ISSUE ANALYSIS

THE CENTRE FOR INDEPENDENT STUDIES

No. 61 14 July 2005

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

Six Arguments in Favour of Self-Funding

Peter Saunders

EXECUTIVE SUMMARY

This is the second in a series of three papers on restoring self-reliance in welfare. The first showed the mass welfare state has outlived its usefulness. This paper explains why we should replace it with greater use of self-funded benefits and services.

Most people earn enough to buy the services they need, but they cannot do so because they have to pay high taxes to fund the services the government wants them to have. The mass welfare state came into existence to provide people with resources they could not afford, but it has evolved into a system that is preventing them from leading independent lives.

The paper lists six key arguments for moving from state welfare to self-funding:

(1) *Efficiency*: When the government taxes people's earnings, and then returns their money to them in the form of welfare benefits or services in kind, it incurs unnecessary *administrative costs*, it imposes *compliance costs*, and it generates *enforcement costs* incurred in detecting and chasing people who fraudulently claim benefits. All three would fall if people paid for their own welfare (although government provision will still be needed in some areas).

(2) *Incentives:* Scaling back the welfare state would dramatically reduce the tax burden. This would raise the rate of economic activity, and lift general living standards.

(3) *Sustainability:* The ageing population will increase pressure on government age pensions and health budgets. A move to self-funding would reduce this pressure. Australia's personal superannuation accounts mean projected spending on pensions is well below the OECD average. Introduction of medical savings accounts would similarly reduce pressure on government health budgets by helping contain escalating public demand for newer, high-cost treatments.

(4) *Personal empowerment:* When people use their own money to provide for themselves and their dependents, they derive a sense of autonomy, self-worth and personal responsibility which is denied when money is taken from them in taxes and then returned as government benefits and services. Because it does not trust us to determine things for ourselves, the welfare state ends up infantilising us. Whenever a problem arises, we expect government to do something about it, rather than tackling it ourselves.

(5) *Social cohesion:* Despite a widespread academic belief that the welfare state promotes social harmony, the reverse is the case. Cohesion is built from the bottom up, not by governments taking responsibilities away from us. Far from contributing to social harmony, increased government welfare spending has coincided with rising social problems such as crime.

(6) *Depoliticisation of civil society:* The welfare state is now the core business of government. As spending increases, so government's influence on society increases. We start to compete to gain a bigger share of government handouts, and the knowledge that the government will pick us up if we behave foolishly has enabled foolish and ill-advised behaviour to flourish.

The key social division today is that between a self-reliant 'middle mass' and a state-dependent, marginalised 'underclass.' The mass welfare state is unravelling because the former can now afford to exit the system. Defenders of this mass system want the escaping 'middle mass' to be locked back in to state dependency by increasing their taxes, thus forcing them to accept state services. A more sensible alternative is to let the existing system wind down, and to redirect resources into boosting the purchasing power of those who are currently unable to afford self-funded alternatives.

Peter Saunders is Social Policy Research Director at The Centre for Independent Studies.

ISSN: 1440 6306
www.cis.org.au

Recap: The $85 billion tax-welfare churn

This is the second in a series of three papers on restoring self-reliance in welfare. The first paper showed that the mass welfare state has outlived its usefulness. This one explains why it now makes sense to replace mass reliance on state benefits and services with an expansion of self-funded benefits and services.

The first paper established that real incomes have doubled in the last 40 years, which means ordinary people who needed to rely on government assistance in the past should not need to today. Most people today earn enough to be able to buy most of the services they need, if only they were allowed to retain more of what they earn. What prevents them from funding their own needs is the taxes they have to pay to fund the services the government provides for them.

Although they do not always realise it, many people who receive welfare state benefits and services pay for most or all of what they get through the taxes they pay in the course of their lifetimes. These people could by-pass the welfare state altogether if they were allowed to retain more of their own money and buy the services they want out of their own pockets, rather than have politicians do it for them.

Although they do not always realise it, many people who receive welfare state benefits and services pay for most or all of what they get through the taxes they pay in the course of their lifetimes.

Of course, even if taxes were dramatically reduced, not everyone could afford to make provision for themselves. Despite rising real incomes, some people still need financial help over and above what they are able to earn for themselves, which means there is still a role for the state in supporting people's incomes. But this role is much smaller than the current scale of the welfare state might imply. Of the existing $170 billion annual budget for the Australian welfare state, at least half is 'churned' (i.e. it consists of money paid into the welfare state budget by individuals who then get it back again in the form of cash benefits or services, either immediately or at another point in their lives). If some way could be found to strip these churned funds out of the welfare state budget, massive savings could be made without making anybody worse off. People who needed help would still receive it, but those who are currently financing their own benefits through the taxes they pay could be left to make their own purchases using their own money.

If, implausibly, *all* the money that is currently churned could somehow be left in taxpayers' pockets, at least $85 billion would be released for tax cuts without making anybody worse off. This is almost enough to abolish income tax altogether.[2] But even if churning can only be reduced rather than eliminated, substantial tax cuts should still be possible—enough to enable households to buy income insurance (rather than relying on government unemployment, sickness and maternity benefits); to save for their own retirement (rather than relying on the government age pension to look after them in their old age); and to take out long-term loans to pay for the education they want their children to receive (rather than having to accept the schooling the government currently offers them).

Even if all the churned money were stripped out of the welfare state budget, it would still leave $85 billion (the money that is currently redistributed rather than being returned to those who contributed it). This part of the budget would still be available, and it could be spent topping up the spending power of households whose earnings were insufficient to make their own purchases. The people who currently get supported by the welfare state would therefore still be supported—the amount of money redistributed would not change. This meets a major concern of those who insist that the mass welfare state is necessary to ensure the most vulnerable people in society are properly cared for. Extensive churning means it is possible to scale back the welfare state without hurting anybody.

A move from mass reliance on the government to greater self-funding would allow Australians to take back the primary responsibility for providing for themselves. But why bother? Just because a change like this looks possible does not necessarily mean we should do it. We no longer need the mass welfare state, but would a shift from state-provisioning to self-provisioning be any better than what we already have?

This is the question addressed in this second paper in this three-part series. It identifies six key reasons why allowing people to spend their own money on the services they want is preferable to taxing them to provide them with the services the government thinks they should have (and it adds a postscript suggesting such a move is probably inevitable anyway in the long-run). A move to self-funding is not only possible—it is desirable too.[3]

Reason (1) Efficiency gains

The first reason why such a change is worth making is that bureaucratic churning is costly. A move to personal funding should reduce the costs of delivering the services people want.

When the government taxes people's earnings, and then returns their money to them in the form of welfare benefits or services in kind, it incurs unnecessary *administrative costs*, for it has to pay for two giant bureaucracies (a tax bureaucracy to take people's money away and a welfare bureaucracy to give it back again). It also imposes *compliance costs* on private citizens and businesses, which have to devote time and money complying with the rules governing the tax and welfare payments. And it generates *enforcement costs* incurred in trying to detect and chase people who evade payment of tax or who fraudulently claim benefits.

Administrative and compliance costs

Federal tax legislation currently runs to 13,500 pages. More than 20,000 people are employed at the Australian Tax Office (ATO) to supervise the increasingly complex procedures by which money is taken away from citizens and transferred to the government. This process of extracting money cost taxpayers over $2.3 billion to administer in 2002-03.[4] Our tax system is now so complex that even the ATO itself struggles to understand it, and tax officials increasingly end up making up the law as they go along.[5]

Bureaucratic churning is costly. A move to personal funding should reduce the costs of delivering the services people want.

To the administrative costs incurred as a result of this complexity and intrusiveness must be added the compliance costs incurred by private citizens and businesses at the receiving end. Most Australians now employ accountants to help them make their tax returns, and membership of the Institute of Chartered Accountants has swollen to some 40,000 members. Alex Robson calculates that the 'tax army' of government officials, accountants and lawyers who make a living from the tax system is three times larger than Australia's real army.[6]

The welfare system is even more complex and costly. According to the Treasury, the social security system cost taxpayers $80 billion in 2003-04, but the Department of Family & Community Services only handed out $62 billion in income support payments that year.[7] Some of the $18 billion shortfall is accounted for by payments processed by other departments (e.g. Veterans' Pensions are paid by Defence), but a substantial slice of it appears to be the overhead costs of running the system. Centrelink alone employs nearly 25,000 people, and to them we have to add thousands more employed in federal and state welfare departments as well as those employed in government-funded agencies such as the Job Network.[8]

On top of these figures we have to add the thousands employed in the giant state and federal bureaucracies which administer welfare state services such as the health and education systems. Because the federal government makes a contribution to the costs of surgery visits and prescription drugs, thousands of bureaucrats have to be attached to Medicare and the Pharmaceutical Benefits Scheme (PBS) to calculate and process thousands of co-payments every day. Moreover, funding of hospitals, schools and universities all has to be micro-managed by a plethora of government departments and agencies, often operating across different levels of government. Tens of thousands of public servants are needed to administer all this.[9]

Altogether, about 4% of the Australian workforce (one-third of a million people) appears to be tied up simply in administering government health, welfare and education services.[10] Of course, any move from state to private transactions would still incur some administrative overheads, for private savings, insurance and loans still have to be managed. But self-funding does not need bureaucracies to take money from people and then hand it back again. A move towards self-funding of services could cut out many of these 'middle men and women'.

