

# **How much inequity should we allow?**

Dr Ken Henry

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How much inequity should we allow?

## Introduction

Firstly, a big thank you to Clare Martin and everyone at ACOSS for the invitation to take part in today's discussion.

It is not just an opportunity to get some important feedback for the review of Australia's tax and transfer system (and because it now appears to bear my name, I have even more incentive to get it right!). It is also a chance to do something for the battered reputation of the profession to which I belong – economics.

Over many years economists have developed a reputation for hostility to distributional issues. Some economists appear to treat them as 'soft' and secondary in importance to 'hard' issues like efficiency and productivity. That approach is a mistake. A mistake, I must confess, that I have made myself in the past. As a brash young Clerk Class 9 working on the Hawke Government's 1985 Tax White Paper, I pushed the line that the tax system was about maximising efficiency, with equity simply a constraint – rather than an outcome with intrinsic value in its own right. Fortunately, I was soon set straight by my then Deputy Secretary, Ted Evans – my immediate predecessor as Secretary to the Treasury. As a result of this and other on-the-job learnings, I am pleased to say that today equity is central to Treasury's mission and policy advice. How we distribute prosperity is absolutely inseparable from how we create it. This is something parts of the welfare sector have been arguing strongly for some time, and it has been pleasing in recent years to see welfare representatives developing this position further. It is something I would like to encourage and I hope what I have to say today adds to this important debate.

I chose the title of this speech – 'how much inequity should we allow?' – for a couple of reasons. For a start, it is mildly provocative, which I thought might help pique your interest. The instinctive response of many to the question would be to answer – none; a just society would not tolerate any inequity. Of course, beyond this instinctive reaction things get complicated. I will return to this later.

Secondly, I selected this title because I consider this to be one of the most significant choices society faces. Indeed, the question assumes inequity is a social choice.

And it is.

Leaving fairness solely to the market to determine should be unacceptable to a civilised society. Societies will choose how much inequity they allow according to the institutions, norms, laws, policies and programs they adopt.

As highlighted in Clare's introduction, my comments today are set against the backdrop of the review of Australia's tax-transfer system, the most extensive such

review since at least Asprey in the 1970's. Indeed, since the current review also includes state taxes and both Commonwealth and State transfers, it could be considered the broadest ever.

The tax-transfer system is the principal means of expressing societal choices about equity. The tax-transfer system is a reflection of the kind of society we aspire to be. As far as I am aware, every major tax review conducted in modern times in any developed country has nominated equity as one of its two or three most important objectives. In our case, the Panel's terms of reference refer to raising revenue in a way that provides equity and our Consultation Paper released in December identifies equity as one of five key design principles.

So, today, I will offer some reflections on my question of 'how much inequity should we allow'. I will reflect on the range of perspectives about equity so far put to the Panel, relate those to traditional concepts of equity and conclude with some personal perspectives on the benchmarks for testing the equity of the tax and transfer system.

## Common sense views about equity

Let us start then by asking what we mean by equity. It is a notoriously slippery concept, which has stretched many great minds, and yet still means different things to different people. However, as I said in my speech to the National Press Club last November, wisdom can often be found in the common sense views of practical people. So, rather than starting with theory, let me share a few practical perspectives from the many submissions the review has received and in the public meetings held across Australia over the past two weeks:

- People in the same circumstances should be treated the same.
- If you have more, you should pay more (and receive less).
- You should not be able to avoid paying your fair share, or get more welfare, by cleverly arranging your finances.
- It is unfair that the system is so complicated that you need to pay someone to help you get what you are entitled to.
- We should look after the most disadvantaged in our communities, but welfare should not discourage people who can work from getting a job or improving their skills.
- It is not always about money. Some people need other help to improve their health, skills and chances in life.

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These views can be related to traditional frameworks for analysing equity which offer useful insights into desirable design features for the tax-transfer system. But they also suggest the need to consider more contemporary approaches to reform of the tax-transfer system.

## Traditional frameworks

There are two broad intellectual traditions relevant to an analysis of the equity of the tax-transfer system. The first is concerned with procedural fairness and is mainly the province of classical liberals. Under this tradition, a tax-transfer system is fair if it respects individual rights. Outcomes are not as important as ensuring processes are transparent and unbiased by the undue discretion by authorities. Such a system aspires to eliminate discrimination on the basis of race, religion, sex or sexual preference. Away from these heady heights, such a system should treat every member of society with respect and care.

