DISSECTING THE PLATYPUS MODEL

Though Australia may have an unusual mix of relatively low taxes and inequality, Australia's government is still too big, argues **Julie Novak**

> … he's no relation to fish nor fowl
> Nor to bird nor beast, nor to horned owl
> In fact, he's the one and only!
> — Old Man Platypus (1930)
> by AB 'Banjo' Paterson

In the Summer 2010–11 issue of *Policy*, David Alexander suggested that Australia is a notable exception to the 'naïve binarism' that claims:

> On the one hand you can be a small government, inequality-tolerant country like the United States; on the other you can be a high taxing, egalitarian state like the Scandinavian countries, and all countries fit somewhere on this spectrum from right to left.[1]

Alexander portrays a distinctive Australian 'platypus model' of 'small government egalitarianism, a unique combination of economic liberalism and egalitarian policy structures.' Australia's relatively small public sector is juxtaposed with a 'tax and welfare' system, characterised by progressive income taxation and strict means-testing criteria applied to transfer payments, ensuring a relatively low incidence of wealth and income inequalities.

Freedom: Not all is well on the good ship 'SS Australia'

Excluding the East Asian city-states of Hong Kong and Singapore, Australia has been ranked the freest economy in the world in 2010 and 2011 by US-based think tank, the Heritage Foundation. Indeed, Australia has gradually improved its ranking on the global economic freedom 'league table' since figures were first published in 1995.

This result implies that policy constraints on the propensity of Australians to 'truck, barter and exchange' are perhaps fewer than those imposed in most other countries, which, as Alexander remarked, 'is a key contributor to the dynamism and strong economic performance the nation has demonstrated over recent history.'[2]

One of the contributing factors of Australia's position has been the relatively small size of its government, proxied by the level of total government revenue as a share of GDP.[3] Total Australian tax and non-taxation receipts in 2010 were estimated to be about 32% of GDP, compared with the OECD average of about 37%.

It is notable that Australia's performance is quite exemplary compared to continental European countries, although there remains a sizeable revenue gap between Australia and some prominent Asian competitor countries.[4] Particular features of the Australian system, such as a greater reliance on direct taxes and the imposition of compulsory superannuation, also need to be taken into account when making international comparisons.[5]

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Furthermore, one must remain mindful of the fact that single-year statistical snapshots obscure the secular trend of an expansion of the public sector, particularly over the course of the last century.

Vito Tanzi and Ludger Schuknecht indicate that average general government revenue for nine advanced countries, including Australia, increased from about 12% in 1913 to about 41% in 1997.[6] Considering Australia in isolation, the amount of revenue acquired by all levels of government, as a share of GDP, has effectively doubled since Federation (Figure 1).

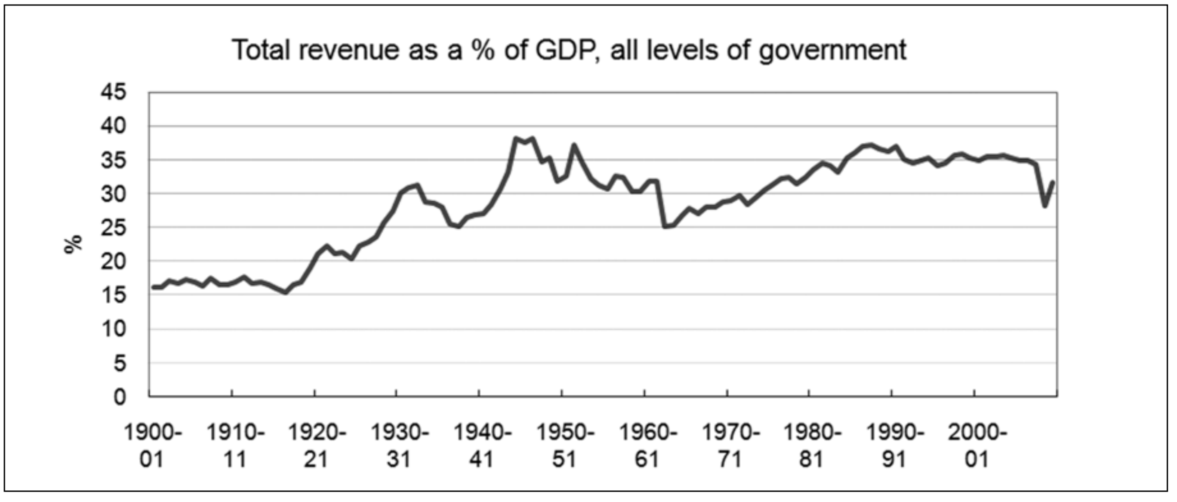
In 1900–01, the Commonwealth, state and local governments collectively raised revenues equivalent to about 16% of GDP. By 2009–10, this had risen to about 32% of GDP, despite temporary reductions due to specific economic events such as the 1930s Great Depression, 1960s credit crunch, and the 2008–09 global financial crisis.

