# *Unscrambling the egg: reform pathways in the tax transfer system*

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## Abstract

*Since 1985 the interaction of the tax transfer system has been reviewed a number of times. This was again a key term of reference of the Henry Review*[1]*. A review of the evolution of the personal income tax transfer system between 1985 and 2007 shows clear trends in rates and entitlements: benefits have become targeted rather than universal; tax rate structures have simplified and flattened; and pension entitlements are now subordinated to superannuation requirements.*

*Recent criticism of the Henry Review has proposed returning to more progressive income tax rates and universal benefits in relation to family benefits in particular*[2]*. This proposal is based on economic modelling as to the impact of the current tax transfer system and the effect that the current structure has on two earner families. However it does not have regard to institutional pathways that have been influential in shaping the current system. Institutional theory recognises that successful change in political institutions depends on previous systems and attitudes to further change*[3]*.*

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1 Australian Treasury, 'Australia's Future Tax System: Final Report' (Australian Treasury, 2010)

2 P. Apps and R. Rees, 'Australian family tax reform and the targeting fallacy' (2010) 43(2) *Australian Economic Review* 153.

3 Robert E Goodin, 'Institutions and Their Design' in Robert E Goodin (ed), *The Theory of Institutional Design* (Cambridge University Press, 1996) 1 ; B. Guy Peters, Jon Pierre and Desmond S. King, 'The Politics of Path Dependency: Political Conflict in Historical Institutionalism' (2005) 67(04) *The Journal of Politics* 1275.

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*In this paper I will examine the argument that the return to universal benefits will make the system more progressive, comparing the pre 1985 system with the current system. I will then consider the role of universal benefits in a welfare system before applying institutional theory to explore the implications of returning to the system of family benefits that was in place in 1985. Finally I will trace the institutional pathway of changes to the family benefit system in Australia since 1985, with reference to shifts in the progressivity of the tax transfer system and the effect of change on workforce participation.*

# 1 Introduction

Tax and transfer systems can be regarded as two separate policy instruments that operate independently with each incorporating a redistributive effect. From this perspective transfer systems are an expenditure item, while tax systems raise revenue. However recent moves to integrate the two systems through tax credit systems require the two to be evaluated using consistent criteria. The interaction between the tax and transfer systems has been recognised as a policy dilemma, with the issue being specifically raised in reviews of the taxation system from the Asprey Review[4] to the Henry Review[5]. For the purposes of this paper the tax and the transfer system will be regarded as a single redistributive mechanism. In evaluating that redistribution this paper adopts the taxation principles of equity, efficiency, simplicity and transparency[6].

Transfer payments are made directly to a qualifying recipient and are generally acknowledged as being more transparent than the tax system in directing funds toward a particular beneficiary. The transfer system is currently the primary means of delivery of benefits to families, showing them as an expenditure item in the annual Budget.

Concurrently tax is collected from taxpayers – who may or may not be recipients of transfer payments. Progressive tax rates are a means of redistribution, as those taxpayers with the ability to pay more tax will face higher marginal tax rates, increasing revenue collections, making these funds available for government expenditure including redistribution as transfer payments. Australia differs from most OECD countries in that income protection benefits are not paid out of an insurance style scheme, but are paid from general revenue. Progressive tax rates are a relatively transparent means of redistribution, as the tax rates are generally widely known.

Tax expenditures are less transparent than transfer payments or progressive tax rates as they reduce the tax collected from the eligible taxpayer through a reduction in income or a tax offset. This reduction is less readily apparent to those scrutinising

4 KW Asprey, 'Taxation Review Committee Full Report' (21 Jan 1975) http://setis.library.usyd.edu.au/oztexts/parsons.html see Chapter 13.

5 Above, note 1, Term of Reference 3.2, page vii.

6 There are many formulations of the principles of a "good" tax system, however the stated principles are included in most of these formulations.

government expenditures. At different times in Australia's history, family benefits have been offered through tax expenditures: tax deductions prior to 1975, tax rebates after that date and for a short period of time in the 1990's through modified tax thresholds.

In this paper I will examine the changes in the structure of the tax transfer system, in relation to family support, over the past twenty five years. This examination will be through an institutional framework. Following this introduction I will examine the arguments that the current system is less equitable than the former system of universal benefits with highly progressive tax rates, and compare the pre 1985 system with the current system. In Part 3 I examine the role of universal benefits in a modern welfare state. In Part 4 I review the literature on institutional theory with particular reference to policy reform processes. Finally I apply the literature to the major reforms of the tax transfer system since 1985[7].

Note that although the relevant payments are not gender specific, the evidence shows that women experience a different pattern of workforce participation as a result of their childbearing and caring roles, and accordingly the impact of the Family Tax Benefit is primarily on choices made in relation to women's workforce participation[8]. To reflect this impact, gender specific language is used in this paper where relevant.

## 2 The argument: universal benefits and progressive tax rates

There is general agreement that over the last twenty five years the transfer system has become more highly targeted through the application of income tests, both by excluding high income earners (affluence testing) and by increasing benefits to low income earners (means testing). Concurrently the income tax schedules have become progressively flatter, accompanied by the introduction of the flat rate GST and the income tested Low Income Rebate (LIR). Views diverge, however, on whether this flatter, more targeted structure produces a more equitable and efficient tax system.

This shift to targeting benefits is particularly apparent in the context of family benefits. Prior to the application of means testing in the late 1980's, family benefits were paid either as a universal transfer payment or as tax expenditures. Although called a tax benefit the current Family Tax Benefit (FTB) is a non-taxable, income tested transfer payment that is withdrawn as family income increases. Apps and Rees[9] have modelled

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7 Note that I will not be examining Business Tax Reform proposals or income support payments other than family payments in this discussion.

8 See, for example, Patricia Apps, 'Taxation and Labour Supply' (2007) 22(3) (September 2007) *Australian Tax Forum* 89 ; Jane Lewis and S Giullari, 'The adult worker model family, gender equality and care: the search for new policy principles and the possibilities and problems of a capabilities approach' (2005) 34(1) (Feb) *Economy and Society* 76; Bettina Cass and Deborah Brennan, 'Taxing Women: The Politics of Gender in the Tax/Transfer System' (2003) 1(1) (2003) *eJournal of Tax Research* 37.

9 Above note 2.

the current structure of the family tax transfer system, and have concluded that the current structure is less equitable to families with two earners, and that Australia should reconsider paying universal benefits, coupled with a higher marginal tax rate for high income earners.

They are particularly critical of the recommendations of the Henry Review that could lead to a flat rate of tax for most taxpayers, coupled with a high tax free threshold[10]. In particular, the authors argue that this will impact heavily on working mothers and two income families[11]. In their analysis the authors have modelled family structures that reflect the norm in Australia, where the rate of women working part time with a male partner working fulltime is among the highest in the world.

