Options for Assisting Low Wage Earners

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Abstract

A number of proposals for reducing unemployment in Australia focus on cuts or freezes in award wages. Typically, such proposals include (often vague) proposals to offset some of the distributional consequences by top-ups or other adjustments to the tax/transfer system. This paper examines the available options and concludes that, given the current structure of the social security system, there are serious obstacles to the most common ones such as the NIT or the EITC. There is a case for further reducing tax burdens on low wage earners, but options in this area tend to be very expensive and/or require targeting on a family needs basis

Introduction

Trends in poverty and the distribution of income

In general, the pre-tax/transfer income distribution in Australia has tended to become more unequal over the last 15-20 years, a trend also observed in many other OECD countries (eg Gregory 1993). However, measurement and conceptual difficulties make it hard to be precise about the exact dimensions of this trend, and it is still subject to considerable debate. Thus, while there is consensus that market income inequality has widened, there is no real consensus on the extent of that widening, or on the relative contribution of different factors to that widening.

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Other trends in labour markets – casualisation and part-time work, women's labour force participation, dual-earner families, and increasing unemployment (especially long-term) – have also tended to impact adversely on the distribution of market incomes. This would normally have been expected to increase poverty, other things being equal. It appears, however, that in Australia the widening dispersion in market incomes has been offset at least partly, and possibly wholly, by changes in the tax/transfer system which have tended to make this system more progressive (Harding 1997b). This is particularly so if non-cash ('social wage') transfers are included in the calculation (Johnson et al 1996).

With current trends in income distribution it may be a matter of having to keep 'running harder' for redistribution policy to keep up. In the future, it is possible that we will see a continuing decline in the relative position of low wage earners, alongside a continuing de-regulation of the wage (industrial award) system. While safety net adjustments granted by the Australian Industrial Relations Commission (AIRC) in recent years may mitigate such trends in the short run, their long-run sustainability is open to question if they push against market forces. Indeed, there are pressures from academic economists for reducing growth in award wages as a means of reducing unemployment. Typically, such economists are also concerned to offset the impact on low-income earners by social security and tax policies. This paper discusses possible policies for achieving this outcome.

Some of the proposals discussed in this paper are fairly radical, at least in the sense that there would be large numbers of winners and losers. This paper does not address the transition issues in moving from our current system to another but readers should bear in mind that for some proposals these political and administrative difficulties can be considerable and would need careful attention.[1]

Incidence of low pay versus the incidence of unemployment

It is now well understood that regulation of wages is a fairly blunt instrument for addressing poverty and inequality. The reason, as Richardson and Harding (R&H 1998b) have pointed out, is that people receiving low wages are often part of families which are not that badly off. 'People receiving low wages are well spread through the distribution of family incomes. This makes Living Wage adjustments a very blunt equity device' (Dawkins et al 1998b).

A substantial proportion of low wage workers live in families in the upper half of the equivalent income distribution – generally because they

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live in a family where another person also earns an income. Low waged workers are distributed fairly evenly throughout the distribution of equivalent disposable income. While a disproportionate number are found in the bottom three or four deciles, substantial numbers are also found in all but the highest decile.

Receipt of multiple incomes (mainly involving a spouse) is a key reason why many low earners are in families with relatively high income (p. 15). Another reason is that many are not supporting children. A single person who receives the minimum wage for a full week's work will be located in the middle of the equivalent income distribution.

Nonetheless, families with a low wage earner are about twice as likely to be 'in poverty' (14.3%) as wage and salary earners generally (6.7% – p. 23). The poverty risk increases only slightly if there are children – indicative of the effectiveness of strategies to combat child poverty in the late 1980s (see Harding and Szukalska 1999). Poverty rates are very high for low wage earners aged less than 21, (33%) but many of these are non-student children living at home with their parents. The families most likely to be in poverty are those with no earners at all. **On the statistical picture presented, no pay is a greater contributor to poverty than low pay.**[2]

The overall impression one gets is that **low wages *per se* are not an overwhelming social problem, whereas unemployment is.** Unemployment is more strongly associated with poverty than is a low wage;[3] 'It follows that a redistribution from low wage earners to unemployed people would make the overall distribution of income more equal.' (H&R: 160) This is an uncomfortable conclusion for some social policy analysts. However, it is not at all clear that reductions in minimum wages would effect such a redistribution. (OECD 1998)

Implications for policy

Harding and Richardson argue, in relation to the spread of low pay across the whole family income distribution, that '... it does not necessarily follow that a cut in low wages is thereby egalitarian' (1998: 160). They adduce four reasons for this. First, if we want to raise the incomes of the unemployed, a 'tax' on low wage workers is a less equitable way to finance this than a tax spread more widely. Second, the employment response to cuts in low wages is unclear, and there are grounds for pessimism. Third, a significant part of any new jobs generated would not go to the existing unemployed, but rather to new entrants to the labour force. Finally, cuts in low wages would exacerbate existing replacement rate problems for people on the borders between the social security system and paid work. To address

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such problems, it might then become necessary to reduce benefit rates for the unemployed.

They conclude that: 'An alternative solution might be to increase the earnings of those in low paid employment, via earnings credits or wages top-ups' (Harding and Richardson, 1998: 160).

It must be said, however, that *Australian* evidence on the impact of unemployment benefits on the length of unemployment spells is weak, as is the evidence on the impact on aggregate levels of unemployment.[4] Further, Australia has relatively low earnings replacement rates (ERRs) for most of the unemployed, particularly the single unemployed who make up the majority of the beneficiary population. Net replacement rates at 2/3 the average production worker's wage are, in Australia, 50% for individuals, 67% for couples, 60% for a lone parent (2 children) and 82% for a couple with two children (Kalisch et al 1998 Table 5.2).

It follows that replacement rate issues mainly arise in relation to traditional 'families'. Reducing relative minimum wages could put pressure on benefit levels for such families, but the current system is actually quite resilient to such pressure. This resilience arises from existing in-work benefits available to the low paid.

Australia, like a number of OECD countries, has responded to concerns about possible work disincentives by tightening work tests and in some cases requiring participation in schemes like 'Work for the dole'. It has also permitted greater retention of earnings from part time employment and – like many other countries – expanded the range and amount of in-work benefits (Kalisch et al Table 5.8 and pp. 61-63).

While acknowledging that minimum wages are not as well targeted at reducing in-work poverty as means-tested in-work benefits, the OECD note some problems with the approach of relying on in-work benefits alone: '... means-tested benefits ... may lead to a fall in the wages of low-paid workers; and they can be very expensive. This suggests that there may be some scope to complement in-work benefits with a national minimum wage' (OECD 1998: 32 and 55-56). In particular, both minimum wages and in-work benefits can reduce the 'unemployment trap' by raising the rewards of work relative to unemployment income (ibid: 57).

The issue, it seems, is not whether there should be complete de-regulation of minimum wages, but rather what level they should be set at, and what complementary tax/transfer policies should be implemented.