Enforcement costs

Self-funding would also reduce the detailed scrutiny of each individual's personal circumstances which is needed under a system of state provision to determine eligibility for benefits. This would reduce costs and strengthen civil liberties.

When government distributes benefits, there is an inherent problem of determining eligibility, and some degree of fraud and/or over-claiming is inevitable. In 2001-02 there were nearly 3,000 convictions for welfare fraud (involving $28 million of payments), but this is almost certainly the tip of a substantial iceberg. Some 9% of Centrelink entitlement reviews (nearly a quarter of a million cases) resulted in payments being cancelled or reduced that year.[11] Furthermore, the declaration of earnings from employment is 30 to 40% higher among unemployed claimants who are required to undertake a mutual obligation activity than among other claimants, and this suggests a lot of claimants outside the mutual obligation net are earning money 'on the side' but are not telling Centrelink about it.[12] The National Audit Office estimates that about $1 billion is lost each year in fraudulent claims and overpayments, more than one quarter of it on the Newstart unemployment allowance. This is the equivalent of $535 per unemployed claimant per year.[13]

A basic feature of self-funded welfare is that, as well as being less intrusive than state provision, it requires little policing.

The National Audit Office estimates that about $1 billion is lost each year in fraudulent claims and overpayments.

- Suppose, for example, that instead of relying on state unemployment benefits, people were expected to build up their own *unemployment savings accounts* to provide them with an income in periods when they are between jobs (a proposal along these lines will be outlined in more detail in the final paper in this series). No government department would then be needed to process claims and distribute money, for people would be drawing on their own funds. Nor would government agencies need to check whether claimants were defrauding the system, for people would not be claiming public money. Indeed, there would arguably be little need even to monitor claimants' job search activities, for it would be in their own interests to get another job before their funds ran dry.[14] 'Bludging' under a system like this would be counter-productive, for those seeking deliberately to avoid work would only be defrauding themselves.

- The same logic applies to other self-funded alternatives to state welfare, such as *medical savings accounts*. When visits to the GP are bulk-billed to Medicare and prescription drugs are subsidised by the Pharmaceutical Benefits Scheme, there is little incentive to limit one's use of scarce health care resources. However, if every visit to the doctor and every prescription was paid for out of one's own medical savings account, use of these services would be self-monitored and self-limiting.

- The same logic applies to *personal superannuation accounts*. At the moment, the way we use our own super funds is tightly regulated by the government because politicians are worried that we might choose to rely on the state age pension instead. Government therefore stipulates the minimum super contribution to be made when people are earning, it regulates the 'preservation age' at which superannuation can be accessed, and it limits the amount that can be withdrawn at retirement as a lump sum rather than as an annuity. But all of this interference is only necessary because the government offers its own non-contributory pension to anybody who has not saved for their own retirement. We only need to be forced to save when government offers strong incentives not to do so. It is only because government rewards penury that it has to introduce rules forbidding people from impoverishing themselves.

Unlike state welfare, self-funding works because it runs with the grain of human self-interest, rather than fighting against it.

The limits to self-funding

There are, however, limits to how far self-funding can replace government provisioning. We have already noted that some people will still need financial help if they are to buy what they need, so the proportion of the welfare state budget that is currently redistributed from richer to poorer households may still need to be spent (albeit, possibly in a different form). But in *The Welfare State as Piggy Bank,* Nicholas Barr goes much further.

Barr argues that, far from being a weakness of the modern welfare state, tax-welfare churning (or what he calls 'income smoothing') is its major strength. By taxing people at one point in their lives in order to return the money to them at another, the welfare state enables individuals to spread their risks, manage uncertainty and cope with imperfect information in a way that would not be possible if they were left to their own devices in a market-based system. Even if everybody could afford to buy the services they needed, Barr concludes the welfare state would still be necessary because it offers an indispensable solution to problems of market failure.

Part of Barr's argument—where he suggests that the welfare state is required in order to overcome problems of *imperfect information*—is unconvincing. He thinks people find it difficult to make rational choices regarding their own welfare when benefits accrue a long time into the future (as with a retirement pension), or when they lack the expertise to process information (e.g. in evaluating competing medical advice). In these situations he suggests 'public production' will be more 'efficient' than market competition because it will generate the right decisions which individuals might not have made for themselves.[15]

But when people are given the responsibility for making their own choices, they generally make the effort to become better informed, and when they lack expertise, they can employ agents to advise them. As the history of the friendly societies makes clear, ordinary working people with only a basic education are quite capable of looking after their own long-term interests and choosing which professional services they want to use without the state having to do it for them. People today only appear incompetent to make their own decisions because the welfare state has made them so.

Ordinary working people with a basic education are quite capable of looking after their own long-term interests.

Barr is on stronger ground, however, when he points to problems of 'market failure' in *insuring against risk and uncertainty*. There are certain kinds of risks that private insurers find it difficult to cope with (insurance pooling often breaks down, for example, as a result of high risk individuals seeking to over-insure while low risk ones decline insurance altogether), and there are some circumstances (inherited illnesses, for example) where insurance may be impossible to organise. Private insurers also have to contend with well-known problems of moral hazard (where individuals deliberately expose themselves to an insured risk in order to claim the benefits), although these obviously arise in state welfare systems too (e.g. in the example of voluntary unemployment).

Few of the problems Barr identifies point unequivocally to the need for a socialised system of provision, but some do indicate the need to retain state regulation in some areas of welfare. Pooled risk difficulties may be overcome, for example by requiring everybody to insure themselves while leaving the choice of insurer up to them. Other problems can be resolved by combining private insurance with personal savings, or by leaving individuals to cover smaller risks while the state retains responsibility for catastrophic insurance. Governments can also subsidise the savings or insurance premiums of high-risk and/or low-income individuals. Barr himself offers examples in his book of how private insurance initiatives in the USA have successfully overcome many of the problems he identifies.[16]

Barr's book reminds us that government still has a role to play in welfare, even though most people can now afford to buy the services they need without government assistance. The transition to greater self-funding in the 21st century is not a move back to the laissez-faire of the 19th century.[17] The welfare state is going to change dramatically in the next 10 or 20 years, but the state is not going to disappear altogether from welfare.

The scope for privatising welfare is, nevertheless, substantial. Even if a pure free market system may prove unattainable, we are a long way yet from encountering the limits of a privatised system.

Reason (2): Stronger incentives
The tax/savings trade-off

Although a transition from state welfare to self-funding would enable a massive cut in taxation, much of the money saved on taxes would have to be devoted to increased expenditure on things like health insurance and savings for old age. It is therefore possible that a shift like this could leave people no better off than before once all their basic needs have been paid for. But even if households ended up spending as much on their private purchases as they previously lost in welfare-related taxes, this would still be a move worth making, for when people retain more of their own earnings, they tend to work harder and save more, and this benefits the whole society.

In Singapore, for example, a system of compulsory personal savings and insurance has operated for 50 years requiring people to self-fund services which elsewhere are provided by governments out of tax revenues (compulsory superannuation in Australia is similar, but it is limited to retirement saving and even then is supplemented by a government-funded age pension system). Because there is only a very limited welfare state in Singapore,[18] taxes are low, but workers are required by law to pay 20% of their earnings (up to an income ceiling) into personal funds, with their employers having to supplement this with a further 20%. Workers draw on these funds to pay for hospital bills, tertiary education fees, life and disability insurance and house purchase as well as retirement savings.[19]

Low taxes in Singapore are thus counter-balanced by high compulsory savings levies on wages, so it could be argued that workers have little more disposable income than they would have had under a mass welfare state system. But this is not the end of the story. For a start, deductions from their wages go into their own personal funds rather than disappearing into the government treasury. This means they defer income but do not lose it. Furthermore, these funds are invested to secure asset growth rather than being spent financing current government liabilities, so workers accumulate wealth. It is important to understand that, even when contributions into a personal fund are compulsory, they are not the same as a tax deduction.[20]

Countries which have significantly cut taxes over the last 20 years have enjoyed average per capita growth rates nearly three times higher than those that have not.

Singapore's current economic prosperity probably reflects the fact that it avoided saddling itself with a western-style welfare state after the war, and went for self-funding instead. Even though Singaporeans still sacrifice a substantial chunk of their incomes into their personal accounts, the dramatically lower taxes that have resulted from this system will have strengthened personal initiative and reinforced work incentives. The lesson for Australia is that, if the tax burden imposed by the increasingly costly welfare state could be lifted so that workers retained more of what they earned (either as disposable income or as long-term savings), the rate of economic activity would almost certainly rise, and the general level of prosperity would rise along with it. In short, scaling back the welfare state should make us all richer.

Lower deadweight losses

The reason has to do with incentives. The high taxes which inevitably flow from the operation of a mass welfare state generate disincentive effects. These can be measured by what economists call 'deadweight losses'—the value of all the work and output that is lost as a result of an increase in the tax on people's incomes.

