Social Security, Taxation Law, and Redistribution: Directions for Reform

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Abstract
While it is now generally accepted that some redistribution of economic power is a legitimate goal of government, there is no consensus as to the type of redistribution that should be pursued. In the absence of a clear redistributive goal, it is impossible to evaluate critically current law, or make recommendations for change. In the first part of this article, we examine alternative models of redistribution and advocate a preferred model, namely, redistribution to promote equality of opportunity and to recognize periods of vulnerability. We then evaluate the operation of Australian social security law and taxation law in light of that objective. We conclude that, although changes made in the 1980s were positive, they were inadequate in terms of the goal we propose. Following is an analysis of the changes required if the social security and tax systems are to work together efficiently in furtherance of effective redistribution. The final part of the paper applies the analysis to the case study of retirement savings and incomes, and proposes fundamental reforms to the current tax system with respect to these questions.
SOCIAL SECURITY, TAXATION LAW, 
AND REDISTRIBUTION: 
DIRECTIONS FOR REFORM

BY ALISON MCCLELLAND* AND RICK KREVER**

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I. THE ANALYTICAL FRAMEWORK

At the beginning of this century, state intervention in the country's economic and social life was limited. The tax base was both simple and small. Macroeconomic management by government was almost unknown, apart from public works projects and tariff manipulation. Redistribution was largely limited to indirect transfers from the politically inept to the politically adept as those in power manipulated tariffs and excise duties to favour the sectors of their principal supporters.

On the threshold of the twenty-first century, state intervention is a pervasive component of virtually all aspects of the country's economy and social systems. It seeks to accomplish a multitude of sometimes complementary, and equally as often, contradictory objectives. The characteristic common to all state intervention is its redistributive effect, whether intended or unintended. Any law that favours one group prejudices another; any intercession puts those who profited from the unimpared market at a relative disadvantage or in a strengthened position; and any endorsement of the free market reinforces the position of those who have used the biased marketplace to extract wealth from others.
The growing significance and volume of interventionist legislation over the century has complemented society’s changing perception of the purpose of redistributive policies. The legitimacy of redistribution as an objective of government policy is now generally accepted, as are the social security and taxation systems designed to achieve that objective. At the same time, however, there is little agreement on the type and extent of redistribution to which the social security and taxation systems should aspire.\footnote{Indeed, it must be conceded that the consensus about the desirability of redistribution in some form that has prevailed since the Second World War has become somewhat precarious in the face of continual challenge by the New Right since the recessionary shocks of the 1970s.} But unless one identifies a coherent model of redistribution, there is no benchmark against which the operation of the current systems can be evaluated.

In Part II of this paper, we develop a set of objectives and a strategy for the achievement of a more equitable Australian society at the end of the twentieth century. The redistributive goal we advocate is equality of economic opportunity. The closing section of this part identifies the relative contributions that the social security system and the tax system can make to the achievement of this objective.

This strategic approach to redistribution establishes the framework for the remainder of the paper. In Part III, we discuss the recent evolution of social security and tax laws and outline their central features. In Part IV, we evaluate the operation of the social security and tax systems in the light of the redistributive objective discussed earlier. We conclude that although some progress has been made, the current systems still fail to achieve this redistributive objective. They have, at the same time, seriously compromised the opportunities for making Australia’s economy more efficient and, as a consequence, impaired the potential for improving the nation’s economic well-being, thus making the redistributive objective all the more difficult to achieve. In Part V of the paper, we briefly outline an agenda for reform of the social security and taxation systems in light of the model.

Finally, in Part VI of the paper, we use a specific case study to show exactly how the social security and tax systems, working together, fail in one important area: the provision of adequate income during retirement. We also explain the changes that should be made in that area if social security and tax law are to accomplish the redistributive goal.
II. THE REDISTRIBUTIVE FUNCTION

A. Redistributive Aims

Public finance literature in the Musgrave tradition identifies three interventionist policies that government pursues in order to increase the welfare of the community. First, government intervenes directly in the economy in order to correct for market failure, improve efficiency by dealing with externalities, and encourage the production and consumption of "merit" goods. Second, it manipulates the economy indirectly in order to achieve macroeconomic equilibrium in the form of acceptable levels of inflation and desirable levels of employment. And third, it intervenes both directly and indirectly in order to correct unacceptable inequalities in ownership of and access to economic resources, in the capacity to consume certain goods and services, and in the ability to participate in the activities commonly accepted as necessary for membership in the community. These redistributive aims reflect a consensus that the distribution achieved through the market reward system is not just.

The social security and tax systems are two instruments that governments use to carry out their redistributive function. The degree of redistribution that a government pursues depends on which of the various definitions of an "equitable" distribution it accepts. Equity, properly speaking, consists of the unequal treatment of unequals (vertical equity) and the equal treatment of equals (horizontal equity). The concept of an equitable distribution, however, is essentially a social and value laden one, about which opinions can differ markedly. If there are many who believe that the notion of an equitable distribution implies the attainment of some state of equality, there are many who do not. Some common definitions of the appropriate goal of redistribution are as follows:

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1. *Equality of outcomes:* everyone achieves the same outcome;
2. *Equality of opportunity:* everyone has the same opportunity to achieve a given outcome;
3. *Equality in the use of resources:* resources, particularly those allocated by governments, are distributed equally; and
4. *The maintenance of minimum standards:* certain basic rights are protected, and no one is allowed to fall below a defined minimum position in terms of matters such as income and access to basic services.\(^6\)

The selection that one makes from this list will depend upon one's views about the necessity of distributive justice and the emphasis that one places on each of three objectives: equity, efficiency, and the freedom of individuals. The widespread perception that there are fundamental conflicts between equity on the one hand and efficiency and individual freedom on the other may lead society to give less priority to the achievement of a greater degree of redistribution.

Okun\(^7\) and others have postulated the notion of a basic trade off between efficiency and equity. Although the validity of this notion has been questioned by others,\(^8\) mainstream economic opinion in recent years has tended to favour options that emphasize the trade off. Saunders points to the dominance in the 1980s of efficiency considerations and of the view that these considerations require free-market solutions.\(^9\) The prevalence of this view led to a neglect of the positive role of public intervention. Furthermore, because the emphasis on free-market solutions was based on a very narrow efficiency perspective, it encouraged policies that were ultimately ineffectual as well as inequitable. Still, as Saunders notes, "the ideology of freedom of choice is a very powerful force in contemporary economics (West and East) which the welfare state cannot afford to ignore."\(^10\)

The consequence of this state of affairs is an increasing emphasis on the libertarian view in debates about the role of government. The

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\(^10\) Ibid. at 27.
proponents of this view favour the "minimum standards" definition of equity, which they would apply narrowly and rather harshly. In the libertarian view, the pursuit of equity should be limited to action that will transfer purchasing power to the very poor. Any additional action to redistribute resources would not be "equitable" or "just," since it would impose an unacceptable constraint on freedom of choice; in addition, it would diminish efficiency. Payment for government services, according to this philosophy, should be related not to ability to pay but to benefits received. This assertion has obvious implications for progressive taxation, among other things.

Another perspective relevant to redistributive policy concerns itself not only with inequalities between individuals or groups but also with the unequal positions of individuals and families at different stages in their lifecycles. This perspective can be translated into a desire to redistribute resources from periods in the lifecycle of less vulnerability to periods of greater vulnerability. The periods of greater vulnerability include old age, periods of parental responsibility for dependent children, and periods of illness or unemployment. This concern with temporal inequalities is reflected in the adoption of income maintenance objectives in the social security programmes of most OECD countries.

We take the view that the redistributive objective of public intervention should in general be to promote equality of opportunity and to recognize periods of vulnerability, particularly when these periods are likely to be accompanied by insufficient income. We choose the objective of equality of opportunity because it balances the demands of equity, efficiency, and freedom of choice. It implies intervention to reduce structural factors that promote inequalities but less intervention than the equality-of-outcome objective implies. The pursuit of equality of opportunity upholds—in fact, it seeks to enhance—freedom of choice. This is not to say that in some specific areas of intervention equality of outcomes for differing groups would not be a desirable result. Indeed, to promote equality of opportunity generally, it is necessary to reduce inequalities of outcome in areas such as education and health status, given their importance to individuals in determining future potential and opportunities, including potential to earn income. The minimum standards approach to redistribution is too limited, since it does not imply a commitment to deal with the structural reasons for substantial inequalities.

There are at least four types of inequalities that public policy must address in order to improve equality of opportunity:

1. Inequalities in income;
2. Inequalities in asset and wealth ownership;
3. Inequalities in labour market earnings potential; and
4. Inequalities in access to community resources.
A public policy approach to achieving equality of opportunity requires a combination of social security, taxation, education, labour market, health, and urban and housing policies. These policies should pursue the following goals:

1. To ensure adequacy of income through tax and transfer arrangements;
2. To help people to obtain secure, well-paid employment by providing education and labour market programmes;
3. To ensure access to affordable housing; and
4. To improve living standards by ensuring access to services such as health care, child care, and transport.\(^{11}\)

A policy approach that adopts these goals addresses both the necessity of improving the short-term position of vulnerable people (through income support payments and services that improve immediate living standards) and the necessity of reducing inequality and vulnerability in the longer term by attacking labour market disadvantage. Dealing with labour market disadvantage is important because employment is the major source of personal income, and lack of employment is the major cause of poverty.\(^{12}\) However, unless employment growth is accompanied by policies to ensure that those with labour market disadvantage obtain employment, its impact on poverty may be limited.\(^{13}\)

Within this broader public policy redistributive framework, the objectives of social security and taxation policy should be:

1. To provide an adequate level of income (in Australia, this is primarily the responsibility of the social security system);
2. To raise sufficient revenue to finance adequate levels of income support and to finance the provision of services such as education, labour market programmes, affordable housing, health, and community amenities;
3. To raise revenue in such a way that economic efficiency is


enhanced and employment opportunities are generated;
4. To provide assistance in such a manner that incentives to
undertake employment are maximized where appropriate; and
5. To ensure that the combined effect of the tax and social security
systems is to reduce rather than reinforce existing inequalities,
and, in particular, to target assistance to those in greatest need.

B. The Complementary Roles of Social Security and Taxation

As later parts of this paper show, neither the social security
system nor the tax system currently in place in Australia are designed to
effect the fundamental and comprehensive redistribution envisaged
above. The social security system falls short of its primary role of
ensuring that all people have an adequate income and are linked to
mainstream economic opportunities. The tax system does not generate
adequate revenue to fund a genuinely redistributive public expenditure
programme, and the assistance that it provides through tax concessions
often directly undermines the operation of direct expenditure
programmes. The tax system's mild progressivity, at best, fails to achieve
the objective of equitable collection of revenue for the social security
support systems. Nor does it operate in a way that enhances overall
economic well-being. Thus, both equity and efficiency are compromised.

The failure of the social security and tax systems to complement
each other and to achieve broader redistributive goals is at least partially
attributable to the lack of a consensus about what these goals should be.
There is also a lack of understanding of the major defects of the tax
system: community debate gives more attention to the alleged failure of
the social security system to benefit those most in need than it gives to
the fact that the tax system often operates to benefit those least in need.

III. AUSTRALIA'S TAX AND SOCIAL SECURITY SYSTEMS:
REFORMS OF THE 1980s

Australia's current tax and social security systems embody a
number of changes introduced by the federal Labor government, which
has been in office since 1983.

In September 1985, after considerable community debate and a
"taxation summit," the Labor government announced a wide array of
changes in income and wholesale sales taxation. Significant income tax
and wholesale sales tax reforms were implemented between 1985 and
Further substantial changes have been made to the business tax and superannuation (pensions and pension funds) taxation since 1987.

Social security reform has been guided primarily by the operation of the Social Security Review, a comprehensive assessment of the social security system commissioned by the government in 1986. The Review followed the introduction in 1985 of an assets test designed to improve the targeting of assistance provided through the pension scheme. The test was later extended to other transfer payments. The changes in social security programmes that resulted from the Review were complemented by substantial changes in the procedures for enforcing maintenance payments for sole-parent households.

The extent and direction of these tax and social security changes has been affected by the broader economic, social, and political context. The federal Labor government came to office in 1983 during a recession, with unemployment levels of over 10 per cent. However, subsequently unemployment increased substantially from 5.8 per cent to 11.1 per cent between June 1989 and June 1992. A key feature of the Labor government's platform was (and remains) an accord with the union movement through the Australian Council of Trade Unions (ACTU). Under the terms of the accord, the government could pursue an incomes policy approach, designed to deliver income and employment growth. It would also seek to restrain inflation, and at the same time, protect living standards through an integrated approach to wage, tax, and social expenditure policies.

The objective of increasing economic and employment growth dominated the first few years of the Labor government. Pursuit of this objective was also accompanied by financial deregulation. However, the marked deterioration of Australia's foreign debt and current account position in 1985-86 led to a new emphasis on structural change and economic restraint. The government adopted a tightened macroeconomic policy based on fiscal restraint and severe cuts in government spending.

As Saunders notes, some of the broader policy outcomes since 1983 have been:

1. An increase of almost 1.5 million in employment from June 1983 to June 1989 and an associated (but not commensurate) decline in unemployment;
2. A real decline of 4.8 per cent in average weekly earnings between 1982-83 and 1988-89; and
3. A reduction of the Federal budget deficit by more than 6 per cent of GDP; thus a deficit of 4.1 per cent of GDP in 1983-84 became a surplus of 2.2 per cent of GDP in 1989-90. As a result of the recession, the deficit has now returned to about 4 per cent of GDP.

The emphasis on reducing the deficit through spending cuts coincided with the Review and limited the capacity of social security reform to increase transfer payments.

A. Tax Reform

After decades of relatively minor tinkering and ad hoc adjustments, the Australian tax system underwent its first and only major restructuring in 1985. The reforms were prompted by a widely perceived need for significant changes in the structure and functioning of the system—a need that had been demonstrated in the 1970s by the findings of the Asprey\textsuperscript{16} and Mathews\textsuperscript{17} reports. It was also increasingly clear that the personal income tax system had been severely undermined during the late 1970s and early 1980s by widespread tax avoidance practices—practices that had often been judicially sanctioned by the High Court.

1. Features of the pre-reform system

Before the 1985 reforms, Australia’s tax system exhibited the following features:

1. *A relatively very low level of taxation as a proportion of GDP*. In 1983, taxation in Australia amounted to 29 per cent of GDP and the OECD average was 36 per cent; only three OECD countries had lower levels of taxation.\textsuperscript{18} However, one of the principles of tax

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reform articulated by the Prime Minister was that reforms should not increase taxes relative to GDP.19

2. The predominance of income taxes as a proportion of total tax revenues. In 1982, only three comparable OECD countries surpassed Australia in their reliance on income taxation. Concerns about the incentives for tax avoidance created by such a high level of reliance led to pressure for a change in the tax mix away from income taxation and toward indirect taxation. Many observers failed to realize that Australia relied on its income tax to collect revenue that other countries collected through specific social security levies that were comparable to income taxes. In 1982, Australia's income tax revenue plus social security contributions and payroll taxes amounted to 15.6 per cent of GDP, whereas the OECD average was 21.3 per cent.20 Indeed, indirect taxation raised 31.7 per cent of total tax revenue in Australia, whereas the OECD average was only 29 per cent.21

3. A narrow tax base for both income and indirect taxation. The perception before reform was that the narrow income and indirect tax bases were inefficient, distortionary, and inequitable.22 The major deficiencies of the income tax base included the absence of an effective tax on capital gains, the non-taxation of imputed rent, and the effective non-taxation of most employment-related fringe benefits. Taxable income was further reduced by a number of concessions, notably superannuation tax concessions; by tax minimization practices, such as the use of income-splitting and tax-favourable company structures; and by the under declaration of income from a wide range of non-employment sources. In the case of indirect taxation, the narrowness of the base arose from the non-taxation of services and a wide range of exemptions from the wholesale sales tax, of which the most significant were food and clothing. Furthermore, the existence alongside the wholesale sales tax of a number of excise taxes meant that in many cases different tax rates applied to different but similar goods, an arrangement that

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21 OECD, Revenue Statistics of OECD Member Countries 1965-82 (Paris: OECD, 1983) at 7. These figures treat the crude oil levy as an indirect tax rather than as a tax on profits.

was seen to be arbitrary and distorting and to reduce the capacity to raise additional revenue from indirect taxation. Proposals for the introduction of a broad-based consumption tax (BBCT) at a single rate with no exemptions arose in response to these perceived problems, as well as from the desire to generate sufficient revenue to substantially lessen reliance on income taxes.

