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Reinventing New Zealand's Welfare State

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Government in New Zealand keeps expanding. The main driver has been the inexorable increase in spending on the welfare state.

New Zealanders are much richer than when the welfare state was founded. People's incomes should therefore be sufficient for them to buy many of the services earlier generations could not afford. This means reliance on government assistance should be declining, but it is escalating.

The main explanation why welfare state expenditure is still growing is tax-welfare 'churning'. Many people pay high taxes only to get much or all of their money back in the form of government payments and services. At least half of all welfare state expenditure in New Zealand is churned in this way.

There are good economic reasons for reducing tax-welfare churning—it is inefficient, it creates work disincentives and it will generate unsustainable levels of government spending in the future. But the strongest reasons are sociological—it disempowers people, undermines social cohesion and politicises civil society.

Reducing tax-welfare churning while still ensuring that everyone is guaranteed a decent, basic level of provision requires three major policy changes:

- Reform of income tax so nobody pays tax until they have earned enough to cover their own basic subsistence needs. This can be done by introducing a tax-free earnings threshold equivalent to the welfare minimum income—about $11,500 for a single person and $19,000 for couples opting for joint taxation.

- All workers should make tax-deductible annual contributions into special personal savings accounts so they do not have to rely on government assistance when their employment is temporarily interrupted by unemployment or sickness. To start them off, the government should denationalise its Superannuation Fund and redistribute the money into these personal accounts, giving every New Zealander an initial $3,000 deposit.

- All those whose tax is currently being churned back to them in welfare state benefits and services should be given the right to opt out of the government health and/or superannuation systems in return for tax reductions, which would be paid directly into their personal savings accounts. They would then be required to build up savings for their retirement and to buy a catastrophic health insurance policy to complement their routine medical purchases.

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INTRODUCTION: WHERE DO WE WANT TO BE IN 2050?[1]

Most political debate and discussion is taken up with immediate concerns and short-term problems. Sometimes, though, it is important to stand back from the details that preoccupy us today and think strategically about where we hope we are going in the long-term.

When we do this, one of the core questions that confronts us concerns the role and size of government. Government has become much bigger over the past fifty years, and its growth shows no sign of slowing. The main driver has been the inexorable increase in spending on the welfare state (not just cash benefits, but also services like health and education), which now soaks up nearly three quarters of all government spending. Even though the population is getting more affluent, and should therefore be more capable of looking after itself without government assistance, the welfare state keeps getting bigger.

Government has become much bigger over the past fifty years, and its growth shows no sign of slowing

Thirty five years ago, the New Zealand government consumed just over one-fifth of the country's output in taxes. Since then government has increased its share of the country's GDP by another 50%. This is mainly because of the growth in social spending by both Labour and National governments. Since 2000 this increase has been dramatic. Core government spending each year is now almost $20 billion higher than it was just seven years ago—a 32% increase in real terms—and there is no evidence that all this extra spending is producing significantly better outcomes for people.[2] Indeed, in some cases (for example, levels of welfare dependency), the more the government spends, the worse the problems seem to get. In 1975, for example, just 3% of working-age adults relied solely upon government benefits for their income. Today the figure is 11%.[3]

Do we want this trend towards higher government spending and increasing dependency on government benefits and services to continue indefinitely into the twenty-first century? If not, how far are we prepared to let these trends go before we decide they have gone too far? If we could specify how we would like New Zealand to look by the middle of this century, would we choose to have government absorbing nearly half of everything we produce, or think it desirable to have large swathes of the population dependent on government services and government hand-outs? Or would we prefer to live in an affluent country where most people manage their own affairs without having to rely heavily on government to provide them with what they need?

I suspect most New Zealanders would much prefer the second of these two outcomes. But if this is the case, we have to start making changes now to set the foundations for a more responsible and freer country in fifty years time. This paper does not claim to have all the answers, but it sets out some ideas for the sorts of reforms we should be considering. It is time to get the debate started.

PART ONE: TAX-WELFARE CHURNING

The key to thinking through the future of social policy in New Zealand lies in understanding what economists call 'tax-welfare churning'. This refers to the way government takes money away in tax, only to return it to the same people as welfare benefits or services.

Most of us think of the welfare state as a system of redistribution that uses taxes from more affluent people to provide benefits and services for others who cannot afford to provide for themselves. This is certainly how modern, western welfare states originated. One hundred years ago, when average real wages were much lower than they are today, many people needed help with the cost of health care, old age and income insurance, and governments gradually assumed responsibility for providing them with what they needed.

But over the last hundred years, countries like New Zealand have become vastly richer. This means that personal incomes should now be able to finance the purchase of many more services than was possible thirty, fifty or one hundred years ago. Logically, therefore, the need for government assistance should be rapidly declining. Yet social spending has

been escalating, not dwindling. Government benefits and services have been expanded and made available to more and more recipients, and the government has been taking over what was previously the responsibility of individuals to organise for themselves. Today, every New Zealander is eligible to receive family support payments, a generous universal pension, government-financed health care and government education no matter whether they could afford to buy these things for themselves or not.

The result is that many people today are paying high taxes to the government, but are then getting their money back in the form of benefits and services. Although they do not always realise it, these people are already paying for most or all of the government health, education and welfare services they think they depend on. They are either paying straight away, losing tax at the same time as they receive benefits ('simultaneous churning'), or they pay at one time and get the benefits at another ('lifetime churning'). Either way, the welfare state functions for these people not like a benign Robin Hood, taking from the rich to provide for the poor, but like a compulsory piggy bank which requires them to pay money in, only to draw it out again immediately, or at a later date.

Churning is destroying people's independence, it is infantilising us

These people could clearly bypass the welfare state altogether if they were allowed to retain their own money and buy the services they want out of their own pockets. Writing about Britain, Labour MP Frank Field notes: 'For the first time a sizeable part of the working class and lower middle class now have incomes that give them real choices'.[4] The same is true in New Zealand. Mass home ownership has been common in New Zealand for a long time, but other inherently expensive items like personal pensions, medical insurance, unemployment insurance and even schooling are also now potentially affordable to many people who could never have acquired such things for themselves just two or three generations earlier. What prevents them from buying these services is the fact that the government forcibly extracts cash from them in taxes in order to finance the services it thinks they should have.

The irony of our contemporary age is that, precisely at the point where the need for extensive government help and provision has been receding, the welfare state has been expanding. Fewer people actually need it than ever before, yet more people than ever are obliged to accept it. The welfare state is like a machine that was set running 100 years ago to meet a requirement that is no longer there. This machine been speeding up ever since, and nobody seems to know anymore what it is there for, or how to switch it off.

Why is churning a problem?

Some economists can't see why churning matters. Peter Whiteford, for example, asks why we should be concerned if money taken in tax is later returned to the same people in the form of benefits or government services. Provided the tax office and the welfare agencies are efficient in handling the money, why should it matter which office does what?[5] In this view, all that matters is the net distributional outcome of money flows, not the way we get these outcomes. As long as the right people end up getting the financial help they need, churning is a non-problem.

But this kind of thinking is short-sighted. The core reason why churning matters is that a dollar *earned* has a very different meaning and significance for people than a dollar *received* from the government. By taking tax from people of modest means, government is forcing them to rely on hand-outs and public services rather than buying what they want using their own resources. Churning is in this way destroying people's independence. That is why it matters. In Theodore Dalrymple's phrase, it is infantilising us.[6]

It is no coincidence that those who think churning is not a problem tend to be economists, for they fail to grasp the importance of what is essentially a sociological issue. They are focused solely on net money flows and are blind to what it *means* to the people involved to have to rely on the government's money rather than being free to spend their own. Peter Whiteford, for example, attacks my concern with churning for 'concentrating on appearances rather than reality',[7] but he fails to understand that

what he calls the 'appearances' *are* the reality. He thinks getting money back from the government is no different from never having it taken away in the first place, but there is a world of difference between keeping what you earn, and getting your tax money back as a government benefit. What Whiteford dismisses as nothing more than superficial 'appearances' is actually the nub of the problem.

There are at least six key reasons why churning is bad for you and 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. Some of these are economic reasons, to do with allocative efficiency and financial incentives. But the most important reasons are sociological, political and even psychological, and have little to do with economics.

Self-worth and personal responsibility is denied if money is taken in taxes and then returned as government benefits and services

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 (the cost of collecting the tax and distributing the benefits), it imposes *compliance costs* on private citizens, and it generates *enforcement* costs incurred in detecting and chasing people who fraudulently claim benefits. All three would fall if people made their own arrangements. Unlike state welfare, self-funding works because it runs with the grain of human self-interest, rather than fighting against it. This makes it much cheaper to organise.

2. *Incentives.* The high taxes which inevitably flow from the operation of a mass welfare state generate severe work disincentives. The cost of these can be measured by calculating what economists call 'deadweight losses'—the value of all the work and output that is lost to the economy as a result of an increase in the tax on people's incomes. In New Zealand, Phil Rennie 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.[8]

3. *Sustainability.* Across the western world, the ageing of the population is posing two huge problems for welfare states: a shortfall in funding for state retirement pensions and a looming crisis in the cost of government health care for the elderly. Unless significant numbers of people start to take more responsibility for their own retirement and health care needs, we are going to end up in 30 or 40 years time with a dwindling base of younger taxpayers having to fund an increasingly burdensome population of claimants making increasingly unrealistic demands on government spending. The way to avoid this nightmare scenario is to enable people who wish to do so to build up their own retirement savings, and to take out their own private health insurance, rather than relying on the government system.

