Australia’s future tax system

Report to the Treasurer

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Part Two
Detailed analysis

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E. Enhancing social and market outcomes

Key points

Not all taxes should be imposed primarily to raise revenue. Sometimes governments intervene in markets to achieve more efficient or equitable outcomes. In the case of goods or services provided by government, direct user charging rather than taxpayer funding can lead to more efficient outcomes. Taxes can also be used to influence the prices faced by the consumers or producers of particular goods or services.

Markets generally allocate resources to their highest value use. But markets do not always arrive at the prices that are best for society. Individuals might make decisions based on their own private interests — including the prices they pay — but fail to take into account costs that spill over onto others. An example is traffic congestion — where motorists will often choose the quickest route for themselves, but not consider the impact of their decisions on overall levels of congestion.

Tax can sometimes be used as a tool to align private incentives with social incentives. If a socially costly activity becomes more expensive because of the tax, the level of that activity generally falls. But not all market failures or spillover costs can be effectively addressed using a tax. Sometimes other approaches, like better defined or enforced property rights, would have better outcomes. In other cases, the lack of information needed to ensure the tax rate is efficient, or the cost of getting it, may limit the usefulness of the tax.

Improving the efficiency of markets

The most efficient way of financing some government-provided goods or services is not to tax at all, but rather to charge users a price that reflects the avoidable cost of providing the good or service. The practicality of user charging partly depends on the degree to which those who are not willing to pay can be excluded from receiving the benefit. This may change over time as new property rights are clarified or new technology becomes available to cheaply restrict access or monitor use. The circumstances in which user charging is appropriate are discussed in Section E1 User charging.

Where direct user charging is not possible, tax can sometimes be used as a tool to improve efficiency, if it can more closely align the price of an activity to the individual with the cost of the activity to society (that is, the social cost). Private costs may deviate from social costs as a result of unpriced spillovers (sometimes called externalities). A spillover occurs when a person's actions impose involuntary costs (or benefits) on others. That is, in addition to the private costs and benefits that accrue to the decision-maker, some costs and benefits can 'spill over' on to others. By imposing taxes that reflect the spillover costs, it is sometimes possible to bring the private cost of the activity (which now includes a tax) closer to the social cost (which counts costs and benefits to everybody). Such taxes give people incentives to make better decisions — about when and where to drive, how much alcohol to consume or whether or not to smoke tobacco (see Box E–1: Where tax avoidance is good for society).

Box E–1: Where tax avoidance is good for society

Many taxpayers are happy to contribute their fair share to society, but almost everyone faces incentives to pay less tax. Tax administrators are constantly identifying schemes, loopholes and arrangements that people use to reduce their tax liability. Governments are constantly responding to this by amending the tax law — often making it more complicated and costly for compliant taxpayers.

But there are some taxes that the government wants you to avoid — for example, you can minimise alcohol tax or tobacco excise by drinking less or quitting smoking. Sometimes the government even helps you to do this. For example, government subsidies to help people quit smoking help people avoid tax. Here, the health of Australians is more important than the tax they pay.

A congestion tax works in the same way. People would reduce or avoid it by sharing rides to work, cutting down on unnecessary trips, and using public transport where possible. The government might also help by building additional rail lines or putting on extra buses for otherwise car-dependent communities.

Some trips at busy times will still depend on cars — for these drivers, the tax would be unavoidable. But they should benefit from faster, more reliable trips, as some of those who do have the chance to avoid the congestion tax are no longer on the road. For example, a tradesperson would spend less time in a van, and more time on paying jobs.

While it is easy to identify many activities with spillover costs, a tax will only be an efficient instrument to deal with them if the marginal spillover cost of the activity can be estimated. A tax that recovers the total spillover costs of an activity from those who cause the harm might be seen as equitable (such as a tax imposed under the polluter-pays principle), but it is only efficient if it provides incentives to improve behaviour. If the costs are high but uneven, other instruments such as regulations may be more appropriate (see Box E–2: A fat tax?)

For example, a tax on drinkers to cover the full spillover costs of alcohol abuse may be seen as equitable, but to be efficient it also needs to encourage drinkers to cut down on levels of drinking that do more harm than good to society.

Box E–2: A fat tax?

The National Preventative Health Taskforce (2009, p. 104) has called on the Australian Government to conduct research into policies and tax incentives that would promote the production, access to and consumption of healthier foods. However, this would not be a simple case of imposing a per unit tax on fat, sugar or salt in food.

While obesity does involve significant health and productivity costs, the relationship between these costs and the consumption of particular products is complex. The risk of obesity is affected by lifestyle, such as diet and physical activity, as well as inherited and social influences.

This makes it very difficult to estimate spillover costs, if any, of identifiable foods or food types. In addition, any quantifiable health benefits of imposing the tax would need to be weighed against the loss to those people who are at low risk.

For reasons of practicality, a tax is usually applied only on inputs to the behaviour (an easily measurable commodity) rather than the amount of the spillover cost itself. The less closely related the taxed input is to the spillover cost, the less efficient the tax will be in creating incentives to reduce the costs. For example, taxing petrol to reduce urban congestion is not particularly effective, even though fuel is used in cars that contribute to congestion. New technology might allow better measurement or targeting of spillover costs.

Market-correcting taxes do not provide a 'free lunch' or costless revenue for the government. Taxes that cannot directly target spillovers will also impact on and reduce activity that does not give rise to spillovers. For example, a tax on alcohol reduces the spillover costs from abusive consumption, but it also reduces the level of consumption and satisfaction of non-abusive consumers. In determining the net benefits of the tax, governments should consider these broader effects.

Unpriced spillover costs are prevalent in the areas of the environment (see Section E2 Taxes to improve the environment), road transport (see Section E3 Road transport taxes), alcohol (see Section E5 Alcohol taxation) and tobacco (see Section E6 Tobacco taxation).

Improving individual welfare

As well as addressing spillover costs on other people, governments sometimes seek to influence people's choices for the purpose of improving their individual long-term wellbeing. This is particularly the case for people with reduced capacity, possibly through reason of age or addiction, to make and execute decisions consistent with their long-term wellbeing.

Addiction is a complex phenomenon, which involves, among other things, highly compulsive use, use despite harmful effects, relapse following abstinence, and cravings (Collins & Lapsley 2008b, p. 10). These effects mean that particularly addictive goods can impair the capacity of individuals to weigh their immediate choices against future consequences. Some goods and services, including alcohol, tobacco and gambling, can be highly addictive for some consumers (see Box E–3: Comparing three potentially harmful and addictive commodities).

Governments use many tools to influence choices, including public education, direct interventions in behaviour, product regulation, product bans and taxation. These interventions have different effects both on the consumption opportunities of individuals, and on their chances of living lives that they value.

Taxation has the potential to improve people's long-term wellbeing if it provides a price signal that reflects the potential for future harm and possible addiction. People may consume a product excessively if they lack information to assess its harmful properties or if they underestimate the difficulty of giving up an addictive good. A tax can bring these costs forward to the present and potentially prevent a pattern of addiction. But, for a tax to be appropriate, the costs and addictiveness of a particular commodity, and the tendency for people to over-consume it, would have to be both well-understood and be broadly uniform across different individuals.

Non-tax regulations to address these problems can also restrict competition, and therefore create economic rent for suppliers of these goods. Taxation might be capable of capturing this rent.

Box E–3: Comparing three potentially harmful and addictive commodities

Alcohol, tobacco and gambling have different consumption patterns and different effects on their users. The proportion of the population that uses these commodities, uses them at risky levels, and suffers significant damage as the result of using them, varies widely from commodity to commodity. In particular:

- Around 83 per cent of Australians aged over 14 consume some alcohol; around 20 per cent sometimes place themselves at risky or high-risk levels of short-term harm, and around 10 per cent place themselves at risky or high-risk levels of long-term harm (AIHW 2007, p. 37). Surveys from the United States suggest that the top 2.5 per cent of drinkers account for around a quarter of alcohol consumed (Greenfield & Rogers 1999).

- Around 19 per cent of Australians aged over 14 smoke tobacco (at least occasionally); of whom around 86 per cent smoke daily (AIHW 2007, p. 25). A long-term study of smokers in the United Kingdom found that 'about half of persistent cigarette smokers would eventually be killed by their habit' (Doll et al. 2004).

- Around 15 per cent of adults gamble regularly, excluding lotteries and scratchies. Of these, roughly one in ten are problem gamblers, who are responsible for a large share of player loss (Productivity Commission 2009a, p. 4.1).

The taxation of such commodities is a complex area, both theoretically and practically. While prices and taxes undoubtedly influence aggregate patterns of consumption — potentially improving the wellbeing of some — they are not well suited to deal with extraordinary forms of human behaviour, and in complex situations can give rise to adverse, unintended consequences. The impact may often fall on the most vulnerable members of the community for whom direct and personal intervention, rather than population-level treatment, is most appropriate.

The appropriateness and efficacy of taxes on alcohol, tobacco and gambling are considered in Sections E5, E6, and E7 respectively.

Equity and compensation for specific taxes

Taxes that are designed to achieve specific social or market outcomes depend on creating incentives for people to adjust their behaviour. They are typically designed without reference to distributive effects, as attempts to shield one group from the effect of the tax means that the spillover costs continue to be borne by another group.

The distributional consequences of market-correcting taxes must, of course, be taken into account. In many cases, it may be judged desirable to compensate affected groups for the loss of purchasing power. However, this should be done using the most appropriate tool. The personal tax and transfer system is generally the most effective way of redistributing income through society, and therefore will often be an appropriate way to compensate taxpayers and transfer recipients for increased taxation on specific goods and services to reduce the costs of market failures.

In other cases, specific compensation to particular groups might be provided by way of specific outlays — for example, additional investment in public transport infrastructure in specific locations may provide a geographically targeted form of compensation for congestion charges.

Another equity-based argument for taxing specific commodities is that the social costs of an activity that harms some people should be borne by those who engage in the activity rather than those who do not. This is essentially an argument based on transferring some of the responsibility for harm to all users of a commodity.

For example, society permits smoking, but arguably requires that smokers collectively must meet the social costs (such as public health costs) that arise, even though not every smoker will ultimately impose those costs. There is also an equity argument that non-smokers should bear some of their own costs. Such arguments operate independently of efficiency considerations, and the scope of their application relies on social and political judgments.

While the main purpose of the taxes and charges discussed in this section should be to align social and private incentives — fundamentally an efficiency purpose — equity arguments are influential in the design of some taxes, particularly those colloquially referred to as 'sin' taxes.

Ensuring sustainability

The rates of taxes designed to improve market allocations should be set by reference to marginal spillover costs, not a revenue target. When a tax is used as an instrument of regulation, its goal is to change relative prices faced by producers and consumers, not to fund specific spending programs.

However, because the tax necessarily raises revenue, there may also be a perceived conflict between the revenue-raising potential of taxation, and the desire to improve market outcomes. This can make it hard for governments to introduce such taxes, or to keep the tax rate close to an efficient level (in the case of congestion, for example). For this reason, institutional arrangements to monitor spillover costs and systematically monitor taxes in this area are essential (see Section G5 Monitoring and reporting on the system).

While this Report concentrates on taxation, it is only one policy instrument available to governments. The appropriateness of taxation should be assessed in the context of the costs and benefits of other, potentially more targeted forms of both supply-side and demand-side regulation, public information and specific spending programs.

Principle

Taxes on specific goods and services can be used to influence relative prices faced by consumers, in order to address spillover costs, or self-control problems related to highly harmful and addictive goods and services.

E1. User charging

Key points

Public goods should generally be funded from broad-based taxes. However, user charging can be an efficient means of financing some government-provided goods and services and of rationing individual access to community resources.

For user charging to be efficient, the user needs to be charged the cost that consuming the good or service imposes on others. This cost will often be what a well-functioning market would charge, but might need to be higher or lower depending on whether there are wider social costs or benefits.

Australian governments do not employ user charging as much as they should, particularly for natural resources. User charging should generally not be used to fund public goods, as users do not directly impose costs on others.

If it is possible to exclude some people from access to a public good, there is potential for it to be financed by a tax set by the direct beneficiaries (such as many agricultural levies). Importantly, this provides a means for the beneficiaries to reveal how much they value the public good.

Taxes and regulations can also be used to correct for spillover costs. Regulatory costs should be recovered from those who are best able to reduce the social costs the regulation is targeting. This will often, but not always, be those who impose on others the costs that lead to the need for regulation.

E1–1 User charging and taxation

Tax revenue is described by the Australian Bureau of Statistics as 'revenue arising from compulsory levies imposed by government. There is usually no clear and direct link between payment of taxes and the provision of goods and services …' (ABS 2005a). In contrast, user charges are voluntary and requited (that is, the person who pays the charges gets something specific in return). In many cases, the distinction is easy to see. Most people would see that there is no direct link between paying income tax and an entitlement to public health and education services. In other cases, the distinction is less clear. For example, while paying a congestion toll means that a driver can drive on a less congested road, many people would value the time they save less than the fee they have paid, even though society as a whole is better off. A congestion toll therefore combines elements of user charge (the benefit of the time saving to the payer) and tax (the benefit to others). See Section E3 (Road transport taxes) for more detail on congestion charging.

The distinction between user charges and taxation is important because user charges tend to provide positive work and saving incentives, while taxes do not. Further, user charges represent voluntary exchanges, while taxes rely on the coercive powers of the government.

Making transparent the distinction between taxes and user charges is therefore important if citizens are to be able to hold their governments accountable.

What probably matters most, however, is whether the government is reflecting the social costs and benefits of the goods and services it is providing when it sets prices, regardless of whether the revenue raised through those prices is classified as tax revenue or user charges.

The Australian and State governments also levy a number of minor taxes. Many apply to narrow bases and are motivated by specific social or industry policy objectives. Many appear to have been introduced as 'user charges' for government-provided goods or services, although in some cases it is not at all clear that they do function as such. This section sets out a framework for assessing user charging arrangements and minor taxes that may appear to function like user charges. Section E8 (Rationalising other taxes) addresses insurance taxes, luxury car tax, tariffs and minor taxes specifically.

What is efficient pricing of government-supplied goods and services?

The key criteria for determining how to price government-supplied goods or services efficiently are:

- rivalry — that is, the extent to which consumption by one person affects the consumption opportunities of others; and
- excludability — that is, whether people can feasibly be prevented from enjoying the goods and services in question.

For example, it is currently not feasible to charge a car for driving on a remote country road (that is, it is not excludable), and such a trip would generally not affect anyone else's ability to use the road (that is, it is non-rivalrous). Many country roads therefore have the attributes of a 'public good'. However, cars compete for road space in the central business district of a large city during peak hours. The presence of congestion, as well as available tolling technologies, reduces the 'publicness' of some roads (see Section E3 Road transport taxes). Different goods (and services) can be categorised according to their degree of rivalry and excludability.

- Public goods, such as national security, are both non-rivalrous — access by one person to the benefits of national security does not diminish the benefits to other people — and non-excludable — it is not possible to exclude anyone in the country from the benefits of national security. Thus, these cannot be charged for and should be funded out of taxes.
- Club goods, such as a suburban swimming pool, are non-rivalrous — there is enough space for everyone to enjoy the pool (except on very hot days) — but excludable — you need a ticket to enter.
- Common pool goods, such as fishing grounds, are rivalrous — past a certain point, an additional fisher reduces the fish available to others — but may be non-excludable for various reasons, for example, if it is unclear who owns the property rights.
- Private goods, such as apples, are both rivalrous (only one person can eat a particular apple) and excludable (the owner of an apple can prevent others from eating it).

In general, markets will price private goods appropriately — sellers and buyers have incentives to reveal how much they value them. If they do not reveal their preferences, their competitors will get more business or other consumers will buy the goods and services instead.

Governments sometimes choose to finance the provision of private goods, such as electricity or postal services. (The term 'private' here does not refer to whether a company or government is the supplier, but the physical qualities of rivalry and excludability.) They may do so for many reasons, such as a community concern that people should consume more (or less) of a particular product than they would if left to the market, or that particular markets are unfair because their operation makes it impossible for people to develop the capabilities they need. Sometimes governments may be concerned about businesses making excess profits from undue market power. At others times, the provision of private goods may be a legacy of historical factors.

Providing public goods is a core function of government, mainly because markets tend to fail — sometimes dismally — to supply sufficient amounts of public goods. Markets undersupply public goods because people have an incentive to hide how much they value them in the hope others will pay for them — this is known as the 'free rider' problem. For example, if a single voter is asked to contribute to defence spending, they would have an incentive to under-report their own valuation of defence, knowing that if they pay for some defence the benefit would be shared with 22 million other Australians. Individual voters can free ride on payments for defence made by other people. In contrast, if the voter buys an apple they know that they will get all the benefit and will not be obliged to share it with others. People cannot free ride on the purchase of apples by others.

When a good or service is non-rivalrous there can be significant social benefits from some form of co-operative collective decision making about how much should be produced. This is because when a non-rivalrous good is produced, everyone can benefit from it at no cost. When a good or service is non-excludable, individuals have incentives to act individually and unco-operatively. Each person is tempted to exploit the commons for their own direct wants and needs.

Governments therefore have a clear role in financing the provision of public goods. They should generally not charge for public goods because, as they are non-rivalrous, it would be wasteful to discourage someone who wants a public good from accessing it.

In some cases, the appropriate pricing regime is not easy to determine because very similar goods and services may call for significantly different prices. For example, the Australian Bureau of Statistics (ABS) provides statistical releases on the internet at no charge. This information has some of the characteristics of a public good. Charging for access to the data would mean some people who value it would not use it, even though there is no material cost to the ABS (and the taxpayer) once the data is compiled.

In contrast, users who want the same information in book form do need to pay a user charge. Only a limited number of people can read a book at one time, making it rivalrous in consumption. Charging for the (marginal) cost of providing the book encourages people to reveal how much they value it, as well as providing the ABS with information on how many to print. This means the book goes to those who value it most and the right amount of resources is more likely to be devoted to supplying it. Importantly, as well as sending signals about value to producers and consumers, user charging relieves the need for the book to be financed from revenue collected through other economically inefficient taxes.

A simple categorisation is illustrated in Chart E1–1, with a suggested funding mechanism for each type of good or service.

Chart E1–1: Funding public goods

	Rival in consumption	Non-rival in consumption
Excludable	**Private good** e.g. apples [user charge]	**Club good** e.g. agricultural levies [beneficiary taxation]
Non-excludable	**Common pool resource** e.g. fisheries, forests [user charge]	**Public good** e.g. national defence [general tax or corrective tax/regulation]

Of course, this is only a starting point for setting prices for government goods and services. Many goods have 'mixed' attributes that make efficient pricing difficult. A country road is close to a public good, whereas when it branches off to a specific farmhouse it becomes more like a private good. A local road system has the attributes of a club good, whereas when it becomes congested it is more like a common pool resource. This means that the ability to appropriately price goods is often limited by transaction costs, such as the costs of pricing technology or other administrative costs. Policy makers need to consider the costs of collecting and enforcing user charges or narrowly based taxes. It is unlikely to be worth the trouble or cost to set up congestion pricing system on a country road. This means charges may not fully reflect their marginal (social) cost — all drivers are charged the same price. Businesses make such decisions all the time. For example, some insurers have only recently moved to charging drivers premiums based on their actual mileage even though this is a relevant indicator of the chance of a claim. Those insurers that are not offering such a policy have effectively made the decision that it is too costly to remove existing cross-subsidises from short to long distance customers.

When such decisions reflect commercial choices, resources are likely to be allocated efficiently. However, governments sometimes make these decisions for equity or other reasons. For example, some States charge compulsory third party motor vehicle insurance without reference to actuarial risks, implying significant transfers between drivers unrelated to reducing transaction costs. There may also be 'second-best' reasons why full optimal pricing may not be appropriate. Sometimes problems in other markets influence the ability to set prices for some goods and services. For example, public transport may need to be subsidised so long as roads continue to be provided 'free' to users. Another example is a waste disposal fee that needs to be set with reference to the risk of illegal dumping.

Governments may also have other social objectives (apart from efficiency) for setting prices, such as a desire to provide merit goods or achieve equity objectives by helping people to develop the capabilities they need (see Box E1–1). Whenever prices are set for any but commercial reasons, the purpose and value of implied transfers should be transparent to the community.

Box E1–1: User charging in Australia's health care system

While most government-provided health care is free to users, some parts of the system do have some form of user charging. For example, the Australian government requires people to make a co-payment for pharmaceuticals under the Pharmaceutical Benefits Scheme, and the States charge for some services, such as ambulance transport. Individuals and families may also pay user charges to non-government health care providers; for example, by paying for a private hospital visit or for private health insurance, although these premiums may be subsidised.

A mixture of charging arrangements is appropriate as health care can be considered to be a public, private or merit good. Charging for a public good, such as medical research, is often not efficient as it is not possible to exclude people from benefiting and the benefits provided are generally not constrained by the number of people receiving them. Charging for private goods — such as a private room in hospital — can support the efficient supply of health care by ensuring that the services provided respond to the price people are prepared to pay. However, even though some goods may appear to have private benefits, certain types of health care, such as child health, can also be considered a merit good that people should be able to obtain regardless of their personal preference or ability to pay. For example, full user charging may not be appropriate where health care generates spillover benefits, or where user charges may restrict access to goods and services deemed important for public policy reasons, or where they would impose high costs on those with high needs.

Where full user charging is not appropriate, partial charging (such as co-payments), safety nets and direct government transfers can also play a role in supporting access to health care services. While these mechanisms deliver a weaker price signal than full user charging, the value of these arrangements is that they still provide a price signal to users but are less of a barrier to access and also protect people from high health care costs.

E1–2 User charging for common pool resources

Another reason why it is difficult to determine how to price many government goods and services is that the same good can be partly private and partly public. In particular, many natural resources are 'common pool'; that is, they provide common benefits to everyone, but unless potential users can be excluded, individuals have an incentive to over-exploit them.

Common pool resources — such as fisheries, underground water and forests — include a range of environmental assets managed by the government on behalf of current and future Australians (see Section E2 Taxes to improve the environment). Without government intervention, individuals may use such assets without taking into account the fact that by doing so they reduce other people's access to them. This can result in a 'tragedy of the commons', where assets are over-exploited and may, in the worst cases, disappear altogether.

Such problems can be addressed by creating property rights over the 'commons'. This relies both on the availability of technology to exclude users and on the community allowing the imposition of a charge for what it previously considered 'free'. A property right enables its owner to exclude users and charge them for any use that reduces the value of the resource.

Set properly, the right will internalise any spillover costs so the owner has an incentive to maintain the environmental value. This has been a common solution to many current environmental problems — such as the over-exploitation of northern fisheries and water in the Murray-Darling Basin, possibly because it often provides existing users with a share of the asset, satisfying community expectations of fairness.

Alternatively, governments can maintain ownership of community resources and impose regulatory fees or charges to ration their use. Setting the optimal price can be difficult because the marginal social cost may not always be apparent (see Box E1–2).

Box E1–2: Broadcasting licence fees

The radio spectrum is an example of a common pool resource — without some form of regulation, individuals would have an incentive to congest the airwaves, reducing the benefit to society overall.

Broadcasting licence fees charge broadcasters for access to the bands of the radio communication spectrum that are primarily used for commercial television and radio services. Legislative restrictions on the number of licences made available also create large economic rents for the small number of licensees. Licence fees are imposed as a means of charging for access to the spectrum and recouping the rents. In 2008–09, approximately $311 million was collected in fees: $287 million from 55 television licences and $24 million from 273 radio licences (ACMA 2009).

Licence fees are based on a percentage of gross earnings from broadcasting advertisements, calculated in accordance with an increasing scale under which the ratio of fee to earnings rises with earnings.[1] There is, however, no clear link between the fee and either the amount of spectrum that is being provided or the economic rents accruing to the licensee. Other users of spectrum pay fees for the right to use spectrum via auctions or annual taxes based on the amount of spectrum used.

The current broadcasting spectrum licence fees are unlikely to reflect the opportunity cost of spectrum and could be leaving significant economic rents to licence recipients. Charging broadcasters a fee based on spectrum use (possibly through an auction) would bring them into line with other commercial spectrum users and would encourage more efficient use of the spectrum.

Charges are particularly important for natural resource management. An environmental 'user charge' reflects the costs that individuals impose on others by exploiting common pool resources. Importantly, the user charge should not reflect the free market price. That would simply replace failing market prices with failing government user charges. For example, governments should not sell their forest timber at prices set by markets in which timber is over-exploited due to the 'tragedy of the commons'. Rather, the price should reflect the market value given sustainable management of the common pool resource.

One way to think of it is that the appropriate user charge would be similar to the price that owners with secure property rights, such as a single profit-seeking owner of the whole resource, might charge even if they were unconcerned with any environmental benefits to

1 Section 6 of the *Television Licence Fees Act 1964* provides details of the methodology for calculating licence fees.

the wider community. In such circumstances, the monopolist (including a possible government owner) would have an incentive to maintain the sustainability of the natural resource and would charge accordingly. This should be the minimum value that Australians expect to receive for the sale of such resources (see Box E1–3).

Of course, even a price that reflects a sustainable timber yield may not reflect the full social value of timber. To the extent that there are wider public benefits from protecting some natural resources more than others, additional taxes, regulation or subsidies are likely to be needed. For example, some forest habitats may have particularly important ecosystems that make them particularly valuable to the wider society.

A sustainable system of taxes and charges should ensure that decisions to harvest native flora and fauna are informed by the environmental and social costs that harvesting can cause. In regulating harvesting activities, it is important for governments to assume that these costs are not negligible. At a minimum, governments should ensure that harvesting does not threaten biodiversity. A socially optimal level of harvesting could be delivered through a pricing structure that appropriately reflects environmental and social value.

Past governments have failed to charge appropriately for the private harvesting of flora and fauna. This has encouraged an unsustainable rate of harvesting, which has led to many species becoming vulnerable, endangered or extinct. In some cases, governments have even charged a negative price through the provision of bounties. For example, bounties were paid on 2,184 thylacines (Tasmanian tigers) prior to the species' extinction. In New South Wales, the bounties paid on more than half a million brush-tailed rock wallabies from 1884 to 1914 have contributed to the species' current listing as vulnerable. Intensive hunting by fur traders of the yellow-footed rock wallaby in South Australia in the 19th century is another example of species overexploitation that could have been avoided through the setting of an appropriate price (DEWHA 2009).

The absence of an appropriate pricing structure has enabled commercial activities to be conducted at an unsustainable rate. For example, commercial harvesting of the *cycas megacarpa* (a native Queensland cycad) for its starch has contributed to the plant becoming an endangered species (DEWHA 2009). Similarly, while concentrated commercial fishing of orange roughy began only in the late 1980s, it was harvested at an unsustainable rate. It took less than 20 years for it to become the first commercially harvested fish to be listed under the *Environment Protection and Biodiversity Conservation Act 1999* (DEWHA 2007).

Box E1–3: Does Forestry Tasmania charge users of forests appropriately?

Tasmanian forests have important social and environmental value for all Australians. Forestry Tasmania is a State-owned enterprise, managing around 1.5 million hectares of forests for commercial, recreational and sustainability purposes.

The financial returns of Forestry Tasmania have been consistently below the risk-free rate of return (Productivity Commission 2006b and 2007).[2] This is difficult to reconcile with the fact that it is largely a monopoly supplier of timber, but probably reflects the strong industry focus in how it harvests and prices timber.

Forestry Tasmania harvests its forests according to a sustained yield forest management technique designed to yield the maximum annual volume of wood from a forest in perpetuity. This may have some poor outcomes for the environment, including:

- forests with negative net returns are harvested along with forests with positive returns, as little account is taken of the market price of the timber or its social value;
- harvesting a constant amount of timber each year can lead to inefficiencies, as markets are constantly changing, with prices changing frequently. As a result, social returns may be higher overall if more trees were cut down in high price periods and fewer in low price periods; and
- it may lead to a greater loss of environmental values than under alternative models of forest management as some age classes of wood, especially old growth timber, may be harvested more quickly (Moran et al. 1991, pp. 110–111).

The pricing of the timber may also reflect commercial, over more sustainable, objectives.

The conventional technique used to price native timber in Australia is the residual value pricing method (Marsden Jacob Associates 2001). This disregards the actual price of timber and instead estimates a derived demand for a timber mill by subtracting ‘reasonable’ costs from the prevailing market price, including an allowance for ‘normal’ profit. Generally, sawmills and chippers receive the same margin for each tree, regardless of the fluctuations in the market price or variances in costs between trees. The residual value method means that if prices are low, native timber can be sold at a price below its cost of ‘production’. This underpricing of timber increases the rate at which native forests are logged, especially in remote areas (Marsden Jacob Associates 2001). Further, prices are generally determined through closed-door bilateral negotiations, and the public is not told what the forest (a public asset) is being sold for. This lack of transparency makes it hard for the public to determine whether they are obtaining an adequate rate of return on timber from the native forest.

Moreover, the residual value method implicitly attaches a zero value to any environmental amenity associated with the forest. If the world price of pulp is sufficiently low, even a 500 year old tree will be sold for nothing — whatever environmental amenity it might be yielding.

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2 The 10-year Australian Government bond rate is widely used as the risk-free return benchmark. The average rate of return on 10-year Australian Government bonds in 2005–06 was 5.4 per cent (Productivity Commission 2007).

Principles

Users of rivalrous goods and services should be charged a price that reflects the value from denying the consumption to others. In many cases, this will reflect the market price.

Governments should presume that all native flora and fauna, for which they are custodian, have a positive environmental value. A sufficiently high price should be charged to those authorised to harvest native flora or fauna, to ensure that the rate of exploitation does not exceed what is socially optimal.

User charging means producers are more likely to supply, and consumers more likely to value, the good or service appropriately.

Importantly, user charging relieves the need for publicly provided private goods to be funded by taxes, which are distortionary.

If governments wish to intervene in markets where there are wider social benefits (or costs) from using particular goods or services — for example, where the goods or services help people develop the capabilities they need — they should use transparent mechanisms such as subsidies or taxes.

The size and purpose of cross-subsidies within user charges — apart from those that reduce transaction costs — should be transparent to the community.

E1–3 Charging for club goods can reveal how much people value them

'Club goods' are a special type of non-rivalrous, but excludable good which can often be provided in markets. All you need to make television excludable is a scrambler and coaxial cable. By charging for an inherently non–rivalrous good — one person watching does not reduce the ability of others to watch — such goods can be left to markets. Other goods may be excludable because their spillover effects are geographically limited, so only those who live in the immediate region benefit from the spending. This is one of the arguments for levying council rates on land (see Section G3 Local government). Governments can assist in the provision of club goods by allowing the imposition of compulsory fees on certain groups, with the rate set by the beneficiaries from the spending. In effect, the tax provides a signal for how much of a local public good is demanded. These arrangements are relatively prevalent in agriculture due to the organised nature of producers and limited spillovers between industries.

Agricultural levies

The Australian government imposes a large number of agricultural levies — 66 at December 2008 (see Table E1–1). Most of these taxes are imposed at a particular rate per unit of production. For example, cherry production is taxed at $0.07 per kilo and exported buffalo are taxed at $4.60 per head. Some important goods, however, are taxed at a particular percentage of value, including wheat, vegetables, wool, exported wine, barley, oats and legumes. The levies are administered by the Department of Agriculture, Fisheries and Forestry.

In total, agricultural levies raised $594 million in 2007–08. These levies are typically charged at very low rates, resulting in very low revenue collection — 33 of these taxes collect, in total, less than $1 million per year. The administration costs of collecting the smaller levies can be very high. At the highest end, the collection costs of the Queen Bee Levy amounted to 38 per cent of the revenue collected by it, while the collection cost of a number of levies was less than 1 per cent of the revenue (Levies Revenue Service 2008).

Table E1–1: Agricultural levies

Levy	Collections 2007–08 ($m)	Levy (continued)	Collections 2007–08 ($m) (continued)
Beef production	9.44	Apple and pear	4.96
Buffalo slaughter	0.02	Avocado	3.37
Cattle transaction	70.29	Cherry	0.50
Deer	0.06	Chestnut	0.05
Goat fibre	0.02	Citrus	1.69
Goat slaughter	0.07	Custard apple	0.08
Goat transaction	0.48	Dried fruits	0.35
Live animal export	4.38	Honey	0.46
Live animal export recovery	0.33	Lychee	0.19
Livestock slaughter	3.40	Macadamia	3.51
Livestock transaction	34.62	Mango	0.85
Pig slaughter	13.36	Mushrooms	2.11
Wool	45.10	Nashi	0.09
Egg promotion	3.40	Nursery products	1.93
Laying chicken	0.90	Onions	0.39
Meat chicken	1.39	Papaya	0.20
Coarse grains	26.18	Passionfruit	0.08
Cotton research	1.99	Persimmons	0.10
Grain legumes	4.73	Potato	1.00
Oilseeds	6.33	Rubus	0.05
Pasture seeds	0.15	Stone fruit	0.96
Rice	0.50	Strawberry	0.49
Sugar cane research	4.82	Table grapes	1.02
Sugar reform	0.01	Turf	0.54
Wheat	41.34	Vegetable	6.34
Wheat export	1.52	AFMA(a)	9.57
Grape research	2.80	AVPMA(b)	1.45
Wine export	2.90	Macropod	0.13
Wine grape	9.64	NRS(c) — game pigs	0.04
All milk	28.34	NRS — horses	0.05
Dairy adjustment(d)	228.10	NRS — ratite slaughter	0.02
Forestry	4.62	Prawn	0.11
Almond	0.46	Queen bee	0.01
Total			**594.86**

(a) Australian Fisheries Management Authority.
(b) Australian Pesticides and Veterinary Medicines Authority.
(c) National Residue Survey.
(d) This levy ceased to operate in February 2009.

The levies fund industry-specific research and development. Most levies have been established at the request of industry participants. Many agricultural industries comprise a large number of producers, each of which accounts for only a small share of a fairly homogeneous industry output. This makes it difficult for a producer to capture all the benefit from research and development for which it pays individually. First, a small producer may be unable to raise the funding, or bear the risk, associated with a large research project. Second, intellectual property rights may not be robust enough to ensure that a producer gains all the benefit of its research and development; for example, it may not be possible to patent or copyright an idea or technique that is not embodied in a machine or software. By collecting a levy from all producers in an industry, it is possible to ensure that all producers share both the costs and the benefits.

For example, a single cotton grower is unlikely to appropriate all the benefits from private research into better sowing methods — other growers would be able to free ride on its innovation. The Australian government therefore taxes all cotton growers to fund the Cotton Research and Development Corporation which shares the results of its research for the benefit of all growers.

In most cases, the government sets the structure and rates of tax on advice from the relevant industry. For this reason, it is a relatively good way of revealing producers' collective judgement on funding levels, although individual producers may have varying preferences. Since the imposition of these levies involves the exercise of compulsory powers by the government, it is important that they do not disadvantage individual producers or particular classes of producers. For example, in some industries a particular type of research might be irrelevant to small producers, even though they are obliged to pay the levy at the same rate as large producers. However, the relative ease with which levies can be established provides a measure of flexibility. The Queen Bee levy, for example, was introduced when queen bee producers left the Honey Levy in 2003.

In most cases, the Australian government matches the amount collected from the levy, dollar for dollar. Such matching funding is not necessary to overcome the spillover problem and instead appears to constitute industry support.

Principles

For taxing club goods to be feasible, the public good needs to be local and excludable; that is, the beneficiaries need to be identifiable.

The rate of tax for a club good needs to be set by a majority of those directly bearing the legal incidence of the tax.

Any government subsidy associated with club good taxation should be based on any social benefits (beyond the immediate group of taxpayers) that arise from the funded activity.

E1–4 Public goods should generally be financed from broad-based taxes

In general, tax revenue should be raised from one of the broad tax bases of income, consumption and land. The broader the base, the lower the rate needed to raise a given amount of revenue and the lower the efficiency costs of doing so.

Market failure can be addressed by taxation

There is a strong case for governments to use policy instruments, such as taxation and regulation, to address market failures. Where some activities result in unintended costs being imposed on others (spillover costs), there may be a role for a tax or regulatory fee. A 'public bad' is an extreme form of negative spillover where the same 'bad' imposes costs on everyone. The case for using taxation to target negative spillovers is discussed in Section E2 Taxes to improve the environment. Generally, taxation can be an appropriate tool for addressing negative spillovers where the social cost can be targeted and is highly correlated with a taxable activity.

Regulation can be used in a similar way to correct negative spillovers. For example, regulation of food preparation may mean an unhygienic restaurant faces sanction for causing harm to others, such as illness for its customers and loss of reputation for similar restaurants. Ideally, the unhygienic restaurant would face costs commensurate with the marginal social cost it imposes: the greater the risks it imposes, the more severe should be the costs.

Regulation can impose costs on people by enforcing a particular standard — for example, the unhygienic eatery needs to employ another cleaner — or by charging a fee or fine. To be efficient, the standards, fee or fine need to reflect the spillover cost. Ideally, restaurants that do not impose spillover costs should face little or no regulatory costs.

When regulatory costs are out of all proportion to actual social costs, they take on the attributes of a tax designed to raise revenue, rather than a regulatory cost correcting for a market failure. In some cases, charges that purport to recover the costs of regulation do so imperfectly and do less than they could to secure the efficient allocation of resources by the regulated industry (see Box E1–4).

Box E1–4: Passenger movement charge

The Passenger Movement Charge (PMC) is a fee of $47 imposed on passengers departing Australia. It raised $420 million in 2007–08.

The PMC was originally introduced to recover the costs of customs, immigration and quarantine processing of passengers entering and leaving Australia, as well as the cost of issuing short-term visitor visas (Senate Standing Committee on Legal and Constitutional Affairs 2008). However, the charge does not recover all the costs of border services, nor does it reflect specific costs. It falls primarily on international passengers and international airlines even though airports, cargo planes and domestic passengers — as well as the broader community — all contribute to the need for border services and benefit from them.

As the PMC does not provide meaningful price signals related to the costs or risks associated with border protection, and is on a relatively narrow base, other sources of tax revenue would be more efficient. Further, the funding provided by the charge may impede the adoption of more efficient cost recovery, such as charging airports directly for some of these services.

The regulatory cost acts like a tax even if the regulation is imposed by standards, rather than fees or fines. If a restaurant is forced to adopt costly procedures — such as new equipment or additional staff — that have no effect on hygiene, then this becomes income to those who provide such goods or services to the restaurant. Alternatively, the restaurant would have an incentive to invest in improving hygiene up to the point where the costs are around the same as any potential fine. In the absence of uncertainty, a fee and a standard would produce similar outcomes. However, where there is uncertainty about how much a business would need to spend to meet a standard, imposing a fee is likely to be more appropriate. Similarly, where there is uncertainty about the size of the costs imposed on others, setting a minimum standard is likely to be most efficient.

Recovering regulatory costs from those who cause the spillover effects has a number of advantages. First, so long as regulatory services are supplied efficiently, regulatory fees or fines should recover the marginal costs of the activity that can be attributed to particular producers (or consumers). These costs will then feed into the prices of the final goods and services (see Box E1–5). Otherwise, the goods or services would be too cheap and too much would be produced and consumed. For example, if the costs of quarantine were not recovered properly, then imported goods and services posing risks to the community would have a competitive advantage over other, less risky goods. Included in the attributable costs should be any administration costs from the regulation. Regulatory administration costs should be cost-recovered, since they are one part of the social costs that the community bears from quarantining goods. In the absence of the spillover, those administrative resources could be used elsewhere.

Box E1–5: Recovering the costs of regulation

Where there is a market failure, due, for example, to information asymmetry about the standard of food preparation, regulation can play an important role in enhancing the wellbeing of society. Without such intervention a number of transactions which would improve each party's wellbeing would not occur as, due to the information asymmetry, one party would not be sure of the quality of the product they were purchasing (even though it actually meets their requirements).

Therefore, government regulation of the market reassures consumers that the product they are purchasing will be of an acceptable standard. Correcting this market failure provides benefits to both the producer (who will be able to sell more) and to those consumers who will either avoid purchasing poor products or now consume where before they would not.

However, regulations are not costless — resources to design, implement and enforce them need funding. Using general taxation to fund this cost is both inequitable and inefficient. It is inequitable, as it imposes a cost on people for regulating this market even though they do not benefit from the transactions occurring in it. It is inefficient, as those operating in the market would not face the true cost of their activities, and hence more than the socially optimal amount would be produced and consumed.

Box E1–5: Recovering the costs of regulation (continued)

A better alternative is for the beneficiaries of the regulation (that is, the producers and consumers of the product) to bear the cost associated with it. It is generally most cost effective if the producer faces such charges, with the true economic cost of the regulation likely shared between the producers and consumers, depending on the elasticities of the product demand and supply (which determines the extent to which producers can pass on the cost of the regulation).

Importantly, these costs should not be over-recovered as this would constitute a tax on the particular product. This would reduce transactions that would otherwise generate value for each party, thereby reducing their wellbeing and that of society as a whole.

Second, recovering regulatory costs means that businesses can take steps to reduce the need for regulatory services (or other businesses can compete to provide the relevant goods or services in less risky ways). When regulatory services are funded from taxes, regulated industries do not face the full social costs of their actions. Businesses with riskier practices pay no more than businesses that are successful at managing risk. In the face of competition, businesses that spend money on effective risk management are worse off (see Box E1–6). This increases the burden on both the regulator and the taxpayer.

Finally, those who pay regulatory charges have an incentive to monitor the quality of the regulatory services and lobby government for better services or lower costs. This reduces the likelihood that regulatory services will be provided inefficiently.

Box E1–6: Recovering the costs of the Civil Aviation Safety Authority

The Australian government taxes gasoline and kerosene used in domestic aviation. In 2007–08, the aviation fuel excise rate was $0.02854 per litre and raised around $75 million in revenue. The revenue is allocated to the Civil Aviation Safety Authority (CASA), which sets and enforces safety standards for the civil aviation sector. It constitutes around one half of CASA's total net resourcing.

CASA ensures aviation safety through operational surveillance, spot checks and audits, based on the risk profile of the organisation. A large, complex charter operation is inspected more often than an aerial work operation with only an occasional charter. However, since half of CASA financing comes from taxing aviation fuel used in domestic flights, airlines pay for regulation according to how much fuel they use on domestic trips, no matter how risky their operations are. Reforming CASA fees to recover costs from those requiring tighter regulation (and therefore imposing the spillover costs) would improve the efficiency of the airline industry.

However, the introduction of taxes, fees or charges that better reflect risk may have unintended effects on existing players. For example, in the case of aviation it might reduce the costs of larger airlines (who currently bear a large part of the aviation fuel excise), but increase the costs of smaller charter operations that service regional and remote communities. To the extent that such services are considered socially important — for example, because they ensure access to medical services — they could be funded directly from the budget, rather than aviation excise.

At times, governments may not want to charge for regulatory services because that would conflict with other social goals, such as concerns for equity. In addition, some forms of regulation are not attributable to a specific negative spillover. In such cases, a regulatory fee acts like a relatively inefficient type of tax. For example, governments sometimes encourage pooling of losses in some markets subject to insurance market failures. Examples include some small State taxes on the sale of cattle, sheep and goats (or their carcasses) to compensate pastoralists in case they are obliged to destroy their stock because of an outbreak of disease. Most States charge compulsory third-party insurance at fixed fees, but because risks vary across drivers, this means that low-risk drivers are subsidising high-risk drivers. In contrast, New South Wales imposes compulsory third party insurance, but with actuarially based fees. These appear to be cost recovery regulatory charges.

If regulation is effective and delivered at least cost, all market participants can potentially be better off. But regulation often benefits certain market participants more than others, leading to some redistribution. The worst types of regulation may harm community welfare while benefiting sectional interest groups. In such cases, regulation is like a tax where all of the revenue flows to a particular group.

Principles

Public goods should generally not be charged for, but financed through general taxation.

Government costs associated with the administration and enforcement of regulation should be recovered by targeted charges or taxes, rather than being funded out of general tax revenue.

Cost recovery taxes should be levied on the parties who are best able to reduce the external costs of an activity. This is normally, but not necessarily, the parties whose activities impose costs on others.

Cost recovery taxes need to be subject to regular and systematic review to ensure that they reflect the cost of providing the regulatory service and that the service is provided in the least costly way.

Narrow-based taxes may be a high cost way to finance spending

Narrow-based taxes that do not target social cost or provide signals on the value of a public good are no more than a relatively high cost means of raising revenue. Two types of relatively narrow-based taxes that are sometimes used are universal service obligation (USO) levies and industry restructuring levies.

Universal service obligations

Governments can impose USOs on some service providers, such as phone, electricity and postal services. USOs can require the provider to provide a service to a particular standard or to certain groups. This requirement needs to be financed by higher charges imposed on customers. By requiring certain users of a good or service to cross-subsidise others, the USO taxes one group and transfers revenue to another.

Where they are used, such arrangements should be made transparent to the community; for example, in government financial statements (see Box E1–7). As the USO 'tax' is on a relatively narrow base, they are likely to be relatively inefficient. Other ways of funding the USO subsidy should therefore be considered.

Box E1–7: Telstra's universal service obligation

The Telstra universal service obligation (USO) aims to ensure that standard telephone services and related services are accessible to all people in Australia for the same price. Telstra provides these services at a standard price in areas where it is not commercially viable to do so. All carriers, including Telstra, are then levied to contribute to Telstra's costs, which are determined by the Minister on advice from the Australian Communications and Media Authority (totalling $145 million in 2007–08).

These arrangements mean that people in cities pay taxes on their telephone bills in order to subsidise regional phone calls. The Budget includes the USO as a tax (paid by all carriers, including Telstra) and a subsidy (paid to Telstra).

Levies to fund industry adjustment

Australian governments have sometimes hypothecated narrow-based taxes to particular industry adjustment programs. A recent example is the Australian government's Dairy Adjustment Levy, imposed on milk sales by processors to retailers on a cents per litre basis. The funds raised were used to fund structural adjustment in the dairy industry. The levy raised $228 million in 2007–08 and ceased to operate in February 2009 (Parliament of Australia 2008).

Taxes of this type have much in common with minor taxes used to fund access to essential services for particular groups, such as USOs. They tend to be narrow-based taxes with relatively high efficiency costs. The fact that consumers of milk will benefit from dairy industry restructuring does not justify imposing a levy on them. Raising the consumer price for milk does not send a price signal that reduces social costs. Rather, it imposes higher costs on society as a whole than would be imposed by raising the revenue needed to fund industry restructuring through broad-based revenue-raising taxes.

Industry-specific levies can be efficiency enhancing when they replace existing regulatory barriers that are more costly. This is one reason why the World Trade Organisation supports introducing tariffs to the extent they replace non-tariff barriers. Such regulatory barriers can be more costly as regulations may not allow lower-cost producers to enhance their output. Regulatory barriers can also deliver benefits to existing industry participants, rather than providing revenue to the government. For example, replacing the existing regulatory burden on taxis with an industry-specific tax hypothecated to licence holders would be a more transparent means of maintaining the existing system, while allowing some improvement in services (see Section E3 Road transport taxes).

Principles

Narrow-based taxes that do not target social costs are a relatively high-cost means of raising revenue.

The value of transfers provided through universal service obligations should be made transparent.

E2. Taxes to improve the environment

Key points

The quality of the environment is critical to the wellbeing of Australians, not least because it underpins our standard of living. This is particularly important since past and present generations of Australians, often guided or directed by government policies, have been degrading their water, land and air, losing many native species and contributing to global climate change.

Many market activities damage the environment, but this damage is often not reflected in the market price of the goods or services these activities produce. These 'spillover' costs are one form of market failure. Government intervention, may provide an effective mechanism for protecting the environment or for making people pay for the damage they do to the environment.

Environmental taxes are among a range of options open to governments to address these spillover effects. Taxes can help deal with these problems by changing prices in a way that encourages people to reduce their contribution to pollution or to reduce their use of a natural resource. Where such corrective taxes are effective, they can be highly efficient — delivering greater environmental benefits for a given cost to the community than other forms of intervention.

However, taxes of this type can be difficult to design and implement. In some cases, regulation or other market-based instruments may be superior.

Once introduced, the Carbon Pollution Reduction Scheme (CPRS) will be the largest environmental policy intervention in Australia. Market-based mechanisms such as the CPRS are the most cost-effective way to reduce Australia's carbon emissions. The efficiency of the CPRS should be monitored, and opportunities taken to improve it, such as by recycling the permit revenue to reduce other taxes (where appropriate), removing supplementary measures, phasing out concessions such as free permits and broadening the scheme's application (as this becomes possible).

E2–1 Why and how should environmental taxes be improved?

The environment directly contributes to the wellbeing of current and future Australians. It provides services critical to good health such as clean air and water, as well as public amenity, recreation and aesthetic pleasure. The environment also improves wellbeing indirectly by providing resources — such as land, timber, minerals and energy — that are necessary to produce goods and services (for example, food), as well as the ecosystems necessary to absorb and assimilate waste. The environment is a key underpinning of market and non-market activity.

As with all scarce resources, trade-offs are required in allocating the environment to different uses. When markets work properly, such trade-offs tend to see resources flowing to their highest value use; that is, the use that generates the highest monetary and social value. For example, a piece of farming land will tend to be used for the farming activity that generates the best return. However, many environmental goods are subject to market (and other) failures that result in over-exploitation. For example, people may use more land than necessary for farming if there is no market value placed on the environmental amenity that nature provides to society. These problems can be significant in terms of reduced wellbeing for society because in many cases the damage to the environment may be irreversible — a characteristic of many of Australia's most pressing environmental challenges, such as climate change and loss of biodiversity.

The need to correct for environmental spillovers

In relation to the environment, the most common form of market failure involves spillovers (sometimes called 'externalities'). A spillover occurs when individual decision-makers fail to take into account the impact of their actions on other parties. An example of a negative spillover is where a river is polluted by inappropriate use of a fertiliser, causing harm to downstream users of the water. But spillovers can be positive too — a farmer who maintains native vegetation may deliver biodiversity benefits for the community, but will generally not be compensated for this service.

Often, these problems arise because many aspects of the environment have *public good* qualities — that is, they are both *non-rival* (able to be enjoyed simultaneously by any number of people) and *non-excludable* (individuals cannot be excluded from enjoying them). Because no-one owns them, these environmental qualities are not priced by the market, and are often used without regard to the costs that may be imposed on others as a consequence. Similarly, because they are not priced, people have no way of making financial returns from providing an environment that benefits the community. As a consequence, the environment is allocated inefficiently between its different uses, resulting in excessive environmental degradation.

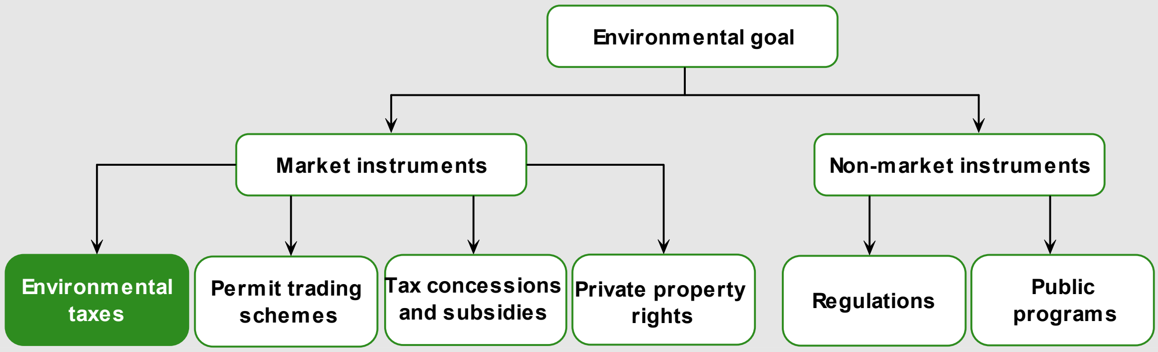
Where market failures occur, selective government intervention may result in an improvement in overall welfare. The use of environmental taxes is one way to correct for spillovers, by providing transparent price signals to purchasers of goods and services that reflect the environmental cost as well as the private costs.

This Section deals with the case for using taxation to address the problem of environmental spillovers and managing environmental public goods. A number of other specific environmental issues are addressed in other Sections in this report. In particular, noise and air pollution are discussed in Section E3 (Road transport taxes), and improving the use of community resources through better pricing of many common-property environmental goods is discussed in Section E1 (User charging).

There is a range of options to address environmental spillovers

The use of an environmental tax is only one option for correcting an environmental market failure, and is one example of a 'market instrument'. Other market instruments include permit trading schemes, tax concessions and establishing private property rights (see Box E2–1).

Box E2–1: Government intervention options to address environmental issues



Permit trading schemes like the proposed Carbon Pollution Reduction Scheme (see Box E2–6) involve capping the desired level of pollution at the outset, issuing pollution permits up to the amount of the cap and allowing the price of the permits to be set in the market. Economically, the difference between trading schemes and environmental taxes is that fixed-rate taxes impose a price on pollution and the market determines the quantity, while a trading scheme controls quantity, creating an implicit tax (the revenue the government receives from the sale of permits) and the market determines the price of the permit.

If the world were perfectly predictable, if the government auctioned all permits, and if the CPRS were not linked with overseas abatement efforts, the economic outcome of a permit scheme would be identical to a corrective tax.[3] In reality, however, where uncertainty is pervasive, trading schemes can be preferable to a tax in cases where the costs imposed by pollution are very sensitive to the level of pollution — and hence where the costs of getting the level of abatement wrong are high (Weitzman 1974).

Tax concessions (often referred to as tax expenditures) are a type of subsidy that aim to make an environmentally beneficial action by the private sector more financially attractive than otherwise. An example of such policies is the Landcare tax concession. Since they need to be available to any taxpayer who meets specified criteria, the challenge for such subsidies is to encourage more of the beneficial activity, and not merely to deliver a financial gain to those who would have undertaken the activity anyway.

An alternative market instrument is to establish, or strengthen, *private property rights* over a common resource. For example, a common forest would quickly be cleared by hunting and logging if no person owned the forest and could prevent the public from taking the timber without their consent.

In addition to market instruments, options available to government include non-market instruments like *regulation*, which may mandate abatement levels or technology standards for emitting industries or products. An example of this is the fuel standards that mandate the qualities of petrol or diesel used in transport.

3 For instance, in Box E2-4, a trading scheme would set the quantity of pollution at Q*. Polluters would pursue least-cost abatement to achieve this target, and the price of permits would rise to T — the same quantum as the environmental tax required to achieve a reduction in pollution to Q*.

Another non-market instrument is the *public program*, which refers to government spending to achieve a policy objective, such as the installation of photovoltaic panels on government buildings to generate electricity.

There is no single instrument suitable for all environmental issues. The nature and scope of the market failure in question will be critical to determining the best policy approach. The appropriate instrument in any particular case is one that maximises the net benefit to society, taking into account the extent to which the instrument can adequately deal with the environmental spillover (and hence deliver a gross environmental benefit) balanced against the costs imposed in addressing the spillover plus the costs of implementation (including administration and monitoring). The decision on what instrument to use is particularly difficult given that the costs and benefits should, in principle, take into account impacts on the present and all future generations (see Box E2–2).

Box E2–2: Reducing environmental damage through market-based mechanisms

When an activity damages the environment and the damage is not reflected in the market price, a 'spillover' (or 'externality') has arisen. Governments have a range of options to deal with spillovers and to ensure that consumers and producers take account of the environmental damage caused by an activity.

Various studies in Australia and other countries have canvassed the range of policy options that may be pursued to achieve improved environmental outcomes. A broad summary of the policy approaches available to government in the context of CO_2 emissions was included in the *Report of the task group on emissions trading* (Australian Government 2007).

That report grouped policy options into four broad categories:

- information and education campaigns;
- various forms of regulation or standards;
- fiscal measures, including grants, subsidies and rebates; and
- market-based instruments, including environmental taxes and tradable property rights.

While each policy approach may have some role to play, the report considered that market-based instruments were superior in achieving large-scale improvements in environmental outcomes at least cost to the economy.

The report noted that although information and education campaigns can play an important role in alerting businesses and households to abatement opportunities, such campaigns on their own will not drive large-scale emissions reductions.

Box E2–2: Reducing environmental damage through market-based mechanisms (continued)

The report considered that implementing non-market approaches through regulations or standards was potentially viable when technologies are relatively standard and their environmental consequences known. The phasing in of new lighting standards is an example of this approach. However, the report noted that where technologies and production techniques vary widely, regulation will be inefficient in achieving environmental outcomes and likely to impose significant costs on businesses and households.

Another drawback of a pure regulatory approach, also highlighted in Box E2–3, is that it normally involves the government specifying outcomes regardless of the costs imposed. This limits incentives to innovate or undertake more abatement than the mandated level.

ABARE modelling commissioned by the Task Group showed that regulatory approaches can cost the economy substantially more than emissions pricing for the same abatement target — up to twice the GDP cost. This is broadly consistent with other modelling undertaken in this area.

The report also considered the merits of subsidising abatement from government budgets. However, this requires the government to pick winners or target specific projects. It could also involve high administrative overheads for the government and for project proponents, and impose higher costs on society from higher levels of taxation. If used extensively, significant losses in economic and administrative efficiency could arise.

Market-based approaches allow the market to determine the lowest-cost means of abatement. Such approaches therefore provide the opportunity to deliver improved environmental outcomes at the lowest economic cost. They also provide strong ongoing incentives for investment in technology research, development and deployment, and in efforts to improve energy efficiency. The report also noted that economic outcomes have often exceeded expectations as a result of market-oriented policy changes, as firms take up opportunities and incentives to innovate and improve productivity.

The community should be compensated for environmental damage

Governments should consider the environment as a community (or public) good that needs to be managed for the benefit of current and future Australians.

As a general rule, approaches that implement the 'polluter-pays' principle (including taxes and emissions trading schemes) are preferable to others on both efficiency and equity grounds. Imposing the cost of environmental harm on those responsible provides them with an incentive to modify their behaviour and reduce the damage their actions cause. From an equity perspective, it is appropriate that those responsible for the harm are required to bear the cost, rather than those forced to live with the consequences.[4] For example, Australia's rich biodiversity can be appreciated by all Australians, regardless of where they live. Those

4 While the legal incidence may be on the producer of the good or service, often the economic burden of the tax can be passed forward. To the extent that the burden is passed forward to the consumer who demands the product which causes the damage this can still be consistent with the polluter pays principle.

who benefit from activities that harm the Australian community's ability to benefit from this biodiversity should compensate the community.

That said, in situations where it is impractical to introduce a polluter-pays approach — for instance, in situations where it is difficult to identify the polluter, or where equity considerations are outweighed by the costs involved in making the polluter pay — a beneficiary-pays principle could be applied (see Box E2–3).

Box E2–3: What are the benefits and costs of 'polluter pays'?

The 'polluter-pays' principle holds that the party responsible for undertaking an activity that causes spillover environmental damage should pay for that damage. This reflects the view that the environment is a community asset and that any party damaging that asset should pay compensation to the community for that damage.

Charging for environmental damage has three advantages. First, it can encourage appropriate use of environmental resources, since environmental damage should arise only where the value of the output associated with the damage is greater than the value the community places on the environment that was damaged by the activity. Second, because the environment is a community resource, there is inherent justice in the community receiving revenue as compensation for use of the environment. Third, people wishing to use the environment for private purposes should bear any transaction costs (such as legal fees) associated with undertaking an activity that may damage the environment.

However, 'polluter pays' may sometimes be difficult or inappropriate to apply. Some forms of environmental damage may be so severe and irreversible that it would not be appropriate to allow them to proceed at any price. In these cases, marginal trade-offs between some environment services or assets and other goods may not be acceptable. For that reason, for example, lead in petrol is simply banned, rather than priced.

At other times, someone other than the polluter may need to pay if the polluter is difficult to identify or to catch, particularly if someone else can reduce the environmental costs more cheaply. In such circumstances the government could impose costs on those best able to ameliorate the pollution, even if they do not cause it. For example, business owners may be required to keep their street frontage free from litter, even if they did not drop the litter. However, business owners may be able to pass forward the cost of keeping their street frontage free from litter to their customers.

Finally, it can sometimes be difficult to determine the 'just' allocation of rights to pollute between two parties. For example, when people build a house on cheap land near an existing airport, should they then be entitled to compensation for the aircraft noise? Compensation should not set up incentives for strategic behaviour that jeopardises good environmental outcomes. Clearly defined and enduring property rights help to overcome such problems.

If the community desires spending to repair environmental damage from past (lawful) pollution, it should not raise the tax rate on future emitters of that pollution simply to generate enough revenue for the task. If set this way, the tax rate will exceed the optimal rate (that which equalises marginal social cost and marginal abatement cost) for future emissions. The clean-up should be funded from efficient general revenue taxes (that is, funded by the beneficiaries).

Imposing an environmental tax

An environmental tax can be imposed on an environmentally damaging activity, thereby raising the cost of that activity to reflect the cost to society of lost environmental benefits.

The purpose of such a tax is to correct the market failure and reduce environmentally harmful actions to a level that yields the greatest benefit to society. While revenue will be raised through such taxes, this is a by-product, not the main policy purpose.

The imposition of the tax provides an incentive for polluters to use non-polluting inputs or processes rather than polluting ones, to the extent that doing so costs less than paying the tax. In addition, it encourages consumers to reduce demand for higher-priced products associated with pollution towards lower-priced, less environmentally damaging alternatives. Box E2–4 illustrates the theoretical underpinnings of an environmental tax.

Box E2–4: The operation of an environmental tax

Assume that a production process results in the emission of pollution as a by-product. This pollution could be reduced in a number of ways, including by adopting less polluting processes or equipment therefore reducing pollution per unit of production, by producing fewer units of production, or by putting in place mechanisms to capture the pollution.

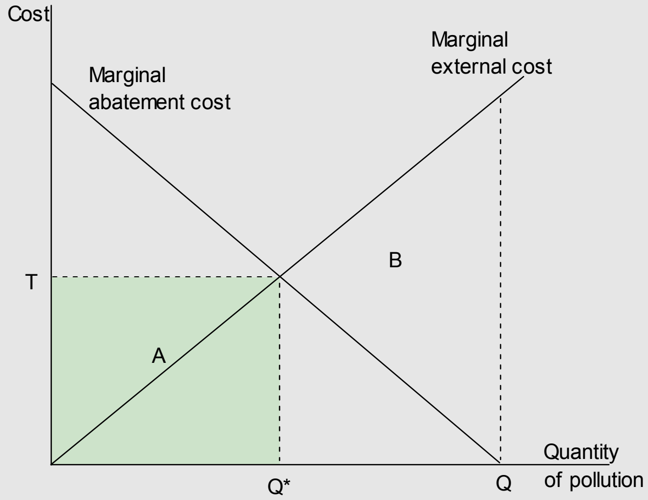
The cost of avoiding each unit of pollution is called the marginal abatement cost. In the chart below, it is drawn as a line with downward slope, reflecting that the cost of reducing pollution increases as each unit of pollutant is abated. The cost increases because the cheaper abatement options are always taken before the expensive ones. Where the polluter pays nothing for polluting, quantity Q of the pollutant is produced (as the polluter chooses not to incur any abatement costs).

At Q, the environmental damage imposes a high cost on society (shown as the marginal external cost) but the polluter is not required to take this into account. Policy-makers note that reducing pollution by a unit would benefit society greatly and yet cost the polluter only a little.

If policy-makers have perfect information about abatement costs and the external cost of pollution, a tax of T would be imposed on each unit emitted. The polluter then has an incentive to adopt abatement measures if they are cheaper than paying the tax (reducing pollution from Q to Q*). The consequent increase in social welfare is represented by the triangular area B. The revenue raised by the tax (a transfer of wealth, not a net gain) is represented by shaded area A.

Box E2–4: The operation of an environmental tax (continued)

Chart E2–1: An environmental tax to reduce pollution



It is worth noting that, with perfect information, an identical economic outcome could be achieved through the use of other market instruments, including a permit trading scheme, where the quantity of pollution is capped at Q*, resulting in a permit price of T.

Unlike environmental taxes, environmental charges do not seek to improve environmental outcomes by reducing spillovers. Instead they impose a charge on an activity in order to raise revenue sufficient to finance the cost of providing the environmental service.[5] In circumstances where the revenue raised funds the collective treatment of an environmental problem associated with the activity, such charges are consistent with a user-pays principle, and may be efficient. For example, national park access fees apply to users and pay for the maintenance of the park environment.

In situations where the service in question is used, either directly or indirectly, by a significant proportion of the population, equity considerations may be outweighed by the benefit of funding the service from general revenue.

In other cases, taxes or charges may be imposed that neither reflect the cost of environmental harm associated with an activity nor provide a service to address it, but are intended to fund environmental programs. For example, the Product Stewardship Oil Levy of 5.449 cents per litre of lubricating oil sold is used to help fund the oil recycling industry. The levy does not change the behaviour of oil consumers once the oil is purchased (that is, once you have paid the tax there is no incentive not to dispose of the oil inappropriately), nor is the associated program a cost-effective means of addressing the issue of inappropriate oil disposal (see Box E2–10).

While these charges are typically levied on narrow bases, there may be some cases where the tax and the associated spending are aligned and well-targeted, so such mechanisms can be used to deliver a 'polluter-pays' outcome and provide incentives for better environmental outcomes (see Box E2–3).

5 The OECD defines environmental charges as 'payments for which a good or service is rendered in return'.

Environmental taxes can efficiently reduce environmental harm …

The key strength of environmental taxes (and emissions trading schemes) relative to other instruments is that they have the potential, if appropriately designed and targeted, to achieve a given level of pollution at a lower abatement cost.

Compared to regulations, which impose requirements such as uniform standards or abatement targets, market instruments can deliver:

- *allocative efficiency gains* — in situations where the costs of abatement varies between polluters, the use of a tax can minimise the cost of abatement by providing an economic incentive to reduce pollution in the least expensive way (see Box E2–5); and
- *dynamic efficiency gains* — because an environmental tax applies to each unit of pollution produced, it provides an incentive for polluters continually to seek low-cost abatement options to reduce their tax burden. By comparison, regulatory approaches may achieve compliance with a technology standard, for instance, but will not necessarily encourage polluters to make further abatement efforts.

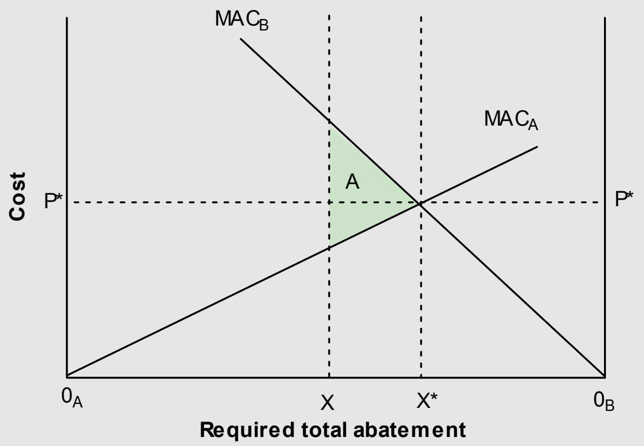
Box E2–5: Allocative efficiency gain from the use of market instruments relative to regulation requiring uniform abatement

Assume there are two polluting firms whose marginal abatement costs differ and are represented below as MAC_A and MAC_B. The total abatement required is represented by the quantity O_AO_B in Chart E2–2 below.

The total abatement could be achieved through the introduction of a tax set at P*, or alternatively through the introduction of a permit system that results in an identical permit price. Under both approaches, firms will abate up to the level where their individual cost of abatement is equal to the cost of the tax (which in the case of permits is equal to the cost of a permit). As a consequence, Firm A undertakes a greater share (O_AX^*) of the abatement effort due to its lower marginal abatement costs.

By comparison, if firms were required by regulation to undertake a uniform reduction in pollution, then both firms would undertake the same level of abatement (that is, O_AX, O_BX), incurring an additional cost represented by the area A.

Chart E2–2: Lower abatement cost using market instrument



Another advantage of environmental taxes compared to many other instruments is that they raise revenue. While this is not the purpose of the tax, it is valuable in that it can be used to reduce other taxes or be used to fund additional government spending. The use of environmental tax revenues is discussed below.

… but the scope for using environmental taxes is limited

The scope for applying environmental taxes is limited by two significant practical concerns.

The environmental harm caused by the pollutant needs to be relatively uniform

In order for an environmental tax to reduce environmental harm in a cost-effective manner, the damage from each unit of the activity should be constant so that a constant tax rate can reflect the cost of the damage. Greenhouse gas emissions are one example of a uniform impact, as each 'unit' of gas contributes equally to climate change, regardless of where it is emitted.[6] However, such situations are uncommon on a national scale. For instance, the human health costs imposed by air pollution are likely to be significantly greater in cities than in less populated areas.

Where the spillover cost of a unit of pollution varies across the area of concern, a uniform tax will be unable to capture these differences. Some sources of pollution would be over-taxed and others would be under-taxed. In net, the use of an environmental tax in such situations could be welfare-reducing and other options (for example, regulation) should be considered.

… and the pollutant needs to be measurable

To apply an environmental tax effectively, the environmentally damaging activity needs to be measurable and verifiable by both the tax authorities and polluters.

For many environmental problems, it is very difficult to measure environmentally damaging activity, particularly where the spillover effect comes from a large number of sources (for example, run-off from hundreds of farms may pollute a river).

Due to difficulties in measurement, some environmental taxes are better applied to a related input or output as a proxy for the pollution, rather than to the pollution itself. Using a similar principle, the Carbon Pollution Reduction Scheme (CPRS) would apply to the carbon content of fuel, avoiding the need for costly monitoring of actual carbon emissions from motor vehicles. While taxing a proxy may be more practical and less costly to implement, it is also less precisely targeted and, unless the pollution is highly correlated with the proxy, the environmental benefit that can be achieved from such an approach may be limited. The carbon content of fossil fuel is reasonably well correlated with actual emissions when it is burned. Taxing the amount of fuel supplied is therefore a relatively accurate way of taxing the amount of emissions. However, if technology develops to allow motor vehicles to capture and store emissions directly, then alternative arrangements will be needed to ensure that the incentive to deploy those technologies is not lost.

Taxing the production or consumption of a good to reduce the cost of its inappropriate disposal (by reducing overall demand for it) has an impact on beneficial uses of the good as

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6 While there are a number of greenhouse gases, their impact is compared using CO_2 equivalent measurements.

well as its environmentally harmful uses. This increases the economic cost of the tax. For example, taxing plastic bags to reduce littering may reduce litter, but it will also impose costs on the many people who use plastic bags and dispose of them appropriately.

Where a tax is levied on a product that typically causes environmental damage, the tax will reduce the damage, but forgoes the opportunity to improve environmental outcomes by developing alternative production methods that do not use the damaging input. For example, some rechargeable batteries contain cadmium, which is a toxic heavy metal and may cause water or soil pollution if it leaches out of landfill. Hypothetically, if a government imposed a tax on the purchase of any rechargeable battery, this would reduce consumption (and therefore, disposal) of rechargeable batteries. But such a tax would provide no incentive for rechargeable battery manufacturers to reduce the level of cadmium in their product, nor would it provide any incentive for consumers to buy non-cadmium or low-cadmium rechargeable batteries.

Such limitations make it difficult, but not impossible, to use taxation to help solve environmental problems.

Principles

Environmental taxes (or emissions trading schemes) should:

- be used to address environmental objectives, rather than raise revenue;
- have their revenue recycled to reduce the associated tax (and transfer) distortions, should governments wish to avoid increasing the aggregate burden of tax; and
- be integrated with existing taxes and transfers.

An environmental tax is more likely to be appropriate in situations where:

- environmental damage due to economic activity is relatively constant (so that a constant per-unit tax reflects the cost);
- the factors causing the environmental damage are measurable/verifiable by both the tax authorities and the agent causing the damage, or there is an input or output proxy that is closely correlated with the damage being targeted;
- the only cost-effective way the taxpayer can reduce their tax liability is to reduce the activity causing the damage (rather than, say, simply dumping waste illegally); and
- other instruments (such as spending and regulation) have been considered and found to be more costly.

Decisions to introduce a tax should be guided by cost–benefit analysis

Decisions about whether to intervene to correct an environmental market failure — and about whether to use a tax or some other policy instrument if the decision is to intervene — should be based on the relative costs and benefits of the available alternatives.

While the costs involved in introducing an environmental tax can be estimated with some degree of accuracy, calculating the benefits is more challenging because of the non-market values involved. The fact that many environmental problems extend over long timeframes, and can involve issues of inter-generational equity and transfers, further complicates cost-benefit analysis. Of course, the fact that such assessments are difficult does not mean that taxes should not be used, particularly if the risks of significant costs from environmental damage are high.

Environmental taxes also impose costs

If environmental taxes are used, the rate of tax needs to be set so as to achieve the amount of pollution that produces the highest net benefit for society as a whole. Environmental taxes, while potentially able to address an environmental spillover in a more cost-effective manner than other interventions, still impose costs. Pollution has a value to those producing it, as well as to those who benefit from the products or services produced from a polluting process. It is the cost of forgone production and/or consumption that needs to be weighed against the overall social benefit from taxes that successfully improve environmental outcomes. For this reason, an environmental tax is not intended to eliminate pollution completely, but rather to 'rebalance' the use of environmental resources to the point where the additional costs of reducing pollution further would outweigh the additional benefits such a reduction would deliver.

Is there a 'double dividend' from introducing a tax?

Intuitively, an environmental tax appears to have two benefits. The first is the benefit from increasing the price of an activity that damages the environment. Society overall is better off because the increase in price would cause a lessening of activity and hence a reduction in environmental damage. Damage reduction (not revenue-raising) should be the only reason an environmental tax is introduced.

The second apparent benefit is the opportunity to use the revenue raised by the tax for other social purposes, such as reducing other distortionary taxes (for example, labour taxes that reduce the incentive to work). In particular, environmental taxes could potentially provide a 'double dividend' of less pollution and less incentive-distorting taxes if the revenue were used to reduce existing labour income or corporation taxes (for example, Pearce 1991).

In the absence of other market distortions, an environmental tax set at a rate equal to the marginal external cost of an environmentally damaging activity would discourage inappropriate use of the environment. To the extent that market production falls, society is better off since less production means an improved environment. Before the tax, resources were misapplied to conducting socially damaging activities. At the margin, the value of lost market production — for example, the workers no longer employed in a polluting industry and the lower wages in other industries — would equal the value of improved environmental amenity. The tax effectively values the environment, generating revenue that would otherwise be appropriated by those continuing to damage the environment. This revenue could then be used by governments to achieve other social goals without any cost to the economy. In this sense, environmental taxes are 'costless' sources of revenue.

However, governments already collect taxes for general revenue-raising, such as the GST and income tax, as well as other purposes. And taxes interact in complex ways. Without understanding how the present tax system affects consumption and production decisions with environmental consequences, it is not possible to know whether a particular environmental tax proposal is actually welfare-enhancing. For example, an environmental tax may be passed on to consumers in higher prices and would add to tax distortions already in place.

There are some cases, however, where even in the presence of existing distortions an environmental tax can improve both environmental outcomes and the value of market production, delivering a 'double dividend'. Some environmental problems can directly affect work incentives. For example, recycling the toll revenue from a congestion charge as lower labour income taxes not only substantially improves environmental amenity, but also encourages people into work (Parry & Bento 1999). Some environmental problems can also have long-run feedback effects on health and productivity. Sometimes existing tax systems are so poor that an environmental tax or charge can raise revenue more efficiently. For example, the CPRS will apply to a broader range of fuels than the existing fuel excise. As the CPRS displaces some of the existing fuel excise, the overall economic cost of raising revenue from fuels should fall. This benefit is in addition to the environmental objective the CPRS aims to achieve.

Empirical studies suggest that, while there may be important exceptions, cases offering a 'double dividend' are not likely to be common (Bovenberg & Goulder 2002). Further, many of the 'second benefits' can be achieved without the need to use the explicit revenue from an environmental tax. Indeed, if there were no institutional constraints, this would ideally be the case. By using specific policy tools for specific targets, governments can ensure that the best instruments are used to most effectively tackle social problems. If there are better options for raising revenue more efficiently than current taxes, then they should be adopted. If there are better options for addressing environmental options than a tax, they too should be used. By mixing objectives in a single instrument — the environmental tax — governments might not use other instruments that could be better at addressing each objective individually.

Of course, environmental taxes should still be considered even where no double dividend exists. In such cases, an appropriately designed environmental tax would see the benefit to the community outweigh the costs.

Earmarking revenue constrains government spending choices

Several submissions to the review have argued that revenues raised by environmental taxes should be hypothecated or 'earmarked' to spending on related environmental programs.

While this may promote public acceptance of a tax, it constrains the ways in which the government can allocate limited revenue between competing priorities. It can result in revenue being spent on hypothecated programs when it could have delivered greater social benefit if directed elsewhere, including through lowering existing taxes.

Hypothecation also creates a risk that the rate of an environmental tax would be dictated by the expenditure requirements of the associated program, rather than by the marginal social cost of the environmentally harmful activity the tax is meant to address.

Hypothecation may be desirable if there is a close connection between the source of funds and their subsequent use. This is because the tax provides signals to producers about the demand for the environmental good or service. In such cases, the levy or charge effectively constitutes a user charge for the provision of goods or services (rather than an environmental tax), which promotes efficient resource allocation. Examples of such charges include national park charges and the Great Barrier Reef Environment Management Charge (for more examples see Section E1 User charging).

Additionally, if the environmental tax is set at the rate that reflects the marginal external cost of the targeted pollution, then net benefit is maximised and no further government spending on that environmental objective will deliver a further net benefit to society.

Even hypothecating the tax raised from ameliorating one environmental problem to fund a program aimed at overcoming another environmental problem is likely to lead to poor outcomes. This reflects that it is unlikely that the funding required for expenditure programs that would pass a social benefit–cost assessment will approximate the tax revenue collected by an environmental tax set at the marginal external cost.

Principle

There is no general case for hypothecating (that is, earmarking) environmental tax revenues to environmental spending programs. However, hypothecated user charges (as opposed to taxes) that reflect the true cost of providing a good or service can be an efficient means of funding environmental programs.

Using additional instruments is likely to be inefficient and costly

A well-targeted environmental tax addresses a spillover by providing a transparent price signal that reflects the marginal external cost of environmental harm. As noted above, once such a tax is applied, there is unlikely to be a need for additional instruments that target the same environmental issue. As a general rule, multiple instruments should be considered only if they complement each other in a predictable way to achieve the desired outcome, and if a single policy instrument could not achieve the outcome in a more efficient and effective way. In particular, supplementary measures may be needed when the measurement of pollution is uncertain or costly. For example, supplementary measures to reduce carbon emissions from sectors difficult to include in the CPRS may reduce the cost of overall abatement.

Principles

In general, a single policy instrument should be used to target a single objective.

Multiple instruments should be considered only where one instrument is not capable of achieving the desired objective, and where the instruments are complementary in nature.

Tax concessions are a blunt tool for dealing with environmental issues

The provision of concessional tax treatment for selected expenditure is another means by which government can give taxpayers an incentive to undertake environmentally beneficial activities.

A number of submissions to the Review have argued that existing tax concessions should be extended to encourage activities and investments to address local environmental issues, such as land degradation, inefficient water use and environmental conservation. Some submissions considered it inequitable that businesses enjoy concessional tax treatment for environmental expenditures while people who are solely doing conservation work do not.

Tax concessions or cash subsidies can, in principle, have equivalent allocative effects to environmental taxes but they have quite different distributional effects. Environmental taxes impose burdens on polluters whereas tax concessions and subsidies impose costs on the whole community through the higher taxes needed to fund them.

However, there are situations where providing a subsidy may be appropriate. These include situations where an effective 'polluter-pays' mechanism, such as regulation or taxation, is not practical — for example, where the polluter cannot be easily identified. Another situation where targeted subsidies may be appropriate is where a government wishes to 'purchase' environmental goods on behalf of the public. An example is the Australian government's Caring for our Country — Environmental Stewardship program, which involves direct payments to landholders in return for biodiversity conservation and improvement (see Box E2–9).

In such cases it is preferable that subsidies be provided directly through grants programs rather than through broad-based tax concessions. Direct grants can be more tightly targeted towards areas of public benefit, are more transparent, and allow for the merits of environmental subsidies to be compared directly with other spending priorities. Further, unlike tax concessions where the size of the benefit of any marginal expenditure is related to the taxpayer's marginal tax rate, a subsidy can be designed to reflect better the marginal benefit of the environmental outcome.

Principles

Since tax concessions with environmental objectives tend to lack transparency, be poorly targeted, impose costs on all the community rather than just polluters and reduce the efficiency of the taxation system, other more effective mechanisms should generally be preferred.

The environmental impact of any other tax concession should be evaluated before it is introduced. Existing concessions should also be evaluated for their environmental consequences.

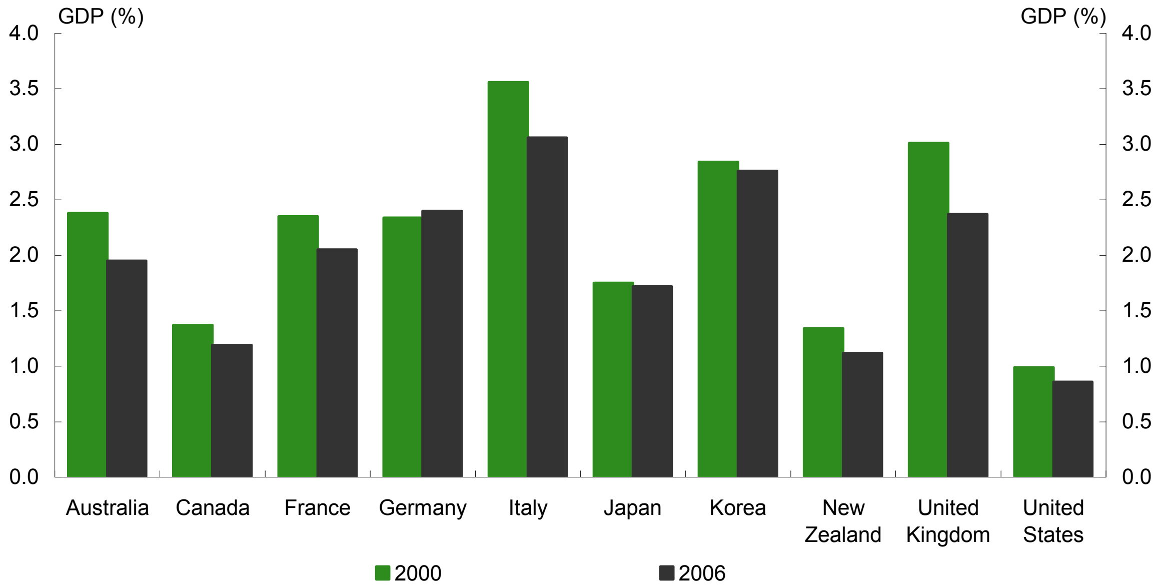
E2–2 Revenue from environmental taxes

The OECD (2006) defines 'environmentally related taxes' as any compulsory, unrequited payments to the government that are levied on tax bases deemed to be of particular environmental relevance. In Australia, regulatory approaches have historically been the primary means of addressing environmental issues. While more environmentally related taxes have been used in Australia recently, not all have been well-targeted or effectively implemented. A number of concessions to encourage positive environmental action, such as tax incentives under the Australian government's Landcare program and for water facilities, have also been introduced.

A number of Commonwealth and State charges, fees or levies are classified as environmentally related but do not address a market failure directly. For example, the purpose of taxes such as the Product Stewardship Oil Levy is not to provide taxpayers with an incentive to reduce an environmental spillover, but to generate revenue to be spent on programs with environmental objectives.

According to OECD data, environmentally related taxes in Australia raised revenue equivalent to around 1.95 per cent of gross domestic product in 2006 (see Chart E2–3). Nearly all of this revenue came from excise on motor fuels and from taxes on motor vehicles. These taxes were introduced to raise revenue, not to achieve environmental objectives.

Chart E2–3: International comparison of revenue from environmentally related taxes



Source: Heady (2009).

The Australian Government intends to introduce the Carbon Pollution Reduction Scheme (CPRS) in 2011 to reduce the production of greenhouse gases in Australia. Under accounting standards, revenue from the sale of emissions permits will be classified as taxation revenue and hence the scheme will be responsible for raising a significant proportion of environmental tax revenue in Australia (see Box E2–6 for a description of the CPRS and its revenue estimates).

Box E2–6: The Carbon Pollution Reduction Scheme

Climate change is one of the key economic and environmental challenges facing Australia and the world. The central element of the Australian Government's climate change policy framework is the introduction of the Carbon Pollution Reduction Scheme (CPRS). The CPRS, planned to commence on 1 July 2011, is an emissions trading scheme that would cap greenhouse gas emissions and issue tradeable emissions permits up to the cap. For the first year of operation, a transitional fixed price of $10/tonne CO_2-equivalent would be applied. Thereafter, emissions prices would be determined by the market (subject to an increasing price cap).

Unlike a fixed-price carbon tax, where the level of aggregate emissions would depend on an emissions price set by government, the CPRS would give the government control over the number of domestic emissions permits released and would allow the permit price to be determined by the market. Under either approach, emissions-intensive goods would be made more expensive relative to low-emission goods, creating an incentive for consumers and businesses to cut emissions by changing what they consume and their methods of production.

The CPRS emissions cap would decline annually, consistent with the Government's emissions reduction targets of between 5 and 25 per cent below 2000 levels in 2020, and 60 per cent below 2000 levels in 2050. The cap trajectory to the end of 5 years would be announced on a rolling basis to provide certainty. Each year the government would issue emissions permits equal to the cap, either through auction or administrative allocation.

Entities covered by the CPRS would be free to emit at any level, within the shrinking overall cap, but would be required to surrender a permit for every tonne of emissions. It is expected that emitters would buy permits if their internal costs of abatement were higher than the permit price, and would reduce their emissions if their abatement costs were lower than the permit price. Similarly, businesses holding permits are likely to sell them and undertake abatement activity if the market price for permits exceeds their cost of abatement. These market incentives work to move permits to their highest value use and to encourage the cheapest abatement to be undertaken first, ensuring that reductions in emissions are achieved at least cost to the community.

In the Australian government budget, revenue from the auctioning of permits is treated as a tax, subject to guidance to be issued under the UN System of National Accounts. The CPRS is expected to generate revenue from permit auctions of around $11½ billion in 2012–13.[7]

The Australian Government has indicated its intention to allocate 'free' permits to emissions-intensive trade-exposed industries and to use revenue from auctioned permits to assist households and businesses manage the transition to a low-carbon economy.

7 2009–10 Mid-Year Economic and Fiscal Outlook p. 37.

E2–3 Reforms and implications for correcting environmental spillovers

Recommendation 58:

Once the Carbon Pollution Reduction Scheme (CPRS) is operational, additional measures which seek to reduce emissions (in sectors covered by the CPRS), and which are not justified on other grounds, should be phased out.

Recommendation 59:

The industry assistance arrangements introduced in consequence of the CPRS should be regarded as transitional. The Government's policy is to commission an independent review of the CPRS, including in relation to emission-intensive trade-exposed (EITEs) assistance, every five years starting in 2014. To complement this, the Productivity Commission should be asked to undertake and publish an annual review of CPRS-related assistance arrangements for the life of the CPRS to provide a basis for future decisions on assistance policy. To assist the Productivity Commission, an Associate Commissioner with appropriate knowledge and industry expertise should be appointed to the review.

Recommendation 60:

The government should continue to monitor tax concessions aimed at supporting environmental outcomes, and consider replacing them with targeted spending programs where this would be a more effective and efficient method of achieving the appropriate environmental outcome.

The Carbon Pollution Reduction Scheme

The proposed CPRS is a broad-based permit trading scheme applied directly to greenhouse gases (and to highly correlated proxies in the case of fuels). As such, it can be expected to achieve given reduction targets in a cost-effective manner relative to other instruments. The Review has not considered the underlying policy goal, or the design, of the CPRS itself.

Supplementary measures to the CPRS

Some submissions to the Review have argued that the CPRS alone will not be enough to achieve sufficient cuts in Australia's carbon emissions, and have proposed a range of additional tax incentives such as accelerated depreciation for investments that reduce carbon emissions, and differential stamp and registration duties for cars.

These arguments are not convincing. Under the CPRS, the quantity of emissions permits will be fixed in aggregate, resulting in a price for carbon. It is the quantity of permits that delivers the reduction in greenhouse gas emissions achieved through a range of abatement activities that respond to the price for carbon across a range of sectors. The principle of the CPRS is that decisions about how this abatement occurs *within the economy* are best left to the ingenuity and innovation of private decision-makers in response to price signals. If more aggressive emission cuts are needed, the most cost-effective way to achieve this would be to lower the quantity of permits.

With the CPRS in place, and provided it retains its design integrity, imposing measures to accelerate the uptake of particular technologies or practices in the sectors covered by the scheme will not deliver additional abatement, but will generally reduce efficiency and increase the costs of reaching the abatement target (see Box E2–7).

Box E2–7: The Carbon Pollution Reduction Scheme and supplementary policies

Under the CPRS the Australian government sets an overall emissions cap and then requires emitters to acquit carbon permits for each tonne of greenhouse gas emissions. Capping emissions below current levels creates demand for scarce permits that leads to the emergence of a carbon price. Over time, the carbon price drives structural change in the economy by increasing the cost of more emissions-intensive goods and services and encouraging the development of low-emissions technologies and processes.

A key benefit of broad-based emissions trading schemes is that, like taxes, they do not dictate how businesses and households reduce their emissions. They are technology-neutral and allow affected entities, which have the best information about their abatement options, to decide the least-cost means of reducing their emissions.

Supplementary policies used in sectors of the economy covered by the CPRS will not achieve more abatement than the CPRS alone. In the example below (Chart E2–4 Panel A) illustrates an emissions trading scheme operating in isolation. The abatement required to meet the emissions reduction target is the horizontal distance A1, and is achieved with permit price P1.

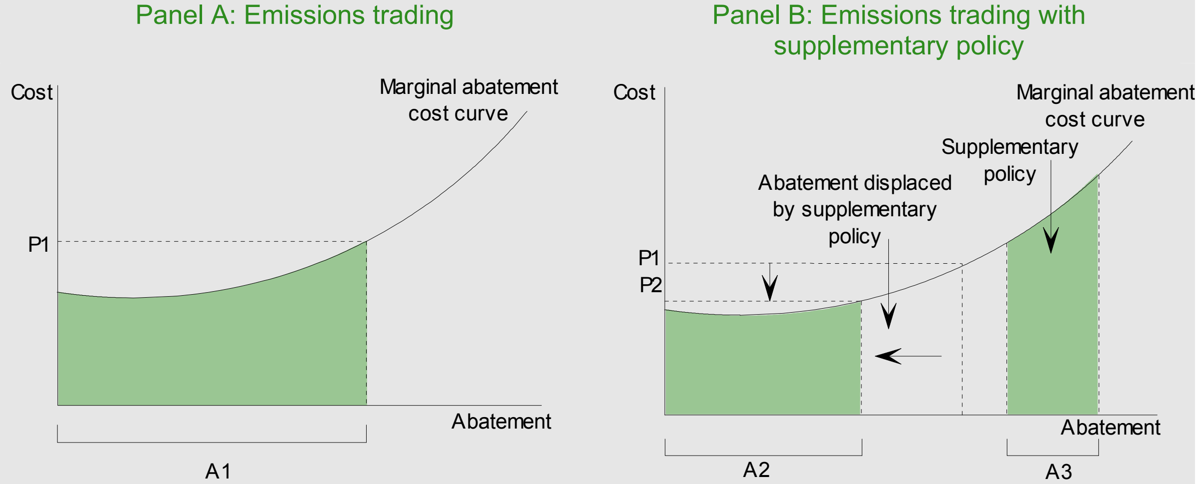
The marginal abatement cost curve is upward-sloping, reflecting that each unit of abatement becomes more expensive as cheaper abatement opportunities are exhausted. The cost of abatement is given by the shaded area under the marginal abatement cost curve.

In Panel B, a supplementary policy is introduced that achieves a quantity of abatement, shown as A3, the cost of which is reflected by the shaded area above A3. As the supplementary policy generates abatement of A3 the abatement required from the emissions trading scheme to meet a specified target falls by the same amount (that is, A1 falls to A2 where A1 = A2 + A3). Total emissions, therefore, are the same with and without the supplementary policy.

In this example, the supplementary policy has encouraged more expensive abatement. This is reflected in Panel B which results in a larger shaded area below the marginal abatement cost curve (that is, the shaded area above A2 and A3 in Panel B is greater than the shaded area above A1 in Panel A).

Box E2–7: The Carbon Pollution Reduction Scheme and supplementary policies (continued)

Chart E2–4: Effect of a supplementary policy in the presence of a general carbon price



Source: Treasury, based on Productivity Commission Submission to Garnaut Climate Change Review 2008.

Supplementary policies do not affect the environmental outcome, but they may affect the economy-wide cost of achieving an emissions reduction goal and who bears the cost. For example, suppose the government introduces concessional tax treatment for one particular form of abatement in a sector covered by the CPRS. The tax concession would lower the after-tax costs faced by firms undertaking the abatement, encouraging a higher level of abatement in the particular sector where the tax concession was introduced. This would be matched by a commensurate decrease in required abatement elsewhere in the economy. Further, instead of polluters paying a tax to society, they would receive payment from society for achieving abatement

In the example above, the abatement achieved by the supplementary policy comes at a relatively high cost (including the cost borne by the taxpayer as the government uses taxes to fund the concession) as it displaces relatively cheaper abatement. That is, if the abatement undertaken due to the supplementary mechanism were as cheap as the next unit of abatement under the CPRS, the supplementary mechanism would not be required because the abatement would have occurred anyway. This highlights the importance of targeting supplementary policies at clearly identified market failures that create barriers to the take-up of cheaper abatement opportunities.

In addition to raising the costs of abatement, ill-targeted supplementary policies can affect the predictability of the carbon price. For example, while raising the overall cost of abatement, the supplementary policy in the example above results in a lower carbon price (that is, P1 moves to P2). This could delay investment decisions and ultimately raise the cost of achieving structural change in the economy.

Supplementary policies to deliver additional greenhouse gas abatement should be considered only where there are clearly identified market failures not adequately addressed by the CPRS. They should only be undertaken where the benefits of intervention outweigh the costs. Areas where there may be scope for supplementary measures include:

- the provision of information where information failures prevent individuals or businesses from adopting cost-effective abatement options; or
- where cost-effective abatement opportunities are available in sectors not covered by the CPRS.

Unless they are consistent with these principles, existing tax concessions for emissions-efficiency investments should be abolished (see Recommendation 58).

Differentiated car stamp duties and luxury car tax

The Council of Australian Governments requested on 2 July 2009 that the Review:

> consider the merit of financial incentives for the purchase of fuel efficient cars and assess the merits of differential stamp duty and registration regimes linked to environmental performance.

Also, the Australian Government requested that the Review consider:

> phasing out the Luxury Car Tax and phasing in a tax on vehicle fuel inefficiency and consequent greenhouse gas emissions …

Both Queensland and the Australian Capital Territory (ACT) have different rates of stamp duty for certain 'environmentally friendly' cars. In Queensland stamp duty varies depending on the number of cylinders, or whether the vehicle has a hybrid fuel/electric engine. The ACT scheme charges different rates according to fuel efficiency of the car. Further, Victoria charges a higher rate of stamp duty on used cars (where the value of the car is less than $57,010) than on new cars on the premise that used cars are less fuel-efficient than new cars.

In relation to vehicle registration renewal, all states levy an annual tax that is higher for heavier vehicles and/or for vehicles with larger engines.

Measures that provide subsidies or impose penalties through registration fees or stamp duties to encourage the purchase of more fuel-efficient vehicles are not supported. Such supplementary measures serve only to increase the overall costs of abatement.

Moreover, targeting vehicle fuel efficiency as a means of achieving reduced emissions is a blunt instrument compared to targeting emissions directly by reflecting the cost of carbon emissions in fuel prices. Individual emissions levels depend not only on the efficiency of the vehicle, but also on other factors, particularly distance travelled, weight carried and driver behaviour. Proposed subsidy schemes would reward people who purchase a fuel-efficient vehicle yet travel large distances, and penalise people who purchases a less expensive, less fuel-efficient vehicle, but travel rarely. Such instruments are less cost-effective than relying on a pollution charge alone.

Furthermore, equity and cost issues arise if stamp duties are used as the basis for delivering a point-of-purchase incentive. Since stamp duties are levied as a proportion of the price of a vehicle, a discounted rate for more efficient vehicles would provide a far greater subsidy to purchasers of expensive efficient cars, even though the higher price delivers no greater fuel saving. Conversely, the price difference between an efficient cheap car and an inefficient cheap car may be too small relative to the lifecycle fuel consumption benefits of the efficient car.

Further, such schemes do not consider the lifecycle greenhouse gas emissions involved in the production and recycling of cars. If levied on second-hand cars, as current stamp duties are, the tax may encourage premature scrapping of older cars in favour of new cars.

Differential luxury car tax, stamp duty and registration schemes aimed at encouraging the purchase of more fuel-efficient vehicles should be abolished once the CPRS (or equivalent scheme) is introduced.

Any lack of readily available information about fuel efficiency could affect efficient vehicle purchasing decisions. This market failure is already addressed directly by requiring that fuel consumption information be displayed on new vehicles.

Longer-term operation of the CPRS

While the CPRS would deliver cost-effective abatement relative to other intervention options, over the longer term the efficiency of the scheme could be further improved by phasing out unnecessary instruments that may reduce its cost-effectiveness and broadening the base, and recycling any revenue raised, in excess of that needed to fund household and other transitional assistance, to reduce other taxes.

Phase out other carbon reduction policy instruments

Australian and State governments have, in the absence of a clear price signal for greenhouse gases, introduced a range of subsidies, tax concessions and expenditure programs to promote greenhouse gas reductions. As noted by Wilkins (2008):

> Currently there are in excess of 200 relevant programs around Australia in the States and Territories. Many have the potential to interfere with an emissions trading scheme.

To the extent that these programs do not address market failures other than those covered by the CPRS, they are unnecessary, inefficient and will ultimately result in higher costs being borne by the Australian public (see Recommendation 58). They should be phased out as quickly as practical once the CPRS becomes operational. The Australian Government's response to the Wilkins Review has removed some of these unnecessary programs but further action, including a rationalisation of state programs, would be beneficial.

One program that should be reconsidered once the CPRS becomes fully operational is the expanded national Renewable Energy Target (RET). The RET legislation is designed to ensure that 20 per cent of Australia's electricity supply is from renewable sources like solar, wind, geothermal and biomass by 2020. Wholesale purchasers of electricity are required to contribute proportionally to an additional 45,000 gigawatt hours (GWh) of renewable energy per year by 2020.

The RET will assist the energy sector transition to the introduction of the CPRS, by helping accelerate the deployment of renewable energy in the shorter term. As noted by Garnaut (2008), a RET will force the use of renewables in instances where non-renewable generation options (like gas) would achieve the CPRS target at lower cost. This implies unnecessarily high electricity prices, leading to higher costs for goods and services produced using electricity as an input (Garnaut 2008). The RET will conclude in 2030 as the CPRS matures.

Broaden the base of the CPRS if it will result in a net benefit

Ideally, the base to which a trading scheme is applied should be as broad as possible to maximise opportunities for low-cost abatement. The sectors covered by the current design of the CPRS account for around 75 per cent of Australia's greenhouse gases.

Additionally, the broadness of the CPRS may deliver benefits over the current tax arrangements in some areas. For example, to the extent that the CPRS will apply to liquefied petroleum gas (LPG) whereas excise does not, the broader base is likely to reduce misallocation of resources by reducing the tax bias in favour of LPG.

Carbon-sink forests and biodiversity

Carbon-sink forests can be included within the CPRS framework on a voluntary basis following accreditation. Associated tax arrangements provide for immediate deduction of establishment costs for such forests until 2011–12, after which the costs would be subject to tax depreciation at the same rate as horticultural plants.[8] Carbon-sink forests are a potentially low-cost means of reducing net emissions while providing the landowner with revenues through progressive harvesting and replanting.

A possible side-effect of these arrangements is the planting of inappropriate, single-tree species, with associated reductions in biodiversity.

While recognising this potential problem, proposals to limit carbon-sink forests to the planting of biodiverse forests are not supported. A number of studies suggest that the use of carbon-sink forests can be a cost-effective means of offsetting carbon emissions (for example, Richards & Stokes 2004, Lubowski et al. 2005). A Senate committee heard recently that the cost of planting a forest with around 40 species of tree is approximately twice that of planting a single-species forest (Senate Rural and Regional Affairs and Transport Committee 2008). Consequently, requiring that only biodiverse forestry projects be accredited under the CPRS would significantly reduce the scope for forests to be utilised as a cost-effective abatement measure.

A more effective means of improving biodiversity outcomes would be to compensate forest providers directly for the additional costs of multi-species forests. This would properly reflect the fact that government is, in effect, purchasing an environmental service, while also targeting spending to the most effective areas.

Arrangements like the Environmental Stewardship Program or Victoria's BushTender program may be appropriate mechanisms to deliver management agreement payments that remunerate carbon-sink forest investors for the additional costs of planting and maintaining biodiverse forests in perpetuity.

8 S40-1005 ITAA97 expenditure can be claimed as a tax deduction at 7 per cent a year. See page 16 of www.environment.gov.au/minister/wong/2009/pubs/wilkinsresponse.pdf.

Phase out transitional assistance

Under the proposed arrangements, all revenue raised by the CPRS would be returned through targeted assistance. This assistance includes:

- *household assistance*: through increases to income support, family payments, tax offsets to support low- and middle-income households and energy efficiency measures;
- *fuel tax adjustment*: reducing fuel excise to maintain the overall tax on petrol over the first three years of the scheme's operation;
- *industry assistance*: comprising free permits provided to emissions-intensive trade-exposed industries (EITEs), which may not be able to pass on costs in the absence of a global agreement on emissions reductions, free permits to some existing coal-fired electricity generation plants, and support for clean technologies;
- *targeted support*: including support for information provision, for medium and large enterprises to reduce the impact of CPRS-related electricity price increases, for the food processing industry, for small business and community organisations to invest in energy efficiency equipment, as well as grants for innovative projects; and
- *structural adjustment assistance*: for those adversely affected by the scheme's introduction.

Assistance in general should be viewed as transitional in nature and, apart from appropriately designed household assistance, be abolished in the longer term. Of course, this will depend in part on future development of CPRS targets and international developments.

The household assistance arrangements applying to transfers will result in automatic and ongoing increases in assistance to reflect any price increase caused by changes in the CPRS target. As a result, no further assistance for transfer recipients for such price changes is required. As wages are not indexed in such a manner, if assistance is to be provided to the broader public it should be done through the income tax system (for example, through the current LITO or through increases in the tax free threshold). Such an approach is aimed at maintaining incentives for workforce participation for those members of society who are particularly sensitive to real wage movements (as higher prices result in lower real wages). Providing such income tax cuts may be important for macroeconomic stability as the proposed tax cuts will lessen the pressure for compensating wage increases (Freebairn 2008).

Assistance to individuals and families in the form of compensation to overall income (such as tax cuts and income support increases) maintain the carbon price signal and therefore the incentive to reduce carbon emissions. On the other hand, any assistance arrangements that would blunt carbon price signals should be avoided.

The fact that the CPRS imposes a price on the domestic production of carbon, for those emitters covered by scheme, is important in considering other forms of assistance to trade-exposed Australian-based businesses emitting carbon. Without other nations imposing mechanisms to price carbon, this could lead to investment in Australia, particularly in EITE industries, moving offshore for no net reduction in global emissions — compared to where no CPRS is in place. On the other hand, investors will consider the risk that carbon pricing will be introduced in other countries before it is actually introduced. In some cases, the certainty provided by an established carbon pricing system may increase the attractiveness of Australia.

Assistance provided to EITEs is scheduled to phase down by 1.3 per cent per annum via the carbon productivity contribution. In 2014 the Independent Expert Review will report on the appropriateness of EITE assistance, including detailed work by the Productivity Commission on carbon constraints in other jurisdictions.

The Government's policy is to commission an independent review of the CPRS, including EITEs assistance, every five years starting in 2014. To complement this, reviews should be undertaken annually by the Productivity Commission to provide a basis for future decisions on assistance policy and should take into account the extent of effective carbon pricing in other countries. To assist the Productivity Commission, an Associate Commissioner with appropriate knowledge and industry expertise should be appointed to the review (see Recommendation 59).

In relation to support for energy efficiency purchases, support for specific abatement activities is redundant under the CPRS and will serve only to increase the overall cost to the economy of achieving any given abatement target. The extent to which energy efficiency will contribute to national emissions reductions should be left to the market.

Similarly, there is no convincing evidence of significant market failures associated with innovation and low-cost technologies to address climate change over and above those addressed by existing intellectual property rights and general support for research and development. Through putting a price on emissions, a key benefit of the CPRS would be to provide a strong incentive for the development of emissions-reducing technologies and practices, whether or not other countries also implement carbon-reduction policies. If there were to be a market failure in research and development, it should be addressed through existing broad-based arrangements to support research and development rather than through targeted, industry-specific programs.

Implications for existing environmental tax concessions

The tax system currently incorporates a number of tax concessions intended to promote environmentally beneficial activities such as Landcare operations and environmental protection expenditures. The majority of these concessions are directed towards primary producers. Three-quarters of land in Australia is in private hands and, consequently, private landholders have an important role in preserving and improving the environment.

Tax concessions are not a successful means of targeting the degradation problems that cause the largest public costs (Mues, Moon & Grivas 1996). Moreover, some commentators, such as Edwards, Dumsday and Chisholm (1996), have suggested that providing subsidies for remediation and rehabilitation may perversely encourage land degradation, since the marginal cost of repairing it is lower.

Furthermore, every tax concession increases the complexity of the tax system. While only a small proportion of taxpayers may be eligible for a given concession, the extra costs associated with understanding, claiming and administering every concession, and their interactions, build up. The cost of this increasing complexity should be considered whenever governments look at options for delivering programs (see Section G4 Client experience of the tax and transfer system).

Environmental land management

The environmental impacts of land use are among Australia's most significant environmental challenges. Major problems include the loss of biodiversity, the pollution of water ways, soil erosion, salinity and soil acidity (Australian State of the Environment Committee 2006). Significant changes in land management practices are needed to avoid passing irreversible environmental damage on to future Australians.

However, the tax system is generally not a practical or efficient means of driving this change due to the limitations of tax concessions discussed above.

There may be considerable national benefit in governments collectively developing and adopting a comprehensive national approach to environmental land management. A central element should be a legislated 'duty of care' on landholders, as proposed by the then Industry Commission in 1998 (see also House of Representatives 2001). This would reflect the principle that the community's right to a clean and sustainable environment overrides the rights of individuals to unrestricted use of their private property.

Several States have already moved in this direction, in relation to specific problems, by legislating for an environmental duty of care including weed control (under which farmers are obliged to take steps to prevent the spread of certain weeds on their property). Another example of such an approach is Queensland's recent strategy to protect the Great Barrier Reef from agricultural runoff pollution (under which primary producers are obliged to adopt practices that limit runoff from their land).

Indeed, duty of care arrangements — which impose obligations on land owners in order to achieve social objectives — have a long history in Australia's urban areas, being used to achieve objectives such as preserving architectural heritage or significant trees.

Some States have also legislated for a general environmental duty of care[9], though these provisions do not appear to have been operationalised to any great extent, possibly due to uncertainty about what *standard* of care the duty actually imposes on landholders (see Box E-8).

Box E2–8: A framework for an environmental duty of care

The objective of introducing a statutory environmental duty of care would be to prevent future environmental harm. It would not demand remediation of past environmental damage. It would require land managers to take all reasonable and practical steps to prevent harm to the environment.

Desired outcomes, focused on preserving ecosystem integrity, would be developed in consultation with affected parties, and incorporated into the legislative framework. Land managers employing practices insufficient to meet the desired outcomes would be considered in breach of their duty of care.

The main challenge would be to define the standard of care required precisely enough to give land managers certainty about their obligations.

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9 Queensland: *Environmental Protection Act 1994* s319; Victoria: *Catchment and Land Protection Act 1994 (Vic)*; also South Australia and the Australian Capital Territory.

Voluntary codes of practice or guidelines for catchment or sub-catchment areas would be developed. These codes would reflect best practice and provide guidance to land managers about appropriate land management practices. Adoption of a code, while voluntary, could be a defence against enforcement action.

A phased approach could be used to encourage compliance, ranging from positive measures such as providing information and advice to official warnings, administrative compliance orders and civil penalties.

Over time, scientific knowledge and technology will improve. This will have implications for the appropriate standard of care. What is expected under the duty of care should therefore be periodically reviewed.

To address this, the introduction of a statutory duty of care would need to be complemented by other instruments, such as codes of practice, indicating how the duty of care can be met. These codes should be included in all relevant jurisdictional legislation, but with the applicable standards developed and applied at an appropriate regional level to reflect environmental and geographical differences. It is important that these standards allow the adoption of flexible and innovative approaches by landholders, and minimise compliance costs.

A duty of care may impose some additional cost on landholders, but this would better reflect the true cost of production. In addition, funding available under existing government programs, such as the $2.25 billion *Caring for Our Country,* could be used to help landholders transition to the required standard where necessary.

Under this approach, services of high environmental value that are beyond the standard of care required (such as extensive remediation of past damage) could be purchased from private landholders by governments through programs such as the Environmental Stewardship program (see Box E2–9).

Box E2–9: The Caring for our Country — Environmental Stewardship Program

Under the Environmental Stewardship Program, the Australian government purchases high-value environmental and ecosystem services on behalf of the broader community from individuals or organisations that own or manage freehold, leasehold or native title land. Landholders enter long-term contracts under which they are paid to deliver such services. The Victorian BushTender program (on which the Environmental Stewardship Program was modelled) operates in a similar way.

The objective of programs like Environmental Stewardship program and BushTender is the same as the objective of current environmental tax expenditures for primary industries, but they avoid many of the problems associated with tax expenditures. Specifically, these programs allow spending to be targeted to high-value conservation and ecosystem service areas identified by the government. The benefit the landholders receive is based on the service they offer the public, rather than the marginal tax rate they face, or whether they operate a business. In addition, government expenditure on these public goods is transparent and is reported in annual budget publications.

Implications for existing environmental taxes

Existing environmental taxes should be retained only if they effectively address a clear market failure and if their quantum reflects the size of the spillover effect involved.

As noted earlier, some existing 'environmental' taxes are not, themselves, intended to address an environmental spillover, but are intended primarily to raise revenue to fund associated environmental programs. For example, the waste levies imposed by some States are unlikely to match the costs of providing landfill services and the environmental spillover associated with landfill. Revenues are sometimes earmarked to environmental programs (see Box E2–10).

Product stewardship schemes

Some product stewardship schemes have the effect of raising revenue to fund associated environmental programs rather than directly targeting the environmental spillover. They target the purchase of the good that may lead to the environmental damage. Those benefiting from that production or consumption should therefore fund any programs designed to deal with the environmental damage that may occur.

If this approach is used it is important that taxing and spending programs are closely aligned. For example, using a tax that then funds a payment (of the same amount) when the product is returned for correct disposal clearly links the tax to the refund.

Product stewardship arrangements aim to reduce the environmental impact of a product throughout its lifecycle. This usually involves holding manufacturers responsible for designing and selling products that have minimal environmental impact while holding consumers responsible for ensuring their use and disposal of a product does not harm the environment.

The Commonwealth Product Stewardship Oil levy (see Box E2–10) is an example of where a levy is applied to all importers and manufacturers to fund the collection and recycling of used oil. South Australia's beverage container deposit legislation is another example. It is most likely that these taxes are passed onto consumers in the form of higher prices.

Governments should implement such arrangements only when the costs of the scheme are less than the cost of damage to the environment, human health and public amenity that the arrangements will prevent. Such schemes are most likely to be appropriate where the damage done by inappropriate disposal is high and it is difficult to prosecute the people responsible.

Reducing the consumption of resources is not sufficient reason for governments to intervene, since the price mechanism reflects scarcity. There has to be a spillover or external cost to society from consuming or disposing a particular product.

Also, each policy instrument needs to be assessed on its individual marginal benefit to the environment. For example, the benefit from applying a tax on pollution arising from production of a good should be considered and assessed independently from the benefit of reducing environmental damage arising from that good's disposal.

When evaluating these arrangements, governments should also consider the incentives they may unintentionally create. For example, beverage container deposit schemes can reduce the viability of kerbside recycling by removing high-value glass and aluminium from the waste stream.

Box E2–10: Examples of environmental taxes and charges intended to raise revenue

State waste levies

Most States impose a levy on waste disposed of in landfill as well as to the gate fee (a user charge). The levies are intended to discourage waste going to landfill. Some States hypothecate the revenue to environmental programs. The revenue collected through these levies can be substantial. For instance, the NSW Waste and Environment levy is estimated to raise $260 million in 2008–09.

As noted by the Productivity Commission, the externalities of disposal to a properly located, engineered and managed landfill are typically small, broad landfill levies are not a practical way to target any residual externalities and, in some States, the levies impose unwarranted costs on the community (Productivity Commission 2006a, pp. 220–228). Moreover, the levies may encourage illegal dumping of waste, rather than waste minimisation.

Product Stewardship for Oil Program levy

This levy is imposed on the purchase of virgin petroleum-based motor oil produced or imported into Australia, at a rate of 5.449 cents per litre. This rate was based on an estimate of the cost of the associated used-oil recycling program.
In 2007–08 it collected $27.6 million.

Used oil can result in significant environmental harm if it is disposed of inappropriately. However, the levy is not intended to change behaviour in relation to oil disposal. Rather, the levy raises revenue used to fund a used-oil recycling program. The merits of the associated oil-recycling program should be reviewed. As noted by Productivity Commission (2006a), the provision of a greater subsidy for recycling used oil into ‘high value’ products distorts the used-oil market. In particular, the merits of a used-oil collection subsidy should be explored.

Implications for other existing concessions that impact on the environment

Tax concessions introduced for non-environmental purposes but which promote behaviour with adverse environmental consequences should be reviewed. Such a review would consider whether the social benefit of the activity supported by the concession outweighs the social cost associated with the environmental damage. Key tax concessions identified by the Review as having environmental consequences include the concessional application of fringe benefits tax to cars and certain concessions provided to the primary production sector.

Fringe benefits tax

The current statutory formula for valuing car fringe benefits applies so that the taxable value of a car fringe benefit falls as total kilometres rise.

At the margin, these arrangements may create an incentive for individuals to travel additional kilometres, adding to carbon pollution and congestion. To address this issue, the

Review is recommending that car fringe benefits be valued at a single statutory rate of 20 per cent that would apply regardless of the kilometres travelled (see Recommendation 9b, Section A1 Personal income tax).

Concessional treatment for primary production

Tax concessions that favour agriculture and forestry include undervaluation of natural livestock inventory increases, and accelerated depreciation for plantation forestry and horticultural crops. These provisions encourage higher levels of the favoured activities. Environmental spillovers may include excessive stocking rates and expansion of primary production into marginal areas (Freebairn 2009).

A range of petroleum excise exemptions may have unintended impacts on the environment. The petroleum excise system is considered further in Section E3 Road transport taxes.

E3. Road transport taxes

Key points

Current road tax arrangements will not meet Australia's future transport challenges. Poorly functioning road networks harm the amenity, sustainability, liveability and productivity of society. Moving from indiscriminate taxes to efficient prices would allow Australia to leverage the value of its existing transport infrastructure. Less congested roads, shorter travel times and investment in road infrastructure that addresses user demand would provide a foundation for further productivity growth, improved living standards and more sustainable cities.

In major cities, location-specific congestion charges would vary according to the time of day. City roads would be less congested during peak periods, with higher travel speeds and shorter travel times saving time for road users, reducing vehicle costs and reducing greenhouse emissions. The revenue from congestion charges on existing roads should flow back to the community, initially to finance public transport in affected areas.

Heavy vehicle charging would ensure that individual trucking operators pay their own specific costs and no longer cross-subsidise other operators. Truck operators would have incentives to avoid route choices and vehicle configurations that cause the highest costs, but would have access to roads and bridges where and when they are willing to pay. Revenue from road-wear charges would directly fund road maintenance.

Negative spillovers not currently amenable to pricing would be addressed through regulations. The transport sector would pay for greenhouse emissions through an economy-wide scheme, not through ad hoc sector-specific taxes.

In exchange for targeted charges, road users would pay less tax, including less fuel tax. Motor vehicle stamp duties would be abolished, compulsory third party insurance would be fairly priced, and taxi licence quantity restrictions that push up taxi fares would be removed.