As income taxes rise, some people will decide to work fewer hours, others will conclude it is not worthwhile training for an additional qualification, others will decide to stay on welfare rather than look for a job, and others will be deterred from the risk of setting up a company of their own. All these decisions represent potential wealth lost to Australian society because high taxes have dissuaded people from making the additional effort, or taking the additional risk, involved in pursuing new activities. Equally, of course, if taxes were to fall, these deadweight losses would be transformed into gains as productive activity increased.

Alex Robson estimates that the total deadweight losses arising from personal taxation in Australia could be as high as $61 billion per year (by comparison, the federal government's total annual health budget is only $38 billion). He estimates that each additional dollar of personal taxation ends up costing at least $1.20 in lost output once deadweight losses are factored into the calculation. These deadweight losses weigh heavily on a country's prosperity. Countries which have significantly cut taxes over the last 20 years have enjoyed average per capita growth rates nearly *three times* higher than those that have not.[21] Tax cuts consequent upon a significant reduction in welfare churning could therefore be expected to feed through in a substantial rise in personal living standards.

Tax cuts, not welfare benefits

It is important to emphasise that prosperity gains from tax reductions cannot be achieved by recycling people's money back to them through higher welfare payments. Deadweight losses cannot be countered by churning.

The federal government claims that taking tax from people and then returning it in the form of government payments is much the same as giving people a big tax cut, because they end up with the same amount of cash at the end of the day.[22] But while it is true that receipt of welfare payments such as Family Tax Benefit (FTB) can balance or even outweigh the amount of tax a low income working family ends up paying, this is not the same as a tax cut.[23] Benefits like this are, for a start, limited to families with children, so many workers get nothing. They are also distributed as a fortnightly cash hand-out, so wages are still reduced by the high tax burden. And benefits are clawed back as soon as people increase their incomes, for they are means tested. This creates a huge disincentive effect.

For all these reasons, attempts to balance high welfare payments against high tax deductions do nothing to strengthen work incentives—in fact, they do more harm than good because of the high 'effective marginal tax rates' they end up creating. To reap the incentive effects of tax reductions, it is necessary to reduce tax. Compensating people with selective welfare top-ups does not do the trick.

Reason (3): Long-term sustainability

Like most other advanced capitalist countries, Australia is facing the inevitability of an ageing population. This is the result of increasing life expectancy and falling fertility rates. Across the western world, this is posing two huge problems for 20th century model mass welfare states, and a switch to self-funding has increasingly been seen as a possible solution.

Problem 1: The crisis of 'pay-as-you-go' state pensions

Because almost all western countries fund their state age pensions out of current tax revenues rather than from accumulated funds, an increase in the proportion of the population beyond retirement age poses questions about how future generations of retirees will be funded. A dwindling workforce supporting a burgeoning number of retirees means that existing pay-as-you-go (PAYG) systems can only survive under one of two scenarios. Either the value of government age pensions (relative to what workers are getting in wages) must fall, or the proportion of wages taken in taxes must rise. Neither option is likely to prove palatable to voters.

There is, however, a third option, more attractive in principle than either of the other two. This involves shifting from pay-as-you-go state pensions to fully-funded personal pensions. Rather than one generation of workers paying the pensions of an older generation of retirees, each generation of workers would then accumulate money for their own retirement in their own funds.

The problem with this third option, however, is how we get from here to there. Whenever the changeover happens, an existing cohort of workers will get caught in a double-payment trap, for they will still have to fund the pensions of their parents' generation at the same time as they put money away in their personal funds to cover their own future retirement.

Some commentators think they can find ways around this problem,[24] but in the end it is probably insoluble. One way or another, some people will have to pay twice in any transition. The reason is that the very first generation of state pensioners got something for nothing, and their debt has been passed on across successive generations ever since. For as long as the working population kept growing in relation to the retired population, this did not matter, but today, with the prospect of an ageing population, Generation X has suddenly been left holding the poisoned parcel as the music stops.

With the prospect of an ageing population, Generation X has suddenly been left holding the poisoned parcel as the music stops.

In Australia, this problem is less urgent than in most other western countries. This is partly because our population is younger (only 33% of post-school Australians will be aged over 65 in 2030, compared with 37% of Americans, 39% of Britons and 49% of Germans),[25] but is also because we have already embarked on a self-funded alternative to the state pension—the Superannuation Guarantee (SG)—which has been running since 1992. This means that we are already making this transition. Ever since 1992, workers have been paying twice (once in their taxes to cover the payment of age pensions to current retirees, and again in the compulsory superannuation contributions paid from the wage fund by their employers to cover their own retirement). Because the SG contribution is relatively low (9% of salary), and because the period since 1992 has been one of strong and sustained real earnings growth, this has not felt too painful—so far.

The existence of our SG scheme will not completely avoid the looming crisis of our state age pension scheme, for the 9% employer contribution is too small to provide most workers with an adequate retirement income, so demand for a top-up from the means-tested state pension will remain high. Moreover, even when the current state age pension is added to their personal super, the total retirement income of many baby boomers is expected to fall short of the recommended level of 60-70% of pre-retirement income, although the generation following them (which will have paid into personal superannuation for much longer) is expected to fare better.[26] Whatever happens, many retirees will continue to access the state pension as well as their own super funds (currently, fewer than one in five retirees is wholly self-reliant).[27]

Both the inadequate level of the 9% SG contribution, and the perverse incentives in the means-tested state system (which encourages retirees to consume their accumulated funds so that they can claim the non-contributory government pension) will have to be addressed in the coming years if pressure on government spending is to be successfully contained.[28] But having noted these weaknesses, at least a system of personal funding is in place in Australia, and this will take some of the pressure off the state age pension in the years to come.

Age care currently costs the federal government 0.7% of GDP, but the number of people needing care is expected to triple by the middle of this century.

Spending on Australia's age pension is projected to rise by 1.7 percentage points of GDP over the next 40 years. While still exerting upward pressure on taxation, this is substantially below the projected OECD average, and it is deemed 'manageable' by the Treasury.[29] We are 15 years ahead of the US and much of Europe, and if the SG can be strengthened in the years ahead (e.g. by introducing an employee contribution or increasing the employer contribution in lieu of wage rises, and by eliminating taxation on contributions), the cost burden of the state age pension for future generations could in time even be reduced.

The crisis of health funding

There is, however, a second and even more pressing reason why an ageing population threatens to destroy the mass welfare state model, and this has to do with its implications for health care funding. Here Australia is less well prepared than on pensions, and recent political initiatives like the introduction of the Medicare safety net make us even more exposed to rising levels of unfunded demand (the Medicare levy funds less than 20% of Commonwealth health spending; the rest comes from general taxation).[30]

The Intergenerational Report predicts a doubling of federal health spending (from 4 to more than 8% of GDP) in the next 40 years. Three-quarters of this increase is predicted to come from advances in health technology (for new treatments are expensive and they increase demand), while the remaining quarter will be generated by the ageing of the population (more elderly people means more demand for high-cost health care). The biggest increase will come in the cost of the Pharmaceutical Benefits Scheme, up from 0.6% to 3.4% of GDP.[31]

There will also be a big increase in demand for nursing home and community-based care for elderly people as the population ages. Age care currently costs the federal government 0.7% of GDP, but the number of people needing care is expected to triple by the middle of this century, and costs are expected to rise to 1.7% of GDP.[32]

Given that the biggest factor driving this huge predicted rise in government spending on health and age care is public demand for newer and better health treatments, the most obvious way to contain it is to transfer a greater proportion of the costs to consumers. Under current arrangements, people can express a demand for more and better drugs or treatment with little regard for the cost implications. A shift towards greater self-funding would allow those who really do want to devote a rising percentage of their incomes to health care to do so without imposing an additional financial burden on other taxpayers who may have other priorities.

Such considerations point strongly to the advantages of a move to personal medical savings accounts together with an expansion of private health insurance. Such a shift may not be able to replace the government's responsibility in providing cover for long-term illnesses or high-cost treatments, but it could substantially reduce public liability for more routine medical care. We shall outline such a proposal in more detail in the third paper in this series.

Is pre-funding a real solution?

The logic behind expanding personal superannuation and individual medical savings accounts is that, by encouraging or requiring people to commit part of their current income to meeting their anticipated future needs, the financial burden of caring for them in their old age is transferred from the shoulders of the generation behind them and is placed on those who will actually receive the benefit. Self-funding means you reap what you have sown rather than imposing a debt on those who follow you.

There is a sense, however, in which the next generation will always have to pick up the tab for the care of its elders, no matter how the finances are structured, for future spending will always depend on future output. Whether pensions, for example, are financed through taxes (PAYG), or through personal savings, the flow of income going to retirees will still represent a deduction from the total value of goods and services being generated at the time when the pensions are actually paid out. Individuals can put current income aside for the future, but whole economies cannot, for as Nicholas Barr explains:

> Given the deficiencies of storing current production, the *only* way forward is through claims on future production. Those claims can be organised through PAYG, through funding, or through both. Whichever method is used, *what matters is the level of output after I have retired.* The point is fundamental… money is irrelevant unless the production is there for pensioners to buy.[33]

The only real solution to the financial problems arising from an ageing population is to increase productivity.

