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Part I in a three part series 'Restoring Self-Reliance in Welfare'

The $85 Billion Tax/Welfare Churn

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EXECUTIVE SUMMARY

This is the first of three papers analysing whether and how the welfare state might be transformed to give ordinary people more control over key areas of their lives which are currently managed for them by government. It demonstrates that, to a large extent, we no longer need the welfare state, for most people could afford to buy most of the services they need if only they were not taxed so highly to pay for the services the government wants them to have.

- One hundred years ago, when average real wages were much lower than today, many people needed help with the costs of health care, old age and income insurance, although a majority of the population still managed to provide for its own needs with relatively little reliance on government.
- In the last 40 years, real incomes have doubled, reducing the need for government assistance. Yet it is in this period that welfare state spending has escalated. The expansion of the welfare state has therefore occurred at precisely the time when the need for government support has been falling away. The welfare state is like a machine that was set running 100 years ago to meet a requirement that is no longer there.
- Government now spends $80 billion every year on welfare payments, and another $94 billion on services such as health and education. This spending absorbs two-thirds of all the federal and state taxes raised each year.
- Although they do not always realize it, many people who use welfare state benefits and services finance most or all of what they receive through the taxes they pay ('simultaneous churning'). These people could by-pass the welfare state altogether if they were allowed to retain their money and buy the services they want out of their own pockets.
- Simultaneous churning is less marked at the extremes of the income distribution, for households in the bottom third of the income distribution rely quite heavily on welfare state transfers. This is why people think scrapping the welfare state would lead to widespread destitution.
- However, the people comprising the poorest third of households change all the time. Poor net recipients of welfare at one time become affluent net tax donors at another, so over a whole lifetime, they too may end up financing many of their own benefits ('lifetime churning').
- At least half of all welfare state spending goes on churning. That is, it is money paid by individuals at one time and reclaimed by the same individuals at the same time or at a later date. The welfare system is like a giant piggy bank.
- If the money that is churned could all be left in taxpayers' pockets, at least $85 billion would be released for tax cuts. This would allow personal income tax to be cut to a flat rate of 10% with the first $20,000 of earnings not taxed at all, which would enable many people to self-fund their health and welfare needs.
- The other half of the current welfare state budget could still then be used to supplement the purchasing power of those who cannot afford to buy the services they need without some additional help.
- It may not be possible to eliminate churning altogether, but a move towards self-funding would involve a combination of personal savings accounts, insurance and loans to spread personal incomes over the life course. The end result would be that ordinary people would re-establish control over how their own money is spent.

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Introduction[1]

The Australian welfare state has outlived its usefulness. While it may once have been necessary for the government to provide the mass of the population with schooling, health care, age pensions, and other necessities of life, it is not now.

We live in an age when most people could afford to buy most or all of the services they need if only they were not taxed so highly to pay for the services the government wants them to have. The welfare state has become a costly anachronism which compels us to pay for inadequate or inferior services which we could purchase at a higher quality or lower price if we were left to spend our own money ourselves.[2]

If it had not been bequeathed to us, we would not invent the welfare state today. Rather, we would keep personal taxes low so that people could afford to make provision for their own needs. We would encourage people to save for retirement in their own superannuation funds; to insure themselves against ill-health, unemployment and other risks; to borrow against their future earnings to finance the purchase of housing or higher education. We would not see the point in paying a government middle man to provide these things for us when we were perfectly competent to take responsibility for them ourselves.

The reality, however, is that we are saddled with a very expensive welfare state, and this means that all of us have grown accustomed to paying taxes in return for government services and benefits, rather than using our own money to make provision for ourselves and our families. When thinking about welfare reform we are not starting from scratch, and we do not therefore have the luxury of drawing up ideal blueprints about how services like retirement pensions, health care and education might best be organised. We have to think about the future development of social welfare from the point we have already reached, and this means that any argument for a radical departure from current practice has to convincingly answer three core questions:

(1) Is there a practical and feasible alternative to the existing system? If so,
(2) Would the proposed new system be better than the one we have now? If so,
(3) How would the new system work, and how can we move from the existing system to the new one?

If it had not been bequeathed to us, we would not invent the welfare state today.

In this series of papers, I address each of these questions in turn. In this, the first of the series, I focus on the question of whether it is possible to replace the existing welfare state in Australia while ensuring that people still meet their needs. In the second paper, I shall ask whether it is worth making such a change, and in the third I shall sketch out an alternative system and consider how we could make the transition.

How did we cope before the government took care of us?

For most of Australia's history, working-age people have expected to look after themselves and to care for their families from their own resources. Those who for one reason or another could not cope or who needed extra help in times of trouble relied on aid from their families, churches, charities, or from prosperous philanthropists who wanted to 'put something back' into their communities by building a hospital or founding a school. The general assumption that able-bodied men of working age could and would look after themselves and their families without seeking support from others underpinned the establishment of the wage fixing system in the early years of the 20th century when it was determined that a working man should receive a wage sufficient to pay for the needs of a wife and three children without relying on outside help and support. The community norm was family self-reliance, and people were proud of their independence.

Self-reliance was expressed in a number of ways. For many it was rooted in home ownership. For the middle classes, it also meant saving to pay school fees and to provide an income in old age, but less prosperous working families generally found private schools, medicine and pensions beyond their means in the 19th century. The churches and charities offered the poorest some help, and medical professionals would sometimes offer their services to the poor for free,[3] but workers in better-paid or more secure occupations increasingly achieved self-reliance by pooling their purchasing power through friendly societies and other mutual organisations which could offer benefits or insurance in return for membership.

The friendly societies typically offered members and their families medical benefits (general practitioner services and hospital cover), together with sick pay and death benefits, in return for regular payments of a few pennies a week. By the start of World War I—the high-point of the Australian friendly societies—almost half of all Australians were covered by such benefits.[4] But membership of such mutual aid organisations required a regular income, and a substantial chunk of the population was still left without secure cover. At periods of high unemployment, such as the 1890s, this resulted in significant levels of hardship in the population.

Government was not entirely absent from everyday life in the 19th and early 20th centuries. Public elementary schooling was provided in all states with compulsory attendance up to the age of 13, although attendance was not always enforced, and compulsion did not apply to Indigenous children.[5] 'Relief work' modelled on the English Poor Law was also available in all states for those who qualified for it.[6] But for the most part, families expected to look after their own needs and requirements. In a period when the society was much less affluent than it is today, and when average real wages were much lower, a majority of the population was nevertheless left to provide for its own needs with little resort to government.

The irony of the history of the welfare state in Australia is that it has expanded in inverse proportion to the need for it.

The great 20th century perpetual motion welfare machine

Despite the activities of the friendly societies, the standard of living a century ago was simply not high enough to enable many of those on low incomes or in intermittent employment to save and insure adequately. To the extent that people needed help in funding their old age, insuring against unemployment or paying medical bills, the coming of the welfare state therefore met a real need.

