tax definition of income were to become more comprehensive (say, by including a deemed income component as a sort of minimum tax on capital income (see Dixon 1985), then the full integration proposal might be worth looking at again.

The asset test issue aside, the compromises necessary to achieve administrative feasibility may reduce the apparent attractions of going down the full integration road. In part, these reflect the aim, in this exercise, of replicating the distributional effect of the current system and might be eased by adoption of a more uniform withdrawal rate. This helps address both the part-year tax scale issue, as well as the issue of how to deal with different income splits within the family. With a fully proportional NIT system these issues disappear entirely.

The conclusion here is that a fully integrated system is the ideal we might aspire to over the long term, but its effective implementation would require a degree of tax base reform which is not currently conceivable.

4 FULL SEPARATION

Full separation, while theoretically less attractive than full integration, may be a more feasible option at the current time. Dixon and Foster (1983b) provide a detailed proposal, the objective of which is to ensure that pensioners subject to the pension income test are not also subject to taxation. To reduce the net benefit to higher income pensioners, the taper rate would be increased to, say 60 per cent. The special rebate would be withdrawn beyond the pension cutout points. The rebate abatement rate can be designed such that, combined with the normal rate of income tax, the ETR of 60 per cent applies until the rebate is fully abated (see Chart 2).



As with the integration approach described above, a special part-year tax system could be applied to those entering or leaving the pension system in any year, in order to simplify administration and to prevent a high income in part of the year prohibiting assistance at other times when it is needed.

The previous government contemplated a similar system, when they promised that age pensioners would be totally removed from the tax system by 1995. The mechanism for doing this is fairly simple, involving extension and modification of the special tax rebate for pensioners.

The Aging Agendas' Review of the pension means test (Barber *et al* 1994) recommended against the Government's promised move, finding that it would create incentives for current non-pensioners to become eligible for pension; be inequitable in relation to those in the workforce with similar incomes to pensioners; and be expensive. However these comments were in a context where there would not be offsetting changes to income test tapers, and would not be relevant if the taper rate were raised as under the Dixon/Foster proposal.

4.1 Separation applied to all additional payments

This refinement is not in the Dixon/Foster proposal, but would appear to be a logical extension of their idea.

Additional payments for families (FTB and Youth Allowance) and for rent would be added to basic benefits and also tapered at 60 per cent beyond the benefit cutout points. There would be matching tax credits in the income tax system, which would start to reduce at a rate of 30 per cent once entitlement to all additional payments was exhausted. The combination of 30 per cent income tax (the standard rate under the NTS) and 30 per cent loss of rebate would maintain the ETR at 60 per cent until the net benefit to each family type was entirely exhausted. All such rebates would be withdrawn sequentially.

This system would virtually abolish *churning* (see below). It would also have the advantage that additional payments for children and rent would become subject to the tighter social security definition of income, which includes imputed asset incomes. Thus full separation becomes a very effectively targeted system.

4.2 Details of operation

There are two alternative ways of operating the scheme. The first is to utilise special rate scales but allow people to flip back to the normal scale once this was to their advantage. The second, as described above, is to use special credits. The following discussion uses the first procedure — special tax scales - since it avoids a lot of practical difficulties that arise because tax obligations depend on income splits within the family.

As with the integration proposal, where a client was on the system only part of the year, income for the year would be pro-rated and the special and ordinary tax scales would apply in that proportion.

4.2.1 Proposed cutouts (\$pa)

Single allowee	13,759
Allowee couple	25,147
Single pensioner	19,859
Pensioner couple	33,210

There would be higher cutouts for those with children and/or those renting privately. Note that these cutouts are lower than those currently prevailing. However clients are not disadvantaged thereby, since they are not paying tax. If their incomes are just above the cutouts they are paying reduced tax by virtue of the special income tax rate scale.

4.2.2 Special tax scales

For pensioners, the special tax applies at the rate of 60 per cent above thresholds equal to the cutouts calculated above. For allowees without children, the special rate is, say, 75 per cent. The allowee or couple would have recourse to the ordinary tax scale as soon as this was to their

advantage; the Tax Office would make this calculation automatically¹¹.

The effect of the special rate scale is to have a family unit of taxation at lower income levels. At higher levels, taxpayers revert to the quasi-individual unit. It would be consistent to do this in a more whole-hearted manner; that is, to abolish the dependent spouse rebate (DSR) both for those with, and those without children. Only low-income earners would continue to benefit from the de facto DSR implicit in the higher tax threshold for couples and families. This has the additional advantage of creating some savings for use within the restructuring package.