Barr's point is that, if the population is ageing, there will be fewer productive workers and more retirees. This will not only affect state PAYG pension systems (for taxes will have to rise to pay the same level of benefit) but also pre-funded personal ones, for when people come to turn their savings, bonds, shares or other assets into an income stream for retirement, there will be fewer workers earning who will be in a position to buy them, so their value will fall. In other words, if an ageing population means falling output in the future, then state pensions and private superannuation will both suffer the consequences.

Barr's observations provide an important corrective to much contemporary thinking, and they remind us that the only real solution to the financial problems arising from an ageing population is to increase productivity.[34] Nevertheless, there are two important differences between state and personal funding of pensions which suggest individuals are still likely to be better off if we switch from the former to the latter.

One relates to control. In a state pension system, the value of your future payments depends entirely on what a future generation of voters and politicians decides to give you, whereas with a personal plan you can increase or decrease the size of your claim on future output (by changing the size of your contributions) as well as switching the balance of your asset holdings to take advantage of market changes. It is true that this will not affect the total size of future output from which you can benefit, but it does give you much more flexibility.[35]

The second advantage of personal funding is that the resources it buys are not tied to one country's population base. Barr acknowledges this point—that while a PAYG state pension can only draw upon the output generated by the citizens of that state at the time the pension is paid out, a private pension fund can invest across the globe, seeking out higher returns from countries with younger, growing and more productive workforces. By purchasing assets in India or China, for example, private pension managers can effectively escape the limits of an ageing population in their own country and can thereby ensure a much higher stream of retirement income for their members than would be possible under a national government's tax-funded pension (while also providing developing countries with much-needed investment capital).

Reason (4): Personal empowerment
The 'servile state'

When people earn their own money and use it to provide for themselves and their dependents, they derive a sense of autonomy, self-worth and personal responsibility which is denied them if their money is taken from them in taxes and then returned as government benefits and services. The early friendly societies understood this, which is why they so passionately defended their autonomy against the growth of state welfare benefits.[36] So too did the 'respectable' working classes of the late 19th and early 20th centuries who took pride in their financial independence, distrusted state hand-outs and distanced themselves from those who chose to rely on the charity of others.[37] Even early generations of Fabian socialists were wary of the effects on personal autonomy and social character of an increase in state provision.

As Hilaire Belloc complained in 1912 (shortly after the introduction of compulsory state health and unemployment insurance in England):

> A man has been compelled by law to put aside sums from his wages as insurance against unemployment. But he is no longer the judge of how such sums shall be used. They are not in his possession; they are not even in the hands of some society which he can really control. They are in the hands of a Government official.[38]

Belloc predicted that the growth of the welfare state would end up providing economic security for working people at the expense of their freedom and dignity. He foresaw 'a future in which subsistence and security shall be guaranteed for the Proletariat…by the establishment of that Proletariat in a status really, though not nominally, servile.' And he was proved right.

By taking people's earnings away in tax, and then compensating them with welfare benefits and services in kind, politicians have ensured that basic needs for health care, income security, education and physical sustenance have been covered, but they have neglected what Abraham Maslow identified as people's 'higher needs' for esteem (or self-respect) and 'self-actualisation' (or fulfillment of potential).

Welfare professionals have tried to 'de-stigmatise' dependency on government aid, redefining claimants as 'clients'.

Self-respect is incompatible with dependency

According to Charles Murray, self-respect can only be earned by 'measuring up' in the eyes of others:

> The threshold condition for self-respect is accepting responsibility for one's own life, for which the inescapable behavioral manifestation is earning one's own way in the world.[39]

The welfare state, however, removes people's responsibility for their own lives, and this undermines their capacity to gain justified self-respect. Welfare professionals have tried to counter this by 'de-stigmatising' dependency on government aid, encouraging people to think of their unearned welfare as a 'right', and redefining claimants as 'clients' (as if they were paying for a professional service) or even as 'customers' (even though genuine customers pay money while welfare claimants receive it).[40] But no matter how much the dependency relationship is denied, redefined or relabelled, it is still impossible for people to retain self-respect if they are contributing less to the world then they are withdrawing from it, and no social worker or academic can change this.

The link between social esteem and acceptance of personal responsibility appears to be a cultural universal. Anthropologists have found that social life is everywhere grounded in this fundamental norm of reciprocity—the principle of give-and-take.[41] In all human societies, long-term dependency on others without some form of reciprocity is associated with low social status, weak self-esteem and powerlessness.[42] Those who constantly rely on help from other people but who offer little in return generally wind up at the bottom of social hierarchies. In some cultures they are pitied, in others they are scorned, but they are never respected.

Since the 1960s, however, social policy intellectuals have explicitly tried to overturn such judgements. They have done this by representing those who rely on long-term state aid as 'victims', which means denying they may have exercised choice in their continuing dependency. Their poverty is blamed on taxpayers, who are chided for their reluctance to part with even more of their money, and their joblessness is seen as the fault of an economic 'system' which deprives the poor of work opportunities. Responsibility is located anywhere but in claimants themselves.

Social policy intellectuals repeatedly warn that we must not 'blame the victim.' They assert that the 200,000 people who have been claiming unemployment benefits for more than a year want to work but cannot find 'suitable employment', just as the 130,000 sole parents living full-time on welfare while their children are in school all day want to go out and earn a wage but employers are too inflexible on hours, or the government does not provide sufficient childcare places.[43] There is always some reason why it would be unreasonable to expect those on welfare to take responsibility for themselves.

The American social policy analyst Lawrence Mead asks: 'Does weakness confer an exemption from normal functioning? Short of outright physical incapacity, should one be excused from routine expectations, such as work, because they are too difficult?'[44] His answer is no, and there are signs that other influential thinkers are beginning to agree with him. Rather than encouraging a victim mentality among those who fail to fend for themselves, Mead argues they need a combination of 'help' and 'hassle.' This means government must put in place clear expectations and requirements, and must then help potential claimants to meet them. Mead understands that long-term dependency on income support payments is destructive of self-respect, and relieving people of responsibility for their own life choices can make their situations worse rather than better.[45]

Prominent Australian advocates like Noel Pearson are beginning to endorse this kind of thinking. Pearson acknowledges that poverty reflects people's behaviour as well as their circumstances, and that some claimants remain dependent on welfare by choice.[46] Accepting that some people encounter more problems and obstacles in their lives than others does not mean we can or should absolve them from the sorts of responsibilities commonly expected of everybody else. Encouraging self-reliance in place of state welfare restores people's self-respect as human beings by applying the same standards and expectations to them as are routinely applied to others.

Rather than encouraging a victim mentality among those who fail to fend for themselves, Mead argues they need a combination of 'help' and 'hassle.'

Self-actualisation versus infantilisation

About one in six working-age adults in Australia lives solely or mainly from government hand-outs, but many more depend on the government to organise their health care needs or to educate their children. This widespread reliance on government services undermines another of the 'higher' needs identified by Maslow—the need for self-actualisation.

According to Murray, self-actualisation (the full expression and realisation of one's human potential) requires that we are challenged (life must not be too easy), yet the defining logic of the welfare state is to make things easier for people by taking control away from them and vesting it in powerful state authorities: 'The purpose of most social policies is to reduce a difficulty, lower a barrier, or insure against a risk.'[47] The result is that we have lost the habit of making decisions for ourselves in some of the most important areas of our lives.

The welfare state does not trust us to determine things for ourselves. Government insists we pay for the health care it thinks we need, and for the schools it wants our children to attend (even when people opt out by paying for private health insurance cover and sending their children to fee-paying schools of their choice, they still have to contribute through their taxes for the government alternatives they have rejected). The inevitable result is that, whenever a problem arises, or a desirable objective goes unmet, we automatically turn to the government to do something about it, rather than working out how to tackle it ourselves. If Murray is right, this is undermining one of the core conditions of human happiness and satisfaction.[48]

The logic of Murray's argument is not that we should strip away all the financial supports that the welfare state has put in place, for Maslow's 'basic needs' for material subsistence and personal security have to be met before the 'higher needs' for self-respect and self-actualisation come into play. The point, rather, is that genuine welfare will offer support to people in such a way that they can take responsibility for their own lives and contribute to the wider society, rather than disempowering them by solving their problems for them. Traditional charities always understood this, but the modern welfare state never has.[49]

People stripped of the responsibility for looking after themselves are likely to become increasingly irresponsible. Theodore Dalrymple went to the heart of this issue when he recently analysed some of the woeful consequences that have attended the growth of the British welfare state:

> State action … has left many people in contemporary Britain with very little of importance to decide for themselves, even in their own private spheres. They are educated by the state (at least nominally), as are their children in turn; the state provides for them in old age and has made saving unnecessary or, in some cases, actually uneconomic; they are treated and cured by the state when they are ill; they are housed by the state, if they cannot otherwise afford decent housing. Their choices concern only sex and shopping… For those at the bottom, such money

> as they receive is, in effect, pocket money, like the money children get from their parents, reserved for the satisfaction of whims. As a result, they are infantilised… For most of the British population today, the notion that people could solve many of the problems of society without governmental *Gleichschaltung*, the Nazi term for overall coordination, is completely alien.[50]

One of the key arguments for moving from state welfare to self-provisioning is to reverse this process of infantilisation and to restore people's faith in their own agency.