There was, for example, a pressing need to help the destitute elderly. Relatively few working people lived long past retirement age, but those who did (and who had few savings or assets) often had little option but to live out their lives in hospitals, for there was no other provision made for them. Following federation, the new Commonwealth Government introduced means-tested age and invalid pensions for those of good character, and this established a pattern of means-tested, non-contributory cash benefits which was extended to other sections of the population several decades later.

In the 1940s, Commonwealth widows' pensions, unemployment benefits and the Child Endowment were introduced,[7] and in the 1950s the Commonwealth began to make a contribution to people's medical fees. Even at this stage, however, reliance on government welfare provisions was still limited. As late as the mid-1960s, only 3% of working-age adults relied mainly or wholly on welfare benefits for their income, and before Medicare was introduced in 1982, nearly three-quarters of families had private health insurance cover.[8]

It was from the 1970s onwards that dependence on government welfare services and cash payments started to rise significantly, and that the mass, bureaucratic and increasingly costly welfare state that we know today started to consume tax revenues at an increasing rate. Expansion of the income support system since the 1970s has led to 16% of working-age adults now relying on welfare benefits for most or all of their income (an increase of more than 500% in less than 40 years), and with the creation of Medicare, state and federal governments now pay for almost three-quarters of all health expenditure while private health insurance coverage is down to 40% of the population.

But this expansion of the welfare state has occurred at precisely the time when the need for government to support us has been falling away. The irony of the history of the welfare state in Australia is that it has expanded in inverse proportion to the need for it.

Economic growth rates since World War II have transformed living standards, and improved economic management has reduced the threat of severe depressions and mass unemployment. In the 1970s, when the welfare state began its huge expansion, the economy was growing at an average of 2% per annum, raising national wealth by a quarter. Following the economic reforms of the Hawke/Keating years, economic growth increased to 3.5% per annum, lifting national wealth by another 40%, and in the last ten years the economy has been growing at an annual rate of 4%, increasing the national wealth by half. This sustained period of growth has meant real per capita incomes have more than doubled since the 1960s.[9] As recently as 1989-90, Australians had an average real income of $25,865. By 1999-2000, this had grown to $32,605 in constant prices, an increase in living standards of nearly 24% in just 10 years.[10] This means that goods and services that our grandparents could never have afforded are now potentially well within the budget of most ordinary people.

British Labour MP Frank Field refers to the post-war emergence of mass affluence as 'political arithmetic's third age'. Writing of Britain he notes: 'For the first time a sizeable part of the working class and lower middle class now have incomes that give them real choices'.[11] The same is true in Australia. Inherently expensive items like personal pensions, medical insurance, unemployment insurance, even schooling, are now potentially affordable to people who could never have acquired such things for themselves just two or three generations earlier.

Yet at precisely the point where the need for extensive government help and provision has been receding, the welfare state has been expanding. In a period when real incomes have doubled, dependency on government cash hand-outs has gone up five-fold and the number of people taking financial responsibility for their own health insurance needs has been halved. The welfare state is like a machine that was set running 100 years ago to meet a requirement that is no longer there. This machine been speeding up ever since, and nobody seems to know anymore what it is there for, or how to switch it off.[12]

This sustained period of growth has meant real per capita incomes have more than doubled since the 1960s.

Where the money goes

The welfare state divides into two parts.

1. Cash transfers

First, the welfare state allocates cash to people it defines as being 'in need'. In Australia, these transfer payments (called 'income support') take many forms, but the four core payments are the age pension (for retired people), unemployment benefits (Newstart for mature workers, Youth Allowance for younger workers), the Disability Support Pension (for those deemed too incapacitated to work) and Parenting Payments (providing an income for jobless and low income single parents and for parents with unemployed partners). All four of these payments are means-tested (you only get the money if you have little or no income from other sources) and are financed directly out of taxation (so unlike most other countries, recipients do not have to establish any entitlement by contributing to a social security fund).

Financial help is also directed to many working families with dependent children through Family Tax Benefit (FTB) which can be claimed as a fortnightly cash payment or credited against tax at the end of the fiscal year. Politicians like to regard FTB as a tax reduction rather than as welfare expenditure, but for 90% of recipients it comes as just another cash hand-out,[13] and it is best understood as the fifth major component of the income support system.

Taken together, the main income support payments totalled $62.6 billion in 2003-04 (36% of the total welfare state budget—see Table 1), while the total cost of social security payments amounted to $80 billion (46% of the total budget).[14]

2. Services in kind

The other 60% of welfare state spending goes on 'free' or subsidised services, of which the two biggest are health and education. Unlike means-tested income support payments, these services are provided on a universal basis (that is, they are made available to all eligible people irrespective of their financial circumstances), although charges are sometimes levied (for example, Medicare co-payments and HECS fees in higher education) and higher income earners are sometimes charged more (a Medicare levy surcharge is imposed on higher rate taxpayers, for example, if they do not have private health insurance).

Over the last 30 years or so, government spending on cash transfer payments and on services in kind has increased through bad times and good, under right-wing as well as

Table 1: Government spending on the welfare state, 2003-04 ($billion)[15]

Main Income Support Payments:	
Family Tax Benefit	13.7
Child Care Benefit	1.5
Newstart (unemployment allowance)	5.3
Youth Allowance [a]	2.3
Parenting Payment [b]	6.2
Disability Support Pension	8.0
Age Pension	20.1
Other payments	5.5
Total	62.6
Additional welfare payments and admin costs [c]	17.4
Health [d]	49.1
Education [e]	41.0
Housing [f]	4.2
Total	174.3

[a] Paid to 297,000 full-time students and 85,000 jobseekers under the age of 25

[b] Parenting Payment (Single) = $4.7bn plus Parenting Payment (Partnered) = $1.3bn

[c] The difference between 'total welfare and social security expenses' of $80bn (*Budget Paper No. 1,* Table A1) and social security payments processed by Department of Family & Community Services (now transferred to Employment and Workplace Relations) of $62.6 billion. Mainly comprises payments made by other government departments (Attorney Generals, Health and Ageing, Immigration and Multicultural Affairs and Veterans' Affairs) as well as administrative costs of relevant departments and Centrelink.

