

Senate Economics References Committee

Inquiry into the Structure and Distributive Effects of the Australian Taxation System

Queensland Government Submission

June 2003

Introduction

The Queensland Government considers the review by the Senate Economics References Committee of the Structure and Distributive effects of the Australian Taxation System to be timely, due to the emergence of the following pressures on the taxation system at State and national levels:

- Recognition of the impact of demographic change on future revenues and expenditure, which will create pressures on the capacity of both State and Commonwealth governments to maintain services;
- Debate about the impacts of high effective marginal tax rates on incentives to move from unemployment to paid work (or to increase paid hours), and integrating changes to the taxation and social security systems;
- Concerns about the impacts of growth of particular types of taxation at the State and Commonwealth level; and
- Continued debate about the relative taxing powers of different levels of Government and the allocation of revenues among the States and Territories.

The assessment of impacts of the taxation system needs to include the impacts on business investment, research and development, and incentives to different levels of government to undertake essential economic reforms. The Queensland Government prepared a submission for the Review of Business Taxation in 1999 which addressed these aspects of the taxation system, and a copy of the earlier submission is attached for the Committee's information. The Commonwealth Budget for 2003-04 announced changes to international taxation, including reduced tax on some overseas business income and capital gains and modernising the tax treaty network, which go part of the way to addressing impediments to trade and investment identified in the submission to the Business Taxation Review, although further action would be required to address outstanding issues in removing barriers to innovation and investment.

In this submission, the Queensland Government concentrates on the following issues of concern related to the current taxation system:

- The impact on workforce participation of the interface between the tax and social security systems;
- Queensland's experience with intergovernmental agreements for both the goods and services tax (GST) revenues and specific purpose payments (SPPs) including incentives to provide services more efficiently and undertake competition policy reforms; and
- Demographic change and fiscal sustainability.

The following sections outline evidence based on research and experience of Queensland Government agencies and suggest some options for the Committee's consideration.

The Interaction between the tax and social security systems: the impact on labour force participation

The Australian taxation and income support systems aim to redistribute income and ensure adequate incomes for people who are unemployed or unable to support themselves. However, the current structure of the tax system, and its interaction with the social security system, may reduce the financial incentives faced by many individuals when making decisions regarding their degree of participation in the labour market. There are two main mechanisms through which these 'disincentives' to labour market participation develop:

1. High effective marginal tax rates (EMTRs): EMTRs measure the effective tax rate applied to any additional dollar of private income when considering the combined impact of marginal tax rates and the withdrawal of social security benefits. Recent Australian studies indicate that it is individuals in "the lower half of the income distribution who face high EMTRs" (Beer and Harding, 1999, p16).
2. High replacement ratios: Replacement ratios measure the amount of after-tax real income received from unemployment and other social security benefits expressed as a ratio of the after-tax income that could be received from gaining employment. In effect, the replacement ratio reflects the extent of the EMTR being faced by the unemployed.

High EMTRs and replacement rates have potentially large economic costs. High EMTRs, by reducing the return from earning additional income, possibly discourage low income earners from working more hours or acquiring further skills to enhance their employability, productivity and thus their standard of living – the so called 'poverty trap' (Keating and Lambert, 1998).

Similarly, higher replacement ratios lower the incentive to search for or accept employment, raising both the rate and duration of unemployment. The resulting fall in the effective labour supply also tends to put upward pressure on wages, lowering labour demand and, thereby, raising the rate of unemployment (Layard, Nickel & Jackman, 1991). Higher unemployment results in reduced economic output due to the under-utilisation of labour. It has been estimated that this impact may have been as much as 6% of Gross Domestic Product during the early 1990s, when unemployment rates peaked at more than 10% (Junankar & Kapuscinski, 1992). Higher unemployment also places fiscal pressures on government, through greater assistance to unemployed and reduced income tax revenue.

Unemployment in Australia has also been linked to various social costs, including social exclusion, loss of skills, poorer health, increased criminal behaviour, stresses on family life, homelessness, poverty, breakdown, stigma, and the erosion of confidence and self esteem (McClelland, 1993; Borland & Kennedy, 1998). Therefore, any reduction in unemployment achieved through policies that reduce the incidence of high EMTRs and replacement ratios will have important economic and social benefits.

Despite their economic and social costs, the incidence of high EMTRs and replacement ratios in Australia has risen over the past two decades. A shift toward social security targeting has resulted in ‘income test stacking’, where multiple income tests overlap each other and income tax bracket thresholds. This has led to an increased incidence of high EMTRs faced by families since the early 1980s (Beer & Harding, 1999). Further, analysis following the introduction of the Australian National Tax Reform (ANTS) package shows that ‘the problem of lower income individuals facing higher EMTRs is just as prevalent, if not more so, in 2002 as it was in 1997’ (Beer, 2002). Changes in withdrawal rates for benefits have resulted in high EMTR’s applying over a wider income range.

Australian replacement ratios have also generally risen over the past three decades (Whitlock, 1994). They increased sharply in the mid 1970s, following a relaxation of the work test and the indexation of benefits to inflation, and again in the 1980s, due to the higher safety net provisions provided under the Accord. Estimates of the impact of higher replacement ratios on the Australian unemployment rate over this period range from 0.7% point to 2.0% points (Pissarides, 1991; Ooi & Groenewold, 1992). A similar increase in replacement ratios internationally has also been linked to the rise in unemployment rates and the duration of unemployment across the OECD (OECD, 1994, 1996).

The effects of high EMTRs and replacement ratios, in terms of the extent to which they act as a disincentive to labour market participation, are likely to be concentrated within particular labour market groups at the lower end of the income distribution:

- ***Families with dependant children:*** As the major income support payments are linked to the number of dependant children, these families often experience ‘income test stacking’ and therefore, face higher EMTRs (Beer, 2002).
- ***Youth*** and others initially entering the workforce, whose initial labour productivity is low, generally face lower potential wages and, therefore higher effective replacement rates (Disney, 2000).
- ***Part-time workers*** tend to have incomes in the range where overlapping means tests apply, causing high EMTRs. For example, Beer (1997) found that in a low income family with dependant children, a worker benefited by only \$12 per week after increasing their hours of work from five to 35 hours per week.
- ***Secondary income earners,*** particularly females, face higher replacement ratios and EMTRs due to defining eligibility criteria on household, rather than individual, income (Apps, 1997).

While low income earners face higher EMTRs and replacement ratios, empirical research suggests that the labour supply of this group is also more responsive to changes in the financial reward from work than that of higher income earners (Heckman, 1993). This is further indication that the current distribution of EMTRs is economically inefficient as well as inequitable (Apps, 1997).

Furthermore, in addition to the differential impacts of high EMTRs and replacement ratios on particular groups, the relative impacts across various labour markets will depend on the underlying wage and industry structure in each labour market. For example, states or regions in which the prevailing industry structure results in generally lower wage levels will tend to have higher proportions of their workforce receiving low incomes, and therefore facing high EMTRs. Similarly, as unemployment benefits are paid at a fixed rate across Australia, replacement ratios facing the unemployed in those regions will be relatively high compared with those faced by individuals in regions where wages are generally higher. Some measures, such as targeted rent assistance, address different housing costs and therefore the differences in effective replacement rates.

The economic literature regarding tax and social security reform is relatively silent on this issue. The next section case studies the Queensland labour market, as an example of one State in which the industry and wage structure play a role in raising the incidence of high EMTRs and replacement ratios. This highlights that, in addition to removing general disincentives to labour force participation, another important benefit of further taxation and social security reform would be to reduce the impact of disparities in wages and labour demand in different regions of Australia.

Tax and Social Security Reform: the role in reducing labour market disparities

Tax and social security reforms aimed at reducing the incidence of high EMTRs for low income earners and replacement ratios facing the unemployed may also help to reduce labour market disparities within Australia. This is because States and regions across Australia vary significantly in terms of their wage and industry structures, resulting in differences in the overall incidence of high EMTRs and replacement ratios. Furthermore, the prevailing industry structure in each region also influences the composition of the region's labour market, particularly the incidence of part-time, female and youth employment, groups which have been identified as being most affected by high EMTRs and replacement ratios.

Therefore, the potential negative impacts of high EMTRs and replacement ratios, which are apparent in the Australian labour market as a whole, are likely to be substantially higher in certain States or regions.

In illustrating this point, Queensland provides a good case study.