Some notable periods of revenue increases included the second half of the 1910s and the 1920s—coinciding with the imposition of land taxes, corporate taxes, and income taxes by the Commonwealth—the early 1940s as the Commonwealth acquired income taxing powers from the states, and the lengthy uplift in revenues during the 'Keynesian consensus' period from the 1960s to 1980s. These events appear to have played some role in ratcheting up the revenue take of Australian governments.

Putting aside the adverse effect of the financial crisis on revenues, the revenue share appears to have stabilised over the past 20 years or so at between 30% and 35% of GDP. This trend encapsulates a host of tax reforms conducted over the period, including the imposition of additional direct taxes during the 1980s and the switch between direct and indirect taxes associated with the 2000 GST reform.

The federal government's *Intergenerational Reports* make clear that the existing suite of public services and welfare payments are not fiscally sustainable without an increase in Commonwealth tax burdens into the future.[7] Similar fiscal pressures are likely to be experienced by state and local governments. The risk of a consequently larger public sector diminishing Australia's economic freedom

Figure 1: A larger government—revenue



Sources: Alan Barnard, 'Government Finance,' in Wray Vamplew, ed., *Australians, Historical Statistics* (Sydney: Fairfax, Syme and Weldon Associates, 1987).
R A Foster, *Australian Economic Statistics 1949-50 to 1994-95*, (Sydney: Reserve Bank of Australia, 1996).
OECD statistics website.

under this scenario has not gone unnoticed by policy observers.[8]

The international empirical evidence, if anything, implies that Australia should not seek to increase or stabilise revenues but in fact *reduce* them. It has been shown that economic growth can be further enhanced if the size of government is somewhat lower, say, at about 20% of GDP or less.[9]

Other things being equal, larger governments tend to impose greater efficiency distortions upon private markets, often as a consequence of high taxation rates. In addition, they tend to provide a wider range of 'merit goods' such as education, health, social welfare and cultural services, which may otherwise be provided more efficiently by for-profit or not-for-profit entities outside the public sector.

While the indirect impact of taxes and other revenue instruments on relative prices, or the efficiency implications of the spending of these revenues by governments, remain the subject of empirical investigation, it is not unreasonable to suggest that there remains substantial scope for Australian governments to benefit from reducing their take of revenues without harming economic performance.

To be sure, Alexander does not necessarily dismiss these issues, suggesting among other things that 'it is easy to find waste in Australian governments.' Nonetheless, static international comparisons that flatter Australia's position in a single year take away from a trend of public sector growth that requires corrective remedy if Australia is to retain its dynamism and freedom over the longer term.

Fairness: There is a big price to pay

According to published OECD data, Australia exhibits a degree of distributional inequality of wealth and income below that of the OECD average. As Alexander noted, when accounting for Australia's relatively high levels of homeownership, the extent of inequality is perhaps likely to be even lower than what many of the published estimates reveal.

Putting aside conceptual and statistical concerns about wealth or income inequality measures, a key point that needs to be made is that the modern Australian welfare state, which attempts to suppress wealth or income inequality, is far from costless to maintain on financial and economic grounds.[10]

As reported in the background paper to the Harmer Pension Review, expenditure on transfer payments by the Commonwealth government alone, as a share of GDP, rose from about 0.5% in 1910 to just under 7% in 2008.[11] According to the OECD, total Australian public sector welfare cash benefits increased from 6% of GDP to 7.4% from 1980 to 2007—an era much decried by critics of markets as the 'age of neo-liberalism.'[12]

Like sporing mushrooms, the types of payments available have grown substantially. The age and invalid pensions were introduced by the Commonwealth in 1909 and 1910 respectively, followed by a non-means tested maternity allowance in 1912. Today, there are at least 40 types of Commonwealth welfare payments allotted to carers, the disabled, immigrants, parents, renters, students, war veterans and others, together with a range of 'in kind' benefits subsidised by Commonwealth, state and local governments.