4. *Personal empowerment*. When people earn their own money and use it to provide for themselves and their dependants, they experience a sense of autonomy, self-worth and personal responsibility that 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.[9] The 'respectable' working classes of the late nineteenth and early twentieth centuries similarly took pride in their financial independence, distrusted state hand-outs and distanced themselves from those who chose to rely on the charity of others.[10] But today the welfare state constantly anticipates problems and compensates failure, so it ends up removing responsibility and control from individuals and households. The welfare state does not trust us to determine things for ourselves. Government insists on providing the health care it thinks we need, the schools our children must attend, the retirement pensions it does not believe we will save for ourselves and the risk insurance it assumes we are too irresponsible to organise. The result is what psychologists call 'learned helplessness'. Whenever a problem arises, or a desirable objective goes unmet,

we turn to the government to do something about it, rather than working out how to tackle it ourselves. This is undermining one of the core conditions of human happiness and satisfaction. As Charles Murray puts it, 'The welfare state drains too much of the life from life.'[11]

5. *Social cohesion*. Defenders of the welfare state believe it strengthens our ties to each other and underpins the sense of responsibility we all owe each other. They think the inter-generational lending and borrowing that flows through the system (what we have called 'lifetime churning') binds us all together in a reciprocal network of give-and-take, and that social solidarity and cohesion would fragment if individuals were left to manage their own affairs. But there is a wealth of evidence that the reverse is actually the case. Far from contributing to social harmony, increased government welfare spending has coincided with rising social problems. In Australia and New Zealand, 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.[12] Many of those who commit crimes are in receipt of welfare benefits—4,600 of New Zealand's 6,000 prison inmates in 2002 were on benefits before they got locked up.[13] Cohesion in social groups develops from the bottom-up, not the top-down.[14] 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. It emerges rather when families, workmates, neighbours or friends come together in formal or informal organisations and networks to solve their common problems through cooperative activity. But the welfare state has taken over the traditional responsibilities of families and small communities leaving them with nothing to do for themselves.

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6. *Politicisation 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 everyday life has become increasingly politicised. Stripped of many of their traditional philanthropic functions, the welfare charities have metamorphosed into vociferous research and campaigning bodies, and voters have come to regard government as a huge cash-dispensing machine, casting their votes for whichever party promises to give them the most money. Caught in the middle of all this, politicians seek to outbid each other with spending promises aimed at this or that section of the electorate, and the more they provide, the more people's expectations get driven even further upwards. Over time, people adjust their behaviour to take account of the new balance of risks and responsibilities created by large-scale state intervention in their lives. People grow 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, and this has enabled or even encouraged foolish and ill-advised behaviour to flourish. People stop saving for their old age, for example, for they know government super will provide them with an income when they get older. They do not bother to insure against ill health because the government says it will provide free hospital care if calamity strikes those who have made no provision for themselves. Drug users whose habit renders them unemployable know they can still get an income from the government even if they keep using drugs, just as men who father children they do not want know the government will support their families if they abandon them. In these, as in so many other ways, the welfare state amplifies the very problems it was intended to resolve. It is forever playing catch-up.

How extensive is churning?

In order to estimate how much of the money spent on the New Zealand welfare state is redistributed from richer to poorer people, and how much is simply churned back to the people who provided the money in the first place, we must investigate both simultaneous churning, and churning over the entire lifespan.

Simultaneous churning

The best estimates of tax-welfare churning in New Zealand that I know of are based on 1997/98 data analysed by James Cox in his 2001 book *Middle Class Welfare.* Cox estimates 'simultaneous churning' (where people pay tax and at the same time receive back benefits or services) but has no measures of 'lifetime churning' (where people pay tax at one time and get benefits at another point in the life cycle). Nevertheless, in the absence of more recent data, and of a national panel survey, this work is the best we have at present.

Cox found that the New Zealand welfare state does redistribute money from richer to poorer households—43% of cash benefits, for example, go to people in the bottom quintile of taxable incomes. However, he also found a substantial amount of churning, not only in cash benefits, but more particularly in the distribution of services, for those on low incomes are paying significant amounts of tax, and those on high incomes are receiving significant amounts of government social spending.

While the middle classes are paying most of the tax, they are also consuming much of the social spending financed by these taxes

Table 1: Proportion of tax paid and welfare state benefits received by different income quintiles, 1997–98[15] (%)

	Lowest quintile	2nd	3rd	4th	Highest quintile
Original income	0.1	5.8	15.8	26.3	52.1
Total tax paid	6.0	9.2	15.5	23.0	46.3
— direct	4.5	6.9	13.6	23.1	52.0
— indirect	9.1	13.7	19.2	22.8	35.2
Total benefits received	31.7	28.5	16.6	12.1	11.1
— cash transfers	42.8	34.6	12.7	5.7	4.1
— health services	24.7	22.2	19.7	17.4	16.1
— education	11.5	20.1	23.1	22.0	23.3
Final income	9.3	12.8	16.3	22.4	39.1

One point to note from Table 1 is how the tax and welfare systems together compress the distribution of final incomes. The poorest 20% of households, for example, increase their share of total income from 0.1% to more than 9% after tax and welfare state transfers have been applied. Conversely, the richest 20% of households see their share of total income fall from more than half to under 40%.

Most of this redistribution is achieved, not by the welfare state, but by the tax system. In Table 1, we see that the top 20% of earners pay almost 12 times more income tax than the bottom 20%, while the bottom 20% receive almost three times as much welfare state spending than the top 20%. Most income redistribution happens, not as a result of welfare state spending, but through the tax system.

A key explanation for this is that the 'middle classes' manage to absorb substantial amounts of the welfare state expenditure they finance with their taxes. Table 1 shows their share of cash benefits is quite small, but they claw back almost their proportionate share of government health spending, and they amass more than their share of government education spending. More than one-third of health expenditure, and almost half of education expenditure, goes on households in the top 40% of original incomes. So while the middle classes are paying most of the tax, they are also consuming much of the social spending financed by these taxes.

Cox measures the extent of tax-welfare churning by looking at the consumption of government services by the top four deciles of taxpayers (that is, the 40% of the population who pay the most tax). He finds this group consumes 27% of all social expenditure—$5.5 billion in 1997/98 money. This is less than their proportionate share—but not a lot less.

They 'only' soak up 9% of family payments, 14% of super and 15% of welfare benefits, but they take 35% of health payments and 48% of the education budget. The bottom four deciles of taxpayers, by contrast, get 54% of all social expenditure.[16]

Not all top-40% taxpayers are heavy users of government benefits and services, of course—these figures are averages. The biggest consumers tend to be families with children, for they put the biggest demands on the education and health budgets as well as getting cash transfers like family payments. Nearly one in five of the top 40% of taxpayers was also among the top 40% of users of government services, and these people were almost certainly families with children. Single people, by contrast, tend to pay a lot more tax than the value of the services they get back.

Cox concludes from all these statistics that substantial numbers of New Zealanders could make their own arrangements if only the government did not take so much tax away from them:

> The net benefit to a household is likely to be small or even zero if the government pays it a benefit but requires a similar amount to be contributed through taxation … The main effect of the government subsidy is to extend the scope of government decision-making and to reduce the extent to which households are able to make decisions about the education, health care or retirement incomes of their members.[17]

Those who earn least in the course of their lives still pay in income tax for more than half of all the income support payments they receive

In other words, far from empowering these people, the welfare state is actively disabling them.

Lifetime churning

Cox notes that many of the people who make heavy demands on government benefits and services do so only for a limited time period. At the time he was doing his research, for example, three-quarters of recipients of unemployment and sickness benefits, and four in ten of those on Domestic Purposes Benefit, left benefits within 12 months. This suggests many of the people who receive cash transfers at one time pay tax towards the cost of these benefits at another.

The same applies to services like health and education, and to superannuation payments accessed after retirement. Workers pay in over a whole lifetime to finance these services, but they only draw down on them at particular points in their lives—when they are sick, when they have children or when they retire. To calculate the full extent of tax-welfare churning, we would need to add up all the tax that people pay into the welfare state in the course of a lifetime, and compare it with all the benefits and services they take out. Realistically, such a calculation can only be made using lifetime income simulation models. I am unaware of any such modelling done for New Zealand, but it has been done in Australia.

Looking first at income support payments and at direct taxes, Ann Harding has estimated that Australians in the bottom 10% of lifetime earnings still pay 12% of their lifetime incomes to fund government cash transfers while receiving 21% of their lifetime incomes as welfare payments.[18] In other words, those who earn least in the course of their lives still pay in income tax for more than half of all the income support payments they receive.

