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Ending the Churn: A Tax/Welfare Swap

John Humphreys

THE CENTRE FOR INDEPENDENT STUDIES

Perspectives on Tax Reform (18)

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Executive Summary

The Australian welfare system—including health, education and handouts—costs more than $250 billion per year. Some of this is redistribution from the relatively rich to the relatively poor. However, about half of the welfare is pointless 'churn,' where the same person both pays taxes and receives welfare benefits.

Some of this churn is 'cash churn' where people both pay tax and receive cash from the government. But the bigger problem is 'services churn' where middle- and high-income earners pay tax and receive government-subsidised health and schooling services.

By removing middle-class welfare in exchange for income tax cuts, the government could reduce tax and welfare by about $80 billion without leaving anybody worse off.

At first, churn may seem benign. After all, the benefit ends up with the person who paid the tax, so all is well that ends well. But the costs add up. The direct economic costs include administration, compliance and efficiency costs. The non-economic costs include lower self-esteem and individual responsibility, political rent-seeking and lack of transparency.

However, the biggest arguments against churn are the dynamic costs. Put simply, the current welfare system is unsustainable. Within 40 years, the government will need to massively increase tax, drastically cut services, or reform the system.

By keeping the welfare state for low-income earners but cutting welfare and tax for middle- and high-income earners, the government can create a sustainable welfare system as well as reap the economic and non-economic benefits of less churn.

The easiest way to achieve this is to means-test government benefits, including health and school benefits, and to link the means-test to an increase in the income tax free threshold to ensure that no family is worse off. High-income families would then be responsible for paying for their own health and schooling costs, but they would now be able to afford these costs because they would have 'saved' thousands in taxes not paid.

There are many areas of government policy that involve difficult trade-offs between competing goals. Political debates rage about whether we should sacrifice some freedom for security or whether we should trade some efficiency for greater equality. But removing churn does not involve any difficult trade-off. Removing the tax-welfare churn for middle- and high-income families produces economic, non-economic, and dynamic benefits while leaving no family worse off.

Ending the Churn: A Tax/Welfare Swap

John Humphreys

Introduction

Australia is a welfare state. The government provides relatively generous income support, family benefits, retirement income, health services, and education at a cost of more than $250 billion per year (over 23% of GDP). This welfare state retains significant support among the general population and politicians.

However, there is one element of the welfare state that produces absolutely no benefit.

This year, up to $140 billion will be taken from Australian taxpayers and given back to the exact same taxpayers. This welfare 'churn' does not achieve any redistribution. The main cause is the so-called 'middle-class welfare'[1] where middle- (or high-) income earners both pay taxes and receive government welfare services.

Although reforming the welfare state is a notoriously difficult political exercise, the argument for addressing middle-class welfare churn is strong and deserves serious consideration.

This monograph will first look at the size of welfare churn in Australia and draw a distinction between the pointless 'cash churn' and the equally pointless but more costly 'services churn' (including government health and education).

The second section will explain in more detail the costs of middle-class welfare churn. Some economists argue that the direct economic costs of churn aren't high, while some sociologists point to the important but unquantifiable social and political impacts. Both groups have a point. However, the biggest costs of churn are the dynamic effects, including long-term unsustainability and lower-quality services.

In contrast, the only benefit from middle-class welfare churn is for politicians—who are seen to be active and handing out benefits to voters.

The third section will look at how to address middle-class welfare churn. The simplest solution would be to remove the welfare state. However, this paper will limit itself to considering options that retain the current levels of government redistribution.

The solution is to have a tax-welfare swap, where some people accept fewer government benefits in exchange for paying less tax. This can be achieved either with an 'opt-out' swap or a 'means-test' swap. While these two approaches have several similarities, there are also some key differences.

The final section will look at how a 'means-test' tax-welfare swap would work in practice. By removing some of the middle-class welfare churn, it will be possible to increase the tax-free threshold to more than $100,000 for some workers and offer up to $80 billion worth of income tax cuts, while leaving nobody worse off. This represents significant tax reform that is worth pursuing.

The tax-welfare churn

It is easy to get confused by Australia's tax and welfare system. We have 125 taxes, 40 cash transfer payments, and dozens of schemes for subsidised services, each with its own special rules and regulations. The complexity of the system allows anomalies to go unnoticed and unreformed (see Box 1).

Australia has 125 taxes and 40 cash transfer payments, each with its own special rules.

Box 1: Example of tax system anomaly: regressive income tax[2]

Most people assume that our marginal income tax rates are progressive, with people on higher incomes paying a higher marginal tax rate. The reported marginal tax rates are 15%, 30%, 38%, and 45%.

However, the true marginal rates are actually much more complex and regressive in two places. The marginal tax rate for somebody earning $20,000 per year is 25%, but the marginal tax rate for somebody earning $25,000 per year is 16.5%. Also, the marginal tax rate for somebody earning $60,000 per year is 35.5%, but the marginal tax rate for somebody earning $70,000 per year is 31.5%.

If the true tax rates were understood, there would be pressure to fix the system. But because the system is not well understood, there is little drive for reform.

Tax-welfare churn is perhaps the largest anomaly in the Australian tax system. The intention of the welfare state is to *redistribute* money from the relatively 'rich' to the relatively 'poor' so that everybody has a certain minimum standard of living.

In contrast, *churn* occurs when the government both takes tax and gives welfare to the same person (or family), with no redistribution of income. It is unlikely that tax-welfare churn was an intended part of the welfare state, but the complexity of the system has made it difficult to reform.

How much churn?

It is difficult to measure exactly how much welfare is redistribution and how much is churn. In his 2007 book on tax-welfare churn, Peter Saunders estimated that about half of the welfare state was redistribution and half was churn.[3]

In its 2007 report *Government Benefits, Taxes and Household Income*, the Australian Bureau of Statistics (ABS) provides information on the taxes paid and benefits received by income quintile for 2003–04 (Table A).

Table A: Tax and benefits by private income quintile[4]

(%)	Lowest	2nd quintile	3rd quintile	4th quintile	Highest
Tax	5.6	9.0	15.4	23.3	46.7
Benefits	41.1	23.0	15.5	11.5	9.0

The ABS data does not cover all taxes and benefits. Of the taxes and benefits measured by the ABS, about 50% of welfare was redistribution from higher-income to lower-income families while 50% was churn between people of roughly the same income. Applying the tax and welfare income distributions from Table A to all tax and benefits from the same year (2003–04) gives us similar results—about 45% of welfare was redistribution and about 55% was churn.

Churn occurs when the government both takes tax and gives welfare to the same person (or family), with no redistribution of income.

Taking the same proportions and applying them to the tax and benefits from the last year with full data (2007–08) indicates that about 44% of welfare is distribution and about 56% of welfare is churn.

These measures are imperfect. Some of the 'churn' will actually be redistribution between different people with the same income but different life situations.[5] Some of the 'redistribution' will occur within a family unit, and so is for all intents and purposes churn. These two effects mean that the above statistics may over or underestimate the true amount of churn. However, it is difficult to adjust for these effects, so this paper will use an estimate that about **50–56% of welfare is churn**.