Their conclusion is based on the following arguments:

- The current tax transfer system results in an "inverted U-shape" profile under which the highest marginal tax rates are borne by families across average incomes. This is a consequence of the withdrawal rates of the LIR and the FTB, which increase the effective marginal tax rate (EMTR) for families with incomes across the respective withdrawal ranges. This has a particular impact on two income families, potentially acting as a disincentive for mothers to remain in the workforce.
- Withdrawing a transfer benefit as income increases has the same effect as paying a universal lump sum benefit that is supported by a particular marginal tax rate structure: the question is how the rates of withdrawal and the tax rates interact[12].
- In terms of efficiency, it does not follow that a means tested benefit will be less costly to the revenue than a universal benefit, as this will depend on the rates of tax, the withdrawal rates, and the resultant work disincentive effects. If the EMTR is perceived as being too high, it will discourage families from increasing their earned income, and this will impact on tax receipts[13].
- The equity impact of flatter marginal tax rates is to shift the tax burden from high income earners to average income families, and this increases inequality across the community[14].
- These changes have been driven by ideology that has favoured high income earners as they are regarded as more mobile and therefore more likely to respond to changes in tax rates[15]. However, this disregards the

10 Above note 1, Recommendation 2.

11 At p 153.

12 At p 154 - 155.

13 At p 156 - 157.

14 At p 157.

15 At p 172.

effect that EMTR's have on women in two earner families who may modify their workforce participation based on the current tax transfer structure.

It is the final point in this argument that is relevant for the purposes of this paper. Although the authors extensively discuss the impact that the current structure of the system has on families by family type, by income levels and at different stages in the Family Life-Cycle, the authors do not explore the ideology of these changes through the lens of institutional analysis.

The conclusion by Apps and Rees is in contrast to the findings of the OECD in relation to the redistribution of income through the tax transfer system[16]. The OECD report finds that:

- The distribution of cash benefits in Australia is the most progressive among OECD countries[17];
- Australia and the US collect the highest proportion of tax from high income earners relative to market income[18];
- Overall inequality in Australia is classified as "stable" based on changes in the Gini coefficient between 1995 and 2005[19]; and
- Australia spends 1.7 times the OECD average on transfers to families with children[20].

However the methodology adopted in the two analyses is different. Apps and Rees[21] have specifically looked at the impact of the tax transfer system on different family structures, comparing across quintiles and single/two earner households. The OECD report examines that data across quintiles and does take family structure into account, but does not specifically examine the impact on single/two earner households.

## Structure pre means testing

In the 1970s The Henderson Report[22] and the Asprey Review[23] drew attention to the impact of the tax transfer system on Australian families in poverty. At that time the family benefits available were primarily through the tax system, which had a regressive effect. From 1976 the system was restructured to pay more generous

16 OECD, 'Growing Unequal? Income Distribution and Poverty in OECD Countries' (OECD, 2008).
17 At p 104.
18 Above at p 106.
19 Above at p 31, Table 1.2.
20 Peter Whiteford, 'Transfer Issues and Directions for Reform: Australian Transfer Policy in Comparative Perspective' (Paper presented at the Australia's Future Tax and Transfer Policy Conference, Melbourne, July 2008).
21 Above note 2.
22 Ronald F Henderson (Chair), 'Poverty in Australia' (Australian Government Commission of Inquiry into Poverty, 1975).
23 above note 4.

Family Allowances in relation to children, while leaving the spouse component in the tax system as a tax rebate. The Family Allowance was initially a non means-tested universal transfer benefit, payable to all families with children, based on the number of children in the family. A supplement for low income earners was introduced in 1983 to assist low income working families.

Means testing was introduced progressively from 1985, applying a family income test firstly in relation to students over 18, then students over 16 until the Family Allowance was fully means tested with effect from October 1987.

This basic structure remains the basis of family benefits, although it has been modified several times over this period, and was renamed the Family Tax Benefit in 2000 as part of the "New Tax System" changes. FTB Part A has replaced Family Allowance and the Family Allowance Supplement. It incorporates two income tests: low income earners are entitled to a higher level of benefit which is withdrawn at 20c per dollar when family income exceeds $45,114. The base rate of FTB is then payable until the second income threshold is reached. The second income test excludes high income earners by withdrawing benefits at 30c per dollar when family income exceeds $94,316 (approx. 1.5 times AWE). The Dependent Spouse Rebate became FTB Part B in 2000, which is now paid as a transfer payment and is income tested against spouse earnings. Further, under changes implemented in 2008 no benefit is payable where family income exceeds $150,000 in a year.

The means testing of Family Allowance was introduced in the same time frame as changes to the progressivity of the income tax rate structure, although the two measures were not linked as policy measures. In 1985 the Review of the Australian Tax System[24] proposed substantial changes to the income tax rates. These changes were proposed in the context of the introduction of a GST, although this reform did not occur until 2000. The flattening of the income tax rates continued through the 1990's, with the highest rate being progressively reduced to the current level of 45% and the width of the bands being progressively broadened. Although Table 1 does not reflect wage inflation, by 2007 – 08 the maximum personal income tax rate cut in at more than 4 times the income level in 1988, while average weekly earnings have increased by slightly less than 300%.

24 Australian Treasury, 'Reform of the Australian Tax System - Draft White Paper' (June 1985).

*Table 1: Change in marginal tax rates following RATS*

| 1983-4 (AWE = $388)[25] | Marginal rates | 1987-8 (AWE = $532) | Marginal rates | 2007-8 (AWE = $1,132) | Marginal rates |
|---|---|---|---|---|---|
| 1–$4,594 | Nil | $1–$5,100 | Nil | $1 - $6,000 | Nil |
| $4,595–$19,499 | 30 % | $5,101–$12,600 | 24 % | $6,001-$34,000 | 15% |
| | | $12,601–$19,500 | 29 % | $34,001-$75,000 | 30% |
| $19,500–$35,787 | 46 % | $19,501–$35,000 | 40 % | $75,001-$150,000 | 40% |
| $35,788 and over | 60 % | $35,001 and over | 49 % | $150,000 and over | 45% |
| Medicare Levy | | | | | |
| Over $7,050 | 0.416% | Over $8,980 | 1.25% | Over $19,695 | 1.5% |
| Low Income Rebate | | Introduced 1993-4 | | | |
| | | < $20,700 | $150 | < $25,000 | $750 |
| | | $20,700 – $24,450 | Reduced by 4c / $ | $25,000 – $48,751 | Reduced by 4c / $ |
| | | > $24,450 | nil | > $48,751 | Nil |

25 AWE based on Male Full-Time Adult Ordinary Time Earnings. ABS data series 6302.0, accessed 10 Dec 2010.

It is the combined effect of these two changes that Apps and Rees criticise: the application of means testing to family benefits with the flattening of the official marginal tax rates, resulting in a higher EMTR for a middle income family in the withdrawal zone than for a high income earner.

## 3 The role of universal benefits in the modern welfare state

The debate over whether benefits should be universal or means tested ranges beyond the economic impacts and requires an understanding of political and sociological institutional theory. The provision of social services and benefits is a feature of the political institution commonly referred to as a welfare state, a term that is used to refer to a state that provides some level of welfare to its citizens. However the basis of the provision of that welfare can take a number of forms and a number of frameworks have been developed to classify welfare states according to the benefits provided.