Case Study: The Queensland Labour Market

Queensland recorded average annual employment growth of 2.7% over the decade to 2002, substantially stronger than the 1.8% average growth recorded in the rest of Australia over the same period. However, the State's unemployment rate has averaged 8.6% over the period, compared with an average of 7.7% in the rest of Australia.

This phenomenon primarily reflects Queensland's stronger labour force growth, which in turn has been underpinned by the State's higher civilian population growth. However, it has also been driven by a consistently higher participation rate, in particular the greater participation by females, youth and part-time workers. Furthermore, the changing industrial structure of the Queensland economy, toward a more service-based economy, has largely resulted in strong growth in part-time employment and a rapid increase in the number of females with intentions of participating in the labour market.

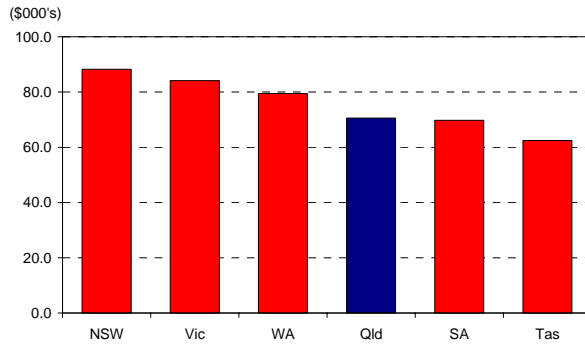
As a result, Queensland is a prime example of a labour market in which high EMTRs and replacement ratios are likely to have more significant impacts. The State's industry mix results in a lower wage structure than other States, raising the replacement ratios facing the unemployed. While Queensland has a higher aggregate labour force participation rate than the national average, this is due to a range of factors which lead to higher participation rates in various cohorts within the State's labour market, while the higher participation rates may themselves reflect the extended job search that results when jobseekers face high EMTRs and replacement ratios. Therefore, Queensland's higher participation rates do not detract from the problems that Queensland may face in relation to high EMTRs and replacement ratios. In fact, the resulting higher incidence of female, youth and part-time workers in the Queensland labour force results in a greater number of individuals and households in income ranges or circumstances where high EMTRs and replacement ratios are likely to be apparent.

Furthermore, a generally lower cost of living in Queensland leads to a higher 'real' value of unemployment and other income support benefits. The combination of a lower wage structure and this higher real value of social assistance could take up of low-skilled work less "attractive" in Queensland relative to other States. This has the potential to push the limit to the extent that the Queensland labour market can absorb the consistently high levels of interstate migrants, particularly lower-skilled migrants, flowing into the State.

Lower Wage Structure

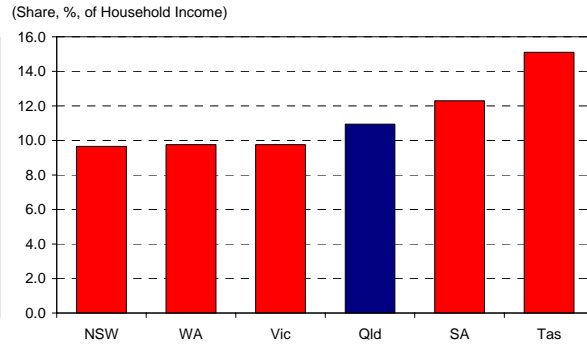
Queensland generally has a lower wage structure than the rest of Australia. The average full time wage and salary earner in the State earned around \$43,100 in 2001-02, \$3,200 below that earned in the rest of Australia (Queensland State Accounts). Differences in average wages at the individual level can lead to substantial variations in household incomes across the States. For instance, Queensland's lower wage structure translated into an average household income (\$70,600) that was \$17,600 (20%) below that in New South Wales (\$88,200) in 2001-02 (figure 1). The incidence of households receiving social assistance is likely to increase at lower income levels. Therefore, reflecting the lower incomes, the reliance on social assistance in lower income States such as Queensland, South Australia and Tasmania is higher relative to higher income States (figure 2).

Figure 1: Average Household Income
(\$000's, 2001-02)



Source: ABS 5220, 3101.0

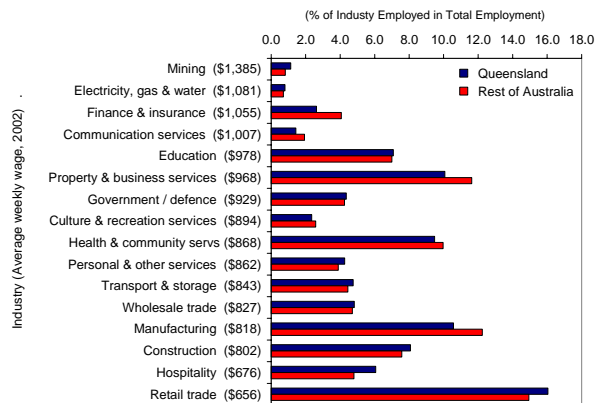
Figure 2: Incidence of Social Assistance
(% of household income, 2001-02)



Source: ABS 5220.0

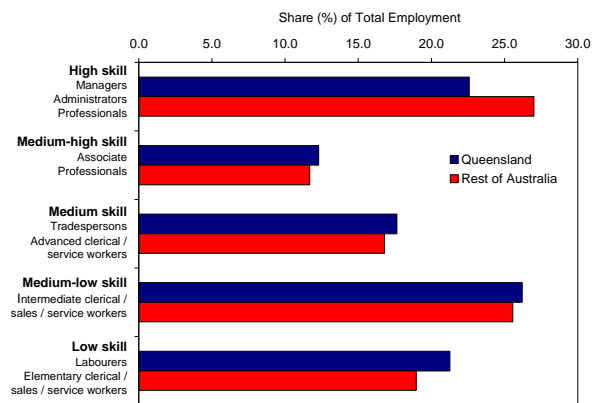
Queensland's lower wage structure is partly due to differences in its industrial structure and skill composition relative to the rest of Australia. Queensland employs a lower share of workers in high-income industries such as Finance and insurance, Communication services, and Property and business services, but a higher share of workers in relatively low-wage service industries such as Construction, Hospitality, and Retail trade (figure 3). Similarly, Queensland employs a lower share of workers in occupations that the Australian Bureau of Statistics (ABS) classifies as high skill, such as Managers and Professionals, but has a higher share in low skill occupations, such as Labourers (figure 4).

Figure 3: Industrial Structure, 2002



Source: ABS 6302.0, 6202.0

Figure 4: Skill Structure, 2002



Source: ABS 6291.0 Unpublished Labour Force Data

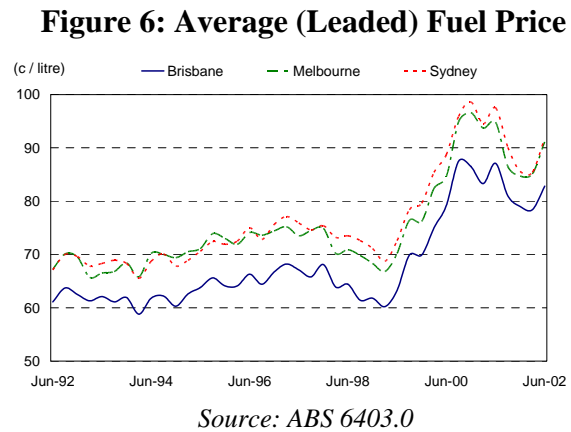
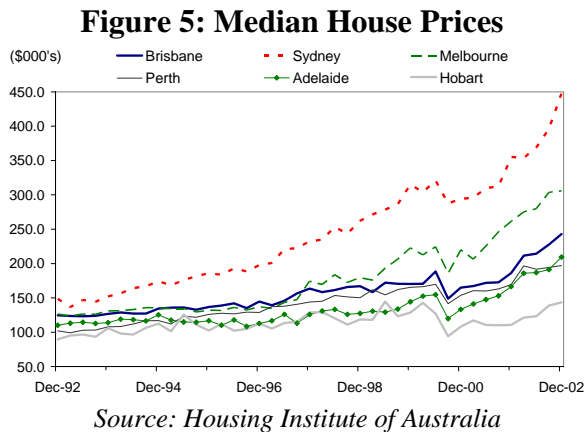
The lower wage structure in Queensland raises the incidence of high replacement ratios in the State relative to the rest of Australia. This is because replacement ratios depend on the wage that the unemployed person can expect to receive in moving into employment. The lower this wage, the more 'attractive' unemployment benefits become and the greater the disincentive to search for or accept work, thereby extending the period of job search. Therefore, unemployed persons in Queensland are likely to have lower wage expectations regarding employment and face higher effective replacement ratios than unemployed in some other parts of Australia.