Given that the total government welfare spending (health, education and transfers) was $253.7 billion in 2007–08,[6] we can estimate total churn to be around $127 billion to $142 billion per year. This is about 12%[7] of GDP every year that is pointlessly churned around the economy with no benefit.

Some churn is inevitable. With some taxes, it will be difficult or impossible to exempt low-income earners from paying. For example, it will be difficult to charge a different rate of GST for people dependent on their income (although Saunders offers some suggestions[8]). And it would be impossible to exempt low-income earners from the consequences of a company tax, which drives up prices and drives down incomes and profits.

However, while some tax-welfare churn may be inevitable, this is not true for income-based taxes. Table B below shows the tax-welfare churn involved in income tax.

Table B: Income tax churn and net tax by income quintile in 2007–08[9]

	Lowest	2nd quintile	3rd quintile	4th quintile	Highest	Total
Income tax ($m)	$426	$6,528	$18,875	$33,493	$82,597	$141,919
Churn ($m)	$426	$6,528	$18,875	$29,176	$22,833	$77,838 (55%)[10]
Net tax ($m)	-	-	-	$4,317	$59,764	$64,081 (45%)

In 2007–08, the total individual income tax (including superannuation and fringe-benefits taxes) was $142 billion. Of this, about $78 billion (55% of income tax) was churned back to people from the same income group, while only about $64 billion (45% of income tax) went for redistribution or public goods.

While it may not be possible to eliminate churn, the above information suggests that it should be possible to reduce it by up to $80 billion per year.

Cash churn v services churn

Government welfare benefits can be split into two distinct categories. Either the government gives people cash to buy what they need or it subsidises certain industries that then provide their services for free or cheap.

'Cash churn' occurs when people pay tax and then receive cash back from the government. For example, a person earning $20,000 per year both pays income tax and is eligible to receive Newstart allowance (the 'dole').[11] More commonly, middle-income families with children often both pay tax and receive child-support payments. Cash payments are generally means-tested,[12] which means that as people earn more money through work, they receive fewer benefits from the government.

If cash payments go only to low-income earners (who pay little tax), then there should be relatively little churn. As Peter Whiteford shows, the Australian government's cash payments are mostly targeted at low-income families and consequently we have the lowest level of cash churn in the OECD.[13]

However, it should be noted that there is still a significant amount of cash churning for people on middle and high incomes, mostly as a result of family benefits. Whiteford explains that 'in virtually all OECD countries, the middle 60% of households receive between 50 and 65% of all transfers, with Australia being towards the lower end of this at 56%.'

The top 50% of income earners in Australia still receive 10% of cash welfare benefits.

Buddelmeyer, Herault and Kalb show that the top 50% of income earners in Australia still receive 10% of cash welfare benefits.[14] They go on to show that the average income tax paid by people in the fifth decile was $5,331, while the average of cash benefits for the same group was $6,805.[15] In total, about 13% of income tax ($18.4 billion) is given back as cash to the people who paid the tax.[16]

This indicates that there is still significant scope to reduce cash churn.

While most research is focused on cash churn, it is only part of the story. 'Services churn' occurs when people pay tax and then receive the money back as subsidised services.

The two most obvious examples of services churn in Australia are health and school benefits. In contrast to cash benefits, government service provision is generally not means-tested, which means that it is also available to middle- and high-income earners. This makes up most of what is called 'middle-class welfare.'

While cash churn is a problem, services churn is a bigger issue. About 42% of income tax ($59.6 billion) ends up going back as services churn to the same people who paid the tax.[17] This means that services churn is actually three times as big as cash churn.

Another way of looking at this is how much of the benefits come from income tax paid by the same people. For cash payments, about 20% of the money comes from income tax paid by the same people who get the benefits. In comparison, about 38% of services benefits comes from income tax paid by the people who receive the benefits. Both these figures underestimate total churn because they only consider the churn that comes from income tax and excludes other taxes paid.[18]

Box 2: Lifetime churning[19]

The above discussion has concentrated on money that goes from taxpayer to government and back to the same taxpayer in the same year. In addition to this 'simultaneous churning' there is also the issue of 'lifetime churning' to consider.

Lifetime churning occurs when a person is a net taxpayer at some points in their life and a net welfare recipient at other points. Some of the welfare identified as 'redistribution' above will actually fall into this category.

With lifetime churning, the government is effectively acting as a bank or insurance company, managing inter-temporal transfers for people by taking their money in their high-income years and handing it back in their low-income years. Various reforms have been introduced to decrease lifetime tax-welfare churn, such as university HECS payments and compulsory superannuation. Peter Saunders has suggested various additional reforms that would further reduce lifetime churning.

While these issues are important, this paper examines only simultaneous churn.

The case for reform: why churn is bad

At first glance, the tax-welfare churn may seem pointless but mostly harmless. After all, the benefits end up with the people who paid tax so all is well than ends well.

Some economists claim that churn is mostly cosmetic and that the economic costs—such as administration and compliance and economic inefficiency—are quite low. In response, some sociologists suggest that the bigger costs are non-economic, including social, political and transparency costs.

Both groups are correct. The direct economic costs are real but relatively small. The non-economic costs may well be larger, but they are unquantifiable. For cash churn, this is the end of the story.

However, for services churn there are additional dynamic costs that are potentially the most important.

Unlike cash churn, services churn decreases individual control over how one's money is spent. This reduces competition between service providers and lowers the quality of services. Further, as the services are not means-tested, government spending continues to grow as society gets richer. Specifically, with an ageing population and ever-increasing demand for health care, it is not sustainable to continue providing government health services to high-income earners.

Direct economic costs

The direct economic costs of churn fall into two categories. By requiring money to pointlessly flow around the economy, churn increases administrative costs to the government and the compliance costs to citizens. In addition, by distorting behaviour the government creates 'efficiency' costs to the economy.

Economists such as Nick Gruen and Peter Whiteford have correctly pointed out that the direct economic costs of churn are not large.[20] However, this does not mean that these costs should be ignored. Rough estimates suggest that the direct economic costs could be several billion dollars per year.

Administration and compliance costs

Tax and welfare policies need to be administered by an ever-growing army of bureaucrats, and understood by an equally large horde of tax accountants and lawyers. Alex Robson estimated that the Australian 'tax army' (people working on tax administration and compliance) in 2001–02 exceeded 80,000, which was more than three times bigger than our real army.[21]

In addition, there are the administration and compliance costs associated with welfare, health and school benefits. Centrelink alone employs about 25,000 people, in addition to thousands of extra bureaucrats in the Commonwealth and state departments of health, education and welfare, as well as outsourced welfare workers.[22]

Tax and welfare policies need an ever-growing army of bureaucrats, and an equally large horde of tax accountants and lawyers.

The bureaucracy in the federal departments of health, education, welfare, and tax costs $5.5 billion every year.[23] If we added other relevant agencies, state bureaucracies, and compliance costs, the total cost would exceed $10 billion.

