

# TAX, WELFARE AND JOBS: A FIRST STEP TO REFORM

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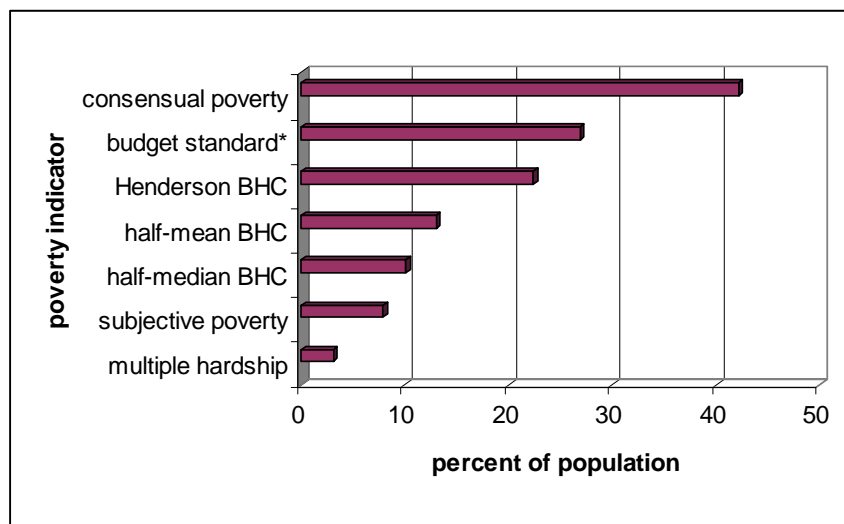
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## **INTRODUCTION: WHY MORE WELFARE IS NOT THE ANSWER TO THE 'POVERTY PROBLEM'**

There are many different ways of defining and measuring 'poverty' – figure 1 shows that published poverty estimates currently range from around 3 to over 40 per cent of the Australian population. 'Poverty' is a highly emotive, inherently politicised and essentially contested concept – there is no 'true' rate of poverty, nor any authoritative definition of what the term means. Poverty statistics are popular with lobbyists for precisely this reason – their elasticity allows them to be pressed into service to support almost any favoured reform proposal. But all poverty measures should be treated with extreme caution, and it will be important to remember this when the current Senate Inquiry into Poverty reports in the new year.

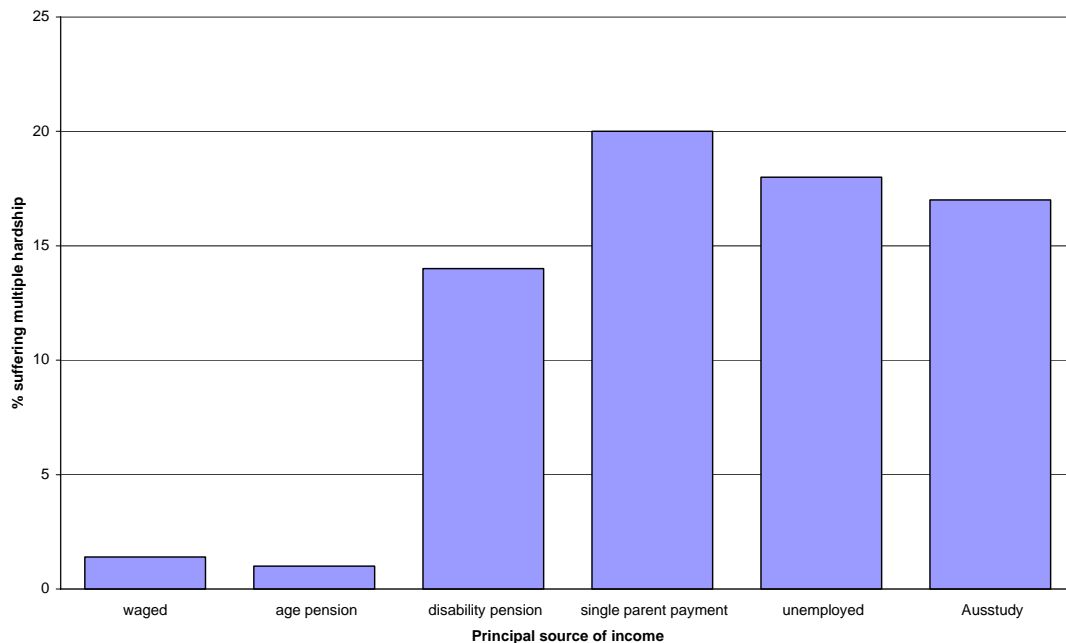
**Figure 1: Poverty rates estimated by 7 different measures**



On one thing, there is widespread agreement. However it is defined, the principal cause of 'poverty' is joblessness. Low income (or 'poor') households are overwhelmingly those where no adults of working age are employed.

Figure 2 uses Rob Bray’s minimal measure of ‘multiple hardship’ (defined as lack of money resulting in experience of two or more of the following in the previous year: missing a meal, going without heating, pawning or selling something and seeking help from a charity). Just 3 per cent of households overall suffer multiple hardship, but rates as high as 20 per cent are found in unwaged households. Much the same pattern comes through when we look at the composition of the households defined as ‘poor’ under other systems of definition and measurement. Despite using a much more generous definition of poverty, for example, the Smith Family’s 2001 report authored by Ann Harding, Rachel Lloyd and Harry Greenwell (*Financial Disadvantage in Australia*) found only 3% of waged households below its ‘poverty line’ as compared with 31% of those relying on welfare.

**Figure 2: Principal source of household income and ‘multiple deprivation’**



Source: Based on Rob Bray, *Hardship in Australia* (Dept of Family & Community Services Occasional Paper, No.4, 2001, Table 15)

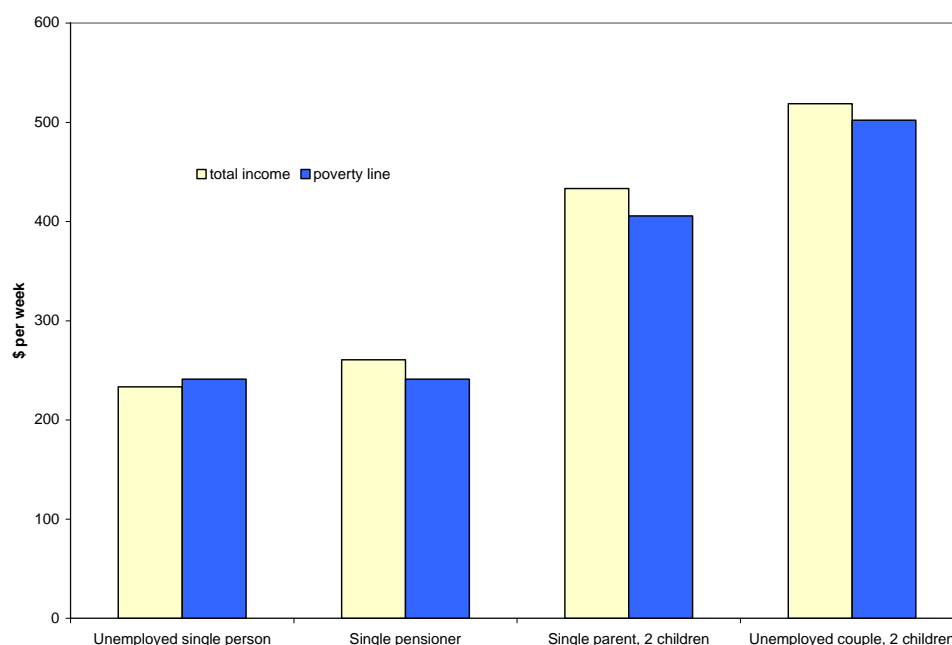
Welfare lobby groups characteristically respond to evidence linking ‘poverty’ to lack of paid employment by claiming that welfare benefits are too low and that an effective anti-poverty strategy requires that we raise the value of benefits. ACOSS, for example, has long demanded that the value of allowances be raised at least to match that of pensions.

