REFORMING AUSTRALIA'S HIDDEN WELFARE STATE

Tax expenditures as welfare for the rich

Dr Benjamin Spies-Butcher and Adam Stebbing

FEBRUARY 2009

CENTRE FOR POLICY DEVELOPMENT ISSN 1835-0135 OCCASIONAL PAPERS - NUMBER 6

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About the authors

Dr Benjamin Spies-Butcher

Dr Benjamin Spies-Butcher lectures in economic and political sociology at Macquarie University and is a fellow of the Centre for Policy Development. He has a PhD in Economics from the University of Sydney. His research focuses on the economics and politics of social policy, and on political participation. Ben previously worked as a Senior Researcher at the Edmund Rice Centre for Justice and Community Education on human rights issues. He is active in a number of non-government organizations and social movements, particularly around Indigenous rights and housing.

Adam Stebbing

Adam Stebbing is a social researcher broadly interested in the interactions of public policy and social inequality. He is currently undertaking a PhD in the Sociology department at Macquarie University. His doctoral research is focused on looking at how social tax expenditures alter our understanding of the Australian welfare state, in terms of its political development and distributional outcomes. He has previously undertaken research exploring how homeless people experience citizenship in Australia.

About this paper

This paper was subject to a peer review process. Thanks to those who contributed their ideas and feedback. Views expressed in the CPD Occasional Papers series are those of the authors and do not necessarily reflect those of the CPD.

REFORMING AUSTRALIA'S HIDDENT WELFARE STATE: TAX EXPENDITURES AS WELFARE FOR THE RICH

Main Points

As Australia enters recession and the Budget enters deficit, one of the least effective and most unfair forms of government spending has increased dramatically. Tax expenditures (for example, tax breaks on superannuation, the private health insurance and childcare rebates, and housing concessions) are increasing in number and cost, despite being significantly less equitable than other forms of government assistance.

Because tax expenditures do not go through the same review process as normal government spending, they tend to be less accountable and transparent. As a result, tax expenditures attract less media attention and less democratic scrutiny. It is essential that their growing slice of Commonwealth spending be scrutinised and, in some cases, reconsidered.

Case study: superannuation

This paper outlines possible reforms to one of the largest tax expenditures, superannuation. By transforming this particular tax expenditure into a rebate program, which would be subject to proper budgetary scrutiny, Australia's superannuation arrangements could be made more accountable and more equitable. If successful, this model could then be applied to other areas of tax expenditure.

Under the current system of tax expenditures on compulsory superannuation contributions:

» Minimum wage earners receive no assistance.

» Those in the top income tax bracket receive on average more than $11,000 per annum.

This paper proposes two alternative models for reform. The first is based on a flat rate similar to the First Home Savers Account. The second has a flat rate for those earning up to $80,000 per annum, phasing out after $100,000 – similar in design to the recent tax bonus included in the stimulus package.

These schemes would provide a much more equitable distribution of benefits.

» Minimum wage earners would be up to $24,000 better off on retirement under the first model and $32,000 under the second; more than a year's additional salary.

» 85 per cent of wage earners would receive higher benefits under the second model.

» Savings by low-income earners would be encouraged, reducing reliance on the pension.

» Both models are revenue neutral.

Contents

Introduction

There is ongoing public concern about and interest in how governments spend their money. The media, academics and commentators debate both the equity and efficiency of social spending. However, while debate tends to focus on the most visible forms of spending such as unemployment payments or direct outlays on hospitals or schools, the most concerning areas of social policy actually lie within the tax code. The current tax review[1] provides a perfect opportunity to review the shift from spending to tax breaks that is threatening the fairness and inclusiveness of Australia's welfare state.

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'Tax expenditure' is the term given to tax breaks and loopholes that allow taxpayers to get out of paying their taxes. These expenditures have grown dramatically since the 1980s, both in the number of tax breaks and in total cost to the budget. Increasingly tax expenditures have been used to replace direct provision or commissioning of social services and social security in areas like health, housing and pensions – areas we normally associate with the spending side of the budget.