Removing tax-welfare churn would not eliminate all these costs. We would still need a tax and welfare bureaucracy, and people would still face some compliance costs. However, if we could remove churn, then each person would only need to deal with the tax system or the welfare system but not both. By removing some people from the tax system and taking others out of the welfare system, each government agency would deal with fewer people and each person would deal with less bureaucracy.

It is impossible to know exactly how much administrative and compliance cost could be avoided if we removed churn, but even if costs could be reduced by only 10%, it could still add up to more than $1 billion per year.

Economic cost of higher taxes

Middle class welfare-tax churn adds around $130 billion to Australia's annual tax bill, including about $80 billion in income tax. Given that each tax dollar creates about $0.20 to $0.40 of additional cost,[24] it seems that churn produces a significant cost to the Australian economy. However, this is a misleading picture. Surprisingly, the economic efficiency costs may be one of the least important costs from tax-welfare churn.

To understand why churn does not create a significant economic efficiency cost, it is necessary to differentiate between two important issues involved with the tax-transfer system. The first issue—and the focus of this monograph—is that welfare can result in pointless churn when a welfare recipient is also paying tax.

The second issue is that when people earn more money, they both pay tax and lose welfare benefits, which results in high 'effective marginal tax rates' (EMTR). For example, a person with an income of $20,000 per year must pay tax at a marginal rate of 25% and loses welfare benefits at a rate of 60%, resulting in an EMTR of 85%. If they earn an extra $100, they must give $85 to the government. It is the high EMTR that creates a disincentive against working, and this is what creates the economic efficiency cost.

Reducing churn while not changing the EMTRs would not improve economic efficiency. Conversely, reducing EMTRs but not reducing (or increasing) churn would improve economic efficiency. Because of this, some economists argue that churn is not a major problem.

This isn't quite correct. While economic efficiency costs are low, they are not zero.

It is possible for some churn to have an impact on incentives. While cash churn does not change disposable income, this is not necessarily true for services churn. If services churn supplies taxpayers with the same service they would have voluntarily bought for the same price, then there is no change in their disposable income or their behaviour and, consequently, no economic efficiency cost.

However, if services churn forces people to spend too much on a particular service (or get the 'wrong' cover), it would leave them with less disposable income and a higher EMTR than they would have had without the tax-welfare churn. The distorted decision represents an economic efficiency cost.

It is very difficult to judge how much of the tax-welfare churn involves an economic distortion. If 20% of people spent 10% too much[25] on health or education, then only about $3 billion[26] of government spending creates a distortion, with an economic cost of perhaps $1 billion.

While the efficiency costs are not high, this does not justify churn. As there are no clear benefits from tax-welfare churn, any efficiency cost is too high. And when we consider all the costs, the case for reform is strong.

There is another lesson to draw from the above discussion. While it is important to address tax-welfare churn, we must recognise that there are other problems associated with the welfare state that need to be addressed. The current system includes high EMTRs for some workers, which creates a 'poverty trap' where people do not get much financial benefit from additional work. It is important to ensure that any tax-transfer reform does not exacerbate this problem.

Non-economic costs

When considering the costs of churn, sociologist Peter Saunders suggests that the 'sociological and psychological' costs are actually more important than the economic costs.[27] Unfortunately, these costs are difficult to quantify.

Non-economic costs of churn fall into three broad categories—the social costs, the political costs, and the transparency costs.

Social costs of dependency

Tax-welfare churning means that people are more reliant on government for their income and services and less personally responsible for their own life. This has a negative effect on the recipients (through lower self-esteem), encouraging worse behaviour (through learned helplessness and distorted time preference), and undermining social capital (by exacerbating social exclusion).

With churn, the 'sociological and psychological' costs are actually more important than the economic costs.

Self-esteem (and Maslow's loftier goal of self-actualisation)[28] is only possible when people are in control of their own lives. While it is comfortable for a child to have the protection of their parents, to fully develop as an adult it is necessary to take responsibility for one's own life and achieve the pride that comes with independently managing one's own affairs. Welfare (both the churn and the redistribution) reduces people's responsibility for the outcomes in their life and instead socialises them into a mentality of dependence and servitude. Put more dramatically, lack of individual responsibility takes away some of the meaning of life and weakens people's sense of controlling their own destiny.

Further, the weakening of individual responsibility leads to less responsible behaviour. In short: incentives matter. While it is true (as welfare advocates claim) that some people suffer for no fault of their own, it is also true that sometimes people make bad decisions. In public policy, it is generally understood that when you want more of something you subsidise it and when you want less of something you tax it. Tax-welfare churn (as well as tax and welfare in general) subsidises bad decisions and taxes good decisions. It is not surprising then that the welfare state has led to some instances of 'learned helplessness,' where people become unable to make responsible decisions. Unfortunately, this irresponsibility meme can be just as hereditary as family genes, and can result in intergenerational dependency.

Another way to look at this issue is through the effect of changing time preference. As noted by Ben O'Neill,[29] any policy that reduces individual responsibility for future position will increase time preference, leading to a greater preference for immediate satisfaction and less concern for future consequences. An excessively high time preference can explain certain 'anti-social' behaviours such as drug addiction, abandoning family commitments, and crime.

A final social consequence of tax-welfare churn (and welfare in general) is the exact opposite to what was intended by the promoters of universal welfare. The claim that government welfare would enhance social harmony, social inclusion, and stability ('social capital') has been shown hollow, as the voluntary personal interactions of concerned citizens in civil society groups have been replaced by impersonal bureaucratic departments.

Humans will always need to cooperate, both to achieve their own personal goals and to help their family, friends, neighbours, and strangers to achieve theirs. This cooperation creates and uses social capital. Unfortunately, as the welfare state grows, the role for voluntary civil society such as Friendly Societies[30] decreases (known as 'crowding out'), which further isolates welfare recipients from the community and contributes to social exclusion and a loss of social capital. Other effects on civil society are considered in 'political costs' below.

The above arguments apply to all welfare. However, this does not necessarily mean there should be no government welfare. If a government provision provides a real benefit, then it may be appropriate despite the costs. But tax-welfare churn contributes to all these costs without providing any additional benefit.

Political costs

More welfare and more churn also impose political costs on the community. The bigger government is, the more opportunity for bad outcomes. Big government leads to wasteful rent-seeking, regulatory capture, politicisation of civil society, greater potential for cheating and abuse of political power, and the building of a political culture of dependence.

The most commonly cited political cost of government programs is that it encourages rent-seeking, where people divert resources from the real economy into lobbying the government for preferential treatment.

Big government leads to wasteful rent-seeking, regulatory capture, politicisation of civil society, greater potential for cheating and abuse of political power.

Public choice theory suggests that government programs will tend to be 'captured' by special interest groups, and the outcomes tend to maximise political benefits and not necessarily community benefits. Money spent on lobbying would be better spent in the marketplace or distributed as charity.