One obvious response to the ACOSS demand is to note that people on single parent and disability pensions appear to suffer multiple hardship as much as those on allowances do, even though their payments are higher. This suggests that raising the value of allowances may not do much to alleviate the problem which may have as much to do with how people manage and spend their money as with how much money they receive in the first place. When a former CIS colleague, Lucy Sullivan, suggested that poverty might have a strong behavioural component (*Behavioural Poverty* CIS 2000) she was vilified, but Bray’s analysis shows that behavioural factors do play a crucial role in influencing people’s exposure to hardship (young people, for example, may prioritise expenditure on alcohol and socialising even at the

expense of money spent on meals). As Bray notes, most people living on benefits do not report hardship, so those that do must be doing (or not doing) something distinctive that results in their failure to make ends meet while on benefits.

Even when judged against an inflated and exaggerated measure of poverty such as the Henderson poverty line (the measure preferred by ACOSS), there is little evidence to support the contention that benefits are too low. The Henderson poverty line generates an absurdly high poverty rate in excess of 20 per cent among Australian households. Since the early seventies it has become increasingly generous because of the way it has been adjusted with inflation – today it would buy 37% more than it would have done in 1973. Yet despite its increasing generosity, calculations by the Melbourne Institute (Figure 3) indicate that the value of the benefits to which welfare claimants are entitled (the allowance or pension, plus partner’s allowance, Family Tax Benefit and rent assistance) are still above the current Henderson poverty line in nearly every case.

**Figure 3: Welfare payments compared with the Henderson poverty line**



Source: based on Melbourne Institute of Applied Economic and Social Research, *Poverty Lines: Australia* (March Quarter 2003). The value of the Henderson poverty line is slightly higher for employed households than for non-employed ones (this reflects the additional expenses incurred in going to work). ACOSS prefers to use this higher line when estimating poverty rates among those on unemployment benefits – this slightly increases the gap shown above for an unemployed single person. However, it should also be remembered that the estimated incomes shown above take no account of the value of concessions available to the unemployed and pensioners.

If we were to accede to the welfare lobby’s persistent demands to make benefits more generous, the result would almost certainly be to increase ‘poverty’ or ‘hardship’ rather than reduce it. This is because higher benefits would further weaken the incentive of people on welfare to get a job while simultaneously increasing the tax burden on self-reliant workers. Our already-high Effective Marginal Tax Rates (EMTRs) would get even higher, more people would stay or end up on welfare, and ‘poverty rates’ caused by joblessness would expand even further. Indeed, one of the ironies of the last 30 or 40 years is precisely that welfare spending has been rising

dramatically yet ‘poverty’ seems not to have been falling as a result. Welfare lobbyists keep pushing for higher social expenditure (and the higher taxes to fund it), despite clear evidence that higher welfare does not lead to lower poverty (and may actually do quite the opposite).

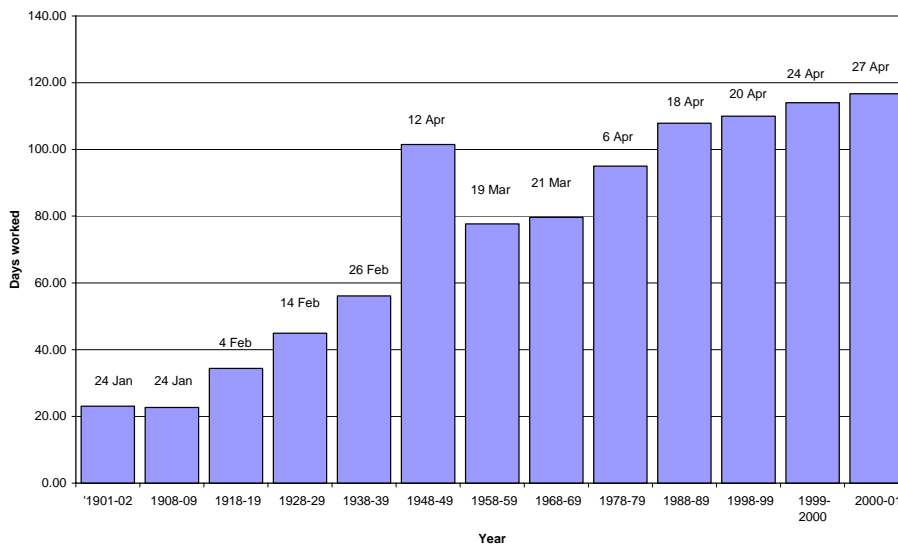
Rather than treating the symptom – the low living standards of some of those living on welfare – we should focus on the cause – lack of full-time employment. This means we should not be looking for ways to increase the value (and hence the attractiveness) of benefits, but should rather be seeking to get as many people as possible off welfare and into paid employment.<sup>1</sup>

To do this, three things are needed, and they have to be done together. There has to be further *labour market reform* (to generate more jobs), there has to be radical *tax reform* (to encourage self-reliance), and there has to be major *welfare reform* (to improve work incentives and reduce dependency rates).

### **TAX REFORM TO ENCOURAGE SELF-RELIANCE**

The total tax take is at a record high. We all work for almost four months every year for the government before we start earning money for ourselves (Figure 4).

**Figure 4: Tax Freedom Day 1901-2001**



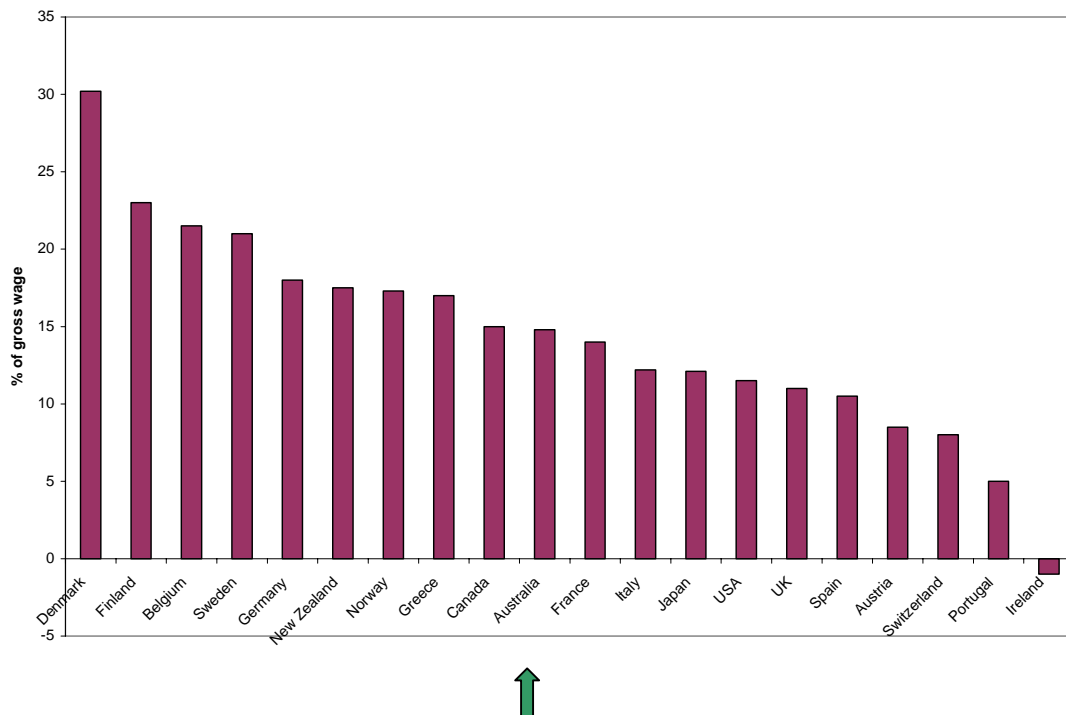
Source: Calculated from ABS *Yearbook 2003* (ABS Cat.1301.0).