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Options for Assisting Low Wage Earners

The following are the main options considered in the remainder of this paper: (1) the negative income tax, (2) earned income tax credits, (3) wage subsidies for low wage earners (including reductions in payroll taxes, and hours-conditioned in-work payments), (4) changes to social security parameters (including major reforms to rationalise EMTRs) and to rent assistance, and (5) reductions in income tax burdens on the low-paid. It should be noted that these are not always mutually exclusive approaches – for example, Garnaut, one of the 'five economists' proposing an earned income tax credit, sees this as a transitional instrument in the path to a full negative income tax system (Garnaut 1999: 9-10).

The Negative Income Tax (NIT)

There are several radical NIT or guaranteed minimum income (GMI) options that have been proposed to address EMTR problems affecting welfare to work transitions. The most recent is the negative income tax proposal of Dawkins et al (1997, 1998a), although this is one in a long list of similar proposals stretching back in Australia to the Poverty Inquiry (Henderson 1975) and overseas to the 1940s (Rhys-Williams 1943; Friedman 1962). But Ingles (1998a) argues that it may not be necessary to radically overhaul the whole structure of the tax/transfer system in order to achieve the benefits being sought.

The NIT in its pure (ie non-categorical)[5] form has a number of significant problems, as well as its well-publicised advantages. These problems include:

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

Because of problems with the 'pure' (i.e., non-categorical, linear tax) NIT, Dawkins et al propose a number of modifications which allow the required tax rate to be reduced; for example, by retaining categorisation and

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by higher initial marginal tax/taper rates. What this illustrates is very simple: that is, it is very difficult to avoid most of the issues that underlie difficulties in the existing system if any new system is to be socially, politically and economically acceptable.

Given this, and all the problems that will therefore remain – proving eligibility, definition of the income unit, the time period for assessment, etc – it might seem preferable to stick with the current system and adopt a more incremental approach, albeit paying particular attention to low income earners. However, it is worth discussing the advantages and drawbacks of a GMI in its 'pure' (ie non-categorical, linear tax) form precisely because it highlights the choices – often implicit – that we have made in choosing a different approach. Here we shall be concerned with four questions in particular: Is it desirable to avoid categorising the population into various eligible groups? Should the definition of income be standardised in the tax and welfare systems? And, is a linear benefit withdrawal cum tax rate optimal? These are discussed below.

To categorise or not?

There is no doubt that the present categorical system is complicated, cumbersome and arbitrary (see for example Perry 1995). There are apparent attractions in moving to a system where the only criterion for assistance is low income. However, there are also major problems. Such a system cannot discriminate between those whose low income is voluntary, and those for whom it is not. In particular, there would be no work test for the able-bodied unemployed. In addition, some individuals, notably the self-employed, are able to manipulate their affairs so as to declare an apparently low income when in fact their full (comprehensive) income may be quite adequate.

For these reasons, we will assume that some form of categorical system will continue to operate. However, some of the options discussed in this paper have the effect of sizeably reducing differences in the treatment of those categorically eligible and those not, and this will generally be a desirable direction for reform.

The definition of income

One basic problem here is that the tax definition of income can be exploited, especially in regard to income from capital. Australia experimented with a means test on income only in the late 1970s, with unwanted results (for example, the growth of a substantial avoidance industry, stashing monies in non-interest bearing accounts, and so on). This led to the re-introduction

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of an assets component in the means test in 1983 and the subsequent introduction of a system of 'deeming'. Under this system, all financial assets are deemed to earn at a rate which is fixed from time to time in accordance with the prevailing level of interest rates. The deeming system is complemented by an asset test affecting only those with relatively substantial assets (and the family home is exempt).

The income concept used in the social security system also differs from the tax one in adding back a number of employment fringe benefits, disregarding negative gearing deductions and adding in foreign source income.

In keeping with its anti-avoidance origins, this assets test is currently structured such that it has a very generous threshold before it is triggered but a fairly high rate of withdrawal of pension once over that threshold. This was and is an effective way of closing off blatant avoidance, but the relatively low nominal rates of return on assets obtaining in today's low inflation environment means that the assets test may become increasingly unpopular (it imputes income from affected assets at an effective 15.6% marginal rate). However, the major practical alternative – a 'merged means test' where all asset income is imputed at a rate somewhere between the assets imputation rate and the deeming rate – was not popular in the past. The basic problem is that if effective rates of taxation on capital income are high, as they must be under a means-tested system, the incentives to avoidance increase commensurately. Moreover, the opportunities for avoidance are quite considerable under an income tax base that falls short of the full comprehensive income ideal.

The Youth Allowance (YA) means test attempts to better assess the real income of the self-employed by using the so-called 'actual means test', which involves a mixture of wealth and consumption measures. However there are major practical difficulties with this test, at least if it is to be applied more generally. Until these issues are resolved using low taxable income as the only criterion of need for assistance, while theoretically attractive, is probably not workable.[6]

The optimal tax/taper rate

Dawkins et al estimate that even if categorisation were retained, the tax/taper rate required to finance existing maximum benefits would need to be 50%, if it were uniform across income classes (1998a: 251).

Raising the benefit withdrawal rate can reduce the general tax rate; the appropriate trade-off between these two is a difficult issue (Ingles 1998b). 'Optimal tax' theory has tended in the past to suggest that a linear rate is

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optimal, but more recent analysis challenges this conclusion. There may in fact be good economic reasons for a higher initial marginal rate.

One critical factor in these analyses is the form of the social welfare function. In particular, are we concerned only with those at the very bottom of the income distribution – ie, poverty – or are we seeking to reduce income inequality more generally? The point in the present context is that our choice of the pattern of tax/taper rates is not merely a technical question about the efficiency of redistribution but involves, in Senator Harradine's phrase, 'moral choice' about the **purpose** of redistribution.

The lower the initial taper the easier it becomes to achieve reasonable ERRs for the unemployed coming back into work. However the higher the initial taper, the lower the average EMTR on taxpayers as a whole. This leads to a difficult trade-off.

Conclusion on the NIT

The NIT is probably not practicable in its pure form. The case for a pure NIT is strongest where the purpose of income redistribution is held to be the reduction of total inequality, rather than simply the alleviation of poverty. The current Australian system is quite explicitly about poverty relief,[7] reflecting the revealed preference of the Australian electorate over many years. One justification for the modifications to marginal rates Dawkins et al propose is to accommodate this preference by making the proposal a more efficient anti-poverty program.

However in the modified form which retains categorical tests of eligibility and a higher initial tax rate, the NIT is a very attractive concept, and one which is not all that greatly different in its effects to the current tax/transfer system, assuming that were to be reformed to rationalise tapers and tax interactions. In particular the modified NIT could achieve many of the objectives of the single workforce age payment (SWAP) proposal, which is designed to remove unwanted differences between payments, and reduce incentives to access favoured payment categories.