Because tax expenditures are less visible than other forms of social spending they have made it easier for governments to expand support to high-income earners and private service providers without facing political resistance or public criticism.

The rapid growth of inequitable tax expenditures presents Australia with an opportunity to create a much fairer welfare state without adding to its cost. Using superannuation as a case study, this paper shows how tax expenditure reform could substantially increase the support given to low and average wage earners. The same logic promises to create a more inclusive, transparent and accountable welfare state.

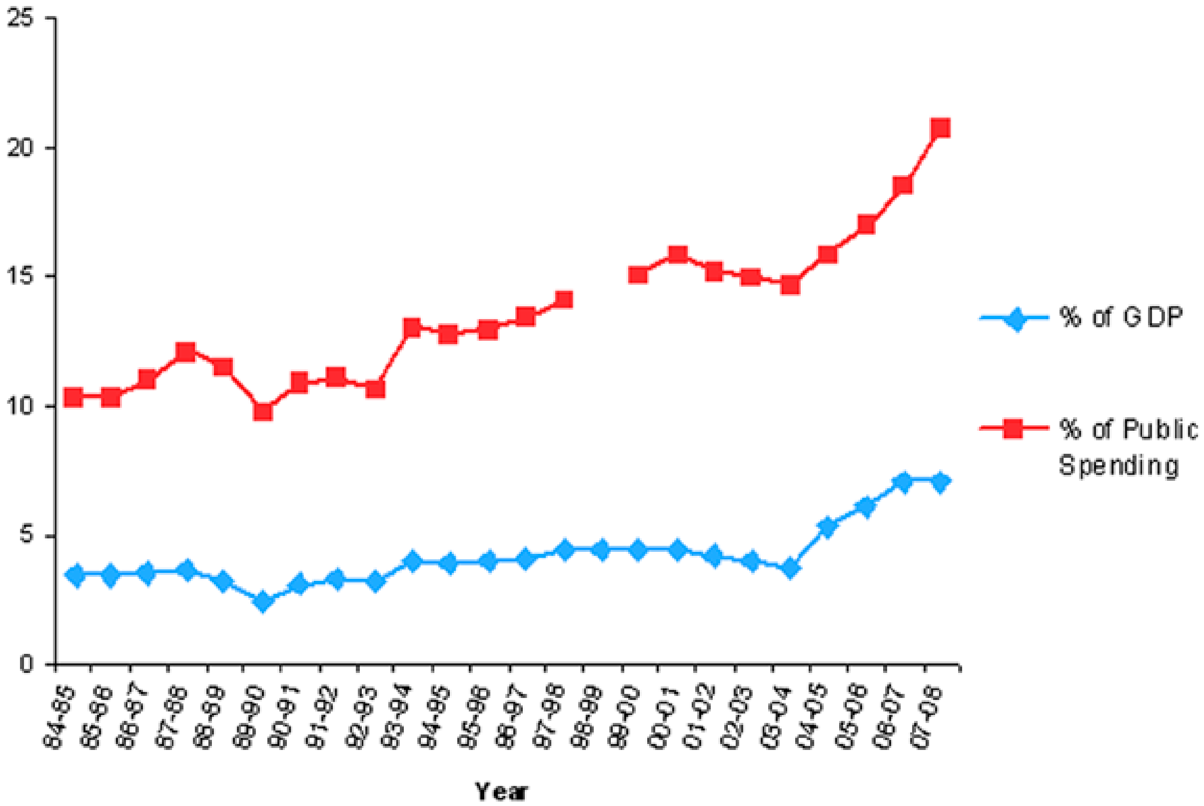
What are Tax Expenditures?