Those who advocate higher government social expenditure and higher taxes point out that total taxation as a proportion of the country’s GDP is lower in Australia than in

<sup>1</sup> Some people, of course, are not capable of working and should not be expected to. This is recognized in our existing welfare system in the distinction between unemployment allowances and pensions, although we shall see that this distinction has become increasingly blurred and that many people on pensions could and should arguably be expected to work. Responding to this blurring, the 2000 McClure Report recommended replacing the existing system of benefits with a single payment, but this would arguably make matters worse (see Peter Saunders, CIS submission to House of Representatives Inquiry into *Reform of Income Support for Working Age Australians*, available at [www.cis.org.au](http://www.cis.org.au))

most other OECD countries (31.5% as compared with an OECD average of over 37%). But this is mainly because our indirect taxes are lower. When we consider net taxation on earnings, Australia is around the middle of the international rankings. Figure 5 shows that a couple with two children living on one average wage loses 15% of their earnings net of all government taxes and transfers – a smaller net deduction than in New Zealand, Germany or Scandinavia, but bigger than Britain, the US, Japan, Italy and even France. Australian workers are not under-taxed by international standards.

**Figure 5: Net income tax and social security deductions (after receipt of cash benefits) for family of two adults and two children on average wage, various countries**



Source: Based on OECD, *Taxing Wages 2002* (OECD Paris 2003)

### ***Bracket creep***

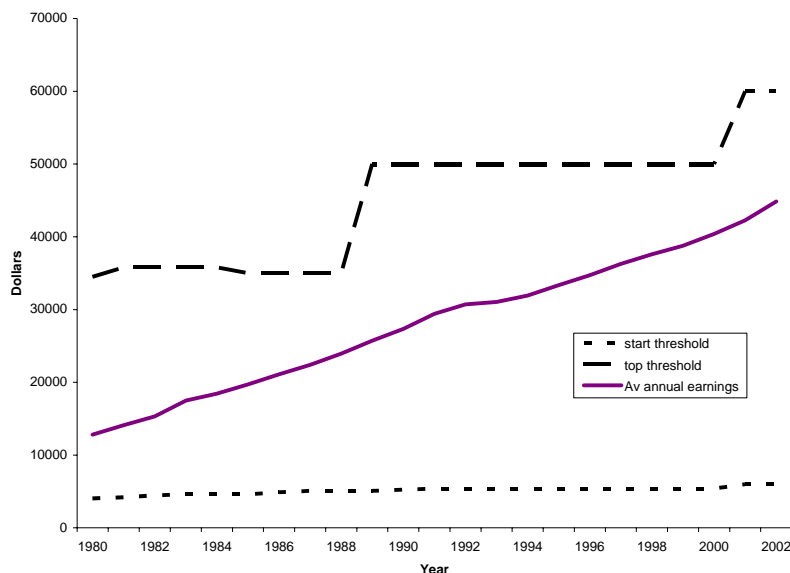
Income tax rates in Australia have declined over the last 20 years, but the tax take has continued to rise because tax thresholds have not kept up with inflation. This is true of both the higher and the basic rate thresholds.

In 1980, workers did not start paying the top rate of tax (which was then 60%) until they earned \$35,000, which at that time was approximately three times the average income. Today, workers start to pay the top rate (47%) on earnings just one and one-third times higher than the average. There is widespread recognition of the need to raise (or abolish) this threshold so as to stop penalising middle-income families.

The erosion in the value of the base personal tax-free threshold has been even more marked. In 1980, workers did not pay any tax at all until they earned \$4,041 per year (one-third of average earnings). Wages have gone up by 350% since then, but this

tax-free earnings threshold has only risen by around 50%, to less than one-seventh of today's average earnings (see Figure 6). Had the threshold kept up with wage inflation, it would today be worth over \$14,000; as it is, it is worth only \$6,000.

**Figure 6: Average earnings and tax thresholds 1980-2002**



Source: Based on table in Bendzulla Actuarial Pty Ltd website ([www.bendzulla.com.au](http://www.bendzulla.com.au))

### *The case for raising the personal tax-free threshold*

There are two strong grounds for arguing that the personal tax-free threshold should at least be raised to a point above the minimum welfare floor.

The first (principled) argument is that workers should be able to earn at least a basic subsistence income before government starts to take their money away in direct taxes. Assuming that the welfare minimum is the government's own definition of a subsistence level income, nobody should be taxed until they have secured for themselves an income in excess of this welfare floor. This would mean, for example, that a single person should be allowed to earn more than \$12,173 per annum (the current unemployment benefit plus rent assistance for a single adult) before being taxed; that a childless couple should between them be allowed to earn at least \$19,893 (unemployment plus partner allowance plus rent assistance) before tax; and that a couple with two children should be allowed to earn \$27,050 between them (unemployment plus partner allowance plus FTB Part A plus rent assistance) before tax.<sup>2</sup>

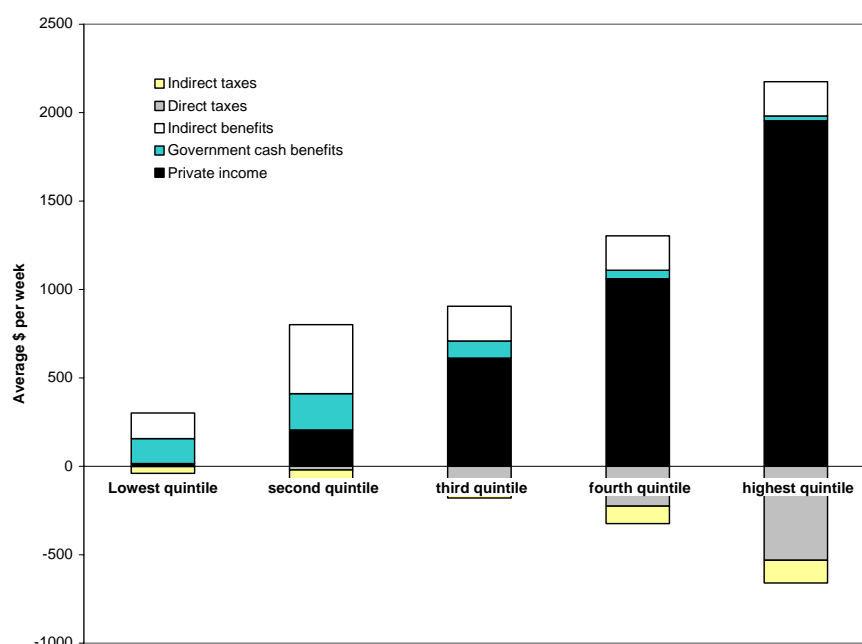
The second (more pragmatic) argument is that raising the personal tax-free threshold would allow us to reduce (or in principle even eliminate) 'churning' of tax and welfare payments. This is because people on welfare would not pay tax, and those

<sup>2</sup> The precise proposals for how this can best be achieved are still under preparation. One idea (Barry Maley, *Family and Marriage in Australia*, CIS 2001) is that all children should be given their own tax-free allowance (or a refundable tax credit) which could be claimed on their behalf by their parent/s and added to their own personal tax-free allowance/s. No other income supplements would be paid, and these child allowances would not be means-tested (thereby avoiding the problem of high EMTRs while increasing horizontal equity between households).

paying tax would not receive welfare. Anybody earning above the appropriate welfare minimum would pay less tax than they do now but would receive no income support top-ups.