Furthermore, the impact of the lower wage structure on the replacement ratio in Queensland may be magnified by the fact that these unemployed are likely to be in lower income households, relative to the rest of Australia. The higher reliance on social security at the household level in Queensland (figure 2), combined with the State's lower wage structure, means that replacement ratios and EMTRs for individuals in Queensland may be higher on average than in other States.

The Cost of Living

People living in Queensland generally face a lower cost of living relative to those residing in New South Wales and Victoria. The Economist Intelligence Unit's Worldwide Cost of Living survey for 2002 indicated that the cost of goods and services excluding housing costs was 12% higher in Sydney and 10% higher in Melbourne, compared with Brisbane. Queensland faces a lower cost of living in terms of housing costs and fuel prices in particular – two major components of household expenditure.

Figure 5 illustrates that the median dwelling price for a first home buyer in Brisbane was \$243,100 in December quarter 2002, some 46% lower than the corresponding price of \$447,300 in Sydney. Given current home loan rates, this difference translates into an average monthly home loan repayment of \$1,319 in Brisbane, compared with \$2,472 in Sydney (Housing Institute of Australia). Meanwhile, the average price for leaded fuel has been historically around 8c per litre lower in Queensland than in Sydney (figure 6).



A lower cost of living in a particular State actually raises the real value of social assistance benefits relative to other States. This is because the *nominal* value of social welfare benefits, that is their value in dollar terms, is fixed at the same level across the States for individuals facing similar circumstances. However, the *real* value of social welfare payments will reflect the relative purchasing power of the benefits, that is the quantity of goods and services, or the standard of living, that can be obtained from a given level of welfare payments. A lower cost of living increases the purchasing power for any given level of social assistance benefits.

A lower cost of living will also account for some of the difference that exists in *nominal* wages between Queensland and the rest of Australia. However, the average unemployed person in Queensland can expect to receive a lower real wage upon entering employment but a higher real value of social assistance while unemployed. This means that unemployed in Queensland tend to face higher replacement ratios relative to other States.

Migration and Labour Market Participation

Queensland's lower cost of living also appears to have been an important factor underpinning high interstate migration into the State (Williams et al, 1997). Queensland recorded an average net inflow of 27,300 interstate movers per year over the past two decades, more than 10 times the average inflow (2,400 persons) into Western Australia over the same period. All other States have on average recorded net outflows of interstate migrants over the past two decades.

Queensland's strong interstate migration has coincided with a greater number of low-skilled arrivals into Queensland, relative to other States (figure 7). Given that a lower cost of living raises the real value of social assistance payments, individuals may find it cheaper, or be able to maintain a higher standard of living, if they are unemployed or working few hours in Queensland, compared with New South Wales and Victoria. Figure 8 provides some evidence of this, with the unemployment rates for migrants without formal qualifications who moved to Queensland over the five years to May 2001 being higher in every age cohort, compared with the same category of migrants who moved from Queensland to other States.

Figure 7: Interstate Migrants Without Formal Qualifications*, May 2001

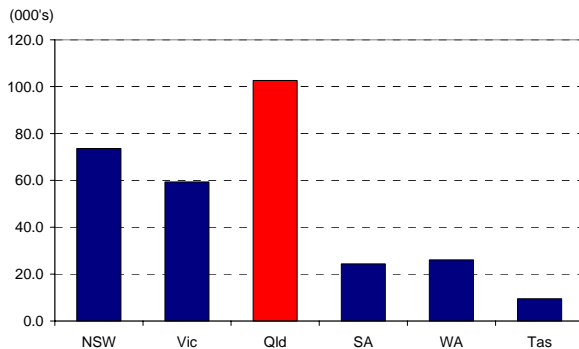
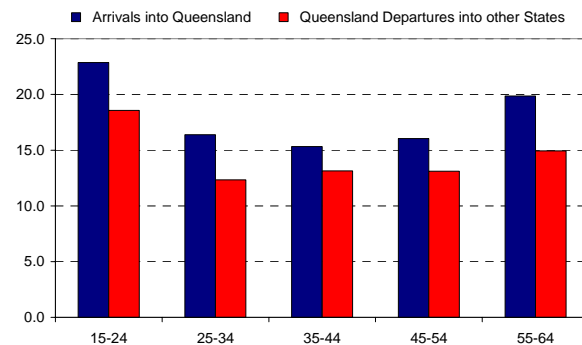


Figure 8: Unemployment Rates of Migrants Without Formal Qualifications*, May 2001



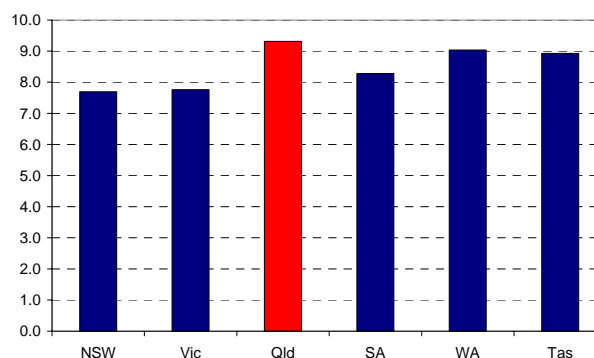
* Interstate migrants are defined as those who were residing in another State or Territory five years earlier.

Source: Census 2001

Youth

Queensland's labour force is more skewed toward youth, i.e. 15 to 19 year olds, relative to the rest of Australia. The proportion of Queensland's labour force that comprised 15-19 year olds was 9.3% over the five year period from 1998 to 2002, compared with 8.0% in the rest of Australia. In fact, Queensland's labour force has the highest proportion of youth of any State and, in particular, has a markedly higher youth component than New South Wales (7.7%) and Victoria (7.8%) (figure 9).

Figure 9: Youth Labour Force
(Proportion of total labour force, %, 1998 to 2002)

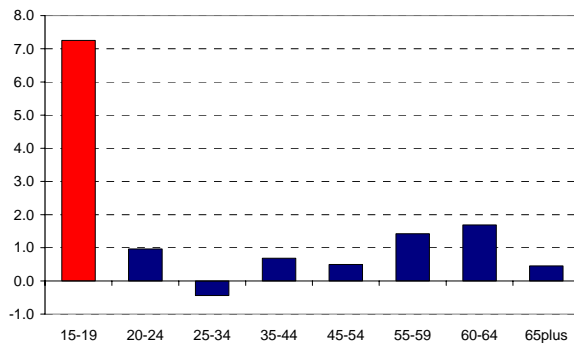


Source: ABS 6202.0

The youth participation rate for 15-19 year olds in Queensland over the five years to 2002 averaged 65.0%, which was 7.2% points higher than the youth participation rate (57.8%) in the rest of Australia (figure 10). As a result, the 15-19 year age cohort contributed more than half of the overall 1.9% points differential in participation rates between Queensland and the rest of Australia over the period.

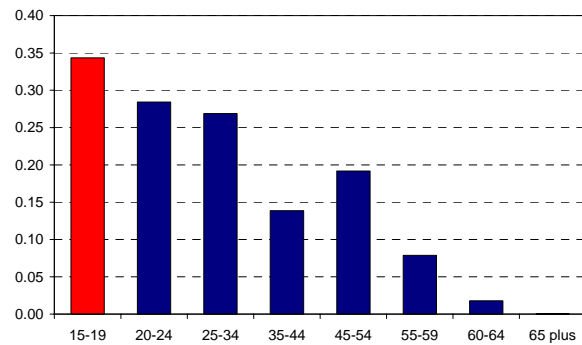
Furthermore, figure 11 highlights that the youth cohort, which comprises less than 10% of the Queensland labour force, accounted for more than one-quarter of the aggregate unemployment rate differential between Queensland and the rest of Australia over the five years to 2002.