[d] 2002-03 figures, computed as 68% government share of total $72.2bn health spending

[e] 2002-03 figures. Includes $23.3bn for primary & secondary schooling and $15.1bn for tertiary

[f] Comprises $1.3bn Commonwealth State Housing Agreement funding (mainly for public housing), $1.9bn Commonwealth Rent Assistance and $1bn on the First Home Owners Grant

Table 2: Tax revenues (all levels of government) 2004-05[16]

Federal Government:	*$m*	*% of total revenue*
Personal income tax	96,900	44.5
Medicare levy	5,790	2.7
Fringe benefits/Super Guarantee	4,580	2.1
Company income tax	40,500	18.6
Tax paid by super funds	5,520	2.5
GST	35,190	16.2
Excises	21,803	10.1
Customs	5,335	2.4
Other	2,151	1.0
TOTAL FEDERAL =	217,770	100 (80.3% of all government)
States & territories:	*$m*	*% of total revenue*
Payroll taxes	11,459	26.7
Property taxes	12,558	29.3
Gambling	4,279	10.0
Motor vehicles (inc rego)	10,894	25.4
Insurance & banking	3,690	8.6
TOTAL STATE =	42,880	100 (19.7% of all government)

left-wing governments. Since the Howard government came to office in 1996, for example, the Australian economy has been booming, real wages have been rising strongly, labour force participation rates have been rising and unemployment has fallen to its lowest level in 30 years, yet the biggest single increase in federal government spending since 1996 has been on income support, up from 41 to 44% of the Commonwealth budget.[17] The welfare state now costs $174 billion per annum (Table 1), which is by far the biggest category of government expenditure.

Who pays for the welfare state?

Where does all this money come from? The answer, for the most part, is that it comes from the same people as the money is spent on.

Federal and state government together raise about $260 billion in tax every year (Table 2). Given total welfare state spending of $174 billion (Table 1), this means 67 cents in every dollar of tax paid from all sources gets spent on welfare benefits and services (and on the bureaucratic costs incurred in providing them).

Virtually all the tax revenue raised by federal and state governments comes ultimately from the pockets of individual citizens, although not all citizens are always aware of this. The source of payments is obvious in the case of personal income tax (which is taken directly out of the money we earn). It may be less obvious when we pay indirect taxes such as GST, for the tax gets rolled up into the total purchase price of the goods and services we buy, and it is handed to the government by businesses (which function as unpaid revenue collectors) rather than by individual consumers. It is even more opaque in the case of company taxes such as taxes on profits, tariffs on imports and special levies, yet here too ordinary individuals end up paying, for these taxes are covered by the price of the goods and services they buy.[18] Money thus pours into the government from many different sources, but ultimately it nearly all comes out of the pockets of individual citizens.

These same individual citizens are also the principal recipients of the government's welfare spending. We rely on the welfare state to provide us with health care, schooling or a retirement income, but we finance these payments and services through the direct and indirect taxes and charges we pay. What we receive with one hand, we pay for with the other.

Money thus pours into the government from many different sources, but ultimately it nearly all comes out of the pockets of individual citizens.

Just as 100 years ago ordinary people financed most of their own welfare services, so they are still financing them today. The crucial difference is that 100 years ago people were in control of their own money, directly purchasing the services they needed. This made for a high level of accountability on the part of service providers, for consumers could withdraw their payments if they found the service unsatisfactory. Doctors employed by friendly societies, for example, were held to account by the individual members at Lodge meetings and could find their contracts terminated if they did not come up to scratch.

Today, by contrast, spending decisions in crucial areas of our lives are made for us by politicians, bureaucrats and professional 'experts' who forcibly take our money from us in taxes, deduct a large slice to cover their own overheads, and then return the rest in the form of the payments and services that they think we should have. This obliges us to accept what we are offered rather than shopping around to find what we really want. It also makes service providers much less accountable to our preferences.

Every few years, we are entitled (indeed, obliged by law) to vote for the people who will make these decisions on our behalf, but as individuals we have no say over how much of our money they spend or what they spend it on. We cannot decide to put more of our money into one kind of service by spending less on another, for these budgetary decisions are all determined for us by politicians, bureaucrats, and pressure groups in Canberra. If as individuals we find a particular service unsatisfactory, we cannot withdraw our patronage–all we can do is contact our elected representative and hope they can do something on our behalf. If we decide we want something different from what the state is offering, we are still required to pay for the service we do not want while paying again to get the private sector alternative we prefer.

Because we have become habituated to large government bureaucracies spending our money in this manner, we tend to assume things have to be organised this way.[19] We have forgotten that our forebears used to decide these things for themselves (even though they had much less spending power at their command than we have). We have lost the habit of making our own choices.

What about the poor?

Because we take the existence of the welfare state for granted, we tend to assume that if it disappeared, we would not be able to afford to buy the services that the government now provides for us. But we forget that we are already paying for these services through our taxes. Without the welfare state we would have more money left in our own pockets to purchase the things we need without having to look to the government to support us.[20]

Virtually everybody pays something towards the billowing costs of the modern welfare state, just as virtually everybody gets something back from it. However, some people pay more than others, and some people take more out. If this massive bureaucratic delivery system were shut down, and the money were left in our own pockets so we could decide for ourselves how to spend it, those who pay least but claim most would presumably lose out. The question, therefore, is whether we still need a welfare state to provide for those who are less fortunate.

One-third of parents choose to educate their children privately . . . and they lose a lot more than they gain by forfeiting their places at schools in the state sector for which they have already paid.

Currently, some people pay a lot more tax than others. Sinclair Davidson calculates that the top quarter of income earners at any one time pay nearly two-thirds of all the income tax collected by the Commonwealth government, although the burden of indirect taxation is spread less unevenly.[21] Not all of this tax goes on welfare, of course—some also helps pay for defence, police, transport and other state and federal government services[22]—so when calculating how much tax people pay for their welfare services, these other items have to be taken out of the equation. This adjustment has been made in all the calculations that follow.

Some people take more out of the welfare system than others. One-third of parents choose to educate their children privately, for example, and although they benefit from government subsidies of private school fees, they lose a lot more than they gain by forfeiting their places at schools in the state sector for which they have already paid. Similarly, the 40% of families that pay for private health insurance enjoy a tax rebate on their premiums, but they end up paying a lot more for the public hospital beds they never use. More broadly, many workers pay through their taxes for government unemployment and disability insurance that they never draw upon, and working couples raising children are taxed to support non-working single parents while supporting themselves from the post-tax income that remains.

The net result of all this differential tax payment and welfare withdrawal is that incomes get significantly redistributed within the population. At any one time, the top 20% of income earners pays 60% of all the income tax (as well as 31% of all the indirect tax) that is spent on the welfare state while withdrawing only 16% of the value of the services their taxes help provide. The bottom 20% of income earners, by contrast, pays virtually no income tax into the welfare budget, and contributes only 9% of the money coming from indirect taxes, but they receive 21% of all the welfare spending.

