

Balancing taxing and parenting

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Paper

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Key findings

- The basic economic and social unit of society is the family and most family payment arrangements are assessed on a household income basis. Our tax system, however, is almost exclusively focused on the individual.
- This system is inefficient because families make decisions as a unit. When different family members face different marginal tax rates they will change who does paid and unpaid work within the family.
 - These tax arrangements make it more difficult for some families to maximise their household income, especially when employment opportunities are not equal between parents, or for those who live far from employment centres.
- This system is unfair because families with similar incomes can pay vastly different amounts of net tax.
 - A single income family on \$80,000 pays around \$6,000 more net tax every year than a double income family on the same income.
 - A double income family could earn up to \$172,000 a year before they pay the same average tax rate as a single income family on just \$86,000 a year.
- Various changes to income taxes and family benefits have meant that single income families on middle incomes (of around \$60,000 to \$120,000) have seen their relative situation worsen by between \$1,000 and \$4,000 per year since 2007.
- Australia's tax system penalises single income households relative to double income households by a greater margin than most countries. Overall, Australia has the fifth most discriminatory tax system for single income families in the OECD.
 - Around half of OECD countries offer some kind of joint taxation treatment between the members of a family.
- Multiple studies demonstrate that full time parental care is the best for young children, and long periods in day care for children, under the age of one, can adversely affect a child's development.
- A more neutral tax system would allow parents to make household decisions for them and their children, without the tax and welfare system interfering with those choices.
- Any successful proposal to narrow the large and growing gap between the tax treatment of single income and double income families must be affordable, progressive and not disadvantageous to double income families.
 - A proposal that makes some intuitive sense would be to provide every family with two tax free thresholds, so that all families do not pay tax until their household income rises above \$36,400. To ensure that this is not regressive, the maximum tax benefit would be capped at \$2,000 per family.
 - The Parliamentary Budget Office estimates that this policy would cost \$1.5 billion a year. Tax relief would be provided to more than 1.6 million parents.
 - The policy would also help reverse much of the deterioration in the relative position of single income families since 2007.
- A more neutral system would deliver more choice and may encourage greater workforce participation because the benefit will only arise if families earn taxable income.
- It will also return more choice about who works and how children are looked after to the people best placed to make that decision — the mother and father of the children.

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Introduction

The basic economic and social unit of society is the family. For a range of evolutionary and cultural reasons, humans have always tended to congregate in family units and make decisions on a family basis. Australia's tax system does a poor job of recognising the family.

Most of our family payment arrangements (such as family tax benefits) assess eligibility of a family on a household income basis. Our tax system, however, is almost exclusively focused on the individual with no regard to the income earned by a spouse.¹

This creates a difference, or a “wedge”, between the tax rates faced by one parent and the tax rates faced by another parent resulting in both efficiency and equity issues.

- From an *efficiency* viewpoint a difference between the tax rates faced by parents will distort decisions. This could result in both a less than optimal level of “paid” work performed and a lower than optimal level of “unpaid” (and hence untaxed) work occurring in the household.
- From an *equity* viewpoint, it can result in substantial differences in the overall tax treatment of otherwise identical families, with the same total household income levels.

Australia needs a tax system that recognises the economic reality that families make decisions as a unit where couples share income and largely make choices on spending and work together.

1 A family based tax system is more efficient

The tax discussion paper states that equity and efficiency are two important principles in designing a well-functioning tax system. Our tax system, in its treatment of some families, fails on both of these principles, and in particular, disadvantages single income families.

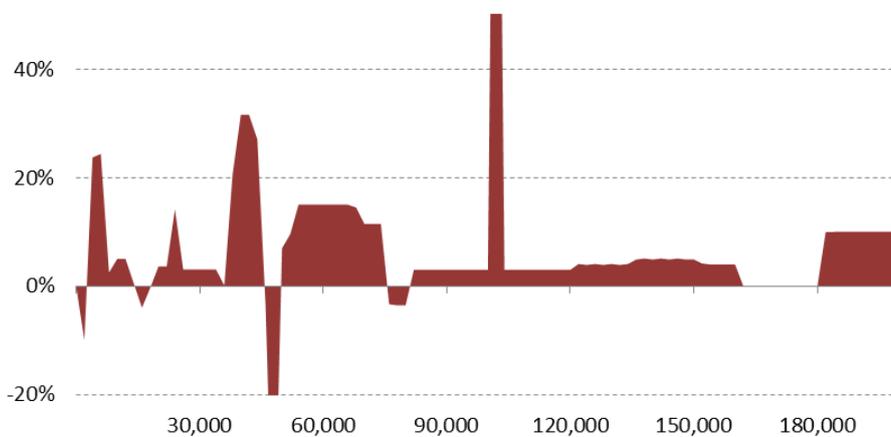
¹ As the Tax Discussion paper notes (p. 39): “The unit of assessment for individuals income taxation in Australia is the individual. This means the progressivity of the individuals income tax system applies to taxable income in the individual's hands, but not necessarily to a household's taxable income (Box 3.1). This is different from the objectives of the transfer system where assistance is generally ... targeted based on the needs of a household.”

When people raise the issue of the tax treatment of single income families they often focus on the equity issues not the efficiency ones. This is natural because injustice is a powerful human response. However, in my view, it is the efficiency impacts that are more important in this debate.

As Gary Becker noted in his work on household formation, families make decisions as a unit, with decisions about specialisation, the sharing of paid and non-paid work, and time substitution crucial to maximising the overall welfare of the family unit (Becker 1991). Because the family acts as a unit, different tax rates between parents is akin to charging someone different tax rates depending on whether they worked as an accountant or a tradesman. The different tax rates will encourage labour supply decisions to change and in a way that is inefficient relative to a world with no tax. To avoid these distortions most tax systems try to keep tax rates equal across broad economic factors, such as one income tax rate, one corporate tax rate and one consumption tax rate. This principle is not applied in the case of families, however, because they often face very different marginal tax rates, impacting the decisions they make.

Single income families with dependent children face higher effective marginal tax rates at almost all income levels (figure 1). For example, the breadwinner, in a single income family earning \$70,000 per year, faces a marginal tax rate of 34.5 per cent (including the Medicare levy). In contrast, each member of a dual income family earning \$35,000 each, faces a marginal tax rate of only 21 cents in the dollar. Australia has some of the largest differences between the marginal tax rates faced by families with a single earner compared to those with two equal earners in the world (OECD 2014 and figure 4 below).

Figure 1 **Difference in effective marginal tax rates between single and dual income families**



Notes: Percentage point difference in effective marginal tax rate (\$2,000 instalments), single earner and 50:50 income split couple family, two children aged 5 and 7, 1 July 2015. Includes newstart allowance, parenting payment and family tax benefit. *Source:* Parliamentary Library estimates (May 2015), appendix B.

These differences in marginal tax rates will affect parental decision making through a number of channels:

- By making it more costly for one parent to earn most of the income it will encourage a substitution of paid work effort from the main breadwinner to the other parent.
- The impact of this substitution effect on overall family income depends on the marginal rate of technical substitution between each parent's paid work effort. In families where both parents have equal ability to earn a good wage in the labour market, the divergence in marginal tax rates will have only a minimal impact on household income. However, in families where one parent has higher skills than the other (or greater employment opportunities), an individual based tax system would be likely to have a serious adverse impact on the ability of these families to maximise their household income.
 - This negative income effect would likely affect areas of high economic disadvantage more harshly. In these areas, it is hard enough for a family to find one job, let alone two.
 - It is also the case that each job has fixed costs independent of the hours worked. For example, families where both parents work have two trips to and from work each day. A system that forces both parents to work will hurt those that live in outer suburbs, far from employment centres, and increase the costs of transport congestion.