The most common classification of the welfare states comes from the work of Esping-Andersen[26] who classified the welfare states as liberal welfare states, corporatist states or social democracies. In making this classification one of the features of welfare states that he took into account is whether benefits in the welfare system are universal; i.e. available to all citizens. Applying his criteria against the three regime types, in a liberal welfare state universal benefits are modest with means testing being used to target benefits, while in a social democracy most benefits are universal. A corporatist state will apply benefits to certain categories, often occupationally based. Australia is generally classified under the Esping Andersen classification as a liberal welfare state.

Korpi and Palme[27] subsequently developed a framework based on the basis of entitlement and the level of benefits, providing a more refined means of analysis. Under this framework only the "Basic Security" model can be described as universal as it provides flat rate benefits based on either citizenship or contributions.

26 Gosta Esping-Andersen, *The Three Worlds of Welfare Capitalism* (Polity Press, 1990).

27 Walter Korpi and Joakim Palme, 'The Paradox of Redistribution and Strategies of Equality: Welfare State Institutions, Inequality, and Poverty in the Western Countries' (1998) 63(5) *American Sociological Review* 661.

*Table 2: Ideal-typical models of social insurance institutions*[28].

| Model | Bases of Entitlement | Benefit Level Principle |
|---|---|---|
| Targeted | Proven Need | Minimum |
| Voluntary State Subsidised | Membership or Contributions | Flat Rate or Earnings-related |
| Corporatist | Occupational Category and Labor Force Participation | Earnings-related<br>Employer and Employee cooperate in governance |
| Basic Security | Citizenship or Contributions | Minimum |
| Encompassing | Citizenship and Labor force participation | Flat Rate and earnings-related |

Under the Korpi and Palme framework Australia would be classified as a targeted welfare system. Basic benefits are provided, but benefits above the minimum level are provided through market systems, for example through private superannuation or health insurance.

Having said that, family benefits are a special case as the payment of benefits, while targeted to those families in most need, extends to recipients that would not be considered to be in proven need. There are two policy reasons that contribute to the special treatment of family benefits:

- The principle of horizontal equity requires that a person's family circumstances should be taken into account when establishing tax levels, and the Family Tax Benefit is an extension of the tax system; and
- The current Family Tax Benefit has evolved from a universal payment, and although the principle of universality has been lost, remnants exist in the structure and basis of entitlement.

Equity in the tax system is generally categorised as horizontal equity and vertical equity. These have been summarised as:

> "The concepts of horizontal and vertical equity are refinements of the ability to pay principle. Horizontal equity requires individuals in the same economic position to be treated the same by the tax transfer system. Vertical equity is generally considered to mean that individuals in different economic positions should be treated differently, usually with those having greater economic capacity paying more."[29]

28 Above, Table 1 at p 666.

29 Australian Treasury, 'Architecture of Australia's Tax and Transfer System' (Australian Government, August 2008) <http://taxreview.treasury.gov.au/Content/Content.aspx?doc=html/home.htm>.

The difficulty in applying the principle of horizontal equity is in determining when individuals are in the same economic position. It is generally accepted that family circumstances are relevant in determining the ability to pay taxes. Early studies in England in the early 20th century[30]showed that family size is among the factors contributing to child poverty, and this finding is still supported by the evidence today[31]. It is on this basis that family support has been provided through the tax transfer system.

Family payments in Australia were paid on a universal basis from the introduction of Child Endowment in 1941 as an adjunct to the minimum wage policy until means testing was applied to the Family Allowance in 1985[32]. The Commission on Poverty[33] regarded Child Endowment as a measure of horizontal equity, on the basis that the taxpayer had an obligation to assist families where wages were insufficient to ensure that a family with a working parent did not fall into poverty. As an implementation of horizontal equity, all families who met the criteria of having the required number of children were eligible for the benefit, whether the family was at risk of poverty or not.

In Australia most income support benefits are based on vertical equity principles, but the base rate of family benefits extends to middle income families, leading to criticism of the FTB as "middle class welfare". However another consequence of the high withdrawal threshold combined with the withdrawal rate is that there are more recipients in the withdrawal zone who are subjected to the higher effective marginal tax rates.

Discussion of universal benefits may be linked to principles of citizenship. Citizenship is most commonly viewed through two theoretical frameworks. Liberalism regards citizenship as a matter of an individual's rights as a member of a society, whereas civic republicanism focuses on the obligations that an individual has within the wider community. In the liberal tradition citizenship is seen as an inclusiveness, under which all members of society have specified rights – although Lister points out that this also confers an exclusiveness that can be used to exclude non-members, as seen in the current debate over global migration and refugees[34].

Applying this perspective to the tax transfer system, if society has an obligation to support families, then under the principle of horizontal equity all families are entitled to that support. This argument relies on the obligation of the community

30 Joan C Brown, *The Future of Family Income Support* (Policy Studies Institute, 1987); John Macnicol, *The Movement for Family Allowances, 1918-45: A Study in Social Policy Development,* Studies in Social Policy and Welfare (Heinemann, 1980).

31 See Henderson, above note 22 at p 661; Jonathan Bradshaw, 'Child Poverty in Large Families' (Joseph Rowntree Institute, 2006).

32 For a history of Child Endowment see Bettina Cass, 'Redistribution to Children and to Mothers: A History of Child Endowment and Family Allowances' in Cora V Baldock and Bettina Cass (eds), *Women, Social Welfare and the State*, Studies in Society (Allen & Unwin, 1988 ed, 1988).

33 Above note 22 at page 62.

34 Ruth Lister, 'Dialectics of Citizenship' (1997) 12(4) *Hypatia* 6.

to support families as an end in itself to strengthen that community, rather than on whether particular families are at risk of poverty. However citizenship rights can also be anchored in need, allowing the differentiation of rights[35] though income testing. Income testing has two main functions: to increase benefits to those families at risk of poverty (means testing), and to reduce payments to those families that are regarded as having sufficient income (affluence testing). Income testing changes the nature of a welfare state from one based on citizenship rights to a residualist system, where only those who cannot be provided for by various market mechanisms are entitled to support through the tax transfer system[36].

Korpi and Palme refer to "The Paradox of Redistribution":

> "The more we target the poor and the more concerned we are with creating equality via public transfers to all, the less likely we are to reduce poverty and inequality"[37].

They conclude that it is the structural institutions of a society that will have the most impact on the ability to reduce inequality. While targeting may transfer resources to the poor, the best way to reduce inequality is through the development of integrative programs available across all levels of society.

## 4 Institutionalist analysis

Institutional theory examines events through the lens of institutions and actors to understand how public policies have developed. This may be through an understanding of the formal and informal institutions involved in setting a policy direction, and/or through an understanding of the prevailing politics[38].

### Role of institutions

A significant structural feature of public institutions that may impact on the ability to achieve a particular policy objective is the number of "veto points" where a policy may be blocked. Where a system incorporates a number of veto points, these must be negotiated in order for the policy to be implemented[39].

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35 Above at p 17.

36 Duane Swank, 'Political Institutions and Welfare State Restructuring' in Paul Pierson (ed), *The New Politics of the Welfare State* (Oxford : Oxford University Press, 2001) 197.

