

RESTOCKING THE ECONOMIC TOOLKIT: CHANGES TO SOCIAL POLICY AND THE ABILITY OF THE STATE TO MANAGE THE ECONOMY

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Recent election campaigns have been dominated by the theme of ‘responsible economic management’. Both major political parties have sought to take credit for the long economic boom in Australia. Yet, increasingly financial markets and economic commentators see governments and politicians as largely irrelevant to the task of economic management. Decades of deregulation and privatisation have removed, or placed political constraints on the use of, many of the traditional levers of economic policy.

The efficacy of the new policy-free economic model remains contested by political economists. Many continue to argue for more traditionally interventionist approaches, from a formal industry policy (Stilwell 2000) through to more radical interventions (e.g. Frankel 2002; Mitchell & Mosler 2002). Many of these proposals have merit. However, within the current framework, policy options are confined.

This article draws on an earlier Keynesian approach to Australian social policy and an emerging economic literature on welfare provision to argue for a renewed focus on the economic implications of welfare state policies. A number of social policy analysts have argued that Australia’s model of social policy has often used economic policy tools and goals – such as macroeconomic stabilisation, arbitration and full employment – as the basis for achieving social policy outcomes (Castles 1985; Smyth 1994; Cass & Freeland 1994; Battin 1997). Here I wish to focus on the reverse, that is how the policies of the welfare state play a role in the traditional jobs of economic policy, particularly in the context of the

(largely ideological) constraints that many claim prevent governments from utilising other more traditionally 'economic' tools.

Social Policy and Economic Policy

The distinction between economic and social policy is a contentious and not always useful one. However, since the 1970s, there has been significant change in the policy frameworks generally associated with economic management – such as interest rates and exchange rates, public ownership, trade policy and industry policy. Yet the scale of public spending, largely connected to the welfare state, has, if anything, increased. This suggests different political dynamics, and makes it more useful to distinguish between economic policies where the deliberative role of the state has been curtailed and welfare state or social policies where government appears to be playing a larger role.

Demographic changes, such as population ageing, along with the rise of an affluent consumer culture, have changed the way governments interact with the economy. Many of the biggest economic challenges facing the long economic boom are now fundamentally problems of social policy. The declining size of the workforce, increased dependency ratios, rising inflation, the shortage of skilled labour, even production bottlenecks – many of these problems are best understood as problems of social policy, or are at least significantly connected to social policy decisions. While the economic debate in Australia has been focused on the narrow confines of aggregate public spending, social policy reforms have perhaps become more crucial to achieving longer term economic goals.

A number of social policy analysts have highlighted the economic costs associated with under spending and privatisation in individual areas of social policy. Similarly, many economists have focused on the economic, as well as redistributive, role of welfare state policies (Barr 2001; Quiggin 2007). My aim is to build on this analysis to make a broader argument about how social policy can be used in a coordinated way to achieve desirable social outcomes and address some of the challenges now facing the boom. In effect this is an argument to reunite the analysis

of economic and social policy and to examine the role of the state in managing both these spheres.

This article begins by addressing the emerging consensus amongst many financial and economic commentators that governments are less and less responsible for the task of macro economic management, and the policy changes that have given rise to this perception. It then develops the claim that demographic, political and cultural dynamics are making social policy more important to economic management. The bulk of the article then briefly addresses four areas of social policy – education, health, housing and pensions – to outline, in a preliminary way, how the shift from public to private provision threatens broader economic goals.

Managing the Economy

In both the last two federal elections the incumbent Coalition Government made much of the economic boom. The Coalition has claimed credit, or at least partial credit, for the long period of sustained economic growth that has seen the official measures of unemployment at thirty year lows (Howard 2007). This no doubt reflects the sustained public support for the Coalition as a superior ‘economic manager’, reflected in opinion polls and public commentary (Shanahan 2007; Lebovic 2007).

However, the economic policy competence claimed by the Coalition, and reflected in public opinion, is not generally shared by commentators or analysts. Financial markets appeared to be indifferent between the parties, with little movement in the lead up to, or post the election (Moncrief 2007). Likewise, a number of academics and commentators have instead credited the boom to the economic reforms undertaken by the Hawke and Keating Labor Governments (Edwards 2006; Charlton 2007).

This later claim is of particular interest, because it ascribes credit for the boom to a fundamental realignment of the Australian state that, in the minds of its advocates, effectively removed much of the state’s capacity to directly manage the economy. Thus, Ross Gittins has argued that the state no longer plays the role of economic manager:

If you think [the role of the federal Treasurer is] to manage the national economy, that's what you're meant to think. But although the politicians on both sides want you to believe it, it hasn't been true for a long time. (Gittins 2007).