That said, there are also serious difficulties to even the modified NIT approach to reform.[8] Nor is it widely understood that the modified NIT has drastic implications for the structure of income tax rates. Specifically, it implies that for non-categoricals the tax threshold should equal the break-even income levels for categoricals (ie, around $15,500 for singles, if the initial tax rate is 60%), and that the tax rate above these levels should be the 'standard' rate – ie, around 45%. The high threshold ensures that non-categoricals rapidly catch up to categoricals, in terms of disposable

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income, with increasing levels of private income (see also the discussion of 'convergence' below).

For all these reasons we favour a more incremental approach to reform, albeit that the end-point we might wish to arrive at may eventually not be all that different to that sought by Dawkins et al, or by Keating and Lambert.

Earned Income Tax Credits (EITCs)

Earned income tax credits have been advocated in Australia by the Australian Labor Party (ALP) in the 1998 federal election, by Keating and Lambert (1998a), and by several economists who see these as a useful trade-off for restraint in award wage growth. They have been advocated or adopted in several OECD countries as part of measures to 'make work pay' (see Kalisch et al 1998 Table 5.8). The principle features of an EITC which distinguishes it from a conventional tax credit are, first, that it is based on earned, not total income, and second that it is not simply a maximum payment which abates as income rises beyond the threshold. Rather, it rises over some earnings range, before being phased out.

Australian Proposals

In the 1998 election, the ALP proposed a set of income tax cuts using credits, the value of which reduced as income rose. These are very similar in effect to an EITC ('A fairer tax system *with no GST*' – ALP 1998). Labor proposed a 'tax credit for working families' worth up to $3,300 pa for a family with two children. The credit was to be restricted to earned incomes.

The credit was to phase in at the rate of 10 cents in the dollar, up to a maximum income of $30,000 pa for one child, plus $3,000 for each extra child up to four. Maximum credit would apply over a plateau range of $10,000 pa (ie up to $40,000, and then phase out at a rate of 15 cents in the dollar. Thus, it would fully phase out at roughly $60-75,000, depending on number of children. By way of comparison, the US EITC pays 40 cents in the dollar up to an income of $14,000 pa, ($AUS equivalent) reaching a maximum of $5,700 and phases out at the rate of around 20 cents above $19,300. The EITC is fully abated when the family income reaches $46,000. It can be seen that the ALP proposal was pitched much more to the middle income group than is the US EITC. This reflects the anti-poverty focus of the US measure, whereas this focus is catered for in the Australian context by direct cash benefits. The ALP proposal can be clearly discerned as a means of focussing tax cuts on a particular target group.

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Because the earnings credit would be combined with family assistance payments, the level of income at which it was tapered would vary according to the size of these other payments. For single individuals and couples without children, there are no such payments so the cutout (on the latest version – *Australian Financial Review* 16.11.98) would be $28,200 pa. Beyond that the credit reduces at a taper of 30%. This level of threshold avoids the taper overlapping with social security allowance tapers, although it does interact with the income tax to produce an EMTR of 64%.

Keating and Lambert calculate that 2.4 million low wage earners (out of a total of 9.3 million) would benefit from this earnings credit if it were combined with the other elements of their proposed new system. The estimated cost is $1060 million, or about 0.4% of the total wage bill. The cost would rise in subsequent years if it were to be raised as part of a 4-year program of wage restraint, reaching $4.5 billion in the fourth year. If confined to families with dependent children, in the first year an estimated 860,000 families would benefit at a cost of $460 million. By the fourth year the cost trebles to $1.4 billion. However limiting the credit to families with dependent children would undermine its credibility as an offset to the proposed award wage freeze. Moreover, such families are no longer at greater risk of poverty than those without children, because of the very substantial increases in low-income family assistance over the last 15 years (see Harding and Szukalska 1999).

The proposed credit is very similar to a cut in the first marginal rate of income tax, partly financed by an increase in tax on incomes above the allowance/family payment cutouts. However the cut, and increase, are on a family unit rather than an individual basis.

EITC issues

1. Do marginal earnings subsidies have any role in optimal tax/transfer schemes? The answer here is that such subsidies reduce EMTRs arising from the interaction of tax and social security benefits. If such reductions are required, an obvious alternative is to do this directly through one or both of these systems.
2. Does it reduce the wage paid by employers? The answer is that it may do, but this can be helpful if wages would otherwise be above their market clearing levels.
3. What are the incentive effects of the EITC? This is a complicated question. While an EITC reduces EMTRs in the phase-in range, it reduces average tax rates in the plateau range, and increases EMTRs

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in the phase-out range. Its overall impact on work effort is theoretically indeterminate. Empirical studies have tended to find that the EITC creates a strong participation effect which brings in additional workers, which is offset partly but not wholly by a substitution effect on existing workers operating in the opposite direction (that is, to reduce labour hours).

4. Does it create too severe a 'marriage penalty'? It seems not. The marriage penalty created by the US EITC has not been found to affect behaviour. In any case, it is no greater than that created by normal welfare schemes assisting sole parents.

5. Is there potential for fraud? Fraud is a serious problem with the US EITC, with overpayments of some 25-30% of total program spending. It is not clear whether recent efforts to stem the overpayment problem have been successful. Canada has abandoned its small EITC program partly because of compliance problems.

6. Should the tax office be involved in the assessment of 'need'? Using the Tax office to run a welfare program creates several difficult issues. The inability to means test against assets is one example. Another major problem in the Australian context is that an EITC based on family income would necessarily have to treat de facto and married couples in the same manner.

7. Should benefits be delivered through the tax or the welfare system? The main effect of an EITC in Australia would be to reduce effective marginal tax rates on low income earners. This immediately points to the possibility, if such an effect is desired, of effecting such reductions directly through modifications to tax/transfer policies.

8. How effective is the EITC in combating poverty? The US EITC takes about 1 million families out of poverty, and raises the incomes of another 6 million poor families. It is therefore reasonably *effective*; doubts revolve around how *efficient* it is. Many of the recipients of the EITC have incomes that place them above the (admittedly meagre) US poverty line, even before receipt of the credit. The breakeven income in the EITC is well above the poverty line for most families. It has been estimated that when the 1993 reform is fully phased in, approximately half of total EITC payments will go to households with incomes above their poverty lines. The fraction of total EITC payments that directly reduce the poverty gap will fall from 47% (pre 1993) to 36% (post 1996). Thus, it is clear that the EITC is not nearly as well targeted as traditional anti-poverty programs. This is exacerbated by non-compliance.

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Conclusion on the EITC

The US EITC is essentially a device to help low income families by increasing the progressivity of the tax/transfer system and by reducing (or even making negative) effective tax rates on them. Its existence, and the emphasis placed on it in US politics, reflects the American public's dislike of 'welfare'. In the Australian context, both of these results are achievable by changes to income tax or social security tapers. For example reductions in the FP taper, like the EITC, both improves work incentives for low earners and gives greatest benefits at the low-middle income range. Such a reduction is already to take place in ANTS. In addition, the taper on Parenting Payment for sole parents (and other pensions) will reduce from 50 to 40%.