The actual outcomes from an individual based tax system, relative to a family based one, depends on the relative direction and strength of these substitution and income effects. What is not in dispute is that an individual tax system will lead to more *people* in the workforce but not necessarily a higher national income. There would appear to be no rationale to set the number of people in work as a public policy goal. The countries with the highest rates of workforce participation (including female workforce participation) are all very poor countries. When you are poor you have no choice but to work.

While it is correct that, in theory, a family based tax system may reduce the number of people working, the extent of that effect is an empirical question. There would not appear to be very strong evidence for concluding that family-based tax systems reduce female labour supply (see box 1).

Box 1 Family tax systems and female workforce participation

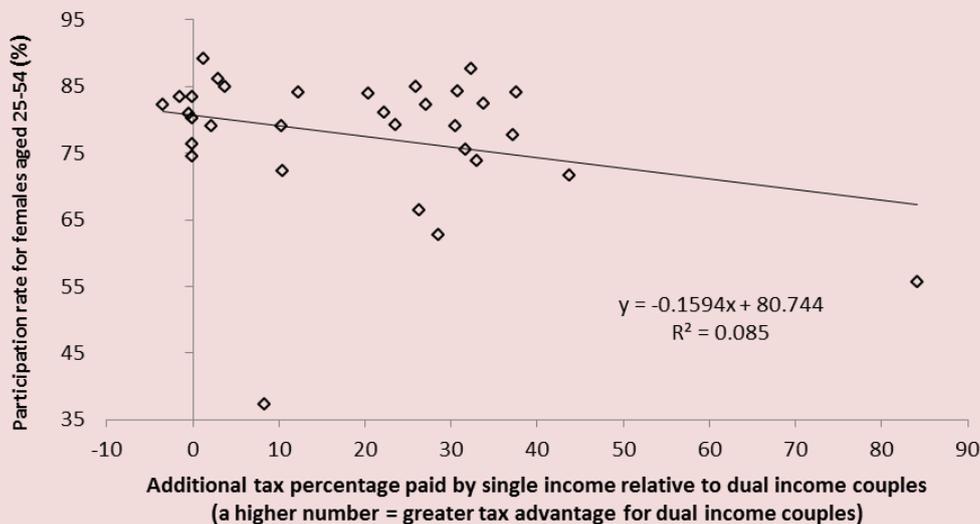
The discussion paper dismisses arguments that our individually based tax system is unfair by seeming to imply that increasing the number of second income earners should be a public policy goal in and of itself:

... [the current system] is sometimes criticised as 'unfair' as households with the same income pay different amounts of tax. However, taxing the individual improves the reward for effort for the secondary earner because they get a tax-free threshold, rather than facing the primary earner's marginal rate on their first dollar of income. (Department of the Treasury 2015b, p. 40)

Yet, improving the reward for effort for the second income earner will reduce the reward for effort for the primary income earner and this may have negative effects.

Even if it were a goal to maximise the number of people in paid work, the evidence does not suggest that female labour force participation rates are adversely affected when a country's tax system allows for joint income treatment. Indeed, the chart below would suggest that countries with more neutral tax systems tend to have slightly higher participation rates for women (although this is not statistically significant).

This result is not particularly surprising. The choices couples make about how they share paid and unpaid work within the household are affected by many factors, and depend on individuals' differing preferences and circumstances.

OECD female participation rates and tax neutrality of single and double income households, 2012

Notes: Contains all 32 countries for which the OECD calculated tax neutrality measures. All four measures of tax neutrality included in the OECD study were tested, and all showed the same weak, but not statistically significant, negative relationship between female participation rates and tax systems that taxed dual income households less heavily than single income households.

Source: OECD 2014a, OECD 2014b.

The actual goal of public policy should be to maximise overall well-being, not the number of people in paid work, and part of achieving that goal will be to maximise (relative to other considerations) the national income, or gross domestic product. The

effect on income will depend on the ability of the second income earner to substitute for the prime income earner. Or to put it the other way around, in a family with two workers who earn different market wages, economy-wide productivity as well as overall GDP, may well be increased if the higher income earner chooses to devote greater effort towards work, either by working additional hours or seeking career advancement. Unless neither parent has a comparative advantage in paid work, an individual based tax system will lead to lower family income, more time away from children (because of transport costs) and greater pressure on public infrastructure. In other words, an individual based tax system is inefficient relative to a family based tax system, given that families work together as teams, not individuals.

Notwithstanding these conclusions, some argue that not enough people are in paid work in Australia and, in particular, not enough females are in paid work. However, Australia has the fifth highest workforce participation rate in the OECD, and its female labour force participation rate is higher than average. It is not clear that Australia has an issue with workforce participation (see box 2).

This conclusion does assume that parents can seamlessly decide how many hours they want to work. In reality, choosing to work often requires a minimum level of hours. These labour market rigidities may mean that an individual based tax system categorically increases the amount of paid work performed and household income. If these rigidities are large enough, once both parents decide that they must work, they might be stuck doing a minimum number of hours.

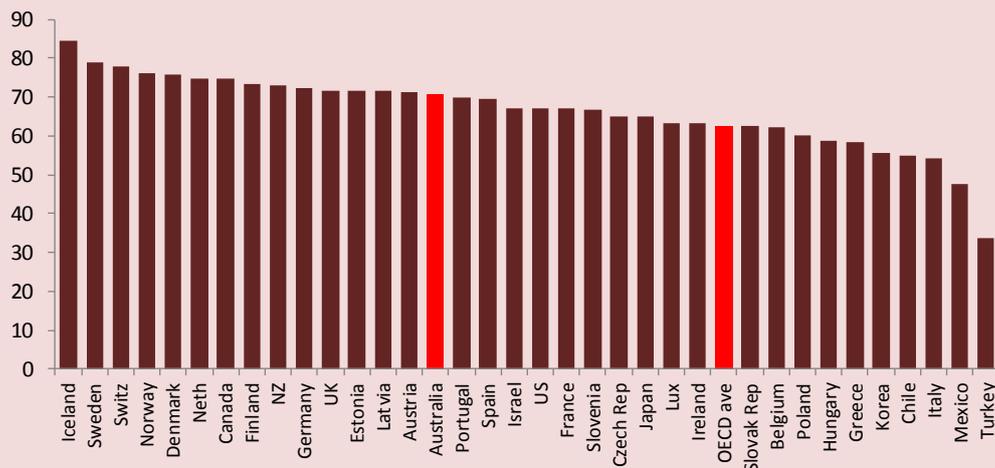
Some argue that this is a desirable social outcome — more people in the workforce means more taxpayers, higher GDP and greater overall wellbeing. But such a conclusion would be simplistic because it ignores the benefits of unpaid work in the family home. In this example, parents are only spending more time in paid work because of the combined effects of the tax system and the inherent rigidities of the labour force. Clearly, without the differences in their marginal tax rates they would have otherwise decided to spend more time at home, including looking after their own children.

In addition, a proportion of the increase to GDP associated with primary caregivers returning to the workforce represent churning, whereby services that families would provide for themselves, such as childcare, are being contracted out to the market economy.

Box 2

Australia has a high rate of workforce participation

Australia does not have a low workforce participation rate — we have the fifth highest workforce participation rate in the OECD (Department of the Treasury 2015a, p 20). And, for women, Australia's participation rates are above the OECD average for all age cohorts (see figure). This is hardly indicative of a crisis, and the evidence does not justify the excessive focus workforce participation receives in the Australian policy debate.