37 Above note 27 at p 661.

38 Above note 3. See also John Campbell, 'Recent Trends in Institutional Political Economy' (1997) 18(7/8) *International Journal of Sociology and Social Policy* ; Peter A. Hall and Rosemary C. R. Taylor, 'Political Science and the Three New Institutionalisms' (1996) 44(5) *Political Studies* 936; Francis G Castles, 'the Institutional Design of the Australian Welfare State' (1997) 2 *International Social Security Review* 25.

39 Giuliano Bonoli, 'Political Institutions, Veto Points, and the Process of Welfare State Adaptation' in Paul Pierson (ed), *The New Politics of the Welfare State* (Oxford : Oxford University Press, 2001) 238.

The Australian Federal system of government policy change involves complex intergovernmental relationships, with multiple veto points. Most policies involve the cooperation of state and federal, and possibly also local, levels of government; and it is rare for these governments all to be of the same political persuasion. Further, Federal and State (other than Queensland) governments have a bicameral system of government, requiring negotiation of change through two houses of Parliament. While it is relatively recent for a government not to hold power in the lower houses where Government is formed, for most of the past twenty five years the Federal Government has had to deal with a Senate that is either hostile or has a third party holding the balance of power, as have most State governments from time to time. Within this dynamic, when in government the conservative parties operate in coalition, and the Australian Labour Party operates through a factional power basis – and these partners do not always have a common policy interest.

Clearly the negotiation of a major policy change through this system is a complex task. This has led to claims of "mandate" in Australian politics, under which a government announces a policy prior to election and, when elected, claims the right to implement that policy.

## Actors v institutions

In addition to the formal institution of government, there are other groups that have an interest in particular policies. Institutional theory recognises three key groups of actors that may have an influence on the development of a particular policy[40].

First are Interest Groups, groups of individuals drawn together by an interest in a particular policy and a shared view of the preferred outcomes.

In the context of Australian public policy development over the past twenty five years, the role of various interest groups has been important. The influence of the union movement over policy has varied from time to time, but during the period from 1983 to 1996 the Hawke-Keating Government and the union movement entered into the Prices and Incomes Accord.

> "The accord covered every area of domestic concern: the economy, industrial relations, tax, welfare, foreign investment, health, education, industry and immigration. Prior consultation with the unions was required for virtually all government decision making....[The document contained] .... a shift in union emphasis from money wages to the social wage in recognition that living standards were set not just by income but by the full range of benefits the government provided through tax, health insurance, education and welfare."[41]

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40 James G. March and Johan P. Olsen, 'The New Institutionalism: Organizational Factors in Political Life' (1984) 78(3) *The American Political Science Review* 734; Paul Pierson, 'Big, Slow-moving, and...Invisible: Macrosocial Processes in the Study of Comparative Politics' in James Mahoney and Dietrich Rueschemeyer (eds), *Comparative Historical Analysis in the Social Sciences* (Cambridge University Press, 2003).

41 Paul Kelly, *The End of Certainty* (Allen & Unwin, 1992) at page 62.

Some of the outcomes of the Accord included the superannuation guarantee levy, Medicare, the 1985 Review of the Australian Tax System, the expansion of childcare provision, childcare subsidies and fee relief, and the 1986 Social Security Review.

Other organisations with an interest in this area of public policy include women's groups and welfare organisations. In the 1970s and 1980s women's' groups[42] were very influential in framing government policies – to the extent that the Hawke Government established the Office of the Status of Women and required a women's budget analysis of policy proposals. Women working in government became known as femocrats, recognising the feminist influence on the bureaucracy[43].

Non government agencies and welfare organisations[44] have also played an important role in advocating for the poor and disadvantaged. Welfare groups working with people in receipt of benefits act as advocates, and are often also engaged in the delivery of services on behalf of the government. These organisations frequently engage policy advisors to research review and analyse the effect of welfare reform on their clients, and it is usual to see submissions from such organisations into tax transfer reform[45].

Secondly, government elites are those engaged in working with the system. Administrators have an interest in designing a policy that not only achieves the policy goals, but that is simple and efficient to administer. Senior administrators usually have a significant input into the practical design features of the tax transfer system, which can impact on the extent to which change is implemented.

There is an interdependent relationship between interest groups and government elites. This relationship may result in regulatory capture as a natural consequence of regular interaction between parties to a regulatory regime. Interest groups need to persuade the regulators that a particular course of action is the appropriate course of action, while the government needs their cooperation to ensure that a policy is workable. Interest groups may also influence government decision making through personal networks, political donations, public media campaigns or other means[46]. While corruption is rare in the Australian environment, the regulatory regime may

42 For example the Women's Electoral Lobby; Country Women's Association; National Foundation for Australian Women.

43 Sara Dowse, 'The Women's Movement's Fandango with the State: The Movement's Role in Public Policy since 1972' in Cora V Baldock and Bettina Cass (eds), *Women, Social Welfare and the State*, Studies in Society (Allen & Unwin, 1988 ed, 1988).

44 For example the Australian Council of Social Services and its state and territory councils; the Brotherhood of St Lawrence; the National Welfare Rights Network.

45 For example the Henry Review received more than 1500 submissions, including submissions from Anglicare Australia, ACOSS, Catholic Social Services Australia, Council of Single Mothers and their Children, Isolated Children Parents Association, National Disability Services, National Welfare Rights Network, Oxfam Australia, Australian Conservation Foundation, UnitingCare Australia, UnitingJustice Australia, Community Housing Federation of Australia, National Foundation for Australian Women, Women's Electoral Lobby and World Vision Australia.

46 Jean-Jacques Laffont and Jean Tirole, 'The Politics of Government Decision-Making: A Theory of Regulatory capture ' (1991) 106(4) *The Quarterly Journal of Economics* 1089.

take steps to limit this risk, leading to increased bureaucratisation of the government agency and increased complexity for all actors[47].

The third group of actors is the mass public. Democracies in particular must engage with the public in developing acceptable policies as the electoral outcomes depend on how the public perceives these polices. Where the public understands and is familiar with an existing policy it will tend to have a "lock-in" effect – i.e. the public will need to be persuaded that change is necessary, which often requires a process of negotiation and trade-offs[48]. In a democratic system, failure to persuade the public will result in an electoral backlash. For example, in 2001, after the introduction of the GST in 2000, there was a series of state and territory elections that showed a strong swing against the Liberal Party and the Australian Democrats who were seen as responsible for the GST. This resulted in swift and significant changes to some of the administrative aspects of the New Tax System.

## Institutional pathways

Institutional theory relies on pathways to trace the development of specific policies. In particular the theory of path dependency considers the difficulties in implementing reforms when a policy is under review. Policy change can be classified as transformative or incremental[49]. From time to time a turning point emerges when a major change in direction is proposed, and the challenge is to manage this disruption without the system breaking down. Streeck and Thelen categorise the type of change and the outcome as follows:

***Table 3: Types of institutional change: processes and results***[50]

<table>
<tr><th colspan="2" rowspan="2"></th><th colspan="2">Result of Change</th></tr>
<tr><th>Continuity</th><th>Discontinuity</th></tr>
<tr><th rowspan="2">Process of Change</th><td>Incremental</td><td>Reproduction by adaptation</td><td>Gradual Transformation</td></tr>
<tr><td>Disruptive</td><td>Survival and return</td><td>Breakdown and replacement</td></tr>
</table>

Major reform processes are an example of disruptive change. The challenge for governments is to ensure that the reform results in continuity rather than in breakdown of the system. However most reforms are implemented through incremental change

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47 David Martimort, 'The Life Cycle of Regulatory Agencies: Dynamic Capture and Transaction Costs' (1999) 66(4) *Review of Economic Studies* 929.