Another cost is that the direct impact of community groups is undermined, and civil society groups shift their resources increasingly towards political action. Saunders calls this the 'politicisation of civil society' where community groups focus their attention on politicians instead of the community they are trying to help. As sociologist Frank Furedi says, modern civil society groups are increasingly 'professional institutions that are in the business of "Doing-For" instead of "Doing-With" people,' 'essentially lobbying groups' and 'predominantly media-focused organisations whose main objective is gaining publicity' instead of actually directly helping people.[31]

The cost here is not simply the resources wasted in rent-seeking and the loss of social capital, but the loss of the valuable contribution made by civil society, which can be more efficient and effective at dealing with poverty.

Community groups sometimes have a better knowledge of the specific circumstances in their community, and have a strong motivation for finding innovative and effective strategies for efficiently helping their community. They are also valuable institutions for building social capital, both among donors, volunteers, and the general community, as well as the clients. As civil society groups merge into political organisations many of these benefits are lost.

Another political concern is the greater the role for government, then the greater the scope for abuse of government power. The more responsibilities that we hand to the government, the greater the possibility that people will benefit from corruption instead of competence and political connections instead of need.

More interaction with the government provides more opportunities for people to 'game the system.' Each government program is subject to some level of abuse. As more people are exposed to more government agencies and programs, the amount of tax and welfare cheating will increase. This has a direct fiscal cost to the government as well as a policing cost, which in turn can result in a further loss of privacy for taxpayers and welfare recipients.

Finally, there is the impact that big government has on political culture. With a universal welfare system supplied to everybody regardless of need, government encourages the view that it is the solution to all of life's problems. This contributes to a political culture where, instead of seeing a problem and working towards a solution, people simply complain and wait for the government to fix the world. In other words, people change from 'problem-solvers' to 'whingers.'

An electorate that expects the government to do everything, combined with politicians who promise they can do everything, leads people to build unrealistic expectations. When these can't be filled, it results in disillusionment with the political process and disempowerment. Furedi suggests that this leads to a 'heightened consciousness of isolation' and that this political dependence helps 'induce an exaggerated sense of weakness and a fatalistic outlook.'[32]

Lack of transparency ('Illusion effect')

A central feature of the tax-welfare churn is that it effectively hides who is a net taxpayer (paying more tax than receiving welfare benefits) and who is a net welfare recipient (receiving more benefits than tax paid). This is the 'illusion effect.'

The tax-welfare churn hides who is a net taxpayer and who is a net welfare recipient.

Ironically, the lack of transparency is sometimes thought to be a virtue of churn. Advocates of both tax cuts and increased welfare spending suggest that the lack of transparency may trick the general public into supporting their preferred policies.[33] While possible, this benefit is purely political and it is not even clear which side of the political debate will get the benefit.

It is also suggested that the lack of transparency may trick people into working hard despite their high (but difficult to determine) effective marginal tax rates.[34] This is possible. However, it is questionable whether this sort of illusion will be effective in the long run as people adjust and learn over time.

The only clear beneficiaries from the illusion effect are politicians who are able to take credit for more government handouts and subsidised services.

In contrast, the illusion effect does have some very real costs. The lack of transparency allows the government to ignore policy anomalies such as high EMTRs or handouts to rich families. If it were easier to identify exactly what was happening, then this would create pressure for policymakers to address problems instead of hiding them.

Dynamic costs from services churn

The direct economic costs and non-economic costs of churn provide a strong rationale for reforming the tax-welfare system. However, there are additional dynamic costs that are specifically related to services churn.

Unsustainable in the long run

Due to demographic change, the nature of health spending, and the growth of long-term welfare dependence, the current welfare state is not fiscally sustainable without significant tax increases.

The purpose of the welfare state should be to help people who have insufficient income to help themselves. As we get richer, we would expect the welfare state to shrink as more and more people become self-sufficient. Surprisingly, the exact opposite has happened.

In the mid-1960s, only 3% of working-age adults relied on welfare benefits for their income, and before Medicare was introduced nearly three-quarters of families had their own private health insurance. As economic growth over the following 40 years led to a doubling of average incomes and ever more money going to charity, we could have expected government welfare to drop to near zero and private health cover to expand across most of the population. Instead, we have 16% of working age adults relying on welfare benefits and the government funding almost three-quarters of health costs.[35]

There are several reasons for this unexpected outcome. First, once the government gets in the business of handing out money, it becomes a target for lobby groups who want more handouts, irrespective of whether they are needed or not. Second, the social costs of welfare can sometimes discourage work, reduce individual responsibility, and 'learned helplessness'—leading to a sustained demand for welfare.

However, the main reason that the welfare state can't shrink is that the government does not target its health and schooling assistance to poor people but instead offers a universal health and schooling system. Such an approach makes it impossible for the welfare state to shrink, no matter how rich we become.

Further, universal government health services put upward pressure on the welfare budget. The reason for this is that as income increases, the demand for health increases faster than the demand for other goods, which puts heavy pressure on the government to always spend more on health.

This trend is exacerbated by the ageing population, where the elderly have greater demand for high cost health care.

By the middle of this century, the percentage of people aged over 65 will nearly double to 25%, and the percentage of people aged over 85 will triple to nearly 6%.

The fiscal consequence of an ageing population and growing demand for health care is a major challenge for the government. Already, over the past four decades, we have seen federal government health spending rise from 1.5% of GDP up to nearly 4%.

Over the past 20 years, health spending has increased by an average of 4.8% per year (rising to 5.8% annual growth under the Howard government). Of this, about 1.8 percentage points was caused by an ageing population.

The federal government's *Intergenerational Report* (IGR) estimates that this trend is set to continue, with Commonwealth health spending predicted to rise from 3.8 to 7.3% of GDP by 2046–47.[36] Even these estimates may be conservative.[37]

Over the past four decades, we have seen federal government health spending rise from 1.5% of GDP up to nearly 4%.

This is the equivalent of an extra $41.2 billion spending per year, which must be funded by an extra $41.2 billion per year in tax. To put that number in perspective, it is more than the federal government Defence and Education budgets combined, or nearly $2,000 per person in Australia. To raise this amount of money, the government would have to significantly increase tax. Even if we doubled the GST to 20%, it would be unlikely to raise enough money to pay for our future Commonwealth health bill.

The actual fiscal problem facing Australia is more dramatic than this. The IGR estimates that federal spending on all areas will increase by about 5% half way through this century—which is the equivalent of nearly $60 billion of extra tax and spending every year. This excludes the growing costs to state and local governments. According to the NSW Auditor-General's report, health spending has been expanding rapidly over recent decades and at the current rate, 'funding for health will consume the entire State budget by 2033.'[38]

At the same time that the welfare state is expanding, the percentage of people in work is expected to decrease. While today we have five people of working age for each person over 65, by the middle of this century there will be fewer than 2.5.[39] The IGR estimates that the decrease in the workforce participation rate will drag the economy backwards by about 0.3% of GDP per year. At the same time, lobbying for health, welfare, and other government spending continues to grow.

Put simply, the current welfare state is not sustainable. At some stage during the next half century the government will either need to significantly increase tax or start cutting back on government spending.

This is not to say that any welfare system is unsustainable. If welfare was provided only to people genuinely in need, then there would be no sustainability problem. Welfare costs would be relatively low, allowing lower taxes, leading to a virtuous cycle of higher incomes, more charity, greater capacity for self-reliance, and less need for government welfare.