Total female participation rates in OECD countries, 2013, per cent, aged 15 to 64

Source: OECD 2014b

Much is made of the higher rates of female workforce participation in New Zealand and Canada than in Australia. However, there are flaws in any comparison between Australia and New Zealand on this score. In most OECD countries, women on paid or unpaid maternity leave are counted as employed, whereas in Australia a mother must have received payment in the last four weeks to be counted as employed.

These statistical inconsistencies accounted for around a 2 to 3 percentage point difference in female participation rates when last examined in 2006 (Abhayaratna, and Lattimore 2006, p.38). In the context of comparison between Australia, New Zealand and Canada, this single statistical quirk accounts for much of the gap in our female workforce participation rates. In addition, Canada's higher rate of female participation rate may have more to do with Canada's lower fertility rate of 1.6 babies per woman, compared to more than 1.9 in Australia and New Zealand.

It is worth asking why female workforce participation for women older than 45 is higher in New Zealand and Canada than in Australia. But then, the workforce participation outcomes of people aged over 45 would have been influenced by government policies stretching back decades. So, making definitive conclusions on the effectiveness of current policy settings from these outcomes is fraught.

This is especially so because Australia's support for working mothers has increased significantly in the past decade. In 2004, the Howard government introduced a non-means tested 30 per cent rebate on childcare fees. In 2008, the Rudd government increased the rebate to 50 per cent of child care fees up to a maximum of \$7,500 per year.

Ten years ago, the Australian Government spent around \$2 billion a year on childcare and parental leave. In 2015-16, that amount had increased to \$7.2 billion per year. This increase has little to do with growth in numbers of children in childcare and is mostly because of substantial increases in childcare assistance. Further, in the 2015-16 budget, the annual cost of childcare assistance is due to rise to \$11 billion per year.

As the Productivity Commission inquiry into childcare and early childhood learning noted:

If non market production simply moves into market production as a result of a change in ECEC [early childhood education and care] policy, the question of whether the community is any better off than before arises. GDP would be higher (and hence government tax revenue would also be higher for the same policy settings), but in terms of community wellbeing, the improvement depends on how much families prefer market goods and services relative to home produced ones, and how much intrinsic gain (or loss) they get from being employed and child attendance at ECEC services. (PC 2014, p. 1032)

One is reminded of the apocryphal country whose inhabitants try to make their living by doing each other's washing.

Non-neutral tax policies make it less attractive for the higher income earner to maximise their work effort, and more attractive for the other member of the couple to seek paid work. The key point here is that couples make choices jointly that maximise their overall wellbeing. And, where these signals are masked by tax or other policies, choices can be distorted and overall wellbeing reduced. These costs are high in Australia relative to other countries, because our system imposes greater disadvantages on single income families.

2 An individual based tax system is unfair

As the tax discussion white paper states:

To be sustainable, a tax system must be accepted by the community as fair. There is general acceptance (not just in Australia but around the world) that taxpayers with a greater ability to pay tax should pay more tax (vertical equity) and that taxpayers in economically similar situations should pay similar amounts of tax (horizontal equity). (Department of the Treasury 2015b, p. 29)

The discussion paper goes on to say that Australia's highly progressive tax system helps meet these tests. However, a negative by-product of that high degree of progressivity means that two households that earn the same amount of joint household income can pay vastly different amounts of tax. As the discussion paper confirms:

Using an individual as the unit of assessment means that a couple with total taxable income of \$100,000 would have different tax outcomes depending on who earns how much of that total income. At one extreme, it may be a single-income couple with one person earning \$100,000 and paying tax of \$26,947 — an average tax rate of 26.9 per cent for the couple. At the other

extreme, each member of the couple may earn \$50,000 and each pay tax of \$8,547 — an average tax rate of 17.1 per cent for the couple. (Department of the Treasury 2015b, p.40)

Similar differences apply across all income levels. These large differences show that the goal of *horizontal equity* is not being achieved in the taxation of households (appendix B). *Vertical equity* is also breached because a double income family could potentially earn up to \$172,000 a year before they pay the same average tax rate as a single income family on just \$86,000 a year (see figure 3).

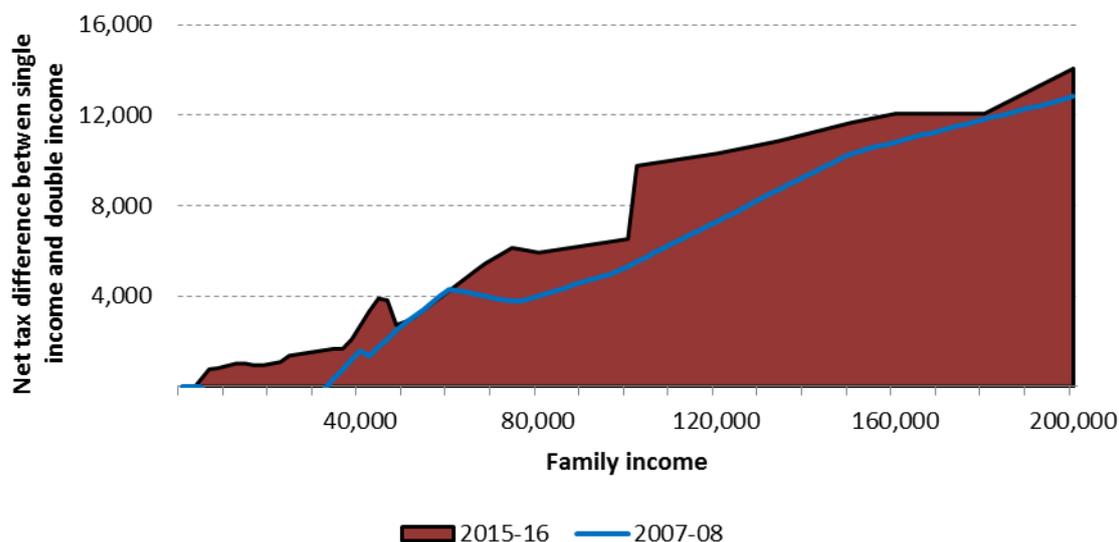
And each family, regardless of the way in which its income is earned, has the same costs, the same bills to pay, mouths to feed and spending obligations to meet.

Family tax benefits introduced by the last Coalition government (in particular Family Tax Benefit B) helped reduce this inequity. But even when family payments are taken into account the inequity remains substantial (figure 2 and 3). From around \$70,000 of household income the difference in net tax paid between single income and double income families rises to more than \$5,000 per year. At \$100,000 of income per year, the cut off for Family Tax Benefit B, the difference jumps to \$9,700 per year.²

Figure 2 demonstrates that the situation has worsened considerably since the end of the last Coalition government for single income families. This is largely a result of the increase in the tax free threshold and the introduction of means testing for Family Tax Benefit B by the former Labor government. In last year's budget, the government further reduced the household income threshold to qualify for Family Tax Benefit B from \$150,000 to \$100,000. The upshot of these changes has meant that single income families on middle incomes (of around \$60,000 to \$120,000) have seen their relative situation worsen by between \$1,000 and \$4,000 per year since 2007. Taking just one example, a single income family on \$80,000 is now around \$2,400 per year worse off relative to a dual income family in net tax terms than they would have been in 2007.