Churning (paying tax with one hand and receiving benefits with the other) is a problem because it is administratively wasteful, and because of its damaging effect on work incentives. Currently, many Australians pay taxes on their incomes while also receiving benefits in cash from the government, (as well as additional benefits in kind). This pattern is especially marked in the middle quartiles of final incomes (see Figure 7). The extent of this ‘churning’ is less marked than in many other countries because we do not have a social insurance system that entitles higher earners to income-related benefits, but churning is still a significant feature of our tax-benefit system, and it is the reason why people moving from welfare into work commonly experience dispiritingly high EMTRs.

**Figure 7: Composition of final income (1998-99)**



Source: Based on ABS, *Government benefits, taxes and household income* (Catalogue 6537.0, Canberra, 2001).

Peter Whiteford and Gregory Angenent (*The Australian system of social protection – an overview*, FACS Occasional Paper, Number 6, 2<sup>nd</sup> edition, 2001) have pointed out that our flat-rate, means-tested, non-contributory welfare benefits system targets those in need more effectively than overseas insurance-based social security systems do. While we spend less in total on income support payments than most European countries do, the value of the net transfers made to the poorest 30% of Australian households is actually higher than in any other OECD country apart from Norway (a finding that again undermines the arguments of the welfare lobby that welfare benefits in Australia are too low). This means that churning in Australia affects a narrower band of income earners than is the case in many other countries where government cash transfers are paid to a much bigger range of original income earners.

Churning is, nevertheless, a major problem in a narrower range of incomes. This is because, as original (earned) income rises, so workers find their taxes go up *and* their welfare benefits tail off sharply (the sharp reduction in benefits is precisely the mechanism which allows us to target benefits on the most needy so efficiently). The result is a massive work disincentive with EMTRs of 80 cents or more in every extra dollar earned.

### ***Raise the threshold rather than introduce tax credits***

Everybody agrees that something needs to be done to reduce these crippling high EMTRs. The solution proposed by the ‘five economists’ is to introduce an earned income tax credit – i.e. an additional cash transfer paid through the wage packet to lower income earners to compensate them for the increased taxes they are called upon to pay and the reduced benefits they receive as their income rises. But (as Kayoko Tsumori and I have argued in the CIS Submission to the House of Representatives Standing Committee on Employment and Workplace Relations Inquiry into *Increasing Participation in Paid Work* – available from [www.cis.org.au](http://www.cis.org.au)) this would be an undesirable move.

Despite its name, an earned income tax credit is really just another welfare hand-out, and it would discourage personal initiative just as other welfare benefits do. If we go down this road, we will end up spending even more than we do currently on income support (the UK Labour government’s spending on its various tax credits has grown alarmingly since 1997), and once granted, it is politically almost impossible to reverse a policy like this and claw the money back. Tax credits lock full-time workers into dependency on government hand-outs, thereby undermining their self-reliance. Former UK Labour Minister for Welfare Reform, Frank Field (*Welfare Titans*, Civitas, 2002) estimates that 83% of UK families are now getting the new Working Families Tax Credit, and he points out that this has made it impossible for most people to work harder and escape welfare dependency. Indeed, like any other means-tested welfare transfer, these tax credits inevitably create new work disincentives, because their value tapers off as household incomes rise. This means that workers further up the income scale start to lose substantial proportions of any additional earnings they accrue, for as they pay more tax, so they also lose their tax credit. While encouraging unemployed people into work, this means tax credits discourage people from working longer hours or getting a higher-paid job, and they penalise second earners in low-to-middle income households who find it is simply not worth their while working.

As ACOSS points out, tax credits also subsidise low-paying employers who can rely on the government to supplement inadequate wages. Indeed, the British experience has been that they encourage fraud, for employers collude with their workers to pay a proportion of the wage ‘off the books’ so as to maximise tax credit payments.

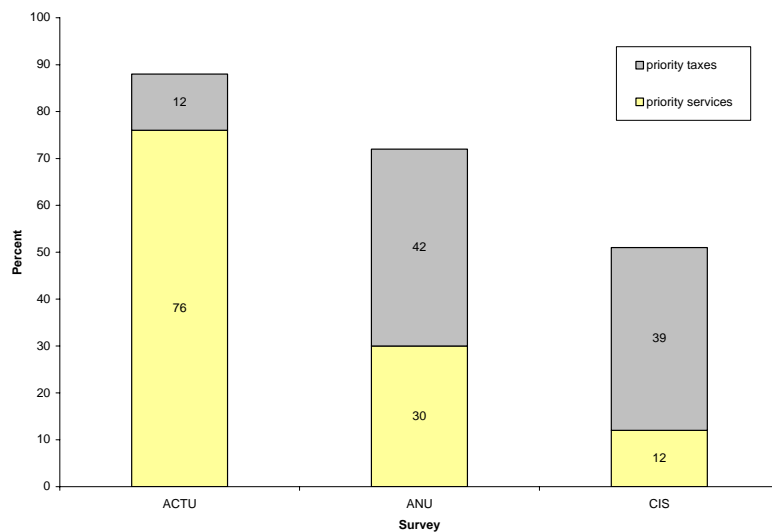
Rather than introduce yet another means-tested income transfer to counter the effects of all the other ones, the best solution to the problem of high EMTRs is to raise the personal tax-free threshold above the minimum welfare floor so that people paying tax do not receive welfare, and people receiving welfare do not pay tax.



## Do workers want to pay more tax?

It seems a stupid question, but it is sometimes argued by those favouring higher taxes and higher welfare spending that most Australians do not want their taxes reduced. Recently, for example, an ACTU survey asked: *Would you prefer the Federal Government to (a) offer you an income tax cut or (b) spend the money on improving services like schools and hospitals?* Only 18% opted for the tax cut while 76% said the money should be spent on services (www.actu.asn.au).

**Figure 8: Public preferences regarding taxes and social expenditure (as recorded in three different surveys)**



Sources: ACTU website (www.actu.asn.au); Shaun Wilson and Trevor Breusch, 'Taxes and social spending' *Australian Journal of Social Issues* vol.38, 2003; First CIS ACNielsen survey (March 2003)

The ACTU President recently used this survey to tell her conference that 76% of Australians wanted more public spending, but these respondents were never asked if they wanted government to *increase* its spending, and other surveys which have asked people if they want government social spending increased have found nothing like three-quarters of the population in favour. A 2003 Australian National University survey (Shaun Wilson & Trevor Breusch 'Taxes and social spending' *Australian Journal of Social Issues* 2003), for example, asked: *If the government had a choice between reducing taxes and spending more on social services, which do you think it should do?* and it found 42 per cent in favour of tax cuts while 30 per cent said they wanted spending increased.

Change the question wording a little more and ask people if they are willing to pay *more* tax to achieve higher levels of spending, and public support for higher government spending dwindles even further. A recent poll carried out by ACNielsen on behalf of the Centre for Independent Studies asked: *Some people want the government to increase income tax and to spend the extra money on welfare and social services. Other people say we are already over-taxed and that the time has come to reduce taxes even if this means reducing total welfare spending. Which do*

*you think the government should do?*<sup>3</sup> Thirty-nine per cent opted for lower taxes and lower spending (much the same as in the ANU survey). But only 12 per cent went for higher taxes and higher spending – far fewer than the ANU estimate, and a figure *six times smaller* than the 76% claimed by the ACTU.

In the same survey, we also asked at what level of earnings people thought income tax should begin. The results (Table 1) reveal strong support for raising the personal tax threshold above the minimum welfare floor.