The revenue from efficient charges could help finance new urban transport infrastructure, and cover the cost of heavy vehicle damage. But these charges would not pay for the full cost of providing and operating the road network. The remaining costs could be funded from general tax revenue, or by retaining a network access charge (such as annual vehicle registration) or a variable charge (such as fuel tax) set to recover the efficient costs of road provision. Important non-economic community objectives would still be funded from general revenue through well-defined community service obligations.

Spending on roads should match anticipated need. This should be determined strategically according to comprehensive and transparent benefit-cost analysis. This would help ensure new roads are built where needed, and roads are maintained to minimise total life-cycle costs, including costs to road users. Road users with specific needs could enter commercial agreements with road suppliers.

Key points (continued)

Existing institutions have not led to the most efficient use and supply of roads. Prices are essential to making the best use of roads, but they must be coupled with improved governance that better serves the needs of road users, now and in the future. New investment based on economic criteria, and accountability for investment decisions would help ensure that roads are in place to address future needs.

The challenge is formidable. It requires coordination across all levels of government. But reform would promote the best investment in and use of our roads, lift national productivity, and improve the lives of millions of Australians.

E3–1 Quicker, more reliable trips on less congested, better maintained roads

Every industry depends on an efficient and competitive transport sector for the timely movement of people and goods between geographically dispersed centres and for access to domestic and global markets. Australia's transport sector is also critical at a social level, providing access to jobs, services and other people. Most people use roads and bridges most days of their lives, whether as a motorist, a pedestrian or a cyclist, to get to work or school or to participate in the community. Road transport is an input to almost all the goods and services we consume.

But despite the fundamental demand for roads, road markets are subject to major market failures and poorly adapted institutions. In particular, congestion costs in urban areas are almost entirely unpriced. Road-wear charges for heavy vehicles do not accurately reflect the damage that particular vehicles do to the roads. These deficiencies impose large costs on the Australian economy.

These costs affect not only individual drivers, but also reduce the nation's wealth — much of which is generated in urban areas that are affected by congestion. Capital cities contributed 78 per cent of the nation's economic growth between 2001 and 2006 (Infrastructure Australia 2008). Much of the innovation and invention that drives sustainable growth occurs in cities and has led to the saying that 'cities are the engines of growth' (Lucas 1988). However, opportunities for growth are hindered by poor use of infrastructure.

In making decisions about where, when and how to drive, road users sometimes make choices that delay others, damage public roads or pollute the environment. Road prices that reflect congestion, road-wear and environmental costs would give road users both the information and the incentive to reduce the trips that are most costly to society. (The potential to use motor vehicle taxes to improve the environment is discussed in Section E2 Taxes to improve the environment.)

This section proposes a major reform of road transport taxes. The vision for road tax reform is for quicker and more reliable trips on roads that are less congested and better maintained. All road users, private and commercial, would save time, vehicle and fuel costs. All drivers would have real incentives to choose different routes, times or transport modes, so as to produce lower emissions and less noise, and help create more sustainable and liveable cities.

Taxes on roads or road user charges should principally be used to provide signals that improve the use or building of roads. There is also a case to recover a fixed-cost component of road use as an access fee or user charge. Coupled with institutional reforms, this could improve accountability in the provision of roads. Fuel tax and other transport taxes are not an efficient or equitable means of financing general government expenditure.

The reforms to road transport taxes proposed in this section would help achieve a road system that meets the social and economic demands of both the general public and the freight industry. The financial incentives for transport agencies would be more closely aligned with the demands of road users. Businesses with specific transport needs could negotiate with road suppliers to provide key infrastructure or service guarantees.

The current institutional architecture is not well-geared to the efficient use and supply of roads. In conjunction with improved pricing, the institutional structure needed to mediate the efficient supply of, and demand for, road infrastructure must be considered. This will require cooperation among governments.

The discussion of roads in this Review is predicated mainly on existing technology for road pricing. In the long term, further technological changes may enable further reforms. The changes to institutional arrangements suggested in this section would facilitate innovation based on such developments.

Principle

Transport-specific taxes should only be imposed where they improve the way that people, businesses and governments make decisions. In general, this means that transport taxes should be designed to correct market failures in the transport sector — specifically, to ensure that users of transport make decisions based on the full costs of their activities on the community (including unpriced costs that spill over to others and the cost of consuming infrastructure).

E3–2 The current system raises revenue, but harms efficiency

In 2006–07, the Australian Government collected around $14 billion in fuel tax, of which roughly $4 billion (ATO 2008) was returned through the fuel tax credit scheme. While fuel tax credits primarily remove tax paid on off-road use, they also make fuel tax used in heavy on-road vehicles partially refundable. Part of the fuel tax credit is withheld as a ‘road user charge’. Light vehicles, including vehicles used for business, are not entitled to fuel tax credits. Deducting fuel tax credits from fuel tax revenue leaves net fuel tax of around $10 billion per year for the Australian government.

In the same year, the States collected a further $6 billion from road users through annual motor vehicle registration charges, stamp duties on the sale of new and used vehicles, surcharges and levies on compulsory third party insurance, car parking space levies, and other minor taxes (Clarke & Prentice 2009, p. 29).

Collectively, this amounts to around $16 billion collected annually from road users in additional taxes. This combination of annual motor vehicle registration and fuel excise could be viewed as a crude ‘two-part tariff’ for road usage. While road taxes are not hypothecated (that is, earmarked) to road spending, revenue from these taxes does cover the direct cost of infrastructure spending on roads and bridges, which was $12 billion in 2006–07. A range of additional costs are also borne by governments in relation to roads (for example, policing, justice, emergency services and additional health expenditure). Nevertheless, it is an open question whether these should be financed through specific taxes on road users, or whether the community at large should pay through more efficient taxes.

There are a range of costs that are not, and cannot be, efficiently priced using the traditional 'fuel tax and rego' model. For example, the costs of urban congestion (which vary according to location and time of day) as well as the costs of road-wear caused by heavy vehicles (which vary according to the mass, distance and location of travel) cannot be efficiently priced through fuel tax. This is because the costs are not closely related to the amount of fuel used. These costs are large, and if not addressed through changes to the way roads in Australia are priced, are set to grow further.

Moreover, the supply of roads and bridges, and access to them for heavy vehicles, is not always responsive to the economic needs of businesses and other users.

Finding

The existing structure of fuel tax, annual registration and other road-related taxes is designed primarily to raise revenue. These taxes more than cover the direct costs of providing road infrastructure, but are not capable of providing specific prices that vary according to location or time of use.

E3–3 Road pricing should reflect social costs

Recommendation 61:

Governments should analyse the potential network-wide benefits and costs of introducing variable congestion pricing on existing tolled roads (or lanes), and consider extending existing technology across heavily congested parts of the road network. Beyond that, new technologies may further enable wider application of road pricing if proven cost-effective. In general, congestion charges should apply to all registered vehicles using congested roads. The use of revenues should be transparent to the community and subject to further institutional reform.

Recommendation 62:

The Council of Australian Governments (COAG) should accelerate the development of mass-distance-location pricing for heavy vehicles, to ensure that heavy vehicles pay for their specific marginal road-wear costs. Revenue from road-wear charges should be allocated to the owner of the affected road, which should be maintained in accordance with an asset management plan. Differentiated compliance regimes to enforce this pricing policy may need to be considered to balance efficiency benefits from pricing against the costs of administration and compliance for some road users.

Recommendation 63:

States should improve compulsory third party insurance to better reflect individual risks.

Recommendation 64:

On routes where road freight is in direct competition with rail that is required to recover its capital costs, heavy vehicles should face an additional charge on a comparable basis, where this improves the efficient allocation of freight between transport modes.

For road users to make the best decisions about where, when and how to travel, they need to know the relative costs and benefits of each available choice. They most often choose the trip that is quickest or cheapest for them. The most obvious costs they incur are the private costs of vehicle operation, any road tolls and the time taken to travel. Each individual and business faces these costs and makes decisions based on them.

But there are additional costs that road users do not pay. The cost of the delay they cause others at peak hour, the wear that a particular truck causes to a specific road, or the local pollution caused by an individual trip, are all costs that 'spill over' onto other road users and the community at large. Because these costs are not priced directly, road users have little incentive to take them into account.

Some level of spillover cost is unavoidable. The costs that spillovers impose on society need to be balanced against the costs of reducing them. The road-wear cost saved by closing a road to heavy vehicle traffic may be far less than the cost of the freight going by a longer alternative route or not being transported at all. The costs of eliminating congestion entirely would far outweigh the benefits.

If people faced prices that included the costs of spillovers, they would make better decisions from the point of view of society as a whole. Congestion costs can be reduced by travelling at different times of the day, by taking a different route, by choosing to catch a bus or train, to cycle or walk, to share a private car or taxi, or by using the telephone or internet instead. A well-functioning and efficient road network would help achieve the best use of infrastructure for society by providing clear and direct price signals to potential road users.

In technical terms, potential road users should face the 'short-run marginal social cost' of accessing the road. They are 'short-run' because they consider the use of only the existing road, without regard to how future roads would be financed. 'Marginal' means that it is the impact of the additional (or next) decision to use the road that is relevant. For example, the marginal cost of driving outside peak times is much lower than the average daily cost (which includes congested peak times). Finally, 'social' refers to the costs to society as a whole — including spillover costs. In contrast, 'private' costs are the costs incurred by the individuals whose activities give rise to the costs.

Individuals mostly make decisions based on private costs. If private and social costs can be brought into alignment, individuals will make the best decisions for society as a whole.

Principle

Variable road prices should be set to reflect the short-run marginal social cost of road use, which includes spillover costs.

The costs and benefits of targeted prices

The more closely targeted the price is to the activity that gives rise to costs to society, the better the resulting allocation of resources. Blunt instruments do little to improve efficiency. For example, while fuel tax marginally reduces road use, it has a relatively trivial impact on spillover costs such as congestion or road damage that depend on where and when vehicles travel. To have much effect on congestion, fuel tax would need to be set at a high rate that would significantly over-tax drivers on uncongested roads.

Improved road pricing also has some offsetting costs, particularly administration and compliance costs. The theoretically ideal pricing system would have prices continuously varying by time and location. While technology is advancing rapidly, the costs of pricing the entire network this way and the ability of road users to respond to the information mean that, in practice, a great deal of averaging over time and location will be necessary, pending major improvement in the cost-effectiveness of emerging technology.

This should not prevent the realisation of substantial gains from efficient pricing using current technology. Most congestion costs are highly concentrated at certain places and times and road-wear costs are significant only for specific types of vehicle.

The degree to which road taxes should be targeted therefore depends on a trade-off between the economic gains from better resource allocation and the economic costs and community acceptance of imposing a road pricing regime.

Principle

Taxes or charges to improve efficient use of infrastructure should be imposed only where the benefits of improved resource allocation outweigh the additional administration and compliance costs. Compliance regimes should be designed to ensure that implementation and transaction costs are not disproportionate to the benefits.

This trade-off between costs and benefits is changing. The cost of road pricing technology has fallen significantly in the past few decades, and the technology is now sufficiently mature to support limited road pricing for specific applications (see Box E3–1). For example, full electronic tolling under free-flow conditions is already in place on many urban toll roads. If current trends continue, the cost of technology will continue to fall.

Box E3–1: Telematic technology in heavy vehicles

Excise fuel taxes have been the primary method of collecting road charges for close to a century. While this form of revenue collection has low costs and is easily administered, technological advances have the potential to enable road pricing that can vary according to vehicle types on specific roads. These telematic technologies have high up-front costs, including the installation of in-vehicle units (IVUs) and toll gates, but could make road user charges for heavy vehicles based on mass, distance and location a reality and facilitate enhancements to road networks.

Telematics technology is only in its infancy but it has much potential. European Union countries currently use IVUs to charge congestion fees and road user fees for heavy vehicles according to the vehicle's class, mass, duration and time of travel. Further advances in telematic technologies and reduced costs would make the installation of IVUs in small vehicles feasible and create the possibility of integrated road networks.

Integrated road networks with telematics technologies can provide real-time traffic flow data to traffic management systems, from which automobile navigation systems can calculate optimal travel routes, coordinating the entire road network and reducing overall travel times. Telematics can also enhance the safety of the network by switching vehicles to auto navigation in the event of a near collision. Additional benefits include telematic drive-as-you-go insurance, mobile data transmission and emergency warning systems.

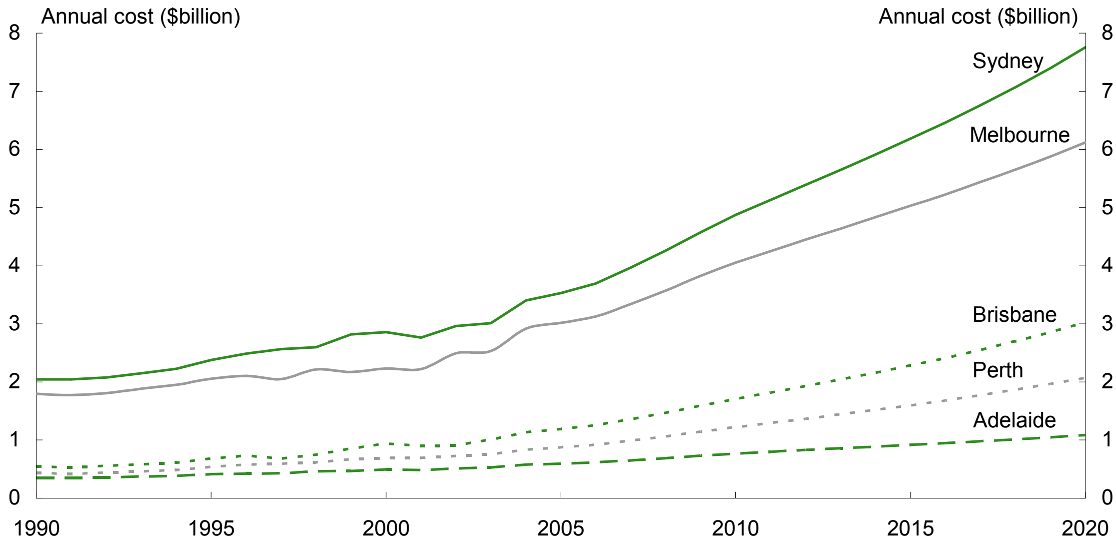
Urban congestion

One of the largest spillover costs from road transport is congestion in Australia's major cities. The typical costs associated with congestion include travel delays, variable travel times (unreliability), higher vehicle operating costs (including higher rates of fuel consumption), reduced productivity, increased driver and passenger stress, additional greenhouse gas emissions, poorer urban environment and air quality (as vehicles under congested conditions emit more pollutants than vehicles under free-flow conditions) and, as a consequence, higher health costs.

Congestion costs are increasing. In the absence of road pricing, the Bureau of Transport and Regional Economics (2007) forecasts that the avoidable social costs of congestion will rise to around $20.4 billion by 2020. This estimate is based on 'business as usual' assumptions about road investment and management.

These costs are concentrated in large capital cities at peak times. The projected costs are set out in Chart E3–1 below. They increase with population growth and economic activity.

Chart E3–1: Social costs of congestion for Australian metropolitan areas
Base case projected estimates (1990–2020)



Projected costs for Canberra, Hobart and Darwin are less than $1 billion in 2020. Time costs are based on deadweight losses for current congestion. That is, social costs refer here to the estimated aggregate costs of delay, trip variability, vehicle operating expenses and motor vehicle emissions — associated with traffic congestion — being above the economic optimum level for the relevant network.
Source: BTRE (2007, p. 109).

Congestion not only imposes costs now, but evidence suggests it also harms long-run growth in heavily congested cities. One reason is that congestion is felt largely around work times, which affects the cost of doing business and getting to work. Congestion acts like a tax on employment, but without any revenue flowing to government. For example, a recent study estimated that, in the United States, a 10 per cent increase in congestion for a heavily congested city such as Los Angeles reduces long-run employment growth by around 4 per cent (Hymel 2009). Poor management of infrastructure therefore reduces productivity.

Findings

Traffic congestion is concentrated in Australia's largest cities. Under a 'business as usual' scenario, the avoidable costs of congestion may grow to around $20 billion in 2020. These costs are concentrated in specific locations, with levels of congestion varying throughout the day.

Most other roads are uncongested virtually all the time, and many urban roads are uncongested at night. Vehicles on these roads impose negligible congestion costs.

Non-price policy responses are limited

Faced with an imbalance between demand for road space and its supply, one option is to increase the supply of roads. While this may have worked in the past, it is likely that for most major Australian cities the cheapest supply-side options have already been taken.

Acquiring more land for urban roads, building new bridges or digging new tunnels are expensive ways to meet future needs. While additional investment in new roads does expand road capacity, it does not lead to an efficient allocation of road space.

Even where expanding capacity is affordable, there is also a question of how many additional roads — and how much additional traffic — can be introduced without undermining the liveability of Australia's major cities, the sustainability of the urban environment and the management of urban sprawl. Evidence from cities in the United States between 1983 and 2003 found that the extension of most major urban (unpriced) roads induces a proportional increase in traffic (Duranton & Turner 2009). A survey of several studies suggests that, within three years, 50 to 100 per cent of new capacity is filled with induced traffic — that is, with new road users (BITRE 2008).

Non-price measures to reduce congestion, such as TravelSmart, also give rise to induced traffic.[10] The additional capacity they create is soon filled up by new road users. This effectively expands supply, which brings economic benefits to the additional travellers.

Introducing congestion pricing does not negate the need for expanded supply of roads in many cases, or other non-price measures. However, pricing is needed to leverage the value of urban road space, to ensure that investment in road capacity is put to its highest value use.

Congestion can be reduced by targeting prices to time and location

Congestion can be reduced by imposing a charge or tax that varies according to prevailing levels of congestion. In practice, this means a variable tax that rises at peak periods, falls away as usage falls, and is zero when there is no congestion. In theory, the tax should be different for different roads and should change at each intersection along any particular road. The purpose of this tax is to reflect the social marginal cost of congestion, and provide incentives for some people to avoid the tax by changing their travel behaviour.

Traffic flows would improve, as fewer vehicles would demand access to roads at peak times. There would be less delay and roads would be used more evenly throughout the day. Congestion would be more widely spread geographically as some road users shifted from the most congested roads to other roads. The purpose of congestion charging is not to eliminate congestion altogether, but to ensure that road users make decisions that reflect the full costs their travel imposes on society.

In theory, a congestion charge or tax would apply to all vehicle types and road users. It would take into account the size of different vehicles. For example, a motorbike takes up significantly less space on the road than an articulated truck and would be charged accordingly. Limited exceptions may be necessary in some circumstances (most obviously, for emergency vehicles).

Congestion charges should be the same for both business and private users, as the spillover costs of congestion are the same for each (see Recommendation 61). However, individual road users will place different values on faster travel, better reliability and reduced driver stress. Road users who need to arrive at their destination quickly or punctually, such as a

10 TravelSmart programs by the Australian and State governments ask people to make voluntary changes in their travel choices, encouraging people to use other ways of getting about rather than driving alone in a car — for example, using buses, trains and ferries, car-pooling, cycling or walking, or through tele-working.

courier or a person going to a job interview, would probably be better off despite having to pay the congestion tax (see Box E3–2 following).

Box E3–2: Getting to the airport on time

While much of the cost of urban congestion falls on commuters, for some people the costs can be more acute. A missed flight not only costs money, but ruins holidays and throws out business schedules.

Tollways already serve many of Australia's major airports, using technology that could readily be adapted for variable pricing.

If at least one lane, to and from the airport, were priced to keep traffic flowing, then an express option with a higher fee would always be available to passengers to get to the airport on time, or to get into town quickly. It would provide an express option when the congestion charge costs less than missing a flight or a meeting.

Moreover, by taxing only one lane, the congestion charge would be optional. People who leave plenty of time before flying would not need to take the express lane. This would also demonstrate the practical benefits of congestion charging compared to conventional roads.

Congestion charges are fundamentally different from conventional road tolls. Road tolls are typically designed to recover the capital cost of building a particular facility (for example, a specific road or bridge). Typically, the toll is the same whether a vehicle is driving at night or at a peak time. In fact, contractual arrangements between toll road operators and State governments often prevent prices from being adjusted to manage congestion levels (Clarke & Hawkins 2006). By contrast, congestion charges are set on a variable basis to ensure the best use of the asset, and fall to zero at times of low demand.

The costs and benefits of particular congestion charging arrangements would vary from city to city and between different parts of the same city. As a first step, there are likely to be benefits from introducing variable congestion charges on individual tolled lanes, or from converting existing toll roads to congestion pricing (see Recommendation 61).

The introduction of simple congestion premiums on the Sydney Harbour Bridge and Tunnel shows that time-variable pricing is feasible using technology that is already in place on some Australian roads (see Box E3–3). Moreover, a major Australian toll road provider is currently building a road in Virginia in the United States, with some lanes that will be tolled using fully electronic time-variable pricing, designed to ensure a free flow of traffic in those lanes at all times.

Box E3–3: Electronic time-of-day tolling on Sydney Harbour Bridge and Tunnel

The objective of time-of-day tolling for the Sydney Harbour Bridge and Tunnel was to encourage use of the road network outside peak times, thereby easing congestion on the network during the peak times. The tolling arrangements are:

- Motorists travelling from 6.30 am to 9.30 am and from 4 pm to 7 pm on weekdays pay an increased toll of $4 to use the harbour crossings.
- For motorists who travel during 9.30 am to 4 pm weekdays and from 8 am to 8 pm on weekends the original $3 toll applies.
- At all other times motorists pay a reduced toll of $2.50.

The full impact of time-of-day tolling is difficult to quantify due to the influence of other factors that affect driver behaviour.

However, to date the data show an increase in the number of vehicles travelling into the city via the harbour crossings in the hour before the peak period, and a corresponding decrease in the volumes during the 6.30 — 9.30 am peak period in 2009, as compared to the same period in 2008.

Source: Road Traffic Authority NSW (2009).

Where tolls are levied by private infrastructure operators, State governments should negotiate to compensate operators if the switch to variable tolls involves a loss of revenue. If there is a gain in revenue, the operator should be required to pass the gain either to the government or to road users through reduced toll levels at off-peak times.

The effect on other parts of the road network of pricing just one part means that the costs and benefits of partial pricing need to be carefully considered, as do the institutional arrangements for setting and monitoring congestion charges. Over time, congestion pricing should extend to all significantly congested parts of the road network, subject to cost-benefit assessment and the pricing technology available.

The introduction of direct congestion pricing would allow indirect measures to deal with congestion, including parking space levies in inner cities, to be withdrawn.

Finding

Road pricing technology already in use on tolled Australian roads could be used to introduce variable congestion pricing in a range of circumstances.

Compensation for congestion pricing

Charging for congestion has different effects on different road users. Those who value their time most highly, and have the means to pay, would receive a net benefit from a faster, more reliable and less stressful journey in exchange for paying the charge. Road users who are unwilling to pay the charge would have options to travel via different routes or at different times, to car-pool, to take public transport, or not to travel at all. Other road users —

particularly those who do not already have access to frequent and reliable public transport services — would have no alternative but to pay.

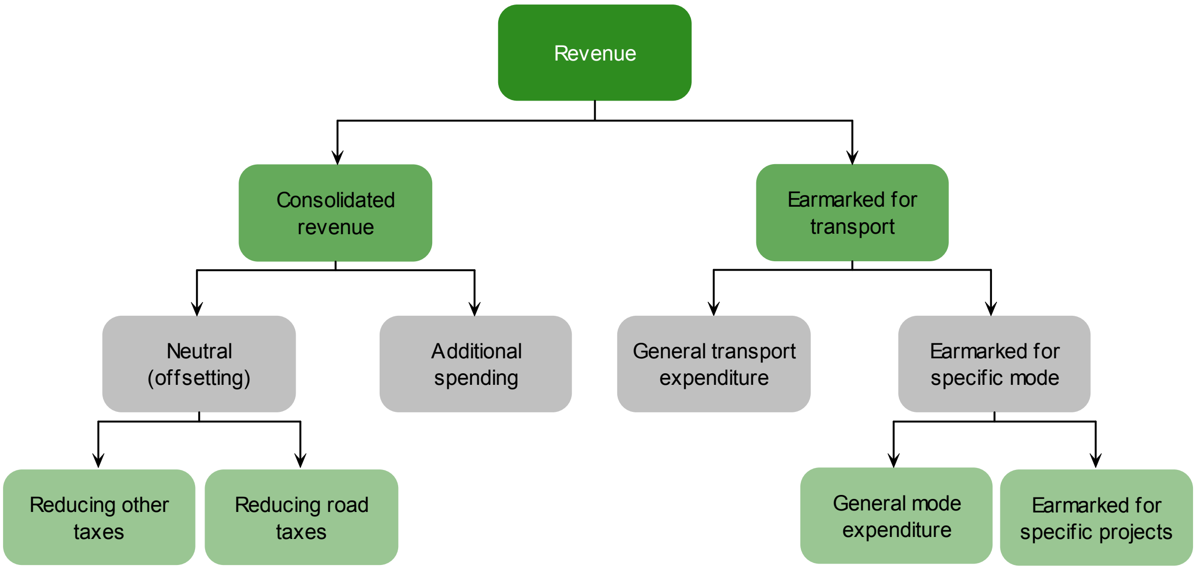
In the long run, people and businesses would adapt, which could lead to more compact urban centres. People would make different choices about where to live, work and study after taking into account the currently unpriced costs of congestion. City dwellers and road users would benefit from improved traffic conditions.

However, for some motorists time savings may not outweigh the cost of the charge, or an absence of transport alternatives in some areas may give groups in some areas little alternative but to pay the tax. Given that the goal of this tax is to correct a market failure, not to raise revenue for government, some form of compensation for these groups could be necessary to ensure broad community support (Hubbard 2009).

This issue of how funds are used is important. If revenue from congestion charging is available for State general purposes, they would have an incentive to allow congestion to increase — in effect charging a rent tax on cities. For this reason, how congestion revenue is used needs to be made transparent (see Recommendation 61).

The Bureau of Infrastructure Transport and Regional Economics (2008) surveyed a range of potential options for using the revenue from congestion charging (see Chart E3–2).

Chart E3–2: Options for disbursement of (net) congestion charging revenue



Source: Adapted from BITRE 2008.

Of these, there is a strong theoretical argument for using congestion revenue to cut taxes on the labour of affected workers (Parry & Bento 2001), though it would be difficult in practice to identify and target all potential users of the congested roads. Coordination between Australian and State governments may be needed to ensure that motorists are not paying twice for roads, and that the impact on vertical equity of road pricing is appropriately addressed.

In the short term, the introduction of congestion pricing on existing roads would place stress on existing public transport services, and make it more apparent where these are inadequate. For this reason, the introduction of congestion charging needs to be coordinated with (and to help finance) additional investment in public transport for affected communities. Congestion charges can also help finance the provision of new road capacity in congested areas (see Section E3–4 How should roads be financed?).

Heavy vehicle road-wear

Another significant cost of road use is the wear on the road. Australia's road network comprises more than 337,000 kilometres of sealed roads (BITRE 2009, p. 32). Roads deteriorate over time, and require ongoing maintenance to keep them up to standard. Some deterioration is purely time- and climate-related. However, the Productivity Commission's (2006) survey of cost allocation studies for road maintenance expenditure showed that between 32 and 100 per cent of maintenance costs are due to heavy vehicles. The remaining unattributable costs are the same regardless of usage. Cars do negligible damage to roads.

Road-wear attributable to heavy vehicles increases exponentially in accordance with the loaded axle-weight of the vehicle. However, the current fuel-based road user charging is levied at a flat rate per litre of fuel — independent of the vehicle, where it is driven or the actual road-wear caused. While fuel use increases with the mass of the load being carried, it does so at a decreasing rate due to economies of scale in vehicle size (Productivity Commission 2006, p. 120). If fuel-based charges alone were used to pay for road-wear, they would over-recover costs at the low end of the range of heavy vehicle sizes and under-recover at the high end. In practice, registration charges that increase with vehicle size are used to make up the difference.

These current arrangements (see Box E3–4) still lead to over-recovery from some heavy vehicles (those that travel fewer annual kilometres, are more lightly laden than the average or are less fuel efficient) and under-recovery from others (those that travel further than the average, or are more heavily laden, or are more fuel-efficient than the average).

Existing charges do not fully reflect the wear that trucks do to individual roads. Pavement durability varies across the road system. Generally, the more heavy vehicles use a road, the greater the appropriate level of investment in pavement durability and in other road assets, such as bridges. Pavements on minor roads are constructed with less strength and therefore suffer more wear from heavy vehicles. Prices that do not differentiate between individual roads give users limited incentive to consider the full road-wear consequences of their decisions about mode, route and types of truck.

Box E3–4: Existing heavy vehicle charging

The Australian Transport Council is responsible for the national operation of a road user charging system for heavy vehicles. This system is designed to recover the cost of ongoing road maintenance for the wear caused by heavy vehicles transporting road freight, as well as making a contribution to the fixed costs of the road network.

The National Transport Commission determines heavy vehicle user charges so as to recover fully those infrastructure costs attributed to heavy vehicles. This includes all vehicles in excess of 4.5 tonnes that access the road network. Charges are recommended by the Commission and decided by vote of the Australian Transport Council, comprising ministers for transport from all jurisdictions. Charges recommended by the Commission are set so that the total revenue generated by these charges recovers that portion of road expenditure associated with heavy vehicles.

The charges comprise a per-litre reduction in eligibility for fuel tax credits and an annual registration charge that varies by vehicle class. The fuel tax component (called a road user charge) is levied by the Australian government. From 1 July 2009, the road user charge is 21.7 cents per litre.

The Productivity Commission (2006) noted that around 30 per cent of the costs associated with heavy vehicle road use are recovered through State government registration fees. These fees are adjusted each year to help keep pace with road spending. Since 2006, the registration proportion has risen and the annual adjustment has been extended to the road user charge component.

The current arrangements also prevent road owners from receiving compensation from users for damage to their assets. Instead of being compensated through road damage charges, road owners (such as local councils) sometimes try to protect the value of their assets through prescriptive regulations or access restrictions.

Finding

Heavy vehicle charges may currently cover the aggregate costs of road-wear, but these charging arrangements do not generate prices or revenues that are closely aligned with social costs. Australia's heavy vehicle task is diverse; as a result there are significant cross-subsidies between different trucks on different routes. This provides little incentive to choose combinations of route, vehicle configuration and loaded mass that take into account the impact on roads. Moreover, road owners, including local governments, do not receive compensation directly from heavy vehicles for the road-wear they cause.

Trucks should pay for the specific road-wear they cause. Charges for road-wear would be based on the actual loaded weight of a truck and vary according to the particular roads on which it travels. Revenue from these charges could be used to compensate road owners (including local governments) for the maintenance costs attributable to the truck.

This process would need to be accompanied by transparent institutional arrangements, to ensure that road owners do not have incentives to maintain roads poorly in order to increase road-wear charges. For this reason, the receipt of revenue from road-wear charges should be contingent on the road owner adhering to a management plan based on economically or socially warranted standards of road condition and pavement durability (see Recommendation 62).

Box E3–5: Avoidable capital costs of pavement durability

There is a view that heavy vehicle pricing should allocate the capital costs of building stronger pavements to heavy vehicle classes. Under this approach, the additional capital cost of building pavements to handle trucks that cause above a given amount of damage is allocated to those trucks.

However, road use pricing theories suggest that this approach does not make best use of available resources once the investments are made. The benefits should be compared with the costs before decisions are made about the most damaging truck types to allow on the network, the maximum loads they are permitted to carry and the pavement strengths to provide.

Once the pavements have been built, it is wasteful to exclude trucks from the network by charging above the short-run marginal costs they actually impose. On the other hand, this approach to road pricing requires that the general taxpayer pays the infrastructure costs of roads attributable to heavy vehicles. In practice, the opportunity cost for government in making these investments might be high.

There may be supply incentive and horizontal equity arguments favouring an allocation of these costs to trucks, and to generate revenues to road owners making these investments; however, these come at some cost to efficiency.

Introducing mass–distance–location pricing

Through its Road Reform Plan, the Council of Australian Governments (COAG) is developing better charging arrangements for heavy vehicles. Its investigation of the feasibility of mass–distance–location pricing is scheduled for completion by December 2011. This process includes a research and policy reform agenda that aims to lay the foundations for alternative models of heavy vehicle road pricing, and to evaluate the costs and benefits of moving to more direct road pricing. Receiving this report earlier could accelerate road pricing reforms (see Recommendation 62).

Pricing based on mass, distance and location would not necessarily require a sophisticated technological solution installed in every truck, particularly those whose road-wear damage costs are small or whose use is occasional. In such cases, the costs of installing and maintaining technology, such as telematic units, might outweigh the efficiency gains from targeting costs. Where possible, technology should be used to support implementation of the policy — but the implementation of technology is not itself a tax policy goal. This approach recognises that the road freight task in Australia is exceptionally diverse.

At one end of the spectrum are very heavy vehicles such as B-triples — weighing up to 82.5 tonnes and measuring up to 36.5 metres in length. These vehicles are used primarily on long-haul intercity routes, and are employed almost constantly throughout the year. Many of them are already fitted with telematic devices for their own fleet management purposes. If road damage is to be priced through mass-distance-location pricing, then a targeted compliance regime for this policy may require information on the loaded weight, distance travelled and roads travelled by some vehicles to be recorded by a certified telematic device.

At the other end of the spectrum, some vehicles may be used only occasionally, on a limited range of roads or for specific tasks. For example, a farmer may use a heavy vehicle three to four times a year as a means of transporting produce to market. In some cases, the costs of installing and maintaining a finely calibrated telematic device are likely to outweigh any efficiency benefits. It may be better to establish a compliance regime based on self-assessment of distance travelled, licensed rather than actual mass, and a reasonable estimation of the types of roads travelled (see Recommendation 62).

Other environmental and amenity costs

Cars and trucks generate a wide range of other spillovers, such as changing the character of cities, and reducing the amenity of the urban environment. In particular, there is an emerging literature highlighting the risks of 'community severance' related to roads. This can be related to physical barriers (imposed by road infrastructure on pedestrians, cyclists and motorists), psychological barriers (including concerns about traffic noise and road safety), and social impacts (particularly on neighbourhood communities) (Department for Transport 2005).

While these have a significant impact on people's quality of life, there may be a limit to the extent they can be targeted directly through road charges. To impose a charge requires a clearly defined activity or person to tax, and evidence to determine the tax rate. Managing some spillovers can be complex and more easily achieved through planning. That said, introducing congestion pricing would help reduce many of these negative spillovers and encourage density near public transport nodes.

The following subsections discuss some of these spillover costs.

Greenhouse gas emissions

In addition to creating urban congestion and road-wear, road transport also imposes a significant spillover cost on the environment. In 2005, transport accounted for around 14 per cent of Australia's greenhouse gas emissions — with road transport contributing almost 90 per cent of transport emissions (Australian Government 2008, pp. 6–9). At the time, transport emissions were the second-fastest growing category of emissions.

Changes in the climate induced by an increased concentration of greenhouse gases in the atmosphere are now widely recognised as a significant spillover from the use of fossil fuels. However, unlike air pollution, which imposes localised costs that vary across regions, the impacts of greenhouse gas emissions are global in nature. An economy-wide response offers the most efficient way for Australia to contribute to global emissions reductions (see Section E2 Taxes to improve the environment).

When the proposed Carbon Pollution Reduction Scheme (CPRS), or similar scheme, comes into operation, it would be inefficient to impose taxes on transport or fuel specifically to reduce greenhouse gas emissions. The different costs of greenhouse gases associated with different fuels would be most effectively targeted using the CPRS, which would provide a relative price advantage to greener fuels.

That said, the other reforms suggested in this section may have incidental effects on greenhouse gas emissions. For example, reducing congestion would also remove the emissions associated with it. On the other hand, any reduction in fuel tax could marginally increase fuel use. However, the environmental impact of any corresponding increase in fuel use would be more than offset by the introduction of a broad-based CPRS, which would lead to a more efficient outcome than imposing a heavier tax on transport. A further practical difficulty arises in determining the appropriate point in the application of the CPRS for the application of full adjustment to fuel taxes.

Finding

In principle, greenhouse gas emissions are best dealt with through an economy-wide tool, such as the proposed Carbon Pollution Reduction Scheme.

Local pollution and noise

Vehicles generate significant levels of local air pollution and noise. The health impact of air pollution from motor vehicles was estimated at between $1.6 billion and $3.8 billion for 2000 (BTRE 2005). However, because most pollution costs are highly localised and contingent on engine and fuel types, attempting to measure them directly for taxing or charging purposes may not be practical with current technology. Alternative policies, such as fuel and engine standards, may be a better way to target this type of pollution, recognising that these impose costs on all road users.

Similarly, problems of measuring vehicle noise — and putting a value on the harm it causes — mean that tax is unlikely to be an appropriate instrument to mitigate this spillover cost. It can, however, be mitigated through improved road design, housing insulation, movement restrictions for certain vehicles and environmental planning policies, as well as engine design and in-service maintenance standards for heavy vehicles. These approaches also have costs, and will be imperfect.

In some cases the costs of addressing spillovers using current technology would exceed the benefits from doing so. Nevertheless, where local pollution and noise costs are highly correlated with congestion, it may be possible to build these spillover costs into a congestion charge. It may also be possible to use pricing more extensively as lower cost technology becomes available.

Finding

The spillover costs of noise and air quality are locally concentrated and difficult to measure and value. Where these costs are closely related to congestion, they might be priced into congestion charges. Otherwise, they could be addressed, at least in part, through appropriate regulations.

Accident, policing and other regulatory costs

The risks associated with road use require substantial government regulatory and operating expenditure. While some of these costs are fixed, others vary with the use of roads. For example, police expenditure on road safety and traffic management was estimated at $674 million in 2006–07 (Commonwealth Grants Commission 2008 p. 7), not including further costs relating to the administration of the justice system.

Road accidents are a source of further spillover costs to the Australian community. There were 1,616 road fatalities recorded in 2007 (BITRE 2009). The Bureau of Transport Economics (2000) estimated the total cost of accidents in Australia in 1996 at $15 billion (1996 dollars). Of this, $8.4 billion were 'human costs' such as death and injury, and the remainder were property and other costs. Many of the direct accident costs associated with road use are spread across individuals and businesses through a range of State-based legal liability rules and compulsory third party insurance (CTP) arrangements.

However, these compulsory third party charges are not specific to individual risk profiles. In this way, they are more akin to a tax on all road users to fund an insurance pool, than an actuarially determined insurance premium that rewards safer drivers. The NSW premium model does better reflect risk than the community-based premium concept adopted in other jurisdictions; however, this is not a pure individually risk-priced model and has high administration costs.

Finding

Compulsory third party insurance premiums are not charged on the basis of individual risk or driving behaviour.

Existing CTP schemes provide little incentive for riskier drivers to drive less, or to drive more carefully. The introduction of distance-related pricing for driver insurance would give explicit recognition to the fact that road safety diminishes, and the likelihood of road accidents increases, with distance driven. For other insurance products, private insurance companies are seeking to remedy this misalignment of risk through the introduction of pay-as-you-drive insurance, under which drivers pay a higher insurance premium the further they drive.

One option that could be explored is linking CTP insurance to driver licensing charges. A rebate (total or partial), based on the individual's driving history, as reflected in demerit points, is feasible, reliable and has a direct link to road safety campaigns.

Recommendation 63 proposes that States improve CTP insurance to better reflect individual risks.

Freight allocation between road and rail on specific routes

Like roads, the provision of rail infrastructure has strong economies of scale and lumpiness of investment; however, it is operated on a broadly commercial basis. It must charge above its short-run marginal costs to achieve cost recovery. The Productivity Commission (2006) found that, in practice, rail fails to cover its full economic costs on many routes, although it is intended to do so. Requiring trucks to meet only the short-run marginal costs of the infrastructure they use raises concerns about competitive neutrality with rail.

For most of the road network, there are no parallel railway lines and no modal competition. But for the major corridors in the national road network, the two modes are, to a varying extent, substitutes (BITRE 2009). As these roads are the most heavily trafficked non-urban roads for trucks, they are built with the strongest pavements and hence have the lowest road-wear costs.

Under the short-run marginal cost principle discussed earlier, charges for heavy vehicles generally and, in particular, for heavy vehicles travelling on these routes, would be lower than they are now. A consequence could be a major shift in mode share from rail to road. In the short term there may be increased congestion, environmental costs and accident costs. In the longer term, there may be increased need for investment in road capacity and closure of railway lines. This could be a less economically efficient outcome than the present situation.

Findings

In Australia, different transport modes tend to complement each other rather than compete. However, on specific routes there is significant competition for freight between road and rail. Where access to rail is priced above its short-run marginal cost for cost recovery purposes, competition with road freight priced at marginal cost might lead to an inefficient allocation of freight between road and rail.

One approach would be to subsidise rail and have both modes charge at short-run marginal cost. However, subsiding rail could lead to other problems. In particular, it could reduce incentives for efficient management and operations. Another solution would be to charge heavy road vehicles above the costs of road-wear to the extent necessary to ensure a reasonably efficient modal split for freight, subject to the constraint that rail covers its full costs (see Recommendation 64).

In practice, it is extremely difficult to estimate the amounts to add on to heavy vehicle road-wear costs to achieve the most efficient modal split. The existing road pricing system, which allocates part of the fixed costs of the road system to heavy vehicles on a vehicle-kilometre basis in addition to the attributable road-wear costs, imposes charges on heavy vehicles that exceed road-wear costs. While this amount is not in any sense economically efficient, it might lead to better intermodal allocation on some routes than a pure short-run marginal cost pricing approach.

E3–4 How should roads be financed?

Recommendation 65:

Revenue from fuel tax imposed for general government purposes should be replaced over time with revenue from more efficient broad-based taxes. If a decision were made to recover costs of roads from road users through fuel tax, it should be linked to the cost of efficiently financing the road network, less costs that can be charged directly to road users or collected through a network access charge. Fuel tax should apply to all fuels used in road transport on the basis of energy content, and be indexed to the CPI. Heavy vehicles should be exempt from fuel tax and the network access component of registration fees if full replacement charges are introduced.

Recommendation 66:

The revenue-raising component of State taxes on motor vehicle ownership and use should be made explicit, and over time only be used to recover those costs related to road provision. The administrative costs of providing government services should be recovered through user charges where applicable. Quantity limits on taxi licences should be phased out.

The Review has been asked to consider taxation arrangements necessary to deal with the demographic, social, economic and environmental challenges of the 21st century. The best structure of road-related taxes depends on whether roads are funded from general taxation revenue, or whether road costs should be recovered directly from road users.

The congestion and road damage charges suggested earlier in this section would not cover the costs of the entire road network, particularly if the revenue from congestion charges on existing roads is invested in public transport infrastructure, or some other form of community compensation. Because most of the road network is not congested, and the road-wear costs of cars are negligible, efficient usage charges do not generate enough revenue to finance road building.

In addition, there are substantial operating costs that cannot be attributed to heavy vehicle road-wear, including time-related pavement deterioration, routine maintenance (cutting grass, maintaining roadside furniture, clearing drains), traffic management, regulatory and policing costs, and accident-related costs that are not paid for by road users either directly or through insurance (see Box E3–6).

Uncongested roads as public goods or cost recovery

Car travel on uncongested roads has the public good characteristic of non-rivalrous consumption — that is, an additional car has negligible impact on other road users and causes no pavement wear (see Section E1 User charging). A price for using a given road deters some people from travelling on the road. Costs of pavement wear associated with weathering are non-rivalrous to all road users, trucks as well as cars. The inefficiency of tolling something that costs nothing to use was first identified by Dupuit (1844), who observed some people going out of their way to avoid a toll-bridge across the Seine River in Paris.

Private network industries (such as electricity, gas and communications) finance the supply of infrastructure by making access to it excludable. They are funded by block tariffs or two-part tariffs (a fixed and a variable charge) set to reflect the financial costs of supply. Most Australian roads, on the other hand, are not specifically excludable, and have been funded over many decades from general tax revenue. Only a few major projects have been funded from specific tolls. The entire road system, however, is excludable, through the requirement that motor vehicles be registered.

New roads, bridges or tunnels built in urban areas are likely to become immediately congested if they are unpriced. Charging a variable congestion toll on these roads would be an efficient way to manage demand for a road, and could also make a contribution to the capital cost of the road itself. Similarly, new roads in development areas might be financed by infrastructure charges, which are discussed in Section E4 Housing affordability.

However, for large parts of the road network, the social opportunity cost of letting another car enter the road is negligible, because there is almost always significant spare capacity. The explanation for this is the nature of road investment — a road must be built or expanded at least one lane at a time, even if it is used by only one car an hour. If roads and cars were perfectly divisible, it would be more efficient to build a cheaper road that is 1/60th of a lane wide but in use almost all the time! Moreover, improvements to road quality to improve safety or travel times (such as straightening roads) also increase their redundant carrying capacity.

Box E3–6: Efficient road pricing and capital costs

Prices that lead to efficient use of roads are unlikely to lead to full capital cost recovery. Economic models suggest that revenue from congestion charges set at efficient levels would approximately cover the full costs of the roads to which they apply. However, for most of the road system there is no congestion most of the time and hence no warrant for congestion charges. This is the case for rural roads, suburban streets and major highways outside of cities. If only congestion and road-wear are priced, over large parts of the road network cars would pay nothing and trucks would be charged only for road-wear.

Much of the explanation lies in the economies of scale in road provision. With efficient investment in capacity, short-run marginal cost and long-run marginal cost become equal (or with time-variable pricing, the sum of short-run marginal costs over an entire cycle equals long-run marginal cost for the cycle). Economies of scale mean that long-run marginal cost, and hence the economically optimal price, lies below long-run average cost. If investment in capacity were restricted to the point where the short-run marginal cost price was as high as the long-run average cost, the economic benefit of increasing capacity would exceed the costs of doing so.

Costs of infrastructure along the sides of roads (shoulders, signs, guide posts, drainage ditches) are a source of economies of scale for non-urban roads. For example, a four-lane road requires the same shoulder widths as a two-lane road. Also, because of the greater passing opportunities, a four-lane road has more than twice the capacity, giving rise to economies of scale (Hau 1992).

Box E3–6: Efficient road pricing and capital costs (continued)

Economies of scale are exacerbated by capacity–quality interactions. Investment to improve road standards by building a wider, smoother, straighter road with more passing opportunities is often found to be economically warranted based on the value of the time, vehicle operating cost, and crash cost savings to road users. However, these improvements also add to capacity, keeping any congestion price to practically zero (Walters 1968).

For major urban roads, economies of scale are offset by diseconomies of scale. For a network in a given area, the number of intersections increases faster than the number of lane-kilometres of roads. Intersections are land-intensive and often require traffic signals or grade separation (Hau 1992).

There are enormous economies of scale in strengthening road pavements (Harvey 1999). For flexible pavements, the rule-of-thumb is that a 10 per cent increase in pavement thickness results in a doubling of the traffic loading required to produce a given amount of wear. A compounding factor is that a large component of pavement deterioration is due to weather. It is the same regardless of vehicle usage.

Lumpiness in investment is another factor that can inhibit cost recovery with efficient prices. When capacity can be changed only in discrete jumps, long-run marginal cost cannot be finely adjusted to equal short-run marginal cost. The basic two-lane road with shoulders and drainage ditches provides ample capacity for most non-urban roads and so becomes a fixed cost (Hau 1992; Productivity Commission 2006).

In summary, short-run marginal cost pricing on congested urban roads is expected to yield sufficient revenues to cover the full costs of the roads concerned, and may generate additional revenue. However, for most of the road network, short-run marginal cost pricing will lead to major under-recovery of costs.

This means that imposing an additional toll to recover capital costs on each trip, where there is significant redundant capacity, would waste the existing resource. For these parts of the network, there are two main models to recover the capital costs of the road — cost recovery from road users, or financing from general tax revenue.

If the fixed costs are to be recovered from road users, this can be done through a tax. This can be enforced by excluding cars that do not pay, for example through motor vehicle registration charges (a fixed charge) or by imposing a tax related to distance travelled (a variable charge).

Finding

The road system as a whole has historically been excludable on the basis of motor vehicle registration requirements. In the future, specific roads or road systems may also be excludable using new technology.

Charges designed only to encourage the most economically efficient use of roads would not recover their full costs. If governments intend to recover the cost of building, operating and maintaining roads from road users, it would be necessary to impose a combination of additional fixed or variable charges above short-run marginal cost. The efficiency costs of specific cost recovery taxes or charges should be weighed against the efficiency cost of raising revenue from general taxation.

Arguments for and against cost recovery for roads

Market test

If road users do not pay the full cost of a road or network of roads, there is no direct feedback from the market about whether they are willing to pay for the infrastructure and hence whether the road or network should be provided at all. It is extremely difficult to make accurate estimates of willingness to pay because it requires knowledge of consumer demand at price levels that have not been observed.

If total revenue exceeds total costs, we can conclude that users' total valuation of the road exceeds total costs. The converse, however, is not necessarily true. In practice, a user charge cannot be designed that perfectly mirrors road users' entire willingness to pay.

Often, the important question is not whether the road should exist, but at what standard it should be maintained. Each improvement in road standard provides existing road users with savings in time, vehicle operating and crash costs, as well as generating new users.

Cost–benefit analysis techniques value these savings and compare them with the costs of building, maintaining or upgrading a road. The revenue impacts of the road upgrade, whether revenue from network access charges or from variable charges, provide little or no useful information. An upgrade to a single road would have negligible impact on revenue from network access charges and any increase in revenue from variable charges would relate to generated traffic only. It would not reflect the gains to existing users.

Relative economic efficiency costs

Charges above short-run marginal costs, whether access charges or variable charges, impose economic efficiency costs. The alternative of funding road infrastructure from general tax revenue also has economic efficiency costs. In principle, the two costs can be compared to determine which policy, or policy mix, is preferable in terms of efficiency.

Raising the necessary revenue from an increase in general revenue-raising taxes may have a lower efficiency cost than a variable road user charge, depending on how it operates. The economic efficiency costs of an access charging system depend on how well it discriminates between road users whose willingness to pay differs, so as to have minimal impact on people's decisions.

Financial

In some cases, funding constraints may prevent road agencies from undertaking economically warranted investment and maintenance. In these cases, greater certainty about future funding levels could improve the capacity of road agencies to plan for the future. An allocated funding stream might overcome some of this uncertainty.

The downside of allocating revenues from road user charges to road providers is that providers face few natural incentives to control costs they can pass on to users. Processes would need to be put in place to ensure accountability. These could include transparent and consistent cost–benefit analyses and independent post-build project evaluations to ensure that road users are charged only for costs that have been efficiently incurred.

A key issue is that Australia's roads belong to many different jurisdictional owners. There is little or no link between road revenues and the road owners. The road owners do not receive the economic rewards from road investment. As a result, road investment is largely determined by the competition for the use of tax revenues rather than efficiency criteria. A key issue for future consideration is whether there would be benefits in linking road revenues to road providers, and on what basis.

Uneconomic road spending (for example, investment projects with benefit–cost ratios below one) that is undertaken for broader social purposes should be transparently funded by government through explicit community service obligations.

Principle

Road investment and maintenance decisions that are taken for reasons of social policy, and are shown by cost–benefit analysis to be uneconomic, should be transparently identified as community service obligations and funded from general tax revenue.

Equity

Cost recovery is consistent with the user-pays concept of equity, which aims to ensure that those who receive the benefits from a government-provided service also pay for it. However, in the case of roads it is unclear that the group receiving benefits from road use can easily be distinguished from the entire Australian population. For example, of the 7.1 million dwellings that participated in the 2006 Australian Census (ABS 2006b), only 9.5 per cent did not have a motor vehicle.

On the other hand, there may be greater differences between the population of road users and, say, income tax payers. There may also be large differences between the users of high-cost roads and general taxpayers, or differences between road users in different jurisdictions.

Given the long life of road investments, there is also a question of intergenerational equity. Current road users obtain the benefit of past investment. They may reap only a small part of the benefits of current investment in roads, while people who no longer use the roads directly may nevertheless have paid in the past for investment that benefits road users today. If the road network was a constant size and required stable ongoing investment, these factors would cancel each other out. However, if investment in road networks is directed to meet anticipated future needs, then debt, to be repaid by future generations, might be a more equitable source of finance than charges imposed on today's users. However, there may be other macro-economic reasons for limiting desirable debt financing by governments.

The user-pays concept of equity ceases to apply where redistribution of income to particular groups is considered desirable or where there are 'merit good' considerations. Stanley and Starkie (1983) argue that the basic access characteristic of rural local roads is regarded as a 'merit good'. This goes some way to explaining why spending on some rural roads exceeds what might be justified under strict economic criteria.

The user-pays concept of equity suggests that much of the cost of local roads used for access to properties could continue to be paid for out of local government revenue from rates. Even households who do not own a car value well-maintained paved roads linking their property with the rest of the road network. Where heavy vehicles traverse local roads, their road-wear charges should be directed to the relevant local government as compensation.

Finding

There are arguments for and against recovering the total costs of the road system from road users. The social opportunity cost of the existing network is in general not subject to charging. Existing users could be charged explicitly for operating and maintenance costs, and for network improvement and expansion. The efficiency loss from raising the required revenue from income or other taxes must be compared with the efficiency loss from the most efficient, practical system of access and variable charges. The full information required to make all these assessments is not presently available.

Cost recovery through network access charges

Existing car registration charges can be thought of as a fixed network access fee, as the annual charge gives access to the entire road network, apart from toll roads. In 2006–07, expenditure on roads by the Australian and State and Territory governments (excluding spending by local governments) was almost $9 billion (BITRE 2009). Excluding an estimated $3 billion for road damage costs, which should be recovered directly through road-wear charges, these costs could be recovered by an average charge of around $500 per vehicle per year.

While these charges have the advantage of not influencing choices about how much and where to drive a vehicle that is already registered, the existence of a fixed charge may discourage some people from owning a car. This is likely to be low-income or low-wealth people and those who travel relatively few kilometres per year.

This effect can be reduced by varying the access charges between groups of users with different willingness to pay. For example, existing car registration charges are discounted for many groups, including pensioners. In some cases, this may reflect a lower than average willingness (or ability) to pay for access to the road network. However, it is doubtful that registration charges that increase with the number of the car's cylinders are closely correlated with the car owners' willingness to pay.

The distance people travel per period of time is related to willingness to pay. People who drive few kilometres per year are more likely to be deterred from owning a car by a flat access charge than people who drive long distances. The most efficient charge for cost-recovery purposes may be a combination of a distance-related charge and an access charge (two-part pricing).

Some variable charging might also be justified on the basis of recovering otherwise unpriced variable costs. The existing fuel tax is an example of a tax that varies with distance travelled. Subject to technology, direct charges based on distance travelled would be an alternative.

The future of fuel tax

Consistent with the principle that transport-specific taxes should be imposed only where they improve social or market outcomes in transport markets, fuel tax as a source of general government revenue should be phased out. However, some fuel tax might be retained as a simple variable charge for variable costs of the road network that cannot be priced directly.

The tax rate would be set by reference to costs efficiently incurred. To ensure its value is not eroded by inflation, the per litre tax rate would be indexed to the consumer price index. Fuel tax credits for off-road use would be retained, to ensure that only on-road use is subject to a charge.

To be an efficient user charge, fuel tax would need to apply to all energy sources used for road transport. This means extending tax to those fuels that are effectively tax-free under current arrangements. These include liquefied petroleum gas, liquefied natural gas, compressed natural gas, biodiesel and domestically produced ethanol. If alternative energy sources for road transport were developed (such as electricity), they would also need to be taxed in their on-road applications. As the energy density of these fuels varies, it would be necessary to tax fuel on an energy-content basis as this is more closely related to vehicle distance travelled (see Recommendation 65).

Different greenhouse emission costs associated with different fuels could best be addressed by price differentials under the Carbon Pollution Reduction Scheme rather than different rates of fuel tax. Similarly, policy relating to energy security or fossil fuel depletion should be more appropriately addressed through specific targeted measures, rather than fuel tax.

Variable charging through fuel tax would not be necessary in cases where technology provides ways to measure usage more directly. For example, as road user charging mechanisms based on mass-distance-location monitoring technology becomes widespread in heavy vehicles, it would be possible to charge heavy vehicles on this basis, and provide full exemption from fuel taxes and the network access component of registration charges (see Recommendation 65).

Other road taxes and charges should be phased out

Governments in Australia impose motor vehicle registration and transfer charges. Some charges relate to the costs of providing government services. In these cases, the charges are likely to have the potential to improve efficient allocation of resources, and should be maintained. However, other taxes impose charges that are disproportionate to any costs that the government incurs in providing the service. Reliance on revenue from these taxes should be phased out, and replaced with more efficient sources of revenue (see Recommendation 66).

COAG has asked the Review to consider the merit of financial incentives for the purchase of fuel-efficient cars and assess the merits of differential stamp duty and registration regimes linked to environmental performance. The use of these taxes for environmental, rather than revenue purposes, is discussed in Section E2 Taxes to improve the environment.

Stamp duty on cars is a highly inefficient source of revenue

State governments do not have the legal power to impose duties of excise, but do tax certain transactions related to goods. In the case of transport, State governments tax motor vehicles by imposing an additional stamp duty whenever a new car is registered, or by requiring buyers of second-hand cars to pay a registration charge on transfer between owners (see Chart E3–3). As stamp duty on housing leads to a misallocation of the housing stock (see Section C2 Land tax and conveyance stamp duty), so vehicle stamp duties impede efficient allocation of vehicles.

Chart E3–3: Stamp duty payable on purchase of new $40,000 car[(a)]

(a) Assumes car is V6 (QLD) and rated between 3.5–4.5 on Green Vehicle Guide (ACT).
Source: Treasury estimates.

Rates of stamp duty vary between States, based on car value and, in some cases, vehicle size or type. Some States apply different rates to passenger and non-passenger vehicles, and some apply tax rates that rise with the value of the vehicle (Australian Government 2008b, p. 86).

These taxes mean that people purchase new vehicles and scrap old vehicles less often, and reduce the overall demand for cars.[11] They mean that some people will continue driving vehicles not suited to their present needs. For example, an older couple whose children have left home might delay getting a smaller car. Alternatively, a young couple may delay upgrading to larger family car when they have children, because of the additional cost.

11 Tcha and Kuriyama (2003) estimate an own-price elasticity of demand for cars of -0.43, suggesting that a tax that increases the price of a car by 3 per cent could reduce demand for cars by around 1.3 per cent.

Finding

Stamp duty on the transfer of motor vehicles is a highly inefficient revenue source.

Restrictions on the number of taxi licences should be removed

Taxis form a small but important component of the transport system, providing flexible mobility when other forms of transport are not viable. But taxi fares are up to 25 per cent higher than they need be because of State government taxes (Productivity Commission 1999, p. 16).[12] These taxes are imposed in a relatively unusual way. The States limit the number of taxis then make money by selling licences.

These restrictions are beyond those necessary to maintain safety or service standards and are simply used to raise revenue. For these reasons, accounting standards and economic reasoning recognise the revenue as tax revenue. Taxi licences now sell on secondary markets for up to $470,000.[13] The purchaser expects that future restrictions on the number of taxis will allow this money to be recouped from future taxi customers — with interest.

The total value of taxi licences in Australia is around $6.5 billion (Clarke & Prentice 2009). Because of the tax, taxi services are more costly and waiting times are longer. This has a number of adverse impacts on Australian society. Businesses pay the taxi tax, or they must use alternative transport less fit for purpose, driving the cost of goods and services up for all Australians.

The taxi tax reduces the ability of Australians to effectively 'share' a motor vehicle by taking taxi trips instead of owning their own car. This means the tax falls disproportionately on those who do not drive (perhaps because of cost), should not drive (due to inebriation) or cannot drive (because of disability). The poorest 20 per cent of the community spends more than twice as much as a proportion of income on taxis as other Australians (ABS 2006c). In regional areas, taxis often replace other urban transport systems, such as rail or bus services that are not available. Taxis are therefore one important means by which people continue to participate in society. The tax impacts on some of the most vulnerable in society, either by reducing their incomes or dissuading them from taking a taxi.

Why does such a bad tax persist? Abolishing the tax would mean retaining only those restrictions on taxi licences that relate to safety and service. This would see the value of plates fall nearly to zero. Existing plate holders — who are often not the actual drivers — would lose all the value of their investment. By selling the plates for revenue up front, governments have effectively created a group of people with an interest in maintaining the asset value of taxi plates so they can recoup their investment.

Some of the financial return plate holders earn reflects the risk that current arrangements may change, so whether they should be compensated at all is an open question. There is no doubt, however, that it would be far better for society to cash plate holders out using revenue from other taxes rather than to retain the highly inefficient taxi tax.

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12 More recently, IPART (2009, p. 21) found that in NSW 'Plate lease costs contribute 13 per cent of the overall cost of providing taxi services in urban areas, and around 11 per cent of this overall cost in country areas.'

13 On the BSX Taxi Market, plate prices averaged $430,000 in 2008–09.

Finding

Quantity restrictions on taxi licences are an implicit tax on taxi users, from which additional revenue flows to existing taxi plate holders and State governments.

Quantity restrictions on taxis should be phased out (see Recommendation 66). This could be done by imposing a price ceiling on the price of new taxi licence plates that reduces over time, triggering the automatic release of new plates. Alternatively, existing taxi licences could be bought back by the government. While for efficiency reasons this should funded from general tax revenue, for equity reasons it could be done by replacing the existing implicit tax on taxi fares with an explicit levy on taxi users. This would be imposed for a limited time until the revenue needed to fund the transition has been raised.

E3–5 Guiding investment in roads

Recommendation 67:

Governments should continue to reform road infrastructure provision, applying economic assessment to investments comparable to that for other forms of infrastructure.

Pricing roads would generate some information for road suppliers about how and where to improve or build roads, as well as other investments that make the best use of road transport. For this to occur, the regulatory authorities setting congestion taxes would need to identify changes in demand for scarce road space and adjust prices accordingly. Similarly, they should increase location-specific prices in response to accelerating pavement deterioration and reduce them following construction of stronger pavements. High prices could help inform decisions, including:

- where to build new roads, increase the capacity of existing roads or provide alternative forms of transport;
- the standard to which new roads should be built or existing roads improved; and
- the routing of traffic to minimise adverse impacts on the environment or society.

However, as already discussed, most individual roads cannot be fully funded from efficient user charges. This means that the revenue from road pricing should not determine the level of funding of a particular road, or even for the road network in general. Decisions about spending on individual parts of the road network in general ought to be made using cost-benefit analysis for investment and cost minimisation for maintenance. These decisions determine the total cost of providing the network, which in turn determines the amount of revenue that needs to be recovered from road users. There is often no economic link from revenue back to spending decisions.

Community service obligations for road infrastructure can be defined in terms of uneconomic spending for reasons of social policy. For investments, this means spending that fails the cost–benefit analysis test. For maintenance, it means providing a standard of road above the economically warranted level.

The data collected by a pricing system can provide invaluable information on traffic flows to support demand forecasting, strategic planning and economic analysis.

Moreover, whole-of-network and economy-wide impacts of road investment must be considered. For example, investment that simply moves bottlenecks may offer very little overall benefit. Similarly, broader impacts on other transport modes should be factored in, as well as the impact on the environment. This should be done by network-wide strategic planning that incorporates forecasting, data collection, land-use planning, inter-jurisdictional issues and forward-looking asset management.

Finding

Provided charges reflect short-run marginal costs and are responsive to changing conditions, they can provide signals and data to assist planning for future investment. However, private commercial investment criteria are not suitable for infrastructure, as many economically beneficial roads would not be financially viable under the current framework. Economic analysis is indispensible to guiding investment and maintenance decisions. Strategic planning is essential for identifying investment projects to examine in more detail and for taking into account the network effects of investment decisions.

The replacement of current road tax arrangements with a different system could alter the pattern and level of road use, and is also likely to affect road financing requirements. In economic terms, the purpose of asset provision is to satisfy future demand. Road infrastructure needs in the long term are affected by trends in the location of population and economic activity driven by climate change, migration, an ageing population, the structure of the economy, and technological and social changes. There is no reason to assume that the current network will be suitable for future use. Finance available to road owners should reflect future network needs, assessed by anticipated traffic levels.

The need to take a forward-looking view of road use creates a central role for planning and forecasting. It is important to develop an understanding of current network limitations; for example, through developing asset management plans. Traffic forecasts are needed to determine network and financing requirements. Accurate forecasting will depend on estimating the future needs of users, as well as traffic counts from the existing road network. While these estimates can be informed by revenue flows derived from efficient pricing, these revenues would reveal only the extent to which road users value the existing road network; they are not a valuation of expected future benefits.

In practice, road agencies try to maintain road standards within a given budget. This leads to important institutional questions — that is, whether the current engineering standards for roads are economically efficient, and whether road agency budgets are sufficient to maintain their networks adequately. Restricting maintenance in the short term can be self-defeating in the long term. If periodic maintenance is not performed, water can seep through cracks, weakening the pavement. The pavement becomes more susceptible to damage by heavy vehicles, which can dramatically shorten its life.

Ideally, public investment in infrastructure would be made on the basis of a rigorous assessment of the costs and benefits to society of the proposed project (see Box E3–7). The desirability of this as a decision-making and appraisal tool to assess which infrastructure projects demonstrate significant long term national benefits has been recognised by

Infrastructure Australia when conducting its national audit of Australia's infrastructure priorities in 2008.

Established in 2008 by the Australian Government as an independent advisory body to drive the development of a long-term, coordinated national approach to infrastructure planning and investment, Infrastructure Australia is committed to the use of rigorous and objective cost–benefit analysis as its primary assessment and evaluation tool.

However, cost–benefit analysis is complex and errors can occur. Analyses are often undertaken or paid for by project proponents who desire a strong positive result. Making analyses transparent and publicly available would open the methodology and assumptions to scrutiny.

Principle

Investment in major projects should be determined by transparent, well-informed analysis of costs and benefits. Investment in pavement durability and maintenance decisions should be made with the goal of minimising overall costs to society (that is, taking into account both the costs of maintenance and the costs to the road user).

Commercial agreements between road users and road suppliers

While efficient charges do not usually cover the cost of individual roads, there may be opportunities in some cases to build closer commercial accountabilities between road suppliers and specific road users. This might improve investment in some roads where specific additional benefits accrue to identifiable users, rather than to society as a whole.

For example, a business with particular operational needs might want to agree with a road supplier to build a new bridge capable of carrying heavier vehicles. Under current arrangements, the non-excludable nature of much of the road network means that such a bridge would not be financed privately, as competing businesses would gain access to the benefit for free.

It might be possible to overcome this constraint by allowing the bridge to be subject to an access charge for other businesses who have not contributed capital. The access charge would be subject to regulation to restrict the abuse of market power, and would only be allowed to continue long enough to allow recovery of costs with a reasonable return on capital. Such charges should be designed to encourage economic investment that may not otherwise take place. While there would still be an efficiency loss from imposing a facility-specific access charge, the outcome would be better than if the bridge had not been built at all.

Other road users might require a level of service from road suppliers over and above the general public standard. For example, an express courier service might require guaranteed travel times for a particular route at a particular time. Allowing road users and road suppliers to contract to meet a particular standard might provide a mutually beneficial outcome for both parties. Such arrangements, made possible under national competition policy, already exist in rail infrastructure.

Recommendation 67 proposes that governments should continue to reform road infrastructure provision, applying economic assessment to investments comparable to that applied to other forms of infrastructure.

Box E3–7: Economic analysis of road investment and maintenance decisions

Road investment decisions should be made using cost–benefit analysis. A cost–benefit analysis compares a base case (business as usual) with one or more project options.

The main benefits from road investment projects are savings in time, vehicle operating costs and accidents. The value of savings in work time is determined with reference to average earnings. Savings in non-work time are valued at something less than earnings, based on behavioral studies. For non-urban roads, State road agencies use computer models to undertake cost–benefit analyses. The models include algorithms to estimate vehicle speeds, vehicle operating costs and accident rates for the base and project cases. Urban road and public transport projects necessitate network models to estimate how traffic redistributes itself across the network in response to the project.

The main cost is the initial construction cost of the project. There will also be ongoing maintenance and operating costs. Costs and benefits are estimated for each year of the life of the project using forecasts of traffic levels. Annual costs and benefits are then discounted to the present. Results are presented as net present values and benefit–cost ratios.

A positive net present value (benefit–cost ratio above one) implies that the project represents a net improvement in economic efficiency. Where investment spending is budget constrained, the most economically efficient investment program is determined by selecting projects in descending order of benefit–cost ratio until the budget is exhausted. In practice, funding constraints mean that many projects with benefit–cost ratios above one will not be selected. Also, governments will choose some projects with low benefit–cost ratios for social or equity reasons (community service obligations).

Economic analysis of road maintenance decisions involves life-cycle cost minimisation. The economically optimal amount of pavement durability and the timing and types of maintenance treatments to apply over the life of a pavement are those that minimise the present value of combined road user and road agency costs. A better maintained pavement will be smoother, resulting in less wear and tear on vehicles, faster travelling speeds and greater safety. However, it requires more frequent and more expensive maintenance treatments by the road agency.

Economic analysis is not costless. Detailed analysis can only be justified for large spending decisions. The level of economic analysis undertaken ought to be proportionate to the size of the project. Also, many projects are not amenable to the standard cost–benefit analysis methodologies — for example, determining the frequency of rest areas along a highway. Small decisions are best left to the judgment of local engineers and managers. Guidelines that set out appropriate standards may be of assistance, and economic analysis can be used to help determine the standards.

The Australian Transport Council has published guidelines for the economic appraisal of transport projects. Austroads has published a guide for road project appraisal that includes standard unit values to use on cost–benefit analyses such as values of time and accident costs.

E3–6 Institutions to support efficient use and supply of roads

Recommendation 68:

COAG should develop a National Road Transport Agreement to establish objectives, outcomes, outputs and incentives to guide governments in the use and supply of road infrastructure. COAG should nominate a single institution to lead road tax reform, and ensure implementation of this agreement.

Historically, roads have been provided by government departments and local governments, funded from general tax revenue. The main challenge has been to connect sparsely populated regions. Roads have been mostly local public goods — that is, any car or truck can drive on the road and, given low patronage levels, cause negligible inconvenience to others. Given the state of technology, road pricing has been both impractical and inefficient.

These institutional structures may no longer be suitable to meet 21st century challenges. The current system has resulted in large congestion costs, concentrated in Australian capital cities, and has not consistently delivered economically efficient infrastructure to meet future demand.

Other bodies have considered institutional arrangements for road transport, to ensure that demand is met with supply — particularly through ensuring adequate finance. For example, the Productivity Commission (2006) considered a range of institutional structures, ranging from a departmental model based on hypothecated (that is, earmarked) taxes, dedicated road funds, a 'public utility' and privatised models of road infrastructure provision. The Australian Transport Council is currently considering alternative institutional arrangements for road provision.

The reform of road pricing has been slow, as it depends on availability of information upon which to base prices, effective regulation to prevent over-charging, the availability of suitable technology, and community acceptance. Outmoded institutions and a lack of coordination in the construction and maintenance of the road network has meant that different road agencies have had limited incentives to improve the national road network as a whole. Current arrangements give limited scope to finance additional road capacity in the face of congestion, or to build roads more resilient to heavy vehicles.

Information and regulation

The introduction of efficient pricing requires comprehensive information on actual costs. Road prices that aim to reflect social cost would need to be carefully regulated to ensure that they deliver the greatest net benefit for society, rather than generating profit for the road agency. For example, while pricing road-wear is easy in principle, determining the actual cost of different vehicle weights and loads on different types of roads is an empirical question. A road damage charge that exceeds actual costs could be just as harmful to economic efficiency as no charge at all.

Efficient pricing and regulation must be underpinned by empirical data — including information on the condition of existing assets and reliable estimates of marginal costs under different conditions — as well as agreement on the allocation of revenue, attribution methods and assumptions underlying the system. Theoretically sound pricing models may need to be adapted to recognise administrative and compliance costs in the real world.

Finding

Institutions are not currently set up to support efficient road pricing, nor efficient investment and operation of roads. Regulation will be necessary to ensure that road agencies do not exploit their market power in setting prices, and to ensure that prices reflect marginal social costs. Institutions will need to be vigilant to adjust prices in response to changing conditions.

Road charging revenues

The road pricing reforms outlined in this section propose that revenue from congestion charges be returned — in the first instance to fund additional investment in transport alternatives — to those affected by the charge. This section also recommends that charges on heavy vehicles for road-wear be allocated to the owners of the roads they drive on. This will only be possible when appropriate reforms have been delivered to the institutional and reporting arrangements applying to road owners, as costs of road-wear vary.

These revenues and their proposed uses form part of a much larger structure of revenues that are spent on roads, including new investments. Some of these other revenues derive from economic charges (such as developer charges or certain investment-related truck charges) and some derive from general government budgets, whether funded from general revenues or from road-related revenues. In turn, the basis of intergovernmental payments for roads also reflects a mixture of economic and non-economic assessments.

A range of difficulties arise in the practical management of these funds. At present, the allocation of road funds is subject to:

- decision-making on spending and investments by State and local governments;
- decision-making on specific grant funding and major investment by the Australian government (advised by Infrastructure Australia); and
- effective re-allocation of grants and other revenues between governments as determined by assessments of relative road revenue and expenditure needs by grants commissions using horizontal fiscal equalisation methods.[14]

The present combination of these arrangements, some using economic criteria and others using broader fiscal needs analysis, raises issues about equity and incentive effects for jurisdictional decision-making. A considerable amount of further work needs to be done to identify mechanisms that can deliver an appropriate integration of pricing revenues and investments. The outcome will depend on the particular structure that develops for future arrangements.

14 The Commonwealth Grants Commission for the States and local government grants commissions for local government grant funding.

To the extent that all or most pricing and funding ultimately follows economic criteria, and that those economic criteria reliably allocate funds and investments across national as well as local marketplaces, in future it may be preferable to shift road infrastructure delivery into the public trading enterprise sector rather than the budget-funded general government sector. In this case, funding and spending would no longer be subject to fiscal equalisation.

In the intervening years, when mixed arrangements will continue to apply, governments will need to give ongoing consideration to the most appropriate pathways for developing institutional and funding arrangements that make best use of increasingly efficient pricing mechanisms.

The need for national cooperation

The transport network in Australia spans State boundaries and involves all levels of government. The gains from congestion charging in State capitals, and better pricing for heavy vehicles, would deliver a national productivity dividend. This is a national goal for road reform that should be agreed through COAG.

A National Road Transport Agreement should include:

(i) an agreed model for financing the road network, including the appropriate assignment of revenue from taxes and charges, a reduction of Australian government fuel tax as efficient road pricing is introduced, and adjustments to other taxes and transfers necessary to maintain equity in the overall tax system;

(ii) a regulatory framework to ensure that road infrastructure providers' incentives are aligned with those of road users, particularly to prevent over-charging or supply restrictions;

(iii) a methodology for identifying and valuing the social purpose components of road funding, to form the basis of an explicit treatment of community service obligations, as well as a consistent methodology for assessing environmental impacts;

(iv) nationally consistent arrangements for asset management, including formal asset management plans, down to the local government level, as a condition for receiving revenue from road-specific taxes or charges;

(v) a framework to support commercial agreements between road users and road infrastructure providers, including agreements for the provision and finance of infrastructure to meet specific needs, and for the delivery of guaranteed service standards;

(vi) a protocol for the collection, handling and exchange of information from road pricing, as well ensuring personal privacy and interoperability of technical standards;

(vii) arrangements to evaluate the efficiency of infrastructure spending by ensuring that major infrastructure projects are subject to post-build evaluations; and

(viii) consideration of the broader impacts of road pricing reforms on other transport modes, particularly on public transport (in relation to congestion pricing) and freight rail (in relation to heavy vehicles charges).

Given the scale and complexity of the proposed reforms, a single agency may be required to develop and monitor their implementation. This would involve reporting on road reform strategies and developments, commissioning and evaluating research, funding and evaluating pilot programs, monitoring State entitlements to agreed funding for transport reform, and reporting to governments on whether specific commitments have been met (see Recommendation 68).

There is also a strong argument for leadership from the Australian government, and for it to provide incentives to the States to facilitate road reform. For example, the Australian government could make any funding of state infrastructure contingent on the adoption of pricing policies for roads that are consistent with this Report. It could ensure that economic appraisals of investment projects are made transparent and that the community service obligation component of road spending is identified and funded as such.

Moreover, responsibility for the largest road tax (fuel tax) rests with the Australian government, while responsibility for direct pricing reform will rest predominantly with the State and local governments who actually own the roads. The transition from taxes on roads primarily designed to raise revenue to taxes on roads primarily designed to improve infrastructure use therefore entails a shift from Australian government to State-level taxes in this area. This will require coordination on a clearly defined timetable.

E4. Housing affordability

Key points

Access to affordable housing is a key policy issue for the Australian community that is only likely to grow in importance. Policies of Australian governments have traditionally treated owner-occupied housing as the preferred housing tenure. This approach reflects the desire of most Australians to own their home. It also recognises the benefits ownership can bring both the community and homeowners, such as greater security in retirement. The approach in this Report is consistent with this policy goal, while recognising that home ownership will not be realistically available, or the right solution, for all households.

Measures of housing affordability emphasise different aspects of the issue, but all reflect the cost of housing and people's ability to pay for it. For renters, reforms to housing assistance would improve the ability of low-income earners to afford rental housing. For purchasers, affordability is constrained by prices that remain high relative to average income levels. While high prices or rents may result from increases in housing demand, they can only be sustained at high levels when supply is not responsive. Evidence suggests that the current supply of housing is insufficient, placing ongoing pressure on house prices.

Reforms to stamp duties and land tax would reduce current impediments to housing supply generated by the tax system. However, as taxation is not the major source of supply constraints in the Australian housing market, housing affordability would be best promoted through wider reforms that facilitate housing supply.

Housing supply can be restricted through a range of policies, such as planning and zoning regulations, as well as the approvals processes that govern them. However, such policies are designed to achieve a range of policy objectives, against which their impact on the price of housing should be assessed. The use of infrastructure charges has the potential to improve the allocation of infrastructure. However, where they are not set appropriately, infrastructure charges can reduce the supply of new housing, which can increase overall house prices.

This is not a straightforward area of policy because while reforms to increase supply may promote housing affordability, they can also reduce existing home values and change the shape of Australian cities in ways that many existing residents do not desire. This suggests a serious community dialogue is needed on the distribution and quality of housing across Australia. As a first step, the Council of Australian Governments should review building and land use policies and infrastructure charges to ensure they do not unnecessarily restrict the supply of housing.

E4–1 The role of housing in Australia

In its myriad forms, housing provides shelter, security and a savings vehicle to millions of Australians. Adequate shelter is fundamental not only in meeting basic human needs, but also in providing a base from which to develop individual capabilities, to raise a family and to participate in the community and the workforce.

The value of housing derives from more than the day-to-day shelter it provides. More than two-thirds of Australians enjoy the benefits of owning their own home. Whether they are a first homeowner with little equity or a retiree whose mortgage has been paid off, the security of tenure associated with home ownership provides an additional benefit over and above physical shelter. In many areas, a stable base of home ownership underpins social integration. Home ownership can benefit not only homeowners, but their communities too.

As well as providing vital services to individuals and communities, housing also forms a large share of Australia's savings. Houses are built to last — many people work hard to pay off their house during middle age, in order to ensure they have access to accommodation with no cash payment obligations when they are old. As a form of savings, housing has additional benefits over other savings vehicles because it not only acts as a store of value, but also reduces exposure to fluctuations in rental costs. In particular, those on fixed incomes are insulated from housing cost fluctuations, ensuring that other necessities like food or energy are affordable and they are protected from the risk of poverty.

Australia currently has one of the highest rates of home ownership in the OECD. In total, 68 per cent of Australians own or are buying the home they live in, compared to an OECD weighted average of 63 per cent. For those aged over 65 years old, the rate is 82 per cent, which is among the highest in developed countries (Bradbury 2008). These high levels of home ownership often reflect strong personal preferences for home ownership over other forms of housing tenure, as well as deliberate government policies to enable owner-occupied housing.

The Review's recommendations are intended to support this policy goal. There is a strong case for continuing Australia's approach of ensuring that owning their own home is within the reach of ordinary families. The role of owner-occupied housing as the key source of voluntary retirement savings is a major reason for continuing to exempt it from income taxation (see Section A1 Personal income tax). Further, owner-occupied housing plays a particularly important role in providing financial security for the large majority of Age Pension recipients who own their own home. Continuing the means test exemption for owner-occupied housing, up to an indexed threshold to ensure fairness of the test, will support this objective (see Section F2 Means testing).

However, home ownership will not be realistically available, or the right solution, for all households at all times. Ensuring access to appropriate rental housing is an integral part of Australia's transfer system. The reforms to housing assistance recommended in this report would mean that the transfer system is better placed to address housing affordability by ensuring access to affordable housing at the rents available in the market (see Section F5 Housing assistance).

In framing its terms of reference, the Australian Government requested that the Review pay particular attention to Australians' access to affordable housing. The affordability of housing, in light of high housing price rises and increasing rents, is a fundamental challenge facing all Australian governments.

E4–2 What is housing affordability?

At its most basic level, housing affordability means ensuring that low-income households can access an adequate standard of housing without unduly compromising their other spending needs. Concern over housing affordability extends beyond this to whether people across a range of incomes can purchase housing without facing undue financial stress.

Studies of housing affordability do not settle on a single definition or way of measuring housing affordability (for example, Robinson et al. 2006; Gabriel et al. 2005). Different measures often reflect different conceptions of what is the most important aspect of housing affordability. Concern may focus on low-income earners' access to housing (often as renters), the degree of home purchase capability enjoyed by moderate-income or first home buyers, or the ongoing cost of sustaining a mortgage for those on average incomes (see Box E4–1). However, what is common through all of these benchmarks is a measure of the price of housing and a household's means to pay for it.

Box E4–1: Different measures of housing affordability

Several measures of housing affordability focus on low-income earners.

'Residual' measures of affordability record the remaining income available to households after deducting the cost of a level of housing (for example, see Harding & Szukalska 2000; Burke & Ralston 2003). This approach can indicate whether households enter housing poverty through rising housing costs or falling income.

'Ratio' measures of affordability compare the costs of housing to household income (for example, see ABS 2002; Harding, Phillips & Kelly 2004). Under this approach, housing is agreed to be unaffordable when housing costs exceed 30 per cent of income for households with incomes in the bottom 40 per cent of the income distribution (for example, see the National Housing Strategy 1991).

The affordability of housing for wider groups in society can be measured in other ways.

A simple measure that reflects the cost of purchasing a dwelling is the ratio of median house prices to average household income.

Several measures assess the ongoing costs of home purchase of a dwelling through a mortgage. The Reserve Bank of Australia compares the cost of repaying a mortgage — based on 80 per cent of the prevailing median house price at the prevailing variable mortgage rate — with average household income (see Richards 2008).
HIA-Commonwealth Bank applies a similar approach to the median house purchase price for first-home buyers (see HIA 2009). While there is no single view of when housing is affordable using such measures, affordability is often interpreted as being at low levels when repayments exceed 30 per cent of income.

Box E4–1: Different measures of housing affordability (continued)

Other measures of purchase affordability reflect the up-front cash required for a deposit on a mortgage and are often used to describe the degree of first home buyers' access to the market. For example, the 'deposit gap' records the difference between typical house prices and the maximum mortgage available on a typical household income (Yates and Milligan 2007).

Developments in housing affordability in Australia

Current measures of housing affordability indicate that Australia faces significant challenges in providing sufficient affordable housing.

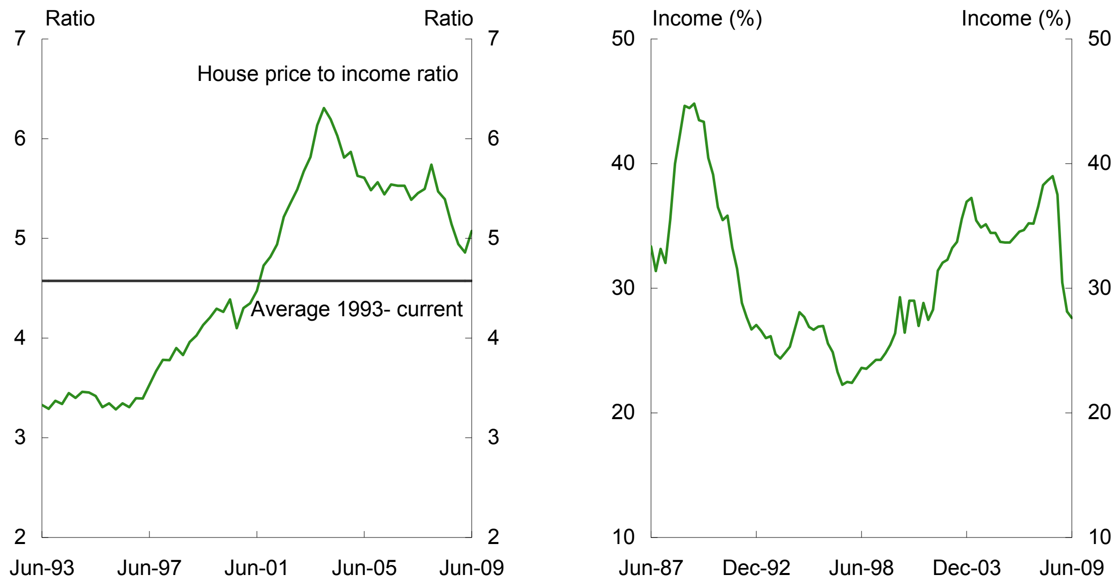
Median house prices have risen from around three times average household earnings in the early 1990s to around five times today (see Chart E4–1 Panel A). Higher prices affect access to housing in a range of ways. Under the Reserve Bank of Australia's measure, loan repayments are only just under 30 per cent of income (see Chart E4–1 Panel B). Houses are more affordable now than during 2007, but the recent improvement reflects interest rates falling to 'emergency lows' to combat the global financial crisis. These low rates are likely to be unwound as the economy recovers. Higher housing prices also meant that the deposit needed by first home buyers reached record highs during 2007 (Richards 2008). Higher house prices may also delay access to home ownership by younger Australians. The proportion of Australians under 35 who own their own home declined from 44 per cent in 2001 to 38 per cent in 2008. Similarly, higher house prices may mean fewer people own properties outright. The proportion of Australians aged 55 to 64 with mortgages has increased from 13 per cent in 1996–97 to 30 per cent in 2007–08. The National Housing Supply Council (2009) also noted that there is a spatial dimension to the affordability of dwellings; 27 per cent of dwellings in different population centres were found to be 'unaffordable' in 2006, while none were in 2001.[15]

15 This is based on the UDIA/Matusik Affordability Measure (2008), which characterised an area as 'unaffordable' when a household spending 30 per cent of the average income in that region on repayments (and with a 10 per cent deposit) could purchase less than 15 per cent of the houses in the region.

Chart E4–1: Housing affordability for owners

Panel A: Median house price to disposable household income

Panel B: Housing Loan Repayments

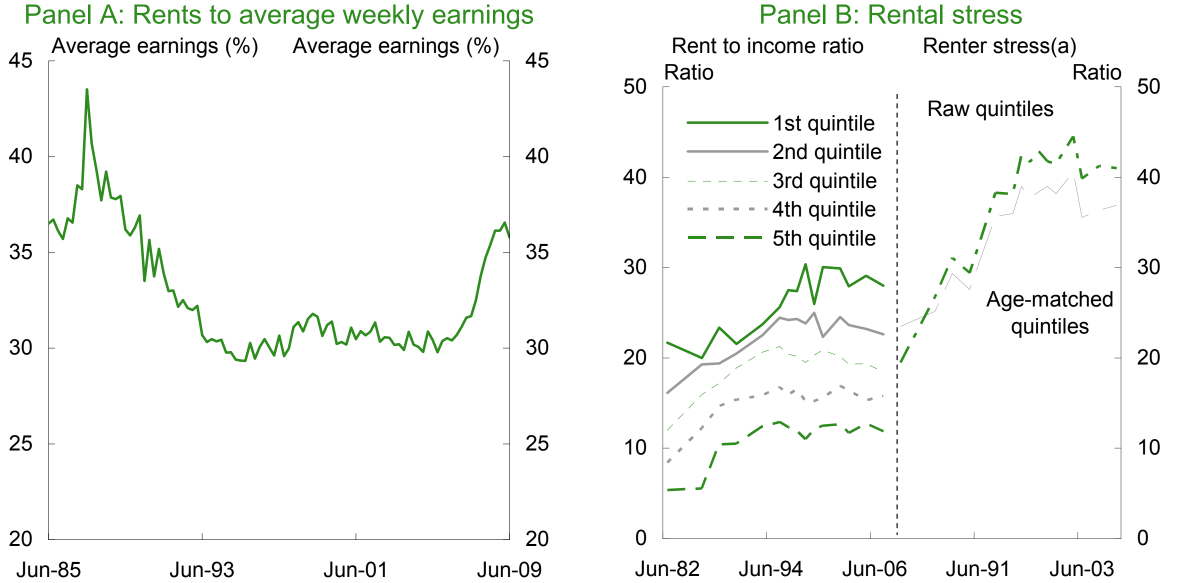


Source: REIA 2009, ABS (2009a) and Treasury estimates.

Source: RBA unpublished.

Importantly for many low-income earners, or transfer recipients, higher house prices reduce rental affordability, as rents need to increase if investors are to maintain their rental yield. The ratio of rents to average weekly earnings has risen to its highest level since the late 1980s (see Chart E4–2 Panel A). As at 5 June 2009 there were 418,000 individuals and families paying more than 30 per cent of their income in rent even after receiving Rent Assistance; 129,000 of these were paying more than 50 per cent of their income. Many of these people, especially age pensioners and disability support pensioners (who make up around one-quarter of Rent Assistance recipients) are likely to have limited capacity to increase their incomes. The number of Rent Assistance households paying more than 30 per cent of their income in rent is at its highest level since 2000.

Chart E4–2: Housing affordability for renters



Source: REIA 2009 and ABS (2009e).

(a) Proportion of households in the bottom two income quintiles, whose rental costs are more than 30 per cent of gross income.
Source: Richards (2008).

The price level of any market good or service is set by its demand and supply. The Productivity Commission (2004) and Reserve Bank of Australia (2003) attribute the increase in house prices around the start of the decade primarily to strong growth in demand. This demand reflected a range of factors, including growth in average household incomes, increased credit availability and relatively low interest rates. In the short term, when housing supply is relatively fixed, price increases are an inevitable response to strong demand.

A persistent gap between housing supply and underlying demand (or the 'need' for housing based on population growth and trends in household formation) indicates that there are problems on the supply side of the housing market. Strong population growth in recent years has led to relatively strong underlying demand for housing. However, the supply response has not been able to keep pace. Over the past five years, the population grew on average 1.7 per cent a year, while housing completions fell on average 2.0 per cent a year.

Thus sustained high levels and strong growth of housing prices are only possible when housing supply cannot increase to meet movements in demand.

There are a range of indicators of tight supply in the current housing market. Rental vacancy rates are currently around the record lows experienced during 2008 (see Chart E4–3). The National Housing Supply Council estimated that there is a substantial shortage of housing in Australia, with an unmet need of 85,000 dwellings in 2008, and construction levels falling short by around 20,000 to 30,000 a year. If the Council's medium growth estimate of underlying demand and medium supply projection were met, there would be a cumulative gap by 2028 of 431,000 dwellings. Annually, the gap would increase by around 23,000 dwellings until 2016, when the annual shortfall would decrease consistent with an ageing population.

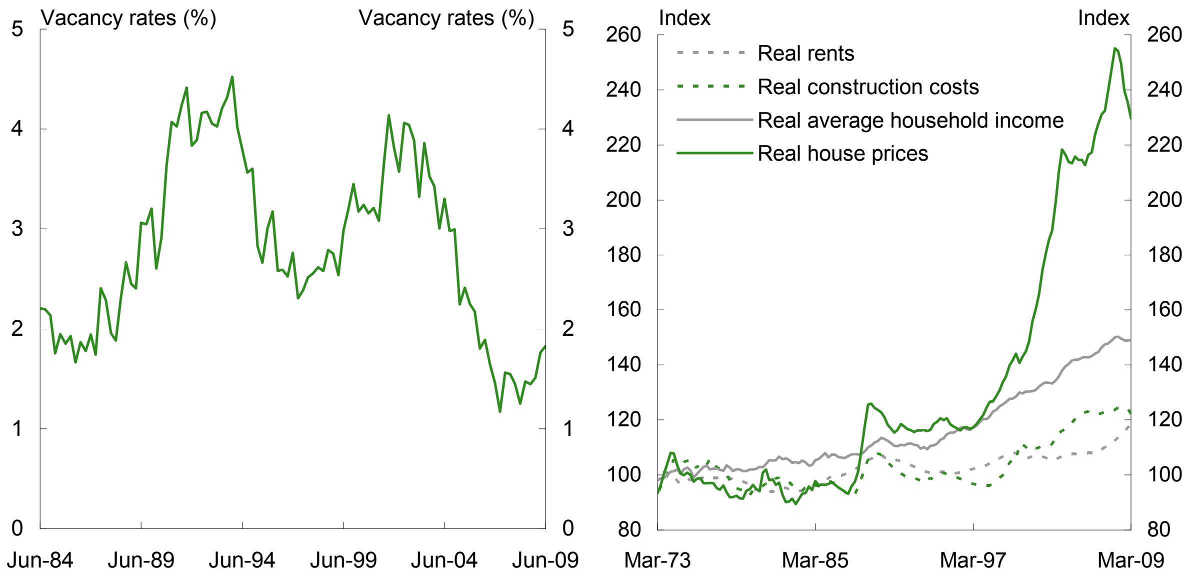
Of course, in markets demand always equals supply so long as prices can adjust. The Council's projections should be seen as an indication of the degree of likely price pressures and the subsequent challenges facing the community.

The growth in house prices largely reflects increasing prices of existing houses, rather than growing costs of construction (see Chart E4–3 Panel B). Land has made up a growing share of house prices, increasing from 53 per cent to 61 per cent in the 15 years to 30 June 2009.

Chart E4–3: Constrained supply

Panel A: National rental vacancy rate

Panel B: House prices and construction costs



Source: REIA (2009) and Treasury estimates.

Source: RBA (unpublished).

The responsiveness of housing supply is influenced by a range of factors. Even in ideal conditions, dwellings take a long time to plan and construct, which will mean that the supply of housing is unlikely to be as responsive as supply in other markets. Currently, difficulties in securing finance for the development of multi-unit developments are a consequence of lending practices changing in response to the global financial crisis. There are, however, many public policy choices that can have a long-term impact on housing supply and housing affordability. As well as tax settings, housing supply and prices are influenced by planning and zoning laws, building regulations, environmental regulations, infrastructure provision and pricing, the availability of skilled labour in residential construction, and even transport policy. As a consequence of achieving other public policy objectives, these policies may affect housing prices.

E4–3 The effect of the tax system on housing affordability

Many taxes influence the housing market. The personal tax system affects the affordability of rental housing through the assessment of income from investment in residential rental properties, offsetting expenses (such as interest costs) and capital gains. The housing market is also affected by the exemption of owner-occupied housing from the personal income tax and the capital gains tax system, stamp duties on housing transactions, GST on the price of supplying new housing, council rates and land taxes.

Prices send a signal to direct resources within an economy. Resources are directed to where they are most valuable when price signals reflect real preferences and resource constraints rather than tax policy settings, which of themselves contain no information about the type or location of dwellings Australians want to live in. Where taxes add to the volatility of demand or restrict the supply of housing, they reduce the efficient operation of the housing market. The general efficiency principle of tax policy, involves minimising its impact on economic activity. Similarly, when the tax system affects housing prices it can also affect fairness, for example, if the tax system makes it difficult for disadvantaged groups to afford housing.

However, other public policy objectives are of relevance for the taxation of housing. The role of housing as a lifetime savings vehicle that provides security in retirement means the income from owner-occupied housing should not be taxed. However, the Review is proposing to tax rental properties in a way that is more consistent with other forms of investment, reducing biases in housing investment and savings portfolios. As a result, these different tax treatments will affect the cost of housing for renters compared to homeowners.

Effect of proposed reforms on supply and demand for housing

Outlined below are a number of proposed reforms to the tax system that would reduce the impact of the tax system on house prices. These reforms are described in more detail in Sections C2 (Land tax and conveyance stamp duty) and A1 (Personal income tax). In concert with other reforms to improve housing supply, they should improve housing affordability by making housing supply more responsive to demand.

Removing stamp duty

Removing stamp duties would improve the supply of housing, as well as reducing a range of other adverse impacts on the housing market.

By suppressing the number of transactions undertaken in the housing market, stamp duties reduce the effective supply of housing.[16] More transactions means a better matching of people to housing, which in turn means a given housing stock can effectively house more people. By adding to the cost of moving to a larger house, stamp duty encourages people to renovate rather than re-locate. This means that more investment is channelled into making existing housing larger than into more affordable and newer housing. These impacts on the supply of housing are on top of the personal costs of stamp duty, which arise when people live in houses that are ill-suited to their needs.

As a turnover tax, stamp duties can also discourage the development of new housing stock. Stamp duties are paid twice in the supply chain of new housing construction: when the developer buys the property from its initial owners and when the final owner buys the land. Stamp duties impose their highest effective tax rate when a property is held for a short period (see Section C2 Land tax and conveyance stamp duty). As a result, they fall heavily on people who hold property over short time periods while it is developed (or redeveloped) into housing. As the liability from a land tax is independent of holding periods, replacing stamp duty would support new housing supply.

16 For example, Leigh (2009) estimates that a 10 per cent increase in stamp duty costs reduces the total number of transactions by 4 to 5 per cent if the increase is sustained over a three year period.

As well as taxing turnover, stamp duties are also a tax on the buildings (or improved value) including in housing. Compared to a tax on land only, stamp duties discourage the construction of new dwellings, which is likely to reduce supply and increase cost of housing.

Land tax

Using the size of holdings and the use of land to determine land tax liabilities has adverse impacts on the housing market. Reforms to levy land tax on all land, based on its value, should reduce these effects.

Apart from the ACT, all States that levy land tax calculate it on the basis of aggregate land holdings. In combination with progressive rate scales, this approach creates a significant bias against large-scale land holdings. In combination with the negative gearing tax advantage available to individual investors, this is a major reason for the residential property market being dominated by small-scale investors.

Policies that discourage large-scale investors from participating in the housing market are likely to have adverse effects on the supply of rental housing and its affordability for tenants. By favouring small investors, housing investment forgoes the potential for lower costs from economies of scale in housing supply. For example, small landlords effectively share the services of tenancy management by purchasing them from property agents. Large scale housing investors may be able to bring the supervision of tenancy arrangements 'in house', reducing their cost and the cost of housing overall. Further, large-scale investors are more likely to invest over longer time horizons, as they are less likely to face cash-flow problems or the need for portfolio diversification that can force sales by small-scale investors. For long-term investors, longer leases would also reduce negotiation costs and provide certainty of income. Such arrangements would be particularly beneficial to some tenants who currently face high costs from insecure tenure, such as many elderly people and low-income families. The security of tenure provided by longer leases would have positive effects for tenants' social integration and for high levels of social capital within communities.

Improvements to housing investment arising from the removal of the aggregation basis for land tax would likely develop over a reasonably long time period in light of the range of other factors affecting housing supply.

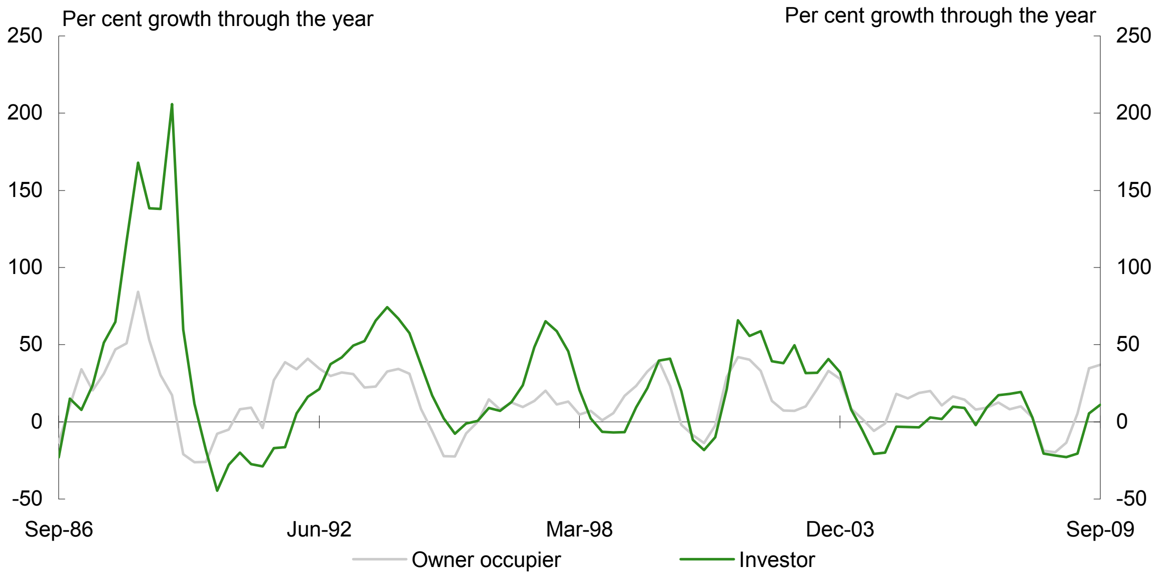
The current exemptions from land tax mean that the tax is unlikely to be fully capitalised into land values (see Section C2 Land tax and conveyance stamp duty). This results in the burden of the tax falling on the users of land, greatly reducing the efficiency of the tax. This is particularly relevant for the housing market. When developers purchase land that was exempt because it was used in primary production and will become exempt in the future (as owner-occupied property), little of the tax will be reflected in lower land values. The exemption is likely to add to holding costs of supplying new housing. Similarly, the burden of the current land tax on investment property is likely to fall predominantly on renters through higher rent. Broadening the land tax would therefore improve housing affordability.

Changes to the taxation of investment properties

The current personal income tax system favourably treats capital gains and amplifies this benefit when investments are geared. By discounting net rental income at the same rate as capital gains, the tax treatment of investor housing will be less responsive to gearing levels and capital gains, creating a more neutral treatment of different forms of savings (see A1 Personal income tax).

The proposed reforms would reduce the bias in favour of the capital gain generated in rental properties by treating it more neutrally compared to rental yield. Over the long term, this is likely to change investor demand toward housing with higher rental yields and longer investment horizons. This may also result in a more stable housing market, as the current incentive for investors to chase large capital gains in housing would be reduced. Finance for investment in rental property appears to be more volatile than that for owner-occupiers (see Chart E4–4). The Productivity Commission (2004) and Reserve Bank of Australia (2003) have suggested that favourable taxation settings can contribute to volatility of the housing market.

Chart E4–4: Volatility of housing finance from investors and owner-occupiers



Source: ABS(2009j).

However, changing the taxation of investment properties could have an adverse impact in the short to medium term on the housing market. Investment returns in the Australian residential housing market are likely driven by capital gains rather than by rental yield. As such, reducing net rental losses and capital gains tax concessions may in the short term reduce residential property investment. In a market facing supply constraints, these reforms could place further pressure on the availability of affordable rental accommodation within the private rental market. These reforms therefore should only be adopted following reforms to the supply of housing and reforms to housing assistance (see Section F5 Housing assistance). The design of these reforms differs from the previous amendment to taxation of rental properties, see Box E4–2.

Box E4–1: Changes to tax treatment of negative gearing, 1985 and recommended

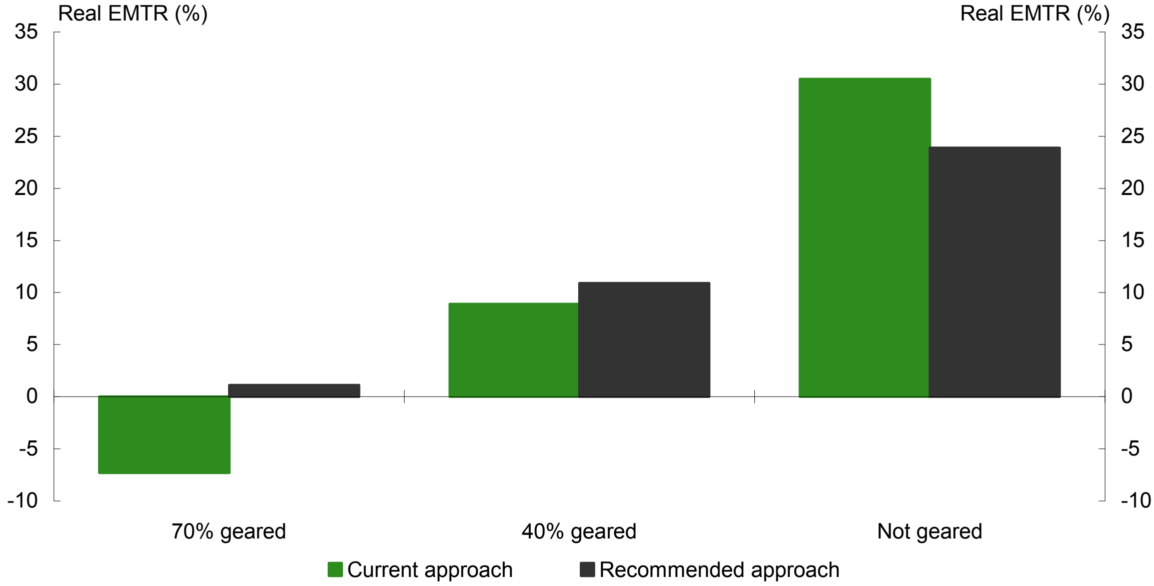
The effect of applying the recommended savings income discount to net rental income would be that a negatively geared investor would still be able to offset net rental losses against other income, including labour income. While the extent of the offset would be reduced, negatively geared investors would continue to access ongoing deductions that they might value for cash flow reasons.

Under the savings income discount, there would also be a generally better outcome for rental property investors that finance out of equity. The more neutral treatment would reduce the crowding out of other potential investors in rental housing by those undertaking negative gearing, and improve the long-term stability of the housing market.

Accordingly, this is quite a different approach to that adopted in 1985 (and reversed in 1987). In 1985 the tax benefits of negative gearing became restricted through the introduction of quarantining measures for excess deductions. As such, negatively geared investors could not access the entire net rental loss in the income year it was incurred, rather, excess interest in any year was carried forward and offset against future rental income or any gains taxable under capital gains tax from the sale of such investments.

In terms of rent setting, a more neutral taxation of investment housing would reduce the tax on some investors, while increase it for highly geared investors (see Chart E4–5). The long-term impact on rents would depend on how these different investors respond and their relative prominence in the rental housing market. Currently, investors with no or low levels of gearing form the minority of the market, so the current tax advantages available to highly geared investment can operate as a subsidy to renters by placing downward pressure on rents.

Chart E4–5: Real effective marginal tax rates on rental property, by gearing ratio



Assumptions: Individual on 31.5 per cent marginal tax rate. 6 per cent nominal return, 2.5 per cent inflation. For rental property, 50 per cent of the return is attributable to capital gain, 50 per cent attributable to rental income and the rental property is held for seven years then sold. Tax on debt provider disregarded.
Source: Treasury estimates.

This implicit subsidy is sometimes cited as a reason to sustain a non-neutral tax treatment. However, while some benefit may accrue to renters through lower rents, the tax advantage is neither transparent nor well-targeted to improve affordability for low-income renters. Further, providing assistance through subsidised geared investment can have other impacts on the availability of rental housing that may not be in the best interests of tenants. Recent work by Wood and Ong (2009) found that negatively geared investors were around half as likely to hold their property after five years as investors who were not negatively geared. For tenants, having landlords who are more likely to sell reduces the security of their tenure. In contrast to negative gearing, the proposed reforms to housing assistance are targeted to those who need assistance, making them a more effective and equitable means of subsidising low-income renters.

Overall impact on the housing market

While these reforms will address significant biases that the tax system introduces into the housing market, the overall impact on housing affordability depends on other factors, such as interest rates and land release policies. A range of other policies are likely to have a more significant impact on housing supply than tax settings.

The tax system is unlikely to be an effective instrument to move housing prices toward a particular desired level and the tax system is not the appropriate tool for addressing the impact of other policies on housing affordability.

Finding

Though the Review's proposed reforms to taxes, in particular stamp duty and land tax, could play significant roles in addressing housing affordability, other policies are likely to have a more pronounced impact on the responsiveness of housing supply.

E4–4 The effect of non-tax policies on housing supply

A range of policies restrict the supply of new housing, whether in new 'greenfield' areas or in infill projects.

Planning and zoning, approvals and building regulations

Features of the planning system intend to enhance the efficiency of land use in two ways: by managing or preventing perceived negative spillovers from development activities that may extend beyond the site of the development itself; and by facilitating positive spillovers through the provision of public goods (National Housing Supply Council 2009). However, planning can also add costs, such as where the regulations are not well-targeted and lengthy development assessment processes are involved. The key question is whether the benefits outweigh the costs.

The zoning process is one aspect of the planning system that controls the manner in which land can be used and regulates the supply of land for new housing. Zoning can have many rationales. It can be used to manage land use to protect the property rights of neighbouring land owners. Zoning can reduce spillover costs by congregating spillovers (such as noise pollution) in common areas (such as industrial zones). Some forms of infrastructure may also be provided at lower cost if they are specific to some forms of land use. Zoning is therefore one mechanism for coordinating different uses of land and reducing spillover costs between owners.

Zoning and planning also can reflect other public policy objectives. A number of Australian cities employ boundaries or growth corridors that aim to limit the expansion of urban land. Limiting the expansion of cities can reduce the need for additional infrastructure, which tends to be more costly to deliver further from urban centres. These limits can be used to contain urban sprawl. The desire to contain sprawl can be motivated by cost considerations, such as reducing costs caused by congestion that results from longer commuting times. Objections to urban sprawl often reflect a range of values, such as a preference for non-urban land to be preserved or a concern that more distant communities may be socially isolated, particularly if the communities do not have access to public transport.

The use of zoning and local interpretation of zoning settings, however, restricts the supply of land for housing and necessarily increases its price. While land values for different types of rural land can be in the range of $50 to $5000 per hectare, the value of land on urban fringes can be substantially higher. For example, the value of land can increase by $300,000 to $400,000 per hectare when zoned for residential purposes (Department of Sustainability Victoria 2005). Such a significant increase will largely reflect the value that results from restricting supply.

Land already zoned for residential use is still subject to a range of constraints on its use. This may include preventing the construction of higher-density dwellings (such as dual occupancy or multi-story dwellings) in certain parts of a city. These restrictions may be motivated by similar reasons to those that underlie zoning itself. For example, a new higher-density residential development may impose social costs on existing residents by lowering the amenity of an area or congesting infrastructure. Another type of spillover is a ‘pecuniary’ spillover where increasing supply reduces the value of existing homes. Existing owners may therefore oppose the removal of restrictions on the supply of housing that maintain house prices at high levels. Limitations on higher density in existing urban areas may harm housing affordability more than restrictions at the fringe. This is because it would be cheaper to house people in areas close to services, transport, workplaces or places of natural beauty. The higher land and house values in inner-urban areas also reflects the fact that these areas are where more people want to live.

The removal of such building restrictions is not justified simply because it would reduce housing prices. Concerns for housing affordability need to be balanced against other policy objectives. Further, potential exists for some of these objectives to be addressed more effectively through price mechanisms. For example, moves toward more effective road pricing and congestion charging would reduce the need to use a growth boundary as an indirect way of reducing congestion costs. For many of the other policy motivations, however, there are clear trade-offs that need to balance concerns of competing groups who can benefit or be harmed by the maintenance of housing restrictions.

One such trade-off is reflected in the governance issues that affect development. In general, State governments are responsible for determining the plans for a city, as these require coordination across a number of local councils and the provision of large-scale infrastructure, for which they are responsible. Local governments often control the zoning or approvals that put broader plans into effect, such as by allowing higher-density housing in the areas designated by the plan. This can result in tension between the wider objectives, which can often include objectives for higher-density housing, and the decisions of local government, which reflect the concerns of their citizens who are most strongly affected by change. It can therefore be difficult for State governments to implement urban infill strategies. There appears to be scope for reforms to planning governance to achieve greater clarity in the roles of institutional policy-setting and decision-making between levels of government (National Housing Supply Council 2009).

Regulations on the use of land need to be governed by approval processes to ensure they are enacted in a transparent and fair manner. These processes require consultation with affected stakeholders and assessment against a range of criteria, such as environmental requirements managed by Australian government legislation. Where these processes are slow, they add to costs of house building and the risk of developing land, thereby reducing the supply of housing. There is some evidence that delays have increased and that approval times can be 50 per cent longer in inner-urban areas than at the fringe (Productivity Commission 2004). Where approval processes are streamlined, they are likely to result in supply being more responsive to changing conditions.

While much of the recent increase in house prices reflects increasing costs of land, higher building costs can also affect housing affordability. National building codes mandate a minimum quality standard of construction. These standards ensure a minimum quality standard to ensure safety, promote environmental outcomes or improve the energy efficiency of buildings. Standards may be imposed to correct perceived market failures, particularly information asymmetry between home buyers and builders and spillover costs to the community that parties to the transaction may ignore. Improving the quality of housing raises its cost. These higher costs need to be balanced against the social and private benefits they deliver.

Findings

Higher house prices are likely to result from restrictions on the supply of housing that result from zoning, lengthy approvals processes and building code and other standards imposed on building quality. Housing affordability needs to be considered against the other policy objectives that motivate these regulations.

Scope for reform

Recommendation 69:

COAG should place priority on a review of institutional arrangements (including administration) to ensure zoning and planning do not unnecessarily inhibit housing supply and housing affordability.

Australia is likely to benefit from greater emphasis on housing supply in a range of policy areas. In particular, there appears to be scope for reforms to planning and approvals processes to enable more responsive supply of housing in greenfield and infill developments. However, the Review has not considered these mechanisms and is not in a position to identify those regulations that may prevent or delay viable developments.

Reforms that could promote the more responsive supply of housing will present serious choices for both the Australian people and their governments. Most starkly, 'improving' housing affordability for purchasers involves policies that cause house prices to be lower or grow more slowly than the community would otherwise expect. While this will benefit those who gain access to housing, it will affect the wealth of the majority of home owning Australians.

Increased housing supply may also change the shape of Australian cities and towns in ways that many existing residents may not desire. How different tiers of government balance their concerns against those of potential new residents is an important question of governance. This suggests that a serious community dialogue is needed on the distribution and quality of housing across Australia. As a first step, the COAG should review the administration of land use policies by local councils and planning authorities, with a view to facilitating greenfield and infill developments.

E4–5 Infrastructure charges

Infrastructure charges (sometimes called 'developer charges' or 'developer contributions') are fees levied on developers to compensate governments for providing facilities necessary for land development. The charges are often associated with basic infrastructure (such as local roads and water mains), but more recently this has sometimes been extended to include major headworks (arterial roads and pumping stations) and social infrastructure (parks and libraries).

Infrastructure charges are widely used by local government as well as some State governments, and are increasingly prevalent in other developed countries. There is limited information and few aggregate statistics relating to infrastructure charges in Australia. Chan et al. (2009) reported that in 2005–06, New South Wales councils collected $232 million and Victorian councils collected $454 million in charges.

What is the potential role for infrastructure charges?

In Australia, the practice of governments charging for infrastructure has been becoming more prevalent since the 1980s. This reflects increasing demand for infrastructure and fiscal constraints on local governments, but also a policy shift towards using economic instruments to allocate infrastructure and influence development decisions (Chan et al. 2009).

In principle, efficient provision of infrastructure would be encouraged where its users pay for the construction of infrastructure that would be avoidable (that is, not needed) if the development did not proceed. By levying infrastructure charges that reflect these costs, State and local governments provide signals to develop housing in ways and places of greatest value. The cost of infrastructure increases directly with distance from essential headworks and inversely with the density of development (Slack 2002). To the extent that a developer can respond to these costs, for example, by choosing to build closer to an existing development or by increasing the density of housing, charging the developer can improve housing supply.

Indeed, in the absence of pricing, developers build without regard to such costs, and governments are more likely to rely on other policy instruments, such as planning regulations, to limit the budget costs of infrastructure associated with housing developments. The absence of effective infrastructure pricing increases the need for development regulations.

There are problems with infrastructure charges in practice

In practice, infrastructure charges have a number of problems.