Australia already provides very substantial assistance to low income earners with dependent children. Indeed, it has what might be described as a full guaranteed minimum income (GMI) for sole parents, and a partial GMI for couples with dependent children. A country operating a welfare system substantially based on the GMI principle has relatively less need for an EITC, since most relevant objectives can be achieved by manipulation of existing tax and welfare parameters. The main argument for an EITC in the Australian context is to reduce income tax paid by low income earners. We later consider reform of the income tax rate structure as an alternative to the EITC.

Other wage subsidies

Wage rate subsidy

The wage rate subsidy was widely discussed in US policy circles in the 1970s (see Browning 1973) and, inspired by other US welfare reforms, and has now been revived somewhat (see for example Phelps 1997 and Layard 1996). Under this approach, wage rates would be supplemented by, say, one half the difference between some target wage rate and the recipients market wage rate. This increases the net wage rates of all recipients by declining amounts as the market wage approaches the target wage rate. In effect, the wage rate subsidy creates a reduction in EMTRs that diminishes as the wage rate approaches the cutout point. This can be shown to have advantages in terms of work incentives.

Browning (1995: 42) argues the wage rate subsidy 'produces results just like the phase-in range of the EITC, but without the disadvantage of a phase-out range'. However, he also notes of the earlier policy discussion that 'the general conclusion seemed to be that it had severe enough defects

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to make it undesirable. These defects included administrative problems and the difficulty of targeting benefits on those with low incomes' (p. 42). Despite its theoretical advantages, the wage rate subsidy has a serious practical obstacle, that its calculation requires knowledge of not only the employees pay but also the hours. Whereas pay is relatively easy to verify, hours are not. A more administratively convenient form is a simple subsidy against pay, but this is no different to an EITC (albeit one based on the individual earner rather than the family).

A low wage subsidy has resurfaced in a back door way in the current Australian policy debate, in the form of proposals to remit payroll tax on low income earners (see eg Debelle and Borland 1998: 357).[9] Presumably this policy means that, instead of payroll tax thresholds/exemptions being based on the aggregate size of the firms payroll, they would be based on the fortnightly or annual pay of the individual employee. Such reform proposals could involve administration and compliance problems, similar in some ways to the problems with wage rate subsidies already alluded to by Browning (albeit that the problem of determining hours worked would not arise). Whereas current state payroll taxes provide an incentive to firms not to grow above the exemption limit, the proposed alternative would provide an incentive to part-time work. That said, the proposal is no different in principle to the low earnings thresholds embodied in many or most social insurance contribution rate structures. Many countries are looking to reduce payroll tax burdens on low wage earners, it being widely accepted that the real incidence on such taxes is on the net pay of those workers (OECD 1999: 97). In Australia there is already a similar implicit threshold of $900/month under the Superannuation Guarantee. Those with income under this are not compelled to make SG contributions.

There is no barrier in principle to making the general structure of payroll tax more like that of a social security contribution with an explicit low-pay threshold. Indeed, it would seem likely to be a considerable improvement on the current situation, though it may have administrative disadvantages. It should also be recognised that the low wage exemption proposal limits the available net cuts in taxes to 5-6%, which is the existing payroll tax rate (it varies slightly between States, as do the exemption levels). That said, however, the policy does offer the possibility of a substantial short-term cuts in the cost of employing low wage earners. By setting an appropriate low pay threshold, it could yield the same revenue as current payroll taxes. If the proposal were revenue-neutral, many firms would face approximately the same aggregate payroll tax burden as they now do. Firms with dispro-

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portionate numbers of low wage or short-time workers would benefit, whereas small firms with well-paid workers would be disadvantaged.

Overall, the drawback of the scheme (after the initial structural impacts are accommodated) is that it creates an incentive for part-time work, and many part-time workers are part of well-off families. That said the existing structure of the payroll tax has no particular economic rationale so, on balance, we believe the approach suggested is both feasible and likely to be effective.

Employment or hours-conditioned in-work payments

These are used in the UK and Ireland (see OECD 1999: 96), and have been experimented with in Canada. Basically, eligibility for an in-work income supplement such as those for children depends not only on low income, but also on working a certain minimum number of hours. For example, the UK *Working Families Tax Credit* will be paid only to families who work at least 16 hours a week. This replaces a similar program now operating. In addition, there is a further program aimed at encouraging nearly full-time work, defined as 30 or more hours a week.

At first glance it may seem an unnecessary complication to vary payments according to hours as well as income. After all, the one is reflected in the other. That said, there might in fact be economic benefits. The reason is that the introduction of an hours criterion makes a welfare payment more akin to a wage subsidy. The hours requirement virtually turns the supplement into a wage rate supplement. This has the work incentive benefits already discussed in the previous section. Further, it helps draw a clear line between unemployment payments and in-work benefits. This may reduce any stigma associated with the latter (while possibly worsening that associated with the former), providing further incentive to work.

The issue for Australia is whether we wish to stick with the (hoped for) simplicity of our GMI approach, or supplement it with new tools such as employment conditioned benefits. Such tools probably make more sense, in our system, if the taper rates on the GMI are high. The alternative is to go down the road of reducing EMTRs within the existing framework.

Changes to social security parameters

The current system provides benefits to the poorest in our society in a manner not too far removed from a negative income tax or GMI scheme, albeit of the categorical type. However, it is a GMI characterised by poor

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design, excessive complexity, and unwanted overlaps with the tax system and other income transfers (Ingles 1998a). If assistance was reduced more gradually and predictably with increasing private income, the system would become much friendlier to low income earners. At the same time earnings replacement rates would improve: that is, become lower.

Means Test Tapers and Effective Marginal Tax Rates (EMTRs)

The effective tax rate which applies at any level of income needs to be calculated by reference to both the tax and social security systems. High (and apparently random) EMTRs are a problem affecting most basic payments, notwithstanding the 1994 reforms to NSA and related payments reducing the maximum rate of taper from 100% to 70% and introducing a partly individual basis of assessment.

EMTR graphs can conveniently be reduced to summary measures of *effective tax rates* (ETRs), calculated over a given range of income. Ingles (1997, 1998a) showed that there are wide bands of income where families either gain marginally by earning extra income, or in some cases even go backwards: the 'low income trap'. Some families face very high effective average rates that over the whole of their first $1,000 pw of private income.

A possible reason for not changing these tapers is that the allowance system needs to avoid incentives for combining part time work and benefit receipt. On this view, allowees should be encouraged to 'jump right out' of the system on obtaining a job. However, with declining relative wages for the low skilled, and an increasing incidence of part-time and casual work, the 'jump right out' approach may prove increasingly inconsistent with labour market realities in the years ahead.

High ETRs arise from both tapers and payment of income tax. Although an EITC is therefore a possible means of addressing this issue, another response is to reduce the taper on allowances, from its current 70% (beyond on initial free area and 50% taper zone) to say, 50%.