Tax expenditures refer to items of the tax code that offer tax breaks to individuals who undertake specified actions or belong to particular social groups. The main forms of tax expenditures include tax exemptions, tax deductions, tax rebates or offsets, tax concessions, allowances, rate relief, provisions for tax deferral, and income tax averaging. The revenue lost by the state through tax expenditures is in effect equivalent to the revenue spent on direct expenditures: both have redistributive effects and impact on state budgets. Like direct expenditures, tax expenditures increase the resources available to their recipients and must be financed by drawing resources from other programs, running deficits or increasing taxation[2]. Unlike a general tax cut, tax expenditures usually require their recipients to change their behaviour in order to qualify, meaning the government is effectively directing the spending into certain areas. Although there is no universal consensus, the tax expenditure concept is widely accepted by most public finance experts, the World Bank and the Organisation of Economic Cooperation and Development (OECD).

There has been a substantial increase in the number and cost of tax expenditures reported in the Tax Expenditure Statement (TES) since the mid-1980s. The number of tax expenditures reported in the TES has increased over 90 per cent from 170 in the 1984-85 financial year to over 324 in 2007-08. The reported cost of tax expenditures rose in nominal terms from $7 billion in 1984-85 to $73 billion in 2006-07, which amounts to an increase from 3.6 per cent of Gross Domestic Product (GDP) to 7.1 per cent (see Figure 1). Not only are the tax expenditures listed in the TES growing, they are also taking up an ever larger slice of the federal budget. Over the same period, 1984-85 to 2007-08, tax expenditures doubled as a proportion of public spending from 10.3 per cent to 20.8 per cent.

From 1984-85 to 2007-08, tax expenditures doubled as a proportion of public spending

FIGURE 1: TAX EXPENDITURES AS A PROPORTION OF GDP AND PUBLIC SPENDING 1984-2008



Source: Treasury TES, ABS Yearbooks, and ABS National Accounts[3]

Limitations of the Data

The TES remains the best data source for tax expenditures, but it is not without its limitations. The TES overstates the growth in the number of tax expenditures because each statement between 1995 and 2007 identified an average of 10 additional pre-existing tax expenditures that had not previously been accounted for.[4] The TES also underestimates the budgetary cost of tax expenditures due to its patchy coverage; only 60 percent of the tax expenditures listed were quantified and around 40 percent were derived from reliable estimates.[5] In other areas, such as private health insurance, the costs of government support are reported in different places depending on the way the benefit is taken up, making it difficult to determine the total cost. Nevertheless, in spite of these limitations, the TES clearly shows that tax expenditures are increasing in magnitude and are a significant form of public support that requires our attention if we are to fully account for government activity.

'Not for the Poor?' The Distributional Implications of Tax Expenditures

Australian direct spending on social services is highly progressive, meaning that most benefit goes to those most in need. While some commentators have complained about a growth in 'middle class welfare', international evidence from the OECD reveals that, without accounting for tax expenditures, Australia has one of the most targeted systems of social insurance. Dollar for dollar, Australia's social spending redistributes more income to those in need than virtually any other developed country.[6]

However, tax expenditures undermine the redistributive effects of government spending by allocating more money to higher income earners. Tax expenditures benefit higher income earners because they are linked both to the income tax system and to private spending on social services. Most tax expenditures in Australia relate to the income tax system, and because they are not capped, they return benefits equal to the notional amount of tax owed.[7] As higher income earners pay more income tax, these taxpayers receive greater benefits.

Tax expenditures undermine the redistributive effects of government spending by allocating more money to higher income earners.

Detailed figures are not available for the distribution of most tax expenditures, but what evidence is available clearly shows this effect.[8]

The most prominent example is superannuation. Super contributions are taxed at a concessional rate of 15 cents in the dollar. Earnings on funds also receive this concessional rate and there are no taxes levied on withdrawals. For those earning over $180,000 p.a. this concession is equivalent to a rebate of 30 cents for every dollar invested or earned, as the top marginal tax rate for these income earners is 45 cents in the dollar. However, for a low-income earner on under $34,000 a year the scheme effectively gives no benefit.

The Australia Institute's Richard Dennis[9] has calculated that the potential lifetime benefit for someone earning over $72,000 p.a. from the super tax concession is greater than the lifetime benefit from the aged pension – meaning the government spends more per person helping wealthy self-funded retirees than helping pensioners.