Figure 10: Participation Rate Differential
(Qld v Rest of Australia, 1998 to 2002)



Source: ABS 6202.0

Figure 11: Contribution to Unemployment Rate Differential
(Qld v Rest of Australia, 1998 to 2002)



Source: ABS 6202.0

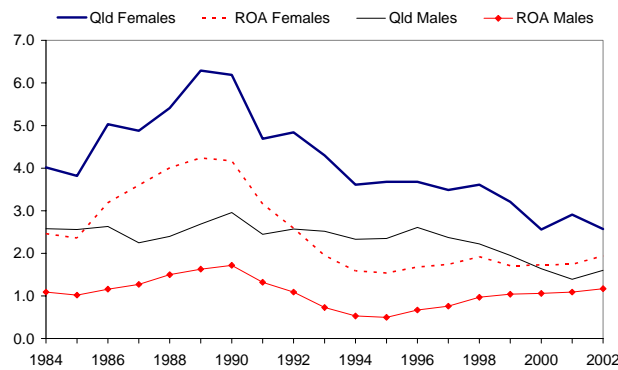
The greater participation by youth in Queensland's labour market partially reflects the State's industry structure. Industries such as Retail trade, Accommodation, cafes and restaurants and other service-based industries tend to offer more opportunities for part-time work and lower-skilled jobs. As a result, these industries are more conducive to youth employment, given the relatively lower skill level of youth.

However, youth seeking employment in these industries face relatively lower wage levels. Therefore, those who are unsuccessful initially in securing employment may face relatively higher effective replacement ratios than other categories of unemployed. This problem may be magnified by the higher real value of unemployment benefits in Queensland. The lower skill set of youth also places them in lower income ranges, where high tapering rates generally apply to various forms of social assistance, such as youth allowance.

Females and Secondary Income Earners

Queensland's strong labour force growth in recent years has been largely due to a rapid increase in the female labour force, which has experienced substantially higher growth than the rest of Australia over the last two decades (figure 12). In terms of average annual growth over this period, Queensland's female labour force grew by 3.9% per annum, compared with 2.5% growth in the rest of Australia. This equates to a 116% increase in Queensland's female labour supply over the period, compared with only a 62% increase in the rest of Australia.

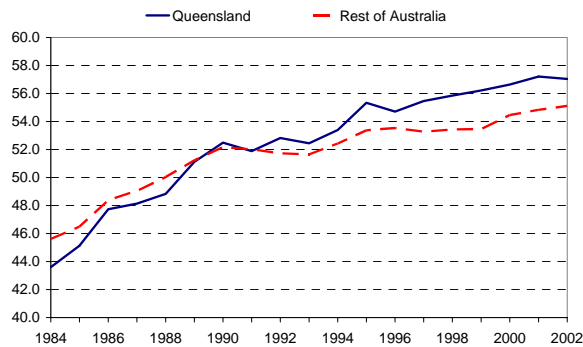
Figure 12: Labour Force Growth
(annual % change, 5 year moving average)



Source: ABS 6202.0

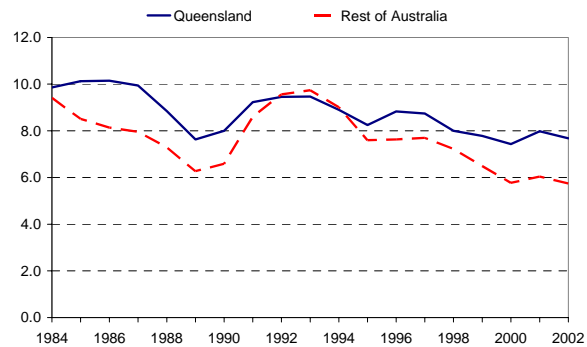
This rapid increase in the number of females in the Queensland labour market has been driven by a combination of strong population growth and a surging female participation rate. Queensland's female working age population (15-64 years) has grown by 62% over the past 20 years, compared with only 29% growth in the rest of Australia. Meanwhile, the female participation rate in Queensland has increased from 43.1% (1.9% points below the rest of Australia) in 1983 to 57% (1.9% points above the rest of Australia) in 2002 (figure 13). As a consequence of the combination of labour force growth and a radical shift in the participation rate, the State's female unemployment rate has remained substantially above that of the rest of Australia throughout most of the past two decades (figure 14).

Figure 13: Female Participation Rates
(%, annual average)



Source: ABS 6202.0

Figure 14: Female Unemployment Rates
(%, annual average)

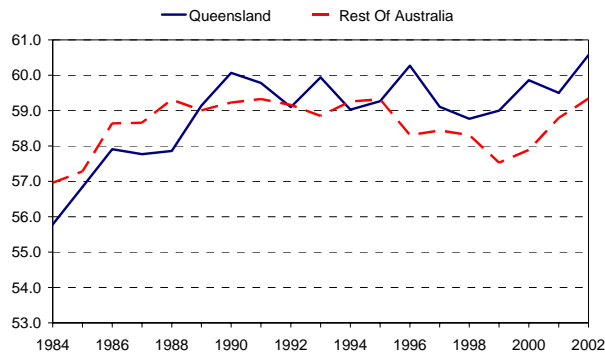


Source: ABS 6202.0

Similar to trends nationally and in other western economies, the source of the strong female labour force growth in Queensland has partly been the substantial increase in the proportion of married females, a share of whom are secondary income earners. As a proportion of the total female labour supply, the share attributable to married women in Queensland has increased from 56% in 1983 to 60.6% in 2002.

In comparison, the proportion of married women in the rest of Australia's female labour supply has only risen from 57.1% to 59.3% over the same period (figure 15).

Figure 15: Proportion of Married Females in Labour Force
(%, annual average)



Source: ABS 6202.0

Females, on average, work less hours and receive less income than males, as they have a greater representation in part-time employment. Lower average incomes, combined with the tapering of social assistance as household income increases, means that women are more likely to face higher EMTRs when attempting to either increase their hours of work or move from part-time to full-time employment.

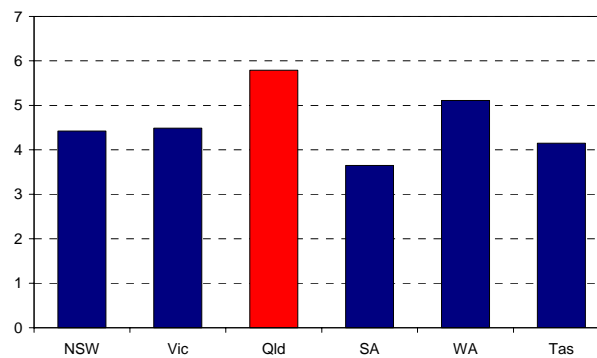
In addition, this group's response to high EMTRs is likely to be more marked than other groups, as females' supply of labour tends to be more sensitive to changes in the financial reward from work. Therefore, they may be more likely than males to withdraw from actively seeking work or extend their period of job search if the potential financial gain from working is reduced.

As a result, the marked difference in female participation rates and female labour force growth in certain States, such as Queensland, suggest that any potential negative impacts of high EMTRs and replacement ratios is likely to be exacerbated in these regions.

Part Time Workers

Part-time employment has grown strongly in Australia in recent decades. However, the extent of this growth has varied considerably between States, with Queensland having recorded the highest annual average growth in part-time employment over the last two decades (figure 16). Part-time employment comprised 27.5% of Queensland's total employment over the five years to 2002, compared with 25.1% and 27.1% in New South Wales and Victoria respectively.

Figure 16: Part Time Employment Growth
(% change, annual average, 1983 - 2002)



Source: ABS 6202.0

Part-time workers, particularly those who are secondary income earners, tend to have incomes in the range where high EMTRs apply. The higher incidence of part-time employment in Queensland also reflects the State's higher rates of labour force participation by youth and females, groups which have already been identified as either facing higher replacement ratios or higher EMTRs.

The Case for Reducing Labour Market Disparities

Based on the above case study of the Queensland labour market, it is clear that some States may face a higher incidence of EMTRs and replacement ratios, relative to others. This is due to differences in industry structure, average household incomes, the relative cost of living and the composition of the labour force, particularly in terms of part-time employment, youth and female labour force participation.

In this sense, tax and social security reform aimed at addressing the incidence of high EMTRs facing low income earners, and replacement ratios facing the unemployed, may also assist in reducing regional labour market disparities associated with active labour market participation and employment outcomes.

Queensland Government Action to Assist the Unemployed

Since 1998, the Queensland Government has assisted unemployed people to gain work experience through the *Breaking the Unemployment Cycle* initiative. This initiative involved expenditure of \$470 million over six years to 2003-04, providing employment and traineeships in locally-based projects and with public sector employers, and assistance to people displaced by company failures. A review of *Breaking the Unemployment Cycle* (Department of Employment and Training, 2002) has indicated that more than half of the participants in the Community Jobs Plan, Community Employment Assistance Program and Public Sector Employment Program had obtained on-going employment.