48 Above note 40.

49 Wolfgang Streeck and Kathleen Ann Thelen, 'Beyond Continuity: Institutional Change in Advanced Political Economies' in Wolfgang Streeck and Kathleen Ann Thelen (eds), *Beyond Continuity: Institutional Change in Advanced Political Economies* (Oxford University Press, 2005).

50 Above, Figure 1.1, at page 9.

that may through a process of gradual transformation ultimately produce a system that is very different from the starting point.

Policies develop and evolve incrementally based on feedback loops. These feedback loops reflect the interests and experiences of the actors. For example the government elite group may be concerned with their capacity to learn and administer a new system, whereas interest groups are more concerned with matching the system to their view of the preferred outcomes. The mass public is generally concerned with the effect of moving from a system that they are familiar with to a new system that will have to be relearned, or the "lock-in effect". Interest groups and the public will also be concerned to hold the policy makers accountable if the change does not meet their expectations[51].

Most tax transfer reform is incremental reform. The introduction of the GST in Australia in 2000 was marketed as a major tax reform, and to the extent that the sales tax and the abolition of some of the state taxes were replaced by the GST there was a significant reform. However most of the other changes introduced as part of the "A New Tax System" package were in fact incremental reform: the flattening of income tax scales continued an existing trend, and the restructuring of Family Tax Benefits merely combined existing benefits into one complex structure.

### *Globalisation*

Institutionalist theorists have been engaged in debate over the implications of increased globalisation over the past twenty five years, and the consequences that this has had on domestic taxation policies. Globally, developed economies experienced a period of growth following the Second World War that coincided with the development of welfare state regimes and growth in the public sector. This so-called "golden age" came to an end in the 1970's largely as a result of impact that the oil price shocks had on economies reliant on oil. Economies generally opened up to globalisation through the abandonment of the Bretton Woods gold standard, increased international trade and the creation of the currency market.

Tax policy in Australia and other developed economies is now largely dominated by discussion of the impact of the globalisation of the economy, and the consequences of the movement of capital and labour between countries. Meade[52] was among the first to discuss the implications of internationalisation on domestic tax regimes. Subsequent tax reviews in Australia have given various degrees of prominence to the issue of mobility of capital and labour[53]

51 Paul Pierson, 'Review: When Effect Becomes Cause: Policy Feedback and Political Change' (1993) 45(4) *World Politics* 595.

52 J E Meade, 'The Structure and Reform of Direct Taxation' (Allen and Unwin, 1978).

53 Australian Treasury, 'Reform of the Australian Tax System - Draft White Paper' (June 1985);Review of Business Tax (Ralph Review) 1999; Review of International Tax Arrangements 2002; Australia's Future tax System (Henry Review) 2010.

One of the most commonly cited reasons for the lowering of corporate tax rates and maximum personal tax rates is based on the mobility of capital and income. It is argued firstly that capital is more mobile than labour, and that investment is driven by the after tax rate of return. The trend across the OECD has been for declining corporate tax rates, with an average rate of 32.5% - slightly higher than the Australian corporate rate of 30%[54]. A flow on effect of the lower corporate tax rate is downward pressure on top personal marginal tax rates. Where there is a significant difference between corporate and personal income tax rates there is the opportunity for taxpayers who are earning income that is not from their personal labour to structure their affairs to take advantage of the arbitrage between their tax rate and the corporate tax rate. While the design of the Australian dividend franking system should ensure that the personal marginal rate of tax is ultimately payable, there are significant deferral and alienation opportunities. Further, the franking system is not neutral in its impact on residents and non-residents.

While most discussion of globalisation has been in the context of movement of capital, there is also some concern about increased mobility of labour. In the absence of a schedular system of taxation,[55] income from investment is taxed to an individual at the same marginal rates of tax as income from labour. There are arguments that skilled labour can more easily obtain work overseas, and that "people's choices about where to work may become more sensitive to tax"[56], however decisions on where to live and work are more complex than decisions on where to invest capital[57], involving personal as well as economic decisions.

In the context of transfer payments, although capital investments and income from those investments are relevant in the application of income tests, the most significant impact of the effective marginal tax rate is the workforce participation impact. High income earners are more likely to be in receipt of investment income, and are also more likely to be highly skilled and able to relocate for employment reasons; accordingly they are more likely to be responsive to changes in income tax rates at the highest marginal tax rates. The withdrawal rates for transfer payments are not likely to be a major consideration as the application of the affluence test would limit any entitlement.

### *Fiscal tightening*

However evidence suggests that domestic tax policy is less sensitive to the effect of globalisation than expected. Swank and Steinmo[58] argue that the evidence shows that although statutory tax rates of developed capitalist countries have been cut in

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54 Note 29 at p 210.

55 Above note 1 see recommendation 14.

56 Above at p 6.

57 This paper will not discuss the concepts of residence and source in determining jurisdiction.

58 Duane Swank and Sven Steinmo, 'The New Political Economy of Taxation in Advanced Capitalist Democracies' (2002) 46(3) *American Journal of Political Science* 642.

anticipation of the effects of increased capital mobility, the tax burden has not been significantly affected by these changes.

They argue that the effects of globalisation are moderated by domestic economic change, fiscal constraints and internationalisation. Although globalisation exerts downward pressure on tax rates, domestic conditions generate demand for increased spending, requiring governments to maintain the overall tax burden. Accordingly this must come from other tax policy changes, for example the rationalisation of tax expenditures. They note a significant cut in general investment incentives between 1981 and 1992 across the countries examined[59].

It is worth noting that over the period being examined in this article, which was based on data from 1981 to 1995, the developed economies were dealing with adverse economic conditions when structural unemployment was the most significant domestic economic policy issue. During the 2000s but prior to the downturn of 2007-08 global economic conditions improved, however current OECD data on the tax burden bears out their conclusion[60].

In the Australian context the tax mix shifted with the implementation of the GST in 2000, however the overall increase in tax collections as a % of GDP arose from the resources boom through increased corporate tax collections and mining taxes.

***Table 4: Tax revenue as % of GDP: Australia***[61]

| | 1990 | 1995 | 2005 |
|---|---|---|---|
| Total Tax Revenue | 28 | 29 | 31 |
| Personal Income Taxes | 12 | 12 | 11 |
| Other Taxes | 16 | 17 | 19 |

Swank also examined the impact of democratic institutions on the welfare state[62]. In a time of fiscal restraint and welfare state restructuring, the process of managing that change will be largely dependent on the institutional structures of that country. Social corporatists have a history of negotiated pacts, and this will be incorporated into the reform process. Econometric modelling of the impact of political institutions on globalisation and fiscal factors shows that where a country has centralised policy processes and a universal basis of entitlements, political institutions are more likely to resist neoliberal reforms and have a significant impact on policy outcomes. However where a country has decentralised processes, electoral inclusiveness, and adopts social corporatism or liberal principles as a basis of entitlement, political institutions have less impact on the reform process.