This effect is reinforced by linking tax expenditures to private spending on social services. As higher income earners have more capacity to spend their own income on social services, they also tend to receive the greatest benefits. The National Centre for Social and Economic Modelling (NATSEM) found that after the extension of tax support for private health insurance, those in the top 20% of income earners were more than twice as likely as other Australians to hold insurance, and therefore qualify for the tax expenditure.[10] The same effect is seen in super, where high-income earners make larger voluntary contributions.

A final implication to note is the impact of tax concessions on the structure of many human services industries. By rewarding private social spending, these policies promote private provision, such as the dramatic expansion of private childcare facilities, private health insurance and private financial institutions controlling superannuation. This makes it significantly more difficult for the state to regulate these sectors to ensure equity and efficiency in service provision, while often increasing the total budgetary cost.[11]

Thus tax expenditures tend to have the opposite distributional effect to spending programs because they pay more to those in higher income tax brackets and because they increase as individual spending increases.

Low Visibility, Low Accountability

Tax expenditures are a relatively hidden form of public spending that are subject to fewer oversight arrangements than direct expenditures and receive much less scrutiny than other types of government activity in media reports. The budgetary oversight arrangements for tax expenditures are compared in Table 1, showing that tax expenditures are the subject of only infrequent audits for the Budget and do not undergo annual review. Moreover, the TES amounts to a list rather than a review of tax expenditures and requires no vote in parliament when tabled.[12]

Tax expenditures receive comparatively little attention in media reports and public debate. The low profile of tax expenditures is to some extent reflective of their design. By decreasing the tax burdens of their recipients, tax expenditures amount to a form of public investment that does not involve monetary transactions. On the one hand, tax expenditures appear to give recipients 'back their own money' instead of conferring a selective benefit from the government. On the other hand, tax expenditures have the budgetary effect of reducing state revenue rather than increasing outlays, which may reduce the scope of government activity and public spending.

TABLE 1: OVERSIGHT ARRANGEMENTS FOR DIRECT EXPENDITURES AND TAX EXPENDITURES

OVERSIGHT ARRANGEMENT	EXISITING DIRECT OUTLAYS	EXISTING TAX EXPENDITURES
Estimates Compiled according to independent standards fit for the purpose.	Yes	No
Identified for all Commonwealth agencies	Yes	No
Subject to regular Budget review	Yes	Infrequently
Reported in Budget estimates	Yes, by Budget Outcome	Infrequently
Subject to Budget monitoring	Yes, by Budget Outcome	Infrequently
Costs measured against measurements	Yes	Infrequently
Subject to annual agency reporting	Yes	Infrequently
Subject to annual audit	Yes	No

Source: Auditor General[13]

While the TES has somewhat enhanced the visibility of tax expenditures, it receives little media coverage – particularly compared to the Budget. The lack of coverage to some extent reflects the timing of its release during the holiday period at the start of the calendar year; over the past 6 years, it was released within a week of either Christmas or Australia Day. Although the Treasury states that the TES is published near the start of the calendar year so that it can inform the Budget[14], its release in this period does little to boost the profile of tax expenditures.[15]

Because of their lack of legislative scrutiny and low public profile, tax expenditures have provided governments of both Liberal and Labor persuasions with a policy backdoor to increase public spending, while avoiding public accountability and appearing to reduce the size of the Budget. As noted by the Treasury[16], in stark contrast to direct expenditures, tax expenditures can be difficult to identify. Moreover, tax expenditures are often subjected to close scrutiny only when they are introduced[17]. Coupled with their rapid expansion and distributional effects, the low public accountability of tax expenditures demonstrates the importance of shining light onto this relatively hidden form of public spending.

Tax expenditures have provided both Liberal and Labor governments with a policy backdoor to increase public spending.

Reforming Tax Expenditures: The Case of Superannuation

The major failings of tax expenditures identified in this paper are connected. The lack of transparency and accountability, we argue, results in less equitable social spending. Highly visible government spending programs that reflected the structure of tax expenditures would likely be less politically defensible. By separating out the functions of revenue collection and social support, with the tax system focused on the former and the payments system focused on the later, we can achieve a more transparent, more efficient and more equitable system.