After tax has been paid and the value of welfare benefits and services has been added, the share of 'final income' enjoyed by high-earners falls from 50% to 38%, while that of low earners increases from 1% to 7% (Table 3). In 1998 dollar terms, the lowest earning households have their incomes increased from zero to $391 per week as a result of tax and welfare transfers while the highest earners drop from $1,305 to $798.[23]

It is clear from Table 3 that the value of welfare state services is spread remarkably evenly across income groups. Indeed, the highest earners receive slightly more than their share of the value of these services (21%) while the lowest earners get somewhat less (16%).[24] Receipt of cash benefits is rather more skewed, for Australia's heavily means-tested payments system excludes higher earners from eligibility for many income support payments, yet even here the share absorbed by the lowest income group is only eight percentage points above its proportionate share, and much of the money goes to households around the middle of the income distribution. Families with children, for example, receive FTB payments even when their household incomes are well above the

Table 3: Distribution of household income, taxes, and benefits by gross income quintile (1998-99)[25]

	Percentage share for each gross income quintile:				
	Lowest quintile	*2nd quintile*	*3rd quintile*	*4th quintile*	*Highest quintile*
Private income	1.0	5.5	15.9	27.3	50.3
Direct taxes	0.2	2.5	12.0	25.4	60.0
Indirect taxes	9.3	14.1	18.6	25.0	32.9
Total taxes	3.1	6.2	14.1	25.3	51.4
Welfare payments	28.3	38.6	18.3	9.3	5.4
Welfare state services	16.4	22.3	20.1	19.9	21.3
Total welfare	20.6	28.0	19.5	16.2	15.7
Final income	7.4	13.5	17.7	23.9	37.5

Many households find themselves paying money into the system only to get it straight back again in the form of government payments and services.

average income, and most retired people receive an age pension, even if they are living in expensive houses and receiving retirement annuities.[26]

Thus, although the money raised to fund the welfare state comes disproportionately from those with higher incomes, it is distributed fairly evenly across the population (after deductions to cover the costs of the bureaucracy). Most of the income redistribution that takes place occurs, not as a result of how the money is spent, but as a result of the way it is raised.[27]

Because welfare benefits and services are spread right across the population, many households find themselves paying money into the system only to get it straight back again in the form of government payments and services. Table 4 shows that, in 1998-99, households in the middle income bracket (with an average private weekly income of just over $600) on average lost $179 in taxes but then received $293 worth of government benefits and welfare services in return. Those in the fourth quintile, with an average weekly gross income of just over $1,000, paid almost one-third of their earnings in taxes ($324) but got most of it back again in the form of welfare ($244).

Table 4: Average weekly value (1999 dollars) of tax paid and benefits received by gross income quintiles[28]

	Percentage share for each gross income quintile:				
	Lowest quintile	*2nd quintile*	*3rd quintile*	*4th quintile*	*Highest quintile*
Total benefits	286	416	293	244	221
Total taxes	40	76	179	324	661
Net benefit/cost	+246	+340	+114	-80	-440

On its own, Table 4 does not prove that it is the same people in each income group who are paying the tax and receiving the benefits. But recent research by the National Centre for Social and Economic Modelling (NATSEM) shows that it often is the same people, and that this is particularly likely to be the case for families with dependent children. Looking at tax and welfare transfers in 2001-02, NATSEM found that younger people without children generally paid more in tax than they received back in welfare, and older people generally received more in welfare than they paid in tax, but for people in their middle years who were earning and raising a family, the activities of the tax and welfare agencies tended to cancel each other out (Table 5).

Couples with pre-school children, for example, paid a weekly average of $374 in income tax and GST but immediately got $292 of this back in cash or services. For all the huffing and puffing of the giant government bureaucracies which were required to process these money flows, the net result was an average adjustment to these families' total incomes of just minus 7% (an average private income of $1,095 was reduced to a final income of $1,014). Similarly, couples with school-age children got a net top-up of just 10%, and those whose oldest child was beyond the school-leaving age had their incomes boosted by a mere 6%.

Table 5: Incidence of tax payments and welfare receipts for different types of households, 2001-02[29]

	Single person <35	*Couple <35 no kids*	*Couple kids <5yrs*	*Couple kids 5-14*	*Couple kids 15-24*	*Couple 55-64 no kids*	*Couple >65 no kids*	*Single person >65*
Private income	630.8	1390.6	1095.4	1160.0	1395.6	684.5	287.6	150.7
Total Benefits ($/wk)	101.7	107.2	292.3	507.8	564.1	264.5	548.8	351.3
Total taxes ($/wk)	208.5	426.9	373.8	393.5	474.4	223.4	102.3	56.1
Net cost/ benefit	-106.7	-319.7	-81.6	+114.3	+89.7	+41.1	+446.5	+295.1
Final income	524.1	1070.9	1013.9	1274.3	1485.3	725.6	734.1	445.9

Anthony de Jasay refers to this process of taking money in tax only to give it back to the same people immediately in benefits and services as 'simultaneous churning'.[30] He suggests this churning comes about largely as a result of politicians trying to buy the support of different sections of the electorate. Different groups get wooed with different offers, but each new promise is paid for out of general tax revenues. The aggregate result is that we all end up paying for each other's hand-outs.[31]

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Obviously, at the extremes of the income distribution, simultaneous churning is less marked than in the middle. The NATSEM study shows that, although most couples with children pay in tax for most or all of what they receive in welfare benefits and services, those who find themselves in the bottom fifth of the income distribution rely heavily on government income transfers, for they have very little private income to start with (these are generally non-employed, welfare-dependent families).[32] This is consistent with the data in Table 4 (which includes all household types) which show that people in the bottom quintile of incomes pay only $40 into the welfare system but receive $286 back, while at the other end of the distribution, the highest earning households on around $2,000 per week lose a lot more than they gain ($661 against $221).

The fact that people with low or no private income still rely heavily on net tax/welfare transfers brings us back to the question of how the poor would fare if the welfare state were wound up altogether. While many Australian households effectively pay for their own welfare already, and should therefore be able to make the transition to a post-welfare state society with little difficulty, it does seem from the evidence on simultaneous churning that the poorest one-quarter to one-third of the population still depends heavily on the welfare state to boost its living standards and keep it out of financial hardship and deprivation.

Lifetime churning—the welfare state as a national piggy bank

This conclusion is, however, too simple, for it rests on an analysis of tax-welfare spending at just one point in time ('simultaneous churning'). It ignores the fact that people's financial circumstances change over the course of their lifetimes, and that the people with least money at one time are not necessarily the same as those who have least money at another. This means that the poorest 30% or so of the population may not need the welfare state to prop them up after all, for it is possible that they are 'poor' for only a relatively short time and that they earn enough at other periods of their lives to make up any shortfall. To gauge how many of us really rely on the welfare state to keep our heads above water, we have to look at total lifetime incomes, not just at one point in time.

The individuals who make up each of the income quintiles identified in Tables 3 and 4 turn over quite rapidly, which means that net welfare recipients this year may turn out to be net tax payers next year. This in turn means that some of the income redistribution which appears to be taking place from higher to lower earners at any one time is really redistribution between high-earning and low-earning stages of people's own lives over time. We pay more money in at more prosperous periods of our lives, only to draw the money out again in poorer periods, which means we are borrowing and lending money to ourselves as much as transferring it to other people.

The NATSEM research summarised in Table 5 hints at precisely this, for the Table shows that, when private incomes are high (early in life, before we have children), receipts from tax/welfare churning tend to be negative, and when private incomes fall (particularly after retirement), receipts from tax/welfare churning tend to be positive. Given that many households in the middle years tend to come out roughly neutral, we can see from this Table that much of what the welfare state is doing is transferring money across the lifecycle from when we are young and prosperous to when we are old and poorer.

