B 8

Acc

THE AUSTRALIAN LIBRARY NATIONAL UNIVERSITY

THE AUSTRALIAN NATIONAL UNIVERSITY

Centre for Economic Policy Research

BOUND SHELF

DISCUSSION PAPERS

DISCUSSION PAPER SERIES B:

Papers Arising From

THE BROOKINGS SURVEY OF THE AUSTRALIAN ECONOMY

Conference Discussion Relating to the Paper

SOCIAL WELFARE

Henry J. Aaron

DISCUSSION PAPER NO. B8

August 1985

G
6HC8
.D57

G.P.O. Box 4, Canberra 2601, Australia

The Centre for Economic Policy Research was established in 1980 as one of a number of University initiatives. It was provided with an annual grant for a period of five years and given a mandate to foster policy oriented studies of the Australian economy. The Centre intends to work closely with other economic research groups - both within the Australian National University and in other Australian universities.

The Discussion Papers of the Centre are intended to make available to a wider audience a series of economic research studies. These studies will have been either commissioned by the Centre (for instance in conjunction with a conference held under the Centre's auspices) or undertaken by its research workers.

Discussion Papers will also be published where economic research work with relevance to policy has been undertaken by individual academics within the Australian National University - or where the Centre is able to act as a focal point for such research.

The Centre will not have any views on policy; individuals will.

CEPR
DISCUSSION PAPER SERIES B

THE BROOKINGS SURVEY OF THE AUSTRALIAN ECONOMY

Proceedings of the Conference Held On
9-11 January 1984, Canberra

Conference Discussion Relating to the Paper

SOCIAL WELFARE *

Henry J. Aaron
The Brookings Institution

DISCUSSION PAPER NO. B8

* The papers delivered at the Brookings Survey Conference were subsequently revised and have now been published in: The Australian Economy - A View From The North (Eds. Richard E. Caves and Lawrence B. Krause), The Brookings Institution, Washington DC, and George Allen & Unwin, Sydney, 1984.

This paper contains the comments prepared by two discussants for the Conference Session on the Aaron paper, together with the edited proceedings. The comments and discussion refer to the paper presented by Henry Aaron to the Brookings Conference, unless otherwise stated.

ISBN: 0 949293 35 0

ISSN: 0725 430X

TABLE OF CONTENTS

SOCIAL WELFARE

Henry J. Aaron

FIRST DISCUSSANT: MR ANDREW PODGER[1]

Professor Aaron's paper is in two parts: the first is primarily descriptive and the second identifies aspects of Australian social welfare policy and policy analysis that strikes the US observer as different. Through both sections of the paper, Professor Aaron draws attention to:

- the role of government in social welfare;
- issues relating to incentives; and
- the importance of an integrated approach to welfare policy analysis that takes into account, in particular, the tax system and private income support arrangements.

The paper concentrates on three areas of welfare - retirement income policies, unemployment insurance and health care.

The introductory pages draw attention to the major difference between the Australian social welfare system and that of most other western countries including the United States - its non-contributory income-tested flat rate benefits not only for the non-aged poor but also for the aged and the unemployed.

---

1 Andrew Podger is Assistant Secretary, Social Welfare, Australian Department of Finance. The views expressed in this commentary are not necessarily the views of either the Department or the Australian Government. Assistance in the preparation of the paper was provided, in particular, by Jenny Stafford and Rob Butterworth.

Australians, we are told, believe that the government has an obligation to provide cash assistance and that people have every right to claim it without loss of pride, but that such assistance should be limited to benefits designed to prevent destitution. The government is not expected to maintain customary living standards during retirement, sickness, disability or unemployment.

Retirement Income

The difference in the role of Australia's age pensions and the United States' social security pensions makes international comparisons of rates and costs particularly difficult. Professor Aaron suggests, however, that:

- maximum age pension rates are around 80 per cent of the average US benefit, corresponding broadly to the ratio of Australian income to that in the United States;
- about one third of US social security beneficiaries, however, receive lower benefits than they would in Australia;
- Australian age pensions comprised about 5.5 per cent of total earnings in 1981 while in 1983 the US figure was about 9 per cent. (For a number of reasons I am not sure that this comparison is meaningful.)2

While Australia's age pensions are aimed at poverty alleviation, we have a system of tax-supported superannuation oriented towards the objective of income protection in retirement. In describing this system, Professor Aaron draws

---

2 The reasons include those mentioned by Professor Aaron - the inclusion of survivor benefits in the US figure and the exclusion of service pensions from the Australian figure. They also include the question of variations in coverage, the payment of many part-rate pensions in Australia, differences in demographic patterns and differences in the tax status of the payments.

attention to:

- its highly uneven coverage;
- the extent to which benefits are realised prior to retirement;
- the lack of adequate vesting provisions; and
- the bias towards lump sum benefits.