When Harding adds payment of indirect taxes to her analysis, the total tax payments made by lower income groups in the course of their lifetimes works out even higher.[19] And when her analysis is expanded yet again to include the value of government services (such as health and education) as well as income support payments, the total amount of lifetime churning at the bottom end rises further still. For example, Harding finds that the poorest 10% of Australians receive A$177,000 worth of health care over a whole lifetime, but that they contribute A$62,000 of this in the direct and indirect taxes they pay (the

richest 10% of Australians, by contrast, pay A$249,000 into the state health system to get A$76,000 worth of services back, for many of them have private health insurance). Although there is clearly some interpersonal redistribution going on here, *each individual on average funds 73% of his or her lifetime consumption of government health services through the taxes he or she pays*.[20] Education spending too involves substantial lifetime churning, with the biggest lifetime earners taking out A$12,000 more (in 2006 prices) in education services than those at the bottom do.[21]

Why not leave us to use our own money to make provision for ourselves, rather than taking all this money away in tax only to give it back, now or later, as government cash benefits or services?

Reviewing all this evidence, Ann Harding concludes: 'Over the lifetime there is significant 'churning' as taxes paid to government at some point in the lifecycle are returned to the same individuals at some other point.'[22] She does not calculate the overall proportion of total welfare state spending that goes in inter-personal transfers as against the proportion that goes on lifetime churning, but it is clear that churning represents at least half of all total social expenditure (much more than half in services like health, where about three-quarters appears to go back to the same people who provided the money in the first place).

How much welfare state spending is churned and how much is redistributed?

Harding's calculations of lifetime churning are based on the Australian 1986 tax and welfare system. Much has changed in the last 20 years in Australia, and New Zealand's tax and welfare system in any case differs in important respects from Australia's. Harding's estimates cannot therefore be applied to New Zealand without substantial qualification. Nevertheless, it is clear that, as in Australia, so too in New Zealand, the welfare state operates as much as a system of compulsory lifetime borrowing and saving (the 'piggy bank' function) as it does as a system for redistributing incomes between different individuals (the 'Robin Hood' function).

There are three significant differences between Australia and New Zealand which suggest that churning is likely to be even greater here than in Australia. One is that Kiwis pay income tax on all their earnings from the very first dollar, whereas Australians enjoy a tax-free earnings allowance of $6,000. This means low income earners in New Zealand are likely to pay a bigger proportion of total tax revenue than their equivalents across the Tasman. Secondly, the Australian government age pension is income-tested whereas the New Zealand equivalent ('superannuation') is not. This means high-income New Zealanders are likely to receive more in government payments than they would in Australia. Thirdly, many more Australian families use private schools, and although places are often subsidised by government, this means wealthier parents tend to consume fewer government education dollars than in New Zealand, where state schooling is the norm for most of the middle class.

These trans-Tasman differences suggest that tax-welfare churning in New Zealand is likely to be even more extensive than it is in Australia, for the poor here pay more tax while the rich receive more benefits and services. New Zealand's level of churning is, however, unlikely to match that of Europe, where state 'social insurance' delivers a wide range of benefits as a right to all workers. In the UK, between two-thirds and three-quarters of total welfare state expenditure is churned,[23] and Foelster finds churning accounting for between 75 and 80% of total social expenditure in a variety of other European countries.[24] It is likely that total churning in New Zealand accounts for more than half, but less than two-thirds, of all welfare state spending.

If this is the case, the obvious question is why not leave us to use our own money to make provision for ourselves, rather than taking all this money away in tax only to give it back, now or later, as government cash benefits or services? If so many of us are already paying for what we receive, why do we need the welfare state to process the transactions for us? If at least half of everything the government is spending is going back to the same people who coughed up the money in the first place, it would be much better to leave it

in their pockets and purses for them to spend themselves. The question then becomes: how can this be achieved in such a way that the poor do not lose out?

PART TWO: REFORM PROPOSALS

Our task is to reduce tax-welfare churning to give people greater responsibility for financing their own health care, retirement savings and income insurance, while still ensuring that everyone is guaranteed a decent, basic level of provision. To achieve this, we need to do three things:

- reform income tax so that nobody pays tax until they have earned enough to cover their own basic subsistence needs;
- establish personal savings accounts for working people so that they do not have to rely on government assistance when their employment is temporarily interrupted by unemployment, sickness or accidents; and
- allow those whose tax is currently being churned back to them in welfare state benefits and services the right to opt out of the government system in return for tax reductions, and to make their own arrangements instead.

The remainder of this paper outlines these ideas in more detail.

Step One: Income tax reform

A crucial first step in reducing tax-welfare churning and restoring self-reliance should involve reform of the income tax and welfare payments systems

A crucial first step in reducing tax-welfare churning and restoring self-reliance should involve reform of the income tax and welfare payments systems and the way they interact with each other. The aim is to increase the amount of earnings workers are permitted to retain for themselves before they become liable to pay income tax. With more of their earnings retained in their pockets and purses, people will be able to buy more of the things they need without having to ask the government for top-ups.

At the moment, anybody who earns anything in New Zealand gets taxed from the first dollar. Inevitably, this means the government is taking money away from people on low incomes who then have no choice but to ask for it to be returned to them in the form of welfare payments or services. It would be far better to take low income workers out of the tax system so that they can spend their own money fulfilling their own needs without having to claim government payments. The way to do this is to introduce a tax-free earnings threshold (TFT) which should be above the subsistence minimum income level.

We can define a 'subsistence income' as the minimum amount somebody would receive if they were living wholly on welfare benefits. As of April 2006, a single unemployed adult over the age of 25 receives $9,069 per annum in unemployment benefit (net of tax), plus an accommodation supplement of at least $2,242 (more in higher cost housing areas). This suggests the minimum subsistence income a single person in New Zealand needs in order to survive is $11,311. Similarly, an unemployed couple currently qualifies for a minimum welfare payment of $18,867, and a single parent gets $17,160, so these sums can be said to represent the minimum subsistence costs for couples and sole parents respectively.[25]

Leaving aside for a moment the question of dependent children, it follows that a tax-free earnings allowances of around $11,500 (for a single person) and $19,000 (for couples opting for joint assessment) would be needed to ensure that any adults living in a household where there is at least one full-time income can achieve a subsistence income without the need for any welfare subsidy. The minimum wage is currently $21,320, which is higher than the subsistence income required by a single person living on their own or by an adult couple living together. With the possible exception of some part-time workers, therefore, TFTs set at these levels would ensure that employed adults would be able to get by without seeking government assistance. The tax and welfare payments systems

would therefore no longer need to overlap, and self-reliance would be a lot higher than it is at the moment.[26]

Of course, households with children will have higher basic subsistence needs than those without, which is why the welfare system helps parents with the costs of raising their children. Couples and sole parents get a tax credit of at least $3,754 per annum for a first child, plus at least $2,451 for each additional child (more is paid if the children are over the age of 12). These sums can be said to represent the minimum subsistence costs of children.

If we were simply to add the subsistence costs of children to the parental TFT, some working households would fail to achieve the basic income they need because some parents do not earn enough to benefit from such a raise. A single-earner couple raising one or more children on a minimum wage, for example, would be unable to claim their full TFT entitlement and would therefore fall short of a subsistence level income unless they received some sort of top-up. For this reason, it is better to allow for the subsistence costs of children by continuing to give Family Support tax credits to parents, rather than boosting their TFT, for a tax credit has value for those earning below the threshold as well as those earning above it.

We need policies that will enable or encourage people who currently use welfare state benefits and services to make their own arrangements instead

A two-child family on one minimum wage of $21,320, for example, would be able to claim the couple's tax-free threshold of $19,000, leaving them liable to income tax on their remaining $2,320 (at 21 cents in the dollar, this leaves them owing $487). But they would set this tax bill against their Family Support tax credit worth at least $6,205 ($3,754 for the first child and $2,451 for the second), thereby turning their tax liability into a negative income tax payment from the government of $5,718. Their net disposable income would then amount to a total of $27,038 with no tax to pay, and they should need no further financial support from the government.

Step two: A temporary earnings replacement account

Introducing a high income tax threshold linked to child tax credits would go some way to restoring self-reliance, but we also need policies that will enable or encourage people who currently use welfare state benefits and services to make their own arrangements instead. One way to do this is to ensure that workers build up sufficient savings to tide them over temporary periods of unemployment or sickness without needing to ask the government to bail them out.

This is not a new or particularly radical idea. Researchers at the National Bureau of Economic Research in Massachusetts proposed some years ago that workers be required to save up to 4% of their wages in Unemployment Insurance Savings Accounts which would replace government benefits during periods of unemployment. Where unemployment persists and accounts get exhausted, the government would lend money into the accounts, and positive balances on retirement would be converted into retirement incomes, while negative balances would be written off. The researchers found that, had such a system been operating over the preceding 25 years, almost all individuals experiencing unemployment would still have had positive balances by the time they moved back into paid work. They also found that a system like this would increase incentives to find work, and that the cost to the government of forgiving negative balances on retirement amounted to half of the cost of the existing government Unemployment Insurance system.[27] The centre-left Hamilton Project in the USA recently resurrected this idea when it proposed a system of 'Temporary Earnings Replacement Accounts'.[28]

The unemployment benefits system in New Zealand is, of course, very different from the Unemployment Insurance system in the USA, but there are still very good reasons why Kiwis too might benefit from switching from a government benefits to a personal savings model to cover temporary periods of interrupted earnings. Because unemployed people would be using their own money to maintain themselves, any shame or stigma traditionally associated with receipt of unemployment benefits would be reduced. Accusations of 'dole bludging' would lose their bite, for the cost of work avoidance would

fall solely on the unemployed person themselves. And because there would be a strong motivation to find work quickly, before savings were exhausted, problems of policing eligibility and deterring fraud which are commonly encountered in the existing system of unemployment benefits would be minimised. People could be trusted much more to search for work, and more attention could be focussed on helping them find it rather than on monitoring their efforts. Knowing that their personal savings are running down, jobseekers would likely be more flexible when assessing employment opportunities, and this would reduce the drift into long-term unemployment.