First, infrastructure charges can sometimes be used to raise tax revenue, rather than focusing on providing efficient user charging. Where the charge exceeds the cost of providing infrastructure, it acts like a tax and can discourage development. This is more likely to occur where the size of the charge is not set relative to the cost of infrastructure but the developer's capacity to pay. In these cases, the charges may attempt to capture part of the increase in value resulting from the provision of infrastructure or from changes in zoning, that is, to impose a betterment tax (see Box E4–2). However, the benefit to the developer is difficult to determine, and attempting to set charges on this basis can lead to negotiations that are protracted and non-transparent. This can slow down development processes and result in payments that are not effective as prices for infrastructure. In general, infrastructure charges will operate more effectively if they are set to reflect the cost of infrastructure, not to tax the profit of development.

Box E4–2: Betterment taxes

A particular form of tax used when land is re-zoned for alternative use is a 'betterment tax' which attempts to capture some of the increase in land value. Betterment taxes are not infrastructure charges since the objective is to tax economic rent, although sometimes the revenues are hypothecated (that is, earmarked) to infrastructure provision.

In concept, betterment taxes are attractive since they aim to tax the economic rent from land rezoning that would otherwise accrue to the landowner. However, in practice, betterment taxes can increase the uncertainty associated with land development. To operate effectively, betterment taxes need to isolate the increase in value attributable to the zoning decision or the building of infrastructure from general land price increases at the local level. This is often difficult since the value of land will move in anticipation of a change in re-zoning. Sometimes this can occur many years before the re-zoning. Betterment taxes may be applied on an ad hoc basis and the rate of the betterment tax is sometimes left to discussions between developers and government as part of the planning approval processes, rather than being set in a transparent manner. Betterment taxation can involve lengthy disputes as, by setting the tax conditions, the dispute is really about how to share the economic rent.

Additionally, having a betterment tax in place may encourage governments to create economic rent through additional zoning restrictions or delays in land release, in order to raise more revenue. Where zoning is used in such a manner, it is likely to stop land being devoted to its most productive use — at least in the short run. A land tax applied to all types of land (see Section C2 Land tax and conveyance stamp duty), is likely to encourage governments to allow land to be used for its most productive use as this will increase the value of the land (and hence increase the revenue raised from land tax).

Second, infrastructure charges can be complex and costly to levy. Ideally, each individual development would be assessed for the avoidable costs of infrastructure, which can be different for a similar item in different developments (McNeill & Dollery 2003). There is therefore a trade-off between the accuracy of user charging and its administrative feasibility.

Some infrastructure items nearly always have benefits that are limited to those residing in the development, including local roads, drainage, stormwater, utilities provision, and land for local open space. Charges should generally be imposed for this type of infrastructure since it directly connects new properties to wider networks and would serve little purpose in the absence of the development.

However, it is much less clear whether charges should be imposed for other forms of infrastructure, including community facilities such as schools, libraries and child care, regional improvements such as parks, open space and capital repairs, public transport capital improvements, regional road improvements and conservation of natural resources. When used in such circumstances, the charges should reflect only the additional costs that the development imposes on society, not the total cost. In many cases, governments would need to expand infrastructure, such as libraries, whether or not it is located in a new development. In such cases there should be no charge to the developer. Similarly, some forms of infrastructure that have network effects, such as electricity generation, should be paid for by all users. The higher prices necessary to recover capital costs serve a useful function in rationing such services to the highest value users (whether in a new development or not).

The scope of infrastructure charges varies significantly between States and internationally (see Table E4–2).

Table E4–2: Public infrastructure eligible for mandatory contributions (excluding basic infrastructure)

	NSW(a)	Vic	Qld	WA	SA	Tas	ACT(b)	NT
Parks	✓ (c)	✓ (c)	✓ (c)	✓ (c)	✓ (c)	✓	✓	×
Education	✓ (c)	×	×	✓ (c)	×	×	✓	×
Trunk roads	✓ (d)	✓ (d)	✓ (d)	✓ (d)	✓ (d)	✓	✓	✓
Public transport	✓ (c)	✓	×	×	×	×	✓	×
Child care centres	✓ (e)	✓ (f)	×	×	×	×	✓	×
Libraries	✓ (e)	✓ (f)	×	×	×	×	✓	×
Community centres	✓ (e)	✓ (f)	×	×	×	×	✓	×
Recreation facilities	✓ (e)	✓ (f)	×	×	×	×	✓	×
Sports grounds	✓ (e)	✓ (f)	×	×	×	×	✓	×
Protection	×	×	×	×	×	×	✓	×
Housing	✓	×	×	×	×	×	✓	×

(a) Relates to infrastructure eligible for local infrastructure contributions mandated under s.94 to s.94EH of the *NSW Environmental Planning and Assessment Act 1979* and includes proposed changes announced by the NSW Premier on 12 October 2007. Under these reforms, mandatory contributions will be limited to the infrastructure and land directly required to support land developments.
(b) Contributions generated by the ACT change of use charge flow into consolidated revenue and can be used to finance any government objective.
(c) Dedication of land only.
(d) Within the sub-division.
(e) Restricted to infrastructure that services the development site or precinct.
(f) In Victoria, contributions for community infrastructure are capped at $900.
Source: Adapted from Chan et al. 2009.

Impact on housing affordability and supply

There is some community concern about the impact that infrastructure charges may have on the affordability of housing. Several submissions to the Review have proposed using tax financing for new infrastructure to improve the affordability of housing. Deliberately charging below cost for new infrastructure would effectively involve ratepayers providing a subsidy for the provision of new housing.

Subsidised infrastructure is a high-cost way to lower house prices because it encourages the delivery of infrastructure to areas where it is of relatively low value. Further, developers have less incentive to build housing that uses infrastructure efficiently (for example, by building more high-density housing).

More importantly, in the face of restricted land supply, an infrastructure subsidy is unlikely to achieve the intended goal of lower house prices. Instead, the infrastructure subsidy is likely to be capitalised into higher land prices for sellers (see Chart E4–6 Panel B). Where new developments are restricted in supply, their prices will be set by the availability of nearby existing dwellings.[17] Sellers are likely capture most of the subsidy as they face high demand for their land. Similarly, if the subsidy is removed, sellers would be unlikely to convince buyers to purchase fringe dwellings at prices exceeding those in neighbouring established areas. When land supply is already restricted, developer charges are borne by the original land holder by reducing the above-normal return (economic rent) they would otherwise receive when selling their land. This is currently more likely to be the case in Australia, suggesting that infrastructure charges are unlikely to affect housing affordability substantially (Productivity Commission 2004).

However, where infrastructure charges are implemented poorly or are designed to operate as taxes, they can discourage housing supply and contribute to higher house prices.

Difficulties in administering infrastructure charges can increase uncertainty, potentially deterring investment. For example, charges on proposed developments are sometimes used to offset local objections, such as community concerns about traffic congestion or overcrowding of public transport. In some cases, councils or State governments have responded to these concerns by imposing additional charges on proposed infill development to upgrade local infrastructure, such as railway stations and pedestrian bridges. When development approval is contingent on development charges of uncertain size, this can also add risk to projects and affect their viability.

Applying infrastructure charges through use of simple flat prices that do not well approximate actual avoidable costs can sometimes reduce housing supply. For example, where charges are levied at a flat rate per dwelling, high-density developments are likely to face higher prices for the infrastructure they require, compared to lower density developments.

Where developer charges are set in an ad hoc fashion or are subject to unexpected changes, they can create uncertainty around new developments. If infrastructure charges are

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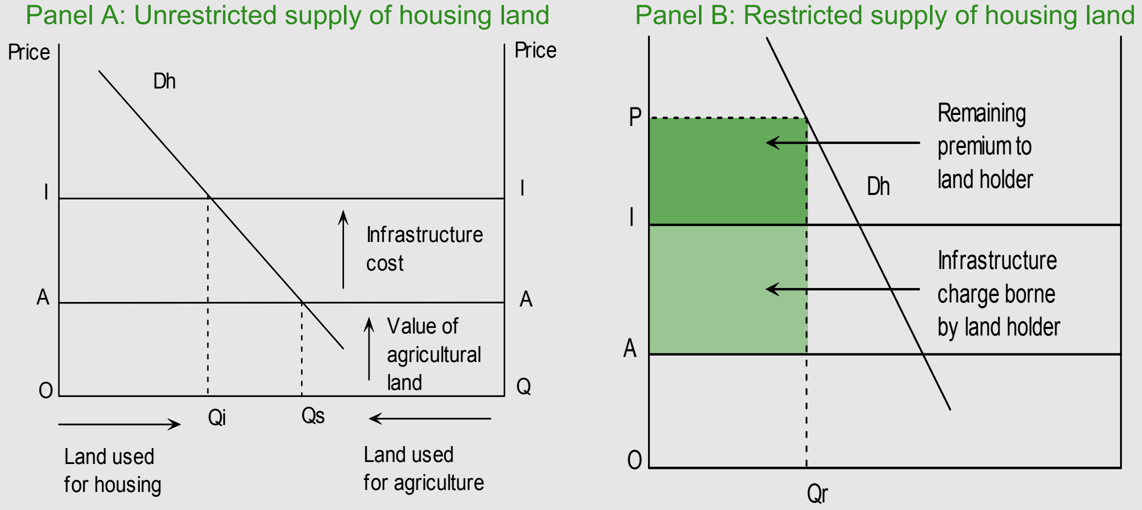
17 In contrast, where land supply is deregulated, subsidised infrastructure is likely to reduce the price of housing in fringe areas, as the price of land can be reduced through competition among buyers (see Chart E4-6: Panel A in Box E4-3). However, this reduction in the price of housing occurs because infrastructure is being supplied in areas where it is of low value.

increased after a developer has bought land from its original owner, they cannot be factored in to the price previously paid for the raw land. In this case, the charge would lower the expected return from the development. In addition, general uncertainty about charging is likely to discourage development activity, which could reduce the overall supply of housing and increase the price of housing.

Box E4–3: Who pays infrastructure charges?

Who bears the burden of developer charges depends on the relative elasticity of the demand and supply of land (Neutze 1997). Following Wood et al. (forthcoming), Chart E4-6 illustrates the impact of infrastructure charges on the price and allocation of land, depending on whether land for housing is freely available or restricted.

Chart E4–6: Incidence of infrastructure and land supply



The amount of total land (OQ) is divided between demand for housing land (Dh) and agriculture, which is valued at a fixed price (OA). To make land useable for housing, infrastructure worth AI must be added to the land.

If there are no restrictions on the use of land for housing at the fringe of a city and infrastructure is provided free, Qs land is used for housing (Panel A). With infrastructure for new housing effectively subsidised, the price of land for housing is equal to the value of agriculture (OA). Where there is a charge imposed for the infrastructure, the amount of land used for housing will fall to Qi. The cost of land used for housing at the fringe increases to OI, so that it equals the cost of agriculture plus the value of infrastructure. In this example, subsidised infrastructure can reduce the cost of housing because additional land can be acquired and converted to residential use at a price OA. However, this is not a good outcome from the viewpoint of efficient resource allocation: if the full social cost of housing is reflected in appropriate infrastructure charges demand for housing is Qi.

Box E4–3: Who pays infrastructure charges? (continued)

In contrast, if the supply of land available at the fringe is limited to the amount Qr due to zoning or planning restrictions (as in Panel B), free infrastructure has no impact on housing supply. The restriction in land supply means that prices at the fringe (OP) are higher than the value a marginal agricultural user would be willing to pay. Landholders receive an 'economic rent' (AP) when developing their land for housing. The price is determined by the demand for land in relation to the constrained supply. An infrastructure charge (IA) levied on land holders who are developing their land for housing reduces the size of this rent (from AP to IP), without affecting the price of housing. Only if the infrastructure charge exceeded AP would it raise house prices.

This is a stylistic comparison of two extreme cases, where land for housing is either fully elastic or fully inelastic. The real situation is likely to fall somewhere between these two extremes. That said, the value of agricultural land at the fringe of cities generally exceeds its opportunity cost in agricultural production, reflecting restrictions on the supply of land for housing.

Findings

Infrastructure charges can be an effective way of encouraging the efficient provision of infrastructure to areas where it is of greatest value and of improving housing supply. Charging for infrastructure may be a more effective means of allocating resources than regulating land release.

Where land supply is constrained, well-designed infrastructure charges are more likely to be factored in to the price that developers pay for raw land, than to increase the price of housing in the development where the charge is levied. However, where infrastructure charges are poorly administered — particularly where they are complex, non-transparent or set too high — they can discourage investment in housing, which can lower the overall supply of housing and raise its price.

Reform directions

Recommendation 70:

COAG should review infrastructure charges (sometimes called developer charges) to ensure they appropriately price infrastructure provided in housing developments. In particular, the review should establish practical means to ensure that these charges are set appropriately to reflect the avoidable costs of development, necessary steps to improve the transparency of charging and any consequential reductions in regulations.

In general, improving the use of infrastructure charges and relying on general land taxation (rather than betterment taxes) is likely to reduce the need for regulations and planning, which can restrict housing supply.

For infrastructure charges, the Review is not in a position to be definitive about which costs should be met by developers, and which costs should be met by governments. However, there is a trade-off between relying too much on a high-level principle and difficulties of applying it in practice. One way of resolving which charges should be borne by developers and which charges should be borne by governments would be to establish principles that set out the funding responsibility for each type of infrastructure. However, the Review has not recommended specific pricing guidelines for future infrastructure charges. This is an issue that requires extensive consultation.

Further, making the charges and the process for setting them public should help ensure they are set close to the right level.

Where charges are transparent they are likely to encourage more efficient provision of infrastructure. If developers understand how charges are determined, they will respond by minimising the costs they face, which is the desired outcome. Setting charges publicly and in advance enables developers to make more effective plans about where to develop and can provide greater certainty to the process. Non-transparent and inscrutable infrastructure charging processes increase risk to developers and reduce valuable infrastructure investment.

Transparency also serves an important accountability role. The Review has received several submissions from housing industry organisations concerned with the lack of transparency in price setting. Because only a small number of taxpayers pay such charges there may be an incentive for governments to rely on infrastructure charges to fund services beyond infrastructure where general taxation would be a more efficient means of raising revenue. Public disclosure may encourage more consistent principles and their application in practice and reduce the chances of under- or over cost-recovery.

E5. Alcohol taxation

Key points

Taxes on alcohol should be set to address the spillover costs imposed on the community of alcohol abuse, when this delivers a net gain to the community's wellbeing and is more effective than alternative policies. Raising revenue is a by-product, not the goal, of taxing alcohol. The tax rate should be based on evidence of spillover costs, and levied on a common volumetric basis across all forms of alcohol, regardless of place, method or scale of production.

While the abuse of alcohol imposes significant costs on society, these are not effectively targeted by current tax and subsidy arrangements for alcohol, which are complex and have conflicting policy rationales. In particular, the wine equalisation tax, as a value-based revenue-raising tax, is not well suited to reducing social harm.

A common volumetric tax on alcohol would better address social harm through closer targeting of social costs. A rate based on evidence of net social costs would help balance the benefits from alcohol consumption with its social costs. Moreover, by removing the distinction between different manufacturing processes, the compliance and administration cost of the existing excise system would be reduced.

In the short term, several specific changes should be made to address the more pressing social costs of alcohol consumption, and to remove structural anomalies in the system of alcohol taxes. The transition to a common alcohol tax should be phased in over a longer term, to ensure that producers and consumers have time to adjust to the changes.

E5–1 The rationale for taxing alcohol

Since Governor Hunter first taxed beer, wine and spirits in the colony of New South Wales, alcohol taxation has provided governments in Australia with an administratively simple tax base. This revenue was once a vital share of government finances. However, government today can raise much larger sums of money from broad-based taxes on income, resources and consumption. These provide a fairer and more efficient way to raise revenue than specific commodity taxes. Narrow-based taxes should be designed primarily to correct particular market failures, not for general revenue-raising (see Section E Enhancing social and market outcomes).

While alcohol excise is administratively simpler than other taxes, its simplicity has eroded over time. Today, commercially produced beer is taxed at eight different rates — depending on alcohol volume, the type of packaging, and whether it is produced for commercial or non-commercial purposes. Brandy is taxed at a lower rate than the domestic spirits rate (which is based on alcohol content), and some imported spirits are subject to an additional duty based on value, on top of the domestic excise rate. Wine is taxed through a separate wholesale tax, based on its value, not its alcohol content.

To enforce the distinction between beer, wine and spirits, a sophisticated system of licensing and bonded warehouses has been devised. This ensures that alcohol produced using one process is not passed off as a lower-tax product. In addition, technological advances mean that alcohol produced using one process can be altered to mimic other beverage types. This has introduced additional complexity — for example, the definition of beer now requires a minimum threshold of 'international bitterness units' and a maximum threshold for sugar. Just to determine the appropriate rate of excise, the Australian Taxation Office (ATO) needs to provide advice on recipes.

While taxes on alcohol should not be used for general revenue-raising, they may have a role in addressing the significant spillover costs on the community associated with alcohol abuse, by changing the price of alcohol faced by consumers. This is a blunt instrument for controlling the spillover costs of abusive consumption, and must be weighed against the wellbeing loss of taxing non-abusive consumers. However, in the absence of more cost effective or better targeted instruments to address abusive alcohol consumption, a tax on the consumption of alcohol can still improve welfare.

Alcohol tax reduces overall consumption, but is not targeted

Economic studies of alcohol consumption around the world consistently find that higher prices do reduce overall consumption of alcohol products. However, in most cases a 1 per cent price rise in the price of alcohol results in less than a 1 per cent decline in consumption (Fogarty 2008). Moreover, not all individuals reduce consumption to the same degree — evidence suggests that heavier drinkers may be less responsive to the price of alcohol than the general population (Ayyagari 2009).

In theory, if alcohol tax could be targeted at an individual's abusive consumption, it would be imposed on a per-drink basis, at a rate set according to the risk of harm for individual consumers. Drinks more likely to give rise to high spillover costs would be taxed prohibitively, while consumption with no risk of spillover costs would not be taxed. In this ideal world, the price of every glass of alcohol would include the risk of harm associated with its consumption.

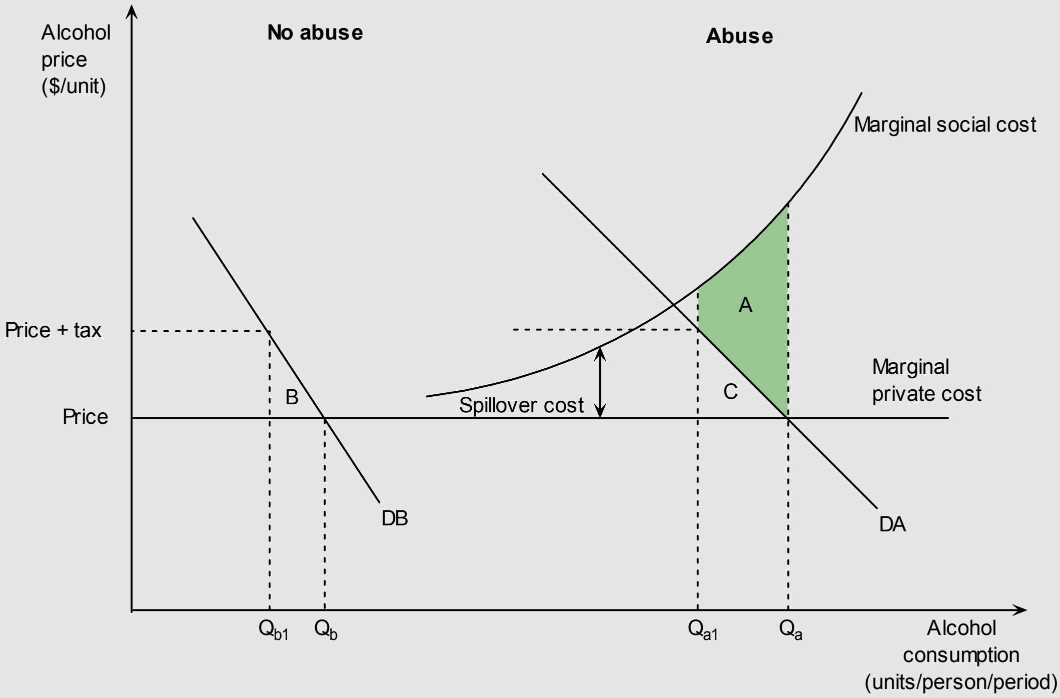
In the real world, however, such a tax is technologically and administratively infeasible, and would be unnecessarily intrusive. Accordingly, alcohol taxes are levied equally on all products of a particular class or type. The effect of this is to raise the cost of drinking, but with the cost averaged across all drinkers, not targeted only at those most likely to cause social harm.

This makes excise a blunt instrument for reducing the spillover costs of alcohol use. It means that consumers who enjoy alcohol responsibly face an unnecessarily high price (and pay too much tax). In other words, even though alcohol tax raises revenue for the government, it is not a costless way of addressing alcohol abuse. As with all policy interventions, the benefits of taxation should be weighed against the costs (see Box E5–1).

Box E5–1: Costs and benefits of taxation

Taxes to reduce social harm can be costly when not all units of consumption give rise to the same spillover cost. Chart E5–1 presents a stylised welfare-economics framework, which splits consumers into two groups — one whose consumption has 'no abuse' (left) and one whose consumption has risks of 'abuse' (right). Consumption with no abuse gives rise to no spillover costs, while consumption with abuse gives rise to spillover costs that increase with the quantity of alcohol consumed in a single period.

Chart E5–1: Taxing to control social costs



Source: Adapted from Pogue and Sgontz (1989).

A tax — levied across both groups — reduces the consumption of both groups. An increase in price reduces consumption by the abuse group (from Qa to Qa1). While this may result in a loss of immediate satisfaction (area C) to the individual, on balance society as a whole benefits from a reduction in spillover costs (area A).

However, this gain needs to be balanced from the wellbeing loss of consumers with no abuse. They too reduce their consumption (from Qb to Qb1), resulting in a welfare loss (area B) that is not offset by any reduction in spillover cost.

Taxes on alcohol should not be increased beyond the point where the marginal reduction in spillover cost exceeds the marginal reduction in the wellbeing of responsible drinkers. One corollary of this is that while a tax on alcohol might be used to reduce social harm, it is not an appropriate tool to eliminate it.

Tax compared to targeted policy intervention

Collins and Lapsley (2008) evaluate a number of policy interventions for reducing the spillover costs of alcohol abuse. They find that higher alcohol taxes would reduce overall spillover costs, but also that individual-based interventions (usually by doctors) are an effective way to reduce hazardous alcohol consumption. Stricter enforcement of random breath testing, and reducing the allowed blood alcohol concentration level for drivers would be effective ways of reducing the costs of drink driving. Complete or partial controls on the advertising and marketing of alcohol would also reduce costs.

As with the use of tax to control the spillover costs of alcohol, the costs and benefits of non-tax programs need to be considered. The advantage of these interventions is that they could be closely targeted at actual spillover costs, unlike an excise that is necessarily averaged over all units of production.

The point of production or importation is not the only point at which it is possible to introduce prices that reflect spillover costs. For example, data on police attendance at alcohol-related incidents in New South Wales suggests that more than half of incidents are related to only 10 per cent of licensed premises (Moore 2009).

To improve the targeting of the price signal, State governments might relate the licence fee for an establishment to the number and severity of violent incidents connected with it. In this way, licence fees would act as a more targeted tax than excise. They would provide operators with a stronger incentive to refuse service to high-risk patrons. Establishments that are sustained sources of violence would pass these costs on to their patrons in higher prices — while consumers who drink in a low-risk setting would not pay the additional cost.

Principle

Taxes on alcohol should be set to address the spillover costs of consumption, when this delivers a net gain to wellbeing and is more effective than alternative policies.

Taxes to reduce spillover costs should target alcohol content

A World Health Organisation (WHO 2007) expert committee concluded that policies that increase alcohol prices have been shown to 'reduce the proportion of young people who are heavy drinkers, to reduce underage drinking, and to reduce per occasion 'binge' drinking'. In addition, the WHO found that '[h]igher prices also delay intentions among younger teenagers to start drinking and slow progression towards drinking larger amounts'.

To the extent that people want to be inebriated — and that this is associated with social harm — it is the alcohol rather than the form in which it is delivered that drives demand. For this reason, it is the alcohol consumed by an individual in a set period, not its value, packaging or the method or place of production, that is most closely related to social harm. Any tax on alcohol designed to address spillover costs should therefore be levied on a volumetric basis.

Principle

Alcohol tax should be levied on a common volumetric basis across all forms of alcohol, regardless of place, method or scale of production.

Rates of alcohol tax should be based on evidence

Spillover costs of alcohol abuse include foetal damage and child abuse, domestic violence, road accidents, crime and violence, increased mortality and a range of diseases and medical conditions.[18] These costs can arise directly (for example, in the form of costs on victims of alcohol-related violence) and indirectly (for example, in the form of the cost to the community of additional demand on a publicly-funded health care system).

There are additional characteristics that may be related to social harm in specific cases. Policy intervention to reduce social harm might also consider the alcohol strength, the environment in which the alcohol is consumed, who is drinking (those more prone to violence) and how (binge drinking). Whether these factors can be taken into account in designing a tax on alcohol production depends on the extent to which particular identifiable classes of beverage can be causally associated with greater or less risk of social harm.

For example, many submissions have argued that 'alcopops' have higher spillover costs than other forms of alcohol, at least for certain groups. Similarly, an expensive single malt Scotch whisky may be associated with lower spillover costs than cheap vodka. Relating classes of drink to risks of harm requires detailed information about the relationship between alcohol products and spillover costs. This relationship may also change over time as producers and consumers adjust their behaviour in response to taxation.

In some cases, the welfare gains from taxing products differently may outweigh the complexity costs, provided that a product can be clearly defined and the net gains identified. However, in the absence of specific information, a uniform rate of tax across all beverages is the least complex and most efficient way of imposing an alcohol tax.

Having different tax rates on beer, wine and spirits is a common feature of alcohol taxes around the world. However, these often reflect the pattern of domestic production, rather than spillover costs. For example, major wine producing countries tend to charge little or no tax on alcohol in wine. Over time, this influences consumer preferences and reinforces demand for particular products.

Departure from uniform taxation also encourages producers to innovate simply to avoid tax. Some Australian firms produce grape-based alcohol products (such as Father O'Leary's) that are very similar to spirit-based products (such as Bailey's Irish Cream). Different tax rates also encourage consumers to change from their preferred drink, without necessarily reducing the risks associated with their drinking.

18 These costs are more limited in scope than those used in the cost of illness methodologies that have been developed in the public health literature (for example, Collins & Lapsley 2008), which also include many of the costs that individuals bear themselves. To estimate spillover costs relevant for setting rates of tax, it is necessary to exclude private intangible costs (such as pain and suffering), and the loss of household production from premature death or sickness. That said, the distinction between private costs and spillover costs is not always clear. For example, if a family utility and decision making model is used, alcohol-related violence against family members and the loss of family disposable income are private costs; but, if an individual utility and decision making model is used, costs borne by other family members are spillovers.

Low-alcohol beverages

While there should be no discrimination between different types of production, submissions from both public health advocates and producers have generally supported lower rates of tax on lower strength products. This can be justified on the basis that alcohol concentration can be readily measured and is correlated with the level of social harm (see Box E5–2).

Indeed, low-alcohol products can be considered as having a social benefit to the extent that they substitute for higher strength alcohol products that impose greater spillover costs on the community.

Box E5–2: Extremely low-alcohol products are mostly harmless

The body can process about one litre of water an hour (more and life is at risk) and about one standard drink (12.7 mL of alcohol) an hour (more and alcohol starts to accumulate). This implies that consuming a product at 1.27 per cent alcohol content or less should have negligible social harm from alcohol as the water would kill the drinker first.

Principle

The rate of tax on alcohol should be based on evidence of marginal social cost.

E5–2 Current taxes on beer, wine and spirits are incoherent

Many Australians enjoy drinking alcohol — around five in six adults drink alcohol each year, though not all drink on a regular basis. In 2007–08, Australians consumed around $12.6 billion worth of alcohol products (ABS 2009b), containing 170 million litres of alcohol (ABS 2009c). Of this, alcohol in beer accounted for 46 per cent of consumption, followed by wine (31 per cent), spirits (12 per cent) and ready-to-drink beverages (11 per cent) (ABS 2009c).

Cnossen (2009) estimated that the costs relevant for calculating alcohol tax rates amounted to around $46 per litre of alcohol when averaged across all alcohol consumed.[19] However, effective rates of tax per litre payable on beer and less-expensive wine are significantly lower than this. Premium wines and spirits-based products are taxed more heavily than this benchmark rate.

The current system does not reflect the risks of consuming different products. Chart E5–2 illustrates the variation in taxation for different products, at different levels of alcohol content. Some products are not taxed at all. The wine producer rebate means that wine produced by a small winery pays no net tax. Similarly, inbound duty-free concessions allow adults to bring 2.25 litres of alcoholic beverage into Australia duty free.

Taken together, current alcohol taxes reflect contradictory policies. They encourage people to drink cheap wine over expensive wine, wine from small rather than large producers, beer in pubs rather than at home, and brandy rather than spirits, and to purchase alcohol at airport

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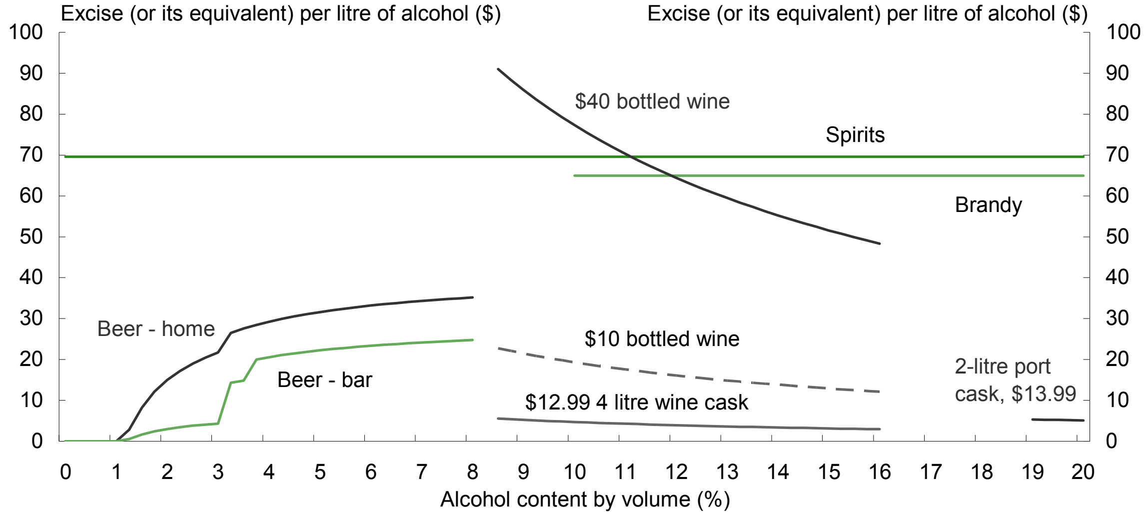
19 These calculations are based on data from 1998–99, and represent a lower-bound estimate of average external costs per adult.

duty-free stores (see Box E5–3). As a consequence, consumers tend to be worse off to the extent that these types of decisions to purchase and consume, which may have no spillover cost implications, are partly determined by tax.

Chart E5–2: Current effective (specific) alcohol tax by beverage



Note: WET calculated using half-retail method.
Source: Adapted from Ryan (2009), Treasury Estimates.

Current wine tax arrangements distort production

Wine is taxed on its wholesale value through the wine equalisation tax (WET). This tax was introduced, in conjunction with the GST, to maintain a tax treatment for wine roughly consistent with the previous wholesale sales tax regime.

Because wine is taxed on a value basis, wines with the same alcohol content are subject to different levels of taxation. The cheaper the wine, the less it is taxed. As such, current tax arrangements are inconsistent with targeting spillover costs.

Box E5–3: Wine, beer and spirits in the Northern Territory

In Alice Springs, a 2-litre wine cask costs $10.99, which includes roughly $1.59 of wine equalisation tax. An equivalent volume of alcohol in full-strength beer would attract $7.48 in excise, and in spirits $16.45.

Source: Alice Springs supermarket, as at 17–18 August 2009. WET calculated at 29% using half-retail price method, assumes 240 ml of pure alcohol from 12% a.b.v. wine. Equivalent excise rates calculated at 5% alcohol by volume for beer, at $41.06 per litre of alcohol (including 1.15% low alcohol threshold); 40% alcohol by volume for spirits at $68.54 per litre of alcohol.

Moreover, the WET affects the type of products being sold into domestic and export markets. A value-based tax favours cheaper wines that tend to have lower profit margins and are often made by large producers.

The wine producer rebate introduced on 1 October 2004 sought to address this bias in favour of larger producers by shielding the first $1.7 million (approximately) of domestic wholesale wine sales per producer (or group) from WET. The rebate is up to $500,000 per year.

The rebate has created risks for tax avoidance, through 'double dipping' and attempts by small producers to transfer the value of the rebate to larger operators in the supply chain.

The rebate also creates biases between smaller and larger producers. Small producers effectively pay no net WET, but the rebate reduces only a proportion of the WET paid by larger producers. Consequently, an expensive wine made by large producers is subject to higher tax per standard drink than a similar wine made by a small producer. While this provides assistance to small producers, it is inconsistent with targeting spillover costs.

The assistance provided by the WET rebate is poorly targeted. It benefits wine produced outside rural and regional Australia, including wine produced overseas. For example, from 1 July 2005 the rebate was extended to New Zealand wine producers, at an expected annual cost of $9 million for 2008–09 (Australian Government 2005, p. 37). Spending targeted at rural assistance is likely to deliver significantly better value for money to the community.

The wine producer rebate fosters small-scale production and supports some small, otherwise uneconomic wineries. The industry currently reports a widespread grape oversupply and that around half of all wine producers are currently unprofitable. This suggests that resources such as land, water and capital are not being used efficiently. Moreover, the rebate may be acting to prevent an appropriate market response to these circumstances by discouraging mergers within the industry. By supporting uneconomic wineries, the current arrangements are likely to increase the costs of inputs to other wineries that would otherwise be more successful.

Findings

Alcohol is widely enjoyed in Australian society, but some alcohol consumption imposes significant spillover costs. Current tax and subsidy arrangements for alcohol are complex, and distort production and consumption decisions with no coherent policy justification. In particular, the wine equalisation tax, currently designed as a value-based revenue-raising tax, is not well suited to reducing social harm.

Effective rates of tax per litre of alcohol on beer and cheap wine are significantly lower than estimates of average spillover costs, while effective tax rates on premium wines and spirits are significantly higher than these estimates.

E5–3 A common alcohol tax would better address social harm

If alcohol taxes are to be effective in reducing social harm, the taxation of beer, wine and spirits needs to be reformed. The ideal tax structure would be a volumetric tax on all alcoholic beverages, set to balance the reduction in spillover costs[20] of alcohol abuse with the cost of taxation on non-abusive consumers, and recognise social benefits of lower-strength products (see Box E5–4).

Policies that are unrelated to social harm, including industry assistance, regional development, and the promotion of small business, undermine the capacity of alcohol tax to

20 The weighted average marginal cost, not average total cost.

target social harm, and should not be delivered through alcohol taxes. To the extent that these programs are desirable, direct government funding or concessions should be delivered in a manner unrelated to the method or quantity of production.

Urgent structural reforms are needed to remove specific exemptions or concessions for certain forms of alcohol most open to severe abuse, including cheap wine. However, convergence to a common volumetric rate of alcohol tax might occur over a longer period, to ensure that the gains from reform are not overwhelmed by immediate shocks to producers and consumers.

Box E5–4: Social benefits from taxing wine on a volumetric basis

Even a low rate of tax on alcohol can significantly reduce spillover costs.

Experience with the Northern Territory Living With Alcohol Program and its associated levy provides evidence of the link between alcohol price and social harm. Beginning in 1992, the levy raised the cost of a standard drink by around five cents. It was wound down following a High Court case that clarified the limits of state power to impose excise duties.

An evaluation of the program found many benefits, including a reduction in alcohol-caused road deaths and Northern Territory government savings in excess of $124 million over the first four years due to the reductions in alcohol-attributable deaths, hospitalisations and road injures (d'Abbs 2001).

As part of a more wide ranging alcohol management plan implemented in Alice Springs in 2007, restrictions on the sale of cask wine were introduced. This resulted in a dramatic fall in the amount of alcohol sold in wine casks, accompanied by an increase in sales of full-strength beer, with a fall in the level of overall alcohol sales. Police said they believed that the restrictions had led to a reduction in violent assaults. Although people had switched from wine to beer, they were not as drunk as before (Senior et al. 2009).

A common alcohol tax would better satisfy consumer preferences

Even before taking into account the spillover costs of alcohol, moving to a single volumetric would minimise the biases introduced by the tax system as to the form in which people choose to consume alcohol.

Removing tax distinctions between different production processes and beverage types would allow for better satisfaction of consumer preferences at the same time as targeting social harm. The range of products available would be less influenced by disparities in tax rates. Moreover, tax treatment based only on alcohol content would reduce complexity, and improve the long-term sustainability of the tax system in the face of technological innovation.

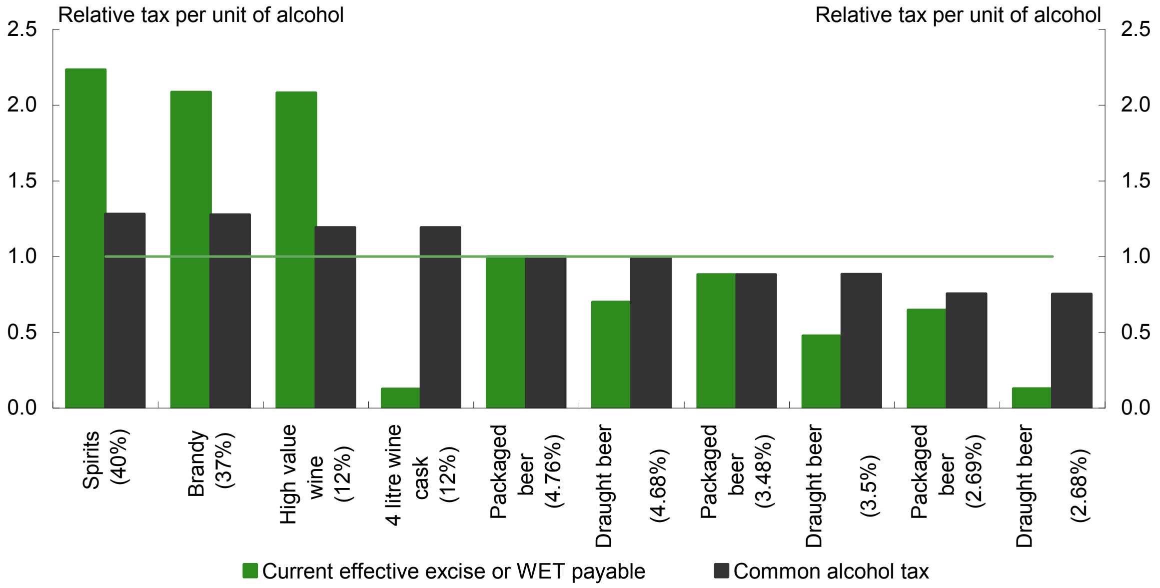
A common alcohol tax base would introduce a 'floor price'

A uniform rate of tax on the alcohol content of all beverages — whether produced as beer, wine or spirits — would relate the alcohol tax base more closely to social harm. It would improve the price signal faced by consumers, currently distorted by a range of tax rates applying to different types of drink. A common alcohol tax would provide a floor price for alcohol (although alcohol could still sometimes be sold below cost or given away).

The maximum amount of alcohol that could be purchased with a fixed amount of money would fall, because forms of alcohol that are currently the cheapest would become more heavily taxed. Products that currently face high effective rates of tax per unit of alcohol, such as high-value wine and spirits-based products, would be taxed less heavily under a common alcohol tax.

For all beverages, the first 1.15 per cent alcohol by volume in any beverage would be exempt from taxation. This recognises that consumption of very low-alcohol products is unlikely to lead to social harm. It also provides a further incentive for producers to reduce alcohol concentration in all products, as less concentrated alcohol products would be taxed proportionately less. For example, Chart E5–3 shows that spirits currently face effective tax rates that are 2.2 times that of full-strength packaged beer. Under a common alcohol tax, full-strength spirits would be taxed around 1.3 times that of full-strength beer.

Chart E5–3: Relative taxation of alcohol under a common alcohol tax[(a)]
By beverage type (alcohol by volume)



(a) The tax per unit of alcohol is measured relative to full strength packaged beer.
Note: The 1.15 per cent low-alcohol threshold reduces the effective tax payable on beer below the statutory rate. For example, the effective excise payable on full-strength packaged beer is 1–(1.15/4.9) = 76% of the statutory excise rate. This treatment would be extended to all beverages under a common alcohol tax. The effective WET liability is calculated based on a 750ml bottle of high-value wine retailing at $40 and a 4 litre wine cask retailing at $12.99.
Source: Treasury estimates, ABS (2009c).

Transition to such a system would need to be managed carefully, to avoid potentially harmful shocks to consumers, and to reduce the impact on existing industry arrangements. For this reason, transitional arrangements might be designed to stabilise the nominal price of some products, and to limit the rate of price change (both upward and downward) for others, while monitoring the effect of these changes on spillover costs.

Setting the rate of alcohol tax

The current wide variation in rates of tax on different types of alcohol makes it difficult to calculate an efficient alcohol tax rate. This is because the distribution of abusive and non-abusive consumption is partly determined by these tax arrangements. In order to estimate the weighted average marginal spillover cost of alcohol, it would be necessary to first reform the structure of alcohol taxation, by removing the current biases to consume alcohol in one form rather than another.

Until reliable estimates are available, the average spillover cost per litre might be used as a proxy. As the current full-strength packaged beer excise rate is closest to the estimates of the average spillover cost of alcohol in Australia, it would be appropriate for rates of tax on other products to converge at this rate over time.

During the transition, data on spillover costs and consumer behaviour should be systematically collected to inform the process of setting the optimal tax rate. The final rate of tax would be intended solely to optimise price signals facing consumers. It should be set without regard to the government's fiscal position, and irrespective of any specific spending commitments related to alcohol abuse. The rate of tax should be indexed to ensure that the real rate of the tax only falls in the event of an adjustment to social cost estimates.

To ensure it is credible and sustainable, the process of determining the tax rate should be based on the best available information and an agreed and transparent methodology (see Section G5 Monitoring and reporting on the system). Consistent with Action 4.1 of the National Preventative Health Taskforce (2009), this process should incorporate independent modelling, in consultation with the departments of Health and Ageing and Treasury and an industry panel.

Estimates and models should be periodically re-assessed to take into account the effectiveness of alternative policies for reducing social harm, as well as changes in culture that affect consumption. If more targeted non-tax measures to reduce social harm are successful, the alcohol tax rate could be lowered.

Taxing alcohol consumed in Australia

Alcohol produced for export should continue to be exempt from tax, as alcohol consumption should be regulated in the jurisdiction in which the spillover costs are borne (that is, in the destination country). Imported alcohol products (including by travellers) should be taxed at the same rate as domestically produced products, as the spillover costs of alcohol in Australia relate to alcohol consumed here, regardless of where it is produced.

Alcohol used for industrial, manufacturing, scientific, medical, veterinary and other purposes that poses no risk of social harm from human consumption would continue not to be taxed.

In principle, the home production of alcohol (for example, home brew or wine-making) would be subject to tax. In practice, this is unlikely to be feasible.

Reducing compliance and administration costs

The excise system has evolved over the past century. In 2008–09, almost three hundred entities in the alcohol industry paid excise duty. This system is administered by the ATO. Excise-equivalent customs duty on imported goods is currently collected through a separate system by the Australian Customs and Border Protection Service.

Much of the existing apparatus for licensing the manufacturing, importing, storing or dealing in excisable products is due to differential (and sometimes high) rates of tax on many different classes of alcohol. Further, the additional value-based tariff on some imported spirits increases compliance costs associated with tracking goods in warehouses.

Treating all alcohol products on the same basis, regardless of how or where they are produced, would make much of this additional regulation redundant. The taxation of alcohol could be brought into a single regime, to ensure consistent compliance obligations between industries and to remove the administrative costs of running multiple systems for taxing alcohol. Such an approach would need to be developed over time in consultation with industry, and could also be extended to include other excisable goods. Businesses that produce a range of alcohol products would not need to deal with multiple tax systems.

The current excise system is particularly costly for smaller producers. However, wine producers, 80 per cent of whom have a turnover of less than $2 million per year, are not currently in the excise system. There are also concessions for microbreweries and 'brew-on-premise' beer.

These small entities need not be immediately included in the current excise system, but should ultimately be brought under a common alcohol tax. The Australian government should explore streamlined arrangements for small taxpayers based on their volume of production. Small alcohol producers might be subject to less stringent licensing conditions, relaxed rules around calibration and testing of equipment, and be allowed to report their liability through the business activity statement. This would help ensure that compliance and audit resources are targeted on a cost-effective basis.

Finding

A common alcohol tax that does not discriminate between beverage types would remove production and consumption biases from the alcohol taxation system, reduce compliance and administration costs, and better target the spillover costs of alcohol consumption.

Recommendation 71:

All alcoholic beverages should be taxed on a volumetric basis, which, over time, should converge to a single rate, with a low-alcohol threshold introduced for all products. The rate of alcohol tax should be based on evidence of the net marginal spillover cost of alcohol.

Recommendation 72:

The introduction of a common alcohol tax should be accompanied by a review of the administration of alcohol tax, to ensure that alcohol taxpayers do not face redundant compliance obligations.

E5–4 Transition

Imposing a common alcohol tax would result in significant absolute price changes, both upwards and downwards, on a wide range of alcoholic beverages. To ensure that producers and consumers have sufficient time to adjust to new arrangements, the Australian government should develop and announce a long-term transition path to a common alcohol tax.

The long-term transition path would depend on the target volumetric rate of tax, the length of time over which the transition is to occur, and the size of the absolute and relative price impacts on various alcoholic products. This could be done by suspending indexation for the highest taxed-products, while increasing the rate of indexation of the lowest rates of tax.

However, some immediate changes to the current rate and structure of alcohol taxes are justified by the spillover costs associated with particular products, or to remove structural complexity from the existing system. For example, a volumetric tax on wine products should be introduced as a matter of urgency to raise the tax paid on cheap wine — effectively introducing a 'floor price' on alcohol. The system could also be simplified immediately by removing the additional 5 per cent tariff on imported spirits, and removing excise categories that provide concessional treatment for specific products.

E6. Tobacco taxation

Key points

While consumer sovereignty is an important principle in tax policy design, government intervention in the tobacco market is justified by the strongly addictive qualities of tobacco, its serious health impacts, its uptake by minors and the costs that smoking imposes on non-smokers.

Whether taxation is an appropriate intervention is an empirical question that depends on its costs and benefits relative to those of available alternatives.

Tobacco taxes raise prices and reduce both smoking rates and smoking intensity. Australian retail prices for cigarettes are moderate by international standards and taxes constitute a relatively small share of the retail price. Indexation of excise rates to consumer prices means that excise falls as a proportion of average wages over time.

To maintain the value of tobacco excise in terms of household income, it should be indexed to wages rather than consumer prices. The existing regime for tobacco taxation in Australia should be retained with the rates of tax substantially increased, depending on further evidence on the costs of harm from tobacco smoking.

E6–1 Why tax tobacco?

The benefits that smokers get from smoking may include immediate pleasure, control of stress, improved self-image and the avoidance of withdrawal symptoms. The costs borne by smokers are primarily the cost of buying tobacco products and, in some cases, serious illness and premature death. Tobacco is a major cause of heart disease (including heart attack), lung cancer, chronic obstructive pulmonary disease (including emphysema) and stroke. Smoking is estimated to have accounted for around 15,000 deaths in Australia in 2003 (Begg et al. 2007). Giving up smoking considerably reduces the chances of serious disease. One study suggests that 4 per cent of quitters will avoid a heart attack, lung cancer, chronic obstructive pulmonary disease or stroke that they would have suffered had they continued to smoke for the next ten years (Hurley & Matthews 2007).

Smokers suffer self-control problems

Tobacco differs from most goods in that its consumption poses self-control problems for most consumers and causes very substantial harm to many consumers. These problems do not by themselves mean that consumers are unable to make decisions about tobacco consumption that give them the most satisfaction over time. Even if a prospective smoker takes into account the chances of becoming addicted, the costs of addiction and the risky costs of consumption, choosing to consume may still be consistent with deriving the greatest available satisfaction over time (Stigler & Becker 1977).

However, there is strong evidence that this 'rational addiction' model does not accurately represent most smokers' choices. First, not only do most smokers become addicted but most addicted smokers display time-inconsistent preferences. That is, they weigh consumption in the present heavily and costs and benefits in the future less heavily. As each day arrives, their preferences shift to give a heavier weight to costs and benefits on that particular day — that is, their preferences change over time (Gruber & Köszegi 2001). A consumer with such preferences may be able to see that their lifetime satisfaction would be increased by giving up smoking and decide to give up smoking at some time in the future, but when the time to give up arrives, they may find themselves unwilling to put their plan into action. Smokers set up commitment mechanisms to help them overcome their inconsistent preferences — betting with others, advertising their decision to friends and relatives or joining a support group — but these are often ineffective. Between 2000 and 2005, about two-thirds of smokers in Victoria attempted to quit but only 30 per cent of these were successful (Brennan et al. 2007).

Second, the decision to start smoking is usually taken by young people. In Australia in 2004, the average age of initiation among those who had ever smoked was 16 (AIHW 2005). In the US, around three quarters of smokers begin smoking before the age of 19 (Gruber 2002). There is also evidence that young people are well informed about the health risks associated with smoking but underestimate how addictive it is. In research from the United States, 60 per cent of adolescents and 48 per cent of adults agreed with the statement 'I could smoke for a few years and then quit if I wanted to' (Arnett 2000).

Third, many daily cigarette smokers support an increase in cigarette taxes, under certain conditions. A Victorian survey in 2008 found that 61 per cent of current smokers supported an increase in tobacco taxes, provided that some of the money was used to fund services to help smokers quit (McCarthy 2009). Evidence from the US and Canada suggests that smokers in jurisdictions with high tobacco taxes are happier than those in low tax jurisdictions (Gruber & Mullainathan 2002). It is unusual for consumers to support higher taxes on a product that they consume themselves, or to be happier in the presence of higher taxes on such a product, and this provides further support for the view that some smokers see higher prices as an incentive to implement their plans to give up smoking.

Individual consumers are usually the best judges of how to spend their money on goods and services of any type ('consumer sovereignty'). But as smoking is addictive, accompanied by inconsistent consumer preferences and predominantly taken up by minors, the government has a legitimate role in mitigating the costs that smoking imposes on smokers themselves.

An important consequence is that tobacco taxes should be set to reduce the costs that smokers impose on themselves and others, not to raise as much revenue as possible. Tobacco taxes can raise significant amounts of revenue but this is only a by-product of their primary purpose.

Principles

Consumer sovereignty is an important principle that underlies much tax policy design.

Several factors justify government intervention to reduce tobacco consumption. First, tobacco is strongly addictive. Second, its consumption is accompanied by inconsistent preferences — smokers place a heavier weight on the current day's costs and benefits than on any other day's. As a result, preferences shift from day to day. Third, smoking is extremely harmful to many long term smokers. Fourth, most people who become addicted do so before the age of 18.

Smokers also impose costs on others

Smokers sometimes impose costs on others. The costs of passive smoking include the costs of disease and premature death caused by passive smoking, as well as the difficult-to-measure discomfort of those exposed to others' smoke. The US Surgeon General has concluded that 'exposure of adults to second-hand smoke has immediate adverse effects on the cardiovascular system and causes coronary heart disease and lung cancer' (US Department of Health and Human Services 2006). A recent assessment by Collins and Lapsley (2008b) concluded that second-hand smoke caused the deaths of 149 Australians in 2004–05.

Babies born to smokers weigh on average about 200 grams less than babies born to non-smokers (US Department of Health and Human Services 2004). Babies with low birth weight have poorer average health outcomes than other babies. Babies of Australian women who smoke during pregnancy are twice as likely as other babies to have low birth weight (less than 2.5 kilos) and are more likely to require special care (Laws et al. 2006).

Which costs are private and which are external will be affected by funding arrangements in the health sector. Given Australia's current health care funding arrangements, only a small proportion — around 17 per cent of all health care costs — is met by individuals themselves. The remainder is met by taxpayers through the public health system, by health fund members and by employers through workers' compensation premiums (AIHW 2008b). In any given year, a smoker's healthcare is likely to cost more on average than that of a non-smoker of the same age and sex. However, because smokers tend to die earlier than non-smokers, the *lifetime* healthcare costs of smokers and non-smokers in high-income countries may be fairly similar. Quantitative studies have reached conflicting conclusions (World Bank 1999).

Taxation is one method of addressing spillover costs but is not necessarily the best instrument available. For example, recent restrictions on smoking in restaurants, shops, workplaces, bars and other public places have reduced non-smokers' exposure to second-hand smoke, though non-smokers may still be exposed to significant levels of smoke in the home.

Principles

The costs that smoking imposes on non-smokers further support the case for government intervention.

Taxation may be an appropriate policy choice where it is an effective way for the government to achieve its objectives in a market for specific goods and services and where the costs and benefits of taxation compare favourably with available alternatives.

E6–2 Existing taxes on tobacco

Currently in Australia, cigarettes and cigars that contain 0.8 grams or less of tobacco are taxed on a 'per stick' basis, regardless of how much tobacco the stick contains. From 1 August 2009 the excise was $0.25833 per stick or $6.46 on a pack of 25. Excise rates are indexed twice a year in line with the CPI. Since wages generally rise more quickly than consumer prices, this means that excise falls as a proportion of average wages over time.

Tobacco products are also subject to GST, which is levied on the post-excise price. On a pack of 25 cigarettes with a retail price of $13.00, excise accounts for 50 per cent of the retail price and GST for 9 per cent.

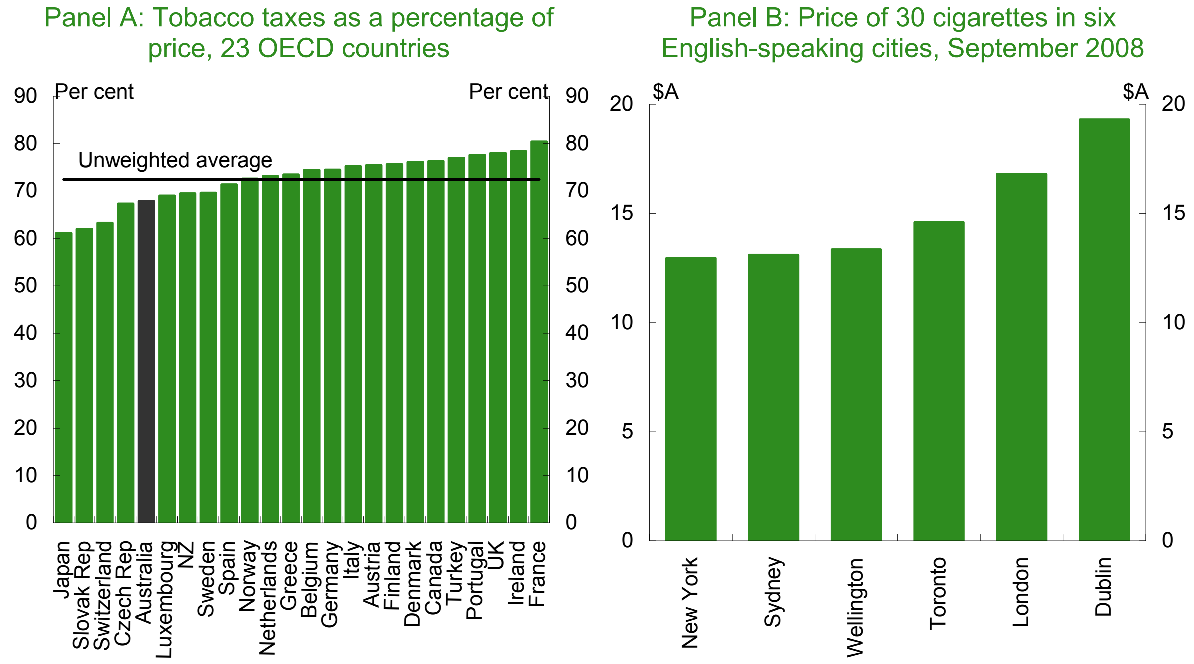
Other tobacco products — including cigars and cigarettes containing more than 0.8 grams of tobacco, rolling tobacco and smokeless tobacco — are subject to excise at a per kilo rate equivalent to the per stick tax on 0.8 gram sticks. From 1 August 2009, this amounted to $322.93 per kilo of tobacco content. The main features of the existing excise system for tobacco have been in place since 1999, when the per-stick rate was introduced. There has been no real increase in the rate of excise since then.

A person over 18 years of age can bring 250 cigarettes (or 250 grams of other tobacco products) into Australia duty free. This tax concession costs the revenue around $200 million per year. The sale of smokeless tobacco has been prohibited since 1991. It may legally be imported for personal use, subject to excise-equivalent rates of customs duty.

In 2007–08, the Australian government raised $5,666 million from tobacco excise and $273 million from customs duty on tobacco imports, together amounting to 1.7 per cent of total tax revenue collected by Australian governments.

Australian taxes on tobacco products are low, as a proportion of the retail price, compared with other OECD countries. Tobacco prices in Australia are moderate by the standards of comparable countries (see Chart E6–1).

Chart E6–1: Tobacco taxes and prices in OECD countries



Note: Tobacco taxes in Panel A include VAT, and Australia's GST, as well as tobacco-specific taxes. Many European countries have much higher VAT rates than Australia's 10 per cent GST rate, so that the differences between total tax rates on tobacco products and other products are smaller in those countries than in Australia. In Panel B, prices are for popular brands from medium-priced stores.
Source: Panel A: Scollo and Winstanley (2008); Panel B: National Preventative Health Task Force (2009).

Findings

By international standards, Australian retail prices for cigarettes are moderate and taxes constitute a relatively small share of the retail price.

Indexation of excise to consumer prices means that excise will fall in relation to wages over time.

Duty-free concessions allow international travellers, whether Australians or foreigners, to consume tobacco products in Australia free of specific tobacco taxes.

Impact of tax on demand

Demand for tobacco products responds to price changes, but less so than demand for many other goods. A 10 per cent increase in price would decrease consumption by around 4 per cent (Chaloupka & Warner 1999). Demand among young people, low income people and men is more responsive than among older people, higher income people and women. Although many young people begin to experiment with cigarettes they obtain from others, there is strong evidence that high tobacco taxes, and consequent high prices, significantly reduce both smoking rates and smoking intensity among young people (Carpenter & Cook 2007; Ross & Chaloupka 2003).

Findings

Tobacco taxes raise prices and reduce both the number of people who smoke and the total amount of tobacco consumed. As tobacco is a highly addictive commodity, consumption does not respond readily to price changes — that is, demand for tobacco is relatively inelastic.

Young people and low income people respond more to tobacco price changes than others.

Low income and disadvantaged people smoke more

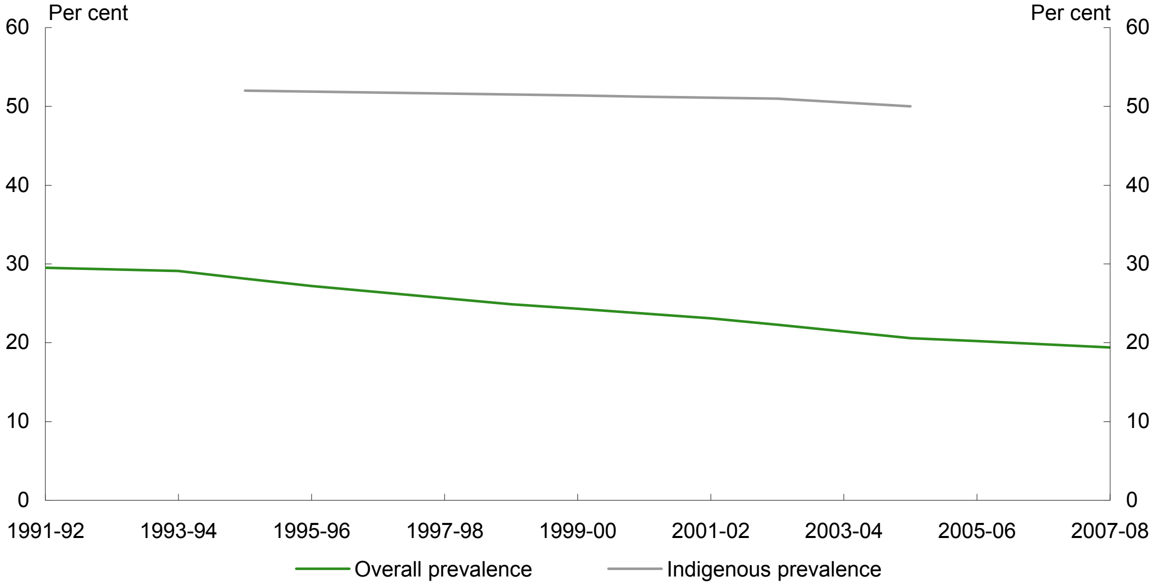
In 2007, 19.4 per cent of Australians aged 14 years or older had smoked in the past 12 months (AIHW 2008a). Eighty-six per cent of smokers smoked daily. The proportion of the population that smokes has been falling over the past 20 years (see Chart E6–2) and the average consumption per smoker has also declined, from 15.7 per day in 1997 to 13.0 per day in 2005 (Scollo & Winstanley 2008). Tobacco consumption varies among different demographic groups. People in lower socioeconomic groups smoke more than those in higher groups. People in the lowest 20 per cent by income devote 1.8 per cent of their total goods and services spending to tobacco compared to 0.8 per cent for people in the highest 20 per cent (ABS 2006c). In 2004, 23 per cent of people with an education level of Year 9 or less smoked while only 11 per cent of those who had studied at university smoked (Scollo & Winstanley 2008). Other indicators of socioeconomic status display a similar pattern (Siahpush & Borland 2001). Smoking rates are also high among some disadvantaged groups.

- In 2004–05, around 50 per cent of Aboriginals and Torres Strait Islanders were daily smokers (ABS 2006d), compared with around 17 per cent of the general population (AIHW 2005). Smoking rates among Indigenous people have not fallen significantly since 1994–95. Smoking is the single biggest contributing factor to the life expectancy gap between Indigenous and non-Indigenous Australians (Ivers 2001).

- People with mental illness are much more likely to smoke than others. A 1997–98 study found that smokers account for 73 per cent of men and 56 per cent of women with psychotic illnesses such as schizophrenia (Jablensky et al. 1999).

- Data from 1995 reveal smoking prevalence among single mothers of 46 per cent, compared with 26 per cent for the general population at that time (Siahpush et al. 2002).

Chart E6–2: Smoking prevalence in Australia, 1991–2007



Source: Scollo & Winstanley 2008.

Lower income people who continue to smoke are adversely affected by tobacco taxes. Many of them incur the health costs of smoking twice over — by paying high taxes designed to reduce those costs and by suffering the health effects of smoking. Assuming unchanged levels of tobacco consumption, a 10 per cent increase in tobacco excise rates would be equivalent to an additional tax on gross household income of 0.16 per cent for households in the lowest 20 per cent of incomes but only 0.03 per cent for households in the highest 20 per cent. A similar regressive impact would apply to specific disadvantaged groups in which smoking rates are particularly high. On the other hand, some lower income people would avoid serious harm by giving up smoking as a result of tobacco taxes — and are more likely to do so than high income people.

E6–3 Excise rates should be higher

Recommendation 73:

The existing regime for tobacco taxation in Australia should be retained, with the rates of tax substantially increased, depending on further evidence on the costs of harm from tobacco smoking.

Recommendation 74:

Tobacco excise should be indexed to a broad measure of wages rather than CPI.

Recommendation 75:

There should be no duty free allowance on tobacco for international travellers entering Australia.

Consistent with the broad approach to goods and services taxation taken in this report, the principal issues for tobacco taxes are whether government policy should seek to contain the very heavy mortality and morbidity costs borne by smokers and, if so, whether taxes are an effective means of doing so.

The strongly addictive properties of tobacco, together with the time-inconsistent preferences that characterise addicted consumers, are sufficient to make an in-principle case for government intervention. Taxation is not, however, the only effective policy instrument available to government. A range of other measures could help to reduce the costs of smoking borne by smokers: banning point-of-sale advertising; banning the promotion of tobacco companies; prohibiting marketing on packaging; limiting the places at which tobacco products can be sold; subsidising nicotine replacement therapies; imposing heavier penalties for, and improving the enforcement of prohibitions on providing tobacco products to minors. Limitations on where people are allowed to smoke can significantly reduce the external costs of smoking.

The Review Panel believes that governments should continue to use non-tax policy instruments to address the costs of smoking. Nevertheless, higher prices for tobacco can significantly reduce tobacco consumption and, therefore, the negative effects of smoking on smokers and others.

There are significant empirical difficulties in calculating an optimal level of taxation in a market where consumers have time-inconsistent preferences. The greatest practical difficulty is to estimate the strength of the extra weighting that consumers give to current period costs and benefits. Spillover costs need to be taken into account but are small compared with the costs borne by smokers themselves.

A model of tobacco consumption that incorporates time-inconsistent preferences, with plausible parameters, suggests that tobacco excise rates could be increased substantially (see Box E6–1; Gruber & Koszegi 2008). There are, however, considerable uncertainties surrounding these calculations: they should be treated only as indicative.

Box E6–1: A model of tobacco consumption with time-inconsistent preferences

Economists have developed a formal model of tobacco consumption that takes into account the time-inconsistent preferences that most addicted smokers display (Gruber & Köszegi 2001). The model allows the calculation of an ideal tax rate that would correct for the self-control problems that smokers experience.

The ideal tax rate depends on a number of parameters. It depends on how strongly smokers privilege current costs and benefits over future costs and benefits. The stronger the current period preference, the harder smokers find it to carry out plans to stop smoking and the higher the tax needs to be to help them overcome their self-control problems. The more harm is done by current smoking, the higher the tax needs to be to limit the damage suffered by smokers with self-control problems. The ideal tax rate also depends on whether the smoker understands their self-control problem — that is, whether they are 'naïve' or 'sophisticated'. A naïve smoker does not realise they have a self-control problem.

Estimating the Gruber and Köszegi model with Australian data, where available, suggests that tobacco tax rates could be either side of current levels (see Table E6–1). In the table, the value representing the strength of smokers' current period preference can range from 0 to 1. A value of 0 would mean that current period preference is absolute, so that a smoker places no weight at all on what happens in future. A value of 1 would mean that there is no current period preference, so that a smoker recognises the full costs of smoking, and can make a rational decision about their current smoking on that basis. The values tested in the table cover the mid-range of empirical estimates.

Table E6–1: Range of optimal tobacco tax rates for Australia ($ per stick)

	Strength of current period preference				
	0.60	*0.65*	*0.70*	*0.75*	*0.80*
Sophisticated smokers	0.31	0.27	0.22	0.18	0.14
Naïve smokers	0.47	0.41	0.35	0.29	0.23

Note: The optimal tax rates for naïve smokers do not take into account behavioural responses that may somewhat offset their self-control problems. Gruber and Koszegi do not derive the optimal tax taking this effect into account as they focus on the case of sophisticated smokers. The parameter for current period preference lies between 0 and 1; the lower the value, the higher the preference accorded to the current period. The current per stick tax is $0.25.

While this is an attractive model that explains much actual smoking behaviour, there are a number of reasons not to place too much confidence in the estimates it generates.

- It is very difficult to measure the strength of an individual's current period preference.
- Different groups may vary in the strength of their current period preference. If so, a uniform tax will overtax some and under-tax others. In particular, young people underestimate their chance of becoming addicted and their smoking responds more to price changes, so estimates for sophisticated smokers may underestimate the appropriate overall rate.
- It is difficult to estimate the value of life-years lost through smoking and of the other harms that smoking causes.
- Not all smokers are the same but they all pay the same tax. High tobacco taxes impose costs on the small proportion of occasional smokers who are at little risk of harm.

As Australia's tobacco taxes are low by international standards, it is feasible to increase them substantially. Doing so would encourage smokers to quit — a 10 per cent increase in the price of cigarettes would reduce the number of people who smoke by about 2½ per cent and would decrease total tobacco consumption by around four per cent (Chaloupka & Warner 1999). The degree of responsiveness among young people, low income people and men is higher than among older people, higher income people and women. As around three million Australians smoke and each long term smoker loses, on average, around six years of life, a substantial increase in the price of cigarettes could considerably reduce the number of life years lost by Australian smokers.

It is difficult to determine the right rate of tax for tobacco products. Assessment of the rate would be easier if we had better evidence about the marginal costs of tobacco use — that is, the costs of one more or less cigarette smoked — rather than just the average costs of tobacco use. More information about the strength of smokers' current period preference would also be useful.

There is, however, a good case for a substantial increase beyond those that would be entailed by the changes to indexation arrangements discussed below (see Recommendation 73).

Tobacco excise should be indexed to wages, not CPI

Since the main public policy purpose of tobacco taxation is to reduce the harm smokers suffer from smoking by keeping prices high, the Review Panel believes it would be appropriate to index tobacco excise to wages rather than consumer prices. Wages tend to increase more rapidly than consumer prices, largely as a result of increased productivity, so tobacco excise, which is currently indexed to CPI, tends to decline as a proportion of average wages. Over time, this makes cigarettes more accessible to wage earners and others, such as pensioners, whose incomes are tied to wages. To maintain the value of tobacco excise as a proportion of average wages and hence, indirectly, as a proportion of household incomes, the Review recommends indexation to a broad measure of wages in the Australian economy (see Recommendation 74).

Higher taxes and illicit tobacco

In 2005, it was estimated that one in 17 cigarettes consumed in Australia contained illegal 'chop chop' diverted from legal tobacco production (PwC 2005). This proportion is likely to have fallen since the end of legal tobacco growing in Australia in 2007. Importation of 'counterfeit' cigarettes — factory made and presenting as legally produced and distributed cigarettes — is relatively limited in scope.

Heavy taxation of any commodity increases incentives for the illegal supply of that commodity. For tobacco, this is a relatively minor problem at current levels of tax. However, if taxes rose significantly, there would be more incentives for illegal production and importation. This makes it more important for policy makers to use instruments other than taxation to address the costs of tobacco consumption. It is, however, unlikely that any feasible increase in taxation would see an increase in illegal supply sufficient to undermine the effectiveness of the existing taxation arrangements.

Duty free tobacco should be abolished

The duty free tobacco allowance undermines the objectives of tobacco taxation and involves a significant revenue loss (in the order of $200 million per year). There is no reason why international travellers should enjoy a tax concession on cigarettes smoked in Australia. The Review Panel believes that inbound duty-free arrangements should be abolished (see Recommendation 75). People could be allowed to bring into the country up to 25 cigarettes or their equivalent duty-free, so that smokers would not have to pay duty on their daily supply.

E7. Gambling taxation

Key points

Government restrictions on the supply of gambling services, implemented through licensing arrangements, mean that some gambling businesses earn economic rent. Economic rent is an efficient tax base and should be appropriated by the government, either through licence fees or taxation.

For the large majority of gamblers, gambling is simply consumption spending, comparable to spending on any other leisure activity. A small minority of gamblers experience self-control problems that lead to excessive losses. Problem gamblers impose costs on themselves and others.

It is not clear how problem gamblers react to higher taxes. In some forms of gambling, the price of gambling is not easily observable. Even if problem gamblers do observe changes in price, it is not clear that they respond by reducing the amount they lose. Gambling taxes that more than recoup economic rent earned by gambling businesses do, however, impose costs on responsible gamblers, who must pay higher prices for their entertainment.

Gambling taxes constitute an important revenue source for State governments. This means that they may have to make difficult choices in balancing revenue-raising with regulating gambling in a way that limits problem gambling. For this reason, the Australian government and State governments should together explore options for the regulation and taxation of gambling that would minimise conflicts in policy-making between revenue raising and addressing problem gambling.

The current tax burden on the gambling industry as a whole may be appropriate, but the way it is distributed across the industry may not be. The current rates of tax on different forms of gambling differ markedly from form to form though the reasons for these variations are not clear.

Gambling taxes should be focused on recouping economic rent generated by government restrictions on the supply of gambling services. If State governments retain gambling taxes, they should increase the focus on capturing rent.

Some gambling taxes and fees are used to provide common services to the industry — for example, some revenue from horse racing is used to support the racing industry.

E7–1 The rationale for gambling taxes

Principles

Government restrictions on the supply of gambling services, implemented through licensing regimes, mean that some gambling businesses earn economic rent. Economic rent is an efficient tax base and should generally be appropriated by the government, through either licence fees or taxation on player loss or turnover.

Taxes can only help problem gamblers counteract their self-control problems if they understand the price they face (the odds) and respond to higher prices by reducing their losses.

Governments that rely on gambling revenue to a significant extent may have to make difficult choices in balancing revenue-raising with regulating gambling to limit problem gambling. The regulatory role should be separated from the collection of revenue.

Regulation and economic rent

Gambling is an activity widely enjoyed in Australia. Eighty per cent of Australian adults engage in some form of gambling (Productivity Commission 1999b). Around 15 per cent of adults gamble regularly, excluding lotteries and scratchies (Productivity Commission 2009a).

Because gambling allocates financial benefits in accordance with uncertain processes, which sometimes allow the gambler to gain a positive return, it has some features in common with investment in a risky asset. For a small number of professional gamblers, gambling functions as an investment that is expected to yield a positive return. For most recreational gamblers, however, spending on gambling is simply consumption spending, comparable to spending on any other leisure activity. A small minority of gamblers experience self-control problems that lead to excessive losses. For these people, gambling is an addictive pursuit.

Despite high participation rates, popular attitudes to gambling are ambivalent. A large proportion of the population regards gambling as a serious social problem and supports more stringent restrictions on the supply of gambling services (Centre for Gambling Research 2004). A common government response has been to place restrictions on the number and size of gambling establishments, their hours of opening, the facilities they offer or the design of games.

As a result of State government restrictions on the supply of gambling services in Australia, the holders of the limited number of licences are able to make more profit than they would in a competitive market — that is, they earn economic rent. Economic rent is an efficient taxation base (see Section C1 Charging for non-renewable resources and Section C2 Land tax and conveyance stamp duty).

In theory the government could appropriate 100 per cent of the economic rent without changing the amount of gambling services that companies would be willing to supply or the price to consumers. This is because — even if all the rent were taxed away — companies would still make normal profits; that is, they would receive enough gambling revenue to cover their costs and offer investors an adequate rate of return on their investment (see Box E7–1).

The government can capture the economic rent through taxation or through auctioning licenses to gambling providers. The price of a licence would generally reflect the economic rent that bidders expect to be able to earn from the gambling business.

If licences could be bought and sold, their scarcity and any taxes payable would be reflected in their market price. Taxes may be imposed up to the point where the market value of a licence falls to zero, that is where taxes consume all expected economic rent. At that point, the investors would still supply capital, but the gambling business would not be prepared to pay for a licence to provide gambling services.

Problem gambling

Consumers will usually make choices about what to consume that provide them with the greatest available satisfaction, without the need for government intervention. A large majority of people who gamble derive satisfaction from it without harming themselves or others.

This principle is not, however, applicable to all consumers. Minors and people with intellectual disabilities, mental illnesses or severe addictions are not always able to make choices that provide them with the greatest possible satisfaction, especially over a long period rather than at a single point in time. In its most recent report on gambling, the Productivity Commission estimates that between 0.5 and 1.0 per cent of adults suffer significant problems from their gambling each year. It estimates that a further 1.4 to 2.1 per cent of adults are subject to moderate risks that may make them vulnerable to problem gambling (Productivity Commission 2009a).

Problem gambling is characterised by chasing losses, spending more money on gambling than intended, failing in attempts to stop gambling, losing time at work or study, accumulating large debts, liquidating assets or misappropriating money (Productivity Commission 1999b).

Problem gamblers can also suffer a wide range of adverse health effects, including depression, stress, anxiety, lethargy, insomnia, poor nutrition, suicidal thoughts, increased caffeine and nicotine consumption, sweats, confusion, panic and ulcers (Amies 1999). There may also be less definable personal costs arising from loss of self-control and the breakdown of family and other relationships. Problem gamblers who commit crimes to finance their gambling impose costs on the victims and may also incur the costs of punishment.

The self-control problems of problem gamblers are associated with 'time-inconsistent preferences' under which a person gives more weight to immediate costs and benefits than costs and benefits in the future (see Section E6 Tobacco taxation). One consequence is that a problem gambler may realise that it is in their long term interest to stop gambling and make plans to do so at a particular time, but find themselves unwilling to carry out their plan when the time to stop arrives. Episodes of problem gambling may also be triggered by environmental cues related to past gambling experiences — for example, if the person is exposed to a place, social situation or experience that is strongly associated with past gambling episodes (Bernheim & Rangel 2004).

In some cases, taxes may help addicted consumers overcome their self-control problems, but only if they understand and respond to the price they face. Other interventions may be more effective, particularly where environmental cues play an important role in triggering episodes of addictive behaviour.

In considering the use of taxation to address problem gambling it is important to remember that taxes on gambling impose costs on all gamblers, including the large majority who are responsible gamblers.

E7–2 Existing gambling taxes

Findings

Gambling taxes constitute an important revenue source for State governments. Online gambling, however, may break down market power in some sectors of the gambling industry and reduce the States' capacity to tax economic rent. Competition between States may also limit their capacity to raise revenue from gambling.

The current tax burden on the gambling industry as a whole may be appropriate, but the way it is distributed may not be. The current rates of tax on different forms of gambling differ markedly from form to form for reasons that are not entirely clear. The burden of gambling taxes may sometimes fall on economic rent, but sometimes on gamblers and gambling businesses. There are also biases in the way different race wagering is taxed, which damages competition.

It is not clear how problem gamblers react to higher taxes. In most forms of gambling, the price of gambling is not easily observable. Even if problem gamblers do observe changes in price, it is not clear that they respond by reducing the amount they lose. Higher gambling taxes do, however, harm responsible gamblers, who must pay higher prices for their entertainment.

How we currently tax gambling

At the Australian government level, GST is payable at a rate of one eleventh on the player loss of a gambling business, across all forms of gambling (ATO 2009a). This is equivalent to the treatment of other goods and services.

The four main types of gambling are wagering (betting on horses, sport etc), gaming machines (poker machines), casino gambling (casino table games like roulette, and gaming machines) and lotteries. Each of the four is taxed by State governments on a different basis.

Wagering is usually taxed on player loss. For example, totalisator wagering (through a TAB) involves the gambling business pooling the bets and deducting a percentage (the player loss) before distributing the remainder as prizes. Different States deduct different percentages. The rate of deduction also varies according to the type of bet. For example, in Victoria, the rate for place bets is 14.25 per cent while the rate for trifecta bets is 20 per cent. A proportion of the player loss is paid to State governments in tax (Australian Treasury 2008). Fees are also paid to the racing industry in each State (Productivity Commission 2009). Wagering through bookmakers is generally free of specific gambling taxes, although small taxes on bookmakers' turnover remain in Tasmania and the NT.

Gaming machines are taxed on player loss. In most States, a club with gaming machines pays tax on player loss according to an increasing scale. For example, in New South Wales marginal rates range from zero for clubs with revenue under $200,000 per quarter to 30.9 per cent for clubs with revenue over $20 million per quarter. (Victoria has a flat rate and Western Australia has no gaming machines outside its one casino.) In most States, a hotel with gaming machines is subject to higher rates than clubs, under either a flat rate on player loss or an increasing scale.

Casino gambling raises revenue for government by means of licence fees, together with a tax based on a measure of revenue, usually player loss. Licence fees vary in their structure. For example, Star City Casino in Sydney paid a one-off licence fee of $256 million. Wrest Point Casino in Hobart pays a monthly licence fee, indexed annually, which amounted to $129,600 in 2008–09. Casinos also pay a tax based on some measure of revenue, usually player loss. Tax rates vary from 8 per cent of gross profit in the Northern Territory to 21.25 per cent of gross gaming revenue (plus a super tax) in Victoria. Lower rates apply to commission-based players (high rollers). Casinos are generally subject to special, lower rates of tax on player loss from their gaming machines (Australian Treasury 2008).

Lotteries are taxed more heavily than other forms of gambling, with tax rates on player loss ranging from 45 to 90 per cent (Australian Treasury 2008). Average tax rates for other forms of gambling range from 20 to 35 per cent of player loss (Productivity Commission 1999a).

Full details of State gambling taxes are available in Treasury's *Architecture of Australia's tax and transfer system*.

In 2004–05, player loss across Australian gambling enterprises amounted to $15.5 billion (ABS 2006d), on a total amount wagered of around $130 billion. In 2007–08, the States raised $4.9 billion from gambling taxes, amounting to 9.1 per cent of their tax revenue. Of this, 7.0 per cent came from race betting, 61.5 per cent from gaming machines, 7.7 per cent from casinos and 23.1 per cent from lotteries (ABS 2008b).

State governments impose restrictions on the availability and design of most gambling services. In every State, off-course wagering is dominated by a TAB (whether privately or publicly owned). In all States, limitations are placed on the total number of gaming machine licences and, in some States, on the number of machines in particular areas or venues. Minimum payout ratios — the ratio of prizes paid to money bet — are also enforced. All casinos are regional monopolies. NSW, WA and SA have a single, publicly owned lottery provider. Queensland has a single, private provider. Victoria and the NT have two private providers. Tasmania has three private providers. The ACT has a public and a private provider.

All State governments allocate part of gambling revenue to social programs such as problem gambling services and research into the impact of gambling on the community. In some States, substantial amounts of revenue are allocated to health services. In Victoria, for example, over $1 billion per year from gambling revenue is allocated to various social programs: the Community Support Fund, the Hospitals and Charities Fund and the Mental Health Fund.[21]

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21 Victorian State Budget 2009–10, Statement of Finances, Budget Paper No. 4, p. 201.

Do taxes help problem gamblers?

Some gamblers experience self-control problems, incurring substantial costs as a result and imposing costs on others. The family and friends of problem gamblers may incur costs from theft and relationship breakdown. It appears that if you have a problem gambler among your family or friends you are more likely to be a problem gambler yourself, so there may also be some external 'contagion' effects (Productivity Commission 1999b). Governments bear costs from problem gambling through the criminal justice and public health systems, though these appear to be relatively limited (Independent Gambling Authority 2003). Health fund members also bear some health costs. Problem gambling may also be associated with loan sharking and other criminal activity, which impose additional external costs (Productivity Commission 1999b).

Taxes are unlikely to be an effective way of reducing the costs of problem gambling. To the extent that existing gambling taxes recoup economic rent they do not affect the odds that gamblers face. But even when taxes do more than recoup economic rent, they can only mitigate the effects of problem gambling if they increase the average amount lost by a player per dollar bet, and if problem gamblers respond by reducing their losses.

The price of gambling for some games, such as many casino table games, is fixed by the rules of the game and will not be affected by gambling taxes (although businesses may be able to adjust the price by providing discounts of various types or making marginal adjustments to the rules).[22] In other games, such as TAB wagering, the price of gambling (that is, the average player loss) may be affected by gambling taxes but is not immediately apparent to the gambler. In such cases, increasing the price of gambling is not likely to affect the behaviour of problem gamblers.

Even where the price of gambling is affected by gambling taxes and is apparent to the gambler, problem gamblers may not markedly reduce their losses. If their gambling is constrained only by the amount of money available to them, their losses will not fall. If they face other constraints on their gambling, like the amount of time they can devote to gambling, higher prices may lead to higher losses and more severe problems (Productivity Commission 1999b).

Only around 1 per cent of the adult population are problem gamblers, so using taxes to help counteract problem gambling imposes high costs on the large majority of non-problem gamblers. Other policy interventions may help to address spillover costs and the costs borne by gamblers themselves. These interventions, some of which have been implemented in Australia, include:

- limiting or prohibiting the advertising of gambling services;
- requiring games to encourage (or be limited to) small bets;
- restricting the opening hours of gambling venues;
- requiring gambling venues to display clocks and admit natural light;

22 Casinos subsidise restaurant, accommodation, parking, and entertainment offerings to induce customers to gamble in their facilities. A variant is to provide customers who meet minimum betting requirements with complimentary goods and services.

- improving information to gamblers about the price of gambling services;
- limiting the granting of credit by gambling providers;
- mandating self-exclusion arrangements, where a gambler can ask a gambling venue not to admit them; and
- requiring the use of electronic card technology to provide gamblers with information on their bets and losses.

Measures such as these may be more closely targeted at targeting problem gambling than gambling taxes. However, given the Review's terms of reference, it has not made recommendations on the appropriate mix of non-tax measures to address problem gambling.

The internet might increase competition and reduce economic rent in the gambling sector

The internet makes gambling services more accessible to consumers and can offer very low cost access to some forms of gambling — though this may be at the cost of some attractive aspects of the gambling experience (such as atmosphere). Australian-based internet gambling businesses should be taxed like other gambling businesses. In the longer term, a competitive internet gambling marketplace, characterised by low-margin and highly accessible offerings, may erode the capacity for State governments to create economic rent by restricting the supply of gambling services. If gambling taxes are focused on economic rent, revenues may fall away as gambling markets become more competitive and more mobile. This would allow consumers to enjoy the benefits of greater access and competition but could also increase the risks that people will develop gambling problems.

E7–3 Improving gambling taxes

Recommendation 76:

Gambling taxes should be reviewed to ensure that they are focused on recouping economic rent generated by government restrictions on the supply of gambling services or are being used efficiently to impose such restrictions.

Recommendation 77:

Governments should eliminate gambling tax concessions for particular types of gambling business, such as clubs. If governments wish to subsidise particular types of businesses, they should do so through direct expenditures.

Recommendation 78:

Governments should consider the allocation of responsibilities for the regulation and taxation of gambling, with a view to minimising conflicts in policy-making between revenue-raising and addressing problem gambling.

Recouping economic rent created by government restrictions

Gambling businesses are able to earn economic rent only because State governments restrict the supply of gambling services (see Box E7–1). Capturing economic rent is the most compelling reason for imposing special taxes on gambling services (see Recommendation 76). Other potential reasons for imposing specific gambling taxes are discussed below.

One option for capturing economic rent that State governments could consider is a simple rent tax calculated on the basis that, for most gambling businesses, the amount invested in the business is closely related to the amount provided to gamblers as prizes. Any return to the business above a normal rate of return on the amount of prizes would be regarded as economic rent and taxed at a relatively high rate.

A tax based on the amount of prizes would, however, be a very rough approximation to a rent tax. A normal profit for a business arises when its sales just meet the full costs of its inputs; that is, wages plus a normal return on the capital invested in the business (taking into account how risky the business is). A business earns economic rent when its sales exceed the full costs of its inputs. In a gambling business, player loss is the gross revenue of the business, equivalent to gross sales for other businesses. In this case a more accurate tax on economic rent could be calculated as:

$\tau\,(B - P - W - K\theta)$ where

τ is the rate of rent tax;

B is the amount of bets placed in the period;

P is the amount of prizes paid in the period;

W is the amount of wages paid in the period;

K is the amount of capital employed in the period; and

θ is the risk-adjusted rate of return.

The allowance for capital could be calculated for each tax paying business individually (at the cost of additional complexity) or could be set at an average value for each form of gambling, on the assumption that cost structures are similar across any particular industry segment. It would also be necessary to consider what, if any, allowance for licence fees should be included in the measure of capital invested.

The effectiveness of gambling-specific taxes in capturing economic rent is affected by the way they are structured. Governments need to consider trade-offs between the accuracy of the tax in targeting economic rent and the compliance costs that it could impose on gambling businesses. Most gambling businesses already calculate the amount bet and the amount paid in prizes for GST purposes, but an allowance for capital would require capital investment to be allocated between gambling and other activities. Some non-profit organisations are not currently required to lodge a Business Activity Statement for GST purposes, so some additional compliance costs might arise in that quarter. It would also be necessary to consider how a gambling rent tax would interact with income tax and the GST, including the priority of debts incurred under the different taxes.

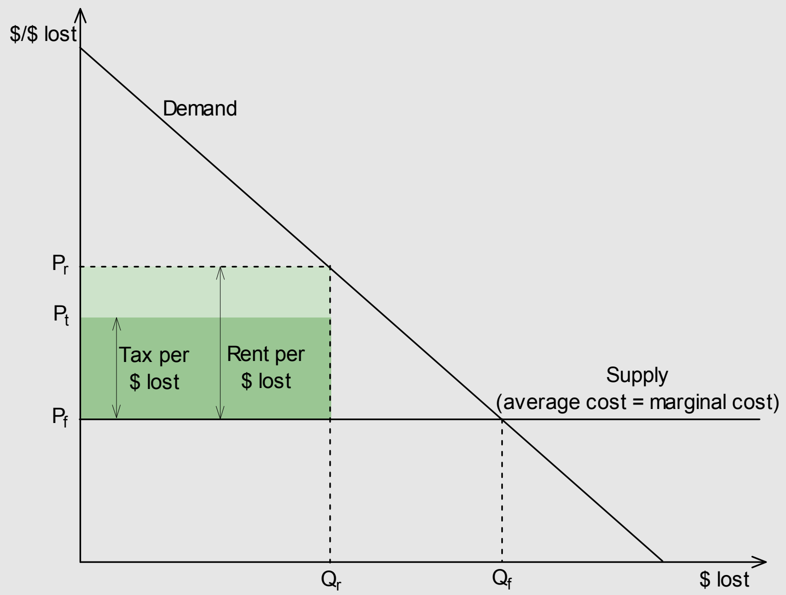
In theory, all economic rent accruing to the gambling business could be taken in tax without reducing the supply of gambling services, but in practice uncertainties in estimating the magnitude of the available rent suggest that a lower tax rate should be adopted.

A simpler step to reduce the efficiency costs of gambling taxation would be to abolish gambling taxes on gambling businesses that operate in competitive markets.

Box E7–1: Gambling rent tax

Chart E7–1 illustrates a gambling rent tax that seeks to appropriate the economic rent generated by regulatory restrictions on the supply of gambling services. It is assumed that the cost of providing the service is the same for each dollar that gamblers lose.

Chart E7–1: Taxing economic rent earned by gambling businesses



P_f per dollar lost constitutes the normal return to the gambling business, that is, the player loss ratio it would need in order to make a normal profit in a competitive market. The restriction of supply to Q_r would create economic rent equivalent to the sum of the shaded and crosshatched areas. If licences were allocated at no cost to the licensees and if no gambling taxes were imposed, licensees would keep the whole of this rent. In theory the government could appropriate the whole of the rent by imposing a tax of $P_r - P_f$ per dollar lost. In practice it is difficult for the government to estimate the amount of the rent. So a lower tax rate of $P_t - P_f$ would allow the government to recoup most of the economic rent without running the risk of overtaxing gambling services. A rent tax could be adopted as the sole means of appropriating economic rent. Alternatively, governments could auction licences and then use a rent tax to appropriate any additional rent.

Raising revenue

Gambling taxes are well-established and constitute an important source of revenue for State governments. While existing gambling taxes have deficiencies, many other State taxes perform even more poorly when assessed against the criteria of efficiency, equity, simplicity, sustainability and policy consistency (see Section G2 State tax reform). State governments may therefore be reluctant to give up this own-source revenue stream.

Rent-based gambling taxes have little effect on equity

Spending on gambling is not proportionally spread across the income distribution — low income people spend a higher proportion of their income — 1.4 per cent — on gambling than high income people — 0.3 per cent (ABS 2006c). Accordingly, gambling taxes appear to be regressive overall, falling as a proportion of income as incomes rise (Smith 1998). However, some gambling taxes represent a transfer of economic rent from the gambling business to the government. In these cases, a marginal change in gambling taxes would not change the supply of gambling services or the prices that gamblers pay to gamble. Reducing taxes would simply increase the profits of the gambling business.

Spending on particular forms of gambling is less evenly distributed than spending on gambling as a whole. For example, participation in casino gaming and sports wagering is strongly biased towards young single men. Lotteries and gaming machines are disproportionately patronised by low income people. Thus where the burden of the tax is borne by gamblers, taxes on lotteries and gaming machines are the most regressive; taxes on wagering are also regressive, though there is significant variability among income groups; and casino taxes are neither regressive nor progressive (Productivity Commission 1999b).

Taxes on specific goods and services should not generally be used for redistributive purposes (see Section E Enhancing social and market outcomes). Even without appealing to this general principle, gambling expenditure is too evenly spread across the income distribution to make reductions in gambling taxes an effective tool for redistributing income.

Tax concessions are a poor way of subsidising clubs

The rationales for imposing specific gambling taxes apply to clubs just as much as they do to other gambling businesses. If governments wish to subsidise clubs for reasons of social policy they should do so through direct expenditures, not through gambling tax expenditures (see Recommendation 77). Direct funding would be much more transparent than the current practice of providing tax concessions for gambling in clubs, and it would relieve clubs of the incentives set up by the current link between concessional gambling tax rates and the delivery of community services.

State and federal governments should together develop policy for regulating and taxing gambling

Given that economic rent in the gambling industry can be created by local restrictions, gambling taxes would appear to be a matter for State governments. However, if they have few other viable revenue sources, reliance on gambling taxes may set up incentives for State governments to manage the supply of gambling services so as to maximise the available revenue. Given that problem gamblers account for around one third of all player losses[23], taxes on gambling by problem gamblers account for around 3 per cent of total State tax revenue. Incentives to reduce the social costs of problem gambling may be diluted by unwillingness to forfeit the tax revenue derived from problem gamblers.

23 Productivity Commission 1999. The figure has been vigorously questioned by the gambling industry.

For this reason, the State and Australian governments should together explore options for the regulation and taxation of gambling that would minimise conflicts in policy-making between revenue-raising and addressing problem gambling (see Recommendation 78). Such policy discussions cannot be undertaken outside a broader consideration of federal financial arrangements (see Section G2 State tax reform).

E8. Rationalising other taxes

Key points

Insurance allows people to manage their risk and provides them with the flexibility to exploit economic opportunities. Australia has high taxes on insurance, both in comparison to the taxes imposed on other products and industries, as well as compared to other countries. Imposing specific taxes on insurance adds to the cost of insurance premiums and can lead to under-insurance or non-insurance. Specific insurance taxes should be abolished.

Luxury taxes should not be used to raise revenue. They are inefficient because of their narrow base. Taxing luxury goods is also an ineffective and arbitrary means of redistributing economic resources. The luxury car tax should be abolished.

Over recent decades the importance of tariffs as a revenue source has declined dramatically. This is expected to continue into the future.

Taxes with narrow bases that raise small amounts of revenue are usually inefficient unless they effectively correct for a failure in a particular market or unless they function as charges for particular goods and services. Governments should undertake a systematic review of existing and potential user charges and minor taxes against the principles set out in this Report. This should be coordinated with the introduction of the proposed system wide Tax and Transfer Analysis Statement.

There are sometimes good reasons for governments to impose taxes on particular types of goods and services, such as where the tax addresses a spillover cost on the community (see Section E Enhancing social and market outcomes). But governments in Australia currently levy a number of taxes on specific goods and services that raise significant revenue but do not correct any market failure. Other minor taxes appear to function as user charges for specific publicly funded goods and services. Some perform this function but others simply raise revenue.

This section discusses three significant taxes — insurance taxes, the luxury car tax and tariffs — as well as a number of more minor taxes levied by the Australian and State governments.

E8–1 Insurance taxes

The role of insurance

There are a range of insurance products which can be purchased, including home and contents insurance, motor vehicle insurance, income protection insurance, health insurance, public liability insurance and workers' compensation insurance (which is largely provided by governments). In 2008, gross insurance premiums paid in Australia to private sector general insurance providers were in the order of $31.6 billion, with assets of $92.7 billion held by these companies. In 2008, $25.8 billion was paid out to settle general insurance claims (APRA 2009).

Insurance allows people to pay a premium to cover a loss if a certain event occurs. By spreading risk among a group of people, insurance products make any particular loss by a member of that group manageable. The ability for people to manage risk appropriately is an important factor in their wellbeing. Further, by enabling transactions that would not have taken place if insurance were not available, insurance plays an important role in encouraging the most productive use of resources. For example, a doctor may not undertake important surgery if they are unable to gain insurance for that procedure and hence may undertake less important, and less risky, activities instead. In other words, access to insurance allows for greater opportunities and flexibility for people and businesses.

Insurance markets are more prone to market failure than many other markets. There are two main sources of this vulnerability. The first is 'adverse selection', where potential buyers of insurance have better information about the probability of loss than insurers. For example, in the health insurance market, people who purchase health insurance know more about their health problems than those providing insurance. In this case, people who know they have above-average risk will buy more insurance than people with below-average risk. Therefore, premiums set by insurers according to the average risk will not be sufficient to cover the claims that eventually arise. The second is moral hazard, where the presence of insurance cover shifts the preferences of insured people towards higher risk behaviour.

Insurance taxes in Australia

Insurance taxes in Australia are levied by the States. All States impose duties on general insurance premiums with the 2008–09 rates ranging from 7.5 per cent to 11 per cent. There are a number of concessions and exemptions: for example, workers' compensation insurance is not taxed in most States. The States also apply different rates for life insurance and term insurance. Some States impose taxes on specific insurance products or have specific tax arrangements for the insurance industry. NSW and the ACT, for instance, impose a levy on health insurance policies (known as the Ambulance Service Levy in the ACT). NSW, Victoria and Tasmania require insurance companies to make contributions to the funding of fire brigades, which are generally passed on to the cost of insurance premiums.

Details of insurance taxes in each State are listed in Table E8–1.

Table E8–1: Insurance taxes in each State, 2008–09

Tax	NSW	VIC	QLD	WA	SA	TAS	ACT	NT
General insurance	9%	10%	7.5%	10%	11%	8%	10%	10%
Life insurance	$0–$2,000: $1.00 Over $2,000: $1.00 + 20c per $200 or part thereof in excess of $2,000	$200–$2,000: 12c per $200 or part. Over $2,000: $1.20 + 24c per $200 or part above $2,000.	$0–$2,000: 0.05% Over $2,000: $1.00 + 0.1% of balance.	na	$1.50 per $100 or part thereof of net premiums of previous year (min $100).	Up to $2,000: 10c per $200 or part. Over $2,000: $1.00 + 20c per $200 or part in excess of $2,000.	$0–$2,000: $1.00 Over $2,000: $1.00 + 20c per $200 or part thereof in excess of $2,000.	10c per $100 or part thereof the sum insured.
Term/temporary insurance	5% of first year premium	5% of first year premium	5% of first year premium	na	na	5% of first year premium	5% of first year premium	5% of first year premium
Insurance protection tax	(a)	na	na	na	na	na	na	na
Health insurance levy	$1.19 per individual per week; $2.38 per week per family	na	na	na	na	na	$1.79 per individual per week; $3.58 per week per family	na
Fire services levy	(b)	(b)	na	na	na	(b)	na	na
Surcharge/levy on motor vehicle third party vehicle	na	10%	10 cents duty per policy. Levies and fees depend on vehicle class	10%	$60	$6 per policy	na	na

(a) $69 million per annum to help meet claims against policies held with HIH in relation to CTP and home owner warranty schemes. $65 million per annum levied on general insurers registered with APRA, with the remainder contributed by a 1 per cent ad valorem tax on overseas general insurers and those domestic insurers not registered with APRA.

(b) Providers of certain insurance products are levied to help fund the provision of emergency services. In NSW 73.7 per cent of the cost of providing the NSW Fire Brigades and the Rural Fire Service is recovered from insurers, while in Victoria 75 per cent of the cost of providing the Melbourne Fire and Emergency Services and 77.5 per cent of the Country Fire Authority is recovered from insurers. Tasmania has a hybrid funding system for fire services, including an insurance fire levy paid by commercial property owners and levied on specified forms of commercial property insurance at various rates.

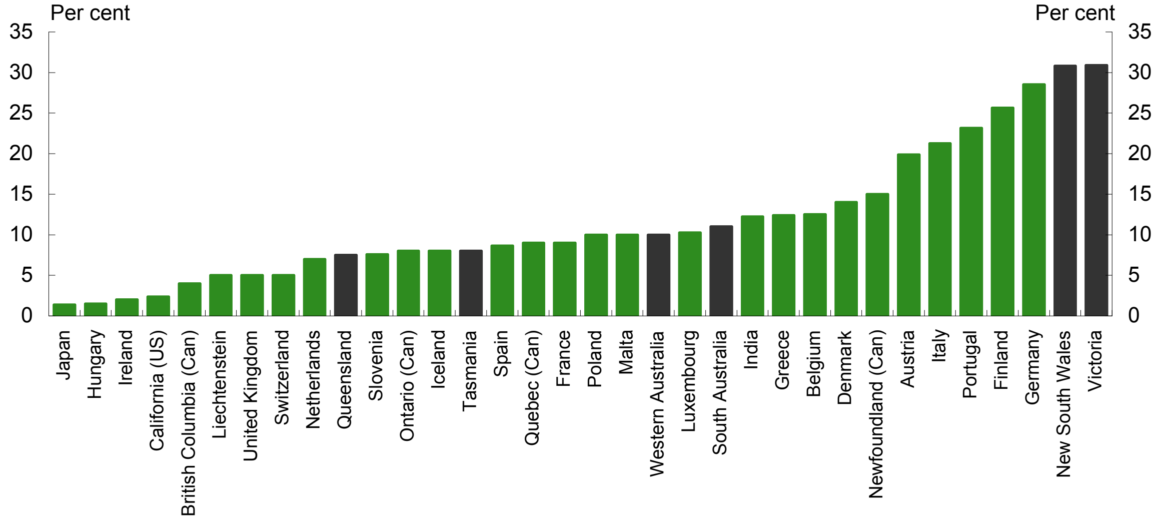
Source: New South Wales Treasury (2009).

Insurance taxes have been a growing revenue source for the States, increasing from $2.0 billion in 1998–99 to $4.3 billion in 2007–08. This represents a (nominal) increase of 112 per cent, significantly higher than the increase in revenue from other State taxes in this period (46 per cent). There has not been a significant increase in the rates of insurance taxes over this period; in fact, some States have reduced the rate of their general insurance duty. This suggests that growth in revenue has been largely driven by increases in the value of insurance premiums.

Compared to other countries, taxes on insurance in Australia are relatively high. The International Comparison of Australia's Taxes (Australian Government 2006) found that of the nine other countries in the OECD–10 that were examined, two did not levy specific insurance taxes, five had rates between 2 and 5 per cent and the remaining two had rates that were still lower than that of the lowest taxing Australian State. Australia was the only country listed with double digit insurance tax rates (which apply in five States). In addition, of the OECD–10, only Australia, New Zealand and Japan applied a value-added tax (VAT) — in Australia's' case, the GST — to insurance contracts.

This finding is supported by the Insurance Council of Australia's October 2008 submission to the Review. Chart E8–1 (adapted from the submission) shows that from the selected group of sub-national and national governments, NSW and Victoria (which fund a high proportion of their fire services from contributions by insurance providers) have the highest level of specific taxes on insurance premiums. When the GST is included, the effective rate of tax on insurance is even higher.

Chart E8–1: International comparison of insurance taxes (excluding VAT and GST)



Source: Insurance Council of Australia submission, October 2008.

Insurance taxes can lead to under-insurance

A number of reports have found that insurance taxes can impose significant costs and are one of the least efficient taxes available to the States. For example, IPART (2008) concluded that insurance duty and fire services funding contributions are the least efficient State taxes. The Centre for International Economics (2009a) noted that the market for insurance is already subject to a number of substantial market failures that has resulted in under insurance and non-insurance, and taxes on insurance provide a further disincentive to insure. Freebairn (2009) notes that, given market failures in the insurance market can lead to under-insurance, if anything, insurance should be subsidised rather than taxed.

Insurance taxes reduce the return for any given cost of an insurance policy, meaning that people and businesses must pay more to achieve the same level of risk reduction. This can deter people and businesses from entering the insurance market or purchasing an adequate level of insurance. This reduces the size of the insurance market and hence the scope for insurers to pool risk, leading to an increase in the cost of insurance premiums beyond the first round impact of the tax.

The rates of non-insurance and under-insurance vary throughout Australia. While States with higher taxes on insurance do not always have higher rates of non-insurance and under-insurance, there are other reasons why differences in States may persist (such as differences in perceived levels of risk). Further, there is evidence that after Western Australia stopped basing its fire services levy on insurance, the level of non-insurance for both building and contents declined (Tooth & Barker 2007). Another study found that if the fire services levy, insurance duty and the insurance protection tax were removed, an additional 300,000 households across Australia would purchase contents insurance and an additional 69,000 households across Australia would purchase building insurance (Tooth 2007).

As well as being inefficient by leading to under-insurance or non-insurances, insurance taxes can also be inequitable. Rates of non-insurance (for building and content insurance) generally decline with higher incomes, and non-insurance can also be higher for certain demographic groups, such as retirees with mortgages and single parents (Tooth & Barker 2007). Because of their financial positions, people in these groups may be more vulnerable in the case of loss.

Other considerations

One of the attractions of insurance taxes is that they are relatively simple to administer. To calculate the general insurance tax, the rate is simply multiplied by the value of the premium. However, not all insurance taxes are this simple. For the fire services levy, the process for determining the appropriate recovery on each insurance product can be complex for insurance companies. In its October 2008 submission, the Insurance Council of Australia argued this complexity comes from insurers being required to provide their contribution to the levy in advance (thereby leaving insurers with the task of forecasting the market when applying the tax to premiums). Further, fluctuations in both the market mix (that is, across classes of business) and premium levels result in insurance companies bearing all of the collection risk. They conclude that under or over collection is an inevitable feature of this system.

By encouraging under-insurance or non-insurance, insurance taxes may also lead to an increase in government expenditure in the event of a disaster. For example, after the 2003 Canberra bushfires the ACT Government provided an additional $5,000 to each affected household that did not have contents insurance, in addition to the $5,000 provided to all whose homes were destroyed. To the extent that the public or governments have previously intervened to provide significant financial support in such circumstances, there can be a moral hazard as people may be less inclined to be insured if they believe they are likely to be compensated by others (including governments) in the case of loss (Victorian Government 2009). However, evidence from the United States suggests that individuals and communities may not base their insurance decisions on such expectation and in fact, in direct contrast to the moral hazard expectation, after the 2009 Victorian bushfires the industry experienced a strong uptake of insurance (Victorian Bushfires Royal Commission 2009).

That the fire services levy is applied to insurance premiums in an *ad valorem* manner results in, all else being equal, those properties with a higher fire risk paying a higher fire services levy (as their insurance premiums would be higher to cover their fire risk). Partially funding the fire services in such a way could be considered fair as it means that those people more likely to need fire services contribute more to their funding, while some government funding contributes to the public benefit of fire services.

However, as noted above, the higher tax on insurance generally leads to a reduction in the number of people insured and will spread the burden of funding such service over less people than desirable. The levy also does not tax motor vehicles, despite that motor vehicle owners, in Victoria, receive around 15 per cent of the benefits of fire services (Victorian Government 2009). Funding fire services in this way also means that people with little fire risk but either higher other risks (which will not call on fire services) or higher value assets contribute more to fire services which they are relatively less likely to use.

Additionally, the uninsured do not contribute to the funding of these services. While there may be mechanisms, such as in Victoria, to recover the cost of fire services provided to the uninsured, in practice it is businesses, rather than individuals, which are charged in Victoria (Victorian Government 2009). Further, those under-insuring face no such charges. Because cost recovery is somewhat limited, and the fact that fewer people insure due to the levy, those insured are likely to bear a higher burden for funding fire services. While consistently applying cost recovery may be seen as more equitable, it would present a risk that the non-insured would not call the fire brigade to avoid the charge, which increases the risk of damage to other properties. This highlights the public good characteristics of fire services.

Findings

Australia has high taxes on insurance, both in comparison to other countries and to the way that other products and industries are taxed. Specific taxes on insurance add to the cost of insurance premiums and can lead to under-insurance or non-insurance.

Low-income earners are more likely than high-income earners to abandon insurance in response to higher premiums. The result is that they bear more risk themselves, although they are less well-placed to do so than people with higher incomes.

Reform directions — abolish specific taxes on insurance

Recommendation 79:

All specific taxes on insurance products, including the fire services levy, should be abolished. Insurance products should be treated like most other services consumed within Australia and be subject to only one broad-based tax on consumption.

There is little justification for levying specific taxes on insurance products. Rather than correcting a market failure, insurance taxes can add to existing problems in the insurance market. The revenue from insurance taxes should be replaced by revenue from a more efficient and equitable tax.

If governments wish to provide incentives for people to consider the fire risks when deciding where to live, other mechanisms — such as a risk adjusted charge on property — may be more appropriate. However, it is not necessary that these charges should be set to exactly match the costs of providing fire services. In fact, it may be undesirable particularly where the cost of providing fire services varies significantly from year to year.

E8–2 Luxury car tax

Taxes on luxury goods can act as an instrument of redistribution by imposing high rates of tax on goods and services that are exclusively or at least predominantly consumed by the wealthy. However, they are a relatively unattractive means of redistributing income. They may have had a role when the administration of a more comprehensive income tax was not feasible, but today's personal tax system, combined with a sophisticated system of transfer payments, is a far superior instrument for the redistribution of income.

In particular, taxes on luxury goods violate the principle of horizontal equity. People with the same economic means will pay different amounts of tax depending on their tastes. Wealthy people with modest tastes pay less than wealthy people with a preference for luxury goods. Australia's current luxury tax, the luxury car tax (LCT), is particularly arbitrary in its impact. It falls on people with a preference for relatively expensive cars, but not on those with a preference for diamonds, fur coats or yachts.

Luxury taxes are also flawed in their impact on vertical equity. Very few luxury goods are the exclusive preserve of the wealthy. Some of the burden of the LCT falls on people of average means with a preference for relatively expensive cars. In some cases, this reflects the fact that price is an arbitrary proxy for luxury within a given product category. Many people would feel that a small sports car is luxurious at $60,000 but a 7-seater minivan is not luxurious at the same price.

Principles

Luxury taxes should not be used to raise revenue. They are inefficient because of their narrow base. Taxing luxury goods is also an ineffective and arbitrary means of redistributing economic resources.

How the LCT works

The LCT is the only Australian government tax currently imposed specifically on luxury goods or services. It commenced on 1 July 2000, when the GST was introduced and wholesale sales tax was abolished. Luxury cars were taxed at a high rate under the wholesale sales tax, along with a range of other goods such as furs, jewellery and electronics. These other goods became subject only to the GST. Luxury cars, however, became subject to the LCT as well as the GST.

The LCT applies to the sale or importation of cars whose GST-inclusive value exceeds a threshold ($57,180 for 2008–09). The current tax rate of 33 per cent applies to the GST-exclusive value of a car that exceeds the threshold. The threshold is also used to set the maximum amount of depreciation deductions allowed on a car in a particular financial year. In certain circumstances primary producers and tourism operators can claim a refund of 8 per cent of the GST-inclusive value of some 4 wheel drive or all wheel drive vehicles (up to a limit of $3,000).

LCT does not apply to fuel-efficient cars with a GST-inclusive value of less than $75,000 (for 2008–09). LCT at the rate of 33 per cent applies to vehicles above this threshold. Some cars are exempt from the tax, regardless of value, including non-passenger commercial vehicles, most second-hand cars, motor homes, campervans and emergency vehicles.

In 2007–08, the LCT raised $464 million in revenue, or 0.1 per cent of total taxation revenue.

LCT should be abolished

Recommendation 80:

The luxury car tax should be abolished.

In the current Australian context, a tax on luxury cars is not a desirable means of raising revenue. It discriminates against a particular group of people because of their tastes. It is not an effective way of redistributing income from rich to poor. Its design is complex and becoming more complex over time.

In particular, the current $75,000 threshold for fuel-efficient luxury cars is a costly and ineffective way of limiting greenhouse gas emissions. If an emissions trading scheme, along the lines of the proposed Carbon Pollution Reduction Scheme, is introduced, governments should not implement additional measures that seek to reduce emissions in sectors already covered by the scheme (see Recommendation 58 in Section E2 Taxes to improve the environment).

E8–3 Tariffs

Australia currently has comparatively low tariffs on imported goods. As Chart E8–2 shows, this reflects policy decisions to reduce tariffs taken over more than 20 years. For many goods, no tariff at all is imposed. For most goods subject to tariffs, the general rate is 5 per cent. In the textile, clothing and footwear industries, a range of ready-made garments and particular fabrics currently attract a tariff of 17.5 per cent, although this is scheduled to fall to 10 per cent in 2010 and 5 per cent in 2015. The passenger motor vehicles sector currently attracts a 10 per cent tariff, scheduled to fall to 5 per cent in 2010.[24] Some automotive products and components are already subject to the 5 per cent rate.

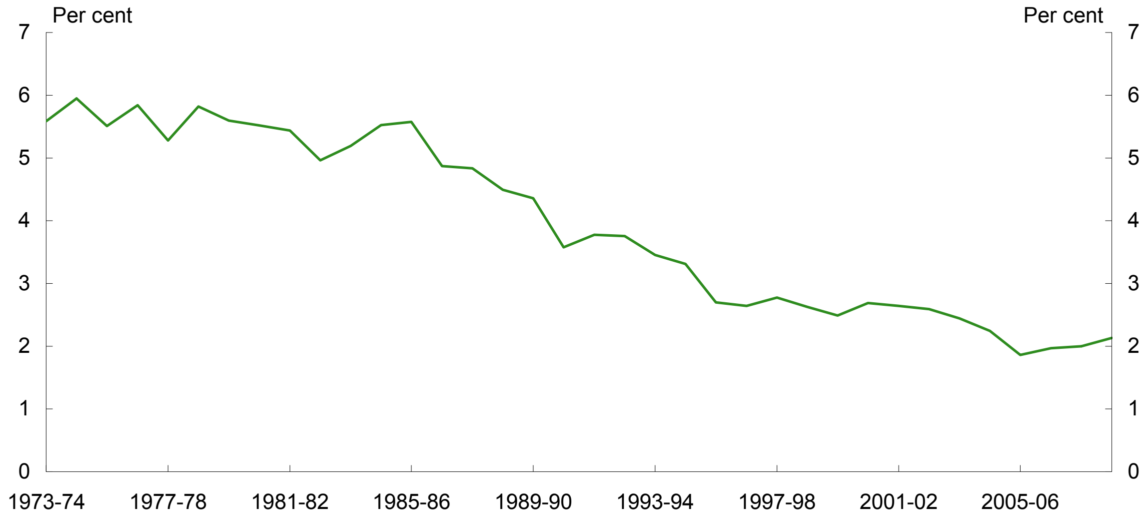
24 Like new vehicles, used or second-hand vehicles attract a tariff of 10 per cent, which will be falling to 5 per cent on 1 January 2010. However, high-volume imports attract an additional import duty of $12,000, which will remain in place after 1 January 2010. The additional duty does not apply to vehicles that are at least 30 years old or to individuals importing a single vehicle.

Chart E8–2: Reductions in tariff rates in Australia, 1990–2015

Note: The textile, clothing and footwear (TCF) rate represents the non weighted average of six separate non-uniform tariff rate reductions among TCF products. From 1992 to 1996 there were two general tariff rates, the chart shows the higher rate which applied in this period.
Source: Industry Commission (1995); Australian Government (2008b).

For two decades until the mid-1980s, Australia and New Zealand had the most protected manufacturing sectors among OECD countries (Centre for International Economics 2009b). However, following a series of unilateral tariff reductions in the 1970s, 80s and 90s, Australia's effective rate of assistance to manufacturing fell from 36 per cent in 1970 (Garnaut 2002) to under 5 per cent in 2007–08 (Productivity Commission 2009). A further consequence of Australia's trade liberalisation efforts is the declining importance of tariffs as a source of tax revenue (see Chart E8–3).

Chart E8–3: Tariff revenue as a proportion of total tax revenue, 1973–74 to 2008–09



Note: The series is based on receipts (cash) data, as this is the only historical data available. Although excise-like tax revenue is different in substance to other tariff revenue, it is collected through the customs duty system and included as part of the above revenue series due to the lack of disaggregated customs duty revenue data available before 2000.
Source: Treasury estimates.