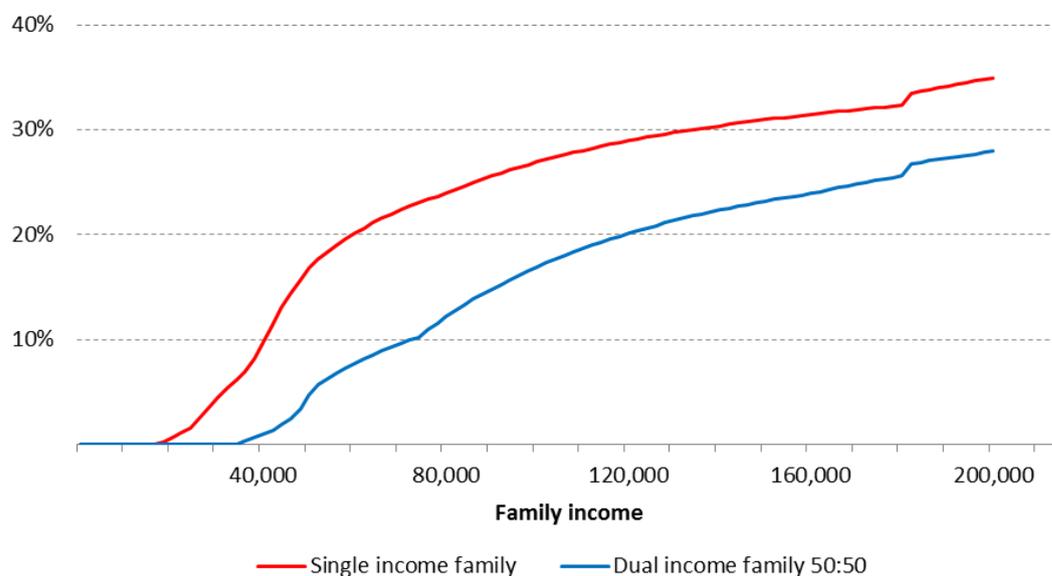
The number of families affected is substantial. There are around 1.9 million couple families with children aged under 15 (ABS 2013). Of these around one third, or 630,000 had one working parent and one stay-at-home parent. Because families are more likely to have one parent stay at home when they have young children, many more than a third of couple families would at some point find themselves in the stay at home parent situation.

² The figure of \$100,000 is rounded. The actual cut-off point is the first dollar of taxable family income above \$100,000 (see appendix B).

Figure 2 **Additional net tax paid by single income families**

Notes: 'Net tax' includes all tax paid taking into account newstart allowance, parenting payment and family tax benefit. Family comprises couple with two children aged 5 and 7.

Source: Parliamentary Library estimates for 2015-16 net tax difference. Calculations for 2007-08 are based on ATO and DSS data and exclude newstart allowance.

Figure 3 **Average net tax rates, 2015-16**

Notes: Total tax paid as percentage of taxable income — single earner and 50:50 income split couple family, two children, aged 5 and 7, 1 July 2015. Includes newstart allowance, parenting payment and family tax benefit.

Source: Parliamentary Library estimates (May 2015).

In addition, substantial numbers of couple families with children had a parent, usually the mother, working part time. In 2011, for families with children where both parents worked, more than half had one parent working part time (Baxter 2013). As Australia's tax system penalises incomes that are unequal, families with one part time earner, whose wage supplements that of the primary wage earner, may also suffer a tax disadvantage relative to couples earning equal incomes.

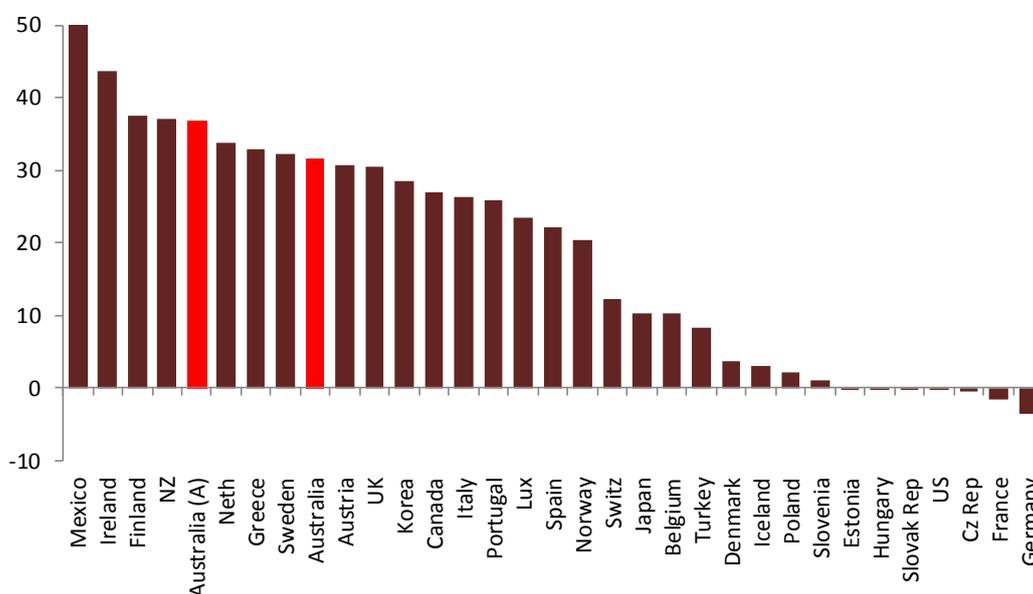
Australia's tax system penalises single income households relative to double income households by a greater margin than most countries (OECD 2014a). For a couple making 133 per cent of the average wage, Australian single income couples paid 32 per cent more tax than dual income couples. The average for OECD countries was 19 per cent and, overall, the analysis found that Australia's tax system was the eighth most discriminatory (figure 4).

Although not picked up in the OECD analysis, Australia's situation worsened substantially as a consequence of the lifting of Australia's tax free threshold from \$6000 to \$18,200 on 1 July 2012 (the OECD analysis was as at 30 June 2012). Correcting for this change would make Australia the fifth most discriminatory to single income families in the OECD.

In contrast, many of the largest countries in the OECD, including the United States, Germany, France and Japan either treat single- and dual income couples in a neutral manner or had very low measures of discrimination. Indeed, around half of OECD countries offer some kind of joint taxation treatment between the members of a family.

There are two broad ways to classify tax systems: individual or joint. Under the former, each family member is taxed as a separate individual and the interdependence between family members is ignored. Under joint taxation, the interdependence of family members is recognised and the family tax bill adjusted to take account of family obligations. This can be done by including special tax allowances or bands, or through income splitting for tax purposes. Under full income splitting, aggregate household income is divided into two or more segments, each of which is taxed as though it were that of a single person without dependants, reducing the overall tax paid by a family (Pearson and Binder 2014).

Figure 4 Additional tax paid by single income families across OECD countries



Notes: As at 30 June 2012. Difference in net transfers to government: single income couples (earning 133 % of average worker earnings) relative to equal dual-earner couples (also earning 133% of average worker earnings). Mexico's result was 84.2 per cent. Axis truncated for charting purposes. Australia (A) shows the difference for Australia using the tax arrangements in place from 1 July 2012.

Source: OECD 2014a.

Just over half OECD countries have separate income taxation of spouses. Countries with joint taxation, or with options for joint taxation, include the Czech Republic (for couples with children), France (families), Germany (married couples), Ireland (married couples), Luxembourg (married couples), Norway (optional), Poland (married couples), Portugal (families), Spain (optional), Switzerland (married couples), and the US (married couples). In addition a number of countries some 'joint elements', that provide tax relief and tax credits which are transferable between partners, including Canada, Denmark, Iceland, and the Netherlands (see box 3).