The special tax scales would be modified where there were dependent children, or where rent assistance was payable. In these cases the scales would have a higher threshold, calculated as follows¹².

For each child

Age	Add \$ pa
0-4	7805
5-12	6568
13-15	7928

Similar calculations would need to be made, and higher thresholds apply, where there were Youth Allowance children.

Where rent assistance was payable, the special tax scales would rise using the same formula, thus allowing all Rent Allowance to taper before taxation commenced. This formula has the effect of detaching rent assistance from basic allowances, and paying this as an in-work benefit to all low-income earners paying higher levels of private rent. (I have argued for this elsewhere as a means of improving work incentives and incomes for low wage earners (see Ingles and Oliver 1999.)

4.3 Integration with the normal tax system

Note that some people have incomes too high to receive pension (albeit below the breakeven points), but would otherwise be eligible. The answer here is that, in the case of pensioners, the special rate scales should apply to the whole of the potentially eligible group: all those aged over

11 These levels are estimated by calculating the tax that would otherwise be payable at the cutout income levels (assuming no special rebates), dividing this by the required additional withdrawal rate (ie the difference between the special and the ordinary tax scale), and adding this figure to the cutouts.

12 Note that this proposal in effect amalgamates the proposed new FTB(A) and FTB(B) by providing a maximum rate equivalent to the maximum provided under these two payments if the wife is not working. The combined payment is then tapered on the basis of the joint spousal income, unlike FTB(B), which is independent of the income of the primary income earner. This scheme is therefore better targeted, albeit that it is more generous to families where there is a secondary income earner and young children.

The maximum rates envisaged are generous to families with young children, compared to estimates of relative costs provided by equivalence scale studies. They thus in effect provide some compensation for some of the indirect costs as well as the direct costs of young children, of the sort associated with childcare and the like. Tax package is similarly generous where the mother does not work, but withdraws assistance very quickly when she does (due to the 'stacking' of means tests for FTB(A), FTB(A) and possibly Parenting Payment. Economic theory, and estimates of relevant net wage/labour supply elasticities tell us that it is necessary to provide reasonable workforce incentives for secondary earners such as mothers with children.

65, for example (and residentially eligible for pension?), and all sole parents.

For working families to receive the benefit of the special tax scale at least one of them would need to be assessed by Centrelink as unemployed, disabled or sick, notwithstanding that their spouse's income may preclude them from eligibility for any direct payment.

There are administrative and other costs associated with this part of the proposal. In effect Centrelink would need to test eligibility not only for its own clients, but also for putative clients in the borderland between part-rate eligibility and the income breakeven points for the special rate scale.

However the magnitude of this task should not be overstated. These are the same people who would otherwise continue to receive a part-rate payment under existing tapers. The special tax scale ought to be regarded as really an extension of the welfare system, and worthy of attention in its own right as looking after the all-important work/social security interface.¹³

To summarise, the above issues with the separation option, while soluble, do illustrate the difficulties involved in having two different definitions of means in the tax and social security systems. The integration option, by contrast, has a single definition of means and therefore avoids the 'grey area' of people who are ineligible for social security, but not liable to tax. It follows that integration should be regarded as the most satisfactory long-run solution to these problems. Separation provides a good interim solution while leaving open the possibility of a more substantial integration of the two systems at a later stage.

4.4 Abolition of churning

'Churning' is the phenomenon whereby some beneficiaries also pay tax, and some taxpayers receive benefits. In economic terms churning may not be all that important. If we net out all tax transfers in a single negative or positive tax payment, the marginal incentives facing people will be unchanged. An extreme example is the choice between a demogrant, combined with a linear tax, compared to a NIT with the same level of guarantee and same linear tax rate. Government expenditure would be much lower under the NIT option, notwithstanding that all average and marginal tax rates would be unchanged.

Nonetheless the appearance, under systems which involve churning, that people are paying a lot of tax may be economically important. Economists tend to give perceptions much less importance in tax policy discussion than they perhaps deserve. For this reason it would appear desirable to avoid churning to the extent that it is administratively convenient.