There are theoretical and practical reasons for believing that a single linear tax rate, or at most a two or three part tax, would be a much better way to achieve a roughly similar distribution of net benefits to the current system.

It can be shown that, if benefits are withdrawn at such a rate, a low income earner will always be better of by working than on benefit, even if he has to combine work and benefit income. This is so even under the current system.

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A disadvantage of reducing tapers at the bottom end is that this tends to have the effect of increasing the *average marginal tax rate* across the whole population. Reform of EMTRs is like pushing on a balloon that bulges in places. If you push in one place, it will bulge out somewhere else. The *average* EMTR can be reduced only by three strategies: (1) an increase the tax base; (2) a reduction in the maximum benefit levels; and/or (3) *front-end load* tapers, by having high tapers on basic benefits and little or no free areas. The problem with 'front end loading is that it most affects those on very low private incomes, many of whom may be particularly sensitive to work disincentives.

The OECD (1994) suggested (admittedly based on stylised assumptions) that average EMTRs can be minimised by having either 100% tapers on benefits, or universal payments. Ingles (1998b) showed that, based on these assumptions, the second part of their conclusion was erroneous, and in fact, 100% tapers with no free areas minimise the population average EMTR. However, he noted that this would be unlikely to be welfare maximising in a general sense.

Optimal tax theory also provides some support for a policy of maintaining high ETRs on work-tested beneficiaries (Bradley 1999), especially if the social welfare function emphasises poverty alleviation rather then reduction of income inequality. A disadvantage of high ETRs, however, is that incentives to work one's way out of unemployment more gradually (eg, by first obtaining a part-time job) are perhaps not that great. Warburton et al's (1999) paper for this Conference shows that allowees with some earned income are more likely to leave unemployment. Another problem is that mothers with young children – whose behaviour is likely to be sensitive to ETRs – would be less likely to seek paid work.

Although the current system already pursues approach 3 (front-end loading of high ETRs) to a considerable extent, there are clearly limits on how far this ought to be pushed without creating serious poverty traps for those trying to earn their way out of the system. Moreover, the arguments for 'front end loading' become weaker, the further we move into that part of the income distribution where many families are located.

This might be a reason for having less severe tapers on family payments than the basic tapers on allowances. This is consistent with some 'optimal tax' theorising suggesting that the marginal rate structure should be 'degressive' – ie, have falling marginal rates as income rises, or possible u-shaped, such that rates first fall then rise. This is still consistent with rising average rates if there is a minimum income guarantee or its equivalent.

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One problem with a relaxation of allowance tapers is not so much the direct cost – likely to be under $500m – but the flow-on cost if the family payment threshold is to be lifted sufficiently to prevent 'sudden death' loss of automatic full-rate FP on coming off an allowance. This latter cost is likely to be considerable.

The Keating and Lambert proposal

Keating and Lambert (1998a and b) have recently put forward a proposal designed to rationalise means tests for families. This proposal is updated in their Submission to the Senate Inquiry into tax reform (K&L 1999). Their EITC scheme is actually an adjunct to this proposal.

Keating and Lambert's method is to first establish a family's potential entitlement for assistance, and then establish their actual entitlement based on their assessed financial means. For pragmatic reasons, pensions and allowances would continue to have different free areas. However, all allowance tapers would become 50%. At the new family payment threshold of $28,200 pa 'second tier' payments would start to abate at a rate of 30%. This tier includes FTB(A), FTB(B), Youth Allowance (YA) and Rent Assistance (RA), but does not appear to include childcare assistance.

Part of the proposal is financed by abolition of the quasi-universal (second tier) component of the Family Tax Payment. The net cost of the proposal is estimated as $470m pa, plus $500m for the reduction in allowance taper. If the proposed rates in ANTS are used, the cost rises to $1.1 billion, or $1.6 billion inclusive of allowance taper reform. This compares with the ANTS family package of $2.3 billion in 2000-01.[10]

The reason that the Keating and Lambert plan can unstack all these payments, reduce allowance tapers and still be cheaper than ANTS is that the ANTS system of family payments still involves considerable 'horizontal equity' type payments. For example, after first tier FTB(A) is exhausted, a flat rate payment continues to be made up to family income of $73,000 pa. Similarly FTB(B) is tested only on the spouse's income, not that of the working partner.

The Keating and Lambert plan effectively adds FTB(B) and (A), so that both taper on the combined parental income. The same effect could be achieved under the present system if FTB(B) were abolished, and replaced by higher payments for younger children in the FTB(A) rate structure. The effect would be to make the age/rate structure for family benefits almost flat.

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Bits of detail in Keating and Lambert need clarification. One problem is that the new family payment threshold of $28,200 only makes sense if the allowance taper continues to be 50/70%. Otherwise, the family payment and allowance tapers interact to produce a 'sudden death' loss of FP on coming off an allowance. This could be resolved in the proposal by setting the new threshold at approximately $33,500, which is the new maximum allowance cutout point with a 50% taper. As already noted, this would be quite expensive.

We conclude that the Keating and Lambert plan, suitably developed, might be a good one, but its financial feasibility may depend on Government's willingness to abolish the remaining quasi-universal family payments. This in turn depends on the relative importance one attaches to EMTR problems in the system compared with meeting horizontal equity concerns amongst middle and upper income groups. Alternatively one could proceed in this direction without abolishing the quasi-universal payments, but the net cost could be quite high.

Proposal for full separation

If the objectives of Keating and Lambert were approved, an alternative means of implementation would be the scheme of full separation of welfare and tax originally proposed by Dixon and Foster in 1983 and recently modified by Ingles (1998a) to include additional payments for children and rent. The mechanism for doing this is fairly simple, involving extension and modification of the special tax rebates for pensioners and allowees,[11] so that they paid no tax over the pension/allowance taper zone.

To reduce the net benefit to higher income beneficiaries, the taper rate would be increased to, say, 65%. Once the basic payment was tapered away, additional payments for children and for rent would then taper sequentially, at the same rate. Additional tax rebates would prevent tax from applying over the extra taper zones. Once benefits are exhausted, the tax rebates phase out sequentially at a rate of 35%, thus maintaining EMTRs at 65% (in conjunction with income tax, assumed to be at 30%) until the whole of the net benefit is tapered away.

The virtue of this plan (which is similar in its effect to the modified Dawkins et al NIT, and indeed to the Keating and Lambert plan) is that a single uniform effective tax rate can be applied right through the means test taper zone. Unlike the Dawkins et al NIT, the social security definition of income continues to apply, and thus include imputed income from assets (and, if desired, a separate 'tall poppies' asset test), as well as permitting

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the responsiveness to current circumstances that a shorter income accounting period permits.

The objective is that all social security clients would have the same incentive to earn additional income.