In answer to my question – how much inequity should we allow – strong advocates of procedural fairness rarely condone any inequity; a fair process based on the protection of everyone’s individual rights is the ultimate test of equity.

I am generally a supporter of the freedoms that this tradition of equity promotes. But not without qualification. More importantly, in my view an equitable tax-transfer system must deliver a lot more than procedural fairness.

The second tradition is concerned with distributive fairness – who should get what of the prosperity we produce. This tradition is often presented through a utilitarian framework where the ‘social good’ is determined by some aggregation of individual welfares. As individual welfare is not directly measurable, income is usually the focus in this tradition, though other measures – such as wealth, consumption or health – are also used.

Many economists have noted that under simple assumptions – such as people generally having similar likes and the next dollar of income being less valuable to the last – complete equality of income is desirable. But they also argue that complete income equity would also destroy incentives to work and reduce economic growth.<sup>1</sup> No one would have an incentive to work or save if the government were to fully redistribute the bounty of individual effort. This leads to the relatively orthodox view that the degree of income inequity we should allow should be that sufficient to maintain incentives conducive to earning income.

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1 For an exposition, see Kaplow, Louis, *The theory of taxation and public economics* (2008), Chapter 3.

Of course, the relationship between equity and income growth can be complex. Not all redistribution policies are inimical to national income growth. Many redistributive policies seek to address market failures that reduce national income. For instance, capital market failures mean that those with low income are unable to borrow to properly invest in their own human capital despite high private and social returns. The tax-transfer system is one mechanism for allowing improved education of low-income earners, promoting both fairness and income growth.

On the other hand, take company tax, which at first glance would be of most interest to wealthier Australians. Reducing it would seem to be inequitable. But there are strong arguments to the contrary. In the face of competition from countries with low company tax regimes, higher company tax rates could work to reduce overseas investment in Australia, which could reduce the number of jobs available, lower the demand for Australian workers and, in this way, lower wages. This is the reason why many economists argue that, in the long run, company tax affecting mobile capital is paid by labour – predominantly geographically immobile unskilled labour.

So the optimal level of redistribution to maximise national income is by no means clear. But, even if it were, there could still be reasonable debate about the extent to which national income might be further traded off in the pursuit of even greater equity.

In addition, regardless of the precise level of inequity chosen, most would accept that a degree of redistribution still accords with a practical view of vertical equity. People with greater capacity to pay should be liable for more tax, and those with insufficient means to meet their basic needs should receive support in the form of transfers.

Redistribution is also consistent with the practical notion that you should not be able to get out of paying your fair share through concessions or loopholes, including those mostly available to the wealthy. Many have claimed in submissions to the review and at public meetings that aspects of fringe benefits tax, and the use of trusts and negative gearing, can lead to people not paying their fair share.

People have also pointed to the regressive impact of complexity in the system, which often falls most heavily on those with the least capacity to deal with it, including because they have the least means to get help. This can lead them to make poor decisions or simply missing out on entitlements. Welfare organisations will, of course, know a lot about this, as they devote much of their resources to helping low-income earners navigate the tax and benefit system. There is a perverse irony in the fact that much of this system complexity may have its roots in the quest for fairness.

As with the procedural fairness view of equity, I am a supporter of distributive fairness. Redistribution is a public good – left to the market, there would be serious

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under-provision of income transfers. Distributive fairness has value because the community desires it; government is necessary to deliver it. But, again, my aspirations for an equitable tax-transfer system are for this and more.

## Contemporary perspectives on equity

For some years I have been concerned about features of the tax-transfer system which cause, contribute to, or fail to redress significant inequities that chronically harm people's lifetime wellbeing.

Where I go beyond more traditional frameworks is my concern for wellbeing, not just income, and in a focus on lifetime, not just current circumstances.

Some of you would know that I have a deep respect for the writings of Amartya Sen. Sen argues that the true measure of human development is that a person has the 'capabilities' necessary to leading the kind of life they value and have reason to value.