This 'income smoothing' over the course of a lifetime is necessary and important, but why does the government have to do it for us? Why couldn't we be left to save, invest and insure for ourselves? Income fluctuations over the life-course indicate that many of the people who depend on welfare state benefits at one time in their lives could nevertheless have resourced these transfers themselves out of earnings accruing at more prosperous periods. Ann Harding estimates that only one-quarter of the individuals in the bottom decile of incomes in any one year are also in the bottom decile of lifetime income. One in twenty are in the top lifetime decile.[33]

This 'income smoothing' over the course of a lifetime is necessary and important, but why does the government have to do it for us? Why couldn't we be left to save, invest and insure for ourselves?

Individuals' financial circumstances not only change as they move through the life-course—they can also change quite dramatically over relatively short time periods. As they move from training into employment, between work and unemployment, from married to divorced, or from parenting to empty-nesting, people's incomes can vary dramatically. Undergoing transitions like these, the same person can find him- or herself at one end of the income distribution this year, and at the other end the next.

Tracking a sample of workers earning less than $10 per hour in September 1994, Yvonne Dunlop found that only a quarter remained low-paid over the next three years. She concluded: 'For a significant number, low-paid employment appears to be temporary with many able to move to higher paid work quickly'. She also found that, having made it to a better job, these workers had a 'high chance of staying out of low pay', particularly if they were young.[34]

The same pattern recurs with people reliant on welfare benefits, many of whom are in transition to self-reliance. Half the people who go onto unemployment benefits, for example, find another job within eight weeks.[35] In any single year, only a quarter of men will receive any cash welfare payment, but in the course of their whole lifetime, 93% of men receive some payment.[36] Depending on when an income survey is conducted, the same individual could appear as a major recipient or as a substantial net donor into the welfare system.

We also know that poverty is largely transitional. Defining 'poverty' as a household disposable income below 50% of the median income, the HILDA household panel survey found 13.6% of Australians were 'poor' in 2001, but only a quarter of these people (3.8% of the total sample) were still 'poor' when they were re-interviewed in 2002 and 2003.[37]

How much churning?

Once we take account of the way people's incomes fluctuate at different points in their lives, it becomes clear that, in addition to all the simultaneous churning that is going on in the tax-welfare system, there is also a strong element of 'lifetime churning'. In the UK it has been estimated that between two-thirds and three-quarters of total welfare state expenditure is devoted to intra-personal 'income smoothing' (that is, taking money away from people during affluent periods of their lives in order to return it to the same people in poorer periods), with as little as a quarter going on transfers between different recipients: '*Most* benefits are self-financed over people's lifetimes, rather than being paid for by others. Of the $133,000 average gross lifetime benefits from the system, an average of $98,000 is self-financed. Nearly three-quarters of what the welfare state does looked at in this way is like a "savings bank"; only a quarter is "Robin Hood" redistribution between different people'.[38]

Because Australia has more tightly means-tested income support payments than Britain, we would expect the total amount of churning here to be less, and comparative analysis of the two countries appears to bear this out.[39] Nevertheless, lifetime churning (or 'income smoothing') within the welfare system as a whole is extensive here too, which suggests that many ordinary Australian households could in principle fund their own lifetime benefits and services (for example, by saving for their retirement in personal accounts or by insuring against sickness and unemployment) rather than relying on the government to provide these things out of the taxes they pay.

Even those who earn the lowest total incomes over a lifetime still end up paying for a substantial proportion of the welfare benefits and services they consume.

Even those who earn the lowest total incomes over a lifetime still end up paying for a substantial proportion of the welfare benefits and services they consume. Looking only at income support payments (which are used mainly by people on low incomes), and at direct taxes (which are paid mainly by people on high incomes), Ann Harding, who has been responsible for much of the analysis of lifetime churning in Australia, finds that the poorest decile of lifetime income earners lose 12% of their incomes in 'adjusted tax' (that is, the portion of income tax spent on financing government cash transfers) while receiving 21% of their incomes as welfare payments.[40] In other words, those who earn least in the course of their lives still pay in income tax for more than half of the income support payments they receive (and if they are male, they pay for all of them).[41]

When indirect taxes are included in this analysis, the share of total adjusted tax payments made by lower income groups in the course of their lifetimes works out even higher, for the burden of indirect taxation is more evenly spread down the income distribution. The degree of lifetime churning therefore increases accordingly.[42]

And when the analysis is expanded still further to include services in-kind as well as income support payments, the total amount of lifetime churning at the bottom end rises even more. Over their whole lifetime, for example, the poorest 10% of Australians receive $86,000 (in 1986 prices) worth of health care, but they also contribute $30,000 of this in the direct and indirect taxes they pay. The richest 10%, by contrast, pay $121,000 into the state health system to get $37,000 worth of services back (they get less back mainly because they tend to rely on private health care providers rather than on government-funded ones). Although there is clearly some inter-personal redistribution going on here, each individual on average funds 73% of his/her lifetime consumption of government health services through the taxes he or she pays.[43]

Education spending too involves substantial lifetime churning, with the biggest lifetime earners taking out $6,000 more (1986 prices) in education services than those at the bottom do. This disparity arises mainly because higher lifetime earners consume more education earlier in their lives—state funding of higher education is notoriously regressive in its distributional effects. This regressiveness would, of course, be even greater were it not for many wealthier individuals receiving much of their education outside the state sector.[44]

Ann Harding concludes: 'Over the lifetime there is significant 'churning' as taxes paid to government at some point in the lifecycle are returned to the same individuals at some other point'.[45] She does not calculate the overall proportion of total welfare state spending that goes in inter-personal transfers as against the proportion that goes on lifetime churning, but it is clear that churning represents at least half of it (much more in the case of services like health, where about three-quarters appears to be self-funded).

It is important to note that Harding's calculations of lifetime churning are based on the 1986 tax and welfare system, and much has changed in the last 20 years. What has not changed, however, is that the welfare state continues to operate as much as a system of compulsory lifetime borrowing and saving (the 'piggy bank' function) as it does as a system for redistributing incomes between different individuals (the 'Robin Hood' function). Many of us end up paying for most or all of our own benefits—if not at the time we use them, then at other points in our lives when we are more prosperous.

Implications

If the current welfare state were scrapped in its entirety, total taxation at federal and state levels could be reduced by two-thirds—a massive cut from $260 billion to under $100 billion in the annual tax take. This would allow *all* tax on personal and corporate incomes (including taxes on superannuation and the Medicare levy) to be abolished.