The recent example of the First Home Savers Account illustrates this point. Prior to the 2007 federal election the then Labor Opposition promised to introduce a new tax supported saving scheme to promote home ownership. The First Home Savers Account would allow first home-buyers to save towards their deposit while receiving the same tax benefits as superannuation account holders.

As discussed above, superannuation is currently taxed at a flat 15% for both contributions and earnings. This grants the account holder an effective tax concession of up to 30%, depending on the account holder's marginal tax rate. The FHSA was to follow the same structure, with both contributions and earnings being taxed at the 15% concessional rate.

On gaining government, Labor charged Treasury with implementing this scheme. Treasury advised that the tax concession arrangement would be administratively prohibitive and instead advocated a rebate scheme, that is a scheme involving government payments, similar to co-contributions, rather than tax concessions.

The discussion paper issued by the Government followed the rebate design, but altered the structure of payments to extend the minimum 15 per cent contribution to all tax payers.[18]

Even this modified scheme generated a political outcry. The new model continued to offer high income earners the highest level of government support, something that was now made more obvious by converting the tax concession into government spending.[19] Following public submissions the scheme was again modified to offer all contributors the same level of support – 17%.

TABLE 2: CHANGING BENEFIT STRUCTURE OF THE FIRST HOME SAVERS ACCOUNT SCHEME

TAXABLE INCOME*	INITIAL LABOR POLICY PRIOR TO 2007 FEDERAL ELECTION	DISCUSSION PAPER MODEL RELEASED EARLY 2008	DISCUSSION PAPER MODEL RELEASED EARLY 2008
$0 - $6 000	0%	15%	17%
$6 001 - $34 000	0%	15%	17%
$34 001 - $80 000	15%	15%	17%
$80 001 - $180 000	25%	25%	17%
$180 000+	30%	30%	17%

*Based on 2008-09 tax scales.

Source: Commonwealth Government of Australia & Treasury[20]

Table 2 documents how the policy changed as it transformed from a tax expenditure to a rebate (or spending initiative). As the structure of tax expenditures is made explicit and transparent, so political imperatives push the structure of social policy in a more egalitarian direction. In the following pages we explore how this logic might be applied to superannuation.

Identifying the exact extent and nature of tax support for superannuation is difficult because of relatively poor reporting. Treasury reports total superannuation tax expenditures, but we do not have complete data on either the distribution of tax expenditures or on the breakdown of the different components of the superannuation tax support.

The most useful figures are for the tax concession on the compulsory 9% employer contributions to superannuation. Here we confine the discussion to this component of superannuation policy. There is already some support for voluntary contributions from low-income earners through the co-contribution scheme. However, reforming the tax concessions for voluntary contributions would likely increase the equity of government support further still.

Table 3 describes the current structure of the superannuation guarantee tax expenditure by income level.

TABLE 3: ESTIMATE VALUE OF CONCESSIONAL TAXATION FOR MEAN Y OF TAX BRACKETS IN 2008-09*

TAX BRACKET 2008 - 2009**	MEAN Y OF TAX BRACKET 2008 - 2009 **($)	TOP MARGINAL TAX RATE (Cents/$)	MEAN VALUE OF SG***	RATE OF TAX DISCOUNT	ESTIMATED VALUE OF TAX CONCESSION FOR SCG
$1 - $6 000	3 153	Nil	284	0	0
$6001 - $35 000	22 313	15	2 008	0	0
$35 001 - $80 000	51 726	30	4 655	15	698
$80 001 - $200 000	109 143	40	9 823	25	2456
$200 001+	419 290	45	37 736	30	11321
Estimated Budgetary Outlay = $6 062 million*					

Source: Australian Tax Office[21]

** Excludes individuals with non-taxable income.*
*** Tax brackets are approximate due to data organisation of axation Statistics.*
**** Calculated using data from Taxation Statistics 2005-06*

The final column shows the average tax concession received by taxpayers in each income group. Table 1 shows that those earning up to $35,000 per annum receive no benefit, while those earning over $180,000 p.a. receive on average $11,321 per annum in government support. We propose replacing the current system of superannuation tax concessions with a system of rebates. Employers would deduct tax from superannuation contributions in the same manner as for other pay, and the government would then provide a rebate paid directly into superannuation accounts. We examine two possible models here, both neutral in their budgetary impact. It should be noted that in both models the problem of promoting retirement savings for those outside the workforce (particularly women) remains, highlighting the disadvantages of Australia's contributory model over other more inclusive insurance models.