In contrast to the US, virtually all private Australian superannuation schemes are reported to be fully funded in the sense that each has sufficient book reserves to pay off existing vested benefits.

The Australian system is heavily supported by tax concessions which provide all workers with "enormous" incentives to save through superannuation schemes (lump sum or pension). With reinforcement from the age pension income test, the tax concessions also make it possible for rather wealthy people to receive lump sum superannuation payments, to pay negligible tax on them, to invest the proceeds in assets yielding negligible taxable incomes, and to remain eligible for income tested age pensions. The apparent unfairness of this arrangement is compounded by the fact that Australia does not tax capital gains and has repealed its tax on wealth transfers by gift or bequest.

The current Commonwealth Government has, however, taken action to extend and strengthen the means test. In addition it has proposed the phasing-in of higher rates of tax on lump sum payments. Superannuation will still be encouraged, and lump sum benefits may continue to have advantages over pensions. No action has been taken on taxing capital gains or wealth.

Professor Aaron has reservations about Australia's retirement income arrangements - not only the current arrangements, but also the arrangements recently foreshadowed. Australia is probably more generous than the US both at the bottom of the income distribution and at the top. The former is due to our more residual-style of age pensions. This Professor Aaron finds somewhat anachronistic given our longevity, low labour force participation amongst the aged and our uneven superannuation coverage. It results in many individuals suffering sharp declines in income after retirement. Superannuation coverage seems unlikely to extend to all occupations and industries for many years, if ever, but the tax concessions are very expensive.

Two broad courses of action are identified as alternatives to the status quo:

- flat-rate age pensions could be replaced with earnings related public retirement benefits; or
- private employers might be required to provide superannuation benefits for all workers, subject to security, vesting and portability requirements.

The key differences between the two approaches are:

- whether the additional outlays should be kept off budget;
- whether financing should be via taxes or compulsory premiums; and
- whether superannuation benefits should remain a part of labour-management negotiations regarding remuneration.

Even if such fundamental changes do not eventuate, Professor Aaron believes reform of the taxation of pensions and capital gains must be considered. He does not object to tax deferral on savings, but believes the principles of tax equity imply full taxation of all payments at the same rate applied to ordinary income. Further, whatever rule is adopted for pension saving and accumulations, it should be equally applied to other forms of saving and other capital income.

Unemployment Insurance

As with benefits for the aged, it is difficult to compare benefits for the unemployed in Australia with those in the United States. Broadly speaking:

- unemployment insurance levels in the US in November 1982 were on average about the same as the average unemployment benefit paid in Australia. But the US amount varies widely across States while the Australian figure varies with family status and age;
- while married people whose spouses are fully employed are effectively denied benefit in Australia because of the income test, the Australian system is comparatively generous to new entrants into the workforce and to the long-term unemployed. As a result, in recent times virtually all the unemployed in Australia have received benefit, while only 36 per cent of the US unemployed qualified for unemployment insurance in August 1983.

Professor Aaron leaves us in little doubt that he believes the more ready availability of unemployment benefits in Australia encourages early retirement, particularly when the demand for labour is weak. He observes that the proportion of the unemployed out of work six months or more is nearly twice as large in Australia as in the United States. Similarly, he implies that the availability of benefits for school-leavers may well have contributed to the relatively low proportion of Australian 16 to 18 year olds at school.

While concerned about these possible incentive effects, Professor Aaron offers no easy solutions. Higher pensions for those who defer retirement would be costly but lower benefits for long-term unemployed when jobs are scarce, might be politically unacceptable. Regarding the young, he notes that extending benefits to those at school via a "universal youth allowance" would be extremely expensive while the politically difficult alternative of restricting benefits to those under 18 could in fact save a great deal of money.

Health Care

Australian medical care blends the characteristics of both the United States and the British systems. As in the US, most Australian doctors practice privately on a fee-for-service basis and patients may visit the doctor of their choice. Hospital services on the other hand, as in Britain, are dispensed by salaried specialists and other hospital employees, but external doctors can admit patients and care for them. Most hospital revenue is derived from State budgets, the States in turn receiving grants from the Commonwealth to cover part of hospital and other health service costs.