4. An absence of indexation of the income thresholds applicable to the marginal tax rates used to calculate income tax liability. The absence of rate indexation, along with inflation and a narrow base, had produced a state of affairs in which high marginal tax rates applied at relatively low levels of income. When the Labor government came to power, households with average weekly earnings were likely to become subject in the near future to the 40 per cent marginal rate. There was considerable pressure to reduce this rate and also to reduce the top rate (60 per cent), which applied to incomes over $35,000. A related problem was the high effective marginal tax rates (EMTRs) faced by many social security recipients as a result of the interaction of the tightly income-tested social security system and the income tax system. Pensioners and beneficiaries, who had little or no private income, found themselves liable for income taxes. Most pensions and benefits were taxable, and the EMTRs on private income that many pensioners and beneficiaries faced ranged from 60 per cent to over 100 per cent. Such rates were termed "poverty traps" because of their possible work disincentive effects on people whose incomes left them on or below the poverty line.23

6. An absence of wealth taxes or death duties. Death duties, previously levied at the state government level, had been progressively wound down since the late 1970s and by 1983 were non-existent. Furthermore, Australia did not have any general wealth taxation and was among the few OECD countries that had neither a wealth tax nor death duties. This situation prompted the following comment by a visiting American researcher:

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The point was made again and again that, with abolition [of death duties], Australia would stand unique in the industrialized western world as a country without any taxes on capital, neither income tax on capital gains nor annual wealth tax nor death tax. ... In its abolition of death and gift duties Australia has set out on a lonely trail.24

2. The tax reform package

In late 1984, the Prime Minister went to the polls promising a consensus approach to tax reform. His government was re-elected, and early in 1985 he announced that a "tax summit" would be held later in the year. In preparation for the summit, the Treasury prepared a Draft White Paper,25 which was released shortly before the June summit. The government's hopes for a broad consensus for income tax rate cuts and a shift toward greater reliance on consumption tax in return for a broader income tax base were dashed when the business community split on the proposed shift and the union movement rejected it.

In September, the Treasurer announced a package of comprehensive reforms. First, there were a number of income tax base-broadening measures, including:

1. A capital gains tax to apply, at ordinary marginal tax rates to real gains (rather than nominal gains) realized on assets purchased after 19 September 1985 (an owner-occupied principal residence was exempt from the tax);
2. The taxation of non-cash fringe benefits at the employer level and the imposition of severe restrictions on the deductibility of business entertainment expenses; and
3. The reduction of some of the tax benefits available through negative gearing related to property acquisition (this provision was subsequently revoked).

Other income tax changes included the introduction of a foreign tax credit system (it was changed in 1988, with effect from 1990, to a partial credit and partial exemption system), the removal of the double taxation of dividends through the introduction of full imputation, and an increase in the company tax rate from 46 per cent to 49 per cent. This increase made the company tax rate equal to the new top marginal tax rate for the personal income tax.

The second set of changes consisted of income tax cuts, which were delivered primarily through a reduction in rates rather than an

25 Supra note 19.
increase in the income thresholds at which the rates applied. The rate changes, which included a reduction in the top marginal tax rate from 60 per cent to 49 per cent, benefited high income taxpayers most. There have since been additional tax cuts, negotiated with the ACTU on the basis of the accord, as part of two packages involving a trade off between wage increases and personal income tax cuts. Like the first tax cuts, these cuts have tended to reduce rates rather than increase thresholds. The result, as Table 1 shows, has been a trend toward a less progressive rate scale. Further cuts in marginal rates, not shown in Table 1, will come into effect in 1994-95 and 1995-96.

### TABLE 1

<table>
<thead>
<tr>
<th>Income</th>
<th>Tax Rate</th>
<th>Income</th>
<th>Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0-4,595</td>
<td>0%</td>
<td>$0-5400</td>
<td>0%</td>
</tr>
<tr>
<td>4,596-19,500</td>
<td>30%</td>
<td>5,401-20,700</td>
<td>20%</td>
</tr>
<tr>
<td>19,501-35,788</td>
<td>46%</td>
<td>20,701-36,000</td>
<td>38%</td>
</tr>
<tr>
<td>35,789+</td>
<td>60%</td>
<td>36,001-50,000</td>
<td>46%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>50,000+</td>
<td>47%</td>
</tr>
</tbody>
</table>

The 1985 changes also included some measures to reduce the poverty traps that faced social security recipients by increasing the threshold of private income at which the income test applied for pensioners, with higher increases for pensioners with children, and by eliminating the separate income test for recipients of rent assistance.

The final set of changes entailed some rationalization of wholesale sales tax rates, and a slight broadening of the base, but they fell well short of the single rate and the expanded indirect tax base envisaged by the BBCT. The rate structure was rationalized into a three-rate system—10, 20, and 30 per cent. More substantial and later changes have effectively broadened the wholesale sales tax base and increased sales tax revenue as a proportion of GDP from 1.5 per cent in

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26 One of the packages also involved agreement by the ACTU to forgo some wage claims in return for a compulsory employer superannuation contribution equal to 3 per cent of wages.
1980-81 to 2.7 per cent in 1989-90. The figures exaggerate the effect of the change, since some of the base broadening was accompanied by the elimination of excise taxes on items now covered by sales tax. The changes included the extension of sales taxation to beer, to a range of federal government commercial enterprises such as Telecom (the national telephone company) and Australia Post, as well as discretionary rate changes for a number of goods.

Business taxation, apart from the introduction of imputation, the increase in the company tax rate, and some changes in the tax treatment of trusts, was left substantially unchanged until May 1988. Then the government announced a drop in the company tax rate from 49 per cent to 39 per cent, a broadening of the base through the removal or reduction of a number of tax concessions, in particular the accelerated depreciation system, the non-taxation of income from gold mining, and the tax concessions available to life offices and friendly societies. The government also announced certain changes in the taxation of superannuation that we shall describe later.

In early 1992 changes to the personal rate scale were announced. The changes, to be phased in over the 1994-95 and 1995-96 tax years, lower the rates applicable to intermediate brackets. At the same time, a modified form of accelerated depreciation was reintroduced and an investment allowance was adopted for large investments. Finally, in early 1993, the government proposed a reduction of the company tax rate from 39 per cent to 33 per cent as part of its election platform. (The opposition Liberal/National coalition proposed an increase in the company tax rate to 46 per cent.) Shortly after its re-election, the Labor government introduced legislation to give effect to the rate reduction.

B. Social Security Reform

Australia, like most comparable countries, has a categorical system of income support. Entitlement for payment is based on old age, disability or sickness, unemployment, or the undertaking of caring responsibilities, such as the sole care of a dependent child or the care of a sick relative. Australia is distinctive, however, in that entitlement under its system is strictly means-tested (through an income and assets test) and financed through general revenue. It does not have social insurance-based payment nor universal (in the sense of non-means-tested) payments.

1. Factors that prompted social security reform

The 1986 Social Security Review was the consequence of a recognition that the existing social security system, a product of the years immediately after the Second World War, needed to be brought up-to-date. It was necessary to address a variety of social and economic changes that had occurred since the system had assumed its present form. The first background paper of the Social Security Review documented these changes, which included the following:

1. **Substantial increases in the rate and duration of unemployment and a change in the composition of unemployment.** While the unemployment rate had declined from over 10 per cent in 1983, it was still almost 8 per cent in 1985, when more than 35 per cent of unemployment beneficiaries had been in receipt of benefits for more than one year.

2. **An increase in the number of one-parent families from 9 per cent of all households with children in the mid-1970s to over 14 per cent in 1983.** Almost 90 per cent of these families were headed by women. Because of the high level of unemployment, the significant labour market disadvantage of one-parent households, and the low level of maintenance paid to them by non-custodial parents, a high proportion (87 per cent) of these households relied on a pension or similar benefit.

3. **An increase in poverty, particularly in child poverty.** Between 1972-73 and 1981-82, the proportion of people in poverty increased from 8 to 13 per cent. Child poverty increased from 8 to 19 per cent. By 1981-82, the poverty rate for female-headed one-parent families was 50 per cent, the rate for married couples with three or more children was 19 per cent, and the rate for families with four or more children was 33 per cent.

4. **The ageing of the population, putting increased pressure on the aged pension.** There was no consistent understanding of the respective roles of the aged pension and occupational superannuation in providing adequate retirement incomes, and the two systems conflicted in many ways. The ACTU, through the accord, had promoted the growth of occupational superannuation. Nevertheless, the coverage provided by occupational superannuation was relatively low and inequitable.

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There were at least two other contexts in which the tax-transfer system failed to provide adequate income support. First, a large number of social security recipients had incomes below the poverty line. Second, the assistance provided to households with children was low relative to the assistance provided to households without children. Both the supplementary income-tested payment to pensioners, beneficiaries, and low wage earners with children, and the Family Allowance, which had been paid since 1976 to all families with children, were insufficient to eliminate this relative disadvantage.

The Review presented evidence that in Australia the level of support for families with children was low relative to the level in most other OECD countries, and evidence from other sources indicates that Australia's relative level of income support for low income families with children was especially low. An international comparative study showed that in 1981-82 the proportion of children below the poverty line after the operation of the tax-transfer system was much higher in Australia than in many other countries.

The level of income support payments had increased substantially in real terms in the early 1970s. However, even though the real pension rate rose slightly between 1976 and 1983, there were real declines in payments for the unemployed and in the supplements paid to pensioners and beneficiaries who had dependent children or who rented privately. In addition, family allowance failed to keep up with price increases and declined by almost 30 per cent in real terms between 1976 to 1986.

The Review also brought out concerns about the operation of the income test for pensioners and beneficiaries and the work disincentives created by the income-test arrangements, particularly for unemployed people, the spouses of unemployed people, and sole parents. As the Review progressed, these concerns broadened into a concern about the lack of active measures to assist the entry or re-entry of jobless recipients into the labour market and the lack of integration

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between the social security system and labour market programmes.\textsuperscript{32}

Finally, there were also concerns about the lack of integration between the tax and income security systems. The income unit for social security purposes was the family; the income unit for most tax purposes was the individual. The two systems used different definitions of income—the definition for social security purposes was broader—and different time periods in assessing income. The administrative complexities of the two systems created confusion for people who had to deal with both of them.

Various schemes for integrating the two systems had been put forward. One, arising from the Henderson poverty inquiry,\textsuperscript{33} was a guaranteed minimum income scheme that abolished the separate social security means test and the categorization of payments, and made all transfer payments taxable (at relatively high but constant rates). Another scheme exempted pensioners from taxation and changed the operation of the pension income test.\textsuperscript{34}

2. The Review's recommendations and subsequent policy changes

The Social Security Review initially defined three areas of social security policy to review: (1) income support for families with children; (2) assistance to people of workforce age; and (3) retirement income policy. It later added the area of disability income support policy.

Throughout the period of its operation, from 1986 to 1989, the Review made detailed policy recommendations. The Review's approach was to accept the continuation of a categorical income-tested system but


\textsuperscript{33} Australia, Commission of Inquiry into Poverty, Poverty in Australia, vol. 1 (Canberra: Australian Government Publishing Service, 1975) (Chair: R.F. Henderson). Commonly known as the "Henderson poverty inquiry," this study was commissioned in 1972 and completed in 1975. It assessed the number of people in poverty in Australia by using a measurement now referred to as the "Henderson poverty line." The threshold was based on a poverty line originally developed in 1966 by Henderson. It was set at the level of the basic wage plus child endowment (a non-means-tested family support payment, which in 1986 was incorporated into Family Allowance), for a single-income couple with two children. It was then varied for different family types by using equivalent scales based on 1954 United States family budget data. Initially updated in conjunction with movements in the average wage, in recent years it has been revised in line with changes in per capita household disposable income.

\textsuperscript{34} D. Dixon & C. Foster, An Alternative Path to Integration of Social Security and Personal Income Tax Arrangements (Occasional Paper No. 1) (Sydney: Australian Tax Research Foundation, 1983). See also Saunders, supra note 9.
to make recommendations that aimed broadly at improving adequacy; to assist labour market integration; to reduce some of the overlap between social security and income tax; to improve private provision in some instances; and to reduce some elements of discrimination.

The government subsequently implemented some of the Review's recommendations. First, it substantially increased some types of payments. The most significant change was the introduction in 1987 of the Family Allowance Supplement (FAS), which was to be paid on an income-tested basis to lower wage families at the same rate as the additional pension-benefit payment for pensioners and beneficiaries with children. It replaced the Family Income Supplement for low wage families, which had been subject to stricter income tests and had had a very low take-up rate. The FAS scheme was part of a package intended to redeem the Prime Minister's pledge in 1987 that "by 1990 no Australian child will be living in poverty." The government later restructured and substantially increased the payments and established payments for children over thirteen, which were higher than the payments for younger children.

Table 2 shows the real changes in social security and related payments between 1982-83 (when the current Labor government was first elected) and 1989-90. As the table demonstrates, there were large real increases during the period in child-related payments to low income families; payments for young children increased by about 45 per cent and payments for older children by well over 100 per cent. Rent assistance for low income families in private rental accommodation also increased substantially in real terms, by between 49 and 64 per cent, depending on the number of children in the family.

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35 A substantial increase in take up of FAS between December 1987 and June 1988, was probably attributable to the FAS publicity campaign. See Department of Social Security, The Family Allowance Supplement Evaluation Report (Canberra: Department of Social Security, 1990).

36 R.J. Hawke, Prime Minister, "Opening of Australian Labor Party Election Campaign" (July 1987) 12:24 Commonwealth Record 1021 at 1023.

### TABLE 2

Real Changes (Per Cent) in Social Security and Related Payments, 1982-83 to 1989-90

<table>
<thead>
<tr>
<th>Type of Payment</th>
<th>CPI</th>
<th>CPI(ex.HM) a</th>
</tr>
</thead>
<tbody>
<tr>
<td>Married Rate of Pension and Benefits</td>
<td>+5.8</td>
<td>+3.9</td>
</tr>
<tr>
<td>Standard Rate of Pension</td>
<td>+5.8</td>
<td>+3.9</td>
</tr>
<tr>
<td>Single Unemployment Benefit</td>
<td></td>
<td></td>
</tr>
<tr>
<td>16-17 Years</td>
<td>-11.9</td>
<td>-13.5</td>
</tr>
<tr>
<td>18-10 Years</td>
<td>-1.5</td>
<td>-3.2</td>
</tr>
<tr>
<td>Single Sickness Benefit</td>
<td></td>
<td></td>
</tr>
<tr>
<td>16-17 Years</td>
<td>-12.0</td>
<td>-13.5</td>
</tr>
<tr>
<td>18-22 Years</td>
<td>-19.5</td>
<td>-20.9</td>
</tr>
<tr>
<td>Additional Pension/Benefits for Children</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Less than 13 Years</td>
<td>+47.3</td>
<td>+44.7</td>
</tr>
<tr>
<td>13-15 Years</td>
<td>+112.4</td>
<td>+108.6</td>
</tr>
<tr>
<td>Mothers/Guardians Allowance</td>
<td></td>
<td></td>
</tr>
<tr>
<td>One Child Under Six Years</td>
<td>+6.5</td>
<td>-8.2</td>
</tr>
<tr>
<td>Rent Assistance</td>
<td></td>
<td></td>
</tr>
<tr>
<td>No Children</td>
<td>+18.7</td>
<td>+16.6</td>
</tr>
<tr>
<td>With Children b</td>
<td>+51.5</td>
<td>+48.8</td>
</tr>
<tr>
<td></td>
<td>+66.7</td>
<td>+63.7</td>
</tr>
<tr>
<td>Family Allowances</td>
<td></td>
<td></td>
</tr>
<tr>
<td>One Child</td>
<td>+17.9</td>
<td>+15.8</td>
</tr>
<tr>
<td>Two Children</td>
<td>-1.0</td>
<td>-2.7</td>
</tr>
<tr>
<td>Secondary Assistance Scheme</td>
<td>+81.0</td>
<td>+77.8</td>
</tr>
<tr>
<td>Tertiary Education Assistance</td>
<td>+17.1</td>
<td>+15.1</td>
</tr>
</tbody>
</table>

Notes:  
(a) CPI(ex.HM) is the Consumer Price Index net of health and medical costs. This discounts for the fall in the CPI that was caused by the introduction of Medicare in 1984.  
(b) The range given reflects the further increases in rates or rent assistance for those with three or more children.

The government increased and restructured the family allowance in 1989 in the context of a "living standards package," which included a package of wage increases, tax cuts, and selective increases in transfer payments. However, the increases in family allowance were not sufficient to overcome a real decline over the period 1982-83 to 1989-90 for families with more than one child. In addition, an income test was applied to family allowance in 1986, although at a relatively high income threshold.

Two further changes of long-term significance in income support for families with children deserve mention. The first was the indexation to price movements of a number of supplementary payments, such as rent assistance and the additional child-related payments. The second was the introduction of a more effective system for the calculation of liabilities for maintenance and the collection of maintenance payments from non-custodial parents. This new child support scheme has the potential to improve substantially the financial circumstances of many sole parent families, one of the most financially disadvantaged family types in Australia.