**Table 1: Public opinion and the personal tax-free threshold**

**4. At what level of annual earnings do you believe people should start to pay income tax?**

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid On every dollar they earn, right from the first dollar	217	3.8	3.8	3.8
On earnings above \$6,000 per year (as now)	764	13.4	13.4	17.1
Not until they earn above the basic welfare benefits level	2445	42.7	42.7	59.9
Not until they earn above the minimum award wage	2014	35.2	35.2	95.1
People should not have to pay income tax at any level	230	4.0	4.0	99.1
Don't know/no opinion	51	.9	.9	100.0
Total	5721	100.0	100.0	

Source: First CIS ACNielsen survey (see footnote 2)

**LABOUR MARKET REFORM TO CREATE MORE JOBS**

Australia's unemployment rate recently fell below 6 per cent. But New Zealand and the UK – two traditionally weak economies which are now enjoying the fruits of radical reforms introduced back in the 1980s – both have unemployment rates lower than Australia's. And although unemployment in the US is today about the same as it is in Australia, this is only because the US economy has been going through a downturn. Over time, the 'structural' rate of unemployment in the US is much lower than it is here and it is no cause for celebration that our unemployment rate has only begun to match theirs when their economy is in a downturn while ours is still strong.

Of particular concern is the number of people out of work for a year or more (so-called 'long-term unemployment'). The ABS Labour Force Survey, which asks unemployed people how long it has been since they started looking for work or since they last had a job lasting for two weeks or more, reported in May 2003 that 22 per cent of all unemployed respondents had been out of work for a year or more. Department of Family & Community Services records, however, suggest that the

<sup>3</sup> N = 5,721 taken from the Australian Internet User Survey in March 2003. The sample was weighted by gender, age, state of residence and annual income to bring it into line with population estimates by the Australian Bureau of Statistics and appears valid on tests of external validity (comparing with marital status and voting preferences). Further details available on request.

figure is much higher. As of June 2001 (the most recent available date), 57 per cent of people claiming unemployment allowances (either Newstart or 'Youth Allowance Other') had been claiming benefits for more than one year and the average time spent on unemployment benefits is more than two years.

The welfare lobby tends to respond to the problem of unemployment by arguing for 'active labour market programmes,' but these policies are rarely effective. A review of *employment subsidies* in France, Germany and the Netherlands as well as the US and the UK found that they 'tend not to be effective with harder-to-serve groups' such as the long-term unemployed (Martin Evans, *Welfare to Work and the organization of opportunity* CASE Report No.15, London School of Economics, 2001, p.49), and the OECD (John Martin, 'Labour market programs' In Business Council of Australia, *New Directions: Rebuilding the Safety Net* (BCA, Melbourne, 2000), 94-97) reports very substantial 'deadweight effects' and 'displacement effects.' International evidence suggests that giving people work experience by employing them in newly-created *public sector jobs* likewise has a 'negligible' impact on their long-term job prospects and rarely provides them with the skills and experience that other employers are looking for (John Freebairn, 'Labour market programs', In Business Council of Australia, *New Directions: Rebuilding the Safety Net* (BCA, Melbourne, 2000), p.100), and the OECD concludes that such measures have "been of little success in helping unemployed people get permanent jobs" (John Martin, 'What works among active labour market policies', *OECD Economic Studies* number 30, 2000/01, p.98). The Productivity Commission concludes that active labour market programmes like these "have variable, but usually small, effects on the employment and earnings of participants" (*Independent Review of the Job Network* p.1.3).

In previous publications, Kayoko Tsumori of CIS has identified three key labour market changes which together could help create more jobs without government giving out subsidies to employers or creating more public sector jobs.

- First, although the *award system* has been scaled back in recent years, we still impose a one-size-fits-all uniformity of wages and conditions on one in five of all Australian workers (and many more are in principle covered by awards). This stifles job creation, particularly in companies facing higher-than-average costs or operating in the least advantageous locations, and there is a strong argument for reintroducing regional variability in awards and increasing the opportunity for employers to seek exemptions or to opt out altogether (Kayoko Tsumori, 'Poor Laws (3): How to Reform the Award System and Create More Jobs' *Issue Analysis* No. 41, November 2003, CIS).
- Secondly, the award system has given us an effective national *minimum wage* that is one of the highest in the OECD. Only France (with its 9.1% unemployment) has a higher minimum wage than we do. A high minimum wage means employers will not find it profitable to employ as many workers in low-skilled positions. If we were to raise the personal tax-free threshold, minimum wages for low-skill jobs could be lowered without reducing workers' living standards (Kayoko Tsumori, 'Poor Laws (2) The minimum wage and unemployment' *Issue Analysis* No.28, December 2002, CIS).

- A third factor is that we impose many onerous and often unnecessary regulations on companies, and particularly on small businesses. The *unfair dismissal laws* are a classic example, for they deter small companies from taking on new employees lest they are unable to get rid of them later. The Melbourne Institute has estimated that the unfair dismissal legislation alone is costing at least 70,000 new jobs in the small business sector (Kayoko Tsumori, 'Poor Laws (1) The unfair dismissal laws and long-term unemployment' *Issue Analysis* No.26, August 2002, CIS).

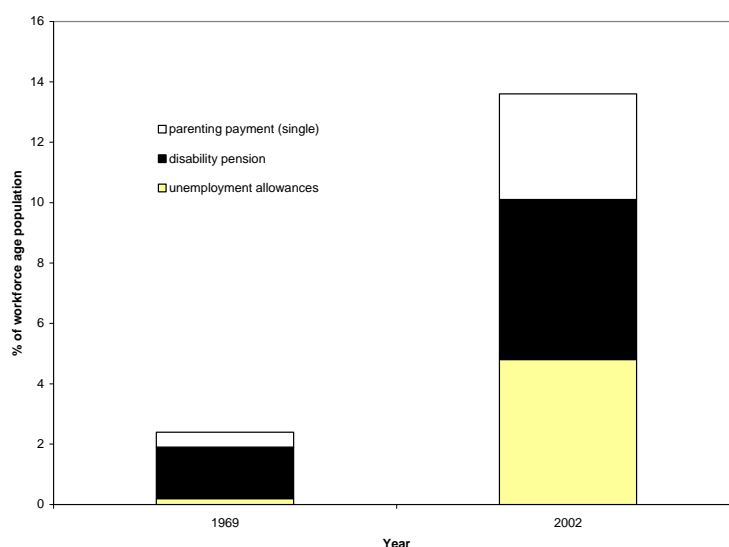
A more flexible award system, a lower minimum wage floor and reform of legislation which inhibits employers from taking on more workers would all help generate more job vacancies.

### **WELFARE REFORM TO REDUCE DEPENDENCY**

In 1969, fewer than 1 in 20 adults below retirement age were drawing welfare payments. Today it is more than 1 in 5, and 1 in 6 working-age adults are dependent on welfare for at least 90% of their income. This means that today there are just five workers paying income tax for every one person reliant wholly or mainly on welfare payments. In the mid-sixties there were twenty-two.

This trend of an ever-increasing dependency ratio is clearly unsustainable (especially when linked to the forecast blow-out in age pension dependency among retired people which will occur as the population ages over the next thirty years). We are chasing our tails – the more people on welfare, the fewer people there are to support them and the greater becomes the disincentive to maintain self-reliance. Self-reliant, tax-paying workers are a wasting asset.