Unfortunately, our current approach of tax-welfare churn means that the demand for government welfare will continue to grow. It is not welfare that is unsustainable but our current tax-welfare churn version of welfare.

Lower quality services

When the government provides a subsidised (or free) service, it often does not have the correct incentives to provide efficient and high quality care. The reason for this is that a government monopoly service does not get the benefits from market competition.

Benefits from market competition include less waste, more choice, better service, better matching of supply to demand, more innovation, more opportunities for specialisation, better risk management, and better use of diverse and constantly changing knowledge. These are outlined in Box 3.

It is not necessary to privatise government health or education services to achieve the benefits from competition. However, to achieve better results and more choices at a lower cost, it is necessary to introduce the discipline of competition with private competitors.

Market competition is severely handicapped if the government continues to offer a subsidised (or free) service available to everybody. While these benefits may well be of value to low-income earners, for people caught in tax-welfare churn the government services provide no net benefit while reducing competition.

By removing the middle-class welfare of services churn, the government can still provide benefits to low-income earners while allowing people to choose their preferred service in a competitive market. This would lead to less waste and higher quality services by both government and non-government service providers.

Note that none of this is a threat to redistribution, government ownership, or government provision for poor people. It is possible to have all these things and still introduce greater competition into the health and school systems.

Box 3: The benefits of competition

Nobel Laureate economist Milton Friedman drew an important contrast between the different ways that people deal with money. When you spend your own money to meet your own goals, then you are careful to get value for money and achieve your objectives. If you spend other people's money on your own goals, then you will tend to be less careful with money, but still aim to effectively achieve your goals. If you spend your own money on other people's goals, then you will be careful about value for money, but less concerned with the effectiveness of your spending. The worst scenario is when you are spending other people's money on other people's goals and have no incentive to be either efficient or effective. This is what happens with bureaucracy and government monopoly.

The solution to the problems of government-run businesses is to introduce competition. It is not necessary to privatise a government business to get the benefits from competition, though this is one option. All that is needed is for government businesses to be put in a competitive marketplace where they are forced to pay closer attention to the demands of their customers and the efficiency of their production.

Most people understand why competition leads to better outcomes. The threat of losing customers drives providers to offer better quality services and lower prices, while the lure of making profits drives providers to do things in the most efficient way possible and quickly adapt to new innovations. Without competition, there is little incentive for high quality, low cost, and efficient service. Comparisons of competitive markets with government monopolies have repeatedly shown the advantages of market competition.

In addition to the above standard economic defence of competition, there is also an evolutionary (or Austrian economics) reason to value competition. Information about preferences, technology and resources is spread among the wider population, and is always changing. In his famous essay on knowledge, Austrian economist Frederick von Hayek showed how markets were better than bureaucrats at best using all available information in society and adapting to new information.

An important benefit from competition is that it provides a diversity of choices for consumers. Different people and organisations often have a particular set of skills and knowledge that allow them to specialise and provide some services better than others. Competition allows customers to match their personal preferences with the suppliers of their choice.

The above argument is the reason that the Australian government does not run clothes shops, farms, hairdressers, grocery stores, bakeries, banks, or airlines. Those countries that have experimented with monopoly government control of business have paid a high price in low efficiency, shortages, poor service, low productivity growth and, consequently, lower wages, and higher prices. A comparison of East and West Germany, or North and South Korea, are just two of many historical case studies.

The solution: a tax-welfare swap

The case for removing tax-welfare churn is strong. It is not the only problem in our tax or welfare systems, but as churn has no clear benefit, it is an obvious candidate for reform.

Some churn is unavoidable. But churn between income tax and middle-class welfare can be removed by trading income tax cuts for less middle-class welfare.

For low-income earners, this will involve little change because low-income earners pay relatively little income tax. The bottom 40% of income earners pay only 4.9% of income tax, while the top 40% pay 86.8%.

At the same time, the top 40% still receive 20.5% of government welfare benefits, mostly through health and schooling subsidies. By removing this middle-class welfare in exchange for income tax cuts, churn could be reduced by as much as $80 billion per year. That means an $80 billion cut to income tax and $80 billion less government spending on middle- and high-income earners, while redistribution remains unchanged.

There are two potential strategies for achieving the above tax-welfare swap and creating a more sustainable health and welfare system: the 'opt-out' swap or the 'means-test' swap.

Opts-out v means test

The 'opt-out' approach is to create a parallel system for those who want to avoid the current tax-welfare system. In the parallel system, people would be responsible for all (or parts) of their own welfare, including unemployment insurance, health insurance, schooling costs, and other areas. In exchange, they would pay a lower level of tax. They would still pay some tax to go towards public goods and redistribution to people who choose to remain in the welfare system. This approach has been advocated in Australia by Peter Saunders,[40] who explains it as follows:

By removing this middle-class welfare in exchange for income tax cuts, churn could be reduced by as much as $80 billion per year.

> The basic idea is that people who agree to take more responsibility for themselves should be allowed to retain more of their taxable income so they can afford to buy replacement services, but that those who prefer to remain in the state system can stay as they are.

Under the Saunders system, people remain in the government system unless they decide to opt out, in which case they reduce their tax payments by an amount equal to the benefits they are receiving. If you do not pay enough tax to cover your welfare benefits, then you can stay in the government system and continue to receive the same welfare. People who do opt out are required by law to buy health care and schooling for their children.

The alternative is a means-test swap.[41] In this approach, the government support is slowly removed from people as they earn more money. They are compensated for this loss through tax cuts, which exactly offset the lost government benefits. Once a person's income exceeds a certain level, then they would be fully responsible for their own welfare (including health insurance and their children's schooling) and be able to afford those payments through lower taxes. As with the 'opt-out' approach, there would be a mandatory minimum level of health insurance and schooling that people must buy.

While both 'opt-outs' and 'means-testing' allow people to 'swap' their middle-class welfare benefits for lower income tax, there are two differences.

Unlike Saunders' 'opt-out' approach, the 'means-test' approach would mean that all high-income earners eventually stop receiving government funding. Saunders prefers the opt-out system because he worries that some high-income earners may want to stay with a government system. However, that is still possible with the means-testing approach. The government can remain as an owner and operator of health cover and schools and allow high-income earners the option of continuing to pay for those government services if they want. Ultimately, the only difference between opt-outs and means-testing is that the means-test approach guarantees lower churn for middle- and high-income earners, while providing all the same options.

The second difference is that the 'means-testing' approach would reduce churn for people who are net welfare recipients but still pay some tax. Under Saunders' 'opt-out' approach these people would continue to pay tax and receive full government benefits. Under the 'means-testing' approach these people would pay no tax and receive slightly fewer benefits. Ultimately, the only difference is that the means-test guarantees lower churn and increases choice for low-income earners, while providing all the same options.

Saunders suggests that the 'opt-out' approach may be more politically feasible. However, this is open to dispute. The concept of opting out is a relatively new and untested policy option in Australia, and the stark differences between two parallel co-existing systems may make the choice of opting-out seem dramatic and un-egalitarian. In contrast, the concept of means-testing is common, widely understood and widely accepted.