The changing perspectives of market commentators have a firm basis in changing policy frameworks. The past 30 years have seen a significant shift in public policy in which many traditionally Keynesian mechanisms of managing the economy have been dismantled (Battin 1997). The currency has been floated. Monetary policy has been left to the Reserve Bank (admittedly an arm of the state, although not of discretionary government policy). Industry policy has been significantly downgraded. Tariffs have been cut. Publicly owned sectors of the economy have first been corporatised and then privatised (see Pusey 2003, Appendix A; Edwards 2006, Ch 2).

These changes do not necessarily mean a reduction in the role of the state, merely a changed role (Block 1994). However, the success of economic reformers has refashioned the Australian state from one that embraced many of the principles of Keynesian interventionism, to one that increasingly allows market mechanisms to coordinate adjustments to changing economic circumstances. So while the reforms may not have reduced the role of the state *per se*, they have changed that role and, in doing so, increased the importance of market mechanisms to the coordination of economic life.

Yet these same processes have been far less effective at restricting the state's role in social policy. While interventionist economic policy has been in retreat, social policy has continued a forward march. Each election has seen new social policy initiatives expanding the role of the state – from baby bonuses to childcare rebates, from family benefits to subsidies for health and education. These new initiatives have come on top of a steady increase in funding for hospitals and aged care facilities. There has been a suite of policies around population ageing, childcare, education and health.

Each of these initiatives has reflected a particular approach to social policy provision, favouring private subsidy to enable choice rather than direct public provision. Many advocates of increased social spending

have criticised the nature of various initiatives, such as family payments and child care (Summers 2003), health policy (Gray 2005; Deeble 2003) and education funding (Marginson & Considine 2000). However, it is important to note that social spending has not been in decline. Indeed, the contrary is the case.

This point has not escaped the advocates of further economic reform. Neoliberal advocates attacked the Coalition for what many of them term 'big government conservatism' (Norton 2006). After initial cuts to government spending in 1996-97, the Coalition Government oversaw significant spending increases. The rise was so significant, that despite a booming economy, once debt servicing is removed, government spending actually increased as a proportion of GDP over the Howard years (Norton 2006: 16). More recently the Commonwealth Treasury has released a report claiming that were it not for the favourable movement in the terms of trade owing to the resource boom, government expenditures as a proportion of GDP would have risen significantly (Laurie & McDonald 2008).

The growth of social spending no doubt reflects complex and often contradictory causes. Public choice theory, favoured by free market think tanks, has long identified incentives for governments to 'over spend', based on the concentrated benefits of spending and the diffuse costs of taxation (see Buchanan & Tullock 1962). Australia's system of progressive income taxation also provides an in-built mechanism to lift government revenues. However, there are other structural reasons that militate in favour of greater public spending.

The best publicised of these factors is the ageing of the population. The Coalition spent considerable energy and resources addressing this issue. Treasury has released two Intergenerational reports (Treasury 2002; Treasury 2007a), in addition to a Productivity Commission report (Productivity Commission 2005) into the economic effects of ageing. While ageing has been viewed as an economic problem, the solutions have continued to be framed in conventional economic ways, with little attempt to understand how alternative social policy approaches might impact on future economic implications.

Treasury claims the costs of ageing are significant, leading to a substantial fiscal shortfall by mid-century and a slowing of economic growth (2007a). The increasing costs in healthcare, and the relatively slow decline in education expenses, predicted by Treasury, reflect the nature of public services. Health, education and aged care are all superior goods. As incomes rise, so the proportion of income spent on these services increases. All these areas are primarily funded by public provision. Thus, as these areas expand relative to the rest of the economy there is a tendency for public spending to rise.

For many the natural conclusion is to solve the fiscal deficit through a small increase in taxation. If people are willing to spend more on health care, and people prefer public health to private health, as surveys suggest they do (Wilson, Meagher & Breusch 2005), then raising taxes to meet the new demand seems justified. However, Treasury explicitly rejects this option.

The costs of social services are also increasing more rapidly. Health, education and housing have experienced higher than average inflation rates for at least the past decade (ABS 2007a).¹ The price index for the education group has increased over 40% between 2000 and 2007, in the health group by over 50% and house prices have also increased over 50% - all well above the average rate of inflation.

These industries are labour intensive, making productivity gains more difficult and making them more vulnerable to labour scarcity. Health is also subject to increasing costs of new technologies, and housing to scarcity issues. The failure to address these issues has added to inflationary pressures.

Social policy, then, appears increasingly important. Spending is growing driven by political, demographic and economic trends. The direct benefits of providing these services more efficiently are significant. However, there are other broader economic benefits as well.

Four key social policy areas – education, housing, health and retirement incomes – illustrate these broader implications. In each of these four areas the focus of social policy has shifted from direct public provision

1 The ABS time series data does not go back beyond 2000 in all cases.

of relatively universal services (with the exception of housing) to an increasing reliance on market mechanisms and the subsidy of private provision. The following survey of these four social policy areas is far from comprehensive. The issues of workforce participation or fertility that arise from policies primarily directed towards women are not considered, for example.