**Figure 9: Proportion of working-age population receiving Unemployment, Disability and Single Parent payments in 1969 and 2002**



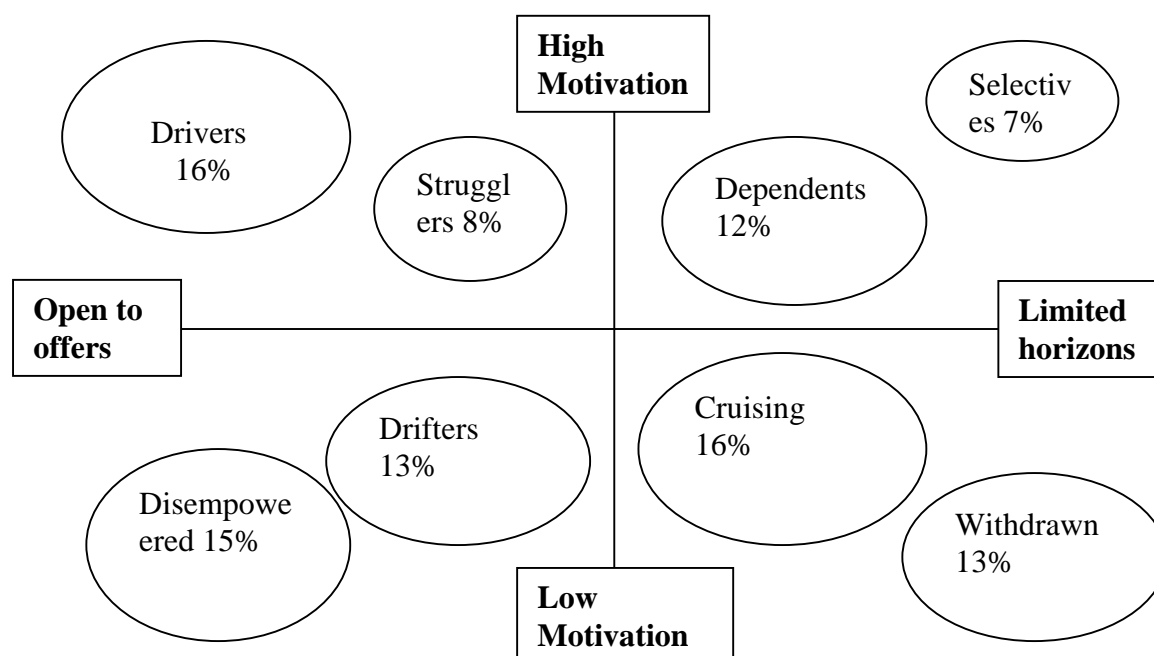
Sources: Australian Bureau of Statistics, *Australian Social Trends 2001: Income and Expenditure, Income Support among people of workforce age* (Commonwealth of Australia, 2002); *ABS Year Book Australia 2003* (ABS Catalogue No. 1301.0)

The increase in working-age welfare dependency has been concentrated in three main groups: the unemployed (benefits now cost \$5 billion per year), people on disability support (\$6.4 billion), and claimants of Parenting Payment Single (\$5.6 billion). It is a key priority that we reduce dependency rates in all three.

***Reforming unemployment benefits by introducing time limits***

Half the people registering as unemployed find a job within eight weeks, but we have seen that half or more of those on unemployment allowances have been claiming benefits for more than a year. The longer a period of unemployment lasts, the weaker the motivation becomes to find a job. As time passes, people start to ‘rationalise’ their continued failure to find or keep a job, concluding that they are ‘too old’, or they ‘cannot find suitable child care’, or employers ‘discriminate’ against them because of their race, or the jobs ‘do not pay enough’, or they are ‘under-qualified’ (or ‘over-qualified’), or the job is ‘dead-end’ and demeaning, or they lack ‘experience’, or they are the ‘victim’ of a drug habit or some other ‘barrier’ that stops them from working. The expectation of failure becomes self-fulfilling. As Lawrence Mead puts it: “Disadvantaged people without jobs find no end to reasons why working is impossible for them... They avoid personal responsibility and blame circumstances beyond their control...a mentality is at work that refuses to believe that opportunity exists, even when it does” (Lawrence Mead, *The New Politics of Poverty* Basic Books, New York, 1992, pp.143-5).

**Figure 10: Orientation to job search of people on unemployment allowances (2002)**



Source: Colmar Brunton Social Research, *Job Seeker Attitudinal Segmentation: An Australian Model* (report for the Dept of Employment & Workplace Relations, 2002); and Labour Market Policy Group, *Job Seeker Attitudinal Segmentation* (Dept of Employment & Workplace Relations, May 2002).

In 2002 a report commissioned by the DEWR (Colmar Brunton, *Job Seeker attitudinal segmentation: An Australian model*) found that about half of the unemployed could be said to exhibit low work motivation (see Figure 10).

Elsewhere (Peter Saunders, 'How to reduce long-term unemployment' *Issue Analysis* 40, September 2003, CIS) I have argued that introduction of time limits on unemployment benefits would reduce long-term unemployment by strengthening what the Productivity Commission calls the 'compliance effect.' The Productivity Commission's *Independent Review of the Job Network* (Canberra, 2002, p.5.14) found that only 38% of people referred to Job Search Training (JST) in 1999 commenced with the program. Similarly only 68 per cent of those referred to Intensive Assistance commenced. It seems that many people when required to undertake these activities leave welfare under their own steam (the Americans found much the same thing when they reformed welfare in 1996).

The Productivity Commission notes: "[C]ompulsory participation in programs can generate a *compliance* (or *motivation* or *deterrence*) *effect* whereby – to avoid having to participate in the program – some job seekers increase their job search activity and find employment, or those inappropriately claiming income support stop doing so because of their lack of availability for participation." Work for the Dole in particular has a very strong compliance effect – Dan Finn (*A new deal for unemployed Australians?* Dusseldorp Skills Forum, Melbourne, 2001) reports that three-quarters of young people referred to 'Work for the Dole' schemes fail to attend the first session, preferring to leave welfare altogether rather than undertake part-time work.

Time limits linked to an extension of WFD could, therefore, be expected to have a substantial compliance effect, resulting in a significant reduction in the numbers of people unemployed for more than 6 months. The prospect of reverting to WFD at the end of six months would increase the sense of urgency among those looking for work and would drive out those whose commitment to finding a job is not serious as well as those who are currently defrauding the system. We might realistically expect a fall of up to 50 per cent in the numbers of long-term unemployed under this proposal (more if the change were coupled with some of the labour market and tax reforms mentioned earlier in this paper). This adds up to nearly 200,000 claimants and an estimated net saving of around two billion dollars per year).

In August 2003, ACNielsen conducted an opinion poll<sup>4</sup> on behalf of the CIS in which respondents were asked their views on the following proposal: *It has been suggested that unemployment benefits should be limited to a period of six months, after which people would be expected to participate full-time in a 'Work for the Dole' scheme until they find a job.* Seventy per cent agreed with the proposal (36.5% said it was a 'very good idea' and 33.5% thought it was a 'good idea'). Only 22 per cent disagreed with it. Support was spread fairly evenly across all income groups and ages. It seems from this that time limits would meet with the approval of a large majority of Australians.