Reason (5): Social cohesion
What the intellectuals believe about social cohesion

Some defenders of the welfare state accept that it is *economically* redundant—that we could cope financially perfectly well without it—but they insist that it is *sociologically* indispensible:

> Many welfare programs redirect resources back to those who originally provided them… Neo-liberal critics of the 'income churning' this implies have argued that the net distributional impact could be achieved with a far smaller state sector if the gross flows between individuals and the state could be netted out. This view is arithmetically accurate but politically naïve, because it ignores the role of broadly based programs in underpinning the support of the middle classes, without which the welfare state would founder politically. Far from being its main weakness, 'middle class welfare' is the lifeblood of the welfare state.[51]

Sociologist Peter Berger points out that cohesion in social groups develops from the bottom-up, not the top-down.

The basic argument here is that the inter-generational lending and borrowing that flows through the system binds us all together in a reciprocal network of give-and-take. Because everyone is tied into the system, the welfare state is believed to generate a high level of social solidarity and cohesion which would fragment if individuals were left to manage their own affairs.

This belief that the welfare state promotes social harmony and cohesion pervades the academic literature. It is grounded in an influential 1950 essay by the sociologist, T. H. Marshall,[52] who thought the welfare state would strengthen social cohesion by creating a new, universal status of 'citizenship', and this thesis has dominated British and Australian social policy thinking ever since.[53] Even economists, who understand that many individuals could afford to provide for themselves without the help of the state, nevertheless feel compelled to warn us that this should not be allowed to happen lest it weaken the social ties of 'citizenship' that bind us all together:

> Increased reliance on user charges, in combination with income contingent loans and private insurance, potentially offers a way of reducing the demands for higher taxation… [but] members of our society are interdependent and have a mutual obligation to each other. In such a society collective or social goods and services make an important contribution to wellbeing. The contention is these services should be available to all, and as far as possible universally used in order to maximise social inclusion and cohesion.[54]

Despite this pervasive intellectual consensus, however, there is absolutely no evidence demonstrating that high taxes and high levels of welfare spending do contribute to social solidarity. Indeed, such evidence as exists suggests the reverse may very well be true—that the welfare state undermines cohesion rather than building it.

What the evidence tells us about social cohesion

Sociologist Peter Berger points out that cohesion in social groups develops from the bottom-up, not the top-down.[55] A sense of common identity and mutual empathy is most unlikely to develop as a result of state bureaucracies reallocating tax revenues from one group of citizens to another, for this is more a recipe for resentment and petty jealousies than for fellow-feeling and solidarity. The real source of social cohesion comes not from government largesse but from the self-activity of what Edmund Burke called the 'little platoons' of civil society. It emerges when families, workmates, neighbours or friends come together in formal or informal organisations and networks to solve their common problems.

We have seen that the welfare state has weakened these little platoons by taking over their traditional responsibilities and leaving them with nothing to do for themselves. The clearest example of this was the way the friendly societies were undermined by the intervention of western governments into health care. Introduction of state-run health insurance before the First World War effectively destroyed the medical clubs in Great Britain;[56] the New Deal dealt a heavy blow to the fraternal lodges in the US in the inter-war period;[57] and government funding of doctors undermined the friendly societies in Australia after World War II.[58] In all three countries, mutualist and cooperative movements which had been a major source of community strength and what today would be called 'social capital' were killed off by the coming of the welfare state.

Despite the wishful thinking of so many social policy intellectuals down the years, high government welfare spending has not bought social harmony. Social cohesion can be measured by tracking trends in indicators like crime rates, rates of substance abuse, suicide rates or rates of depression and mental illness.[59] Most of these indicators have been increasing alarmingly over the last 30 or 40 years, yet this is precisely the period when welfare expenditures have been growing most vigorously.

In Australia, the incidence of serious crime (perhaps the best single indicator of social fragmentation) has risen more than six-fold in the 40 years since the early/mid-1960s, yet this was precisely the period when government welfare spending was rising fastest.[60] It is much the same story in New Zealand and the UK—in all three countries, greater equality and higher welfare spending went hand-in-hand with *more* crime and social fragmentation, not less.[61] There is also evidence that many of those who have been committing these crimes are in receipt of welfare benefits, which casts doubt on Marshall's belief that welfare makes people feel they are part of a larger social family.[62] As an insurance against crime and disorder, it is clear that welfare has not worked.

Just as increased welfare does not reduce crime, so reducing welfare does not increase it. American states dramatically cut back welfare spending throughout the 1990s, yet their crime rates plummeted. Between 1989 and 2000, the proportion of Americans reporting they had been victims of assault fell by more than one-third and the proportion reporting they had been burgled was halved. The number of robbery victims dropped three-fold, and there was more than a four-fold drop in the number reporting their cars had been stolen.[63] These remarkable results made a mockery of American critics of welfare reform who warned that it would trigger a new crime wave.

American states dramatically cut back welfare spending throughout the 1990s, yet their crime rates plummeted.

Given this evidence, it is difficult to see how higher welfare spending could still be offered as a serious policy route to a stronger, safer and more 'civilised' society. The social policy establishment continues to hold to the old Marxist nostrum that welfare buys harmony and consensus,[64] yet the evidence nearly all points the other way.

Thinking the unthinkable

Recently some social affairs commentators in Britain have begun to suggest that the welfare state may be more the cause of the social ills afflicting that country than the solution to them.

Theodore Dalrymple thinks the infantalisation of the population created by deep and widespread dependency on government has contributed directly to the growth of boorish and irresponsible behaviour. Because people are required to take such little responsibility for themselves, he suggests they now grow up with little sense of any responsibility towards others. Similarly, James Bartholomew suggests that the expansion of welfare benefits has encouraged cheating and lying; that welfare support for lone parents has encouraged men to disown responsibility for their children; that state schooling has fostered alienation and delinquency among disenchanted youths; and that state housing has created ghettoes of crime and incivility. He concludes:

> The honesty, kindness and civility of British people—once so noted—has been undermined by the welfare state… The welfare state has been a disaster for Britain. It is indeed 'as bad as that.' The welfare state has ruined lives and left people morally and culturally impoverished.[65]

British Labour MP Frank Field, who represents one of the poorest constituencies in the country, broadly agrees with this diagnosis. In his book *Neighbours from Hell*, he suggests that 200 years of progress in building civility in Britain has been unravelling. Institutions like the churches and mutual aid organisations used to promote civic virtue (as did public officials), but the welfare state has undermined it by disregarding the importance of personal responsibility when allocating benefits to people:

> The unconditionality of much welfare has severed the connection between a person's actions and accepting the consequences of that pattern of behaviour... The idea that welfare should be received free of conditions is a very recent development. For most of the last 400 years the receipt of welfare has been dependent on fulfilling a series of conditions. Only since the 1960s did an opposing idea gain ground…[the] damaging belief that no matter how badly a person behaves the right to welfare is inviolate.[66]

In the run-up to the most recent federal election John Howard's Liberals increased their spending promises by at least $60 billion over four years to secure re-election.

Field has explicitly warned Australians not to follow in Britain's path, but few of our social policy intellectuals seem prepared to listen. Most still cling to the assumption that the mass welfare state is a means of achieving social solidarity rather than undermining it, and that more state spending will somehow buy a stronger and happier society. The more they are proved wrong in this assumption, the more energetically they demand even higher rates of spending.

Reason (6): Depoliticisation of civil society

As increasing numbers of people have come to rely on the government to provide them with an income or to deliver them with services, so civil society has become increasingly politicised. A move from a mass welfare state to greater self-funding is important to keep the shadow of the state from falling too far over our everyday social activities.

With more people dependent on welfare payments for an income, the welfare lobby has become increasingly strong and vociferous, alert to any attempt to reduce the flow of public funds to those it represents. Aware of the increasingly heavy tax they are carrying, taxpayers then jostle to ensure they get their 'fair share' of government spending and that nobody else is doing better than they are. Drawn by the lure of some $240 billion of annual public expenditure up for distribution each year, all sorts of pressure groups mobilise to win the ear of spending ministers or to put pressure on politicians through well-funded media campaigns. More and more time gets spent manoeuvring to maximise revenue flows from government, and gradually people learn to look to Canberra whenever a problem arises in their lives rather than sorting it out through their own initiative and enterprise.