Given tax cuts of this magnitude, many Australians would be able to purchase the same or better quality services as they currently get from the state without experiencing a significant fall in their net incomes or living standards. Rather than have the government transfer their money from the richer to the poorer periods of their lives, they could organise this for themselves by borrowing or saving to pay school fees, insuring against ill health and saving for old age through personal superannuation, and they could pay for all this using their tax savings. This would allow them to enjoy the same (or better) security than the welfare state currently offers while also making their own spending decisions, as earlier generations did.

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Not everybody, however, could afford to self-provision, for not all current welfare state expenditure is churned between the same individuals. Some of it is transferred to people who would not be able to afford all the services they need, even if they spread the cost over their entire lives through saving, borrowing and insurance. As the NATSEM research team reminds us, 'It is important in this debate not to lose sight of the redistribution by the welfare state from richer to poorer Australians, as well as from younger to older Australians.'[46]

It follows that the government's role in ensuring people's welfare needs are met cannot be abolished in its entirety. Some provision still has to be made for people whose lifetime incomes are insufficient to enable them to self-provide and who would therefore suffer if current arrangements were wound up and nothing was put in their place. Most obviously, people who cannot earn an income in the course of their lives due to some permanent mental or physical incapacity still require support from the wider community. In addition, households whose lifetime earning capacity is limited (whether as a result of low pay or of interrupted career earnings) may also need the state to 'top-up' their spending power before they can join everybody else in self-providing.[47]

Nevertheless, we have seen that at least half of all the welfare spending consumed by Australians is self-financed by them in the course of a lifetime (that is, at least half of all welfare expenditure consists of churning). Although it is probably an under-estimate, let us therefore cautiously assume a 50:50 split in the current budget between intra-personal churning and inter-personal transfers.

If the 50% of total welfare expenditure that currently goes on churning could all be stripped out of the welfare budget and left in taxpayers' pockets, total welfare state expenditure would be reduced from $174 billion to around $85 billion, releasing the other $85 billion or so for tax cuts.[48] A reduction in government spending of this magnitude would still allow a huge reduction in personal income tax. For example, we could allow every taxpayer to earn $20,000 per year tax-free (compared with the current $6,000), levy a flat tax of 10 cents in the dollar on all earnings above that threshold (replacing the current 17, 30, 42 and 47% tax bands), and still have enough left over to scrap the Medicare Levy, Fringe Benefits Tax and tax on superannuation contributions.[49]

The *quid pro quo* for tax cuts of this enormity would be that people would have to self-fund much more of their health and welfare needs than they do at the moment. Workers on the average wage of $50,000, for example, would pay only $3,000 in income tax as against their current tax burden of $11,172, a saving of more than $8,000 per annum. They would, however, be expected to use at least some of this money to assume responsibility for the 'income smoothing' which is currently carried out on their behalf by the welfare state. This would mean saving more for their own retirement, taking out more insurance for their own health needs, saving for school fees, and so on.

Meanwhile, the remaining $85 billion of tax that is currently spent on the welfare state would still be collected, but it would be used mainly to supplement the purchasing power of the 'lifetime poor' who cannot afford to self-fund without additional help (a shift in the role of the state from 'income support' to 'asset-based welfare').[50] Just as the present system devotes up to half of the budget to redistribution between 'lifetime rich' and 'lifetime poor' individuals, so the new one would also make these transfers, so nobody would be left needy. The government budget required to do this would, however, be much smaller than it is now, and the money collected in taxes would be spent very differently, putting control in the hands of consumers rather than state managers and politicians.

The end result would be that ordinary people would reclaim control over how their money is spent, making their own judgements about priorities, and deciding for themselves how to meet the needs they identify. Health, education, and income insurance services would be opened up to choice and competition between different providers, and the massed ranks of the welfare bureaucracy (which currently decides how to spend our money) could be side-stepped altogether.[51]

Conclusion to Part I

The welfare services we consume do not come 'free', despite the misleading rhetoric of welfare professionals and politicians who talk of services 'free at the point of demand'. Either we pay through compulsory taxation for the education, health, age pensions and income security insurance that we consume, or we pay for these things through voluntary purchases. Either way, we end up paying—the question we have to ask ourselves is whether the same money we spend today on taxes could be better spent by organising our affairs in a different way.

We have seen in this paper that it should be possible to shift from compulsion to voluntarism, from state taxation to personal choice, without driving people into destitution. Winding down the 'piggy bank' function of the welfare state would allow government welfare spending to be cut by up to $85 billion per year without making anybody any worse off than they are now. If the full $85 billion could be left in people's pockets, we could move to a flat personal income tax of just 10 cents in the dollar, thereby delivering a huge boost to individual enterprise and work incentives while still ensuring everyone gets access to the basic services they need. Even if it proved impossible to eliminate churning altogether, substantial tax cuts should still be possible, opening the way for a significant increase in self-provisioning.

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Just because a radical change like this is possible, however, does not necessarily mean that we should do it. In the second paper in this series, I shall consider whether a shift to self-funding is a desirable move to make, and whether it would be any more efficient than the present system. All that we have established so far is that it could, in principle, be done.

Endnotes

1. I wish to thank Ann Harding, Mark Harrison, Helen Hughes and April Palmerlee for valuable comments on earlier drafts.
2. The welfare state has become anachronistic for many reasons. The key one is that many of us can now afford to buy what we need, but changes in family life (which have undermined the male wage-earner model on which many welfare systems were based) and the decline of low-skilled, proletarian manual labour have also helped bring existing arrangements into question. See Gøsta Esping-Andersen, 'After the Golden Age?' In Esping-Andersen (ed), *Welfare States in Transition* (London: Sage, 1996).
3. According to David Green and Lawrence Cromwell, *Mutual Aid or Welfare State* (North Sydney: Allen & Unwin, 1984), doctors would often cross-subsidise between their wealthier and poorer patients.
4. As above, Appendix 9.
5. The other major source of schooling was the Catholic Church which began to offer alternatives to state schools from the 1880s, although two-thirds of all teachers in 1901 were still employed by state education departments. Public high schools were established across the various states between 1905 and 1915. See Gerald Burke and Andrew Spaull, 'Australian Schools: Participation and funding 1901-2000', in Australian Bureau of Statistics, *Year Book Australia 2002*, Cat No. 1301.0.
6. Michael Jones, *The Australian Welfare State* (St. Leonards: Allen & Unwin, 4th edition, 1996); Patricia Harris, 'From relief to mutual obligation' *Journal of Sociology* 37 (2001), 5-26. Jones points out that with full employment, relief work was rarely needed.

[7] New South Wales introduced widows' pensions and family allowances in the 1920s. See Michael Jones, *The Australian Welfare State*. Unlike other benefits, the Commonwealth Child Endowment was not means tested but was paid as a flat rate to all parents. This has, however, subsequently been replaced by the means tested Family Tax Benefit (FTB).

[8] Peter Saunders, *Australia's Welfare Habit, and How to Kick It* (Sydney: CIS, Duffy & Snellgrove, 2004); Jennifer Buckingham, ed., *State of the Nation* (Sydney: The Centre for Independent Studies, 2004).