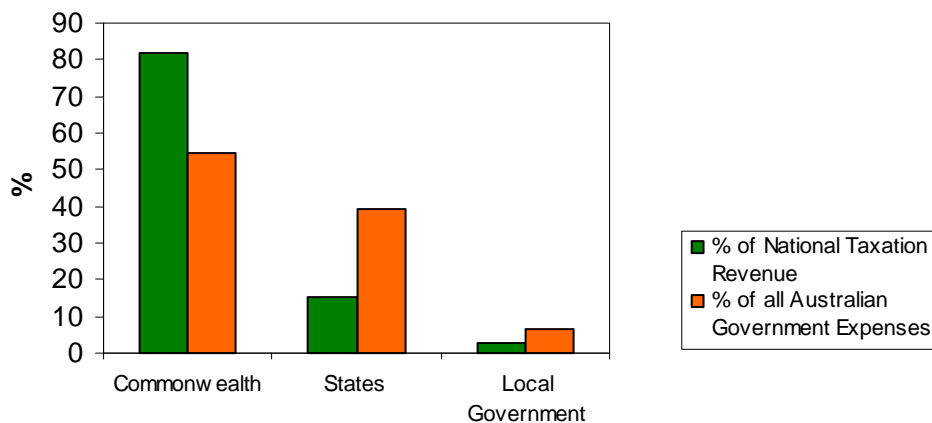
While action to address high EMTRs and disincentives to employers would be an important part of addressing long-term unemployment, targeted assistance such as that provided by *Breaking the Unemployment Cycle* would allow a larger proportion of unemployed people to take advantage of any additional demand for labour.

Experience with Commonwealth-State Taxation Arrangements

Background

There is a mismatch in Australia between the revenue raising capacities and the expenditure responsibilities of the levels of Australian Governments. Such a mismatch is a common characteristic of federations internationally, although rarely as pronounced as in Australia, and underlies the nature of the financial relationship between the Commonwealth and State¹ Governments.

**Figure 17: Vertical Fiscal Imbalance in Australia
2000-01**



Source: *Government Finance Statistics 2000-2001, ABS Cat. No. 5512.0*

Note: Government expenses have been adjusted to exclude Commonwealth transfers to State and Local Governments, and State transfers to Local Government

The mismatch is called Vertical Fiscal Imbalance (VFI). Arrangements for transfers of taxation revenue from the Commonwealth to State Governments are therefore a necessary characteristic of inter-governmental relations in Australia. These transfers are not discretionary, but an essential redistribution of taxation revenue if the Commonwealth of Australia is to be maintained as a successful, cooperative federation.

Prior to 1 July 2000, the major financial transfers between the Commonwealth and State were general purpose Financial Assistance Grants (FAGs) and tied Specific Purpose Payments (SPPs). These grants were paid from Commonwealth revenue, predominantly income and company taxation revenue and wholesale sales tax revenue. Commonwealth taxation revenue sources were broader and relatively more growth responsive than the taxation revenues available to States. Generally, a narrower base and less efficient taxes such as land and property taxes are available for States to raise own-sourced revenue.

¹ 'States' refers to States and Territories, unless otherwise indicated.

National tax reform included significant changes to Commonwealth-State financial relations, agreed by all Australian Governments in the *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations* (IGA). The Commonwealth agreed to pay all the revenue from the Goods and Services Tax (GST) to States as general purpose grants. The GST revenue replaces the FAG and the revenue forgone by the abolition of a number of State taxes. States agreed to abolish bed taxes, Financial Institutions Duty (FID) and stamp duty on the transfer of quoted marketable securities. Queensland had never levied bed taxes or FID. Governments also agreed to abolish debits tax by 1 July 2005 subject to Ministerial Council review, and agreed Ministerial Council would review the need to retain a number of business stamp duties by 2005. Initially, it had been intended that the payment of the GST revenue to States would allow for the abolition of these financial transaction taxes and business stamp duties. However, abolition of these taxes was postponed when the GST base was reduced following negotiations between the Commonwealth Government and the Australian Democrats on food and other exemptions.

The revised financial arrangements have increased VFI between the Commonwealth and States. In 1999-2000, the Commonwealth raised 78% of national taxation revenue and met approximately 53% of national government expenditure. In contrast, States raised 19% of national taxation revenue and met approximately 40% of national government expenditure. In 2000-01, the first year after national tax reform, the proportion of national taxation revenue raised by the Commonwealth increased to 82%, while the proportion of expenditure met by the Commonwealth increased marginally to about 54%. The proportion of national taxation revenue raised by States declined to about 15%, while States' share of national government expenses declined marginally to about 39%.

The Australian Bureau of Statistics *Government Finance Statistics* regard the GST correctly as a Commonwealth tax. But even if the relative proportions of national taxation revenue are adjusted to include the GST as State taxation revenue, VFI is still pronounced. Adjusted to include the GST as State revenue, in 2000-01 the Commonwealth and States collected 71% and 26% of national taxation revenue respectively, compared with meeting 54% and 39% of national government expenses.

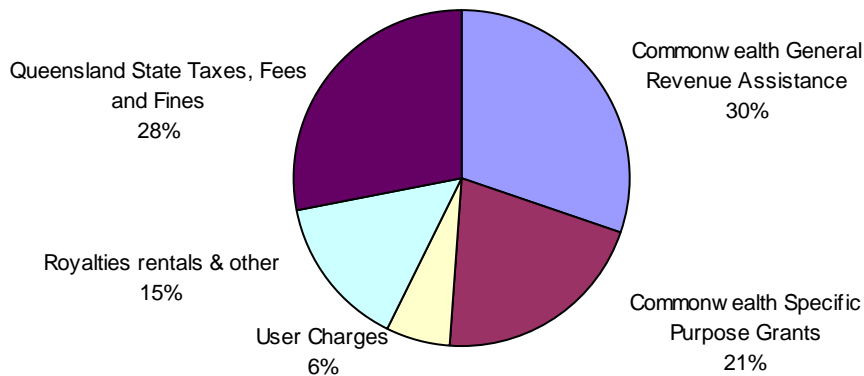
The IGA did not change arrangements for SPPs. The Commonwealth agreed in the IGA to continue to provide SPPs to States and undertook that it had no intention of cutting aggregate SPPs as part of the tax reform process, consistent with the objective of States being financially better off under the new arrangements.

As part of its undertaking that States would not be worse off under the national tax reform arrangements, the Commonwealth agreed to provide Budget Balancing Assistance (BBA) to supplement the GST grants. A State receives BBA if its share of GST revenue does not at least equal a calculated Guaranteed Minimum Amount (GMA). The major components of the GMA are estimates of the FAG each State would have received under the previous Commonwealth State financial arrangements, estimates of Revenue Replacement Payments for excise on tobacco, alcohol and petrol that the Commonwealth previously collected on behalf of States, revenues forgone by the abolition of State taxes and some additional expenditures States agreed to accept under the IGA.

States also receive National Competition Policy Payments (NCPPs). In 1995, the Council of Australian Governments signed the *Agreement to Implement the National Competition Policy and Related Reforms*. Under the agreement, States are eligible for three tranches of ongoing NCPPs. The third tranche commenced in July 2001. States receive NCPPs as general purpose grants.

The importance of Commonwealth transfers to the Queensland Budget is illustrated in the following chart on the sources of general government revenue in Queensland in 2001-02:

Figure 18: Composition of Queensland General Government Revenue in 2001-02 (\$18,852million)



Source: Consolidated Financial Report of the Queensland Government for the year ended 2002.

In 2001-02, Queensland received \$9,579 million of the total \$52,414 million Commonwealth grants made available to States. Commonwealth grants to each State and Territory were:

Table 1: Commonwealth Grants to States 2001-02 (\$ million)

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	Total
GST	8,132	5,593	5,019	2,518	2,477	1,060	544	1,290	26,632
BBA	1,577	977	524	352	365	138	63	98	4,094
NCP	243	180	148	71	56	17	12	8	733
SPPs	6,672	4,910	3,888	2,450	1,648	535	360	492	20,955
Total	16,624	11,660	9,579	5,391	4,545	1,751	978	1,887	52,414

Source: Commonwealth Final Budget Outcome 2001-02, Part IV: Federal Financial Relations

Queensland receives less than an equal per capita share of Commonwealth grants. This is illustrated in Table 2. Overall, in 2001-02 Queensland received \$70 per capita less than the national average per capita allocation of Commonwealth financial assistance for the States.