There are various ways a savings account scheme could be implemented, but certain core elements are common to all versions. Accounts would have to be built up through regular compulsory contributions. These could be made by employees alone, or could be split between employees and their employers. Contributions should either be tax-exempted or should be credited in full against people's tax liabilities. Contributions should be paid into personal accounts of people's own choice (not a government pooled account), and they could be self-managed or run by professional fund managers.

With regular contributions on top, most people would rapidly establish funds big enough to offer a high degree of income security for the rest of their working lives

In periods of unemployment or sickness, people would draw down on their funds up to a weekly limit corresponding to the existing level of government benefits. Once their fund is exhausted, they could either borrow from the government (repaying debts from their contributions once they return to work), or they might volunteer for some sort of 'work for the dole' scheme to provide a basic income until they find fresh employment. Either way, the existing system of unemployment and sickness benefits could be wound up.

People's funds would continue to grow for as long as they did not draw on the money. Rather than paying tax every year of their working life for what is essentially a compulsory, government-run unemployment insurance scheme, workers would now be putting the equivalent amount of money into their own savings accounts, building up their own asset balances. Unused or surplus balances could be cashed on retirement, or might be diverted to other uses such as medical insurance or a retirement annuity.

One idea that is worth considering is that the government should kick-start people's funds with an initial lump sum deposit derived from denationalising the New Zealand Superannuation Fund. This government Superannuation Fund was created in 2001 to help defray the future cost of government superannuation payments, for like many countries around the world, New Zealand has an ageing population, and the number of retired people is expected to double by 2050. Each year the government has been allocating around $2 billion to this fund in the hope of building up reserves that can help meet the cost of all these people's retirement incomes. Currently the fund is estimated to contain $12.2 billion.

If this money were divided equally into four million personal savings accounts (one for every New Zealand permanent resident, children as well as adults), everyone would receive around $3,000. This money alone would be enough to replace a single person's unemployment benefit (including accommodation allowance) for at least three months, and most periods of unemployment do not last that long. With regular contributions on top, most people would rapidly establish funds big enough to offer a high degree of income security for the rest of their working lives.

If the government were to redistribute its Superannuation Fund in this way, it should also undertake to spend about $174 million each year endowing newborn children with funds of equivalent value to those established for everybody else.[29] The money to pay for this annual government contribution to new-born New Zealanders (a Kiwi equivalent of the Blair government's new Child Trust Fund) could come out of the $2 billion currently earmarked for the government's own Fund every year (the remaining $1.8 billion could then be used to defray the cost of tax rebates on people's annual contributions to their funds). New immigrants should also be required to establish a fund of their own to the value of $3,000 before taking up residence in New Zealand. This way, every New Zealander would have their own fund, now and into the future.

Critics may argue it is 'irresponsible' to raid the government's Superannuation Fund

Money paid into people's individual accounts would strengthen self-reliance and reduce government outlays

in this way, especially given that rare political consensus now supports its existence.[30] But even at its peak, the government's Fund will only cover 14% of the total cost of superannuation.[31] The rest will still have to be met by the taxpayers of the future. The best way to help future generations meet these liabilities is to increase the size of the economy. Taking more tax than is necessary from individuals and businesses now, in order to build up a government savings fund for later, depresses private investment and savings and arguably leaves future generations worse off than they would otherwise be.[32]

Moreover, by reducing people's reliance on government unemployment and sickness benefits (by around $500 million each year), personal savings funds would reduce the pressure on public spending in the future. Hording taxpayers' money in a central government fund may increase the government's *supply* of money in the future, but encouraging everyone to build up their own savings will reduce the future *demand* for government services. The money paid into people's individual accounts could not be spent on immediate consumption, but would be used to replace present or future calls on government benefits or services. It would therefore strengthen self-reliance and reduce government outlays, thus proving a much more effective 'investment in the future' than if it remained in the hands of the government.

Step three: Health and superannuation opt-outs

For some people, the new personal savings funds I have proposed would replace unemployment and sickness benefits, and would serve no other purpose. But for some people, these funds could offer much more than this. For New Zealanders who currently have some or all of their tax churned back to them as welfare benefits or services, these personal funds could provide a means of opting out of government health and superannuation schemes and funding personal alternatives in their place.

This possibility will not suit everyone. Some people do not earn enough over a lifetime to put money away for their own retirement or to make provision for their own health care needs, and even among those who do, not everyone will prefer a private to a government solution. But for those taxpayers who prefer to save for their own retirement rather than depend on the government's superannuation scheme, or who would rather make their own health care arrangements than rely on the government to do it for them, the establishment of personal savings funds offers the potential for opting out of the government systems and building up personal retirement and medical savings instead.

Entitlement opt-outs or contribution opt-outs?

The basic idea behind extending the scope of personal funds to cover retirement or medical savings is that people who agree to take more responsibility for themselves should be allowed to retain more of their taxable income so they can afford to buy replacement services (those who prefer to remain in the state system can stay as they are). Thus, people seeking to opt out could be allowed to exchange some or all of their current welfare entitlements for tax reductions, but those who prefer to remain in the state system would continue to pay their full tax liabilities.

Proposals to allow people to cash-out their welfare state entitlements are not new. In Australia, prominent 'centre-left' thinkers like Vern Hughes and Noel Pearson have suggested that people might be allowed to cash out their entitlements to Medicare,[33] and in New Zealand, Sir Roger Douglas has gone much further, suggesting that all the money currently spent by government on health, education and income support should be spent instead on tax credits (that is, tax reductions for those earning above a high tax-free earnings threshold, and top-ups for those with incomes below it).[34] Douglas also proposes tax credits should fund personal super contributions, arguing that this could gradually replace spending on the government scheme.

Douglas wants to return power and responsibility to working people by enabling everyone to buy services for themselves rather than having the government deliver them. This would be achieved by cashing out people's existing welfare state entitlements. The

size of the government's budget would be slashed while household disposable incomes would be enlarged. Single people with no dependants would, for example, end up $6,500 better off each year, for they would be allowed to earn $32,000 before paying any tax (see Table 2), and those with incomes below $32,000 would receive a top-up. A married couple with two children would end up $21,500 better off, enjoying a TFT of $76,000 with a tax credit for those earning below this amount.

It might be better to allow people voluntarily to opt out of the government's system and into private alternatives, rather than compelling them to assume responsibility for themselves

Table 2: Value of tax-free threshold/tax credits for different types of households under the Douglas reform plan[35]

Household type	*Increased income*	*Elements*				*TFT*
		Super	*Welfare*	*Health*	*Education*	
Single	6,500	4,000	1,000	1,500	nil	32,000
Couple	12,000	8,000	1,000	3,000	nil	50,000
Couple + 2 children	21,500	8,000	1,000	4,000	8,500	76,000
Single parent 2 children	16,000	4,000	1,000	2,500	8,500	63,000

Of course, households would have to spend much or all of the extra money in their pockets providing services for themselves that are currently provided by government. As Table 2 makes clear, the huge TFT/tax credits they would enjoy are made up of four elements, and all four would involve some new, compulsory expenditure on their part.

- The first and largest element is earmarked for *superannuation*. Every individual of working age would be required to contribute $4,000 every year into a super fund of their choice (although Douglas suggests that anyone who preferred to stay in the existing state system could do so and would forego the $4,000 tax credit).[36] Douglas calculates that funds left untouched over 47 years of a working life would build to a final sum of $850,000 in real terms, which could be used to fund a decent retirement income.
- The second element is to replace existing *unemployment, sickness and accident benefits* with a $1,000 tax credit which would have to be spent on private income insurance. Government benefits would only be paid after a full year out of work.
- The third element consists of a tax credit to enable people to pay for catastrophic *health insurance* as well as everyday health expenditures.[37] The size of this component of the TFT/tax credit would vary by family size (and perhaps also by age and risk group), so a single person would qualify for $1,500 while a couple with two children would claim $4,000. The total cost of tax credits would equal the amount currently spent by government on providing health care.
- Finally, there would be an *education* tax credit (what Douglas calls an 'Opportunity Scholarship') worth around $4,500 per dependent child. Parents could spend this on any approved school of their choice.

Douglas believes his package is affordable, for the only new spending is the superannuation component (the rest is simply transfers from existing government budgets back to households). There are nevertheless two features of his radical reform programme that require further thought.

One is that (with the exception of retirement savings) his plan *forces* people out of the existing state system and into the private sector where they would be compelled to save or insure. This would undoubtedly generate major political tensions, for some people would almost certainly prefer to remain with existing arrangements. It might be better to allow people voluntarily to opt out of the government's system and into private alternatives, rather than compelling them to assume responsibility for themselves.