The first model, shown in Table 4, provides a flat 15% rebate on all compulsory super contributions, similar to the final FHSA model. This is the same level of support currently offered to those earning $35,000-$80,000 per annum. This model effectively redistributes income currently given to those earning over $80,000 per annum to those earning under $35,000.

TABLE 4: FLAT-RATE 15% CO-CONTRIBUTION SCENARIO FOR MEAN Y OF TAX BRACKETS IN 2008-09*

TAX BRACKET 2008-2009**	MEAN Y OF TAX BRACKET 2008-09*** ($)	MEAN VALUE OF SCG***	CO-CONTRIBUTION RATE	ESTIMATED VALUE OF 15% FLAT RATE CO-CONTRIBUTION
$1 - $6 000	3 153	284	15	42
$6001 - $35 000	22 313	2 008	15	301
$35 001 - $80 000	51 726	4 655	15	698
$80 001 - $200 000	109 143	9 823	15	1473
$200 001+	419 290	37 736	15	5660
Estimated Budgetary Outlay = $5 978 million*				

** Excludes individuals with non-taxable income.*
*** Tax brackets are approximate due to data organisation of Taxation Statistics.*
**** Calculated using data from Taxation Statistics 2005-06.*

Source: Australian Tax Office[22]

The net result is that a worker on the current minimum wage would expect to receive an additonal $381.74 per annum. Over their working life, a worker employed on the minimum wage for 40 years could expect to increase the value of their superannuation by approximately $24,000 in real terms, almost a year's salary.[23]

The second model is similar to the structure of the recently announced tax rebates in the stimulus package, providing a flat rate rebate of 20% support for those earning up to $80,000 per annum and then decreasing the rebate by 1 percentage point for each additional $1,000 of earnings, until it is phased out completely for those earning over $100,000 per annum. In 2005/06, this model would have left over 85% of wage earners better off. [24]

TABLE 5: PROPOSED TAPERED CO-CONTRIBUTION SCHEME

TAXABLE INCOME 2008- 2009 ($)	MEAN VALUE OF SG ($)*	CO-CONTRIBUTION RATE (%)	ESTIMATED VALUE OF TAPERED CO-CONTRIBUTION ($)
1 - 6 000	284	20	57
6 001 - 35 000	2 008	20	402
35 001 - 80 000	4 655	20	931
80 000	7 200	20	1 440
85 000	7 650	15	1 148
90 000	8 100	10	810
95 000	8 550	5	427
100 000	9 000	0	0

** Calculated using data from Taxation Statistics 2005-06.*
** Mean Y of tax payers earning between $1 and $80 000 calculated from 2005-06 Taxation Statistics.*

Under this second model, a worker on the minimum wage would receive an additional $509 per annum in government support, and would expect an increase in the value of their superannuation over their lifetime of $32,000 in real terms – more than a year's salary.

A worker on full-time male average weekly earnings (including overtime), would receive $1,271 per annum, $303 per annum more than the current tax concession.[25] This amounts to an increase of $19,100 in superannuation at the completion of the wage earner's working life – with a total benefit (including the current level of support) of $76,500. All these figures take into account the 15% tax on earnings and inflation.

Both these models involve the same total level of spending (or lower) than the current concessional tax arrangements. It is likely that there would in fact be a net budgetary saving as those on lower incomes are offered greater support and therefore are less likely to rely as heavily on the aged pension – this effect has not been calculated however.

The current structure of superannuation concessions provides greatest support to those already able to provide for themselves.