Education

Education was highlighted during the 2007 federal election as an issue, not only of social policy, but also of economic policy. It has long been recognised that education has a significant effect on economic well-being and growth (OECD 2007; Schleicher 2006). In Australia numerous economic commentators have pointed to the need for greater investment in education (e.g. Edwards 2006), and the danger that a lack of investment can generate a skills shortage. Concerns about a skills shortage have focused on both some blue-collar trades and a number of professionals working in social service delivery, such as nurses and teachers. In most of these areas public policy heavily influences supply to these labour markets.

The past decade has also seen a significant reduction in per student funding of technical and vocational education and a shift of resources from public to private provision. Using government statistics, the Teachers Federation estimates that federal per student real funding for the sector declined by 26.3% between 1997 and 2003 (Bradley 2005).

In response to the emerging skills crisis the Howard Government increased funding to technical and vocational training, but did so by establishing a new system of colleges, separate to the state run institutions that provide the great bulk of such training at present. Private schools were eligible to tender to run the new Australian Technical Colleges (ATCs), and they are run by an independent board chaired by a local business representative (AEU 2005: 4). The duplication of services has led to a much higher cost structure, with the cost per graduate in the ATCS being more the double that of existing public providers (Bartlett 2007).

University education provides a somewhat exceptional case within the Australian welfare state, in that rising demand has not translated into higher costs. This is largely due to the capacity for cross subsidisation from non-citizen international students (and to a lesser extent increases in fees for domestic students). Australia is alone in the OECD in reducing its public spending in this area between 1997-2004 (OECD 2007, 217). At the same time there has been a significant increase in funding from private sources (OECD 2007, 222).

This funding structure raises a number of concerns. Some of these are less specifically economic, such as the nature of graduates and of universities. There are concerns, though, about the sustainability of the current model. International student numbers to traditional destinations (e.g. USA) have already flattened and there is substantial growth in the number of university positions in neighbouring countries, especially China, creating increased competition (AEI 2006, 2-3). Increased reliance on fee paying students has also raised quality concerns (e.g. Jobson & Burke 2005; Patty & Alexander 2007), that have reputational implications for future student numbers. As education now represents Australia's third largest export sector (ABS 2007b), any damage to the sector's international reputation could be significant.

However, the most significant shifts in public policy are those aimed at school education. Over a number of decades there has been a steady shift in federal education spending patterns in favour of private education. In the late 1970s the Commonwealth spent approximately two and half times as much per private student as it did per public student. That figure is now almost five times (Dowling 2007, 3).

There has also been a shift within the private sector, with greater funding increases going to relatively affluent independent schools compared to relatively poor Catholic schools (Cobbold 2007). Even a recent review by the federal Education Department reportedly recommended significant reductions in funding to some private schools based on equity considerations (Patty 2008a).

The shift in funding threatens to reinforce the existing inequalities of Australia's education system. While Australia performs well in average test scores compared to other rich countries, the range of results, and

their relationship to socio-economic status, reveal a much higher degree of inequality than elsewhere (Keating & Lamb 2004; McGaw 2003). Australia's school education system is also becoming more segregated, driven by increasing numbers of private schools, public selective schools and greater freedom to study out of area. Research from both the Secondary Principals Council and the University of Western Sydney has raised concerns over increasing racial segregation and tension (Patty 2008b).

Reinforcing such inequalities, or even tolerating and reproducing them, threatens longer term economic goals. Poor educational outcomes are associated with numerous costs, such as higher incarceration rates and poor health, and forgone benefits, such as loss of production and taxation revenues.

In California, for example, state authorities have reportedly begun to use fourth-grade reading level results to determine future demand and investment in the prison system (Block & Weisz 2004: 19). Individual studies have shown returns of up to 700% on early intervention educational programs (Reynolds, Temple, Robertson and Mann 2002).

Concentrating and reproducing intergenerational disadvantage leads to a dislocation of those affected from the labour market. Tony Vinson's (2007) social surveys reveal a clustering of disadvantage, much of it related to educational attainment. These concerns are also central to the previous Government's concerns about 'welfare dependency'. Indeed the Government recognised this effect as a key threat to workforce participation (Treasury 2005; FaCS 2000). A declining workforce is identified by the Productivity Commission as the most serious economic threat posed by the ageing of the population (2005: 47-91).

Interestingly, the most comprehensive analysis of the effects of education spending on economic growth, Peter Lindert's study of economic growth and the welfare state, reveals that, not only does education spending increase growth, but *public* education spending increases growth in particular. The main reason for this, Lindert argues, is that public education is more accessible to a greater proportion of the population. In other words, it produces a quantity effect on labour supply (2004: 32).