59 Above at p 643, Table 1.
60 OECD, 'Taxing Wages 2007-2008' (OECD, 2009).
61 Above, extracted from Table A1 page 476.
62 Above note 36.

This seems to hold true in the Australian case. Australia has a federal, dispersed, model of government which is elected; and is generally classified as a liberal democracy under which the government and the market work together to ensure a stable economy and the rights of citizens. During the 1980s the Federal Government (Hawke, Labor) adopted a more centralised approach to policy making, as evidenced by the Accord with the union movement, however with the change of government to the Howard coalition government the policy making process returned to a more liberal democratic, market based model.

### *Changes in family structures and workforce participation*

Family tax transfer systems are also sensitive to changes in family structures and workforce participation patterns. Over the last thirty years there have been significant changes in the way in which women participate in the workforce in Australia and other OECD countries. This has been described as a shift from the "male breadwinner" model typified by a family where the adult male is the main breadwinner, with the adult female undertaking the majority of the family based care to the "adult worker" model where the adult female is undertaking more paid work[63]. This increased participation in the labour market is not, of itself, a bad thing, as it can lead to improved long term financial security for women, and a reduction in the feminisation of poverty.

Women's workforce participation rates are highly elastic, particularly during the period that mothers are juggling child rearing duties with paid work[64]. Decisions as to whether a mother will work, and the extent to which she will work, are affected not only by taxation considerations, but also by the need to purchase services to replace those she would normally provide – particularly child care and other domestic services.

The FTB creates incentives to limit the carer's paid work. Two separate means tests are applied to the combined benefit: a means test for FTBA based on family income and a separate means test for FTBB based on the income of the secondary earner. The withdrawal rate for a mother earning between $4,000 and $20,000 can be 40% before taking personal tax rates into account. The impact of the high EMTR applied on the earnings of the secondary earner can be a strong disincentive to increase participation, particularly where a woman is balancing caring responsibilities with that participation, and it impacts more on low income families than higher income families[65]. Accordingly the profile of the average Australian family with young children is one full time worker and one part time worker[66] - a 1.5 worker model.

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63 Jane Lewis and S Giullari, above note 8.

64 Patricia Apps, above note 8.

65 Matthew Toohey and Gillian Beer, 'Is it worth working now? Financial incentives for working mothers under Australia's new tax system' (NATSEM, 2003) http://www.canberra.edu.au/centres/natsem/publications.

66 Australian Bureau of Statistics, '6202.0 Labour Force Australia' (accessed at 10 December 2010).

## 5 Institutional turning points in Australia since 1985

To apply this analysis in an Australian context, there have been a number of significant reports over the past twenty five years that have contributed to the current structure of the tax transfer system in Australia that have resulted in significant disruptive change. However, overall the impact on the progressivity of the system, as criticised by Apps and Rees[67], is more of a gradual transformation.

### 1985: Reform of the Australian tax aystem

In 1985 a range of tax reforms were proposed in the Draft White Paper "Reform of the Australian Tax System"[68] , which were debated at the 1985 National Tax Summit. This Tax Summit was called by the Hawke (Labor) Government following the 1984 election to facilitate debate on future tax reforms, by invited stakeholders. In the spirit of the Accord, the Government was seeking consensus among stakeholders, particularly business and the union movement. The major issues addressed in the Draft White paper were related to broadening the tax base and tax avoidance issues. In many respects the paper followed up on reforms proposed by the Asprey Committee a decade earlier: the introduction of a broad based consumption tax (although this did not eventuate for another fifteen years); a capital gains tax; dividend imputation and a fringe benefits tax.

The paper did revisit the question of whether the unit for personal income tax should be based on individuals or families. The two concerns noted[69] were the use of income splitting structures and devices to reduce tax and the consequence of the progressive tax scales on single income families relative to two income families.

The paper recommended no change to the individual basis for income tax on the grounds of equity between individuals, and economic efficiency as it encourages women's participation in the workforce which was consistent with government policy to promote equal opportunity and economic independence for women.

In considering the existing recognition of family circumstances through the dependent spouse rebate and the sole parent rebate the government decided not to recommend any changes to those rebates, with the Family Allowance remaining as a transfer payment. The paper also reviewed the problems that arose from means tested Social Security payments although at that stage the Family Allowance was not yet means tested.

The White Paper recommendations to reduce income tax rates relied substantially on comprehensive reform that included the introduction of a Broad Based Consumption Tax that would allow reductions in income tax rates for lower income earners, and

67 See note 2.

68 Above note 24.

69 Above, Chapter 6.

compensatory packages for lower income earners[70]. One form of compensation that was contemplated was the extension of the Family Income Support Scheme. There were no specific proposals regarding reform of withdrawal rates, as the drafters relied on the proposed income tax rate reductions to address the high effective marginal tax rates imposed by the combined effects of the two systems.

The proposed packages incorporating the consumption tax were rejected at the National tax Summit held in June 1985, with the government proceeding with a number of base broadening measures that did not include a consumption tax. These measures included the Capital Gains Tax, the Fringe Benefits Tax, Dividend Imputation and changes to the taxation of Foreign Source Income. It would be fair to regard these measures as major, transformative reform, but in relation to the structure of the tax transfer system, the changes were more in the nature of incremental reform.

The income tax cuts were phased in over a number of years, with the new structure emerging by the 1987–8 year. The biggest tax cuts were at the highest tax brackets, with reductions from 60% to 49% and corporate tax rates reducing from 49% to 36%. A new tax bracket emerged for the lowest low income earners, but this was not in the order contemplated by Option C which would have seen a tax rate of 20% applying on incomes up to $19,500[71].

## 1986: Social security review

In the following year the Social Security Review[72] considered the relationship between horizontal and vertical equity more explicitly than the Commission on Poverty[73]. The discussion paper raised the following issues in relation to universal benefits:

In favour of universal benefits:

- All families with children incur additional costs as a result;
- Means testing has work disincentives
- EMTR's are not increased by the withdrawal of benefits, in contrast to a means tested system
- Universality reduces the stigma that recipients of income tested benefits may suffer
- The distribution of the tax burden between people with and without children is more balanced

Against universal benefits:

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70 Options B & C.

71 See Table 1 for details of the Income Tax Scales implemented by RATS.

72 Bettina Cass, 'Income Support for Families with Children' (Issue Paper No 1, Department of Social Security, 1986).

73 Above note 22.

- Where resources are limited, priority should be given to those families in most need
- The same amount of government resources can assist more low income families if means tested
- Higher income families do not require this assistance.

These arguments can be considered under the headings of citizenship, disincentive effects, fiscal constraint and equity.

The citizenship argument in support of universal benefits is based on the view that society has an obligation to support all families, based on their status as members of society. This support should be recognised as a right and not a handout. However the counter argument reflects the view that if a family does not need that assistance, they have an obligation to support those families that are in need by foregoing that benefit.

As pointed out by Apps and Rees[74] income testing can create disincentive effects, and be considered a form of taxation, as the withdrawal of benefits contributes to a high EMTR when the combined effect of the tax and transfer system are taken into account. This has a particular impact on the secondary earner in a family as they are more likely to be in the area of the "inverted U" where the withdrawal of benefits results in a marginal tax rate well in excess of the official marginal tax rate. This can result in reduced workforce participation rates by married women.