This scheme has three advantages compared to that of Keating and Lambert. First, rather than EMTRs being a somewhat unpredictable outcome of tax interactions, they become a single designed rate. Second, the system is very effectively targeted, since the social security definition of income is tighter than the tax one, and includes an asset test. And third, 'churning' is abolished. Those who receive welfare transfers do not pay tax; those who pay tax do not receive transfers. This would result in a considerable reduction in the apparent level of government transfer spending. One disadvantage is that the tax treatment of those on payments for part of the year will require some moderately complex 'pro rating' of income tax scales. However, this may be no more complex than the current system of pensioner and beneficiary rebates.

Rent assistance options

Another option might be to reform the Rent Allowance (RA) means test to extend RA further into the income distribution. RA for families currently tapers after all FP is lost, and at the same rate: 50%, but to become 30% under ANTS. By contrast, RA for allowees tapers, once the basic allowance is lost, at the allowance taper rate of 70%. If this were reduced to the same 30% rate proposed for families, and provided free of activity test it could be transformed from a benefit essentially restricted to our categorical clients, to one which is a general form of in- or out of-work assistance to low income earners facing high rental costs.[12] There would also be an improvement in earnings replacement rates for such people.

Income tax rate structure

In general, the effect of the EITC is to increase the progressivity of the tax/transfer system. It reduces EMTRs on low income earners (including those currently affected by high EMTRs under the allowance tapers), and increases them on those further up the income scale. Given the current pattern of EMTRs on low income earners, this may be desirable.

Looking at the Keating and Lambert plan, their proposed tax credit is very similar to a cut in the first marginal rate of income tax, partly financed by an increase in tax on incomes above $28,200. However the cut, and

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increase, is on a family unit rather than an individual basis. Further, the tax rate increase is at income levels dependent on the size of the family.

Another issue is that if compensation were limited to *earners,* those on low capital incomes might well be aggrieved. Pensioners and the like are already finding their incomes reduced by declining interest rates.

This leads to the question of what might be done using the current system in order to achieve roughly the same impact as an EITC, assuming that were deemed to be a desirable goal (for example, to sell award wage restraint to the Commission). Another objective would be to address the declining relative earnings of low income earners, a trend that seems likely to continue irrespective of any formal award wage freeze.

There is certainly a case for reducing income tax burdens on low wage earners, although ANTS will make an improvement. Many individuals and families with relative low incomes are required to pay income tax. For families with children, their incomes are then supplemented by direct family payments and rent assistance. This sort of 'churning' seems to be inefficient, although it can be defended as a means of intra-family income redistribution – the tax is taken from the principal earner and paid to the principal carer (that is, transferred 'from wallet to purse'). While an EITC is one means of addressing this inefficiency, there may be other approaches.

Reform of the income tax rate structure as an alternative to the EITC

If we wish to direct additional assistance to those not in the social security system but with earnings below the existing tax threshold, then the refundable tax credit approach may be required. However, our main concern should be the deteriorating position of those on low full- or nearly full-time earnings – ie, with incomes well above the current tax thresholds (details are below).

Current tax thresholds and effect of ANTS

Inclusive of the low-income rebate of $150, the current income tax threshold is $6,150 pa. It is not easy to state the tax threshold where there is a spouse and dependent children, because such families have the option of using tax assistance provided through the Dependent Spouse Rebate (DSR), or accessing an equivalent cash payment through the basic component of Parenting Payment. In the former case, the DSR of $1452 pa means that the primary earner threshold is effectively increased by $7,260, to $13,410. If

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there are no children the DSR is $1,324 and the effective threshold is $12,770.

Basic Parenting Payment is $1692.60 pa. If BPP is regarded as an offset against income tax, it effectively raises the tax threshold for a primary earner to $14,613. In reality, however, the primary earner faces a positive effective marginal tax rate beyond $6150.

The threshold for a secondary earner is much less. The spouse rebate shades out by $1 for every $4 by which the spouse's income exceeds $282 pa. The Basic Parenting Payment reduces on the allowance income test; that is, at 50% and 70% above $1560 pa. What this means is that the effective tax threshold for a family varies greatly, depending on the distribution of income within the family.

ANTS will increase the tax threshold to $6,000, or an effective $6,882 inclusive of low-income rebate. Single income families with a young child will have an effective tax threshold of $13,882, made up of the new $6,000 threshold plus the equivalent (through FTB(B) cash benefits) of $2,000 for one dependent child and a further $5,000 for single income families with a child under 5 years of age, plus $882 from the low income rebate. The fact that FTB(A and B) are refundable tax credits complicates these tax threshold calculations. In practice positive effective marginal tax rates commence at familial incomes below the calculated tax threshold. The loss of Basic Parenting Payment as spousal income rises beyond $1560 pa, combined with the loss of FTB(B) as her income rises beyond $4587 pa, has a similar effect.

Possible policy options

Raising the tax threshold is expensive. With almost 8.5 million taxpayers, a $1,000 pa increase in the threshold costs almost $1.7 billion. This could be partly financed by imposing a higher initial marginal rate (currently 20%, and to become 17% under ANTS). The effect of the higher initial rate is to quarantine the benefits of the threshold increase to low income earners. For example, a $5,000 pa threshold increase could be recouped by the first rate step ($20,000) if the initial marginal rate were raised from 17 to 26.4%.[13] Only those with incomes between $6,882 and $20,000 would benefit, with the maximum gain being $850 at an income level of $11,000.

Juggling the parameters allows the gains to be extended to any desired income level. For example, the first marginal rate might be 30%, and the threshold becomes $12,067 pa.

One objection to raising the tax threshold is that this is not target-efficient, because it benefits high-income earners, secondary earners, income

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splitters and the like. This objection is partly addressed by the proposal to raise the initial marginal rate, although it remains true that many low-income earners who would benefit are in families with high incomes. However, working spouses are less advantaged, through the loss of DSR or family payments as their income rises.

Another reason for wishing to raise tax thresholds is both to decrease interactions between means tests and income tax. However, tax thresholds apply to *individual taxpayers*. If the emphasis is to be on greater assistance for low income *families* (including couples) our options become more difficult.

Extra assistance equivalent to an increase in the family tax threshold could be achieved through increase in the spouse rebate or its social security equivalent, Basic Parenting Payment (BPP). The problem with the latter is that it extends benefits right to the bottom of the income scale, and so does not improve incentives. In practice there would need to be an offsetting decrease in the other (welfare) component of Parenting Payment. The practical effect would be to decrease that component of PP subject to familial means testing, and increase that component which is only means-tested on the spouse's income. A problem with both approaches is that they confer additional benefits right up the family income scale if there is a non-earning spouse.