Table 2: Commonwealth Grants to States 2001-02 (\$ per capita)

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	Total
GST	1,230	1,157	1,370	1,316	1,634	2,245	1,698	6,527	1,364
BBA	239	202	143	184	241	292	197	495	210
NCP	37	37	40	37	37	37	36	38	38
SPPs	1,010	1,015	1,061	1,280	1,087	1,134	1,123	2,488	1,073
Total	2,515	2,411	2,614	2,817	2,999	3,708	3,054	9,548	2,684

Source: Commonwealth Final Budget Outcome 2001-02, Part IV: Federal Financial Relations and ABS Estimated Resident Population at end of December quarter 2001, Cat. No. 3239.0.55.001

Queensland's Experience with Inter-Governmental Agreements

The IGA undertaking to provide all GST revenues to States offers the promise of access to broad based taxation revenue that will grow in line with growth in the Australian economy. However, while there are some benefits for Queensland, the GST is not the windfall to States claimed by some Commonwealth Ministers and media commentators. As Queensland is one of the first States to be in the position where the State's share of the GST distributed by the Commonwealth will exceed the State's GMA, the Queensland Government is concerned with the growth and allocation of GST revenue.

One issue of concern is the high degree of budget uncertainty inherent in the State relying on GST revenue for more than a quarter of its General Government Revenue. Although it is appreciated the administration of the GST is taking some time to settle down, one factor contributing to the high degree of uncertainty is the unreliability of the Commonwealth's current Budget year and forward year estimates of GST collections.

GST collections have to date been consistently overestimated by the Commonwealth. The Commissioner of Taxation determined in June 2001 that GST cash collections for the financial year 2000-01 would be \$24,355 million. A few months later, the Commonwealth Budget Outcome for 2001-02 revealed cash collections had been \$578M less than determined (subsequently further revised to \$518M). In 2001-02, the GST cash collections were again overestimated. The Commonwealth Budget Outcome for 2001-02 released in September 2002 identified GST cash collections were \$532M less than had been estimated in the Commonwealth Budget four months previously.

These concerns have not been allayed by the Commonwealth's reluctance to share information that could impact the forward estimates of GST collections. The Commonwealth's forward estimate of GST cash collections in 2003-04 was reduced by \$80M at the Commonwealth's Mid Year Economic and Fiscal Outlook 2002-03. On past experience, the Commonwealth does not disclose in confidence to States the likelihood of changes to its GST estimates outside of its budget context. The Queensland Government generally brings down its Budget a few weeks after the Commonwealth. The State Budget is framed with expectations of the quantum of available GST revenues. Significant variation to this estimate at a late stage of the Budget process could clearly be destabilising. These risks are a new and increasingly important aspect of the Commonwealth-State financial relationship.

Whether States will benefit from replacing the Financial Assistance Grant with GST revenue will also depend on future actions and policies of the Commonwealth Government. States' experiences to date give a number of grounds for concern.

Although the Commonwealth undertakes in the IGA not to reduce aggregate SPPs as part of the new tax arrangements, there are from time to time statements made by Commonwealth Ministers that States should use GST revenue to fund areas of expenditure currently funded by the Commonwealth through SPPs to the State. GST revenues will genuinely benefit States if the additional revenues are available for States to improve service delivery to their communities. This will not be possible if the additional revenue is diverted to fund additional expenditure responsibilities transferred from the Commonwealth to States.

It is a concern to Queensland that while the Commonwealth may be meeting its undertaking not to reduce aggregate SPPs, a closer look at the detail of SPP transfers reveals that SPPs 'to' States have grown at much lower rates than other SPPs since 1999-2000 and the discrepancy is estimated to continue. For example, SPPs 'to' Queensland are estimated to increase by 2.4% from 2002-03 to 2003-04, compared with an estimated increase of 36.8% in Commonwealth SPPs direct to Local Government in Queensland and an estimated 7.8% increase in SPPs 'through' the State². (The SPPs 'through' the State mainly comprise the Local Government Financial Assistance Grant and financial assistance for non-government schools, funding for non-government schools accounting for most of the increase.)

The Commonwealth's funding offers on major SPPs currently under negotiation are disappointing. The Commonwealth State Housing Agreement (CSHA) expires on 30 June 2003. The Commonwealth's offer represents a decrease in funding to Queensland of 14.8% in estimated 'block' assistance in 2003-04 compared to 'block' funding in 2002-03. This decrease includes the Commonwealth's removal of compensation for the impact of the GST on the cost of providing public housing assistance. Another example is the Commonwealth's offer for the renewed Commonwealth State/Territory Disability Agreement which would provide in total only an additional \$3.2M Commonwealth contribution towards specialist disability services in Queensland in 2003-04 compared with 2002-03.

In 2002 the Commonwealth Government revised its framework for managing SPPs, establishing principles for a more coordinated approach to the negotiation and renegotiation of agreements. One of the issues of concern to Queensland is the emphasis placed on Commonwealth input and policy control of States. In negotiations since the Commonwealth revised its SPP management framework, the Queensland Government has noticed a trend for the Commonwealth to seek to obtain States' commitments to particular levels of States-own expenditure in the area of an SPP. This is happening in agreements that have not previously had matching conditions, and even in agreements where the Commonwealth's contribution to funding services is minor compared to States' contributions.

This trend has implications for the delivery of the Commonwealth's promise that States will be better off under the tax reform arrangements. States will only be better off if GST funds are available for general purposes as guaranteed in the IGA, and available to be allocated towards a State's emerging budget priorities. States will lose budgetary flexibility if large areas of their budgets are covered by commitments made to the Commonwealth in the context of SPP negotiations.

Queensland is also concerned by trends for the Commonwealth to impose its policy objectives on States through SPP conditions. For example, the draft CSHA provides for up to 5% of funds to be withheld if States do not comply with the Commonwealth's public housing rent policy and specified reporting requirements. The Queensland Government is disturbed by suggestions by a Commonwealth Minister, in response to the Cole Royal Commission into the Building and Construction Industry, that a recommendation the Commonwealth would only engage contractors that adopt the Commonwealth's industrial relations policies contained in its National Code of Practice would also apply to funding arrangements with States. In SPP agreements, States are not contractors to implement Commonwealth policies and meet Commonwealth objectives. The essence of SPP agreements needs to be partnership between Governments.

² Treasurer's press release dated 28 March 2003 following Ministerial Council meeting.

Uncertainty in National Competition Policy Payments (NCPs) is a further example of budget risk. Deputy Prime Minister John Anderson and Federal Minister for Agriculture Warren Truss have argued for renegotiation of the NCP agreements to require States to use their competition payments to compensate irrigators for any loss their water "property rights" as the result of making more water available to meet environmental needs. The Commonwealth is increasingly arguing any costs associated with decisions to reduce entitlements should become a State responsibility, even though such a requirement is not part of NCP agreements. Furthermore, no agreement is in place to suggest current irrigation allocations are a property right which, if adjusted to meet valid environmental requirements, would trigger compensation. The Commonwealth is yet to confirm whether it will continue the competition payments past 2005-06. States and Territories argue, based on an objective reading of the relevant NCP agreement, that the payments are on-going beyond 2005-06. It has been proposed that this matter be discussed at a future CoAG meeting.

Assessment of Commonwealth-State Financial Relations

Queensland supports the current broad structure of Commonwealth-State financial relations. It supports the distribution of the GST based on the principles of horizontal fiscal equalisation (HFE). As Commonwealth Treasury noted in its 2002-03 Budget Paper No. 3, "HFE gives practical effect to Australians' concerns about equity and substance to the Federation by giving each State a more equal capacity to provide their citizens with access to essential services (such as health and education) at a standard that is not lower than other States".

New South Wales and Victoria have created considerable debate on HFE and its "negative" impact on economic efficiency. Based on New South Wales' and Victoria's claims at the 1992 Financial Premiers' Conference, a Heads of Treasuries' (HoTs) Working Party was formed to examine the adequacy of the Commonwealth Grants Commission's (CGC) scope and methodology and principles of HFE. At the same time, two other studies by independent consultants were commissioned by New South Wales (a qualitative review examining the economic and social impacts of the current HFE) and Victoria (a quantitative analysis of HFE arrangements on efficiency, economic activity and prices and income). These three reports, in addition to the CGC's 1993 Review of Methodologies report, were to be available for the 1993 Premiers' Conference.