Changes in assistance levels for older people, particularly aged pensioners, have been less marked. The government has increased the basic pension rates somewhat, reduced the lag between price changes and pension increases, and introduced annual indexation of the pension income-test threshold. It has also made a commitment that by 1995 it will not subject aged pensioners to taxation; in the interim, it promised to increase the level of private income at which tax liability commences. More recently, budget deficit pressures have caused the government to withdraw the commitment. The most substantial gains have been made by aged pensioners in private rental accommodation (the group of older people most vulnerable to poverty), who have benefitted from the increase in the rent assistance described above.

Some groups have missed out or have been made relatively worse off. Payments to younger unemployed people and sickness beneficiaries have been reduced in some instances. Payments to certain

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38 Price movements are measured quarterly by the Australian Bureau of Statistics and published as an index, the Consumer Price Index. The Index comprises both national changes in prices and regional variations. For example, changes are estimated for the capital cities in addition to the country as a whole.

39 Saunders, supra note 9. To date, however, the gains to the income levels of sole parents resulting from the operation of the new child-support system have been limited. Even in the longer term, many one-parent households will not benefit. Some households will not qualify for the scheme (owing to its non-retroactive operation); in other cases, the non-custodial parent will not be able to make even modest maintenance payments.
other groups have been reduced or removed by changes that limit eligibility or make it subject to review. The groups in this category include older sole parents whose youngest child is over sixteen (a reduction in eligibility), unemployed and sole parents (who have become subject to special reviews to assess eligibility), and some pensioners with financial assets (owing to changes in the definition of income for the purposes of the income tests). There has also been a selective extension of waiting periods for unemployment benefits.

Finally, the government has introduced a variety of measures designed to assist workforce re-entry by unemployed people, sole parents, and people with disabilities. These measures have included some selective easing of income tests, particularly for unemployed people. In addition, there are provisions that allow the retention of some benefits and assistance over the period of workforce re-entry, and a package of assistance that prioritizes entry into labour-market programmes. For example, a programme called Jobs, Education and Training (JET), introduced in 1989 and aimed at sole-parent pensioners, provides education, training, and child-care assistance to sole parents.

IV. REDISTRIBUTION OBJECTIVES AND THE CURRENT TAX AND SOCIAL SECURITY SYSTEMS

This part evaluates the current performance of Australia’s social security and taxation systems in light of the redistributive objectives outlined earlier: (1) to raise sufficient revenue to fund relevant expenditure programmes, including income support; (2) to provide an adequate level of income support; (3) to enhance incentives and opportunities for employment; and (4) to be equitable in terms of the combined impact of social security and taxation.

The tax and social security systems still fail in many respects to achieve even the minimum goal of redistribution—the provision of adequate support for the maintenance of basic living standards—let alone the broader redistributive goals advocated in Part II.

40 Social Security Act 1991, ss. 1073, 1074, and 1099. Some capital investments were subject to deemed rate of return rules in 1988 and in early 1991 a deemed rate of return was extended to bank deposits containing more than $2,000.
A. Revenue

In the latter half of the 1980s, the Australian government directed its tax and expenditure programmes to the achievement of three macroeconomic objectives. The first objective was to restrain wage demands. To this end, in the context of the accord, the government negotiated a number of "wage-tax" trade offs with the union movement. In each case, organized labour agreed to forgo higher wage claims in return for targeted tax reductions that delivered some after-tax gains. As noted earlier, for the most part, the tax reductions merely offset the effects of bracket creep. The lost revenue could have been used to fund increased transfer payments to recipients whose costs of living had increased in a complementary fashion. The second objective was a reduction in the federal deficit as a way of controlling a spiralling current account deficit and an equally dizzying rise in interest rates. The third objective was to move resources from the public sector to the private sector in what proved to be a terribly misguided and unsuccessful attempt to improve economic efficiency.

Both the wage-tax trade off and the deficit reduction programme were funded by expenditure cuts. In the six years from 1983-84 to 1989-90, the government moved from a budget deficit of almost eight billion dollars and to a surplus of just over eight billion dollars, a shift of 6 per cent of GDP. Although taxes as a percentage of GDP remained relatively stable over the period, federal outlays as a percentage of GDP declined from 29.6 per cent to 23.6 per cent. To the extent that other expenditure cuts resulted in declining investment in the nation's social infrastructure and physical capital, the government's broader wealth generation and redistribution objectives were significantly undermined.

It is highly questionable whether the federal government really had to neglect direct-income support programmes or general public

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41 See above, Table 1 at 76, and see text accompanying note 26.

42 Organized labour did not seek only to maintain after-tax remuneration in the trade-off arrangements. For example, the 1989 negotiations led to the adoption of a "living standards package" that contained some increases in transfer payments, including family allowance and RAS (see text above at 82 following note 37, supra). The wage-tax trade offs also included support for the extension of occupational superannuation through the introduction of a compulsory 3 per cent employer contribution to superannuation.

43 J. Disney, Infrastructure and the Community (Sydney: Australian Council of Social Service, 1990) at 7-11. Disney notes that public sector investment is now at a lower level than it has been for forty years. The decline in public investment has been especially severe at the state and local government level. Over the past five years investment by these governments, which are responsible for over three-quarters of all public infrastructure in Australia declined by 20 per cent.
sector investment in order to fund the wage-tax trade off and the deficit reduction programme. The alternative to expenditure reduction is, of course, increased revenue raising. Given the government's wage-tax trade-off strategy, direct increases by means of rate alterations were not a feasible option. The clear alternative was to maintain, or even increase, revenues in real terms by broadening the tax base. Many countries used the base-broadening approach in the late 1980s to fund tax-rate cuts. In addition to its revenue-raising potential, base-broadening can play a significant role in achieving the horizontal and vertical equity objectives of income taxation. It can also improve the neutrality of the tax system and thereby contribute to economic efficiency.

Base-broadening to increase tax revenues was both feasible and desirable. Australia was a lightly taxed country. In 1983, the nation's tax revenue accounted for 29 per cent of GDP; the average for the OECD countries was 36 per cent. By 1988, the Australian figure had risen slightly, to 30.8 per cent, and the OECD average had risen substantially to 38.4 per cent. Australia, formerly the OECD country with the fourth-lowest level of taxation, now had the third-lowest level.44

One reason for this performance is that the effects of the government's rate-cutting measures overwhelmed the effects of its base-broadening measures. The 1985 base-broadening initiatives, such as the Fringe Benefits Tax (which raised $1.168 billion in 1989-90) and the capital gains tax ($543 million)45 were more than offset by the personal income tax cuts over the period and the 1988 reduction in the company tax rate by ten percentage points (which was expected to cost $1.5 billion annually).46 In addition, the introduction of imputation probably lowered the tax levied on distributed company profits by another $250 million annually.47

The base-broadening measures were, in any case, far from being comprehensive, and, given this lack of comprehensiveness, implied much more than a loss of potential revenue. For the most part, the new measures simply redefined old concessions and omissions. The "reforms" retained and, to some extent, even enhanced costly economic

44 OECD, supra note 18.
distortions and biases toward inefficient investment (in terms of pre-tax returns).

One serious shortcoming of the base-broadening changes was the inadequacy of the capital gains tax adopted in 1985. The features of the tax that have most seriously limited its capacity either to raise revenue or promote efficiency are as follows:

1. The exemption of gains realized on assets acquired before 20 September, 1985. This exclusion eliminated all opportunity to increase tax revenues substantially in the shorter term. It also encouraged investors not to realize their gains from existing investments and thus, has locked in a sizeable portion of the nation’s investment capital.

2. The indexation of realized gains. No other types of income are indexed in Australia, so this preference maintains the bias toward investment in assets that generate capital gains, which the former capital gains exemption established. Potential revenue losses from the preference can only increase over time.

3. The exemption of the family home. This exemption is a source of both short- and long-term revenue losses. Moreover, it compounds the cost of inefficient investment encouraged by the non-taxation of imputed rent.

4. The lack of a deemed-realization-at-death provision. This omission will become particularly significant in the long term.

The base-broadening changes also failed to deal with the absence of matching rules for interest expenses and any resulting investment income. The most serious problem arose in the context of interest expenses incurred on loans used to acquire property primarily for the purpose of generating capital gains. Before 1985, when capital gains went untaxed, taxpayers could deduct interest expenses from other income with no offsetting inclusions. Since 1985, taxpayers have been able to deduct fully the nominal value of interest expenses when payments are made, to defer recognition of the resulting capital gains until realization, and then to include only the after-inflation component in assessable income. The government’s only attempt to address the problem was its introduction in 1985 of a set of quarantining rules that limited deductions for current interest on loans taken out for the purpose of acquiring rental property. These measures were, however, abandoned less than two years later when the government decided they were a political liability in the short term.

Other income-tax leakages arise because of an absence of provisions to control deductions for hobby and recreational properties.
Finally, the government has directed no attention at all to the serious problems associated with income splitting.

B. Income Support

We showed in Part III that since 1983 the government has substantially increased income support payments to certain groups, notably low-income families with children and low-income people in private rental accommodation, and has, through indexation, ensured that the improvement in payments will be maintained over time and will be insulated from the effects of future price increases.

There have been other improvements as well. They include small real increases in the basic pensions and benefits paid to adult recipients and an increase in the adult unemployment benefit (which started from a lower base) of 18 per cent in real terms between 1982-83 and 1989-90 (see Table 2). The increases in assistance to families “has had a significant impact on the living standard of the poor ... excluding farm families, the real income levels of the 10th percentile of two-parent and sole-parent families with children are estimated to have increased by 12 and 15 per cent respectively.”

Despite these increases, the income support paid through the social security system still fell short in most cases of the Henderson poverty lines. Table 3, below, shows the different Henderson poverty lines for different groups and income support payments for these groups in 1989-90. Apart from payments to aged persons, all of the payments were below the poverty line and in some cases substantially below it. The fact that the poverty line had risen much more quickly than the Consumer Price Index (CPI) was partially responsible for this result. Further research on the costs of maintaining children has confirmed that, although the increases in child-related payments were substantial, the payments still fell short in many cases of the levels required by the Henderson poverty line and other equivalent scales.

48 Bradbury, Doyle & Whiteford, supra note 37 at 55.

49 Supra note 33.

50 The equivalent scales are based on research on the costs of maintaining children and are determined by estimating the additional income required for people with children to reach the same standard of living as people without children. See B. Bradbury, The Family Package and the Cost of Children (Sydney: Social Welfare Research Centre, 1989) at 27-31.
TABLE 3

Income Support Levels and Henderson Poverty Lines
1989-1990

<table>
<thead>
<tr>
<th>Income Unit Type</th>
<th>1989-1990</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Income</td>
<td>Poverty</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Support</td>
<td>Line</td>
<td></td>
</tr>
<tr>
<td></td>
<td>$ per week</td>
<td>$ per week</td>
<td></td>
</tr>
<tr>
<td>Single person:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>aged under 25 (^b)</td>
<td>102.20</td>
<td>135.90</td>
<td></td>
</tr>
<tr>
<td>aged 25 to 44</td>
<td>126.30</td>
<td>149.10</td>
<td></td>
</tr>
<tr>
<td>aged 45 to 60/65 (^c)</td>
<td>126.30</td>
<td>148.20</td>
<td></td>
</tr>
<tr>
<td>aged 60/65 and over (^c)</td>
<td>133.40</td>
<td>129.40</td>
<td></td>
</tr>
<tr>
<td>Couple, no children:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>head aged under 65</td>
<td>222.30</td>
<td>246.60</td>
<td></td>
</tr>
<tr>
<td>head aged 65 and over</td>
<td>222.30</td>
<td>195.70</td>
<td></td>
</tr>
<tr>
<td>Couples with:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>one child</td>
<td>255.40</td>
<td>308.60</td>
<td></td>
</tr>
<tr>
<td>two children</td>
<td>288.50</td>
<td>362.20</td>
<td></td>
</tr>
<tr>
<td>three children</td>
<td>321.60</td>
<td>411.20</td>
<td></td>
</tr>
<tr>
<td>four children</td>
<td>354.70</td>
<td>459.60</td>
<td></td>
</tr>
<tr>
<td>five children or more (^d)</td>
<td>390.80</td>
<td>514.60</td>
<td></td>
</tr>
<tr>
<td>Sole parent with:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>one child</td>
<td>179.00</td>
<td>205.50</td>
<td></td>
</tr>
<tr>
<td>two children</td>
<td>212.00</td>
<td>264.00</td>
<td></td>
</tr>
<tr>
<td>three children</td>
<td>245.20</td>
<td>307.10</td>
<td></td>
</tr>
<tr>
<td>four children or more (^e)</td>
<td>278.30</td>
<td>381.00</td>
<td></td>
</tr>
</tbody>
</table>

Notes: (a) The poverty lines shown are the sample mean for each income unit type. All figures have been rounded to the nearest 10 cents. Children are assumed to be aged under 13 years in calculating income support levels, which include family allowances.
(b) Unemployment benefit payable to an adult aged 19.
(c) Aged 65 for males; aged 60 for females.
(d) Assumes five children.
(e) Assumes four children.

Source: Saunders, supra note 13 at 31.
In some areas of social security assistance, including payments to young people, there were no increases at all, despite evidence that the existing payments fell short of the poverty line.

After 1984, severe cuts in government expenditure constrained the ability of the social security system to increase income support payments further. Between 1985 and 1989, government expenditure as a proportion of GDP declined from 38.8 per cent to 33 per cent.\textsuperscript{51} Outlays on social security and welfare declined as a proportion of GDP from 8.4 per cent in 1985 to 7.1 per cent in 1990.\textsuperscript{52} Spending cuts were the key element in a policy of fiscal restraint invoked by the balance of payments crisis in Australia. Other countries too were restraining their spending. Among the OECD countries, average government expenditure as a proportion of GDP also declined from 47.4 per cent in 1985 to 45.5 per cent in 1989. In Australia, however, government spending relative to GDP was already well below the OECD average, and during the late 1980s it fell even further below that average. The decline was especially marked in the case of expenditure on social security transfers. In Australia, such expenditure declined as a proportion of GDP from 9.6 per cent to 8.8 per cent between 1985 and 1988, whereas the average for the OECD countries remained stable at 15.9 per cent of GDP.\textsuperscript{53}

What made it possible to increase the level of some transfer payments, in spite of a decline in the proportion of national income allocated to transfer payments generally, was a drop in the number of transfer recipients. Between 1985 and 1990, the number of pensioners and beneficiaries declined from 204 to 186.9 per thousand.\textsuperscript{54} This decline was the result of four factors:

1. A decline in unemployment, and therefore, in the number of people reliant on unemployment benefits;
2. Special reviews of the eligibility and entitlement of social security recipients, particularly unemployment beneficiaries and sole-parent pensioners;
3. An increased reliance on means tests, including those applicable to age pensioners, to family assistance, and to young unemployed people; and

\textsuperscript{51} Saunders, supra note 9 at 4.

\textsuperscript{52} Department of Social Security, \textit{Ten Year Statistical Summary 1980-1990} (Canberra: Department of Social Security, Statistical Analysis Section, 1990) [hereinafter \textit{Ten Year Statistical Summary}]. As noted, see text below at 95, following note 61, \textit{infra}, the reduction in social security outlays was partly the result of a reduction in unemployment.

\textsuperscript{53} Saunders, supra note 9 at 7.

\textsuperscript{54} \textit{Ten Year Statistical Summary}, supra note 52 at 38-39.
4. A denial of any entitlement to support to people in certain categories and a reduction in eligibility and entitlement for some other social security recipients, including young people and sole parents with older children. A related development was a decline in payments for members of some significantly disadvantaged groups, notably people aged twenty years or less who have been unemployed, or sick, or who are disabled. This development, together with the reductions in eligibility for certain groups, has very serious implications for the adequacy of income support in general.

C. Employment Opportunities and Incentives

Between 1983 and 1989, Australia experienced a remarkable growth in employment. This growth was reflected, in part, in a reduction of unemployment levels from over 10 per cent in 1983 to 5.8 per cent in 1989.

Employment growth has declined dramatically since 1989, when Australia entered a recession largely brought on by a federal government that hoped to curb its continuing large current-accounts deficits by cooling off the economy. Since 1989, unemployment has increased to over 10 per cent, and it continues to climb.

For our purposes, the remarkable growth and scarcely less remarkable decline in employment opportunities over the past decade raises two questions. First, what was the redistributive impact of the employment growth that occurred between 1982-83 and 1988-89, particularly on families in poverty? Or, to put the matter in a somewhat different way, to what extent did employment growth further the redistributive aims of government? The second question, closely related to the first, is to what extent did deficiencies in the tax system contribute to the economic difficulties—and the consequent decline in employment growth—that Australia experienced after 1985-86? In particular, to what extent were such deficiencies responsible for Australia's inability to generate sufficient investment and structural change to improve its international trading performance and balance of payments position?