Eligibility and the level of benefits received vary across these programs, adding to the overall complexity of the welfare system.

Not surprisingly, as the number and coverage of welfare benefits have grown, so have the numbers of recipients. In 1965, only 3% of the working-age population relied on government welfare for most or all of their income, compared to about 16% today.[13] Even these figures understate the extent to which individuals and families have become reliant on subsidised 'in kind' benefits in education and health care.

The gradual extension of welfare program eligibility from the genuinely poor to the middle and upper classes has led to a fiscal phenomenon known as 'churning,' in which governments acquire revenue from people only

Table 1: A churning welfare state—Distribution of household income, taxes and benefits by gross income quintile.

	Lowest	Second	Third	Fourth	Highest
Private income (% share)	0.9	6.5	16.4	26.4	49.8
Total taxes (% share)	3.9	7.8	15.7	24.5	48.2
Social assistance benefits in cash (% share)	31.8	34.0	17.2	11.1	5.9
Social assistance benefits in kind (% share)	17.0	20.9	19.2	21.3	21.5
Total social assistance (% share)	22.3	25.7	18.5	17.6	15.8
Total income (% share)	7.8	13.2	17.4	23.8	37.7
Total benefits minus total taxes ($)	348.40	341.70	65.00	-110.60	-571.00

Based on 2003–04 data for average weekly values.
Source: ABS (Australian Bureau of Statistics), Government Benefits, Taxes and Household Income, 2003–04, Cat. No. 6537.0.

to effectively return it to the same people (less overhead costs of government administration) through welfare payments and benefits. Table 1 provides some indication of the extent to which the possible interaction of taxes and welfare payments have contributed to fiscal churning.

As alluded to by Alexander, a means-testing policy framework helps ensure that cash benefits are directed at people situated at the bottom of income distribution. However education, health, housing, and welfare services are skewed towards those situated within higher income quintiles. On balance, this means that even people in middle income brackets are likely to receive welfare benefits and services in excess of the taxes they pay as contributions to the system.[14]

The significant degree of fiscal churning comes at a heavy price to the Australian taxpayer. For example, a fraction of each dollar of taxation (or other) revenue is absorbed in the form of salaries and other overheads that support public servants who devise welfare policy and administer benefits. Indeed, as implied by 'Director's Law,' the modern welfare state is maintained and extended for the benefit of middle-class public servants in the first instance.[15]

According to statistics provided by the Australian Public Service Commission, about 36,100 people were employed by selected Commonwealth welfare agencies in 2010.[16] The Australian Taxation Office, responsible for collecting the revenues that finance Commonwealth welfare programs, employed more than 23,500 people. Many more are employed or contracted by the Commonwealth, state and local governments to deliver 'in kind' services.

At the Commonwealth level, a considerable amount of the churning welfare state is financed by a progressive income tax system. Key features of the tax include statutory rates of 15, 30, 38 and 45% (plus a Medicare levy of 1.5%), a tax-free threshold of $6,000, and a tax rebate for individuals on lower incomes.

Alexander notes the Australian income tax ensures that relatively low levels of tax burden are imposed upon those on lower incomes. However, it has long been established that income taxes distort individual choices between work and leisure, affecting labour supply.

Published estimates suggest that an additional dollar of income tax revenue raised in Australia imposes deadweight efficiency costs of between 20 and 30 cents. In other words, the personal income tax, which is estimated to raise $131 billion in revenue this financial year, is associated with a loss in economic activity of between $26 billion and $39 billion.

The adverse effects of the progressive income tax on labour supply are compounded by its interaction with the means-tested welfare system. Essentially, when individuals, particularly on lower incomes, earn more they pay both additional tax and lose their existing welfare benefits, resulting in high 'effective marginal tax rates' (EMTRs) of up to 60% in some cases.

The lack of financial benefit attributable to work for those affected by high EMTRs may entrench welfare dependency. Other policies such as the mandatory minimum wage, which is relatively high by OECD standards, can aggravate the extent of 'lock out' from labour markets for those lacking workplace-relevant skills and aptitudes.

