RESEARCH REPORT
SNAPSHOT

THE CENTRE FOR INDEPENDENT STUDIES

MEDI-MESS: Rational Federalism and Patient Cost-Sharing for Public Hospital Sustainability in Australia

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A state income tax will save the states from Medicare

The rejection by premiers of Prime Minister Malcolm Turnbull's 'tax swap' federalism reform proposal at the April 2016 COAG meeting shows state governments are yet to understand why their best interests would be served by levying a state income tax to fund the cost of their health services.

The only recourse open to state governments to save themselves from the financial blight of Medicare is by advocating rational federalism and genuine reform in health and entering into 'hard conversation' with their electorates about the future of public hospitals.

Revision of the federation is imperative to end the federal meddling in state health systems—which has jeopardised the state finances—and to allow the states to reclaim full control over both the funding and policy responsibility for health. This would enable them to make the rational health policy decisions that their rigid and financially onerous obligations under Medicare currently prevent.

Medicare is the problem

Since the establishment of Medicare in 1984, the federal government has funded state health services on the condition that state owned and operated public hospital care is delivered to all Australians without charge at the point of consumption.

The federal government's control of the overall health policy framework prevents state governments taking effective action to address the critical demand-side issues that perpetuate unaffordable growth in public hospital services costs that threatens to swamp state budgets in coming decades.

Without price signals, demand for universal free access to hospital care will inevitably grow faster than supply, and the inherent moral hazard causes over-use and over-servicing for doubtful health gain. Since 1984, the need to control the financial risk of paying for potentially unlimited free public hospital care has forced state governments to ration access to public hospital services.

Under Medicare, the irreconcilable policy objectives of increasing 'free' access, while containing the cost of a 'free' system, has created the public hospital 'mess'—a dilemma that state governments understandably find impossible to solve under the existing health policy settings.

Dilemma of a free system

Under the terms of the 2011 federal health funding agreement, all Australian public hospitals are now funded on an activity basis, where possible, for each occasion of service they actually deliver; and are remunerated at the 'national efficient price' (based on average costs across the public hospital system nationally).

Activity-based funding and other supply-side initiatives—including micro-economic reforms such as outsourcing the delivery of public hospital care to more efficient private sector providers—can be important to reduce waiting times, increase community access to care, and enhance policymakers' ability to achieve the best value for taxpayer's dollars by extracting the maximum level of services obtainable from available health resources.

However, the overall effect on the cost of hospital services to government budgets could prove more expensive. Since activity-based funding creates an incentive to treat more patients, the consequent higher service volumes mean the more productive hospitals, even if they are funded at supposedly efficient prices, may cause the total cost of public hospital care to increase. This intensifies the need to contain costs by rationing, with resultant queuing and intractable waiting times.

Hence the long-term projected cost of even 'efficient', 'free' public hospital services is unsustainable in an ageing and growing Australia. The scale of the 'hospital funding crisis' under the current Medicare setting is indicated by the states' unrealistic calls for the federal government to either fully restore the 2014 Budget '$50 billion cuts' to federal hospital funding over 10 years , or increase the Goods and Services Tax (GST) from 10% to 15% to pay for state health services – a 50% tax hike that would represent the largest single peacetime taxation increase in Australian history.

Federalism and demand-side reform

To avoid the financial calamity of fundamentally unsustainable free hospital systems, state governments must lead the way on reform of federal-state financial relations to safeguard their own budgets from Medicare.

Reform of the federation can be driven only from the bottom up when states exercise their right to take back their income tax powers—which would initially be equivalent to the amount of federal hospital funding. This would effectively release a state from its obligation under Medicare to provide free public hospital care, and free them to undertake the demand-side policies that are key to sustainable hospital services.

The percentage of the federal income tax surrendered would thereafter be designated 'state income tax', and could rise or fall as determined by participating states and as necessary to meet the cost of public hospitals. The political responsibility for raising the state income tax rate would encourage states to undertake the demand-side initiatives to control the use and contain the cost of public hospital care.

To make public hospital systems sustainable, state governments need to enlist the help of the people, and start asking citizens to accept greater personal responsibility for health.

To better manage demand for hospital services, state health policy should include patient cost sharing in the form of a compulsory co-payment for public hospital treatment, which should be introduced as a 'revenue neutral' measure to pre-empt equity and electoral concerns.

Quarterly compensation could be automatically paid to all households in the state equivalent to the actuarial cost of a typical household's expected co-payment charges—regardless of whether or not they accessed public hospital services.

Not all jurisdictions may have the appetite for a state income tax—let alone demand-side hospital reform. An alternative 'opt-out' approach would be to permit one or more states individually and voluntarily to commit to assert their income tax powers and simultaneously reclaim authority over public hospital policy to pursue their own path in budgetary and hospital system sustainability (see Box).

Box 4: An opt-out model for federalism reform

- Optional reform of the federation, state-by-state, in an indirect but constitutionally valid form would still be possible. For states acting alone, this could be done if the federal government were to agree to:
  - A. Convert the existing federal specific purpose payment for state health services into a general purpose payment. This would simultaneously release the state from its Medicare obligation to provide the free public hospital care inherent in the conditions of the specific purpose grant.
  - B. Index the general purpose payment to the amount of health funding the state would otherwise receive according to the formula used to distribute health funding to other states.
  - C. Identify the value of the general purpose payment with the equivalent percentage of federal income tax revenue collected in the state. This would become the 'public hospital levy' in all but name.
  - D. A state could, if it wished, supplement the federal public hospital levy either by imposing its own income tax surcharge or levy or by issuing a tax rebate under its own legislation but administered by the ATO.

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