Saunders\(^5\) demonstrates that the growth in employment between 1983 and 1989 did not reduce poverty levels by as much as might have been expected. He cites three reasons for this outcome:

1. Employment growth did not lead to a corresponding reduction in

\(^{55}\text{Supra} \text{ note 13.}\)
the rate of unemployment, since the labour force participation rate also increased over the period.\textsuperscript{56}

2. Between 1983 and 1989, there was only a slight reduction in the proportion of families without an employed member and almost no decline in the proportion of married-couple households without an employed member. Given how low pension and benefit payments were in relation to the poverty line, the main route out of poverty was to have at least one family member who was employed. The main change during this period was a substantial increase in the proportion of families in which two or more members were employed. More than one-third of the 1.45 million extra jobs went to people in families in which another member was already employed.

3. There was substantial growth in part-time employment—an increase from 16 per cent of all employment in 1980 to 21 per cent in 1989.\textsuperscript{57} Part-time employment, particularly in the context of Australia's income-tested social security system, is not likely to raise family incomes above the poverty line.

Thus, although the number of people employed grew by over 1.4 million between 1983 and 1989, the number of people on unemployment benefits declined by only 245,000.\textsuperscript{58}

Why did families that depended on social security benefits fail to gain proportionately from the employment growth of the 1980s? Two possible explanations suggest themselves.

First, the operation of the income tests may have discouraged people from taking up employment opportunities. There is no evidence on the actual disincentive effects of income tests on pensioners and beneficiaries. However, because the amount of private income that a recipient could earn before payment was withdrawn—the so-called income-test-free area—was relatively low, it is likely that the income tests did discourage participation in the workforce, especially part-time participation and especially part-time participation by sole parents and the unemployed spouses of unemployed beneficiaries.\textsuperscript{59} Although the government liberalized the income test for beneficiaries over the period,

\textsuperscript{56} Growth in the participation rate for married women was especially strong; the rate rose from 42 per cent in August 1983 to 51 per cent in 1989. See Bradbury, Doyle & Whiteford, supra note 37 at 13.

\textsuperscript{57} \textit{Ibid.} at 12.

\textsuperscript{58} Ten Year Statistical Summary, supra note 52 at 23.

\textsuperscript{59} Bradbury, Doyle & Whiteford, supra note 37.
it effectively tightened the test for pensioners, including sole-parent pensioners, in real terms. In addition, the income test for beneficiary couples with children was more stringent than the test for couples without children. Nor did the amount of private income not subject to income-testing increase with the number of children in the family. The spouses of unemployment beneficiaries, particularly if they had children, faced substantial barriers to workforce participation.

Second, the degree of labour market disadvantage experienced by many pensioners and beneficiaries would have prohibited them from competing successfully for new employment opportunities with new workforce entrants. To overcome this disadvantage, labour market programmes were required. However, federal government expenditure on labour market programmes declined over the period, from just under $1,200 per unemployed person in 1983-84 to well under $900 per person in 1989-90. In addition, the nature of the programmes changed: the government reduced expenditure on employment-experience programmes by 90 per cent and increased expenditure on training programmes, particularly short-term training programmes that may well have been less relevant to the needs of many disadvantaged long-term unemployed people. The government did introduce a special package of measures, collectively called "Newstart," with the object of helping long-term unemployed people obtain jobs or access to appropriate labour market programmes. JET, a similar programme, was offered on a voluntary basis to sole parents. These programmes were introduced relatively late in the period, and it is still too soon to judge their success.

The tax system bears a heavy responsibility for the increase in unemployment since 1989. As we mentioned in Part IV (B. Income Support), the system makes no attempt to match the deduction for interest with the assessment of capital gains. The arbitrage possibilities presented by the interest deduction and capital gains assessment rules bias investment away from the production goods necessary for the development of a sustainable and competitive manufacturing and industrial sector and toward speculative investment in property and shares. The principal-residence exemption encourages consumptive over-investment in owner-occupied housing, particularly at the expensive end of the market. During the late 1980s, therefore, inefficient investment encouraged by illogical tax rules reduced Australia's capacity to generate activity in the traded goods sector of the economy or to generate employment.

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The tax distortions also played an important role in exacerbating Australia's current-account deficit, the government's response to which eventually wiped out all employment gains of the previous seven years. Each of the factors that led to the deficit—financial deregulation, the dismantling of barriers to the transfer of funds into and out of Australia, high rates of interest, and high levels of inflation—combined with the tax bias to encourage excessive reliance on debt, including overseas debt, to fund unproductive investment. At the same time, the nation's capacity to finance its growing foreign debt charges diminished as both the export and import-substitution manufacturing industries fell victim to declining investment in private sector and public infrastructure.

Faced with an unsustainably high current-account deficit by the end of the 1980s and unwilling to inhibit excessive consumption of imported goods by raising tax or tariff rates, the government deliberately induced an economic downturn, which by 1991 had developed into a serious recession that threatened to produce record unemployment.

D. Equity and the Combined Impact of Social Security and Taxation

The Australian social security system has a redistributive impact\(^6^1\) that is not sufficiently reinforced by the operation of the tax system. Whereas the social security system distributes income to those most in need, the tax system does not always levy taxes on the basis of ability to pay. Moreover, the assistance provided to specific groups through the tax system does not reinforce the targeted approach to assistance taken by the social security system.

On the face of it, the tax changes since 1983, by increasing income tax revenue as a share of total federal tax revenue, should have increased the progressivity of the federal tax system: income taxes (personal and company) accounted for 60 per cent of federal tax revenues in 1983-84; in 1989-90, they accounted for 68 per cent.\(^6^2\)

But is the income tax, in fact, markedly progressive? In an analysis of the changes in tax incidence in Australia between 1975-76 and 1984-85, Warren found that, at the beginning of the period, average income tax rates rose consistently with income. Toward the end of the period, however, middle-income groups increasingly bore the burden of

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Warren conceded that the actual incidence of the tax would probably be even less progressive than the study showed because the impact of tax avoidance and the receipt of non-taxable income such as capital gains tend to increase with income. Both overseas and local data support Warren's suggestion that the proportion of income derived as capital gains increases with overall income, which means that, before the introduction of the capital gains tax in 1985, the income tax system ignored increasingly greater portions of income as a taxpayer's ability to pay rose.

Table 4 shows that the income tax rate changes introduced since 1983-84 have, on the whole, reduced nominal average tax rates for low- and high-income tax groups. The reductions have been substantial for very high, single-income earners and for low-income taxpayers with children (owing to the substantial increase in income-tested family payments). Middle-income taxpayers have either had no reductions or experienced slight increases. Thus, nominal rate changes have continued the trend toward increasing the share of the total tax burden borne by the middle-income groups.

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65 Average weekly earnings [hereinafter AWE] is the term used to refer to the mean earnings of Australian wage and salary earners. There are actually a number of different measurements of AWE. The version frequently used as a benchmark for social security payments is average weekly ordinary time earnings of adults in full-time employment.

66 The Australian Institute of Family Studies estimates that between 1983-84 and June 1991 the average tax rate for a person with one-half AWE will drop from 15.5 per cent to 13.5 per cent, the rate for a person with average AWE will drop from 22.8 per cent to 22.7 per cent, and the rate for a person with four times AWE will drop from 47.5 per cent to 40.84 per cent. The various AWE measurements are determined by the Australian Bureau of Statistics on the basis of quarterly surveys. See Australian Institute of Family Studies, Taxes, Families and the Labor Party 1990 (Melbourne: Australian Institute of Family Studies, 1990) at 26. The figures were based on a lowest marginal rate of 21 per cent. Accordingly, they do not reflect the drop in the lowest marginal rate to 20 per cent, which took place in January 1991.
TABLE 4

Average Tax Rates for Individuals and Families

<table>
<thead>
<tr>
<th>Level of family income</th>
<th>1983-84 %</th>
<th>1989-90 %</th>
<th>June 1991 %</th>
<th>1983-84 %</th>
<th>1989-90 %</th>
<th>June 1991 %</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Single persons</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>0.5 AWE (^a)</td>
<td>15.5</td>
<td>13.3</td>
<td>13.5</td>
<td>6.8</td>
<td>6.1</td>
<td>6.4</td>
</tr>
<tr>
<td>AWE</td>
<td>22.8</td>
<td>22.6</td>
<td>22.7</td>
<td>18.4</td>
<td>19.0</td>
<td>19.1</td>
</tr>
<tr>
<td>1.5 AWE</td>
<td>30.3</td>
<td>29.4</td>
<td>29.5</td>
<td>27.4</td>
<td>27.0</td>
<td>27.1</td>
</tr>
<tr>
<td>2 AWE</td>
<td>35.1</td>
<td>33.9</td>
<td>33.8</td>
<td>32.9</td>
<td>32.1</td>
<td>32.0</td>
</tr>
<tr>
<td>4 AWE</td>
<td>47.5</td>
<td>50.9</td>
<td>40.4</td>
<td>46.4</td>
<td>40.0</td>
<td>39.5</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>One-income couples without children</strong></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>0.5 AWE (^a)</td>
<td>-14.7</td>
<td>-24.3</td>
<td>-24.2</td>
<td>-16.4</td>
<td>-29.3</td>
<td>-30.4</td>
</tr>
<tr>
<td>AWE</td>
<td>13.9</td>
<td>14.9</td>
<td>15.0</td>
<td>18.2</td>
<td>15.8</td>
<td>15.9</td>
</tr>
<tr>
<td>1.5 AWE</td>
<td>24.3</td>
<td>24.2</td>
<td>24.3</td>
<td>27.9</td>
<td>24.8</td>
<td>25.0</td>
</tr>
<tr>
<td>2 AWE</td>
<td>30.6</td>
<td>30.0</td>
<td>29.9</td>
<td>33.3</td>
<td>30.5</td>
<td>30.5</td>
</tr>
<tr>
<td>4 AWE</td>
<td>45.3</td>
<td>39.9</td>
<td>30.3</td>
<td>46.7</td>
<td>39.2</td>
<td>39.6</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>One-income couples with two children (^b)</strong></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>AWE</td>
<td>15.5</td>
<td>13.3</td>
<td>13.5</td>
<td>12.1</td>
<td>9.8</td>
<td>10.1</td>
</tr>
<tr>
<td>1.5 AWE</td>
<td>20.4</td>
<td>18.3</td>
<td>18.5</td>
<td>18.0</td>
<td>16.0</td>
<td>16.2</td>
</tr>
<tr>
<td>2 AWE</td>
<td>24.2</td>
<td>22.6</td>
<td>22.8</td>
<td>22.4</td>
<td>20.9</td>
<td>21.0</td>
</tr>
<tr>
<td>4 AWE</td>
<td>36.0</td>
<td>33.9</td>
<td>33.8</td>
<td>35.2</td>
<td>33.9</td>
<td>33.8</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Two-income couples (^c) without children</strong></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>AWE</td>
<td>15.5</td>
<td>13.3</td>
<td>13.5</td>
<td>12.1</td>
<td>9.8</td>
<td>10.1</td>
</tr>
<tr>
<td>1.5 AWE</td>
<td>20.4</td>
<td>18.3</td>
<td>18.5</td>
<td>18.0</td>
<td>16.0</td>
<td>16.2</td>
</tr>
<tr>
<td>2 AWE</td>
<td>24.2</td>
<td>22.6</td>
<td>22.8</td>
<td>22.4</td>
<td>20.9</td>
<td>21.0</td>
</tr>
<tr>
<td>4 AWE</td>
<td>36.0</td>
<td>33.9</td>
<td>33.8</td>
<td>35.2</td>
<td>33.9</td>
<td>33.8</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Two-income couples (^c) with two children (^b)</strong></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
</table>

Notes:  
(a) Average Weekly Earnings  
(b) One child aged less than 13, one aged 13 to 15 years.  
(c) Income divided between spouses in the ratio 60:40.  

Although changes in marginal and average tax rates would seem to imply a lessening of progressivity over the decade, these changes have been offset in part by the base-broadening measures introduced since 1985. For example, of the $306 million in taxes levied on taxable capital gains derived by individuals in 1989-90, 60 per cent was collected from individuals with incomes over $50,000. Before 1985, most of these gains would have been untaxed. At the same time, however, deficiencies in the base-broadening measures have ensured that most of the tax minimization strategies pursued by high-income taxpayers, including negative gearing, the conversion of income to capital gains, and income splitting, remain fully viable. Moreover, other “reforms,” such as the introduction of imputation credits for dividend income, have directly lowered the tax levied on some types of investment income. It is high-income taxpayers, of course, who are most likely to own shares.

The case study on retirement income in the following section describes the changes in superannuation tax concessions since the early 1980s and compares the distributional impact of providing assistance for retirement incomes through tax concessions for superannuation with the distributional impact of providing assistance through the social security system, via the aged pension. The salient point is that although tax concessions available for superannuation have been reduced somewhat since 1983, these reductions have had a more severe impact on low- to middle-income earners than on high-income earners. Meanwhile, substantial tax concessions for superannuation continue to be available to high-income groups. Furthermore, assistance to aged pensioners through the social security system has became more closely targeted as a result of the introduction of the assets test, the income test for people over seventy, the effective reduction in the real value of the income-test-free area, and changes to the definition of income for income-test purposes.

Thus, there continue to be considerable inequities and inconsistencies in the treatment of retirement incomes. Moreover, although the government has introduced an assets test for social security recipients, it has failed to introduce any form of wealth taxation or death duties. This inconsistency between the social security system’s treatment of assets and the tax system’s treatment of assets is reinforced by a similar inconsistency in the two systems’ treatment of income from

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assets. The social security system has introduced definitions of income from investments that are substantially more stringent than the definitions for income tax purposes. For example, as we mentioned earlier, the social security income-test rules now prescribe a deemed minimum return on many investments. No similar provisions apply in the income tax system.

Family assistance is provided mainly through the social security system and, to a much lesser extent, through the income tax system. This provision has been targeted in a reasonably consistent way. However, this assertion is also subject to two caveats.

First, the income test for family allowance payments was introduced in 1986, not long after the top marginal tax rate for income earners had been significantly reduced. The test was first applied on a tapered withdrawal basis: the payments diminished as total parental income rose above $50,000. (The threshold was later indexed, and in 1990 the tapered test was replaced with a sudden-death test—100 percent withdrawal above the threshold.) Thus, high-income single taxpayers without children benefitted from a tax cut at about the same time as high-income taxpayers with children had their family allowance payments reduced.

The second source of inconsistency is the dependent spouse (income tax) rebate. The rebate has a two-tiered structure. One rebate is available for taxpayers who support a spouse alone; it is withdrawn at the rate of one dollar for every four dollars earned by the spouse over $282. A second, higher rebate is available for taxpayers who support a spouse and one or more children. The rebate does not increase with the number of children. The rebate was indexed in 1988 but the $282 threshold was not.

The equity assumptions that underlie the dependent spouse rebate have been questioned on many occasions. The principal argument against its retention is that the presence of a dependent spouse does not reduce economic well-being and capacity to pay tax. The rebate has nevertheless been retained, and its supporters defend it as an additional support mechanism for families. Unlike the family allowance, however, it has not been income tested. During the 1993 election campaign the Government announced plans to replace the dependent spouse rebate for parents at home caring for children with a Home Care Child Allowance of $60 per fortnight, paid directly to the primary caregiver.

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V. SOCIAL SECURITY AND TAXATION LAW REFORM: AN AGENDA FOR REFORM

The years since the mid-1980s have seen some commendable changes in Australia's social security and taxation systems, changes that have improved the systems' redistributive capacity and potential. The changes in social security have included improvements in income support for many of the most disadvantaged; an increase in efforts to assist workforce re-entry by long-term unemployed, including sole parents and disabled people; and the introduction of the Child Support Scheme. Tax reform, through the personal and company income tax base-broadening changes, has increased the tax system's ability to provide additional revenue on a more equitable and economically responsible basis in the longer term.

Yet significant problems remain. Many social security payments, especially those for sole parents and young people, are still inadequate. Given that unemployment is now over 10 per cent, the social security system faces the challenge of ensuring that there will not be, as there was in the period from the mid-1970s to the early 1980s, a substantial growth in the cohort of long-term unemployed. Yet prospects for avoiding this outcome are very bleak.