As Robert Carling recently noted, complexity has become a hallmark feature of the Australian progressive income tax:

> High marginal tax rates, erosion of the tax base, and complexity are intertwined. High marginal rates create pressure for selective tax relief in the form of deductions, offsets and concessions, which erode the tax base. Selective relief becomes entrenched and comes at a heavy cost in foregone revenue, which creates pressure to keep marginal rates high. At the same time, selective relief makes the system more complex and opaque.[17]

The prospect of tax complexity aggravating fiscal illusion, in turn providing opportunities for the public sector to expand even further, was identified explicitly by James Buchanan and Friedrich Hayek in their body of academic work.

The heavy economic and fiscal costs of comparatively lower wealth and income disparities suggest there is a strong case to reform the personal income tax and welfare system that improves economic efficiency and fosters greater self-reliance, without necessarily frustrating equity objectives.

Services provision: A missing piece of the low-tax, high-equity puzzle

A distinctive feature of the Australian landscape is its relatively high degree of non-governmental expenditures on selected social services, such as education and health, compared with many other OECD countries.

In 2007, the level of private funding to Australian school and vocational education, net of public subsidies, was equivalent to 0.4% of GDP. This was greater than the OECD average of 0.3%, and was exceeded only by Chile (0.9%), Korea (0.8%), Mexico and New Zealand (0.6%), and Switzerland (0.5%).

In relation to health care, total expenditure from private sources (including private insurance and out-of-pocket payments) as a share of GDP in Australia was 2.8% in 2007. This compared with an OECD average of 2.4%. Countries with a greater share of private health spending are few in number, such as the United States (8.7%), Switzerland (4.4%), Greece (3.8%), Mexico (3.2%), Korea (3.1%), and Canada (3%).

> Even people in middle income brackets are likely to receive welfare benefits and services in excess of the taxes they pay.

According to statistics published by the OECD, the relative share of school expenditure from public sources in Australia has declined marginally from 2000 to 2007. This reflects in part the observed shift in student enrolment share from government schools to non-government schools over the period. On the other hand, cost pressures on publicly provided and subsidised health care have contributed to a slight increase in the health public expenditure share in Australia since 2000.

While the extent of public subsidisation towards non-government social services contributes to the fiscal churning problems identified above, it is also apparent that existing government payments are set at levels effectively ensuring that the usage of subsidised non-government services represent an implicit saving to Australian taxpayers in net terms.

It has been estimated that in 2007–08, the average level of recurrent Commonwealth and state government funding per student in a government school was $12,639, compared to $6,607 for a student in a non-government school.

On this basis, enrolling an additional child in a non-government school (excluding capital costs) saves the taxpayer an average of more than $6,000. Indeed, if the government school enrolment share were to instantaneously return to 1980 levels (of about 78% of full-time equivalent students), then an additional $2.6 billion would need to be extracted from taxpayers.[18]

It has also been shown that the existing rebate on private health insurance premiums (combined with other measures such as lifetime health cover introduced by the Howard government) that encourage people to use private hospital treatments, instead of those available at a public hospital, represents a modest saving for taxpayers.[19]

Public subsidies for non-government social services are routinely criticised by vested interests, such as teacher unions and public health academics, even if they are relatively cost-effective and promote choice. However, these criticisms often overlook the fact that the wealthy routinely consume public hospital services and enrol their children in government schools.

Conversely the extent to which those on lower incomes select (often low-fee) non-government schooling or maintain their private health insurance cover, and thus may also pay for users of publicly provided services via Commonwealth or state taxes, is also often overlooked in the funding debate.

Finally, it is often not recognised that the significant annual capital investments by non-government schools and private hospitals are largely privately financed. Parents and donors contribute on average about 80% of funds for capital works in independent schools,[20] while private hospitals fund their own capital expenditure on new buildings and medical equipment.[21]

While only offering a partial explanation, the development of a significant private role in the funding and delivery of services plays an important role in Australia's position as a relatively low revenue-raiser among the developed world. It is this reasonably unique feature of Australian life that should be maintained and enhanced if we are to keep our strong economic performance and adherence to economic freedom into the future.

Conclusion

It is difficult to quibble with Alexander's contention that Australia compares favourably against many other OECD nations, including the big-government, low-growth economies of the European Union sagging under the weight of unsustainable levels of public indebtedness. Crafting an argument for Australian policy exceptionalism through a resourceful use of the available statistical evidence is a particularly impressive feature of Alexander's article.

As impressive as Australia's performance is, particularly against the European cohort of the OECD, there should be no room for complacency on the economic reform front.