Alternatively, the current funding system reinforces inequalities. It is based on a formula that links per student funding in the private system to per student costs in the public. As funding has shifted to the private system, so have students. However, this shift has been concentrated amongst the most affluent and socially advantaged cohort of students. This has meant that disadvantaged students now make up a larger proportion of the public school student body, increasing the average cost per student in the public system (Dowling 2007: 5).

Under the federal funding system this has resulted in further increases in private school funding. In other words, the current funding system rewards the private system for creaming off the easiest to teach students, and places further pressures on a public school system that does the majority of the work of teaching those in greatest need.

As a result, education policy is not only contributing to a range of capacity constraints. A lack of planning and funding in technical training has interacted with lower unemployment and the minerals boom to produce a skills shortage. But potentially of more import is the inequalities promoted in schools education. These policies directly contribute to intergenerational disadvantage that is closely tied to lower labour force participation. As population ageing increases dependency rates, so education policy threatens to turn this into a genuine capacity constraint that could increase inflationary pressures.

Housing

Housing affordability was also a key election issue in November, 2007. In terms of purchasing a home, housing affordability measures show a sharp deterioration around 2003, which has yet to be reversed. In 2007 the average monthly repayment on a typical first-home mortgage rose above \$2,000 for the first time (HIA 2007). The number of low-income households experiencing housing stress, defined as spending more than 30% of their gross income on housing, was over 850,000 in 2002/03, the majority of whom were private renters (Yates & Gabriel 2006).

Julian Disney summarises the changes taking place in the Australian housing market. Over the past 10-15 years he notes that house prices

have roughly doubled, the proportion of first home buyers has fallen by 20%, the proportion of low rent homes has fallen by at least 15% and the opportunities to rent in public housing have declined by about one third (Disney 2007a). In addition, recent interest rate increases, on top of high house prices, have led to an increase in mortgage foreclosures, particularly in New South Wales, a situation that was well under way prior to the recent subprime crisis (RBA 2007).

There is also growing acceptance that the combination of policies, particularly at the federal level, effecting investment in housing generates some of these problems. Government provides at least \$25 billion in assistance to the housing sector (Disney 2007b). The vast bulk of this assistance is in the form of tax concessions on owner occupied housing.

Australia's combination of tax exemptions on the family home and restrictions on private rental accommodation have produced high rates of private home ownership. More recently, however, this has been combined with an increased emphasis on subsidy of private rental provision over public housing. One of the most controversial elements of this is negative gearing, which allows investors to claim a loss on an investment property, including a loss due to high interest repayments, against other income.

Negative gearing has been criticised as expensive, poorly targeted and as leading to unfortunate unintended consequences. There is some evidence that the concession leads to an increase in housing supply in the long run due to increased demand. However, the increased demand effect also raises all property prices, leading to additional affordability issues (Hanegbi 2002). In addition, much of the concession is effectively capitalised in higher house prices, reducing the benefit to renters and instead delivering substantial gains to generally wealthier investors and existing homeowners.

The Hawke Labor Government briefly removed negative gearing during the 1980s. Housing construction did appear to slow during the period the exemption was removed (Hanegbi 2002). The evidence on rents is less conclusive, with rapid increases in inner-Sydney, but stability or even declines in other markets (Hayward & Burke 1988). A strong political backlash, however, saw the exemption quickly reintroduced.

More recently, changes to capital gains tax have exacerbated the problems generated by negative gearing. In 1999, in response to the Ralph Review of taxation, the Coalition Government changed the formula for capital gains tax. Rather than being applied to the real capital gain, capital gains tax on investments held over 12 months is now only applied to half the nominal realised gain. In a period of low inflation and high asset price inflation these changes effectively halve the rate of capital gains tax.

The capital gains tax concession costs almost \$7 billion per year (Treasury 2007b: 10), while negative gearing is estimated at costing \$3-4 billion (Colebatch & Maiden 2005). At the same time, investment in public housing, which provides direct low cost housing, has fallen significantly (Disney 2007a).

In 2004 the Productivity Commission, in its report into housing affordability, singled out these changes for special comment. The Commission acknowledged that much of the increase in housing prices was due to the combination of low inflation and low interest rates, which had increased borrowing capacity and thus fuelled housing demand. However, it also argued that the interaction of changes to capital gains tax and the existing negative gearing provisions had produced a pro-cyclical policy mix:

Nonetheless, aspects of those provisions, particularly the CGT (Capital Gains Tax) arrangements, appear to have 'pro-cyclical' effects that potentially distort investment flows whether into housing or other asset classes. (Productivity Commission 2004: xxv).

The combination of tax policies, then, contributes not only to unaffordability, but also to macro economic instability. Negative gearing encourages investment that is focused on capital gains rather than producing an ongoing income stream. The capital gains tax concessions then reduces tax on this capitalised gain. The net effect is not only asset price inflation – the underlying cause of housing unaffordability – but also speculative flows of investment into assets that are experiencing rapid capital gains.