The tax system still embodies deficiencies that both undermine its capacity to raise revenue equitably and severely reduce economic efficiency. Many of these deficiencies also undermine the targeted approach taken by the social security system. For example, the lack of a tax on imputed rent and the exemption of the family home from the capital gains tax are tax concessions that largely benefit wealthy homeowners and that drive up the price of housing. Meanwhile, low-income private renters continue to receive a relatively low level of rent assistance, and this assistance is strictly targeted. Similarly, higher-income earners continue to receive substantial tax concessions for their retirement whereas the aged pension is subject to a tight income test whose impact falls mostly on retired people with relatively modest levels of private income.

In brief, the gamut of redistribution is still far too narrow. Proposals for broadening that gamut must, however, take into account the significant economic and social changes that have occurred in recent years or are still occurring: changes in workforce participation patterns, changes in family formation, changes in the structure of the labour market, and the onset in Australia of a long period of serious economic difficulties and restraints. Many of the reforms of the past nine years
have been attempts to promote broader redistributive goals while recognizing the claims of this new set of social and economic realities. If not all of the reforms have been successful, at least the essential strategy of reform has been correct. Therefore, the aim of further reform should be to build upon the positive features of the changes achieved during the 1980s.\(^7\)

We should retain the broad features of Australia's present social security system, and further social security reforms should be consistent with those features. The proposal that we retain the broad features of Australia's income-tested categorical system of income support implies a judgment that the alternatives of a guaranteed minimum income system or a universal social insurance system would not be appropriate. The advocates of the guaranteed minimum income or basic incomes approach point to its perceived advantages of simplicity, uniformity, and the promotion of an adequate income as a right inherent in citizenship. These are major strengths, but another feature of the basic incomes approach is a lack of attention to the need to link income-support arrangements with the labour market, particularly for people of workforce age. If workforce re-entry and mainstream participation is to be a significant objective of social security reform, the basic incomes approach has significant disadvantages. Furthermore, the community is not likely to accept the cost of an individually based guaranteed-minimum-income proposal.

Supporters of social insurance and/or non-income-tested schemes point to the weakness inherent in income-tested schemes, namely, that although they may be efficient in targeting assistance to those in need, they may fail to obtain sufficient community support and thus, attract insufficient resources to accomplish their aims. In addition, universal systems reduce the danger of marginalization that can occur under an income-tested system. However, following a period characterized by increased unemployment, population ageing, and the formation of one-parent families, the trend in those countries that have universal social-insurance-based systems has been toward systems that rely upon means-tested social assistance payments as well as social insurance arrangements. As Cass and McClelland have noted:

> In the period of fiscal restraint from 1980 to 1988 a number of OECD countries exercised severe restraint in their insurance-based employment benefit schemes, holding down or reducing real benefit levels and in some countries demanding a longer minimum employment record. Fiscal restraint has also affected the real levels of payment under

\(^7\) See Cass & McClelland, supra note 11.
The strengths of Australia’s social security system include a strong focus on poverty alleviation and a high degree of target efficiency. The challenge, therefore, is to build on these strengths while seeking to achieve the alleged advantages of the basic incomes model—adequacy, uniformity, and simplicity—and attract sufficient community support to generate the needed resources. It is also imperative that changes in the social security system are complemented by tax reform and an agenda to reduce labour-market inequalities.

Two things must be done to avoid the danger of marginalizing social security recipients. First, it must be ensured that the recipients’ labour-market links are retained and strengthened. Second, it must be ensured that additional assistance, whether it is provided through the tax system or whether it is employment-based, has broad coverage and is not inequitable. It is critical that attention be given to the level of assistance provided by the tax system or through workforce participation. The solution to the danger of marginalization must be:

[To] link the interests of people outside the work force to those of low income working people ... [W]hat is required is an integrated combination of policies which break down the rigid dichotomies between work force participation and receipt of welfare and a much firmer commitment that combinations of market incomes and social wage transfers will become increasingly prevalent and accepted.  

It is especially important that these policies deal with the labour force circumstances and earning capacities of women, since a large proportion of poor families are headed by women.

Further social security reform should proceed as follows. First, the social security system should extend income support, where it is needed, to people within the workforce. The Family Allowance Supplement is an example of such support. Opportunities for part-work, part-welfare combinations should be enhanced, particularly for people for whom full-time work is unlikely to be a viable option (at least for a time) including sole parents, long-term unemployed people, the wives of unemployed men, older people, and people with disabilities. This goal implies the need for a selective liberalization of social security income-testing in order to enable members of these groups to retain or improve their labour-market attachment and supplement their social security income.
Second, the social security system should increase its base-level income-support payments and make them more equitable. To be specific, it should introduce further targeted increases (particularly for younger recipients and sole parents), establish a long-term benchmark for adequacy (from 25 per cent to 30 per cent of average weekly earnings), and ensure that all categories of recipients receive similar levels of payment. In particular, it should eliminate the differentials between the payments for pension recipients and beneficiary recipients.

Third, social security programmes such as JET and Newstart should be retained and strengthened. These programmes seek to link people on pensions and benefits to opportunities for labour-market participation. By supporting and improving beneficiaries' capability to compete for good jobs, the programmes reduce long-term vulnerability. Programmes of this kind are most effective when participation is voluntary.

The significance of labour-market programmes such as work experience and training cannot be overstated in the context of a social security strategy that is based on integration with the labour market. The social security initiatives must be backed by programmes that help people to find jobs and improve their workforce skills and by policies that protect the position of disadvantaged people in the workforce. Thus, it is essential that social security reform be accompanied by:

1. Further labour-market reforms to reduce unemployment and improve the position of low wage workers;

2. The provision of adequate labour-market and education programmes; and

3. The provision of community services, including child care, transport, and housing, particularly in low-income areas.

The income tax system too requires reform. The goals of a reformed income tax should be: (1) to provide sufficient revenue on a continuing basis; (2) to complement the redistributive effects of social security; and (3) to promote and enhance economic growth, particularly employment-producing growth. The priorities for reform should be to strengthen the income tax base-broadening changes introduced in 1985, and especially, to reduce intertemporal distortions that promote economic inefficiencies.

Many reforms are needed. To begin with, we recommend the following changes in the capital gains tax:


2. Removal of the exemption for gains realized on the disposal of a principal residence. If this step proved to be politically
impossible, the second-best remedy would be to replace the present exemption with a universal, limited lifetime exemption for a designated amount of capital gains derived from any assets. Such an exemption would not reduce inequities between those most likely to realize capital gains and those unlikely to do so. It would, however, address the inequities that the present exemption causes between urban and rural owners, inner-city dwellers and suburban owners, and residents of different states. It would also reduce the present bias toward investment in principal residences rather than in capital-gains-generating assets generally.

3. The treatment of testamentary transfers in the same manner as other gratuitous transfers or transfers for value. That is, death should be treated as a period of time when a taxpayer realizes the value of accrued gains.

4. Steps to close some of the loopholes in the legislation. The loopholes include the failure of the capital gains tax to catch gains realized by debtors when debts are forgiven, gains realized on the disposal of motor vehicles, and gains realized when taxpayers are reimbursed for previously deducted expenses.

A second goal of reform should be to eliminate opportunities for mismatching income and outgoings. The existence of these opportunities has contributed to intertemporal inefficiencies and encouraged reliance on debt funding. There are two separate elements to the problem: (1) a lack of inflation adjustment for outgoings that is complemented by full inflation adjustment for gains; and (2) a timing difference between recognition of outgoings and resulting income.

The preferable solution to the first problem is, of course, the elimination of inflation. So long as that goal remains unattainable, the second-best solution is consistent treatment of inflation throughout the income tax system. Unfortunately, a number of technical and international constraints appear to preclude the adoption of a fully inflation-adjusted income tax base.\textsuperscript{73} And, a partially indexed system, as Vann and Dixon note, is worse than no indexation at all.\textsuperscript{74}

Thus, inflation adjustment of capital gains alone is undeniably


\textsuperscript{74} Vann & Dixon, \textit{ibid.} at 5.
the best approach in the best income tax system. But in an income tax system that uses nominal dollars for all other measurement purposes, an inflation-adjusted capital gains tax would amount to a distorting preference. The answer is to eliminate the preference by measuring all income and outgoings in nominal dollars.

The timing problem too will require a second-best approach. The best solution would be to measure both interest expenses and accrued capital gains on an annual basis. This is not possible so long as capital gains are assessed on a realization basis. An approximation of the annual assessment system can be accomplished by treating gains and outgoings consistently and requiring taxpayers to defer recognition of outgoings when they defer recognition of the resulting gain. Quarantining systems that limit current interest deductions to the amount of realized investment income and capital gains are common in other jurisdictions and, as experience in Australia has shown, pose few technical problems. They do involve some political risk, but appropriate trade offs and public education programmes would smooth their implementation.

Our third proposal is that consideration be given to the introduction of an alternative minimum tax. Reform of the income tax base has narrowed the gap between the measurement of taxable income and that of real world profits. Many preferences remain, however, along with many opportunities for "legitimate" minimization of tax. There has been much criticism of the use of tax expenditures to encourage specific economic activities, from film making to resource exploitation to research and development. The critics argue that direct expenditures can achieve the objectives of tax expenditures in a far more efficient and equitable manner, a conclusion with which we agree. Ideally, the tax expenditures would be eliminated; so long as they remain, however, there is a strong case for limiting the extent to which they can be exploited to reduce taxable income. The introduction of an alternative minimum tax whose rates were set as percentages of the ordinary rates would be the easiest way to accomplish this end.

A fourth goal of reform should be the adoption of a new basis for changes in income tax rates. Overall, the income tax rate cuts introduced since 1985 have heavily favoured the highest brackets. The increasing income tax liability of middle-income earners cannot be sustained, especially since inflation has in recent years substantially eroded the real values of income thresholds. Rate reductions of the sort employed in Australia are, in fact, leading to a de facto flat-rate income tax.

Attacks on progressivity have two serious consequences. First,
they make the tax itself potentially less effective as a redistributive tool; obviously a tax that extracts more from high-income taxpayers than from low-income taxpayers is more redistributive than one that does not. Second, the progressivity of the income-tax rate scale reinforces popular perception of the tax's redistributive role and the legitimacy of redistribution itself. This perception of legitimacy in turn supports compliance objectives and reinforces support for redistributive expenditure programmes funded from income tax revenues.

An obvious alternative to the use of rate reductions to accomplish income-tax cuts is the upward adjustment of rate thresholds. A preferable way of carrying out rate-band adjustment is indexation of the thresholds. At present, neither major political party displays any interest in personal tax indexation. It must be conceded, therefore, that the supporters of rate indexation face major hurdles. The drawback of threshold indexation is that it increases the gains from income splitting. Threshold indexation should be considered, accordingly, in the context of a reform programme that includes anti-splitting measures.

And hence our fifth proposal for reform, the adoption of comprehensive anti-income-splitting measures. Judicial and legislative endorsement of income-splitting arrangements has led to widespread tax minimization by higher-bracket taxpayers who derive property income or professional or business income. Judicial and legislative irresponsibility has been matched by administrative complacency. The Tax Office has failed to use effectively the few tools available to combat splitting, such as the capital gains provisions. This broad official endorsement of income splitting by higher-bracket taxpayers has seriously eroded the progressivity of the income tax, disabling its equity and redistributive objectives, and undermining support for the tax by those who are unable to engage in similar avoidance schemes.

Our last proposal for income tax reform is that the existing regime of superannuation tax concessions be replaced by a credit-based system. We describe this proposal in detail in Part VI.

Next in importance to the income tax system is the indirect tax system. The replacement of the wholesale sales tax with a broad-based consumption tax (BBCT) was a central element of the opposition Liberal/National coalition's platform in the 1993 election, a platform solidly rejected by the electorate. Although many of the presumed benefits of a BBCT, such as an increased incentive to save, have been exaggerated, the introduction of a BBCT in Australia is probably inevitable in the longer term as Australia's rejection of the tax becomes increasingly anomalous in an international context.

A BBCT would be more regressive than the income tax, and
depending on its design features, might be more regressive than the existing indirect and excise tax regimes. The distributional consequences of a BBCT would depend, therefore, on whether it simply replaced the existing federal wholesale sales tax and the excise taxes, or replaced both these taxes and reduced the income tax burden somewhat. Either outcome would require the introduction of a compensation package appropriate to the resulting regressivity problem.

Another possibility in the context of possible changes in the federal-state financial relationship is the use of a BBCT to replace some of the more narrowly based state taxes and charges. Once again, various compensation questions arise.

Finally, it is important to maintain support for the reintroduction of death and gift duties or the introduction of a wealth tax, or both. Unfortunately, neither of the major political parties appears to be interested in tackling the political difficulties associated with these taxes, despite the taxes' obvious redistributive strengths and the less obvious efficiency reasons for their inclusion. However, the time is ripe for a debate. The conspicuous squandering of assets by many prominent wealthy business people in the late 1980s has provoked public concern, and institutional support for wealth taxation has been expressed.75

VI. A CASE STUDY: INCOME SECURITY FOR THE AGED

A. Retirement Income Security

The federal government uses both the social security system and the tax system to provide income security assistance to the aged. The social security system provides a means-tested aged pension to older persons. The tax system provides subsidies in the form of low tax rates for employment income invested in special retirement savings funds (superannuation funds) and for investment income generated by those savings. Further subsidies are available for benefits withdrawn from superannuation funds, provided they are received as lump sum payments. Do these measures satisfy any of the definitions of redistribution that we postulated earlier? The answer seems to be that they do not satisfy even the most basic definition: the maintenance of a minimum adequate income standard for all.

75 See, for example, Catholic Bishops of Australia, Commonwealth and Common Good: A Statement on Wealth Distribution from the Catholic Bishops of Australia (Melbourne: Collins Dove, 1991).
The provision of income security for the aged is one area in which the social security and tax systems could complement each other well. Together they could supplement current resources to ensure that people are able to set aside sufficient savings to generate an adequate retirement income. This is not the way in which the current tax and social security systems work. Rather than encourage savings for retirement, the means-tested aged pension encourages people to consume currently most of the income they receive during their working lives in order not to disqualify themselves from a pension entitlement. Meanwhile, the tax subsidies for retirement savings provide assistance inversely to a taxpayer's needs; subsidies are skewed to those with the highest incomes and fade out as a taxpayer's ability to save decreases. And, to the extent that a person has managed to save for retirement, the tax system subsidizes immediate consumption following retirement by setting low rates on lump-sum retirement benefits. Immediate consumption ensures inadequate resources for the remaining retirement years and immediate eligibility for the means-tested pension.

The phenomenon that arises from the perverse harmonization of the tax and aged pension systems is colloquially known as double dipping, though it would be more accurate to call it triple dipping. First, taxpayers exploit the tax subsidies for retirement savings. Second, they exploit the preferential rates for lump-sum benefits and consume those benefits as quickly as possible. Finally, they exploit the availability of the aged pension for persons who have consumed their retirement savings.

The costs of these inefficient programmes increase steadily as Australia marches toward the twenty-first century as an ageing society. Cognizant of the inevitable long-term costs, the government has moved to reform both the pension and tax subsidy systems. The reforms have not been harmonized, however. As the next section explains, the trend in the aged pension area has been to target benefits by reliance on means testing. This approach has the effect of further encouraging retired persons to dissipate their assets in order to retain eligibility for the pension. Recent changes have reduced the tax subsidies for lump-sum retirement benefits that can be consumed quickly, but, as the following section notes, these benefits continue to receive preferential treatment. Changes have also slightly reduced the retirement savings subsidies accorded to high-income taxpayers. Once again, however, the subsidies remain biased in favour of those least in need.
B. The Aged Pension System

The federal aged pension was introduced in 1909 following the establishment of an Invalid and Old Age Pension Trust Fund, which replaced separate state government schemes. The pension was paid at a maximum rate of ten shillings per week, which, at that time, was about 18 per cent of AWE. The age of eligibility was initially sixty-five for both sexes, but it was lowered to sixty for women in 1910.

The option of a contributory social insurance scheme was canvassed before (and after) the introduction of the first federal aged pension, but no action was taken on this front. The aged pension was established as a means-tested payment. It had an income test with a sudden death 100 per cent withdrawal above the threshold and a property test, which operated in an equivalent fashion. In 1961, the two tests were merged. In 1969, the combined means test became a tapered test with a 50 per cent withdrawal rate for income over the threshold. During the 1970s, there was bipartisan support for the removal of the means test and the provision of the aged pension on a universal basis. The means test was abolished in 1973 for those aged seventy-five or more and in 1975 for those aged seventy or more. In 1976, the property test was abolished for all pensioners, so all that remained was an income test for persons under seventy.

The tightened economic situation of the late 1970s and the early 1980s led to a reversal of this brief flirtation with universality. The universal component of the pension (the part that applied to persons aged seventy or more) was frozen in 1978, and in 1983, it was once again income tested, although the test was more generous than the one applied to persons under seventy. In 1985, the asset test was reintroduced, partly in response to double dipping by retirees who received large lump-sum superannuation payments, benefitted from the associated tax concessions, and then invested the capital in schemes that avoided the impact of the income tests.