Box 3	OECD countries with joint tax treatment
USA	Families taxed in one of three ways: jointly if married; separately; or (if unmarried) as heads of household. Married couple taxed jointly get \$11,900 deduction, heads of household \$8,700, singles \$5,950. Refundable (non-wasteable) earned income credit for low income families. No general cash transfers.
Canada	Tax is levied separately. Income splitting of up to \$50,000 allowable subject to a cap of \$2000 per eligible couple. Credits given for spouse and eligible dependent (subject to spouse's income) and children. Ceiling for spouse tax credit.
France	Tax unit is aggregate family income. Quotient system applies to married couples and to civil union partners. Refundable tax credit for low income earners, partly being replaced by new cash benefit.
Germany	Jointly assessed couples get double allowances including child tax credits.
Ireland	Tax on combined income – can opt out but tax payable by both spouses must be same as payable under joint taxation. Alternatively spouse can opt to be taxed as single. Married person's credit is double basic credit. Single parent also gets a double basic credit.
Estonia	Tax unit is the family. Child allowance for second and subsequent children.
Luxembourg	Married couples taxed on joint income. Tax paid on 2 times half their income. Income from minor children included. Family allowance.
Norway	Separate rate schedule for married opting for joint taxation and also single parents. Allowance for child care cost – may be transferred to other spouse. Cash payments for dependent children – single parents get extra child support.
Poland	Couple taxed on 2 times tax on half income. Singles with children can use income splitting – quotient is 2. Tax credit for each child.
Portugal	Income splitting – tax credits for each spouse. Single parent gets more tax credit than unmarried taxpayer but less than married couple.
Switzerland	Tax deductions for married couples and children. Also a small tax credit. Special rate schedule for married couples, widowed, separated, divorced and unmarried with children.

Source: Pearson and Binder 2014.

3 The benefits of stay at home parenting

There are many benefits associated with stay-at-home parenting but the prime benefit is its positive impact on the health and wellbeing of young children. Study after study demonstrates that full time parental care is the best for young children, and long periods in day care for children under the age of one can adversely affect a child's

development. It is important to stress that these effects are, of course, outcomes *on average*. They do not mean that any particular infant would be harmed by long day care, or indeed, that some children will not benefit from day care where their family life may be dysfunctional.

Yet the evidence is stark and the findings are consistent across many countries. The benefits are also independent of breastfeeding issues. Given the strength of the evidence it is inconceivable that more is not done to support stay at home parents, if not from the child development perspective alone. The Australian and State governments spend more than \$50 billion per year on childcare and schooling to progress child development. In comparison, our tax system actively discourages parents from looking after their children themselves, a model of care that demonstrably benefits a child's development, including by improving their performance at school later.

When reviewing the international evidence, the OECD (2007) stated:

Taking stock of the evidence, it seems that child development is negatively affected when an infant does not receive full-time personal care (breastfeeding issues aside...) for at least the first 6 to 12 months of his/her life. (pp. 110–111)

Moreover, as the Productivity Commission (2009, p. 4.39) stated in its report on paid parental leave:

Most of the more recent evidence tends to support the view that the use of non-parental care/child care (usually necessitated by maternal employment) when initiated within the first year of a child's life can contribute to behavioural problems and, in some contexts, delayed cognitive development (Han et al. 2001; Hill et al. 2001; Waldfogel et al. 2002; Brooks-Gunn et al. 2002; Baker et al. 2005).

Box 4 provides additional results from research over the past decade.

In addition to the benefits to the child, there are wider social and economic benefits that stay at home parenting provides. For example, persons working full time in the paid workforce are likely to have less time to do charity and other volunteer work. Women working full time have substantially lower volunteer rates than those working part time (ABS 2011). Further, children whose parents were engaged in volunteer work were also more likely to do volunteer and charity work. As the ABS notes:

There is evidence that family and childhood experiences have some effect on the propensity to volunteer. 66% of volunteers reported that their parents had done some voluntary work compared to 44% of non-volunteers. 43% of

adult volunteers had undertaken some voluntary work as a child compared to 27% of adult non-volunteers. (ABS 2011, p. 6)

Hence, any declines in volunteer work by parents are likely to have long-term social costs.

Box 4 Types of care and child development

This article identifies the effects of maternal marketplace work in the initial months of an infant's life on the child's cognitive development. Results suggest that such work in the first year of a child's life has detrimental effects. Where significant, the results also indicate negative effects of maternal employment in the child's first quarter of life. (Baum 2003, pp. 408)

The growing labor force participation of women with small children in both the U.S. and Canada has led to calls for increased public financing for childcare. The optimality of public financing depends on a host of factors, such as the "crowd-out" of existing childcare arrangements, the impact on female labor supply, and the effects on child well-being ... we uncover striking evidence that children are worse off in a variety of behavioral and health dimensions, ranging from aggression to motor-social skills to illness. Our analysis also suggests that the new childcare program led to more hostile, less consistent parenting, worse parental health, and lower-quality parental relationships. (Baker et al. 2005, p. 1).

[L]onger leaves that extend beyond the first few months of life are associated with improved health outcomes for women and children. These beneficial health effects may come about in part through breast-feeding. Breast-feeding is associated with better health outcomes for children, and women who take leave are more likely to initiate breast feeding and to continue the practice for a longer period of time. (Waldfogel, J. 2001, p.104)

Maternal employment by the ninth month was found to be linked to lower Bracken School Readiness scores at 36 months, with the effects more pronounced when mothers were working 30 hr or more per week and with effects more pronounced for certain subgroups (i.e., children whose mothers were not sensitive, boys, and children with married parents). Although quality of child care, home environment, and maternal sensitivity also mattered, the negative effects of working 30 hr or more per week in the first 9 months were still found, even when controlling for child-care quality, the quality of the home environment, and maternal sensitivity. (Brooks-Gunn et al. 2002, pp. 1052)

Recent research on maternal employment, that contains better controls and more sophisticated strategies for accounting for heterogeneity than earlier studies, finds that labor supply during the child's infancy period has a deleterious impact on cognitive development (e.g. Han et al., 2001; Brooks-Gunn et al., 2002; Baum, 2003b; Ruhm, 2003; Ruhm, 2004). (Ruhm, C. 2004, p. 8)

Our results demonstrate small but significant negative effects of maternal employment on children's cognitive outcomes for full-time employment in the 1st year postbirth as compared with employment postponed until after the 1st year. (Hill et al. 2005, p 833)

Regarding parental time inputs, we find that students with mothers who work longer hours have significantly lower test scores in all subjects except numeracy. However, the working hours of the father have no statistically significant effect. (Nghiem et al 2015, p. 12)

Volunteer and charity work can provide enormous benefits, not only to recipients, but also more broadly through greater social stability and cohesion. Unpaid work also represents a significant contribution to the nation's economic activities. The Australian Family Association notes (2015, p. 8):

More women with young children in the paid workforce and the resulting fewer volunteers available for community service results in services being outsourced at commercial rates. That does not make sense financially.

While both forms of unpaid work fall outside the restricted definition of production used when compiling GDP estimates, voluntary work undertaken on behalf of the community has been estimated to add \$43 billion to the Australian economy, while non-market childcare production was recently valued at \$65 billion. Obviously household production is economically important and should not be excluded when considering the relative benefits of paid and unpaid work.

4 A way forward

Our tax and welfare system has tilted the playing field too much against parents who choose to stay at home and look after their children. Our system is inefficient — as it prevents families maximising their paid and unpaid work as a unit — it is unfair — because it treats families on similar incomes, with the same number of children, very differently — and it ignores the development benefits of stay at home parenting for children.