Criticism of means-testing

In his report on middle-class welfare, Luke Buckmaster outlines a number of criticisms of means-testing.[42] These include:

- high effective marginal tax rates (EMTRs) and a 'poverty trap';
- perverse incentives;
- intrusive process;
- possibility of low uptake of the programs; and
- administration costs.

Perhaps the most serious of these points is the point about EMTRs and the 'poverty trap,' which is linked to the issue of perverse incentives. As Saunders explains, means-testing can decrease the incentive to work because:

> [A]s soon as people work harder and earn more, not only do they pay more tax, but they also start to lose their government benefits. This double-whammy creates very high rates of effective taxation' at the margin (that is, people retain relatively little of each new dollar they earn), and this depresses incentives.[43]

Saunders goes on to say, '[i]ncreased use of means-testing (either for access to income support or for access to government services more generally) would make this problem even worse than it is already.'

These criticisms do apply to a simple means-test and are a strong reason to reject that approach. But the means-test swap, where means-testing is linked to matching income tax cuts, does not face these problems.

By exchanging middle-class welfare for income tax cuts, the effective marginal tax rates would not increase.

By exchanging middle-class welfare for income tax cuts, the effective marginal tax rates would not increase. Indeed, as explained previously, the tax burden would actually decrease for some people, leading to improved incentives.

The other concerns suggested by Buckmaster are similarly not relevant for the means-test swap. Concerns about low-uptake can be fixed by having compulsory uptake and automatic government coverage for low-income earners. And while there would still be some level of administration costs and intrusiveness, these problems would actually decrease by removing churn.

There is another potential concern with the means-test approach. The government services (health cover and schools) do not currently have a price. However, this could be calculated by the government and would create the additional benefit of providing greater transparency about government activity.

From theory to practice

Following the means-testing approach for a tax-welfare swap, it is possible to outline roughly how such a system would work in Australia.

As discussed earlier, only about one-quarter of tax-welfare churn comes from cash-churn, while the remainder comes from health and schooling subsidies going to middle- and high-income earners. Further, services churn has all of the costs of cash churn, plus the dynamic costs of unsustainability and lower quality services. This section focuses on services churn, but it is worth noting how cash churn could be addressed.

The best way to remove cash churn (and also to lower EMTRs) is to take cash welfare recipients entirely out of the tax system. This can be achieved by increasing the tax-free threshold to the point where people stop receiving cash welfare. While this would remove the costs of churn and improve work incentives, it would come at a significant fiscal cost to the government in lost revenue.

A more moderate approach, which would remove cash churn (but not change the EMTRs), is to take cash welfare recipients entirely out of the tax system and increase the means-test on their cash welfare benefits. For example, if a person was paying 20% in tax and losing 50% of welfare benefits for every dollar earned, this can be replaced by paying zero percent in tax and losing 70% in welfare benefits.

Such a reform would not change the EMTRs or disposable income of the cash welfare recipients. While the changes would be relatively minor, they would still bring several benefits such as greater transparency, reduction in administration and compliance costs, fewer social and political problems associated with welfare and big government, and a greater sense of self-reliance.

Health spending churn

In 2006–07, the government (Commonwealth, state and local) spent a total of $64.5 billion on health goods and services.[44] This represented a health subsidy of nearly $3,000 per person per year. So if government health were properly costed, it would cost about $3,000 per person for complete government health care.

If we remove churn, low-income earners would continue to receive the full subsidy of $3,000 so that complete health care was always available.

However, now that we have a clear understanding of the subsidy involved in government health cover, it is possible to means-test this subsidy for people with relatively higher incomes. The reduction in the health subsidy for middle- and high-income earners would be directly linked to an offsetting decrease in income tax via an increase in the tax-free threshold.

For example, individuals previously facing a marginal income tax rate of 16.5% (the rate for people earning $25,000 per year) and receiving the full government health cover would instead pay zero percent income tax and have their health subsidy phased out at 16.5%. That is, for every dollar they earn, their health subsidy would reduce by 16.5 cents.

A single person earning about $31,300 per year would no longer receive any government health subsidy and would have 'saved' $3,000 in taxes not paid. They would only start paying tax on the money earned above $31,300 per year.

As it would be compulsory to have a minimum level of health cover (at least covering catastrophic health insurance), that person would be obliged either to continue to buy the government health cover for $3,000 (and be in the same position as the current scheme) or decide to purchase elements of health cover (perhaps hospital cover or general practitioner insurance) from the private sector. While it would not be legal to purchase too little health cover, it would still be possible for people to purchase extra health cover if they chose.

A single person earning about $31,300 per year would no longer receive any government health subsidy and would have 'saved' $3000 in taxes not paid.

In addition, parents would have access to a $3,000 health subsidy for each of their children, and would be required to purchase health cover on their behalf. Like the original benefit, this would be means-tested, with the lost benefits exactly offset by lower taxes so that the family cannot be in a worse situation than they are under the current system.

This approach allows for the government to continue offering its government health services—including hospitals, general health insurance (GPs and other Medicare benefits), ambulance cover, and pharmaceutical insurance. This ensures that people always have the option of continuing with the exact same health cover they current have, and at the same price.

Box 4: The next step in health reform

It is an open question whether the government health subsidy should only be available to purchase government supplied health cover. If the subsidy was only available for government health care, most low-income people would remain in the government system, as the government system would be effectively free, but they would be required to pay the full amount for private health cover. Alternatively, if the subsidy could be used for any health cover (government or private), then low-income earners would have the choice to use their $3,000 government subsidy to buy any range of government or private health options. This paper does not aim to resolve this debate.

It is likely that private providers, both for-profit and not-for-profit, would emerge to compete with the government in providing these services. It would be necessary to maintain a level of regulation over private health providers to ensure that they do not unfairly discriminate or reject people on the basis of health risk. This could be achieved in a number of ways.[45]

School spending churn

In 2006–07, the government (Commonwealth, state and local) spent $58.2 billion on schooling—including both private and government schools.

This represented a school subsidy of about $12,000 per government student and about $6,300 per private student per year.[46] So if schools were properly costed, government schools would charge about $12,000 per year and private schools would cost on average $6,300 per year more than they do now.[47]

If we remove churn, low-income earners would continue to receive the full amount of this subsidy so that government schools remained free and private schools remained subsidised.

Like the health subsidy, once we have a clear understanding of the subsidy involved in government schooling it is now possible to means-test this subsidy for people with relatively higher incomes. This means-test would be directly linked to an offsetting decrease in income tax via an increase in the tax-free threshold.

For example, someone paying 35.5% in income tax (paid by somebody earning $40,000 currently) and receiving the full government schooling cover would instead pay zero percent income tax and have their schooling subsidy phased out at 35.5%. That is, for every dollar they earn, their schooling subsidy would reduce by 35.5 cents.