The HoTs Working Party report concluded that HFE is central to the achievement of economic efficiency and ensuring citizens across the nation have equal access to basic services provided by governments. It found that there was a strong case to retain the current fiscal equalisation arrangements. The HoTs report was presented to the 1994 Premiers' Conference then lapsed into obscurity along with the reports from New South Wales and Victoria.

New South Wales, Victoria and Western Australia have since jointly sponsored a review of Commonwealth-State Funding Arrangements to coincide with the CGC's 2004 review of revenue sharing methodologies. The review arose from dissatisfaction on the part of those three States with the funding outcomes of current CGC arrangements. Their review incorporated modelling work which suggests efficiency gains could result from a move to a more equal per capita distribution of the GST and SPP funding. Queensland has used the same model, with more realistic assumptions, to show the result would be efficiency losses of up to \$620M. Notwithstanding the possible losses, a move away from the current HFE distribution of the general purpose GST funding would result in severe economic and social dislocation in smaller States and Territories which would far outweigh the meagre efficiency gains argued by the sponsoring States.

These three States sought to have their review discussed at the 2003 Ministerial Council (MINCO). At MINCO, it was noted that all States agreed to the current HFE arrangements in 1999 when State Premiers signed the IGA, and in the absence of any agreement to a new review of HFE by the majority of states, the Commonwealth Treasurer decided not to pursue further the issues raised by New South Wales, Victoria and Western Australia. It was also noted at MINCO that the CGC is currently undertaking its major review of revenue sharing methodology, with its report due in 2004.

While satisfied with the overall framework for Commonwealth-State financial relations, the Queensland Government does have some concerns with trends in the management of the relationship, some of which have been outlined in the submission above. Particularly in relation to SPPs, the Commonwealth Government has to decide if it is a purchaser of services from States or a funder of services in partnership with State Governments.

An outcomes/outputs based accountability framework would be consistent with a partnership model for the Commonwealth's management of SPPs. Overly prescriptive input controls would be consistent with a view that States are merely service providers to be controlled as closely as possible by the Commonwealth as purchaser. The Australian community will be poorly served if the latter view prevails.

An original objective of the IGA was to eliminate a number of inefficient taxes. States may have little choice but to continue their reliance on an inefficient tax base given that gains from GST revenue streams are likely to be offset by restrictions imposed by the Commonwealth in a variety of SPP agreements currently being negotiated.

Issues in Fiscal Sustainability

The Intergenerational Report (IGR) released with the Commonwealth Budget for 2002-03 presented an assessment of the long-term fiscal prospects for the Commonwealth sector, derived from models of future demographics, people-related federal outlays, and labour-force trends, including labour productivity, labour force participation rates and unemployment.

The central IGR scenario projects a Commonwealth budget deficit equivalent to 5% of GDP by 2041-42, in the absence of any policy change. This projection is driven by the estimated effects of population ageing and non-demographic cost drivers on Commonwealth outlays and revenue. The implication is that this deficit will need to be addressed through higher tax rates, reduced expenditure, or reduced grants to the States and Territories.

Overall, the IGR is a timely contribution to the debate on population ageing and health care. It shows that these drivers could exert strong fiscal pressure on the Commonwealth Government which would have significant ramifications for all levels of government and for the private sector. However, the IGR also illustrates a number of important lessons regarding this type of analysis:

- Because of the long timeframe and fundamental uncertainty, the analysis is assumption-driven. Small differences in assumed annual changes cumulate to large differences at the end of the 40-year timeframe. For example, some two thirds of the projected increase in real Commonwealth health and aged care expenditure is due to assumed *non-demographic* cost inflation, rather than the headline issue of population ageing.

- As this type of scenario analysis is based on a continuation of current policy settings, it can indicate more about future impacts of present policies than the likely future trends.

In the IGR, the Commonwealth provided the view that the long-term fiscal impacts on the States and Territories will be minimal. The Queensland Government believes that this view is a misleading one that does not take into account the totality of State social expenditure, State revenue, or the implications of increases in costs and utilisation of services, and the ageing of the population.

Long Term Pressures on the Queensland Budget

The Commonwealth's superficial assessment of the long-term fiscal impacts of population ageing and other factors on the States and Territories only considers two areas of social expenditure – education and health. The potential impacts on the remainder of State expenditure are ignored, along with the potential impacts on State revenue. The Queensland Government's intergenerational research program on potential budget impacts will take into account *all* areas of the Queensland Budget.

Expenditure

The Queensland Government is currently analysing the long-term prospects for all areas of State expenditure, given current policies.

The categories and issues of highest priority are as follows:

- *Education outlays.* In the IGR, the Commonwealth offered the opinion that State education expenditure will decline as a proportion of Gross Domestic Product (GDP), due to the relatively smaller proportion of children in the population. Factors which may offset this trend are: increases in Year 12 retention rates; the addition of a preparatory year prior to Year 1, increases in the size of the adult client base, associated with the skilling and re-skilling of an older workforce, and adoption of information and communication technologies to better equip students for participation in the knowledge economy.

Additionally, the recent economics literature on 'endogenous growth' points to the centrality of human capital in generating innovation and productivity growth, an issue that will become of increasing importance as the size of the labour force declines relative to the overall population. An objective of the Queensland Government's research in this area is to determine the net impact of these and other factors on future education expenditure.

- *Health and Community Services outlays.* The Queensland Government expects the implications of ageing, cost inflation and increased utilisation to have a similar impact at the State level as those outlined in the IGR for Commonwealth health expenditure, given that the shares of health expenditure in the Queensland and Commonwealth budgets are very similar. The Queensland Government also provides ambulance, rail, rates, electricity and electricity life support concessions to eligible persons. The ageing of the Queensland population, and the impact that this will have in relation to concessions, is an additional fiscal issue for the State. Commonwealth Government initiatives that extend pension eligibility either through policy changes or by raising the allowable income or asset means tests, as well as the growing proportion of people reliant on the social safety net, would result in increasing numbers of persons becoming eligible to access State Government concessions.

- *Public Order and Safety outlays.* The Queensland Government is currently researching the linkages between demographics and crime. The effects of population ageing on crime, and therefore on public order and safety outlays, are the product of the demographics of both offenders and victims. Analysis and modelling is being undertaken to determine the potential net impact on the Queensland Budget.
- *The impacts of differential ageing across Queensland's regions on infrastructure requirements and service delivery costs.* Rural and remote communities appear to be 'ageing faster' than eastern Queensland. For example, there is a trend for young people to seek employment closer to or in the large centres of the State. This impacts on rural economies and the services required in these areas, as well as along coastal Queensland. Local governments will be key players in strategies to deal with population ageing and are already requesting increased subsidy programs for disability and aged care facilities and for improved access to infrastructure for older people.

Revenue

The Queensland Government is also concerned about the impacts of population ageing on its revenue base.

The categories and issues of highest priority are:

- *The size of the GST revenue pool.* The Commonwealth has frequently claimed that a key benefit of the GST is that it will allow the funding of increased ageing-related government expenditure, because of its broader base. However, GST revenue may not grow in line with the broader economy, as population ageing shifts some household expenditure towards items which are GST-free, such as health and basic food. The Queensland Government is currently conducting its own modelling of this issue.
- *Queensland's share of GST revenue.* The Queensland Government is currently researching the implications of the changing spatial distribution of the Queensland population on the portion of GST revenue that Queensland receives.
- *Payroll Tax revenue.* The changes to the structure of household expenditure will also generate changes in the industry structure of the Queensland and Australian economies. This is likely to affect Payroll Tax revenue because of the link between industry classification and firm size.
- *Other own-source revenue.* It is likely that other components of own-source revenue are partly related to age, and would therefore vary as the population ages. Possible examples are stamp duties on mortgages, gambling taxes, and motor vehicle registration fees and other levy-based revenues.
- *Specific Purpose Payments.* Historically, the failure of Commonwealth Grants to keep up with economic growth has been a source of fiscal pressure for the States. The passing of GST revenue to the States has been an improvement in this area, but the issue still applies to Specific Purpose Payments, which constitute around a fifth of State revenue.

The Need for Innovative and Responsive Policies

The current needs and choices of older people may not be that of future generations. Life experiences of those who reach their seventies and eighties in the next 25 to 40 years time will differ significantly from previous generations. Tomorrow's seniors will have higher education levels, more varied work experiences and improved economic circumstances. Higher proportions of women will have been in paid employment through to retirement and families will have fewer children. The social and economic circumstances of tomorrow's seniors will affect their future lifestyles and care choices.