What is less well recognised is that the tax policy combination is also pro-cyclical. As George Fane and Martin Richardson have pointed out, the new capital gains tax system cuts tax on capital gains when these gains are significantly greater than inflation. But because the tax is now applied to nominal gains, the same system actually increases tax on capital gains if the gains are less than twice the rate of inflation (Fane & Richardson 2005: 251). The net result is likely to be the exaggeration of booms and busts in the housing market. There is already some evidence for this. The proportionate high and low in borrowings for investment housing during the last cycle (2001-2005) was greater than in previous cycles during the 1990s. This was not the case for owner-occupied housing credit (RBA 2007: 13).

Fortunately, the recent decline in the housing market has not fed into a broader economic decline, partly because the resource boom has offset the negative impact for the economy as a whole. However, the housing cycle has contributed to the two-speed economy effect, with New South Wales and Victoria entering a period of slowing growth just as Western Australia and Queensland, fuelled by the resource boom, experienced rapidly increasing growth rates (Mitchell & Bill 2006). Instability in the housing market has long been a source of broader instability in the macro economy, but there are also other economic implications.

An increase in land prices accelerates the process of gentrification. Low-income households are forced to the edges of the major cities, or into ghettoised enclaves. As a number of symptoms of social dysfunction are associated with income and class, so this stratification process tends to cluster disadvantage. Changes to public housing tenancy rules, which effectively force low-income workers out of public housing, reinforce this dynamic (Disney 2007a). This is precisely the phenomenon identified by the Howard Government as 'welfare dependency', which it acknowledged undermined labour force participation.

The concentration of wealth and poverty geographically also leads to other issues of labour supply. Like many financial centres, Sydney displays elements of a world city (Sassen 2001). Analysts of world cities have noted the tendency for a bifurcation of the labour market, with a highly paid primary labour market employed by global industries in key coordination tasks and a secondary labour market providing personal

services to the primary workers (Friedman 1986). Many of the jobs associated with the secondary service sector are location specific. Stacking selves in supermarkets, cleaning homes and minding children all need to take place near the homes of affluent workers. Falling house affordability forces low paid workers away from the city, and this tends to generate labour shortages.

Correcting this labour market imbalance either requires a concerted attempt to solve the problem of housing affordability or policies to create additional sources of low paid labour, most likely through immigration or labour market deregulation. Both these later options were embraced under the Howard Government, but both have also experienced significant political resistance. A more logical approach would be to promote policy aimed at coordinating housing and labour needs.

Finally, policies like negative gearing and the capital gains tax concession tend to encourage investment in less productive asset classes. Land is subject to forms of scarcity that do not apply to other resources, because location and accessibility are such key components of land's value. Thus, much of the increase in housing wealth represents a form of asset price inflation that is not commensurate with increased factor productivity. As the workforce shrinks and dependency ratios increase, so productivity becomes more central to increased standards of living (Productivity Commission 2005).

As with education, a shift in social policy from direct public provision to increased subsidy for private providers has a number of indirect and undesirable economic implications. In the housing market private subsidy is not only inequitable, it also leads to a number of supply side capacity issues by constraining labour force growth, misallocating investment spending and generating asset price inflation.

Health

Economists have also long influenced Australian health policy. The current system of public health insurance, Medicare, was the creation of health economists, and its structure and rationale largely reflect the application of traditional neoclassical ideas of market failure to the health

insurance market (Scotton & Macdonald 1993). Since its adoption, advocates of Medicare have continued to utilise an economic critique of private health insurance, and the private health industry more generally, to advance social democratic policy positions.

Despite support for public provision from many conventional health economists, health policy has also seen a switch in favour of private provision. The most notable example of this has been the increase in support for private health insurance.

Since Medicare's introduction, until recently, there had been a long-term decline in private health insurance coverage. Private health insurance coverage fell from over 60% of the population prior to Medicare's introduction, to barely 30% in December 1998 (PHIAC 2003). Similarly, bulk billing rates rose consistently during the 1980s and most of the 1990s, hitting a peak of 80% of GP services, and 72% of all medical services by the late 1990s (HIC 2003).

The fall in coverage accelerated during the recession of the early 1990s, leading to calls for intervention. The first move came from the Keating Labor Government, which made it easier for funds to target younger, healthier members (Productivity Commission 1999, 66-9), although this had little effect. The Coalition then introduced a 30% rebate on private health insurance for low-income members following their election in 1996. However, this only slowed the decline.