The aged pension is now paid to men aged sixty-five or more and women aged sixty or more on a means-tested basis. It is subject to both an income test and an assets test. The income test applies to single persons with private income above $43 per week and to married couples with combined incomes above $76 per week. Above these levels—commonly referred to as the income-free thresholds—the level of the pension is reduced at the rate of 50 cents per one dollar of private income. The assets test exempts the family home and compulsorily preserved superannuation. To compensate for this concession, non-
homeowners are allowed a higher level of assets before the test is applied. The basic pension rates are indexed to the CPI.

In June 1989, there were over 1.3 million aged pensioners. Almost three-quarters of them were receiving the maximum pension, and over two-thirds of them were homeowners. Outlays on the aged pension in 1988-89 amounted to $7.4 billion, or 39 per cent of total social security outlays. By May 1993 there were 1.5 million aged pensioners, and aged pension outlays totalled $9.9 billion.

C. The Tax Expenditure Programme

Special tax treatment of retirement savings has been a feature of Australian federal income tax law since its inception in 1915. The original Australian income tax rules encouraged retirement savings by providing a deferral of tax on investments in special savings vehicles known as superannuation funds (after the English terminology). No tax was payable on the original contributions or subsequent investment earnings until benefits were distributed to a taxpayer by way of regular pension payments following retirement. If benefits were withdrawn from superannuation funds in lump-sum form, the deferral could be converted to an outright tax exemption.

As could be expected, the combination of tax deferral for investments realized as a pension and exemption for savings withdrawn as a lump sum, made superannuation funds popular savings vehicles for higher-income taxpayers. Their popularity fell with income levels, partly because the value of the tax concessions fell with income and partly because lower-income taxpayers were less able to negotiate tax-effective remuneration packages.

1. Superannuation savings: the pre-1983 regulatory aspects

Originally, neither federal income tax legislation nor state legislation defined the exact character of a “superannuation fund.” The common law (or, more accurately, equity law) considered such funds a type of trust. Some state superannuation fund legislation was

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76 See, for example, P. Szabo, C. Beeny & P. Trewin, Superannuation: A Practical Approach (Melbourne: Leo Cussen, 1981) at 3. One practical consequence that flows from a trust characterization is illustrated in Case G20 (1975) 75 A.T.C. 118, where the Board of Review assessed a superannuation fund that failed to qualify for concessional tax treatment as a trust, using the trust provisions of the income tax legislation.
eventually formulated, but the principal source of regulation was the income tax legislation that established ground rules for eligibility for the tax-free status sought by superannuation funds. The legislation was deliberately broad and vague, however, and it left to the Commissioner of Taxation the task of promulgating guidelines for the conditions that superannuation funds had to meet in order to qualify for tax exemption.

For the most part, guidelines issued by the Taxation Office were concerned with mandatory and prohibitory investment policies. For example, they stipulated the minimum percentage of invested funds that had to be placed in government securities and the maximum percentage that could be invested in or loaned to the employer or a related party.

The guidelines did not address substantive issues related to the rights of fund beneficiaries, and most funds contained some exploitive features. Vesting periods for employer contributions ranged from somewhat lengthy to obscenely long. (Ten- to fifteen-year vesting periods were not uncommon, and some funds stipulated twenty-five-year vesting periods.) Returns on employee contributions were often minimal and sometimes zero. In some cases, in both the private and public sectors, funds charged management or administrative fees, so departing employees actually received less than they had contributed.

The combination of inordinately long vesting periods and conservative actuarial estimates meant that many defined benefit superannuation funds accumulated significant surpluses. Employers in need of extra capital on occasion, sought to withdraw the surpluses, though their attempts were often challenged, rarely with success, by unions on behalf of beneficiaries.

The most unfortunate consequence of the government's hands-off approach to superannuation fund regulation was the rise of "cherry picker" funds in the tax avoidance era of the 1970s and early 1980s. These funds were established by small businesses to exploit simultaneously all of the weaknesses of the superannuation regime: long vesting periods, tax exemption of contributions and earnings, and generous concessions on distributed benefits. Employers who established cherry picker funds generally made the entire workforce members of the scheme, often without their knowledge. Employees who might achieve continuity of service sufficient for vesting were dismissed shortly before the requisite time, and when only the employer and close family members remained as potential beneficiaries, the funds were wound up. The benefits were distributed as lump sums to the remaining

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members, and for reasons explained below, were largely tax-free.

Apart from changes in the legislation to deal with such blatant tax avoidance schemes, no attempts were made to codify rules for the operation of superannuation funds eligible for tax exemption. The Commissioner's guidelines and rulings were similarly directed at exploitative and abusive schemes, and, apart from some rules on eligible investments and caps on maximum investment contributions, did not address any policy issues. Thus, when Labor was elected to power in 1983, superannuation funds operated without constraints on vesting periods, portability rights (the right to transfer entitlements to a new fund on change of employment), or preservation conditions (the obligation to retain tax-exempt savings until retirement).

2. Superannuation savings: the pre-1983 taxation system

The tax concessions that encouraged retirement savings by means of superannuation funds covered four discrete areas: (1) the treatment of employer remuneration deposited directly into a superannuation fund; (2) the treatment of employee contributions to superannuation fund; (3) the taxation of investment income derived by the funds; and (4) the taxation of benefits received by a member from a concessionally treated superannuation fund.

1. **Employer contributions.** From its inception, Australian income tax legislation provided special treatment for employers' contributions to superannuation funds. Employers' contributions to the funds were deductible to the employers\(^7\) and exempt from taxation when received by the funds.

2. **Employee contributions.** The 1915 Tax Act allowed employees and self-employed persons a deduction for contributions made to a superannuation fund. The deduction was replaced by a rebate (tax credit) in 1942, which was replaced in turn by a deduction in 1951. In the 1970s, the deduction was again abandoned in favour of a rebate, and in the 1980s, a system of rebates and deductions was adopted.\(^7\) The value of the relief was restricted to relatively small contributions, and for employees in employer-sponsored funds, it eventually disappeared.

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\(^7\) For a brief history of the switch back and forth from deductions to rebates see Asprey Report, supra note 16, para. 21.31. The Asprey Report incorrectly identifies the deduction available in the 1915 Tax Act as a maximum of £100; it was actually limited to a maximum of £50: see the 1915 Tax Act, ibid., s. 18(g).
altogether (to be revived to a small extent in 1990). The role played by the deductions or rebates for employees in encouraging retirement savings was minor.

Surprisingly, organized labour and employers alike failed to appreciate the advantages they both could secure through the use of employer-funded superannuation funds. Both public and private sector employers required significant employee contributions, a condition to which representative unions invariably acquiesced.

3. Fund earnings. The 1915 Tax Act included an exemption for investment income derived by superannuation funds, and the exemption survived in successor legislation. Provided that a fund satisfied the minimal regulatory standards imposed by the Tax Office, it was completely exempt from income taxation.

4. Superannuation benefits. The key to the distinctiveness of the Australian retirement savings system was an apparently innocuous provision inserted in the original 1915 Tax Act, which included only 5 per cent in assessable income “of the capital amount of a retiring allowance or gratuity which is paid in a lump sum.” When the section was first enacted, few employees were members of superannuation funds and lump-sum retirement payments were usually “golden handshakes,” not distributions of accrued savings and earnings. From a modern public finance perspective in which income is synonymous with economic gain the 5 per cent inclusion provision seems excessively generous. At the time, however, the taxation of even part of a capital payment was a notable base-broadening initiative. Nevertheless, the effect of the 5 per cent inclusion was, of course, to exclude from taxable income 95 per cent of such payments.

The lump-sum superannuation benefits to which the 5 per cent rule applied consisted of three elements: untaxed employer contributions, untaxed superannuation fund earnings, and after-tax employee contributions. The lump-sum tax contained no dissection formula. Accordingly, to the extent that it applied to previously taxed employee contributions, it amounted to a double tax. Such contributions constituted a small part of most lump sums, however, and the injustice was more than offset by the 95 per cent exemption side.

The interplay of tax and superannuation rules is something of a

80 Ibid., s. 11(1).
81 Ibid., s. 14(1).
82 The exclusion effect was confirmed in Rebeck v. F.C.T. (1975), 5 A.I.T.R. 538, when the Commissioner failed to assess 5 per cent under the lump-sum provision and the remainder under a general charging provision.
chicken-or-egg question, but most observers conclude that the 5 per cent tax rule is the single most important factor behind the common availability of lump-sum benefits from Australian superannuation funds. The option to commute all pension rights to a lump-sum entitlement is not uncommon, and lesser commuting rights, often for 50 per cent or 75 per cent of pension rights, are available from most funds that do not offer the option of 100 per cent commuting.

We mentioned earlier the perverse manner in which the option of a lump-sum superannuation benefit operated in conjunction with the aged pension provisions. There was every reason to use any lump-sum benefit received and thus, qualify for the pension. The pension was seen as a fair return on a lifetime of taxation, and consequently loss of entitlement was widely perceived as an effective tax.

Tax policy analysts recognized the illogic of the 95 per cent lump-sum exclusion, and the first government commission to examine the income tax system after the Second World War, the Spooner Committee, strongly criticized the concession. It recommended that the 5 per cent inclusion system be capped; and proposed the adoption of a formula under which the maximum lump sum that could be sheltered under the 5 per cent inclusion provision would be set at the equivalent of one year’s salary for each eight years of service, subject to an overall maximum of $30,000. Proceeds that exceeded the ceiling would be fully taxed. The government endorsed the sentiment of the Spooner Committee’s recommendations but it reduced the value of the concessionally taxed component significantly by adopting a formula of one year’s salary for every twenty years of service, subject to an upper limit of $20,000.

The Bill containing the proposed changes provoked a chorus of protests when the government introduced it into Parliament in 1952. Its opponents criticized the absence of grandfathering provisions and its consequent reduction of after-tax benefits of existing superannuation fund members. Furthermore, it was argued, in a context of high marginal tax rates (the top rate was then almost 70 per cent) the proposed changes could lead to a severe bunching problem. The government yielded to the storm and deleted the retirement benefits provisions from the Bill.

The combination of generous tax concessions, minimal statutory rules, and weak Tax Office guidelines invited avoidance, an invitation that many taxpayers accepted. The Ligertwood Committee, a tax-review

83 Australia, Report of the Commonwealth Committee on Taxation (Canberra: Government Printer, 1951) (Chair: E.S. Spooner).
committee appointed in late 1959, exposed many of the most abusive avoidance schemes, but the committee's recommendations, released in 1961, led to only minor legislative and administrative reforms. \(^{84}\)

In 1972, a new tax-review committee, the Asprey Committee, was appointed. The committee's final report, issued in 1975, \(^{85}\) offered two alternative paths to the reform of retirement savings. Under the first plan, lump-sum benefits would be assessable in full, subject to generous averaging provisions \(^{86}\) and transitional provisions. \(^{87}\) Under the second plan, lump sums would be exempt up to a given figure (the Committee suggested $50,000), and amounts in excess of that figure would be subject to forward averaging.

Almost none of the Asprey Committee's recommendations on retirement savings and benefits or other matters were implemented. A Labor government elected in late 1972 came into office with a comprehensive tax reform agenda but was dismissed from office by the Governor-General in 1975 before implementing serious changes. A Liberal-dominated coalition formed an interim government pending elections from which the coalition emerged victorious. Inhibited by the questionable legitimacy of its road to power, the coalition government moved cautiously on most fronts and hardly at all in the area of tax reform. Legislative inaction contrasted with judicial activism to dismantle the narrow tax base the legislature had adopted, and the result was a decade of unprecedented avoidance and evasion, the former at least unambiguously endorsed by the judiciary.

3. The first Labor reform package

When Labor returned to power in early 1983, the government chose retirement savings as the subject of its first major tax reform initiative. In mid-May 1983, the Treasurer announced the government's intention to tax lump-sum retirement payments in full, subject to special rate ceilings. The proposals generated a barrage of criticism by vested interests, and by August, the Treasurer had retreated significantly, proposing a 30 per cent maximum rate applicable to lump sums received

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85 Asprey Report, supra note 16.

86 Ibid., paras. 21.68-21.77.

87 Ibid., paras. 21.80-21.91.
by taxpayers under fifty-five and a dual-rate maximum tax applicable to taxpayers fifty-five or older. For these taxpayers, a concessional maximum rate of 15 per cent would apply to the first $50,000 of lump-sum benefits and a 30 per cent maximum rate would apply to benefits in excess of $50,000 (later raised to $55,000).

The new rates would apply only to lump-sum retirement payments received after 30 June 1983 (the Australian tax year runs from 1 July to 30 June). Grandfathering rules would be adopted for pre-July 1983 benefits. The August announcement proposed a pro-rata grandfathering formula based on the taxpayer's pre- and post-membership periods. Thus, for example, if a taxpayer had accrued twenty years of fund membership before 1 July 1983 and remained in the fund for a further ten years, two-thirds of his or her final benefit would be taxed under the old 5 per cent rule and one-third under the new system. The generosity of the grandfathering provision surprised many commentators. It not only maintained the 95 per cent exemption for benefits accrued before July 1983, but it extended the generous treatment to a portion of all subsequent earnings.88

The original reform proposal, announced in mid-May, provided a lump sum roll-over for taxpayers joining new superannuation funds, but commentators suggested the concession would be of limited value, given the number of taxpayers who moved to new employment with firms that had existing superannuation plans, or whose superannuation funds did not make provision for transfers from other funds.

The Treasurer's August announcement on the new lump-sum tax rates addressed these criticisms by establishing a new class of retirement savings vehicles: approved deposit funds (ADFs). These could act as holding vehicles for lump-sum benefits awaiting reinvestment in another superannuation fund or in a retirement annuity policy. The concept caught the imagination of the public and the investment community, which quickly laid the groundwork for a range of ADFs, which offered tax-free savings in a variety of portfolios, including debt, equity (both foreign and domestic), and real estate. From a modest start, the ADF industry grew quickly.

Early in 1984, Parliament adopted legislation that gave effect to the government's reform proposals from 1 July 1983.

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88 The use of a generous grandfathering system established a precedent for Labor tax reform that has been followed many times since. The most notable example was the capital gains tax, which exempted all gains on assets owned prior to the date of commencement of the tax.
4. The second Labor reform package

The 1983 tax changes did not address a number of key questions raised by the special tax rules for superannuation, and critics of the concessions, particularly in the welfare sector, campaigned for further changes.89

The critics adopted a tax-expenditure analysis and studied the concessions as subsidies. To the extent that the post-reform system retained a partial exclusion for lump-sum payments, the critics regarded the superannuation tax system as a tax-exemption system. To the extent that the post-July 1983 component of lump sums became taxable and all pensions were taxable, they described the tax concessions as a deferral of tax, akin to an interest-free loan, not available to gains realized on all other types of savings.

Given a tax-expenditure analysis, the critics said, the concessions could be rationalized as a subsidy for retirement savings intended to encourage and assist taxpayers to save for retirement. Viewed in this light, they argued, the scheme suffered from two principal defects: its "upside-down" effect and the lack of targeting in its application.90 In regard to the first point, the critics noted that the value of the interest-free loan diminished with income and fell to nothing for those with incomes below the tax threshold. Thus, the concessions provided large subsidies for those least in need of assistance and no subsidies for those most in need.

The tax rules were also deficient from a targeting perspective. To begin with, the critics noted, the provision of subsidies bore no relation to need. The government not only gave more help to higher-income taxpayers, but made no attempt to restrict access to the subsidy to taxpayers who needed no help to save for retirement. The critics called for caps on subsidized savings to limit exploitation by taxpayers who could and would save outside the subsidy system.

The critics of the tax concessions also argued that they should be targeted to savings in superannuation funds whose rules clearly furthered the goals of providing adequate retirement income. They called for certain restrictions on qualifying superannuation funds. The

89 See, for example, Brotherhood of St. Laurence, Tax Reform, Jobs and Justice: Principles, Issues and Directions for Change (Submission to the Economic Advisory Council, January 1985) [unpublished].

proposed restrictions related to four matters: vesting, preservation, portability, and the type of benefit a fund could provide.

The critics called for the imposition of strict vesting periods on qualifying funds. If immediate vesting was not feasible, no more than a minimal waiting period should be allowed. The call for preservation rules arose from a perception that many people were using superannuation funds as short-term, tax-exempt savings vehicles. Existing superannuation deed rules did not guarantee that the funds would remain invested until they were needed for retirement, even though the principal rationale for the tax concession was the subsidization of savings for retirement income.