Caught in the middle of all this, politicians get drawn into an unseemly electoral competition every three years, each outbidding the others with spending promises aimed at this or that section of the electorate, and none having the courage to risk alienating voters by turning down their demands for more. But the more government does, the more it is called upon to do as expectations get driven upwards. As Anthony de Jasay puts it, 'The beast must be fed *continually*.'[67] This explains why, in the run-up to the most recent federal election (and notwithstanding their professed commitment to the principles of limited government and personal responsibility), John Howard's Liberals increased their spending promises by at least $60 billion over four years to secure re-election.[68]

It is this political ratchet that has created tax-welfare churning. Each new demand is headed off by new expenditure targeted at whichever specific section of the population is making the most noise or wielding the most votes—single parents, working families with young children, age pensioners with health problems, students, apprentices, carers. The cost is then spread thinly, almost imperceptibly, over everybody else. But the next time this happens, a different group is bought off, and again, everyone pays a bit more tax. In the end, things come full circle as each group winds up paying for each other group's benefits:

> As the bias of the system is such that the state tends to say at least a partial 'yes' to the bulk of them, the major result is bound to be churning. *Both* Peter *and* Paul will be paid on several counts by robbing *both* of them in a variety of more or less transparent ways, with a possibly quite minor net redistribution in favour of Paul emerging as the residual by-product.[69]

The major factor driving this perpetual expansion of government is the welfare state, for the welfare state is now the core business of government. It soaks up two-thirds of all the revenue collected by federal and state governments, it employs one-fifth of all Australians who have jobs, it educates two-thirds of the nation's children, it provides full medical cover for the 60% of households who eschew medical insurance, it provides the sole source of income for one in six working-age adults, and it supports more than half of the retired population who have no other source of income than their age pension. This is quite a constituency, and it helps explain why the mass welfare state is proving so difficult to dismantle, even though it has outlived its usefulness. Every year it keeps on growing despite the increasing capacity of the population to look after itself.

A second reason for inertia has to do with the problem of 'moral hazard.' The welfare state persists because it has become an established part of our society, and people have adjusted their behaviour accordingly. Several generations have grown up expecting the government to pick them up and bail them out if they behave foolishly or if things go unexpectedly wrong in their lives. This has enabled or even encouraged foolish and ill-advised behaviour to flourish, with the result that increasing numbers of people come to depend on the services the government has put in place to cater for people who behave foolishly.

The era of the mass welfare state is gradually coming to an end as dissatisfied (or 'aspirational') consumers exit the system.

People stop saving for their old age, for example (or they disinvest on retirement), for they know the age pension will provide them with an income when they get older if they have no money of their own. Similarly, people do not bother to insure against ill health because the government says it will provide free hospital care if calamity strikes. Moreover, people who engage in self-destructive behaviour have no incentive to change because they know they will never have to bear the consequences of their actions. Drug users whose habit renders them unemployable know they can still get an income from the government even if they keep using drugs, and men who father children they do not want know the government will support their families if they abandon them. The welfare state creates and reproduces the very problems it is designed to resolve. We are forever playing catch-up.[70]

Yet despite the political log-rolling, the competition for votes, the vested interests of those who live from the system and the learned helplessness of those who have come to depend upon its hand-outs, there is one powerful factor which is gradually eroding the mass welfare state and which seems destined to grow in the years to come. As a result of the rising level of affluence in the population, increasing numbers of people are withdrawing from what the government is offering them and are choosing private sector alternatives instead. The nail in the coffin of the mass welfare state is rising prosperity.

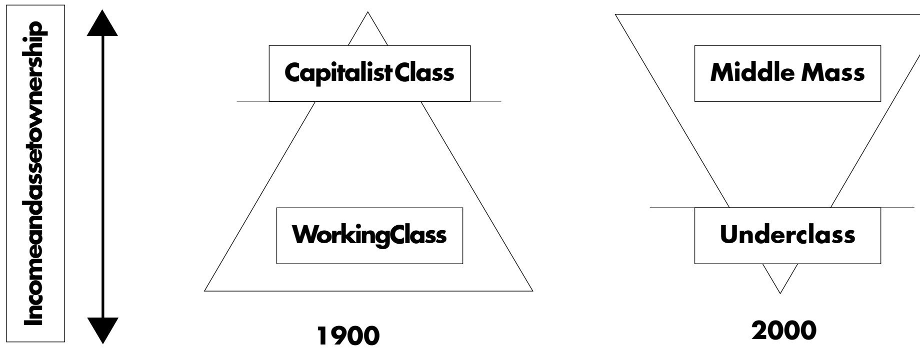
One more reason: It is happening anyway

The era of the mass welfare state is gradually coming to an end as dissatisfied (or 'aspirational') consumers exit the system. The welfare state was a 20th century response to an early 20th century problem which is well on the way to resolving itself as a result of growing affluence. Since World War II, our society has undergone a dramatic revolution of affluence.[71] The mass of the people are as a result of this revolution gravitating towards self-funded alternatives to state provision.

This switch out of the state system into self-funding has often been aided by government policy, but policy has been following the trend more than leading it. About 40% of the population is covered by private health insurance, for example, yet all these people still have to pay for government hospitals and Medicare through their taxes. They can, however, recover part of the cost of their private cover through a tax rebate, and this has helped boost their numbers. Similarly, more than one-third of parents now send their children to non-government, fee-paying schools. While also paying through their taxes for the government schools they do not want, the fees they have to pay are reduced by federal government subsidies to the non-government sector, and this has brought the private alternative within reach of many more parents.[72] We should also not forget that two-thirds of the population own or are buying their own home (only about 5% live in state-owned rental housing),[73] and home ownership has long been favoured by policies such as exemption from Capital Gains Tax. In all these cases, the switch to private alternatives has been enabled by government policies, but it has not been caused by them.[74]

The fundamental explanation for why this switch to private provision has been taking place lies not in government policies, but in our changing social structure. When the welfare state first came into being in western capitalist democracies, it was a response to a socio-economic order in which the majority of the population earned little and owned even less. The social structure at that time corresponded to the familiar income-asset triangle in which a large number of people with very little clustered at the bottom with a small number of wealthy people at the top. If the masses at the bottom of this triangle were to be adequately housed and educated, kept in reasonable health and looked after in retirement, it seemed reasonable to develop a mass system of service delivery to do it.

Figure 1: The income-asset triangle, 1900 and 2000



But in the century that has passed since then, this triangle has become inverted (Figure 1). Not only have real wages and salaries increased enormously, but it has become normal for ordinary people to accumulate substantial assets and to pass them on to the generation coming up behind them.

This means the fundamental class division identified by Marx, between owners of capital and a propertyless class which has only its labour power to sell, has dissolved. In today's era of popular capitalism, the biggest owners of share capital are financial institutions like superannuation funds and insurance companies, but their assets are themselves owned by millions of ordinary workers.[75] Today, most of us work for a living (Treasurer Costello was in this sense right when he claimed recently that we are all 'working class'),[76] but most of us also own (directly or indirectly) the capitalist enterprises that employ us. Capitalism has democratised and universalised itself, turning the mass of the population into both workers and owners of capital. In the language of Marx's dialectic, the capital-labour contradiction has synthesised.

In today's era of popular capitalism, the biggest owners of share capital are ... owned by millions of ordinary workers.

What has replaced the old capital-labour class division is a growing polarisation between a 'middle mass' of the population, which is sharing in the country's growing prosperity through active participation in the labour market and the gradual accumulation of assets like housing, shares and superannuation, and a marginalised 'underclass' which is characterised by a peripheral attachment to the world of paid work and by its lack of any accumulated wealth or assets.[77] The key social division in the 21st century is shaping up to be that between a self-reliant, property-owning middle mass and a state-dependent, marginalised underclass.

It is the socio-economic transformation identified in Figure 1 that is undermining the welfare state, for today we have a 'mass' system which no longer corresponds to the needs and aspirations of the 'mass' of the people. Defenders of this mass system, worried that it is collapsing, explicitly argue that the escaping middle mass must be locked back in to state dependency by increasing their taxes so as to force them to accept the state services they no longer want. Only in this way, they say, can a popular constituency for a high-spending, mass welfare state be maintained.[78]

This means a welfare state whose original purpose was to deliver security to people who could not achieve it for themselves is now being defended by forcing people to pay for schools they do not want their children to attend, by imposing a health care system they never intend to use, and by bribing them with their own money into sticking with state provisions they could better provide for themselves. The welfare state has gone from providing people with resources they do not have, to relieving them of the means for achieving their own independence, and policy professionals who cannot bear to let go have responded by embracing tax-welfare churning as the only way of retaining popular support for a system most people no longer require.

Fortunately, these advocates of coerced welfare appear to be fighting a losing battle. The more real incomes rise, the higher people's expectations and aspirations become. Where one generation was grateful for mass services delivered by governments at a basic but adequate level, the next begins to demand personalised services in which they can exert control and autonomy and decide for themselves what quality they are willing to pay for. And the more people who shift from public sector to private sector provision, the more this momentum is strengthened as those left behind come to realise that it is possible that they too could get something better than what they are being given. The more the mass welfare model crumbles, the harder it becomes to shore it up.

The key question for 21st century policy experts should not be how best to defend the welfare state and stop the haemorrhaging into the private sector (the question that has been preoccupying them for the last 20 or 30 years), but how to manage the transition from a mass welfare state to a system of self-funding while ensuring that the marginalised minority is enabled to participate. If we persist with existing arrangements even as increasing numbers of people vote with their feet and exit the state system, the result will be to exacerbate the growing divide between a self-funding 'middle mass' of the population and an increasingly marginalised 'underclass' relying for its income and its principal services on an inferior state system. The more sensible alternative is for the government itself to take the lead in winding down the existing system and redirecting resources into boosting the purchasing power of those who are currently unable to afford self-funded alternatives.

In the third and final paper in this series, we shall look at how this might be done.