A second round of reforms saw the extension of the rebate to all those with private insurance and the introduction of Lifetime cover, a modification to community rating. The community rating system prevents funds charging premiums based on risk, as it is believed this would unfairly impact on the relatively sick. The Lifetime cover changes allowed funds to apply a surcharge to members who joined after turning 30, with the surcharge increasing for every year membership is delayed until age 70. The changes resulted in a massive surge in private fund coverage, increasing from little more than 30% in 2000 to over 45% in 2001 (PHIAC 2003).

A number of studies have identified Lifetime cover as the most significant policy change in increasing private fund membership. Initial studies credited the policy with virtually all of the increase (Butler 2001).

More recent analysis has argued the effect was less profound, but even these studies still suggest Lifetime cover was the most significant element (Vaithianathan 2004; Palangkaraya & Yong 2005).

Lifetime cover had virtually no direct budgetary cost. In contrast, the most expensive element of the Coalition's policy, the rebate, appears to have had little impact on health fund coverage. Since this measure was initially implemented it has been increased for older fund members, peaking at 40% for those over 70. In 2005/06 the total cost of the rebate was \$3.2 billion (AIHW 2007, 34).

These benefits are strongly targeted towards higher income earners. A survey conducted by the Australia Institute in 2004 found that, while only 24% of Australians in households earning below \$25,000 *pa* held private health insurance, 69% of Australians in households earning over \$100,000 *pa* held such insurance (Dennis 2005). Research from the National Centre for Social and Economic Modelling also suggests that the increase in fund membership achieved this decade has been concentrated within the highest quintile of income earners (Walker *et al* 2005).

This is unsurprising for a number of reasons. In particular, as Ian McAuley (2005, 166) has argued, many people are now better off taking out private health insurance irrespective of their desire or intent to use it. Prior to this year's Budget, the tax penalty for those without insurance had remained unindexed since it was introduced in 1997, and unlike most of the tax system, is based on an average rather than a marginal rate. The effect was that any single person earning over \$50,000 per year, or couple earning over \$100,000 per year,² was liable for a 1% tax penalty. The combination of this tax penalty and the rebate means that the cost of lower end health insurance policies is actually negative – that is the government pays people to have insurance. Indeed, it is perhaps more telling that some high income earners choose to pay money not to have

2 There are small changes in these thresholds for those with children. More major changes, lifting the limits, were made in the 2008 budget by the Rudd government.

insurance. Even with the higher thresholds³ announced in the Budget, this situation will remain the case for many higher income households.

The policy changes, particularly the rebate, have been justified partly on the grounds that they relieve pressure on the public hospital system, thus offsetting the cost of providing the subsidy (Elliot 2006). However, a recent study suggests that less than 20% of the cost of the subsidy is offset through this effect (Frech & Hopkins 2004). In other words, for every \$1 spent on the rebate, the public sector saves less than 20c. This is similar to results in other studies (Deeble 2002).

In the current context of a large budget surplus, the net cost of the rebate may be thought to be justifiable in terms of other policy goals, such as promoting choice or responsibility in health care provision. However, the economic costs of the shift in favour of private provision are more profound. The most recent *Intergenerational Report* (Treasury 2007a) concludes that by 2046/7 current policy settings will leave the budget in an annual deficit of 3.5% of GDP. Public health spending is expected to rise from less than 4% to GDP to over 7% by 2046/7, accounting for virtually the entire fiscal gap. This is partly due to ageing, as older people use more health services, but it is mostly due to other factors, such as new drugs and technology (Treasury 2007a: xiv-xv). This in turn reflects the fact that health is a superior good. As private subsidies tend to cost more than they save, increases in such subsidies are likely to add substantially to future fiscal pressures.

In addition, the shift to the private system has inflationary consequences that are likely to further increase *total* health spending, as well as *public* health spending. That is, not only do the social policy settings threaten fiscal policy, they also threaten to undermine broader standards of living by significantly increasing the cost of a set of goods and services that make up a large and increasing proportion of output.

This broader inflationary effect is the result of three factors. Firstly, private funds have higher administration costs than Medicare, the public sector alternative. McAuley estimates that private fund administration

³ The new thresholds are \$100,000 pa for singles and \$150,000 for families (Treasury 2008, 19).

costs are over 10%, compared to less than 5% in the public system. This reflects the additional costs of advertising and competition, as well as the lower costs of collecting revenue through taxation (McAuley 2005: 169).

Secondly, numerous studies have pointed to the ability of the public sector to use its monopsony power to constrain prices. Private health insurance premiums increased rapidly during the 1990s (Owens 1999: 181-185), in part reflecting the relatively poor price control exerted by the funds (Richardson 1995). In contrast, the government has used its monopsony power and economies of scale to achieve savings (see Leeder & McAuley 2000: 3; Deeble 1991; 1999). The structure of Medicare positions the government as the main purchaser of health care services. All bulk billed services, as well as all medical services provided to public hospital patients are paid for by the state. This gives the state significant leverage to maintain price control.