The other longer-term benefit of such arrangements is the increase in transparency. As a government payment, support for superannuation would be included in normal budgetary processes and be subject to normal political scrutiny.

Such an approach could easily be applied to the other components of superannuation – earnings and voluntary contributions. Here there would be additional benefits from changed incentives. The current concessional tax arrangements give large incentives for high-income earners to save, even though these individuals have a higher average propensity to save,[26] and many would already achieve retirement incomes well in excess of the pension without such support.

Tax expenditures are often defended as a form of government assistance that promotes self-reliance by creating positive incentives for citizens to save for their own needs. This argument has been used to promote tax expenditures in areas like private health insurance and superannuation.

However, the structure of these schemes often fails to deliver. Subsidies for private health insurance for example actually penalise those who self-insure by confining benefits to particular forms of insurance.[27] The current structure of superannuation concessions provides greatest support to those already able to provide for themselves, whilst denying support to those on low and middle incomes that may benefit from incentives to save.

Should the models proposed here be extended to voluntary contributions, incentives would be changed to promote savings from middle-income earners not currently eligible for the low-income earner co-contribution, potentially further decreasing the reliance of these groups on the aged pension.

Reforming Tax Expenditures

The logic of converting open ended tax concessions into rebates applies to other tax expenditures such as negative gearing or the capital gains tax concession. The likely benefits from such reforms are substantial in both accountability and budgetary terms.

Tax expenditures which are uncapped lead to uncertain but potentially very large increases in costs[28] and the relative lack of accountability means this is likely to remain unnoticed by policy makers far longer than would be the case with direct spending programs. Tax expenditures also add to purchasing power without necessarily addressing supply side capacity constraints, and this can lead to inflationary pressure – simply pushing up the price of services like child care and health insurance rather than increasing their affordability. Numerous private providers are in effect supported by the tax expenditures given to their customers, but the government's ability to constrain costs is undermined by the lack of a direct relationship with these providers.[29]

It is also interesting to note the final result of schemes like the FHSA and our proposed reforms to superannuation. These schemes effectively unite two separate welfare states – the targeted system mostly utilised by low and middle income earners and the tax expenditure system primarily benefiting high income earners.

Even in the models we propose, and the current FHSA scheme, government support continues to increase as contributions increase, reflecting the logic of a contributory system of social insurance. However, more Australians would benefit, creating a more inclusive welfare state. This move towards a more inclusive system would be achieved at no net budgetary cost.

In reality, Australia's welfare state is already much larger than is generally acknowledged, but its most generous support is reserved for the genuinely well off and is obscured from public debate. By returning the tax system to its primary purpose of collecting revenue, and combining disparate social support schemes into the system of government payments, we could create a more inclusive, more generous and more affordable welfare state.

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Appendix: Methodolgy

Table 4 and table 5 are based on estimates using Taxation Statistics 2005/06. Benefits for minimum wage earners are based on the 2008 general Wage-Setting Decision of the Fair Pay Commission of $543.78 per week, or $28,277 per annum. Benefits for full-time average male total earnings are based on ABS 6302.0, Table 3, for August 2008.

In both cases yearly benefits are based on the compulsory superannuation contribution, taken as 9 per centof the annual wage, multiplied by the additional benefit proposed. The lifetime benefit is based on a working life of 40 years, with a real interest rate of 3 per cent per annum and an inflation rate of 3 per cent per annum taking account of the 15 per cent tax on earnings. The resulting compounded interest rate is 2.1per cent per annum.

Total budgetary cost of the schemes is approximated using Taxation Statistics 2005/06. The value of the tax concession for the compulsory superannuation contribution was estimated for each income bracket (taxed at the rates identified in tables) and then multiplied by the number of tax payers that fell into it in 2005-06. The subtotals for each income bracket were then added together to estimate the total budgetary cost of the proposed schemes.

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PUBLISHED BY THE CENTRE FOR POLICY DEVELOPMENT, FEBRUARY 2008

Centre for Policy Development

Level 7, 280 Pitt Street

Sydney, NSW Australia 2000

t: +61 29264 0263 e: CONTACT@CPD.ORG.AU