A second problem is that large numbers of people would still be encouraged to look to the government to give them money. True, government would no longer be providing people with schools, health care and welfare benefits, but it would be directing a lot of cash at them in the form of tax credits to enable them to buy these services for themselves. This

People remaining in the state system should not be any worse off than they are now

is certainly a step forward from present arrangements, for having money in your pocket extends personal choice, but extensive reliance on tax credits is still likely to promote a sense of dependency on government revenues. A welfare state based on massive cash transfers is still a welfare state.[38]

If the aim is for more people to take on genuine responsibility for themselves and their dependants without having to rely on government cash transfers, then a better way to do it would be to allow them to withhold tax payments in return for giving up claims on the welfare system. Rather than cashing in their current *entitlements* in return for tax credits, as Douglas proposes, they would have the right to withhold some or all of their current *contributions.*

The entitlements cash-out favoured by Douglas (and in different ways by Murray, Hughes and Pearson too) would allow people to cash in the total value of the benefits and services they currently enjoy, irrespective of how much of their own money they have paid in. A contributions opt-out, by contrast, would only allow people to retain money that they themselves currently pay in. An entitlements opt-out would give people their own money (which is currently churned back to them) plus money raised from other taxpayers and redistributed to them. A contributions opt-out is much more constrained, for it allows you to keep your own money but not to cash in other people's.

There are arguments for and against both entitlement and contributions opt-outs. Both allow people more choice and control than the existing system does, and in this sense either would be an improvement on what we have at the moment. Entitlements opt-outs will probably appeal more to the left (for they are more inclusive as anybody can cash in their entitlements), while contributions opt-outs will probably appeal more to the right (since they are limited to people withholding their own money and redistribution is confined to the welfare system rather than spilling into the tax system).

Arguments against opt-outs

One concern about opt-outs is the worry is that affluent people who can afford to buy good quality services will take their money out of the public system, leaving poorer people marooned in a declining state sector from which they cannot afford to escape. Economists refer to this as the 'adverse selection' problem.

Adverse selection should not be a problem, however, if affluent people are only permitted to withhold that proportion of their taxes that is currently being used to finance their own needs, for the only people who will be affected will be them. Under the proposals outlined here, people who choose to opt out of the government health or superannuation systems will continue to pay that part of their taxes that is currently used to fund health and retirement provisions for others who cannot support themselves. This means people remaining in the state system should not be any worse off than they are now.[39]

We saw earlier that no more than half of the money spent on the welfare state at the moment is redistributed from richer to poorer households, while the other half is churned back to the people who provided the money in the first place. The redistributive component of the existing system would continue under a system of opt-outs. The only welfare spending that would be reduced would be that which is currently churned back to taxpayers, not that which is redistributed. In principle, therefore, poorer people remaining in the state system should not be any worse off as a result of opt-outs.

A related concern is that allowing people to opt out of their contributions will incur 'deadweight losses' for the government. For example, about 40% of adults currently pay for private health insurance (to get medical treatment in non-government hospitals), while simultaneously paying taxes for the public hospital system they choose not to use. Why allow these people to withhold some of the taxes they are currently paying when they are already opting out of the public system with fewer or no such concessions?[40]

This is, however, the wrong way of looking at the problem. The more pertinent question is why people who do not want what the government is providing should be

forced to purchase it? Requiring people to subsidise others on lower incomes is one thing, but requiring them to buy a service for themselves that they do not want to use is quite another. The real question we should be asking is not how we can defend a universal welfare state by forcing people to pay for services they do not want, but how we might enable more people (especially those in the lower half of the income distribution) to exercise the sorts of choices that more affluent people are already enjoying?[41]

It should be possible for people to trade off welfare entitlements in one area of government provision while remaining in the state system in another

Can lower income households opt out?

Around the middle of the income distribution, people with families often find they are getting more out of the tax-welfare system than they are putting in. More than half of all taxpayers earn below $20,000, and they pay just 12% of all the income tax paid in New Zealand.[42] Their scope for opting out might therefore seem limited.

However, the net tax-welfare contribution of many households is not as tight as these statistics appear to suggest. The reason (as we saw earlier) is that most people's incomes fluctuate over time. International household panel studies report substantial income mobility over relatively short time periods. In Australia, 21% of households fell below the 'poverty line' at some point between 2001 to 2003, but only 6% were below the poverty line in two of these three years, and only 4% were below it in all three years. Nearly one-fifth of those below the poverty line in 2001 had moved into the top half of the income distribution by 2003.[43] Similar patterns have been reported for New Zealand. One-quarter of New Zealanders in the bottom quintile of incomes at some point between 1980 and 1987, for example, improved their position within 12 months, and nearly a half had moved up within seven years. And the *Family, Income and Employment Dynamics* survey reports substantial upward movement from the lower income quintiles over the three year period between 2002 and 2005.[44]

So while it is true that only a relatively small number of people pay substantial amounts of income tax at any one time, many more pay a substantial amount of income tax over the course of a whole lifetime. Many of those who appear relatively 'poor' today probably enjoy some capacity for opting out of government services when their lifetime tax payments and welfare receipts are examined.

We should also remember that opting out does not have to be an all-or-nothing decision. It should be possible for people to trade off welfare entitlements in one area of government provision while remaining in the state system in another. People might opt out of the government superannuation system, for example, but stay with the public health system. Given this sort of flexibility, even those who pay little tax in the course of their lives should be able to find some benefits which they could afford to trade in for tax reductions if they choose to do so.

Opting out of government superannuation

Australians are already familiar with the idea of personal retirement savings, for since 1992 employers have been required to pay a proportion of their employees' wages (currently 9%) into a personal superannuation fund. Workers enjoy the right to determine which fund these contributions are paid into, they can 'sacrifice' additional earnings into their funds if they want to, and they can decide what to do with the money when they draw it out. Because of compulsory retirement saving, Australian government expenditure on income-tested age pensions is expected to rise by less than 2 percentage points over the next 50 years, which is *three times less* than the growth of projected government spending on superannuation in New Zealand.[45]

Australia was not the first country to introduce personal retirement savings. The trailblazer was Singapore which established a compulsory scheme in 1955 under which workers and their employers were obliged to deposit a percentage of earnings into individually-earmarked accounts run by a government-managed Central Provident Fund (CPF). This original scheme has expanded in the last 50 years so that today contributions

Taking care of your health-care needs should be like keeping your car on the road. You pay for the ordinary upkeep with cash and use insurance to protect against expensive accidents

fund personal medical expenses, house purchase and education as well as retirement. All deposits, withdrawals and interest earned are free of tax, but the government makes no contribution. Funds administered by the CPF now amount to 60% of Singapore's GDP, and the scheme covers some 2.5 million wage and salary earners.[46]

In 1981, Chile followed Singapore's example by privatising its retirement pensions system, which was threatening to collapse into insolvency. As in Singapore, workers were compelled to pay a proportion of their earnings (minimum 10%) into a private account, but unlike Singapore, they could choose between as many as twenty competing fund management organisations (now down to just six). As in Singapore, the Chilean government does not contribute to these funds, but—unlike Singapore—it does use general tax revenue to make up any shortfall in people's accounts when they reach retirement age. By the turn of the century, total assets in these schemes had grown to 42% of Chile's GDP, and they were claimed to cover 95% of full-time workers.[47]

Australia, Singapore and Chile have all made personal retirement saving compulsory, but some governments have gone down the voluntary path instead. Argentina set up a system of private retirement accounts in the mid-1990s, allowing workers to transfer from the state system if they chose, and in 2000 Sweden allowed workers to use 2.5% of their payroll tax contributions to fund so-called 'premium accounts' which they manage themselves. Poland too introduced personal retirement accounts in 1999.[48]

In New Zealand, a voluntary superannuation opt-out might work by allowing taxpayers to reclaim income tax up to a maximum of, say, $4,000 or $5,000 per year, in return for which they would relinquish all future claims on the government super system. The taxes thus saved would be deducted from weekly earnings and paid directly into people's personal savings funds, along with their compulsory temporary earnings replacement contribution. All earnings on funds would be tax-free, and savings could only be withdrawn at retirement.

This proposal is different from the superannuation reform proposed by Roger Douglas in that it offers a tax reduction to those who pay income tax, but it does not offer a payment (a 'tax credit') to those who do not. But for taxpayers who decide to opt out, the calculations would be much the same as in the Douglas scheme. We saw earlier that Douglas estimates a $4,000 annual contribution over 47 years of a working life would generate $850,000 in real terms to fund a retirement income. This should be ample to guarantee a reasonable living standard and would generate an income considerably better than anything likely to be offered by the government's superannuation scheme in the future. If more were needed (or if a similar sum had to be built up over a shorter period of time), additional tax concessions could be made available on extra contributions.

Opting out of government health care

With the exception of Singapore, most personal savings schemes introduced around the world have been limited to funding retirement. But the example of Singapore shows there is no reason in principle why personal savings (compulsory or voluntary) should not be used to help fund other provisions such as health care. If people can save enough to pay for their own retirement needs, why shouldn't they also save to meet the cost of less expensive lifetime expenditures such as health care?

One obvious problem with personal health savings accounts is that nobody can possibly know how much money they need to save to cover their future health needs. What if somebody has a prolonged bout of sickness and runs down all their savings? And what about those who require expensive medical treatment, the cost of which far exceeds what they have managed to put aside in a personal account?