Governments are also concerned with fiscal constraints when determining benefit entitlements. Transfer payments are the largest area of government spending, with family benefits reflecting a significant component of those payments. There is a clear connection between progressive marginal tax rates and transfer payments. However where benefits are universal, taxpayers may be entitled to a return of some of the taxes paid as transfer payments – a process known as "churn". An alternative to means testing would be to include family benefits in the assessable income of the recipient, ensuring that the benefits are clawed back through the tax system, at the top personal marginal rate of tax. However taxing the family allowance in a system based on personal income requires consideration of how the family income is to be taken into account. For reasons of gender equity[75] family benefits are usually paid to the carer, who is also likely to be the lower income earner. To achieve the desired policy effect, the benefit would need to be taxed based on aggregated income.

Finally the question of whether universal payments are more or less equitable than targeted payments comes back to an assessment of whether horizontal or vertical equity should be given priority. If comparing families with children with taxpayers who do not have children, then a universal benefit does deliver a measure of horizontal equity. However, if the goal is to ensure that those families in need have access to adequate levels of income, then they need income support payments in excess of that

74 Above note 2.
75 Bettina Cass and Deborah Brennan, above note 8.

available to families that have adequate earned income. The real issue, as Apps and Rees[76] show, is not the redirection of benefits to low income earners, but that average earners now bear the highest EMTR as a result of the flattening of the marginal tax rates at the higher end of the income range.

The Social Security Review did not specifically endorse a move to means testing of Family Allowance, but it heralded a period of reform under which targeting of payments became the main driver of the Australian transfer system. In 1984 the value of tax and transfer payments to families was below the average for OECD countries. Over the next two decades the increased targeting resulted in Australia's tax transfer system being recognised as one of the most targeted in the OECD[77].

## 1996: Family tax initiative

After the election of the Howard Government in 1996 there were two significant changes to the family tax transfer system, both of which could be classified as "Abrupt and Discontinuous change", and both of which were subsequently abandoned.

One of the centrepieces of the election platform for the Liberal Party In the 1996 election was the introduction of a Family Tax Package paid through the tax system. Howard also committed the coalition to maintaining the family components built into the existing social security system. In particular this meant that the Family Allowance and the Family Allowance Supplement would continue to be paid to the principal carer as a transfer payment[78].

The FTI package was implemented with effect from the 1997 income tax year. The tax threshold for eligible families, including sole parents, was increased by $1,000 for each child in the family with a further increase of $2,500 if there was a child under the age of five in the household. These increased thresholds were subject to an income test of $70,000 increased by $3,000 per child. At the prevailing tax rate of 20%, this was effectively a tax cut of $200 per child with a further $500 if there was a child under the age of five.

Criticisms of previous systems that providing family relief through the tax system ignored the needs of families that were not taxpayers were addressed by operating a parallel payment through the transfer system for families that earned less than $20,700 pa. The FTI could also be differentiated from previous tax deductions forms on equity grounds: by increasing the tax threshold the concession available was closer to a tax rebate than a deduction. As a deduction allows a tax concession at the claimant's marginal rate of tax, high income earners on higher levels of income obtain greater benefits. Raising the tax threshold effectively allows all claimants tax relief at

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76 Note 2.

77 Above note 16; note 20.

78 Equality Of Opportunity And Lifestyle Choice Policy Statement Liberal Party of Australia, *Coalition Policies 1996* Pandora, National Library of Australia http://nla.gov.au/nla.arc-10569; accessed 26 April 2011.

the lowest rate of tax: 20% at that time. The FTI lasted only four years, being dropped in 2001 when the Family Tax Benefit was introduced.

Secondly, in the 2001 election the Liberal Party promised to introduce one of the more controversial family payments of the Howard Government. The First Child Tax Offset, was a shortlived incentive, available only in relation to children born between 1/7/2001 and 30/6/2004, intended to assist families experiencing a drop in income after the birth of their child:

> "Recognising the family experiences a fluctuating income where the mother leaves the workforce to look after a child the coalition will introduce a system which effectively averages income over 5 years and allows a mother to claim back the tax paid on her income in the year prior to the birth of her child."[79]

The main elements were:

- It was available to parents following the birth, adoption or taking legal responsibility for the first child after 1/7/2001 (the child event);
- It was based on tax paid by the mother, allowing a tax offset of up to $2500 pa until the child turned five years of age;
- It was an income tested offset, with low income earners (earning less than $25,000 in the claim year) having a minimum entitlement of $500 pa
- It could be claimed through the tax system, by direct claim from the ATO or transferred to a spouse

Criticism of this offset centered around the equity issues: the more tax the mother paid, the more benefit was available up to a maximum of $12,500 over five years. This equated to a taxable income of $53,733 in 2004. Secondly, there needed to be a reduction in income to less than $25,000 pa for five years to maximise the claim. This second requirement ignored the reality that bringing up a family often requires a dual income; and that women earning incomes in excess of $50,000 are less likely to leave the workforce for a prolonged period of time.

The form of this offset breached the principle of vertical equity, as the offset was based on the amount of tax that the claimant paid in the base year. Clearly a person on a higher income had paid more tax, and therefore, over a five year period, benefited more from the tax offset. While the minimum and maximum claims did go some way to addressing this issue, it was possible for a high income earner who left work, and did not return to work before the child's fifth birthday, to receive $12,500 through the offset; while a low income earner may have received as little as $2,500. Although the rebate was available for the first child born after introduction of the offset, in circumstances where a person had left the workforce following the birth of a previous

79 Election Policy Liberal Party of Australia 2001 Pandora, National Library of Australia http://nla.gov.au/nla.arc-10569; accessed 26 April 2011.

child the offset was of less value as the claimant may have only qualified for the base rate of $500.

In the 2004 Federal Budget, the government responded to the criticism of the family tax benefit, and the first child offset, by repackaging the offset as a Maternity Payment, which became known as the Baby Bonus. A non means-tested lump sum of $3,000 became available in respect of the birth of each child born to a new mother after 30 June 2004[80].

## 2000: A new tax system

In the 1993 Federal election the Liberal Party had presented the electorate with a blueprint for tax reform that it labelled "Fightback", which incorporated a GST, welfare and tax reform. This was rejected by the electorate.

The Howard government took a new proposal to the 1998 federal election. In common with other proposals since 1975 it was based on the introduction of a consumption tax, with appropriate compensation for groups of taxpayers adversely impacted by the increased indirect tax. This was emphasised in the name, which packaged all of the measures together as "A New Tax System" bills.

Focussing on the measures relating to family support, as part of the compensation package the Howard government introduced the Family Tax Benefit from 1 July 2000, to replace the tax incentives and transfer payments that had been available to families. Whereas the 1996 election policy documents spelled out that most of the income support payments available to families would remain untouched by the implementation of the FTI, the ANTS reforms claimed to be simplifying the system.