Problems with portability were tied to the vesting and preservation questions. Few funds provided for portability of beneficiaries’ entitlements to accrued vested rights and virtually none provided for portability of non-vested accrued benefits. For employees whose interests in employer contributions and a share of fund earnings had not vested when they changed employment, the lack of portability ensured the loss of their accrued but non-vested benefits. Employees with vested interests in funds with no portability rules had no choice but to cash out their benefits when changing employment.

Finally, the critics argued that subsidies should not be available where superannuation funds offered lump-sum benefits. Lump-sum benefits, largely a product of historical accident, could not be justified as an appropriate tool for providing security from retirement until death.

Apart from its taxation power and perhaps its commerce power, the federal government had no legal right to police or to establish standards for superannuation funds. However, the income tax legislation afforded the Commissioner of Taxation considerable latitude in determining which funds qualified for tax exemption. As a result, the Tax Office’s unofficial standards became the de facto rules with which superannuation funds had to comply. Most of the rules were designed to combat tax avoidance or exploitation of the exemption; they dealt with such things as loan-backs to the employer and direct or indirect investment in the employer or a related party. The Tax Office also sought to establish minimal prudential standards by stipulating minimum investment levels in government debt. Not surprisingly, many commentators suggested that the motive for this rule was to reduce the government’s borrowing costs, not to improve the funds’ security. The rules did not address important substantive issues such as vesting, preservation, and portability.

One important function of the Commissioner’s rules was to place a cap on access to the tax concession by imposing “benefit limits” on
funds eligible for tax concessions. The limits referred to the maximum lump sum that could accrue for a beneficiary in a tax-exempt superannuation fund. Analogous limits were established for pension benefits and combination lump-sum and pension benefits.

The Tax Office originally adopted a “progressive” scale to establish maximum benefits, although it had no legislative authority for this innovation. The scale defined maximum lump-sum benefits as multiples of final average salary, starting with seven times final average salary for salaries of $27,000 or less. A progressively smaller multiple applied to each step of additional salary. The upper limit for the largest multiple was $192,500, for taxpayers with a final average salary of $27,000, and the lower limit for the smallest multiple was $340,250, for taxpayers with a final average salary of $90,500. In 1985, the Commissioner of Taxation gave the regressivity of the superannuation tax concession an unexpected and unexplained boost by replacing the tapering limit scale with a flat rate, seven-times-final-average-salary formula. The benefit limit for a taxpayer with a final average salary of $27,500 continued to be $192,500. However, the benefit limit for a taxpayer with a final average salary of $90,500 rose from $340,250 to $633,500.

The 1983 "reform" of superannuation fund taxation had minimal impact on the cost of the superannuation subsidy. In 1981-82 the deferral of tax on taxable benefits and the 95 per cent exemption for lump-sum benefits amounted to a $2.4 billion tax expenditure. By 1984-85, the tax expenditure had risen to an estimated $3 billion annually, and some observers considered even that estimate to be a conservative one. The financial pressure of maintaining the subsidy was supplemented by increasing political pressure as the union movement and welfare lobby pressed for reform, particularly with regard to vesting, preservation, and portability standards. It was inevitable that superannuation reform would find itself back on the government's agenda.

Renewed action became imperative in mid-1985 when the ACTU made superannuation a key bargaining point in its ongoing negotiations.

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91 Grbich & Grbich, ibid. at 116.
92 Treasurer, News Release (5 March 1986).
93 D. Dixon, “Suggested Refinements of the Treasury Costings of the Occupational Superannuation Tax Concessions” (1986) 3 Aust. Tax F. 223. However, Knox suggests the Treasury estimates may have been high; he estimates the concession to be about $2 billion annually. See D. Knox, Taxation Support of Superannuation in Australia: Its Costs, Equity and Efficacy (Sydney: A.T.R.F., 1987) at 36.
with the government for a renewed wages accord and wage-tax trade off. Two important elements of the 1985 agreement between the government and the ACTU were the adoption of operational standards for the vesting, preservation, and portability of superannuation funds, and a proposed 3 per cent productivity award in the form of contributions to industry-based superannuation funds (that is, funds in which the union movement had some or even substantial influence).

In June 1986, the Treasurer announced both a draft version of the new operational standards and his government's intention to establish an Occupational Superannuation Commission, which would monitor the new standards and introduce further appropriate standards. Many observers thought the proposed standards were weak. For example, although the standards required a 100 per cent immediate vesting of new productivity fund contributions by employers, they were silent on other employer contributions.

Pending establishment of the Occupational Superannuation Commission, an interim body in the Treasury promulgated initial guidelines, which were released in the second half of 1986 and early in 1987. The guidelines did not tread on sensitive areas; they applied for the most part on a prospective basis to funds established after the Treasurer's December 1985 announcement, and most of the conditions they imposed, such as immediate vesting for employee contributions, were hardly onerous.

By May 1987, when legislation was introduced to establish the Commission, the scope of the proposed office had broadened somewhat. The new law established the office of the Insurance and Superannuation Commissioner, which combined the functions of the proposed Superannuation Commission with an existing Life Insurance Commission, Insurance Commission, and Government Actuary. The legislation contained no superannuation operating standards. Instead, it established a formal framework for the Insurance and Superannuation Commission to issue prescribed standards as regulations under an Occupational Superannuation Standards Act.

The extension of occupational superannuation and the promulgation of new operating standards for new funds did little to reduce the pressure for further reform. The concerns of the critics were not new: inadequate vesting, preservation, and portability standards; the continuing bias towards lump-sum benefits; and the inequitable and

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95 Treasurer, News Release (11 June 1986).
inefficient subsidy nature of the tax concessions, which provided greater assistance to taxpayers with higher incomes and no benefit to those most in need. In regard to the last point, the critics directed their concern at both the “upside-down” nature of the tax deferral benefit for any given amount of savings, and the fact that the “seven times” rule allowed concessional savings to rise as income increased.

The pace of discussion increased when the government indicated that it would unveil a major economic and tax reform programme in the first half of 1988. Speculation followed in the financial press about the possibility of the full or partial removal of the tax exemption for superannuation contributions and earnings. Proposals for the full taxation of superannuation fund income had first become prominent in 1981, when the Campbell Committee called for a tax on superannuation funds to establish neutrality in the field of retirement savings between investments through funds and direct investments. Calls for a superannuation fund tax were renewed in a number of academic papers in the mid-1980s. Proponents of the tax gained considerable support when New Zealand decided in December 1987 to end its tax concessions for superannuation savings.

The theoretical rationale for fund taxation—to establish capital-market neutrality—was perhaps less interesting to the government than two important, pragmatic considerations. The first was revenue potential. By moving the tax up front, from the distribution of benefits to the original derivation of income, the government could accelerate revenue collection and, by reducing the benefits of deferral, reduce the overall costs of the concession. Immediate revenue gains were important, given the government’s plan to slash the corporate tax rate. The second consideration was that a tax on superannuation funds would greatly alleviate the serious problem of dividend streaming. Under the imputation system adopted in July 1987, taxable shareholders were fully credited for company taxes previously paid on distributed income. The credits for company taxes were lost when such income was distributed to tax-exempt shareholders. Streaming involved the selective distribution of fully taxed company income to taxable shareholders and untaxed company income to tax-exempt shareholders.

A succession of anti-streaming measures had proved ineffective;


taxpayers devised new arrangements to counter each new amendment. Commentators in the financial press had argued that the only solution was to impose the income tax on superannuation funds while offering the funds access to imputation credits, since the funds would then seek distributions of fully taxed income to the same extent as other taxable shareholders.

It was clear to many observers concerned with the equity and efficiency aspects of retirement savings subsidies that a tax on superannuation funds would violate both of those norms. So long as the tax was below the highest personal marginal rate, the subsidy would be skewed towards high-income savers. The inequity of an upside-down subsidy system would be mirrored by its inefficiency; those least in need of assistance would receive the largest subsidies, whereas those most in need would receive nothing.

Proposals to tax the funds did not engender opposition, however, from the two groups whose constituencies stood to suffer most if a tax were implemented: the ACTU, which represented organized labour, and the Australian Council of Social Service (ACOSS), which concerned itself with the position of low-income earners. Concerned primarily with the goal of spreading superannuation coverage, the ACTU seemed not to appreciate the significance of the tax concessions inherent in the existing tax system. ACOSS suggested that it would accept a proposal to impose a flat-rate tax on superannuation funds if the tax were accompanied by new limits on lump-sum benefits, caps on the subsidized benefits available to high-income taxpayers, and increases in government assistance provided to low-income people during retirement—or, at worst, no decline in the level of assistance.

Given that, as a subsidy instrument a tax on superannuation funds would be both inequitable and inefficient, ACOSS explained its support on broader macroeconomic grounds: "The strongest argument for taxing fund earnings is to remove investment distortion." ACOSS realized, however, that distortions could not be fully eliminated unless funds were taxed at the corporate tax rate, which was then aligned with the highest personal marginal tax rate. Of course, the higher the rate imposed on superannuation funds, the greater the inequity for the tax on low-income taxpayers.

As support grew for the superannuation fund tax proposals, some critics of the existing system canvassed an alternative proposal.

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99 Ibid.
This proposal addressed the equity and efficiency problems directly by calling for the scrapping of the existing concession and the adoption of a tax-credit-based system.\textsuperscript{100}

A number of versions of the tax-credit-based proposal appeared. While they varied in detail, they all exhibited the same basic features. Superannuation funds would be treated as flow-through entities, and both employer contributions and fund earnings would be attributed directly to beneficiaries for tax purposes. In the case of defined contribution or accumulation funds, income would be allocated on an exact basis. In the case of defined benefit funds, attributed income would be calculated on the basis of the actuarially determined increase in benefit rights. Allocated or attributed income would be taxed directly in the hands of beneficiaries at their ordinary marginal rates. Provision for the payment of members' tax liabilities by superannuation funds may be desirable where taxpayers face liquidity problems.

To encourage superannuation savings, refundable tax credits would be available to beneficiaries of approved funds. Since the tax concession would take the form of a credit rather than a deduction, exemption, or low tax rate, it would be of equal value to all taxpayers regardless of their marginal tax rates. Use of a refundable credit would extend the concession and the incentive to save to persons below the tax threshold. Moreover, as a fixed credit, the concession would automatically be capped; taxpayers could save as much as they wished, but the government subsidy would be limited to the available credit.

Finally, appropriate standards could easily be imposed by allowing taxpayers to use the credits only to offset tax on income attributed or allocated by approved superannuation funds, that is, those funds that met the appropriate vesting, preservation, and portability standards. Similarly, once an appropriate benefit policy had been selected (pension only or pension and a nominal lump-sum entitlement), that policy could be made a condition of approval.

Although the credit-based system received some attention from academic lawyers and economists, it was not endorsed by any of the key sector organizations. ACOSS did use the occasion of its submission to describe the credit-based system, however, and it went so far as to suggest that it might be necessary to replace the existing system of

concessions with such a system if a superannuation fund tax were adopted.\textsuperscript{101}

In May 1988, the Treasurer released details of the foreshadowed taxation and economic reform programme. Its central element was a reduction in the company tax rate from 49 per cent to 39 per cent at an estimated annual revenue cost of about $1.5 billion. Company tax base-broadening measures recouped $0.6 billion of the revenue losses and a tax on superannuation fund contributions and earnings was proposed to fund the remaining loss, $0.9 billion.\textsuperscript{102} Thus, the changes in the superannuation tax concessions were driven, in the first instance, by the need to fund cuts in the company tax.

The Treasurer's statement proposed a 15 per cent tax on fund contributions that were deductible to the contributor and a similar tax on fund earnings. It also proposed certain corollary changes in the taxation of superannuation benefits: the generous 95 per cent exemption for the portion of lump-sum benefits based on employment before July 1983 would not be touched, but the maximum rates on post June 1983 components would be altered to take into account the tax already levied on the income at the fund level. At the same time, the threshold between the low lump-sum rate and the high lump-sum rate would be raised from $55,000 to $60,000. Provision was also made for indexing the threshold. Superannuation pensions were to be fully taxed (apart from the portion that represented the return of the pensioner's non-deducted contributions). However, taxpayers would be entitled to a credit to offset the effect of the tax previously imposed at the fund level.

The new rates on superannuation lump-sum and pension benefits were based on the assumption that all superannuation contributions and earnings had been subject to the new 15 per cent tax, which clearly would not be the case for many years. The reductions in the tax rate on benefits would be phased in over five years, a transition period whose brevity conferred a significant windfall on taxpayers to the extent that their final benefits represented contributions or earnings derived before July 1988.

Although the superannuation fund tax slightly lessened the deferral advantage of superannuation savings for the highest-bracket taxpayers, it did not address the inequities or inefficiencies of the previous system. The amount of tax deferred was reduced slightly, but its magnitude increased with the beneficiary's marginal tax bracket. The

\textsuperscript{101} ACOSs, supra note 98.

\textsuperscript{102} Economic Statement May 1988, supra note 46.
skewing of benefits toward upper-income taxpayers was compounded by the retention of maximum rates on lump-sum earnings that were well below the highest marginal income tax rates. For many lower-bracket taxpayers, indeed, the 15 per cent tax on funds wiped out the concessional element of superannuation savings.

The government's concession to the welfare lobby's criticism of the upside-down effect of the tax subsidy concession system was the adoption, in the 1988 reform package, of new limits on a taxpayer's ability to exploit superannuation funds as concessional savings vehicles. These were known as reasonable benefit limits (RBLs). RBLs are based on the expected present value (or lump-sum value) of a taxpayer's superannuation entitlement at the time of retirement. Enforcement of RBLs is achieved through two means. First, superannuation funds that permit excess contributions may be denied tax-preferred status. Second, excess benefits are fully taxed as ordinary income at the recipient's marginal tax rate. The double taxation of such benefits (that is, the absence of any credit for taxes imposed at the fund level) is designed to offset roughly the benefit of deferral that results from the low rate of tax imposed on the fund.

Like their predecessors, the new limits were based on a multiple of final average salary. However, the multiples declined on a progressive basis with salary—the RBLs ranged from seven times final average salary until $35,000 to three times the excess over $65,000. The cut-in points for declining multiples were indexed from July 1988. Analogous multiples applied to pension benefits. Benefits subject to the RBL rules did not include non-deductible employee contributions that attracted no tax concessions.

The previous benefit limits allowed a taxpayer with a final average salary of $100,000 to accumulate in a tax-exempt superannuation fund savings sufficient to generate a lump-sum benefit of $700,000. Under the 1988 RBL rules (if one ignored the indexation of the brackets), the limit for the same taxpayer was $500,000. The pre-1988 RBL rules allowed a taxpayer with a final average salary of $500,000 to accumulate a lump sum of $3.5 million; the 1988 limit for such a taxpayer was $1.7 million.

The 1988 "reforms" did little to ameliorate the inequities and inefficiencies of the superannuation tax subsidy program. Critics argued that the subsidy continued to have the "upside-down" effect.

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103 Seven times $35,000 plus five times $30,000 plus three times $35,000 = $500,000.

104 Seven times $35,000 plus five times $30,000 plus three times $435,000 = $1,700,000.
characteristic of many tax expenditures and that the caps on exploitation by higher-income taxpayers were both insufficient and ineffective. Once again, the reform process had failed to endorse measures to discourage lump-sum benefits. Only limited progress had been made on preservation and portability, and even some employers' representatives acknowledged that the rules on vesting remained ineffective.\footnote{See, for example, the position of the Business Council, an influential commercial body, in "New steps towards a Retirement Income Policy—A ten year reform program" (May 1989) 53 Bus. Coun. Bulletin 14.}

In October 1988, the Social Security Review issued a study entitled \textit{Towards a National Retirement Incomes Policy}.\footnote{\textit{Australia, Towards a National Retirement Incomes Policy} (Social Security Review Issues Paper No. 6) by C. Foster (Canberra: Department of Social Security, 1988).} The paper dealt with both government transfer payments and private retirement savings. It focused on the disincentives, inequities, and inefficiencies caused by the unplanned and often anomalous interaction of the two. The paper's release renewed the public debate on retirement savings and transfer payments programmes as Parliament debated the May 1988 superannuation tax changes.

In August 1989, the Minister for Social Security unveiled the government's new retirement incomes policy. The new policy put considerable emphasis on reducing the high, effective marginal tax rates imposed on pensioners when additional income triggering pension reductions was also taxed.

In announcing its new initiative, the government acknowledged the criticisms that had been levelled against the superannuation concession but defended its policies. In particular, it reaffirmed its commitment to providing taxpayers with the option of receiving lump-sum benefits. Rather than further restrict or penalize lump sums, the government proposed adopting more lenient RBLs for savings in superannuation funds, which provided more than half the benefit as a pension. It also tightened further vesting, preservation, and portability standards, though the rules remained woefully inadequate.