To overcome these problems, health savings accounts need to be backed-up by some sort of insurance based on pooled risks. Charles Murray draws a parallel with vehicle insurance: 'Taking care of your health-care needs should be like keeping your car on the road. You pay for the ordinary upkeep with cash and use insurance to protect against expensive accidents.'[49]

Relying on insurance to cover highly-expensive eventualities is itself not without problems, however. Nicholas Barr points out that high risk individuals might try to over-insure while low risk ones decline insurance altogether. [50] There are also some circumstances (inherited illnesses, for example) where people may find it impossible to get themselves insured unless government obliges companies to accept them. Private insurers also have to contend with 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.

Problems like these require a continuing role for government, if not in providing insurance, then in regulating it.[51] Pooled risk difficulties may require laws insisting that everybody insure themselves up to a certain level (while nevertheless leaving the choice of insurer and comprehensiveness of cover beyond the basic level up to them). Similarly, to ensure that everyone can find affordable insurance, government may need to impose 'community rating' and 'guaranteed issue' conditions on the insurance industry.[52]

There is also the problem of cost, for health insurance is expensive. But it could become more affordable if people had access to personal savings which could be used to fund excess payments ('deductibles') on any claims they make. In the USA, the health insurance industry estimates that increasing the size of the deductible by $1,300 reduces the annual premium by $500.[53] Reliance on personal medical savings should also drive down the cost of many routine health care treatments.[54] In part this is because it is cheaper to run a primary health care system based on personal savings than one based on government payments or commercial insurance.[55] It is also because patients who pay for some or all of their treatment from their own savings are more conscious of cost and are therefore more inclined to 'shop around' to find the best bargains. In South Africa, where a system of Medical Savings Accounts has co-existed with private health insurance since 1992, people with their own accounts pay an average of 11% less for their prescription drugs than those who rely on health insurance, for they have a direct financial incentive to seek out the cheapest supplies.[56]

Heightened cost consciousness would reduce unnecessary or trivial use of health care resources

Heightened cost consciousness would also reduce unnecessary or trivial use of health care resources.[57] Indeed, health outcomes might even improve if the incentive to save money was translated into a desire to prevent health problems from occurring in the first place. In Singapore, where a comprehensive system of medical savings accounts ('Medisave') has been running since 1984, health costs have stayed remarkably low by international standards, yet health outcomes measured by indicators like the infant mortality rate are extremely positive.[58]

Introduced into New Zealand, a system of personal health savings accounts, backed up by compulsory catastrophic insurance and by safety net guarantees, could offer people on modest incomes the chance to control their own health care for the first time since the friendly societies went into decline. A system like this would also help slow the rate of increase in health spending in the coming decades, for it should deliver high quality treatment at lower costs by making the final consumers responsible for at least part of the expenditure their treatment incurs.

Everyone could be offered the right to pay a portion of their earnings (up to an annual ceiling) into their personal savings fund to cover routine GP and pharmacy expenses and to buy insurance against medical costs such as hospital treatment. In return, they would pay correspondingly less tax. The total value of government health services which people currently consume obviously varies according to factors like their family circumstances and their age. Douglas estimates a single person would need about $1,500 per year to replace the government services they currently consume, while a couple with two children would need closer to $4,000. If these estimates are correct, these would be the value of the tax reductions that could be claimed by people foregoing their right to government health care. The money would be paid directly into their personal savings fund where it would be used to buy health insurance and to meet routine medical expenses. Any money not used for health purposes in any one year would accumulate to be used for medical or other approved purposes later on.

Direct government funding of schools appears to be the most harmful strategy, for it insulates schools from consumer demand

A note on schooling—necessary churning?

If their tax burden were reduced, many New Zealand households could afford to provide most or all of their own health cover, retirement savings and income insurance from their own incomes. But it is unlikely that many households could afford to pick up the tab for the education of their children. The reason is that schooling is a big cost that recurs every year over an extended period. It also falls at a time in the family life cycle when few parents have reached their maximum earning capacity, when they are facing many other demands on their income (notably housing loans), and when their household income is often depleted by one parent temporarily leaving the workforce or reducing their working hours.

Given that the state requires that all children be educated, the state has to subsidise the cost in one way or another.[59] The crucial issue is how these subsidies can best be organised so they are least destructive of parental responsibility and control over their children's education.

Direct government funding of schools appears to be the most harmful strategy, for it insulates schools from consumer demand. By putting money in the hands of teachers and education managers, it empowers them at the expense of parents and pupils. Directing cash aid to parents so they can buy the schooling they want is a much better option, for it enables parents to retain decision-making powers. By ensuring that schools must compete for customers, this strategy increases the chances that they will pay attention to the kind of schooling parents want their children to have.

One way parental purchasing power can be supported is by giving parents education vouchers. But the problem with education vouchers is that they reinforce the idea that it is the government's responsibility to pay for the services we use. Giving parents a voucher to spend is certainly preferable to the current system of giving the money directly to the education providers, but it still involves extensive churning and creates unnecessary dependency on government. As Roger Douglas suggests, a better solution would be to require parents to pay school fees with their own money, but to help defray the cost by offering them education tax credits.

The key advantage of tax credits is that parents retain the responsibility for paying for schooling out of their own resources. As Jennifer Buckingham explains: 'The benefits of tax credits are non-fiscal: the psychological significance of parents spending their own money, whenever possible; and the diminution of the possibility for state intervention in non-government schools.'[60]

CONCLUSION

The proposals outlined in this paper can be summarised as follows:

- A tax free threshold for income tax should be introduced, corresponding to the welfare subsistence income. Couples who wish to be taxed jointly should be allowed to claim a joint tax-free earnings allowance, equivalent to the welfare minimum for couples. Parents with dependent children will in addition be able to claim the Family Support Tax Credit to help cover the subsistence costs of their children.
- All adults should enjoy the right to relinquish current welfare state entitlements in return for tax reductions. Those who wish to remain in the state system can do so. Nobody should be entitled to cash out more than the total value of the tax contributions they would otherwise be making.
- Voluntary opt-outs would apply to the government superannuation and health care systems. In each case, those opting out would be required to make alternative provision for themselves using personal savings and (in the case of health care) insurance.
- Money spent on the state schooling system should be redirected to parents in the form of tax credits. Every parent would receive an education credit and

would be free to buy an education for their children at a school of their choice (government or private).
- The government's Super Fund should be closed and the funds transferred to new personal savings accounts, one for every adult and child. Workers should then be required to make regular contributions from wages into their funds. The cost of this would be compensated by an equivalent tax reduction.
- The primary use of personal savings funds would be to replace government benefits during temporary periods of unemployment or sickness. For those opting out of government super and health care, however, funds would also be used as retirement savings vehicles and to pay for routine medical expenses and health insurance.

The primary use of personal savings funds would be to replace government benefits during temporary periods of unemployment or sickness

The best way to illustrate how these proposals might work out in practice is to consider their impact on a single person in her twenties with no dependants earning $40,000 pa gross (just below the average full-time wage of $43,000). The example assumes constant prices throughout.

Currently she pays $8,070 in income tax.[61] Under the changes proposed here, her initial income tax liability falls from $8,070 to $6,225 as a result of increasing the tax-free earnings threshold to $11,500—a saving to her of $1,845 every year.

She receives a one-off payment of $3,000 into her new personal savings fund, and is required to pay a certain amount (say 2.5%, or $1,000) into this fund each year to provide her with a replacement income should she become sick or unemployed. Given that her income tax liability is reduced by the same amount, her net income is unchanged by this annual contribution. For as long as she has no unemployment or sickness claims, her fund will continue to grow by $1,000 every year (plus whatever the money in the fund earns) for the rest of her working life.

Suppose she chooses to trade in her eligibility for government superannuation and to opt out of the public health system. She must now make arrangements to look after herself for the rest of her life rather than expecting the government to bail her out.

Her health opt-out means she will reduce her tax liability by $1,500 per year. However, all of this will now be deducted from her income and paid directly into her personal fund to cover her health care expenses. Using this money, she will be required to take out a catastrophic health insurance policy, and the balance will remain in her savings account to pay for routine medical expenses. She might, for example, buy a catastrophic health insurance policy for $1,000 per annum, leaving the remaining $500 in her savings fund to cover expenditure like GP consultation fees and pharmaceuticals purchases (she should be able to negotiate a lower insurance premium if she agrees to a higher excess on any claim she makes).

Her super opt-out entitles her to a further income tax cut of $4,000 per annum, but again, all of this money goes straight into her personal fund to save for her retirement.

Her total income tax bill is therefore reduced by $6,500 per year to compensate for her spending on superannuation, health and unemployment insurance. Together with the tax savings of $1,845 accruing from the introduction of the tax-free earnings threshold, her total annual tax liability is therefore completely wiped, going from $8,070 to zero. However, she only receives $1,845 extra in her net pay, with the other $6,500 going into her personal savings fund to pay for services which were previously the government's responsibility.

Her disposable income is higher than it was before, but more importantly, she now has a personal savings account which will build into a considerable asset over time. The deductions from her salary are now going into her own funds rather than disappearing into a black hole in the IRD, so every year from now on, she is building up her own capital. All this will transform her economic situation later in life.