The introduction of Medibank did nothing to alter the health care delivery system. What it did do was extend health insurance to a significant minority previously without adequate protection, simplified coverage for the rest, shifted much of the financial responsibility for medical care to the Commonwealth and reduced the importance of premiums.

The resurrected Medibank ("Medicare") will maintain Commonwealth grants to the States in the form of lump sums so that over-runs in hospital budgets will remain the responsibility of the States.

In the health area, Professor Aaron appears rather less concerned about the incentive effects of the system on individuals. He notes the debate on user charges - would user charges make patients more price conscious and so reduce the demand for services, or would they have perverse effects due to patients' lack of information or leverage? - but he then shrugs his shoulders because of the general lack of political inclination in the western world to rely heavily on direct charges on patients to control health expenditure.

The rejection of such control mechanisms shifts the responsibility for determining the quantity of resources allocated to health care to agents other than patients or providers, both of whom have every reason to increase those resources.

Interestingly, Australia appears to have performed relatively well since 1975 in restraining cost pressures on health outlays. Three factors are identified. Hospitals are subject to budgets stringently enforced by States. The Commonwealth grant formula puts the States at risk for cost overruns. And reimbursement for the services of physicians is governed by a fee schedule. While these factors may also have restricted the availability of services, they do provide a brake on expenditure.

Family Assistance

The paper touches only briefly on family assistance, noting that family allowances are more generous than the tax benefits for children in the US. Unlike the tax benefits in the US the Australian cash benefits have a constant value regardless of income, are available to those who do not pay tax and provide an independent source of income to mothers.

Alternative Perspectives on Reform

On the role of government, Professor Aaron is surprised by the extent to which the debate in Australia concentrates upon the issue of means tests. The Australian system of flat rate means tested benefits suggests that the role of government is essentially residual, cash assistance and social services being confined to the truly needy. At the same time levels of assistance and other features that are quite generous by US standards mean that large numbers do in fact receive assistance.

In the United States, the debate appears to be less ideological and more pragmatic. Accordingly, the question of means testing is resolved in different ways for different programs. Furthermore, the pattern of universality and selectivity appears to be well accepted.

On the question of incentives, Professor Aaron is very concerned about the lack of Australian debate and analysis. Whatever one's views on policy regarding transfer payments, he says, the view that they have little or no effect on economic behaviour is no longer defensible, if it ever was. Yet Australians have done little research into this issue and many Australian analysts seem to think incentive effects are not important.

On the role of social welfare, Professor Aaron once again expresses concern about the Australian debate. Social welfare policy is not merely about the redistribution of income from rich to poor; it also has to extend beyond the single program focus.

It may be that the tax system is better suited to dealing with excessive concentrations of wealth. If it did so, criticisms of an age pension structure that provides benefits not only to the poor might be negated.

Putting this point the other way round, Professor Aaron says that any program of social welfare reform that ignores tax reform is incomplete. For example, a comprehensive retirement policy must not only take account of age pensions and fringe benefits but also the virtual exclusion of capital gains from taxation.

Bringing these three issues together, Professor Aaron criticises the purely residual role for government. The government is an active participant in the economic milieu playing an active role in the determination of incomes and thus the pattern of income distribution. Given this primary role, it is obliged to play an active secondary role through income redistribution. In so doing, however, increased attention should be given to the effects of its activities on economic incentives.

COMMENTS

Professor Aaron's paper is a very welcome and refreshing contribution to the debate on social welfare in Australia.

I hope it helps to free the debate in this country from the confines of ideological arguments, though there have been some important non-ideological contributions to the debate in recent

[3] years. My comments on the paper are mostly by way of supporting evidence for Professor Aaron's concerns about the nature of the Australian debate on the three issues of the role of government, incentives and the scope of social welfare analysis. For the most part, like Professor Aaron, I will use the retirement income policy area as the main example. As Willie Sutton said: "That's where the money is". It is also the main focus of the welfare debate at the moment, attracting much media coverage and occupying a great deal of the time of politicians and their advisers.

Before commenting directly on the three main issues raised, I would like to make some general remarks about the nature of the Australian system.