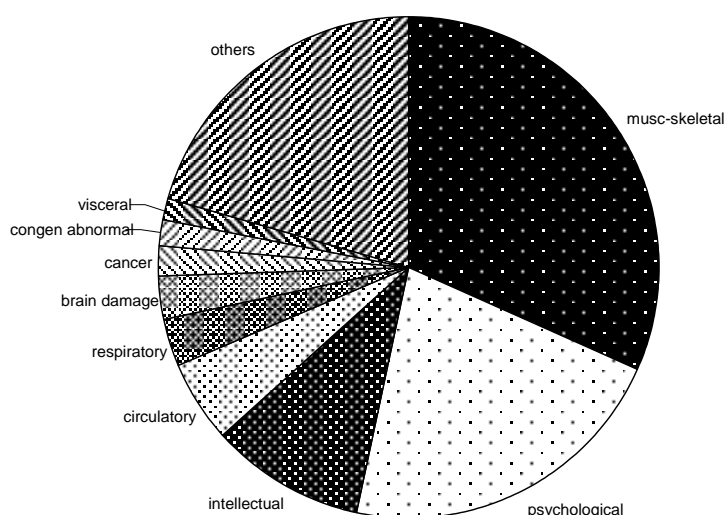
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<sup>4</sup> This is a different survey from the one referred to earlier (see footnote 2). The target population of this second survey was 1,850 internet users, of whom 467 (25%) responded in August 2003. The sample appears representative of the Australian population as a whole when checked against national data on age, gender, income, state and region, and has not therefore been weighted

## ***Reforming eligibility for Disability Support Pension***

In 1980, just 2 per cent of the working-age population was receiving a disability payment; today it is 5 per cent (more than 625,000 people), and the proportion is still rising. Some disability pensioners suffer major impairments, but the most common conditions are ‘musculo-skeletal’ problems (e.g. bad backs), which account for 32% of the total, and ‘psychological/psychiatric’ problems (not including intellectual and learning difficulties) covering another 22% (see Figure 11). Such conditions can be debilitating, but they are rarely incapacitating. The OECD estimates that across western countries, only one-third of those on disability payments are suffering the sorts of ‘severe disabilities’ that make paid employment difficult or impossible (‘Disability programmes in need of reform’ *OECD Policy Brief* Paris, March 2003, p.2).

**Figure 11: Main disability recorded for Disability Support Pension recipients aged 16-65**



Source: Based on Australian Bureau of Statistics, *Australian Social Trends 2002: Income and Expenditure, Income Support, Trends in Disability Support* (Commonwealth of Australia, 2002)

Australia’s system of income support provides a strong incentive for unemployed people to have themselves reclassified as ‘disabled’. People on Disability Pension are not currently subject to mutual obligation requirements – they receive their payments without having to undertake any activity tests or sign up to any participation agreements. They also receive a higher rate of payment than those on Newstart and are subject to a more lenient income test. Once on the Disability Pension, they normally stay there, undisturbed, right through to retirement (rates of exit from DSP other than through death or retirement are tiny – see John Landt and Jocelyn Pech ‘Work and welfare in Australia’, *Australian Social Policy* 2000, number 2; also ‘Why has the disability program grown so much?’, Report on seminar by Bob Gregory, *FaCS Research News* No.15, March 2003, 13-14).

Reviewing Centrelink file data, Bob Gregory has found that half of all disability pensioners in Australia are recruited directly from the unemployment rolls, and that the average time spent by these people on the Newstart Allowance before transferring to the Disability Pension is more than one year. This means that at least 300,000 of those claiming DSP have transferred out of long-term unemployment. Clearly, a significant proportion of those on DSP represent ‘displaced unemployed’ claimants, and it was in an attempt to reduce this flow of displacement that the federal government issued proposals to redefine ‘inability to work’ from its current 30 hours per week definition to 15 hours per week.

**Table 2: Public opinion on tightening DSP eligibility rules<sup>5</sup>**

**2. Do you agree or disagree that we should tighten up the rules for deciding whether somebody can claim a Disability Pension?**

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid Strongly disagree	471	8.2	8.2	8.2
Disagree	772	13.5	13.5	21.7
Neither agree or disagree	747	13.1	13.1	34.8
Agree	2022	35.3	35.3	70.1
Strongly agree	1579	27.6	27.6	97.7
Don't know/no opinion	130	2.3	2.3	100.0
Total	5721	100.0	100.0	

Source: First CIS ACNielsen survey (see footnote 2)

Such a move would certainly help stem the growth in DSP dependency, and CIS opinion survey research suggests it would be popular. Respondents were told: ‘The proportion of working age people who are claiming Disability Pension has doubled to more than 600,000 in the last twenty years’ and were then asked whether or not they thought eligibility rules should be tightened (Table 2). Nearly two-thirds thought they should and only one in five opposed it. Nevertheless, the government’s proposal remains blocked in the Senate where the Opposition parties refuse to support it.

### ***Reforming Parenting Payment***

Parenting Payment is a welfare benefit paid as a wage supplement or replacement for a caring parent, single or partnered. It is not intended to cover the costs of raising children (parents get FTB and other allowances to help with this).

Australia is one of a very few western democratic countries that permits parents to remain on welfare benefits for as long as they have a child below the school-leaving age.<sup>6</sup> One in ten of Australia’s lone parents claim no government benefits at all, and

<sup>5</sup> For survey details, see footnote 2.

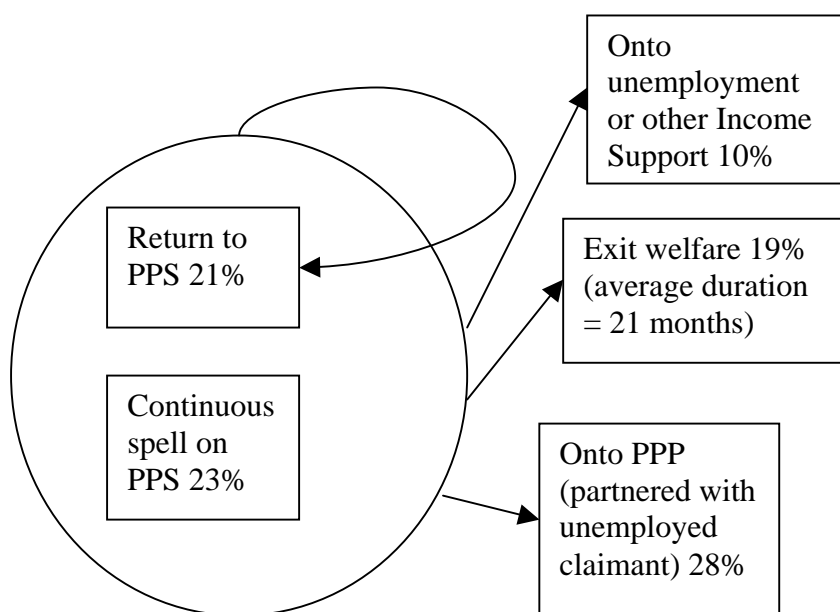
<sup>6</sup> The UK does not require lone parents to rejoin the labour force until their children reach school-leaving age, but most other countries have tighter expectations. In the USA, 1988 legislation reduced from 6 to 3 the age of child at which lone parents were exempt from work requirements, and since 1996 this has been left to individual states to determine. Germany and the Netherlands have both extended labour force participation requirements for single parents to those with primary school age children, and in France, participation is assumed to occur once the youngest child reaches three (see Martin Evans, *Welfare to Work and the Organisation of Opportunity* (Case Report No.15, 2001, London School of Economics). In Denmark, Sweden and Norway, it is expected that sole parents will



another one in five rely on benefits for less than 20 per cent of their total income. At the other extreme, however, one-third of lone parents have no income other than their welfare payment, and another 20 per cent rely on welfare as their principal source of income (Peter Whiteford and Gregory Angenent, *The Australian System of Social Protection: An Overview*, FaCS Occasional Paper Number 6, 2<sup>nd</sup> edition, 2002, Table 9).

Bob Gregory has estimated that single parent claimants are spending an average of twelve years on benefits. His longitudinal research found that many lone parents who leave PPS do not leave welfare, but simply exchange one kind of benefit for another (see Figure 12). Over a five year period, Gregory found that only one in five single parents went from welfare into financial self-reliance (either as a result of finding a job, or finding a new partner who was employed and who earned enough to support them).