In 2008–09, the Australian government raised $6.2 billion from customs duty; however, $383 million of this was returned in refunds and drawbacks. The remaining $5.8 billion is made up of $1.5 billion raised through the general 5 per cent tariff, $790 million from tariffs on passenger motor vehicles, $1.1 billion from tariffs on textiles, clothing and footwear and over $2.7 billion from taxes collected on excise-like imported goods. Although excise-like tax revenue is different in substance from other tariff revenue, it is collected through the customs duty system to ensure that such goods are taxed consistently whether they are produced domestically or overseas. Tariffs are applied to some excise-like goods; however, the total amount collected is relatively minor ($12 million in 2008–09).

General tariff rate on imported products

The general tariff raised around $1.5 billion in 2008–09, half of this from products imported from China and Japan. Both of these countries are currently negotiating preferential trade agreements with Australia. If general tariffs are eliminated for imports from these two countries, revenues from the general 5 per cent tariff will fall substantially.

The importance of tariffs as a revenue source is very likely to decline from its already low level over the next few years.

The Review has determined that industry and trade policy generally falls outside its terms of reference, and so makes no specific recommendations on tariffs. However, the likely future loss of revenue from this source will need to be taken into account in the future structure and rates of other taxes.

Finding

Over recent decades the importance of tariffs as a revenue source has declined dramatically. This is expected to continue into the future.

E8–4 Australia's minor taxes

Taxes with narrow bases that raise small amounts of revenue are usually inefficient unless they effectively correct for a failure in a particular market (see Section E Enhancing social and market outcomes) or unless they function as charges for particular goods and services (see Section E1 User charging).

What we have now

Australia has at least 14 minor taxes that are not addressed elsewhere in this report. They are motivated by a wide range of public policy purposes and are mainly levied on narrow bases, restricted to individual industries or activities. Summary information about them is presented in Table E8–2. Together they raised more than $1.4 billion in 2007–08.

A number of other relatively minor taxes are dealt with elsewhere in this report:

- land tax, stamp duty, land rich acquisitions duty and lease duties are considered in Section C2 Land tax and conveyance stamp duty;
- the Australian government imposes 66 agricultural levies on a wide range of commodities. These are discussed in Section E1 User charging; and

- motor vehicle registration duty and other taxes on motor vehicles, together with parking space levies, are considered in Section E3 Road transport taxes.

Some smaller financial transaction taxes are levied by some States but, consistent with the *Intergovernmental Agreement on Federal Financial Relations*, are scheduled to be abolished before 1 July 2013. The relevant taxes are stamp duties on mortgages, bonds, debentures and other loan securities; non-quotable marketable securities; and non-real non-residential conveyances (that is, business assets such as goodwill or intellectual property).

This report deals with all the significant taxes levied by Australian governments and efforts have been made to identify all the taxes in the nine Australian jurisdictions. Nevertheless it is sometimes difficult to decide whether two taxes should be recognised or just one and sometimes difficult to distinguish between taxes and sources of non-tax revenue. This report does not, therefore, claim to present a definitive list of Australia's taxes.

A review agenda for minor taxes

Recommendation 81:

Governments should undertake a systematic review of existing and potential user charges and minor taxes against the principles set out in this report. This should be coordinated with the introduction of the system wide Tax and Transfer Analysis Statement proposed in Recommendation 132.

This Report includes comments on a number of Australia's minor taxes (see Section E1 User charging). However, given the time and resource constraints under which the Review has been conducted, and given the need to focus on the major taxes that have the greatest impact on Australians' wellbeing, the Review has not made firm recommendations about each of the minor taxes now levied in Australia. In many cases, it would have been necessary to conduct a specialised program of research and solicit input from specific stakeholders before it would have been possible to draw firm policy conclusions. Rather than attempt this large task, and run the risk of neglecting more central features of Australia's tax and transfer system, this Report sets out a number of principles for evaluating narrow-based taxes on specific goods and services (see Sections E Enhancing social and market outcomes; E1 User charging).

The Review recommends that the Australian government and all state governments commit to a systematic review of their minor taxes (see Recommendation 81). Where a tax is found to perform poorly against the five core criteria identified in this report — efficiency, equity, simplicity, sustainability and policy consistency — it should be abolished and the revenue replaced with revenue from better performing taxes, particularly broad-based revenue raising taxes. This review should be coordinated with the process for the introduction of the system wide Tax and Transfer Analysis Statement proposed in Recommendation 132.

Table E8–2: Summary information on minor taxes

Tax	Revenue (2007–08, $m)	Rationale	Legal incidence	Base	Rate	Destination of receipts
Passenger Movement Charge (Cth)	420	Contributing to the funding of customs, immigration, quarantine and short-term visa processing services. In principle these services should be directly cost recovered or funded from the budget.	Passengers, though in practice collected by airlines and other carriers.	Passenger departures from Australia.	$47 per departure.	Consolidated Revenue Fund (CRF).
Aviation fuel excise (Cth)	77	Contributing to the funding of civil aviation safety services. In principle these services should be directly cost recovered or funded from the budget.	Refiners and importers	Litres of aviation fuel.	$0.02854 per litre.	CRF, then to the Civil Aviation Safety Authority.
Annual Carrier Licence Charge (Cth)	37	Recovers from carriers the cost to government of regulating the telecommunications industry. A carrier owns network infrastructure. There were around 170 carriers in Australia in 2007–08.	Telecomms carriers.	The costs of the Australian Communications and Media Authority, the Australian Competition and Consumer Commission, and Australia's contribution to the International Telecommunications Union.	Fixed minimum amount (calculated by formula), $50K each in 2007–08, plus variable component, totalling $37m, divided among carriers in proportion to eligible revenue.	CRF then to ACMA, ACCC
Save the River Murray Levy (SA)	22	Funds programs to increase environmental flows in the Murray River. No direct link between the charge and amount of water used.	SA Water account holders.	SA Water accounts.	$38.65 a quarter for most account holders	SA Water remits the levy collections to the SA government.
Universal Service Obligation Levy (Cth)	158	Revenue is used to fund consumer access to telecommunications services in areas where that would otherwise not be viable. In principle, all cross-subsidies should be transparent and other more efficient funding arrangements considered.	Carriers.	Total cost of providing universal service beyond what is commercially viable.	The cost of providing the universal service is estimated, then divided among the carriers in proportion to their share of eligible revenue.	Universal service provider (Telstra) by way of a Special Account administered by ACMA.
Summary information National Relay Service Levy (Cth)	12	The objective is for carriers to contribute to the cost of providing telecommunications access to people who are deaf or who have a hearing or speech impairment. In principle, all cross-subsidies should be transparent and other more efficient funding arrangements considered.	Carriers,	Estimated National Relay Service cost for the current quarter, plus any net levy shortfall from previous quarter.	Cost is calculated then recovered from carriers in proportion to their eligible revenue (for carriers with more than $10 million in eligible revenue).	Relay service provider and Outreach service provider by way of a Special Account administered by ACMA.

Table E8–2: Summary information on minor taxes (continued)

Tax	Revenue (2007–08, $m)	Rationale	Legal incidence	Base	Rate	Destination of receipts
Annual Numbering Charge (Cth)	60	Charges carriage service providers (CSPs) for the use of phone numbers A CSP is a business which provides phone or internet access. The charge aims to encourage the efficient use of numbers by CSPs.	CSPs.	An arbitrary revenue target has been set at $60m since 1998.	The rate is set annually to hit the revenue target, by reference to numbers held in April each year. The rate for a standard 10 digit number is $0.81, for 9 digits, $8.11 etc. 'Opportunity cost' methodology. Some types of number get lower rates.	CRF
Coal Mining Industry Levy (Cth)	72	Maintain industry-wide long service leave scheme in the black coal industry.	Black coal producers.	Payroll.	2.8%	CRF, then to statutory fund.
Livestock compensation levies (Vic, WA, SA)	Aggregate figures not available.	Provide pastoralists with compulsory insurance against livestock disease. In principle, fees should reflect actuarial risks.	Sellers of livestock.	Livestock sale price.	Varies according to the type of livestock and from State to State.	Statutory funds.
International Oil Pollution Compensation Levy (Cth)	0.2	Provide universal insurance against tanker spills of 'persistent oil'. Fund created by international treaty.	Receivers of tanker shipments of persistent oil.	Tonnes of oil received.	Varies from year to year.	CRF, then to International Oil Pollution Compensation Fund.
Broadcasting Licence Fees (Cth)	282	Charging broadcasters for access to broadcasting spectrum bands, and recovering scarcity rents created by regulation. Nearly all ($259m) comes from TV broadcasters, very little ($22m) from radio broadcasters. In principle, the fee should be transferrable and reflect the scarcity value created by regulatory restrictions.	Commercial radio and television broadcasters.	Gross earnings in previous year.	Calculated as a percentage of the base which increases as gross earnings increase. The maximum rate is 9 per cent.	CRF
Apparatus Licence Tax (Cth)	143	Recovers regulatory costs (not attributable to any one licence) and provide a return to government for use of the radio spectrum resource.	Owners of radio communication devices.	Radio transmitters: aeronautical, aircraft, amateur, broadcasting, datacasting, ships, scientific etc. Radio receivers: for ships etc.	Proportional to bandwidth. Higher in congested locations and spectrum bands. Taxes are indexed to CPI.	CRF
Parks Charge (Vic)	102	Funds parks in Melbourne.	Property owners in Melbourne.	Improved property value.	0.0189 per cent of value for most properties.	Parks Victoria, botanic gardens, zoos.
Metropolitan Region Improvement Tax (WA)	78	Fund parks in Perth.	Landowners in Perth	Unimproved property value.	0.14 per cent on value in excess of $300,000 for most properties.	Western Australian Planning Commission.

F — The transfer system

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F. The transfer system

The primary purpose of government assistance payments to individuals is to provide them with a minimum adequate standard of living. In seeking to meet this goal, Australia has traditionally placed a higher weight on poverty alleviation than on income maintenance compared with many other countries. Most OECD countries have systems that provide both social insurance related to previous earnings and tightly targeted social assistance for poverty alleviation.

Australia's emphasis on poverty alleviation means that it has one of the most targeted and redistributive transfer systems in the OECD. This is largely because of the unique nature of the income support system. Australia has a 'flat' rate structure that does not take into account previous earnings and is financed from general government revenue. Assistance is not time-limited and is targeted to 'need' using means tests that are relatively generous compared to other social assistance schemes.

Principles

The primary purpose of government assistance payments is to ensure a minimum adequate standard of living, taking into account individual circumstances and prevailing community standards.

The design of the income support system, including amounts of payments and means test withdrawal rates, should take into account how the income support system and the personal income tax system together affect incentives to work and save. Design of the income support system should also take into account overall budget sustainability.

The main features of the Australian system should be retained. These are its targeted and category-based income support payments and family assistance, paid to income support recipients as well as working families.

Public spending on cash benefits in Australia is lower than in many other countries and is only 70 per cent of the OECD average. Australia has the most progressive benefit system in the OECD. Because of the design of assistance payments and taxes, Australia's system of redistribution is also very efficient in that there is minimal churning,[1] and most money is transferred to low-income households (Whiteford 2009).

The combined redistributive effects of the personal tax and transfer system are substantial at the aggregate level compared to overseas systems. However, payment adequacy, structure and incentives could be improved.

Government assistance payments comprise cash payments to individuals for income support, payments to families to help with the costs of raising children, and subsidies for

1 Tax–welfare churning occurs when governments tax individuals and then spend tax revenues on providing income and services 'back' to those same individuals.

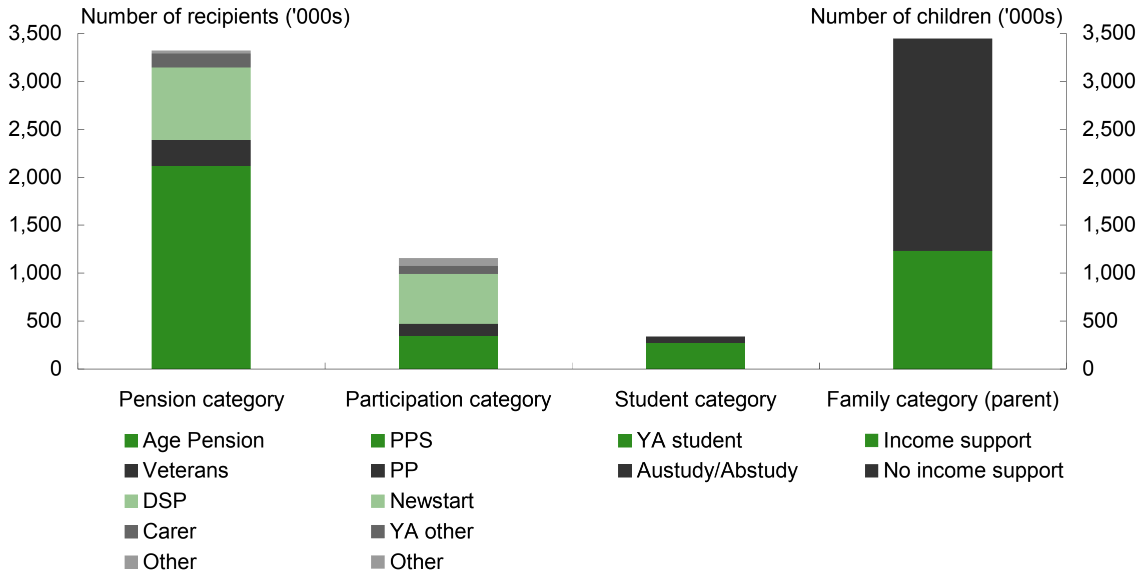
specific goods and services such as housing rent and child care. Access to these forms of assistance is means tested to target assistance to those with the greatest need. Government also provides assistance to individuals through subsidies to providers — public and private — for goods and services such as health care, education, training and housing.

There were around 40 Australian government assistance payments amounting to outlays of over $85 billion in 2008-09 and representing more than a quarter of Australian government spending. This Review has focused on the main income support payments for the aged, people with disability, the unemployed, parents and full-time students. It has also considered family assistance paid to income support recipients and working families, rent assistance and child care subsidies.

The income support system assists a large number of people — more than 4.8 million people, excluding children — and family assistance is paid to parents (receiving income support or working) in respect of more than 3.4 million children (see Chart F-1). The scope of the income support system is very broad and the Review Panel has not undertaken a detailed review of adequacy or reviewed individual payments. Instead this Report has focused on the broad architecture of the system — such as the relationships between payment categories — and its interactions with the personal tax system. In considering payment adequacy, the Review has taken the policy settings established by the Australian Government following the 2009 Pension Review as establishing the highest level of income support payment. The primary focus of this Report is the structure and relationship of working-age income support — for the unemployed, parents, people with a disability and students (see Section F1 Income support) — to the pension. The way in which assistance is targeted to individuals and families by means tests is examined in Section F2 Means testing.

Chart F-1: Income support recipients, and children for whom Family Tax Benefit Part A is paid

June 2009



Source: Australian government administrative statistics.

While overlap between the tax system and the transfer system has increased in recent decades, full integration to achieve a single system would involve common treatment for income definitions, the unit of assessment (for example, individual or family) and the period of assessment. While full integration may be technically possible in the future, it is considered that assessment of need in the Australian transfer system and capacity to pay in the tax system are sufficiently different to warrant retention of a categorical means tested income support system based on joint assessment of need for couples. This differs from the tax system, where capacity to pay is assessed on an individual basis, on an annual rather than fortnightly basis.

An important reason to improve the income support system is to make it more work-focused for more people. Structural ageing of the Australian population makes it particularly important that people in the community who wish to and have some capacity to work should not be discouraged from doing so by the personal tax and transfer system. But structure of income support alone is not sufficient, as Whiteford (2009) has concluded:

> Among the most disadvantaged and long-term jobless the problems appear to include very low levels of educational attainment (around 60 per cent having Year 10 qualifications or below), lack of access to reliable transport, relatively unsafe neighbourhoods for families with children, and complex personal problems including poor health and disabilities among adults and children. While it is possible that poorly designed tax and transfer systems might exacerbate these problems, it is difficult to see that transfer reform can resolve them. Instead, what seems more promising for these groups is a more effective mix of services that support participation generally (for example, better child care) plus targeted employment support programmes and activation policies (p. 30).

As stated earlier, the primary purpose of government assistance payments to individuals is to provide a minimum adequate standard of living. Poverty alleviation is a central feature of this purpose, but if poverty has dimensions beyond income then an income support system will not be sufficient to eliminate it. In the absence of measures that address these other dimensions there are limits to what the income support system can achieve. It may in fact entrench poverty if income support creates a barrier to employment.

In an influential work, Sen (1992) proposed that poverty is a function of capability — in effect, the choices people have in life. In this view, income is only one dimension of poverty — depending on the social surroundings, such things as poor health, poor education, poor family life or poor political voice can all be seen as valid measures of poverty because they limit individual capability and hence autonomy and happiness.

Significantly, these different dimensions can vary over time and across societies, which means that the importance and nature of instruments to address these dimensions — such as through the income support system — can also vary over time. It is difficult to predict the evolution of future social attitudes and arrangements, so policy choices will primarily reflect current Australian society.

Viewed in this way, alleviating poverty also involves reducing disincentives to work created by the tax and transfer system. This could include changes to payment rates, income withdrawal rates, activity tests, and access to child care, rental subsidies and other services.

Therefore the impact of all aspects of the tax and transfer system should be considered — including cash transfers, subsidies for housing, child care, concessions and other social services. While some of these areas are outside the Review's terms of reference, parallel reforms in aged care, disability and employment services will be crucial to managing the pressures of an ageing population. These pressures include the growing unmet need for aged care, and the need to ensure a high level of employment and a productive workforce.

The current disability service system is fragmented, insufficient to meet current needs, difficult for people to access, and has no incentives to promote increased efficiency or effectiveness. This system will face considerable challenges in the future in meeting the demand for accommodation, care and respite services for people with a severe disability. Despite increased spending, the rate of growth in demand is around 7.5 per cent. In this context the Productivity Commission will explore the merits of a national disability insurance scheme and review the efficiency, effectiveness; sustainability; case for increased investment (including the private sector); consistency of access; and planning for lifelong care in the provision of disability services.

There are two particular demographic groups — single parents and people with a disability — for whom increases in employment rates could substantially improve outcomes.

Income support

The income support system is a crucial social institution. As in the past, it will need to continue to be adapted to changing social and economic needs (see Section F1 Income support).

The primary focus of the income support system has been and should continue to be the provision of a minimum adequate level of income to people who are unable to support themselves through work or their savings. This focus on payment adequacy, however, has to be balanced with incentives to work. And payments need to be seen as affordable, sustainable and fair by the community at large.

There are large differences in rates and conditions of payment for people of working age. These differences produce very different outcomes for people with similar capacity to work. They can create disincentives to work or incentives to move to non-activity tested payments.

There should be three primary payment categories that reflect societal expectations about the level of work that can reasonably expected to be undertaken by an individual — a pension category where there is no expectation of work; a participation category for those who are expected to work now or in the near future; and a student category for those undertaking full-time study in an approved course. Rates of payment for those in the pension category should generally provide a higher level of adequacy than rates in either the participation or student categories.

To improve equity, the current differences in rates of payment should be reduced through increases in the single person's rates of payment in the participation and student categories. These single rates of payment would be lower than in the pension category; however, increases over time in the rates of payment should establish a consistent treatment of households of different size and composition based on the current relativities between the single and combined couple rates of payment in the pension system.

Under present indexation and benchmarking arrangements, the relative adequacy of allowances diminishes over time relative to pensions because different indexation methods apply. The last adjustment to the single rate of allowance — apart from normal price indexation and compensation for the goods and services tax — was in 1994. Similarly, youth rates of allowance have not been increased since 1987 when Austudy was introduced. Once established, relative levels of adequacy should be maintained over time. This could be achieved by a consistent approach to indexation across the three payment categories. But it should be noted that developing a consistent indexation regime that meets community expectations and is fiscally sustainable is challenging.

Means testing

Means testing is an important tool for targeting government payments to those with most need and for managing the sustainability of the transfer system (see Section F2 Means testing).

The transfer system should have a broader assessment of means than the tax system, which is focused on a person's ability to pay. The concept of means for income support payments should include not only income but also a person's ability to generate an income from their assets.

Means test arrangements should ensure that people on the same payment with similar means, including their income and their assets, receive an equivalent level of income support or other assistance.

As means testing has similar economic impacts as taxation, the settings for a means test should have regard to its impact on a person's decision to work and save as well as its primary objective of targeting government payments.

The current means test for income support payments is not as equitable as it could be because it results in people with similar need for support and the same level of means receiving different rates of income support. This reduces the fairness of the system and creates incentives to hold wealth in particular types of assets. In its strategic report on the retirement income system (AFTS 2009) the Review Panel foreshadowed that there should be a comprehensive means test that replaces the assets test by extending the income test by deeming returns on a greater range of assets.

Assistance for families and youth

Family assistance (including payments for dependent youth) is the part of the transfer system that has the greatest overlap with the tax system because it is paid to many households with children where parents are not receiving income support. Because family payments can be substantial and are means tested, they raise effective tax rates for both recipient and non-recipient households. Consequently, family assistance has considerable potential to affect incentives to work.

Because family assistance and income support for dependent young people are similar in nature, these forms of assistance are considered together in the report in Section F3 (Family and youth assistance). Rates of payment for income support recipients aged under 21 (22 for full-time students), including rates of Disability Support Pension and Carer Payment, need to be considered in the context of the principles underlying family assistance rates and in the context of the principles underlying income support rates for adults. These issues are also discussed in Section F3. Australian families are increasingly balancing work and family responsibilities. The workforce participation rate of secondary earners, who in most cases are women, has risen steadily over the past few decades. The design of the system needs to be responsive to that.

The tax and transfer system can impact on the benefits of working relative to the benefits of not working. This can include the choice to work or to take care of children at home. It is therefore a major influence on some parents' ability to participate in the workforce. The system is inherently biased against paid work because of the taxation of wage income (but not home production), the removal of benefits as earned income increases and the availability of government payments as a substitute for paid work.

The current system of family assistance can be rationalised and remodelled to create a family assistance program that is simpler, more transparent and provides greater support where needed. Support provided through family payments should be designed to assist with the direct cost of children, while support for adults (including parents) should be provided through income support payments.

The family assistance system includes a number of payments with overlapping objectives. This increases the compliance costs for parents and increases the challenge of designing a system that is fair to families in different circumstances. The existence of multiple payments also results in overlapping withdrawal rates, which increases effective rates of tax.

Family payments should be the main form of assistance for children up to the age of 18 or until the completion of secondary school. Beyond these points, youth payments alone should be available and should be focused on encouraging study, training or workforce engagement. There should be a seamless transition from family payments to youth payments. Youth payments should be the main form of income support from the age of 18 until the age of independence.

The rates of youth payment should reflect that youths generally have lower needs than adults, but should be sufficient to support investment in education, training and other capability-building activities. Youth rates should not favour unemployment over education and training. Youths in different living arrangements and personal circumstances have different needs, for example young people living away from home have higher costs than those living at home.

Access to high-quality and affordable child care is important to facilitate the workforce participation of parents, particularly secondary-earner parents and single parents with the primary care of children. For parents who use child care in order to participate in paid employment, child care is a cost of employment. The costs of child care may mean that in the short term parents receive minimal financial benefit from returning to work, even though the long-term gains from working are much greater for parents and their children, and for the broader community when this lowers reliance on income support. Helping parents to access good quality and affordable child care can help overcome these barriers to workforce participation.

The level of child care assistance currently provided to families is broadly adequate. However, the current payment structure could be simpler and more transparent (see Section F4 Child care assistance).

Rent assistance

The purpose of rent assistance should be to ensure that adults with limited means can afford to live in an adequate standard of rental housing (see Section F5 Housing assistance).

Rent Assistance payment rates should be increased so that assistance is sufficient to support access to an adequate level of housing. Maximum assistance should be indexed to move in line with market rents. Rent Assistance should be extended to public housing tenants, with recipients generally paying rents that reflect market rates, subject to transitional arrangements.

A new source of funding should be made available in respect of the tenants who have high housing needs, such as those with high costs due to disability or people likely to face discrimination in the private market. The payment would be based on the needs of recipients and where practical directed by them to providers of their choice.

The Australian government and the States should retain the option of providing capital for housing construction.

Transfers tied to goods and services

While transfers are usually thought of as cash payments, governments also provide transfers such as concessions and payments that are tied to the purchase, or supply, of a particular good or service. These transfers are often provided to encourage the consumption of goods and services that help people improve their capabilities (see Section F6 Transfers tied to goods and services).

All three levels of government are involved in the funding and provision of transfers tied to goods and services; however, the approach across the federation is not always coherent with other aspects of the tax and transfer system.

Transfers tied to goods and services can be tailored to people with high need. A person may have high health or support needs due to illness or disability, or their costs may vary depending on where they live. Determining a rate of payment based on what an average person requires can result in some people receiving less support than they need, and others receiving more. In cases where levels of need vary considerably across the population, a transfer provided as a concession may entail less risk than a cash payment of under-compensating those with high needs and over-compensating those with low needs. It can also allow people to manage their risks better by giving them access to goods and services at times when their needs are higher.

F1. Income support payments

Key points

Current income support policy settings do not adequately reflect changing employment patterns and changes in the composition of the working-age population.

Large differences in payment rates and conditions create incentives to switch to high payment categories that carry greater risk of long-term welfare dependency. Restructuring income support can reduce this risk, but only if it is clear that income support recipients are expected to find work and there is adequate investment in employment-related services.

Restructuring income support within three categories — a pension category, a participation category and a student category — would more appropriately balance payment adequacy and incentives to work and study for people in different circumstances. Pensions would be paid at the highest rate in recognition that people eligible for them are likely to rely on them fully for a long time. Participation payments would be paid at a lower rate to maintain incentives to work. Student assistance for adults would continue to be paid below the participation rate on the basis that it is intended to be supplemented by other means.

The difference in rates between the three categories of payment should be reduced, particularly for singles. To achieve this, rates of payment for the participation and student categories need to be increased to establish appropriate payment relativities. To maintain these relativities over time there should be a consistent approach to indexation across the three payment categories, although achieving this while balancing incentives to work and fiscal sustainability will be a challenge. There should also be a consistent treatment of households of different size and composition based on the current relativities between the single and couple rates of pension.

F1-1 Striking the balance between payment adequacy and incentives to work

The primary focus of the income support system is poverty alleviation through the provision of a minimum adequate standard of living to people unable to support themselves through work, savings or other means.

Societies can choose to meet this objective in a number of ways. They include negative income taxes, social insurance and category-based mean-tested approaches. A negative income tax system could be based on a single basic level of income paid to everybody and taxed at a single rate. Alternatively there could be a number of category-based minimum-income payments with different tax rates. A pure negative income tax system with an adequate basic income would involve a very high tax rate as every individual would be paid a transfer. This would be unlikely to gain public acceptance in the face of perceptions that people are being paid regardless of need, obligations or behaviour. To date, no country has instituted a pure negative income tax based scheme.

Most countries provide assistance to people's category-based life circumstances or contingencies such as old age, disability, sickness and unemployment. The two main models are social insurance and general revenue-financed means tested assistance payments. Many countries combine both approaches; however, Australia has opted for category-based means-tested assistance payments supplemented by private superannuation (including a mandatory component — the superannuation guarantee), industrial entitlements (including sick leave) and State government workers' compensation schemes.

Social insurance is based on income-related contributions and pays income-related benefits. History has shown that there is unlikely to be support for a major shift in Australia to social insurance as there is an underlying social preference for payments targeted to poverty alleviation rather than to income maintenance. Also, the transition costs of moving to a social insurance scheme could be particularly high. This would be the case even if payment levels were not increased because more people would receive a payment, or an increase in payment, which would have to be funded by higher taxes on those already in the workforce. While history and revealed preferences should not rule out major policy changes, current approaches are widely supported. For those who wish to make additional provision for possible risks, insurance arrangements are generally available.

While there is currently no strong case for a shift away from a categorical approach, the number and structure of categories — including differences in rates of payment, means tests and activity requirements — can and should reflect changing social expectations such as attitudes to work (and retirement), parenthood and disability.

Targeting support to categories of need

Categorical distinctions — such as single parenthood, disability or unemployment — assist in targeting support to those with varying need and capacity to support themselves. Such distinctions also give effect to various social judgements about who should receive assistance.

Within a categorical means tested system of income support, the most important design elements — aside from the eligibility criteria for different payments — are the adequacy or rate of the payment, means tests (how assistance is withdrawn as income rises and need falls), and participation or activity requirements. Participation requirements primarily define who is and who is not expected to undertake an approved activity in return for assistance. Requirements are based on social expectations of particular groups to undertake paid work in order to support themselves. For unemployed adults, the primary activity requirement is to look for full-time work, while primary carers are subject to part-time activity requirements when their youngest child is aged six. Disability Support Pension and Carer Payment are not subject to participation requirements, as recipients are either unable or unavailable to participate in significant part-time work in the open labour market.

Another argument in favour of categorisation is that different groups of people respond differently to the incentives they face, particularly in relation to work. Total costs and disincentives to work may be minimised if rates of payment and means tests reflect group differences (Akerlof 1978). However, there can also be significant differences within groups, and this may impact on the effectiveness of incentives targeted to a particular group (Viard 2001).The practical effect of varying the incentives faced by different groups of people is to maximise the number of hours worked in the economy — maximising full-time work by those able and available to work full-time and maximising part-time work by those who are not able, not available or not expected to work full-time (Saez 2001; Kaplow 2006).

A disadvantage of categorical income support systems is that they are complex. There is also a tendency to increase complexity by creating new categories of payment and additional means tests in an attempt to target the payments ever more tightly to need, while ensuring that no deserving group is left out. There is certainly an optimal level of categorisation[2], though determining this would be difficult in practice. The level would in any event vary with social, economic and labour market conditions. However, one factor to take into account in determining the effectiveness of existing categories is the extent to which differences in rates and conditions of payment give people an incentive to change their category.

To the extent that it is possible for the same person to be eligible for different payment categories, or to experience large changes in assistance without commensurate change in circumstance, there will inevitably be concerns with horizontal equity (that is, treating people in similar economic circumstances similarly). For example, a person with disability who is assessed as being able to work 14 hours a week rather than 15 hours a week can receive a higher level of assistance and lower rate of withdrawal of income support. Another example occurs for single parents on their youngest child's eighth birthday. Even if the single parent was already working 20 hours a week, their disposable income would fall significantly on the birthday of their child.

Principles

Income support payment categories should be limited in number and reflect current social expectations about the responsibilities that individuals in different circumstances have to look for work.

Differences in the treatment of individuals in similar circumstances on different payments should be limited to minimise horizontal inequities and disincentives to work created by categorical differences. This means that minor changes in personal or family circumstances should lead to only minor changes in payment conditions.

Payment adequacy, poverty and incentives to work

There is no single agreed definition of income poverty, nor is there an agreed way to measure the adequacy of support rates. What would have been seen as an adequate level of payment according to 'community standards' in 1950 might not be seen as adequate today, and what might be seen as adequate today might not be seen as adequate in 2020. Aside from changes in living standards and the distribution of work and income, views about the best way to avoid or alleviate poverty can also change.

2 This can be defined as 'the point where the marginal social benefit equals the marginal social cost in terms of distortions in decisions of what group to belong to' (Moffitt 2008, p. 11).

The level of payment has to be balanced with incentives to work. It also needs to be seen as affordable, sustainable and fair by the community. These considerations would support a lower level of payment for those expected to work full-time compared to those not expected to work and likely to be reliant on income support for a long time. For all those not expected to work, maintaining incentives to work is not as crucial. Social expectations that individuals would be able to share resources such as income or accommodation — with parents or a partner — may also justify different rates of payment.

While there is no clear principle for establishing the level of payment for those who are expected to work, the rate once determined should be maintained against some measure of community living standards. One measure that has been used for pensions is a wages benchmark. Alternatively, there could be indexation to some other measure with regular review of whether this was continuing to meet community standards. Indexation of the payment solely to prices can reduce adequacy relative to members of the community who work.

Principles

The highest level of payment — pensions — should be paid to those who are not able or expected to work and who are likely to be reliant on income support for a long time. Rates of payment for those who are able and expected to undertake significant levels of work — allowances — should be lower in order to maintain incentives to work.

Relativities between pension and allowance rates of payment should be maintained by indexing all rates by the same measure of community standards.

The higher the level of income support for people of working age, the more likely it is a disincentive to work. The point at which an individual will choose to work will vary with individual characteristics (such as skills, experience and capability reflected in a person's potential wage rate), work preferences (for example, to work full-time, part-time or not at all), and the design of the tax and transfer system (such as income support participation requirements and withdrawal rates as income from work increases).

Participation requirements ensure that income support recipients with the capacity to undertake paid work actively seek such work. Participation requirements also provide assurance to the broader society ('taxpayers') that those experiencing a period without sufficient means are not only provided with an adequate level of income but are obliged to make appropriate efforts to reduce their reliance on government assistance.

Another consideration is the level of income support relative to minimum wages, and minimum wages relative to median earnings, as this will determine the number of people whose workforce incentives may be affected.

These factors interact. For example, where there is a high minimum wage and a moderate payment rate, it is possible to have a high income support withdrawal rate with little impact on incentives to work. This would occur where individuals wish to work full-time and income support is withdrawn well before the minimum wage. This conclusion would be less clear if there were limited labour demand for low-paid full-time work, but some demand for low-paid part-time work.

In addition, some people prefer part-time work to non-employment but prefer non-employment to full-time work, such as some people with caring responsibilities or primary care of young children. Others may not be able to work full-time (due, say, to disability) and would be adversely affected by an incentive structure that favoured full-time work.

If income support is withdrawn beyond the minimum wage there would be limited impact on incentives to work for individuals who prefer part-time work. This is likely to be the case for many primary carers of young children. However, such a design may create disincentives to work if individuals prefer full-time work.

In considering the effect of any incentives to work, it is important to consider both *substitution effects* and *income effects*. A substitution effect is where an improvement in the return from work, for example due to either a withdrawal rate or marginal tax rate reduction, leads to an increase in the hours worked, with a reduction in the return from work leading to a fall in the hours worked. Income effects occur when additional income — for example, from an income support rate increase or an effective tax rate reduction — reduces hours worked, as the person can achieve a similar standard of living with less work. Conversely, the income effect could mean that a rate reduction or withdrawal rate increase would lead to an increase in hours worked.

These effects are present together in almost any change to the financial arrangements of income support. It is important to consider both effects at the same time. For example, a reduction in the withdrawal rate of Parenting Payment Single (PPS) may have the effect of increasing the return from working. But it may also increase disposable income for those on PPS, thereby reducing or negating the positive effect of the reduction in the withdrawal rate. Put another way, if people can achieve an adequate standard of living by only a limited amount of work they are more likely to do so. In any given change, which of these effects dominates is a matter of empirical evidence — theory will not tell us which is more important. However, in most circumstances the substitution effect tends to dominate the income effect where income levels are low, in which case higher taxes and tighter means tests will reduce the amount of work by those who face them. This is less of an issue where a person is highly motivated to work and can attain enough work to get off payment altogether.

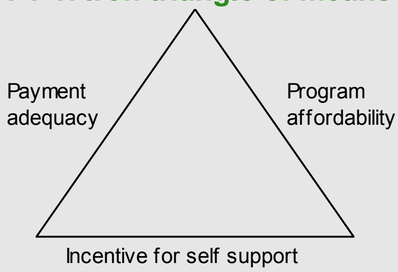
Ideally, the rate of payment to people expected to take up full-time work should remain well below the minimum wage and cut out before the minimum wage. This would help to ensure that people can see a clear benefit from work. The effectiveness of this minimum wage constraint depends on a number of factors, including how easy it is for people to qualify for higher-rate payments such as the Disability Support Pension or Parenting Payment Single, and the structure of payments for children as parents increase their work effort. It will also depend on the overall need to ensure that recipients take up part-time or intermittent work where it is the only work available to them.

The trade-off between payment adequacy and program affordability or sustainability is outlined in Box F1-1. To reduce disincentives to work without reducing payments for income support recipients would involve either relaxing (or removing) means tests or targeting payments to people according to characteristics such as age or duration on payment. The income support system uses both of these strategies.

Box F1-1: Balancing adequacy, incentives and affordability

With any income support payment, there is an 'iron triangle' associated with means testing (see Chart F1-1). The generosity of the payment (including the breadth of its coverage) needs to be balanced by how much it costs taxpayers, and the incentive for people to get off the payment by earning income. Improving one of these worsens one or both of the others.

Chart F1-1: Iron triangle of means testing



To improve incentives without reducing the payment level there are only two possible strategies:

- relax or remove some means tests — apart from raising inevitable questions of 'middle class welfare' and 'churning', this would greatly increase the cost to taxpayers and jeopardise affordability; or
- reduce or remove the payments to some people on grounds other than income, such as age or an expectation that duration on income support will be short — this would reduce the total income of those people and may compromise adequacy.

Whether the pattern of incentives is changed by adjusting the means test or using a tax instrument such as an earned income tax credit does not affect this trade-off; it simply changes it from a question of welfare design to a question of tax design. Which is the better approach depends on other issues such as administrative practicalities, signalling effects (such as the weight given to work), and tax churning.

F1-2 Arrangements need to reflect changing realities

The income support system is a crucial social institution. In the future as in the past it will need to continue to be adapted to changing social and economic needs. Changes in workforce participation, the level of unemployment, and the mix of full-time and part-time work all have an influence on the numbers receiving income support.

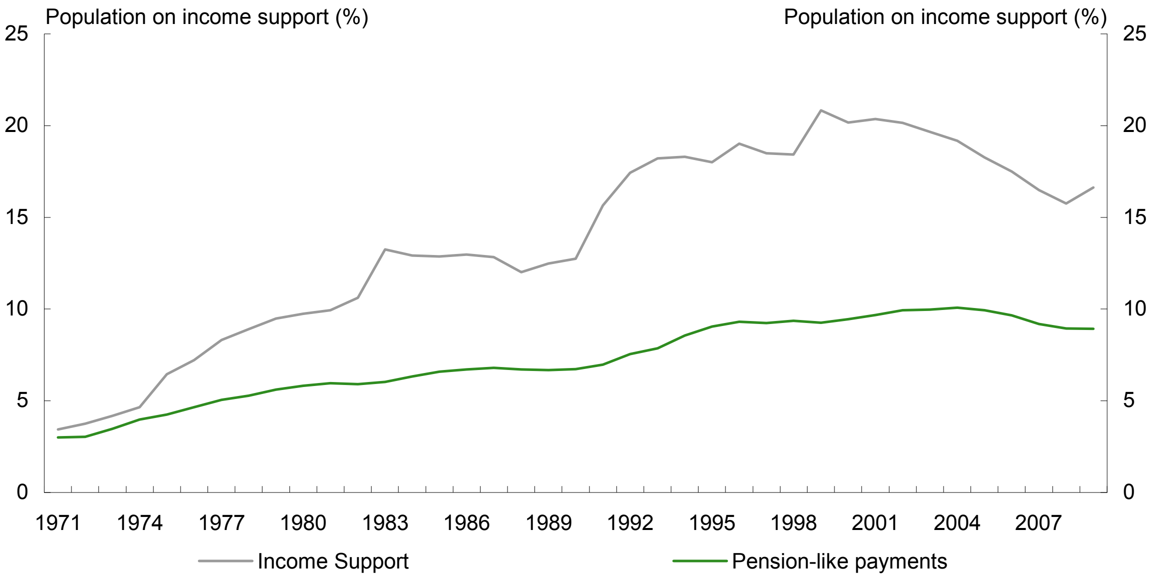
Working-age income support receipt and employment trends

From 1970 the percentage of the working-age population receiving income support increased steadily for nearly 30 years (see Chart F1-2). There are many reasons for this growth, such as the ageing of the baby-boom cohort, recessions, industry restructuring, the growth of female workforce participation, and increasing rates of single parenthood. Policy has also contributed to this growth, in some cases by allowing people to receive income support while working. In other cases decisions to target payment increases to particular groups has increased incentives for some people to remain on and for others to seek to qualify for higher-rate, non-activity tested payments, such as Disability Support Pension (DSP).

The nature of work has changed considerably over the past 40 years, as have attitudes to women depending on their partners' income. This has been reflected in continued changes to the tax and transfer system. Partners of the unemployed have been required to claim income support payments in their own right. Payments made to women because they were wives of age or disability pensioners or partners of allowance recipients have been closed to new entrants. Payments to single parents, introduced in response to the rising incidence of single parenthood and concerns about poverty in that group, have been adjusted in line with increasing rates of workforce participation of mothers and women more generally. The employment rate of women has increased considerably since the 1970s (from 39 per cent in 1971 to 55 per cent in 2008). The number of people working part-time has also substantially increased — from 15 per cent of total employment in 1978 to 28 per cent in 2008. Women accounted for 70 per cent of part-time employment in 2008.

In the early 1970s, unemployment was very low. Working-age income support largely comprised pensions for war veterans, people with disability, women who were eligible for the Age Pension at age 60, wives of age and disability pensioners, and widows. The proportion of the working-age population on pensions was around 3 per cent. Today the proportion is about 9 per cent, which is over half of all working-age income support recipients.

Chart F1-2: Percentage of working-age population receiving income support and pension payments (1971–2009)[(a)]



(a) Pension payments include: Age Pension; Disability Support Pension; Parenting Payment Single; and Carer Payment.
Source: Annual ABS population figures for people aged 15 to 64 and Australian government administrative data.

After nearly 30 years of growth in working-age income support receipt, the favourable labour market conditions from the late 1990s to 2008 led to a consistent downward trend in the proportion of the population receiving working-age income support. This was largely due to falling unemployment, but in the fours years preceding the global financial crisis the proportion of the working-age population on working-age pensions (particularly DSP and Parenting Payment Single) also started to fall as a result in part of welfare to work measures. This lag between falling unemployment and a fall in the proportion receiving working-age pensions is a result of two factors: first, the small number of people who move off payments such as DSP to full-time work and, second the fact that lower skilled and more marginal workers are among the first to lose their jobs in economic downturns and the last to regain jobs in the recovery phase. The key to preventing people who have a reasonable capacity to work from becoming dependent on income support is to reduce inflows to pension payments. Favourable economic conditions are a pre-requisite, but income support settings can also assist by reductions in disincentives to work, including by making payments conditional on job search for more people.

Payment adequacy and categories

Category-based systems of income support can provide different rates of payment, and conditions, to people in different circumstances. While theory cannot tell us what the rates should be for the different payments, a number of factors can be considered. These include '*community standards*', expected *duration* on payment, *incentives* to work and the overall *coherence* of the income support system.

Payments are currently paid at two main rates, with a higher rate for pensions and a lower rate for allowances.[3] Student and youth payments are paid at a rate below the general allowance rate unless children are present. Pensions are paid to eligible aged and people with disability, carers and single parents whose youngest child is less than eight years.

Newstart Allowance is paid on the basis that a person is expected to actively seek and accept suitable work, consistent with their ability and availability for work. For most recipients the expectation is for full-time work; however, part-time requirements apply for a person with disability who has a partial capacity to work and primary carers of dependent children aged under 16. Other groups of people are exempted from requirements — for example, they have a temporary incapacity for work, are attending rehabilitation or are in the period of confinement prior to childbirth. Other allowance payments with the same rate structure and means-testing arrangements provide for specific contingencies that limit a person's ability to work, such as short-term sickness or illness, or that limit their availability for work, such as the primary care of a young child. As with single parents with a young child, partnered parents with young children are not expected to actively seek and accept suitable work. This decision is left up to the individual.

The Pension Review considered the adequacy of the Age Pension, Carer Payment and Disability Support Pension. It was not required, however, to comment on the relationship between these pensions and other payments (such as Parenting Payment Single) and allowances (such as Newstart Allowance). In establishing a rate it ' … considered that the full rate of pension should provide a basic acceptable standard of living for those who are wholly reliant on it, often for extended periods, without any assumptions about access to private income or assets' (FaHCSIA 2009, p. xii). The Pension Review considered that the level of assistance should move in line with community standards.

3 Since September 2009 Parenting Payment Single, although a pension, is paid at a lower rate. Also Austudy is paid at a lower rate than the main Newstart Allowance rate.

The single rate of allowance is currently $228 a week whereas the single rate of Disability Support Pension (including Pension Supplement) is $336 a week, a difference of $108 a week. The difference is $89 a week where a single person receives the higher allowance rate.[4]

The size of this difference is due to historical differences in policy settings that have allowed this gap to increase over time, but some difference in the level of payments can be justified on the basis of differing needs and presenting different incentives to different groups. If a person is expected to take immediate full-time work whenever they can, it is important that they are much better off taking that work. If a person is never expected to work at all, then incentives for them to do so are irrelevant and the rate of assistance should be sufficient to meet the minimum community living standard. If a person is also receiving family assistance or youth payments for dependent children it is important that the adult's rate of income support provide for a similar standard of living so as to not compromise the assistance for children.

Harder to justify is the fact that rates of pension and allowances are not merely different, but the gap between them is widening. Since 1997 pensions have been increased in line with the greater of indexation to prices and benchmarking to Male Total Average Weekly Earnings — a measure of community standards — and allowances to prices. This has resulted in a growing gap between allowance rates such as Newstart Allowance and Parenting Payment Partnered and pension rates such as DSP and PPS. As economic growth causes real wages to increase, the gap between the two will continue to grow. If the current indexation arrangements remain in place, it is likely that by 2040 a single pensioner would be paid more than twice as much as a single unemployed person (see Table F1-1). A continuous decline in Newstart Allowance against community standards would have major implications for payment adequacy and the coherence — in terms of horizontal equity — of the income support system.

Table F1-1: Single adult Newstart Allowance compared to single adult pension
$ per fortnight

	1980	2010	2040 (projected)(a)
A Single allowance rate	$51.45	$456.00	$902.05
B Single pension rate	$57.90	$671.90	$1,945.40
A/B	89%	68%	46%

(a) Assumes 2.3 per cent per annum CPI growth, 4 per cent per annum MTAWE growth.
Source: Australian government administrative data.

Another measure of community standards — apart from the pension, which is benchmarked to Male Total Average Weekly Earnings — is net (after personal income tax) median income. The OECD considers that a person is in poverty if their income falls below 50 per cent of equivalised median disposable incomes. Using this measure a single person who received Newstart Allowance for the full year in 2007–08 had an income of 31 per cent of net median income.

Measuring poverty by a relative financial measure is always problematic and there is no accepted measure of poverty for policy purposes (FAHCSIA 2008, p. 15). However, poverty analysis can be used with other analyses to identify areas of concern.

4 The higher single rate of allowance is paid to recipients aged 60 and over, after nine months of continuous income support receipt; and to other singles with the care of children, including those with greater than 14 per cent of the care of a child aged under 16 or a Youth Allowance recipient aged under 18.

Using the OECD poverty measure, the Melbourne Institute estimated that around 12 per cent of Australians were in poverty in 2006 (Melbourne Institute 2009). It is important to note that much of this poverty is not persistent. While in any given year 12 per cent of Australians may be living in poverty according to this measure, most only experience poverty for short spells. Only 7.9 per cent of Australians were below this poverty line for four or more years of the survey. Only 2.6 per cent of the population were below this poverty line in all six years. Among the working-age population the Melbourne Institute analysis indicates that the household types most likely to be in income poverty are single parents (19.4 per cent) and single people (19.5 per cent). The rate of children living in poverty is significantly higher (28 per cent) for those living with one parent, compared with those living with both parents (6 per cent).

Duration on income support

While expected duration is a reason for differences in payment rates, there is the question of whether actual durations on income support are different enough to expected durations to justify large differences in payment rates. It needs to be borne in mind when interpreting actual duration data that it is an outcome of underlying economic conditions, payment conditions, and personal characteristics. The data used in the following analysis cover a period of favourable labour market conditions. Payment conditions also changed during the period, particularly for single parents, which led to transfers to other payments such as Newstart Allowance, Disability Support Pension and Carer Payment.

Age and Disability Support Pension recipients have the longest durations. In the ten years to 2007 Age Pension recipients spent 8.9 years on average on income support and DSP recipients spent 8.2 years (FaHCSIA 2008, p. 33).

Between July 1999 and July 2008 — a nine-year period — an average of 4.5 years was spent on working-age income support by single parents who became eligible for Parenting Payment Single in 1998–99. This compares with 3.2 years for Parenting Payment Partnered recipients and 2.6 years for Newstart Allowance recipients. Average durations are considerably higher for those who were already on income support at the beginning of 1998-99. Parenting Payment Single recipients spent an average of 6 years compared to an overall average for all working-age income support recipients of 4.8 years (see Table F1-2).

Newstart Allowance recipients have the lowest average durations on income support because a large number get work and exit income support within a year. However, differences in average durations between those on Newstart Allowance and PPS and DSP could reduce in coming years because of increased numbers of single parents and people with a partial work capacity who will receive Newstart Allowance following *Welfare to Work* policy changes in 2006.

About a quarter of current Newstart Allowance recipients have been continuously on income support for over two years, even in the very strong labour market of recent years.

Table F1-2: Average time on working-age income support in the period July 1999 to July 2008

For new recipients in 1998–99 or existing recipients at the beginning of 1998–99[(a)]

Recipient type	Average number of years in receipt of income support	Average years as a percentage of the whole period (%)
New Newstart recipients	2.6	29.2
All Newstart recipients	4.4	49.2
New Parenting Payment Partnered	3.2	35.2
All Parenting Payment Partnered	4.9	54.4
New Parenting Payment Single	4.5	50.0
All Parenting Payment Single	6.0	67.3
All New recipients	3.1	34.2
All recipients	4.8	53.0

(a) Excludes time spent on the Age Pension. New recipients are individuals who had previously had at least a 6 week period without income support, or 13 weeks where a previous period of income support was greater than 46 weeks.
Source: Australian government administrative data.

A substantial number of working-age people, including some on Newstart Allowance, spend comparatively long periods on one or more working-age income support payments. These long durations are consistent with the large number of movements between payment categories while on income support, often as the result of commonplace life events such as a change in partner status, a birthday for the recipient or their children, or a move into study or employment.

Table F1-3 shows the payment-to-payment moves of working-age people during 2008. It shows that around 307,500 people transferred between categories in the working-age income support system in 2008 (compared to about 682,100 who exited income support and 870,900 who moved to these payments from outside the income support system). There are a great variety of moves. A large number of people become unemployed and access Newstart Allowance and then move off payment relatively quickly (about 60 per cent have been on Newstart Allowance for less than one year and 24 per cent, or 135,000 people, have been on for more than two years).

More people move to Carer Payment and DSP from another income support payment than from outside the transfer system. A similar number move from other payments to Parenting Payment Partnered (29,800) and Parenting Payment Single (34,700) as move from outside income support (32,300 and 39,700 respectively).

Table F1-3: Working-age payment transfers, rounded to the nearest 100 (2008)

	Transfer from(a)											
Transfer to	ABY	AUS	CAR	DSP	NSA	OTH	PPP	PPS	YAO	YAS	Total	Inflow(b)
ABY	0	0	0	0	1,400	500	100	100	700	400	3,100	6,746
AUS	0	0	100	0	8,100	200	500	600	0	500	10,000	16,000
CAR	100	200	0	600	10,700	1,500	3,100	3,400	700	400	20,500	16,300
DSP	100	100	1,500	0	34,900	3,400	1,800	4,600	1,300	800	48,400	38,500
NSA	1,300	8,400	6,300	1,300	0	5,500	5,900	17,700	13,800	11,500	71,800	375,500
OTH	0	100	1,300	100	1,900	0	100	400	2,900	2,000	8,900	37,400
PPP	100	300	300	0	8,000	500	0	17,600	2,800	300	29,800	32,300
PPS	100	200	900	100	11,800	300	16,200	0	4,700	400	34,700	39,700
YAO	2,600	0	200	100	0	1,900	200	600	0	48,500	54,200	75,900
YAS	100	0	100	0	3,700	500	100	100	21,600	0	26,200	135,800
Sub total	**4,400**	**9,200**	**10,700**	**2,300**	**80,400**	**14,400**	**27,800**	**45,100**	**48,400**	**64,800**	**307,500**	
AGE	0	0	3,500	34,500	8,600	20,800	100	200	0	0	67,600	96,900
OFF	5,000	14,700	9,400	30,800	322,000	38,100	43,300	51,900	74,000	92,900	682,100	
Total	9,400	24,000	23,500	67,700	411,000	73,300	71,100	97,100	122,400	157,700	1,057,200	870,900

Recipient loses income — Recipient gains income — Recipient income faces little change

(a) ABY: ABSTUDY; AUS: Austudy; CAR: Carer Payment; DSP: Disability Support Pension; NSA: Newstart Allowance; OTH: Other payments (including Sickness Allowance and Special Benefit); PPP: Parenting Payment Partnered; PPS: Parenting Payment Single; YAO: Youth Allowance Other; YAS: Youth Allowance Student; AGE: Age Pension; OFF: off payment.
(b) Excluding transfers from other payments and people who had not previously been on a payment.
Source: Australian government administrative data.

In 2008, some 57,000 people transferred from Newstart Allowance to a higher-rate pension payment with no requirement to look for work (mostly DSP, Carer Payment or PPS). There were also 17,600 movements from PPS to PPP (a reduction in payment associated with changed partner status, resulting in a drop to an allowance rate and means test) and 16,200 moves in the opposite direction involving a potentially large increase in income support for the primary carer.

There were about 8,000 moves from PPS to a higher payment than Newstart Allowance (DSP and Carer Payment) and about 18,000 from PPS to Newstart Allowance (which can involve a large drop in income). The latter is continuing to increase as a result of the 2006 *Welfare to Work* policy changes. The death of the person being cared for can result in a large drop in income. For example, in 2008 some 6,300 people (or nearly 5 per cent of people on Carer Payment) moved from Carer Payment to Newstart Allowance. Relatively few people move off DSP. Most people who do move to the Age Pension.

There are also significant numbers of movements between youth (Youth Allowance Other) and student payments (Youth Allowance Student and Austudy), and other higher-rate working-age payments such as Newstart Allowance and Parenting Payments. This most likely reflects movements due to the cessation or commencement of full-time study, for example, (movements between YAS and YAO and between Austudy and Newstart), birthdays (for example; YAO to Newstart Allowance), or the birth of a child (YA to PPS).

From one point of view the large number of transfers between working-age payments shows that the income support system is responsive to changing personal circumstances. However, it also suggests there is a large group of people with a similar capacity to work who receive very different levels of income support.

Finding

Existing categorical differences between pension and allowance rates reflect a range of decisions, including expected duration of payment. However, actual durations for some working-age recipients, even for those on allowances, can be substantial.

The large number of working-age payment-to-payment transfers indicates that large differences in rates of payment can have a large impact on many individuals.

Incentives to work

Paying income support can reduce incentives to work. The higher the payment the higher the potential impact, although this will also depend on differences in responsiveness of individuals to financial incentives.

Labour supply research would support the application of high withdrawal rates to unemployed people without the primary care of dependent children because they are more likely to prefer full-time work and respond less to changes in financial incentives. Research also supports low withdrawal rates for primary carers of young children with a preference for part-time work and for people with disability unable to work full-time because they are more likely to respond to incentives (Dandie & Mercante 2007). Current policy settings largely reflect these findings. The major exceptions are single parents with a youngest child eight or older and people with a partial capacity to work.

Single parents with a youngest child under eight face a 40 per cent withdrawal rate**.** Age pensioners, people with a disability receiving DSP and Carer Payment recipients face a 50 per cent withdrawal rate. Unemployed people, partnered primary carers, single primary carers with a youngest child aged eight or more, people with disability with a partial capacity to work as a result of a disability, and students face an income test with both a 50 and 60 per cent withdrawal rate.

Single primary carers of young children face participation requirements when their youngest child turns six but remain on a higher pension rate of payment until the child turns eight. Single primary carers with a youngest child aged eight and over with a part-time work requirement face the same income test as a single unemployed person who is expected to look for full-time work. On the other hand, a single parent with a youngest child between six and eight who is also expected to look for work faces the lowest income support withdrawal rate (40 per cent).

There are limits on the extent to which incentives to work can be improved by adjusting income support withdrawal rates. One limit is the policy trade-off between designing means tests to target payments to those expected to either work full-time or part-time. The trade-off between the two would be easy if people with different labour force responses fitted into discrete payment categories, for example, if all single parents are paid Parenting Payment Single or all people with disability are paid DSP.

Another limit is the relationship between rates of income support and withdrawal rates on the one hand, and the minimum wage on the other hand. This is important because the potential for impacting on the incentives of large numbers of people increases significantly beyond this point in the income distribution.

Current maximum single rates of payment vary as a proportion of the net minimum wage. The net replacement rate (NRR) compares the after-tax value of income support payments to the amount of after-tax income the person could receive if they worked full-time in a minimum wage job. For example, the NRR of the lower rate of Newstart Allowance compared to the net minimum wage is 46 per cent. By comparison the NRR for the standard single rate of Austudy is 37 per cent, and for DSP it is 56 per cent (see Table F1-4).

The net replacement rates increase if rent assistance or family payments are included. For example, the NRR increases from 50 to 59 per cent for a person on the higher single rate of Newstart Allowance who also receives rent assistance and pharmaceutical allowance.

While all maximum rates of income support are significantly below the minimum wage, the addition of supplements and differences in rates of income withdrawal can mean that some people receive income support while working significant hours. For a single parent with one child receiving PPS, income support (excluding family assistance) is payable up to 149 per cent of the minimum wage. This compares to 78 per cent for the lower rate of Newstart Allowance (see Table F1-4).

Table F1-4: Comparison of working-age income support and Federal Minimum Wage (FMW) ($543.78 a week)
September 20, 2009

Payment	Net income no private income ($ per week)	Net income at FMW ($ per week)	Net replacement rate(a) (%)	Transfer Payment cut-out(b) ($ per week)	Cut-out (% of FMW)
Single person					
Newstart (lower)	228	497	46	427	78
Newstart (higher)	247	497	50	458	84
Newstart, (higher with rent assistance and pharmaceutical allowance)	306	514	59	556	102
Austudy (standard rate)	186	497	37	434	80
Austudy (long-term transferee, with rent assistance)	281	527	53	594	109
Disability Support Pension (DSP)	336	597	56	743	137
Single parent					
Parenting Payment, one child (excludes family payments)	290	615	47	809	149
Couples					
Newstart single income :					
Primary earner (P1)	412	629	65	390 (P1)	72 (P1)
Partner (P2)				733 (combined)	135 (combined)
DSP/Carer (one earns FMW income)	518	824	63	1137	209

(a) Net replacement rate is income support payment after tax as a proportion of the post tax minimum wage.
(b) Payment cut-out is the point at which the last dollar of income support is paid.
Source: Australian government administrative data.

The eligibility of people at incomes above the minimum wage for income support has been a longstanding concern that has impacted on the structure of the transfer system. However, in recent decades a number of policy changes have sought to extend assistance to some people in work. These include the separation of child income support from the income support system (starting with Family Income Supplement in 1983 and culminating in the present-day Family Tax Benefit) and the introduction of sequential income testing.[5] Parenting Payment Single is paid beyond the minimum wage because it is intended to allow some level of part-time work.

It is not clear what effect these differences in relativities to the minimum wage have on employment outcomes — for example, whether they would lead to reduced or increased hours of work. For single parents and people with a limited capacity to work they may lead to increased hours of work, especially if the choice is between no work and some work. For those who are expected to work full-time they may lead to reduced hours of work. There has been no definitive quantitative analysis of this issue in Australia, largely because sufficiently detailed data to support such studies have not been available until recently. Available data on the numbers of people on Newstart Allowance who also receive income from employment show that the proportion with earnings has remained very stable over the past six years at around 20 per cent.

The majority of people who work part-time do so in response to life-cycle events (Productivity Commission 2008a, p. xxii). For these individuals, targeted tax and welfare changes may have only small effects on preferences for full-time work. It is more likely that transition to full-time employment occurs when the family circumstances change — for example, as a child gets older a parent may increase the hours they work. Also, for a substantial number of employees actual hours worked depend on the state of the labour market. At least 10 per cent of young people and working-age males working part-time said they were unable to find full-time work or they accepted part-time work because they liked the job (Productivity Commission 2008a, p. xxiii).

Trends in employment suggest that part-time work has become increasingly important in its own right, irrespective of whether or not it provides a ‘stepping stone’ to full-time employment.

Finding

There is a case for applying a low taper rate to single parents with primary care of young children. There is scope to improve the rewards for work for people with disability who have a partial capacity to work. As the cut-out points for income support already extend beyond the minimum wage for several groups of income support recipients, increases in rates of assistance or reductions in withdrawal rates would extend these further.

System coherence

The increasing difference in payment rates between pensions available to people of working age, and allowances, will also increase the impact on individuals of such common events as a birthday or relationship change. It also increases the cost to the individual of administrative decisions such as the Job Capacity Assessment (which determines access to Disability Support Pension by judging whether an individual can work more or less than 15 hours a week).

5 In sequential income testing, once a person’s income has reduced their own payment to zero, any excess over that point (‘partner income excess’) is applied to the other partner. This is achieved by an income test on partner income excess.

In September 2009 a person receiving Newstart Allowance and working 15 hours at the minimum wage had a disposable income of $338.62 a week. A person receiving the maximum rate of DSP had a disposable income of $335.95 — only $2.67 a week lower — and would not be expected to work. If they worked for 15 hours a week, they had a disposable income $143.16 a week higher than the Newstart Allowance recipient and $140.16 more than the Newstart recipient with a partial capacity to work (see Table F1-5).

Once a person receives a higher payment, there are strong reasons to avoid jeopardising it, and the evidence indicates that few people leave DSP other than to move to the Age Pension. The greater the difference between the high and low payment rates, the more critical it is to ensure that categories reflect real differences between individuals.

Table F1-5: Disposable income of income support recipients working 15 and 20 hours a week at Federal Minimum Wage ($14.31 an hour)

$ Per week, 20 September 2009

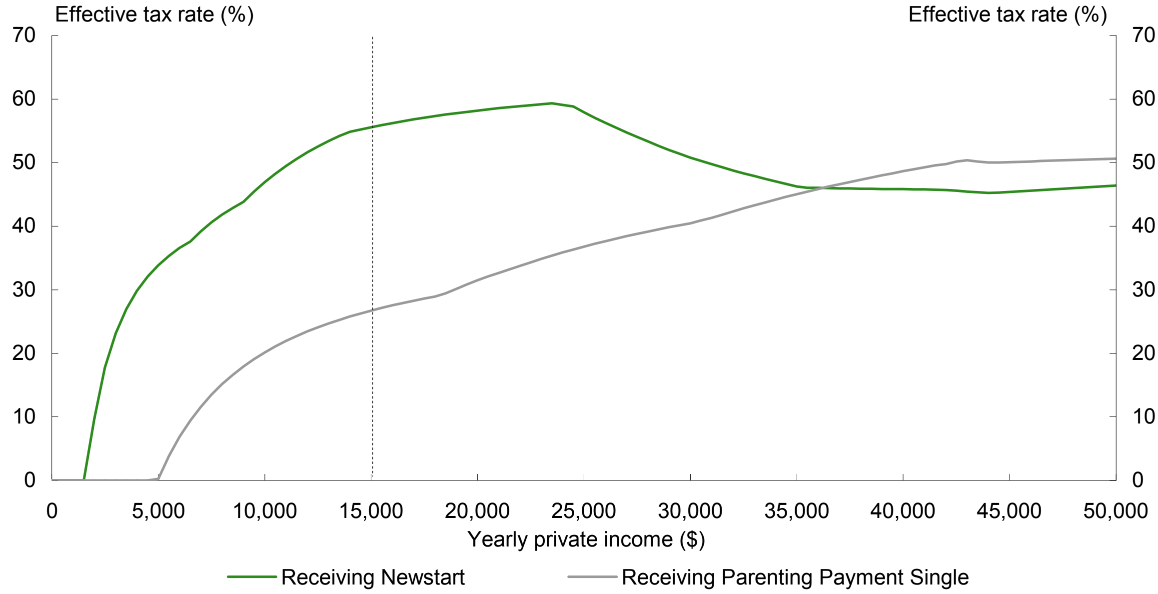
Gross earnings	No work (0)	15 hours a week (214.65)	20 hours a week (286.20)
DSP	335.95	478.78	514.55
Newstart	228.00	335.62	355.35
Newstart PCW(a)	231.00	338.62	358.35

(a) Partial work capacity greater than 15 hours a week.
Source: Australian government administrative data.

A similar issue arises for single parents at the boundary of Parenting Payment Single and Newstart Allowance when their youngest child turns eight. For example, a single parent receiving PPS and working 20 hours a week at the minimum wage (about $14,900 a year) would have a participation tax rate of 27 per cent. On the birthday of their child, this would increase to over 50 per cent (see Chart F1-3). Even though they may be working to the expected level of 20 hours a week, their income would fall by $118 a week or $6,136 a year.[6]

6 20 September 2009 rates.

Chart F1-3: Single parent[(a)] participation tax rates[(b)]
20 September 2009



(a) A single parent receiving Parenting Payment Single has a youngest child less than eight years of age. A single parent receiving Newstart Allowance has a youngest child eight or older. In this example the parent has two children.
(b) The participation tax rate is the average effective tax rate from no work to the level of yearly private income.
Source: Australian government administrative data.

Finding

Large differences in rates of payment and means test taper rates across categories can currently produce very different outcomes for working-age people with similar capacity to work. These differences can create disincentives to work or incentives to move to non-activity tested payments.

Another aspect of the current structure of income support that creates horizontal inequities is the large variation in the ratio of single to couple income support payments. Chart F1-4 compares levels of income support for singles and couples without children for various payment types. For students on Austudy without dependent children it is 50 per cent, whereas for allowance recipients the ratio is 55 per cent for those without dependent children. It is 66.33 per cent for pensioners (excluding PPS). Rates of payment for those on Youth Allowance and Austudy without children are considerably less than the adult allowance rate.

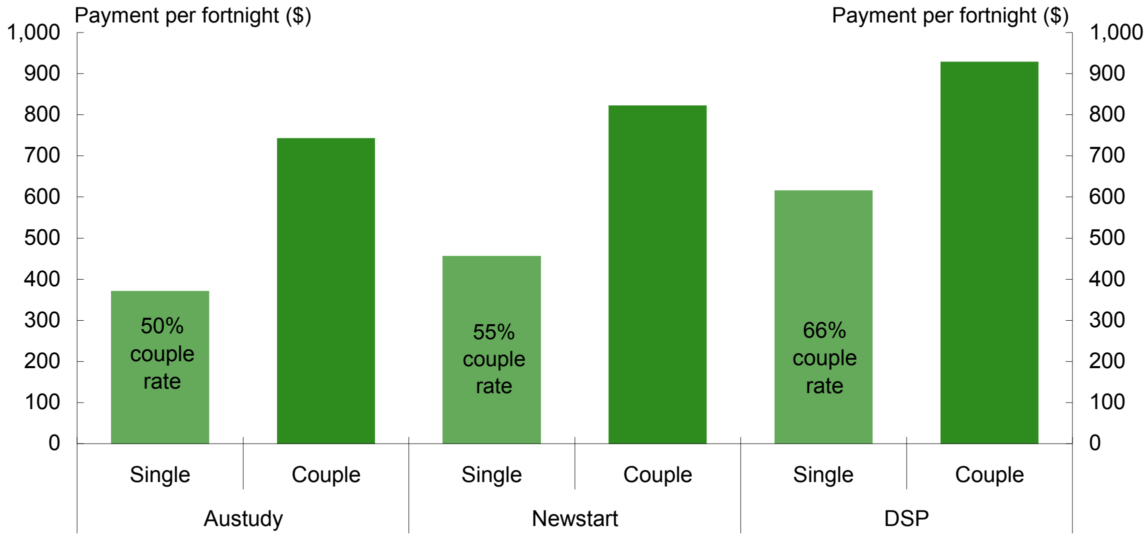
The Pension Review found that the relativity of the rate of pension for singles living by themselves and couples is too low. For single pensioners who share accommodation the existing relativity was found to be broadly adequate. A relativity of between 64 to 67 per cent was seen as more appropriate than the current relativity. A relativity approaching 67 per cent was found to be appropriate for singles living by themselves with 64 per cent reflecting the average needs of single pensioners.[7]

7 FaHCSIA 2009, pages 50–51. In the 2009–10 Budget the Australian Government announced that it would establish the new relativity at 66.33 per cent from 20 September 2009.

Following the recommendations of the Pension Review, on 20 September 2009 the Government increased the single rate of pension and established a new ratio between single and partnered pension rates. The new ratio sets the single pension at 66.33 per cent of the combined couple pension rate. This is consistent with the modified OECD equivalence scale,[8] which suggests that a ratio of around 67 is appropriate where the policy goal is to provide a single person with a standard of living equivalent to a member of a couple. The new ratio was applied to the base rate of pension and the new pension supplement, but not to rent assistance.

Renting privately (and receiving rent assistance) is the predominant housing tenure for Parenting Payment Single recipients (45 per cent) and Newstart Allowance recipients (37 per cent). Given that renting involves higher costs, the level of rent assistance is particularly important in achieving adequate levels of after-housing income (that is, after rent costs) for working age recipients reliant on income support (see Section F5 Housing assistance). There are also significant proportions that own or are purchasing a home. Therefore the adequacy of rates of income support with and without rent assistance is very important.

Chart F1-4: Adult single and couple relativities (no children): primary income support payments (20 September 2009)[(a)]
Per fortnight



(a) The same base payment is payable for Austudy singles and members of a couple, ABSTUDY (for students 16–20 years who are living away from home or independent with no children and couples with no children) and Youth Allowance (for singles with no children not living at home and couples with no children). The rate of Newstart is the lower rate paid for single people under age 60.
Source: Australian government administrative data.

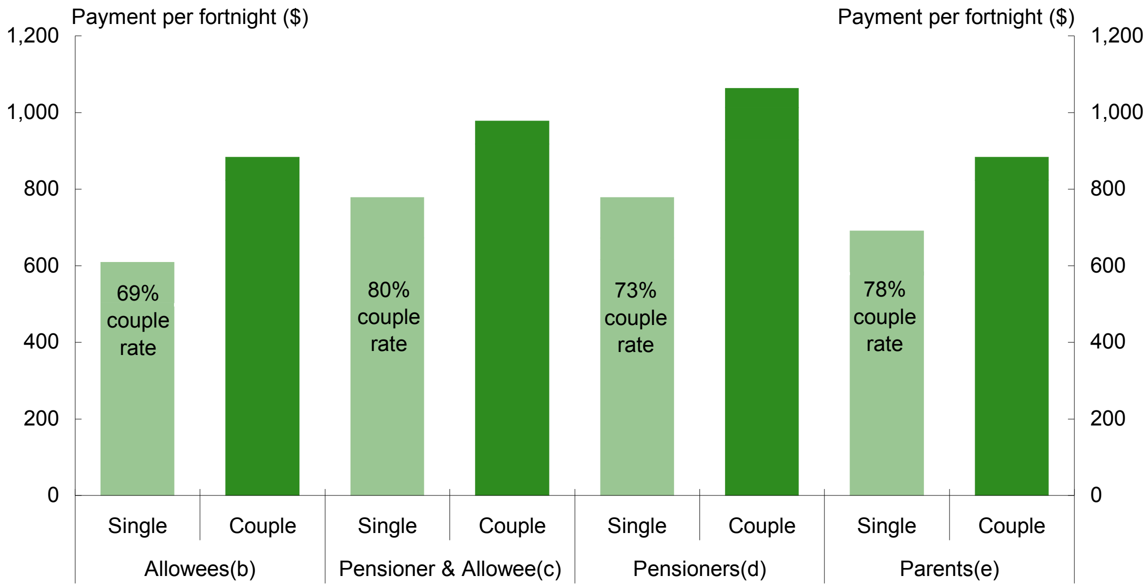
Working-age households may also include children. Chart F1-5 includes Family Tax Benefit B (FTB B) as a payment for parents not children. FTB B significantly increases the amount of assistance provided to parents (single and couple) and also the amount provided to single parents relative to couples. Having a child increases adequacy of payments for single parents compared to partnered parents to 69 per cent for both Austudy and Newstart Allowance recipients (see Chart F1-5). Rates of payment for Youth Allowance, Austudy and

8 The OECD modified scale assigns a value of 1 to the household head, 0.5 to each additional adult and 0.3 to each child. So a single person would receive 66.7 per cent of the combined couple rate.

Newstart Allowance recipients with children are broadly equivalent, with point in time differences due to bi-annual rather than annual indexation. However, rates of payment for people on Youth Allowance and Austudy without children are considerably less than the adult Newstart Allowance rate. The relativities between single and couple parents also vary considerably; from 69 per cent of allowees to 80 per cent for a single parent pensioner (such as DSP) compared to a DSP and Newstart allowee couple. The relativity for a single parent (PPS) compared to an allowee couple is 78 per cent.

Chart F1-5: Adult single and couple parent relativities: Primary income support payments and Family Tax Benefit Part B (20 September 2009)[a]

Per fortnight



(a) Excludes FTB A, but includes FTB B as a payment for a parent (in respect of child aged less than 5).
(b) Either Austudy or Newstart parents.
(c) Single DSP recipient and DSP-Newstart couple.
(d) Pensioner single and pensioner couple.
(e) Single parent (PPS) and PP-Newstart couple.
Source: Australian government administrative data.

The increase in assistance for parents through payments such as FTB B since 1997 reflects a priority to target assistance to families with children.

Among other things, these differences reflect the higher pension levels of assistance for single parents with a young child compared to the amounts available under other payments, and the availability of FTB B in addition to primary income support.

Expenditure data are not sufficiently disaggregated to enable reliable estimates of what singles in a variety of circumstances need to spend to achieve equivalent living standards to members of a couple in the same circumstances. The evidence base available to make these judgements is therefore not strong.

However, budget standards research using normative judgements of expenditure needs implies that working-age income support recipients have broadly similar economies of scale in consumption as age pensioners. That is, a single working-age recipient living alone needs much the same proportion of working age recipient couple's payment as a single age pensioner does of an age pensioner couple's payment. For example, using after-housing cost budget standards to remove sensitivities around housing cost assumptions, a single 35 year old renter would need 66 per cent of the income of a private renter couple. This compares to a single 70 year old homeowner requiring 68 per cent of the income of an aged couple who are homeowners (DSS 1998, p. 491). Given these sensitivities, and also the contestable normative judgements needed to construct budget standards, these results cannot be treated as definitive. They are, however, broadly in line with overseas research that uses alternative approaches to derive equivalences.

Equivalence research cannot indicate whether couple rates of payment are adequate or not in themselves; rather, it indicates whether current single rates are likely to be inadequate compared to couple rates.

Given the new single-to-couple ratio for pensions (and the consistency of that ratio with comparable overseas measures like the OECD modified scale) there is a case for making similar changes to the single-to-couple ratios for working-age payments, particularly for singles living by themselves. A lower relativity can be justified where it is expected that single people will share housing, as might be the case for students or some other singles without children.

Finding

There are large variations in the relativities between single and couple rates of payment in the working-age income support system. These are not based on analysis of the amounts of income that single people need to achieve the same standard of living as members of a couple. Available evidence supports the same relativity for working-age income support payment rates as is applied to pension rates.

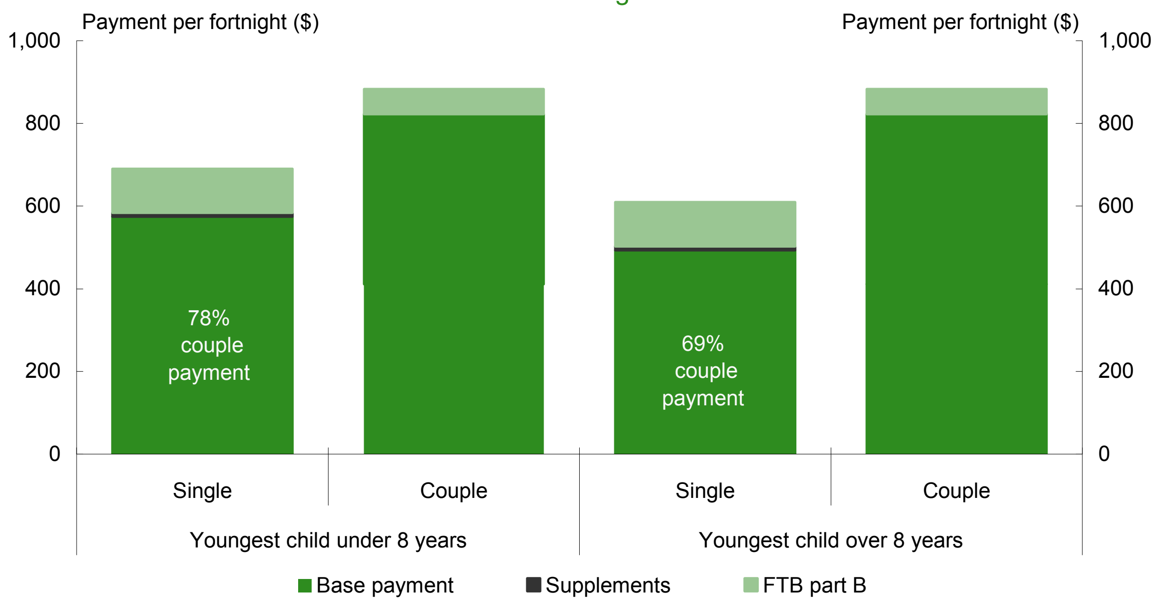
Single and partnered parents

Single and partnered parents are significant groups within the income support system. Parenting Payment consists of two different rates and conditions of payment. In part this is because income support for single and partnered parents has evolved from different payments.

Until September 2009, PPS was paid at the same rate as other pensions (Age and Disability Support Pension and Carer Payment), with the same income test. PPS recipients did not receive the 20 September 2009 pension increase, and nor was the income withdrawal rate increased from 40 to 50 per cent. As a consequence PPS is now a different category of income support payment. PPS has payment rates that are less than other pensions, and the lowest income test withdrawal rate in the income support system. Along with other pensions it is benchmarked to wages, although it is benchmarked to 25 per cent of Male Total Average Weekly Earnings (MTAWE) rather than 27.7 per cent that applies to other pensions.

These differences in payment conditions combine to produce large differences between the payment outcomes for PPS and PPP recipients, and also between PPS recipients and single parents with older children, who do not qualify for PPS but instead must claim another income support payment, generally Newstart Allowance.

Chart F1-6: Single/couple parent relativity (20 September 2009)[a]
Per fortnight



(a) Single to couple relativity including: income support payments, FTB Part B and relevant supplements such as Pharmaceutical allowance. The base payment of a single parent with a child less than 8 years is 70 per cent of total couple base payments (or 60 per cent of total couple base payments if the child is over 8 years).
Source: Australian government administrative data.

Chart F1-6 shows the relativity between income support payments for single parents (who receive PPS with a child aged between five to seven years of age, and Newstart Allowance when their child is eight to 15 years) and for couples. The relativity between assistance for these two categories (including primary payment, supplements for pharmaceuticals and telephone concessions, and Family Tax Benefit Part B) falls from 78 per cent to 69 per cent when the child turns eight.

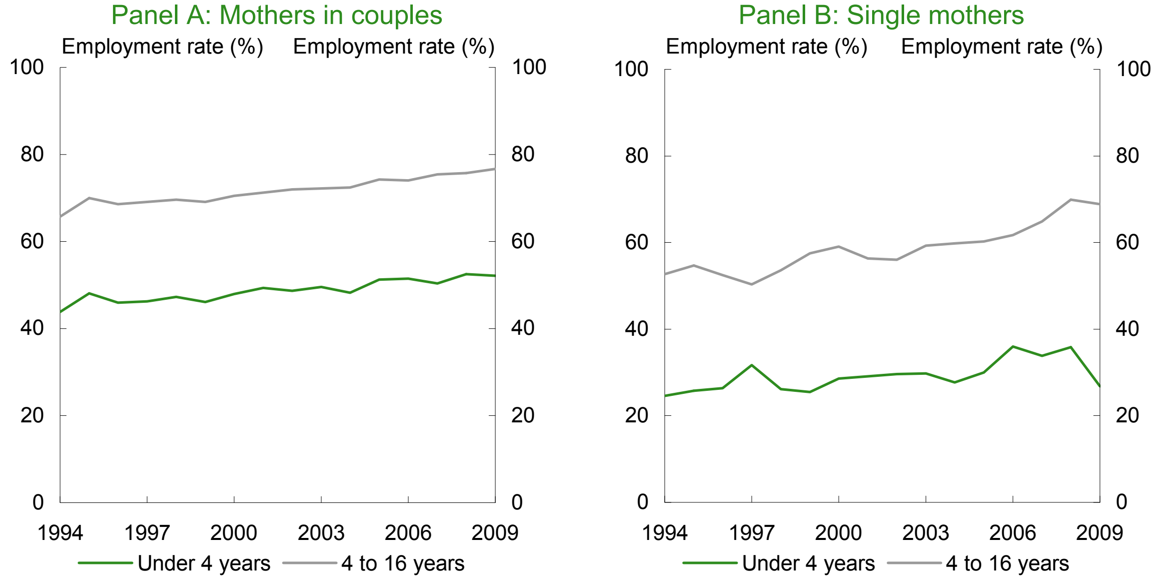
One reason for providing a relatively high level of income support for single parents is because they have a higher risk of poverty. This argument is supported by a range of evidence including self-reported measures of financial stress (for example, could not pay bills or rent on time) and hardship (for example, pawned or sold something, went without meals or were unable to heat the home). Single parents had a higher rate of financial stress than couples with dependent children and single people under 65. However, they had lower rates of multiple hardship than single people under 65 and a similar, albeit slightly higher, rate than couples with dependent children (FaHCSIA 2008, pp. 16–17).

Another argument for a higher level of income support is that single parents face higher direct and indirect costs because they have no partner in the household to help with child rearing and other household tasks. The argument for a higher payment for single parents is strongest when they are caring for young children.

The direction of recent policy for single parents has been two-pronged: to increase their employment through limiting access to the more generous pension package of assistance to single parents with young children, and to introduce participation requirements for parents (both single and partnered) with school-age children . These changes, introduced in 2006, have contributed to significant reductions in the number of parents with school-age children who receive income support. There has also been a small reduction in the number of single parents of pre-school-age children receiving income support.

While the employment rate of single parents has increased, there is still a sizeable gap between their employment participation rate and that of partnered mothers, especially while the children are young (see Chart F1-7). Where there is a child younger than four there is a 25 percentage point gap; for a child aged over four and up to sixteen the gap is 8 percentage points. There is no gap between employment rates of single parents and partnered mothers when the youngest child reaches 16 years of age.[9] These differences may to some extent reflect selection biases (as indicated by lower average wage rates and education levels for single compared to partnered women). When single parents do work they have higher median hours of work than secondary earners in couple families. However, it is also the case that Australia's assistance to single parents is among the most generous in the OECD (Whiteford 2009, p. 49). Also, Australia has the fourth-highest joblessness rate in the OECD for households with children, and this joblessness is concentrated among single-parent families (Whiteford 2009, p. 57). Another policy consideration is the growing evidence that long periods out of the workforce reduce the probability of eventual employment and harm both single parents and their children.

Chart F1-7: Employment rate of mothers in couples and single parents

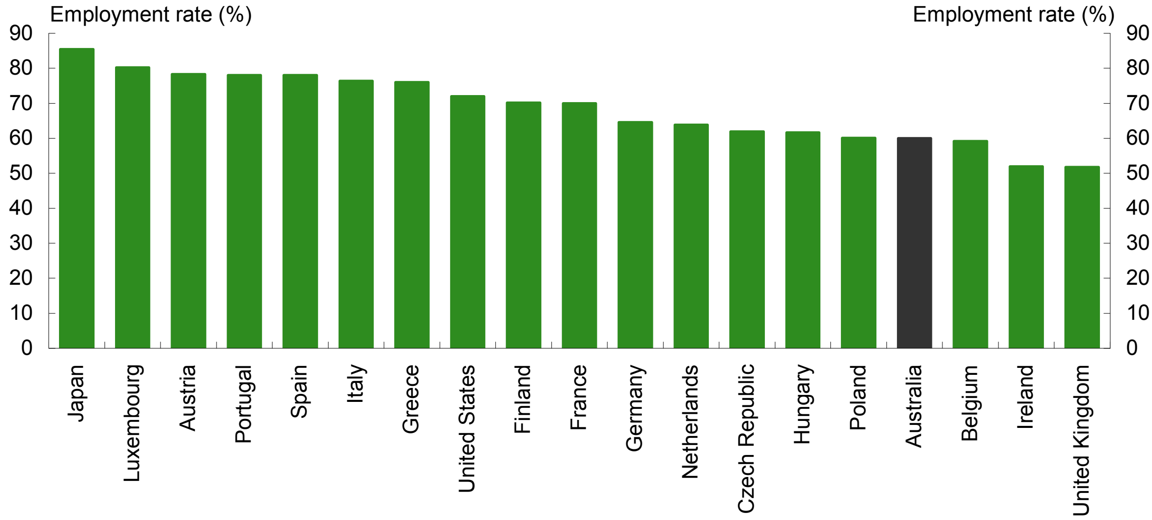


Source: ABS (2009g).

Despite the increasing workforce participation rate of single parents, Australia still has one of the lowest levels in the OECD (see Chart F1-8).

9 ABS 2006b, 5 per cent sample.

Chart F1-8: Employment rates of single mothers in OECD countries
2007



Source: OECD 2007, OECD Family database, LMF3 Maternal employment by family status.

Finding

Single-parent employment is increasing but it still falls well short of rates for partnered women and is low compared to most other OECD countries.

People with disability

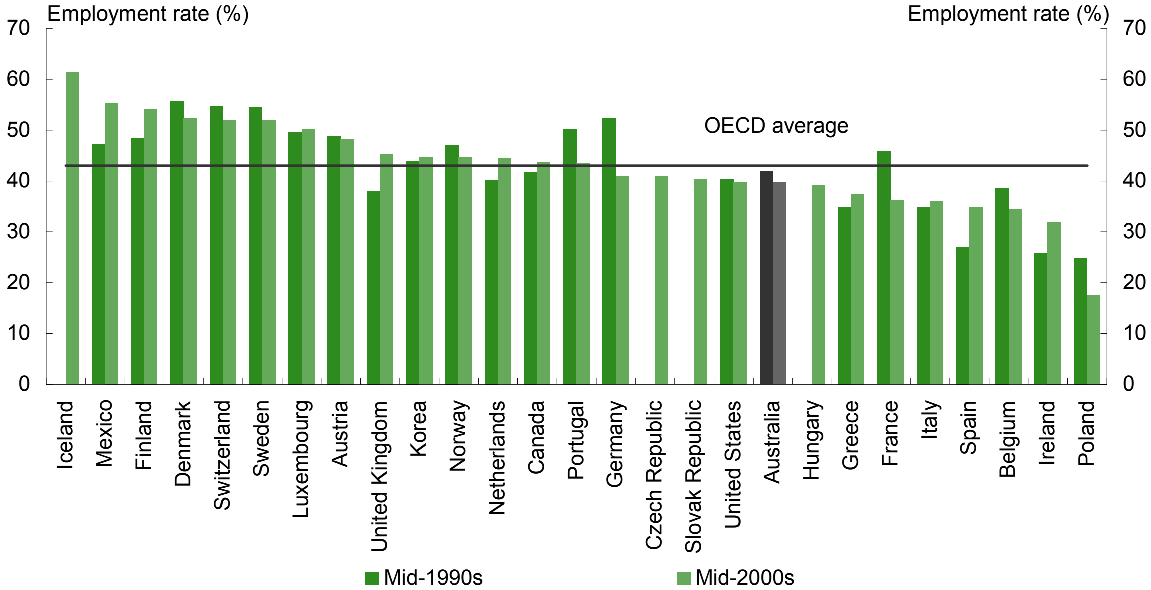
Working-age people with disability can receive a number of different income support payments. The largest number — 757,000 — receive the Disability Support Pension, with a smaller number on Newstart Allowance.

The employment rate of people with a disability in Australia was 39.8 per cent in 2003. Australia is ranked 19th of 27 countries in an OECD comparison and is below the OECD average of 43.0 per cent. No country has high employment rates for people with a disability, although a number of OECD countries — such as Finland, Denmark and Switzerland — have achieved rates above 50 per cent (see Chart F1-9).

The employment rate in Australia fell by 2.1 per cent between the mid-1990s and mid-2000s, while 15 of the 23 countries as defined by the OECD over the same period either increased or remained steady. The employment rate of people on DSP is even lower, with less than 2 per cent leaving DSP each year to return to work, and only 9.1 per cent reporting earnings (September 2009). Of these, a quarter is in supported employment through Australian Disability Enterprises.

Chart F1-9: Employment rates of the working-age population with disability in OECD countries

Mid-1990s[(a)] and mid-2000s



(a) Data not available for the mid 1990s for four countries.
Source: OECD (2009c), 'Sickness, disability and work: keeping on track in the economic downturn', Background paper, p. 12.

There are many possible reasons for Australia's relatively poor performance for people with disability, including lack of employer demand, labour market restructuring, and the absence of work requirements associated with income support for most people with a disability.

A person can remain on DSP for a very long time. Of the 740,000 people on DSP in December 2008, 53 per cent had been on it for more than 10 years. Also, although disability increases with age, there are large numbers of younger people receiving DSP. Sixteen per cent of recipients are under 35 years of age, 16 per cent are 35–44, 26 per cent are aged 45–54 and 42 per cent are 55 and over.

The proportion of the Australian working-age population on DSP in 2007 was 5.4 per cent. Australia is ranked 14th of 28 countries in an OECD comparison (based on 2007 or latest available year). While Australia is currently lower than the OECD average of 5.8 per cent, our position is likely to deteriorate further with the increased flow of women onto DSP as other payment options with similar rates of payment become less available.

The largest source of growth in the DSP in the past decade has been by women. In that period, the number of women receiving DSP increased by 63 per cent, while the number of working-age women rose by only 17 per cent. Women now make up 44.2 per cent of DSP recipients, up from 35.4 per cent 10 years ago. A major reason for the growth is the increase in the Age Pension age for women and the closure of alternative dependency-based payments, including wife and widows' pensions and Partner Allowance. There is also evidence of significant flows of single parents onto DSP when eligibility to PPS is lost; however, this effect is expected to lessen over time as the Welfare to Work changes to PPS eligibility and take effect. Women are claiming DSP at an earlier age and remaining on payment longer.

To be eligible for DSP, which is paid at a higher rate and with a more generous income test than Newstart Allowance, a person must satisfy two tests administered by a job capacity assessor. The impairment test requires that a person's condition is diagnosed, treated and stabilised. It uses evidence from a health professional on the level of a person's impairment against a set of tables. The test for continuing inability to work requires that a person's impairment must prevent them from achieving at least 15 hours a week of work at full award wages within two years after rehabilitation and/or retraining.

As pointed out by the OECD (2009c, p. 17):

> The inherent problem with most public disability schemes is that entitlement is not determined according to a reliable and valid assessment of a person's labour market competitiveness. Instead, a medical practitioner with minimal or no training in the complex task of assessing how various injuries and ailments reduce labour market competitiveness, is required to estimate globally whether a person is unfit for work, including into the future … The result being that significant numbers of people with partial work capacity and who are not wholly uncompetitive in the labour market, become deemed unable to work.

Australia has sought to address this problem by moving away from a purely medical model of assessment, replacing medical officers with allied health professionals under the Better Assessment changes of the early 2000s, and by introducing Job Capacity Assessments under the *Welfare to Work* program introduced in 2006. It was thought that allied health professionals who have experience in finding employment for people with disabilities would have a better insight into work capacity. There is some evidence, however, that decisions about DSP eligibility decisions continue to give greater weight to impairment than ability to work.

Previous efforts to address deficiencies in the test for continuing inability to work have failed. Changes in 1995–96 to require decision-makers to think more broadly about 'any' work and on-the-job training had no impact on DSP inflows. Similarly, the expected reduction to the DSP inflow under *Welfare to Work* was not realised.

A key deficiency of the DSP claiming process is that the continuing inability to work test is assessed before most claimants have had any retraining or rehabilitation. Around half of people granted DSP come onto payment from employment without having tested their capacity to be retrained for work, and many of those who were on activity-tested payments had a medical exemption from activity test requirements. The job capacity assessment therefore requires a prospective assessment or prediction about a person's future capacity to work, with little information about the likely benefits of an employment intervention.

Finding

Employment rates of people with disability are relatively low and few people on Disability Support Pension (DSP) report earnings or leave DSP for work. DSP should continue to be an important part of the income support system for people whose disability precludes substantial work. However, it is important for the wellbeing of people with moderate disabilities that the work test associated with access to DSP is effective in identifying people who could be assisted into substantial part-time or full-time employment.

Indexation

Indexation is used to maintain the real value of policy settings — such as rates of payment — over time. This can also include maintaining the value of assistance relative to broader community standards, rather than just the purchasing power of payments.

The choice of indexation arrangements has important consequences for the sustainability of the income support system, in terms of community acceptance, in terms of incentives to work, and in fiscal sustainability.

Prior to 1997, income support rates automatically increased in line with price increases. Governments provided additional ad hoc increases to improve the real value of payments either in pursuit of a policy goal, to align assistance between groups or to improve relativities between groups of recipients. For example, ad hoc increases were made in order to achieve and maintain the single rate of pension at 25 per cent of Male Total Average Weekly Earnings, with these increases also being paid as ad hoc increases to partnered allowance and single allowance recipients with children. Other ad hoc increases improved the single rate of allowance.

Since 1997, pension rates, but not allowance rates, have also benefited from legislated benchmarking of rates to community living standards, as measured by increases in the a wages measure (Male Total Average Weekly Earnings).[10] Given budgetary pressures as a consequence of population ageing there is a need to ensure that the measure used for indexation appropriately reflects changes to community living standards. A measure that overstates such change will not be fiscally sustainable and could compromise the integrity of the tax and transfer system.

For those recipients expected to work, applying this factor could change the relationship between rates of income support and the minimum wage if the minimum wage grows slower than wages in the broader community. The Pension Review report (FaHCSIA 2009, p. 68) notes that faster payment growth for pensioners:

> may raise questions about the rewards for work as the incomes available to those on income support grow relative to earnings … pensioners receiving a part rate of pension can already have a higher disposable income than low-income taxpayers who are funding pension spending through their taxes.

Reflecting changes in community standards is important but cannot be achieved solely through automatic adjustments. For example, changes in community living standards as measured by wages are relatively easy to reflect with automatic adjustments. Slower shifts, such as changes in the composition of households and the nature of workforce participation, can be more appropriately dealt with through separate government decisions. As the Pension Review report noted (p. 66), 'it is hard to see a rationale for such changes to impact on the rate of the pension'.

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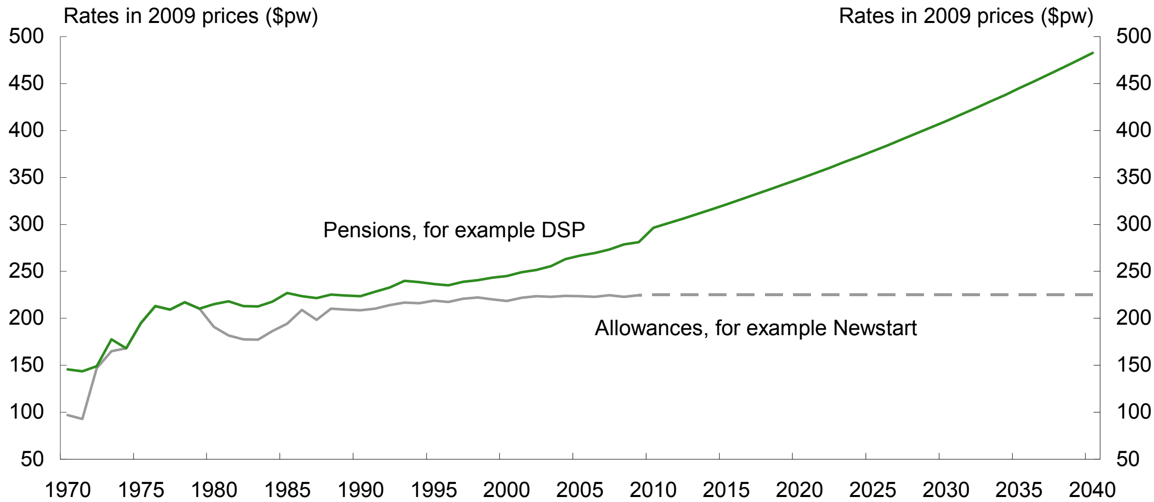
10 Prior to 1997 pensions and partnered rates of allowance and the higher rate of Newstart were increased periodically by ad hoc decisions against a benchmark of 25 per cent of MTAWE. Legislation introduced to provide for automatic indexation against this benchmark in 1997 did not link increases for partnered rates or the higher single rate of Newstart allowance.

A regular review of payment amounts, for example at five-yearly intervals, would enable these non-wage drivers of community standards to be reflected in income support payments. Such a process may of course alter the relativity between pension and allowance rates of payment. The last adjustment to Newstart Allowance, apart from increases related to price indexation and compensation associated with the GST, was an increase of $2.95 (or 2 per cent) in 1994.

When different components of the tax and transfer system are indexed differently, the relationship between them can change over time. An important example is the widening disparity between pension and allowance rates, resulting from the additional benchmarking of pensions to wages while allowances are indexed solely to price changes. Chart F1-10 compares the real rates of these payment types over time, including projections of future growth. It shows that the gap between these payment types is larger today than it has ever been, and will continue to widen if current settings are maintained.

Chart F1-10: Pension and allowances over time[(a)]

2009 prices



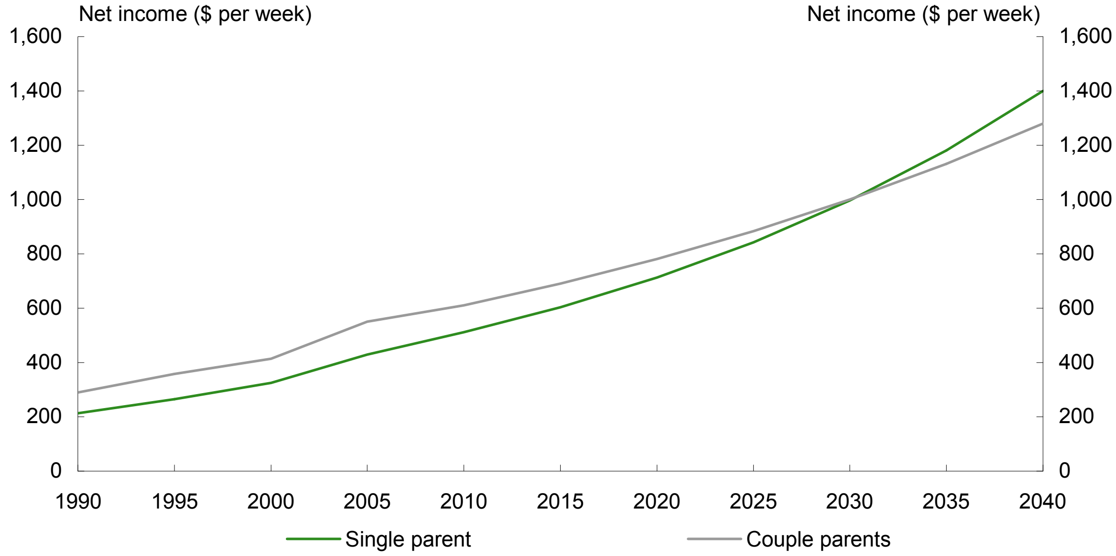
(a) Projected values assume no policy change.
Source: Treasury estimates.

The gap presents people with strong incentives to test their eligibility for a pension, and not to jeopardise their pension entitlements by taking up work. It also places increasing pressure on the assessment process for DSP, particularly from people with weaker employment prospects.

Differences in indexation are also producing changes in the relativity between income support for single parents and couples. Chart F1-11 shows that if current indexation arrangements continue, by 2030 a single parent with a youngest child aged five to seven will receive the same amount of assistance (income support and FTB-B) as an unemployed couple with a child of the same age. The ratio was 65 per cent in 1990 when automatic indexation was extended to family payments, 67 per cent in 1997 prior to MTAWE applying to PPS rates and not partnered allowance rates and 78 per cent in 2009.

Chart F1-11: Disposable income of single parent with one child compared with a couple with one child[a]

$ Per week, 1990 prices[b]



(a) Single parent receiving maximum rates of Parenting Payment Single and a couple receiving maximum rates of Parenting Payment Partnered and Newstart Allowance.
(b) Projected values assume no policy change.
Source: Australian government administrative data and Treasury estimates.

Indexation arrangements have also brought about a decline in the real value of the free area for allowances — the amount of income that a person can have before payment is withdrawn. In 1986 the allowance free area — the amount that a person can have before their payment is reduced — was 31 per cent of the lower single rate of allowance. By 1995 this had fallen to 20 per cent and is currently 14 per cent. This is because the free area has not been indexed. It is difficult to see a rationale for these outcomes, other than that the cut-out point for Newstart Allowance is higher in real terms in 2009 than in 1986 and 1995 following reductions in the income withdrawal rate in 1995, with a further reduction and an increase in the income level at which the higher withdrawal rate applies in 2006.[11]

Finding

Different indexation for pensions and allowances is creating an ever-widening gap between pensions and allowances that can create inequities between assistance for individuals in similar circumstances as well as disincentives to work.

11 Prior to 1980 unemployment benefit was withdrawn dollar for dollar over a permissible earnings limit. From 1980 onwards income was first withdrawn at 50 per cent and then at 100 per cent. In 1995 the 100 per cent withdrawal rate was reduced to 70 per cent, and in 2006 it was reduced to 60 per cent.

F1-3 A restructured income support system

Recommendation 82:

There should be three categories of income support payments:

(a) A **pension category** for people who are not expected to support themselves through paid work, whether because of their age, disability or because they are providing full-time care for a person with disability (or frail aged). This pension would be paid at a rate that provides a basic acceptable standard of living, having regard to prevailing community standards.

(b) A **participation category** for people of working age who are expected to support themselves through paid work now or in the near future. This would cover the unemployed including youth (both under and over 18), those who are temporarily incapacitated, people with a partial capacity to work and primary carers of dependent children. The rate of payment, for those who are expected to work, should provide a basic level of adequacy while maintaining incentives to work. This would be less than the pension rate. Parents on income support would receive a higher total level of payment. Unemployed youth aged less than 21 would be paid no more than full-time students to avoid creating incentives to leave full-time study for unemployment.[12]

(c) A **student assistance category** for people engaged in full-time study. Students aged 21 and over would continue to be paid at a lower rate than the unemployed and at the same rate as younger students in similar circumstances. Some students have the capacity to work part-time to supplement their income support. Other students could be given the ability to borrow against future income to supplement their student assistance.[13]

Recommendation 83:

There should be a more consistent approach to payment relativities within each of the three categories of payment based on the single to couple pension relativity. A more consistent approach would mean an increase to base rates for single income support recipients in the participation and student assistance categories. However, a lower relativity for singles in these categories without children may be warranted given their greater capacity to share accommodation.

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12 Rates of payment for participation category customers aged less than 21 are discussed in Section F3 Family and youth assistance.

13 Rates of payment for student assistance category customers aged less than 21 are discussed in Section F3 Family and youth assistance.

Recommendation 84:

Payments and income test parameters should be indexed in a consistent way to maintain relativities across the three payment categories and to reflect changes in community standards. Governments should regularly review indexation as community standards are likely to be affected by significant changes in the composition of the workforce and household incomes in coming decades. The current community standard for pensions is set by reference to Male Total Average Weekly Earnings. Indexing all payments to this standard has been projected to involve a significant increase in budgetary outlays over the coming decades so it will be necessary for governments to regularly review the appropriateness of this measure and the level of the benchmark.

Recommendation 85:

Income support arrangements for parents should support and encourage participation in work while maintaining adequate levels of assistance to families. As a condition of payment parents should be required to look for part-time work once their youngest child turns four. Parents would receive supplements as follows:

(a) For couples and single parents with a youngest child under six years, the amount of the supplement should be set such that the total support for single parents on income support will be equivalent to the maximum rate of pension. The supplement would be paid through the family payment system.

(b) For single parents with a youngest child aged six or older, the supplement should be paid at a substantially lower rate through the family payment system.

(c) For couples with a youngest child aged six years or older, the lower rate supplement should be paid through the income support system.

Recommendation 86:

People with disability who have a partial capacity to work, excluding people receiving Disability Support Pension (DSP), should have a part-time work requirement. They should be subject to a means test or payment arrangements that provide an incentive to work part-time and that recognise that they face higher average costs of work. This could also be achieved by an in-work supplement and/or an earnings disregard in the means test.

Recommendation 87:

Students should have access to an income test that facilitates significant part-time work at a level that does not compromise educational outcomes. Adults requiring additional income should be able to borrow to top up their student rate of income support to the level of the participation payment rate. The feasibility of using the existing income-contingent loans scheme and the potential impact of it on access to higher education of students from a low socioeconomic background should be examined.

The system should do more to encourage employment

The ageing of the population and a policy focus on individual wellbeing imply that the structure of income support should do more to encourage employment. This goal applies to all income support recipients. Two groups — single parents and people with disability with the capacity for substantial part-time work — have particularly low workforce employment rates. Improving employment rates for these groups should be a policy priority.

There are now considerable differences between pensions and allowances in terms of payment rates and conditions. This significantly affects the simplicity, equity and efficiency of the tax and transfer system. Again, two groups are particularly affected — the differences are most stark at payment boundaries for single parents and people with disabilities. Building a system that supports people's efforts to work entails a three-way trade off. While higher transfer payment rates provide recipients with a better standard of living, they can compromise incentives to work and are more expensive for the general community of taxpayers to support. This is why participation requirements are necessary. On the other hand, low rates that do not facilitate looking for work or participating in society can compromise employment outcomes (reducing tax revenues and increasing income support outlays) and social cohesion (crime levels, a more unequal distribution of income), which is also more expensive for the community to support.

The policy challenge is to ensure that those on income support have an adequate standard of living, and at the same time to give those with the capacity to work incentives that make work attractive. Maintaining category-based differences as proposed in Recommendation 82 will continue to be a way to meet this challenge. However, the boundaries between categories can be adjusted to ensure that an individual's capabilities are increased through employment. This is particularly needed for single parents and people with disability with significant capacity to work. Differences in payment relativities across the three categories and between payments within the categories should also be reduced to create a more coherent and simpler income support system (see Recommendation 83).

There are limits to the extent to which effective marginal tax rates can be reduced to improve incentives to work. This is particularly the case for parents, because at some point the total level of assistance — comprising income support, family and rent assistance — has to be withdrawn.

Within a categorical approach to income support it is possible to target incentives to work through participation requirements: continued eligibility for payment is conditional on job search. Further extension of activity testing is warranted in the case of parents — single and partnered — as a clear signal not to stay out of the workforce for too long and as a reflection of community norms and expectations.

Paying the same basic rate of income support to all people in the participation category — Newstart Allowance — with supplements for parents, children and rent costs, would reinforce the participation focus of income support for people of working age. Disability Support Pension and Carer Payment would continue to be separate categories of payment in the pension category.

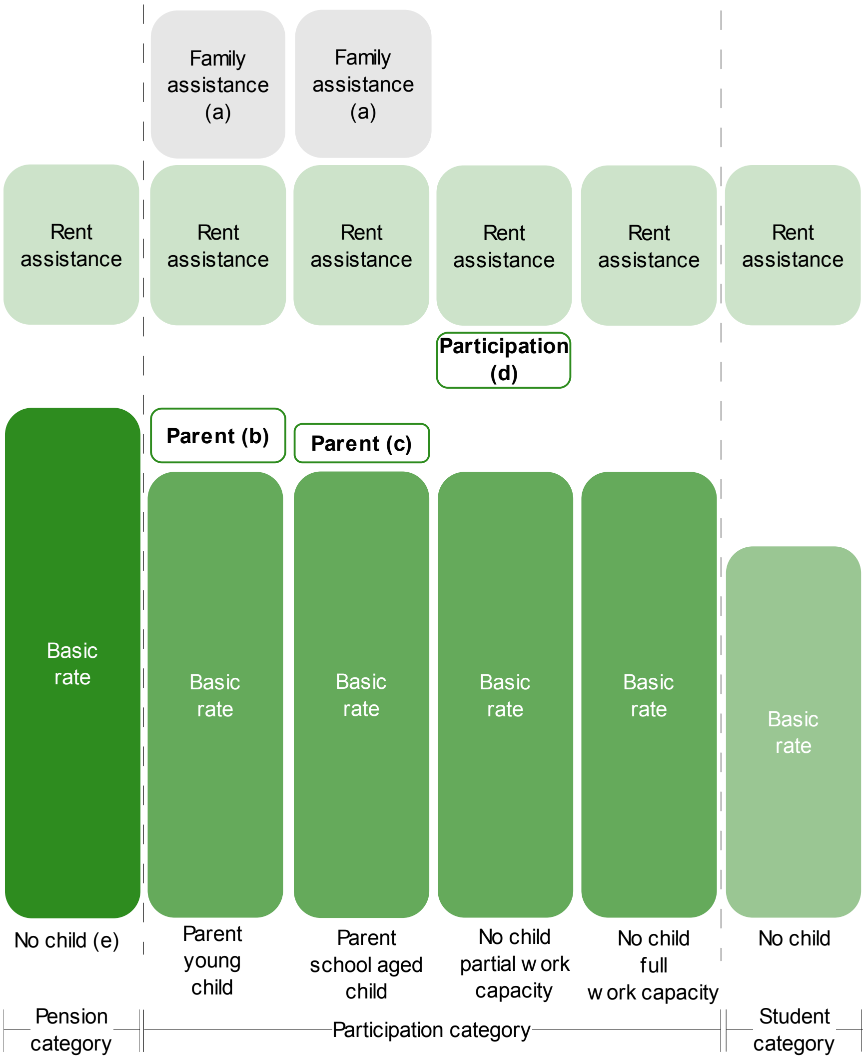
The level of assistance for those who are expected to work is a trade-off between adequacy, work incentives and other priorities and is ultimately a matter for governments to decide. There is a case, however, for increasing the level of assistance for single unemployed and students, particularly for singles not sharing with another adult. This is based on a range of analysis, including appropriate single and couple payment relativities and the disincentives to work caused by large differences in rates of payment for people in similar circumstances. There is also a case for indexing payments on a common basis, and/or for conducting regular reviews of adequacy against community standards, so that differences between rates of payment do not increase too much.

Restructuring the income support system will be costly. It will have to deal with the difference in payment rates at the same time as providing strong incentives to work and adequate support services to ensure that new entrants to the labour market or people increasing their work effort succeed in getting jobs. The cost of indexing allowances to male total average weekly earnings is projected to increase from 0.08 per cent of GDP in 2019–20 to 0.35 per cent of GDP in 2049–50. Reforms will therefore have to be prioritised and phased in over the longer term.

Some differences between rates of assistance for people neither expected nor likely to work again and for those expected to look for work are justified to preserve incentives to work. However, the differences in the current system are growing and too large. They should be addressed.

A new structure for income support is outlined in Chart F1-12.

Chart F1-12: Indicative structure of adult working-age income support
Single person



(a) Family assistance for the direct costs of children.
(b) Parent supplement for families with a youngest child aged under six would be paid through family assistance and be available to working families.
(c) Parent supplement for single parents with a youngest child six and older would be paid through family assistance. For partnered parents it would be paid as part of income support.
(d) Participation supplement could be delivered through the means test.
(e) Age, Disability and Carer pensioners would be eligible for the parent supplements.

The broad architecture of the system is based on three payment categories: a pension category, participation category and student assistance (see Chart F1-12). In addition there would be supplements in respect of the direct costs of children (see Section F3 Family and youth assistance), significant rent costs (see Section F5 Housing assistance), and a parenting supplement. There would also be a per family participation supplement in respect of the costs of work for people whose disability means they only have a partial work capacity.

Carers providing constant care and people assessed as having disability that precludes any level of workforce participation would receive the highest rate of payment, as they are more likely to be reliant on income support for a long and indeterminate time. The rate of payment for those aged 21 and over or aged under 21 with dependent children would be as established by the Australian government following the Pension Review.[14]

The participation category

In the longer run, the direction of policy should be to simplify working-age income support by reducing the number of payment categories and reducing differences between current categories. The UK government has committed to consult on such reform through a single income-replacement benefit for people of working age (UK Department of Work and Pensions 2008, p. 32).

For most people unemployment lasts for only a short time, which is one reason why rates of payment for Newstart Allowance can be less than pension rates. However, the unemployed population is becoming much more diverse as a result of changes to eligibility for Parenting Payment and Disability Support Pension access. Also, a sizeable proportion of unemployed people, even under favourable labour market conditions, spend more than two years on payment.

Australian unemployment assistance is based on the notion of 'reciprocal obligation' — that the taxpayer will support a person in return for the person actively pursuing ways to avoid the need for further support. Most jobseekers are expected to seek full-time work. Government policy since the mid-1980s has typically aimed at improving the rewards for part-time work to avoid poverty traps and to improve financial outcomes for those in work, while at the same time continuing to ensure that jobseekers seek further work or improve their employment prospects via the application of full-time activity tests.

In recent years this policy has been made more flexible. There are now substantial groups, such as people with partial work capacity and single parents with school-age children, who are expected to look only for part-time work. Activities other than job search are sometimes taken as satisfying recipients' obligations.

Under the Review's proposals (see Recommendation 82), the participation category would consist of those who are looking for work — the unemployed — and those who are working to their 'required level' but who are not income-tested off payment (such as those with part-time requirements). It would also include people expected to look for work in the future, such as primary carer parents whose youngest child is below age six and people with a temporary sickness or impairment that precludes work.

Single people and couples expected to look for work would face a full-time work requirement. Parents and people with disability with the capacity to work significant part-time hours who are expected to look for work would face a part-time work requirement.

Participation payments should focus on capability not disability, as many people with disability or another barrier to work still have a substantial capacity to work. A focus on capability would increase individual wellbeing. While this Review focuses primarily on the architecture of the tax and transfer system, it recognises that many people require tailored

14 Rates of payment for pensioners aged less than 21 without dependent children are discussed in Section F3 Family and youth assistance.

services to ensure a successful entry into work. These services are provided through the employment services system. Further development of this system may be required.

Unemployed people with full-time job search requirement

Jobseekers with a full-time work requirement would receive a minimally adequate base rate of payment and have access to employment services according to their individual needs. Assistance for singles would increase relative to the couple rate, to be more consistent with the relativity for the pension.

Increasing payments for the unemployed to a higher proportion of the pension, or indexing them to the same wages index as pensions, may mean that more people will be able to combine substantial part-time work with income support. However, this effect will be countered by participation requirements to continue to pursue full-time employment.

If participation requirements are considered insufficient and it is considered undesirable to assist those in low-paid work through the income support system, it may be necessary to consider other approaches. For example, the income test on payments could be tightened (through a low free area and a high withdrawal rate). If this were not considered sufficient, a 100 per cent withdrawal rate could be applied and earned income tax credits could be used to achieve a desired pattern of effective marginal tax rates. For example, single parents could be given a different set of work incentives compared to single people without children. Alternatively, the conditions for receipt of income support could be progressively modified — by reducing income withdrawal rates — to allow people to more easily combine work and benefits simultaneously.

Parents

Recommendation 85 focuses on workforce participation and income support for parents.

In moving to a participation-focused income support system, there should be a more coherent structure of assistance for parents who are primary carers and for other people who are expected to work in the future.

One possible approach for reform is a system like those of Scandinavian countries, where parents (including single parents) have high rates of workforce participation. Both parents, even of quite young children, are expected to work, just as any other capable adult is, but very extensive support is provided in the form of high-quality child care and early education. Further, there are extensive provisions in labour law to ensure 'family-friendly' workplaces.

While there is some movement in Australia in this direction — such as through child care subsidies, extension of early childhood education, and parental leave — fully implementing the Scandinavian approach would be very expensive in the short run.

Instead of enforcing an expectation that both parents work full-time when their children are young, current policy is explicitly aimed at keeping primary carers in touch with the labour market. That usually means some form of part-time work. The future direction of policy should involve requiring parents on income support to look for work when their children are younger. A first step would be to align the age of the youngest child at which single parents are expected to look for work with the reduction in income support. This should be the same age for partnered primary carer parents. In the short term, this should be at age six. In the longer term, this should be reduced in line with significant changes in the availability of early childhood education and affordable child care (including after school care). Such a shift should also be contingent on an adequate and affordable supply of child care and 'family-friendly' conditions of work.

Policy should be directed at increasing the workforce participation of single parents, as single-parent households constitute a significant proportion of all jobless households. A priority for income support policy should be to introduce a means test structure that provides a more seamless transition to work when the youngest child turns six.