The split between funding for private and governments schools creates an added complexity when means testing a school subsidy. It is possible to argue that the higher subsidy should always go to the poorer families, irrespective of whether they go to a government or private school. However, while the author is sympathetic to such a reform, such a change goes beyond the scope of this paper, which focuses only on removing the tax-welfare churn. Consequently, the reform proposal in this paper will use the current approach to school funding, which has differential subsidies depending on whether a child attends a government or private school, with a bias towards government schools.

For example, a single person with one child in a government school earning about $76,000 per year would no longer receive any government health subsidy or school subsidy, and would instead have 'saved' about $18,000 in taxes not paid. That money is available for them to pay for two lots of health cover ($3,000 each) and one lot of government schooling ($12,000).

In contrast, a single person with one child in a private school would earn about $59,000 before they no longer received any government health or school subsidy, and they would have 'saved' about $12,300 in taxes not paid. That money is available for them to pay for two lots of health cover ($3,000 each) and one lot of private schooling ($6,300).

Box 5: The next step in school reform

To ensure that nobody in the current system is disadvantaged, it would probably be necessary to take the above two-tier approach to the schools subsidy. However, there would be a number of ways that this could be reformed for future recipients to ensure that families with a similar income received a similar benefit.

One option would be to offer an average subsidy of $10,000 to all people, irrespective of whether their child went to a government or private school. However, if there were no efficiency savings at government schools, this may require some families to pay a top-up to their government school of perhaps $500 per term. If this was considered unacceptable, then the extra $2,000 per year could be paid for from the general revenue, which would reduce the budget balance by about $0.5 billion each year for 12 years as the new system was introduced.

Another option would be to offer the larger $12,000 subsidy to all parents of new students and have the phase-out rate increased slightly. The consequence of this would be to provide a larger subsidy to poor families with a student at a private school and reduce the subsidy to richer families with a student at a government school. The problem with this approach is that it would marginally increase the EMTR for families during the phase-out of the subsidy.

Equalising the schools subsidy (or equivalent tax cut) for all students would open up the benefits of greater competition in the school market.

Benefits from the reform

The above reforms mean that people who are paying income tax would not receive government benefits and people who are receiving government benefits would not pay income tax.

One consequence of this is that the tax-free threshold would be increased. An individual's tax-free threshold would depend on how many children they have and whether they go to a private or public school. The specific tax-free thresholds for different taxpayers are outlined in Table C below. These rates only factor in the removal of services churn. For some people, the removal of cash churn may push these tax-free thresholds even higher.

Table C: New tax-free thresholds and tax savings[48]

	Tax-free threshold	Tax saving
Individual	$31,500	$3,000
With one child (not at school)	$41,000	$6,000
With one child (private school)	$59,000	$12,000
With one child (government school)	$76,000	$18,000
With two children (private school)	$86,000	$21,500
With two children (government school)	$114,500	$32,500

People with an income under their tax-free threshold would still be receiving government benefits. People earning an income above their tax-free threshold would no longer receive health or schooling benefits. They would be effectively independent of the welfare state.

The benefits of this system relate to unwinding the costs of churn, as outlined earlier in this paper:

- Administration and compliance costs would be reduced as each government agency had fewer clients and each person had to deal only with one agency;
- Fewer economic distortions and improved incentives;
- Lower social costs from welfare—allowing people to have higher self-esteem, giving people back a sense of responsibility which leads to better decision making, and building social capital;
- Lower political costs as greater self-reliance leads to less rent-seeking, fewer opportunities for corruption or cheating, less need to invade privacy, and less alienation from the political process;
- Greater transparency as each taxpayer and welfare recipient can more clearly understand government policy and their position in the tax-transfer system;
- A sustainable system that will be able to avoid the coming fiscal problems associated with universal health care and an ageing population. Instead of growing welfare resulting in $60 billion more tax each year, an increasingly prosperous society will have less need for welfare; and
- Greater choice and competition, especially in health, will lead to less waste, more diversity, better service, more innovation, and a better use of all available information in producing more effective and efficient services.

The most obvious impediment to this reform is that it would take away the chance for government to take credit for pointlessly churning money around the economy. The transparency of the system would consequently be a cost to politicians and people who prefer complexity. However, an inconvenience to politicians is a small price to pay for a better tax-welfare system.

These reforms would also require some adjustment to Commonwealth-state financial relations. While the total impact on government would be neutral, the income tax cuts would reduce Commonwealth government revenue, while the welfare reductions would be split between the Commonwealth and state governments. It would be possible for the governments to arrange new financial arrangements to reflect the changed responsibilities.

Conclusion

There are many areas of government policy that involve difficult trade-offs between competing goals. Political debates rage about whether we should sacrifice some freedom for security or whether we should trade some efficiency for greater equality. It is unlikely that any of these disagreements will be resolved soon.

An inconvenience to politicians is a small price to pay for a better tax-welfare system.

In contrast, addressing tax-welfare churn does not involve any such difficult trade-off. Removing tax-welfare churn can be done, it will have benefits, and there are no real costs.

The Australian welfare state (including cash handouts, government health, and government schools) costs us about $250 billion per year. Approximately half of this is redistribution from rich to poor. But the other half is pointless churn between people on the same incomes. Not all of this churn can be addressed, but the $80 billion associated with income tax can be fixed.

The solution is to means-test government benefits and compensate people with offsetting income tax cuts. This approach means that anybody who needs government help will still get it. However, people on higher incomes will exchange their government subsidy for a tax cut that would allow them to personally pay for health and schooling.

It is true that this reform would not resolve many outstanding problems in the tax-welfare system, such as high effective marginal tax rates or the crowding out of civil society. However, there are important benefits that would flow from this reform, with lower administrative and compliance costs, greater economic efficiency, fewer social costs from welfare, fewer political costs from big government, greater transparency, a sustainable welfare system, and a more efficient and effective health and schooling system.

It is rare that a reform proposal can offer $80 billion worth of tax cuts while promising not to make anybody worse off, but that is exactly what this proposal does. It is an idea that can be supported by people from across the political spectrum. Tax-welfare churn can and should be addressed now.