The policy challenge in the next 20 years will be to extend opportunities for self-provisioning from the middle mass (who will seize them anyway) to the marginalised minority.

Conclusion

Like the Old Man of the Sea who implored Sinbad to help carry him across a stream but who then refused to get off his back, the welfare state started out as a reasonable and manageable strategy for relieving hardship, but has become increasingly onerous and parasitic on our whole society. The people it was originally intended to help are now among its principal victims, prevented from exercising the autonomy and personal responsibility that should come with growing affluence because of the amount of money the government takes away from them to fund its continuing commitment to an outmoded, one-size-fits-all, welfare state model. The longer this is allowed to continue, the bigger the problem becomes.

The policy challenge in the next 20 years will be to extend opportunities for self-provisioning from the middle mass (who will seize them anyway) to the marginalised minority (who will otherwise get left behind relying on a declining, second-class state sector). It is time we stopped defending the indefensible and started to think seriously about how to get the welfare state off our backs.

Endnotes

1 I wish to thank an anonymous referee for comments on an earlier draft.

2 It is the equivalent of cutting personal income tax to a flat rate of 10% with the first $20,000 of earnings not taxed at all—and this takes no account of efficiency gains from cutting taxes.

3 These six are not the only grounds for reform, but they are the key ones. In his recent analysis of the legacy of the welfare state in Britain, James Bartholomew constructs an inventory of the damage caused by social security in which he lists eleven harmful effects including the creation of large-scale joblessness, the spread of alienation, the growth of crime and incivility, discouragement of work, discouragement of savings, the erosion of self-respect, high taxation and low economic growth. See *The Welfare State We're In* (Politico's: London, 2004), 85.

4 Australian Taxation Office Annual Reports 2002-2003 and 2003-2004, cited in Alex Robson, 'The Costs of Taxation', Policy Monograph 68 (Sydney: The Centre for Independent Studies, 2005).

5 Geoffrey de Q. Walker, 'The Tax Wilderness: How to Restore the Rule of Law', Policy Monograph 60 (Sydney: CIS, 2004).

6 Alex Robson, 'The Costs of Taxation'.

7 *Budget Papers 2004-05*, Number 1, Table A1. Social security spending is expected to reach $87 billion in 2005-06.

8 According to an EU press release cited by Christian Kerr ('Janet raises the Eurocrats' ire' www.

crikey,com.au, May 16, 2005), Centrelink has 24.632 employees. The 2001-02 Department of Family & Community Services annual report lists 6,115 staff employed in the Department in Canberra (http://www.facs.gov.au/annualreport/2002/volume2/part3/08.html).

9 The Community and Public Sector Union, which represents public officials at both state and federal level, boasts 180,000 members, although this includes people employed outside of the welfare state sector in areas like agriculture and roads (http://cpsu-spsf.asn.au/about_us/).

10 Peter G. Saunders, *The Ends and Means of Welfare* (Sydney, Cambridge University Press, 2002), p.52. He estimates almost one-fifth of all employed Australians work in the welfare state. Note that this is a different person from the present author although we share the same name. In this paper, he is distinguished by adding his middle initial.

11 Centrelink 'Fraud Statistics' www.centrelink.gov.au/internet.nsf/about_us/fraud_stats.htm.

12 Department of Employment & Workplace Relations, *Work for the Dole: A net impact study* (Commonwealth of Australia, 2000).

13 Luke McIlveen, 'Welfare cheats owe us $1bn'. *The Daily Telegraph* (31 August 2004).

14 The third and final paper in this series will outline a proposal for self-funded unemployment savings accounts to replace state unemployment benefits.

15 Nicholas Barr, *The Welfare State as Piggy Bank* (Oxford University Press, 2001), 17 and 52-3.

16 An example of what he calls a 'genuine strategy' is the Stanford University employee health scheme—see Nicholas Barr, *The Welfare State as Piggy Bank*, 65. Despite this, he still persists in arguing that 'the major vehicle for health finance should be public funding' (70).

17 See the second edition of my *Social Theory and the Urban Question* (London: Hutchinson, 1986) for a fuller analysis of the historic transitions from a market, to a socialised and then to a privatised 'mode of consumption'.

18 The state does still fund schooling and has played a key role in providing housing, although more than 80% of Singaporeans now own their homes.

19 Mukul Asher, 'Compulsory savings in Singapore: An alternative to the welfare state', *Policy Report* No.198 (National Center for Policy Analysis, September 1995); Bob Davis and Matt Moffett 'From nations that have tried similar pensions, some lessons', *The Independent* (New Zealand) (16 February 2005) (reprinted from *The Wall Street Journal*).

20 In Australia, where employers make a 9% compulsory contribution to their employees' personal superannuation funds, it is sometimes argued that this contribution is tantamount to a tax, but this is misleading, for employees retain ownership of the money in their own funds. It is generally recognised that 9% is not enough to provide an adequate sum for retirement (e.g. the Senate Report on *Superannuation and standards of living in retirement* (Commonwealth of Australia, December 2002, paras. 1.2 to 1.5) concluded that 'current arrangements are unlikely to deliver' a replacement retirement income of 70 to 80%). If this levy were increased to, say, 15%, and further contributions were then made to cover things like unemployment insurance, health care and some educational expenses, levies on the wage fund would probably mop up most or all of any personal tax gains achieved by scaling down state welfare spending.

21 Alex Robson, 'The Costs of Taxation'.

22 'Since coming to office, the Government has increased total assistance to families by over $6 billion a year… A family with a single income of $35,000 with two dependent children (one under five) currently receives more than $10,000 a year in family tax benefits. They pay no net tax until their income reaches $41,808… Although family tax benefits appear on the expenditure side of the budget, in reality they represent tax relief.' John Howard, 'Wider choice, greater security', Speech to the Menzies Research Centre, Sydney (3 May 2005).

23 There are three major differences. First, unlike a tax cut, receipt of FTB is limited to families with children. Single people and couples without dependent children pay tax and get nothing back. Secondly, unlike a tax cut, FTB is means-tested, so affluent households get nothing, even if they have children, while poorer households lose money as they increase their earnings. If it really were the case (as the PM claims) that a two-child family on $35,000 paid 'no net tax' until its income reached $41,808, it would retain every extra dollar that it earned up until it reached this higher income. What actually happens, however, is that each extra dollar it earns is reduced by a combination of 30 cents income tax and a further 20 cents taper on the FTB means test. Far from cancelling out the disincentive effect of income tax, therefore, FTB exacerbates it, for low income families face an effective marginal tax rate of at least 50% on each additional dollar earned. Thirdly, FTB is not administered as a tax cut would be, for 90% of recipients opt to receive it as a fortnightly payment (just like any other welfare payment). Even the remaining 10% still have to pay tax up front and then get reimbursed at the end of the fiscal year.

24 For example: Alex Pollock, *A New Approach to Personal Social Security Accounts* (American Enterprise Institute for Public Policy Research: Washington, April 2005). Pollock suggests the Treasury could offer to pay inflation-indexed retirement bonds directly into people's personal accounts, and workers could then choose between this and remaining in the existing system. Either way, they would continue to pay taxes which would fund the pensions of the current generation of retirees, but over time, the number of retirees depending on the state pension would fall. This looks like an elegant solution, except it does nothing to reduce future calls on the Treasury, for all that has changed is that under the new system, individuals hold pieces of paper showing their eligibility for an income flow.

25 Simon Kelly, Ann Harding and Richard Percival, *Live Long and Prosper?,* Paper to the Australian Conference of Economists Business Symposium (4 October 2002), Table 1.

26 *Live Long and Prosper?,*16-18; Michael McKinnon, 'Boomers 'must sell homes to retire', *The Australian* (6 June 2005).

27 54% get the full rate pension and another 28% get a part-rate—Commonwealth of Australia, *A More Flexible and Adaptable Retirement Income System* (Canberra: FaCS, 2004), 2.

28 It was originally intended that the contribution should rise to 15% of salary but the Government cancelled planned increases in 1997.

29 As things stand, the cost of the state age pension will still rise, even with the SG, but nowhere near as fast as if private super had not been introduced in 1992. 'Over the next 40 years, Age Pension costs are projected to rise by a manageable 1.7% of GDP' (*Australia's Demographic Challenges* Treasury Discussion Paper, 25 February 2004, Commonwealth of Australia, 11). This increase is similar to that projected for the USA, but is much less than the OECD average of a rise of more than 3 percentage points of GDP.

30 In 2003-04, the Medicare levy raised $5.5 billion, or 17% of total Commonwealth health spending—Australian Bureau of Statistics, *Yearbook Australia,* Cat No.1301.0.

31 Commonwealth of Australia, *Intergenerational Report* (Budget Paper No.5, Part III, 2002-3). As the report notes: 'Most of the projected growth in health spending reflects the increasing cost and availability of new high technology procedures and medicines, and an increase in the use and cost of existing services. Consumers have a high demand for more effective treatments, and expect these treatments will be provided to them soon after the technology first becomes available.'

32 *Intergenerational Report,* Table 8.

33 *The Welfare State as Piggy Bank*, 91.

34 It is worth noting that Barr's comments appear to undermine the case for a government 'Future Fund', such as that established in the 2005 budget. For this fund can only ever represent a claim on the output created by a future generation of workers.