Parents in the income support system would receive a supplement where there is a youngest child aged less than six to provide a higher level of adequacy for those likely to be outside the workforce. Single parents with a young child would receive the same rate of income support as a single pensioner (including the pension supplement). This would be achieved through the combination of the participation payment and the parent supplement. In addition there would be family assistance to reflect the direct costs of children (see Section F3 Family and youth assistance).

The additional assistance for single and partnered parents of children aged less than six would be paid as a separate per-family supplement — whether or not they receive income support — through the family assistance system. A single parent would receive the same amount as a couple.

Where the youngest child of a single parent is six or older a lower rate supplement would also be paid through family assistance and single parents receiving income support would be subject to a part-time work requirement.

Partnered income support recipients with a youngest child six or older would receive the lower parent supplement as part of their basic rate of income support and be income tested as part of the basic rate of income support to avoid stacking of income tests.

The parenting supplement would continue to be paid until the youngest child turns 18 or while there are children in the household receiving at home rates of payment.

Workers with partial capacity for work

Recommendation 86 proposes that people with a disability who have a partial capacity to work, excluding those receiving DSP, should have a part-time work requirement.

Many people with disability already work, and others would like to work. A system that supports work for people with a disability would enable them to increase their lifetime income and contribute to society in a wider range of ways.

Some OECD countries are applying activity test requirements to their disability payments, but these countries generally have much higher proportions of their working-age population on payment than Australia has.

If it is accepted that the current DSP qualification settings are appropriate — that is, that people who cannot work 15 or more hours a week due to a permanent disability require long-term income support because they are unable to support themselves through significant employment — there is little point in introducing requirements for people with such limited capacity to work. However, there should be better satisfaction that this is actually the case before a person gains entry to DSP.

It is inherently difficult to forecast the long-term employment prospects of many people with a disability, and errors in both directions will inevitably be made in the assessment. On the one hand, not paying DSP to someone who genuinely can never support themselves through work may seriously reduce their wellbeing. On the other, paying DSP to someone who may be able to find some work could also reduce their long-term wellbeing as well as incurring higher public outlays.

The risks and costs of these errors can be managed by reducing the differences in treatment (such as payment rates) between those assessed as being able to undertake significant part-time work, those deemed marginally able to work and those deemed unable to work, and by changes to the work test that determines eligibility for DSP.

The introduction of an expectation that people applying for DSP (except those who are manifestly eligible) should first test their ability to be assisted back to work would establish a greater level of objectivity and should lead to greater levels of workforce participation.

Previous attempts to tighten access to DSP have had limited success. Not only is it a matter of the disabled person's incentives, but also assessors are likely to be aware that refusing entry of marginal cases to DSP can have a high cost for individuals. Addressing the prospective nature of the current work test may be a way of ensuring that those who have a substantial capacity to work are assisted to find employment. Those who demonstrate capacity to work reasonable part-time hours without ongoing support in the workplace would not gain entry to DSP. In this way the focus of the payment would shift toward capability and away from disability.

Limited availability of employment services program places has in the past hampered the requirement for DSP claimants without a manifest entitlement to participate. However, recent increases in the availability of places will make it feasible to assess a person's capacity for work in this way. Strict safeguards would need to be in place to ensure exemptions form assessment for people who will clearly never be able to work.

People with disability who are limited to part-time work have similar workforce participation costs to those of full-time workers (such as the costs of transport to and from work for a person with the capacity to work five short days in a week), yet because part-time workers earn less, these costs can account for a greater proportion of their take-home earnings.

People with an assessed partial capacity to work more than 15 hours a week should be subject to an income test that provides a reasonable return to part-time work. This could be achieved through a higher income test free area, a lower withdrawal rate, or something similar to the work bonus for age pensioners. Alternatively a supplement could be paid, although this would be more complex to administer. This would also assist with the ongoing cost of workforce participation, reduce the incentives to seek DSP and recognise that this group is likely to have a longer duration on payment than other income support recipients.

The student assistance category

Recommendation 87 focuses on students' ability to work part-time while studying.

The decision whether to study beyond school leaving age is discretionary. For that reason, adult student income support differs from most other forms of income support, which are required because of circumstances over which the claimant has little control — they are unable to find paid work, they are aged or have a disability that limits their capacity for work (see Box F1-2).

Box F1-2: Rationale for student income support

The rationale for adult student income support is different from that for people who are not expected to work, are unable to work or are temporarily unemployed. There are two distinct arguments for student support:

1. Efficiency**:** It is in society's interest to subsidise education because it benefits society as well as the individual.
2. Equity**:** Because there are limits to the ability of students to borrow against their likely future income, those without the means to support themselves while studying can get an education only if the government provides support. This argument also has a substantial efficiency aspect — if talented people of lesser means are unable to get a tertiary education then this represents a cost to society.

Policy in Australia has dealt with the efficiency and equity arguments for student support by treating the **direct** costs of higher education (tuition fees, textbooks, etc) quite differently from the larger but more **indirect costs,** predominantly in income forgone by not working. The Higher Education Loan Program (HELP), which replaced the former Higher Education Contribution Scheme (HECS), is explicitly aimed at sharing the direct costs with the student through income-contingent loans. Around 92 per cent of domestic university students are in places supported by the Australian government and are therefore eligible for HELP.

For direct costs the efficiency argument has held sway — through HELP the student covers part of these costs, while other costs are covered by a system of grants to the States and to tertiary institutions.

However, student income support — which can be seen as either support to mitigate the indirect costs of education or income support to a person undertaking an approved course of study to improve their long-term employment prospects and self-reliance — has always focused on and been justified by the second argument; without this support, access and equity in higher education would be compromised.

Income support for students is spread across several programs with varying conditions and rates — Youth Allowance, Austudy and ABSTUDY. In addition, the parents of many full-time students receive the base rate of Family Tax Benefit Part A — an arrangement that can continue until the student is aged 25 (see Section F3 Family and youth assistance).

The Government announced that the age of independence for students (the age to which the parental income test is applied) will be lowered to 22 by 2012. Young people become eligible for Newstart Allowance at 21. Aligning the age of independence with the age at which young people become eligible for adult rates of unemployment payments would create a simpler system and avoid favouring unemployment over studies.

The single without child rate of Austudy and Youth Allowance are lower than both the single and partnered rates of Newstart Allowance. Student income support has been the focus of recent major reforms, following the Bradley Review of Higher Education, which found that higher education is becoming less affordable. It concluded that 'the contributions made by students themselves through the income-contingent loans scheme are currently appropriate and should not be increased any further' (DEEWR 2008, p. 58). It went on to recommend some changes to income support for students relating to the extent and the circumstances in which students should be considered dependants of their parents, such that the parents, rather than the taxpayer, should be called on where they are able to partly or fully support them. It also recommended a relaxation of the income test free area for student assistance to allow students to keep a higher proportion of what they earn. The Australian Government has accepted this last recommendation. In addition, the Bradley Review made two findings of relevance to this Review:

- The level of income support paid to eligible students should be considered in the context of the findings of the Pension Review.
- Further work should be undertaken on the feasibility, and impact on students, of introducing a loans supplement scheme or using FEE-HELP as an instrument for income support (p. xxvii).

The Review Panel is in favour of further analysis of an optional income support top-up through the existing income-contingent loans scheme.

The basic structure of student income support is Youth Allowance for those under 25, Austudy for those 25 and over, and ABSTUDY for full-time Indigenous students (for whom there is additional support). These payments differ from other income support payments in several ways.

- Payment rates are the lowest in the income support system for those without children, although, subject to the passage of enabling legislation, relatively generous lump-sum scholarships will now be paid by the Australian government yearly to university students, especially if the student has to move away from home.
- Personal income tests are more generous than for most other income support payments. An income bank effectively allows work over long holidays to be averaged over a longer period.
- The notion of 'dependency' on parents will be reorganised, subject to the passage of enabling legislation. On the one hand, more students are considered dependent for income support purposes. On the other hand, the taxpayer's contribution to middle-income families with dependent students has been greatly increased through changes to the parental income test.

This structure is based on the idea that full-time students can supplement their income with paid work, either part-time or in holidays, or both. As a consequence, Australia now has the highest rate in the OECD of tertiary students who are also doing paid work. There are good arguments that people's study years and labour supply years should be separated, particularly where there is a risk that the need to work compromises study choices and achievement. But there are also good arguments that combining work and study can improve both. Even if it is considered generally desirable for post-school students to work part-time, some of them may risk hardship under the current system, such as those unable to supplement their student income support with paid work because of where they live, their choice of course or study load, the unavailability of suitable employment, caring obligations or disability.

The rates of Newstart Allowance for single adults are sometimes compared with the rate of Austudy and student Youth Allowance for those over 21. That Newstart Allowance is paid at a higher rate may present adults with an incentive to abandon full-time study for unemployment. However, the loss of future income in abandoning full-time study is so large relative to any short-run differences in income support rates, and the number of students affected so relatively small, that this may not be a significant practical problem.

F2. Means testing

Key points

Means testing is an important tool for targeting government payments to those with most need and for managing the sustainability of the transfer system. It should continue to be used in the transfer system, but could be improved so that income and assets are more fairly assessed and incentives to work and save are strengthened.

Means testing is a key characteristic of Australia's unique transfer system, which is more highly targeted than other OECD countries. This high level of targeting is a strength of Australia's approach to income support that should be maintained. The concept of means for income support payments should include not only income but also the ability of a person to generate an income from their assets.

However, means testing can increase the level of complexity a person faces in interacting with the tax and transfer systems and can affect their incentives to work and save. Striking an appropriate balance between targeting based on need and maintaining incentives to work and save is a significant challenge in designing a means test.

Within the current two-part means test — the income test and the assets test — some assets are assessed under both tests, while other assets are assessed only under the assets test. This results in people receiving different levels of government payments even though they have the same level of wealth. This reduces the fairness of the means testing system.

A more uniform treatment of assets in the means test would reduce these outcomes and be more equitable. This could be achieved by having a comprehensive means test that determines access to all income support payments, including Newstart Allowance and the Age Pension. This means test would include deeming an income on most assets. The deeming rates would be based on the returns expected from a portfolio of assets that would be held by a prudent investor.

The comprehensive means test would provide a platform for tailoring the means test parameters such as free areas, withdrawal rates and earnings disregards to the circumstances of particular groups.

Family payments are in part paid to reduce the tax burden on those supporting dependent children, so it is more appropriate that the income base on which they are assessed is aligned with the taxation base. Taxable income on a family basis should therefore continue to be the sole means of determining a person's eligibility for these payments.

F2-1 Designing equitable means tests to reduce impacts on work and saving

The tax system and the transfer systems often use different concepts of means to determine a person's tax liability and their eligibility for income support. Under a progressive tax system the more income a person has the higher is their tax liability. Under a means tested transfer system, the level of income support decreases as the means a person has at their disposal increase. Another difference between the systems is that the transfer system includes all means available to a person, including those of their spouse or partner, while the tax system only considers the means belonging to the individual.

Both the tax system and the transfer system include employment income as means, although the transfer system does not generally reduce a person's income by their work expenses when determining their level of means. Apart from the treatment of the means of a partner, another difference between the two systems in calculating a person's means is the treatment of assets.

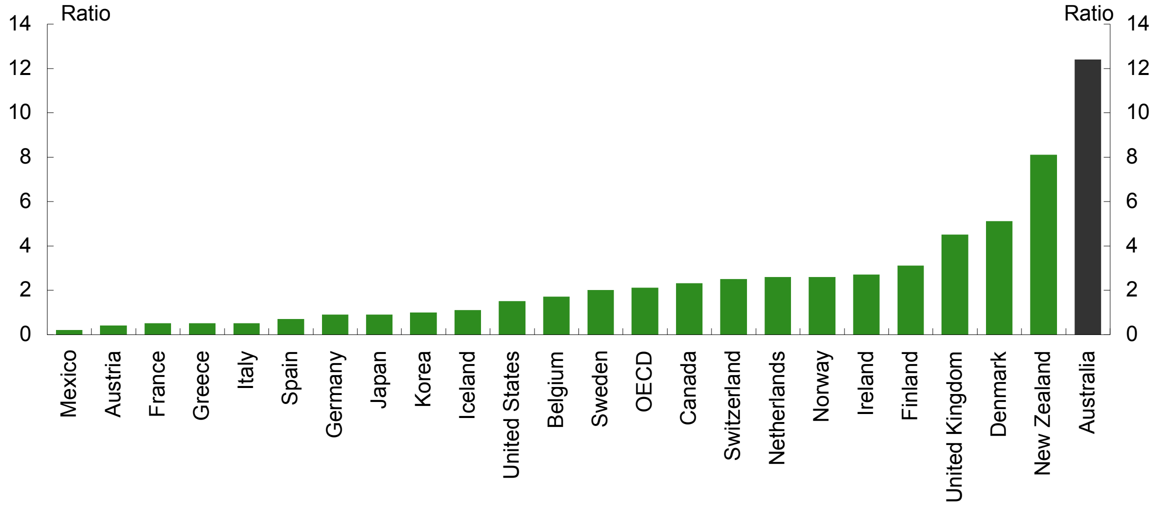
The tax system includes only the income generated from assets, such as rent, dividends and interest. A change in the value of assets does not have an immediate effect in the tax system. Changes in asset values only affect a person's income when there is a disposal or other realisation event in relation to the asset.

The transfer system, however, looks beyond whether an asset actually generates an income to consider the amount of assets at a person's disposal. It assumes that a person can use their assets to generate an income to support themselves. This includes their non- or low-income earning assets. Changes in means, such as increases in assets values, are therefore tested more frequently in the transfer system.

The different treatment of assets in the transfer system is a reflection that targeting on the basis of need requires a broader view of a person's ability to maintain themselves than that which is implied by testing income only. Without an effective assessment of assets, income support would enable greater transfer of assets to younger generations through bequests, rather than targeting assistance to people in need.

Means testing can be an effective mechanism for targeting assistance to people in need. Australia relies more on means tested payments than many other countries, with the result that its transfer system is more progressive than those of other OECD countries. Chart F2-1 shows the ratio of benefits received by the poorest 20 per cent of people to the benefits received by the richest 20 per cent of people in OECD countries (Whiteford 2009). Whiteford finds that within the OECD, Australia has the most progressive distribution of disability benefits and unemployment benefits, ranks second in the distribution of Age Pension benefits and ranks fifth in the distribution of family benefits.

Chart F2-1: Progressivity of cash benefits
Ratio of benefits received by households in the poorest to the richest quintiles, total population 2005



Source: Whiteford 2009.

The targeted nature of Australia's income support system has a number of benefits. It contributes substantially to the progressive effect of the tax and transfer systems on income distribution. Means testing is important to the sustainability of the income support system. By focusing spending on a smaller group, the level of benefits provided to those most in need can be kept higher.

While means tests and taxes have a different conceptual basis, they can have a similar economic impact. Empirical research shows that means testing affects decisions to work as strongly as tax does (Meghir & Philips 2009). Means testing raise effective tax rates which reduce the return people get from work and saving. For example, a person who earns an additional $100 of income may not only pay tax on that amount but also lose some of their income support.

It is therefore essential to limit means testing to the core transfer payments, in particular income support and family payments. Payments and supplements should be withdrawn so that the cumulative effective tax is not excessive.

The existence of multiple separately means tested payments results in overlapping withdrawal rates, which raise effective rates of tax. This can be particularly problematic where services and concessions are linked to payments and create 'sudden-death' loss of assistance once a particular income level is crossed.

The level of efficiency of taxes and means tests as ways of raising revenue (or limiting outlays) has been a crucial question in the Review's deliberations. Although means tests reduce the returns from work or saving, they can be designed in ways that reduce this impact. Indeed, some features of means tests may make them a more efficient instrument than direct taxes. For some working-age transfer payments, means tests are accompanied by activity-testing that directly requires recipients to look for, or undertake, employment.

Principles

The transfer system should have a broader assessment of means than the tax system. The concept of means for income support payments should include not only income but also the ability of a person to generate an income from their assets.

Means test arrangements should ensure that people on the same type of payment with similar means, including their income and their assets, receive an equivalent level of income support or other assistance.

The settings for a means test should pay attention to its impact on a person's decision to work and save as well as its primary objective of targeting government payments.

Means testing should be limited to essential payments, in particular income support and family assistance payments, to avoid an unnecessarily high effective rate of tax created by the cumulative nature of means test and tax.

While the targeted nature of Australia's income support system is on balance a strength of the system, there are areas where means testing could be improved. In particular, people who are receiving the same type of payment and have similar means should be treated consistently. It is also important to maintain incentives to work and save.

F2-2 The current system treats income and assets differently

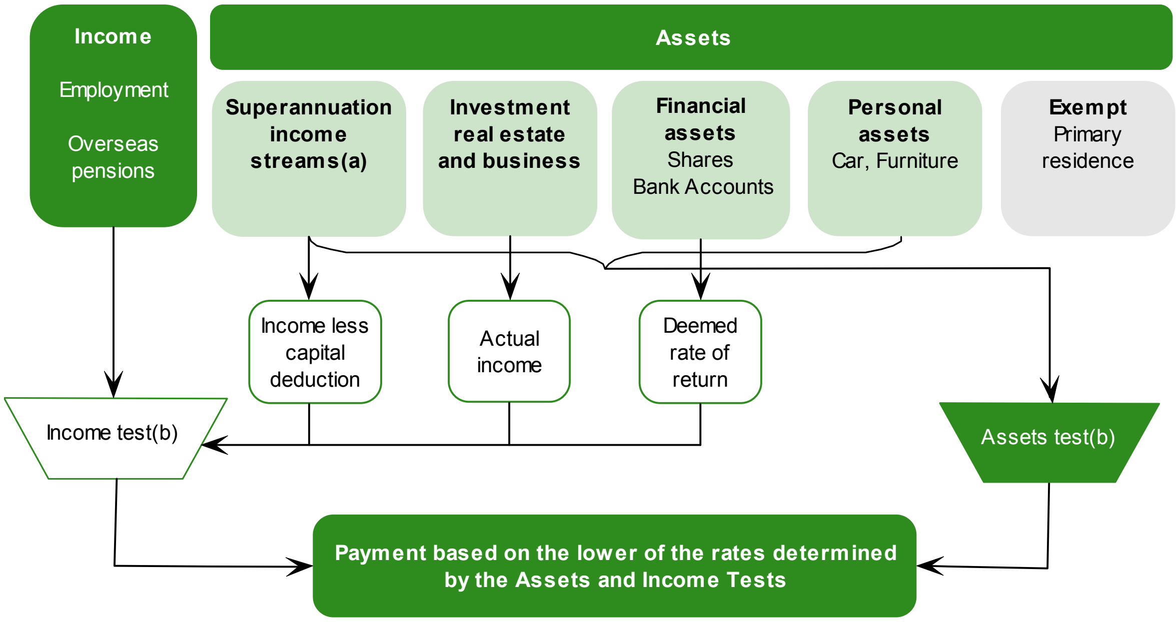
Means testing is used to determine the rate at which transfer payments are made. Transfer payments subject to means testing include: allowances (for example, Newstart Allowance, Youth Allowance and Parenting Payment (Partnered)); pensions (for example, Disability Support Pension, Carer Payment, Parenting Payment (Single) and the Age Pension); and family assistance (for example, Family Tax Benefits Part A and Part B, and Child Care Benefit).

The means test for allowances and pensions has two parts: an income test and an assets test (see Chart F2-2). A person's payment is calculated by applying the test that results in the least amount of payment.

- The income test reduces payments at a specified withdrawal rate per dollar of income above a free area. The withdrawal rate is 50 cents for all pension recipients (except Parenting Payment (Single) where it is 40 cents), and 50 and 60 cents for Newstart Allowance recipients. It applies directly to earned income (with certain concessions), but uses a variety of methods to assess income from assets. Actual income from real estate and trusts is used, while deemed income is used for financial assets (see *Deeming rate* in Section F2-4).
- The assets test includes most assets, and reduces pensions (other than Parenting Payment (Single)) by $1.50 per fortnight (or $39 per year) for every $1,000 of assets above the free area. Allowance and Parenting Payment (Single) recipients lose their payment entirely if they have assets above the free area. The principal home is exempt from the assets test (although there is a higher asset free area for non-homeowners).

The assets test has a similar effect as deeming a rate of return on assets for those people affected by it.

Chart F2-2: The existing means test base for income support payments



(a) Accumulated superannuation benefits which are not being drawn down through an income stream are treated as financial assets for people over Age Pension age. They are not included in the means test for people under Age Pension age unless they are being drawn down.
(b) Free areas and withdrawal rates apply to determine the amount of income support payment.

No asset test applies to family assistance payments (Family Tax Benefit Part A, Family Tax Benefit Part B, Baby Bonus) and Child Care Benefit. Eligibility for these payments is determined by adjusted taxable income. Adjusted taxable income comprises taxable income with adjustments made to improve the fairness of the system and move the means test for these payments closer to that for income support payments. For example, net investment property losses, salary sacrificed superannuation contributions and the adjusted or 'cash' value of fringe benefits are added back to taxable income.

Eligibility for Family Tax Benefit Part A is based on an estimate, made in advance, of the family's annual adjusted taxable income. The payment is reduced by 20 cents for each dollar above a threshold (currently $44,165) until it reaches the base rate of payment (this depends on the number and age of children and whether the family is receiving Rent Assistance). The base rate is then withdrawn from $94,316 (plus $3,796 for each child after the first child) by 30 cents for every dollar over that amount until the payment reaches nil.

Family Tax Benefit Part B has a two-stage test for couple households, such that it is only payable if the higher-income earner has an income of less than $150,000. If this test is satisfied, eligibility is based on the income of the lower earner. The full rate of assistance is payable where the lower earner earns less than the threshold (currently $4,672 a year). The payment is reduced by 20 cents for each dollar earned above this threshold. Full phase-out of the payment depends on the age of the child, with a higher payment and therefore higher phase-out level for children aged less than five years.

Single parents qualify for the full rate of Family Tax Benefit Part B if they have income of less than $150,000 a year and receive no payment when income exceeds this amount.

The income thresholds for receipt of Family Tax Benefit do not apply where people receive an income support payment from Centrelink or the Department of Veterans' Affairs. Rather, in situations where the income cut-out point for receipt of a part-rate of income support is above Family Tax Benefit income thresholds, income support recipients with qualifying children receive the maximum rate of Family Tax Benefit.

In the current system, multiple family payments create overlapping withdrawal rates and increase barriers to participation. Each payment withdrawal taper can be added to other taxes and withdrawal tapers and can contribute to higher effective rates of tax.

Additive tapers for family payments affect secondary earners in particular. The simultaneous withdrawal of Family Tax Benefit Part A and Part B add to effective marginal tax rates of secondary earners. Given other costs associated with working, this may deter secondary earners from entering or re-entering the workforce.

The full rate of Child Care Benefit is paid to families with combined incomes less than $37,960. Above this threshold, assistance is tapered away at various rates, depending on the number of children using approved care. The income cut-out points for Child Care Benefit are around $131,560 for families with one child using approved care, $136,375 (two children) and $153,995 (three children) plus an additional $29,077 for each child after the third.[15]

The Child Care Rebate is a payment in lieu of providing a tax deduction for child care, in recognition that this is a cost of employment. It is therefore appropriately not means tested, but should have a participation requirement attached (see Section F4 Child care).

Separate means testing arrangements apply to aged care and are considered in Section F7 Funding aged care.

F2-3 The current means tests treat people with the same means differently

The current approach to the means testing of income support payments is not as equitable as it could be, particularly in the assessment of assets and its effects on people with similar means. Some assets are assessed under both the assets and income test, while non-income-producing assets are only assessed under the former. For example, a holiday house is assessed only under the assets test, while financial assets, such as term deposits, are assessed under both tests (with the test that results in the least amount of payment applying).

Table F2-1 shows the reduction in pension payments due to an additional $1,000 of assets above the asset test free area, held in different forms, and assessed in different ways.

15 These figures are as at 20 September 2009.

Table F2-1: Pension reduction due to an extra $1,000 of assets above the free area[a]

Asset class	Means test treatment	Current pension reduction ($ per annum)
Own home	Exempt	0
Land	Asset test	39
Land (non-income producing)	Income test	0(b)
Term deposit	Income test — lower deeming rate(c)	10(d)
Term deposit	Income test — higher deeming rate(c)	15(d)
Term deposit	Asset test	39
Allocated pension	Income test	Varies(e)
Allocated pension	Asset test	39

(a) Shows the pension reduction due to the income and assets test assessment of these assets. Free areas are set out in Table F2-2.
(b) Income from income producing land is assessed under the income test.
(c) Different deeming rates apply depending on the person's overall level of financial assets.
(d) Based on current deeming rate of 2 and 3 per cent. Deeming rates have varied in the past (see Chart F2-5).
(e) Actual amount can vary depending on factors such as when the pension was taken and a person's drawdown choices. These factors can lead to no income being included in the income test.
Source: Treasury estimates.

Because income from some, but not all, assets is included in the income test, people can receive different levels of government payments even though they have the same aggregate level of wealth. It can also result in people receiving the same level of payment even though they have considerably different aggregate levels of assets. For example, a person earning $3,000 a year (an amount marginally below the current income test free area) can have around $170,000 of non-financial assets and receive the same pension as someone earning the same amount without any assets. This is because non-financial assets that do not produce income are not counted under the income test.

Findings

Means testing as it applies in Australia is a strength of the transfer system because it targets government payments to those with the most need and assists in managing the system's sustainability.

The current means test for income support payments is not as equitable as it could be because it results in people with different assets of the same value receiving different rates of income support. This reduces the fairness of the system and creates incentives to hold wealth in particular types of assets.

This can affect a person's choice on how to hold their assets. For example, a person in the example above may choose to invest their $170,000 in land instead of term deposits because it would have less effect on their income support payments. This reduces the fairness of the means testing system and the allocation of resources in the economy. A more uniform treatment of assets in the means test would promote a more equitable outcome.

F2-4 A new system would treat assets more consistently

Recommendation 88:

The current income and asset tests for income support payments should be replaced with a comprehensive means test based on a combined measure of employment income, business income and deemed income on assets. The comprehensive means test would:

(a) extend deemed income on assets in addition to other financial assets, including superannuation income streams, rental housing and other asset classes (whether income-producing or not). Superannuation income streams where deeming income would be difficult to apply would be tested on gross income but with an actuarially fair deduction for capital;

(b) have low and high deeming rates based on the returns expected from a portfolio of assets held by a prudent investor. These rates should be set by reference to an appropriate benchmark;

(c) continue the means test exemption for owner-occupied housing up to a high indexed threshold;

(d) set a high capped exemption for personal-use assets;

(e) retain the current concessional treatment of employment income for certain allowances and pensions;

(f) have different free areas for pensions and allowances; and

(g) remove the liquid assets waiting period and the sudden-death cut-out that applies to people on certain payments.

Means testing should continue to be part of the transfer system. However, the inequitable treatment of assets under the current means test highlights the need for reform. The objectives of reforming the means test would be to:

- ensure that the full range of a person's assets is effectively and fairly assessed;
- achieve greater neutrality in the treatment of different forms of savings;
- ensure people have appropriate incentives to use their savings effectively; and
- provide appropriate incentives for people, particularly for older Australians, to undertake paid work.

A comprehensive means test

The Review Panel foreshadowed in its report on strategic issues in the retirement income system that there should be a comprehensive means test that removes the assets test and extends the income test by deeming returns on a greater range of assets (AFTS 2009). While that report focused on retirement income payments, the same holds for other income support payments, such as Disability Support Pension, Parenting Payment and Newstart Allowance.

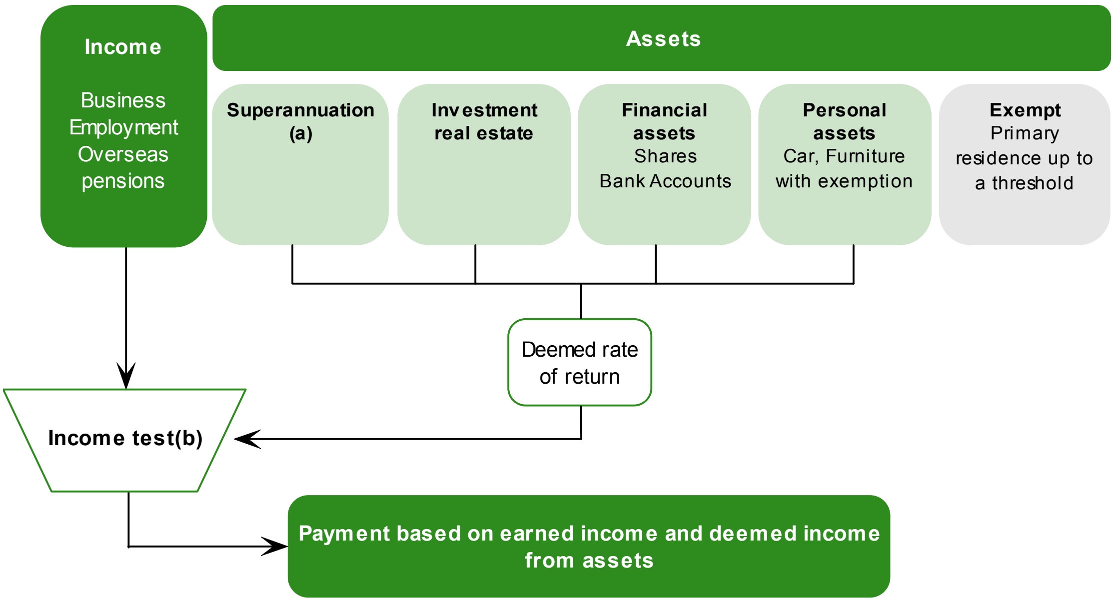
The removal of the assets test would make income the sole test of a person's means. However, removing the assets test without capturing non-income-producing assets would worsen the inequities evident in the current means test between these assets and financial assets. Therefore, to protect equity, an income would need to be deemed on non-income-producing assets to ensure they are incorporated into the means test.

Extending deemed returns to a broader range of assets would target the first three objectives for a comprehensive means test outlined above. It would include a broad range of a person's private means (income and assets) in the means test. It would be fairer than the current means test arrangements, as it would treat most assets in the same way when determining a person's eligibility for income support. It would also encourage a person to use their assets to generate an income to support themselves while they are accessing income support.

The effectiveness of a comprehensive means test would depend on having the broadest possible asset and income base with minimal exclusions. If there were significant exclusions, there may still be a need for a residual assets test. There is a case for special arrangements to apply to owner-occupied housing and to personal-use assets (that is, assets that do not generate an income but may have sentimental value). These arrangements are discussed in the section titled 'Value of assessable assets' below.

The structure of the base for a comprehensive means test is illustrated in Chart F2-3.

Chart F2-3: A comprehensive means test base



(a) Deeming on account-based superannuation assets would apply from Age Pension age. Special arrangements would apply to income streams where deeming is difficult. Superannuation assets would not be deemed for people under Age Pension age unless they are being drawn down.
(b) Free areas and withdrawal rates would apply to determine the amount of income support payment.

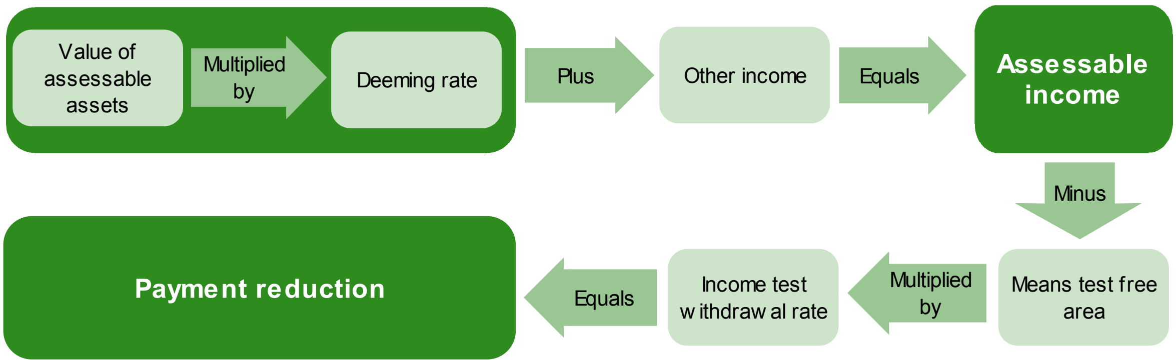
Under the means test, a person's income would depend on the value of their assets and the deeming rates that apply to these, in addition to their other income (income from employment, overseas pensions and other non-asset backed sources). Income for means testing purposes would continue to be based on a person's ordinary income — that is, income from employment, savings and other sources before deductions — as it better reflects a person's capacity to support themselves. However, payments should not be reduced as a result of the inclusion of compulsory superannuation contributions in taxable income (see

Effect on government payments and child support in Section A2-2 Taxing retirement incomes).

The current income and assets tests treat income-producing assets in different ways. Under the income test, deeming is generally applied to the gross value of financial assets. By contrast, the assets test generally includes only the net value of assets. Under the comprehensive means test, deeming would be based on the net value of assets (that is, the market value of the assets less any encumbrances, such as loans, secured against them). The net value of assets provides a more accurate reflection of the amount of assets a person has at their disposal. Arrangements would need to be put in place to ensure that the allowance for encumbrances was not abused.

The amount of income support payments would also depend on the free area (the level of income a person can have before it affects their payment) and the withdrawal rate (how quickly payments are reduced as income increases). Chart F2-4 outlines the key components of a comprehensive means test.

Chart F2-4: How the means test would work



There may be circumstances where these parameters are adjusted to achieve particular participation or distribution goals. For example, for single parents and people with a disability, the means test arrangements should provide an incentive to work part-time and recognise the higher costs of work they may face (see Recommendations 85 and 86).

Value of assessable assets

Deeming is a device to establish an income from an asset. The principle underlying deeming is that where an asset value can be simply and effectively determined, deeming would result in a fairer and straightforward means test assessment.

Deeming an income on more assets would involve more frequent assessment of their value. This would make the means test more responsive to changes in people's circumstances, including changes in market conditions. As with deeming on financial assets, this does not mean that income support recipients would need to report the value of their assets fortnightly.

Extending deeming would also change the means testing arrangements for many assets, including investment properties and some pensions paid from superannuation funds and life insurance companies.

Rental income from an investment property is currently included in the income test. Under the base for a comprehensive means test, income would be deemed on the value of the property. Other properties such as holiday homes would be treated in a similar way. The value of properties would be determined, and reviewed, using the approach currently adopted under the assets test, with properties valued at their net market value.

Account-based superannuation pensions, such as allocated pensions, would be included in the extended deeming arrangements. Such pensions are similar to other financial assets as there is an easily determined account value. Under the base for a comprehensive means test, an income would be deemed on the account value like other financial assets. The current rules for the assessment of these products (gross income minus a deduction for capital) would no longer apply.

However, there are some assets where deeming may be difficult to apply. In these cases other arrangements may be appropriate. Some examples of these assets are set out below.

Some people may receive a guaranteed income for life that commences when they retire. This may be paid from a defined benefit superannuation fund or purchased from a life insurance company. The Review has also identified the role that deferred annuities can play in an ageing society (see Section A2-3 Responding to increasing life expectancies). These products commence from a specified age and are a type of insurance against running out of income in retirement. When a person dies their premium can be used to support other people who have purchased this insurance. Deeming an income on these products would be difficult because an underlying asset value cannot be easily identified.

Where deeming cannot be simply and accurately applied, the gross income received may be the simplest measure of the asset's value to the person. However, as part of the gross income of these products is a repayment of the person's own capital, the income should be reduced by an actuarially fair deduction for capital.

The base of the comprehensive means test would include income received from private companies, sole proprietors, partnerships and trusts. Under the current system, income received from these arrangements is included in the income test (less deductions for expenses necessary to operate the business), and the value of the trust or company assets is included in the assets test. Income from these arrangements would be included in the base, but further work would need to be undertaken on the appropriate method for assessing assets in these entities.

Personal-use assets such as furniture, cars and clothing are usually purchased for reasons other than to generate a return. People may also have assets that have sentimental value, such as small collections. These assets are included under the current means test via the assets test, which effectively deems an income on them once a pensioner has total assets above the assets test free area. However, the base of the comprehensive means test would result in more of these assets being assessed. To help address sensitivities about reductions to payments due to the assessment of income from these assets, there would be a capped exemption from the means test for these assets. This would particularly assist people with moderate asset holdings.

The definition of personal-use assets would need to be considered carefully — in particular, whether it would extend beyond personal effects, household contents and cars to include boats and caravans. Such assets could be assessed at their market value, as they are currently, with the owner's estimate of market value accepted in some cases.

Deeming rate

Deeming is a device to establish an income from an asset. An appropriate deeming rate would be set with reference to the returns likely to be generated on a portfolio of assets a prudent investor is likely to hold. Actual income above the level of deemed income is not included in the means test.

Currently there are low and high deeming rates on financial assets that are set by agreement between the Minister for Families, Housing, Community Services and Indigenous Affairs and the Minister for Education, Employment and Workplace Relations. Financial assets include investments such as bank deposits, shares and managed investments.

The low deeming rate is set at a rate of return that people with relatively few savings are likely to receive. It also reflects the returns on highly liquid and safe assets, such as bank deposits, which are likely to be preferred by people with few savings. This rate applies to the amount of financial assets a person has below a prescribed threshold. The high deeming rate reflects an expectation that people with more savings can obtain, and should seek, higher returns on some of their savings. This rate applies to the value of financial assets above the threshold.[16]

The deeming rate applied is likely to vary between different classes of income support recipients because of the level of assets they hold. Few young people, for example, will have sufficient assets to incur the higher deeming rate, while many retirees will.

Chart F2-5 shows how these deeming rates have changed over time. Given the likely risk preferences of income support recipients with low asset balances, retaining both low and high deeming rates remains appropriate.

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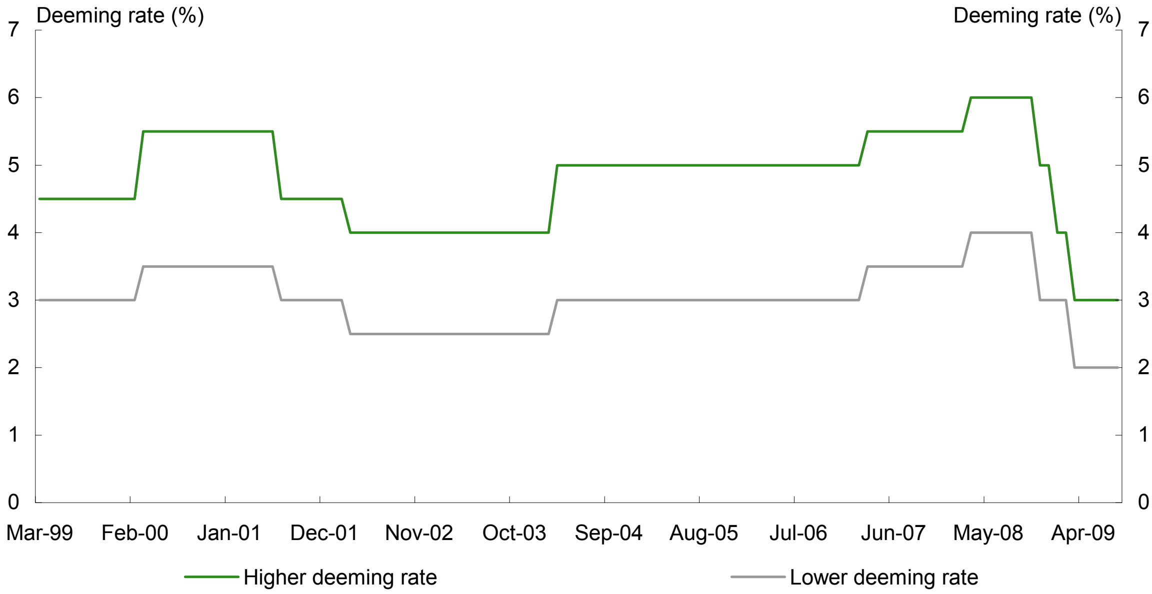
16 The low deeming rate applies to: the first $42,000 of total financial assets for a single allowee (a person receiving an allowance) or pensioner; the first $70,000 of a pensioner couple's total financial assets; and the first $35,000 of total financial assets for each member of an allowee couple. These amounts are indexed yearly to the consumer price index (CPI).

Chart F2-5: Deeming rates — March 1999-August 2009



Source: Department of Family, Housing, Community Services and Indigenous Affairs.

However, it would be more transparent if these rates were set with reference to a benchmark rather than by the relevant ministers. The low and high rates could be set at a discount or premium to a relevant benchmark, such as the cash rate or Treasury bond rate, at least twice a year. A mechanism would also be put in place to allow for changes to the deeming rates to occur more regularly in case of sudden movements in the market.

Other income

The actual value of employment income and overseas pensions would be included in the means test, subject to any disregards or discounts applied to particular groups (see below).

One of the objectives of reforming the means test is to provide appropriate incentives to work, particularly to older Australians. For this reason the existing concessional treatment of employment income for some income support recipients should be retained. For example, under the Work Bonus, only half of the first $500 of fortnightly employment income is included in the means test for pensioners over Age Pension age.[17]

The Working Credit scheme, which applies to other income support recipients,[18] and the Student Income Bank[19] should also be retained. Working Credit allows a person to accrue up to $1,000 of credits they can use to offset employment income once they commence work.[20] Student Income Bank allows a person to accumulate up to $6,000 of any unused portion of their fortnightly income free area that can later be used to offset income above the free area.

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17 This commenced from 20 September 2009. For example, a person over Age Pension age who has $400 of employment income per fortnight will only have $200 included in the means test for that fortnight.

18 Working Credit applies to Newstart Allowance, Youth Allowance (Job Seeker), Partner Allowance, Mature Age Allowance, Sickness Allowance, Widow Allowance, Parenting Payment (Partnered), Parenting Payment (Single), Wife Pension, Widow B Pension, Carer Payment, Disability Support Pension and Bereavement Allowance.

19 Student Income Bank applies to full-time students who receive Youth Allowance, Austudy or ABSTUDY.

20 A person accumulates credits if their income from all sources is less than $48 a fortnight.

This recognises that students generally earn much of their income during their holidays, rather than throughout the year.

Means test free area

Currently there are separate free areas for the income and assets tests. These free areas set the level of income or assets a person can have before they start to lose some of their payment. Tables F2-2 and F2-3 following set out the current free areas and cut-out points for pensions and allowances.

Table F2-2: Pension income and assets tests free areas and cut-out points[(a)]

Income test (per fortnight)		Assets test	
Free Area:	$142 (single) $248 (couple)	***Cut-out points for full pension***	
		Homeowners:	
Cut-out points:	$1,485.80 (single) $2,274.00 (couple)	Single Partnered (combined):	$178,000 $252,500
		Non-Homeowners:	
Pensions are withdrawn at 50 per cent for every dollar above the free area.(b)		Single: Partnered (combined):	$307,000 $381,500
The income test does not apply to a permanently blind person receiving an Age, Service or Disability Support Pension.		***Cut-out points for part pension***	
Cut-out points for part pension may be higher if receiving Rent Assistance or if separated due to illness.		*Homeowners:*	
		Single: Partnered (combined):	$626,000 $928,500
		Non-Homeowners:	
		Single: Partnered (combined):	$755,000 $1,057,000
		Pensions are withdrawn at a rate of $1.50 per fortnight for every $1,000 above the threshold.	
		Cut-out points for part pension may be higher if receiving Rent Assistance or if separated due to illness.	
		The assets test does not apply to a permanently blind person receiving an Age, Service or Disability Support Pension.	

(a) Cut-out points as at 20 September 2009. Free areas are indexed in line with CPI and increase from 1 July each year.
(b) Parenting Payment (Single) recipients have a withdrawal rate of 40 per cent. They have a free area of $166.60 per fortnight, plus $24.60 for each additional child.
Source: Australian government administrative data.

Table F2-3: Allowance income and assets tests free areas and cut-out points[(a)]

Income test (per fortnight)		Assets test	
Free Area:	$62	*Homeowners:*	
Withdrawals:	50 per cent on income between $62-$250 60 per cent on income above $250	Single Partnered (combined):	$178,000 $252,500
		Non-Homeowners:	
Cut-out points:	$853.34 (single) $1,558.34 (couple)	Single: Partnered (combined):	$307,000 $381,500
Partner income test:		If assets are assessed as being above the free area by any amount entitlement to payment is zero. The free area and cut-out points are therefore identical.	
Free Area: Withdrawal:	$780 60 per cent		
If the recipient's partner is a pensioner, a joint income test applies. Individual income is calculated as half the combined income of the couple. This amount is then subject to the person's individual income test.			
If the recipient's partner is not a pensioner, a sequential income test applies. Individual income test is applied to own income. Partner income over the partner income free area is subject to a 60 per cent withdrawal.			
Cut-out points for part pension may be higher if receiving Rent Assistance or if separated due to illness.			

(a) Cut-out points as at 20 September 2009. Free areas are indexed in line with CPI and increase from 1 July each year. Allowances include Newstart Allowance, Parenting Payment Partnered, Sickness Allowance, Mature Age Allowance, Widow Allowance and Partner Allowance and exclude student and youth payments. Allowance assets test limits also apply to Parenting Payment (Single). Cut-out points for student and youth payments vary based on age, whether the person is living at home or not, and whether they are partnered. A single person aged 18 or over living at home can earn up to $236 a fortnight and still receive full student payments, with the benefits cutting out at $656. If they were living away from home, these limits are $236 and $868 respectively. The personal income threshold is proposed to increase to $400 from 1 July 2012. The withdrawal rates are set out in the Withdrawal rates section below.
Source: Australian government administrative data.

Free areas serve a range of purposes, including to:

- avoid reducing payments on the basis of small levels of income and assets;
- reduce the administrative burden associated with reporting on small levels of income and assets;
- provide some recognition of the costs associated with obtaining income (whether through employment or investment); and
- provide incentives for people to take up paid work.

These objectives must be balanced against the broader objectives of maintaining a targeted and sustainable income support system. There are different free areas depending on the type of income support payment. The pension free areas are currently more generous than those for allowances. The different free areas for pensions and allowances should be maintained under the proposal.

The free areas for pensions are designed to protect the adequacy of the income of pensioners with small amounts of non-pension income. Many pensioners are not able, or expected, to support themselves through paid work. This means that pensioners have a heavier reliance on their savings to provide their non-pension income. A higher free area ensures they are not forced to dissipate these savings too quickly. At the same time the higher free area provides an incentive for pensioners to supplement their income where they are able to do so.

The free areas for allowances are set at a level that ensures that targeting is met and workforce incentives are maintained. This recognises that people on allowances generally have more opportunity to support themselves through paid work.

There are also free areas for family payments and child care assistance. These operate to ensure that family payment and child care assistance withdrawal do not coincide with income support payments for those likely to be able to take up employment (for example, allowance recipients).

Withdrawal rates

A person's income support payment is reduced by a set amount for every dollar of income, or $1,000 of assets, in the case of asset tested pensions, above the respective free areas. The withdrawal rates vary between the various payments. For example, the income test withdrawal rate for the Age Pension is 50 per cent while for Newstart Allowance there are two withdrawal rates: 50 per cent applies for income over $62 per fortnight up to $250 per fortnight and 60 per cent applies from that point.

The design of withdrawal rates seeks to balance a range of objectives, including workforce incentives and targeting assistance to those most in need. In general, a steeper withdrawal rate would reduce incentives to work and save (although this impact can be reduced by the use of activity requirements). A shallow withdrawal rate would not reduce incentives by as much but, as more people would receive some payment, it would increase the number of people exposed to reduced incentives to work and save. In the case of Newstart Allowance, the stepped withdrawal rate of the income test seeks to balance these two effects.

Arrangements for couples

The means test for members of a couple currently operates differently depending on the type of payments the couple receives. If neither member of the couple receives a pension, a person's income first reduces their own payment. If their income completely withdraws their payment, their remaining income then reduces their partner's payment. This arrangement does not apply to couples who are both pensioners, or where one receives an allowance and the other receives a pension. In these cases, a person's income is split 50:50 with their partner and therefore reduces both payments at the same time.

Requiring pensioner couples to split their income in this way can weaken their incentives to participate in the workforce. It also means that a person's payment is reduced at a low level of partner income, which may not reflect an increase in the resources available to them. The option of having a consistent treatment of income for all couples on income support should be further explored. However, this should take into consideration the potential increase in complexity these people would face in how they manage their affairs. This complexity would arise due to the distribution of assets between a pensioner couple affecting the total pension payment to the couple.

Arrangements for payments to young people

A parental income test applies to people receiving Youth Allowance and ABSTUDY who are regarded as being dependent on their parents. Currently, Youth Allowance and ABSTUDY are withdrawn at a rate of $1 for every $4 above the parental income threshold (currently $32,800), which is based on the previous year's taxable income.[21]

A family assets test also applies to Youth Allowance and ABSTUDY. Under this test, a person is not eligible for a payment once their family's assets exceed a threshold (currently $571,500).[22]

Given the need for a means test to consider most of the resources available to an individual, the parental income test and family means test should remain until the individual is assessed as being independent.

Interactions with taxation settings

Making transfer payments non-taxable will lead to simpler interactions between the tax and transfer systems (see Section A1 Personal income tax). When payments are withdrawn at the same time as tax is paid, the stacking of the means test and tax scale can result in high effective tax rates. This can harm participation incentives. Where appropriate, means tests could be adjusted to take account of the underlying tax scales to deliver a desired effective tax rate. Given the different treatment of income and period of assessment in the two systems, this may be difficult to achieve precisely.

Transitions to a new system

A more equal treatment of assets under the comprehensive means test base may reduce a person's entitlement to income support if they have assets not currently captured by the income test. Transitional arrangements could be put in place to reduce the impact of this change. This could include freezing the current level of payment a person receives but not indexing that amount until their income support is equivalent to that which would apply under the new arrangements.

If such arrangements were considered too complex, an alternative would be to announce that the comprehensive means test would be introduced some years in the future. This would give people time to make adjustments. This approach has been adopted for the increase in superannuation preservation age from 55 to 60 and increases in Age Pension age.

Owner-occupied housing

Owner-occupied housing plays an important role in Australian society. In the strategic report on the retirement income system (AFTS 2009), the Panel supported continuing the exemption of owner-occupied housing from the means test. However, the report highlights that an uncapped exemption provides for very high levels of wealth to be sheltered from means testing.

Owner-occupied housing would continue to be exempt from the proposed comprehensive means test base. However, to increase the fairness of the means test, a cap should be applied to the exemption. Only the amount above the cap would be included in the means test and

21 The threshold increases for each additional child in the parent/s care. The parental income test does not apply if the parent/s gets an income support payment or has a low-income Health Care Card. In determining a person's payment the parental income test applies before the personal income test.

22 A 75 per cent discount applies for farm/business assets.

subject to deeming. This would ensure that the means test exemption applies to housing that meets the primary role of providing shelter and other support. Beyond this point, housing can be considered like any other asset a person purchases with an expectation of generating a future return.

The cap would ensure that the means test targets only housing of significant value. For example, it is estimated that a cap of $1.2 million would currently mean that around 10,000 age pensioners' homes would be partially assessed under the means test. In setting a threshold, consideration should be given to the effect on regional areas.

The design of a comprehensive means test also needs to deal with housing transitions. Neutrality between housing choices is an important public policy goal. These choices include whether to be a homeowner or renter, and different home ownership options, for example, downsizing from a three-bedroom family home to a smaller unit.

Currently, a number of aspects of the tax and transfer systems may deter people from downsizing. A person must pay stamp duties when choosing to sell their home and purchase a new one. The Review is recommending that stamp duty be reduced or removed (see Section C2 Land tax and conveyance stamp duty). Selling a home can also result in a person losing part of the income support payment. For example, a person who sells their home for $600,000 and purchases a new one for $400,000 would have the $200,000 difference included in the means test.

In the existing means test arrangements, the difference in the assets test free areas for homeowners and non-homeowners reduces the disincentives for a pensioner to sell their home and become a renter. While the assessable assets of a pensioner who has sold their home and becomes a renter increase, they benefit from a higher free area.

The removal of the assets test and assets test free areas under a comprehensive means test would remove any difference in the treatment of homeowners and non-homeowners. The reforms to Rent Assistance recommended in Section F5 (Housing assistance) would mean that homeowners and renters would be treated equitably in the income support system. There would therefore be no reason to maintain different free areas for homeowners and non-homeowners under the comprehensive means test. However, consideration would need to be given to how retirement village entry contributions and eligibility to Rent Assistance for those in retirement villages might be assessed.

The proposed comprehensive means test would have less impact than the current dual means tests on income support payments for people who move from owner-occupied housing to renting. This is due to the combination of the proposed reforms to Rent Assistance and the lower pension withdrawal rates that would apply under a comprehensive means test. The lower effective withdrawal rate would also reduce disincentives to move from larger to smaller houses. A pensioner who moves from a large to a small house would still be moving assets from an exempt to an assessable environment but the lower withdrawal rate in the new comprehensive means test would result in an increase in their total income.

In addition, the Review is recommending that the comprehensive means test base incorporate rules that create flexibility for homeowners who experience temporary changes in their circumstances, or who are moving from one housing arrangement to another. These rules would generally be based on the assets test rules that currently operate in these circumstances:

- Where an income support recipient temporarily vacates their principal home, the home continues to be considered as their principal home and remains exempt under the assets test for up to 12 months. The exemption applies even when the person expects to be absent for more than 12 months. Where the home is lost or damaged the temporary absence can be extended to up to 24 months if certain criteria are met.

- The value of an accommodation bond of unlimited value paid on entry to residential aged care is an exempt asset. A pensioner's former principal home is generally exempt from the assets test for up to two years from the time they move into residential aged care.

- The proceeds from the sale of a pensioner's principal home they intend to use to purchase another home are an exempt asset, generally for up to 12 months.

Liquid assets waiting period and sudden-death cut-outs

The liquid assets waiting period applies to Newstart Allowance, Youth Allowance, Sickness Allowance and Austudy. If a person would otherwise be eligible for one of these allowances but has more than $5,500 in liquid assets ($11,000 for a couple or single with dependents) they have to wait for a period before they can access a payment. This period can range from one week to 13 weeks depending upon the level of liquid assets. The purpose of the waiting period is to ensure that people rely on their readily accessible assets such as bank deposits before becoming eligible for income support.

However, the liquid assets waiting period can result in inconsistent and inequitable treatment of some people with relatively small levels of savings. It can act as a disincentive to save, especially for people who expect to need income support in the near future. It can also encourage people to run down their savings more quickly in order to qualify for income support.

A more consistent treatment of assets for means testing purposes would provide a better measure of means for people applying for allowances, removing the need for the liquid assets waiting period.

A sudden-death assets test exists for Newstart Allowance, Widow Allowance, Partner Allowance, Sickness Allowance, Special Benefit, Parenting Payment, Youth Allowance and Austudy. This means that once a person's assets (not including the family home) are $1 above the threshold they lose 100 per cent of their payment. The Review is not recommending that this aspect of the current means test arrangements be retained in the comprehensive means test. A sudden-death threshold can result in an inequitable situation where people with assets marginally below the threshold receive full income support while people with assets marginally above the threshold receive no support.

How the comprehensive means test affects pensioners and allowees

Table F2-4 sets out some indicative means test parameters for a single age pensioner and Newstart Allowance recipient that may apply under a comprehensive means test. The actual impact of the proposals on payments will depend on the setting of parameters such as the precise treatment of particular assets (for example, personal-use assets and assets in trusts), withdrawal rates, free areas and transition arrangements.

Table F2-4: Indicative parameters of a comprehensive means test (single person)

	Age pensioner	Newstart allowee
Free area (per fortnight)	$142	$62
Withdrawal rate (on income above the free area)	50 per cent	65 per cent
Employment income	The means test only includes 50 per cent of the first $500 of fortnightly income. Amounts above $500 are fully included in the means test.	100 per cent from first dollar of income is included in the means test.
Treatment of assets	First $42,000 of assets deemed at low rate Assets above $42,000 deemed at high rate Exemptions: Owner-occupied housing up to a threshold of $1.2 million First $75,000 of personal-use assets	Same as for pensioners

The comprehensive means test would reduce the effect assets have on a person's payment relative to the effect from the current assets test. Under the indicative comprehensive means test the withdrawal rate on a pension would reduce to 50 per cent until the payment phases out completely. Under the current assets test, the effective withdrawal rate of a pension can be higher than 50 per cent. For example, a pensioner loses $1.50 of payment per fortnight (or $39 a year) for every $1,000 of assets over the free area. This equates to an effective marginal withdrawal rate on income of 78 per cent, assuming a 5 per cent annual return on those assets. This rate will vary depending on asset holdings and the assumed rate of return.

The indicative comprehensive means test would increase the assets people could hold before their payment is phased out completely. It would also increase the effective 'cut-out' point for allowees who rely solely on income from their assets.

F2-5 Means testing family assistance payments

Recommendation 89:

Means testing for family assistance payments should be based on the same measure of taxable income as for income tax, including fringe benefits. However, payments should not be reduced as a result of the inclusion of compulsory superannuation contributions in taxable income. Consideration should be given to aligning the definitions of income and periods of assessment for family assistance payments more closely to those that apply to income support payments. However, this should not include deeming income on assets.

Family payments should continue to be means tested by reference to an estimate in advance of the family's annual adjusted taxable income. Family assistance payments are to assist in the financial support of children. Actual income, rather than deemed income, is a more appropriate basis to means test these payments as it reflects the income readily available to families to support their children. Deeming an income on assets may also discourage families from saving while they have children, which may affect their future wellbeing. Family assistance payments are described in more detail in Section F3 Family and youth assistance.

Currently, taxable income is adjusted to include amounts such as the 'cash' or adjusted value of fringe benefits and salary sacrificed superannuation contributions. The Review is recommending that fringe benefits and superannuation contributions be included in a person's taxable income (see Section A1 Personal income tax) so these adjustments would no longer need to be made. However, including compulsory superannuation contributions in taxable income should not affect family assistance payments (see Taxing retirement incomes in Section A2-2). This could be achieved by increasing the thresholds for family payments. Taxable income would be reduced by the proposal for a 40 per cent savings income discount to individuals for non-business related net interest income, net rental income and capital gains (and losses). See Section A1 Personal income tax.

In the longer term, basing entitlement to family assistance on a test of current actual income using the same definitions and periods of assessment as income support should be explored. This would be more responsive to changes in people's circumstances because fortnightly payments would reflect the current circumstances of the family and not an estimate of its income over a 12-month period. It would also end the current situation where a family can incur a debt at the end of the income year because of unforeseen changes in their circumstances.

Child care assistance is provided to encourage participation in employment or training for low-income families and to recognise that child care is a cost of employment for all families. For this reason, child care should be means tested from a high rate of assistance for low-income families down to a base rate of assistance for all families that use child care in order to engage in the workforce. See Section F4 for more detail on child care assistance.

The means testing arrangements for child care need to operate coherently with other means tested payments received by parents. Because families are potentially eligible for a number of payments and services, it is essential that child care withdrawal rates are considered in conjunction with other withdrawal rates (see Recommendation 100).

F3. Family and youth assistance

Key points

Family payments should be sufficient to ensure that children have access to a basic acceptable standard of living. The rate of family payments should reflect the direct costs of children in low-income families. Current rates of assistance do not adequately reflect the direct costs of older children, but are more than adequate for very young children and for larger families.

Family payments provide a degree of horizontal equity between taxpayers with and without dependent children. For a given amount of funding, this horizontal equity role must be balanced with the need to ensure vertical equity.

Family payments should also assist parents who are nurturing young children to balance work and family responsibilities. Assistance could continue beyond the early years for single parents and families in specific circumstances, such as parents caring for disabled children and foster care children with higher needs.

The total amount of family assistance should be withdrawn using a single means test based on family income which avoids cumulative withdrawal rates that create unnecessarily high disincentives for working.

Current arrangements for family payments are complex in terms of the number of payments, the design of individual payments and their interaction with the rest of the tax and transfer system.

Family payments should be provided in a simple and transparent form coherent with other parts of the tax and transfer system. A single, simple family payment should be provided to cover the direct costs of children. Because these costs increase as children grow older, assistance should be higher for older children. The payment should be means tested based on family income and should be designed to minimise the impact on workforce incentives.

Family payments should be the main form of assistance for children up to the age of 18 or until the completion of secondary school. Beyond these points, youth payments alone should be available and should be focused on encouraging study, training or workforce engagement. There should be a seamless transition from family payments to youth payments. Youth payments should be the main form of income support from the age of 18 until the age of independence.

The rates of youth payment should reflect the fact that young people generally have lower needs than adults, but should be sufficient to support investment in education, training and other capability-building activities (including combining part-time work and part-time study). Youth payment rates should not favour unemployment over education and training and should reflect the fact that young people in different living arrangements and personal circumstances have different needs. Those living away from home have higher costs than those living at home.

F3-1 What is the role of family and youth assistance?

Ensuring children have access to a basic acceptable standard of living

Parents have primary responsibility for the financial support of their children. However, some families do not have a level of private income sufficient to adequately support their children. As income support payments are designed to be adequate only for their recipients, these families need additional income to adequately support their dependent children.

The primary role of family payments, as distinct from income support payments, is to ensure all children have access to a basic acceptable standard of living. To achieve this goal, family payments must work hand in hand with income support payments so that parents have the means to provide themselves and their children with a basic acceptable standard of living. The provision of a basic acceptable standard of living encompasses both poverty alleviation and social inclusion objectives.

Access to services such as education and health is also fundamental to ensuring access to a basic acceptable standard of living for children and to facilitating their social inclusion. Children's access to these services is as relevant as the role that family payments play in addressing the objectives of poverty alleviation and social inclusion. From early childhood onwards full access to health services and participation in education should not be restricted by a family's financial circumstances.

Poverty alleviation and social inclusion should not be considered in a static sense. While it may be necessary to provide financial assistance to families when their available income is low, social inclusion is not likely to be sustainable if families continue to rely on transfer payments as a primary source of income. It can be difficult to find the right balance between providing an adequate level of support and not providing government transfers at a level where these payments become a substitute for employment.

A general principle is that the rate of family payments should reflect the direct costs of children in low-income families — that is, the out-of-pocket expenses parents must incur to provide a basic but adequate standard of food, clothing, housing and other items necessary for the development of children. Family payments should combine with income support payments to provide an adequate level of support for both parents and children.

Principle

Family payments should be sufficient to ensure that children have access to a basic acceptable standard of living. The rate of family payments should reflect the direct costs of children in low-income families.

Horizontal equity

The principle of horizontal equity is that individuals with a similar ability to pay taxes should pay the same amount. For family payments, this involves acknowledging that people with children have greater costs and greater needs than people without children at the same level of income, and recognising that children are a valued social resource on which future living standards and the wellbeing of society as a whole depend. This suggests that taxpayers supporting dependent children should have a lower net tax burden than those without dependent children. This lower net tax burden could be achieved through tax offsets or family payments.

Applying the horizontal equity principle in pure terms would mean a universal family payment; that is, families with similar characteristics (such as, age and number of children) would receive the same amount of assistance irrespective of income. However, because family payments in Australia are paid at relatively high rates to achieve adequate levels of support for low-income families, it would be extremely costly to provide universal payments. Phasing out payments using a low withdrawal rate can provide some level of assistance to most families without the full cost of a universal family payment.

Horizontal equity can also refer to providing similar tax treatment to couples that receive their income primarily through one earner, relative to couples where both members undertake significant work. Because of the progressivity in the tax and transfer system, the couple where both members work pay lower net tax. The current system provides assistance to dependent spouses through Family Tax Benefit (FTB) Part B for those with children and through the Dependent Spouse Tax Offset, where the primary earner pays sufficient tax, for those without children.

Historically, assistance for families has addressed vertical and horizontal equity for families with dependent children in different ways. Vertical equity — the concept that people with low means should receive greater assistance than those with higher means and that those with greater economic capacity should have a higher tax burden — has been addressed by the provision of additional assistance or higher rates of family assistance to low-income families.

Although family payments in Australia have generally provided a degree of horizontal equity, since the late 1980s governments have also tended to identify points on the income spectrum where assistance has no longer been considered necessary. In the current system, this occurs through the provision of a base rate of assistance for middle-income families (though not fully horizontal, as this is also means tested).

Principle

Family payments provide a degree of horizontal equity between taxpayers with dependent children and taxpayers without dependent children. For a given amount of funding, this horizontal equity role must be balanced with the need to ensure vertical equity.

Supporting parents with young children

Families may also experience indirect costs (such as loss of income) when parents need to care for their children and have limited capacity to work. The Paid Parental Leave (PPL) program scheduled to begin in 2011 will encourage time out from the workforce after the birth of a child and provide an alternative source of income for primary carers who satisfy the employment requirements before their child is born.

Supporting the role of parents is particularly important in the period immediately following the birth of a child. OECD studies and the Productivity Commission's report on PPL identify a period after the birth of a child when it is significantly advantageous for both the child and the mother to be at home (around 0 to 6 months), with a reasonable prospect that longer periods of parental care (9–12 months) are also beneficial (OECD 2007c; Productivity Commission 2009b).

The literature also identifies a period (beyond five months) over which absences from the workforce become more critical to parents' longer-term employment prospects (Jaumotte 2003; Ruhm 1998). Maternal participation is in turn important for longer-term outcomes for mothers and their children (OECD 2007c; Jaumotte 2003).

In Australia, most primary carers (who are usually mothers) who choose to return to work after the birth of a child do so between one and three years of the birth (see also Section F1 Income support).

Family payments have a role in ensuring that the choice to spend a reasonable length of time out of the workforce to care for young children is not constrained by financial need. PPL provides a strong signal that an absence from employment is appropriate and provides an alternative source of income for primary carers after the birth of a child.

Beyond the immediate post-birth period covered by PPL, many parents continue to stay out of the workforce or reduce their hours of participation to provide care to young children. Low- to middle-income families should continue to be supported in the interests of the welfare of children, while still fostering increasing workforce attachment. For some families, one parent remains out of the workforce or works reduced hours; for other families, both parents reduce their hours of employment or forgo employment opportunities. The family payments system should support families with young children through this period, while minimising disincentives to participate in paid work, and acknowledge that families balance their work and family responsibilities in different ways.

The income support system also provides a safety net of support for parents, to ensure that both parents and children have a basic acceptable standard of living if they are unable to earn sufficient income to support themselves. Paying an additional amount for parents with young children assists in improving the adequacy of payments for this group.

Supporting parents with children six years and older

For all parents with a youngest child aged six years and over, supplementary parental support should be provided to raise the level of adult income support payments above the rate of those without children, reflecting the need to ensure that the total support provided to families is adequate.

For couples, the supplement should be provided through the income support system and withdrawn with income support payments. This recognises that the combined withdrawal of two income support payments occurs well above the minimum wage and close to the average wage.

For single parents, the supplement should be provided through the family payment system and withdrawn with family payments. Applying the income support method (used for couples) to single parents would result in assistance cutting out at relatively low levels of income, which is not desirable.

Section F1 (Income support) provides detail on the payment rates for partnered parents with youngest children aged six years and older.

Principles

A degree of assistance with income replacement for a parent after the birth of a child (to recognise their reduced capacity to participate in the labour market) should be provided through paid parental leave, and through higher rates of family assistance in the pre-school years.

Income support for low-income parents with children should, in combination with family payments, provide a higher rate than standard income support payments.

Some additional assistance (over and above the direct cost of children) should continue to be provided to single-parent families with youngest children aged six years and older.

Supporting educational attainment

Family payments should also support older children to continue with education and training. Changes to technology and the labour market have increased the need for all workers to develop their skills. It is well established that higher levels of educational attainment are associated with higher levels of workforce participation. The participation rates of both men and women in Australia with no post-school qualifications are around 10 percentage points lower than those with post-school qualifications (Kennedy et al. 2009).

Decisions to undertake post-compulsory education will be determined by a number of influences throughout a young person's life, but important decisions are often made at the point when they reach school-leaving age. For many older children and their families, access to financial support plays an important role in decisions about Year 12 completion and post-secondary school training and study.

Beyond the age of compulsory education, older children have the option of participating in the workforce on either a part-time or full-time basis. Assistance for older children should recognise that there may be pressure on them to earn income from work, in addition to or instead of full-time study, because of the financial circumstances of their family. If adequate support is not available, some people (particularly from low-income families) may be forced to compromise their educational performance or discontinue their education.

Within Australia, Year 12 completion rates vary according to socioeconomic status, location and Indigenous status. For example, James et al. (2008) found that in 2006, while the Year 12 completion rate[23] was 67 per cent across Australia, for low socioeconomic status students it was 59 per cent compared with 78 per cent for high socioeconomic status students. The corresponding figures were 52 per cent for remote students and 69 per cent for metropolitan students. The rate for Indigenous students was 40 per cent. As the completion of secondary education can have a significant impact on a person's ability to find and retain employment,

23 In this case, the Year 12 completion rate was measured as the number of Year 12 completions (Year 12 certificates issued by State/Territory education authorities) as a proportion of the estimated population that could attend Year 12 in that calendar year.

and is usually a pre-requisite for further education, the failure to complete Year 12 can have a large impact on an individual's future workforce participation.

Recent Council of Australian Governments (COAG) reforms aim to guarantee that young people have access to education and training opportunities. The reforms also impose a requirement that they participate in education, training or employment.[24] These reforms need to be complemented by ensuring that young people have access to appropriate financial support when they do participate in appropriate education or training.

Principle

Assistance for older children and youth should support young people to continue with education and training. This requires the provision of adequate support accompanied by appropriate conditions so that payments do not favour unemployment over education and training.

Recognising diverse youth transition paths

As children grow older and become more financially and socially independent, it becomes less appropriate for parents to receive payments for their direct costs. While family payments can generally be provided without conditions on what children do (other than the requirement that they attend school), beyond the age of compulsory education, older children make more choices independently. As older children transition into early adulthood, it is more appropriate that assistance should be contingent on the circumstances of the young person, and less on the circumstances of their parents.

The transition paths of older children into early adulthood are diverse and involve many dimensions, including:

- living arrangements — some older children will need to move away from home in order to complete their secondary or post-secondary education;
- participation in education and training — different career paths require different levels of education and training, which take varying amounts of time to complete; and
- participation in the workforce — different career paths imply different ages at which young people move into full-time work. Young people will also have varying capacities to combine education and training with work.

It is therefore difficult to design assistance for young people in a 'one size fits all' model. Assistance needs to be flexible enough to accommodate diverse transition paths. This may require different types of payments to people in different circumstances.

Assistance to young people should also take into account the expected availability of financial support from their parents. Although this will require imposing somewhat arbitrary distinctions between dependent and independent older children, if independence

24 These reforms are detailed in the COAG communiqué of 2 July 2009 and the National Partnership Agreement on Youth Attainment and Transitions.

tests are designed effectively they can be a useful way to ensure that appropriate levels of assistance are available for different circumstances.

While assistance for young people should be flexible, there should also be a seamless transition from family payments to youth payments. Youths and families should be able to understand the assistance available to them and what they are required to do to receive it. There should be a single clear mechanism for assistance based on circumstances, rather than a complex choice between a number of different forms of assistance.

Principles

There should be a seamless transition from family payments to income support for young people based on a young person's circumstances.

Youth payment rates should reflect the fact that young people generally have lower needs than adults, but should be sufficient to support investment in education, training and other capability-building activities. To accommodate diverse transition paths, assistance should be flexible and should recognise that the financial needs of young people vary depending on their age, living arrangements and availability of financial support from parents.

Trade-offs and interactions with other parts of the system

The design of family payments will be a function of how objectives are prioritised. Although the objectives may be complementary to some degree, for a given aggregate level of family payments they involve trade-offs with other parts of the tax and transfer system.

Adequacy of family payments and workforce participation

The objective of family payments in relation to participation should be the same as that of the broader tax and transfer system — that is, payments should not discourage participation beyond the level that is unavoidable when providing any safety net support. There are two aspects to this. The first is ensuring that the withdrawal of family payments does not significantly add to effective marginal tax rates (EMTRs) for a large number of people. The second is ensuring that government assistance does not become a substitute for income earned from working.

In the current system, the withdrawal of income support payments can result in relatively high EMTRs. FTB Part A has therefore been designed so that it is not withdrawn at the same time as income support payments. The FTB Part A income test begins to withdraw benefits beyond the cut-out points for allowance payments and the single pension, but operates over the same income range as the income test for a partnered pensioner. The degree to which these payments can be tightly targeted at low-income families is limited by the withdrawal of income support payments.

While means testing payments keeps assistance targeted and affordable, it also necessarily imposes higher EMTRs over the withdrawal range. While the payment may achieve a poverty alleviation goal in immediate financial terms, a poorly designed means test can have a detrimental impact on participation, leading to lower family income in the longer term. The more that means tested payments are provided to families, the more significant is the compounding effect of these withdrawal rates on EMTRs.

Child care assistance also plays a role in assisting parents (particularly secondary earners and single parents) to balance paid employment with parental caring responsibilities. Child care assistance is discussed in detail in Section F4.

Principle

Family payments should be designed so as to limit the participation disincentives inherent in all targeted transfer payments. In particular, where families are eligible for more than one means tested payment or concession, the means tests need to be designed to operate in a coordinated way to avoid means test stacking resulting in high EMTRs.

Relationship of horizontal equity to poverty alleviation and workforce participation

If family payments are designed to provide for poverty alleviation for families with low incomes and pure horizontal equity between all parents of dependent children and taxpayers without dependent children, then disincentives to workforce participation for a broader range of people will be introduced. This happens because an alternative to earned income is available to a larger number of people — as family payments would be extended to families with higher incomes currently affected by the means test, and because other taxpayers would incur a larger tax burden to fund a larger total amount of family payments.

On the other hand, fully universal payments (without means tests) would reduce the EMTRs for some families, which could increase workforce participation incentives.

The degree to which payments impact on participation depends on the rate of assistance (which reduces incentives through an income effect), the withdrawal of payments (which reduces the amount of each dollar of earned income that the family keeps after tax and transfer withdrawal), and the distribution of families affected by the withdrawal of payments.

Within a given budget constraint for family payments, 'pure' horizontal equity would necessitate a reduction in the adequacy of the payment available to low-income families. If a government's budget constraint is less binding, payments could be set high enough to meet the adequacy objective, but tax rates across the population would need to be higher to support the higher cost of universal family payments.

As the primary goal of family assistance is to ensure adequacy, this objective should not be traded off against horizontal equity. Similarly, parents have primary responsibility for the financial support of their children and should not be discouraged from working due to the provision of horizontal equity payments.

Horizontal equity payments for dependent spouses (either with or without children) are payments or tax allowances intended to provide support to couples where one partner does not participate in paid employment. To ensure that this assistance is restricted to spouses who are dependent, an income test on the secondary earner's income is necessary, and this can create a disincentive to participating in paid employment. The withdrawal rate and the interaction with other income support and family payments, as well as the number of people affected by the assistance, will determine how significant the participation impact is.

Providing payments simply

Like all areas of the tax and transfer system, family payments should be easy to understand, both in how the payments operate and in the way they interact with other parts of the system. Families should be able to understand their entitlements and navigate the system without difficulty and without incurring debts. This can also build greater community support for family payments.

Simpler payments can make it easier for assistance to respond to changes in family circumstances in a timely way. The birth of a child and other events — such as returning to work, separation, re-partnering and the birth of subsequent children — impact on the family and its finances. If payments are unnecessarily complex, it can be difficult for a family to understand what is required when circumstances change.

The interaction of family payments with other parts of the tax and transfer system can be a significant source of complexity. If family payments are withdrawn at an income level where other tax and transfer rates are also changing, this can complicate decisions related to workforce participation.

Principle

Family payments should be provided in a simple and transparent form that is coherent with other parts of the tax and transfer systems.

F3-2 The current system could be simpler, more transparent and better targeted

Table F3-1 summarises the main forms of assistance now available for families and youth.

Table F3-1: Family and youth assistance[(a)]

Payment description	Maximum rates of payment	Income test(b)	Number of recipients and expenditure(c)
FTB Part A Per-child payments for dependent children aged under 16; and dependent young people aged 16-20; and 21-24 year old full-time students not in receipt of an income support payment. To be eligible, a parent must have care of a dependent child for 35 per cent or more of the time. Can include Large Family Supplement and Multiple Birth Allowance. Can include Rent Assistance (children aged under 16) where a parent has care of a dependent child for 14 per cent of the time.	Maximum rates (annual)(d) 0-12: $4,803.40 13-15: $6,033.45 16-17: $2,018.45 18-24: $2,467.40 Base rates 0-17: $2,018.45 18-24: $2,467.40	Families are paid the higher of the maximum or base rate after the operation of the following income tests: The maximum rate is available until family income reaches $44,165 a year, after which a withdrawal rate of 20 per cent applies. The base rate is available until family income is $94,316 a year (plus $3,796 for each FTB child after the first) after which a withdrawal rate of 30 per cent applies.	1.77 million families paid in respect of 3.44 million children Expenditure: $12.576 billion
FTB Part B Per-family payment to single income families (including single parents) and to couple families where the secondary earner's income is low.	Maximum rates based on age of youngest child(e) (annual) 0-4: $3,828.85 5-15*: $2,774.00 (*Or 16-18 if full-time student not in receipt of an income support payment).	Limited to families where the higher-income earner in a couple, or a single parent, has an income of $150,000 a year or less. When the income of the lower earner is over $4,672 a year, the payment is withdrawn at a rate of 20 per cent.	1.36 million families comprising 770,000 couple families and 590,000 single-parent families Expenditure: $4.360 billion
Baby Bonus Payment on the birth of a child or the adoption of a child.	$5,185 per eligible child paid in 13 fortnightly instalments.	Payable to families whose estimate of combined adjusted taxable income is $75,000 or less in the six months following the birth of a child or the child's entry into care.	278,000 recipients in respect of 283,000 children Expenditure: $1.411 billion
Paid Parental Leave (PPL) Payment to help parents spend time with newborns and adopted children. Recipients must fulfil employment criteria in months before birth or adoption to be eligible. Parents receiving PPL cannot receive the Baby Bonus (except in cases of multiple births) or FTB Part B for the time they receive PPL.	Allows eligible parents up to 18 weeks of leave at the Federal Minimum Wage (currently $543.78 per week).	Primary carers will be eligible if they earned less than $150,000 in the full financial year prior to the birth or adoption of a child.	Introduced from 1 January 2011
Youth Allowance (YA) YA (Student): Income support for full-time students aged 16-24 in secondary or tertiary education or training and full-time apprentices. YA (Other): Income support for young people aged 16-20 seeking or preparing for work or temporarily unable to work.	At home rates (annual equivalent) Under 18: $5,285.80 18 and over: $6,354.40 Away from home and partnered rate: $9,656.40 (Higher rates are available in some circumstances — for example, parents).	Following a recommendation of the Bradley Review, the Government introduced legislation in late 2009 to improve the YA personal income threshold (PIT). The changes will increase the PIT threshold to align it with the income test threshold applying to the maximum rate of FTB Part A and replaced the YA per child 25 per cent taper rate with a 20 per cent family taper rate.	YA (Student): 273,100 YA (Other): 82,900 Expenditure YA (Student): $1.829 billion YA (Other): $0.539 billion

(a) Payment rates and income tests are current as at 20 September 2009, except where noted.
(b) The income tests refer to the relevant family or parental income test. Youth Allowance recipients are also subject to a personal income test with separate income tests applying for students and non-students. For FTB Part A, a limit on the income earned by children may also apply.
(c) Recipient numbers as at June 2009. Expenditure is for 2008-09.
(d) FTB Part A amounts include the FTB Part A supplement of $711.75 per-child for 2009-10.
(e) FTB Part B amounts include the FTB Part B supplement of $346.75 per-family for 2009-10.
In addition to the payments listed in Table F3-1, income support recipients may receive a higher rate of payment if they have dependent children and will have adjusted activity requirements.
Source: Australian government administrative data; FaHCSIA and DEEWR 2008–09 annual reports.

The current system could be rationalised and remodelled to create a family assistance program that would be simpler, more transparent and provide greater support where it is needed. Support provided through family payments should be designed to better reflect the direct cost of children, including older children in secondary school, while support for young people and adults (including parents) should be provided through income support payments.

Unnecessarily complex, with multiple payments

The family payments system has a number of payments with overlapping, and in some case, competing, objectives. This increases the compliance costs borne by parents and increases the challenge of designing a system that is fair to families in different circumstances. The existence of multiple payments can also result in overlapping withdrawal rates, which raises EMTRs at certain income levels above the levels that would otherwise be achieved with a single family payment.

For families with inconsistent and unpredictable income flows, the need to estimate taxable income ahead of actual earnings can be problematic. This may not only contribute to over- or underpayments through the year, but may also lead to families adjusting their participation due to concern about accruing family payment debts.

Finding

Current arrangements for family payments are made unnecessarily complex by the number of payments, the design of individual payments, and their interaction with the rest of the tax and transfer system.

Payments are not consistent with supporting workforce participation

Workforce disincentives are inherent in any safety net support system; in this way family payments can be seen to contribute to workforce disincentives (both because they provide an alternative to earned employment income and because they withdraw as earned income increases, raising the effective rate of tax paid by parents in the withdrawal range).

Given the objective of providing a basic acceptable standard of living for all Australians, particularly for children in low-income families, conceding the participation objective to some degree is unavoidable. Where assistance is provided in addition to that required to meet safety net objectives, impacts on workforce incentives are a major concern.

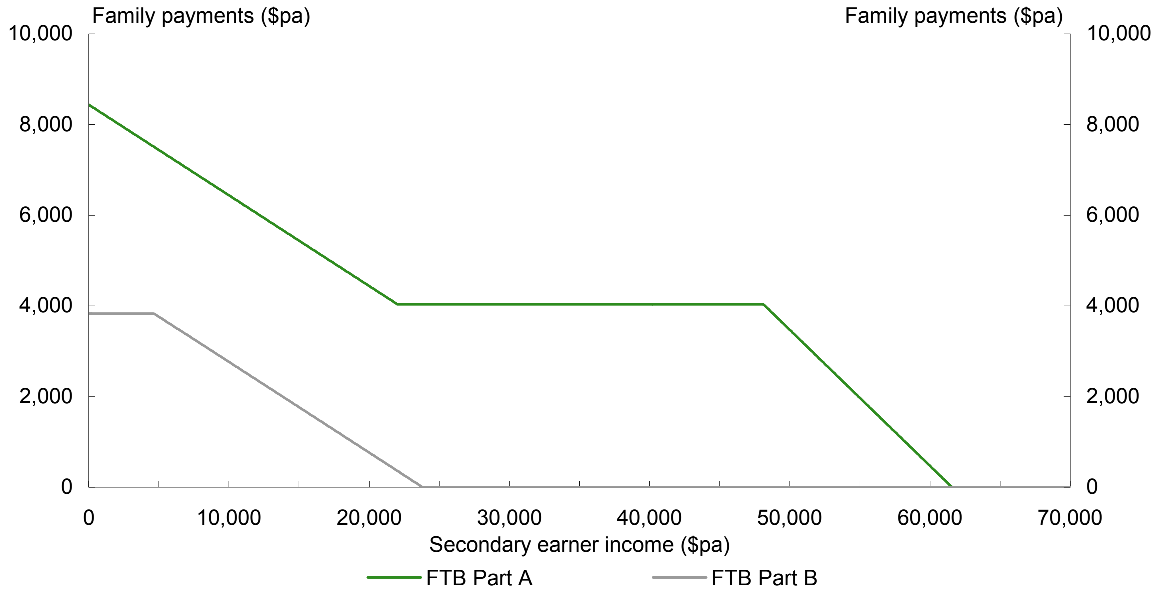
However, assistance can be delivered in ways that have different impacts on the incentives people have for workforce participation. In the current system, multiple family payments create overlapping withdrawal rates and increase barriers to participation. Each payment withdrawal rate can add to other taxes and withdrawal rates and can contribute to higher EMTRs.

Cumulative withdrawal rates for family payments affect secondary earners in particular. The simultaneous withdrawal of FTB Part A and FTB Part B add to the EMTRs for secondary earners, as shown in Charts F3-1 and F3-2. These charts show the situation for a secondary earner with a partner who earns $50,000. As the family has two young children, FTB Part A (which begins to be withdrawn when family income reaches $44,165) continues to be withdrawn at a rate of 20 per cent as the secondary earner begins to earn income. Further, FTB Part B begins to be withdrawn at a rate of 20 per cent when the secondary earner's income reaches $4,672.

The combination of FTB Part A and FTB Part B withdrawal rates, together with income tax rates, can lead to high EMTRs for secondary earners. In combination with the other costs associated with working, this may deter secondary earners from entering or re-entering the workforce or increasing their hours of work, particularly when children are young and out-of-pocket child care costs are incurred.

Chart F3-1: Withdrawal of FTB Part A and FTB Part B, 2009-10

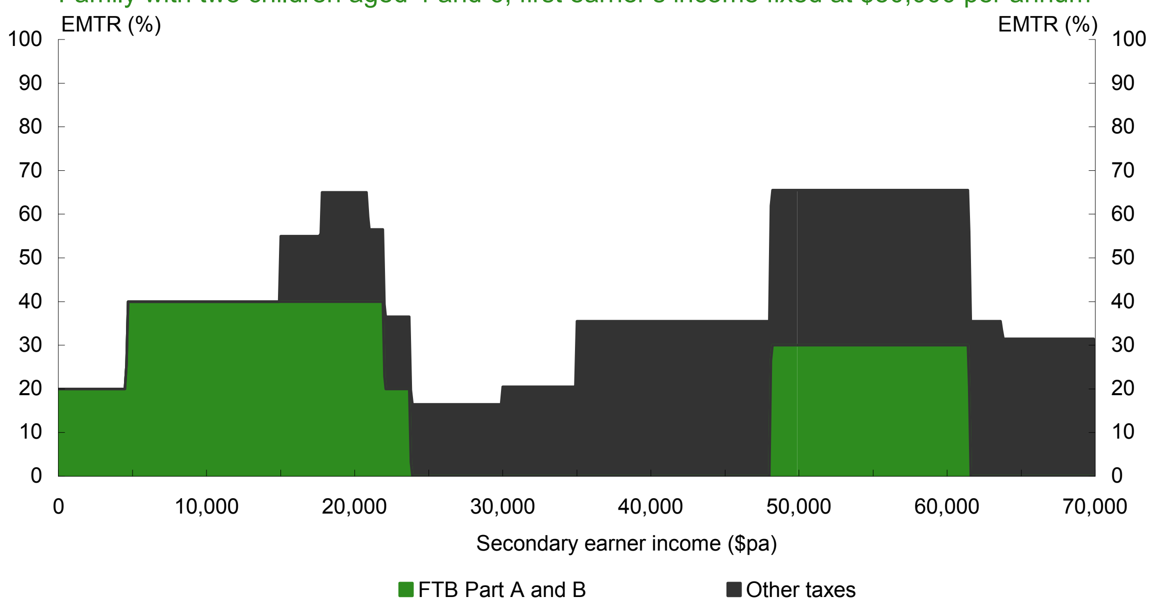
Family with two children aged 4 and 6, first earner's income fixed at $50,000 per annum



Source: Treasury estimates.

Chart F3-2: Effect of withdrawal of family payments on secondary earner's effective marginal tax rates, 2009-10

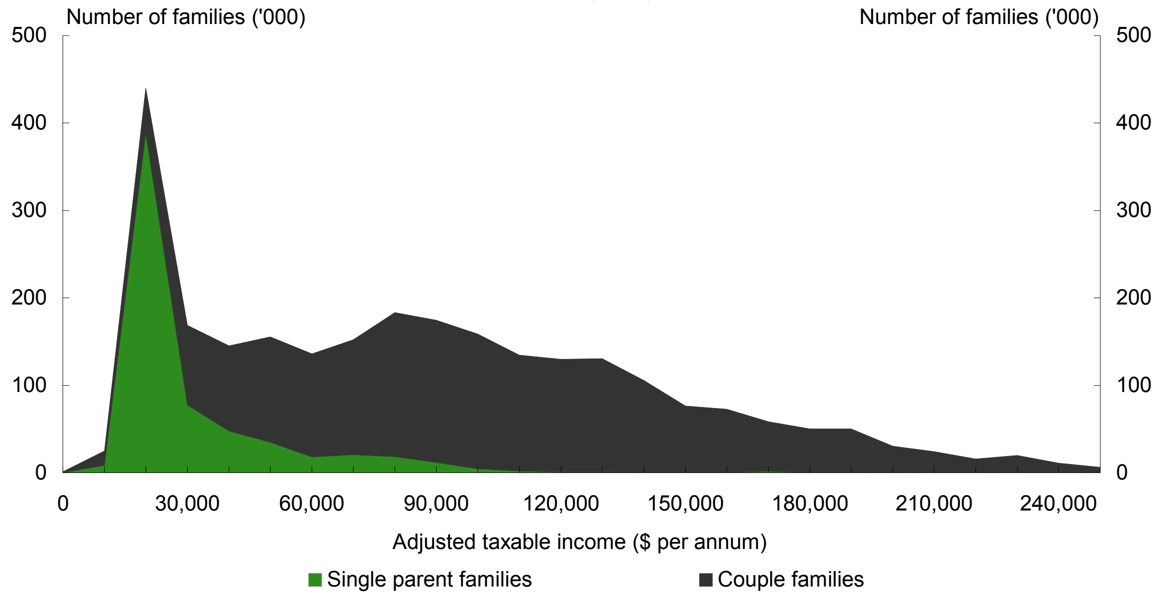
Family with two children aged 4 and 6, first earner's income fixed at $50,000 per annum



Notes: Family Tax Benefit Part A begins to withdraw at a rate of 20 per cent when family income is $44,165, while Family Tax Benefit Part B begins to withdraw at a rate of 20 per cent when the second earner's income is $4,672. The combination of these withdrawal rates, together with income tax rates, can lead to high effective marginal tax rates (EMTRs). Other taxes include the marginal tax rate, the low income tax offset and its withdrawal, and the Medicare levy shade in. Source: Treasury estimates.

While high EMTRs can be a disincentive to work, it is also important to consider the number of people actually affected by them. Chart F3-3 shows a distribution of families by income and provides an indication of the number of families who would be affected by means tests at different levels of family income.

Chart F3-3: Distribution of families by adjusted taxable income, 2009-10



Note: The chart shows an estimated distribution of families with dependent children by combined adjusted taxable income for 2009-10. The distribution of families by combined adjusted taxable income is by $10,000 increments up to the income band of $240,000 to $250,000. Adjusted taxable income includes income support.
Source: Treasury estimates.

Finding

Overlapping withdrawal rates from different family payments can increase the workforce disincentives inherent in means tested payments.

Transfer payments need to be designed in a way that supports participation, but that also recognises that some parents are participation-constrained and may still require support. For example, low-income families (including single parents), where parents are working at full capacity (though not necessarily full-time), may still require in-work assistance where their earned income is insufficient. In other families, participation of one or both parents will be limited by circumstances such as foster caring, child or adult disability.

Finding

Transfer payments need to be designed in a way that supports participation, but that also recognises that some parents are participation-constrained and may still require support.

Payments could be better targeted at the cost of children

There is much research on the direct costs of children and different ways to estimate these costs. Research generally indicates that the costs of children increase as they get older. This reflects older children's food consumption, clothing needs, the cost of other school-related items and increasing social needs.

Research also suggests that current FTB Part A rates are broadly adequate for 5–15 year olds and are more than adequate for 0–4 year olds. For 16–17 year olds, FTB Part A is significantly below the cost of children, and Youth Allowance (which offers a higher rate of assistance, with a tighter means test) also falls short of the direct cost of children.

The costs of children increase markedly at the following points in the lifecycle: starting primary school, starting secondary school and entering the final two years of secondary school. The current FTB Part A rate structure is poorly aligned to these points. Rates of assistance are unchanged on starting primary school. The higher 13–15 year old rate only begins to be paid well after most children have started secondary school. Assistance for 16-17 year olds has eroded relative to rates for younger children over the past 20 years.

While less research has been carried out on the cost of older teenage children, the research available does indicate that older teenage children cost more than younger teenage children. For example, Percival et al. (2007) found that in single-child low-income couple families a child aged 16 to 17 cost 43 per cent more than a child aged 13 to 15. These percentages are consistent with major overseas findings (Henderson et al. 1970; McClements 1978).

Table F3-2 provides estimates of the cost of children based on the cost of children research.

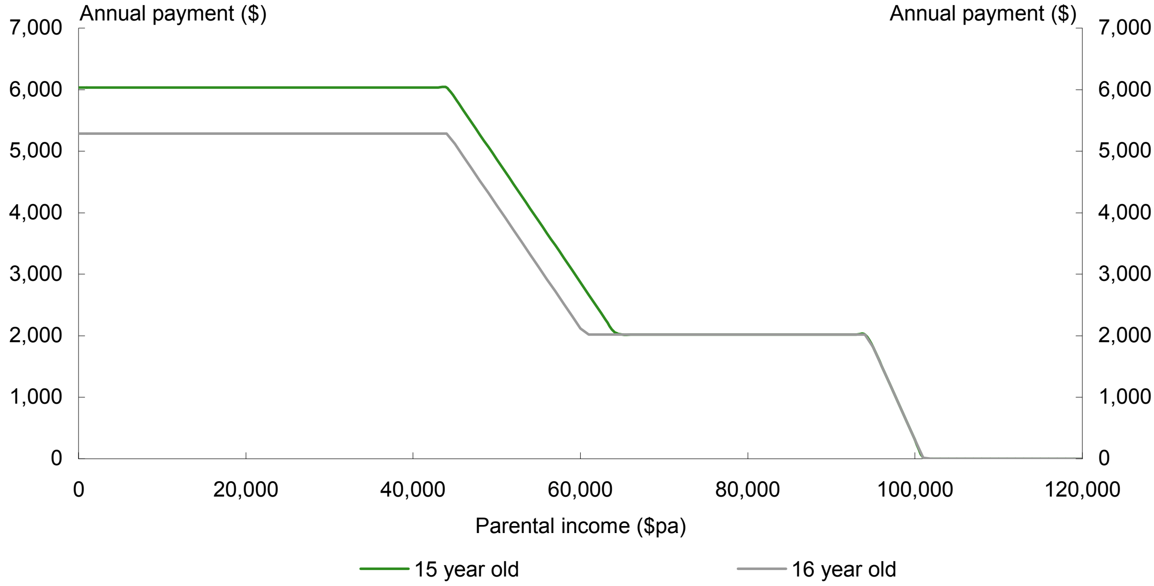
Table F3-2: Direct cost of children estimates 2008–09

Age band	Average cost in a low income family ($ per annum)
0–4	3,842.72
5–11	4,803.40
12–15	6,033.45
16–18	7,541.81

Source: FaHCSIA modelling.

The current rates of payment can result in drops in assistance as children grow older. For example, as Chart F3-4 shows, there can be a drop in payment for some families when children turn 16. This is of particular concern as the fall in payment affects low- to middle-income families where there is a greater likelihood of pressure for older children to earn money to support themselves or contribute to the family budget, rather than continuing with education.

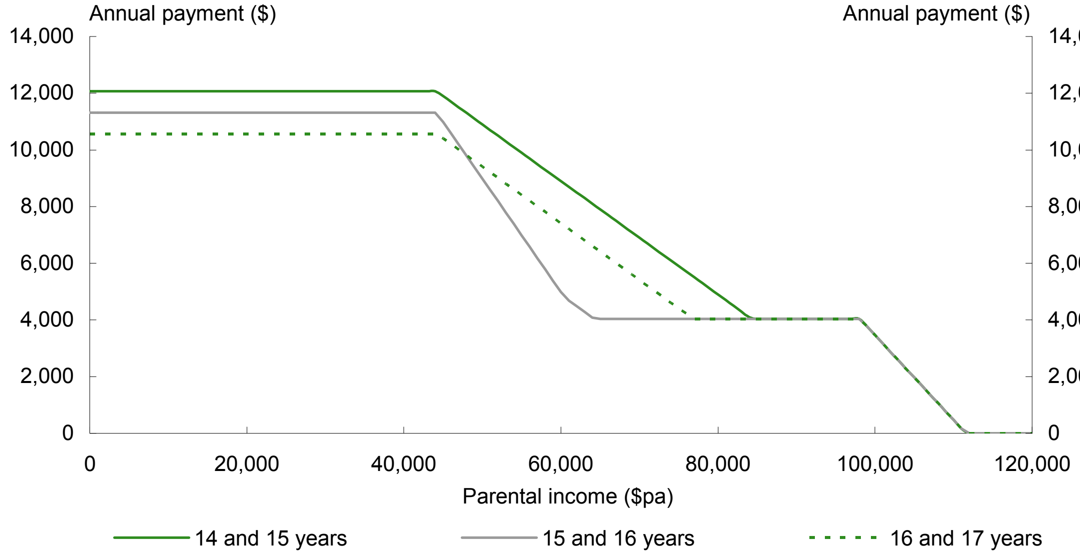
Chart F3-4: Comparison of payments for 15 and 16 year olds at home



Note: Assumes that the threshold for the Youth Allowance parental income test has been aligned with the income test threshold applying to the maximum rate of FTB Part A and that a 20 per cent family withdrawal rate applies to Youth Allowance. The rate of payment for a 16 year old in the chart is the higher of Youth Allowance and FTB Part A at different levels of parental income.
Source: Treasury estimates.

For families with dependent children receiving FTB Part A and Youth Allowance, the reductions in assistance can be larger when the oldest child turns 16, as the family experiences simultaneous reductions from the operation of two 20 per cent withdrawal rates (the FTB Part A family income test and the Youth Allowance parental income test) rather than a single 20 per cent rate. This can compromise not only the effectiveness of Youth Allowance for the older child, but also FTB Part A for younger children. Chart F3-5 provides an example of how assistance for a two-child family can change as the children become older.

Chart F3-5: Assistance to a two-child family at different ages



Note: Assumes that the threshold for the Youth Allowance parental income test has been aligned with the income test threshold applying to the maximum rate of FTB Part A and that a 20 per cent family withdrawal rate applies to Youth Allowance. The rate of payment for 16 and 17 year olds in the chart is the higher of Youth Allowance and FTB Part A at different levels of parental income.
Source: Treasury estimates.

It is easier for parents to work as children grow older, so it is reasonable that the activity requirements involve greater expectations of workforce participation on adult income support recipients as children grow older. However, the maximum rate of per-child family payment should be set so as to ensure that where parents are unable to find employment, or to earn enough to support their children, the payments are sufficient to provide for the direct costs of the child.

Infants

In addition to FTB payments, families may receive the Baby Bonus, which is provided to assist with the costs arising from the birth or adoption of a child. The Baby Bonus in effect covers more than the additional direct costs around the birth or adoption of a child and can be considered to assist with forgone income as well. The latter objective will in effect become redundant from January 2011 with the introduction of PPL.

At its current rate of $5,185 per eligible child (paid in 13 fortnightly instalments), the Baby Bonus provides a higher rate of assistance than is necessary to cover the direct costs associated with a new child.

Budget standards work and qualitative research undertaken by the Department of Families, Housing, Community Services and Indigenous Affairs (FaHCSIA) indicate that actual direct costs at birth for low-income families are around $2,000 for a first child and $1,000 for a second child. The direct costs of the second child are lower as some items acquired for the first child can be reused for the second child (although this would not always be the case depending on gender and the age gap between children).

Multiple children

In addition to FTB payments, families may receive the Large Family Supplement to compensate for additional direct costs of third and subsequent children and the Multiple Birth Allowance up to age 18 years for families that have three or more children born on the same day. However, evidence does not support the proposition that on average each additional child costs the same or more than the last.

Costs of children generally decline with the number of children in a family. A recent study found that in low-income families, the average marginal cost of the second child is around 83 per cent of those of the first. The average marginal cost of the third and fourth children were estimated to be 71 per cent and 63 per cent of the cost of the first child (Percival & Harding 2007[25]).

Other research finds that any economies achieved by families relate primarily to the additional housing cost associated with children (Henman 2005). If a child shares a bedroom, the economies are significant, but if a child is assumed to require an additional bedroom, the economies are small.

While research identifies varying degrees of economies of scale with additional children, there is no indication that the costs of additional children rise, even where housing economies are not achieved. Aspects of the current system, such as higher thresholds for

25 These figures are based on Table 2: Estimated average costs of children in couple families, by number of children and family income, 2005–06, page 12 (Percival & Harding 2007).

larger families, Multiple Birth Allowance for children born on the same day up to 18 years of age and the Large Family Supplement are not justified by evidence of the cost of children.

Shared-care families

Children raised in shared-care families (that is, living in more than one household) generally cost more than children living only in one household. For example, the two households face similar housing costs (such as furniture) and often face additional transport costs. Family assistance does not currently recognise the additional costs of children who spend time in two households.

For families with shared-care arrangements, the financial resources available for children involve both family payments and child support transfers. Any changes to family payments, including shared-care rates, would need to be considered in the context of child support calculations.

Single parent families

FTB Part B assists single parent families with additional direct costs of managing a family as a single parent. For the most part, these additional costs relate to costs of housing. While this may be able to be dealt with in part through improvements to Rent Assistance, this does not assist single parents with additional housing costs across all tenures.

Assistance with the additional direct cost faced by single parents is warranted. The current level of FTB Part B is, however, higher than the average additional direct cost of single parents and delivers assistance to single parents up to very high incomes.

FTB Part B for single parents is less detrimental to workforce incentives than for secondary earners (given the means testing arrangements). However, it does raise issues of equity, given that the full rate of assistance is provided up to $150,000, whilst dual-income families lose FTB Part B at much lower income levels.

Housing costs and children

One of the major components of the cost of children is the housing costs parents face for each additional child. Some families achieve economies of scale through shared bedrooms, particularly for younger children and children of the same gender. However, where family payments are made on a per-child basis, not related to sibling gender or sibling ages, it is more appropriate to factor in a consistent per-child additional cost of housing per child.

Under the current arrangements, the per-child family payments are sufficient to cover the additional housing costs associated with each child. In addition, higher maximum rates of Rent Assistance apply to parents with children, which provide a more adequate level of assistance for families than the low level provided to singles and couples without children.

Housing costs associated with children are best taken account of through a per-child family payment, rather than through a housing assistance payment. However, housing assistance payments for parents in rental housing would need to be sufficient to ensure that child payments are not required to cross-subsidise assistance for parents with housing costs (see Section F5 Housing assistance).

Using family payments to assist with the cost of housing associated with children has a number of advantages. Child-related housing assistance is paid to parents irrespective of their housing tenure, that is, whether they rent privately or publicly, and whether they own or are purchasing their own home. Providing housing assistance in this way ensures that the marginal cost of housing associated with children is also provided to those with mortgage costs. The simplest way to do this is through the family payments system.

Findings

Current rates of assistance generally reflect the direct costs of children, but not in all circumstances, and particularly not for older children. FTB Part A rates are broadly adequate for 5–15 year olds and are more than adequate for 0–4 year olds. For 16–17 year olds, FTB Part A is significantly below the cost of children, and Youth Allowance also falls short of the direct cost of children.

Payments that provide additional assistance to larger families are inconsistent with evidence that suggests that the incremental cost of each additional child in a family is not on average more than the cost of the first child.

Shared-care families face higher per-child costs than couple families.

Housing costs associated with children are best taken account of through a per-child family payment, rather than through a housing assistance payment.

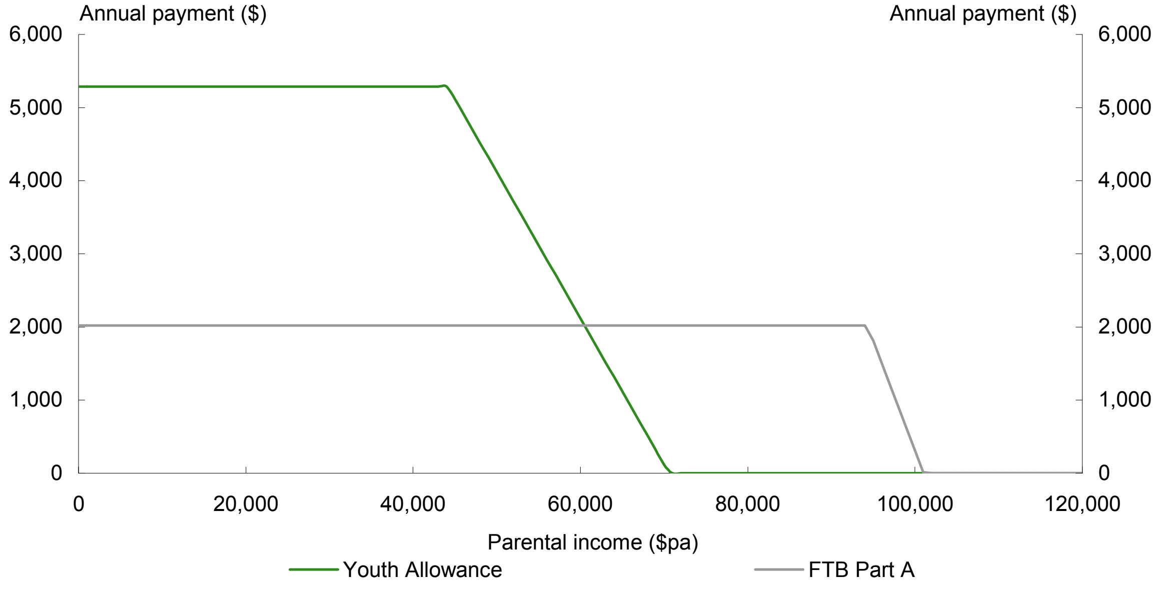
Older children and their families face complex choices

When a dependent child reaches 16 years, income support — generally in the form of Youth Allowance, ABSTUDY living allowance, or Disability Support Pension — becomes available. Significant changes to the assistance available to older children and youths were announced by the Australian Government in the 2009–10 Budget. Participation requirements will be introduced for FTB Part A children aged 16–20 from 1 January 2010.

There are still areas of concern, particularly relating to the interaction of FTB Part A and Youth Allowance. Youth Allowance is the primary form of government assistance for young people who are independent or who come from low- to middle-income families. While FTB Part A remains available to parents of dependent 16–20 year olds and full-time students aged 21–24, the maximum rates of assistance are significantly lower.

Differences in payment rates and the existence of the more generous income test on the base rate for FTB Part A, means that there is a point on the income spectrum where one payment becomes more attractive than the other. Chart F3-6 illustrates this for a family with a 16 year old at home.

Chart F3-6: Comparison of FTB Part A and Youth Allowance for a 16 year old dependent child at home



Note: Assumes that the threshold for the Youth Allowance parental income test has been aligned with the income test threshold applying to the maximum rate of FTB Part A and that a 20 per cent family withdrawal rate applies to Youth Allowance.
Source: Treasury estimates.

The existence of two payments for youths in identical circumstances but different parental income levels creates complexity. FTB Part A and Youth Allowance are not only paid at different rates but also have different parental means testing and personal income testing arrangements that use different periods of assessment and definitions of income. For many families, the payment that provides them with greater assistance will change over time as children age, parental income fluctuates or payment parameters and assessment periods change.

The choice families make is complicated further because of additional forms of assistance related to the receipt of FTB Part A and Youth Allowance. For example, families receiving FTB Part A may also be eligible for FTB Part B[26], whereas FTB Part B cannot be received for similarly aged Youth Allowance children in full-time study. To ensure that they receive the maximum amount of available assistance, people must know a great deal about the payment system and must be able to accurately predict family, second earner and child income.

The choice between payments is a concern for all age groups where both FTB Part A and Youth Allowance are available, although the complexity involved in this choice can vary. For example, at most income levels, Youth Allowance will provide a higher payment for families with multiple children eligible for Youth Allowance.[27] The lowering of the age of independence to 22 by 2012 will result in FTB Part A for 22-24 year olds becoming irrelevant.

26 FTB-B is available (subject to the income tests) for families with a child aged under 16. If the child is aged over 16, it is available until the end of the calendar year the child turns 18.

27 This assumes that the changes to the Youth Allowance parental income test occur and that families are not affected by the family assets test or Family Actual Means Test (FAMT). The FAMT applies where a parent's income used for the Youth Allowance parental income test is deemed to be an insufficient measure of the means available to the family. The FAMT can apply even where a parent receives an income support payment.

Finding

For 16–24 year olds, there can be a complex choice between payments with the higher rate of support dependent on a number of factors. This can be confusing for those making choices about which payment to apply for.

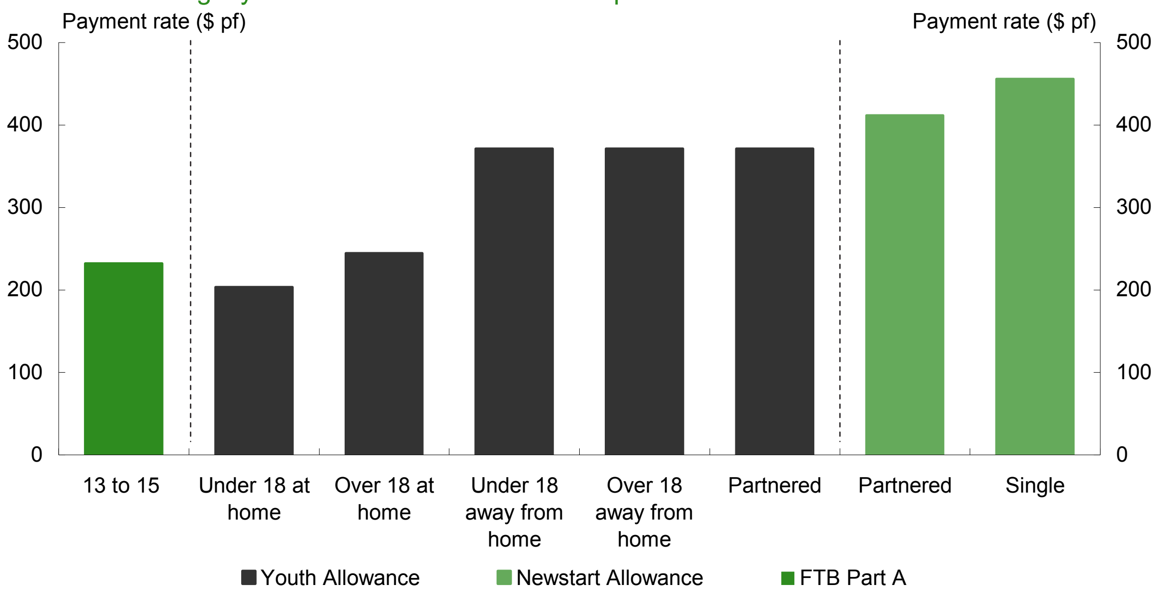
Youth payments are not always coherent with the system

The rates of payments to young people reflect the fact that those people have lesser needs than adults. Chart F3-7 shows that the current rates for Youth Allowance can vary to account for differences in age and living circumstances, but they are not always coherent with other parts of the tax and transfer system. For example, the rate of Youth Allowance for those 18 and over at home is slightly higher than the FTB Part A rate for 13–15 year olds, but the Youth Allowance rate for those under 18 at home is lower.

The higher rate for youths living away from home reflects the fact that youths living at home have lower accommodation costs. For recipients without dependent children, the current rates of Youth Allowance are also lower than the rates of Newstart Allowance. The rate for single young people living away from home is the same as the rate for partnered young people.

Chart F3-7: Youth rates of payment

Maximum fortnightly rates of Youth Allowance compared to Newstart Allowance and FTB Part A



Note: Payment rates are current as at 20 September 2009. The rates of payment shown in the chart are for recipients without dependent children. The fortnightly rate for FTB Part A for 13 to 15 year olds includes the FTB Part A supplement.
Source: Australian government administrative data.

Higher rates of Youth Allowance are available to recipients with dependent children. In contrast to those without dependent children, for both single and partnered people with dependent children, the rates of Youth Allowance are similar to equivalent Newstart Allowance rates.

Youths with a disability may be eligible for Disability Support Pension (DSP) paid at rates equivalent to Youth Allowance plus a Youth Disability Supplement. Young disability support pensioners with children receive adult rates of DSP. Young people with a partial capacity to work who live away from home are paid at adult Newstart Allowance rates, while those living at home are paid youth DSP rates.

While the maximum rates of payment do not depend on the independence of the recipient, non-independent youths are subject to a parental income test. A person is regarded as independent if they are unable to live at home, have a partial capacity to work, are married or in a marriage-type relationship, have a dependent child, have satisfied workforce participation criteria or have reached the 'age of independence'. The age of independence for a non-full-time student is 21. For a full-time student it is 25, but the Australian Government has announced that this will be progressively reduced until it reaches 22.

Findings

Youth payment rates should reflect the fact that young people in different living arrangements and personal circumstances have different needs. Young people living away from home have higher costs than those living at home.

Current youth payments could be made more coherent with other parts of the tax and transfer system.

F3-3 Reform directions — a single family payment and refined youth support

Recommendation 90:

Current family payments, including Family Tax Benefit Parts A and B, should be replaced by a single family payment. The new family payment should:

(a) cover the direct costs of children in a low-income family (that is, the costs associated with food, clothing, housing, education expenses); and

(b) assist parents nurturing young children to balance work and family responsibilities.

Recommendation 91:

The direct cost of children component of family assistance should be a per child payment.

(a) Rates of payment should increase with the age of the children to recognise the higher costs of older children. Three rates of payment should apply: for 0–11 year olds; 12–15 year olds; and 16–18 year olds while in secondary school. These age bands would appropriately accommodate the increasing costs of children (this would require higher payments rates for 12, 16 and 17 year olds). The Baby Bonus should be abolished and a small supplementary payment, reflecting the direct costs of a new-born baby, should be paid over the first three months.

(b) A shared-care rate to recognise the higher costs of separated families should be considered, taking into account interactions with child support as well as other income support payments.

(c) Additional payments for larger families, including the Large Family Supplement, the Multiple Birth Allowance for children over one year, and higher thresholds for larger families should be reconsidered as the case for these payments is not strong.

Recommendation 92:

A supplement for parents nurturing young children (aged under six years) should be provided as a per-family payment, means tested on family income in addition to the recently announced Paid Parental Leave arrangements.

(a) The maximum rate of the supplement should be set such that the total support for single parents wholly reliant on income support is equivalent to the maximum rate of pension.

Recommendation 93:

For single parents with children aged six or older, a parental supplement (which should be considerably smaller than under Recommendation 92), should be paid through the family payment system.

Recommendation 94:

For couples with children aged six or older, a parental supplement at the same rate as for single parents should be paid through the income support system (see Section A1 Personal income tax).

Recommendation 95:

Assistance for families should also recognise that there are specific circumstances, such as parents caring for disabled children and foster care children with higher needs, for which additional support beyond the early years is appropriate.

Recommendation 96:

The total amount of family assistance should be withdrawn with a single means test to avoid cumulative withdrawal rates which create unnecessarily high disincentives for working. A single low taper rate of 15–20 per cent would be appropriate to minimise workforce disincentives.

Recommendation 97:

While family payments should be the main form of assistance for families with children up to the end of secondary school, or the school year in which they turn 18 (the earlier of the two), youth payments should be available to older children in some circumstances.

(a) Dependent older children for whom a suitable pathway may be leaving school and looking for work or combining part-time work and part-time study should have access to a youth payment, governed by strict participation requirements.

(b) Children without access to financial support from their families should continue to have access to a youth payment, governed by strict criteria.

Recommendation 98:

Youth payments should be the main form of income support from the age of 18 until the age of independence.

(a) Family payments should not be provided for those aged 18 and over unless they are completing secondary school in the year they turn 18.

(b) Youth payment rates should reflect the fact that most young people have lower needs than adults but need adequate assistance to participate in education and training.

(c) Dependent youth payment recipients should be subject to a parental income test consistent with that applying to family payments. Family means tests should be designed so that families with dependent children in both the family payments and youth payments system are not disadvantaged.

(d) The age of independence should be aligned for full-time students and non full-time students.

A single family payment for the direct costs of children

Age of child and rate

Rates of assistance for family payments should be guided by evidence of the direct costs of children; that is, the out-of-pocket expenses that parents incur in providing food, clothing, housing and other items necessary for the development of their children. These costs are distinct from the indirect costs that parents incur as a result of being responsible for children, such as income forgone because their availability to work is reduced by the need to care for children.

A three-tiered approach with increasing rates for 0–11 year olds, 12–15 year olds and 16–17 year olds (including 18 year olds in secondary school) would appropriately and simply reflect the changing costs of children as they grow older. These ages also broadly reflect the ages of transition in the education system. While the cost of 0–4 year olds is generally below the cost of 5–11 year olds, the difference may not be sufficient to warrant a separate rate.