A more neutral tax system would allow parents to make household decisions for them and their children without the interference of the tax and welfare system. To move to a perfectly neutral system for all families, on all income levels, we would need to adopt the American system of joint filing of tax returns — that is income splitting in full. The American system is an attractive solution but for a number reasons it is not practical for Australia to adopt at this time.

First, a joint filing system would be unaffordable. There have not been any recent estimates of the cost of full income splitting model in Australia, but estimates in the 1980s put the cost at around 5 per cent of personal income tax revenues (Department of the Parliamentary Library 1994). If this broad estimate remained relevant today, a full income splitting model would reduce tax revenues by around \$10 billion per year. In the context of a budget that, at the moment is in a deficit of \$35 billion, this is clearly unaffordable.

Second, moving from an individual based system, to a joint filing tax system, would be regressive. As the analysis above shows, single income families on even moderate household incomes would benefit from an income splitting model. For example, a single income family on \$80,000 per year would be \$6,000 per year (or more than \$100 per week) better off under an income splitting model. Nonetheless, richer families would benefit by even more under full income splitting — although not disproportionately so. For example, a family on \$160,000 would be better off by \$12,000 a year (or more than \$200 per week better off).

Third, a full income splitting model does not take into account the benefits of home production to the single income household. Unpaid work, such as in-home childcare, cleaning or cooking, provides an untaxed benefit to the household. This “non-neutrality” in the system would encourage more families to do their own cooking, cleaning and child-rearing, rather than pay someone to do these tasks in post-tax earned income.

It is important to note that this is not an issue that only effects parenting. Under existing tax arrangements, anyone who earns a higher hourly rate, and then elects to work fewer hours than someone with a lower hourly rate, is left with more time for leisure and hence more implicit income. People living off annuities and investment income also have more free hours and hence a higher implicit income.

What this issue really amounts to is a reason to restrict any income splitting or sharing proposal to parents with children. That way any benefits are flowing to families that are most likely to be caring for the next generation, not simply engaging in other forms of household production or consumption. Given the benefits of in-home childcare noted above, a tax system that encourages parental care could not be characterised as deficient.

Of course, our current system is a long way from encouraging parental care of children. The above issues do not arise under our current system because it is heavily biased against single income families. Nonetheless, any proposed change should take into account these points of view. In my view, any successful proposal to narrow the large and growing gap between the tax treatment of single income and double income families must be one that is affordable, progressive and not disadvantageous to double income families.

Within those constraints, it is possible to borrow from examples overseas to design a more limited form of income splitting. Canada has recently introduced a policy of parental income splitting. This policy allows eligible taxpayers to transfer up to \$50,000 of income to their spouse for tax purposes, collecting a non-refundable tax credit of up to \$2,000 per year in return (Canada Revenue Agency 2015). According to estimates prepared by the Parliamentary Budget Office, if the Canadian model were introduced in Australia it would cost \$2.5 billion per year.

Most likely this is still too costly in the current budget context, however, the \$50,000 sharing amount chosen by Canada is somewhat arbitrary and can be adjusted according to what is affordable. One alternative would be to reduce the \$50,000 figure to \$18,200 — effectively giving all families two tax-free thresholds. Such a proposal makes some intuitive sense because most double income families do not pay tax until their household income rises above \$36,400. In contrast, a single income family starts paying tax after earning \$18,200.

A slight modification to the Canadian model could see a proposal that ensures that all families do not pay tax before they earn \$36,400. This would be achieved by allowing each family to transfer *up to* \$18,200 to ensure they also do not pay income tax before earning more than \$36,400. Under this model, the primary income earner could transfer income equal to \$18,200 *less* the income earned by the second income earner. If the second income earner earns more than \$18,200 no transfer of taxable income would be possible. It is proposed that the model retain the \$2,000 cap on benefits as in the Canadian model.

Table 1 provides some examples to make this proposal clear. A family with a primary breadwinner earning \$65,000, and a secondary earner on \$15,000, would be able to transfer \$3,200 from the primary to the secondary earner for the purposes of tax calculation — delivering a tax benefit of \$1,104. A couple on the same total income (\$80,000), but with the primary earner being the sole breadwinner, would be able to transfer the full amount of \$18,200 and receive a (capped) tax benefit of \$2000.

Table 1 Illustrative examples of income splitting proposal

<i>Primary income earner</i>	<i>Secondary income earner</i>	<i>\$18,200 less secondary income</i>	<i>Tax reduction based on primary income earner marginal tax rate</i>	<i>Total tax saved per couple (after cap of \$2000 applied)</i>
65,000	15,000	3,200	1,104	1,104
80,000	0	18,200	6,279	2,000

Details of the income splitting proposal are included in appendix A. But in essence, the proposal involves allowing a couple with children to, in effect, transfer income from the higher income earner to the lower income earner for tax purposes subject to the following conditions:

- the couple has at least one child aged under 18;
- the maximum amount of income that can be transferred per couple is \$18,200 less the taxable income of the lower income earner — when the income of the lower earner reaches \$18,200 they are unable to transfer any income under the policy;
- total tax relief per couple would be capped at \$2,000 per year;
- both spouses must live in the same residence;
- either spouse may claim the credit once they have lodged their tax return;
- income transferred is not counted for the assessment of any Government payments; and
- all other eligibility requirements for Family Tax Benefit B.

The proposal would also be unlikely to impose large transaction costs or be administratively difficult. The tax system already allows joint assessment of income for family tax benefits and this proposal could simply use existing system to judge whether the transfer of up to \$18,200 would be beneficial. Indeed, individual families most likely would not need to do anything additional on their tax returns, the calculations could instead all be done by the Australian Tax Office using existing information provided.

Costings prepared by the Parliamentary Budget Office indicate that this policy would cost in the order of \$1.5 billion a year. Tax relief would be provided to an estimated 815,000 couples (table 2). This policy would apply from 1 July 2016. Couples would be able to claim the credit when they file their 2016-17 tax returns.

Table 2 **Distributional analysis — income splitting proposal**

Current taxable income split (b)		Number of couples (f)	Percent of couples (%)	Average family taxable income (c) (d) (\$)	Average transfer of taxable income (d) (\$)	Average tax benefit (e) (\$)	Percent of revenue impact (%)
Primary (%)	Secondary (%)						
100	0	550,000	68	118,000	18,000	2,000	72.5
95	5	80,000	10	132,000	12,000	2,000	10.6
90	10	70,000	8	92,000	8,000	1,800	8.1
85	15	40,000	5	78,000	6,000	1,600	4.1
80	20	25,000	3	66,000	6,000	1,400	2.5
75	25	20,000	2	54,000	4,000	900	1.2
70	30	10,000	1	46,000	4,000	700	0.5
65	35	15,000	2	38,000	4,000	400	0.3
60	40	5,000	..	38,000	2,000	200	0.1
55	45	..	..	62,000	10,000	1,300	..
50	50	..	..	..	..	..	..
All		815,000	100	110,000	8,000	1,800	100

.. Not zero, but rounded to zero. (a) This analysis only includes couples who would benefit from this proposal. Where the secondary income earner has negative taxable income, the primary earner is considered to earn 100 per cent of the family's taxable income. Totals may not add to sum of components due to rounding. (b) Figures rounded to nearest 5 per cent. (c) These figures represent the sum of the primary and secondary earners taxable income. (d) Figures have been rounded to the nearest \$2,000. (e) These figures represent the average reduction in tax payable. Figures have been rounded to the nearest \$100. (f) Numbers have been rounded to the nearest 5,000 couples.