Finally, the government announced its intention to extend tax concessions for superannuation contributions by employees. For self-employed taxpayers and employees whose employers made no contributions on their behalf to superannuation funds, the deduction for contributions would be enlarged from $3,000 per year to $3,000 plus 75 per cent of any contributions in excess of $3,000, up to the reasonable benefits limits. Deductions for superannuation contributions would be extended to other employees for the first time, with a sliding scale of
allowable deductions; the maximum deduction would depend on the level of employer superannuation support (as a percentage of salary). This proposal suffered from a number of technical and related problems, and it was replaced with a disappearing tax credit system for employees who were members of employer-sponsored superannuation schemes. To provide further opportunities for low-income taxpayers, particularly part-time women workers, superannuation deductions were made available to taxpayers who worked as little as ten hours a week. Special deeming provisions provided these taxpayers with an RBL determined by reference to a $25,000 "base salary."

The 1989 reforms further tidied the superannuation tax subsidy system but failed to address its fundamental shortcomings. In addition, it continued to skew subsidies toward high-income taxpayers. The government subsidy portion of a dollar contributed to a superannuation fund would be 7.25 per cent for a taxpayer with an income of $17,000 and 33.25 per cent for a taxpayer with an income in excess of $35,000. The benefits in the form of a lump sum rather than a pension were reduced, but the incentive to take almost half of the available benefits as a lump sum remained. And the sliding scale capping superannuation savings meant that the total subsidy, as well as the subsidy per dollar invested, increased with the taxpayer's income and ability to save.

Debate over the government’s superannuation policy continued throughout 1990 and early 1991. In the first half of 1991, a new proposal emerged. This proposal called for two things: (1) replacement of the 3 per cent employer contribution negotiated in the context of the national wage-setting system with a compulsory retirement savings contribution scheme with higher contribution levels, and (2) elimination of the current tax-subsidy system and its replacement with a credit-based system.

To overcome any potential constitutional difficulties, the proponents of the proposal advocated the adoption of a social security levy that would operate as a sanction for non-compliance with the

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109 This proposal was raised in an early draft of this article, prepared for the Osgoode/Monash symposium, Towards the 21st Century: Canadian-Australian Legal Perspectives, held in June 1991. Drafts of the paper circulated in Australia in the months preceding the conference, that is, in the first five months of 1991.
expanded superannuation coverage standards. The levy would be imposed on all employers, but employers who made sufficient contributions to qualifying superannuation funds would qualify for a complete rebate of the resulting tax. The tax collected from employers who failed to make sufficient contributions would be deposited into superannuation funds for the benefit of the employees identified as insufficiently covered.

Growing awareness of the limitations of a system that relied on industrial wage agreements as the basis for expanded superannuation coverage caused the government to rethink its policies by mid-1991. Proposals by the ACTU for a further 3 per cent employer's contribution to be adopted as part of the national wages system were rejected by the government and instead in the August 1991 budget, the Treasurer revealed the government's intention to establish new minimum compulsory superannuation contribution levels to be enforced by means of a superannuation guarantee levy on employers whose contributions fell below the minimum levels.

Full details of the government's proposals were released four and a half months later, in December 1991. They were passed at the end of that year and took effect from mid-1992. The compulsory contribution scheme adopted resembled the model discussed outside government circles in the first half of 1991 in most respects, but with some significant differences—most importantly, the government's proposal envisaged no change in the current tax-subsidy system. The levy changed the contribution side of the retirement savings programme, but it will preserve the program's inequitable and inadequate tax-subsidy aspect.

The Government's response to continuing pressure for further reform was the mid-1992 release of a new set of "simplification" proposals, which were legislated later in that year. The most important of these was the replacement of the climbing reasonable benefit level limits with flat dollar limits from 1 July 1994. The initial lump sum limit will be $400,000 and the initial pension scale limit will be $800,000, with both amounts indexed. Taxpayers who have accrued higher entitlements under the current rules will be allowed to retain the higher entitlements. The Government also proposed to raise the

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110 Supra note 42.
preservation age to sixty years over a period of thirty-two years.\textsuperscript{113}

D. A Retirement Income Reform Programme for the 1990s and Beyond

Australia's programme for providing retirement income security, in spite of recent reforms, is both inefficient and inequitable. It fails to encourage sufficient deferral of consumption from employment years to retirement years by those who need encouragement and assistance. It fails to discourage the payment of lump-sum retirement benefits and it encourages the rapid depletion of capital after retirement. It provides inadequate security for people who have no other resources and unjustifiable windfalls for those who can and will save for retirement anyway. Finally, it establishes a large group of tax-preferred investors (that is, superannuation funds), whose exploitation of arbitrage opportunities biases and distorts the operation of the nation's capital markets.

This part of the paper describes an alternative system, one that can achieve the equity and efficiency that the current system lacks. The model is based on a premise that we presented earlier, namely, that the most effective redistribution programme is one that redistributes economic opportunity and that recognizes periods of vulnerability over the life cycle, including retirement. If everyone had access to sufficient economic resources to fund both current consumption and retirement savings, no further provision would be needed for direct or indirect government assistance in the form of social security payments or tax concessions.

Unfortunately, Australia's current redistributive programmes have not established the fundamental access to economic opportunity that would make a retirement income security system of this sort possible. (Nor, for that matter, are they intended to accomplish this result). Quite simply, too many persons have insufficient resources to make provision for retirement savings. Many do not derive adequate employment earnings, and others have no employment income. The superannuation guarantee charge (as the levy was called in the enacting legislation) will increase the number of workers with some employer-sponsored savings, but coverage is likely to remain inadequate for workers with very low wages and for those with marginal or intermittent labour-market attachment. Some intervention is needed to

\textsuperscript{113} Statement by the Treasurer, 20 June 1992, Security in Retirement—Planning for Tomorrow Today.
assist those who are unable to put aside adequate resources to fund future consumption. Moreover, the new levy system will be punitive in respect to low-income employees, whose inadequate or marginally adequate consumption resources will be reduced to the extent that employers have sufficient leverage to trade off wage rises for increased superannuation contributions. And finally, the compulsory savings charge is unduly restrictive in relation to the range of savings needs of different households across the life cycle.

The model we propose builds upon the recently adopted compulsory employer contribution system. Our alternative model for achieving the same objectives is a universal pension system funded either from invested social security tax revenues (a fully funded scheme) or current social security or income tax revenues (an unfunded scheme). A universal pension system would not be as greatly dissimilar from the new superannuation guarantee charge as many believe. A pension system extracts provision for retirement savings from individuals through compulsory levies. A guarantee levy system extracts contributions made on a compulsory basis through regulations directed at employers, and these regulations can be extended to employees as well. A pension system can be redistributive if its benefits are approximately capped and taxed, while the taxes used to fund the benefits, be they progressive income taxes or progressive social security levies, are not capped. A guarantee levy system can be redistributive if it directs appropriate assistance and subsidies to those least able to make adequate contributions to their retirement savings.

Examples of both systems may be found in a number of jurisdictions, some of which rely on hybrids of the two. Either can achieve the income security objective in an equitable and efficient manner. One basis for choosing one over the other is political viability. Which system is more likely to be achievable, given the current political and social climate and the trends in retirement income savings that have emerged over the past decade? And, in the context of an ageing society, which system has the best prospects for surviving into the next century in the face of the shifting agendas of competing political parties?

A lack of political viability is the flaw of the universal pension option. In the current Australian political-economic climate, universality is difficult to sell. There is increasing popular sentiment for tax and expenditure reduction, and the provision of services on a user fee basis, and for tightly targeted welfare and social security programmes. The current subsidies for private superannuation savings are hidden from popular scrutiny in the tax-expenditure budget. The pension costs are subsumed in the general tax revenues. By contrast, the
costs of a universal scheme would be visible whether they took the form of a discrete levy, higher taxes, or constant taxes in a system in which taxpayers have come to expect regular tax cuts as an alternative to bracket indexation. In conclusion, the sentiment against universality probably precludes serious consideration of a universal pension option.

A retirement income security system that took the form of an expanded, (indeed, de facto universal) superannuation savings system within the framework of an efficient and equitable tax subsidy regime would have the following features:

1. The present compulsory employer contribution system, policed by an alternative non-deductible levy, would be maintained as the basis for initial contributions to retirement savings funds.

2. All contributions to funds and fund earnings would be fully taxed to the individual beneficial owner at that taxpayer's ordinary marginal rate. (Employees' contributions would be taxed, as at present, prior to investment in the fund.) In the case of defined contribution (accumulation) funds, actual contributions and earnings would be attributed to each fund member. In the case of defined benefit funds, the actuarial value of the year's increase in entitlement would be assessed. The latter calculation is administratively simple, provided that schemes are fully funded and immediate vesting rules are enforced. This approach addresses the problem of vertical inequity caused by the present preferential tax-rate system and eliminates all market distortions caused by the preferential position of institutional investors. Liquidity problems that lower income taxpayers might face can be solved by transferring the actual liability, once calculated at the beneficiary's marginal rate, to the superannuation fund.

3. Taxpayer's retirement savings would be subsidized by means of a diminishing, quarantined, universal, and refundable tax credit. All contributions and earnings would be assessed, but taxpayers could use the credit to offset some or all of the tax otherwise payable on retirement savings. The credit would be a diminishing one, so its value would gradually decline as current income increased. Higher-income taxpayers need less assistance

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114 Head has suggested that the technical difficulties of funded schemes with uncertain vesting periods and unfunded schemes generally preclude the adoption of a full accruals method of taxation, as advocated here. See J. Head, "Issues in Australian Tax Policy for the 1980s" in J. Head, ed., Taxation Issues of the 1980s (Sydney: Australian Tax Research Foundation, 1983) 1 at 4. The solution, clearly, is not to abandon accruals for a rough approximation, which Head suggests is the only alternative, but rather to adopt adequate vesting rules to simplify the determination of the value of annual increments in entitlement.
to save for retirement; it is easier for taxpayers with higher incomes to defer some present consumption. The claw-back calculation would be based on total income, not just employment income. This provision would ensure that the subsidy would diminish and eventually disappear for persons deriving income from property as well as for persons deriving income from employment or business. The credit would be quarantined, so it could be used only to offset the tax liability imposed on superannuation contributions or earnings. To the extent that the credit exceeded the tax liability imposed on retirement savings, it would be refundable, but the value of the refund would have to be contributed directly to a superannuation fund. Contributions funded by "refunded" credits would provide income security for persons who had no other resources to set aside for old age. Accordingly, it would be reasonable to restrict the type of funds to which they could be contributed to ensure that they were not transferred to risky or speculative funds. A preferable option could be to establish a government-sponsored fund to which all refunded credits would be directed automatically. The credit would be universal, so it would be available to unemployed persons and employees with low pay, who could thus establish retirement savings entitlements. The credit would be refundable, so it would provide tangible value to low-income persons by generating investment funds for retirement savings purposes. In the case of low-income employees, the availability of the credit could be used to limit the level of employer contribution required. This would minimize or eliminate the risk of reduced current consumption that would otherwise follow if the price extracted by employers for increased superannuation contributions were lower wage rises.

4. The tax subsidy would be available only for contributions to, and investment earnings by, complying funds. Compliance standards would preserve retirement savings both until retirement and thereafter until death. The standards would include immediate vesting requirements, tighter preservation and portability standards, and most importantly, a compulsory pension payout for all benefits. In other words, no lump-sum option would be available. Risk-adverse members could be given the option of a slightly reduced pension and guaranteed minimum return, as is now available to life annuity purchasers.

5. Credit levels would be determined by reference to the final income level desired in respect of persons with no contributions
apart from the refunded credit. For example, if it were decided that a new superannuation pension equal to the current aged pension (or to a multiple of the current aged pension) was appropriate, credits would be set at a level such that the refunded credits would be sufficient to fund the chosen pension amount.

Further issues raised by the credit proposal include the following:

1. *Appropriate rules for secondary earners.* Because their incomes are low, secondary earners would be likely to qualify for the credit subsidy. It might, therefore, be possible for high-income households to exploit the credit, unless entitlement were based on combined spousal income rather than the individual taxpayer’s income. On the other hand, there is no reason why individual spouses should not have separate retirement income entitlements; there is no guarantee that a current relationship will still be in effect at the time of retirement. One approach would be to provide primary earners with the choice of either an individual or a higher spousal credit; the latter would be available only where the non-working or the secondary-earner spouse had a vested right in the superannuation entitlement of the primary earner.

2. *Appropriate transitional measures.* The changes that have been made in the superannuation system since 1988 would greatly facilitate a change to a credit-based system. Already, most funds are geared to accept employee contributions that are taxed at the employee level. The administrative shift to taxing employer contributions at the employee level would not pose undue difficulty for either employers or employees. Although some employers will have to increase their contributions to meet the new standards, some current superannuation arrangements already meet or exceed the standards, particularly in the case of defined-benefit funds. In these cases, it would be necessary to recalculate members’ benefit entitlements to take into account the non-taxation of benefits distributed to members. A similar downward adjustment in entitlements was carried out in 1988 when a tax was first imposed on superannuation contributions and fund earnings, and both the funds and their advisers are now highly familiar with the logistics of altering entitlements and fund deeds accordingly. The Insurance and Superannuation Commissioner is equally experienced in supervising this sort of change. Integration of the old and new superannuation systems
would be simple from a tax perspective. If each fund member's entitlement were determined as of the day the new regime came into effect, only later contributions and earnings would be included in the member's assessable income. To the extent that benefits represented the post-credit system savings, they would be tax exempt when distributed. To the extent that benefits were derived from pre-credit system contributions and earnings, they would continue to be taxable to employees. However, credit would be available for the 15 per cent tax they bore prior to the change to the new system.

3. The role of the pension. Over time, the new system would cover an increasing proportion of the retired population. The existing aged pension would become increasingly less important as a means of ensuring income security for the retired. The aged pension would nevertheless have an ongoing function because the new, universal superannuation pensions would not be adequate for all persons in the short to medium term. The new superannuation system would be designed to achieve retirement income security for persons who had made superannuation contributions (either directly or by way of employer contributions) over a working life. It would, therefore, take at least a generation for the new system to provide an adequate retirement income for persons who did not enjoy adequate superannuation coverage when the system was introduced. In the meantime, it would be necessary to supplement the new superannuation pension payments with the aged pension to raise total income up to the current aged pension level or higher. There is a danger that, as the relative importance of the aged pension decreased, it would become marginalized in the sense that it would apply to ever fewer and less influential persons. The risks are twofold. First, as the importance of the aged pension diminished and it applied to a decreasing number of persons, real pension levels might not be sustained. The many people who currently receive the aged pension constitute a significant and influential political force. Second, the aged pension serves as the benchmark for a number of other social security payments. If the real value of aged pensions were to fall, so too would the value of other less politically popular pensions and benefits.

These risks are real. However, it is important to realize that they exist whether or not the system we propose is adopted. As inefficient and inequitable as the current superannuation regime may be, it is the case that it will apply to an ever-growing proportion of the population, and
that the role of the aged pension will decline. More and more, the persons who rely on the aged pension will be drawn from the fringes—from those who were never employed or who were unemployed for a significant part of their working lives, from immigrants whose contributions to the superannuation system were minimal, and so forth. The solution is to take the initiative now in redefining the role of the aged pension. In the immediate future, the aged pension will continue to provide the basis of an adequate level of retirement income. In the longer term, the aged pension will act as a supplement that bridges the shortfall between payments from the superannuation system and the minimally acceptable income level. And, that level should be the standard on which aged pension supplements and all other pensions and benefits are based.

VII. DIRECTIONS FOR REFORM

This paper has argued that one of the fundamental goals of government activity should be to ensure equality of opportunity, especially in relation to employment. It has demonstrated that taxation and social security reform can advance that goal. Such reform should aim to tackle the present features of the structure of Australia's taxation system, which inhibit the long-term generation of employment through sustained economic growth. Reform should also aim to improve both the efficiency and equity of government assistance to people during periods of reduced labour force participation or as a supplement to low wages in certain circumstances. The combined impact of taxation and social security arrangements should be the focus of this reform.

Problems with the present arrangements have been graphically illustrated in the case study of retirement income in Part VI. This case study pointed to the inequities and inefficiencies of the combined impact of tax transfer arrangements, primarily but not solely as a result of the structure of tax concessions for superannuation savings. Assistance through the tax system is poorly targeted, giving preferential treatment to high-income earners and, at the same time, providing little incentive to preserve a regular income for the whole retirement period.

Part VI suggested an alternative approach to government assistance for retirement incomes. Alongside the more general reforms to both the taxation and social security systems that were outlined in Part V, this would widen the scope and improve the quantum of government assistance to redistribute. Tax reform is fundamental; it cannot be achieved by social security reform alone. However, to go
further, or even to achieve these changes, a wider community consensus about the role of government and in particular, its redistributive objectives is urgently needed. In the end, the most serious obstacle to redistribution is lack of political will.