If she has children, family benefits/tax credits will make her eligible for negative income tax transfers, depending on her income. She may also choose to increase her

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health insurance to cover her children (which would trigger a further reduction in her tax liability), although the state system would continue to cover children's health care by default. She will receive education tax credits to help with the cost of the children's school fees, but as she goes through life she will depend on government for very little other help than this.

If she retires at age 65 after 40 years of contributions, she will have a personal fund made up of three elements:

- her compulsory temporary income replacement contributions of $1,000 per annum, plus earnings on deposits, less any money drawn down in periods of sickness and unemployment;
- her medical savings, plus earnings on deposits, less routine health care expenses incurred;
- her retirement savings, plus earnings on deposits.

Assuming a real rate of compound interest of just 5% p.a. over the 40 years, the retirement savings component alone will be worth $535,519. If we assume that she draws down half of her temporary income replacement contributions in the course of her working life, and that she manages to save an average of $250 p.a. on her medical savings contributions, she will accumulate another $100,410 from these two sources over the 40 year period, giving her a total fund value of almost $636,000. At age 65, a single woman in good health should be able to buy an annuity generating in excess of $30,000 p.a. for about half a million dollars. She can therefore retire on three-quarters of her working salary for the rest of her life, and the remaining $136,000 will be more than enough to pay her continuing health insurance and other expenses.

All of this has been achieved on an annual salary of just $40,000, which is below the current average wage in this country. For people on middle and higher incomes, the prospects look even more encouraging.

But can the government afford it? The major new expense would be the introduction of the Tax-Free Threshold. This might drain $4 billion from government revenues. There is in addition the cost of covering the annual contribution of every full-time worker into the temporary earnings replacement fund, for workers are to be compensated by corresponding tax cuts. If 1.6 million workers paid an average of $1,000 per annum, this would drain another $1.6 billion from the government's coffers.

Opt-outs from superannuation and health are likely to start small and build up over time as people see how well they work. They will also probably appeal most to the young. If, at the outset, 25% of all employed under-30s avail themselves of the full opt-outs, this would cost $550 million in tax revenues foregone, giving a total rough cost in Year One of $6.2 billion. But against this, there are savings. The biggest is the $2 billion per annum saving from scrapping the government's Super Fund. There will also be small savings on health expenditure from people opting out of health (although young people make very light demands on the government health budget), and from scrapping unemployment benefits (about $500 million per year). The bigger savings come longer term—in a lower rate of increase in state health expenditure and a lower future burden on the government's superannuation budget.

Overall, therefore, the policies outlined in this paper might have an immediate cost to the government of $4 or $5 billion per year. To put this in context, the government currently spends $55 billion a year and this year its budget surplus is forecast to be $11 billion.

Notwithstanding these financial calculations, however, the biggest pay-off of all from the implementation of these proposals is likely to be social, not economic. It will come in a gradual rediscovery of the spirit of independence and self-reliance, a spirit which has been trampled and eroded over the last thirty or forty years as the welfare state has taken over more and more responsibility for our lives.

We have seen in this paper that as our society grows richer, the opportunity arises to take more responsibility for ourselves. But if we are to take back control of our own lives and keep government at a manageable and appropriate size over the coming decades, we need to start making structural changes now to our increasingly greedy welfare state. The ideas outlined in this paper are intended as a contribution to a debate that we urgently need to join.

The spirit of independence and self-reliance has been trampled and eroded over the last thirty or forty years as the welfare state has taken over more and more responsibility for our lives

Endnotes

[1] This paper draws on arguments I developed in a series of four papers on the reform of the Australian welfare state: Peter Saunders, *The $85 billion tax-welfare churn* Issue Analysis No 57 (Sydney: The Centre for Independent Studies, April 2005); *Six arguments in favour of self-funding* Issue Analysis No 61 (Sydney: The Centre for Independent Studies, July 2005); *Twenty Million Future Funds* Issue Analysis No 66 (Sydney: The Centre for Independent Studies, December 2005); and *A welfare state for those who want one, opt-outs for those who don't* Issue Analysis No 79 (Sydney: The Centre for Independent Studies, January 2007). I am particularly grateful to Phil Rennie for help and advice in translating the Australian arguments and analysis into a New Zealand context. I also wish to thank Sinclair Davidson, Roger Douglas, Helen Hughes, Stephen Kirchner and Greg Lindsay who all commented at one stage or another on the development of these ideas. The responsibility remains mine.

[2] Phil Rennie, *New Zealand's spending binge* Issue Analysis No 83 (Sydney: The Centre for Independent Studies, March 2007).

[3] http://www.msd.govt.nz/documents/media-information/benefit-factsheets/fact-sheet-income-tested-benefits-06-dec-31.doc.

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

[5] Peter Whiteford, for example, observes: 'The real question is the administrative efficiency of both systems acting together, not the magnitude of "churn"' (response number 5 in the thread on 'Protecting our social security system from churn and burn' Club Troppo Blog, 22 September 2006).

[6] Theodore Dalrymple, 'The Roads to Serfdom', *City Journal* (Spring 2005). On a similar theme, see James Bartholomew, *The Welfare State We're In* (London: Methuen, 2004), pp 333–4; Frank Field, *Neighbours From Hell* (London: Politico's, 2003), pp 33, 95, 98.

[7] Peter Whiteford, comment 21 in the thread on 'Protecting our social security system from churn and burn' (Club Troppo 22 September 2006).

[8] Phil Rennie, *Why tax cuts are good for growth* Issue Analysis No 75 (Sydney: The Centre for Independent Studies, October 2006).

[9] There were 250 friendly society lodges in New Zealand by 1880 (Ian Lythgoe, *Friendly Societies* http://www.teara.govt.nz/1966/F/FreemasonryAndFriendlySocieties/FriendlySocieties/en). On Australian friendly societies, see David Green and Lawrence Cromwell, *Mutual Aid or Welfare State?* (Sydney: Allen & Unwin, 1984).

[10] 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.

[11] Charles Murray, *In Our Hands: A Plan to replace the welfare state* (Washington DC: AEI Press, 2006), p 120. I discussed this problem in my University of Sussex Inaugural Professorial lecture, later reworked and published as 'Citizenship in a liberal society' in *Citizenship and Social Theory* ed. Bryan Turner (London: Sage, 1993).

[12] See Peter Saunders and Nicole Billante, 'Does prison work?' *Policy* 18:4 (Summer 2002–2003), pp 3–8.

[13] See Muriel Newman, 'A recipe for a successful welfare system', 21 May 2002, www.act.org.nz/action/murielnewman.html.

[14] Peter Berger and Richard Neuhaus, *To Empower People* (Washington: AEI Press, 1987).

[15] Table reconstructed from Table 5.1 in James Cox, *Middle Class Welfare* (New Zealand Business Round Table, Wellington, 2001), p 128.

[16] They get less than their proportionate share of education spending (just 29%), and only just above their proportionate share of health spending (45%). They also get 61% of income-tested benefits, 62% of family payments and 75% of superannuation assistance.

[17] James Cox, *Middle Class Welfare*, pp 159–60.

[18] Ann Harding, 'Lifetime versus annual tax-transfer incidence: How much less progressive?', *The*

Economic Record 69 (June 1993), Tables 1 and 3.

[19] Jane Falkingham and Ann Harding, 'Poverty alleviation versus social insurance systems'. These estimates are based on the tax and welfare system as it existed in Australia in 1986, but I have updated Harding's figures to 2006 prices.

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

[21] In 2006 prices, the richest lifetime income decile receives $92,700 worth of education, compared with $79,500 received by the poorest: Ann Harding, *Lifetime Income Distribution and Redistribution.* Simultaneous and lifetime churning of education spending is discussed in detail in Mark Harrison, *Education Matters* (Wellington: The Education Forum, 2004), ch 5.

[22] Harding, *Lifetime Income Distribution and Redistribution*, p 168.

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

[24] S Foelster, 'Asset-based social insurance in Sweden' in eds S Regan and W Paxton (eds) *Asset-based welfare: International Experiences* Institute for Public Policy Research, London, 2001, p.75

[25] These and subsequent figures are taken from the Ministry of Social Development website, http://www.workandincome.govt.nz/get-assistance/rates-info.html

[26] The issue of topping up earnings of low-paid part-time workers is more complex. I discuss it in Appendix I of my forthcoming book, *The Government Giveth, and the Government Taketh Away* (Centre for Independent Studies, forthcoming)

[27] Martin Feldstein and Daniel Altman, *Unemployment Insurance Savings Accounts* (Cambridge Mass: National Bureau of Economic Research, December 1998). See also Lawrence Brunner and Stephen Colarelli, 'Individual unemployment accounts', *The Independent Review* 8 (2004), pp 569–585.

[28] 'Doling up the dole', *The Economist*, 23 September 2006, p 80.

[29] There were 57,745 registered births for the year ended 2005 (see Statistics New Zealand *Demographic Trends 2006 reference report*, http://www.stats.govt.nz/analytical-reports/dem-trends-06/default.htm). If each child is given $3,000 into their personal fund at birth this will have an annual cost to the government of $174 million. Invested in trust at, say, 5% real compound rate of return, a new-born child's $3,000 would be worth $6,237 in constant money terms by the time they reached 15, even with no additional deposits in the intervening years.