[9] Peter G. Saunders [no relation], 'The paradox of affluence' *Dialogue* 21 (2002), 34-42; Gregory Hywood, 'Different chefs but the result's a fiscal feast', *The Sydney Morning Herald* (6 May 2004); Phil Ruthven, 'Jobs for the future', *The Bulletin* 119:44 (2002).

[10] Des Moore, *Why We Need to Reduce Health 'Welfare',* Paper to the Bristol-Myers Squibb Seminar on Health Policy, Melbourne (19 June 2001), 4.

[11] Frank Field, *Welfare Titans* (London: Civitas, 2002), 11.

[12] I have elsewhere explained why the welfare state keeps expanding. Technological changes (that have reduced demand for traditional male unskilled labour) and changes to family life (particularly the erosion of marriage and the dramatic increase in rates of single parenthood) ma provide part of the explanation, but other factors (improvements in health following from a higher standard of living, the increase in household incomes with the growth of female employment, and reduced demands on family budgets with lower fertility levels) should have pushed in the opposite direction. The key factor appears to be governmental weakness in the face of pressure group demands, together with vote-buying at elections. Put simply, once established, the welfare state created a political constituency which ensured its continuing development. See Peter Saunders, *Australia's Welfare Habit,* chapter 1.

[13] Ninety percent claim it as a cash payment from Centrelink. See Brian Toohey, 'Howard's family secret', *Weekend Australian Financial Review* (12-13 February 2005).

[14] According to the 2004-05 *Budget Paper Number 1*, Table A1 (www.budget.gov.au/2004-05/bp1/bst6-03.htm) total social security and welfare 'expenses' in 2003-04 came to $80 billion - $17.4 billion more than the amount handed out by FACS in income support payments. The difference is made up of payments (such as Veterans' Pension) processed by other departments, plus the admin costs of FACS and Centrelink. Assistance to the aged, for example, amounted to $27.2 billion, of which age pension payments made up $20 billion. I am grateful to Robert Gardner of the Treasury Social Policy Unit for clarifying this.

[15] Sources: Income Support data from Department of Family & Community Studies *Budget Statement 2004-05* Chart 1.1 (www.facs.gov.au). Data on additional welfare assistance computed from 2004-05 *Budget Paper Number 1*, Table A1 (www.budget.gov.au/2004-05/bp1/bst6-03.htm). Housing data from Productivity Commission, *Report on Government Services 2005, Volume 2* Commonwealth of Australia, 2005. Note that ABS figures for income support payments (Australian Bureau of Statistics, *Year Book Australia 2005,* Cat.1301.0) differ slightly from those in the Budget Statement.

[16] Based on Tables 1 and 2 from Terry Ryan, 'Compendium of taxes in Australia's federal system of government' *Tax Policy Journal* 1 (2005), 34-38.

[17] 'Bring on the big budget bucks', *The Weekend Australian* (8-9 May 2004).[18] Company taxation also forces down the dividends companies can pay to shareholders, and since the superannuation funds are major shareholders, this means we pay again by accumulating less in our retirement funds.

[19] 'There is an understandable tendency to regard any set of social arrangements which has prevailed for over fifty years, as so affected the lives of two generations, as a norm. But in fact, the position of the state in society over the second half of the 20th century was historically most unusual, even anomalous' (Tim Congdon, 'Towards a low tax welfare state' *Politeia* (2002), 1).

[20] And these services would probably be cheaper than they are at the moment with an inefficient state monopoly supplying them. In the case in education, for example, the average cost of a state school education ($9,176) is much greater than for a Catholic school one ($6,822) and is almost as much as in the independent sector ($9,682) where the quality of the service is generally much higher (which is why parents are willing to pay twice in order to send their children to them). See Jennifer Buckingham, ed., *State of the Nation*, Figure 4.2. I shall consider the relative efficiency of private and state provision of welfare in the second paper in this series.

[21] Sinclair Davidson, *Who Pays the Lion's Share of Personal Income Tax?* CIS Policy Monograph 63 (Sydney: CIS, 2004).

[22] Although income tax and GST are both federal taxes, some of the revenue raised is diverted to the states to help pay for services provided at the state level.

[23] Gianni Zappala 'Executive Summary', in Zappala (ed), *Barriers to Participation* (Sydney: The Smith Family, 2003), 11-12.

[24] The shortfall in the share achieved by the lowest quintile is explained mainly by the over-representation of small households at the lower end of the income distribution (the second quintile does better for it contains more larger households). The extensive 'middle class welfare' going to the top two quintiles is explained by the greater propensity of higher income earner households to take-up services such as post-16 education, as well as absorbing significant amounts of government health spending. In 1998-99, the top quintile of equivalised disposable incomes (i.e. income after tax and welfare payments, and allowing for household size) received $51 worth of state education and $62 worth of state health

spending each week. These amounts compare with the $44 of education and $93 of health received by the lowest quintile. See Ann Harding, Rachel Lloyd, Harry Greenwell, 'The spending patterns and other characteristics of low-income households', in Zappala, Table 1.11. Des Moore calculates that the top 40% of gross income households consume over 40% of health benefits—about $10 billion worth (see *Why We Need to Reduce Health 'Welfare',* 5).

25 Neil Warren, *Tax: Facts, Fiction and Reform* (Sydney: Australian Tax Research Foundation, 2004), Table 2.12, based on ABS, *Government Benefits, Taxes and Household Income 1998-99,* Cat No. 6537.0 (August 2001). Figures may not add to 100% due to rounding.

26 According to Castles, 'Means tests have been drawn not at the line separating the poor from the rest, but rather at the line which obviates 'middle class welfare'. He claims that nearly three-quarters of the aged qualify for the age pension or other age-related payments. 'Needs-based strategies of social protection in Australia and New Zealand', in Esping-Andersen, 107.

27 A recent paper finds that as gross earnings have grown more unequal over the last 10 years, income tax has become even more 'progressive', nullifying the widening gap in private incomes. See Neil Warren, Ann Harding, Rachel Lloyd, *ANTS and the Changing Incidence of Australian Taxes: 1994-95 to 2001-02* Paper to the 17th ATTA Conference, Victoria University of Wellington (New Zealand, 26-28 January 2005).

28 ABS, *Government Benefits, Taxes and Household Income 1998-99.*

29 Abstracted from Rachel Lloyd, Ann Harding and Neil Warren, *Redistribution, the Welfare State and Lifetime Transitions,* Paper to the conference on 'Transitions and Risk' (Melbourne, 24 February 2005), Table 1.