The Baby Bonus does not reflect the additional direct costs of children at birth, because in effect it includes an element of income replacement. With the introduction of PPL, the Baby Bonus should be abolished and a small supplementary payment, reflecting the average direct costs of a new born, should be paid over the first three months as part of the per child family payment (including to those receiving PPL).

Abolition of multiple child add-ons

While costs of children studies indicate varying degrees of economies of scale, additional children do not cost more than the first child. It is therefore more appropriate to provide per-child assistance that does not increase with additional children.

Shared-care rates

The costs of children in shared-care families are higher than for those in families where parents cohabit. To provide the same level of support for children in shared-care households, it would be necessary to provide a slightly higher rate of family assistance.

Child support arrangements are built around the current family payments arrangement. As such, any change to family payments would need to be considered in the context of child support calculations.

Higher rate of assistance for parents with young children

Government payments have a role in ensuring that the choice to spend time out of the workforce to care for young children is not unduly constrained by financial need. PPL provides a strong signal that an absence from employment at this time is an appropriate choice and provides an alternative source of income for primary carers after the birth of a child.

Beyond the immediate post-birth period covered by PPL, up to when the youngest child turns six years of age, low- to middle-income families should be paid a supplement as part of family assistance, subject to the family payment means test in order to assist parents to balance work and family responsibilities.

The maximum pension rate is the appropriate benchmark payment rate for single parents with young children. The parental supplement should be set to ensure that a single parent with young children on the participation payment receives a combined amount equivalent to the maximum pension rate. The couple rate should be set at the same rate as that for single parents.

Supporting parents with children six years and over

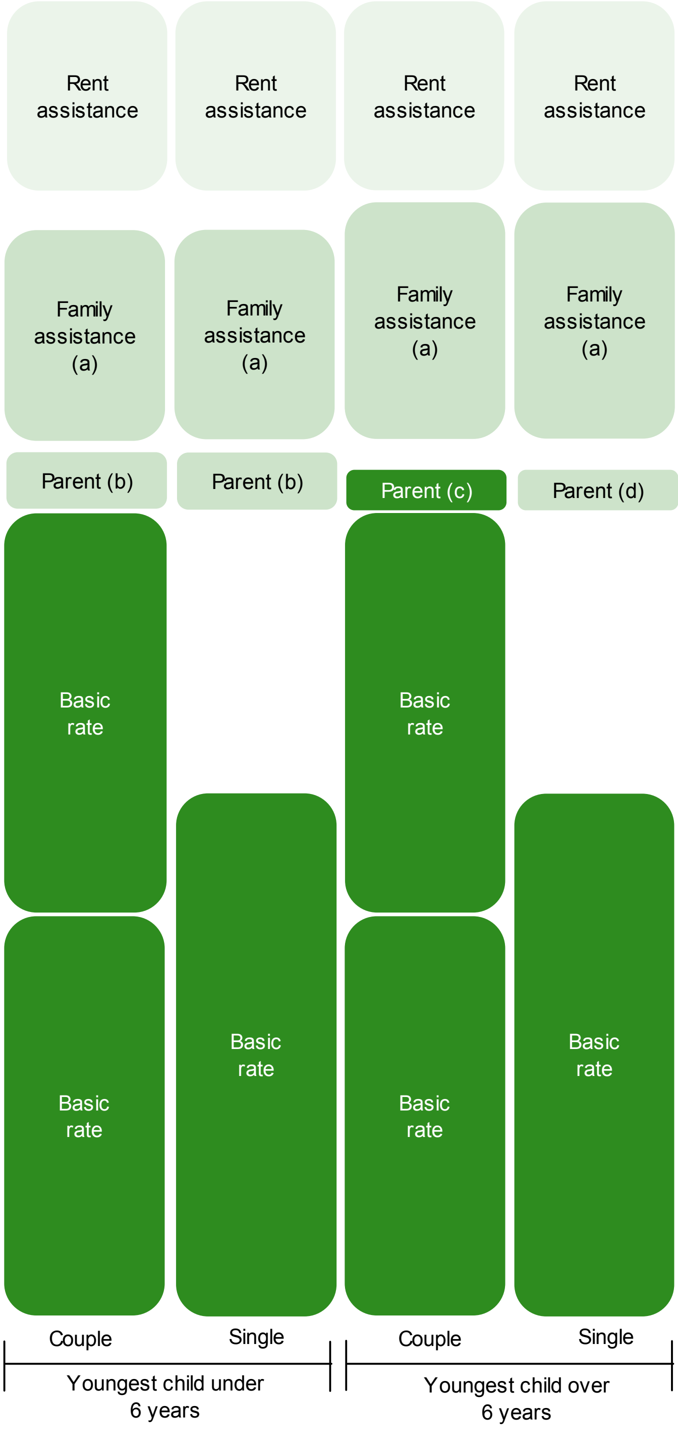
Supplementary parental support should be provided to parents with youngest children aged six years and over, to raise the level of adult income support payments above the rate of those without children. This reflects the need to ensure that the total support provided to families delivers a higher rate of adequacy, but at a lower rate to that provided for parents with younger children.

For partnered parents, the supplement should be provided through the income support system and withdrawn with income support payments. This recognises that the combined withdrawal of two income support payments occurs well above the minimum wage and close to the average wage.

For single parents, the supplement should be provided through the family payment system and withdrawn with family payments to extend the income range over which the supplement is available.

The proposed payment structure for families, including the arrangements for the Parent Supplement are outlined in Chart F3-8 and Table F3-3.

Chart F3-8: Payment structure for families



(a) Assistance with the direct costs of children.
(b) Additional parental supplement where the youngest child is under six years, paid as part of the family payment and means tests with the family payment.
(c) Smaller parental supplement for couple parents where the youngest child is over six years, paid as part of income support.
(d) Smaller parental supplement for single parents where the youngest child is over six years, paid as part of the family payment and means tests with the family payment.

Table F3-3: Parent Supplement arrangements

	Youngest child under aged six years	Youngest child aged six years or older
Single parent family	Higher rate of supplement (equivalent to gap between allowance and pension rates) Paid as part of family assistance Means tested on family income.	Lower rate of supplement (set at, for example, half the higher rate) Paid as part of family assistance Means tested on family income
Couple family	Higher rate of supplement (equal to single parent rate) Paid as part of family assistance Means tested on family income.	Lower rate of supplement (equal to single parent rate) Paid as part of income support Means tested on personal and partner income.

Parents with older children in special circumstances

Assistance should also be provided in other specific circumstances, such as parents caring for children at older ages with high needs, including some children with disability, and foster care children (taking into account interactions with existing support for these groups).

Education Tax Refund

The Education Tax Refund (ETR) was introduced as a refundable offset to assist certain prescribed education expenses. (See Annex A1 Concessional offsets in detail).

As with any payment that is linked to receipt of other payments (in this case FTB Part A), the ETR creates a sudden death cut out and results in very high (over 100 per cent) effective tax rates at the point at which the main payment (FTB Part A) is extinguished. In addition, as a tax refund, there is a time lag for payment.

Recommendation 6c (see Section A1 Personal income tax) is that the ETR should be removed from the personal tax system and replaced with automatic advance payments through the family payment system at the beginning of each school semester.

Assistance for youth

Family payments should apply when children are under the primary care of their parents; that is, both financially dependent and reliant on their parents for day-to-day needs. As the majority of children progress through secondary education and go on to complete Year 12, it is appropriate that family payments continue to be the primary form of assistance for children up to the end of secondary school or the school year in which they turn 18 (the earlier of the two). Youth income support payments (including Disability Support Pension for young people) should generally become available from this time.

There are older dependent children for whom a suitable pathway may be leaving school before Year 12 and looking for work or combining part-time work and part-time study. In these circumstances, it would be appropriate for a youth payment to be available, with eligibility governed by strict participation requirements. There are also older children who do not have access to support from their family. Youth payments, governed by strict independence criteria, should also be available for these older children. Although this would mean having two payments for older children, there would be no need to make a choice between payments, as the applicable payment would be determined by the activities of the child.

Youth payment rates should reflect the fact that young people generally have lower needs than adults, but should be sufficient to support investment in education, training and other capability-building activities (including combining part-time work and part-time study). Youth rates should not create inappropriate incentives for young people to leave full-time study prematurely and should not favour unemployment over education and training. The rates of payment must make further study practical for those from disadvantaged backgrounds.

The future arrangements for youth payments should build on aspects of the current system, but with some changes that would improve coherence with other aspects of the tax and transfer system:

- Assistance for youths should have an 'at home' rate and an 'away from home' rate. The at home rate for youth payment recipients under 18 should be aligned with family payment rates to avoid providing incentives to leave education or training. The at home rate should be higher for youths 18 and over. Away from home rates should not create inappropriate incentives for young people to leave home prematurely. Consistent with adult rates of income support, away from home rates should reflect the fact that that partnered youths have lower costs than single youths.

- The same rate should be paid to dependent and independent young people with similar living arrangements. While all youth payment recipients should be subject to a personal income test, dependent young people should also be subject to a parental income test. This parental income test should be broadly consistent with that which applies to family payments. To avoid reductions in assistance for families with both family payment and youth payment recipients, one option is to operate the two means tests consecutively, with the youth payment parental income test operating after the family payment income test.

- Young pensioners (including Disability Support Pensioners) have a greater need for assistance than other young people, but have lower needs than adult pensioners. A youth rate structure for pensions minimises inappropriate incentives for young people to claim these payments. To maintain system coherence, the relativity between adult rates of pension and participation payments should be reflected in the youth rate structure.

- While young people generally have lower needs than adults, some young people have adult responsibilities and face similar costs as adults. The payment of lower youth rates to young parents would result in these families having a lower standard of living than other families. Assistance for young parents should therefore be aligned with that for adults to avoid compromising the welfare of dependent children.

- Youth payments should be the main form of income support from the age of 18 until the age of independence. The current age of independence for a non-full-time student is 21 while the Australian Government has announced that the age of independence for full-time students will be progressively reduced to 22. The age of independence should be aligned in the future at 21.

F4. Child care assistance

Key points

Child care assistance should facilitate workforce participation of parents and support the development of children, particularly those from disadvantaged backgrounds.

Child care assistance should in most cases be provided as transfers to parents rather than subsidies to child care providers. The current child care payment structure could be simpler and more transparent.

Child Care Benefit and Child Care Rebate should be combined into a single payment to parents (or to child care centres in respect of each child) based on a percentage of out-of-pocket costs. This payment should be structured so that low-income families would be required to make a small co-payment. The payment should be means tested, but a base rate of assistance should be available to all families. The base rate of assistance should be linked to the marginal rate of tax faced by the majority of taxpayers.

F4-1 What is the role of child care assistance?

Assistance to access high-quality and affordable child care is important to the workforce participation of parents, providing them with the means to support and provide opportunities for their children. This is particularly important given the expected large increase in the dependency ratio — the number of people aged 65 and over per 100 workers — due to population ageing. All societies will need to ensure that the tax and transfer system does not unduly discourage workforce participation, particularly for parents returning to work after the birth of a child. The availability of affordable child care is more significant for women's than men's participation, given that women still undertake a greater role in caring for children in the home.

Access to quality child care also plays a role in early childhood development, particularly of children from families experiencing, or at risk of experiencing, social exclusion.

Child care and workforce participation

Australian families are increasingly balancing work and family responsibilities. The workforce participation rate of secondary earners, who in most cases are women, has risen steadily over the past few decades. Between 1982 and 2007 the participation rate of mothers with a youngest child aged 0 to 4 years increased from 29 per cent to 51 per cent. For mothers with a youngest child aged 5 to 9 years the rate increased from 51 per cent to 75 per cent. Of mothers in paid work prior to childbirth, 74 per cent return to work within 18 months of the birth, although mothers on lower wages are less likely to return to work within 18 months than those returning to average or higher-paying employment. Many mothers returning to work do so through part-time employment (Productivity Commission 2009b). These trends are broadly consistent with experience in other OECD countries.

As noted in the discussion on family assistance (see Section F3 Family and youth assistance), the value of parental care of children relative to the value of parental attachment to the workforce varies with the age of the child. Parental care is particularly important when the child is very young. The Productivity Commission's report on paid parental leave found that for the first six months it is significantly beneficial for the child and the mother to be together at home, with a reasonable prospect that longer periods (of up to 9 to 12 months) are also beneficial (Productivity Commission 2009b).

The OECD (2007c) notes that longer absences from the workforce can influence a mother's longer-term employment prospects. In this period, connection (or reconnection) with the workforce can become important. A system that supports parents to balance caring responsibilities with participation is important to social and economic outcomes for parents and their children.

For parents who need to use child care in order to work, child care is a cost of employment. The costs of child care may mean that parents receive minimal financial returns from returning to work in the short term — even though the long-term gains for parents, children and society more broadly from continued engagement with the workforce are much greater. Providing assistance so that parents can access good quality and affordable child care can help overcome these barriers to workforce participation.

Child care and early childhood development

The role of child care in early childhood development is a contested area of research and public policy debate. Much of the evidence is drawn from studies conducted in North America that focus on extensive interventions targeted at specific groups, including children from families with very low incomes.

While noting these caveats, the broad conclusions from the literature are that the quality of care makes a significant difference to outcomes and that children aged over two years experience positive outcomes from quality child care (although very long hours in care may be detrimental). For younger children, the outcomes are mixed and depend heavily on quality of care, hours in care and the home environment (that is, poor home environments mean better comparative outcomes for those children in child care).

Access to quality child care is particularly important in supporting the development of children from families experiencing, or at risk of experiencing, social exclusion. This can include children from jobless or low-income families, Indigenous children, children from minority cultural or linguistic backgrounds and children with a disability. For such children, evidence suggests that quality child care can lead to significantly better outcomes than no child care (COAG 2009). Making child care available to these children can not only assist their development and help them adjust to school, it can also help their parents take advantage of opportunities for economic and social participation.

Principle

Child care assistance should aim to facilitate workforce participation of parents and to support the development of children, particularly those from disadvantaged backgrounds.

How should assistance for child care be provided?

Funding parents versus funding providers

Government assistance with the costs of formal child care could be delivered by directly subsidising child care providers (including government-owned providers) or by providing payments directly to parents (consumers of child care). In the current system, the majority of assistance is provided to parents (or on behalf of parents) through a voucher-like payment.

There are a number of advantages to this approach. Providing parents with the resources to access child care services allows parental needs to drive where child care centres are established and the type of care available. The government does not have to determine where child care centres should be located or which ones should receive additional funding. Providing funding directly to parents allows for better targeting of assistance to particular groups of parents and children based on their individual characteristics.

Subsidising child care providers directly can be appropriate where the costs of establishing and running centres are so high that even after assistance to parents has been provided, a market does not emerge; or where there are strong social benefits to children or parents. For example, providing subsidies to providers may be appropriate in geographically remote areas.

While parents are usually best placed to decide how much and what type of child care is best for their children, there are some aspects of the quality of child care and its impacts on child development that parents may not be able to assess as well as government regulators. The choices parents make about child care therefore need to be combined with appropriate quality standards. Governments are best placed to make decisions about mandatory qualifications for child care staff and about health and safety standards for centres. They are best able to gather, assess and distribute information on service provision and, where necessary, adjust standards.

Higher-quality standards increase the costs of child care and consequently the participation choices of parents. It is therefore important that the benefits of setting standards are clear and outweigh the impact that higher costs will have on the ability of families to access child care.

Principle

Child care assistance generally should be provided as transfers to parents (or on behalf of parents) rather than subsidies to child care providers. Governments have a role in setting quality standards and ensuring that good information on child care services is available to parents.

Targeting assistance

To facilitate workforce participation and improve early childhood development, parents and children in different circumstances will require different amounts of assistance.

For low-income families, assistance with the cost of child care plays a significant role in facilitating workforce participation, a key factor for some families in breaking out of the cycle of poverty. This suggests that relatively more assistance should be provided to families with lower incomes.

Even at higher income levels, however, the tax and transfer system impacts on the benefits of working relative to the benefits of not working (including the choice to care for children at home). The current system includes a number of biases against paid work because of the taxation of wage income, the removal of benefits as income increases and the availability of government payments as a substitute for paid work.

The combination of these objectives suggests that the amount of child care assistance should be higher at low income levels and means tested as income increases, but that a base level of assistance should be provided across the income spectrum to facilitate participation. Given the policy rationale of providing assistance to facilitate participation, the base level of assistance should be provided with a participation requirement — that is, on the condition that single parents or both parents in couple families are participating in work, education or training.

For low-income families in particular, there is an additional objective of enhancing child development, and some child care assistance should be provided without a participation requirement. The number of hours of assistance available without a participation requirement should be limited. This could, for example, be set with regard to the number of hours available of universal pre-school that are available.

Assistance to parents could be provided as a transfer or as a tax deduction — recognising that child care is a cost of employment. Providing assistance as a tax deduction would not always assist low-income families, as many are not taxpayers and, where they are, the delay in assistance would significantly reduce the benefit of the assistance. For low-income families, assistance therefore needs to be provided as a transfer payment.

In terms of administration and compliance costs, it is likely to be simpler to provide assistance through a single mechanism in the transfer system, rather than through a tax deduction and transfer payment — although the rates of payment should be set with reference to the value that a tax deduction would provide.

A separate question is whose income should be used as the basis of the means test: should it be the combined family income or the income of the secondary earner? While the combined family income is a better proxy for a child's social circumstances, it is the secondary earner's work decisions that are likely to be impacted to a greater extent by child care costs.

Application of a family income is consistent with means testing arrangements for family payments and could be applied for child care. If a base rate of assistance was provided, a family income means test would still ensure that low-income secondary earners could receive some level of assistance, regardless of primary earner income. A measure of taxable income should be used as the basis for assessment (consistent with family payments).

While it is important for low-income families to be able to access quality and affordable child care, it is appropriate that they make at least a small co-payment towards the cost of child care. The existence of a price signal reduces the risk of parents taking up child care places when they are not needed.

In some circumstances, particularly for at-risk or vulnerable children with multiple disadvantages, it will be appropriate to cover the full costs of care to actively encourage the use of child care. It would not be appropriate to provide this rate of assistance based on family income alone: better measures of disadvantage may come from the health, community services or child protection systems. Other special circumstances (including grandparents caring for children and children in foster care) will also warrant non-means tested support.

Principles

Higher levels of child care assistance should be provided to low-income families. To recognise that child care costs are a cost of producing income, a minimum universal level of assistance should be available.

Child care assistance is more effectively provided through the payments system rather than through a tax deduction. Assistance should be means tested using a measure of family taxable income.

Requiring at least a small co-payment for low-income families reduces the risk of parents taking up child care places when they are not needed. In some cases, particularly for at-risk or vulnerable children with multiple disadvantages, it may be appropriate to cover the full costs of care.

F4-2 Current arrangements are complex and could be better balanced

The majority of child care assistance currently provided by the Australian government is in the form of payments to (or through) families to assist with the cost of care. There are two main child care payments: Child Care Benefit (CCB) and Child Care Rebate (CCR).

- CCB is a means tested payment per hour rate of assistance. The CCB rate for an hour of care is determined by a combination of factors including family income, the number of children in care, the number of hours used, whether the children attend school and the type of child care used.
- CCR covers 50 per cent of out-of-pocket expenses for approved child care; that is, 50 per cent of the amount of the fee *less* any entitlement to CCB and Jobs, Education and Training Child Care Fee Assistance. CCR is paid quarterly and has a maximum annual value of $7,778 per child in 2009–10.

Other child care assistance is provided through payments such as Jobs, Education and Training Child Care Fee Assistance, which provides help for parents undertaking job search, work, study or rehabilitation; and the Child Care Services Support Program, which provides payments to child care services to meet a number of objectives, including the provision of services to children with ongoing high support needs.

There is also a fringe benefits tax (FBT) exemption for child care facilities provided on an employer's business premises for the benefit of employees. Salary sacrificed payments for child care (from pre-tax income) or employer subsidised child care are not subject to tax in the hands of the employee or the employer.

Employers can allow employees to salary sacrifice the cost of their child care, or child care may be provided as part of a remuneration package. This is equivalent to providing a tax deduction, but only to a narrow group of parents given the condition that the child care facilities are provided on the employer's business premises for the benefit of employees.

Given that CCR provides a rebate for 50 per cent of out-of-pocket expenses up to a maximum of $7,778 per child for 2009–10, the FBT exemption provides a greater level of assistance only for families with very high child care costs on either the top marginal tax rate or second top marginal tax rate.

The FBT exemption for child care provides a higher rate of assistance for taxpayers earning over $180,000 and incurring child care costs over $16,727 ($64.33 per day in full-time care). Taxpayers with incomes lower than $180,000 would need to be incurring costs in excess of $19,691 to receive a higher rate of assistance from the FBT exemption, although that figure is accurate only for those taxpayers with incomes close to $180,000 because as a taxpayer's income begins to fall below $180,000, any benefit from the FBT exemption falls exponentially due to lower marginal tax rates and higher entitlement to the means tested CCB.

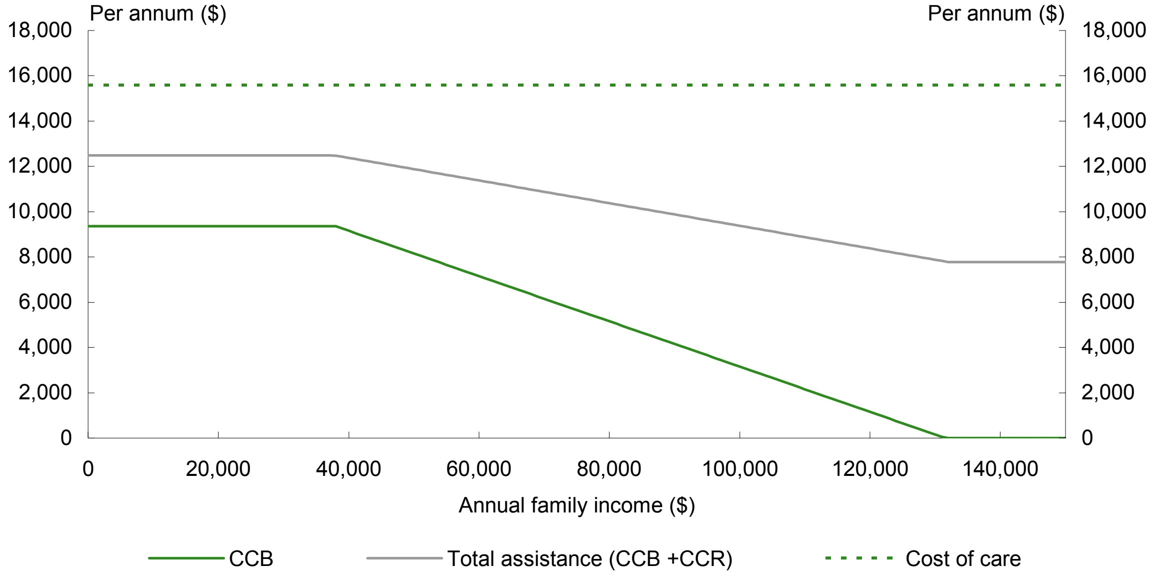
Further, while CCB and CCR are conditional on child care being provided by regulated providers for quality assurance purposes, these important conditions do not apply to the FBT exemption.

Australian government expenditure on child care has risen from around $2.6 billion in 2007-08 to a projected $3.6 billion in 2009–10. This reflects an increasing demand for child care services and policy changes that increase the level of assistance, most notably the increase in the CCR from 30 per cent to 50 per cent in 2008–09.

Chart F4-1 shows how assistance for child care changes as family income increases. For a given weekly fee, out-of-pocket costs increase as CCB is withdrawn. As CCR covers 50 per cent of out-of-pocket expenses, it provides relatively more assistance as CCB is withdrawn.

Chart F4-1: Child care assistance, 2009–10

One child in full-time care (50 hours per week) assuming a weekly fee of $300 per week



Note: Assumes that the child is in approved care and not of school age and that the child care fee is constant across all income levels.
Source: Treasury estimates.

The example presented in Chart F4-1 shows that, in combination, CCB and CCR cover the majority of child care fees for a low-income family. This result, however, depends on the child care fees: out-of-pocket costs will be higher if child care fees are higher. There is wide variation in child care fees across Australia, with fees in metropolitan areas significantly higher than fees in regional and remote areas (Australian Government 2009a).

Complexity in the calculation and delivery of payments

Current arrangements for child care assistance can be complex for parents, providers and administrators. The calculation of CCB is particularly complicated as the standard hourly rate can differ based on the type of care, whether the care is part-time or full-time, the number and ages of children a family has in care and whether the care is work-related. While tailoring assistance to particular groups is important, it comes at the cost of additional complexity. This can make it difficult for parents and providers to interact with the system and may deter them from doing so.

The existence of two child care payments and the way they interact can also add to complexity. The current system of child care assistance includes a payment that provides a dollar amount per hour of care (CCB) and a fixed proportional out-of-pocket child care expenses (CCR). The 'hourly rate' payment is means tested while the 'out-of-pocket assistance' payment is not, so that the former provides relatively more assistance to low-income earners and the latter provides relatively more assistance to high-income earners.

Sustainability of current payments

Although the maximum rates of CCB are indexed to CPI, in recent years child care fees have generally increased at a faster rate than CPI. If this trend were to continue, the proportion of child care costs covered by CCB would decline over time. In contrast, an out-of-pocket assistance payment, such as CCR, automatically adjusts to cover price increases (up to the maximum rate of CCR). Over time, this would shift the relative weight of child care assistance away from low-income families and create a flatter rate of child care assistance across the income spectrum.

The use of a pure hourly rate payment can result in the rate of assistance not automatically moving with increases in the cost of child care from year to year, particularly where child care prices rise at a faster rate than CPI. In addition, an hourly rate payment is not responsive to fee differences across service types and locations, which is a feature of the Australian system. As higher-quality care may also come at a higher cost, a flat hourly rate may constrain the use of high-quality care by low-income families.

While assistance provided as a proportion of out-of-pocket costs can help overcome these issues, it may put more pressure on child care fees and government expenditure, particularly if the supply of child care providers is constrained. Putting a dollar amount cap on the out-of-pocket assistance — as is currently done with CCR — can ameliorate these effects.

The sustainability of current payments also needs to be considered in the context of the proposed Council of Australian Governments (COAG) reforms that aim to improve quality standards in child care through the National Quality Agenda by introducing a new National Quality Standard and a new unified national regulatory environment. Over time, these reforms will increase staff qualification requirements and staff-to-child ratios, and these changes are expected to flow through to higher prices for child care.

In the absence of these reforms, child care prices would be likely to rise as a result of State-based changes to child care standards. Victoria has recently legislated improved quality standards. New South Wales, South Australia and the Northern Territory have announced similar intentions. Streamlining the regulation of the sector by moving to a national system will also result in savings for some service providers.

Payment delivery

The way payments are delivered impacts on the experiences of parents and providers. In the current system, CCB can be paid to child care providers who then deduct the relevant amounts from child care fees, or they can be made direct to families. Providing payments to providers as fee reductions (in respect of each family using care) reduces the number of payment points, but may place greater upward pressure on child care prices if the full rate of assistance were provided in this form.

While CCB is generally provided fortnightly, CCR is paid quarterly, so there is some disconnect between when this assistance is provided and the decisions parents make about the purchase of child care. This may affect low-income families, particularly in high-fee areas, who have difficulty paying in advance and may not take the full value of the assistance into account when making decisions about work and child care. It does, however, reduce the pressure on prices by ensuring that parents are subject to a larger proportion of the up-front cost.

Findings

The current child care payment structure could be simpler and more transparent, and could provide greater levels of assistance to lower-income families.

- The formula for calculating Child Care Benefit (CCB) is overly complex. The existence of two different payments with different types of assistance can add to complexity.
- CCB makes up the largest proportion of assistance to low-income earners. This assistance has not kept pace with increases in child care prices.
- Although providing assistance that covers a proportion of out-of-pocket costs can put higher pressure on child care fees and government expenditure, it is more responsive to changes in child care prices and to differences in prices across Australia.

Fringe benefits concessions are not an effective way of targeting child care assistance.

F4-3 Reform directions — a streamlined child care payment

Recommendation 99:

Child Care Benefit and Child Care Rebate should be combined into a single payment to parents (or to child care centres) in respect of each child based on a percentage of child care costs. The payment should have the following features:

(a) a high rate of subsidy for low-income families that covers most of the costs of child care (up to 90 per cent). This would involve a small co-payment for low-income families;

(b) a base rate of assistance for all families that use child care to facilitate parental engagement in the workforce. The base rate of assistance should be set as a proportion of child care costs, with reference to the marginal tax rate faced by the majority of taxpayers. (Based on the indicative personal income tax rates scale in Section A1, this would indicate a rate of assistance of 35 per cent);

(c) access to the base rate of assistance subject to a requirement that parents participate in work, education or training. Where parents are not participating, the maximum rate of assistance should be available for a limited number of hours. The number of hours subsidised without a participation requirement should be the same as the number of hours of universal access to pre-school (15 hours by 2013); and

(d) coverage of the full costs of child care for at-risk children and children facing multiple disadvantages, without participation requirements on parents.

Recommendation 100:

The child care payment should be means tested down to the base rate of assistance based on family income and should have regard to the interaction with other means tested payments (income support and family payments) and marginal tax rates, to ensure that effective marginal rates of tax are not excessive.

Recommendation 101:

The fringe benefits tax exemption for child care facilities provided on an employer's business premises for the benefit of employees should be removed.

Designing a single child care payment

A key element in simplifying the delivery of child care assistance would be to combine CCB and CCR into a single payment. To maintain rates of assistance over time and to accommodate the wide distribution of child care prices in Australia, the assistance (maximum and base rates) should be set as a percentage of out-of-pocket expenses.

Low-income families should receive a high rate of assistance to facilitate workforce participation and support the use of child care for early learning and development. It is envisaged that, in the long term, up to 90 per cent of out-of-pocket expenses would be covered.

Assistance would be means tested on family income (consistent with the family payment arrangements) and would provide a base rate of assistance for all secondary earners (regardless of primary-earner income) and all single parent families.

Because the means test adds to the effective rates of tax faced by the parent whose employment decisions depend on the cost and availability of child care, the threshold for means testing of child care will need to interact coherently with income support means testing. It is particularly important that child care means testing be coherent with the effective rates of tax from the withdrawal of other transfer payments faced by secondary earners and single parents. If assistance is based on a percentage of out-of-pocket costs, the means test would need to take into account families who have multiple children in child care.

To recognise that child care costs can be a cost of employment for single parents and secondary earners, the payment should have a base rate of assistance for all families. Using the marginal rate of tax faced by the majority of taxpayers may be an appropriate proxy for this, as some secondary earners will face lower rates of tax and some will face high rates. Under the illustrative rates scale (see Section A1 Personal income tax), this would imply a base rate of 35 per cent of out-of-pocket costs. For families receiving the base rate of assistance, an annual cap on assistance should be retained (but indexed), to limit assistance to a standard level of child care services for high-income families.

To link child care assistance with workforce participation (or activities that support future workforce participation), access to the base rate of assistance should be subject to a requirement that parents be participating in work, education or training. Where parents are not participating, the maximum rate of assistance should be available for a limited number of hours. The number of hours of child care that are subsidised without a participation requirement should be the same as the number of hours of universal access to pre-school. The Early Childhood Education National Partnership specifies that this will be 15 hours by 2013 (COAG 2008).

For children 'at risk' or facing multiple disadvantage, assistance for the full cost of care to encourage use of child care is envisaged. Access to quality child care is particularly important in supporting the development of children from families experiencing, or at risk of experiencing, social exclusion. This can include children from jobless or low-income families, Indigenous children, children from minority cultural or linguistic backgrounds and children with a disability.

To ensure the child care payment is sustainable and maintains cohesion with other aspects of the tax and transfer system, the parameters underlying the payment and the means test would need to be reviewed over time. This includes the timing of how assistance is delivered; that is, the proportion of assistance delivered up-front compared to the proportion of assistance delivered each quarter (or other time period). While the majority of assistance (at least for low-income families) should be delivered on a regular basis, the quarterly payment approach could be retained for the base rate of assistance, or some portion of the base rate of assistance, for all families. This could help to balance the objectives of maintaining a meaningful price signal to parents and providers and ensuring that child care remains affordable for low-income families.

Fringe benefits tax exemption is not appropriate

The fringe benefits tax (FBT) exemption for child care facilities provided on an employer's business premises was intended to encourage the creation of additional child care places. However, only higher-income employees working for larger businesses able to establish a child care centre can benefit from the concession.

Even if the exemption were to be broadened to remove the restriction on the employer providing the child care, an FBT exemption is not an appropriate vehicle for providing child care assistance because it adds complexity, relies on employers being prepared to put in place salary sacrifice arrangements and does not operate coherently with the other child care payments (CCB and CCR).

The FBT exemption cannot be used to assist low-income families with child care. While it is possible to provide this assistance separately, it would remain difficult to provide the two forms of assistance in a coherent way.

CCB and CCR are intended to be the primary form of child care assistance. The FBT exemption is now a remnant of an older system of support largely overtaken by an alternative system of direct support.

F5. Housing assistance

Key points

Adequate housing is integral to a decent life. As well as providing basic services, such as shelter, it enables people to participate fully in society. Ensuring access to adequate housing should be a key part of the social safety net by providing assistance based on the means and needs of individual recipients.

Including rent assistance as part of the income support system allows the assistance to be targeted to need and delivered in a way that does not discourage workforce participation. However, the current maximum levels of assistance for private tenants are too low, cutting out below a level that would ensure access to an adequate standard of housing. Indexation of assistance to the Consumer Price Index means that assistance is not well-targeted over time, exposing recipients to the risk of rent fluctuations.

The higher average level of assistance to public tenants is not well-targeted to need. As a majority of public tenants have similar means to recipients of the government's Rent Assistance payment, the large difference in assistance levels is inequitable. The gap in assistance leads to rationing through queuing and can lead to poor outcomes for tenants in the long term.

In public housing, the use of queues to ration assistance and income-based rent setting discourage workforce participation. Current public housing funding neither effectively targets assistance nor encourages use of the housing stock in ways that reflect the needs of clients.

Rent Assistance should be increased so that assistance is sufficient to support access to an adequate level of housing. Assistance should be more appropriately indexed to reflect the growth in line with market rents. Rent Assistance should be extended to public housing tenants, with recipients paying rents that reflect market rates, subject to gradual transitional arrangements.

Social housing providers should receive a new source of funding in respect of tenants with high housing needs, such as those with high costs due to disability or people likely to face discrimination in the private market. The payment would be based on the needs of recipients and could in many cases be directed by them to providers of their choice. In combination with Rent Assistance, this assistance will encourage the formation of a more dynamic social housing market that would reduce reliance on the current system of block grants.

The Australian government and the States should retain the option of providing capital for housing construction.

F5-1 Housing assistance — why is it needed and what form should it take?

Why does government provide housing assistance?

A key function of national government is the prevention of capability deprivation — that is, the absence of fundamental capabilities that enable people to participate fully in society. Income support is a major mechanism for achieving this end. It provides people with resources to maintain an adequate standard of living and supports their participation in the community, including the workforce (see Section F1 Income support). There is a further need for specific housing assistance in recognition of the special role it plays in supporting wellbeing.

Access to adequate housing is necessary for both a decent standard of living at a point in time and for development of capability over the long term. Housing is a complex good that performs a range of valuable functions. As well as providing basic shelter, it is a key factor in health, child development and workforce participation, and a platform for broader social cohesion. Poorer households need to dedicate a greater proportion of their incomes to achieving an adequate standard of housing. In 2007–08, renters with household incomes in the bottom 20 per cent of the income distribution spent 36 per cent of their income on rent, compared to 19 per cent for renters in the middle 20 per cent. Poorer households also devote a large share of their income toward housing if they do not have the option of occupying social housing where rents are charged proportional to incomes. Their access to affordable housing is affected by a range of supply constraints, such as requirements for Australian housing to meet a minimum standard of quality, which are discussed in greater detail in Section E4 Housing affordability.

A further role of government assistance is to ensure access to adequate housing for people with high needs who would be unlikely to access it in the private market. The private market is likely to fail people with a range of needs — for example, people with mental or physical disabilities or substance-abuse problems — either through discrimination, lack of suitable housing or excessive premiums for risk. The key role of assistance for people with high needs is to enable their access to housing by funding social housing provided by State housing authorities (public housing) or non-government organisations (community housing). Housing assistance should also reflect the difficulty Indigenous Australians can face in accessing mainstream housing markets. In addition, the particular housing needs of Indigenous Australians in remote areas should be addressed through specific measures, such as the provision of capital for house building.

This focus on people with special needs and the broader role of social housing in the current Australian housing market means that some supply side measures are also a critical element of a comprehensive social housing system. Projected population growth will require that supply of social housing keeps pace to ensure that homelessness is prevented.

How should assistance be provided?

Housing assistance should be provided in a way that is equitable, does minimum harm to participation incentives and gives recipients choice in the housing they occupy.

Housing assistance for people with limited means is best provided as an integrated component of the income support system. The comprehensive assessment of income and assets undertaken through the income support system is the most effective way of targeting housing support to people with limited means. It also ensures that people of similar means receive the same level of support.

As a part of the income support system, housing assistance can be designed to minimise disincentives to work. With a person's total income support reflecting assistance for housing and other costs of living, the total amount of assistance can be reduced consistently as their means increase. This enables the impact of all taxes and transfer withdrawal to be considered together, with the total effective marginal tax rate set to minimise harm to participation while a person receives income support.

Housing assistance for people with high needs is most effective when targeted to their needs directly, rather than indirectly through providers. Recipients being able to direct the assistance to providers of their choice enables competition, which can help ensure the housing they receive meets their needs. Funding that is directed by recipients can also be scalable to enable successful housing providers to expand their provision.

The overall system of housing assistance and funding should support the viable provision of social housing for people with low incomes and high housing need. There is a particular need for the provision of capital funding in some circumstances, such as Indigenous Australians in remote areas. To ensure that housing assistance is effective, the roles and responsibilities of different levels of government in its provision should be made clear.

The form of housing assistance

Housing assistance should be designed to enable recipients to access an adequate standard of housing. Further, housing assistance should be set with reference to base rates of assistance to ensure that income after housing costs is sufficient for consumption of an adequate standard of other goods and services.

As the cost of housing can fluctuate significantly with changing market conditions, housing assistance should be structured to remain adequate over time and not expose its recipients to undue risk posed by large increases in housing costs. As housing constitutes a large share of expenses for people with limited means, market fluctuations can affect them significantly.

Housing assistance should aim to treat people in the same circumstances in the same way. In general, a person's housing tenure is only a rough proxy for their means or needs and is therefore a poor mechanism for targeting assistance. Where possible, assistance should be based on means and needs because it allows people greater choice and is fairer. A system that is tenure-neutral — that is, it provides assistance independent of a particular form of tenancy — would allow recipients of housing assistance to move more easily between types of tenure. This would be most important for long-term recipients of income support.

Balancing tenure neutrality with targeting need

A system that follows strictly the principle of tenure neutrality would take no account of how people spend assistance, including the amount or type of housing they consume.

However, it is important that tenure neutrality be balanced by consideration of a person's housing costs, as this affects their need for assistance.

Information used to determine people's eligibility for housing assistance should include information about their housing costs so that those who face higher costs can receive higher levels of assistance. This approach differs from that used more generally in income support for several important reasons.

Housing costs are readily observable, which enables assistance to be better targeted. Tighter targeting of assistance means that for the same fiscal cost, greater assistance can be provided to people with high housing costs.

Further, high housing needs are likely to be associated with financial stress. People enter the income support system — perhaps because of loss of work or marriage breakdown — with differing levels of housing costs, reflecting earlier choices. Providing additional assistance to people with higher housing costs minimises the financial stress of moving in and out of income support.

Principles

To ensure it is effectively targeted, assistance for housing should be an integrated component of an income support system designed to alleviate poverty that:

- ensures people requiring assistance can access an adequate standard of housing;
- is based on a comprehensive assessment of individual means and the costs of housing; and
- minimises harm to workforce participation.

Additional assistance should be provided to ensure access to adequate housing for people whose high needs would otherwise make it unlikely they could find adequate housing in the private sector. This assistance would be most effective when it is based on recipients' needs and directed by them to providers of their choice.

The overall system of housing assistance and funding should also include funding for capital costs to support the viable provision of social housing for people with low incomes and high housing need.

F5-2 Assessment of the current system

Overview of housing assistance

Two major forms of housing assistance are available to low-income earners: Rent Assistance and public housing. A person can access only one or the other.

Rent Assistance is a component of the Australian government's income and family support systems. Eligibility for Rent Assistance requires eligibility for income support or more than the base rate of Family Tax Benefit Part A and rental costs that exceed a minimum level. Assistance is paid for rents above this level at 75 cents per dollar of rent up to a maximum cap (details at Table F5-1). In 2007–08, Rent Assistance was provided to around 940,000 recipients at a cost of $2.3 billion.

Table F5-1: Rent Assistance per fortnight

Rates and proportions as at September 2009

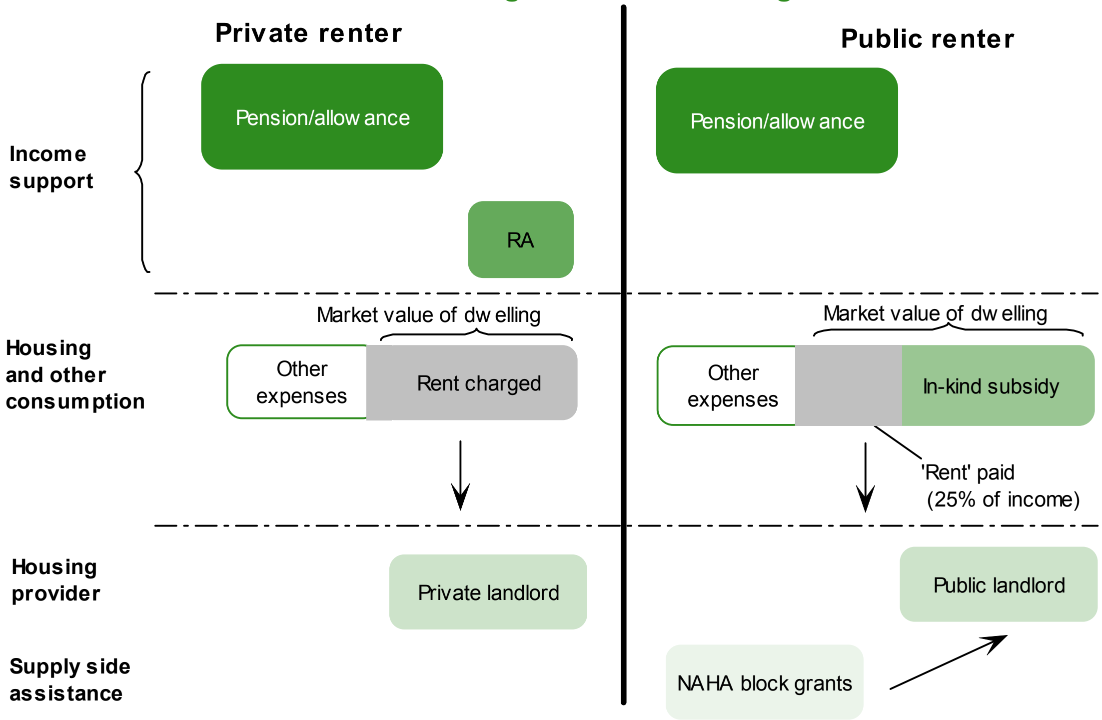
Recipient type		Minimum rent for eligibility for assistance	Rent at which maximum asistance received	Maximum amount of assistance	Proportion of all recipients (%)
Single	sharer with no children	$99	$199	$75	15
	alone with no children	$99	$248	$112	38
	with one or two children	$131	$306	$131	18
	with three or more children	$131	$329	$148	4
Couple	with no children	$162	$303	$105	9
	with one or two children	$194	$369	$131	11
	with three or more children	$194	$391	$148	5

Source: Centrelink 2009 and FaHCSIA unpublished.

Public housing is an in-kind benefit that operates independently of the income support system. Eligibility is determined by State housing authorities and based on income combined with other criteria indicative of housing need. Rents are typically set at a maximum of 25 per cent of tenant income, with the assistance equal to the difference between the charged rent and market rent. At 30 June 2008, there were around 330,000 households in public housing, who received an aggregate subsidy of around $1.6 billion. Through the National Affordable Housing Agreement, the Australian and State governments provide around $1.3 billion in annual funding, including for both ongoing and some capital costs, to public housing authorities.

These arrangements are depicted in Chart F5-1 for a recipient with no private income.

Chart F5-1: Current arrangements for housing assistance



Community housing is also a form of housing assistance for around 30,000 low-income households. Community housing organisations are non-government organisations that provide subsidised housing funded through government grants and private donations. Eligibility for community housing is determined by the provider, but is generally based on criteria similar to those for accessing public housing. Community housing tenants can receive Rent Assistance. In general, providers set rents at 25 per cent of their income. Increasingly, community housing providers set rents to include all the Rent Assistance their tenants receive. In 2007–08, the Australian Government provided grants of around $68 million to a range of not-for-profit providers of housing to disadvantaged people.

As set out in Table F5-2, a number of other housing assistance programs focus on different aspects of housing need. The Review has assessed neither these programs in detail nor alternative supply- or demand-side policies.

Table F5-2: Housing assistance programs

Program	Provider	Purpose	Cost
National Affordable Housing Agreement	Australian Government	In addition to providing funding for public housing, the National Affordable Housing Agreement provides untied funding to states and territories for housing and homelessness services. It replaced the Commonwealth State Housing Agreement (including identified programs such as the Crisis Accommodation Program and the Aboriginal Rental Housing Program) and the Supported Accommodation Assistance Program. It is supported by National Partnership Agreements on social housing, homelessness and remote Indigenous housing.	NAHA — $6.2 billion over five years. National Partnerships — $7.1 billion over 10 years.
Nation Building — Economic Stimulus Plan Social Housing Initiative	Australian Government	Provides funding to states and territories for the construction of new social housing and repair and maintenance to existing public housing dwellings.	$5.638 billion over three and a half years, including $400 million for repairs and maintenance.
First Home Owners Grants	States (ongoing) and Australian Government (one-off supplements)	The First Home Owners Grant was introduced with the introduction of the GST to compensate non-home owners for the increase in the cost of housing arising from higher construction costs of new homes. To provide short-term assistance to the housing sector, the Grant has been increased temporarily in 2001–02 and through the First Home Owners Boost introduced in October 2008.	First Home Owners Grant — $1.3 billion in 2008–09. First Home Owners Boost — $934 million in 2008–09.
National Rental Affordability Scheme	Australian Government with States	Assistance to housing providers to encourage supply of housing that is rented out to low- to moderate-income earners at below market rents.	$72 million in 2008-09 (growing to $357 million in 2011-12)
Housing Affordability Fund	Australian Government	To reduce the cost of charges levied by State and Territory and Local Governments on homebuyers, by providing an incentive for reform of inefficient processes and a contribution towards infrastructure costs.	$512 million over five years.
First Home Saver Accounts	Australian Government	To assist young Australians save over a number of years for their first home, through low tax savings accounts that the Government contributes to each year.	$245 million over five years from 2008-09.
Home purchase assistance for Indigenous Australians	Australian Government	The Home Ownership Program (HOP) and the Home Ownership on Indigenous Land Program (HOIL) assist low income Indigenous households to purchase their own homes.	HOP — $552 million in outstanding loans at 30 June 2009. HOIL — $1.3 billion in approved loans in 2008-09
Home purchase assistance	States	To assist low- to moderate-income households with the costs of home purchase, including direct lending, deposit assistance and mortgage relief.	$22 million of interest rate assistance and mortgage relief and $1.1 billion of direct lending in 2007–08.
Private rental assistance	States	To assist low-income households who have difficulty securing and maintaining rental accommodation.	$25 million in rental grants, subsidies and relief payments and $47 million in bond loans in 2007–08.

As the current system provides assistance according to tenure, the following assessment of assistance considers Rent Assistance, public assistance and assistance for low-income mortgagors.

Rent Assistance

The structure of Rent Assistance is appropriate

In a number of ways, Rent Assistance aligns with the principles for delivering housing assistance.

Basing Rent Assistance on the recipients' rent levels means the payment can be well-targeted to need. By paying assistance above a rent threshold, around 40 per cent of income support recipients who could otherwise be eligible for Rent Assistance do not receive the payment because they pay low or no rent. Further, paying assistance at 75 cents per dollar of rent in excess of the threshold means the recipient faces a co-payment of 25 per cent for their rent.

Around 30 per cent of people receiving Rent Assistance are paid less than the maximum rate, which suggests that the co-payment provides recipients with some incentive to economise on their rental costs.

The maximum rates of Rent Assistance are different depending on whether a person is single, in a couple or sharing with others. This approach allows maximum Rent Assistance to be reduced in line with the economies of scale that can be achieved through sharing or living with a partner. Reducing assistance in these circumstances is consistent with the principles of a targeted system and lowers the overall cost of assistance.

For adults without children, Rent Assistance is included as an integrated component of income support. In terms of means testing, Rent Assistance is added to a recipient's base payment so that, as recipients' private means increase, their base income support is withdrawn before Rent Assistance is reduced. Though this extends the income range over which Rent Assistance recipients face payment withdrawal, it results in withdrawal rates determined by base payments alone. This means status as a renter does not influence withdrawal rates, which are set to reflect workforce participation objectives. Further, the alternative of 'stacking' — withdrawing base payment and Rent Assistance simultaneously — would create higher withdrawal rates and deter people from entering the workforce. This is particularly important because a substantial proportion of housing assistance recipients are single parents. When surveying empirical results, Wood et al. (forthcoming) state that 'the weight of evidence suggests that Rent Assistance has only small, negative impacts on employment outcomes'.

However, the maximum level of assistance is low and indexed inappropriately

The rent caps where maximum Rent Assistance is paid are set at low levels of rent. For singles, the cap of $124 per week represents the bottom 10 per cent of one-bedroom dwellings rented in capital cities. Across the country, around 220,000 dwellings rent for less than the couple rent cap of $151 per week, well below the number of childless households who receive Rent Assistance. At June 2009, the average rents of Rent Assistance recipients are $147 per week for a childless single (non-sharer) and $198 per week for a childless couple.

Because the maximum rate of Rent Assistance is reached at relatively low levels of rent, many recipients divert their base income support payment from other expenses in order to acquire an adequate level of housing. As an indicative example, renting a dwelling for $165 per week[28] leaves a single pensioner with around 68 per cent of their base payment and a single Newstart Allowance recipient with 52 per cent of their base payment for other living expenses.

28 This is broadly equivalent to the 25th percentile of one-bedroom dwellings and the 5th percentile of two-bedroom dwellings.

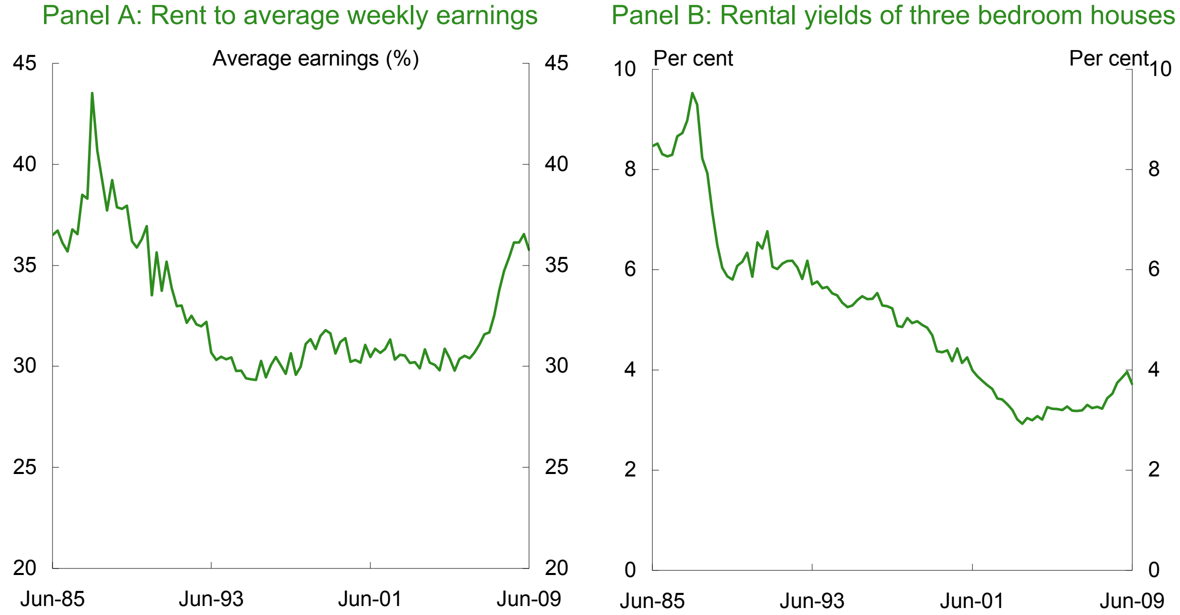
The minimum rent thresholds below which Rent Assistance is paid are the same for each payment type, irrespective of the recipient's base payment. This means that people on allowances must use more of their base payment to get an adequate standard of housing than recipients of pensions.

One reason that the maximum Rent Assistance is reached at a low rent level is that it is indexed by consumer price index (CPI) changes. Significant short-term fluctuations in real rents do occur. Over the past three years, average rents have grown at an annual rate of around 10 per cent, outstripping growth in the maximum rate of Rent Assistance at 2.7 per cent per year as well as average wages (Chart F5-2 Panel A). The yield obtained by rental property investors is determined by combination of a range of factors in addition to rent, such as expected capital gain and potential tax advantages. This combination is not stable over time, as shown by the movement in rental yield over the past 25 years (see Chart F5-2 Panel B). Not indexing assistance to rents exposes recipients to the risk of structural shifts in yield that can be driven by market forces and policy changes. Recipients of housing assistance are less likely to be able to bear the risk of large changes in housing costs than others in the community.

The composition of the CPI basket also means that it is a poor reflection of the housing costs of low-income renters. Around 6 per cent of the CPI basket is rent, while rent represents around 35 per cent of income for Rent Assistance recipients.

Inadequate indexation leaves fewer resources available for other expenditure and harms the overall wellbeing of recipients. From 2004 to 2009, overall real income support for Rent Assistance recipients (after rent) has fallen by around 23 per cent for Parenting Payment Single recipients and 36 per cent for recipients of Newstart Allowance.

Chart F5-2: Variation of rents over time



Source: REIA (2009) and ABS 6302.0.

Source: REIA (2009).

Rent Assistance in respect of children and for families

For families who rent, the housing assistance paid in respect of their children is not coherently designed. The number of children in a household is taken into account when determining the maximum level of Rent Assistance. For example, the maximum rate for a single person with one or two children is $131 per fortnight, $20 per fortnight more than a childless single. In addition, all parents receiving income support also receive the Family Tax Benefit (FTB) Part A family payment. FTB Part A recognises the direct costs of children, including housing costs, and is paid at the same rate to all parents regardless of tenure. As it is not clear that income support recipients who rent face greater marginal housing costs from children than non-renters, there is no obvious rationale for providing additional assistance to renters in respect of these costs.

The current approach for providing Rent Assistance to families blurs the roles of income support and family payments. As set out in Section F1, income support reflects the needs of adults with limited means, while family payments should assist with the direct cost of children (discussed in Section F3 Family and youth assistance). Families whose income makes them ineligible for income support still receive Rent Assistance as long as they receive more than the base rate of FTB Part A (which has a higher income cut-off). For these parents, their continued eligibility for Rent Assistance is effectively due to their status as a parent. This structure involves a trade-off between the coverage of low-to-middle income families and the adequacy of assistance.

Public housing

Public housing is a significant mechanism for providing housing to disadvantaged groups. It has become the primary source of housing for people who cannot access appropriate or adequate housing in the private market such as people with a mental illness and Indigenous Australians who still too often face discrimination in the housing market. Social housing (public housing and community housing) provides a valuable stock of houses in the context of Australia's housing supply difficulties, and in some areas such as remote Indigenous communities is the only viable source of housing.

However, there are a number of areas where social housing is not adequately supporting the Australian households that rely upon it for adequate housing.

Differences in assistance do not target need well

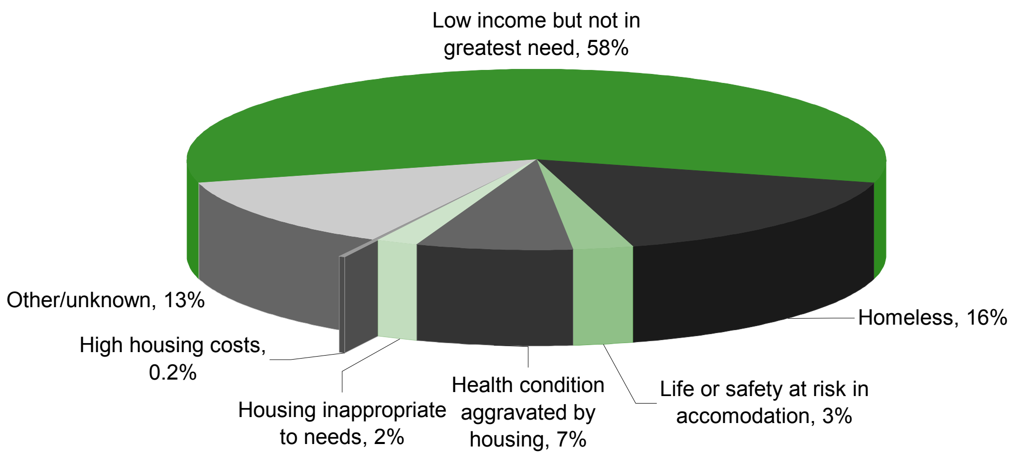
Public housing confers a greater average level of assistance to recipients than Rent Assistance. This is inequitable but can also lead to poor long-term outcomes for recipients.

Setting public housing rents as a proportion of incomes results in the average level of support being around $220 per fortnight, while average assistance is only around $90 per fortnight for Rent Assistance recipients. Rationing of public housing through queues is a key indicator of the difference in levels of assistance between the two types of tenure. At 30 June 2007, around 176,000 applicants were on waiting lists for public housing (that is, current demand exceeded supply by around half). In 2006–07, around 30 per cent of tenants allocated to public housing had waited for two years or more. There is also significant variation in assistance within public housing, as the level of assistance depends on market value of the dwelling to which a recipient is assigned.

Public housing also provides greater tenure security than is available to many people in the private market. Tenure security can be important for tenants[29] as it provides greater certainty in their lives and saves on moving costs, which may be significant for some recipients (such as those with disabilities). Around 75 per cent of public housing tenants have been with their provider for five years or more. Long levels of occupancy reflect the fact that tenure is for life in most States, although this may also be influenced by public housing eligibility rules.

As indicated in Chart F5-3, a significant minority of new entrants to public housing are assessed as having high housing needs, such as being homeless or having their health at risk. However, the variation in public subsidy is not directly targeted to tenants with assessed as in 'greatest need'[30], who instead receive preferential placement, which results in shorter average wait times for access to housing. Tenants assessed as not being in 'greatest need' and who are eligible for public housing based on their low income alone, generally receive higher levels of assistance than people with similar means who rent privately.

Chart F5-3: New allocations to public housing by need category (2006–07)



Source: AIHW 2008.

The existence of large differences in the size and nature of assistance can also lead to poor outcomes for recipients. As public housing entitlements generally are not portable, the large gap with Rent Assistance discourages people from moving out of public housing. This has the potential to lock people in to depressed areas and to discourage moving for work. People may modify their behaviour to gain access to the immediate financial benefit of public housing in ways that have negative long-term consequences. To remain eligible for public housing, the incomes of prospective tenants must stay low while they are on the waiting list. Dockery et al. (2008) suggested that this was a significant reason why unemployment rates are 11 percentage points higher for prospective male tenants on public housing waiting lists, and 5 percentage points higher for females.

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29 In the 2007 National Housing Survey, around one-quarter of respondents nominate tenure security as a reason for moving into public housing (AIHW 2007a).

30 The greatest need standard includes households that at time of allocation were: homeless; their life or safety was at risk in their accommodation; their health condition was aggravated by their housing; their housing was inappropriate to their needs; or they had very high rental costs.

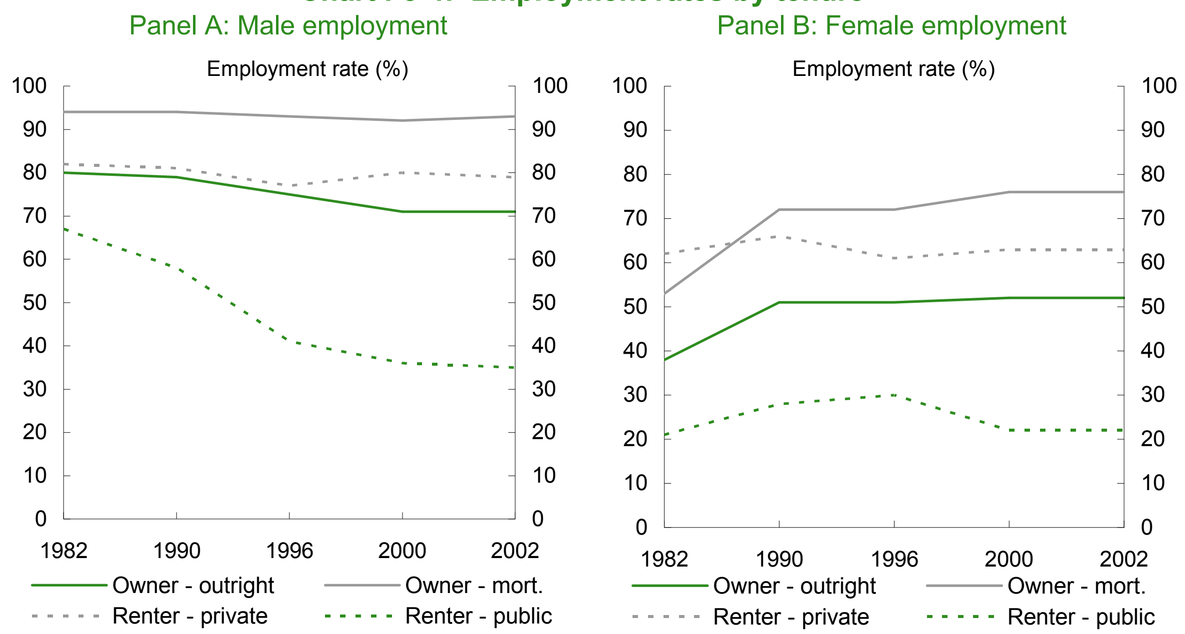
Barriers to workforce participation

Ensuring that the transfer system supports long-term capability development by doing minimum harm to workforce participation is of particular importance for housing assistance. The characteristics associated with high housing need — such as disability or addiction problems — are also likely to affect the participation prospects of housing assistance recipients. This heightens the need to ensure that the system does not fail vulnerable recipients by giving them incentives that fail to enhance, or even reduce, their self-reliance.

Employment rates among public housing tenants are low and have been declining over time (see Chart F5-4). While this reflects the fact that public housing is targeted toward people with poor participation prospects, public housing rent-setting also reduces incentives to work.

Public housing rents are generally set at 25 per cent of income. As this rent stacks on top of income support withdrawal rates, public housing tenants face an effective marginal tax rate that is 25 percentage points higher than if they privately rented or owned. Public housing rent-setting policies can also contribute to intergenerational poverty traps, as children of public housing tenants may also have to contribute 25 per cent of their income for rent.

Chart F5-4: Employment rates by tenure[(a)]



(a) Employment rates over this time period would have been affected by a range of factors including economic conditions, the increase in participation by females and the ageing of the population.
Source: Wood et al. (forthcoming).

There is strong evidence of the impact that public housing has on employment incentives. Modelling by Dockery et al. (2008) estimated that around 110,000 recipients are in 'employment traps' where high effective marginal tax rates discourage entry to the workforce. Wood et al. (2007) found employment by female public tenants (64 per cent of primary earners in public housing) was lower than that of equivalently skilled private renters.

State housing authorities use a range of programs to promote employment, perhaps in recognition of these incentives. For example, the Australian Capital Territory provides the Employment Rent Rebate Extension, which preserves below-market rents for the first six months of employment. In Victoria, the Public Tenant Employment Program provides tenants with training and advises them of job vacancies. While such programs may promote participation where they are used, they are unlikely to counteract the negative incentive effects inherent in the system.

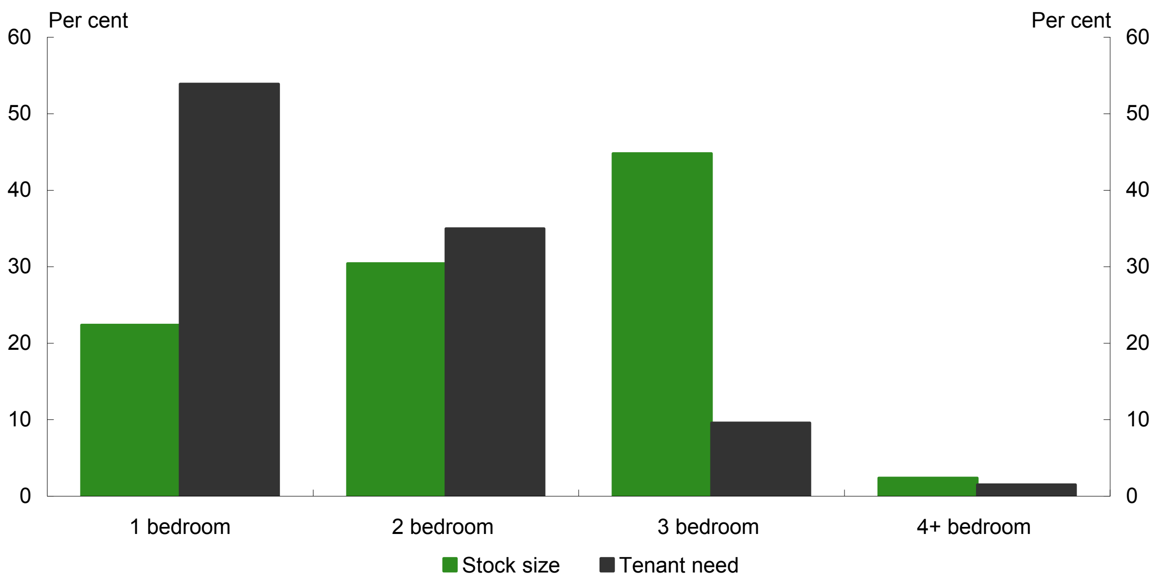
Funding arrangements create poor incentives for effective use of the housing stock

Public housing has two sources of funding: rents from tenants and grants from governments. This system provides poor incentives to both recipients and providers of public housing and may not be sustainable.

Setting rents with reference to tenant income means there are no effective price signals governing the allocation of public housing. The rents providers receive give them no information about the type or location of housing their tenants prefer, which ideally should be reflected in their housing stock. Tenants with the same income pay the same rent regardless of the size, location, condition or general amenity of the house they occupy. This means they have an incentive to maximise their 'in-kind subsidy' — that is, they try to stay in larger and better houses than they would normally occupy if they had to pay directly for their housing. Whelan (2009) found that recipients of dwellings with higher market rent tended to have longer tenancies than equivalently sized households occupying cheaper dwellings. Many would use the value of the subsidy differently if they had the choice.

However, many public housing recipients have little real choice about the particular dwelling they occupy. Facing significant wait times and movement to the back of the queue if an offer of housing is declined, recipients have an incentive to accept whatever housing they are offered. Further, the type of housing available can be incompatible with a recipient's need. The public housing stock is dominated by three bedroom houses, yet most recipients are singles or couples without children, as illustrated by the Tasmanian stock in Chart F5-5.

Chart F5-5: Tasmanian housing stock
Public house sizes compared to room needs of tenants (2006–07)



Source: FaHCSIA 2009.

Public housing providers are financed through a combination of government grants — the Commonwealth State Housing Agreement to 2007–08 and the National Affordable Housing

Agreement from 2008–09 — and the rents that public housing authorities charge recipients. For funding to be sustainable, it must at least meet the cost of providing the housing services.

Assistance being provided through grants enables housing services to be delivered at below market rents. Until the new funding agreement in 2008–09, grants had been declining over time in real terms, falling by around 25 per cent in the ten years to 2006–07. The lack of clarity in the roles and responsibilities of the Australian government and State governments may have affected funding levels, with each tier of government seeking to transfer the fiscal cost to the other.

Public housing has increasingly been rationed to recipients with high needs. However, the grants are not based on the likely need or number of such clients, nor on the overall quantity or quality of housing provided. The current grants are provided through block funding, based on the population in each State. This funding mechanism provides an incentive for States to transfer management of public housing to community providers. The tenants transferred to community housing become eligible for Rent Assistance and, with fewer tenants, the effective per-dwelling funding in the public housing stock increase.

The scope for use of tenant rental charges has declined in line with levels of employment in public housing. At 30 June 2008, around 88 per cent of recipients paid below market rents, with the remainder having their rent capped at the market level. With low private income, recipients pay their rents out of income support, the indexation and level of which affects the viability of providers. Providers receive a larger payment from pensioners than recipients of allowances (like Newstart Allowance) for providing the same dwelling. While growth in pensions through wage benchmarking generally outpaces CPI-indexed allowances, neither payment type is likely to move systematically with private market rents.

In aggregate, public housing rent setting and funding policies have led to a declining level of funding over time. From 1997–98 to 2007–08, public dwellings have decreased from 6 per cent to 5 per cent of the overall housing stock. Lower supply further contributes to unmet demand for public housing.

Low-income mortgagors

In 2005–06, around 300,000 (or 11 per cent) of income support recipients were repaying a mortgage.[31] How mortgaged borrowers are affected through the tax and transfer system is not straightforward to assess.

Unlike renters, they do not receive assistance with their ongoing housing costs. The only direct assistance available to low-income earners with mortgages is provided through small direct lending and temporary mortgage assistance, which is available in only some States.

However, comparing means of mortgagors and renters is complicated by the fact that home equity earns a tax-free return and is not included in the means testing of income support. Depending on the level of equity in their home, this may confer greater assistance than Rent Assistance. For example, a single mortgagor on a part-pension with less than $116,000 of

31 The proportion with a mortgage varies considerably by type of recipient. It is 6 per cent for Age Pension; 21 per cent for single parent pensioners or 16 per cent for those receiving Newstart Allowance.

equity in their home would receive less assistance from the transfer system than if they were a renter.

Findings

The different levels of subsidy between tenants in different tenures, such as social housing and private rental, are inequitable and not well-targeted to need.

The current rent caps for Rent Assistance are too low and do not reflect an adequate level of housing for many recipients. Indexation of Rent Assistance to CPI means that assistance is less well targeted over time and exposes renters to housing cost risks.

In public housing, the use of queues to ration assistance and income-based rent setting discourage workforce participation. There is a need to reform public housing funding to better target assistance and encourage use of the housing stock in ways that reflect the needs of clients, and to make the funding model sustainable in the long term.

F5-3 Reforms for adequacy, targeting and participation support

The Panel proposes reforms to housing assistance to ensure that assistance is adequate, targets need and supports participation incentives.

Recommendation 102:

The maximum rate of Rent Assistance should be increased to assist renters to afford an adequate standard of dwelling. To ensure that Rent Assistance can be maintained at an adequate level over time, the rent maximum should be indexed by movements in national rents, which could be measured by an index of rents paid by income support recipients.

Recommendation 103:

To better target an increase in the maximum rate, Rent Assistance should be part of the income support system, with eligibility based on rent paid and the income support means test, rather than on eligibility for another payment (for example, Family Assistance).

Recommendation 104:

Mechanisms should be developed to extend Rent Assistance equitably to public housing tenants along with removing income-linked rent setting in public housing.

Recommendation 105:

A high-need housing payment should be paid to social housing providers for their tenants who have high or special housing needs or who may face discrimination in the private market. This payment should be funded by the Australian government. The Commonwealth and the States should retain the option of providing capital for social housing construction.

Recommendation 106:

Income-linked rents should be phased out in social housing, with providers charging their tenants rents linked to the market rate, with existing rent-setting for current tenants phased out using grandfathering or other transitional arrangements. However, continued use of income-limited rents is appropriate in some circumstances, such as in remote Indigenous communities.

Rent Assistance to better target adequacy

The rent caps for Rent Assistance should be raised. They should be set to ensure assistance is paid up to an adequate level of housing and does not compromise an income support recipient's consumption of non-housing goods and services.

While the Review has not conducted a detailed survey of adequacy or of the rental market, it appears that setting the upper cap of rent with reference to rental costs of one- and two-bedroom dwellings in the 25th percentile of rents across capital cities is a reasonable benchmark for determining adequacy (Recommendation 102). Dwellings of this size are consistent with the need for housing in assessments such as the Budget Standards (Saunders et al. 1998). One- to two-bedroom dwellings should be adequate for households without children — assistance for the housing costs of children in families is discussed below. Setting the rent cap rents with reference to the capital cities should ensure access to job markets and reflect the housing costs where the majority of Australians live. Set with reference to rents at the 25th percentile, there should be a reasonable standard of housing and number of dwellings available. However, this benchmark should be reviewed over time to take into account future developments in rental markets.

A cap set with reference to this level should also be consistent with ensuring an adequate level of non-housing consumption. Rent Assistance involves a co-payment, without which there would be no incentive to economise on housing costs. As such, it is not possible for income after housing expenses to be the same across renters with different costs, between renters and non-renters, or between pensioners and allowees. Adequacy should focus on the remaining base payment of pensioners receiving maximum rate of assistance.

Providing additional assistance to low-income renters is likely to increase their demand for housing. Where supply is restricted or slow to respond, this may place some upward pressure on rents. However, several factors will limit the potential for more adequate Rent Assistance to increase rents. The co-payment associated with Rent Assistance will limit this potential, as not all recipients will choose to demand more housing. The increased assistance for recipients who currently pay more than the existing caps would accrue to them, and the scope for their landlords to further raise rent is limited by its level being tied to the term of the tenancy agreement. Though they are a significant proportion of the rental market, Rent Assistance recipients will represent a minority of that market, which, along with their modest means, limits the potential impact on overall rent setting.

Importantly, the potential for increases in rents is not a reason to deny an increase in Rent Assistance caps. Such increases in rents would result from greater spending power and choices for low-income earners. This provides a market signal to suppliers of rental housing to shift toward provision of the type of housing demanded by Rent Assistance recipients. Suppressing price signals is not conducive to promoting increasing supply over the long term. There are, however, constraints to supply in the housing market overall, which reflect a range of factors including tax and, especially, non-tax policies, which are discussed at Section E4 Housing affordability.

Rent Assistance should continue to include single, couple and sharer rates, with the rent caps set to reflect economies of scale in housing. Budget Standards found the relative housing needs for singles and couples to be the same in terms of bedroom numbers, suggesting that couples can achieve large economies of scale through the sharing of a room. However, assessments of housing need for a couple should recognise that some additional floor space, such as for storage or living areas, may be required with a second person. As such, it would be appropriate to set the rent cap for couples at a slightly higher level than for singles. A sharer rate should continue to be used. It should ensure that sharers have an incentive to occupy housing of a similar quality to the adequate standard used for singles and couples. However, unlike the desire to live with a partner, the decision to share is predominantly motivated by achieving cost savings. If the sharer cap were set too low and discouraged sharing, this would be counterproductive as sharing is beneficial both recipients and taxpayers, through lower costs of subsidies. To ensure Rent Assistance is applied consistently across all income support types, the sharer rate should be extended to recipients of Disability Support Pension and Carer Payment.

To ensure assistance continues to target an adequate level over time, the maximum caps threshold should be indexed to move in line with national rents (Recommendation 102). While the rental component of the CPI is a readily available and transparent measure, use of an index of rents paid by Rent Assistance recipients would provide a more accurate assessment of their rental costs.

The minimum rent thresholds are currently set as a flat amount, which means recipients of allowances pay a greater share of their base payment in rent before Rent Assistance starts than pensioners. Setting assistance as a percentage of a recipient's base rate of payment, such as 20 per cent of the base payment, would result in a more consistent recognition of rent costs for income support recipients and be consistent with targeting assistance toward those facing high housing costs.

Eligibility for Rent Assistance

The purpose of Rent Assistance should be to ensure that adults with limited means can afford to live in an adequate standard of rental housing. As such, Rent Assistance eligibility should be based on a person's means and rental costs. This is best done by paying Rent Assistance as part of the income support system. Eligibility for Rent Assistance will therefore be set by the interaction of the maximum rates of payment, rates of Rent Assistance, and the taper rate. An increase in the maximum rate of Rent Assistance may mean that some Newstart Allowance recipients with high rents receive a portion of their payment even when engaging in full-time work at the minimum wage.[32] Though the Review's position is that participation payments should generally be withdrawn before this point, providing Rent Assistance in these circumstances is consistent with minimising disincentives for taking on work.

Rent Assistance should be paid to tenants in public housing to provide more equitable and effective assistance. The interaction of eligibility for Rent Assistance and overall funding for social housing is discussed below.

In line with reforms that ensure family payments cover the housing costs of children, Rent Assistance caps should no longer be increased based on the number of children in a household. This will ensure clear functions for both payments, with Rent Assistance contributing to the income support for adults and family assistance providing for the direct costs of children (see Section F3 Family and youth assistance).

Equally, eligibility for Rent Assistance should no longer be attached to receipt of more than the base rate of FTB Part A. The means testing of the income support system determines when people have sufficient incomes (or assets) to support themselves. The proposed increase in the maximum amount of Rent Assistance will have the effect of increasing this income level at which people who have high rent costs can access Rent Assistance. This increase will mean more families will be eligible for Rent Assistance on the basis of their income. Removing eligibility for parents whose income exceeds income support cut-offs is consistent with the greater targeting of Rent Assistance to need. However, grandfathering arrangements should accompany the introduction of such a change to prevent income shocks for people currently eligible for Rent Assistance only through FTB Part A. In addition, consideration will need to be given for single parents whose income may be affected due to reforms to FTB Part B (see Section F3 Family and youth assistance).

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32 This currently occurs for recipients of higher rate Newstart (such as long-term recipients aged over 60) who receives maximum rate Rent Assistance. For example, the remaining income support, after income testing, for a person in this position earning the minimum wage ($28,276) would be around $9 per fortnight.

Not extending an equivalent of Rent Assistance to mortgagors

While homeowners with a mortgage may face cash flow pressures similar to those faced by renters, the Review does not recommend extending the general scheme of rental assistance.

Mortgagors have access to mechanisms to smooth cash-flow difficulties — including repayment deferral or restructuring options through their banks, or through accessing equity in their homes — that are not available to renters. Further, assistance for mortgagors based on the cost of their mortgages would in effect be an interest rate subsidy. This poses a significant moral hazard problem of encouraging greater borrowing, which does not apply to Rent Assistance for renters. Though not well-targeted to housing stress, the non-taxation of the equity in their home, and its exclusion from income support means tests, benefit mortgagors.

While mortgage stress is a real issue, it would be very difficult to design a fair and simple assistance arrangement that addresses these issues, and the Review does not recommend it at this time.

A high-need housing payment to assist recipients with special needs

Housing assistance would be incomplete if it did not provide a mechanism for assisting people likely to have high housing costs or unlikely to be well served in the private market. Recipients of such assistance should include people who, for behavioural or cognitive reasons, find it difficult to sustain a private tenancy, or are likely to face discrimination in accessing the private rental market. Funding should ensure that social housing providers have an incentive to provide such recipients with an adequate standard of housing.

High-need tenants should be assisted with a new form of funding. A high-need housing payment would provide assistance for the higher costs of housing people with special needs. The level of assistance would be based on the high-need category to which a recipient belongs, such as having a disability or being homeless. The payment would reflect the potential costs associated with housing high-need clients, such as modifications to housing or the greater need for maintenance and repair.

The high-need housing payment would depend on the assessed needs of an individual recipient and would be portable across different eligible social housing providers. This would ensure competition among providers, which should encourage the delivery of housing that best meets the needs of their tenants. The assistance would also be scalable, allowing providers who meet the needs of their clients to expand their provision. This would encourage development of a more dynamic social housing sector.

The high-needs housing payment should be tied to housing, as it is an entitlement to enable recipients to access social housing that reflects their needs. As such, while directed by individual recipients, it should be paid to the provider of their choice. However, the high-needs housing payment reflects only housing costs, so it is not intended to replace funding that providers can also receive for delivering other support services to their tenants.

Though the majority of high-need renters will receive Rent Assistance, eligibility for the payment would best be governed by assessment of a person's high-need characteristics, rather than their income. Ongoing eligibility assessed by periodic review would mean that recipients would not have a disincentive to take on work, which may occur if eligibility were also linked to income.

The high-need housing payment should be provided by the Australian government. As noted in Section F1 Income support, preventing capability deprivation is a public good, best provided by a national level of government. The high-need housing payment would supplement the redistributive nature of Australian government income support. Further, having the Australian government pay all providers through the same mechanism is consistent with ensuring competition among community providers and State housing authorities.

As the majority of high-need recipients are currently likely to live in social housing, the reform should focus on that sector when introduced. Once established, however, the scope for extending the high-need housing payment to private providers should be explored.

A national assistance program

The Review does not recommend that Rent Assistance or the high-need housing payment vary geographically. Higher rents based on locations are generally associated with access to better services or lower costs of travel of those areas. It can also be difficult to set meaningful rent boundaries as there can often be as much variation in rents within a major city as there is between the average rent in that city and the average rent in a regional area. Setting Rent Assistance with reference to all capital cities should enable recipients to live in those areas or move to them to find employment.

Further, the responsibility for providing assistance to people with limited means and high needs is a Commonwealth responsibility, with assistance responsive to movements in national rents. Where regional rents vary significantly from national averages this is likely to be due to forces beyond the control of a national government. State and local governments have responsibility for aspects of policy that overlap with housing — such as infrastructure provision and planning regulation — and are likely to affect the rental costs of particular regions. High rents in a specific region can only be sustained where supply restrictions constrain the addition of supply. Policies that address the source of regional variations in rents would be more effective in the long term.

Rent setting and funding of social housing

Income-related rents generally should be phased out in social housing, with providers charging their tenants rents linked to the market rate (see Recommendation 106). Carefully targeted transition arrangements will be necessary to ensure households are not forced into housing-related stress or dislocation from social networks.

As recipients of social housing would receive Rent Assistance, the amount they pay to their landlord should reflect the market rent of a dwelling. A dwelling's rent reflects the range of benefits it provides, such as the building's size and quality and the location's proximity to employment, services or nearby amenities. Charging market rents would allow recipients to make trade-offs between these aspects of housing and other elements of their consumption. It would also provide signals to social housing providers about the housing that is valued by their clients. In combination, Rent Assistance based on market rents should encourage the provision of social housing that is of value to tenants.

There will, however, be some circumstances where the use of market rents will be neither possible nor appropriate. For example, in some remote Indigenous communities there is no effective market for rental housing. It may not be possible for market rents to be used in these areas. In a limited number of areas — such as in mining towns facing supply constraints in the provision of rental housing— market rents may reach a level where even the enhanced Rent Assistance program envisaged by the Review will not provide assistance that makes social housing affordable by low income households. A short-term departure from setting market-based rents may be the most effective way of addressing such cost pressures on tenants. In such cases, there may be a need for social housing to limit rents with reference to tenant incomes.

The Review Panel considers that combining access to Rent Assistance with market rents would improve the equity of housing assistance. However, this approach would be a significant departure from the existing approach of charging income-based rents. Transitional arrangements would need to be considered as part of any changes to rental subsidy arrangements (see Box F5-1).

Box F5-1: Transition mechanisms in social housing

The proposed approach for rent-setting and funding in social housing is a substantial shift from current practices.

Even with access to increased Rent Assistance, tenants who occupy dwellings of high market value would be exposed to a reduction in income if these reforms were introduced suddenly. The move to market rents should be phased in gradually. A potential approach could be for tenants to receive Rent Assistance based on the market value of their social housing dwelling, but have their providers charge them a rent at a discount to the market value to ensure that they are not initially worse off. This discount could be reduced at an annual proportion, enabling a very gradual transition toward market rents over a number of years. A gradual approach would enable tenants time to find alternative housing if they find it better value than the dwelling they currently occupy. In some cases, grandfathering of existing tenants may be necessary.

The National Affordable Housing Agreement would require renegotiation to facilitate reform, which should take into account transitional arrangements for tenants.

The high-need housing payment would involve very substantial reform to the current National Affordable Housing Agreement. In combination, the Rent Assistance and high-need housing payment would direct assistance to recipients on the basis of their means and needs and would also be a reliable and transparent form of funding for housing providers. Through Rent Assistance and the high-need housing payment, the Australian government would become the main funding provider for housing assistance. Housing for low-income and disadvantaged households would be delivered by State housing authorities and community organisations, as well as private providers. This approach would effectively create a user-directed funding model for the provision of public and community housing. Allowing assistance to be directed by recipients gives them greater choice and places pressure on providers to deliver housing that recipients want to live in. Housing support that is neutral between public and private rental tenures would encourage more responsive provision of social housing. The 2007 National Housing Survey indicates that 63 per cent of public housing tenants are satisfied with their dwelling, while 78 per cent of community housing recipients are satisfied with theirs (AIHW 2007a and AIHW 2007b).

However, the Rent Assistance reforms and the high-need housing payment will not replace the need for governments to provide capital funding for social housing. This is particularly the case for Indigenous housing in remote areas, where the Australian government has already assumed responsibility for the provision of capital funding. As the social housing sector will need to continue to provide a significant part of the stock of housing in Australia, capital funding can also enable a more immediate increase in supply when the housing market is constrained.

Tenure security and housing assistance

Tenure security is an important aspect of social housing for some recipients. Because many renters are unable to purchase long-term secure leases at a reasonable cost in the private market in Australia, social housing has tended to become the default provider of long-term secure rental properties. However, under the current arrangements, security of tenure comes at a large cost to providers, as the rent they receive from tenants generally moves in line with income support (indexed to CPI or wages), which is unrelated to the market rent of the dwelling. Further, while they receive tenure security, it is only for one dwelling, which can lock recipients in to particular housing.

The proposed funding model for social housing should enable security of tenure for recipients. By providing assistance in line with the likely costs of tenants, the high-need housing payment provides an incentive for social housing providers to house tenants with special needs. As Rent Assistance is proposed to move in line with rents, this reduces risks to clients and enables social housing providers to charge market rents. This should facilitate the use of long-term leases that are valuable for both recipient and provider.

In addition, the Review's proposed reforms to land tax (see Section C2 Land tax and conveyance stamp duty) and income taxation (see Section A1 Personal income tax) should facilitate improved tenure security in the private market over time. These reforms would reduce barriers for larger investors, such as superannuation funds, to invest in the housing market. Institutional investors are more likely to invest over long-term horizons.

F6. Transfers tied to goods and services

Key points

While transfers are usually thought of as cash payments, governments also provide transfers such as concessions and payments that are 'tied' to the purchase, or supply, of a particular good or service. These transfers are often provided to encourage the consumption of goods and services that help people improve their capabilities.

All three levels of government provide concessions. The approach across the federation is not always coherent and the interaction of concessions with other types of transfers provided by different levels of government makes it difficult to determine whether concessions provide value for money. The Productivity Commission should review concessions across all levels of government and provide recommendations for consideration by the Council of Australian Governments (COAG).

Governments also support people to improve their capabilities through the direct provision of public services such as health and education. The capacity of the tax and transfer system to deliver improvements to people's wellbeing is highly dependent on how governments fund and deliver these services. The Productivity Commission should also examine the principles of public service delivery and the mechanisms that are available to governments to deliver public services.

F6-1 The relative merits of 'tied' and 'untied' transfers

Transfers help individuals and families improve their wellbeing by helping them purchase goods and services. Transfers are normally thought of as cash payments made directly to people. They include pensions, allowances and family payments. While the recipients of these payments may need to have certain characteristics (such as being unemployed or having a disability) or undertake certain activities (such as looking for a job) to be eligible, they can generally use these payments to purchase goods and services according to their own preferences. That is, the payments are not 'tied' to any specified use.

Another group of transfers are specifically linked, or tied, to the consumption of certain goods and services. The adequacy, equity and efficiency effects of cash transfers cannot be fully assessed without considering tied transfers. For this reason, the Review has considered some major tied cash transfers such as child care assistance (Section F4) and rental housing assistance (Section F5). This section discusses the issues related to tied transfers, since they arise across a wide range of other government programs and assistance.

Tied transfers can be provided by way of:

- discounted prices at the point of purchase available in specified circumstances and for specified goods and services, such as lower public transport prices for concession card holders; and

- entitlements that can be used at the point of purchase or cash rebates available some time after the purchase of specified goods and services. For example, the Child Care Benefit provides eligible families with funding to reduce their child care fees.

Recently, the tying of some income support has also been trialled in parts of Australia. A proportion of cash transfers are directed to priority needs of individuals, families and children. The central idea of these transfers is that government support should be conditional upon personal and socially responsible behaviour.[33]

Governments provide a mix of untied cash transfers and tied transfers — either to encourage some types of consumption or to limit or prevent other types of consumption. The purpose, design and relative merits of these different types of transfers are discussed below.

Cash transfers can provide freedom and choice

In general, united cash transfers allow people to make the best use of available resources to meet their particular needs. For example, people in rural areas may pay less on rent but more on transport than people living in the city. Providing a cash transfer means they can allocate their resources as they wish, rather than having to spend some minimum amount on rent or transport.

It is also easier to integrate cash transfers with other aspects of the tax and transfer system. Cash transfers can be targeted to people with different incomes by withdrawing the value of the transfer payment as their private income increases. Some transfers tied to goods and services can be withdrawn in a similar way; for example, the value of an entitlement could be based on income. If there are many entitlements for different goods and services, however, simultaneous withdrawal as income increases can create high effective marginal tax rates. In contrast, a cash transfer that helps people access a range of goods and services can be withdrawn as a single payment with a single withdrawal rate.

Transfers provided in the form of discounted prices can be particularly difficult to integrate with other aspects of the tax and transfer system. Because of the complexity of providing individualised discounts to people based on their income and other characteristics, these transfers are typically provided as a set discount to a wide group of people. For example, access to a concession card may be given to all recipients of income support payments. Although this is simpler than providing differentiated discounts, it can result in people with large differences in financial capacity receiving the same amount of assistance. It can also result in 'sudden death' drops in the value of transfers when people lose eligibility for the discount. In some areas, particularly the health system, this risk is removed by providing universal transfers without means testing.

Tied transfers can encourage consumption of merit goods

While cash transfers have advantages, there are circumstances where they will not be the most effective way of delivering assistance. Sometimes people may spend cash in a way that is inconsistent with the community's reasons for providing the assistance. For example,

33 Examples of this type of approach include aspects of the Northern Territory Emergency Response and Cape York Welfare Reform Trials.

many people might object to people spending cash transfers on alcohol rather than their child's education. In such cases, education is a merit good — that is, a good that people should consume regardless of their preferences for other things. At other times, governments may want to limit access to certain goods that may be detrimental to society or a person's development. For example, alcohol may be considered a 'demerit good' for someone who is attempting to escape addiction and poverty. Linking transfers to certain goods and services can encourage the consumption of merit goods and limit the consumption of demerit goods (provided that the transfer cannot be easily exchanged for cash). This can be particularly beneficial for people who have trouble managing their income.

Tying a transfer to a good or service can also ensure that the transfer goes to those in most need. Since cash is of benefit to anyone, people will have incentives to present themselves as being in need (Akerlof 1978). However, by tying a transfer to a particular good or service, the government can ration the good or service to those who actually need it. For example, few people would be interested in having access to disability support services unless they have a disability, but many more would be interested in a (similarly valued) cash transfer. Tied transfers are more likely to be of direct value only to the targeted recipients.

Transfers tied to goods and services can also be tailored to those with high need. A person may have high health or support needs due to illness or disability, or their costs may vary depending on where they live. Determining a rate of payment based on what an average person requires can result in some people receiving less support than they need, and others receiving more. In cases where levels of need vary considerably across the population, a transfer provided as a concession may entail less risk of under-compensating those with high needs and over-compensating those with low needs. It can also allow people to manage their risks better by giving them access to goods and services at times when they need them most. For example, it can be difficult for someone to predict when their health expenses will be high. Providing low-income earners with a guarantee of a discount on their health expenses rather than an ongoing cash payment can be a better way of managing their risk (although for some insurance can also serve this function).

The design of a transfer should take into account whether it will affect how much of a good or service people will consume and how much (and what quality) providers will supply. A transfer tied to a particular good or service can mean that the consumer does not respond to price signals. For example, if the price of water increases, people who receive a discount on their water bill may not reduce their consumption by as much as they would have done if they had they been paying the full price. Capping the value of the transfer can help reduce this effect.

On the supply side, transfers can be delivered by governments requiring providers to charge lower prices or to supply fixed quantities. If providers do not receive the full price from a high proportion of consumers (and they are not compensated for having to provide their good or service at a lower price), they have less incentive to increase supply, or improve the quality of their product. For example, if a large proportion of commuters on a rail service are travelling for free, the rail company has less incentive to invest in the service. While governments have a role in ensuring that quality standards are adequate and can be trusted by all users, regulatory obligations on providers should generally not be used to provide transfers to particular groups. That is, community service obligations should be funded by governments, not by cross-subsidies between consumers. This does not mean, of course, that businesses should not engage voluntarily in social responsibility programs or pricing policies that assist particular groups.

Providing tied funding to people (potentially tailored to their characteristics) and allowing them to choose between providers can often be the best way for governments to encourage the consumption of certain goods and services while also supporting efficient service provision.

Principles

Cash transfers are generally a better way to provide general living assistance because they can be provided simply, allow recipients more choice and are more easily integrated with the rest of the tax and transfer system.

Transfers attached to specific goods and services can be effective in encouraging the consumption of merit goods (especially for people with income-management problems) and delivering assistance to people with diverse needs. These transfers should be provided by assisting people so they have the resources to access goods and services — not by regulating providers or through imposing cross subsidies. These transfers can be provided in a manner that supports efficient service provision, consumer choice and equitable outcomes.

Providing transfers in the federation

Many, if not most, Australians are concerned about other Australians living in poverty. Poverty alleviation can therefore be viewed as a national goal. If the best approach to poverty alleviation is providing a mix of untied and tied transfers, then the national government is best placed to undertake this role as competition between sub-national governments can lead to a sub-optimal level of transfers. For example, if one jurisdiction had higher rates of payments, it may encourage the poor to relocate to that jurisdiction. To prevent this response, sub-national governments may reduce the transfers they provide (Wellisch 2000).

This suggests that the Australian government should fund transfers that are aimed at poverty alleviation to ensure that all Australians have access to a basic standard of living. This includes cash transfers and some transfers tied to goods and services (which may be explicitly linked with the receipt of a cash transfer). State and local governments may choose to provide additional funding to reflect their different priorities, the different needs of their population or the different ways that goods and services are provided in their jurisdiction.

It would be necessary for governments to reach agreement on which transfers tied to goods and services are necessary for poverty alleviation.

Principle

Poverty alleviation is a national goal that should be financed by the national government. The Australian government should be responsible for funding those transfers that ensure that all Australians have access to a basic standard of living. State and local governments may choose to provide additional funding, reflecting area-specific concerns.

F6-2 Concessions — their scope and role in the transfer system

Concessions are generally provided as reductions in prices or bills and are used to provide low income groups with more affordable access to commonly used goods and services such as water, energy and transport. Concessions are also provided for government taxes and user charges. For example, certain groups of taxpayers receive concessions on local government rates (see Section G3 Local government).

Concessions play a large role in the transfer system and all levels of government in Australia deliver them. It is difficult, however, to determine the total expenditure on concessions because the value of the concession used in some transactions may not be recorded.

The Australian government's concession card system acts as a gateway to a number of concessions throughout Australia. Concession cards are broadly available to people receiving a pension or allowance, as well as people and families with low incomes and seniors. Over 5.2 million Australians (around one quarter of Australia's total population) hold one of many concession cards, principally Pensioner Concession Cards and Health Care Cards.[34] Around 85 per cent of people over Age Pension age hold an Australian government concession card, either a Pensioner Concession Card, or its equivalent in Veterans' Affairs, or a Commonwealth Seniors Health Card (FaHCSIA 2009).

The Australian government plays a central role in the provision of health and related concessions, including through the Pharmaceutical Benefits Scheme, and Medicare co-payments and safety nets. There are substantial price subsidies for Pharmaceutical Benefits Scheme medicines as well as the Pharmaceutical Benefits Scheme safety net, which has a lower threshold for concession card holders. For medical costs, the Medicare safety nets limit out-of-pocket costs for medical services provided out-of-hospital — again there are lower thresholds for concession card holders.

State and local governments fund and administer a number of concessions and generally make decisions on the type and level of concessions they offer. State and local government concessions include discounts for council and other property based rates; utilities, including energy, water and sewerage; public transport; and motor vehicle registration. The forms of concessions include fixed amount discounts; percentage discounts that may also be capped at a maximum dollar amount; and rebates on or exemptions from charges. While similar concessions are available in each of the States, there is variation in the value of concessions available in each State.[35]

The Australian government contributes some funding towards selected State-based concessions through a national partnership payment. The partnership specifies a number of concessions the States must provide to all Pensioner Concession Card holders, and requires the States to provide public transport concessions for all Seniors Card holders, irrespective of their State of residence.

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34 There are also approximately 2 million dependants listed on concession cards who have access to some concessions.

35 Tables 2.27 to 2.34 of the Australia's Future Tax System Architecture Paper provides information on the range of concessions available in each State.

Concerns with the current approach to concessions

Current concession arrangements raise concerns in terms of incentives to work, equity and complexity.

Work disincentives

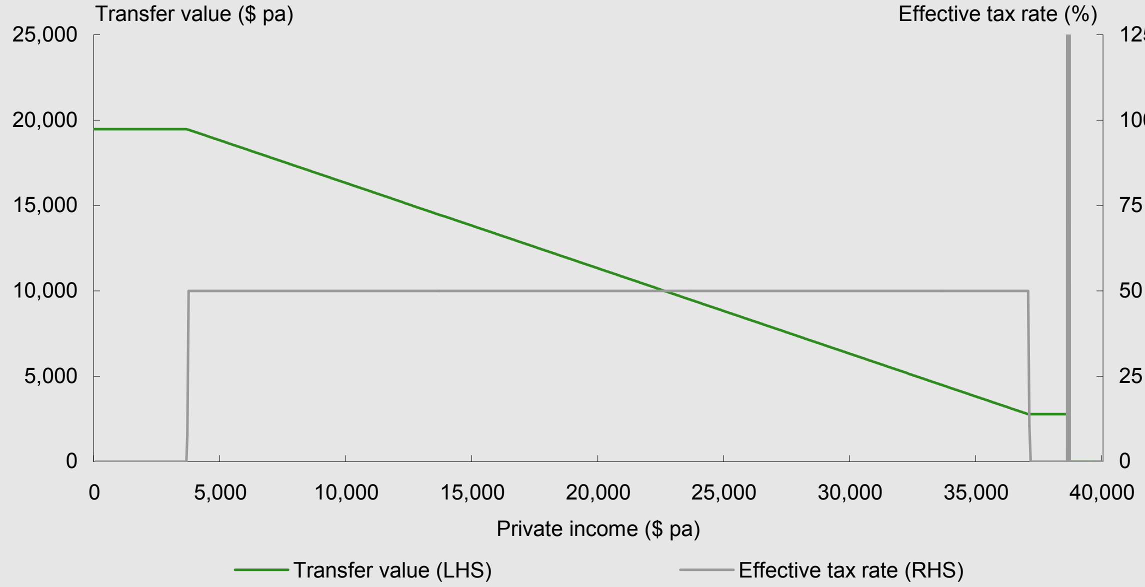
Eligibility for many concessions depends on whether a person holds a concession card. Concessions and concession cards are not withdrawn gradually like income support payments — all individuals who have the same concession card get the same concessions regardless of differences in their personal income. That is, a person receiving the maximum amount of income support will generally have the same access to concessions as a person who qualifies for only one dollar of payment. This creates a high effective tax rate on the last dollar of payment and provides strong incentives for people to gain or retain eligibility for payments (see Box F6-1).[36] This is particularly relevant for people who are heavy users of their concession cards or who value their concession card highly because of the insurance it provides. Disability Support Pension recipients, for instance, may be reluctant to jeopardise the concessions they receive for health and disability goods and services by testing their ability to work.

36 Once people no longer qualify for relevant payments, they must generally stop using their concession cards. However, in some circumstances, people can retain their concession cards for a short period of time after returning to work. These provisions are designed to assist people to make the transition from income support to work.

Box F6-1: Concession cards and effective marginal tax rates

Chart F6-1 illustrates how linking eligibility for concession cards to the receipt of any amount of transfer payment can contribute to high effective marginal tax rates. The chart shows the value of transfers that a single pensioner receives from their pension (including pension supplement) as well as their pensioner concession card, assuming that the concession card provides $2,000 worth of value each year. The chart shows the total value of the transfers (pension, supplement and concessions) on the left-hand axis and the contribution to effective tax rates on the right-hand axis.

Chart F6-1: Concessions and effective tax rates



At income levels above the free area ($3,692 per annum), the pension payment for single pensioners is withdrawn at a rate of 50 per cent. The minimum rate of the pension supplement is kept until income reaches a level that would otherwise reduce total payments to zero. At this income, eligibility for the pensioner concession card is also lost. For the last dollar of payment, both the minimum rate of pension supplement and the value of the concession card are lost. While the chart shows the effective tax rate rising above 100 per cent, if the concession card provides $2,000 worth of value (and an alternative concession card is not available), the effective tax rate on the last dollar will be over 200,000 per cent.

Equity

If a concession card is widely available, its value as an indicator of financial need can be diminished. In particular, as the number of card holders rises, the need for a concession card may lose acceptance among service providers and the general population. For example, the Pension Review's consultation process found that some general practitioners have become less willing to bulk bill concession card holders, as not only do they represent a very high proportion of their patients but some card holders have significant private income (FaHCSIA 2009).

In some cases concessions may operate regressively. For example, concessions for local government rates can be regressive with respect to wealth holdings because the dollar value of the concession is often greater for people with higher-value properties. Additionally, renters may effectively pay rates in the form of higher rental payments and get no assistance. Although the value of concessions for local government rates is generally capped, these concessions can still be worth significant amounts of money over time.

Further inequities can arise if higher-income concession card holders live in areas where there is better access to services (such as transport), so they benefit more from their concession card.

Complexity

All three levels of government are involved in the delivery of concessions and there are a large number of concessions available. It can therefore be difficult for people to determine what concessions are available, the level of government responsible for the delivery of the concession and how much governments are spending on concessions. For governments, it can be difficult to identify the outcomes from providing concessions and hence whether they give value for money. This is further complicated when there are other types of transfers with similar policy objectives (see Box F6-2).

Box F6-2: Different forms of assistance provided by different governments — but with a similar purpose

The Australian government and State governments provide different forms of assistance for accessing transport services. The Australian government provides assistance through Mobility Allowance — a payment available to people with a disability aged 16 and over who are unable to use public transport without substantial assistance and are required to undertake work, training or job seeking activities. A number of State governments also provide taxi subsidies to people who cannot use public transport. For example, in NSW, the Taxi Transport Subsidy Scheme allows eligible applicants with a permanent disability to travel by taxi at half fare up to a maximum of $30 per trip. A similar scheme operates in Victoria (the Multi-purpose taxi program) where the maximum per trip subsidy is $60. For both programs, the subsidy may be used for taxi travel in other States.

Differences in concessions for local government rates may also be seen as a source of complexity. The current arrangements allow the States to set their own levels of concessions: some provide concessions as a flat amount, while others provide a percentage reduction. Further, some States increase the value of the concession on an annual basis, while in other States the value of the concession has not changed for many years.

Findings

The use of concession cards as a gateway to a number of concessions provided by the Australian, State and local governments creates strong incentives for people to gain eligibility for concession cards.

While eligibility for concession cards is targeted, some concessions are regressive because they provide higher value transfers to people with higher means.

The interaction of concessions with other types of transfers provided by different levels of government makes it difficult to determine whether concessions provide value for money.

Reform directions

Recommendation 107:

The Productivity Commission, constituted to include an appropriately qualified and experienced member, should review concessions across all levels of government and provide recommendations for consideration by COAG.

While some concessions complement other forms of assistance in the tax and transfer system, a number of current concessions have questionable objectives and equity outcomes. Further, continuing to provide concessions under the existing arrangements may not be sustainable as the population ages, particularly considering the number of people who have access to concession cards at the moment.

There is a strong case for rationalising a number of concessions as well as converting some into cash transfers or tax reductions. Concessions that provide relatively more value to people with greater means should be priorities for reform. There is also a case for greater coordination across the federation to ensure equity and consistency in the way concessions are funded and delivered.

Because of the number of concessions in the current system and because reform to concessions would affect funding across all levels of government, the Productivity Commission should review concessions across all levels of government and provide recommendations for consideration by COAG. To assist the Productivity Commission, an Associate Commissioner with appropriate knowledge and expertise should be appointed to the review. Reforms could then be implemented through an intergovernmental agreement (for more detail, see Section G2 State tax reform).

In the long term, technology may also allow for alternative ways to deliver assistance currently provided as concessions. This could come from a combination of a single customer account that could be viewed and managed online, and the use of smart card technology that would allow concessions to be granted at the point of sale. Point-of-sale information could be brought together to help governments determine the particular needs of different people, based on their characteristics (for example, disability, age or location).

Such a system offers the potential to facilitate better income management, as the assistance provided by governments would be more transparent. It may also allow governments to tailor assistance to those with diverse needs, rather than issuing a concession card that gives all holders access to the same level of assistance.

F6-3 Differing mechanisms to deliver government-supported goods and services

The use of transfers tied to goods and services to support the consumption of merit goods raises the broader question of how governments provide support for merit goods in general. Governments support a range of goods and services in Australia, such as public hospitals and public schools. For these services, governments generally provide funding to a limited number of suppliers (usually government-operated) in a block grant type arrangement.

While this funding is not provided directly to people in the same way as other transfers are provided, it also helps people access goods and services to improve their wellbeing.

Current arrangements appear to have largely historical origins rather than to result from comprehensive assessments of the best ways to fund or deliver services. For example, there is a strong presence of direct public sector provision in schools and hospitals, but not in child care or aged care where large increases in demand have emerged relatively more recently. Changes are slowly evolving — in recent years there has been a shift to greater private provision in schools and a decline in the role of public housing. There has also been a growing reliance on contracting services to non-government organisations. But in these and other cases it is not clear whether developments are following changes in demand or assessed needs, or whether other forces are shaping funding and supply policies.

One result of current arrangements is that there are substantial differences in the ways in which the same or similar services are funded and delivered through public and private mechanisms. It is not clear that these differences ensure that public objectives such as equity are being met, nor that the full potential benefits of user-directed choice are being obtained. These differences are further complicated by the fact that the different levels of government take different levels of responsibility for providing funding. In general, the Australian government often provides funds for private sector provided services, usually requiring or allowing private co-payments, and often providing a degree of user choice. The States, on the other hand, assisted by grant funding, usually provide public services free of charge on a universal access basis (hence often also generating waiting lists). The combination of these arrangements may or may not produce equitable outcomes, and may or may not produce efficient service delivery. In many areas, there is considerable concern about various aspects of these outcomes. The different roles of the different levels of government also raise issues about transparency and accountability for outcomes.

The assistance governments deliver through direct service provision often interacts with parts of the tax and transfer system that aim to deliver similar outcomes. For example, the need for the medical expenses offset or the private health insurance rebate is influenced by how governments fund (and how people are able to access) hospitals and health services. Another example arises in the housing sector, where access to affordable housing is supported by three broad mechanisms:

- housing funded and provided directly by governments at rental rates below market rates, such as public housing;
- housing provided by non-government or private providers who are funded under government contracts, such as grants to community housing providers; and
- housing provided by non-government providers where renters are given government funding, such as rent assistance, directly.

The mechanism that governments choose to deliver assistance is to a large degree dependent on the objectives governments want to achieve. For example, if the government's goal is that all household rubbish is collected, it may be more effective to provide the service directly or contract a single provider, rather than providing individualised assistance to households and compelling them to contract a service provider.

However, as cost pressures grow in the future, governments need to make sure the mechanisms they use are as efficient and equitable as possible. Governments also need to ensure that the mechanisms they use do not lead to unintended outcomes. For example, while governments may choose to subsidise public transport with the aim of reducing traffic congestion and carbon emissions, such subsidies may provide greater benefit to those with higher incomes. IPART (2004) found that over 60 per cent of full-fare paying trips on Sydney ferries (which are subsidised and priced below actual cost) are taken by residents with household incomes over $100,000 a year. Further, in 2001 and 2002, CityRail's subsidy per passenger kilometre was significantly lower than subsidies provided by Sydney Ferries, despite the fact that users of CityRail services come from lower-income households than users of Sydney Ferries.

Governments and the public should be aware of such outcomes, but the manner in which these subsidies are provided often makes it difficult to identify and quantify them.

Reform directions

Recommendation 108:

The Productivity Commission should examine the principles of public service delivery and the mechanisms that are available to governments to deliver public services and their implications for financial arrangements in the federation. The findings of this study should be considered by COAG.

While the size and range of government-supported services is outside the terms of reference of the Review, it is clear that the capacity of the tax and transfer system to deliver improvements to people's wellbeing is highly dependent on how governments fund and deliver public services such as health and education. Governments should explore the potential for different mechanisms to deliver government-supported services in more effective ways. This is particularly so because governments in Australia have moved to a much more complex environment for service delivery. In this environment, the same or similar services are provided via a range of mechanisms.

While the overall provision of government-supported services in Australia (compared to 22 other OECD countries) has been found to be relatively efficient (Afonso et al. 2003), other studies that have focused on specific services in Australia have revealed many areas where better outcomes could be achieved. Population ageing is likely to put greater pressure on the need to achieve value for money in public service delivery.

A useful starting point would be for the Productivity Commission to examine the principles of public service delivery; that is, what governments should be seeking to achieve in funding public services. This study should also examine the mechanisms that are available to governments to deliver public services and how appropriate they are for different types of public services.

The outcome of any review of these issues would potentially have significant implications for the tax and transfer system, including the best assignment of taxing powers between the levels of government. It is possible that they would lead to a stronger funding (as opposed to service delivery) role for the Australian government. It would be unfortunate if tax and transfer decisions were made in isolation of the consideration of these related issues by all governments.

As all three levels of government in Australia are closely involved in public service delivery, the findings of the Productivity Commission study should therefore be considered by COAG.

F7. Funding aged care

Key points

The priorities for governments are to determine what an adequate level of aged care should be to ensure a decent quality of life for older people, the necessary pricing and regulatory arrangements to deliver it, and the most sustainable funding arrangement to ensure access by those who cannot afford it.

Recent reviews of the aged care system have called for increased choice for consumers and reduced regulation on aged care providers. Limiting the number of subsidised aged care places and associated price controls impedes competition between providers, undermining both their capacity to respond to the needs of older people and their incentive and ability to plan for future growth in an industry driven by an increasingly ageing population.

Responsive and sustainable aged care services are particularly important because many people requiring the services are vulnerable, and the fiscal costs to the economy are increasing.

The Australian Government has announced a Productivity Commission inquiry into aged care to be conducted in 2010. This inquiry will examine all aspects of aged care and make recommendations on options for redesigning Australia's aged care system to ensure it can meet the challenges facing it in coming decades.

Australia's aged care sector is complex in both its regulatory system and its funding arrangements. It is beyond the scope of this Review to examine aged care in detail and, given the Productivity Commission inquiry, it would clearly be premature. However, a range of issues related to the tax and transfer system should be considered alongside the Productivity Commission's recommendations, including changes to the current funding arrangements to improve equity across aged care programs and support for structural reforms aimed at improving consumer choice in aged care services.

F7-1 Funding and charging for access, equity and efficiency

Access to adequate aged care services is a key component of the wellbeing of older Australians. A key reason for government funding of aged care is to ensure that older people of limited means can access these services.[37]

Aged care spending is projected to grow rapidly — from 0.8 per cent of GDP in 2008–09 to 1.9 per cent of GDP in 2048–49 — and was the fastest-growing component of government expenditure identified in the Intergenerational Report 2007 (Australian Government 2007a). This growth is driven largely by demographic changes, with the number of people aged 85

37 The government also has a role in other aspects of the aged care sector, including addressing failures likely to occur in market provision, such as exploitation arising from lack of information by care users.

and over projected to increase from 378,000 at 30 June 2009 to 1.8 million by 2049 — a more than four-fold increase. The life expectancies of older Australians are also projected to rise, and care needs tend to increase with age. In 2003, 32 per cent of those aged 65 to 74 required assistance, while this number increased to 86 per cent of those aged 85 and above (Productivity Commission 2008b).

Demand for aged care services is also expected to become more varied in the future. Aged care recipients are likely to have a wider range of complex or high-level care needs, as advances in treatment enable people with chronic diseases to live longer. Increasing affluence and ethnic diversity are also expected to lead to a wider range of client preferences. In particular, demand for care provided at home will increase, due to strong preferences for independent living among the baby boomer generation. Common to all these factors is recipients' desire to exercise greater choice about the care they receive, greater capacity to 'age in place' and better continuity of care.

Features of the current aged care sector are significant regulation of supply and pricing, together with limited choice for recipients. These features restrict the delivery of care consistent with recipients' preferences. The Productivity Commission is expected to examine the aged care sector in detail in its inquiry during 2010. Accordingly, this Review focuses on the funding and charging arrangements for aged care. Charges for aged care affect the incentive for people to save for retirement and the adequacy of their income during retirement. Public financing of the sector represents a growing pressure on the taxation system. While funding from the public purse is necessary for some older Australians, those with sufficient means should be responsible for contributing to the costs of their own care.

What is aged care?

Aged care services are actually one or more of a number of different services that can be used by older Australians, including personal care, health care, assistance with everyday living and, in residential aged care, accommodation.[38]

Personal care

Personal care services include assistance in eating and drinking, personal hygiene, managing bodily functions and minor medical treatments. Many older Australians have diminished capacity to perform such functions by themselves because of frailty or disability.

Personal care services are generally the most expensive of the range of services provided in aged care, accounting for half to three-quarters of total residential aged care costs (Productivity Commission 2003). There is a wide spectrum of personal care depending on individual needs, ranging from low levels of episodic assistance to high levels of ongoing assistance. The variation in care costs is substantial. For example, care costs can range from less than $1000 a year for occasional assistance to perhaps more than $50,000 a year for a people with dementia, whose care need can continue for a number of years.

Addressing personal care needs provides the major rationale for government intervention in aged care. For an aged care system to provide an adequate level of personal care, this care must reflect the particular needs of individuals, which can be highly variable. As the cost of

38 Considering aged care in its various components is common to most studies, such as Hogan (2003).

these services can also be very large, it would not be effective to fund them through regular transfer payments to recipients. Instead, specific assistance for personal care should be targeted to the needs of individuals.

Adequacy depends not only on the degree of financial support, but also on aged care services reflecting the needs and preferences of recipients (see Section F6 Transfers tied to goods and services). Facilitating consumer choice ensures that the services people use are the ones they value most, leading to greater satisfaction and sense of autonomy among users. Choice can also improve the efficiency of provision, as providers will receive funding only when they deliver services that are valued by users. And choice puts competitive pressure on providers to reduce unnecessary costs.

Health care

Aged care can involve a range of health services similar to those provided through the health care system. These include access to nurses to administer injections, or to allied health professionals such as physiotherapists. Providing health care services through the aged care system can reflect the overlap in skills needed by providers of personal care services and allows coordination of recipients' care needs.

Assistance with everyday living

Aged care services can include assistance with a range of 'everyday living' expenses, including food or laundry expenses.

Accommodation

'Residential aged care' facilities can provide personal care, health care and assistance with everyday living, along with accommodation. When these services are instead provided in a recipient's house, they are referred to as 'community care'.

'Unbundling' aged care to assign funding responsibilities

For each of the different services available through the aged care system, the provision of assistance and the assignment of funding responsibilities are best considered separately, as these services can be provided both inside and outside the system. By 'unbundling' services and responsibilities in each component, assistance for aged care can be targeted most effectively. In particular, unbundling funding for care (both personal and health care) reduces the potential for cross-subsidies across different care types or between different users. Cross-subsidies in funding arrangements can lead to inefficient provision, encouraging people to use one type of service just to gain access to the service they really want. Care assistance that is not linked to accommodation can enable people to 'age in place' in their homes, which can improve their wellbeing by providing care where they are comfortable and allowing them to maintain their links with the community.