Endnotes

1 The term 'middle-class welfare' is commonly used to refer to welfare that goes to people who aren't in poverty, which includes both the middle- and high-income earners.
2 John Humphreys, 'Revealing Australia's real income tax rates,' Winter *Policy* 25:2 (2009), 32–34.
3 Peter Saunders, *The Government Giveth and the Government Taketh Away* (Sydney: CIS, 2007).
4 ABS, *2003/04 Government Benefits, Taxes and Household Income Australia* (Canberra: ABS, 13 June 2007).
5 For example, people may be treated differently because they have a disability or because they are on the old-age pension.
6 In 2007–08, the Commonwealth government spent $18.6 billion on education, $44.5 billion on health, and $97.2 billion on social security and welfare. In the same year, the state and local governments spent $39.6 billion on education, $41.5 billion on health, and $12.3 billion on social security and welfare. That comes to a total of $253.7 billion. This excludes $17.5 billion spent on housing by Commonwealth, state and local governments. Data available at ABS.
7 If churn is 50%, then it amounts to 11.3% of GDP. If churn is 56%, then it amounts to 12.6% of GDP.
8 Peter Saunders, *The Government Giveth and the Government Taketh Away*, as above, Appendix II, 125–127.
9 Taken from the ABS, Commonwealth Budget, and author's own calculations.
10 Note that this measures the percentage of income tax that goes back to the same people in welfare. This is a different statistic to the churn estimate, which estimates how much of the welfare originally came from tax from the same people.
11 It is worth noting that a person with an income of about $20,000 per year can face an effective marginal tax rate of 85%, meaning if they earn an extra $100 they must give $85 to the government. This is because they face an income tax of 15%, Medicare Levy of 10%, and their Newstart Allowance is withdrawn at 60%.
12 Until recently, there were some notable exceptions to the means-testing of cash payments. However, in the 2008–09 and 2009–10 Commonwealth budgets, there were new means-tests placed on the Baby Bonus and the Family Tax Benefit.
13 Peter Whiteford, 'The welfare expenditure debate: "economic myths of the left and right" revisited,' *Economic and Labour Relations Review* 17:1 (2006). See also Peter Whiteford, *Transfer Issues and Directions for Reform: Australian Transfer Policy in Comparative Perspective* (2009).
14 Hielke Buddelmeyer, Nicolas Herault, and Guyonne Kalb*, 'Churn' within the Australian tax and transfer systems of 2003/04 to 2008/09: an analysis using the Melbourne Institute Tax and Transfer Simulator (MITTS)* (University of Melbourne: Melbourne Institute of Applied Economic and Social Research, September 2008). Buddelmeyer, Herault and Kalb looked at how much various income deciles paid in income tax and the Medicare Levy, and how much they received in family payments, pensions and allowances.
15 For the same decile, the median annual tax was $3,297 while the median annual cash benefit was $5,639.
16 As with the estimates of total churn, this measure is imperfect. Some of the 'churn' will actually be redistribution between different people with the same income but different life situations. Some of the 'redistribution' will occur within a family unit and so is effectively churn.
17 As shown in Table B, total churn from income tax is 55% of income tax. If 13% of that is given back as cash, then that leaves 42% for services churn.
18 As discussed above, about 50–56% of benefits come from tax paid by the same people. Of this, approximately 30 percentage points come from income tax while the remaining churn comes from other taxes.
19 For more information about lifetime churn and how it may be addressed, see Peter Saunders, *The Government Giveth and the Government Taketh Away*, as above.
20 Quoted in Peter Saunders, *The Government Giveth and the Government Taketh Away*, as above, 39.
21 Alex Robson, 'How High Taxation Makes Us Poorer,' in Peter Saunders (ed.), *Taxploitation* (Sydney: CIS, 2006), 21–38.
22 Peter Saunders, *The Government Giveth and the Government Taketh Away*, as above, 42.
23 Data taken from Portfolio Budget Statements for the Australian Taxation Office ($3.2 billion); Department of Health and Ageing ($0.7 billion); Department of Education, Employment and Workplace Relations ($0.9 billion); and Department of Families, Housing, Community Services and Indigenous Affairs ($0.6 billion).

24 For a discussion of economic efficiency cost of taxation, see Alex Robson, 'Why Churning is Bad for You,' in Peter Saunders (ed.), *Taxploitation*, as above.
25 In economics, people spend 'too much' on something if they could have received greater benefit by spending their money in a different way. For example, if a person wants to spend $100 on health and $200 on education but are forced to spend $150 on each, then in economics they would be said to have spent '$50 too much' on health and '$50 too little' on education.
26 This is 2% of the total health and education spending of $145 billion.
27 Peter Saunders, *The Government Giveth and the Government Taketh Away*, as above, 40. Note that there are two British sociologists called Peter Saunders. The author quoted here is the Saunders who worked at the CIS.
28 In 1943 Abraham Maslow proposed a 'hierarchy of needs' in order of importance. The five needs were (1) physiological; (2) safety and security; (3) love and belonging; (4) self-esteem; and (5) self-actualisation.
29 Ben O'Neill, 'Liberty, time preference and decadence,' Autumn *Policy* 25:1 (2009), 45–48.
30 Before the 1911 Pension laws were introduced in the United Kingdom, over half of the population benefited from Friendly Societies, and three-fourths of the population were covered through private welfare programs. For more information, see David Green, *Reinventing Civil Society: the Rediscovery of Welfare without Politics* (London: IEA Health and Welfare Unit, 1993).
31 Frank Furedi, *Politics of Fear: Beyond Left and Right* (Continuum International Publishing Group, 2005), 111.
32 Frank Furedi, as above, 73.
33 For a tax-cutting perspective, see Adam Lerrick, *Obama and the Tax Tipping Point* (American Enterprise Institute for Public Policy Research, November 2008). For the welfare argument, see Luke Buckmaster, *Money for Nothing? Australia in the Global Middle Class Welfare Debate* (Parliamentary Library, 2009).
34 Andrew Leigh, *Why Tax Reformers Should Learn About Ignorance*, *Online Opinion* (28 April 2009). Note that Leigh is not necessarily arguing in favour of this approach. He is simply pointing out that the complexity may hide the true costs of the policy.
35 Peter Saunders, *The Government Giveth and the Government Taketh Away*, as above, 15.
36 Commonwealth Treasury*, International Report 2007* (Canberra: Commonwealth Treasury, 2007).
37 Jeremy Sammut, *The Coming Crisis of Medicare*, Policy Monograph No. 79 (Sydney: CIS 2007).
38 Auditor-General's report, *Performance Audit: Delivering Health Care Out of Hospitals* (Sydney: NSW Department of Health, 2008), 2.
39 Commonwealth Treasury*, International Report 2007,* as above.
40 Peter Saunders, *The Government Giveth and the Government Taketh Away*, as above, 98.
41 John Humphreys, 'Declaring Independence,' in *Declaring Dependence, Declaring Independence: Three Essays on the future of the Welfare State*, Occasional Paper 111 (Sydney: CIS, 2008). This approach is a variant on the reforms suggested by New Zealand politician Sir Roger Douglas. Details of the Douglas approach are available in Peter Saunders, *The Government Giveth and the Government Taketh Away*, as above, 82–86.
42 Luke Buckmaster, as above.
43 Peter Saunders, *The Government Giveth and the Government Taketh Away*, as above, 44.
44 Of this, $61.1 billion was spent on hospitals, pharmaceuticals, Medicare benefits, and associated health services. The remaining $3.5 billion was a subsidy for private health insurance (figures don't add due to rounding).
45 The most obvious method of avoiding unfair risk assessments is to not allow private health companies to discriminate on the basis of people's risk-rating. Another option is to allow companies to discriminate on the basis of risk-rating when somebody changes insurers but require the old insurer to pay the risk premium to the new insurer. This will not disadvantage the old insurers as they have also reduced their exposure to a high risk customer.
46 Note that this is the average cost. There is a large variance in government subsidies for different private schools. Adjusting for this would add a level of complexity to the arrangements but would not change the nature of the scheme.
47 With the higher fees, it would be necessary for schools to allow parents to pay over the course of the year so that the cost of schooling could be matched to the tax savings that the parents would receive over the course of the year.
48 Numbers have been rounded to the nearest $500.

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