Churning is not easy to measure accurately. The OECD measures churning in Australia as 6.5 per cent of private income — almost the lowest for the whole of the OECD area. This measure is based on the Household Expenditure Survey 1993-1994. For each decile of households, transfers are compared with direct taxes, and whichever is lower is then calculated as a percentage of private *income* in that decile (in fact the correctly weighted figure is 4.5 per cent (see Whiteford 1998). Using the same procedure, but calculating churning as a percentage of total *transfer expenditure*, rather than income, I find it to be almost one-third (32.5 per cent): some \$16 billion pa.

13 In the long term, the real solution here is to align the tax thresholds with the allowance cutouts, and have a high initial marginal rate (in order to quarantine the benefits to those with modest incomes). This approach, which in effect creates a categorical GMI, is outlined in the Section on Convergence.

This is a large over-estimate. In essence it assumes that there is one income unit in each decile. In fact each decile comprises a huge variety of different household types, including some which combine several income units. An accurate measure of churning would require the use of a full micro-simulation model, and compare direct taxes and transfers for individual income units. A fully comprehensive measure would also include indirect taxes and benefits. Further, even if churning could be entirely eliminated on a current income basis, there would still be churning as measured on an annual basis as beneficiaries move into the workforce and become taxpayers, and vice versa.

But the main point is that even if avoidable churning is, say, 7-10 per cent of total transfers, this corresponds to a huge dollar expenditure in the Federal budget: around \$4-5 billion annually. If this could be eliminated, there would be a large reduction in the apparent size of government. This may be of particular importance in an environment where the increase in indirect taxation will see a big rise in government transfer expenditure just to maintain the current real value of transfer benefits.

Churning is entirely avoided by the combination of full separation of basic benefits and of additional payments described in the previous section. Further, because the asset test operates over the whole of the payment system, the combined system is more effectively targeted than any of the other proposals in the paper.

4.5 Similarities with NIT and Keating/Lambert proposal

This scheme has many similarities with the Dawkins et al (1998a) scheme for a categorical GMI with a higher (60 per cent) tax rate on social security clients. It is also very similar to the Keating and Lambert (1998b) scheme for rationalising tapers on benefits and family payments. This scheme envisaged amalgamating all additional payments for children, rent and students (and possibly childcare) and tapering them sequentially at a common 30 per cent rate, thus avoiding overlapping tapers. It should really be regarded as an alternative means of implementation. However, it has several advantages compared to Keating and Lambert's plan and also the Dawkins *et al* modified (categorical) GMI, viz:

- Rather than EMTRs being a somewhat unpredictable outcome of tax interactions (in Keating and Lambert), they become a single designed rate.
- 'Churning' is abolished. Those who receive welfare transfers do not pay tax; those who pay tax do not receive transfers. This would result in a considerable reduction in the apparent level of government transfer spending.
- The system is very effectively targeted, since for those who receive net payments it relies on the social security definition of income, which is tighter than the tax one, and includes an asset test.¹⁴

4.6 Convergence: using separation to achieve a categorical GMI

The basic idea underlying the non-categorical GMI is that all those on similar low incomes are similarly in need of assistance. *Convergence* is a less extreme form of the same idea.

¹⁴ Note that this scheme would re-introduce an asset test for family payments, which was abolished with the introduction of Family Tax Benefit in the July 2000 new Tax System.

Convergence refers to the reduction in the gain from being in a categorical group as income rises. Achieving rapid convergence is one way of reducing the distortions brought about by categorisation, and thereby achieving better horizontal equity as between people on similar incomes. In general, a means-tested system like the Australian one achieves convergence at the benefit cutout points. The current system achieves fairly rapid convergence for allowees, but much less so for pensioners (the cutout point for a pensioner couple under the NTS is in excess of \$45,000 pa). My comments on convergence apply mainly to the workforce aged; in the case of age pensioners different considerations such as savings incentives apply.

Convergence can be maximised by: (a) abolishing free areas, (b) maximising benefit tapers and (c) minimising tax on non-categoricals with incomes less than cutout points. At the extreme this would imply having a 100 per cent taper on benefits, and setting tax thresholds equal to cutout points. Clearly, there is a trade-off between the objectives of rapid convergence, and those of work/saving incentives.

A less extreme form might have a taper of say 75 per cent, and tax thresholds correspondingly higher (\$15,371 pa, single, and \$25,147 pa, couple). This could be partly financed by an increase in the initial and second marginal tax rate, which (for revenue neutrality) would need to become something like 35 or 40 per cent. (Another financing option is increased indirect taxation.) In this manner the proposal for full separation can be made into a categorical GMI with a three-rate effective tax structure: eg. 75-35-50 per cent. Unlike the previous GMI proposal in Australia there would be no lower-tier GMI for non-categoricals, the high tax threshold serving the same purpose.