The Australian System

As Professor Aaron points out, our flat-rate, general revenue financed, largely means tested social security system is not like the social insurance arrangements of Europe and North America. In pointing this out, Professor Aaron immediately shows greater understanding of the underlying tenets of our system than some other overseas visitors in recent years and, indeed, some home-grown commentators who have attempted to assess our

---

3 These include, for example, the contributions from within the bureaucracy such as those of the Department of Social Security, the Social Welfare Policy Secretariat and the Bureau of Labour Market Research, and the contributions from outside researchers such as Professor Gruen and Dr Gregory and their associates at ANU, and Meredith Edwards, Bettina Cass and Peter Saunders.

performance using inappropriate overseas standards. For example, it has been suggested that ours is a particularly mean system because we do not spend as much on social security as a percentage of GDP as most OECD countries and because our average benefit levels are lower than those in some other countries.

Professor Aaron also draws attention to the fact that there is more to our system than the social security pensions and benefits which are mostly directed towards poverty alleviation. Our system also provides: tax support for superannuation; compulsory workers compensation; selective sick leave provisions; and in some instances compulsory severance pay provisions.

The main element of our retirement income system is, nonetheless, the age pension, and it is that element which best characterises our system. Our age pension, which provides a guaranteed minimum for virtually all the aged, has certain strengths:

- the minimum income it guarantees is not ungenerous by international standards. As Professor Aaron notes, about one third of the US aged receive benefits - and probably have total incomes - below the level equivalent to our pensions. For those elderly Australians who have no income other than the pension, but who own their own homes, the pension would seem to allow a reasonable basic standard of living.

- it provides a regular and reliable source of income. For those used to receiving regular though low ages, the pension ensures a reasonable continuity of living standards at retirement without major disruption;

- it is fully protected against inflation;[4]

---

4 Since 1976 this protection has been guaranteed by legislation.

. it provides full protection against the risk of longevity.

Each of these attributes would seem to have received widespread support. There are few who suggest that pension levels should be reduced and few who suggest large scale increases across-the-board. The Government's policy is for an essentially marginal increase in pension levels to be effected over a number of years. I wonder whether such a guaranteed minimum income for the aged could attract similar consensus in the US?

The challenge now is to find ways of building upon these strengths in order to overcome the weaknesses that no doubt exist in the achievement of the two main goals - alleviation of poverty and protection of living standards.

While there is little support for large scale increases in basic rates of pension, there are some for whom the basic pension might not provide adequate support. The direction of reform for greater alleviation of poverty may already have been identified by the sort of changes that have taken place in recent years in the area of supplementary assistance which have involved selective increases for those who do not own their own homes and are not in public housing.

The other main area of concern relates to the income protection objective. While our system has developed from a basic concern to alleviate poverty, we now provide support to the majority of the aged and offer tax benefits to encourage people to spread their life-time earnings. In contrast the retirement income policies of other countries originated from a basic concern to protect living standards, though much effort has since been given to ways of ensuring minimum income support.

Recent changes made or foreshadowed in Australia should improve our income protection performance. The foreshadowed increase in taxation of lump sums will gradually reduce the bias towards a form of benefit that is not particularly conducive to the spreading of life-time earnings. At the same time the foreshadowed measures in the areas of annuities will provide access for the more affluent to a form of retirement income that has some of the strengths of our age pension structure that I mentioned above - regularity and reliability, protection against inflation and protection against the risk of longevity. I would suggest that these attributes - which are the hallmark of the indexed superannuation pensions available to many in the public sector - are highly desired by Australians but up until now have been unavailable or subject to taxation and means test disadvantages.

These measures include the removal of a tax penalty on annuities, the introduction of indexed securities which are intended to encourage the development and use of indexed annuities as a means of providing for income in retirement, and the introduction of a provision under the new assets test to treat purchased annuities as capital rather than income where this is to the benefit of the annuitant.[5]

---

5 All three are significant. The last in particular, however, has received very little attention despite the fact that it will mean, on average, that about 40 to 50 per cent of income from purchased annuities will be effectively disregarded for means test purposes.

These changes will not, however, lead to the degree of income protection provided by the US system at other than low income levels. With the gradual reduction in the excessive benefits to high income groups provided by our current lump sum tax concessions, it would seem that we will be relatively generous only to those with much-below-average earnings during their working lives. In this regard I think that Professor Aaron may have understated the effect of the tax benefits available in the US which contribute to the relative generosity of the US system towards middle income earners and, indeed, also makes the US system more generous than ours at high income levels. For example, US social security pensions are not taxed and a substantial tax threshold is available for any supplementary occupational superannuation pension. Whereas for non-pension income above the age pension income test free areas in Australia our effective marginal tax rates - the combined effect of tax and income test - are at least 65 per cent, in the US the effective rate applying to private income is under 10 per cent. As a result, the disposable income of US retirees who were previously on high incomes is generally far greater than that of the comparable Australian retiree, with the margin of advantage being greatest for those with large private pensions. It should also be noted that fringe benefits in the US are generally available on a universal basis whereas in Australia a retiree with a large private pension is not eligible for such benefits.