The ageing of the population will present significant challenges to government in responding to a range of related issues. These include healthy ageing, capacity to access goods and services, employment and recreational opportunities, and mobility or access to transport within the community, as these are primary determinants of personal well-being and quality of life.

Changing demographics and the ageing of the population will require innovative policy and service delivery models responsive to the needs and aspirations of the whole population in the context of a rapidly changing market and technological environment. The Queensland Government is taking a leadership role in doing this with the Government's Chief Executive Officers Committees examining demographic change issues, including ageing, to ensure effective, holistic policy and program responses. Research will include the impact of ageing on social services; demographic changes impacting on employment, economic development and infrastructure; workforce demographics; and emerging geographical patterns of land development in Queensland.

Options for Consideration

The Committee could investigate further the following options for addressing the issues raised in relation to incentives to work and long-term fiscal sustainability.

Tax and Social Security Reform: policy options

The previous sections have discussed the problems that emerge with a welfare system and highlighted particular aspects of the Queensland economy that make it subject to particular problems. The rest of this paper explores some options available for reform.

A body of literature has emerged in Australia in recent years regarding the need for tax and welfare policy reform aimed at reducing the incidence of high EMTRs and replacement ratios currently facing low income earners and the unemployed seeking lower-paid jobs.

Several of the general policy options, such as general tax cuts, increasing minimum wages and reducing the social security safety net have drawbacks of either being costly or having other negative employment or equity impacts which outweigh their potential benefits. However, there are a range of possible policy options, some of which have already been adopted in other countries and/or partially introduced in Australia, which appear to offer potential net benefits. These include:

Reforming the structure of marginal tax rates: A restructuring of Australia's income tax rates may require a mixture of policy changes. These include raising the tax-free threshold and adjusting the income thresholds at which lower marginal tax rates increase. This would help reduce the overall tax burden and the incidence of high EMTRs being faced by low-income earners, as well as reducing the replacement ratio facing the unemployed, by raising the after-tax income earned from work.

However, an increase in the tax-free threshold would need to be combined with other changes to the tax rate structure in order to minimise any negative budgetary impacts. These other changes would also be necessary to maintain the equity of the tax system, otherwise higher income earners and secondary income earners in high income households would also receive the benefit of the higher income tax-free threshold (Ingles, 2001).

Alternative options that have been proposed which may achieve the same objective but appear to be more equitable include increasing the low-income rebate or paying a separate higher rebate for couples, thus introducing an element of family unit taxation into Australia's predominately individually-based income tax system.

Earned Income Tax Credits: The concept of an earnings supplement paid to the low income individual or family in the form of a refundable tax rebate has the potential to partially negate the high EMTRs currently faced by low income earners and increase the return from moving into paid employment.

This policy alternative has attracted significant attention and debate in Australia in recent years, following the publishing of a paper by five of Australia's best-known economists in 1998. This paper argued that the introduction of an income tax credit, combined with slower growth in real award wages, would result in a substantial improvement in employment outcomes in Australia.

Several countries, including the United States and the United Kingdom have adopted tax credits in order to assist in reducing unemployment, particularly long-term unemployment, and increasing the net income of low-income households.

The adoption of these measures in other countries indicates how an income tax credit in Australia could operate. The United States Earned-Income Tax Credit scheme involves a payment which is maintained across a fixed range of private earnings and gradually withdrawn as earnings increase, while the United Kingdom's Working Families Tax Credit is available at a flat rate to individuals with sufficiently low earnings who satisfy an hours of work test. An assessment by the Brookings Institute of the impacts of this policy in the United States indicates it has reduced poverty, increased workforce participation and reduced income inequality (Brookings, 2003)

However, the likely effectiveness of a tax credit for lower paid employees in Australia would depend on the level and targeting of the credit. In the United States, the Earned Income Tax Credit supplements relatively low minimum wages and welfare payments. However, in countries like Australia, with higher levels of benefits and relatively high wage floors, the distribution of wages is more compressed, with a greater proportion of workers receiving wages at or near the minimum wage. Therefore, in-work benefit policies are likely to face higher fiscal costs and, with a greater proportion of workers being in income ranges which fall in the withdrawal region of the benefit, may also reinforce disincentive effects for some income ranges as a result of higher EMTRs. (OECD, 2002).

As a result, the OECD suggests that policy interventions in countries with high minimum wages should be more focussed on wage subsidies, as the essential problem is one of increasing labour demand for low skilled or inexperienced workers (OECD, 2002).

Based on the US model, this policy would have a family unit basis, which offers some advantages. However, it may also continue to have disincentive effects because the income tax credits taper off as household income increases. Therefore, they encourage unemployed people into work but may discourage people from working longer hours or getting a higher paid job, as well as penalising secondary income earners in low to middle income households (Saunders, 2003). Overseas experience has also shown that Income Tax Credits can also be susceptible to fraud, with some major compliance issues having developed in the United States (Ingles, 2001).

Rationalising Social Security payments: Changes to the current system of social security payments may reduce the incidence of high EMTRs and replacement ratios facing low income earners. These include reducing taper rates at low income levels and removing any remaining 'sudden-death' thresholds which apply to benefits.

However, reducing taper rates would lead to less targeting of the social security system. These types of changes may also have considerable negative budgetary impacts and other changes would need to be made, either to the social security system or tax structure, to minimise net budget costs. This is a particularly important consideration, as proposals with large budgetary impacts risk negative employment consequences through higher taxes and/or increased interest rates. The opportunity cost of these proposals may also be large, through the displacement of other public investments or private expenditures which may have positive employment impacts.

Further consideration could also be given to the possibility of a single income test on cash transfers, which would help remove the 'income test stacking' which currently results from the separate means tests for each of the various assistance payments. Once again, this would require careful consideration of the potential budgetary impact.

This type of policy approach has been partially addressed through the changes made to the structure of family benefits as part of the ANTS package in 2000 and following the McClure report on Welfare Reform. However, the fact that many low income earners continue to face high EMTRs and replacement ratios, it appears that further reform in this area would be beneficial.

Greater complementarity between State and Federal programs and assistance: The potential benefits of reassessing current social security payments as discussed above should also be extended to include State Government assistance programs. The incidence of high EMTRs and the effect of income test stacking can be exacerbated for low income earners if State Government assistance (such as subsidised housing) is based on income tests similar to those of Federal social security payments. Therefore, increased complementarity between State and Federal programs and assistance is likely to overcome, or at least reduce, the problem of 'income test stacking.'

Financial Assistance for Transition to work and Temporary Return to Work payments:

The option of providing additional payments during the transition to work phase was identified in the McClure Report as a possible policy option. The rationale behind this policy option is that substantial costs could be incurred by a jobseeker obtaining employment (transport and communication, child care, relocation costs and training costs). If the financial returns from obtaining a job are not great, the incentive to incur such costs to obtain work may be weak. A further possible extension of this form of targeted payment may be to target people in vulnerable groups seeking work or returning to work in regions that are most affected by the disincentives resulting from high EMTRs and replacement ratios.

Innovative Forms of Federal Assistance: Given the labour market disparities that exist, there is also scope for a more innovative approach to Federal assistance to those seeking employment or on low incomes. This could include the State Governments being given more discretion in how Federal funding is utilised in terms of assistance payments, effectively giving the States the ability to direct the assistance to regions or groups within the local labour market who are most affected. This form of approach would obviously require major policy changes at both Federal and State levels, but the piloting of specific schemes in certain regions, such as those within Queensland that are most affected, may prove to be more effective than the current system.

In summary, there is a range of possible policy options which could help reduce the disincentives to active labour market participation due to high EMTRs and replacement ratios faced by low income earners. As a result, the successful implementation of these policies would also help reduce the substantial labour market disparities that currently exist across Australia. In particular, this would help improve labour market outcomes in States and regions in which a higher proportion of the labour force consists of those groups that have been identified as being most affected by the presence of high EMTRs and replacement ratios.

However, it appears that no single policy option is necessarily going to achieve the desired objective of reducing EMTRs and replacement ratios for low income earners, while also maintaining or improving the equity of the tax/social security system and minimising any budgetary impacts. It is apparent that some combination of these various policy approaches is required to achieve this aim.

Long-Term Fiscal Sustainability

The separate analysis by Commonwealth and State Governments on long-term impacts of demographic and economic change on the fiscal position of governments could be pooled into a cooperative national analysis to take account of actions all levels of government may need to take to address these changes.