Ingles (1998a) has suggested that there is a case for a partial family unit basis to the income tax. The aim is to smooth tax and transfer interactions; since the transfer system is necessarily based on the family unit (the alternative being too expensive and perhaps inequitable),[14] this forces the tax system to adopt a similar unit, *especially at the bottom end.* This is already the case with the Medicare Levy, whose 'shade-in' provisions take into account income by the taxpayer's spouse.[15]

If the spouse is not working then using the DSR to achieve the higher threshold for a couple spreads assistance all the way up the family income scale. An alternative approach would be to change the low income rebate (LIR) so that there was a separate, higher rebate for a couple (compared with a single taxpayer) and a separate, combined income withdrawal threshold. The rebate could be quite large, or at least could be phased in so that it became large. This would be a back-door means of implementing a family unit tax structure for low income earners.

Suppose, for example, that the LIR for singles was not \$150 pa but \$1,000, and that for couples was \$2,000. The effective tax threshold for singles would become (6,000 + 1,000/.17 = \$11,882; and for couples with one earner, (6,000 + 2000/.17) = \$17,765 (or \$23,764 with two earners).

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While this will exacerbate some high EMTRs over the Newstart allowance/PP taper range, the effects would be modest. However the revenue costs of this proposal are likely to be considerable.[16]

To implement a family unit tax system more thoroughly, the tax threshold could be abolished and replaced entirely by low income rebates of, say, $2,000 for singles and $3,0-00 for couples. This would produce tax thresholds of $11,765 and $17,647 respectively: amounts approximating the respective at-work poverty lines for such families.[17] If it were further desired to reduce the benefits of a family tax base at higher income levels, this could be achieved by abolition of the DSR. This would still leave the issue of families with children gaining equivalent benefits through Basic Parenting Payment. Perhaps this, too, could be abolished. The effect would be to have a fully family-based tax system at the low income end, a transition through the middle income ranges, and a fully individual basis at the top end.

Some will be horrified at the proposal for an increased spouse rebate or a family unit tax system. However it is a logical consequence of greater tax/social security integration. Currently the tax system is based predominantly (but not wholly) on the individual; the social security system mainly on the couple. Since an individual basis of entitlement is not possible in the social security system- it is simply not affordable – the two systems can only be made more compatible by moving the tax system at least partially towards a family basis. And while the EITC is one means of achieving this, there are advantages in seeking a more systematic set of design changes.

A complication is that the Tax office would need to assess who is and who is not a couple, lest individuals living together are advantaged relative to married couples. This is already a contentious area in income support policy. It requires a degree of intrusion into people's domestic arrangements that may not be permitted to the Tax office.

Another reason for wishing to raise tax thresholds is both to decrease interactions between means tests and income tax, and to increase the rate at which the incomes of social security beneficiaries 'converge' with the incomes of those who have no categorical eligibility. The issue of convergence is discussed below.

Convergence

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

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By convergence, we refer to the reduction in the gain from being in a categorical group as income rises. Achieving rapid convergence is one way of reducing the distortions brought about by categorisation, and thereby achieving better horizontal equity as between people on similar incomes. In general, a means tested system like the Australian one achieves convergence at the benefit cutout points. The current system achieves fairly rapid convergence for allowees, but much less so for pensioners (the cutout point for a pensioner couple is in excess of $35,000, and will increase under the 40% taper in ANTS).[18]

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

A less extreme form might have a single taper of say 65%, and tax thresholds correspondingly higher ($13,912 pa, single, and $23,208 pa, couple). This would be partly financed by an increase in other marginal tax rates, as discussed above. These would probably need to rise to around 40% at the first and second rate steps. The effect would be to create a 65/40/50 rate structure, rather similar to Dawkins et al's modified NIT. This proposal, to work properly, would require either a family unit tax system, or an increased spouse rebate.[19]

Conclusion

Low wage earners can be helped in many different ways. A lot depends on the objectives we are seeking to achieve, and whom we wish to help.

If we wish to ensure that low pay does not result in poverty then the present system, with minor refinements, is probably adequate to this task (Option 1). For families with dependent children, substantial in-work assistance is already provided to low wage earners. In addition, low-wage couples can receive unemployment assistance if one of them is willing to seek full-time work. For the medium term future, low pay is unlikely to cause poverty for single individuals or working couples without children, so the lack of social security supplements for these groups is not an immediate issue. If supplementation were required, it should relate in the first instance to those with high housing costs. Hence the option in 3.4.5 for changes to the rental assistance scheme.

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Although the current system addresses poverty, lower minimum rates of pay may start to cause problems of earnings replacement rates. The answer here (we exclude the 'solution' of cutting benefits) is to ease EMTRs for those on the margins of the welfare system. This is already being done for family assistance, under ANTS. For couples coming off allowances, EMTRs are currently very high. Two approaches are possible. One is to directly reduce allowance tapers (Option 2). A problem with this strategy is that, while not that expensive in itself, it pushes out the necessary threshold for the family payment means test and therefore has significant flow on costs.

Another possible problem is that it creates a whole class of people receiving a part-allowance, and this may not be a desirable development from either a policy or an administrative view. Easing allowance tapers would extend already-existing trends for them to become in-work supplements for low paid workers. This would require a new philosophy as to the role of unemployment payments in particular, which have not hitherto been (widely) seen as a form of low wage subsidy.

The alternative solution is to reduce income tax payments for those on the welfare margin (Option 3). This has the advantage, compared to Option 2, of keeping people out of the welfare system. It also helps in terms of tax/welfare interaction generally, which cause significant EMTR problems. Many of those who would benefit from easier tapers also pay income tax; often in substantial amounts. Reducing income tax on the low paid will therefore reduce churning, compared to the easier taper option, and it also helps those outside of the formal social security system. However it is likely to be even more expensive than Option 2, as it is more difficult to confine the benefits to a small target group.

The EITC is one version of this strategy (Option 3a). It can be tightly targeted if it is based on the family rather than the individual. But it may be better to explicitly change the tax unit – particularly at the low income end – to reflect relative needs of families. A number of approaches for doing this are explored.

Another problem which policy might seek to address is that of increasing inequality, rather than poverty (the two are related, but not identical). However the policy response to this is not likely to be greatly different to Options 2 and 3. Once we move from a focus on poverty alleviation to one where we are concerned about work incentives for those on the margins of the welfare system, we inevitably end up giving extra assistance to those on relative low to middle incomes.

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A third possible objective is to 'buy' award wage restraint before the Industrial Commission. In this context, a virtue of the EITC is that it would be a highly visible and saleable offset to any scheme of award wage restraint, and might make such a scheme acceptable to the Industrial Commission (and, with less likelihood, the trade union movement). However, it might only be a matter of time before the credit was scrapped and its effect embodied in the formal structure of income tax rates. (In saying that we acknowledge that we would have made the same comment about the Medicare Levy, twenty-five years ago, and the Low Income Rebate, six years ago, and been completely wrong!)

A problem with an EITC as a compensation mechanism is that it limits compensation to a sub-group of the affected population. Indeed, this is precisely its point (from a cost perspective), but it is a serious weakness from a political perspective. In particular it implies that the union movement would be extremely unlikely to support the wage/tax tradeoff as currently envisaged by its proponents.