However the structure of the Family Tax Benefit is remarkably similar to the former Family Allowance system. The component in relation to family size, FTBA, is income tested to increase benefits to low income families, consistent with the former Family Allowance Supplement and withdrawn from high income families, consistent with the former Family Allowance. The modified tax thresholds of the Family Tax Initiative were no longer available but they were incorporated in the rates of FTB payable. Tax offsets for spouses and sole parents in families with children were rebadged FTBB, with the option of taking it as a transfer payment. The rates were increased across the board, but particularly in relation to FTBB. This was justified as part of the compensation for the introduction of the GST.

From an institutional pathway perspective, it is interesting to note the response of the public to the delivery methods for the new payment. While these payments were labelled as tax benefits, claimants were allowed to claim their benefit either through the tax or the transfer system. Since inception, over 95% of claimants have received the benefit as a transfer payment to the primary carer. The nomenclature as a tax

80 Note that this is now an alternative to any Maternity Leave entitlement, which is not addressed in this paper.

benefit seems to have been for a number of reasons: the government could claim to have complied with its election commitments to provide tax credits for families; it was part of the "New Tax System" package introduced with the GST; and tax credits are less stigmatising in the eyes of recipients. However the public was familiar with the payment of the Family Allowance as a transfer benefit to the primary carer, and overwhelmingly chose to continue to receive the benefit in this way. Applying the Streeck and Thelen framework[81], this is an example of an incremental, continual change where the public simply continued doing business in the way that they had before.

## 2009: Australia's future tax aystem

It is not yet possible to examine the impact of the most recent review, the Henry Review[82], as its recommendations have not yet been put forward as policy proposals. In relation to the progressivity of the system and the interaction of the tax system with family transfer payments, the Henry Review made a number of recommendations[83].

> Recommendation 2: Progressivity in the tax and transfer system should be delivered through the personal income tax rates scale and transfer payments. A high tax-free threshold with a constant marginal rate for most people should be introduced to provide greater transparency and simplicity.
>
> Recommendation 4: Income support and supplementary payments should be tax-exempt.
>
> (a) Family assistance should remain exempt from tax because it addresses direct costs associated with children….
>
> Recommendation 89: Means testing for family assistance payments should be based on the same measure of taxable income as for income tax, including fringe benefits. However, payments should not be reduced as a result of the inclusion of compulsory superannuation contributions in taxable income. Consideration should be given to aligning the definitions of income and periods of assessment for family assistance payments more closely to those that apply to income support payments. However, this should not include deeming income on assets.

Apps and Rees[84] are critical of this structure as it is a continuation of the flatter tax rates that have been pursued since 1985. Although it incorporates the effect of the Low Income Tax Offset and the Medicare Levy, improving transparency, they argue that it will increase the burden on average two (or 1.5) income families. When taking the proposed discount on income from investments[85] into account, it further increases the workforce disincentives as income from labour would be taxed at a higher marginal rate than income from investments.

81 Above note 49.
82 Above note 1.
83 Above note 1 at 80,96,97.
84 Above note 2.
85 Above note 1, recommendation 14.

# 6 Conclusion

The development of the Family Tax Transfer system in Australia over the past twenty five years is an example of how public policy reform can evolve through a series of relatively minor changes to result in a system that has a different function and impact than the original system.

In the case of family transfer payments, the initial significant, disruptive, change was the imposition of means testing between 1985 and 1987. Changes since that time have involved relabelling, adjusting thresholds and withdrawal rates but the basic features of the system have remained. The impact of these changes, however, has been significant as other changes have occurred within Australian society and the economy.

In particular, more families are impacted by the withdrawal of benefits and accordingly face the workforce disincentive effects of the withdrawal of benefits as a result of:

- Higher workforce participation rates by mothers as the secondary, frequently part time, earner in a family
- The withdrawal rate of 30% at the higher income test extends the number of families in the range where income testing applies; and
- The level at which the higher income test applies is now about 1.5 times AWE compared to twice AWE when the test was introduced, which means that a typical family with one full time and one part time worker is likely to be in the withdrawal range for benefits.

Concurrently the income tax scale has been restructured. In particular concerns arising from the issues surrounding business taxes and the mobility of capital have been used to reduce the progressivity of the tax rate, with significant cuts in the highest personal marginal rates of tax and the corporate rate; and the Low Income Tax Offset was introduced to address concerns about vertical equity, but with an impact on the EMTR of taxpayers within the withdrawal range for that offset[86].

The proposal that has been put forward by Apps and Rees[87] is to restructure both the FTB and the personal income tax scales to restore the universality of benefits and the progressivity of tax rates. They are silent on whether there should be a claw back of benefits paid to high income earners through making the FTB taxable or through some other means.

While the evidence as to the impact of the current structure on different family types is clear from the analysis, the proposal does not take into consideration the likelihood of successfully applying the change. As an example of the reform pathways, the changes that have occurred since the implementation of means testing – which was itself phased in – have been incremental, discontinuous changes that have resulted

86 Similar concerns apply to the Medicare Levy.

87 Above note 2.

in a gradual transformation of the system. This system is now accepted by the mass public and administrative changes that have been implemented over the past decade, such as the FTI and the delivery mechanisms of the FTB, have evolved back to the systems understood by the public. The delivery mechanism for the FTB is now solely through the transfer system, as with the Family Allowance in 1985.

In relation to the flattening of the tax scales, while the links between the FTB and the progressivity of the tax system may not be well understood, increasing marginal tax rates would require Australia to move against international trends to lower the tax rates on capital, which is linked to setting the top personal marginal rate of tax. While studies show that the tax burden is less strongly linked to globalisation theory than may be intuitively believed, it is clear that business interest groups believe that this link does exist[88]. It is likely that these interest groups would mount a strong campaign to prevent this reform from proceeding.

It is also clear from the history of consumption tax reform in Australia that all major interest groups must be willing to participate in the tax reform process for it to succeed. In 1985 it was the opposition from the unions that caused the Broad Based Consumption Tax to fail at the Tax Summit; it was not implemented until after ACOSS and the Chamber of Commerce agreed twenty years later to discuss how a GST could be designed to be fairer. The current debate over the Carbon Tax faces similar hurdles.

While the mass public accepts that taxes must be paid in order for the government to provide the necessary transfer payments and services, they are resistant to tax increases; which increases the risk of tax minimisation by arbitraging any significant difference between business and personal tax rates. Where such major tax reform has been proposed in the past, it has generally involved a tradeoff between a visible reduction in tax rates with base broadening, which may be visible, as with the GST in 2000, or appear to be targeting those who can afford to pay, as with the CGT and FBT in 1985. There has been no increase in personal income tax rates since the end of the "Golden Era" in the 1970's, as tax increases have been through the removal of tax expenditures and changes in the tax mix.

While it may well be true that a return to the previous system of higher marginal tax rates and universal benefits, with an appropriate clawback, would have equity gains, institutional theory suggests that such a reform would be considered a radical reform. It would be disruptive, discontinuous reform that would not be likely to succeed.

The only way to make such a reform succeed would be with the support of all of the relevant interest groups who would negotiate the reform past the many veto points. Ultimately the mass public would have the final veto – at the ballot box.

88 As seen in numerous submissions to the Henry Review, the Ralph Review and the Reform of International Tax Arrangements – see note 53.

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