[30] Although there are still weaknesses and uncertainty surrounding New Zealand Super, with one academic describing the current position as '… more of a cease-fire than a genuine accord on this matter', Dr Andrew Ladley, Director of Institute of Policy Studies, in the foreword to Richard Hawke, *Retirement Income Provision in New Zealand: A Way Forward* (Wellington: IPS, 2005).

[31] Michael Cullen speech, http://www.beehive.govt.nz/Print/PrintDocument.aspx?DocumentID=11285.

[32] See Australian Chamber of Commerce and Industry, *The Future Fund is Not the Best Use of Budget Surpluses* (Canberra: ACCI, 2005); Stephen Kirchner, 'Future Fund or future eater?' *Policy* 22:3 (Spring 2006), pp 28–35; Alan Wood, 'Income tax reform beats parking our money in Costello's future fund', *The Australian*, 9 December 2006.

[33] Vern Hughes, 'A cure for health care' *Policy* 20:1 (Autumn 2004), pp 22–27; Noel Pearson, *Welfare Reform and Economic Development for Indigenous Communities*, CIS lecture, Sydney, 25 October 2005. Hughes proposes that individuals should be permitted to divert their share of government health expenditure to health care cooperatives of their choice, and Pearson advocates a similar model of communal Medicare opt-outs for remote Indigenous communities.

[34] Roger Douglas's ideas have been developed in a number of publications including *Unfinished Business* (Auckland: Random House, 1993); *Reform of New Zealand Public Services* (paper delivered to CIS, May 2003, available from PO Box 97-161, SAMC, Auckland, NZ); *Welfare reform symposium*, paper delivered at ACT Party symposium, Parliament Buildings Wellington, August 2004, available from http://www.rogerdouglas.org.nz/welfsym1.htm; 'Can New Zealand fly again?', interview with Susan Windybank in *Policy* 19:2 (Winter 2003), pp 21–7. What follows is based on all of these sources, with later publications superseding earlier ones where policies appear to have changed.

[35] Douglas, *Reform of New Zealand Public Services*, p 13. All figures are NZ dollars.

[36] He accepts there will be a long transition period until everyone who began work before the change was introduced reached retirement age. For these people, entitlements built up in the existing system would still be honored, alongside benefits from their personal super fund.

[37] In *Unfinished Business*, ch 6, Douglas also proposes a second compulsory health insurance, costing 2–2.5% of income each year from age 18, to cover health insurance premiums after the age of retirement.

[38] This is also my basic objection to Charles Murray's recent call for an unconditional guaranteed minimum income (Charles Murray, *In Our Hands: A Plan to replace the welfare state*). Murray argues that all existing welfare payments should be scrapped, government retirement pensions should be abolished and Medicare should be dismantled. All the money saved should then be used to give everybody over the age of 21 an annual payment of US$10,000. But he underestimates the impact a money-for-nothing lifetime government payment is likely to have on the way people start to think and behave. If you offer everyone money for doing nothing, you will most certainly end up with more people deciding to do just that.

[39] Welfare economists generally believe that policy should strive for a condition of 'Pareto optimality,' where nobody can be made better off without someone else being made worse off. If a change is possible which benefits one person and leaves others undiminished, then the change should be made. This is the case with these opting out proposals.

[40] For an example of this argument see http://www.fulbright.org.nz/voices/axford/docs/axford2006_blumberg.pdf.

[41] I have been arguing for many years that rising affluence is driving an increasing popular demand and expectation for private provision in areas such as health. These aspirations should be enabled wherever possible by governments, not deliberately thwarted. See Peter Saunders, *Social Theory and the Urban Question* (2nd edition) (London: Hutchinson, 1986), ch 8.

[42] Treasury, 'Key facts for taxpayers' (Wellington: Treasury, 2006), http://www.treasury.govt.nz/budget2006/taxpayers/default.asp

[43] Bruce Headey, Diana Warren and Glennys Harding, *Families, Incomes and Jobs* (University of Melbourne, 2006), pp 43–47

[44] Cox, *Middle Class Welfare*, p 119; Statistics New Zealand, *Survey of Family, Income and Employment Dynamics* (Wave 3)(Wellington: Statistics New Zealand, September 2005).

[45] Commonwealth of Australia, *Budget Overview* 2002 (Canberra: Treasury, 14 May 2002), p 5.

[46] David McCarthy, Olivia Mitchell and John Piggott, *Asset rich and cash poor: Retirement Provision and Housing Policy in Singapore* Pension Research Council Working Paper, Wharton School, University of Pennsylvania, 2001; Luke Buckmaster, 'Medical Savings Accounts: a possible health reform for Australia?' Parliamentary Library *Research Note*, 23 March 2006, Parliament of Australia.

[47] McCarthy et al, *Asset rich and cash poor: Retirement Provision and Housing Policy in Singapore*.

[48] Bob Davis and Matt Moffett, 'From nations that have tried similar pensions, some lessons', *The Wall Street Journal*, 3 February 2005.

[49] Charles Murray, *In Our Hands*, p 43.

[50] Nicholas Barr, *The Welfare State as Piggy Bank* (Oxford University Press, 2001), pp 17 and 52–3.

[51] Of course, as Barr points out, the more modifications and requirements we introduce into the organisation of private insurance systems, the closer we come to a socialised, government-run, insurance scheme. Nevertheless, the point remains that the difficulties can be overcome through sensible use of regulation, and Barr himself offers examples of private insurance initiatives in the USA which have successfully resolved many of the problems he identifies (for example, the Stanford University employee health scheme)—see Nicholas Barr, *The Welfare State as Piggy Bank*, p 65.

[52] Interestingly, Charles Murray insists that $3,000 of his proposed $10,000 annual hand-out to all citizens should be earmarked for purchase of health insurance (that is, insurance would be compulsory), and he also insists that insurers should be required by law to treat the entire population as a single risk pool.

[53] Marilyn Moon, Len Nichols and Susan Wall, *Medical Savings Accounts: A policy analysis* (Washington: Urban Institute, March 1996), www.urban.org/publications/406498.html.

[54] Thomas Massaro and Yu-Ning Wong, 'Positive experience with Medical Savings Accounts in Singapore,' *Health Affairs* (Summer 1995), pp 267–72, draw an interesting comparison between Singapore and Hong Kong and conclude that, 'Singapore has developed a very sophisticated health care system over the past decade at much less than the world market price' (p 270). Hong

Kong is also a prosperous city-state with a strong Chinese heritage of personal savings but has no MSA programme. From 1984–1990, it increased real health spending by 13.1% per year compared with Singapore's 11%, yet its economy grew more slowly (6.7% real annual GDP growth compared with 8.3%).

[55] Greg Scandlen, 'It is far less expensive for a provider to present a bill and be paid at the time of service than it is to file a claim and wait, often for weeks or months, to be reimbursed by an insurer … MSAs can be a windfall for all', *Policy Backgrounder* No 157 (Washington DC: National Center for Policy Analysis, November 2001), p 9. See also Richard Epstein, 'Medical Savings Accounts', *Australian Private Doctor* 17:1 (May 2005), p 19.

[56] Michael Cannon, 'Answering the critics of health accounts', *Brief Analysis* No 454 (Washington DC, National Center for Policy Analysis, September 2003).

[57] The obvious concern here is that people might put their health at risk by trying to cut their treatment costs, but studies suggest this does not happen. In a US randomised trial, people using heavily-subsidised health plans achieved no better health outcomes than a group which had to meet more of its costs from their own pockets, and in South Africa, researchers found no evidence of MSA patients foregoing necessary treatment in an attempt to protect their savings. See Cannon, 'Answering the critics of health accounts'.

[58] Singaporean workers pay between 6 and 8% of wages into their Medisave funds, and this money is dedicated to payment of hospital fees when required (GP services, outpatient care and long-term care are excluded). When they reach age 55, they are permitted to withdraw unused balances over and above a legal minimum deposit and to use the surplus cash for other purposes. They can also pool their funds with other family members. Those who have insufficient funds to meet their hospital bills can get help from a government safety net called 'Medifund'. Everyone also enjoys catastrophic health insurance through the government's 'Medishield' scheme, and older, disabled people can get help from another government scheme, 'Eldershield'. See Luke Buckmaster, 'Medical Savings Accounts—a possible health reform option for Australia?', Parliament of Australia *Research Note*, 23 March 2006, Parliamentary Library, Canberra. Also Mukul Asher, *Compulsory Savings in Singapore: An alternative to the welfare state*, National Center for Policy Analysis Policy Report No 198, 1995.

[59] It is noticeable that most libertarian blueprints for reforming the welfare state stop short of recommending that government withdraw its funding of education. Murray's *In Our Hands* makes no recommendations for stopping state funding of schooling. Nor does Roger Douglas in *Unfinished Business.*

[60] Jennifer Buckingham, *Families, Freedom and Education* Policy Monograph No 52 (Sydney: The Center for Independent Studies, 2001), p 73. Buckingham's book contains an excellent, detailed outline of how education tax credits might work.

[61] Treasury, 'Key Facts for Taxpayers' (Wellington: Treasury, 2006), http://www.treasury.govt.nz/budget2006/taxpayers/default.asp.

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