More generally, international evidence has pointed to a link between public funding and overall cost constraint. Examining OECD evidence, McAuley finds a positive relationship between private health insurance expenditure as a proportion of total expenditure and total health expenditure as a proportion of GDP. That is, as the proportion of private health spending increases so the total cost of health care to the population increases. This increase has not been associated with any improvement in health outcomes. McAuley argues that once prices begin to rise in the private sector due to a lack of price control, these increases then flow on to the public sector (2005). Similar conclusions have been drawn by the OECD, which has warned Australia that the private health insurance industry appears to have led to an increase in health utilisation, *ie.* over servicing, leading to higher overall health costs (Colombo & Tapay 2003).

In other words, policy changes that shift resources from the public to the private sector in health care have considerable economic costs. These costs include an increase in overall health costs and an increase in public sector outlays. This is particularly serious, given that health is set to be one of the fastest growing areas of government spending, and indeed total spending, in Australia, and already consumes over 8% of gross national product. As such, these policies pose challenges in terms of fiscal policy and inflation targeting.

Retirement Incomes

Given the focus on the ageing of the population, one of the most significant social policy challenges is likely to surround retirement incomes. This was identified under the Hawke-Keating Governments, which initiated the universal system of superannuation as a mechanism to ensure workers would have adequate savings to fund their retirement. Superannuation has always been an economic as well as social policy tool, and was used to both increase national savings and ease inflationary pressures. While life expectancies have increased, participation rates for older workers remain low. Thus, there is likely to be a growing group of people outside or at the margins of the workforce who rely on pensions and investment income for their livelihood.

The extent of this challenge is disputed. The Productivity Commission concluded that, while the cost of pensions would rise, this would be partly offset by falling costs in other areas (2005: Ch 8). Richard Denniss (2007) has also argued that the challenge is effectively a manufactured problem, stemming from rapidly rising expectations, rather than any demonstrable need. If older people today live comfortably on the pension, then why should they not in the future? Denniss also claims that current levels of superannuation will ensure suitable retirement incomes for most people in the labour force.

That system of superannuation has been at the centre of a profound shift from public to private spending and control, consistent with the trend in other areas of social policy. A number of different models exist around the world for dealing with pensions and retirement incomes. The Australian model opts for a considerable degree of private control. Despite early suggestions from the union movement that government place limitations on the control of funds (ACTU 1987) – either through a national fund or through regulation of how money was to be invested – the system is now largely deregulated.

In addition, changes to taxation and public spending have left retirees who earn investment income as one of the least taxed and most supported groups in the community. Prior to the tax changes announced as part of the 2006-7 Budget, Australia's system for taxing superannuation was

already low relative to the OECD average (Warburton & Hendy 2006). The changes saw those taxes lowered further still. In addition, other tax changes have effectively raised the tax-free threshold for older Australians – meaning retirees in the workforce pay less tax than those with children and mortgages.

The concessional tax arrangements for superannuation constitutes the single largest source of tax concessions in the federal budget (Treasury 2007b: 9-10). The cost of these deductions (\$23 billion) is rapidly approaching the cost of the aged pension, although the beneficiaries are a generally smaller group. Indeed the structure of concessions is highly regressive, granting the largest proportionate deductions to higher income earners and the smallest deductions to those on low incomes. Denniss (2007: 42) has claimed that the cost of concessions to a self-funded retiree with an average annual lifetime income of over \$72,000 is now greater than the cost of a full pension.

This, of course, has serious implications for future fiscal policy. As the population ages, so those over 65 and outside or on the margins of the workforce become a larger proportion of the overall population. As this occurs, so this group also becomes a larger proportion of the potential tax base. The changes to superannuation have significantly undermined the future tax base of the federal government. Because most of the deductions apply to earnings on investment, these changes have significantly shifted the tax base away from capital and towards labour.

Not only has social policy in relation to pensions constrained the state's taxation capacity, the structure of superannuation continues to reshape investment decisions and priorities. Superannuation was initially hailed as a mechanism to increase national savings. However, most of the expected gains have been offset by rising private debt (Connolly & Kohler 2004). There are also real questions over the usefulness of any national savings strategy in an era where the category of national savings itself is less meaningful given globalised financial markets (Coates 2004).

However, the structure of superannuation has ensured that this new pool of savings is firmly located in the private sector. This opens up retirees to significant risks from market fluctuations, something that has become all

too evident with the stock market volatility at the beginning of this year. As with much of the welfare state this has involved a shift in risk, from the collective capacity of the state to individual investors.

Just as importantly, super funds, for most purposes, act like any other managed fund in terms of the ways in which money can be invested. They are regulated by prudential guidelines, but they are not required to invest in any specific areas. The effect of this has been to create a large and growing pool of private savings at precisely the same time that neoliberal economic sentiment has seen fiscal discipline applied to the public sector. This combination has led to what John Kenneth Galbraith (1958) termed private affluence and public squalor, as well as a re-privatisation of the nation's investment function.