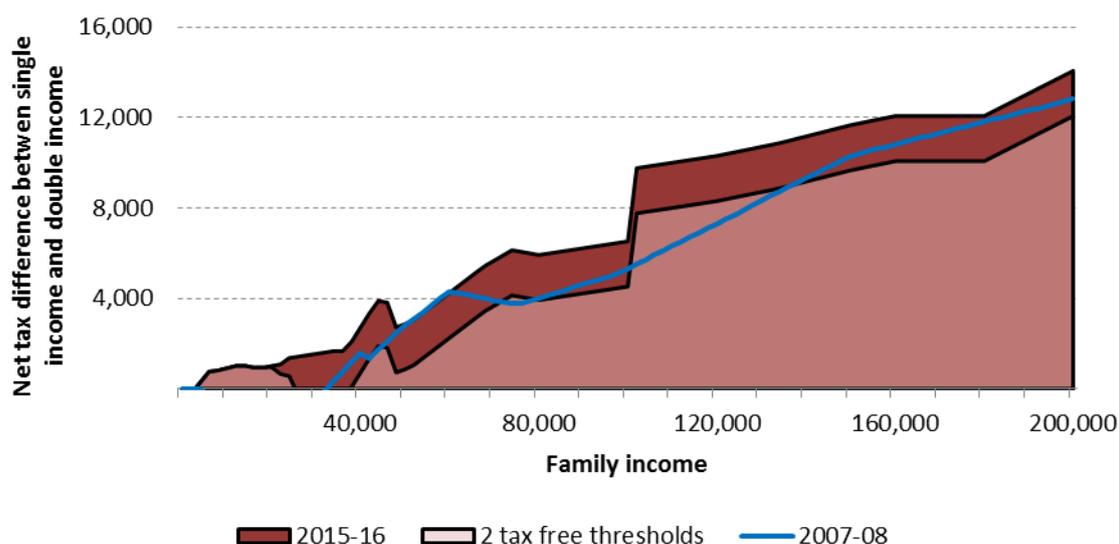
Source: Estimates prepared by PBO 2015.

Further details of this proposal, and the PBO costings of a more generous proposal based on the income splitting model adopted in Canada in October 2014 are provided in appendix A.

The proposed change would not eliminate the inequity for single income families but it would help narrow the gap. The proposed policy is not regressive because the benefit is capped at \$2,000. Even well off families would still only benefit to the same extent as a family on \$75,000 per year. In this way, it would be a policy that helps reduce both horizontal and vertical inequity.

This new policy would also help reverse much of the deterioration in the relative position of single income families since 2007. The proposed policy reduces the gap between single income families and double income families, shown in figure 5 by a downward shift in this gap. Again, it would not fully correct for these changes but it would help lower income families disproportionately. Families between \$50,000 and \$70,000 annual income would be better off relative to their position in 2007. Nonetheless, while families between \$100,000 and \$140,000 will be better off than they are today (by \$2,000 per year) they would still be behind relative to their position in 2007.

Figure 5 **Additional net tax paid by single income families**



Notes: Includes newstart allowance, parenting payment and family tax benefit, family comprises couple with two children aged 5 and 7.

Source: Parliamentary Library estimates for 2015-16 net tax difference. Calculations for 2 tax free thresholds and for 2007-08 are based on ATO and DSS data and exclude newstart allowance.

The effects of this policy, however, go beyond its potential to deliver a more equitable tax system. This policy would make the tax system more neutral between the decision to stay at home and look after children, or for both parents to find work.

As discussed earlier, a more neutral system will help a family have more choice in their work and non-work decisions. This may in fact encourage greater workforce

participation because it will lower the marginal tax rate faced by the primary income earner.

Moreover, this income sharing policy helps return the choice of who works and how children are looked after to the people best placed to make that decision — the mother or father of the children. This would lead to greater self-provision by families to meet their own needs — resulting in reduced churn in the tax and welfare system.

Finally, the ultimate benefit of the policy would be to allow more parents to look after their own children especially when they are young. The overwhelming evidence is that parental care is important for child development and we should have a tax and welfare system that supports that fundamental reality.

Appendix A Details of the ‘two tax free thresholds’ proposal

Summary

Changes to tax laws to allow a couple with children under the age of 18 to, in effect, transfer income from the higher income earner to the lower income earner for tax purposes.

The maximum amount of income that can be transferred per couple is \$18,200 minus the taxable income of the lower income earner.

Total tax relief per couple would be capped at \$2,000.

Hence, when the income of the lower earner reaches \$18,200 they are unable to transfer any income under the policy.

The intention of this approach is to allow a couple with children under the age of 18 to effectively have access to two income tax free thresholds.

Tax relief is calculated on the basis of the difference in tax before and after the effective transfer of income

Income transferred to the lower income earner is not counted for assessment of benefit payments, including Family Tax Benefit B.

This policy would apply from 1 July 2016. Couples would be able to claim the credit when they file their 2016-17 tax returns. Either spouse may claim the credit.

Purpose of policy

The purpose of the policy is to promote a more equitable tax treatment of families with children with similar total incomes, but different shares earned by each partner. The principle underlying the policy is that families with similar taxable capacity should pay similar amounts of tax. Australia’s current taxation arrangements contravene this principle. Large increases in tax free thresholds associated with the introduction of the carbon tax have substantially increased the inequality.

Eligibility

Eligibility with regard to individuals and family status would broadly follow the requirements for family tax benefits. Some guidance is set out below.

Qualifying individual

To be eligible for the credit for a taxation year, in general an individual must:

- be an Australian resident at the end of the taxation year;
- have an eligible relation for the year; and
- have a child under the age of 18 at the end of the year who ordinarily resides throughout the taxation year with the individual or the individual's spouse or partner.

When can the credit be claimed

To claim the credit, both spouses must meet reporting requirements with the ATO and Department of Social Security. The credit would be available in the year of birth, adoption or death of a child, and in the year of death of the individual or their eligible relation.

Where a child under the age of 18 resides with the child's parents throughout the year, either of those parents may claim the credit, but not both.

Timing

To be eligible for the credit, both spouses must have been living in the same residence for the full financial year for which the claim is made.

Calculation of the credit

The value of the credit would generally be determined as the difference between

- the combined taxes payable (after non-refundable tax credits are claimed) by the qualifying individual and that individual's eligible relation; and
- the combined taxes that would be payable (after non-refundable tax credits are claimed) by them if the higher income individual could have notionally transferred taxable income (up to \$18,200) to the lower income individual.

However, if this difference exceeds \$2000, the credit would be limited to this amount.

Financial implications over the forward estimates of the 'two tax free thresholds' income splitting option

Table A3 provides the financial implications of the 'two tax free thresholds' income splitting option canvassed in the body of this submission.

Table A3 Financial implications – allowing up to \$18,200 per annum minus the taxable income of the secondary income earner to be transferred ^(a)

Impact on	2014-15	2015-16	2016-17	2017-18	Total
Underlying cash balance (\$m)	-	-30	-1,520	-1,520	-3,070
Fiscal balance (\$m)	-	-30	-1,520	-1,520	-3,070

(a) A negative number for the fiscal balance indicates a decrease in revenue or an increase in expenses in accrual terms. A negative number for the underlying cash balance indicates a decrease in receipts or an increase in payments in cash terms.

Source: Estimates prepared by PBO 2015.

Breakdown of costing for ‘Canadian’ income splitting model, applied to Australia from 2016-17.

Table A1 provides the disaggregation of the impact on the underlying cash balance of the proposal to allow couples with at least one child to equally split their taxable income (with the transfer of income capped at \$50,000) for income tax purposes (with tax relief capped at \$2,000 per couple). It is estimated that the proposal would decrease the underlying cash and fiscal balances by around \$7.5 billion over the 2015-16 Budget forward estimates. This impact reflects a decrease in revenue of \$7.4 billion and an increase in departmental expenses of \$90 million over this period.