30 Anthony de Jasay, *The State* (Oxford: Basil Blackwell, 1985).

31 The 2004 federal election provides a clear example of how this process operates. In just one day, Prime Minister Howard announced six new policies costing a total of $6 billion in new spending. They included more spending on child care (appealing to parents with young children), increased family payments (to attract families with older children), new colleges and apprenticeships (pitched at younger voters) and tax breaks for small businesses (aimed at reinforcing the support base among independent entrepreneurs). Over the whole campaign, the Howard government promised $10 billion of additional annual spending on health, education, child care, aged care and other commitments, all of which had to be funded out of other people's taxes. See John Garnaut and Louise Dodson, 'It's about those promises', *The Sydney Morning Herald* (5-6 February 2005); Gregory Hywood, 'Does Howard have the courage to cut tax?', *The Age* (3 February 2005).

32 As above, Figure 6.

33 Harding estimates that only one-quarter of the individuals in the bottom decile of incomes in any one year are also in the bottom decile of lifetime income, while one in 20 are in the top lifetime decile. See Ann Harding, *Lifetime Income Distribution and Redistribution* (Amsterdam: North-Holland, 1993).

34 Yvonne Dunlop, 'Low paid employment in the Australian labour market, 1995-97' in Jeff Borland, Bob Gregory and Peter Sheehan (eds), *Work Rich, Work Poor* (Melbourne: Centre for Strategic Economic Studies, 2001), 104.

35 ABS, *Australian Social Trends 2002: Work—Under-utilised labour, Searching for Work* www.abs.gov.au/ausstats.abs.

36 Ann Harding, *Lifetime Income Distribution and Redistribution.*

37 *Living in Australia,* Housing, Income and Labour Dynamics in Australia Survey Annual Report (Melbourne: Melbourne Institute of Applied Economic and Social Research, 2004).

38 John Hills with Karen Gardiner, *The Future of Welfare* (York: Joseph Rowntree Foundation, 1997), 19, emphasis in original.

39 See Jane Falkingham and Ann Harding, 'Poverty alleviation versus social insurance systems', *Discussion Paper* No.12 (Canberra: National Centre for Social and Economic Modelling, April 1996). They estimate that in Britain, the bulk of lifetime welfare cash payments is self-financed from the third income decile upwards (at the third decile, people receive 134,000 in lifetime benefits but pay $84,000 in direct tax), whereas in Australia this does not happen until the sixth decile ($64,000 received and $54,000 paid in tax.

40 Ann Harding 'Lifetime versus annual tax-transfer incidence: How much less progressive?', *The Economic Record* 69 (June 1993), Tables 1 and 3.

41 Remarkably, the poorest men pay for *all* of their welfare benefits in the course of their lifetimes, for the main redistribution which takes place in the income support system is not between rich and poor households, but between men and women. This is because women earn less (so pay less tax), receive family support payments, and live longer (thereby receiving a larger chunk of age pension spending). The poorest decile of men receive 12% of their lifetime incomes in welfare payments, but pay 13% of their incomes in tax; the poorest decile of women, by contrast, receive 31% of their lifetime incomes as welfare payments while paying just 10% of their incomes in tax. On average, men pay $90,000 (1986 prices) of tax into the income support pot but take only $40,000 out. See Ann Harding, *Lifetime Income Distribution and Redistribution.*

42 Jane Falkingham and Ann Harding, 'Poverty alleviation versus social insurance systems'. Given that these calculations are based on the 1986 tax and welfare pattern, when indirect taxation was lower

than it is now, the incidence of churning will presumably have increased still further in the years since this analysis was completed.

43 Ann Harding, Richard Percival, Deborah Schofield and Agnes Walker, 'The lifetime distributional impact of government health outlays', *Discussion paper* No.47, (Canberra: National Centre for Social and Economic Modelling, February 2000). The paper estimates that over their lifetimes people on average pay $46,000 for government health care and receive back $62,000 (at 1986 prices).

44 In 1986 prices, the richest lifetime income decile receives $45,000 worth of education, compared with $38,600 received by the poorest. The gap would be much bigger were it not for the fact that many of the richest are educated in private schools. See Ann Harding, *Lifetime Income Distribution and Redistribution.* Simultaneous and lifetime churning of education spending is discussed in detail in Mark Harrison, *Education Matters* (Wellington, The Education Forum, 2004), chapter 5.

45 *Lifetime Income Distribution and Redistribution*, 168.

46 *Redistribution, the Welfare State and Lifetime Transitions,* p.22.

47 Topping up is the logic of 'voucher' schemes in education, but it could also be extended to the financing of personal pensions, purchase of health care, insurance against unemployment, and so on.

48 The potential savings are almost certainly even greater than this, for we have seen that churning is more extensive in services like health and education than in the income support system, and these services take the lion's share of the total welfare budget.

49 Ninety-six billion dollars is currently raised in personal income tax (see Neil Warren, *Tax: Facts, Fiction and Reform,* Table 8.8 for detailed breakdown). Given a reduction in spending of $85 billion or so, only $11 billion would need to be collected. Raising the tax-free threshold from $6,000 to $20,000 would cost about $20 billion ($21 billion is currently raised from the existing 17% tax band which applies to income between $6,001 and $21,600). $36 billion currently comes from the 42% and 47% tax bands ($7.7bn from the former and $28.3bn from the latter). If these rates were reduced to a flat 10%, the total sum raised would fall to ([7.739 * 10/42] + [28.326 * 10/47]) = $7.87bn, reducing current revenues by another $28 billion overall. The $48 billion cost so far still leaves around $37 billion for reducing the current 30% rate. Currently, this tax band generates $39bn. Reducing the rate by two-thirds to 10% would reduce this revenue by $26 billion. This still leaves $11 billion which could be used to scrap the Medicare levy ($5.8 bn) and the employer taxes on fringe benefits and the superannuation guarantee ($4.6bn). Given the huge productivity boost that personal tax cuts of this scale could be expected to generate, it is possible that income tax could simply be scrapped altogether.

50 The third paper in this series will outline how this topping up might be organised. On the concept of 'asset-based welfare', see Michael Sherraden, 'Asset-building policy and programs for the poor' (In Thomas Shapiro and Edward Wolff, eds., *Assets For the Poor* (New York: Russell Sage Foundation, 2001)) and the essays (including a contribution from former Labor Party leader Mark Latham) in Sue Regan and Will Paxton (eds), *Asset-based Welfare: International Experiences* (London: Institute for Public Policy Research, 2001). In contrast to the approach taken here and in the next two papers in this series, most advocates of asset-based welfare see it as complementing rather than replacing the existing welfare system.

51 Peter G. Saunders estimates that, 'almost one-fifth of all employed Australians work in the welfare state and earn their living from it' with as many as 4% working as welfare state administrators (*The Ends and Means of Welfare* [Sydney: Cambridge University Press, 2002], 52). Most jobs, of course, would remain, for we would still employ teachers, doctors, and other service providers, but many of these functions would be transferred into the private sector. Some of the administrative and managerial positions that got scrapped in the public sector bureaucracy would also be replaced by equivalent new positions in the private sector savings and insurance sectors (the second paper in this series will consider the question of efficiency savings). The key difference, however, is that all these producers and managers of services would have to compete for paying consumers rather than receiving tax dollars directly from the government.

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