A system that involves cross-subsidies is also likely to be inequitable. For example, people whose means enable them to cross-subsidise other aspects of their own care (or even others' care) may receive preferential treatment from aged care providers. To prevent this, the prices received by providers should reflect the cost of providing care, rather than the means of recipients. Unbundling allows providers to charge prices in line with costs, while recipients' means determine their level of financial support.

Individuals should finance the costs of everyday living and accommodation, just as they do outside the aged care system. Assistance for these services is provided on a means tested basis through the income support system. Accommodation and everyday living costs are fairly predictable expenses and not exclusively associated with increasing frailty or disability. As such, these costs should be a private responsibility inside the aged care system, with the recipient paying the full cost of their provision. This would remove incentives for people to change their living arrangements to access aged care, potentially harming living standards in retirement.

To ensure that all Australians can access aged care, people with limited private means should be provided with assistance so they can receive an adequate level of care at no financial cost to them. Ensuring access to an adequate level of care irrespective of means is a 'public good' similar to other aspects of the redistributive system, such as income support, and should be funded by the community through general taxation. Where people do have means, they should be user charged for the services they receive. A particular personal care service is a 'private good' in that the greatest benefit from its use accrues to the care recipient, rather than the community as a whole. Charges for care should be set with reference to both a person's means and the cost of their care. Means testing should have regard to the impact of means testing undertaken in the broader income support system (see Section F2 Means testing).

It is an underlying principle of Australia's transfer system that the Australian government helps to support those with limited means while the remainder of the community supports itself. Reliance solely on taxpayer funding would most likely undermine the sustainability of the aged care system. The absence of any price signals could also reduce the efficiency and raise the cost of providing the service.

Governments need to finance the health care-related elements of aged care. Health care provided through aged care should be subject to similar charging arrangements as occurs in the health care system. This means that the health care component should generally be free or accompanied by modest co-payments. However, this general approach would need to be balanced by practical considerations, as the distinction between health care and personal care can be difficult to draw in aged care.

Ensuring access to an adequate standard of services should not preclude people from purchasing a higher standard of service, provided they pay the full additional cost. The existence of additional services does not, of itself, reduce the standard of care for those who receive no more than the adequate level. Preventing the purchase of a high standard not only denies access to care that people value, but is also likely to stifle the delivery of higher-quality care. Access to higher-quality services would also provide an additional reason for potential recipients to retain their assets into retirement.

Principles

Equitable provision of assistance for aged care would ensure that recipients of limited means can access an adequate standard of care. To ensure that aged care services meet the needs and preferences of users, funding should be tailored to the needs of users and directed in line with choices. As care may often be delivered effectively in both recipients' homes and aged care facilities, assistance for care should generally not be tied to a particular care setting.

Recipients should generally pay for accommodation and living costs provided through aged care with user charges equal to the cost of their provision, as these costs are personal responsibilities outside the aged care system.

Recipients with sufficient means should contribute to the cost of their care, which should result in more efficient provision of care and reduced cost on taxpayers. Means testing of aged care assistance should be consistent between residential and community care options while taking into account other taxes and means tests applying to older Australians.

The provision of means tested care should not preclude the provision of aged care beyond the adequate standard of service. Recipients should be fully user-charged for such care.

F7-2 Current funding and charging arrangements have weaknesses

Overview of the system

A range of government-subsidised aged care services are available through either residential or community care programs. Table F7-1 summarises features of the available programs.

The majority of recipients of aged care services receive relatively low levels of support in the community through the Home and Community Care (HACC) program. This care is funded by both the Australian and State governments, with access to programs governed by providers who follow guidelines established by States.

The other care programs are funded by the Australian government. Access to subsidised aged care services are regulated in two ways:

- Potential recipients are assessed by Aged Care Assessment Teams (ACATs), who act as gatekeepers to subsidised care. ACATs determine a person's eligibility for a type of care (residential or community, high or low needs, permanent/respite).
- Subsidised care must be delivered by an approved provider, whose supply is regulated according to needs-based planning arrangements, which limit the number of providers in the following ways:
  - Across the country, 113 aged care places are provided for every 1000 people aged 70 years or over. The total number of places is divided between 44 high-level residential care places, 44 low-level residential care places, 21 low-level community care packages and 4 high-level community care packages.

- These places are allocated geographically within regions of a State in line with the proportions of elderly in each area. Once an allocation to a particular area is made, it is not generally subject to subsequent review. The ability to become a care provider is tied to a particular area and allocated through a (non-price-based) competitive tender.

Table F7-1: Current aged care programs

	Health and Community Care (HACC)	Community Aged Care Packages (CACP)	Extended Aged Care at Home (EACH)	Extended Aged Care at Home — Dementia (EACH-D)	Residential (Low level care)	Residential (High level care)
Number of recipients	831,500	61,740			160,000	
Government funding	$1.7 billion(a)	$729 million			$6.7 billion	
Source of government funding	Commonwealth (60%) and States (40%)	Commonwealth			Commonwealth	
Total cost per recipient ($)	2,086	15,100	43,630	49,150	39,550	63,300
Private contribution	5	16	5	5	53	26

(a) Excludes additional funds from state and territory governments over the matching requirement (estimated to be $119 million in 2006–07).
Note: These figures overstate the private contribution towards the cost of residential aged care services compared to community care. These private contributions for residential aged care reflect payments toward accommodation and daily living expenses, which are paid for by recipients of community care services.
Source: Department of Health and Ageing (2009a).

Residential aged care

The following sections discuss the funding and charging arrangements for the different services provided in residential aged care.

Personal and health care

In residential aged care, the Aged Care Funding Instrument (ACFI) is used to determine the level of assistance for both personal care and some health care costs. The ACFI divides the type of care a resident requires into three domains and each domain has three funded levels (see Table F7-2). The higher the level a resident is assessed at in each domain, the higher the cost of their care and the larger the payment received by the aged care facility to provide their care. For example, the cost of care for a resident assessed as low on activities of daily living, medium on behavioural supplement and high on complex health care supplement would be $99.01 per day or $36,139 for a year.

Table F7-2: Daily ACFI subsidy rates (at 30 June 2009)

Level	Activities of daily living	Behavioural Supplement	Complex Health Care Supplement
Nil	0	0	0
Low	$29.78	$6.81	$13.40
Medium	$64.86	$14.11	$38.17
High	$89.85	$29.72	$55.12

Source: Department of Health and Ageing (2009b).

This funding arrangement is essentially 'user-directed' funding, as the assistance goes to recipient's choice of provider. However, the benefit of this funding model is limited by the supply restrictions enforced through the needs-based planning ratios, which operate as a second gatekeeper on care (Productivity Commission 2009).

Supply restrictions can lead to high occupancy rates in care facilities and the use of waiting lists for access to care. As noted by the National Health and Hospitals Reform Commission (2009), limited availability of places can lead people to choose the first available place, rather than choosing their preferred facility. When this occurs, providers have little incentive to attract clients by delivering better-quality care. The restrictions also act to prevent popular providers expanding their share of the market. While funding through ACFI (with 64 different levels of assistance) provides scope for significant tailoring of assistance to assessed need, recipients are allocated to a care entitlement in either a low-level or high-level facility. The use of these broad categories can affect access to care because providers are able to charge recipients differently for non-care costs depending on these categories, which will be discussed in greater detail below.

The means tested fees paid to providers reduce the government subsidy, which ensures that providers receive the same payment for each recipient to whom they provide care. The resident's fee is equal to 41.67 per cent of their income in excess of $20,376, a figure set equal to a full rate single Age Pension (including supplement) plus the income-free area of the income test. The maximum fee a resident can be charged can not be greater than the cost of their care, as determined by the ACFI, or greater than $21,674, set as 150 per cent of the annual single basic Age Pension (see Table F7-3). The effect of care fees is considered below in combination with other means tested fees in residential aged care.

Table F7-3: Funding of health and personal care in a residential aged care facility (annual)

	Income	Care cost	Resident fee	Government subsidy	Provider revenue
Full pensioner	$19,000	$36,139	0	$36,139	$36,139
Part pensioner	$40,000	$36,139	$8,177	$27,962	$36,139
Self-funded retiree	$60,000	$36,139	$16,510	$19,629	$36,139

Source: Department of Health and Ageing (2009c) and Treasury calculations.

Assistance with every day living costs

Residential aged care provides people with food and other living costs, such as laundry. These services can be provided at a standard quality or a higher 'extra service' level.

All residents who receive standard service pay a fee equivalent to 84 per cent of the single Aged Pension, currently equal to $36.94 per day or $13,483 per year. This fee is notionally allocated to the funding of activities of daily living.

'Extra service' can include a range of additional services such as better food or pay TV, hairdressing, newspaper delivery or a larger room (interacting with accommodation, which is discussed below). Providers must be approved to provide a place offering extra services, and the number of extra service places in a region is capped to ensure that residential care remains available to people who cannot afford the additional charges.

Providers may charge an additional 'extra service daily amount' for providing these services. As well as cost recovery, the use of extra service fees affects other aspects of aged care funding and charging. Regulations reduce a provider's residential care subsidy by 25 per cent of the extra service fees they charge clients. A further regulatory implication is that if a high-care resident uses extra services their provider can charge them differently (often more) for their accommodation than they could otherwise. These funding arrangements give both suppliers and users a disincentive for the use of extra service places.

Accommodation

Residents can be charged for the accommodation they receive through either a charge or a bond. Charges are used for residents entering high-care facilities, unless they chose to receive 'extra service' which allows providers to charge them bonds. Providers can ask all low-care residents to pay a bond.

The level of an accommodation charge is determined by residents' asset levels. No charge is paid for residents whose assets are below $36,000, with the charge increasing to a maximum of $26.88 per day at an asset level of $91,910.40. The Australian government provides an 'accommodation supplement' in respect of residents who do not pay the full charge. This is an effective accommodation subsidy for those residents, which ensures providers receive the same payment for accommodation irrespective of recipient means. Access to an accommodation subsidy of some form is appropriate in aged care, as outside the system older people who face high housing costs are eligible for Rent Assistance on top of their pension.

Residents entering low-care or high-care 'extra service' places can be asked to pay an accommodation bond whose value is agreed between the resident and the provider. The only limit on the size of the bond is that it must not leave the resident with less than $36,000 in assets. Providers retain any earnings on the bond for as long as the resident uses their service. In addition, for or up to a maximum of five years providers can retain 10 per cent of the bond each year, with the amount capped at $3,588 per annum (for bonds over $35,880).

Table F7-4: Funding of accommodation services in residential aged care

	Assets	Charge	Government subsidy(d)	Bond income	Provider revenue (charge)	Provider revenue (bond)
Full pensioner	0	0	$9,811	na	$9,811	na
Full pensioner	$80,000(a)	$7,195	$2,616	$6,388	$9,811	$6,388
Part pensioner	$200,000(b)	$9,143	$668	$14,088	$9,811	$14,088
Self funded retiree	$400,000(c)	$9,811	0	$24,588	$9,811	$24,588

(a) Pays a bond of $40,000.
(b) Pays a bond of $150,000.
(c) Pays a bond of $300,000.
(d) Only if resident pays a charge not a bond. The provider revenue from the bond assumes a return of 7 per cent.
Source: Department of Health and Ageing (2009c) and Treasury calculations.

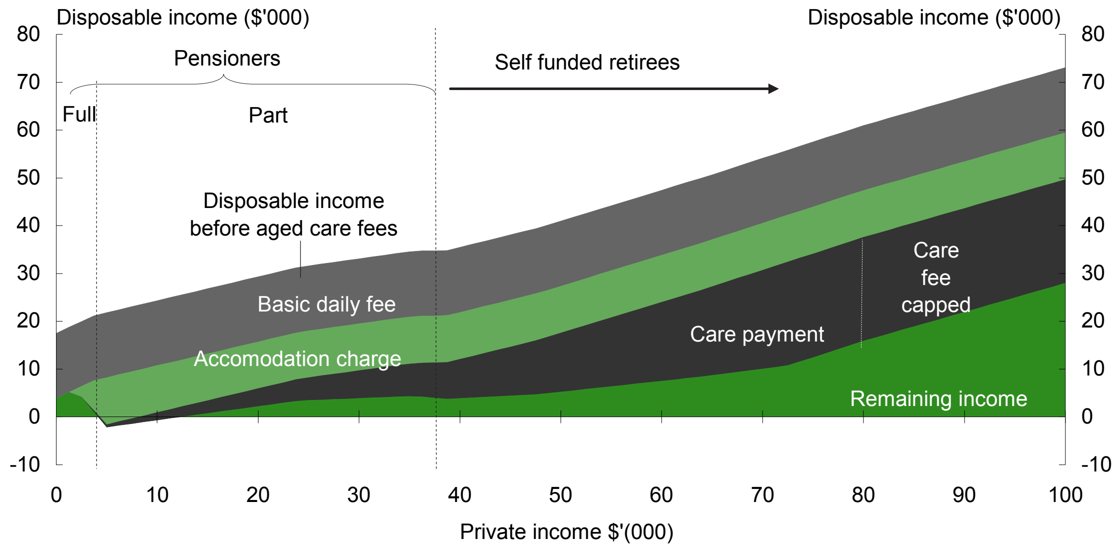
The design of a bond is more like a tax, limited by people's capacity to pay, rather than a user charge, which would be limited by the costs of their accommodation. As noted by the Productivity Commission (2009), supply restrictions result in providers gaining monopoly pricing power in local regions. Bonds are the only aspect of the market where providers have pricing flexibility and the amount they receive does not offset other government subsidies. This has led to substantial growth in bonds providers can charge, with the average accommodation bond agreed with new residents rising from $58,400 in 1997–98 to $212,958 in 2007–08. Where bonds exceed around $90,000, they result in people paying more for their accommodation than those levied with a charge.

This difference is inequitable. It leads to substantial difference in the accommodation payments based on care need. In addition, bonds mean that high-wealth clients are more financially lucrative to providers than low-wealth clients, even though the service they are provided with is the same. This provides an incentive for providers to 'cherry pick' their clients according to wealth, which was suggested by Ergas (2008) to be a reason why wait times were higher for low-income recipients.

Total effect of means testing

The total effect of means testing on aged care residents who pay an accommodation charge is set out in Chart F7-1.

Chart F7-1: Total effect of means testing



Note: Disposable income includes private income plus pension less tax. Private income is assumed to be derived from assets earning a 5 per cent rate of return.
Source: Department of Health and Ageing (2009c) and Treasury calculations.

Means tested charges for the costs of care should be set so they do not harm income adequacy in retirement and are consistent with pension means testing. As the Age Pension is designed to ensure access to an adequate basic standard of living that does not include significant personal care costs, these costs should generally not be levied on recipients of a full Age Pension. Following the approach in the income support system, means testing should not be designed to force the drawdown of assets, but instead target the income from assets. The charge should also take into account the effective tax rate already applied to private income through the pension means test and income taxes, with the total effective marginal tax rate being less than 100 per cent of income. These features are necessary to provide an incentive for people not to draw down their assets excessively to avoid means testing. These combined parameters — starting means testing from a level of income adequate to cover other expenses, ensuring the total taper on private means does not remove all incentive to maintain savings, and limiting the charge to the cost of care — should allow means testing to target assistance tightly. This ensures that users with sufficient means are able to reduce the funding pressure on the wider community through higher taxes.

The current approach to means testing appears inconsistent with this approach in two ways. For a reasonable estimate of the earning capacity of assets, the rate at which the accommodation supplement is withdrawn creates effective marginal tax rates in excess of

100 per cent on asset earnings. For example, if the assets subject to the test ($55,910) earned a 5 per cent rate of return, they would generate only around $2,800 of income, compared to the $9,784 annual charge. As such, this test results in depletion of asset values.

For higher income ranges, however, the total effective marginal tax rate can fall. Further, the cap on means testing charges for personal care provides a benefit to wealthy recipients of aged care, as it takes effect from incomes of around $72,000. This results in taxpayer funding for the costs of care that, given the income levels of the recipients, are a personal responsibility. A more consistent approach to means testing would be to target a consistent effective marginal tax rate until these costs are covered.

Community aged care

Community aged care services provide personal care services and some assistance with standard living costs, such as provision of food. Access to community aged care is governed through a combination of State-managed assessment and the ACAT assessment teams for Australian government programs. Recipients are allocated to their providers, who determine the level of care based on their assessment of the recipients' needs. The funding a provider receives for their care is not tightly matched by recipients' care needs and is governed by a different mechanism than used in residential care. The approach to means testing also varies between these services, and compared to residential aged care.

Funding care levels

The Home and Community Care (HACC) program funds a range of personal care, health care and assistance with standard living costs set out in Box F7-1. Eligibility for HACC is determined by service providers in each State, with care funding delivered to providers through block grants. Most HACC clients (97 per cent) receive, on average, services worth about $1,200 per year (in 2007–08 prices), although this includes non-care services. About 3 per cent of HACC clients receive services worth more than $16,000 per year (Department of Health and Ageing 2008). Expenditure on these clients accounts for about 30 per cent of all HACC expenditure.

Three community aged care programs are funded entirely by the Australian government: the Community Aged Care Program (CACP) and the Extended Aged Care at Home (EACH) program and the EACH — Dementia (EACH-D) program. CACP does not fund health care services but does include personal care. EACH and EACH-D both fund specialist nursing care as well as personal care. The cost of a CACP package is $15,100 per person, $43,630 for an EACH package and $49,150 for an EACH-D package.

Box F7-1: Services provided through community care

The services provided through a Home and Community Care (HACC) package vary by State. For example, in Victoria, services include personal care, respite home care, property maintenance, nursing, allied health, delivered meals and planned group activities.

A Community Aged Care Program (CACP) package includes personal care, such as bathing and dressing, and domestic assistance, such as housework and shopping, as well as help in participating in social activities. Examples of services may include:

- meal preparation;
- laundry;
- assistance with continence management;
- transport;
- personal care;
- social support;
- home help;
- gardening; and
- temporary in-home respite care.

An Extended Aged Care at Home (EACH) package provides a range of assistance, including nursing input, and services such as:

- care by an allied health professional such as a physiotherapist or podiatrist;
- personal care;
- domestic assistance;
- in-home respite;
- transport;
- social support;
- home help; and
- assistance with continence management.

An EACH — Dementia (EACH-D) package includes:

- linkages to services to meet the specific needs of recipients with dementia;
- care by an allied health professional such as a physiotherapist or podiatrist;
- personal care;
- home help; and
- assistance with continence management.

Source: Victorian Department of Health Services (2009); Department of Health and Ageing (2009).

Eligibility for the three levels of Commonwealth-funded community aged care is determined by ACATs. Based on their entitlement, recipients are allocated to a provider, who receives the funding for the care. Providers receive an amount per client based on the average care cost in the relevant broad category of community care — CACP, EACH and EACH-D — rather than the individual's specific needs. Providers supply care across recipients with differential needs so that their average level of servicing equates to what they are paid by government.

This funding for community care can constrain care and choice by recipients in several ways. Recipients are allocated to specific providers in a given region that hold the contract to provide the care to which they are entitled. This reduces the competitive pressure on providers to deliver high standards of care and means recipients may have to leave trusted providers when moving to a higher level of care. In addition, providers receive care based on an average level of assistance, rather than an individual's particular need, which can lead to recipients 'falling through the gaps' of care levels, as noted by NHHRC (2009). The restrictions on the numbers of Australian government care packages can limit the choice of recipients. In addition, many recipients would be eligible for a higher level of care subsidy if they moved into residential aged care.

Fee setting

Though underpinned by broad national program guidelines, fee policies for HACC services vary across States. The Department of Health and Ageing (2008) noted that the fees are generally lower than in Australian government packaged care programs. For example, in both Victoria and Western Australia, there is no distinction between the charge levied on full- and part-pensioners. Fees can be set such that they are discounted for multiple use. Further, some living expenses, such as meals, are provided below user cost. However, as HACC is often provided by small providers with assistance occurring on an infrequent basis, some variation in fee-setting policy is expected, given the compliance cost of undertaking more comprehensive means tests.

In Australian government aged care programs, fees for full Age Pension recipients cannot exceed 17.5 per cent of income. While some services provided through CAC-P packages can include living costs for which it would be appropriate to user-charge, the flat 17.5 per cent payment is unlikely to reflect these. Where this amount is for personal care, it reduces the income adequacy for full-rate pensioner. This is most likely to occur for recipients of EACH or EACH-Dementia, as the majority of this care reflects personal care.

Clients with income above the full rate pensioner income can be charged up to 50 per cent of this income (see Table F7-5). This amount is uncapped by the costs of care and does not offset the government subsidy. Providers therefore have an incentive to 'cherry pick' wealthier clients, which undermines the equity of the system. Further, if recipients pay more than the cost of their care, they are effectively cross-subsidising the care of less wealthy recipients. Ensuring that people with limited means can access care would be more appropriately financed through broad-based taxes, rather than through an effective tax on care users. For recipients facing a means tested payment, the effective marginal tax rate is slightly higher than what is expected from residential aged care recipients.

Table F7-5: Funding of Commonwealth community aged care programs (annual)

	Income	Av care cost	Resident fee	Government subsidy	Provider revenue
CACP					
Full pensioner	$19,000	15,100	$3,325	$12,684	$16,009
Part pensioner	$40,000	15,100	$13,378	$12,684	$26,062
Self-funded retiree	$60,000	15,100	$23,378	$12,684	$36,062
EACH					
Full pensioner	$19,000	$43,630	$3,325	$41,449	$44,774
Part pensioner	$40,000	$43,630	$13,378	$41,449	$54,827
Self-funded retiree	$60,000	$43,630	$23,378	$41,449	$64,827

Source: Department of Health and Ageing (2009a) and Treasury calculations.

Findings

The current aged care system is complex, and the funding arrangements have several poorly performing features that affect the wellbeing of older people at a vulnerable time in their lives.

Means testing of charges is not applied consistently. The difference in charging for accommodation in low-level and high-level residential care appears particularly inequitable. The difference in the provision of assistance across aged care in residential and community settings limits the choice of recipients. Where funding sourced from wealthier recipients cross-subsidises the care of others, as occurs in community aged care, providers have poor incentives to deliver care efficiently and less well-off recipients' access to care can be harmed.

F7-3 Reform directions

Recommendation 109:

There is considerable scope to align aged care assistance with the principles of user-directed funding to provide assistance in line with recipients' needs, enable their choice of care and support the fiscal sustainability of the aged care sector. However, effective user-directed funding is significantly limited by regulations that govern supply and price, reforms to which would have complex sequencing and transition issues. The Productivity Commission should consider this potential reform direction in its upcoming inquiry into aged care.

Recommendation 110:

It is important for governments to determine what an adequate level of aged care should be, the necessary pricing and regulatory arrangements to deliver it, and the most sustainable funding arrangement to ensure access by those who cannot afford it. Given this, and noting that the Productivity Commission will be inquiring into the disability insurance scheme, its consideration of aged care should include the potential for insurance to play a role in helping to fund aged care as Australia's population ages.

Potential reform to financing arrangements

The Review has considered the funding and means testing arrangements for aged care in the context of growing need for high-quality care and fiscal pressure that flow from satisfying the needs of an ageing population. There is some potential for reforms to financing arrangements, particular user-directed funding, to further these objectives.

The Review supports the recommendations in the final report of the National Health and Hospitals Reform Commission that:

- government subsidies for aged care should be directly linked to people rather than places;
- there should be a more flexible range of care subsidies for people receiving community care packages, determined in a way that is compatible with care subsidies for residential care;
- people supported to receive care in the community should be given the option to determine how the resources allocated for their care and support are used; and
- care subsidies and user payments should be aligned across community care packages and residential care, and older people should be given greater scope to choose for themselves between using their care subsidy for community or for residential care.

The application of consistent means testing arrangements across aged care programs would also support choice for consumers of aged care services. In line with unbundling of care funding, there is some scope for more targeted means testing of care, which would improve the fiscal sustainability of the care system.

However, in light of the existing supply and price regulations, the benefits of reform to the financing arrangements of aged care would be limited. Further, changes to the financing and regulatory framework of aged care would require careful sequencing to ensure that access to care is not harmed during any transition. The potential for user-directed and consistent means testing should be considered as part of the Productivity Commission's inquiry into the aged care sector (see Recommendation 109).

Long-term sustainability of funding arrangements

Reforms to facilitate user-directed funding and ensure recipients with sufficient means finance their own care costs would improve the fiscal sustainability of aged care. However, several factors limit the scope for greater user funding of the system through means tested user charges.

As the superannuation guarantee scheme matures, cohorts of older people should have larger assets balances available to them at retirement. However, these assets will need to provide an adequate stream of income over a person's retirement, the duration of which is uncertain for individuals. The expected increase in average life expectancy is likely to add to this risk. Further, the use of aged care services is particularly intensive for people aged 85 and upwards, once many have been retirement for 20 years or more.

As is discussed in greater detail in Section A2 (Retirement incomes), wider availability of products that can insure against longevity risk would give greater certainty around income over a long retirement. This would facilitate a more dependable income stream on which users of aged care services could draw to pay for the costs of their care. It is also possible that moves towards a universal levy on taxable income could be used to offset future fiscal risks of government financing aged care.

The uncertain and potentially high costs of aged care mean that many people would not be able to provide for their care costs out of their savings. When insufficient provision for the costs of aged care results in inadequate access to care, the wellbeing of older Australians is significantly harmed. The introduction of a compulsory insurance scheme should be considered as a way to deliver a funding source to ensure that all individuals can access an adequate standard of care.

Currently, insurance companies are prohibited from offering voluntary insurance products for aged care costs. Further, the current restrictions on the supply of aged care would likely limit the use of insurance, even if it were available.

The Review supports consideration by the Productivity Commission of the potential for insurance, whether compulsory or voluntary, to assist in the task of funding aged care as Australia's population ages (see Recommendation 110). Further, aged care insurance would have many of the social insurance attributes of broader disability insurance, which is also the subject of a Productivity Commission inquiry.

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G1. A responsive and accountable tax system

Key points

Australia needs modern and sophisticated tax policy and administration processes that can deliver a tax system to meet the demands of the 21st century. The tax system will face a range of challenges over the next few decades that will affect how tax policies are developed and administered. It is imperative that the tax system can meet these challenges and respond to the needs of the community.

The operation of Australia's tax system is fundamentally sound and there is general confidence in the system. The level of voluntary compliance is high, reflecting positive perceptions about the fairness and integrity of the system and how it is administered. Many of the current institutional arrangements will continue to perform well. However, a number of changes would further the system's ability to meet future challenges.

The nature of any tax system means there will always be some tension between taxpayers and tax authorities. The tax law is complex and there are inevitable uncertainties in its development and application to complex commercial arrangements or in novel situations. This can create tension about the authorities' interpretation of the law and efforts to improve certainty through amendments to the law. A more transparent and accountable system has the potential to ease these concerns.

We should further develop open and inclusive processes by which the community can raise issues and have them considered by government. Building on its existing strengths, the Board of Taxation could act as a 'circuit breaker' in the system — to quickly identify problems in the system, particularly those that arise at the boundary between policy and administration.

An advisory board would contribute further external views into the management of the Australian Taxation Office (ATO). These external views will help the ATO meet the considerable demands of the coming decades. Other changes would improve the effectiveness of external scrutiny of the system.

G1-1 A responsive tax system

The tax system is a fundamental part of Australia's social and economic infrastructure. The operation of the system should reflect the type of society Australians want and the role of government in that society. It will not be feasible for the tax system to be reformed in a single step to accord with the vision laid out in this Report. And even once it has been reformed, the objectives for the tax system may need to be adjusted in response to changes in understanding, priorities, technology or the economy.

The tax system needs to keep pace with these developments so that it does not unnecessarily impede Australian businesses in competing internationally, and supports the nation's capacity to attract overseas investment.

The tax system operates through a number of institutions that together design and implement tax policy and govern administration of the system. These include parliamentary, executive and judicial bodies. In combination, these institutions, and the relationships between them, influence how taxpayers experience the system. As in other areas examined by the Review, it is clear that the institutional architecture of the tax system has been developed incrementally, and in some respects it does not operate in a fully coherent and effective whole. The Review has examined these arrangements from a whole-of-system perspective to see whether they are capable of meeting the demands of the coming decades.

Principles for responsive policy and law

The tax system needs to reflect and support Australia's social and economic objectives because it exerts a powerful influence on social and economic outcomes.

While timely changes are necessary to ensure that the system remains relevant, change is a costly process and can create significant uncertainty. The higher the rate of change, the more difficult it is for people to understand their rights and obligations. Changing the system can involve significant upheaval. These costs need to be taken into account when changes are under consideration. So, while the system needs to adapt to changing circumstances and expectations, the features that work well should remain stable. In practice, this is a difficult balance to achieve.

Somewhat perversely, the desire for certainty can also be a significant source of instability in the system. A high level of precision in the tax law can provide the certainty needed to make the best decisions at lower cost and with lower risk. However, while prescriptive rules can provide immediate certainty to anticipated issues, they are usually not flexible enough to cover other similar cases that arise later. They also risk producing unintended consequences.

Without careful management, tax changes can have significant unintended impacts on individuals, businesses and the wider economy. At times, policies are developed without fully anticipating their impact, such as when they inadvertently disrupt longstanding arrangements or cause uncertainty. Policy-makers need to recognise the potential consequences of changes in policy and law, particularly when complex business arrangements are involved.

The system needs effective mechanisms for identifying and addressing uncertainty. A transparent and accountable process, by which users of the system can raise issues with government and receive feedback on their representations, is necessary for the ongoing health and maintenance of the tax system.

A consultative approach to developing policy and legislation can help ensure the system responds to the needs and expectations of the community. It provides stakeholders with an opportunity to inform policy-makers about the impact of the tax system on their different circumstances. It allows governments to benefit from the practical experience, skills and knowledge of stakeholders and incorporate this into policy design. This helps generate better targeted and more practical solutions. It also gives governments more information about the range of options available and the benefits, costs and risks associated with those options.

Principles for responsive administration

It is important for the tax authority to administer the tax system in a way that builds community confidence. The way taxpayers interact with the tax authority affects public perceptions of the system and the degree of voluntary compliance with the tax law. The tax authority should help people understand their rights and obligations and make it as easy as possible for them to comply with their obligations.

While the tax authority should support people who are trying to comply, it has a responsibility to apply the law firmly to people who do not. The community needs to have confidence in the fairness and integrity of the system — that everyone is paying their fair share. When taxpayers perceive that others are avoiding or evading taxes, they are less inclined to pay taxes themselves.

The administration of the tax laws can have a significant bearing on the level of certainty taxpayers have about their obligations. A challenge for the tax authority is to be responsive to the individual circumstances of taxpayers while at the same time being fair and consistent. Timely and consistent advice and self-help products that taxpayers can rely on reduce the uncertainty associated with complex laws. However, complexity in the tax system can be as much of a challenge for the tax authority as it is for taxpayers.

The administration of the tax system can benefit significantly from experiences and perspectives developed in the private sector. A consultative approach can contribute greatly to the tax authority's ability to understand the position and perspectives of taxpayers. In particular, consultation can help the tax authority take compliance costs into account when designing and implementing its administrative systems. Consultation also promotes a common understanding of the role and responsibilities of the tax authority, which helps build community trust and respect for the system.

Principles

The tax system needs to be flexible enough to respond to economic and social change in a timely way, while offering stability and certainty. The system needs effective mechanisms for identifying and addressing areas of uncertainty. In particular, the tax system should have an open and inclusive process by which the community can raise issues and see itself as having a responsibility and interest in doing so.

Tax policy, legislation and administration should be developed using a consultative, transparent approach to help achieve better targeted and more practical solutions, reduce unintended consequences and support community confidence in the system.

Taxpayers should be able to organise their affairs with good information about the tax consequences. While the tax authority should support people who are trying to comply, it has a responsibility to apply the law firmly to people who do not.

How responsive is the current system?

The operation of Australia's tax system is fundamentally sound and there is general confidence in the system. Voluntary compliance is at a high level, reflecting positive perceptions about the fairness and integrity of the system and the way it is administered. A relatively transparent and participatory approach to the development of policy and legislation has helped establish and maintain a sound framework that has served Australia well. The vast majority of taxpayers (86 per cent of individuals and 90 per cent of businesses) consider that the ATO is doing a good job (ATO 2009b). The ATO has developed a positive reputation internationally and is widely regarded as one of the leading tax authorities (JCPAA 2008). Much of the institutional architecture of the existing tax system will continue to perform well. However, a number of changes should be made to increase our ability to meet future challenges.

An increasingly open approach to designing and administering the system

An increasingly open, inclusive and consultative approach to the development of policy, legislation and administration is helping to identify, develop and implement changes needed in the system. These approaches can reduce the number of unintended consequences, as well as helping to recognise and address the ones that do arise.

The ATO has developed extensive consultation arrangements to help it administer the tax system fairly and efficiently. It has around 50 consultative forums for taxpayers, businesses and tax professionals (ATO 2009b).

Extensive consultation arrangements also exist in the tax design process. Since 2002, there has been formal consultation on most substantive tax measures. In 2008, the Government announced changes to the consultation arrangements for tax policy and legislation. These focused on making consultation more accessible, inclusive and transparent, to improve the contribution that the private sector makes to the development of the tax system. The key change was to increase the involvement of the private sector at the initial policy design stage to reduce the likelihood of unanticipated consequences.

In addition to the range of consultative forums (such as the ATO's National Tax Liaison Group) that enable organisations, businesses and tax professionals to raise views about the operation of the tax system, the community can raise issues through a number of avenues.

- People can write directly to ministers at any time. However, neither the letters nor the Minister's responses are generally published.
- Each year the government invites the public to submit ideas for the Budget, including ideas for tax changes. Submissions are not published and detailed responses are not routinely provided.
- People, including professional bodies, can also raise minor policy and administrative issues relating to the care and maintenance of the tax system through the Tax Issues Entry System, a website jointly operated by the Treasury and the ATO. It includes a register of issues raised and details on whether, and how, each issue is being addressed.

So, while there are several ways in which the community can raise problems with the tax system, it is sometimes unclear which is the best way. It can also be unclear whether an issue has been previously considered by the government. The same issue may be raised a number of times by different parties, because the government's position is not publicly known.

The impacts of complexity on the system

The tax system is excessively complex. The current tax law is a morass of technical detail — for example, the income tax law now extends to almost 6,000 pages, despite the repeal of more than 4,100 pages of inoperative income and other tax law in 2006. It has reached a point where any change to the law is as much about dealing with the interactions between the change and the existing system, as it is about the change itself. This generates uncertainty about the way the system operates and the way it should operate. This uncertainty tends to reduce trust between stakeholders in the system. At worst, this can undermine confidence in the integrity and legitimacy of the system.

Complexity reduces the system's transparency, makes it harder for taxpayers to understand their obligations, increases the risk of non-compliance and hinders the making of properly informed decisions. It creates uncertainty and risk, which taxpayers spend time and money dealing with. Some taxpayers arrange their affairs to take advantage of the complexity and its unintended consequences.

To some extent, the complexity of the tax system reflects the complexity of the wider world. Over time, policy objectives have also tended to become more sophisticated, including many different treatments for specific groups of taxpayers. Cultural issues are also an important cause, as well as a symptom, of complexity and uncertainty. The culture of the tax system is a subset of the wider national culture. It reflects the community's recognition of the connection between taxes and the supply of government services. It has emerged from the historical approach to imposing taxes together with the way taxpayers and government interact according to prevailing values like trust and a sense of obligation. The vast majority of taxpayers recognise and accept their tax obligations, but the nature of the tax system means there will always be some tension between taxpayers and the tax authorities. The challenge is how to moderate the impacts of these inherent tensions in the system.

The administration of the income tax system follows a process of self-assessment. Self-assessment was introduced in the 1986–87 income year to improve system efficiency — it shifted the ATO's focus from processing returns to helping taxpayers to comply with the law and taking enforcement action against those who do not. The introduction of self-assessment shifted the distribution of cost and risk between the government and taxpayers. It exposed taxpayers to more risk by removing some of the finality of the assessment process. As the tax laws have become more complex, self-assessment has also exposed some taxpayers with more complicated affairs to greater compliance costs.

To address concerns about the imbalance of cost and risk created by self-assessment, a system of binding rulings was introduced in 1992 to give taxpayers greater certainty about the application of the law and to reduce penalties. Further refinements have been undertaken since. Treasury's 2004 review of self-assessment led to changes that made even more ATO advice binding; it also reduced the periods in which the ATO can amend assessments, and reduced the interest payable in some cases. More recently, the ATO has entered into Advance Compliance Agreements with some large businesses to provide them with the real-time certainty they need. The ATO also offers a priority rulings process for commercially significant and time-sensitive transactions.

Under the system of income tax self-assessment the ATO advises and guides taxpayers about their obligations and applies the law to collect revenue. More broadly, the ATO also seeks to create an environment that is increasingly conducive to high levels of compliance. This involves helping people to understand their rights and responsibilities, making it as easy as possible for people to comply with the law, and providing an effective deterrence to non-compliance to support honest taxpayers. In addition, the ATO plays a role in safeguarding Australians' retirement income through its administration of significant aspects of the superannuation system. It also promotes online dealings between government and business through its stewardship of the Australian Business Register.

Self-assessment places great importance on taxpayers having a good understanding of the tax law and voluntarily complying. As the tax system has become more complex, ATO advice has taken on a more significant status, as taxpayers (and advisers) in more complex matters may not have the capacity to understand the tax law.

Paradoxically, the pursuit of certainty about tax obligations and entitlements has itself become a source of the complexity. Some larger businesses are increasingly looking for the comfort of prescriptive legislation or rulings to give them certainty about the tax treatment of their particular arrangements. This has increased the size and complexity of the law and of ATO rulings.

The complexity of the system also affects the way the Treasury develops policy and legislation, and the ATO approach to interpreting the law. Often taxpayers criticise the laws for being too comprehensive and taking a disproportionate approach to addressing the revenue risks of tax avoidance. Accepting some degree of greater risk in this regard could ease complexity and make it easier to change the law when necessary. However, in an environment where some taxpayers actively use the complexity of the tax system for tax avoidance, the Treasury and the ATO are cautious about establishing precedents that could compromise the integrity of the system.

Submissions to the Review by some segments of the large business community have suggested that the level of uncertainty in the tax system is creating excessive compliance risks. In particular, these submissions have argued that the ATO does not always meet the need for timely, consistent and reliable advice. The ATO has also been criticised for not recognising the commercial impact of its decisions. In particular, these taxpayers argue that the ATO has sometimes undermined certainty by revisiting long-settled interpretations of the law or changing its established administrative practices — the Inspector-General of Taxation is currently reviewing these issues.

A further dynamic is the relationship between the Treasury and the ATO. The Treasury is responsible for advising the government on tax policy and the ATO is responsible for administering the law. However, there is unavoidably a grey area at the boundary between these responsibilities. It is sometimes unclear whether a solution to a problem lies in policy or administration. A lack of transparency and accountability for issues at the boundary means that the tax system is not as responsive as it could be. Before 2002, the ATO was responsible for designing, as well as administering, tax legislation. In 2002, this function was transferred to the Treasury, which already had policy responsibility. This change was made to bring accountability for tax policy and legislative design more directly under ministerial control and to reinforce the need for a whole-of-government perspective in tax law design. While this goal has largely been achieved, some perceive that the change has reduced the ability of ATO to administer the law purposively since it is less intimately involved in the development of tax policy. However, while the Treasury has responsibility for designing the tax laws, in most cases the ATO continues to participate in all stages of the tax policy and legislation design process. The Government formalised this involvement in 2008, deciding that tax measures should be developed by a tri-partite team comprising Treasury, the ATO and the private sector. This arrangement allows the ATO to contribute to, and understand, the policy objective of new laws. Beyond this, the ATO can also consult with the Treasury in forming its view on the interpretation of law. While Treasury views are not determinative, the ATO considers them along with the views of other stakeholders in arriving at a purposive interpretation of the law. However, as these have been treated as confidential communications within the government, the arrangements lack transparency.

Findings

The operation of Australia's tax system is fundamentally sound and there is considerable evidence of general confidence in the system. There is an increasingly open, inclusive and consultative approach to the development of tax policy and legislation and the administration of the system. While there are several ways in which the community can raise problems with the tax system, the best way is sometimes unclear.

The complexity of the current system imposes considerable costs on the community. It has exposed both taxpayers and government to higher levels of risk and uncertainty. This has led to behaviours that add to the cycle of increasing complexity. The level of complexity is such that considerable attention is needed to ensure that the system is operating as intended. There is a need for a process to identify and resolve problems quickly and transparently. There is also a need for greater transparency about the policy objective of the tax laws.

Making the tax system more responsive

Some complexity and uncertainty in a tax system is inevitable. In particular, large business taxpayers that have sophisticated arrangements and that operate in a vibrant globalised economy will always face significant complexity. In these cases, there is a need for a process to identify and resolve the areas of greatest uncertainty quickly.

To stem the growing complexity and uncertainty experienced by large businesses, there needs to be greater collaboration, trust and understanding between them, the Treasury and the ATO. This ultimately depends on the values and behaviours exhibited by both taxpayers and government. While consultation arrangements can help, other institutional reforms may be needed to rebalance the dynamics of the system to support the desired cultural changes. In particular, a more transparent system has the potential to build the confidence needed to support a system where there is less complexity and uncertainty and an increased willingness to accept the risk that does exist.

Recommendation 111:

The government should establish a more transparent means of dealing with community ideas about the tax system by extending the Tax Issues Entry System website and further developing its use.

Recommendation 112:

The government should commit to a principles-based approach to tax law design as a way of addressing the growing volume and complexity of tax legislation, and as a way of helping those laws to be interpreted consistently with their policy objectives.

Recommendation 113:

The Board of Taxation should be empowered to initiate its own reviews of how current tax policies and laws are operating, in consultation with the government. This would be in addition to reviewing matters referred to it by the government, though it should not engage in substantive policy development unless requested by the government.

In giving effect to these changes to the nature and functions of the Board, the government should ensure that the Board has adequate resources (including its own permanent secretariat). The government should also consider:

(a) how to manage the increased workload for the Board, including whether the Board would require further members and/or members who can devote more time to the Board;

(b) whether the Secretary to the Treasury, the Commissioner of Taxation, and the First Parliamentary Counsel should be appointed as advisers to the Board, rather than as members; and

(c) whether the Inspector-General of Taxation, the Auditor-General, the Commonwealth Ombudsman and the Chair of the Tax Practitioners Board should be appointed as advisers to the Board.

Recommendation 114:

Information or advice provided by Treasury to assist the ATO in determining the purpose or object of the law, or materials used by the ATO to determine policy intent (other than correspondence with or from government) should be made public.

A more transparent approach to community ideas for tax changes

The community can already raise ideas for changes to the tax system in number of ways, but there needs to be a more transparent approach to dealing with those ideas. This would increase community understanding of, and participation in, the tax design process.

Greater transparency would be achieved by extending the Tax Issues Entry System website so that it records community suggestions about substantive tax policy issues, as well as minor policy and administrative issues (see Recommendation 111).

This would offer another easy way for people to raise issues with government, but it would not replace the existing avenues. In particular, people could continue to write directly to government raising concerns and suggesting ways to redress those concerns (including making Budget submissions).

A more principles-based approach to designing the tax system

As discussed above, a major source of complexity in the current system is the way policies are designed. Over time, policy objectives have tended to become more sophisticated. Policies have also tended to be changed in isolation, and without a coherent framework for the whole system. This has complicated the tax laws and made tax compliance and administration more difficult.

While policy design needs to place a premium on reducing complexity, this alone is not enough to ensure that taxpayers will experience a more certain system. The way in which the laws are designed, and the administrative approach taken to implementing those laws, also influence the level of complexity experienced by taxpayers.

As one way of addressing the growing volume and complexity of tax legislation and to reduce unintended consequences, the drafting approach used for recent tax legislation reflects a preference for more principles-based rules — which emphasise the policy objective the law is trying to achieve, rather than simply describing the legal mechanisms and concepts for producing that objective.

A principles-based approach to designing the tax laws has the potential to stem the cycle of increasing complexity by building a more stable platform on which to base the system. By making the policy objective of the laws clear, the approach can help the laws to be interpreted consistently with the policy objective and reduce the incidence of unintended consequences. The approach can also produce rules that apply properly to the changing arrangements of taxpayers without the need for constant amendment. In these ways, the principles-based approach can make our tax laws more certain and sustainable in the long-term. The government should continue to pursue a principles-based approach to tax law design (see Recommendation 112).

As noted above, the length and complexity of the tax laws impose considerable costs on the community. All participants in the tax system — taxpayers, government, Parliament and the courts — bear and contribute to these costs. A better understanding of the costs associated with the traditional black-letter approach to designing tax laws (particularly the cumulative long-term costs) will put into perspective the short-term risks and costs of moving to a principles-based approach. The institutional changes recommended elsewhere in this section will improve transparency in the system, which should help support the levels of trust needed to accept the risks of a changed approach.

A ‘circuit breaker’ in the system — an expanded role for the Board of Taxation

Policy and administrative issues need to be resolved in a more timely way to provide taxpayers with greater practical certainty. Independent views of the system help to identify and resolve these issues. To some extent the Australian National Audit Office (ANAO), the Ombudsman, the Joint Committee on Public Accounts and Audit (JCPAA), the Board of Taxation and the Inspector-General of Taxation perform this kind of role in different areas. The Board undertakes tax policy and legislation reviews at the request of the government, though it can also suggest areas of review to the government. The Inspector-General can initiate reviews of systemic tax administration issues. To date, neither the Board nor the

Inspector-General has had a role in initiating reviews of policy and legislation, although the Board does undertake post-implementation reviews if asked by the government.

Box G1-1: Board of Taxation

The Board of Taxation is a non-statutory advisory body that contributes a business and broader community perspective to improving the design and operation of the tax laws. The Board advises the Treasurer on improvements to the general integrity and functioning of the tax system and commissions research on tax matters approved or referred to it by the Treasurer.

The Board comprises ten members, seven of whom have been appointed from the private sector. There are three public sector members — the Secretary to the Treasury, the Commissioner of Taxation and the First Parliamentary Counsel. The Board is supported by a secretariat drawn from the Treasury, the ATO and the private sector. The Board also makes extensive use of consultants from the private sector and academia.

The Board does not make tax policy — that is the responsibility of the government. Similarly, the Board has no authority to direct the Commissioner of Taxation on how to administer the tax laws. Nevertheless, the Board has a wide role in advising the Treasurer on the development, implementation and ongoing operation of the tax laws. In particular, one of the functions of the Board is to conduct post-implementation reviews of legislation to assess its quality and effectiveness in achieving its intended effect.

The Board has made a valuable contribution to improving the tax system. One measure of that success has been the very high rate at which its recommendations have been accepted and implemented by successive governments.

Since its inception in 2000, the Board has produced 16 reports on tax issues that affect individuals, welfare organisations, and small and large businesses. Some of the significant events that have followed the Board's recommendations include: the repeal of over 4,100 pages of inoperative tax law; the reform of international tax arrangements; the establishment of the office of the Inspector-General of Taxation; and the government commitment to consult on substantive tax measures. The Board's advice also informed government decisions not to codify the common law definition of a 'charity', not to proceed with the taxation of trusts as companies, and not to proceed with the tax value method for calculating taxable income.

The Board is well positioned to understand stakeholders' concerns about, and priorities for, the tax system. It has advised the government in the interests of all Australians — it has not acted as a lobby group for special interests, nor has it been a rubber stamp for government proposals. The Board has arrived at its advice and recommendations independently, though it has worked closely with the Treasury and the ATO. These are considerable strengths of the Board, which have supported its achievements to date. The Review considers that the Board could make an even greater contribution if it was given an expanded role. However, this should be done in a way that preserves the features that have made the Board successful in the past.

The Board should be able to initiate its own reviews of lower order tax policy issues, in consultation with the government (see Recommendation 113). In this way, the Board would be positioned to act as a 'circuit breaker' in the system — to quickly identify and propose solutions for lower order policy issues relating to problems experienced by taxpayers given their varying and complex circumstances. However, the Board should not engage in substantive policy development unless requested by the government.

While the Board already can, and does, suggest areas of review to the government, it requires a formal reference from the government. The Board should be expressly permitted to initiate its own reviews, albeit in consultation with the government. Consultation would ensure that the government is aware of the Board's activities and ensure that the Board is conscious of the government's priorities. This would balance the need for a timely review of issues against the desirability that this review is relevant and effective.

This would improve transparency and accountability for issues that remain unresolved due to uncertainty about whether a legislative remedy is required. These delays, and the lack of transparency about their cause and the process for resolving them, can generate considerable uncertainty for taxpayers.

The Board should continue to be an advisory, not a decision-making, body. While it should continue to recognise the government's responsibility for determining policy, it should provide the government with advice about community concerns and priorities for tax policy and legislation.

The Board should not have access to taxpayer information and should not consider the ATO's administrative decisions that relate to specific taxpayers. Nor should the Board audit matters of administrative efficiency or effectiveness, which is a role performed by the Auditor-General.

A focus for the Board should be to examine unintended consequences that arise in the application of tax policy to the varying and complex circumstances of different taxpayers. While a consultative approach to developing policy, law and administration should reduce the incidence of unintended consequences, the complexity of the system makes it inevitable that there will be some. For instance, laws will sometimes be designed or administered in a way that causes unnecessary complexity, uncertainty, compliance costs or inconsistency with the intended policy.

While the Board would not be in a position to direct the government to amend the law, its independent advice would highlight which issues are most important to taxpayers. This would be a valuable input into the government's work program, though it would still need to consider proposals in the context of its overall legislative priorities. The Board would publish its findings and recommendations.

The recommended changes to the nature and focus of the Board would increase the opportunity for taxpayers to voice concerns about the operation of the system. In addition to receiving submissions directly from taxpayers, the Board would be expected to monitor the government's Tax Issues Entry System website (see Recommendation 111). Another source of issues would be those the Board uncovers while reviewing matters referred to it by the government.

It is likely that the community will raise many more issues than the Board can examine, particularly when these are added to the other matters referred to it by the government. In consultation with the community, the Board should develop an annual work program to outline its planned activities for the coming year. While the Board should examine issues that are important to taxpayers, it should focus on areas that are also priorities for the government, so that its advice continues to be relevant and effective.

The government should ensure that the Board is adequately resourced to undertake these additional responsibilities. It might be necessary to appoint further members and/or members who can devote more time to the Board, while ensuring the Board retains its strong links to the business and broader community. The Board should also be resourced to attract and retain a permanent secretariat that can draw from the private and government sectors.

The Board needs to be seen as independent of both the Treasury and the ATO, with its own direct access to the government. The Review of Business Taxation (1999) recommended that the Board be established as a statutory body, though the government of the day decided to establish it as a non-statutory body. Formally establishing the Board by an Act might emphasise its independence, establish a more substantial ongoing status, and make its functions and powers clearer. However, with greater independence comes the risk that the Board might lose some of its ability to work in partnership with the Treasury and the ATO to make constructive suggestions to the government. These are strengths of the current arrangements, which have enabled the Board to have considerable influence. While it is desirable to emphasise the independence of the Board, this should not be at the expense of its relevance and effectiveness. On balance, the Review does not favour establishing the Board as a statutory body.

The Board includes three public sector members — the Secretary to the Treasury, the Commissioner of Taxation, and the First Parliamentary Counsel — though these members are not bound by the Board's recommendations. The government should consider whether these public sector officials should be advisers to the Board, rather than members. This change could reinforce that the Board is independent of the public service, but ensure that the Board is still appropriately connected to the functionary arms of government.

There is some potential for overlap between the Board's expanded role and the review functions currently performed by the Inspector-General of Taxation, the ANAO and the Ombudsman. As one way to ensure that there is no inadvertent duplication of effort, there should be consultation between them. This could be assisted by appointing the Inspector-General, the ANAO and the Ombudsman as advisers to the Board. In addition, appointing the Chair of the newly established Tax Practitioners Board as an adviser to the Board of Taxation could bring a further perspective about the practical operation of the system.

An objective and purposive approach to interpreting tax laws

Taxpayers and practitioners have a legitimate expectation that the advice they receive from the ATO should be accurate and unbiased. Some submissions to the Review have alleged that the ATO's advice is motivated by a pro-revenue bias and that the ATO has inadequate incentive to administer the law consistently with its policy intent. The Inspector-General and the JCPAA have found no objective evidence to support this claim. Further, according to surveys, the ATO's private rulings for large business received a 95 per cent satisfaction rating, with another 2.5 per cent neither satisfied nor dissatisfied. Of the rest, 2 per cent were dissatisfied, and 0.5 per cent very dissatisfied. The ATO's class rulings to large businesses received similarly high ratings, with 91 per cent of respondents satisfied and 9 per cent neither satisfied nor dissatisfied. Nevertheless, some have suggested that the ATO's ruling and revenue-collection roles should be separated.

In Sweden, private binding rulings are given by a body independent of the revenue-collection agency (OECD 2008). This separation differentiates tax collection and legal interpretation and attempts to introduce greater independence in the interpretation of the law. This arrangement came about as a result of criticisms that the revenue collector was not objective and independent. A difficulty with the Swedish system is the delays that applicants experience in receiving ruling decisions, of which there are relatively few (IGT 2008). If a similar system were implemented in Australia, this problem might be overcome with adequate resourcing of the rulings body. The government could redirect some of the ATO's current budget to fund the new agency. If needed, this could be supplemented by charging application fees for more complex rulings.

Of greater concern than potential delays would be the risk that an independent rulings body might reduce the flexibility and responsiveness taxpayers want from the ATO. An independent rulings body would be detached from the practical consequences of its interpretations (because it would not be responsible for either changing the law or for implementing it), and there is the prospect that it would take an overly legalistic approach. While the ATO is sometimes criticised for applying tax laws too literally, it often exercises discretion to help taxpayers comply. Arguably, a more independent body may have less of an appreciation of the impacts of its decisions. To some extent, these institutional incentives could be corrected by having the right governance and accountability arrangements in place. In particular, the rulings body could be established under a charter that sets out an expectation that it should promote voluntary compliance.

While the rulings function could be moved to an independent body, the ATO would still have to interpret the law in order to fulfil its administrative role. In the absence of the ATO's 'in-house' binding rulings regime, taxpayers would have a reduced understanding of the ATO's view of the law and a reduced capacity to bind the ATO to those of its views that were known. Even if the independent body had issued a ruling that bound the ATO, there could be doubt about the ATO's view on whether or not it applied in a given case.

Rather than creating a separate institution to issue tax rulings, the Review Panel considers that the ATO should continue to execute that role in a way that builds community trust in the fairness of its approach. The ATO should continue to bring a practical administrative perspective to the purposive interpretation of tax laws. Greater transparency about the policy objective of the tax laws will support a purposive approach to interpretation. A principles-based design of the law will help make the policy objectives more explicit (see Recommendation 112). Transparency would also be enhanced by publishing information or advice provided by Treasury to assist the ATO in determining the purpose or object of the law, or materials used by the ATO to determine policy intent (see Recommendation 114).

G1-2 An open and accountable tax administration

Principles for an open and accountable tax administration

The tax authority is responsible for decisions that affect millions of taxpayers, often having a direct impact on their financial position. The resources of the tax authority mean that there is a significant imbalance of power between it and most taxpayers, especially individual and small business taxpayers. Disputes between the tax authority and taxpayers are resolved through the tribunals and the courts. However, this is often a costly and time-consuming process, despite improvements such as the small claims division of the Administrative Appeals Tribunal, and alternative dispute resolution mechanisms.

The tax authority should be independent in its administration of the law. This independence is founded on strong equity and integrity arguments — namely, that it would be undesirable for the administration of the tax laws to be influenced by political forces. Although independent, the tax authority performs a critical function of government, which means effective monitoring and scrutiny are essential.

Public confidence in the tax authority is particularly important in a system of self-assessment. This system relies substantially on voluntary compliance, which is more likely to be forthcoming when taxpayers have confidence that the tax authority is administering the law fairly and efficiently.

Principles

The tax authority should be independent in its administration of the tax laws. However, the independence of the tax authority, together with its considerable responsibilities and powers, means that it should have extensive and clear accountabilities, to help ensure that it administers the system fairly and efficiently.

The ATO — its current role and accountability

The role of the ATO

The ATO will recognise its centenary of service to Australia in 2010. It has been part of enormous changes in the tax system over this period. The ATO originated in an era when the design of the tax system was determined largely by the feasibility of basic administration. Over time, the size and sophistication of ATO operations have grown in response to policy changes that expanded the revenue base, as well as seeking to achieve a range of economic and social objectives.

Tax policy goals have become more sophisticated, reflecting the increasing complexity of our society. For example, a growing number of Australian taxpayers now own equity investments, are involved in complicated business structures, and invest or work overseas. Increasing globalisation, e-commerce and financial innovation have also prompted more sophisticated tax rules. As a consequence, the tax laws have needed to become more complex — as noted previously, the income tax laws have grown from 526 pages in 1975 to be almost 6,000 pages in 2009. This complexity makes it hard for taxpayers with more complicated affairs to have the certainty they need to comply with the law.

At the same time, the ATO has assumed a greater role in administering non-tax policies, which themselves have become more complicated to administer. The ATO administered transfers totalling almost $17 billion in 2008–09 — including paying around $8 billion to over 8.5 million taxpayers as part of the Government's economic stimulus package. Even apart from the one-off stimulus package, there has been a significant growth in the payments and transfers administered by the ATO in recent years. The ATO administers transfers to families and individual taxpayers such as the private health insurance offset and superannuation co-contribution payments. It also administers a variety of fuel schemes that affect businesses, and provides industry assistance via the research and development tax offset and large-scale film production tax offset (ATO 2009b). The ATO is one of only a handful of tax administrators in the OECD that also has responsibility for administering student loans and valuations (OECD 2008). The ATO also administers significant aspects of Australia's retirement income systems, as well as the Australian Business Register.

In the course of meeting these demands, the ATO has grown into an organisation of more than 20,000 staff. It is the second-largest government agency, employing around 15 per cent of staff in the Australian Public Service (APSC 2008). The ATO's operating budget for 2008-09 was $3 billion (ATO 2009b).

Globalisation, technological progress and international competitiveness will influence how the system operates in the future and will add to the pressure on the ATO to perform at a high level. Taxpayers will continue to demand more tailored assistance and personalised services from the ATO (see Section G3 Local government). At some point, it might make sense to have a single national body, such as the ATO, collect and administer all the taxes in the federation (see Section G2 State tax reform). Such changes will increase the significance of the ATO, and increase the importance of its accountability and transparency.

Accountability of the ATO

The Commissioner of Taxation has a statutory independence to administer the main federal taxes. Independence means that the Commissioner makes the decisions about how to implement and apply the tax laws. Of course, disputes between the Commissioner and taxpayers are arbitrated through the legal system, with the courts providing authoritative interpretation of tax laws.

The ATO is an agency in the Treasury portfolio. Therefore, Treasury ministers are accountable to the Parliament for the performance of the ATO under the principles of responsible government. However, the Commissioner's statutory independence means ministers have limited involvement in the governance of the ATO. In particular, ministers have no power to direct the Commissioner's administration of the tax laws and exercise limited control over the management of the ATO.

The high-level management of the ATO is the responsibility of the Commissioner, three Second Commissioners and senior executives appointed by the Commissioner who are responsible for finance, operations, information and communications technology and human resources. They are supported by a number of consultative and internal committees that include members drawn from outside the ATO to contribute external perspectives (ATO 2009b).

- The ATO's Audit Committee oversees the internal governance and assurance policies used to monitor and evaluate its internal controls. The committee also ensures that recommendations of external scrutineers are implemented, including those of the Australian National Audit Office, Inspector-General of Taxation and Ombudsman. The committee includes external representatives who bring high-level public and private sector experience and relevant financial expertise.

- The ATO's People Committee supports the ATO Executive on people, culture and integrity issues. The committee includes representation from the Australian Public Service Commission, the Ombudsman's office and private sector companies. Other external advisers attend meetings on invitation.

- The Change Program Steering Committee sets the direction, outcomes and priorities for the ATO's change program. It includes the ATO's information technology consultants and independent assurers.

The ATO also has a number of advisory panels that include external representation, such as the Public Rulings Panel, the General Anti-Avoidance Panel, the new Offshore Voluntary Disclosure Panel and the Wide Settlements Panel. In addition, there is an independent Integrity Advisor reporting to the Commissioner, and a Special Revenue Advisor seconded from the Treasury.

The Commissioner is required by law to report annually to Parliament on the operation of the ATO. The Commissioner also appears before parliamentary committees to explain the ATO's administration of the tax laws. In addition to the normal Senate estimates hearings, the ATO has attended biannual hearings of the JCPAA since 2007 to answer questions about the ATO's administration and to outline its future plans. While many stakeholders support these arrangements, the complexity of the tax system makes it difficult for parliamentarians to examine the operations of the ATO effectively. If Parliament had a better understanding of the difficulties experienced by taxpayers and the ATO it would also be in a better position to critically examine the tax laws it makes.

A number of agencies complement these parliamentary accountabilities by scrutinising different aspects of the Commissioner's work. The Australian National Audit Office conducts financial, performance and business support process audits on the ATO. The Ombudsman and the Inspector-General of Taxation both have review functions, each with differing perspectives but with some potential for overlap.

The Ombudsman's main role is to investigate and resolve taxpayer complaints about the ATO. It sometimes examines systemic administration issues. In 1995, the position of the Taxation Ombudsman was established to give a special focus to the handling of tax complaints. While the Ombudsman is available to assist businesses and individuals equally, in practice mainly individuals and owner-operated small businesses approach the Ombudsman.

The Inspector-General of Taxation reviews systemic tax administration issues. The office was established in 2003 to strengthen the advice given to the government about tax administration. The Inspector-General reports to the government on the way the ATO administers the tax system. Like the Ombudsman, the Inspector-General is able to investigate systemic tax administration issues that affect individuals or businesses. However, the Inspector-General has come to focus his activities on issues that affect mainly businesses, in part reflecting the Ombudsman's focus on individual taxpayer concerns.

The Ombudsman and the Inspector-General liaise with each other to avoid duplicating effort. However, there remains the potential for taxpayers to be confused about which body is the appropriate one to deal with a complaint about the ATO.

When compared with the resources of the ATO (more than 20,000 staff and an annual budget of around $3 billion), the resources committed to review the ATO by the Ombudsman and the Inspector-General are not substantial. The Ombudsman had an annual budget of around $20 million in 2008–09 and employed 152 staff, though this was to investigate all Commonwealth agencies, not just the ATO. In 2008–09, 1,422 complaints (7 per cent of all complaints) to the Ombudsman related to the ATO (Ombudsman 2009). The Inspector-General had an annual budget of around $2.2 million in 2008–09 and employed seven staff. During 2008–09, the Inspector-General completed four reviews and, as at the end June 2009, had five reviews under way (IGT 2009).

In the United States, relatively more funding is directed to the scrutiny of the Inland Revenue Service (IRS). The IRS has around 90,000 staff (IRS 2009) and is subject to scrutiny by the National Taxpayer Advocate, which has about 1,150 case advocates (NTA 2009). However, there are a number of explanations for this apparent disparity between Australia and the United States. To a great extent it reflects the more proactive role of the Taxpayer Advocate, especially in representing the interests of individual taxpayers in disputes with the IRS. In other comparable countries, such as the United Kingdom, the resources dedicated to scrutiny of the tax administration are similar to that in Australia.

Findings

Over the nearly 100 years of its existence, the ATO has assumed considerable responsibilities and powers. It has grown to become a large and modern organisation. Throughout this evolution it has recognised the value of engaging external perspectives into its management. The need for this expertise is likely to become greater as the ATO faces a range of future challenges.

The ATO is scrutinised by many bodies, including the Parliament, the Commonwealth Ombudsman, the ANAO and the Inspector-General of Taxation. However, the effectiveness of this scrutiny is dependent to some extent on the resources and other responsibilities of these institutions.

While the Ombudsman and the Inspector-General of Taxation perform valuable roles, they would be more effective if their roles were clarified to remove the potential for overlap between them.

While the Commissioner of Taxation is ultimately accountable to Parliament, the complexity of the tax system makes it difficult for parliamentarians to perform an active role in the cycle of public accountability of the ATO.

Independent surveys continue to find that Australians have a high level of confidence in the ATO. This was recognised by the JCPAA in its recent extensive review of the ATO.

Improving the accountability of the ATO

Recommendation 115:

A board should be established to advise the Commissioner of Taxation on the general organisation and management of the ATO. The board would not be a decision-making body and would have no role in interpreting the tax laws or examining individual taxpayer issues. The government would appoint members to the board.

Recommendation 116:

The government should clarify that the role of the Inspector-General of Taxation is to examine systemic tax administration issues that affect businesses.

Recommendation 117:

The government should ensure that sufficient resources are devoted to the functions of the Inspector-General of Taxation, the Australian National Audit Office and the Commonwealth Ombudsman, recognising their importance in maintaining a fair and efficient tax system.

Recommendation 118:

The Joint Committee of Public Accounts and Audit should examine reports of the Inspector-General of Taxation and the Commonwealth Ombudsman, and monitor the ATO's implementation of the recommendations in those reports.

An advisory board for the ATO

The independence of the ATO, together with its very significant powers and responsibilities, means that it should be subject to very high levels of public accountability and transparency. While the independence of the Commissioner needs to be preserved, governance arrangements need to strike a balance between maintaining that independence and getting the best performance from the ATO.

In the course of its consultations, the Review heard suggestions that the ATO should be overseen by a board of directors drawn from the wider community. These submissions pointed out that the revenue authorities in Canada, the United Kingdom and the United States are overseen by boards that include representatives with backgrounds outside the bureaucracy. A key function for these oversight boards is to inject a range of experience and perspectives into the management of those tax authorities. In line with this objective, all of these boards have a role in developing corporate strategies and plans. Significantly, though, none of them are involved in the interpretation of the tax laws or in the affairs of particular taxpayers. This limitation preserves the independence of the tax administrators in relation to the application of the tax laws. In the United States, the IRS oversight board was established in response to a general crisis of taxpayer confidence in tax administration (US Congress 1997). This is not the situation in Australia, where the vast majority of taxpayers are satisfied with the performance and approach of the ATO.

The suggestions for an oversight board also draw on the experience of governance arrangements in the private sector. Private sector models can provide some insights about appropriate arrangements for the public sector, but significant limitations apply in the public sector context. These considerations were canvassed in the 2003 Uhrig review of the corporate governance of public sector authorities which found that executive management, rather than a board of management, is likely to be the most effective governance arrangement for an organisation that essentially delivers government services (Uhrig 2003). The Uhrig review found that the presence of an oversight board often obscured the accountability of a statutory authority to a minister. These were considerations in the government decision in 2005 to wind up the governing boards of Medicare Australia and Centrelink and to introduce executive management.

While the ATO is not subject to the same day-to-day ministerial direction and control as many other government agencies, it is subject to many other accountabilities and lines of reporting. The Commissioner also has very specific personal responsibilities under the tax laws and other laws such as the *Financial Management and Accountability Act 1997* and the *Public Service Act 1999*. The Review does not consider it appropriate to disturb these existing accountabilities and has concluded that the ATO should continue to be led by the Commissioner as an executive manager directly accountable for the performance of the organisation.

However, the Uhrig review found that the accountabilities of a statutory authority could accommodate an advisory board that advises the chief executive in a non-binding manner. This Review considers that such an advisory board should be established for the ATO (see Recommendation 115). This would usefully add to, formalise and elevate the existing consultative arrangements that support the Commissioner's management of the ATO — such as the participation of externals in the ATO's Audit Committee, People Committee and Change Program Steering Committee. This should not be seen as a criticism of the current management of the ATO. Rather, the Review's aim is to put the ATO in the best possible position to meet the significant challenges of the future. Though the current management arrangements have served the system well in the past, the pace and significance of changes to the ATO's work mean that it could benefit from additional management arrangements that offer an even greater range of expertise and perspectives.

The creation of an advisory board would increase the ability of the ATO to benefit from external experiences and perspectives. The discipline of a regular external review of the ATO's corporate reports and plans, in addition to that already carried out by the JCPAA, would also ensure the ATO is suitably focused on the strategic challenges of the future. It would also contribute to a more open and transparent environment, which would promote greater trust and confidence in the operation of the system.

Responsibilities of the ATO advisory board

The advisory board would not be involved in the interpretation of the tax laws or in the affairs of particular taxpayers. This limitation would preserve the Commissioner's independence in relation to the administration of the tax laws.

The advisory board would provide the ATO with more high-level strategic advice and apply private-sector experience and expertise to improve the ATO's performance. It should also review the ATO's management practices to ensure the highest standards of corporate governance continue to be maintained. It would bring an additional diversity to the mix of expertise, experience and skills available to the ATO, including in areas such as information technology, human resources, finance and communication.

The board would not be a decision-making body and is intended to assist the Commissioner to exercise his existing role, rather than to interfere with the Commissioner's responsibility for running the ATO. While ultimate responsibility would remain with the Commissioner, the role of the advisory board would be to advise the Commissioner about the general organisation and management of the ATO, including advising on the ATO's:

- strategic plans;
- financial performance and budget;
- corporate values;
- human resources strategies; and
- management of significant resources and contracts.

The advisory board would complement the executive management arrangements that already exist in the ATO. As noted above, the ATO Executive is currently supported by many committees and forums that include external representatives. The advisory board would bring together other external representatives into another body. This board would provide advice to the ATO Executive, drawing on the information generated by the ATO's management committees. For instance, the advisory board could be expected to complement the ATO's People Committee in advising the Commissioner on strategies to increase the diversity of skills and experiences held in the ATO.

The advisory board will add to the JCPAA's review of the ATO's governance reports and corporate plans. However, whereas the JCPAA meets the Commissioner twice a year, the advisory board would be a standing source of advice for the Commissioner.

Composition of the ATO advisory board

The size of the advisory board would need to take into account the size and complexity of the ATO's operations and the board's proposed role. A board of between six and nine members would be consistent with current thinking about the most effective number of members for boards (Uhrig 2003). However, over time the size of the board might change in line with changes in the responsibilities of the board and of the ATO.

In line with the responsibilities of the board, the government should appoint members with regard to the need for the board to have practical expertise in finance, information and communications technology, and human resources. Of course, the ATO should continue to access these skills and experience through other avenues as it does now, although over time it might look to rationalise these in the context of new arrangements. Board members would not be selected to represent the interests of particular organisations or interests and would not necessarily be tax experts. Instead, the government should select board members according to their personal ability to contribute to the good management and organisation of the ATO.

As noted above, the ATO could have a greater role in administering State taxes in the future (see Section G2 State tax reform). If so, it might be appropriate for the States to have a closer relationship with the ATO. One way to achieve this would be to give the States a role in the selection of some advisory board members.

Clarifying the roles of the Ombudsman and the Inspector-General of Taxation

As outlined above, the responsibilities of the Commonwealth Ombudsman, the ANAO, the JCPAA and the Inspector-General of Taxation overlap considerably. This has the potential to cause confusion and uncertainty and to involve a wasteful duplication of effort.

One approach to this problem would be to merge the tax investigation functions of the Ombudsman and the Inspector-General into one organisation, and limiting the scope of scrutineers, including the ANAO and the JCPAA, from reviewing matters otherwise covered. Potentially, this would provide a more complete overview of the issues faced by taxpayers in their dealings with the tax system. In particular, it would improve the ability of the organisation to identify systemic issues arising from individual taxpayer complaints. This could help to resolve problems before they impact on many taxpayers. Taxpayers could also benefit by being able to seek assistance on tax administration issues from a single agency. Finally, there might be modest administrative efficiencies in amalgamating the two functions into one agency, and in reducing the impact on the ATO of overlapping scrutiny.

Having the Ombudsman perform the Inspector-General's role would involve the Ombudsman reporting to Treasury ministers on tax administration issues as well as generally reporting to the Parliament. Some taxpayers may see this as reducing the Ombudsman's independence. Another potential concern is that resources intended for the review of systemic issues might be diverted to addressing individual taxpayer complaints.

Another option is that the Ombudsman's responsibilities for investigating tax issues could be performed by the Inspector-General. However, this might lead to confusion since it would mean tax complaints are dealt with differently from complaints against other government agencies. Importantly, such a change would remove the ability of the Ombudsman to apply the lessons learnt from investigations of other areas of government administration to tax issues (and vice versa), which is a significant advantage of the current arrangements. Another consideration is whether transferring the complaint-handling function to an Inspector-General within the Treasury portfolio may result in a perceived loss of independence in reviewing taxpayer complaints. A final consideration is whether tax administration issues would have a sufficient profile within an Ombudsman's office that is responsible for reviewing complaints against all government agencies, but which has a specific role of Taxation Ombudsman focusing on the ATO. The separate office of the Inspector-General has established a strong profile with taxpayers, especially within the large business community. It has allowed for a specific focus on tax administration issues and encouraged regular interaction with taxpayers, tax professionals and the community.

So, there are considerable advantages to maintaining the separate offices and roles of the Ombudsman and the Inspector-General of Taxation. However, as noted above, both have a role in examining systemic tax administration issues and there is a need to clarify these responsibilities to reduce the risk of overlap. Much of the potential for overlap could be removed by directing the Inspector-General to investigate systemic tax administration issues that affect businesses (see Recommendation 116). This would formalise the current practice, an arrangement that has developed through consultation between the Ombudsman and Inspector-General, and in response to the business community's concerns with systemic tax administration issues. Similar arrangements could apply to address the potential duplication arising from reviews by the ANAO and the JCPAA.

Resourcing the Ombudsman, the ANAO and the Inspector-General of Taxation

It is imperative that the Ombudsman, the ANAO and the Inspector-General are sufficiently resourced to adequately perform their important roles.

It is not clear whether there is an unmet demand for reviewing tax administration issues in Australia. In relation to taxpayer complaints, there has been a downward trend in recent years, which the Ombudsman attributes to the ATO's improved handling of complaints and efforts to improve dealings with taxpayers. In relation to systemic reviews, the Inspector-General appears to have met community expectations for the number, scope and detail of investigations. However, these are important matters and the government should examine the resource needs of the Ombudsman, the ANAO and the Inspector-General in more detail to ensure that they are able to perform their roles effectively (see Recommendation 117).

Improving accountability to the Parliament

As noted above, the ATO is ultimately accountable to Parliament. The Review has not sought to disturb these accountabilities, but considers that improvements can be made to make Parliament more effective in holding the Commissioner to account for the performance of the ATO.

An important way in which Parliament operates is through its committees. The JCPAA holds Australian government agencies to account for the lawfulness, efficiency and effectiveness of their operations. In 2008, the committee concluded a major review into the operation of the tax system. Following that report, the ATO has attended biannual hearings of the JCPAA and provided it with a significant range of performance information. The Review has considered ways in which the JCPAA might provide more active oversight of the ATO on behalf of the Parliament.

Some submissions to the Review have expressed concerns that the ATO is not sufficiently accountable for its responses to recommendations of the Inspector-General of Taxation and the Ombudsman. These submissions suggested there should be a power to compel the Commissioner to accept and implement these recommendations. However, the Review does not consider it appropriate for these recommendations to be binding on the ATO, which is ultimately responsible for the administration of the tax laws. Nor is it appropriate that these recommendations be binding on the Treasury or the government.

Instead, the Review considers that the JCPAA should take a role in monitoring the ATO's actions on these recommendations (see Recommendation 118). This would be similar to the role the JCPAA currently performs in examining government responses to reports of the Auditor-General. Like the Auditor-General, the Inspector-General and the Ombudsman perform roles for which Parliament itself is not well suited. The Inspector-General and the Ombudsman have the expertise needed to assess whether the ATO is administering the law in a fair and reasonable way. In reviewing the reports of the Inspector-General and the Ombudsman, the JCPAA could require the ATO to explain whether it has implemented the recommendations made in those reports and its reasons for disagreeing with any of those recommendations.

The JCPAA's primary purpose in reviewing these reports would be to assess whether the ATO has responded appropriately to those reports. In most cases the JCPAA would be expected to avoid going over issues covered during the Inspector-General's and the Ombudsman's inquiries and would focus instead on any disputed issues and on whether the ATO has acted on its responses to the recommendations.

G2. State tax reform

Key points

The States need to have revenue to fund their expenditure and should have autonomy over how some of this revenue is raised. Because of factor mobility across States and the desire to have a less complex tax system across the federation, some taxes are more appropriately assigned to the States than others.

Although the States currently have access to significant taxes, there are problems with either the quality of these taxes or the way they are levied. Increasing the rates of tax on existing State taxes would not be a sustainable way of funding services in the future.

The States would be better placed to meet cost pressures in the future if they received the revenue from a broad-based cash flow tax. This could fund the abolition of a number of State taxes. The States could also raise some revenue from tax base sharing of the personal income tax, with the Australian government keeping a share of the consumption tax revenue.

Reforms to State taxes should be implemented over time through an intergovernmental agreement to allow for revenue stability as taxes are reformed and to facilitate good policy outcomes across the federation.

G2-1 Principles for assigning tax responsibility in a federal system

The tax system spans the three levels of government in Australia — the Australian government, State governments and local governments. Individual governments separately administer their own taxes, but there is much interaction between the policy objectives and the administration of taxes levied by different governments.

Improving the structure of the tax system should begin with recognising that the wellbeing of the Australian people is affected by the taxes of the entire federation. A poorly performing tax affects people no matter which government is responsible for it. People also respond in their work and savings decisions to taxes as a whole, regardless of which level of government administers them. For example, the States' payroll taxes and the Australian government's personal income tax both affect the post-tax wages available to workers, which in turn impact on workforce participation decisions.

In this respect, recommendations for the design of a future system have been based, in the first instance, on the quality of particular taxes. The assignment of tax responsibility to a particular level of government is then a secondary, but important, consideration. The role of the States in the tax system and the implications of reform directions for State taxes are discussed in this section.

It is worth noting that many issues within the federation relate to governments' spending and other responsibilities and the way different levels of government deliver services. While these issues are largely beyond the Review's terms of reference, reforms to taxes across the federation can also provide a platform for future reforms that seek to improve the performance of governments more broadly.

The role of different levels of government in the tax system

For a number of reasons, including history, institutional arrangements and differences in the size and scope of their operations, the different levels of government in Australia raise tax revenue in different ways. Both the way that governments raise taxes and the proportion of tax revenue raised by each level of government have changed significantly since federation. They will inevitably change in the future as well, as each level of government will be affected by the drivers of change in different ways. Three of these drivers — increasing mobility of economic resources, demographic change and technology — are particularly relevant when considering the future roles of each level of government in the tax system.

- Increasing mobility of productive resources, particularly the mobility of capital, will tend to favour tax systems with lighter taxation of mobile factors and fewer complex or unpredictable taxes levied on business. Factor mobility is generally higher within a country than between countries. This calls into question the capacity of sub-national governments to raise revenue from taxes that fall on highly mobile factors.

- Demographic change will affect different tax bases and types of government expenditure in different ways. Given the current allocation of tax and expenditure responsibilities in Australia, governments will face fiscal pressures at different times. Population ageing means that taxes (and transfers) will need to be designed to encourage workforce participation and to not impede people moving around Australia to work where they are most productive.

- Technological change will provide opportunities for governments at all levels to finance expenditures in different ways. For example, technology may allow roads to be more efficiently priced from direct charging (see Section E3 Road transport taxes).

Although Australia will retain its three levels of government, at least for the foreseeable future, there will likely be changes in their roles and responsibilities. It is therefore difficult to be definitive about tax assignment in the federation: as circumstances change, the ideal allocation of taxes to levels of government may also change. However, principles can be developed to help define the role of different levels of government in the tax system; that is, how much revenue they should raise and the type of taxes they should levy. Further, institutions can be set up to allow flexibility in these arrangements so that governments can adapt more easily to changing circumstances.

The amount of tax revenue for each level of government

Traditional fiscal federalism theory provides two benchmark models for how much taxing power should be available to each level of government in a federation. Musgrave (1959) and Oates (1972) argue that national governments are better placed to raise most taxes as sub-national taxation of potentially mobile factors tends to be distorting. Under this benchmark, the tax system in a federation would be largely centralised, even if sub-national governments have significant expenditure responsibilities. In contrast, Tiebout (1956) suggests a greater role for sub-national governments in the tax system. His view rests on the assumption that competition for mobile taxpayers ensures that each sub-national government will offer residents their preferred mix of taxes and government services.

In practice, these benchmarks are not found in a pure form. A comparison of federations reveals diversity in how much taxing power is given to sub-national governments relative to their expenditure responsibilities. As Bird and Smart (2009) note after comparing a number of developed federal countries, neither standard fiscal federalism theory nor the differing economic circumstances of different countries appears to offer a ready explanation for the substantial differences observable in the level and structure of State finances in different federations. They argue that this is because federations are largely a product of their history, rather than a desire to structure the tax system according to a particular model. In Australia's case, these historical factors include how the federation was set up (that is, the powers that the Constitution gave to different levels of government) and the way that Australian governments have responded to various crises, events and long-term pressures since federation.[1]

It is clear, however, that because of the practical difficulty of exactly matching revenue and expenditure at each level of government, all federations operate with some degree of 'vertical fiscal imbalance'. In the overwhelming majority of cases, it is the national government that collects more revenue than it spends. Usually this is due to the desire to have a more centrally coordinated tax system combined with decentralised provision of government services. Vertical fiscal imbalance has existed in Australia since federation, although the level has changed over time.[2]

More recent theory on fiscal federalism has focused less on benchmark models and more on the incentives and institutions that would best serve federal systems. In summarising the recent theory of fiscal federalism, Oates (2005) notes that the challenge for federations is:

> one of determining the kinds of institutions that can accommodate fiscal decentralisation so as to realise the political advantages and economic gains from local control, while avoiding the potentially distorting and destabilizing effects that can result from soft budget constraints.

Under a 'soft budget constraint', a government can receive additional revenue without being accountable for how that revenue is raised. This can occur when a sub-national government is provided with additional grants from the national government, or when a national government withdraws grants to a sub-national government, to fill a revenue gap that, for example, has arisen due to poor fiscal planning. If a government is not accountable for the revenue it raises, it may not face the full cost of how it spends revenue and may have less incentive to be disciplined in how it spends that revenue.

A sub-national government could, in theory, face a hard budget constraint without raising any of its own revenue if there was a fixed agreement with the national government about the amount of revenue it received. In practice, such an arrangement would not be sustainable

1 The most notable example of this was during the Second World War when the Australian government assumed control of income tax (in exchange for grants to the States) to finance and coordinate the war effort.

2 See Chart 10.5 in the Australia's Future Tax System Architecture Paper.

or desirable as it would deny sub-national governments flexibility to make spending decisions. A better way to ensure that sub-national governments face hard budget constraints, while allowing them the flexibility to change the amount of revenue they receive, is for sub-national governments to have access to taxes they can increase (or decrease) to finance spending decisions. Bird and Smart (2009) note that a government will face a hard budget constraint if it is able to increase or decrease spending only by increasing or decreasing its revenue in such a way that it is publicly responsible for the consequences of its actions. In other words, if a government chooses to spend extra money on a particular program, that government must raise the revenue required to fund that program rather than burden another level of government and it needs to be clear to people they are paying tax to fund the extra spending.

This does not necessarily mean, however, that sub-national governments have to fund all their spending from their own taxes. In a developed federation, it can be expected that there is some base level of goods and services that all sub-national governments will provide and that requires a commensurate amount of revenue. This revenue can be provided by the national government. Because of differences in preferences between jurisdictions, individual sub-national governments will want to provide different sets of goods and services. So that they can meet the preferences of their citizens, sub-national governments should have the capacity to raise tax revenue to fund significant marginal expenditure beyond the base level.

In applying this principle to the Australian federation, the question becomes how much of their own tax revenue State governments need in order to fund significant marginal expenditures. To a large degree, this is dependent on their expenditure responsibilities — both in terms of size (their total amount of expenditure) and nature (how different types of expenditure change over time). It is also a question that cannot be answered with a great deal of precision, as significant marginal expenditure is difficult to quantify. A general principle, however, is that as long as State governments have significant expenditure responsibilities, they should have access to significant and sustainable tax revenue. Furthermore, to enforce a hard budget constraint, they should also have some autonomy over (and responsibility for) the amount of revenue they raise.

Principle

The assignment of tax responsibility in a federation should take into account the revenue needs of each level of government. Each level of government should have access to tax revenue it can use to finance significant marginal expenditure decisions.

The type of taxes each level of government should levy

Because of differences in their size and their interaction with each other, different levels of government in a federation may have more or less capacity to raise revenue from a given tax on a sustainable basis. For example, it is unlikely that local governments in Australia could raise revenue sustainably from company income taxes as it would be relatively easy for businesses to move to a different local government area where they paid a lower amount of tax. All local governments would then have an incentive to keep lowering their taxes, either by lowering their tax rates or providing concessions to specific businesses. The likely end result is that they would not raise enough revenue to fund their expenditures.

Principles of tax assignment have been developed with the aim of ensuring that each level of government has access to a sustainable tax base while maintaining the coherence of the whole tax system. Principles developed by Musgrave (1983) suggest that if tax bases are highly mobile or distributed unequally across sub-national jurisdictions, they should be levied by national governments. Further, if taxes are used for redistribution or macroeconomic stabilisation, they should be levied by the national government, as it is better placed to coordinate these functions. These principles then suggest that appropriate tax bases for sub-national governments are ones that are immobile, are more equally distributed across jurisdictions and have limited inter-jurisdictional interaction.

The nature of a government's expenditure responsibilities may also be relevant to the question of tax assignment. For example, Warren (2006) includes in his benchmarks for tax assignment the principle that tax revenues should be able to expand in line with expenditure. That is, if a government has expenditure responsibilities that are expected to grow over time, then this expenditure should be financed from a tax base that is expected to grow.

While assignment rules are relevant to all federations, they will result in different outcomes in different federations. This is because federations are structured differently to begin with. There may be constitutional restrictions, as there are in Australia, on the taxes that different levels of government can levy. Further, the size of sub-national governments and the preferences of their citizens will influence the mobility of productive resources between them.

Principle

To the extent that there is a choice about the assignment of taxes in the federation, the Australian government should have control of taxes with more mobile tax bases and taxes used for redistribution and macroeconomic stabilisation. The States should have control of taxes on more immobile bases.

Own-source taxation is not the only way that sub-national governments can raise revenue autonomously. Autonomy is dependent on the extent to which governments can change the tax base and the tax rate. For tax bases that are more mobile between jurisdictions, the tax base may be more sustainable if it was uniform across all jurisdictions and not able to be changed by any individual government, as governments would not be placed under pressure to introduce tax exemptions or concessions. Revenue autonomy could still be achieved by allowing individual governments to change the rate of tax they apply to the uniform tax base.

Governments in a federation can coordinate in a number of different ways to raise tax revenue, including:

- Individual governments may choose to apply a similar policy, or the same policy, as applies in other jurisdictions. For example, in recent years, a number of Australian States have harmonised most aspects of their payroll tax legislation.

- Governments at one level may arrange for a higher level of government to undertake the collection and administration of a particular tax on their behalf (this would be easier if the tax base was uniform across the lower level of government).

- Tax base sharing arrangements can involve two (or more) levels of government taxing the same base. Each jurisdiction can set its own rate and receive the revenue raised in, or derived from, that jurisdiction. Tax base sharing arrangements are used in a number of federations. For example, in Canada, all provinces (except for Quebec) have a base sharing agreement with the federal government for personal income tax that allows them to set their own rates and thresholds that apply in addition to the federal rates and thresholds. Tax collection agreements enable federal and provincial taxes to be administered centrally with the relevant revenues provided to provinces. Individuals need to file only one set of tax forms each year covering their federal and provincial tax.

To the extent that these arrangements provide the States with revenue from broader based taxes, they can also help the States avoid using less efficient and less equitable taxes.

Principle

Tax base sharing or centrally administered State taxes can provide the States with the capacity to raise revenue sustainably and with some autonomy.

Implementing the principles outlined above may come at the expense of other principles for the tax system as a whole. For example, if there is a tax that individual sub-national governments have full control over (that is, they can adjust the tax base and the tax rate) and they can raise tax revenue from this sustainably, the fact that the same tax is levied by different governments may create complexity for businesses that operate in different jurisdictions.

Taxes that are harmonised across jurisdictions and cannot be changed by an individual government may avoid this complexity. However, locking in the tax base may reduce the flexibility needed for policy to adjust to changing circumstances. For example, a change to the tax base may be necessary to ensure that a new type of good, service or transaction (which was not envisaged when the tax base was designed) is treated consistently. If institutional arrangements do not allow changes to be made easily, inconsistencies may accumulate and the efficiency of the tax may be impaired.

Principle

The assignment of tax responsibility should take into account how different arrangements affect the complexity of the tax system and its capacity to respond to changing circumstances.

Intergovernmental grants

If a government is to face a hard budget constraint, it must have access to taxes it has the autonomy to increase (or decrease) to finance its spending decisions. Sub-national governments are also likely to receive intergovernmental grants. It is important that these grants are provided in such a way that they maintain the need for sub-national governments to rely on their own taxes to finance their marginal expenditure decisions. If intergovernmental grants are excessive, then sub-national governments may use them as substitutes for raising their own tax revenue.

A particular issue associated with intergovernmental grants is the bailout problem. The national government may have a tendency to provide higher grants to sub-national governments facing difficult financial circumstances. While such grants provide a form of insurance, they can also create a moral hazard problem — that is, if governments know they will be bailed out, they have less incentive to exercise fiscal discipline (Inman 2003).

Intergovernmental grants will support a hard budget constraint if they are transparent; that is, if people can understand how much grant money is received and under what conditions. Grants should also not be subject to discretionary change in a way that allows sub-national governments to seek additional ad hoc funding.

These conditions are also relevant to ensure that the national government maintains a hard budget constraint. If a national government exercises poor fiscal planning, it may seek extra revenue through withholding previously agreed grants to sub-national governments. If intergovernmental grants cannot be subject to discretionary change, national governments could be restricted from withholding grants.

A revenue-sharing arrangement, under which sub-national governments share a fixed proportion of the revenue from a tax over which the national government has policy control, is consistent with these requirements. Such revenue effectively becomes 'infra-marginal'; that is, it has little bearing on sub-national governments' ability to deliver marginal services. Revenue-sharing arrangements can make clear exactly what sub-national governments are receiving. Further, because the revenue sub-national governments receive cannot exceed its share of what is being raised, if the share amount is adhered to the amount of revenue cannot be subject to grant seeking (or cutting) behaviour.

The revenue from a revenue-sharing arrangement could be distributed to sub-national governments in a number of ways. For some taxes it would be possible for revenue to be returned to the jurisdiction in which it was generated. This would provide sub-national governments with greater ownership over the revenue they receive. However, for other taxes, there are practical difficulties in determining the jurisdiction where the revenue was generated and distributing the revenue on a derivation basis is not possible. For example, for a business that operates in a number of jurisdictions, it may be difficult to determine where profits, and hence company income tax revenues, are generated. In such cases, alternatives for distributing revenue include allocating on the basis of population share or weighting revenue shares based on the relative fiscal capacities of sub-national governments.

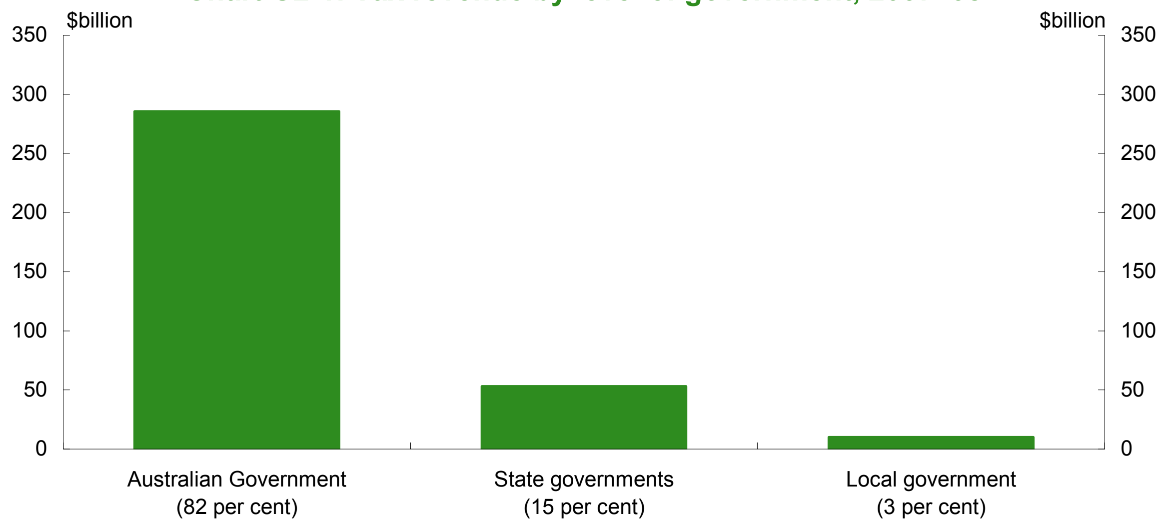
Principle

To ensure that governments face a hard budget constraint, any intergovernmental grants should be transparent and not easily subject to discretionary changes.

G2-2 Current State taxes are not well placed to fund services in the future

The Australian tax system is highly centralised. Chart G2-1 shows that in 2007–08, 82 per cent of total tax revenue was raised by the Australian government.

Chart G2-1: Tax revenue by level of government, 2007–08



Source: ABS 2009, *Taxation Revenue, Australia, 2007–08*, cat. no. 5506.0, ABS, Canberra.

The Australian government raises the majority of tax revenue in the federation and levies the largest taxes: personal income tax, company income tax, the goods and services tax (GST) and excises. To some degree, this accords with the principles for tax assignment: the company tax base is relatively more mobile while the personal income tax base is used for redistribution.

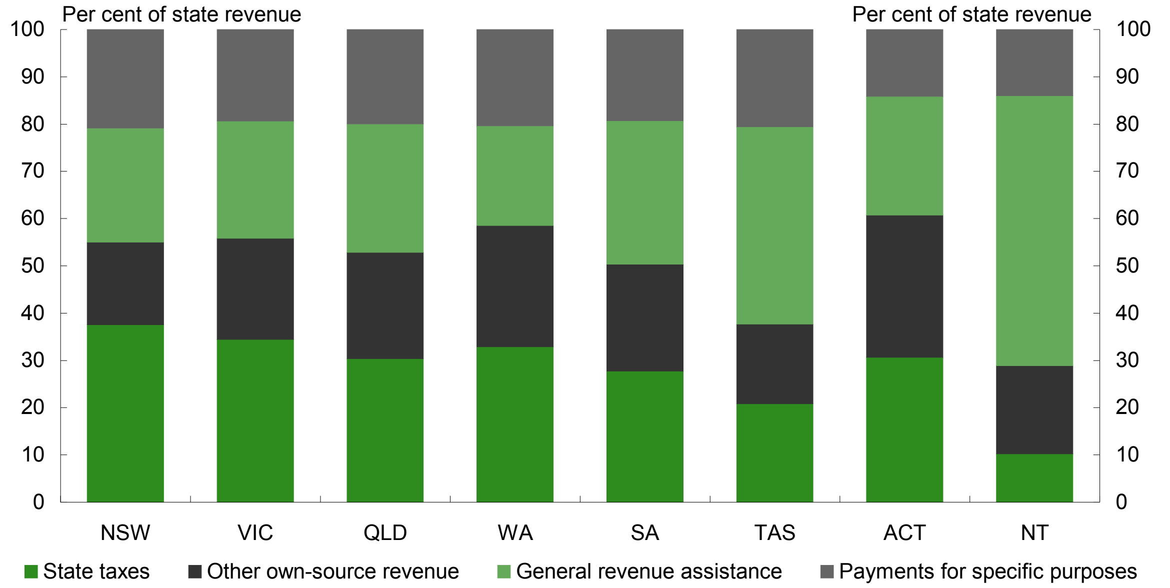
The high degree of centralisation in the Australian federation is also a function of the Constitution. In relation to taxing powers, the Constitution prohibits the States from imposing certain taxes, including:

- customs and excise duties under section 90;
- taxes that conflict with the provision in section 92 that 'trade, commerce and intercourse among the States … shall be absolutely free'; and
- taxes on Commonwealth government property under section 114.

While section 90 provides the Commonwealth with exclusive power to impose customs and excise duties, it does not clearly define what these are. Successive High Court interpretations of the Constitution have restricted the States from imposing taxes on the production, manufacture, sale or distribution of goods. Australia's broad-based consumption tax — the GST — is therefore levied by the Australian government, although under present arrangements, all the revenue from the GST is distributed to the States under the principle of horizontal fiscal equalisation.[3]

In 2007–08 the States raised $53.1 billion in tax revenue, which comprised around one-third of their revenue. A significant proportion (46 per cent in 2007–08) of the States' total revenue comes from the Australian government as either general revenue assistance (primarily GST revenue) or payments for specific purposes. As Chart G2-2 shows, the proportion of revenue that each State receives from the Australian government ranges from 39 per cent for the ACT to 71 per cent for the NT.

Chart G2-2: Sources of State revenue, 2007–08



Source: ABS 2009, *Taxation Revenue, Australia, 2007–08*, cat. no. 5506.0, ABS, Canberra; Australian Government 2008b, *Final Budget Outcome 2007–08*, Australian Government, Canberra; ABS 2009, *Government Finance Statistics, Australia, 2007-08*, cat. no. 5512.0, ABS, Canberra.

The main sources of State tax revenue are payroll tax, conveyance duty and land tax, as well as taxes on motor vehicles, gambling and insurance contracts. In total, the States levy around 25 different types of taxes. While there are similarities in the main taxes used in each State, the thresholds, rates and range of exemptions often differ between States. As Chart G2-3 shows, there is variation in how much each State relies on different taxes, reflecting differences in revenue-raising capacities as well as differences in policy.

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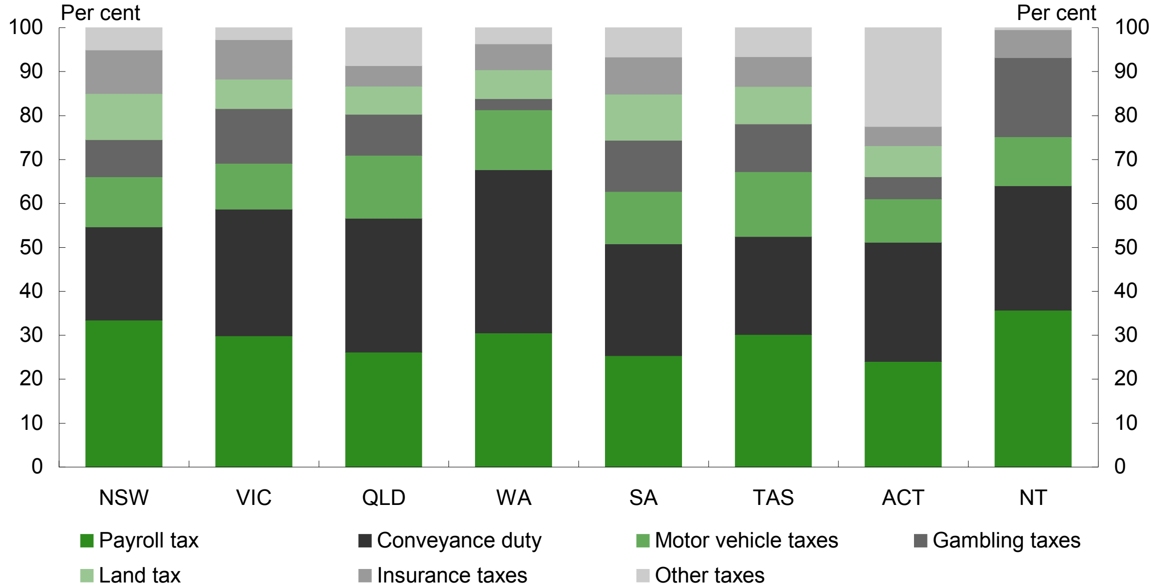
3 Horizontal fiscal equalisation has been defined as follows: 'State governments should receive funding from the Commonwealth such that, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency, each would have the capacity to provide services at the same standards.' (Commonwealth Grants Commission 2002 p. 5)

Chart G2-3: Sources of State tax revenue by State, 2007–08



Note: As the ACT does not have local councils, 'Other taxes' for the ACT includes revenue from rates (around 15 per cent of their total revenue).
Source: ABS 2009, *Taxation Revenue, Australia, 2007–08*, cat. no. 5506.0, ABS, Canberra.

The States are facing increasing cost pressures

The suitability of current State taxes is closely related to how well they can contribute to the funding of future expenditure. As noted in Section G2-1, demographic change will affect different tax bases and types of government expenditure in different ways. In the only comprehensive assessment of the fiscal pressures facing both Australian and State governments, the Productivity Commission (2005) estimated that in the absence of policy responses, expenditure for all levels of government in Australia would increase by 6.5 percentage points of GDP between 2003–04 and 2044–45, resulting in a fiscal gap of around 6.4 per cent of GDP by 2044–45.

While the Productivity Commission's base case found that the States would bear a relatively small increase in cost pressures (0.8 percentage points of GDP), this was predicated on the assumption that specific purpose payments (SPPs) to the States grew in line with service needs. Under the alternative assumption that SPPs grow in real per capita terms, the gap the States face would be over three times as large (2.3 percentage points of GDP). Given that the States' own tax revenues currently account for around 4.3 per cent of GDP, these cost pressures are significant.

Narrow-based and complex State taxes hamper revenue sustainability

Assuming no change in expenditure responsibilities between levels of government, the States will need better access to sustainable tax revenues to deal with these cost pressures. Although the States currently have access to some significant taxes, the analysis of individual State taxes (or groups of taxes) throughout this report has shown that there are many problems with current State taxes.

Narrow-based taxes are not desirable

A significant proportion of State tax revenue comes from stamp duties, which are narrowly based transaction taxes on the value of conveyances, insurance contracts, motor vehicles (on the transfer of ownership) and other financial transactions. These taxes can impose significant costs. For example, taxing property only when ownership is transferred discourages people from buying and selling. Individuals and businesses may choose to continue to hold property instead of a preferred alternative simply to avoid the tax. Transaction taxes can also be inequitable as people with similar incomes may pay different amounts of tax because they buy and sell a taxed good more frequently.

Transaction taxes can also be volatile sources of revenue because the tax base is determined not only by the value of the good but also how often it is bought and sold (the volatility of conveyance duty revenue is discussed in Section C2 Land tax and conveyance stamp duty).

Tax bases should be broader

A broad consensus that has emerged from reviews of State taxes is that the States currently have two potentially very efficient taxes, payroll tax and land tax.[4] To the extent that the burden of a broad-based payroll tax will fall on workers and a broad-based land tax on landowners, the immobility of these resources (relative to capital) make them good taxes for the States.

However, the current State payroll taxes and land taxes are not levied on the ideal broad bases. Payroll tax applies only to businesses with payrolls above a certain threshold and certain groups of employers and types of payments are exempt (see Section D3 Payroll tax). As a consequence, fewer than 100,000 of Australia's 2 million businesses are liable for payroll tax and around 95 per cent of businesses are exempt for one reason or another. Land tax is levied on land used only for certain purposes and its rate often differs between taxpayers according to the use of the land and the scale of landholdings. These features affect who bears the burden of these taxes. For example, because the land tax does not apply to all types of land, some of the burden of the tax is likely to be passed from landowners to renters (see Section C2).

Differences between States can create complexity

While the mix of taxes levied by each State is similar, there are many differences in the details of individual taxes from State to State. These relate to what is taxable, who is exempt from paying the tax, the rates and thresholds of the tax and when the tax must be paid.

Some of these differences are desirable because they allow State governments to modify their taxes to account for differences in geography, climate, industry structure and revenue needs. However, differences can also create complexity for individuals and businesses that operate in more than one State, or that move between States. Even though the burden of a tax may not fall on businesses, it is businesses that will often have to deal with the complexity of the tax system. More complex and uncertain tax arrangements across the federation can

4 For example, Gabbitas and Eldridge (1998) note that these taxes are relatively efficient, equitable and stable and have broad bases capable of raising substantial revenue. In its review of NSW taxes, IPART (2008) found that payroll tax is the highest ranking State tax in terms of performance against standard taxation principles while land tax is a relatively efficient tax, with substantial scope to improve its efficiency.

discourage business investment — affecting the sustainability of tax revenues more generally.

Without reform, increasing the rates of tax on existing State taxes would not be a sustainable way of funding increased cost pressures in the future.

Finding

Many of the current State taxes are inherently of poor quality while other State taxes need to be reformed. Increasing the rates of tax on existing State taxes would not be a sustainable way of funding services in the future.

G2-3 Reform directions for State taxes

The reform directions for individual State taxes or groups of State taxes are detailed in various parts of this Report. Table G2-1 provides a summary of these reform directions and references to the relevant sections of the Report.

Table G2-1: Reform directions for State taxes (including resource royalties)

State tax	Reform direction	Reference
Payroll tax	Payroll tax should be replaced by a tax that better captures the value-add of labour. This could be a broad-based wages tax or, preferably, a cash flow tax.	Section D3
Conveyance duty	The removal of stamp duty should be achieved through a switch to more efficient taxes, such as those levied on broad bases (including consumption and land).	Section C2
Land tax	Land tax should be levied using an increasing marginal rate scale applying to the per-square-metre value of the land. The tax should be calculated per land holding, not on an entity's total holding. There should be no specific exemption for principal place of residence or primary production.	Section C2
Insurance taxes	All specific taxes on insurance products, including the fire services levy, should be abolished.	Section E8
Motor vehicle taxes	State taxes on motor vehicle use and ownership, including motor vehicle registration transfer (stamp) duty and taxi licence fees, should be replaced with efficient user charges where possible.	Section E3
Gambling taxes	Explore options for reducing conflicts in policy-making between regulation and revenue-raising.	Section E7
Resource royalties	Most existing output-based royalty and resource rent tax arrangements imposed on non-renewable resources should be replaced by a single rent-based tax. The Australian government and State governments should negotiate an appropriate allocation of the revenues and risks from the resource rent tax.	Section C1

The long-term reform directions for State taxes would mean that the States rely less on transaction taxes and more on the efficient and immobile land tax base. The abolition of a number of taxes would contribute to a more coherent tax system across the federation.

Providing the States with better revenue sources

The States would need access to alternative sources of revenue to fund the abolition of a number of existing taxes. While the broadening of the land tax base is expected to yield additional revenue, it is envisaged that this reform would principally replace the revenue from conveyance duty.

Providing the States with more efficient and sustainable revenue sources is to some degree contingent on the reforms to consumption taxes, including payroll tax, outlined in Section D. Over time, revenue from a broad-based cash flow tax could provide a sustainable revenue base for the States to meet future cost pressures.

Different variations of consumption tax reform will have different implications for the role of the States. For example, the States currently levy their own payroll taxes, setting both the base and rate and could continue to set their own rates on a broad-based wages tax. In contrast, as a cash flow tax would be applied to business cash flows across Australia, to avoid significant complexity, and possible constitutional issues, the rate of the cash flow tax would need to be uniform across Australia.

Tax base sharing options

While the reforms to State taxes outlined above would provide the States with better revenue sources, the States would lose some discretion over how they raised their revenue (particularly if payroll tax was absorbed into a new cash flow tax). This calls into question whether the States would have sufficient revenue-raising autonomy — that is, whether they would have the capacity to raise revenue to finance significant marginal expenditure. How the States raise or receive revenue may also impact on how large cost pressures are over time. In Germany, for example, a reliance on intergovernmental grants in some German states have been linked to weakened fiscal discipline (Stehn & Fedelino 2009). If the States are not responsible for raising any of the revenue to fund increased spending, then there may be less incentive for them to provide services in more cost-effective ways.

While the States would have control over a reformed land tax, there may be some practical limitations on how this tax could be used to fund changes in expenditure. Although a reformed land tax base would be an appropriate revenue source for the States, the relative variability in land values may mean that changes in land tax rates may not always be a responsive mechanism for the States to use to fund expenditure decisions. Further, the revenue from the land tax may not be enough to allow States to have control over a significant amount of revenue (relative to their expenditure responsibilities).

If the States require further revenue-raising autonomy, then this could come through a tax base sharing arrangement. The Australian government currently raises significant amounts of revenue from two broad tax bases: the company tax base and the personal income tax base. It is possible that the States could share one of these bases, by applying a State-based surcharge.

While company tax has a broad base, as capital is highly mobile, it is expected that in the future the proportion of company tax revenue to total tax revenue will be lower than it is now (see Section B1 Company and other investment taxes). Further, as capital is mobile, States are likely to face pressure to reduce rates and they may be forced in to a 'race to the bottom' as they compete to maintain investment in their State. It is likely that these pressures are magnified (compared to international competition) in the case of States as the other characteristics that may attract investment (such as skilled labour and strong governance structures) are similar in each State. This would make the rate of the surcharge in each State a relatively more important factor in businesses' decisions about where to locate within Australia. At the same time, a State surcharge on company tax could not satisfactorily be integrated with the dividend imputation system.

The personal income tax base, which largely comprises the labour income of individuals, is less mobile between the States (as people move less freely than capital investment). Even where the personal income tax base includes some return to capital (for example, income from savings), the base is relatively immobile as the surcharge rate of tax would be based on where the person lives, not where the investment is undertaken.

Tax base sharing of income tax operated in Australia before the Second World War, although there was little coordination between the two levels of government. In 1976, the Australian government introduced the possibility of the States levying a personal income tax surcharge to replace financial assistance grants. No State took up the option.[5] A key reason for this was that the Australian government did not reduce its own tax rates to make room for the States (Carling 2007).

For a tax base sharing arrangement to work, therefore, it would be necessary for the Australian government to reduce its tax rates to allow room for the States. The revenue from tax base sharing that the States raised (and the Australian government gave up) should be offset by a reduction in grants from the Australian government or by the Australian government keeping a share of revenue from an existing revenue sharing arrangement. The revenue that the Australian government kept should be commensurate with the amount of revenue it gave up from the personal income tax base.

Administrative arrangements

While sharing of the personal income tax base appears to be constitutionally possible, there would be a number of administrative issues that would need to be considered, including the necessary State legislation. The administration and collection of the tax would need to allow for the revenue derived in each State to be returned to that State. It would also be necessary for taxpayers to be able to identify the Australian government and State government components of the tax that they pay, even though both would be administered centrally. This would allow people to link the additional tax they pay to the State government with the benefit that expenditure delivers in that State.

Key design elements of a tax base sharing arrangement are how much scope the States would have to change or influence the tax base and rate thresholds that applied in their State. As the personal income tax would continue to be centrally administered, the tax base should be uniform for all jurisdictions, and the Australian government would maintain policy control over changes in the tax base. One option could be that changes in the tax base would have to be agreed by the States — similar to the way the GST currently operates. However, this could compromise the flexibility that the Australian government needs to ensure that the tax base can remain coherent with changes in the economy and business practices. Further, as the Australian government would still raise the majority of revenue from personal income tax, it should maintain policy control of the tax base, and the States can be assured that the Australian government has the incentives that the tax base is managed appropriately.

In terms of setting the rate thresholds, as the Australian government is the appropriate level for determining distributional policies, one approach is for the Australian government to retain policy control of tax thresholds and the structure of the rate scale. While the structure

5 The legislation allowing the States to impose a surcharge was repealed in 1989.

of the personal income tax would be nationally uniform, the States could levy a flat rate surcharge on total income tax payable to the Australian government (with the surcharge payable based on the individual's place of residence). For example, if an individual's liability for Australian government personal income tax was $20,000, a State surcharge of 10 per cent would add $2,000 to the taxpayer's liability (which would be returned to the relevant State government).

Alternatively, the States could levy a tax rate (or rates) on the uniform tax base, potentially providing the States with more scope to change the structure of rates and thresholds. However, this could lead to a proliferation of marginal tax rate structures across the different States. Accordingly to ameliorate interaction with distributional policies and to limit complexity, it would be sensible under this approach to have some restrictions on the choices States had over rates and thresholds. A suitable approach may be the States being restricted to levying a flat rate of tax on income above the tax-free threshold.

If a personal income tax base sharing arrangement was desired, consideration would need to be given to how alternative approaches would impact on the complexity of the personal income tax structure and the administrative arrangements for returning revenue to the States. The personal income tax is also a key mechanism for the Australian government to influence workforce participation. The rate that States could levy in addition to the Australian government's personal income tax rates would need to be determined with careful consideration of participation objectives, particularly the relationship between the personal income tax and the transfer systems.

Finding

If the States required additional fiscal autonomy, they could raise revenue from sharing the personal income tax base. This could be done by the States levying a flat rate surcharge on income tax payable to the Australian government or a flat rate of tax on income above the tax-free threshold. The Australian government would need to reduce its rates of personal income tax and the States would receive lower revenue from grants or an existing revenue sharing arrangement. Any tax base sharing arrangement would need to be designed so that it was consistent with national objectives for redistribution and workforce participation and avoiding additional complexity.

Administration of State taxes

The reform directions suggest a reduced role for the States in the administration of taxes in the future. The abolition of a number of State taxes with the replacement revenue largely coming from centrally administered taxes would mean that the States could devote fewer resources to tax administration.

There is a possibility in the future that a single national body — the ATO or a successor organisation — could collect and administer all the taxes in the federation. This would reduce the costs of having separate administrations for each State and provide an opportunity to further reduce complexity in the overall tax system. However, if all State taxes were centrally administered, it would reduce the autonomy that States enjoy in raising their revenue. The States would need to decide if differences in taxes across the States are sufficient to warrant separate administrations. If in the future there were substantial convergence in the way States levied their taxes, the costs of maintaining separate administrations may outweigh the benefits.

Longer-term reforms to the administration of taxes and transfers and changes in the way that people interact with the tax and transfer system are also relevant to State taxes. For example, an online client account could be used by all levels of government to give people up-to-date personalised information, including information about liability for State taxes and charges (for more on the online client account, see Section G4 Client experience of the tax and transfer system).

G2-4 Intergovernmental agreements and federal financial relations

Recommendation 119:

Reforms to State taxes should be coordinated through intergovernmental agreements between the Australian government and the States to provide the States with revenue stability and to facilitate good policy outcomes.

Intergovernmental agreements to achieve State tax reform

The implementation of a number of recommendations related to State taxes would require cooperation between the Australian government and the States. Further, some recommendations related to Australian government taxes would also impact on State taxes; for example, the recommendations relating to company income tax (Section B1) and resource taxes (Section C1). Depending on when some of the recommendations are implemented, the States may also be subject to losses in revenue that could not easily be made up from other revenue sources. Funding from the Australian government may at times be necessary to ensure that the financial position of a State is not adversely affected.

It is also important that reforms are sequenced in a way that allows people to understand the reason for change and how they will be affected. In many circumstances, changes will occur not only to taxes but also to transfers and other types of expenditures. For example, the reforms to the road transport sector outlined in Section E3 would require action by all levels of government — both in the way taxes and user charges are levied, and how services are delivered. Similarly, there is a high level of interaction between reforms to housing assistance and reforms to taxes that impact on the housing market (including conveyance duty and land tax). The process of State tax reform should not be seen only as an exercise of replacing poorly performing taxes with more sustainable taxes. It should also be seen as a mechanism to deliver better policy outcomes across the federation.

One way to coordinate and implement reforms over time is through an intergovernmental agreement between the Australian government and all the States. Examples of such agreements include the agreements related to the implementation of National Competition Policy, the *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations*, which accompanied the introduction of the GST, and the recent *Intergovernmental Agreement on Federal Financial Relations*. Although the objectives of each of these agreements were different, experience suggests that intergovernmental agreements tend to be more effective if they have the following characteristics:

- The objective of reforms is clearly outlined and agreed to by all parties.
- Reforms involve a commitment from all governments and the roles and responsibilities of each government are clearly defined.
- Timelines linked to outcomes are clearly agreed. To allow for flexibility, it is preferable for reforms to be undertaken by a specified date, rather than on a specified date. In some circumstances, reforms may be contingent on certain events occurring, for example, the availability of cost-effective technology for road user charging.
- Performance reporting by all jurisdictions is transparent and enhances public accountability.
- If provided, any incentives and penalties associated with reform are clear and binding so that good performance is rewarded and poor performance is penalised. Any rewards and penalties for all parties are based on an independent review of performance.

Other aspects of federal financial relations

As noted in Section G2-1, reforms to taxes across the federation should provide a platform for improving the performance of governments more broadly. The existing institutions for federal financial relations, however, need to support reforms to State taxes. Key aspects of these institutional arrangements are horizontal fiscal equalisation and payments for specific purposes.