35 This is particularly the case if people are allowed to accumulate different kinds of assets as part of their personal retirement account. For example, if they can purchase housing as well as putting money into approved funds, they can reduce their outgoings in later life by avoiding costs like rent.

36 David Green and Lawrence Cromwell, *Mutual Aid or Welfare State?* (Sydney: Allen & Unwin, 1984).

37 In England, early government moves to introduce state schools, public health insurance and other such policies were often distrusted by working class people. See Henry Pelling, *Popular Politics and Society in late Victorian Britain* (London: Macmillan, 1968), chapter 1.

38 Belloc's 'The Servile State', quoted in Theodore Dalrymple, 'The Roads to Serfdom', *City Journal* (Spring 2005).

39 Charles Murray, *In Pursuit of Happiness and Good Government* (New York: Simon & Schuster, 1994), 122.

40 See Peter Saunders and Kayoko Tsumori, 'Poor Concepts: 'Social Exclusion', Poverty and the Politics of Guilt', *Policy* (Winter 2002).

41 Peter Saunders, *Australia's Welfare Habit* (Sydney: CIS, 2004), chapter 1.

42 Peter Berger, *Exchange and Power in Social Life* (New York: Wiley, 1964).

43 For example: 'It is inconceivable that any appreciable proportion of workers would willingly choose to remain unemployed as a way of life' (Fred Argy, *Where to From Here?* (Sydney: Allen & Unwin, 2003), 82; 'The fault does not lie with the individual. It lies with the inability of the market to reach and sustain acceptable levels of economic participation for disadvantaged Australians' (John Meahan, St Vincent de Paul Society Acting President, quoted in *Media Release*, 12 March 2002); 'Motivation is not the issue. The reality is there is only one job for every six job seekers' (Stephen Ziguras, Research Manager at the Brotherhood of St Laurence, *Media Release* (11 September 2003); 'Most single mums want to work but without adequate child care, family friendly workplaces and some training—they can't get jobs and look after their children' (Kathleen Swinbourne, Sole Parents Union President, quoted in *Daily Telegraph*, 22 February 2005); and so on.

44 Lawrence Mead, *The New Politics of Poverty* (New York: Basic Books, 1992), 127.

45 'Victorian homilies about self-reliance, about God helping those who help themselves and about the corrupting effect of charity, have practically disappeared from public discourse… the more a person is helped in his need, and the higher he rates the probability of the help forthcoming (until, in the limiting case of certainty, he ends up by having *entitlements*), the more his conduct will be reliant on it…the more he is helped, the lesser will become his capacity to help himself. Help over time forms a habit of reliance on, and hence the likelihood of a need for, help' (Anthony de Jasay, *The State,* Oxford: Basil Blackwell, 1985, 209).

46 'There is a behavioural dimension to work and disadvantage… personal responsibility and obligation are key elements that are corroded by long-term dependency… there must be high pressure for people to work because we now have a significant entrenched behavioural problem' Noel Pearson, 'Working for a better life', *The Australian* (17 May 2005).

47 *In Pursuit of Happiness and Good Government*, 156.

48 I discussed this problem in more detail in my University of Sussex Inaugural Professorial lecture, later reworked and published as 'Citizenship in a liberal society' (In Bryan Turner, ed., *Citizenship and Social Theory* London: Sage, 1993)

49 See Robert Whelan, *Helping the Poor* (London: Civitas, 2001).

50 Theodore Dalrymple, 'The Roads to Serfdom', *City Journal* (Spring 2005).

51 Peter G. Saunders, *The Ends and Means of Welfare,* 59.

52 'Citizenship and social class' in T.H.Marshall, *Citizenship and Social Class, and Other Essays* (New York: Doubleday, 1964).

53 Alan Deacon, 'Learning from the US?', *Policy and Politics* vol.28 (2000), 5-18. This belief has also repeatedly been expressed in Marxist analyses, which see the welfare state as capitalism's defence against revolution—for a review, see Peter Saunders, *Social Theory and the Urban Question.*

54 Michael Keating 'The case for increased taxation', *Academy of the Social Sciences* 2004/1, 21-22.
55 Peter Berger and R. Neuhaus, *To Empower People* (Washington: American Enterprise Institute, 1987).
56 David Green, *Working Class Patients and the Medical Establishment* (Temple Smith/Gower, 1985).
57 David Beito, *From Mutual Aid to the Welfare State* (Chapel Hill: University of North Carolina Press, 2000).
58 David Green and Lawrence Cromwell, *Mutual Aid or Welfare State* (Sydney: George Allen & Unwin. 1984).
59 See, for example, Richard Eckersley, 'Redefining progress', *Family Matters* vol. 51 (1998), 6-12. The Australian Bureau of Statistics has also recently developed a series of indicators intended to measure 'social progress' which includes things like burglaries, imprisonment rates, divorce rates, suicide rates and drug-related deaths (ABS, *Measuring Australia's Progress* Commonwealth of Australia 2002; *Measures of Australia's Progress* op cit).
60 Jennifer Buckingham, Lucy Sullivan and Helen Hughes, *State of the Nation* (Sydney: CIS, 2001); Jennifer Buckingham, *State of the Nation: An Agenda for Change,* (Sydney: CIS, 2004).
61 See Peter Saunders and Nicole Billante, 'Does prison work?', *Policy* (Summer 2002-03), 3-8.
62 In New Zealand 4,600 of the country's 6,000 prison inmates were on benefits before they got locked up. See Muriel Newman. 'A recipe for a successful welfare system' (21 May 2002) (www.act.org.nz/action/murielnewman.html).
63 Saunders and Billante, 'Does prison work?'
64 For a recent example, see the St Vincent de Paul Society claim that unless the government eradicates poverty by increasing welfare spending by a further 2% of GDP, 'The community will face the costs of sharpening divisions, discord, increased crime and urban deterioration' (John Wicks, *The Reality of Income Inequality in Australia,* St Vincent de Paul Society, May 2005, 11).
65 James Bartholomew, *The Welfare State We're In* (London: Methuen, 2004), 333-4.
66 Frank Field, *Neighbours From Hell* (London: Politico's, 2003), 33, 95, 98.
67 'The beast must be fed *continually*… whatever of its subjects' liberty and property the state manages to appropriate must be redistributed to others. If it does not do so, the redistributive offer of its competitor would beat its own and power would change hands.' Anthony de Jasay, *The State*, 206).
68 David Uren, 'A pie in face of tax reform', *The Australian* (28 September 2004).
69 Anthony de Jasay, *The State*, 238.
70 Just as decades of growing state provision have encouraged people to abdicate personal responsibility for their lives.
71 Even in just the last eight years, average real disposable incomes in Australia have risen by 15%. According to the ABS, average real disposable income rose 15% between 1994-95 and 2002-03, with even those at the bottom (few of whom are in the labour market) increasing their real spending power by 12%—ABS, *Household Income and Income Distribution* Cat No: 6523.0 (December 2004). GDP grew by an average of 2% p.a. in the 1970s, rising to 3% in the 1980s and 4% in the 1990s—Gregory Hywood, 'Different chefs but the result's a fiscal feast', *The Sydney Morning Herald* (6 May 2004).
72 Jennifer Buckingham (ed), *State of the Nation* (Sydney: CIS, 2004).
73 Australian Bureau of Statistics, *Housing Occupancy and Costs,* Cat No: 4130.0 (February 2005).
74 The one example where government has led rather than followed has been the shift to self-funding of retirement savings.
75 See Peter Saunders and Colin Harris, *Privatisation and Popular Capitalism* (Buckingham: Open University Press, 1994), chapter 1.
76 'Anybody who derives their income from labour is part of the working class' (Peter Costello, quoted in John Garnaut, 'Costello taxes the point', *The Sydney Morning Herald*, 17 May 2005).
77 For a fuller analysis of the polarisation between a middle mass and a marginalised minority, see Peter Saunders, *A Nation of Home Owners* (London: Unwin Hyman, 1990), chapter 6.
78 For example: 'It is the taxes of the middle classes that ultimately provide most of the revenue on which the welfare system depends, and it is therefore necessary to give the middle class a stake in the welfare system by extending its benefits to them.' Peter G. Saunders, *The Ends and Means of Welfare,* 223.
79 'Fairy Tales from the Arabian Nights' www.wollamshram.ca/1001/Dixon/dixon01_13.htm,downloaded 6 September 2004).

THE CENTRE FOR INDEPENDENT STUDIES

ISSN: 1440 6306
www.cis.org.au

Issue Analysis is a regular series published by The Centre for Independent Studies, evaluating public issues and government policies and offering proposals for reform. Views expressed are those of the authors and do not necessarily reflect the views of the CentreÊs staff, advisors, directors or officers. *Issue Analysis* papers (incluing back issues) can be obtained from the Centre for $5.00 each (including GST) or can be downloaded from **www.cis.org.au**.

To order, or for a complete listing of titles available, contact The Centre for Independent Studies.
PO Box 92, St Leonards, NSW 1590 Australia
p: +61 2 9438 4377 f: +61 2 9439 7310 e: cis@cis.org.au