Appendix 1: The Government's Tax Package (A New Tax System – ANTS)

ANTS is *inter alia* designed to address problems, particularly work disincentives, arising from high effective tax rates in both the income tax and the transfer payments system. These problems are being addressed by lowering income tax rates and increasing tax thresholds; simplifying the structure and administration of family assistance; raising the income test thresholds for family assistance and reducing taper rates; and providing extra assistance for social security recipients and other lower income groups, while maintaining clear work incentives (Costello 1998).

Almost as radical as the GST is the reform of family assistance in ANTS. Twelve family benefits (8 cash payments and 4 tax benefits) are simplified to three. As part of this reform all 'sudden death' cutouts are abolished and replaced by uniform tapers of 30%. The 50% taper currently applied to FP and Rent Assistance also reduces to 30% which, in combination with the reductions in marginal tax rates mentioned earlier, dramatically lowers EMTRs facing families. The new structure will take effect from July 2000.

Apart from families, ANTS will also decrease pension tapers from 50% to 40%. This affects age and invalid pensioners, and sole parents. Coupled with the general reduction in marginal income tax rates, the effect should be an improvement in the rewards for pensioner's work and savings. The latter is a particular issue insofar as the current system can involve quite

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considerable incentives for pensioners to invest their savings in exempt assets such as their home, and thus has the potential to create considerable economic distortions.

Notes

1 The proposals for wage/tax trade-offs proposed by the 'five economists' are discussed in the Barbara and Gahan paper elsewhere in this symposiuum.
2 See also Harding and Richardson (H&R 1998).
3 A related issue is the increasing dichotomy between two-earner and no-earner households (OECD 1998 Ch1) and the associated high correlation between the unemployment status of partners. It is not clear whether this is due to similar personal characteristics (education etc – so-called 'assortive mating'), or to work disincentives for second earners inherent in the benefit system.
4 There is a debate about the extent to which current earnings replacement rates for those on unemployment-related payments impact on the level of unemployment – see eg Kalb 1998. This debate is particularly hard to untangle in Australia because a lot of the evidence from overseas studies relates to quite different benefit schemes. There is particular reason to doubt the applicability to Australia of the many studies of the effects of the 'notch' when time-limited insurance benefits (which have little stigma, no means testing and often little work- testing) cease, and are replaced by flat-rate social assistance benefits (which carry stigma, which effectively require disbursement of assets and are generally tightly work-tested).
5 'Non-categorical' implies that the full negative income guarantee would be available to all those with sufficiently low incomes, without reference to their eligibility under categories such as the aged, invalid, unemployed etc.
6 Another serious problem arises in trying to have a common period for income assessment for positive tax, where annual income is appropriate, and negative tax, which must necessarily be based on a shorter time-frame. This problem is only avoided under a pure linear rate NIT, where the time pattern of receipts becomes irrelevant
7 Although some parts of the system – notably retirement incomes – seem in recent years to be moving away from this traditional goal in favour of broader ones of income security and reduction of overall inequality.
8 First, it doesn't handle the issue of capital incomes very well, unless there is a wholesale reform of the income tax base (eg, including deemed income from capital). Second, it is not clear how the administration would be handled in practice, especially the transition from the negative to the positive tax system. (The simplest system, of a universal demogrants and uniform tax rates, is the NIT least likely to be achievable, and in any case does not sit well with the 'mutual obligation' philosophy that now underpins much thinking about welfare reform.) Third, it is hard to find a single definition of income that simultaneously allows the credit to effectively address current need while preventing manipulation of the timing of earnings to maximise entitlement). Forth, the suggestion of an initial tax rate of 60% is probably optimistic, given that most allowances are already taxed back at well over 70%. Finally, it is not at all easy to get from here to there: there would be a good number of losers, as well as winners.

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9 A potentially important difference is that the wage rate subsidy might be paid direct to the employee, whereas the payroll tax remittance benefits the employer. Economic theory predicts that both approaches have the same long-run behavioural implications, but the differences might be important in the short run, especially where interaction with an existing minimum wage is an issue. Where there is a minimum wage (as in the US and Australia) there may be merit in seeking to mitigate its potentially adverse employment effects by an accompanying payroll subsidy. In effect, this argument sees the subsidy as a sort of compensating distortion.

10 These costings are prior to the rate rises in ANTS Mk ii. They are used here for ease of comparison.

11 The previous government contemplated a similar system, when they promised that age pensioners would be totally removed from the tax system by 1995. This did not proceed, mainly for the reasons that it would be inequitable in relation to those in the workforce with similar incomes to pensioners; and be expensive. However, these comments were in a context where there would not be offsetting changes to income test tapers, and would not be relevant if the taper rate were raised as under the Dixon/Foster proposal.

12 A logical extension of this principal would be that assistance should become available to low income earners with high housing costs, whether they be for rent or for repayment of a mortgage. However, it should be noted that the government has already foreshadowed a new scheme of homebuyer assistance as a means of compensating for the price impact of the GST. It should also be noted that homeowners are generally tax favoured as compared to renters – although this is not true of those with very low levels of equity in their home.

13 Note that this policy is not revenue neutral. Rather, it is designed to confine any net benefit to those taxpayers below the designated income point.

14This is not strictly true. One could design, for example, a system of individual tax credits and a proportional tax (possibly involving supplements for those living alone). But the tax credit for the second earner in any couple would be the de facto equivalent of the DSR, and has all the same distributional implications.

15 The peculiarity and complexity of the Medicare levy shade-in provisions is a good illustration of the difficulties of reconciling a family-based welfare system with an individually based tax system. When the levy was introduced it had to be designed in this way because a principal aim was to exempt from the levy any group which got free medical services before the introduction of Medicare. This included those with social security concession cards whose eligibility depended on their **joint** income.

In the current benefit system, the rate for a couple is roughly 165% of that for singles. Applying this ratio implies that if the threshold for singles is $6882, that for couples should be $11,470 (compared to $12,770 currently).

16 The LIR will shade out above a threshold of $20,000; there would appear to be logic in setting this threshold lower for singles (say, $12,500). This would create some savings. For singles, this has the effect of increasing the marginal rate beyond the LIR threshold from 17% to 21%; for couples with one earner over $20,000, the marginal rate increases from 30% to 34%.

17 $12,659 for the single person, and $16,934 for the couple. This is not to endorse the Henderson lines, which have well known deficiencies, but they are the only ones in common use which provide for costs of working.

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18 Although the introduction of the Low Income Aged Persons Rebate (LIAPR) in 1996 is a response by the government to a perceived horizontal inequity between age pensioners and other low-income retirees, it is a mechanism for the sort of convergence discussed here.

19 The spouse rebate could, if desired, be clawed back with rising family income in the same manner as proposed in Section 3.4.4 for other special tax rebates. What should be done with 'basic' Parenting Payment, which is in effect a cashed-out DSR, is another complication. The logical implication of the proposal is that basic PP be abolished, and the DSR be re-vitalised, in effect reversing policy changes which have occurred over the 1990s.

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