This proposal, to be fully effective, would require either a partial family unit tax system, or an increased spouse rebate — which would need to again become available to couples with children. Some will be horrified at the proposal for an increased spouse rebate or a partial family unit tax system. However it is a logical consequence of greater tax/social security integration. Currently the tax system is based predominantly (but not wholly) on the individual; the social security system mainly on the couple. Since an individual basis of entitlement is not possible in the social security system — it is not affordable¹⁵ — the two systems can only be made more compatible by moving the tax system at least partially towards a family basis. As suggested under the Section dealing with *Separation*, the spouse rebate could be clawed back with rising family income in the same manner as proposed for other special tax rebates, so that at higher income levels that tax system would revert to an individual basis.

One ameliorating feature is that, with more uniform tax rates, the differences between the two approaches become less significant. It should also be noted that the spouse rebate in this proposal is the exact analogy of the NIT payment for a spouse under the Dawkins *et al* proposal.

The nicest feature of this means of implementing a categorical GMI is that those outside of social security categorical groups, while not gaining access to a payment, would benefit from very substantial tax-free areas. This would greatly improve equity between those low-income earners with and those without categorical eligibility.

15 This is not strictly true. One could design, for example, a system of individual tax credits and a proportional tax (possibly involving supplements for those living alone). However, the tax credit for the second earner in any couple would be the de facto equivalent of the DSR, and has all the same distributional implications.

This proposal, while theoretically interesting, shares some of the drawbacks of the Dawkins *et al* and other NIT options. Because it is highly redistributive, it has the potential to have negative implications for work incentives and tax evasion. In other words convergence — horizontal equity — is achieved at the expense of efficiency.

This trade-off might, at least on the face of it, be ameliorated by use of heavier indirect taxation. But ultimately, indirect taxes are just as much a part of the tax ‘wedge’ as direct taxes. Marginal incentives ought really be measured by reference to both the direct and indirect tax systems. It follows that a strategy of increasing indirect taxes only reduces EMTRs by virtue of the partial and incomplete way in which these are measured in our conventional tax/benefit models, which confine themselves to direct taxes (as used in Discussion Paper 423 (Paper 1 of this set)). Ultimately, in assessing the utility of tax mix changes, one confronts the same trade-offs that characterise the optimal tax/taper problem.

The same effect as an increase in indirect taxation could be implemented directly by a continuation of a low income tax rate coinciding with the taper range – in other words, pretty much what we have now, with a lowered rate for couples as proposed below. However the tax mix change option has two advantages:

- the (direct) tax/benefit system starts to look more logical
- heavier use of indirect taxation may help lower the *perceived* burden of taxation, and perceptions are not unimportant in peoples’ behavioural responses to taxation.

A program of tax threshold and bracket increase on a family unit basis provides one solution to problems of social security and tax integration. Certainly it might provide a neater solution than the use of *ad hoc* devices such as the Earned Income Tax Credit (EITC), although one advantage of the EITC is that — at least on the US model — it introduces a form of family unit taxation.¹⁶

A disadvantage of raising tax thresholds and marginal rates together is that any gradual process will actually *exacerbate* high EMTR problems for allowees on the run-out of the allowance taper. Only if the tax thresholds are completely aligned with the allowance cut-outs is this problem avoided. It follows that any gradualist program of change needs to focus on the family unit issue, with priority to be given to the combined income range where really high EMTRs occur: \$20,000 pa to \$29,000 pa. Specifically, for couples, the 17 per cent tax bracket could be extended from \$20,000 pa to \$29,000 pa, providing tax reductions for the couple of up to \$1170 pa (\$22.50 a week). This would provide interim relief from EMTR problems, pending more substantial structural change.