Contrary to Alexander's view that the 'platypus model' provides an environment conducive to reform, the ongoing expansion of the welfare state financed by ever-growing government revenues risks the development of powerful political constituencies opposing beneficial change.

Perhaps more worryingly, the entrenchment of the welfare state will only serve to erode a sense of individual responsibility and self-reliance that is pivotal to Australia's reputation for dynamism and ingenuity.

To alleviate the prospect of public sector expansion in the face of population ageing, reforms are needed to encourage additional social and welfare services provision by for-profit and not-for-profit entities.

Measures should also be enshrined to ensure better targeting of government services to those genuinely in need, thus reducing the extent of unnecessary 'in kind' services churn within the Australian welfare state. Finally, tax reform measures focused on flattening and broadening the personal income tax base should be implemented.

It is only when such changes conducive to smaller government are realised that the platypus will truly be able to swim freely.

Endnotes

1 David Alexander, 'Free and Fair—How Australia's Low-Tax Egalitarianism Confounds the World,' *Policy* (Summer 2010–11), 3.

2 As above, 4.

3 The Heritage Foundation's *2011 Index of Economic Freedom* uses the less comprehensive, but arguably more easily quantifiable, measure of taxation revenue-to-GDP as one of its underlying indicators of country-level economic freedom.

4 Using data extracted from the International Monetary Fund (IMF) World Economic Outlook Database (October 2010), it is estimated that Australia's revenue-to-GDP ratio of 32% exceeds that of Hong Kong (21%), Singapore (22%), and Malaysia (26%).

5 For a comprehensive comparison of Australia's taxation regime with other countries, see Richard Warburton and Peter Hendy, *International Comparison of Australia's Taxes* (Canberra: Commonwealth of Australia, 2006).

6 Vito Tanzi and Ludger Schuknecht, *Public Spending in the 20th Century: A Global Perspective* (Cambridge: Cambridge University Press, 2000). According to OECD figures for the same nine countries, this figure had eased marginally to an estimated 40% in 2010.

7 Intergenerational Report, *Australia to 2050: Future Challenges* (Canberra: Commonwealth of Australia, 2010).

8 David Alexander, 'Be prepared for a fatter, big-taxing government,' *The Australian* (16 April 2010).

9 For example, see Gerard W. Scully, 'Optimal taxation, economic growth and income inequality,' *Public Choice* 115 (2003), 299–312.

10 A useful summary of issues are canvassed in Will Wilkinson, 'Thinking Clearly about Economic Inequality,' *Policy Analysis* 640 (Cato Institute, 2009).

11 Jeff Harmer, *Pension Review Background Paper* (Canberra: Commonwealth of Australia, 2008).

12 OECD Social Expenditure Database. The OECD data include a range of social expenditures by state and local governments, such as concessions and allowances for seniors.

13 Peter Saunders, 'Australians are living off the public teat more today than ever before,' *The Australian* (21 February 2009).

14 Using another measure of income, John Humphreys estimates that more than half of welfare paid is churn between people of approximately similar incomes. John Humphreys, *Ending the Churn: A Tax/Welfare Swap*, Policy Monograph 100 (Sydney: The Centre for Independent Studies, 2009).

15 George Stigler, 'Director's Law of Public Income Redistribution,' *Journal of Law and Economics* 13 (1970), 1–10.

16 Australian Public Service Commission, *State of the Service Report 2009–10* (Canberra: Commonwealth of Australia, 2010). Includes Aboriginal Hostels Ltd, Australian Institute of Family Studies, Australian Institute of Health and Welfare, Centrelink, Department of Families, Housing, Community Services and Indigenous Affairs, and Department of Human Services.

17 Robert Carling, *The Unfinished Business of Australian Income Tax Reform*, Policy Monograph 108 (Sydney: The Centre for Independent Studies, 2010), 9.

18 Julie Novak, 'The AEU tax premium,' Catallaxy Files blog, http://catallaxyfiles.com/2010/12/14/the-aeu-tax-premium (2010).

19 Harper Associates, *Preserving Choice: A Defence of Public Support for Private Health Care Funding in Australia* (2003).

20 Independent Schools Council of Australia, *Independent Schooling in Australia: Snapshot 2010*.

21 Australian Private Hospitals Association, Submission to Productivity Commission Research Study into the Performance of Public and Private Hospitals (July 2009).