Horizontal fiscal equalisation

Horizontal fiscal equalisation (HFE) is designed to provide GST revenue to the States so that if each State made the same effort to raise revenue from its own sources and operated at the same level of efficiency, each State would have the capacity to provide services at the same level. Part of this process is to assess the revenue-raising capacities of each of the States.

A change in tax mix adopted by all States will change their relative revenue-raising capacities, therefore affecting the distribution of GST revenue. A change in tax mix might be revenue-neutral to the States in an aggregate sense, but an individual State might have one of their relatively stronger bases replaced with a relatively weaker base, such that revenue from their own taxes is lower. However, this loss in revenue could be made up through the HFE process, as the loss of their relatively stronger tax base means that their revenue needs are higher. In theory, if all States apply the same revenue-raising effort, no State would have a financial incentive to resist or favour a revenue-neutral reform of State tax base composition on the basis of the local strength or weakness of particular tax bases.

In practice, however, the States will be affected differently because they apply different policies to their existing tax bases and are likely to continue to do so in regard to tax bases they have access to in the future. The redistribution of GST revenue will not take into account the impact of changes to tax bases on a State where it does not apply the average policy. That is, if a State is raising more than the average revenue off a base that is abolished, HFE will not compensate for revenue lost above the average, just as if a State was making a below-average effort that State would not be penalised. This may cause difficulties for some States, particularly if the States do not have the same ability to raise marginal revenue from the new tax base as they did with the old one.

As such, the States will need to consider whether, and to what extent, such differences should be reflected in replacement taxes.

While GST revenue is currently used as the pool for implementing HFE, HFE could currently be achieved with a smaller pool of revenue. The amount of revenue needed to achieve HFE changes over time with changes in revenue-raising capacities, the costs of providing services, population shares and the way that other grants from the Australian government are distributed. Changes to tax and expenditure responsibilities would also affect the size of the pool that is needed to achieve HFE.

Payments for specific purposes

The *Intergovernmental Agreement on Federal Financial Relations* introduced significant reforms to payments for specific purposes from 1 January 2009. The new framework involves providing the States with National Specific Purpose Payments (National SPPs) for five key service delivery sectors (healthcare, schools, skills and workforce development, disability services and housing) and National Partnership payments designed to support the delivery of specified projects, to facilitate reforms or to reward States that deliver on nationally significant reforms.

While it is too early to assess the impact of the new arrangements, the reforms have generally improved the transparency of specific purpose payments. The National SPPs are provided as a contribution to the States' funding of key services, so the States can be seen as having the responsibility for funding marginal expenditure associated with the delivery of these services. Depending on the level and growth of these payments, they should be consistent with a hard budget constraint.

National Partnership payments can be a good mechanism to coordinate the delivery of national public goods; that is, goods and services the States are in the best position to deliver, but which produce benefits that extend beyond an individual State. If National Partnership payments are used too much for discretionary purposes, however, there is a risk that the payments will become more complex and will lead to the States will having softer budget constraints.

Expenditure responsibilities

While changes to expenditure responsibilities are largely beyond the review's terms of reference, changes to the way that services are funded and provided across the federation are likely to be ongoing. As there is a strong relationship between the expenditure responsibilities of each level of government and the taxes and revenue sources that it needs, the assignment of taxes and revenues may need to change over time to reflect changes in expenditure responsibilities. The institutions in the federation will need to be flexible to respond to any significant changes.

A number of goods and services provided by governments are increasingly thought of in national terms. While the States provide health, education and community services, they often do this within a framework of national objectives and targets, often agreed through

COAG. There is also an increasing desire to create national economic and regulatory frameworks to support the efficient and equitable provision of goods and services. These trends suggest that there may be pressure for the Australian government to assume greater responsibility for funding the provision of, or access to, a number of goods and services currently funded by the States. For example, the National Health and Hospitals Reform Commission (NHHRC) recommended that the Australian government assume some additional responsibility for the funding of health services, including public hospitals, public dental services and community health services (NHHRC 2009).

The appropriate response of tax and revenue assignment to significant changes in expenditure responsibilities will depend on the type and amount of expenditure involved. In general, the following approaches could be adopted:

- Changing the proportion of revenue for each level of government from a tax base sharing arrangement. For example, if one level of government takes over some expenditure, it can increase the rate of tax it levies on the uniform tax base, while the level of government that no longer has to fund the expenditure can reduce its rate of tax. This can be done so that the total tax burden does not change.

- Changing the shares of each level of government under a revenue-sharing agreement. The level of government undertaking more expenditure would receive a greater share of revenue.

- Changes to intergovernmental grants. If the Australian government undertakes more expenditure, it could keep some of the grants it currently provides to the States.

- Changes to taxes. One level of government could raise more in own-source taxes and the other level of government would raise less. The increase in revenue should come from a better (or, at least, no worse) tax than the tax being reduced.

A number of these options are currently possible and if personal income tax base sharing was introduced, then changing the proportion of revenue for each level of government from a tax base sharing arrangement would be an option in the future. If there were any changes to taxes and revenue to reflect changes in expenditure responsibilities, these changes should also be consistent with the principles outlined in this section.

G3. Local government

Key points

Local governments are generally established under State and Territory legislation. They have access to one tax — local government rates levied on properties within the municipality. The majority of local government expenditure is funded through own-source revenue (83 per cent in 2005–06), with rates making up around 45 per cent of that own-source revenue.

The immobility of land makes local government rates based on land value an appropriate tax base for local governments to use to fund local public goods and services. States should allow local governments a substantial degree of autonomy to set the tax rate applicable to property within their municipality.

Over time, State land tax and local government rates should be more integrated. This could involve moving to a joint billing arrangement so that taxpayers receive a single assessment but are able to identify the separate State and local components. This could also mean that land tax and local government rates use the same valuation method to calculate the base (with this method being consistent across the State).

When implemented correctly, user charging is an appropriate funding mechanism for local governments to deliver private goods and services.

Grants to local government made up 17 per cent of total local government revenue in 2005–06. The distribution of untied financial assistance grants to local governments should be reviewed.

G3-1 Local government's roles and revenue sources

The roles of local governments vary across Australia

There are around 560 local governments in Australia, the majority of which are statutory bodies constituted under State and Territory legislation.[6] Although they are not formally referred to in the Constitution, local governments have come to play an important role in the delivery of government services in Australia.

The revenue-raising mechanisms of local governments across Australia are similar, but there is much variation in the roles individual local governments play. Often this variation is driven by characteristics of each type of local government. For example, to meet their community needs, some rural and remote local governments operate aerodromes so that fly-in medical assistance can be accessed (Productivity Commission 2008).

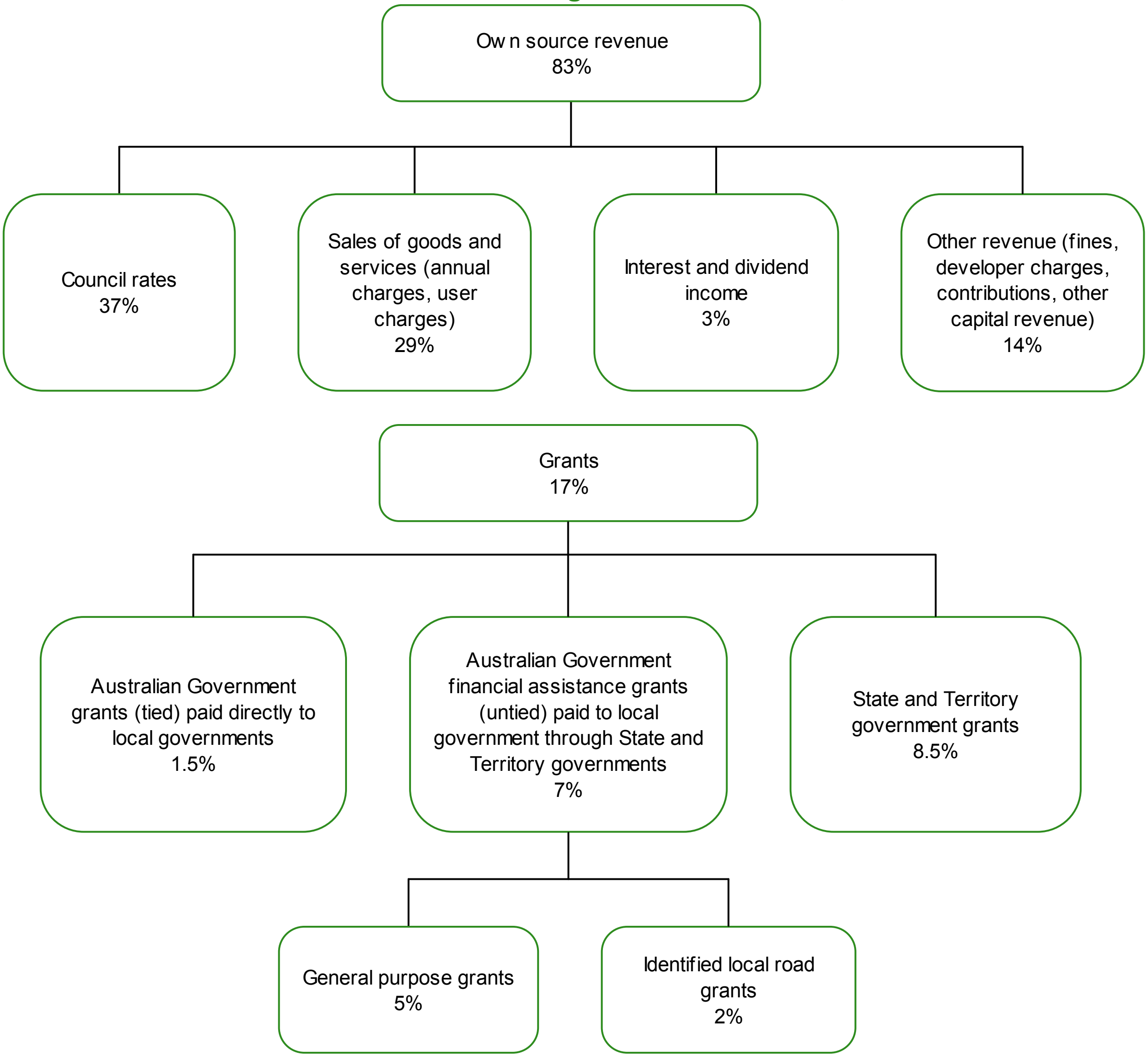
6 There are no local governments in the ACT. The ACT Government performs many of the functions that local governments perform in other jurisdictions.

Local governments typically provide a range of goods and services, some of which are public in nature, such as a local park that provides benefits to the wider community and is consumed at a low per-unit cost. Other goods and services local governments provide are more private in nature. For example, some local governments provide child care services. For some goods and services, the delineation between public and private is not always clear and can depend on circumstance (see Section E1 User charging). For instance, a car park provided by a local government in a major city is likely to be private in nature as more people will want to park their car there than the number of places available. But in less populated areas, the good is likely to have more public good characteristics as car parks are more likely to remain available for the public at large (hence one person using the car park does not stop another using it). The diversity of goods and services local governments provide suggest they should raise revenue from a mixture of taxes and user charges (consistent with the principles in Section E1).

Local governments raise most revenue from their own sources

Local governments (in aggregate) raise the majority of their revenue from their own sources. Chart G3-1 shows that in 2005–06 local governments raised 83 per cent of revenue from their own sources with 17 per cent of revenue received as grants from other levels of government. For individual local governments these percentages can vary significantly, reflecting differences in revenue-raising capacity.

Chart G3-1: Sources of local government revenue, 2005–06



Source: Adapted from Productivity Commission (2008).

Rates

Local governments have access to just one tax base: local government rates (often referred to as municipal rates). In 2007–08, local governments (and the ACT Government) raised around $10.2 billion from rates.

Local government rates are a tax charged on the value of property, with most types of land included in the tax base. The tax rate, however, can vary according to the type of land. For example, land for residential use may be charged a different tax rate from land for commercial use. Local governments generally have autonomy in setting the tax rate although there may be restrictions on how rates can be varied. In New South Wales, for example, the Minister for Local Government determines the maximum percentage by which general income from rates and charges may vary from the previous year.

The average tax rate varies significantly across jurisdictions. Jurisdictions with lower average land values tend to charge higher tax rates for a given property value. This may reflect that if one area has lower land values than its neighbour, it must charge a higher tax rate to raise the same level of revenue so it can provide the same level of services.

The tax rate applied by a local government can also vary from year to year, as local governments generally set the rate to achieve a revenue target. A significant rise in land values from one year to the next can lead to a lower average tax rate if the local government's revenue target does not change significantly.

Local governments use a variety of valuation methods (although differences between some of them can be minor). Unimproved value, site value, capital improved value (that is, the total value of the property) or rental value are all possible valuation methods. Some States allow local governments a choice in the valuation method, while others do not (Productivity Commission 2008). The merits of different valuation methods are discussed in Box G3-1.

Box G3-1: Land valuation methods for local government rates

Local government rates can be levied on the improved or 'property' value or on the unimproved land value. There are at least two competing theories about which of these are more efficient — the 'benefits tax' view and the 'capital tax' view (see Zodrow 2007). The benefits tax view argues that improved or property value taxes are efficient, as they simply recover spending on local public goods that benefit the property owner. However, people are less likely to improve their property if that leads to an increase in taxes, and improved-value taxes therefore provide a disincentive to invest. Nor is it easy to see why the ratepayer who improves a property gains more benefit from the council's spending on public goods than a ratepayer who does not.

In contrast, the capital tax view argues that improved or property value taxes distort the use of capital within a jurisdiction. That is, taxing the capital used to develop land is likely to be less efficient than taxing more immobile bases, such as the land itself. Zodrow (2001) found that the empirical literature in the United States provided limited support for this view.

The fact that capital can move between councils more easily than it can move between countries suggests that council rates should be levied on unimproved or site value. Using unimproved or site value would still reflect the beneficiary principle, as local government spending that improves a local area is most likely to be reflected in land values.

However, taxes on improved value are only inefficient to the extent that they impact on marginal investment decisions — as is the case with stamp duties on property — and therefore act as a disincentive to invest. In regard to local government rates, the consensus is that the distortions and efficiency costs of using improved value are small (Productivity Commission 2008). If the tax liability depended on the improved value of all houses in the area, rather than an individual assessment of a specific house, then the inefficiency is likely to be substantially reduced. However, some ratepayers may regard this as inequitable.

Exemptions (such as land owned by other levels of government) and concessions (such as for pensioners and other income support recipients) from local government rates are prescribed in State legislation. State governments usually rebate local governments for revenue losses due to pensioner concessions (although in New South Wales local governments only receive a partial rebate) (Productivity Commission 2008).

Because local government rates are generally a tax on land, which is a highly immobile tax base, they are a relatively efficient tax (see Section C2 on land taxes). Further, given that land is immobile, local government rates are an appropriate tax base for local governments to use to fund the provision of local public goods (see Section G2 State tax reform).

Finding

The immobility of land makes local government rates based on land value an appropriate tax base for local governments to use to fund local public goods and services.

User charges

Local governments charge fees for many goods and services — such as sporting grounds, and water and sewerage services — that are private in nature. As Chart G3-1 shows, around 29 per cent of total local government revenue comes from user charges. Provided these charges accurately reflect the cost of provision (see Section E1 User charging), they are an appropriate revenue source for local governments.

Local governments also receive revenue from developer charges, often known as infrastructure charges. Infrastructure charges can operate as either user charges or taxes, depending on the level at which they are set. They are user charges when they reflect the cost of providing the additional infrastructure needed for the development, but operate as taxes when they exceed such costs. The supply of infrastructure and the associated charging are important factors in the supply of land suitable for housing and they can have significant consequences for affordable housing. Infrastructure charges are discussed further in Section E4 Housing affordability.

Finding

User charging, when implemented correctly, is an appropriate funding mechanism for local governments to deliver private goods and services.

Local governments receive tied and untied grants

In 2007–08, local governments received more than $2.3 billion in grants from the Australian government. This consisted of $1.78 billion in untied financial assistance paid through the States and $554 million paid directly to local governments and 'tied' to specific purposes. State governments also provide grants to local governments for specific purposes or services, as well as to reimburse rate concessions.[7]

Australian government untied financial assistance is provided under the *Local Government (Financial Assistance) Act 1995* and consists of general purpose assistance and an identified road component. The road component is identified but untied and can be spent according to local government priorities.

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7 It is difficult to determine the total amount of State grants to local government as some State governments also provide contract payments to local governments to carry out some State functions. The Productivity Commission (2008) estimated that in 2004–05 State government grants to local government were $1.831 billion. As a comparator, the Productivity Commission estimated Australian government grants to local government were $1.813 billion in 2004–05.

Each year the Australian Treasurer determines an escalation factor to be applied to the untied financial assistance grants. It is set by reference to population growth and the consumer price index.

The untied financial assistance is paid to the States on the condition that it is fully passed on to local government. The general purpose assistance is distributed to States on a per capita basis, while the road component is based on fixed historical shares. The distribution within States is in accordance with recommendations made by State grants commissions. These recommendations are required to conform to a set of national principles (See Box G3-2).

Box G3-2: Principles for distributing untied revenue assistance to local governments

State grants commissions are required to distribute untied revenue assistance provided under the *Local Government (Financial Assistance) Act 1995* in accordance with the following principles:

- Horizontal equalisation: each local government should be able to function, through reasonable self-effort, at a standard not lower than the average of other local governments in that State.
- Effort neutrality: actual revenue or expenditure policies should not impact on the grant received by local councils.
- Minimum grant: no local government can receive less than 30 per cent of its per capita share of the untied revenue assistance provided to its State under the *Local Government (Financial Assistance) Act 1995*.
- Other grant support: any grants received by local governments in respect of assessed expenditure needs should be accounted for in the assessment.
- Aboriginal and Torres Strait Islander people: assistance should be provided to councils in a manner that recognises the needs of Aboriginal and Torres Strait Islander people within the local government area.
- Identified road component: this funding should be allocated on the basis of road expenditure needs.

There seems little reason that local governments with large fiscal capacities should receive a guaranteed minimum grant (which allows them to tax their residents less than they otherwise would) at the expense of local governments with relatively small fiscal capacities (which result in them taxing their residents more than they otherwise would). The current requirement that each council receives 30 per cent of its per capita share of untied financial assistance grants may prevent State grants commissions from redistributing to councils that require greater assistance.

G3-2 Reform directions for own-source and grant revenue arrangements

Recommendation 120:

States should allow local governments a substantial degree of autonomy to set the tax rate applicable to property within their municipality.

Recommendation 121:

Over time, State land tax and local government rates should be more integrated. This could involve:

(a) moving to a joint billing arrangement so that taxpayers receive a single assessment, but are able to identify the separate State and local component; and

(b) using the same valuation method to calculate the base for local government rates and land tax (with this method being consistent across the State).

Own-source revenue: towards more autonomy, accountability and integration

If local governments are to be accountable to ratepayers for their expenditures, it follows that they should have full (or at least greater) autonomy over the setting of the tax rate applied to properties in their jurisdictions (see Recommendation 120).

Unless there are genuine policy reasons for doing otherwise and these reasons provide greater benefits than the associated costs, land-based taxes should make use of the same valuation method as this is likely to reduce administration costs. Therefore, as State governments make more use of the land tax base over the long term (see Section C2 Land tax and conveyance stamp duty), there should be one valuation method across the State used to calculate the base for both rates and land tax (see Recommendation 121). That is, land valuation would be the same for both taxes. However, local governments could continue to charge a fixed charge to ratepayers and there should not be a low land value threshold for local government rates, as even those who own land with a low per square metre value receive benefits from local government services.

If land tax and council rates can be better integrated with landowners receiving one bill per year covering both, it may be possible to have a single point of contact for enquires, debt management and compliance of both taxes.

Such a reform could see taxpayers receive one tax assessment notice for both taxes, with each tax rate and tax liability clearly identified. In some States this change would substantially alter some rate assessments — a long transitional arrangement may be appropriate in these cases.

Integrating and sharing this tax base may also facilitate a reassignment of tax responsibilities within the federation, as it is relatively simple to alter the rate of tax charged by each level of government (leaving overall revenue collected unchanged) to alter the amount of revenue received by each level of government. This may be necessary if there are major changes to user charging. As outlined in Section E1, governments in Australia should contemplate opportunities to expand user charging for the provision of private goods. This is highly relevant for local governments and may offer the opportunity to lower local government rates and other charges.

The road and transport reforms outlined in Section E3, for example, may offer local government a significant opportunity to recover from heavy vehicles the maintenance costs they impose on local government road assets. In its May 2009 submission to the Review, the Australian Local Government Association highlighted that local governments own and manage around 80 per cent of Australia's road network, and roads expenditure is the largest expenditure for most local governments. If road reforms result in heavy vehicle road-wear charges flowing to the owner of the road, local governments are likely to receive significant amounts of additional revenue from these reforms (as they presently do not collect motor vehicle taxes). Of course, substantial parts of the local road system would not be fully funded from road-wear costs and would continue to require funding assistance. Consideration would need to be given to the revenue and grant implications at the appropriate time.

Reviewing the minimum grant principle

Local governments are generally established under State legislation and deliver services that would otherwise be delivered by State governments. As such, it may be more appropriate for State governments, rather than the Australian government, to be responsible for ensuring that local governments have access to enough revenue — including through untied financial assistance — to provide local services. The ability of the States to fund untied financial assistance is contingent on the States themselves having access to sustainable tax revenue.

Whichever level of government is responsible for funding untied financial assistance, there is a strong case to review the principles for the distribution of untied financial assistance, particularly the minimum grant principle. If the minimum grant principle was removed, the overarching principle for untied assistance could simply be horizontal equalisation within the relevant jurisdiction. The other principles could be considered when determining the distribution needed to achieve horizontal equalisation.

Payments to local government for specific purposes — either from the Australian government or State governments — are likely to have an ongoing role, as intergovernmental cooperation involving local government is often necessary to deliver reforms of national or State significance. Other levels of government can use these payments to purchase the delivery of goods and services from local government. Given the expertise that local governments have in the delivery of some goods and services, these payments can represent value for money for higher levels of government.

G4. Client experience of the tax and transfer system

Key points

People's interactions with the tax and transfer system tend to be complex and fragmented.

A 21st century tax and transfer system should allow individuals to engage with it in ways that meet their needs and preferences — a citizen-centric design. It should help people make informed decisions that are in their best interests. It should be transparent and trusted in its operation, and aligned with the 'natural systems' of individuals and businesses (the things they do anyway).

While improvements to individuals' experiences of the present system have been pursued by delivery agencies, policy and program complexity has continued to increase, such that the system remains confusing, costly and risky for people. Tax and transfer administrative and technology systems do not have unlimited capacity to absorb this complexity while maintaining a simple interface for citizens.

Significant improvements in client experience require a new approach to policy design that gives far greater weight to the experience of the system by users. This goal has underpinned many of the recommendations of this Review. If achieved, it will be possible to employ modern technologies far more effectively to deliver programs and enhance client experience and outcomes.

Greater use of technology, improved coordination and management of information, plus better design and integration of processes will enable more automation of reporting. It will also empower clients to better understand and engage with the system through online, up-to-date access to their own tax and transfer accounts.

Current government strategies such as the Standard Business Reporting Program will improve businesses' experience of the system, including through reducing compliance costs. Such strategies have the potential to generate further improvements in the business experience of the system and bigger compliance cost reductions if extended to cover further business interactions with other government regulators.

A high-level taskforce should be established to progress, oversee and regularly report on a whole-of-system reform of the policy, administrative arrangements and technologies that deliver the client experience of the tax and transfer system.

G4-1 Simplicity and client experience

The current tax and transfer system is complex. It combines individual-basis annual tax assessment with household-basis 'real-time' means testing of income, family and other assistance.[8] It requires detailed client information to deliver finely tailored results, with different programs using different measures of client circumstances. It involves income-linked arrangements for child support, tertiary education funding, superannuation, health insurance and other programs. Not surprisingly, individuals may have very complicated experiences in dealing with the system.

In many different ways and at various times, the tax and transfer system affects every person in Australia. For example, almost all individuals interact with the income tax system (11.8 million individuals lodged a return in 2006–07), and many individuals deal with the transfer system (in June 2009 for example, around 1.77 million families received Family Tax Benefit A in respect of 3.44 million children, 1.36 million families received Family Tax Benefit B, while 356,000 people received Youth Allowance). Other interactions with the system are less frequent; for instance, 55,199 Australian government disaster recovery payments were granted to provide assistance and support to survivors of the Victorian bushfires, while 85,065 grants had been paid under the Australian government's LPG Vehicle Scheme (as at 30 June 2009, for the 2008–09 financial year).

Submissions provided to the Review and meetings with the general public have highlighted concerns that the tax and transfer system is difficult to understand, laden with inaccessible jargon and inconsistent in its use of terms. Complex rules and the different ways in which various elements of the system are administered create costs and risks for people.

The Review has recommended policy reforms that would lead to a simpler system, such as abolishing many State taxes, and rationalising tax offsets and tax deductions. Simplification will have many benefits for clients, including greater transparency, less information to collect, and forms and processes that are easier to understand.

Nevertheless, the complex objectives of the tax and transfer system, the world in which it operates, and the desire to tailor its impacts to the diversity of people's lives mean that even a simpler system has the potential to be complex, costly and risky for the people interacting with it. The Review has referred to this interaction as the client experience of the system and believes that improved client experience is an important element of Australia's future tax and transfer system.

G4-2 Desirable features of client experience

A citizen-centric design

Over the past decade, concerted efforts have been made in a number of countries to improve the relationship and interactions between government and citizens. A consistent theme in these reforms has been a move to more citizen-centric government (Briggs 2009). 'Old'

8 Eligibility for transfers is means tested in 'real time' because recipients have to provide up-to-date income information on a fortnightly basis.

government service delivery has been characterised as transaction-based service delivery systems built around, and aligned with, program boundaries. Citizen-centric government instead matches services delivery to the needs and preferences of the individual. The government would come to be regarded as approachable, services would be easy to locate and understand, and citizens would be able to choose from a range of service models based on their particular needs, without having to understand which agencies deliver what services (Briggs 2009). Authentication and personal information would need to be provided only once in order to access government services, and diverse transactions would be grouped and completed together (Briggs 2009).

In a European Commission report titled *A vision of public governance in 2020*, the characteristics of this new citizen-centric environment were outlined as fully joined-up open government administrations which are responsive to user needs and which empower citizens to participate in a democratic government (EC 2008). In Europe, this new environment has manifested itself in services such as web portals that allow people to access a range of government services in one place (for example the United Kingdom's Customer First Programme and the Netherlands e Citizen Programme). In Canada, Service Canada was created in 2005 to bring together a range of federal and local government services to make things easier for clients.

In Australia, improvements to client experience have included service delivery reforms to co-locate and combine services. Examples include the ongoing development of online government portals, such as australia.gov.au, vic.gov.au and brisbane.qld.gov.au (Brisbane City Council is the largest local government in Australia). Examples of co-location of services include making a range of municipal services available in local government shopfronts and making Centrelink services, particularly family assistance, available in Medicare offices.

Being more citizen-centric requires a better understanding of what people want and need. Results from surveys of peoples' attitudes and preferences indicate that Australians want streamlined, integrated service delivery. They are frustrated by interactions with many different agencies that require them to assimilate complex information from multiple sources and by the need to communicate with lots of people and fill out lots of forms to get their issues resolved (AGIMO 2008). For most simple transactions, they want an efficient service they can access at a time and using a channel convenient to them. This service should provide accurate, comprehensive information appropriate to their personal circumstances, and the service should be consistent regardless of how or by whom it is delivered (AGIMO 2008).

There are many opportunities to further streamline and integrate services by reducing duplication in websites, telephone lines and communication materials within and across agencies. However, rationalisation is only effective up to a certain point — people also value dealing with someone who is knowledgeable enough to handle their issues effectively. Rationalisation of all government call centres into a single number could result in reduced quality and increased levels of referral or escalation. Consolidation of too many government services in government shopfronts can lead to reduced responsiveness because counter staff cannot maintain expertise over a very broad range of services. So a critical issue for servicing clients is determining the right balance of service provision, integration and appropriate service channels.

In many cases people prefer to access services over the web, but they also value face-to-face interactions where they have complex needs or where they are in situations of risk.[9] In those interactions, people want to be treated fairly and politely by competent and sympathetic staff. People would also like to provide their information to government only once, that is, they want to complete one application (or ideally pre-populate one form) and have it dealt with by any of the relevant agencies or service providers rather than sending separate completed forms to each agency or service provider.

The trend towards citizen-centric government has implications far beyond the Review's focus on the tax and transfer system. Nevertheless, citizen-centric design of the tax and transfer system implies that individuals should be presented with 'real-time' information about their whole relationship with government on taxes and transfers. People would interact at a time and in a way that suits their preferences and needs (but not always over the internet). They would provide their information once or have it provided by third parties such as employers, other government agencies or financial institutions. This information would be used to update their details with all agencies and to pre-populate forms, generate liabilities and confer entitlements.

Box G4-1: Example of citizen-centric design

Citizen-centric design starts with understanding the needs of citizens rather than the problems of service providers. Canada is often described as a leader in citizen-centric services.

Service Canada officially began operations in September 2005 but its origins date back to 1998 when the Government of Canada began developing an integrated citizen-centred service strategy based on detailed surveys of citizens' needs and expectations. Service Canada aims to provide a one-stop, single-window, multi-channelled service network, centred on the needs of Canadians. It provides a wide range of welfare services relating to families, employment and retirement as well as providing services on behalf of other agencies such as passport and boat licence applications.

Governments commonly use service integrators, but a design that merely connects citizens to services does little to resolve difficulties citizens have in dealing with multiple government organisations built around program or jurisdictional boundaries. Service Canada also has a mission to integrate services over time to minimise overlaps, reduce duplication and fill gaps in service.

Helping people make informed decisions in their best interests

People should have a right to readily see what identifying and financial information (from any source) is held about them by tax and transfer agencies. They would benefit from being able to receive immediate feedback about the impact of actual or hypothetical changes (such as becoming unemployed, starting a new job or having a baby) on their whole financial relationship with government. Providing clients with quick and accurate information on how such changes could affect (or have affected) their financial position makes it easier for

9 For example, people may be in situations of risk because they are disadvantaged, vulnerable or in urgent need because their personal safety is at stake.

them to make decisions in their best interests. Currently, people can test changes in circumstances against specific parts of the system, but then need to assemble these pieces of information to get an overall answer. This process requires people to be quite knowledgeable about the system and is prone to client error.

Choice defaults for complex decisions can help people to achieve better outcomes (Dunstall & Reeson 2009). Behavioural studies have shown that the more complex a decision is, the less well equipped many people are to handle it. When faced with complexity or uncertainty, people procrastinate about or avoid making decisions, stick with (less than optimal) defaults, or if they are confused about a decision, they can be prone to follow misleading advice. As a result, people often make decisions that are not in their best interests (Dunstall & Reeson 2009). A more client-focused system would apply insights from behavioural economics, behavioural finance and psychology, facilitated by advances in information technology and improvements to service delivery, to alleviate the burden of this complexity for individuals making such decisions. A future system would adopt defaults for complex decisions that would leave clients in a reasonable position. Carefully designed, such choice 'nudging' could significantly assist people while still giving them full control over the choices in question so they can easily make different decisions if they wish.

Box G4-2: Use of defaults — 'uplift' of Family Tax Benefit income estimates

With the introduction of A New Tax System in 2000, fortnightly Family Tax Benefit payments were paid provisionally based on a family's estimate of their income for the financial year. The family's actual entitlement was determined only once their taxable income was assessed at the end of the financial year. Initially, the complexity and uncertainty of estimating income for the next period led many people to underestimate their income. Many others did nothing and their previous year's estimate automatically 'rolled-over' to the next year, even where the estimate was inaccurate in the year it was given. Reliance on estimates that were too low meant that many people incurred debts once their fortnightly payments were reconciled with their actual entitlement.

To assist people, in 2006 the government introduced a default income estimate. The default is the previous year's estimate 'uplifted' by reference to the increase in average wages. The default is specified in a letter sent before the start of each financial year to each family assistance customer, requesting an estimate of their family income for the following year. It is open to the customer to provide their own estimate, but in the absence of further communication, Centrelink uses the default to calculate fortnightly payments.

Transparent and trusted in its operation

Another desirable feature of the client experience of Australia's future tax and transfer system is that the system be transparent and trusted in its operation.

Information held in agency systems and the flows of information between them should be visible to clients. The protections applied to information about clients (obtained from them or third-party information systems) and the circumstances in which information can be provided to others also need to be clear.

People need to know what information provided by third parties has affected their taxation position or their transfer entitlements. If they wish, people should be able to see the information from third parties that is being used. The calculations used to determine a client's position should also be available so they can easily understand the result.

To the maximum possible extent, third-party information should be obtained by agencies in advance of administrative decisions, for example to pre-populate tax returns, rather than as a check on the information provided by clients themselves. In order to assist clients, electronic systems should make it possible to minimise the risks of error or misunderstanding with them, and not test those clients' knowledge about, or the accuracy of, the records they provide.

Finally, creating client trust in the operation of the system requires a clear and effective review and complaints system. Where clients believe that a breach of their rights has occurred, they need a review mechanism which is convenient for them to use, efficient, inexpensive and which delivers results in which they have confidence.

Aligned with the 'natural systems' of individuals and businesses

Third parties have considerable obligations, risks and costs placed upon them in relation to providing information about people to government. For example, businesses need to provide information about their employees' Pay As You Go withholding details to the Australian Taxation Office (ATO) for tax purposes. They incur the cost of doing this, and must ensure the information is accurate and provided on time.

Therefore it is important that policy design is as simple and straightforward as possible, and that reporting obligations fit readily with established business systems.

'Natural systems' are those systems that individuals and businesses use, provide information to or interact with regularly for non-tax and non-transfer purposes. Examples of natural systems include payroll systems for businesses and bank accounts for individuals. By aligning with natural systems, the future tax and transfer system could operate seamlessly, drawing relevant information from the everyday processes and interactions of people and businesses. People and businesses would be able to comply with their obligations without doing anything additional that they would not have done in any case.

For example, a client receiving a family transfer (who currently needs to report changes in income to Centrelink as and when they occur) would no longer need to do this if information about their income (drawn from their employer's payroll system under the employer's control) were provided directly to Centrelink. This would avoid many problems for clients such as incurring a transfer system debt if they forget to report an increase in salary.

Another example would be the exchange of information between hospital systems, birth registries, Centrelink and Medicare on birth of a child. By drawing on information provided to the hospital at birth, the process of registering the birth, registering the child for Medicare and applying for family assistance could be automated.

Relying on the natural systems of business, such as their financial and payroll systems, can reduce compliance costs for business. These costs can relate to the assessment of tax liabilities for the business itself, as well as reporting and withholding requirements in respect of its employees. There would also be benefits for the integrity of the system as automated exchange of data would likely improve business compliance, reduce errors and enhance confidence in the system.

Principle

The tax and transfer system should allow individuals to engage with it in ways that meet their needs and preferences (a citizen-centric design). It should help people to make informed decisions that are in their best interests. It should be transparent and trusted in its operation, and be aligned with the 'natural systems' of individuals and businesses.

G4-3 Building the future client experience

Moving beyond current approaches

Public meetings and submissions to the Review have raised significant issues about the difficulty of interacting with the tax and transfer system, and how this affects the experience of clients. Overall, the current way of interacting results in clients being exposed to cost, risk and inefficiency, as well as driving client disengagement.

There are numerous examples of innovative government service delivery aimed at improving the experience of clients, some using technology and others a more personal approach. The creation of Centrelink in 1997 was itself a reform aimed at improving the experience of clients. It aimed to deliver previously disparate social security payments and services, as well as government assistance, with a consolidated focus and a whole-of-government approach.

A more recent specific example, the Australian government drought bus, provides advice on tax, health and mental health issues in addition to specific drought and flood relief services. This initiative recognises that people in need rarely have problems that are confined to the responsibilities of one agency or service deliverer.

Over the past decade the ATO has dramatically reduced its use of paper forms by offering its clients internet-based options. In 2008, over 2.2 million individuals lodged their tax return using e-tax (ATO 2009c). Benefits include 24-hour availability, faster processing times and automatic estimation of the tax refund or debt. Taxpayers and agents preparing an electronic income tax return are able to utilise pre-filling. Pre-filling partially completes the tax return using information supplied by third parties such as employers, banks and other government agencies. The pre-filled information is the same as that sent to the ATO for information-matching purposes. This initiative has improved the client experience through reducing time and effort spent preparing and lodging tax returns, while improving accuracy and compliance.

While such initiatives will improve the experience of clients to varying degrees over time, most are still primarily organisational or portfolio-specific. Furthermore, the policy and program complexity of the system has continued to increase while these initiatives have been under way. Tax and transfer administrative and technology systems do not have unlimited capacity to absorb this increasing complexity while offering citizens a simple interface.

Without a change in current approach, Australia's tax and transfer system will continue to be designed and administered in ways that do not give primacy to the experience of users.

People will be confused about the overall impacts on them and continue to face frustrating processes to undertake basic transactions with government. Carrying out a simple task such as reporting a change of address or a change of partner might still involve being referred to multiple areas and agencies, providing the same information again and again.

A new approach that brings together policy design and implementation across agencies and portfolios is needed to achieve the kind of transformation summarised in Box G4-3 following.

Box G4-3: Transforming the client experience

Old system	New system
Limited range of transactions can be performed online.	All transactions (except those that need to be conducted in person due to a policy requirement) can be performed online.
Information has to be reported multiple times, sometimes in different ways.	Information such as a change in address or new employment details will be provided once and used across the system.
Account balance information for tax and transfers is not easy to access.	Totality of financial relationship with government will be accessible online with clients able to see historical data as well as real-time information.
Difficult to calculate how a change in income or circumstances such as having a child or retiring will affect a client's tax liability and transfer entitlements.	Clients will be able to see how their tax and transfer situation will change if their income or circumstances change.
Different processes for benefits and transfers administered by different policy departments.	Common processes so clients have a similar experience when transitioning between payments.
Many rebates, offsets and deductions providing welfare-type assistance in the tax system.	Greater use of standard deductions and outlays.
Information from third parties such as financial institutions and employers is pre-filled in electronic tax returns where available; other information is manually entered.	Tax and transfers reporting is designed so that most information can be pre-filled automatically.
Many clients get assistance to manage their tax and transfer affairs.	Most clients will feel confident to manage their own affairs because the process is simpler and more automated.
Clients use face-to-face and call centre services to make queries or provide information when they would be willing and able to use self-service applications if they were available.	Extensive self-service options are complemented by personalised assistance for those needing more intensive assistance.

Finding

While a range of recent and current initiatives will improve client experience, the system remains confusing, costly and risky for people. A new approach to policy design and implementation is needed which gives primacy to users' experience of the system.

A rapidly evolving environment

The precise trajectory for development of the new client experience and the speed at which it could be implemented, are not clear. Developments in technology and their use in delivering services are occurring very rapidly, creating new possibilities and expectations for government service delivery.

The continuing evolution of technology-based information and communication services is enabling a paradigm shift in delivering services. The world is moving beyond a 'cottage industry' model of technology-based service delivery in which organisations develop and deliver in-house services over the web. Instead the advent of global industrial models for technology-based service delivery is becoming apparent, under which entities would store information and then provide technology-based service delivery on behalf of other organisations to those organisations' clients. Large global enterprises (such as Google and Amazon) are leveraging low-cost technology in sophisticated, disciplined ways to deliver high-quality services at very low cost. Not surprisingly, existing approaches to technology used by the Australian government cannot match this new approach in terms of cost or quality.

At the same time, a more sophisticated version of citizen-centric service delivery is emerging, which some have dubbed citizen-driven service delivery (Di Maio 2009). To date, citizen-centric service delivery models have been characterised by government agencies joining up services in ways they think people will value, rather than letting them do it themselves. New approaches emerging from the private sector would allow citizens to configure services or information directly or via intermediaries to match their needs. For example, citizens today are adopting new information technology that allows them to combine or 'mash-up' existing services and content in ways that fit their preferences. Using mash-ups allows a client to create entirely new services tailored to them. It also allows intermediaries to innovate and mash-up online services in ways they think people will want.

Box G4-4: New technology: Mash-ups

A mash-up is the integration of two of more web services from internal and external information sources (Bradley 2007). An example of this is the iGoogle service, which enables non-expert customers to select the set of services they want to access on a regular basis. Users can create a personalised homepage that combines live content such as news, weather and cinema guides with other tools such as foreign language translators and recipe finders.

Other examples include websites and mobile applications combining public transport timetables with mapping and event information from different sources.

Six enablers for improved client experience

Recommendation 122:

A tax and transfer client account should be developed, based on customer research and with customer input into its design. The account should include at least the following features:

(a) up-to-date presentation of income earned from all sources, taxes withheld, tax liabilities incurred, transfers received and information flows from third parties;

(b) complete information from past periods;

(c) an optional single point for updating personal information, undertaking transactions, and reporting information or making applications, with extensive pre-filling of forms based on information previously provided; and

(d) the ability to test the impact of hypothetical changes in circumstances.

Recommendation 123:

Pre-filled personal income tax returns should be provided to most personal taxpayers as a default method of settling their tax affairs each year.

Recommendation 124:

Existing tax and transfer provisions should be reformed to support improvements in client experience, including greater alignment of income definitions and reporting, rationalising of personal tax deductions and offsets, and streamlining of mandatory administrative requirements. Future new policy proposals should be subject to comprehensive, published expected impact assessments on client experience systems and outcomes.

Recommendation 125:

Where possible, information required for determining tax liabilities and transfer entitlements should be collected from third parties, including employers, government agencies, financial institutions, and share and property registries.

(a) Over time, electronic provision of this information by third parties should be made mandatory.

(b) To reduce current and minimise new compliance costs, reporting obligations should as far as possible be aligned with existing information concepts and systems of third parties, and facilitated through electronic interaction with information held in the 'natural systems' of those entities.

Recommendation 126:

Further approaches (extension to and approaches which build on Standard Business Reporting) should be pursued to reduce the compliance costs associated with business interactions with government.

Recommendation 127:

The government should assist small businesses to be 'business ready' when they begin business. This could be achieved through education and financial assistance, which may include assistance to small business to get ready for Standard Business Reporting (SBR).

Recommendation 128:

Common information standards, leveraging from the standards and governance put in place by the Standard Business Reporting Program, should be developed and adopted to support system interoperability between tax and transfer agencies, and between those agencies and third parties, such as employers.

Recommendation 129:

A modern privacy and secrecy framework should be developed and adopted that maintains and streamlines protection of personal information held by government agencies, and facilitates exchange of information (other than an individual's health information) between agencies to support improved client experience of the tax and transfer system.

Recommendation 130:

A method of linking records, for example by linking existing client identifiers, should be developed to facilitate development of a single client account for tax and transfer financial information. This would allow better service delivery by supporting interoperability and data exchange between the appropriate government agencies, and flows of tax and transfer information from third parties to those agencies. Information should not include individual health information.

Recommendation 131:

A high-level taskforce be established, under central agency leadership, to progress a whole-of-government approach to improving the client experience of the tax and transfer system, with:

(a) membership from relevant agencies, the private sector and client representatives;

(b) terms of reference requiring the taskforce to:

  1 develop, consult, oversee and regularly report to government and Parliament on a whole-of-system reform of the administrative arrangements and technologies that deliver the client experience of the tax and transfer system;

  2 position these reforms within the overall government initiative to improve the relationship between it and citizens; and

  3 lead consultations with relevant stakeholders, including citizens, privacy advocacy groups, professional associations, financial institutions and employers.

(c) a mechanism for capturing feedback from citizens on government service delivery, including both current administration and new proposals.

Despite uncertainty about the pace and direction of these trends, a focus on six enablers will position Australia to deliver improved client experience of the tax and transfer system.

(i) Doing more for people

As noted previously, even a simpler tax and transfer system has the potential to be complex for some people who have to deal with it. Improving client experience will require smart service delivery that makes complexity easier for people to navigate.

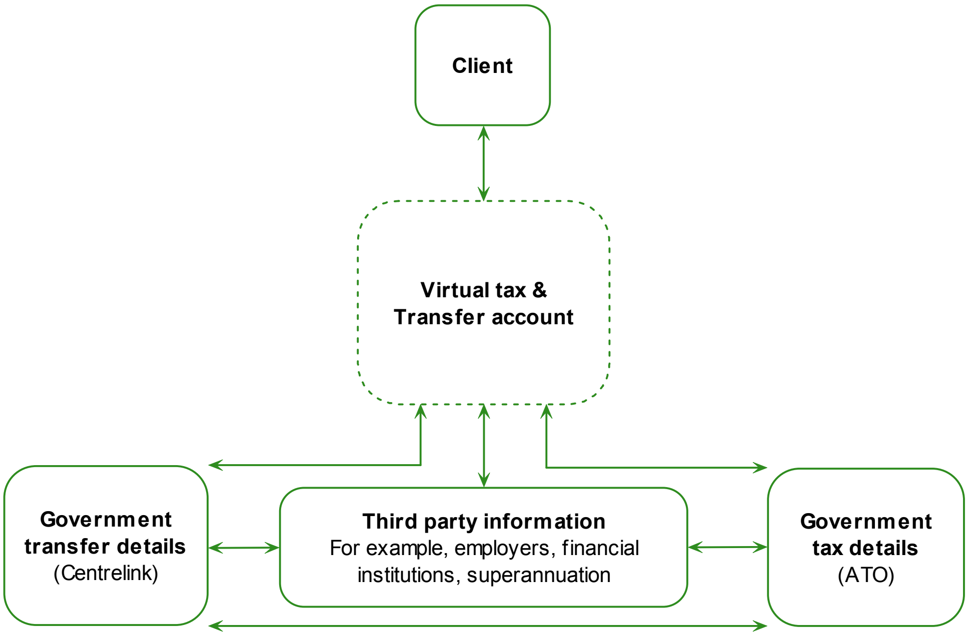
A client account

To provide convenient access to information about all their tax and transfer affairs, people should have a single client account (or possibly a structure of accounts) with government, which can be viewed and managed online (see Recommendation 122). The account would provide individuals with a single view of their financial relationship with government, including details of their personal income tax, transfers, repayment of education loans, child support and aspects of superannuation (see Section A2-4 Improving people's awareness of the retirement income system). With consent, the account would also present relevant information of other family members (for example, where entitlement to transfers depends on family income).

People would be able to view how their rolling balance with government is building up during the year, including income earned from various sources, taxes withheld and transfers received. Complete information from previous periods would also be available. The account would provide a single point for updating personal information that would then flow to all relevant agencies. For example, transactions could also be undertaken through the account, with information already provided being used to pre-fill forms. Information flowing from third parties affecting liabilities and entitlements would be visible in real time. Finally, the account would provide people with immediate feedback on the impact of changes in their circumstances (such as having a baby or increasing their hours of work) on their net tax and transfer position, as well as allowing them to test the impact of hypothetical changes in their circumstances to better inform their decisions.

The account is illustrated in Chart G4-1 below.

Chart G4-1: Client account



Developments in information technology and potential privacy concerns suggest that the account may not take the form of single government database. Instead a virtual account would be created whenever a client seeks to access it, drawing information in real time from relevant agency systems. Direct personal use of the account would be optional. People preferring to access information or transact directly with agencies through other channels (for example, by telephone or face-to-face) would still be able to do so.

The specific details and features of the account would be determined in light of research on client preferences and involvement of clients in its design.

Use of defaults and 'nudges', including pre-filled tax returns

As noted above, it is well recognised that many aspects of observed human decision-making differ from the so called 'rational' behaviour of individuals assumed in economic models. This has a major impact on decision-making behaviour. People are fearful of losses, handle risk inconsistently, dislike uncertainty, are prone to procrastination, tend to stick with the status quo and are easily swayed by irrelevant numbers. For all but the simplest of decisions, people generally do not attempt to find the optimal solution, but rather apply simple decision-making strategies rather than searching for the best outcome (Dunstall & Reeson 2009).

Insights from human behavioural research indicate how choices are presented to clients in complex systems, such as the tax and transfer system, can have significant impacts on the decisions those clients make (Dunstall & Reeson 2009). To help clients to make choices in their best interests and so to protect their wellbeing, the Review recommends the application of the results of this behavioural research to the administration of the tax and transfer system. This should include utilising assisted decision-making and choice 'nudging' in relation to complex decisions to alleviate the burden of complexity.

A focus of the application of behavioural research should be on providing people with assistance to comply with obligations they find the most difficult. The major one for most individuals is filing their income tax return. Completing income tax returns is a major reason for individuals seeking the assistance of intermediaries such as tax agents. Greater pre-filling of client information into income tax returns is a major way to alleviate this burden for clients, and to improve their experience of the system. With more information pre-filled, the ATO might be able to send returns directly to people. The ATO might still ask the taxpayer to confirm the information in the return and to add any additional information if the person has more complex affairs. But, for most people, the pre-filled return would be a reasonable default. Those who chose to accept it could avoid the complexity of the process of lodging a tax return, as well as the expense of a tax agent.

Recommendation 123 proposes that pre-filled personal income tax returns be provided to most personal taxpayers as a default method of settling their tax affairs each year.

Box G4-5: How pre-filling of tax returns could assist clients in the future

Providing clients of the future tax system with default pre-filled tax returns will be of great benefit to many people.

People with very simple tax affairs (for example, those with employment or bank deposit earnings that have been reported to the ATO) could be sent a pre-filled tax return by the ATO. If correct, these taxpayers could simply confirm the return's details and finalise their tax obligations for the year without resorting to a tax agent. Based on 2007–08 data, around 11 per cent of tax return filers (around 1,380,000 people) could benefit from this approach.

Again, based on 2007–08 estimates, a further 31 per cent of tax filers (3,820,000 people) with deductions for expenses such as work-related expenses and the cost of managing tax affairs would only need to decide whether to accept the standard deduction calculated and pre-filled by the ATO, or provide additional information where their expenses exceeded the standard deduction threshold. Beyond this, a further 14 per cent (1,790,000 people) of filers would need to provide details of gift deductions.

This means that up to 56 per cent of tax filers, or around 7 million people, could complete their annual tax obligations by accepting the standard deduction and specifying the amount of their eligible deductible gifts.

In addition to these people with fairly simple affairs, a further 25 per cent of tax filers (around 3,160,000 people) would have had only had one further label to complete on their tax return to finalise it.

(ii) Policy reforms to simplify the client experience

Policy changes to align definitions and processes in different parts of the system and to simplify rules for determining tax liabilities and transfer entitlements would make the system easier for people to understand and interact with. It would also assist the system being able to do more for them.

For example, there could be greater alignment of income definitions between the tax system and the transfer system. A large number of different income definitions are currently used for different purposes. Moves towards greater commonality of tax income definitions with the transfer system would reduce complexity and simplify the client experience. They would also facilitate streamlined reporting arrangements for clients.

Policy reform to rationalise the number of deductions and offsets for personal income tax would also simplify the experience for clients. As discussed in Section A1 (Personal income tax), the Review recommends that a wide range of deductions and offsets be rationalised and removed from the system, and that a standard deduction be adopted for work-related expenses and for the cost of managing tax affairs. Rationalising deductions and offsets would reduce record keeping requirements and simplify completion of personal income tax returns. It would also enable the ATO to provide a significant proportion of taxpayers with a substantially complete pre-filled personal income tax return as a default.

Streamlining mandatory administrative requirements for clients of the tax and transfer system would also simplify the client experience. Significant administrative requirements present themselves to tax and transfer clients (especially in relation to applying for transfers) as a large number of forms require clients to physically sign and return them, either by mail or in person. Clients may also need to provide original or certified copies of documents, either by mail or in person, to establish their identity or support their application. These cumbersome requirements are a source of constant irritation for clients. To facilitate an improved client experience, the Review recommends such administrative requirements be reformed to relieve clients of unnecessary contact and administrative burdens and provide clients with more convenient service delivery channels.

To ensure these improvements to the client experience of the system are maintained, future tax and transfer policy proposals should be subject to comprehensive impact statements. The effect new policy proposals have on administrative systems (such as technology and administrative application processes) supporting the client experience, as well as on the overall experience of clients interacting with the system, should be determined. These impact statements should be published.

Recommendation 124 proposes that existing tax and transfer provisions be reformed to support improvements in client experience, and future new policy proposals should be subject to comprehensive, published expected impact assessments on client experience systems and outcomes.

(iii) Greater use of real-time third-party reporting

Recommendation 125 proposes that, where possible, information required for determining tax liabilities and transfer entitlements should be collected from third parties, including employers, government agencies, financial institutions, and share and property registries.

More extensive third-party reporting of information needed to determine tax liabilities and transfer entitlements would mean people would need to do less themselves. Real-time reporting of this information and visibility of these flows through a person's client account would enable the system to be more responsive to changes in circumstances and more transparent to individuals.

A wide range of information about clients is provided to tax and transfer agencies by third parties such as employers and financial institutions. This information is used for a range of tax and transfer (and other) purposes, including confirming entitlement to transfers, but is not generally provided to agencies in real time.

If wage and salary information from employers, information about interest paid into bank accounts and information from property and share registries were reported to tax and transfer agencies in real time, clients would be able to meet many of their obligations under the system without having to do anything further. If salary data were reported in real time to a transfer agency, for example, a client's transfers could be recalculated immediately.

A first impression may suggest that such changes could create (possibly significant) additional compliance burdens for third parties. However, aligning such information reporting requirements with natural systems of businesses (such as the payroll system which processes payment of fortnightly salaries of employees) through the use of current and emerging technology, means that after the transition to these changed requirements is complete, overall compliance costs for businesses may actually fall.

These approaches could build on the experience of the Australian government's Standard Business Reporting (SBR) Program (see Box G4-6). The SBR Program is streamlining reporting requirements for business by working with developers of business software to ensure reporting information is held in a consistent way and reports required by regulatory and revenue authorities can be automatically generated.

Box G4-6: Standard Business Reporting

The report of the Taskforce on Reducing the Regulatory Burden on Business, *Rethinking regulation*, released in April 2006, recommended a whole-of-government business reporting standard. In 2008, the Council of Australian Governments endorsed SBR as one of nine additions to the regulation reform agenda.

The main goal of the voluntary SBR Program is to reduce the regulatory reporting burden on business by developing a single set of reporting definitions in a single language. A further goal is for the information to be sent directly and electronically from the business' systems to participating agencies.

From July 2010, businesses and their intermediaries will be able to see complete or partially complete reports, edit and confirm the details, and send these reports electronically to the appropriate government agency directly from SBR-enabled accounting, financial and payroll systems. Financial reporting is the initial focus, since this affects most businesses. Forms in scope include the ATO's Business Activity Statement, ASIC's Financial Statement and payroll tax administered by State and Territory revenue offices.

SBR is expected to result in businesses and their intermediaries spending less time preparing reports for government, with savings expected to reach approximately $800 million per year when fully implemented (Madden 2009).

Strategies such as the SBR Program (and approaches that build on it) will not just facilitate improving the experience people have of the system, but will also help improve the experience businesses have of the system. Among other things, such strategies will alleviate business compliance costs that arise out of interactions with government (see Recommendation 126).

The capabilities provided by the SBR Program will produce significant improvements in relation to government reporting for businesses. The benefits to business of using SBR, however, are not limited to government reporting. The use of SBR's reporting definitions, and the process of mapping those definitions to the information held in businesses' accounting and financial systems, offers further potential for improving reporting both within and between business entities.

Box G4-7: Building on Standard Business Reporting — beyond 2010

The current scope of SBR focuses on the high volume and frequent financial reporting by businesses. Once the current scope and base capability of SBR is delivered and bedded down, work will begin on increasing SBR's scope.

The key design principles for SBR involve the development and implementation of a single set of definitions and language for government reporting; enabling business accounting and financial systems to become the portal for business to report to government; as far as possible, making reporting to government a by-product of natural business systems and processes; and applying open and international standards based approaches wherever possible.

These principles have been applied to the current SBR design and it is intended the principles will be applied to other forms of reporting from business to government where information in accounting and financial systems can be leveraged to satisfy reporting requirements.

Further areas of reporting that would quickly leverage the SBR approaches include extension of the use of the 'single SBR credential' to other government agencies; occupational health and safety and workers' compensation reporting; the not-for-profit sector to enable the development of the proposed single chart of accounts; Department of Human Services requirements in relation to employees (for example, those of Centrelink); the superannuation industry; the Carbon Pollution Reduction Scheme; and sustainability reporting.

Given the SBR business model (and possible approaches building on it) relies on reporting directly from the accounting or financial systems used by business, the benefit of such approaches will increase in line with the number of businesses that use them. Use and acceptance of SBR approaches to reporting will be further enhanced by encouraging and enabling small businesses to adopt these approaches wherever possible.

It is well accepted that compliance costs have a proportionally greater impact on small businesses than on larger businesses, and these costs appear to have been growing over time (Board of Taxation 2007). Governments have made progress to help small businesses reduce compliance costs through a mix of education, streamlining administration and tax concessions. A further approach government could adopt to support small businesses to comply with the tax system (and help them improve people's and their own experience of the system) is by assisting them to be 'business-ready' to meet their reporting and compliance obligations when they commence business (see Recommendation 127).

Such assistance would aid small business to cope with their tax compliance obligations and to make informed investment decisions from the outset. Such assistance could include supporting small businesses to obtain professional accounting and legal advice in establishing their record keeping and accounting processes/systems, or assisting them to acquire appropriate technology in order to manage the taxation and other regulatory systems.

Despite the value of existing programs designed to help small businesses with their taxation obligations, there may be opportunities to provide assistance beyond current education and training, such as providing financial assistance to seek professional advice, or acquiring technology that enables electronic lodgement of forms and record keeping. Such an approach would provide an incentive to the software industry to develop products fit for purpose for small businesses but able to be scaled up to larger operations as the business grows. Such assistance, for example, could include providing support to small businesses to help them into (so to receive the benefits of) the SBR Program (see Recommendation 127). This assistance may consist of providing small businesses with a voucher that can be spent on software or technology to enable their business to utilise SBR.

As noted previously, relying on the 'natural systems' of third parties is also likely to improve the integrity of the system through more comprehensive and accurate provision of information.

Greater use of real-time third-party reporting would require legislative change to authorise it and, over time, make electronic reporting mandatory. Currently the rules about electronic reporting to government vary depending on the type of obligation. In some cases only large organisations are required to use electronic channels but many smaller organisations choose to deal with government electronically because of the convenience and efficiency offered. To enable individual citizens to access automated tax and transfer reporting, the third parties with which they have financial relationships will need to provide data to tax and transfer agencies that is accurate, timely and presented in a format that can be used by the client account.

(iv) Information standards to support interoperability

To take advantage of advances in technology and innovations in service delivery, urgent attention is needed to develop and adopt information standards that support interoperability of government and private sector systems. Specific initiatives, such as the client account and enhanced pre-filling, will not be possible without such standards.

Currently, government information management is fragmented. Client information and data are currently recorded in many different ways by various government and private sector bodies. Even simple things such as names and addresses are not recorded in a uniform way by such bodies. To facilitate a better client experience, it is important that information about a client can be recorded in a standard format that is easily interchangeable. Even with advances in information technology and data matching, verification of non-uniform client information can be a difficult and time-consuming process.

Development and adoption of standards is a substantial undertaking requiring a disciplined approach. The SBR Program provides a useful illustration of the processes and governance required to streamline and standardise information collection across multiple agencies and levels of government. The SBR Program has identified a potential reduction of 71 per cent in the number of unique pieces of data that business has to assemble, analyse and report to government — cutting it from 9,648 to 2,838 (Madden 2009).

Recommendation 128 proposes that common information standards, leveraging from the standards and governance put in place by the SBR Program, should be developed and adopted.

(v) A modern privacy and secrecy framework

People will be more willing to engage with a system that they trust and that is transparent to them.

Maintaining trust needs to be married with people's expectations that they should not have to provide government with the same information many times. Under the current tax and transfer system, where clients provide information to one government agency, that agency is sometimes unable to provide the information to other government bodies, due to privacy and secrecy laws. These laws limit the types of information that can be shared with other agencies and the circumstances in which it can be shared.

Having a modern privacy and secrecy framework that facilitates exchange of client information between government bodies would improve client experience of the system. Such a framework would, among other things, support the pre-filling of client information into application forms for transfers as well as the pre-filling of income tax returns.

The Commonwealth's secrecy and privacy laws are currently under examination.[10] In line with the general directions for change emerging from these processes, the future client experience will need a privacy and secrecy framework that obtains informed consent for broader use of information collected by any specific agency. This is likely to involve broadening the scope of the 'purpose for which the information is collected' to include supporting the management of a person's financial relationship with government.

Recommendation 129 proposes that a modern privacy and secrecy framework be developed and adopted.

A building block for facilitating information exchange is common authentication processes. For information to be exchanged easily between different types of organisations and entities, a reliable method is required for identifying records relating to a specific individual across different systems.

Currently many different client identifiers are used by federal, State and local government agencies. Private sector organisations use their own identifiers. A more efficient exchange of client information to facilitate improved client experience of the tax and transfer system requires either consolidation or linking of these identifiers (see Recommendation 130).

Linking records can have a number of benefits. These include increased administrative efficiency and enhanced data accuracy. It can also support evidence based policy development by facilitating drawing together administrative data into longitudinal cross agency sets. Academics and other external researchers could then access suitably confidentialised extracts.

On the other hand, linking records raises a number of privacy issues such as a possible change in the relationship between the individual and those they provide information to. Such a change in relationship could occur because the amount of client information available

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10 The Australian Law Reform Commission is currently reviewing the Commonwealth's secrecy laws. The Government's response to the Australian Law Reform Commission report 'For Your Information: Australian Privacy Law and Practice' was released at the Australia and New Zealand Chapter of the International Association of Privacy Professionals conference in Melbourne on 14 October 2009.

to different government agencies may possibly be broader and much more detailed than what is currently available to those bodies.

Health information is especially sensitive because it is very personal to individuals. For the purposes of privacy law, health information includes details about a person's health, any disabilities they may have, and medical treatments they may have undertaken. Due to the sensitivity attached to this information, it attracts additional privacy protections. Reforms under way to the Commonwealth's privacy laws, as well as initiatives to improve service delivery to individuals, acknowledge the delicate nature of such information. Given this sensitivity, health records should not be linked to arrangements discussed above.

An alternative (or perhaps a stepping-stone) to either consolidation or linking of client identifiers by government could be for clients to choose to link their various identifiers. Where individuals wanted the improved service benefits such linking could provide, they could choose to link their identifiers. As a result, when an individual filed their tax return or applied for a benefit, they might be asked to provide (once) multiple identifiers (for example, their tax file number, Medicare number and Centrelink reference number). Thereafter, these numbers would be linked and their client service enhanced.

(vi) Institutional reform

The existing institutional framework for taxes and transfers makes it difficult to achieve reforms that improve client experience quickly or reliably. As noted earlier, this is because initiatives to improve client experience in the system are largely progressed on a portfolio or organisational basis. Portfolio priorities thus determine what improvements are made. Portfolio priorities also tend to be given greater weight than cross-portfolio objectives, such as improvements in the way clients experience the whole system. Further, new policy objectives adopted in either the tax system or the transfer system (or other parts of government) may compromise future client experience objectives. Improving the client experience of the tax and transfer system requires a whole-of-system approach to governance.

Canada is considered an international leader in integrated service delivery. It has coordinating councils and support organisations that contribute to the development of common standards and approaches to integrating services and technology between agencies and levels of government.

In Canada, the Public Sector Chief Information Officer Council and the Public Sector Service Delivery Council have been in existence since the late 1990s. They bring together federal, provincial/territorial and municipal officials to exchange information on best practices, conduct joint research, adopt common practices and collaborate on service delivery.

Further, the Institute for Citizen-Centred Service (ICCS) is a non-profit organisation with a board of directors made up of leaders in service delivery and information technology from municipal, provincial and federal public sectors across Canada. The ICCS undertakes research to identify citizens' service needs and expectations, to assist the public sector in identifying and applying innovative, best practice service solutions, and to respond effectively to citizens' service needs.

The above initiatives may well be worth considering in the Australian context, but go beyond reforms of the tax and transfer system.

To achieve the narrower objective of improving client experience of the tax and transfer system, the Review recommends that a high-level taskforce be established under central agency leadership with the task of progressing the recommendations contained in this section (see Recommendation 131).

The taskforce could take a similar form to the SBR Program. There would be a small expert secretariat charged with implementing the reforms. It would need members with a mix of skills, with membership drawn from relevant government agencies as well as the private sector, including tax and transfer client representatives.

Key functions of the taskforce would include developing, consulting and overseeing reforms of the administrative arrangements and technologies that deliver the client experience of the tax and transfer system. The taskforce would regularly report on its progress to the Australian government and to Parliament. Additionally, to achieve its aims, the taskforce would lead consultations with relevant stakeholders, including citizens, privacy advocacy groups, professional associations, financial institutions and employer groups.

As a range of government processes are currently exploring citizen-centric service delivery, the taskforce would also be responsible for positioning the client experience reforms within the government's overall initiatives to improve the interaction between government and people.

The Review has gained great value from its public consultations and supports citizens being given more opportunity to contribute to service delivery design of the tax and transfer system.

There are some interesting international examples of getting citizens involved in service delivery reform. In 2003 the Belgian Secretary of State for Administrative Reform was asked to reduce the 'rigmarole' experienced by citizens and businesses in dealing with government regulation. Contact points were set up where people could make remarks and suggestions about administrative simplification. Every day, www.kafka.be received about ten proposals on how to improve existing regulation. As a result, within four years more than 200 laws and regulations were abolished or simplified.

In Australia, the Gov 2.0 Taskforce has been formed to investigate how the Australian government can use new 'Web 2.0' approaches to expand the uses of Commonwealth information and improve the way government consults and engages with citizens. The taskforce will make recommendations on how to maximise the extent to which government utilises the views, knowledge and resources of the general community.

Similarly for the proposed taskforce, a mechanism for engaging citizens in service delivery reform and capturing feedback from citizens on government service delivery, including both current administration and new proposals, would be of benefit. The ability to confirm with citizens what their preferences for improved client experience are, and to test possible reforms before implementing them, would be of great value.

Box G4-8: A day in the life of clients of Australia's future tax and transfer systems

Abby and Hank are a couple with two children. Abby works full time and Hank will be starting a new job tomorrow, after taking a year off from work to care for the children.

Updating his personal details with regard to the new job, Hank logs onto his government client account and in one transaction is able to provide his updated details to all relevant private and public sector bodies. This includes advising his employer of his tax file number and withholding details, and advising Centrelink of his employment income that may lead to changes in family or other transfer payments.

A month later, Hank accesses his client account to see a summary of his whole relationship with government, including his running balance of tax liabilities and transfer entitlements in real time. Hank checks his salary details, tax liability and transfer payments to determine what impact his employment income has had on his transfer payments. He uses a link to his superannuation account to check that payments of superannuation by his employer have commenced. Abby logs onto her client account and verifies that her details about transfer payments are the same as Hank's.

At the end of the financial year, Abby and Hank log onto their client accounts to see what transfers they received and the tax-related information used to finalise their affairs for the year. Using the client account, Abby and Hank's tax affairs are straightforward. Neither has to fill in a tax return as all relevant information has been collected from third-party information systems. They are both provided with a statement of their annual tax result.

The experience of clients of the future tax and transfer system such as Abby and Hank is much simpler, more transparent, accessible and timely than it was for clients in 2009.

G5. Monitoring and reporting on the system

Key points

Monitoring the tax and transfer system is essential to its long-term performance. Without government action, too little information will be collected about the operation of the system. This information is necessary to identify areas where particular transfers or taxes are not meeting their policy objectives. It can support research that improves understanding of the effects of the system, and guide policy responses to emerging problems.

High standards of transparency and accountability should apply to all forms of taxation, transfers and government expenditure. However, despite their similarities, tax expenditures and spending programs are not created, maintained, reviewed or reported in the same way. This means that there is often less transparency and accountability in the use of tax expenditures. While this situation continues, programs should not be delivered as tax expenditures unless there is a clear countervailing benefit in terms of efficiency, equity, complexity, sustainability and policy consistency.

G5-1 Monitoring the performance of the system

Australia needs a tax system that is efficient, equitable, simple, consistent and sustainable in the long term. Monitoring the system is essential to judging its performance against these criteria. Where possible, the performance of specific taxes and transfers should be measured objectively to identify whether they are meeting their policy objectives or not. An objective evidence base can reinforce public and government support for successful economic reforms (Wilkie & Grant 2009), and helps to determine when existing policy settings are no longer appropriate.

The Review has undertaken widespread public consultation in forming its recommendations and has been presented with many conflicting points of view. The judgment of experts about what to tax, and how, departs markedly from current practice in many cases. Moreover, there is no community consensus about existing taxes. Very few taxes received consensus support in submissions; many attracted conflicting recommendations, while a few received both condemnation and praise.

Sometimes, differences in opinion about taxes depend on underlying values or ideology. However, viewpoints are sometimes based on theory or conjecture that can be proved or disproved by appeal to the evidence. Wherever possible, policy-makers should draw on empirical observations in Australian conditions (Leigh 2009).

This becomes more important as governments seek to use tax-like instruments for a range of purposes beyond raising general revenue. For example, quite detailed knowledge is required to set rates of tax to correct market failures. To ensure such taxes actually make society better off overall, they should be calibrated to reflect the latest evidence on marginal social costs and benefits of different activities (see Section E Enhancing social and market outcomes).

Box G5-1: Better evidence is needed to set the rate of alcohol tax

Some taxes, such as congestion taxes and alcohol taxes, are designed to correct spillovers (or 'externalities'), which occur when individual decision-makers fail to take into account the impact of their actions on others. These taxes, while theoretically sound, are hard to implement in practice because objective and reliable information on marginal social costs is often not available.

This makes it difficult to set rates that actually target spillover costs. In the absence of clear evidence, the public may perceive a conflict of interest between setting tax rates to target social problems, and raising revenue. An acute example is the taxation of alcohol (see Section E5 Alcohol taxation).

In submissions and in meetings with the Review, stakeholders stressed the need for data based on an impartial, transparent and open methodology. These data could then form the basis for determining tax rates. For instance, the National Drug Research Institute (NDRI) submitted that:

> The drinking culture and characteristics of countries vary, as does that of different demographic and psychographic groupings within countries. Trends, behaviour and disposable income change over time. It is necessary to develop relevant data and to continually update those data.
>
> To optimise tax settings designed to influence price points as a contribution to safer and healthier consumption of alcohol, continual empirical scientific study is needed on price elasticities, cross-elasticities and substitution effects in the Australian context (Stockwell & Crosbie 2001). Such research needs to be done independently of vested interests. NDRI urges the Government to provide substantial ongoing funding for such work.

The paucity of information on some specific taxes or transfers means that data designed for other purposes are often used for analytical purposes. For example, the Review has received many submissions from a range of stakeholders about the taxation of alcohol. In making their arguments, many submissions relied on evidence about the social cost of alcohol consumption, drawing on Collins and Lapsley's cost of illness studies (2008b) as well as survey data from the National Health and Medical Research Council. However, the findings in these studies cannot be directly imported into a tax policy context. In his research for this Review, Cnossen (2009) highlighted some of the methodological issues involved.

As a means of increasing the availability of evidence and informing debate, the Review Panel has commissioned a series of papers to explore significant tax and transfer policy issues.

Principles

Monitoring the system is essential to judging its long-term performance. Where possible, governments should objectively measure the performance of specific taxes and transfers to identify whether they are meeting their policy objectives or not. Data on the tax system should be freely available to the public.

Data on the tax system are a public good and should be freely available

Unbiased and systematically collected data on the tax system, based on widely accepted methodology and appropriate for tax policy purposes, are rare and often not available in the public domain. Because such information is a public good (see Section E1 on user charging), and even though society would benefit through improved tax policy based on it, incentives for individuals or businesses to produce it are weak. In addition, the capacity of non-government actors to generate this type of information is limited when government holds much of the data needed to conduct analysis.

Some data on the effect of taxes and transfers are already being produced. In many submissions to the Review, stakeholders have supported arguments with data that range from in-house survey results to more sophisticated economic modelling. The Review has considered this information in coming to its recommendations. However, if the underlying sources and methodology are not transparent, it is difficult to judge between competing claims.

There is a greater risk of biased evidence where the functions of data collection and analysis are not clearly separated. If data are gathered for the purpose of supporting a particular argument or interest group, they are unlikely to persuade those with competing interests.

In some cases, estimates are produced, but only as a snapshot at one particular point in time, and often only on a small or partial scale. For example, while there have been a few studies of compliance costs imposed by the tax system (such as Pope 1994 and Evans et al. 1997), there has been no aggregate study of compliance costs in Australia since 2000 and there is no system-wide study of compliance costs that can monitor, on an ongoing basis, the costs of complexity. Proxies, like the number of tax agents or the length of the income tax laws, are of limited policy use. Well-designed system-wide surveys are expensive, but they would provide valuable information on where simplification would yield the greatest returns.

There is also little published information about the extent of non-compliance with the tax laws. The Australian Taxation Office (ATO) does not currently attempt to derive aggregate estimates of non-compliance for key income and deduction items or publish detailed results of its non-compliance activities.

There is very little information on compliance costs incurred by clients in meeting their obligations in respect of transfer payments — for example, in claiming payments, reporting earnings or changes in income and participating in reviews of their entitlements. However, Centrelink and various policy agencies conduct a range of surveys and analytical exercises that could be extended to provide better, ongoing information about client compliance costs.

The reliability of information could be improved by adopting a consistent methodology, classifications, concepts and data collection approaches that could operate as a common standard for tax data, irrespective of who produces it. This would improve the capacity of business, academics and government agencies to produce evidence to inform the policy process.

The prime consideration for the collection of data is to ensure that collection is not biased. The Australian Bureau of Statistics might be best placed to conduct surveys on compliance costs, as well as the social costs associated with particular activities (for example, the consumption of alcohol, tobacco or transport).

Existing data sources could be better utilised

In the past, Australian tax unit record files have not been generally available for research purposes. However, in 2009 the ATO produced and released a confidentialised 1 per cent sample file containing individual tax return information. Over time, expanded availability of this, and similar data for other taxes, would allow deeper analysis of the individual-level effects of the tax system. These data should only be used for statistical purposes, and should never be provided in a form in which individual privacy could be compromised. The guarantee that data will be kept confidential produces better quality data and higher response rates. Further developing protocols for making such data available for research purposes would unlock valuable public information resources.

Data on the transfer system are more readily available than tax data. Confidentiality and privacy concerns are addressed by providing de-identified data under strict terms relating to its use and safe storage. Research undertaken using social security data has generated many insights that have fed into policy development, including information on the persistence of welfare dependence among specific groups, the 'transmission' of welfare dependence between generations, the responsiveness of different groups to policy changes, and the effectiveness of policies in achieving their intended outcomes. Linked datasets, especially longitudinal datasets, are a powerful tool for evidence based policy. The experience of the Department of Families, Housing, Community Services and Indigenous Affairs (FaHCSIA) has highlighted the considerable benefits that can be derived from making this type of data available to academic and other researchers.

Findings

Unbiased and systematically collected data based on accepted methodologies and appropriate for policy purposes are rare and often not publicly available.

While society as a whole would benefit through improved tax policy from this information, the incentives for individuals or businesses to produce it are weak. Also, the capacity of non-government actors to conduct analysis of the system is limited when much of the information needed to do this is held by government.

Periodic analysis is needed to judge the system's performance

Recommendation 132:

The government should, every five years, publish a Tax and Transfer Analysis Statement that analyses and reports on the overall performance and impact of the system, including estimates of efficiency costs and distributional impacts.

Recommendation 133:

The Australian and the State governments should systematically collect data on aspects of existing taxes and transfers — including compliance cost data — according to consistent and transparent classifications and concepts, and make this information — including confidentialised tax unit records — freely available for further analysis and research.

Recommendation 134:

The government should support one or more institutions to undertake independent policy research relevant to the Australian tax and transfer system.

Australia needs a tax and transfer system that is efficient and equitable in the long term. To see whether these objectives are being met, it is important to analyse and report on the system's performance objectively and comprehensively. Currently, no such assessment of the system is undertaken.

Instead of assessing the performance of the tax and transfer system as a whole, it has become customary to consider elements of the system separately. As a consequence it is difficult to get a sense of the system's combined performance and effects, and to determine whether the system is making a coherent contribution to our national objectives.

The tax and transfer system is subject to continual change, and operates in a constantly evolving environment. Periodic analysis is needed to ensure it continues to perform as intended, and to identify areas that require attention. In theory, it might be desirable to constantly review and assess the system, but this is not feasible in practice. Instead, the Australian government and the States should periodically report on the performance of the entire system in a 'Tax and Transfer Analysis Statement'. This assessment could be carried out at regular intervals, such as every five years, to balance costs and benefits of the exercise (see Recommendation 132). The Australian government should initiate this change, with the Council of Australian Governments to examine the ways in which the States could follow suit.

Among other things, the Statement could estimate the total and marginal efficiency costs of taxes, tax expenditures and means tests. It could include information about the economic burden and distribution of taxes and transfers, and about tax expenditures not possible to publish in the annual Tax Expenditures Statement (discussed below). The problem of tax evasion and avoidance could be monitored and assessed by publishing detailed estimates of the level of non-compliance. This would inform the policy and administration changes needed to maintain the integrity of the system.

The Tax and Transfer Analysis Statement would contribute to ongoing research and debate about the objectives and performance of the tax and transfer system. Academics, practitioners and the general public should be encouraged to contribute to, and contest, the analysis presented in the Statement. All data used in the analysis and a full description of methodologies should be available to the public and ideally subject to peer review.

Government agencies should ensure that data on all aspects of the tax and transfer system are shared as widely as possible (see Recommendation 133). Provided that confidentiality of individual records is guaranteed, as much data as possible should be freely available to researchers, universities, think-tanks, businesses, other agencies and the public at large. While the analysis of this data would clearly be contestable, it would help provide a common point of reference for discussions of the tax and transfer system.

Another approach would be to establish an academic institution or a partnership between institutions that could draw funding from public and private sources to undertake tax research and evaluation (see Recommendation 134). An arrangement like this exists in the United Kingdom, where an independent business tax research centre is funded by the business community and has access to government data sources.[11] Similar bodies operate in Australia, in other areas of research.

On the transfer side of the system, the Department of Families, Housing, Community Services and Indigenous Affairs funds research organisations to provide it with independent, high-quality research services. The research allows social policy to be made on a strong evidence base and permits information, data and analysis to be disseminated for public use. Aside from ongoing formal arrangements such as these, there is also a role for conferences and other forums to facilitate open discussion between public officials and private sector experts.

Any government institution would need to be careful not to 'crowd out' analysis from universities, think tanks and peak bodies. However, it could identify and help fill gaps in analysis, or identify where there are holes in the data available to researchers.

G5-2 Managing, measuring and reporting on tax expenditures

The main objective of any tax system is to raise revenue to fund government activities. However, the system also provides a government with the opportunity to achieve objectives directly, by reducing taxes to encourage certain activities and to direct assistance to particular groups. These forms of assistance are known as tax expenditures.[12] They can be provided in many ways, including through exemptions from tax, tax deductions, tax offsets, concessional rates of tax, a change in the timing of a deduction or the deferral of a tax liability. Not all concessions delivered through the tax system are tax expenditures. For instance, some refundable tax offsets are classified as spending programs, even though they are administered through the tax system.

Tax expenditures provide many billions of dollars of relief from taxes, with significant effects on the budget and the economy. They reduce revenue that, if collected, would have been available to fund spending programs to meet similar objectives. Accordingly, their net effect on the budget is similar to that of spending programs. Assuming the case for government assistance has been made, a decision for policy-makers is whether to deliver that assistance by making a direct payment (such as a grant) or conferring a tax concession.

High standards of transparency and accountability should apply to all forms of government expenditure to engender greater community trust in, and therefore engagement with, the tax and transfer system.

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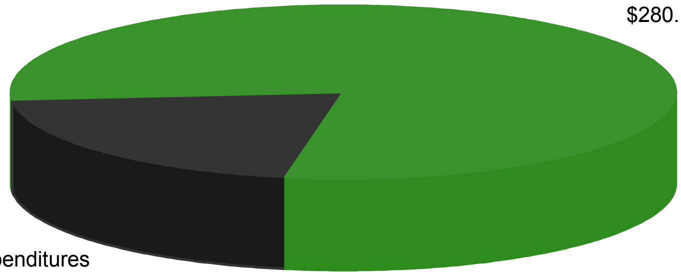
11 The Centre for Business Taxation was established in 2005 as an independent research centre of the University of Oxford.

12 The focus of this section is on those tax expenditures that reduce tax liabilities. However, the tax expenditure concept is defined as being any deviation from the 'normal' tax benchmark, and so also includes aspects of the tax system that increase tax liabilities. These 'negative tax expenditures' might be thought as being equivalent to a fee or an additional tax.

Chart G5-1: Tax expenditures and direct expenditures in 2007–08



Source: Tax Expenditures Statement 2008.

Principles

Tax expenditures should ideally be subject to the same levels of transparency and accountability as equivalent spending programs. Without such transparency and accountability, programs should not be delivered as tax expenditures, unless there is a clear countervailing benefit in terms of efficiency, equity, complexity, sustainability and policy consistency.

Comparing tax expenditures and equivalent spending programs

Despite their resemblance, tax expenditures differ from spending programs in a number of ways. For instance, tax expenditures often receive Parliament's attention only at the time they are introduced, and they are subject to a less comprehensive management and reporting framework than spending programs. These differences, examined in more detail below, are often the source of concerns about the transparency of tax expenditures.

Tax expenditures and direct spending programs are often designed in quite different ways. In particular, the design of tax expenditures is often constrained in practice by the policy, legislative and administrative framework of the tax system. These constraints can significantly affect the efficiency, equity, complexity, sustainability and policy consistency of tax expenditures.

Efficiency

Like direct expenditure programs, tax expenditures can impose efficiency costs by encouraging taxpayers to undertake tax-favoured activities at the expense of other activities.

Some tax expenditures aim to correct market failures and so may improve efficiency by encouraging activities that would otherwise be underprovided. However, governments aim to encourage such activities without providing a windfall gain to people who would undertake them without the tax expenditure. It can be difficult for governments to set the level of a concession that encourages the favoured activities to the intended extent. This can also be true of spending programs. However, the fact that tax expenditures are typically claimed at the end of a financial year means there is less opportunity for the government to monitor the effect of the tax expenditure during the year to ensure it is having the desired effect.

On the other hand, use of tax expenditures rather than spending programs can reduce the need for direct government supervision of a policy, thereby saving administration costs. For example, there may be administrative savings from using the tax system rather than establishing a new bureaucracy to implement a spending program. However, in some cases the costs of a tax expenditure may simply not be as apparent. While establishing a new agency will have obvious budgetary and administrative costs, the extra costs borne by the tax administrator may not be as obvious.

In some cases, the tax system is a more administratively convenient way of delivering assistance than an equivalent spending program. However, the tax system may not be as efficient for the types of assistance that depend on characteristics not commonly reported in tax returns.

Finally, there is a question about the ability of the tax authorities to deliver non-tax programs efficiently. Naturally, tax authorities have built their expertise around the collection of taxes. The proliferation of tax expenditures has increased pressure on tax authorities to develop the ability to deliver other programs. It is important to consider whether the tax authority is properly equipped to perform this role, and also whether this impedes the ability of the tax authority to perform its core revenue collection function.

Equity

Many tax expenditures have been introduced to improve the fairness of the system. However, some tax expenditures actually reduce the equity of the system by directing benefits disproportionately to people on higher incomes.

For example, some tax expenditures directed towards individual taxpayers are delivered through income tax deductions. Progressive rates of the personal income mean these tax deductions have a greater value for those on higher incomes.

This is not an inherent weakness of tax expenditures as a policy tool. Rather it is a consequence of delivering particular tax expenditures as personal tax deductions, when they could have been provided as tax offsets (which have the same value to all recipients).

Complexity

Tax expenditures can add complexity to the tax system. They complicate the law and create additional choices for people. They can generate unintended opportunities for tax planning.

While providing a benefit through the tax system may reduce program administration costs, in practice it may impose extra compliance costs on taxpayers who need to understand how the concession applies. It may also impose costs on taxpayers who do not benefit from the tax expenditure, particularly in a system of compulsory filing. Moreover, as new tax expenditures are added, complexity increases because taxpayers need to understand the compounding number of interactions between the many rules.

Most tax expenditures could be delivered as direct expenditures. This would improve the tax system but would not necessarily reduce the overall level of complexity imposed on society. In the end, the focus should be on total complexity, regardless of whether that complexity arises within or outside the tax system.

Sustainability

Tax expenditures should be considered in light of revenue sustainability. Policies need to be affordable over the longer term, particularly in light of the demographic challenges facing Australia.

Tax expenditures can be difficult to contain. They can lead to erosion of the tax base as different groups put their case for further concessions. Once the system features a number of tax expenditures, the case for further tax expenditures is strengthened. In other words, the special treatment of one sort of taxpayer or activity tends to weaken the benchmark treatment against calls for similar concessions for other taxpayers or activities.

Tax expenditures can make it difficult to appreciate the extent of government intervention. For instance, they can reduce both tax collections and direct expenditures, making government appear smaller than it would if the same policies were pursued through direct expenditures. Once a tax expenditure is established, it can be politically difficult to remove it because that can be portrayed as a tax increase.

The proliferation of tax concessions may also threaten the integrity of the system. Voluntary compliance of taxpayers is a valuable aspect of our tax system. In particular, the collection of income tax under a system of self-assessment depends heavily on the community's trust in, and commitment to, the system. Tax expenditures can undermine this trust, especially when they are seen to be unfair or complex. As noted above, the design of many tax expenditures, and their lack of transparency and accountability, can contribute to these perceptions.

Around 320 tax expenditures were identified in the *Tax Expenditures Statement* 2008. In the past five years, around 50 new tax expenditures have been added to the federal tax system. A similar number have been identified as tax expenditures for the first time during this period. The value of tax expenditures has risen from an estimated $50.2 billion (5.3 per cent of GDP) in 2004–05 to an estimated $73.7 billion (7.1 per cent of GDP) in 2007–08.[13] While tax expenditures are not projected to continue to grow at this pace, the figures highlight the significance of tax expenditures and the restrictions they impose on the government's ability to fund services.

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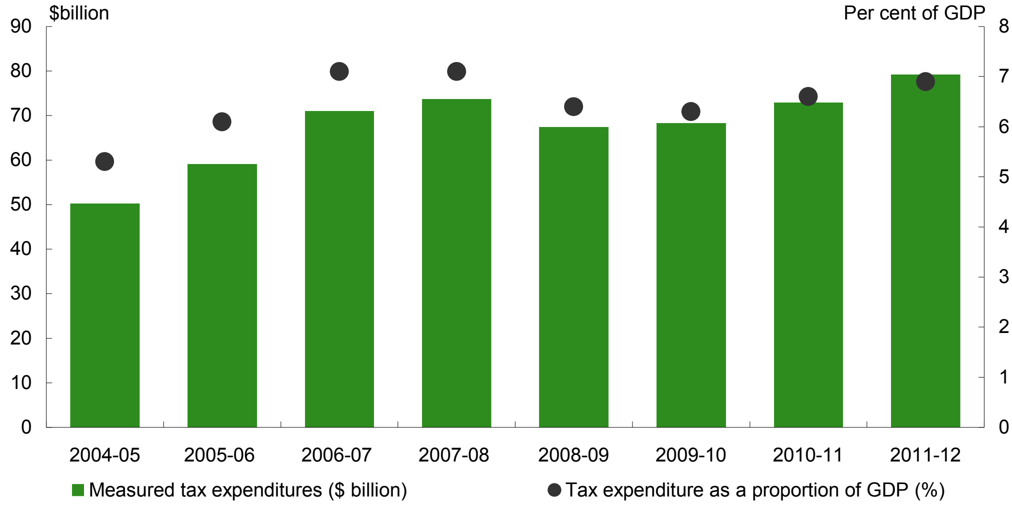
13 Tax Expenditures Statements, various years.

Chart G5-2: Australian government tax expenditures



Source: Tax Expenditures Statement 2008.

Policy consistency

A final design principle is that the tax and transfer system should be consistent with broader policy objectives. This suggests that all policies should be considered in an integrated way, and that it is their combined impact that matters. This is particularly relevant when assessing the role of tax expenditures, since the justification for many of them lies in other economic and social policy objectives.

Findings

While tax expenditures and direct spending programs are conceptually similar they are often designed in quite different ways. The design constraints on tax expenditures can significantly affect their efficiency, equity, complexity, sustainability and policy consistency.

Determining whether the benefits of tax expenditures justify their costs depends on effective monitoring and scrutiny. Tax expenditures are currently subject to less comprehensive management and reporting than spending programs. This hampers the effective supervision of individual tax expenditures and means that, in many cases, it is not possible to work out whether objectives are being achieved.

Making tax expenditures more transparent and accountable

Recommendation 135:

The Australian government should ensure that the rules governing the development of the Budget encourage trade-offs between tax expenditures and spending programs. Budget decision-making processes should measure and treat tax expenditures and spending programs symmetrically, to ensure that there is no artificial incentive to deliver programs through one mechanism rather than another.

Recommendation 136:

The government should introduce legislation to amend the *Charter of Budget Honesty Act 1998* to recognise the publication of detailed information about tax expenditures in a Tax Expenditures Statement separate from the Mid-Year Economic and Fiscal Outlook (MYEFO). However, the Tax Expenditures Statement should continue to be released by the end of January in each year, or within six months of the last Budget, whichever is later.

Recommendation 137:

The government should ensure that reporting standards are independently developed for the identification and measurement of tax expenditures in the Tax Expenditures Statement. In addition, the standards should establish a basis for reporting the broader economic and distributional effects of tax expenditures in the periodic Tax and Transfer Analysis Statement (see Recommendation 132).

Recommendation 138:

The Council of Australian Governments should examine the ways in which the States could uniformly report tax expenditures annually according to the independent standards developed under Recommendation 137.

Encouraging trade-offs between tax expenditures and spending programs

The Budget is the government's key decision-making process for revenue policy. It is therefore the most important process by which new tax expenditures are created and existing tax expenditures can be reviewed.

Under the Budget process, tax expenditures are settled after spending measures. The two are not usually examined together. This means that tax expenditures are not directly compared with other policy priorities and new spending proposals. There are no formal processes to ensure that tax expenditures are prioritised against other spending or to assess the efficiency of a tax expenditure in achieving outcomes. This increases the risk that tax expenditures are not properly coordinated with spending programs in the same policy area.

Ministers may, in conjunction with the Treasurer, propose new tax concessions on the basis that the reduction in revenue is offset by savings from within the Minister's portfolio. In this way tax expenditures can be controlled at the policy development stage by ensuring that the cost of any new concession is counted against the relevant portfolio budget and that offsetting savings are required in the same way as for spending programs.

However, ministers are not usually able to claim as savings any increases in revenue that might flow from the removal of an existing tax expenditure. In the past, this has tended to discourage the replacement of tax concessions with equivalent spending programs.

A more symmetrical treatment of tax expenditures and spending programs as part of the Budget process would encourage trade-offs between them and would help to ensure that policy objectives are pursued at least cost (see Recommendation 135). To do this, however, requires that expenditures and tax expenditures are measured on a consistent basis.

The establishment of 'spending rules' that limit the size or growth of government spending can have the perverse incentive of encouraging new tax expenditures, unless there is a similar constraint on revenue policy. Such rules create incentives to use tax expenditures as substitutes for government spending. This was a problem Sweden experienced when it imposed a spending cap with no restriction on tax expenditures (OECD 2009a). Australia should be mindful of this example and ensure that the restraint applied to spending proposals is also applied to tax expenditures.

Reporting tax expenditures more effectively

In contrast to direct government spending, which is generally scrutinised during the annual Budget process, tax expenditures often receive attention only at the time they are introduced. Systematic reporting of tax expenditures is therefore necessary to ensure they receive a similar degree of scrutiny as direct expenditures. This also makes it easier to compare tax expenditures and direct expenditures.

Australian governments have published annual estimates of tax expenditures since 1980, initially as an appendix to the Budget. The first separate Tax Expenditures Statement, providing detailed estimates of tax expenditures and the associated benchmarks, was published in 1986. The publication of this information became a legislative requirement under the *Charter of Budget Honesty Act 1998*.

An element of the framework established by the Act was that the Mid-Year Economic and Fiscal Outlook (MYEFO) would include detailed estimates of both tax expenditures and spending programs, thereby enhancing the scrutiny of both forms of expenditure. However, MYEFO estimates of tax expenditure have not yet been presented in a disaggregated form. Instead, this information is published separately in the Tax Expenditures Statement. MYEFO is released by the end of January in each year, or within six months of the last Budget, whichever is later. The separate Tax Expenditures Statement has also been released within this timeframe.

The purpose of MYEFO is to update key information in the most recent Budget. It provides an update on the government's fiscal and revenue strategy, rather than a comprehensive account of all measures. So, even if detailed estimates of tax expenditures could be produced for MYEFO, it would be difficult to compare them against spending programs in any detailed way.

Including fully detailed tax expenditure estimates in MYEFO would significantly change its focus as an update to the government's fiscal and revenue strategy and could delay its release. A better means for managing tax expenditures is by ensuring they are examined in the same way as spending programs in the Budget process. Detailed estimates of tax expenditures need to be prepared far enough ahead of the Budget to allow them to inform government decisions. The Tax Expenditures Statement should continue to be released within the same timeframes as MYEFO, though not necessarily at the same time. The *Charter of Budget Honesty Act 1998* should be amended accordingly (see Recommendation 136).

Identifying tax expenditures

In order to identify a tax expenditure, the tax treatment that would normally apply (the benchmark) needs to be identified.

Not all concessional elements of the tax system are classified as tax expenditures. This is because some concessions are considered to be structural elements of the tax system and are incorporated in the benchmark. For example, the personal income tax system includes a progressive marginal tax rate scale, which results in individuals on lower incomes paying a lower marginal rate of income tax than those on higher incomes. This arrangement is a structural design feature of the Australian tax system and is therefore not identified as a tax expenditure. There may be different views on which structural elements to include in the benchmark. These benchmarks can vary over time and can sometimes be perceived as arbitrary.

The original concept of a tax expenditure includes only some of the concessional features of the tax system provided under the law. However, many tax benefits arise as a consequence of administrative practice or through non-compliance with the law. Some consider that these 'benefits' should be reported in the same way as other tax expenditures (ANAO 2008).

The purpose of reporting tax expenditures is so the community can understand how the tax system affects the economy and society more broadly. Benchmarks should allow an objective evaluation of the effects of government policy, rather than represent that policy. For example, if a tax concession is set up to assist a particular industry the benchmark should not incorporate this objective, but should provide a basis for identifying and valuing the concession. This allows the community to judge whether this form of assistance is appropriate.

Currently, many of the most important economic and distributional effects of taxes are incorporated in the benchmarks and so are not reported in the Tax Expenditures Statement. As noted above, a separate and broader Tax and Transfer Analysis Statement could include this kind of information about structural tax features. Even if this information is not reported annually in the Tax Expenditures Statement, the benchmark should be defined according to transparent and independently established standards.

The *Charter of Budget Honesty Act 1998* requires budget reporting to be undertaken against a set of external standards. External standards are also supposed to apply to the reporting of tax expenditures, but no such standards exist. The development of these standards would improve the integrity of the process. They would provide greater consistency in the identification and measurement of tax expenditures, which would allow more reliable examination of trends over time.

Consideration needs to be given to whether an existing body should develop these standards or whether a new body should be established. One option the government might wish to consider is the establishment of an academic advisory panel that could independently develop standards for identifying and measuring tax expenditures. Whichever option is adopted, the body charged with the task should be equipped with the necessary skills and experience and should operate independently (see Recommendation 137).

Measuring tax expenditures

Unlike direct spending by the government, tax expenditures represent the *notional* cost to government of not collecting revenue that would otherwise be collected. These notional costs can be difficult to estimate, and the estimates can sometimes be misinterpreted as the amount of revenue that could be raised if the tax expenditures were abolished. For these reasons, tax expenditure estimates need to be treated with some caution.

The Tax Expenditures Statement estimates the value of tax expenditures using the 'revenue forgone' approach. This method is seen as the most reliable approach for estimating the level of assistance the tax system provides to taxpayers. Most other OECD countries also use this approach.

The revenue forgone approach calculates the benefit of a tax expenditure to taxpayers, rather than the budgetary cost of the expenditure. Estimates calculated by the revenue forgone approach identify the financial benefit to taxpayers of receiving a tax expenditure relative to taxpayers that do not. It does not necessarily follow that there would be an equivalent increase to government revenue from abolishing the tax expenditure. This is largely because of changes in taxpayer behaviour that removing the tax expenditure would cause (for example, removing one concession may result in increased use of others).

The 'revenue gain' approach has sometimes been proposed as an alternative to the revenue forgone approach in order to produce tax expenditure estimates that are more comparable to budget revenue estimates (ANAO 2008). This would directly measure how much revenue would increase if a concession were removed. It involves making assumptions about the way taxpayers would respond to policy changes. It also requires assumptions about the order in which tax expenditures are removed. This means there are considerable difficulties in preparing such estimates for all tax expenditures in the Tax Expenditures Statement. However, the Tax Expenditures Statement 2008 included revenue gain estimates for some major tax expenditures.

The revenue gain approach does not necessarily reflect the value of the concession to taxpayers. For instance, where an activity is highly sensitive to a concession, the increase in revenue from removing the tax expenditure could be very small. In these cases, revenue gain estimates give the impression that the tax expenditure has little impact, when in reality the recipients derive significant benefits. However, the revenue gain approach is useful when reviewing a tax expenditure since it indicates the revenue that could be realised for government if the expenditure were abolished. Revenue gain estimates for significant tax expenditures should continue to be published in the Tax Expenditures Statement.

A third approach to measuring tax expenditures is the 'outlay equivalence' approach. This approach estimates how much direct expenditure would be needed to provide a benefit to a recipient — assuming the payment is subject to the usual tax treatment for that type of income —that is equivalent to the tax expenditure.

The outlay equivalence method has the advantage of estimating tax expenditures on the same basis as spending programs, which may allow a better assessment of their comparative merits. Outlay equivalence estimates are likely to be most useful when policy-makers are considering whether to deliver a program as a tax expenditure or a spending program.

These estimates can differ significantly from estimates produced under a revenue forgone approach, which focuses on the annual effect of a concession on revenue collection. The Tax Expenditures Statement shows the annual effects of tax expenditures and so makes no distinction between concessions that defer tax and those that reduce tax. In effect, a tax deferral is a loan made by the government to a taxpayer and the value of the loan is the interest concession. For instance, the effect of accelerated depreciation is to allow taxpayers to claim larger deductions in the early life of an asset, and lower deductions in the latter part of the asset's life. Accelerated depreciation does not increase the size of the deductions that can be claimed overall, but it does bring them forward. This bring-forward represents an interest-free loan made by the government to taxpayers. Using the revenue forgone approach, the Tax Expenditures Statement shows the lower taxes paid in early years and the higher taxes paid later, rather the interest value of the deferred taxation. In contrast, the outlay equivalence method would estimate the value of the interest-free loan. This type of information about tax expenditures should be presented in the periodic Tax and Transfer Analysis Statement (see Recommendation 132).

Reporting State tax expenditures

In order to give a comprehensive sense of the level of government assistance provided through the entire tax system, tax expenditures need to be measured for all taxes. The Australian government currently reports tax expenditures across its main taxes. However, there is no comprehensive or consistent reporting of tax expenditures by the States. In particular, the benchmarks used by States differ significantly, so it is not possible to make a direct comparison of tax expenditures between jurisdictions.

To remedy this, reporting standards should be developed and applied across the range of State taxes in a uniform and thorough way. The Council of Australian Governments should examine the ways in which the States could uniformly report tax expenditures annually (see Recommendation 138).

Glossary

Term	Definition
Adjusted taxable income	For the purposes of certain means-tested assistance programs, taxable income is adjusted to include other income items, such as fringe benefits, certain tax-exempt foreign income amounts and net investment losses.
Ad valorem tax	A tax that is levied as a percentage of the value of a particular good or service; for example, a 3 per cent royalty on the value of gold production or an 8 per cent tax on the value of an insurance premium.
Allowance for corporate equity (ACE)	A form of business expenditure tax that provides a deduction (allowance) for corporate equity at the corporate level, equivalent to that provided for interest on debt.
Allowance for shareholder equity (ASE)	A form of expenditure tax similar to the allowance for corporate equity that provides a deduction (allowance) for shareholder equity at the shareholder's level.
Allowee	A person who receives an income support allowance (for example, Newstart Allowance or Youth Allowance), rather than a pension, such as the Age Pension or the Disability Support Pension.
Average weekly earnings	Average weekly earnings statistics represent average gross (before tax) earnings of employees. Estimates of average weekly earnings are derived by dividing estimates of weekly total earnings by estimates of number of employees.
Average weekly ordinary time earnings (AWOTE)	Weekly ordinary time earnings refers to one week's earnings of employees for the reference period attributable to award, standard or agreed hours of work. It is calculated before taxation and any other deductions (for example, superannuation, board and lodging), have been made.
Capital income	Earnings from investments and savings, including interest, net rental and business income, capital gains and dividends.
Cash flow tax	A system that taxes the difference between cash receipts and cash outgoings.
Categorical income support	Income support that is paid on the basis of eligibility conditions that divide people into groups. For example, age, disability, caring responsibilities, and those undertaking education or training.

Term	Definition
Compliance cost	Expenses incurred in meeting the requirements of legislation or regulations. Compliance costs include a wide range of monetary and non-monetary costs.
Concessional superannuation contribution	A contribution that has not been taxable as income in the hands of an individual, or for which the person has received a deduction. These contributions are currently taxable within a superannuation fund.
Corrective tax	A tax designed to make markets more efficient by exposing producers and consumers to prices that reflect the costs that they impose on others (such as pollution).
Cut-out point	The level of income or assets that results in a person no longer being eligible for a transfer payment.
Deduction	Losses or outgoings incurred in producing income or running a business that can be used to reduce assessable income.
Deeming	Assuming a rate of return on an asset regardless of its actual rate of return. Used in determining eligibility for some transfer payments.
Depreciation (economic)	The decline in the market value of an asset over its life.
Depreciation (tax)	The decline in value of an asset for taxation purposes, which may differ from economic depreciation.
Distortion	Any action or thing that reduces economic efficiency. Distortions generally arise when private action (such as price-fixing by a cartel), or public action (such as a tax imposed by government), changes an individual's or firm's behaviour.
Dividend imputation	A system that integrates the taxation of companies and shareholders by allowing companies to pass imputation credits (representing tax paid at the company level) to shareholders upon payment of a dividend. This allows the shareholder to take into account any company tax paid in respect of a dividend they receive when calculating their tax liability. For example, if a shareholder has a marginal tax rate of 30 per cent and receives a fully franked dividend (one paid out of earnings that have already been subject to the 30 per cent company income tax), they would not be required to pay any additional personal income tax.

Term	Definition
Dividend streaming	A strategy that aims to direct ('stream') dividends with imputation credits attached to those shareholders for whom imputation credits are of most value. For example, as resident shareholders are able to use imputation credits to lower their tax liability while non-resident shareholders cannot, dividend streaming would see profits that have imputation credits attached to them paid to resident shareholders, while profits without imputation credits attached to them would be paid to non-resident shareholders.
Dual income tax	A dual income tax system imposes differential rates of tax on capital and labour income.
Economic incidence	The individual or entity which bears the final burden of a tax (or receives the benefit of a transfer), after response effects, such as price and wage changes, are taken into account. This is distinct from the legal incidence of the tax or transfer. For example, the legal incidence of a consumption tax is often the supplier of goods and services who is legally required to pay the tax. However, the supplier may be able to factor in the tax they pay into the price of their products or services that they charge to consumers. This results in the consumer paying a higher price for the good or service. In such cases, the consumer bears the economic incidence of the tax through paying higher prices even though it is the supplier that is legally liable to pay all of the tax.
Economic rents	An economic rent is the excess of the return to a factor of production above the amount that is required to sustain the current use of the factor (or to entice the use of the factor). For example, if a worker is paid $100,000 but would still be willing to work at the same job if they were paid $75,000, their economic rent would be $25,000.
Effective life	The period over which a depreciating asset can be used for income-producing purposes.
Effective tax rates (labour taxes)	Effective Marginal Tax Rates (EMTRs) for labour measure the proportion of gross pay lost in taxes and reduced transfer payments due to a small change in gross income (for example, a change of $1.00). Effective Average Tax Rates (EATRs) for labour are a measure of the proportion of gross pay that is lost to tax or reduced transfer payments due to that gross income.

Term	Definition
Effective tax rates (savings and investment)	Effective Marginal Tax Rates (EMTRs) on savings and investment measure the effect of taxation on the return to an investment in a marginal project, which is one that earns no super normal profits. Effective Average Tax Rates (EATRs) for investment measure the effective tax burden on an additional unit of investment. EATRs can be used to examine the tax burden on investments with super normal profits.
Efficiency	Efficiency means making the best use of resources. 'Technical' or 'productive' efficiency means producing as many goods or services as possible from a given set of inputs. 'Allocative' or 'economic' efficiency means putting productive resources (like labour, land or capital), to their highest value use and distributing goods and services to consumers in a way that best satisfies consumer needs and wants.
Elasticity	A measure of the responsiveness of one variable to changes in another. For example, the 'price elasticity of demand' refers to the percentage change in the amount of a good purchased ('demand') following a percentage change in its price. If the percentage change in demand is more than the percentage change in price, demand is said to be price 'elastic'; if it is less, demand is said to be price 'inelastic'.
Entity	A unit for taxation purposes. Entities include a company, trust, partnership, any unincorporated body or association, and an individual.
Excise	A commodity-based tax levied on the manufacture or production of selected goods in Australia (including liquid fuel, tobacco and some alcoholic beverages). Imported equivalents are subject to an excise-equivalent customs duty.
Excise-equivalent customs duty	An import tariff applied as the equivalent to an internal tax to ensure that goods that would otherwise be subject to excise if manufactured or produced in Australia are subject to the same rate of duty when imported.
Expenditure tax benchmark	A theoretical tax structure that involves levying tax on a person's consumption (or expenditure). Expenditure can be measured in a variety of ways, including as income less net new savings. This benchmark differs from *income tax benchmark*, by proposing that income from savings not be taxed.

Term	Definition
Factor (of production)	An input into the production process. The four broad factors are labour, capital (including plant and equipment, buildings, skills or 'human capital' and know-how, or 'intellectual property'), land (including natural resources), and enterprise (which brings the other factors together in a productive endeavour).
Family payments	Australian Government transfer payments made to parents with dependent children. For example, Family Tax Benefit.
Flow through	A form of integration between an entity (such as a company), and its underlying owners (the shareholders). It can apply to the entire operations of the entity, such that individual shareholders are taken to have earned their relevant share of assessable income of the entity and incurred the relevant share of losses and outgoings.
Foreign direct investment	Foreign investment that conveys a significant degree of influence in the management or control of the entity in which the investment is made. In Australia, an equity interest of 10 per cent or more by a non-resident investor is defined as foreign direct investment.
Free area	The level of income or assets a person can have before a person starts to lose part of their transfer payments.
Fringe benefits	Benefits received by employees from their employer in respect of employment that are in a different form to salary and wages, such as the use of a car for private purposes.
Gift deductibility	Personal donations to some organisations may be tax deductible where they are: made to a deductible gift recipient; money or a certain type of property; made voluntarily and without material benefit to the donor; and comply with other relevant gift conditions.
Grandfathered	The preservation of the benefits of previous arrangements for those who qualify, while phasing in new arrangements for the future.
Horizontal equity	Horizontal equity refers to people in similar circumstances being treated in a similar way. For instance, by paying a similar amount of tax in the context of the tax system, or receiving a similar level of benefit in the transfer system.
Horizontal fiscal equalisation	The process by which the capacities of sub-national governments to provide services to their citizens are made more equal. In Australia, State governments receive funding from the Commonwealth through the horizontal fiscal equalisation process such that, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency, each would have the capacity to provide services at the same standards.

Term	Definition
Imputed rent	The estimated rent that an owner-occupied dwelling would attract if it was rented at market rates.
Income effect	If the price of a commodity (of any type) rises, there are two effects. Firstly, the real income of people who use it falls. This generally, but not always, causes them to use less of it and/or other goods. This is called the income effect. Secondly, the price of that commodity rises relative to other commodities, causing people to use less of it and more of the other commodities. This is called the substitution effect.
Income support	Transfer payments from government to low-income individuals and families to assist with the cost of living. There are two types of income support payment in the existing Australian transfer system: pensions (for example, the Age Pension or the Disability Support Pension), and allowances, like Newstart Allowance and Youth Allowance. In most cases, pensioners are not expected to work while allowees are expected to work, either immediately or (at least) soon. Pensions are paid at a higher rate than allowances.
Income tax benchmark	A theoretical tax structure that involves levying tax on all additions to an individual's ability to purchase goods and services in a given period. It taxes both the return from labour and the return from savings. A nominal income tax taxes the entire return from saving. A real income tax taxes only the return from saving in excess of inflation; that is, it taxes additions to the real quantity of goods and services the individual can purchase in a given period.
Intangible assets	Assets that cannot be seen or touched, such as goodwill, patents, software, trademarks and copyright.
Interest withholding tax	A tax levied on interest paid to a non-resident lender. The tax is withheld by the Australian payer on payment of the interest.
Legal incidence	The individual or entity legally liable to pay a tax or receive a transfer bears the legal incidence of the tax or transfer. The legal incidence often differs from the economic incidence (*see* economic incidence).
Longevity insurance	A product that a person can purchase that will pay them an income until they die.

Term	Definition
Market failure	Markets fail when they do not allocate resources efficiently. There are four main causes of market failure: Market power, which arises when a single buyer or seller can exert significant influence over prices or output; Spillovers (sometimes referred to as 'externalities'), which arise when the market does not take into account the effect of economic activity on people not directly involved. For example, a firm may ignore the costs it imposes on others by polluting the environment; Public goods, such as national security, where enjoyment of the good by one person does not reduce the consumption possibilities available to others; and Incomplete or asymmetric information; for example, where an applicant for insurance knows more about the risk that they will make a claim than the insurance company.
Mutual receipts	The receipts that not-for-profit, member-based organisations (such as licensed clubs), collect from trading with their members. These receipts are generally treated as non-assessable, non-exempt income.
Negative gearing	An asset is negatively geared when its interest payments on borrowings used to finance the asset exceed the income it generates, net of other expenses. Negative gearing commonly refers to the ability to deduct such a loss against another source of income, such as wages.
Not-for-profit organisation (NFP)	An organisation that is not operated for the profit or gain of its individual members, both while the organisation is being carried on, and on its winding up.
Offshore banking unit (OBU)	An offshore banking unit provides financial intermediation services between non-residents. OBUs are concessionally taxed on such income, (currently subject to an effective tax rate of 10 per cent), and are entitled to withholding tax concessions.
Offset	Tax offsets directly reduce the amount of tax paid. They are different from deductions, which reduce total assessable income. Tax offsets were previously known as rebates. They can be non-refundable (that is, they can reduce a taxpayer's liability to zero, but cannot result in a refund), or refundable.
Operating costs	The administration and compliance costs associated with a tax.

Term	Definition
Ordinary income	In the tax system, ordinary income is an income measure that describes earnings such as income from labour or the return on investment, such as interest, dividends or rent. In the transfer system, ordinary income is an income measure used to determine eligibility for pensions and allowances. This is broader than the tax definition as, generally, it does not allow for deductions, salary sacrificed amounts and fringe benefits.
Participation	Labour force participation is people in work or looking for work. The labour force participation rate is the labour force as a percentage of the civilian population aged 15 years and over.
Participation tax rate (PTR)	The proportion of gross pay lost in taxes and reduced transfer payments when a person takes up paid employment.
Personal use asset	An asset other than a collectable that is used or kept mainly for personal use or enjoyment.
Petroleum Resource Rent Tax (PRRT)	The petroleum resource rent tax applies to all petroleum projects in offshore areas, other than certain production licences subject to the excise and royalty regime. It is applied to super normal profits derived from the recovery of petroleum in a project.
Portfolio investment	Investment (including loans), that does not convey a significant degree of influence in the management or control of the entity in which the investment is made. In Australia, a foreign portfolio equity investment is defined as one where the non-resident investor has an equity interest of less than 10 per cent.
Post-tax contribution	A superannuation contribution made by a person from income on which they have already paid tax.
Productivity	The amount of goods or services that can be produced from a given set of inputs. Productivity rises when more outputs can be produced from a given number of inputs.
Profit-based royalty	A royalty levied on the net cash flow or some other measure of the profit of a project.
Profit shifting	Shifting the location of profit between entities, which are typically in different countries, without corresponding changes in real activity.
Progressive taxation	Where the average rate of tax increases as income increases.

Term	Definition
Property rights	Rights that an individual or a legal entity like a company enjoy in relation to any 'thing'; for example, the right to use (but not to sell) a particular piece of land or the right to use (and to sell) a chair.
Public good	A good where the enjoyment of that good by one person does not reduce the consumption possibilities available to others. For example, one person receiving a benefit from national defence does not reduce the ability of others to enjoy such benefits. Public goods have the characteristics of being 'non-rivalrous'— consumption of the good by one individual does not reduce availability of the good for consumption by others — and 'non-excludable' — no-one can be effectively excluded from using the good.
Rebateable employer	A non-government, non-profit organisation that is currently eligible for a rebate of 48 per cent of the amount of fringe benefits tax that would otherwise be payable.
Regressive taxation	Where the average rate of tax decreases as income increases.
Resource rent tax	A tax that applies to the super normal profits, or economic rent of a resource project.
Rulings	The Commissioner of Taxation's statements about how the tax law applies in particular cases. They include public rulings which apply to taxpayers generally, or to a class of taxpayers, and private rulings which apply to a particular taxpayer. Tax law rulings are usually legally binding on the Commissioner.
Social costs	The total costs of an activity. This includes the private cost as well as the spillover or external cost imposed on people who are not directly involved in the activity.
Specific royalty	An output-based royalty that is levied as a set charge per physical unit of production; for example, $1.00 per tonne of marble.
Spillover	A spillover (sometimes referred to as an 'externality'), occurs when the actions of an individual or firm impose involuntary costs (or benefits) on others. That is, in addition to the private costs and benefits that accrue to the decision-maker, some costs and benefits can 'spill over' on to others.
Substitution effect	*See* Income effect.
Tangible assets	Assets that can be seen or touched, such as an oven or a building.
Tax base	The tax base is the assessed value upon which a tax is levied; for example, taxable income.

Term	Definition
Tax expenditure	A tax concession that provides a benefit to a specified activity or class of taxpayer.
Tax wedge	An economic distortion caused by a particular tax measure. For example, a tax on labour results in a wedge between the gross amount that the employer pays and the take-home pay the employee actually receives.
Thin capitalisation	An entity is thinly capitalised where it uses a high level of debt, relative to equity, to finance assets.
Transfer	A transfer is a direct government payment, grant, or in-kind benefit made to an individual or a family based on certain eligibility criteria, rather than being made in return for goods or services. State governments also provide transfers, including through concessions.
Transfer payment	A transfer payment provides direct financial assistance to individuals or families who are unable, or are not expected, to fully support themselves.
Transfer pricing	The practice of pricing related party transactions in a way that artificially shifts profits between the parties.
Trust	A trust exists when a person (the trustee) holds property on behalf of others (the beneficiaries) who are intended to benefit from the property or income of that property.
Untaxed fund	A superannuation fund that does not pay tax on some, or all, of its contributions and earnings.
Vertical equity	Vertical equity is the principle that people with low means should receive greater assistance than those with higher means, and that those with greater economic capacity should have a higher tax burden.
Vertical fiscal imbalance	The situation in a federation where the capacity of different levels of government to raise revenues does not match their expenditure responsibilities.
Volumetric taxation	A tax based on the volume of a product (for example, litres of alcohol), rather than its price.
Wealth tax	Wealth taxes can be either recurrent or levied on transfers between one party and another (for example, bequest and gift taxes). A recurrent wealth tax is levied on the entire wealth of a household or business. A tax on a specific asset class, like a land tax, is a property tax but not a wealth tax.
Withdrawal rate	The rate (also known as a 'taper rate'), at which government assistance is reduced as private income or assets increase.

Index — Part Two

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