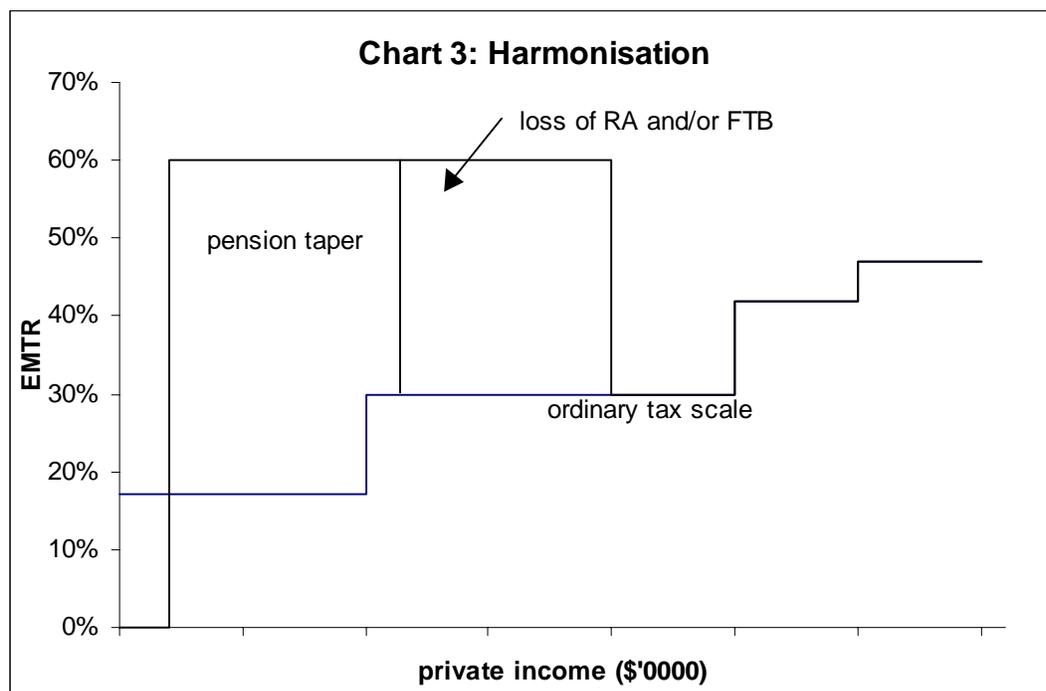
Ultimately a categorical NIT based on *full separation* of tax and social security and reform of the income tax rate structure to reduce income taxes on low-income *families*, would be the preferred medium-term model for reform.

5 HARMONISATION

In some ways this is the easiest of the four main reform options considered here, being less of a departure from current arrangements than either full integration or full separation. In essence,

¹⁶ For a discussion of EITC issues see Ingles 2000 and Ingles and Oliver (1999).

pension tapers and tax would continue to operate as at present, but they would be coordinated in such a way that the combined withdrawal rate comprised a rational whole (see Chart 3).



It should be noted that harmonisation is not as well targeted as full separation. The reason is that the pension means test, with its broader base, does all the initial work under the separation option, whereas it combines with the tax system under the harmonisation option. Further, harmonisation is administratively more cumbersome. That said, harmonisation might be an acceptable second best. The reform options discussed in Part 1 of this set (Discussion Paper 423) are all forms of harmonisation.

6 CONCLUSION

The proposals contained herein indicate that a large smorgasbord of options exist for rationalising tax and social security interactions. It is important that they be rationalised, because the current system doesn't always make a lot of economic sense and in all likelihood has profound implications on incentive to work and save for some, perhaps many, people. However, the 'iron law' of income redistribution is such that rationalisation will involve some very hard decisions.

The basic problem is that peaks in EMTR schedules can only be levelled by imposing higher EMTRs in income ranges and on taxpayers whose EMTRs are currently low. Moreover, the lower the income ranges where EMTRs are being 'levelled up', the more effective is this process. Moreover, horizontal equity and the aim of convergence require that average tax rates not be increased (and preferably fall) for those not categorically eligible for any payment, yet below the cutout points.

The Government's NTS Package achieves substantial benefits in relation to EMTRs for many low income (and some high income) families, and for pensioners. However considerable problems will remain, which, while they can be addressed in part by further incremental reform, preferably should be redressed through broad systemic change. While Keating and Lambert have put forward one possibility, and Dawkins et al another, it is argued here that the preferred system would be one not too greatly different to the modified GMI set out in this Paper, based on *full separation* of tax and social security basic payments, combined with dramatic increases in tax thresholds — to the allowance cutouts — and (unavoidably) in the initial and second marginal rates.

If this system were thought to involve too severe an increase in the effective progressivity of the tax system, this could be mitigated by either retaining a low rate of income taxation on incomes below the cutouts (utilising a family income unit to achieve this) or by an increase in the relative weight of indirect taxation, utilising the GST, recognising that the latter option is not one currently favoured by either political party.

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