Capabilities allow an individual to fully function in society; they are not 'income' and, while they include basic civil rights and political freedoms, they are not limited to 'rights'; they are 'substantive freedoms', including with respect to both processes and opportunities. Thus, its not enough to be concerned with procedural fairness issues if that means ignoring deprivation of substantive opportunity. But neither is it enough to be concerned only with the adequacy of opportunity, since the capability that people have to choose a life they value depends also upon the nature of the processes that bring the opportunities about.<sup>2</sup>

Sen points to some capabilities that are close to being absolute — 'to meet nutritional requirements, to escape avoidable disease, to be sheltered, to be clothed, to be able to travel, and to be educated.'<sup>3</sup> Others, like the capability to live without shame or to participate in the activities of the community, are relative to community standards. Being computer literate was not necessary to participate in society 30 years ago, but it is now. Sen views poverty as capability deprivation. And, seen in those terms, poverty is clearly intolerable. It is a form of personal injury that should not be abided in any just society.

Poverty is something that is of interest to all people concerned with equity. But it is not their only concern. And nor should it be.

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2 Sen, A 1999, *Development as Freedom*, Oxford University Press, p 17.

3 Sen, A 1983, 'Poor, relatively speaking', *Oxford Economic Papers*, 35, pp 153-69.

Yet even in the broader domain of equity considerations, Sen's approach – of focussing on individual capabilities, and the proper role of society in fostering those capabilities<sup>4</sup> – is instructive.

I know there is a risk that this highly abbreviated reference to Sen's valuable perspective will confuse rather than enlighten. For where I want to get to today, its enough that you accept that there might be a case for moving beyond a narrow focus on either rights or incomes, or even material wealth, to look at the capabilities that make a direct contribution to long-term wellbeing.

## Implications for the tax-transfer system

What does this mean for tax-transfer design?

There are at least three important implications I would draw.

First, and most obviously, if a system of income redistribution is to ensure that people enjoy the capability of having basic needs guaranteed then the level of redistributed income must be adequate. As you may know, part of the tax-transfer review has been an examination of the adequacy of pensions, led by one member of the Panel Jeff Harmer Secretary of the Department of Families, Housing, Community Services and Indigenous Affairs.

Second, and perhaps most importantly, the system should not encourage decisions motivated by short-term benefit, but which compromise development of capabilities which could open up medium to long term opportunities of improved wellbeing. It should not discourage people from working or studying or retraining if they can.

Panel members have heard time and again of disincentives that do just this.

Many have pointed to the way in which the withdrawal of benefits combined with taxation of income lead them to deciding it is just not worth their while working. For example, a parent with a couple of young children who has to pay for child care will often find the current system of tax, benefit withdrawal and child care benefits offer minimal financial returns from moving to part-time paid work. The longer-term capability costs of the decision not to work, for both the parent and for the children of such households, should be of concern to policy makers.

Others point to differing rates of payment, work tests or rates of benefit withdrawal leading to preferences for receipt of particular benefits motivated by immediate

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4 On this, see Sen A 1999, p 288.

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advantages, but which lock people into the welfare system, potentially entrenching chronic deprivation of capabilities. Take the predicament of people with less severe disabilities who would be able, with help, to do at least some work. If they are single and on the Disability Support Pension (DSP) they will get around \$70 a week more than single people on Newstart. On a pension, they can earn more than twice as much before their payment starts to reduce, and the payment reduces more gradually. They are also exempt from the activity test. In fact, if you are in the grey area between unemployment and disability it seems better in every way to be on DSP. But is it really? What concerns me is the extent to which the system could be discouraging some people from work that could make them happier and healthier and our society more equitable. While I recognise that many people on DSP cannot do any work at all, I wonder whether we could not redesign the system to reduce disincentives to workforce participation.

I should stress that the Panel has reached no conclusions on the categorical distinctions between payments like Newstart, Parenting Payment, Disability Support Pension and Carer Payment. There are good reasons for many of these distinctions. Nevertheless, the long-term incentive effects of these structures warrant careful consideration.

The third implication of a focus on capabilities is tied to the last of the practical observations about equity I referred to at the beginning of my comments today. It is not always about money. Indeed, studies of entrenched generational disadvantage, suggest that provision of additional income support can sometimes be counter-productive. Some people need other help to make the most of opportunities in life. Assistance that directly addresses capability deficits – in education and health, in particular – may be more effective at raising long-term wellbeing. In other words, we ought not think that the income redistributing tax-transfer system on its own will be sufficient to eliminate capability deprivation. Indeed in the absence of appropriate health, education or community services, government transfers may simply entrench disadvantage. And if they entrench disadvantage, whatever they might do to reduce dispersion in the short-term distribution of income is simply not important.