**Figure 12: What happened over the next 66 months to sole mothers on Parenting Payment in January 1995**



Source: Based on Bob Gregory, Keynote Address to Australian Institute of Family Studies Conference, Melbourne, 2003

For a single parent to stay at home, on benefits, for twelve years does no good either for the child or the parent. In the USA, researchers have found that children who grow up in welfare-dependent households probably do not suffer in early childhood, but as they approach adolescence, continued ‘exposure’ to welfare significantly damages their educational attainment (Inhoe Ku and Robert Plotnick, ‘Do children

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actively seek paid employment once a child reaches three years of age (Tony Eardley, Peter Saunders, Ceri Evans, *Community Attitudes Towards Unemployment, Activity Testing and Mutual Obligation* SPRC Discussion Paper No.107, 2000, p.29). In contrast, the ‘Australians Working Together’ package introduced in September requires single parents with children of primary school age to attend one Centrelink interview per year, and those whose children are at senior school now have to undertake an average of six hours per week of some recognized activity such as community work or training.

from welfare families obtain less education?’ *Demography* 40, 2003, 151-70). As for the parents themselves, an extended period of welfare dependency means their skills and qualifications erode, their work-readiness decays, and their self-esteem plummets. It also means their income remains at a much lower level than would be the case if they were working – possibly at or below ‘poverty level’, depending on how that is defined. As Jocelyn Pech and Helen Innes suggest: “The social security system might, under the guise of allowing women choice, be helping to entrench some in poverty and disadvantage” (‘Women in the Australian labour market’ *Social Security Journal*, 1998/99, p.23).

If we were devising the welfare rules today, it would not occur to us to allow lone parents to stay on welfare for up to fifteen years (or longer if they have more than one child), for it is now common for mothers to go to work once their children start school. Through most of the western world, sole parents are expected to return to the workforce once their children start school.

In a previous paper (‘The tender trap’, *Issue Analysis* No.36, June 2003), I have argued that Parenting Payments (for sole parents and for coupled parents who claim PPP) should be payable in full only while a parent has responsibility for a child under the age of five. Once the youngest child starts school, the expectation should be that the parent will seek part-time work, and the rate of Parenting Payment should be adjusted accordingly. If these changes were introduced, even with no other reforms to the system, the annual saving on PPS alone would be over \$1 billion.

**Table 3: Public opinion on reforming Parenting Payment (Single)<sup>7</sup>**

**3. When do you think it is reasonable to expect a sole parent to go out to work part-time?**

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid By the time the youngest child reaches its first birthday	346	6.0	6.0	6.0
Once the youngest child is old enough to attend pre-school	1906	33.3	33.3	39.4
Once the youngest child starts primary school	2563	44.8	44.8	84.2
Once the youngest child goes to high school	488	8.5	8.5	92.7
Once the youngest child turns 16	354	6.2	6.2	98.9
Don't know/no opinion	64	1.1	1.1	100.0
Total	5721	100.0	100.0	

Source: First CIS ACNielsen survey (see footnote 2)

As with the proposed changes to unemployment and disability payments, so too with Parenting Payments, a change like this would attract widespread support. A CIS opinion survey first told respondents: ‘Sole parents who look after a child and do not go out to work can currently claim Parenting Payment.’ They were then asked when

<sup>7</sup> For survey details, see footnote 2

it is reasonable to expect a sole parent to work part-time. Table 3 shows that 84% thought sole parents should be expected to work at least part-time once their children have started school.

### **SUMMARY: A SHORT-TERM STEP TOWARD LONGER-TERM REFORM**

Our immediate aim should be to reverse the 40 year rising trend in welfare dependency by increasing self-reliance through employment wherever this is practicable. A strategy for achieving this must entail three linked areas of policy reform.

First, there must be further labour market reform to increase the supply of jobs – *not* ‘active labour market programs’ like subsidies and an expansion of the public sector, for these either do not work or are very expensive, and they can end up destroying jobs in the real economy. Rather, an employment strategy designed to increase the availability of jobs for those at highest risk of long-term unemployment should seek to bring about

- a more flexible award system
- reform to Unfair Dismissal laws and other job-destructive legislation
- a lower effective minimum wage (compensated by raised tax thresholds).

Secondly, we need to reform income tax to increase work incentives and rewards and reduce churning (high EMTRs). This is best achieved, not by tax credits (which are another means-tested benefit with disincentive effects) but by:

- raising personal tax-free thresholds at least to the equivalent household welfare minimum levels so that (in principle) nobody who pays income tax receives welfare, and nobody on welfare pays income tax<sup>8</sup>
- reducing punitive higher rates with a view (longer term) to establishing a flat rate income tax.

Thirdly, we must radically reform the Income Support system so as to reduce welfare dependency. This can be done by:

- introducing time limits on unemployment benefits to increase the compliance effects of Work for the Dole (estimated 50% reduction in unemployment over 6 months duration)
- accepting tighter eligibility rules for DSP to stop displacement from unemployment into disability and to re-establish a clear distinction between those who are expected to work and those who are not (the target should be a return to the 1980 level of DSP claims – a reduction of 150%)

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<sup>8</sup> As noted earlier, the details of how this would work have yet to be finalized, but a system of tax-free thresholds above the welfare level coupled with flat-rate allowances or credits for dependent children should be enough to ensure that all working families end up with an income above the welfare level, that no working family receives welfare other than a child allowance, and that the transition from welfare to work does not entail high EMTRs.

- expecting part-time work on the part of parents with school-age children and adjusting the value of Parenting Payments accordingly (possible saving around \$1 billion per annum).

Taken together, these proposals represent a package for implementation over the short-term. Longer term, it will be important to add policy reforms designed to encourage savings as well as work, for self-reliance involves accumulation of capital and assets as well as receipt of an independent income:

- The current age pension is unsustainable (given the ageing population) and creates perverse disincentives by combining means testing with the non-contributory principle. There is evidence that some retired people organise their finances in such a way as to maximise eligibility for the age pension, and those who make provision for self-reliance in old age are arguably penalised while those who do not are supported. To overcome these problems, we need to develop a strategy for buying out the future age pension entitlements of younger cohorts in the population (using privatisation receipts and bond issues) so that all citizens in future take personal responsibility for their own old age retirement income planning.
- The current superannuation guarantee is known to be inadequate in its coverage of people's projected financial needs. It is also deficient in many other ways (e.g. in the reliance on employer-only contributions, in the triple taxation of super funds, and in the limited choice of savings instruments recognised as acceptable forms of retirement saving). Reform is needed to make superannuation more attractive and more adequate.
- Reform of super could be accomplished as part of a broader move to individual savings/insurance accounts designed to cover not only retirement income but also unemployment and sickness insurance and health care cover. Lifetime tax/welfare churning is even more marked than churning at any one point in time – most of us in the course of a lifetime pay for most of the health and social security services we consume. This means the welfare state is functioning as a vast communal piggy bank, taking money from us at one time only to return it to us at another. It should be possible to replace this system with one based on personal accounts, supplemented where necessary by limited income transfers.

In future work we shall develop these longer-term proposals in more detail. I mention them here only as a reminder that we should not see the tax, welfare and labour market reforms outlined in this paper as an end point, but as a beginning. I have argued elsewhere ('Do we still need the welfare state?', Paper to Australian Institute of Family Studies conference, 2003) that the welfare state as it currently exists in Australia is an anachronism, designed to meet the needs of an age that has past, and increasingly doing more harm than good. To extricate ourselves from this institutional legacy, the first step must be to reverse the forty-year trend of growing expenditure and escalating dependency. After that, we can begin to rebuild.