Table A1 Financial implications – underlying cash and fiscal balance (outturn prices) ^(a)

(\$m)	2015-16	2016-17	2017-18	2018-19	Total to 2018-19
Receipts/Revenue					
Individuals	-	-2,400	-2,500	-2,500	-7,400
Payments/Expenses					
Administered Expenses Impact	-	-	-	-	-
Departmental Expenses Impact	-30	-20	-20	-20	-90
Impact on underlying cash and fiscal balances	-30	-2,420	-2,520	-2,520	-7,490

(a) A negative number for the underlying cash balance indicates a decrease in receipts or an increase in payments in cash terms.

Source: Estimates prepared by PBO 2015.

Table A2 provides a distributional analysis by the split of their taxable incomes for couples with at least one child under 18 children who would benefit from the proposal.

Table A2 **Distributional analysis — income splitting proposal (Canadian proposal)**

Current taxable income split (b)		Number of couples (f)	Percent of couples (%)	Average family taxable income (c) (d) (\$)	Average transfer of taxable income (d) (\$)	Average tax benefit (e) (\$)	Percent of revenue impact (%)
Primary (%)	Secondary (%)						
100	0	550,000	32	120,000	40,000	2,000	44.8
95	5	90,000	5	200,000	40,000	2,000	7.5
90	10	100,000	6	180,000	40,000	2,000	8.2
85	15	100,000	6	175,000	40,000	2,000	7.9
80	20	130,000	8	175,000	40,000	1,800	9.9
75	25	155,000	9	145,000	35,000	1,400	8.8
70	30	175,000	10	150,000	30,000	900	6.4
65	35	155,000	9	145,000	20,000	600	3.8
60	40	105,000	6	145,000	15,000	500	2.0
55	45	95,000	6	140,000	5,000	100	0.6
50	50	45,000	3	145,000	..	..	..
	All	1,710,000	100	145,000	30,000	1,400	100

.. Not zero, but rounded to zero. (a) This analysis only includes couples who would benefit from this proposal. Where the secondary income earner has negative taxable income, the primary earner is considered to earn 100 per cent of the family's taxable income. Totals may not add to sum of components due to rounding. (b) Figures rounded to nearest 5 per cent. (c) These figures represent the sum of the primary and secondary earners taxable income. (d) Figures have been rounded to the nearest \$5,000. (e) These figures represent the average reduction in tax payable. Figures have been rounded to the nearest \$100. (f) Numbers have been rounded to the nearest 5,000 couples.

Source: Estimates prepared by PBO 2015.

Appendix B Family tax cameos

Set out below are cameos showing social security entitlements and tax liabilities for a family at different income levels from 1 July 2015. For each calculation, a two-parent family with two children, aged five and seven is used. Four family income levels have been modelled as cameos: \$80,000, \$100,000, \$101,000 (to show the impact of the FTB-B cut-off) and \$120,000. For each, the tax and transfer treatment of the family is calculated for when the total income was assigned to one earner and when 50 per cent of the total income was assigned to a second earner.

The calculations are based on currently legislated and expected settings as at 1 July 2015 — legislation before the Parliament, if passed, would result in changes to some benefit and tax rates and means test thresholds. Childcare payments and Rent Assistance are not included — this would involve the imputation of childcare and housing costs. Families are assumed not to have private health insurance (so may be required to pay the Medicare Levy Surcharge but this also means no imputation of insurance costs). As such, the cameos provide a basic picture of the tax and transfer treatment of almost families — who are ostensibly identical except in respect of whether they are sole or dual earner families.

2015–16 Couple, P1 earning \$80,000pa, P2 no earnings, 2 children aged 5 and 7

P1 Earnings	\$80,000
P2 FTB-A	\$5,214
P2 FTB-B	\$3,190
Schoolkids Bonus	\$860
Single Income Family Supplement	\$303
P1 Tax	-\$17,534
P1 Medicare	-\$1,600
Disposable income	\$70,433
<i>Total gov. payments</i>	<i>\$9,567</i>
<i>Total tax liability</i>	<i>-\$19,134</i>

2015–16 Couple, P1 earning \$40,000pa, P2 earning \$40,000pa, 2 children aged 5 and 7

P1 Earnings	\$40,000
P2 Earnings	\$40,000
FTB-A	\$5,214
Schoolkids Bonus	\$860
P1 Tax	-\$4,064
P1 Medicare	-\$800
P2 Tax	-\$4,064
P2 Medicare	-\$800
Disposable income	\$76,346
<i>Total gov. payments</i>	<i>\$6,074</i>
<i>Total tax liability</i>	<i>-\$9,728</i>

2015–16 Couple, P1 earning \$100,000pa, P2 no earnings, 2 children aged 5 and 7

P1 Earnings	\$100,000
P2 FTB-A	\$2,828
P2 FTB-B	\$3,190
Schoolkids Bonus	\$860
Single Income Family Supplement	\$303
P1 Tax	-\$24,934
P1 Medicare	-\$2,000
Disposable income	\$80,247
<i>Total gov. payments</i>	<i>\$7,181</i>
<i>Total tax liability</i>	<i>-\$26,934</i>

2015–16 Couple, P1 earning \$50,000pa, P2 earning \$50,000, 2 children aged 5 and 7

P1 Earnings	\$50,000
P2 Earnings	\$50,000
FTB-A	\$2,828
Schoolkids Bonus	\$860
P1 Tax	-\$7,464
P1 Medicare	-\$1,000
P2 Tax	-\$7,464
P2 Medicare	-\$1,000
Disposable income	\$86,760
<i>Total gov. payments</i>	\$3,688
<i>Total tax liability</i>	-\$16,928

2015–16 Couple, P1 earning \$100,001pa, P2 no earnings, 2 children aged 5 and 7

P1 Earnings	\$100,001
P2 FTB-A	\$2,828
Single Income Family Supplement	\$303
P1 Tax	-\$24,934
P1 Medicare	-\$2,000
Disposable income	\$76,197
<i>Total gov. payments</i>	\$3,131
<i>Total tax liability</i>	-\$26,934

2015–16 Couple, P1 earning \$50,001pa, P2 earning \$50,001, 2 children aged 5 and 7

P1 Earnings	\$50,000.50
P2 Earnings	\$50,000.50
FTB-A	\$2,828
P1 Tax	-\$7,464
P1 Medicare	-\$1,000
P2 Tax	-\$7,464
P2 Medicare	-\$1,000
Disposable income	\$85,901
<i>Total gov. payments</i>	\$2,828
<i>Total tax liability</i>	-\$16,928

2015–16 Couple, P1 earning \$120,000pa, P2 no earnings, 2 children aged 5 and 7

P1 Earnings	\$120,000
Single Income Family Supplement	\$303
P1 Tax	-\$32,334
P1 Medicare	-\$2,400
Disposable income	\$85,569
<i>Total gov. payments</i>	\$303
<i>Total tax liability</i>	-\$34,734

2015–16 Couple, P1 earning \$60,000pa, P2 earning \$60,000, 2 children aged 5 and 7

P1 Earnings	\$60,000
P2 Earnings	\$60,000
P1 Tax	-\$10,864
P1 Medicare	-\$1,200
P2 Tax	-\$10,864
P2 Medicare	-\$1,200
Disposable income	\$95,872
<i>Total gov. payments</i>	\$0
<i>Total tax liability</i>	-\$24,128

Source: Parliamentary Library Estimates May 2015.

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