Role of the Government

It seems likely that the Australian and US systems will continue to reflect differences in the role of the government - the US system involving a greater degree of income protection. I I do share, however, Professor Aaron's concern about the social welfare debate in Australia on this issue. Our debate has a tendency to ignore that there is an income protection objective and to ignore concerns such as incentives to work and to save in order to achieve income protection. It seems to assume that social welfare is inherently inefficient or inequitable if anyone other than the genuinely needy receives benefits. The popular image of "middle class welfare" contrasts dramatically with the picture painted by Professor Aaron of Australia's generosity - relative to the US - at both the top and bottom ends of the income distribution but **not** in the middle. As suggested above, I believe in fact we are also relatively less generous at the top.

Greater consideration of the income protection objective, however, might not necessarily lead to the conclusion which Professor Aaron seems to imply that a compulsory earnings-related social security system should be introduced. For example, I noted considerable attraction towards the existing Australian system amongst certain delegates at an OECD meeting on the growth and control of social expenditures which I attended in October 1983.

Disadvantages of compulsory contributions-based schemes which need to be considered include the question of freedom of choice and the likelihood of additional costs. Despite Professor Aaron's option of extending fully-funded occupational schemes to cover everyone, it seems likely that any compulsory, earnings related national superannuation scheme would increase costs for current workers in order to pay for the benefits for current aged people, and the costs of future workers to support the future aged.

The experience of some OECD countries also suggests that it is more difficult to adjust budgetary priorities with a national superannuation scheme. The implicit intergenerational contract involved, for example, seems to make it more difficult for governments to spread the burden of a recession fairly across the whole population including the aged. To respond that this can be done through the tax system may technically be correct, but does not deny that an area of budgetary flexibility is lost or severely curtailed when such schemes operate.

In looking at the advantages and disadvantages of different reform options it would be unfortunate if no consideration were given to options of a more incremental nature lying somewhere between the residual model and the full compulsory national superannuation model. The fact is that there are many options for making our retirement income system more coherent and for reducing the problems of coverage, lack of portability and so on; each has advantages and disadvantages. It is not essential, as the Life Insurance Federation of Australia and the minority of the Superannuation Committee of Inquiry have illustrated, that a "national superannuation" scheme should necessarily involve compulsory contributions and mandatory earnings-related benefits, though, as Professor Aaron suggests, such a scheme has its advantages.

Incentives

Our apparent lack of interest in incentive issues seems to be Professor Aaron's greatest worry. I share his concern.

The playing down of incentives may well have contributed to the extent to which our welfare debate is based on ideology. For example, much of the discussion on retirement income policies over the last year has centred more on ideological than practical considerations. On the one hand "double dippers" are seen to have been manipulating the system to their own advantage. On the other hand the self-interested and overly-superannuated public servants and politicians are seen as being determined to take away the life savings of the (private sector) aged.

I would suggest that the problems of current arrangements have less to do with ideology, the motives of different individuals, or extra-legal activities, than with the incentive structures inherent in prevailing tax and social security provisions. To analyse the problems and to compare superannuation benefits it is necessary to look very carefully at the interaction of the two systems.

Appendix A provides an example which illustrates how, under the tax and social security legislation prior to recent and foreshadowed changes, a lump sum benefit of $100,000 confers an advantage over an indexed pension of $10,000 a year for a single man aged 65. In the example, the lump sum recipient is able to maintain the same standard of living as the indexed superannuation pensioner for some 16 years - longer than the normal life expectancy of a male aged 65. Should he die early, he is clearly better off; should he die later he always has the age pension to rely on if his lump sum runs out. Given the probabilities of dying at different ages, the expected benefits from the lump sum are clearly greater than the expected benefits from the indexed pension. I should emphasise that this example assumes that the lump sum is placed in income producing investments and that the income is fully assessable for both tax and the social security income test. There is no tax or income test avoidance involved, either of which would exacerbate the disparity.

The advantage of the lump sum recipient is brought about by two factors: the low level of tax on lump sums and the role of social security in protecting lump sum recipients from the risk of longevity and running down all their assets - a risk that superannuation pensioners and annuitants must pay to cover. The advantage is not brought about by anti-social people determined to manipulate the rules unfairly or in any way which could be considered outside the spirit of the legislation itself.