On the other hand, it may be that the tax-transfer system can be used as a tool to improve access to, and tailoring of, services and other supports. For example, Australian governments target housing assistance to people who are least likely to find adequate housing without public assistance. However, people eligible for help receive different levels of aid and face markedly different incentives depending on whether they receive rent assistance or public housing.

Public housing generally provides a greater level of housing subsidy than rent assistance, with public rents generally set at 25 per cent of income. Compared to rent assistance recipients, public renters also face lower risk, as their rent is not influenced by movements in market rents and their tenure is generally guaranteed.

However, the provision of public housing can discourage workforce participation to a far greater degree than rent assistance. As public housing tenants' rent is linked to their income, their effective marginal tax rate is 25 percentage points higher than if they receive rent assistance, which is not subject to a separate taper. Further, a public housing entitlement is linked to a specific house and may be lost if a person needs to move for work or other reasons. Rent assistance, by contrast, is fully portable, which may enable recipients to choose housing that they prefer.

It is not obvious why we should use such different mechanisms for people who are in need of housing assistance, particularly if one approach carries with it the greater risk of entrenching long-term capability deprivation. Perhaps it would be better if low-income earners received the same assistance, irrespective of whether their landlord was the state or in the private sector. Of course, it is likely that compromise would be needed to balance incentives to work with some stability of tenure for tenants. It would also need to recognise the increasing role community housing is playing in the delivery of housing assistance.

By investigating such ideas, the tax-transfer review gives us the opportunity to debate how best to create a more equitable tax and transfer system, better suited to the needs of the 21st Century.

Before I conclude, let me make a final point. All this raises wider questions about how we think of equality and about redistribution in a modern economy. The way we think about these things has changed profoundly over the course of the last hundred years. During the early years of the Twentieth Century – during the age of steam power, when this magnificent building we are in today was a locomotive workshop and the centre of intense trade union agitation – Australians thought equity could be improved primarily through the industrial relations system. After the Second World War, in the eras of Keynes and post-war reconstruction, we thought it could be solved through the provision of universal pensions and a commitment to full employment. Still later, we thought equality required steeply progressive taxation and the further expansion of the welfare state, notably into areas like public housing. But today – when this old workshop we are in is a centre for high-tech research; and the blue collar jobs it once housed have gone; and many of the people who would have performed those jobs are now long-term unemployed or even on the DSP and perhaps living in public housing estates which offer few chances of improved wellbeing – our answer to inequity also needs to change. In my view, the answer should lie to a large extent in building up people's capabilities. Investing in people. And the tax review has a big role to play in this. We have had debates about capital versus labour, about public versus private, about the state versus the individual. Today we should be thinking about the role of public policy in giving people the capabilities to choose lives of value for themselves.

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## Conclusions

So – how much inequity should we allow?

My comments today suggest the answer requires a value judgement. Different people have different views and different priorities for what it means for our tax-transfer system.

Today, I will offer just three of my own conclusions.

First, I would support a system that operates fairly; free from bias and arbitrariness. A system that treats people in the same circumstances the same way. If you like, a system that is procedurally fair.

Second, while some level of inequity in the distribution of income and wealth may be necessary to induce national income growth, the relationship between growth and equity is important – redistributive policies can be anti-growth, but they can also be pro-growth. In addition, an equitable tax-transfer system would not allow two people with the same means and undertaking the same activities, to pay less, or receive more, simply depending on the way they organise their affairs.

And third, while we may need to tolerate some inequity in the distribution of income and wealth, we should have zero tolerance for severe capability deprivation. And more generally, an equitable society is one in which every citizen has the capabilities necessary to be able to choose lives they value. As to this, the complexity of tax-transfer arrangements can be a particularly pernicious form of capability deprivation.

Perhaps a simpler way of distilling all three points is to say that rights are important and income redistribution worthy, but on their own they not enough. What is essential to equity is to develop people's capabilities. The tax-transfer system must be designed with this goal firmly in mind.

Thank you.