Indeed the situation has become so lopsided that new financial markets and mechanisms have been created to correct it. Two elements of this are of note. Both are captured in Chris Jefferis and Frank Stilwell's (2006) recent analysis of the so-called Macquarie Bank model. According to Jefferis and Stilwell, the Macquarie Bank model has absorbed superannuation savings via two important processes. The first is through the securitisation of mortgage debt, and secondly, by making private investment in public infrastructure more profitable.

The first of these processes creates a new pool of liquidity, much of which has been accessed by investors taking advantage of the capital gains and negative gearing concessions outlined above. The resulting housing boom has not only reduced housing affordability, it has also significantly increased household debt. Steven Keen has argued that this increased debt has not been properly offset by increases in assets, as the same process has led to land price inflation that artificially inflates the price of assets without increasing the real stock. Keen argues that this process cannot continue indefinitely and poses one of the greatest threats to the future of the boom (Keen 2007).

The second process channels private super funds into public infrastructure spending. Under the Macquarie Bank model, large infrastructure projects are made profitable through a process of refinancing that brings forward capital gains as current profits. Effectively, as the price of the asset increases, so the fund will refinance,

increasing the total debt in line with the paper value of the asset. These new borrowings are then used (in part) to pay dividends and management fees (Jefferis & Stilwell 2006).

This is increasingly the way in which public infrastructure is financed. The public sector contracts with a private fund, which then refinances the asset to access superannuation savings. As much of the increased value of infrastructure is based on land price, this also fuels land price inflation. The net result is a loss of public control over infrastructure, a reluctance to build new public infrastructure and an increase in the cost of infrastructure.

Boris Frankel (2002; 2004) has argued that most of these problems could be avoided through a modest change to the regulations surrounding superannuation. By insisting that a small proportion of super be invested in government bonds, the government could ensure a steady stream of savings into the public sector. By capturing a small part of the increase in investment funds (and of total debt), the public sector could correct for the under-investment in infrastructure that has been widely identified as leading to constraints on economic capacity while also potentially easing the pressures that give rise to asset price inflation.

Conclusion

In the current debates about economic management there is an emerging consensus that the dominance of neoliberal reforms has greatly reduced the role of the government in actively managing the economy. Increasingly, decisions about key economic policy instruments, such as exchange rates, interest rates, industrial structure and employment are essentially determined by market forces, rather than deliberative policy making.

Despite the decline in the importance of many traditional economic policy instruments, a number of other policy areas are becoming increasingly important. Many of the emerging challenges for the economy, such as the skills crisis, infrastructure bottlenecks, fiscal pressures and inflationary pressure, can be linked to the direction of social policy.

Social policy has been dominated by a trend from public funding and control to private funding and control. This shift has occurred with limited explicit retrenchment of existing social policy. Despite this, the changes have created a number of economic pressures.

By targeting spending to those most in need, and by using its spending power to control production costs, the public sector often enjoys a considerable advantage over the private sector in key social policy areas (see Barr 2001). As funding and control have shifted, so total costs have tended to rise, something evidenced by the high inflation outcomes for social components of the CPI. The private sector also faces challenges of market failure, which in areas of social policy are often profound. Health, education and housing all have significant externalities, and are themselves affected by market structures that tend to misallocate spending.

Both these factors – cost control and market failure – have become more significant because of demographic change. As our population ages and becomes more affluent, so there is a shift in spending priorities towards these key areas of social policy. Thus, the comparative advantages of public provision become far more significant for the overall health of the economy.

It is not only that we spend more on social services. These demographic changes, particularly the ageing of the population, affect labour supply. Economic globalisation has also made the quality of labour more significant to the distribution of employment, income and investment. As a result, services that affect the overall quality and quantity of labour are key to the nation's continuing economic success. In both cases it is social policy, rather than economic policy directly, that is likely to make the biggest impact.

Social policy has also grown in significance in terms of overall investment decisions. Changes to housing policy have significantly shaped investment priorities, diverting money into one of the least productive sectors of the economy. Superannuation has limited the public sector's access to capital, and in doing so has reduced the ability of state governments to provide the infrastructure that would expand capacity and reduce inflationary pressures.

Many of the challenges facing the Australian economy relate to the problems of coordination and capacity, as well as the somewhat artificial and political constraints on Australia's fiscal base. In all these cases social policy is a core component of the toolkit governments will need to use to address the issues. This is not to give up on the use of other more traditionally economic policy tools. Rather it is to recognise that demographic, policy and global trends have all tended to make social policy even more central to economic outcomes.

For the coming century, the initial model of political economy appears to be becoming ever more relevant. The artificial distinctions between economy and society are breaking down. Only by treating the economy as a social institution will governments be able to properly manage our economic fortunes.

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