This example may go some way to explain the paradoxes of superannuation at the moment:

- that both employers and employees prefer lump sum schemes. The fact is that the Government contributes sufficiently to lump sum recipients both to make lump sum benefits more attractive to employees than pensions and to make lump sum benefits cheaper for employers than pensions; and

- that employers regard the indexed pension provided by government superannuation schemes as overly expensive, while public servants and potential entrants to the public service complain about the lack of lump sum benefits in certain public sector schemes.

This direct financial bias towards lump sums challenges the common assumption made in Australia that Australians are naturally disposed towards lump sum benefit schemes, rather than attracted to them for perfectly rational and responsible reasons.

As the Government's new measures take their effect, it will be important to review the interaction of occupational superannuation, tax and social security in order to reassess financial incentive effects and to make meaningful comparisons between benefits available for different groups. It will also remain important to monitor the wider incentive effects of those arrangements on aggregate saving and working behaviour.

Scope of Social Welfare Analysis

My earlier comments also reinforce Professor Aaron's call for the social welfare debate to include the issue of tax reform. Recent action in the area of retirement incomes suggests some progress in the debate in Australia - a realisation that a coherent retirement income policy requires consideration of the tax system as well as the social security system. There remains a tendency, however, to assume that redistributive effects can be gauged simply by identifying the incidence of cash transfers without requiring, at the very least, a fuller consideration of the interaction of tax and social security. Professor Aaron illustrates the point by suggesting that the provision of pensions to people other than the "genuinely needy" may not be of concern if the tax system successfully dealt with excessive concentrations of wealth. There is an important corollary to this - that a tax such as an indirect tax that may appear regressive may not cause concern on the grounds of its redistributive effect if there are suitable cash transfers to protect the needy.

The two points may be illustrated by a simple example.[6] It is possible to design a tax transfer system involving income tested benefits and an income tax with a high threshold that would achieve the same redistribution as a system of universal benefits with a proportional income tax and no threshold. Looking at the cash transfers and the tax arrangements separately, the first system would seem to be more progressive on both accounts than the second - it has selective benefits and a progressive tax structure - but the overall effect would be exactly the same.

Nonetheless, universal benefits, and particularly earnings related benefits, would require additional revenue. If the net effect is to be a fair redistribution (whatever that means), political impediments to both increased tax and to greater tax equity will need to be overcome. Hopefully the Economic Planning and Advisory Council's review of the Australian Taxation System will not be confined to revenue raising considerations.

Final Remarks

My final remarks relate back to Professor Aaron's implicit views about the basic nature of our social security system.

Our emphasis on flat-rate benefits aimed at poverty alleviation has, rightly or wrongly, continued to receive a lot of support through the years. Much of the debate over the last 10 years has been about how to make our arrangements more uniform -

---

6 See Podger, Raymond and Jackson, "The Relationship Between the Australian Social Security and Personal Income Taxation System - A Practical Examination", in Mendelsohn (Ed) **Social Welfare Finance: Selected Papers**, Canberra: Centre for Research on Federal Financial Relations, ANU,Canberra, 1982.

by the extension of uniform assistance for all sole parents, the greater standardisation of rates of benefits and pensions and the more uniform availability of additional allowances and fringe benefits. The perceived advantages of such moves towards uniformity are strongly felt - greater equity and reduced complexity.

Professor Aaron, however, is not so sure about the advantages of uniformity when incentive considerations are taken into account. Nor should we be. Indeed, there are at least two areas where I think that uniformity may be inappropriate:

- there are strong reasons for maintaining some difference between the level of unemployment benefit for 16 and 17 year olds and that for adults, the main reason being the need to consider relativities with junior wages and associated incentives to undertake full-time work (the existing benefit cut-out point for juniors of $90 a week is already of the order of some full-time wage awards); and

- there are also advantages in the income test on benefits remaining more stringent than that on pensions. The main reason is to ensure that people are not better off unemployed or in part-time work than if they were in full-time employment.

Professor Aaron, of course, suggests going further, possibly by restricting the eligibility of under 18's for unemployment benefits, setting higher rates for pensions than for longer-term unemployment benefits, and not applying means tests for the aged but providing earnings-related benefits in that area.

There may be other areas where incentive considerations suggest a review of our uniform, flat-rate, means tested system - for example the possibility of work testing sole parent pensions for those without young children was suggested at a seminar run by the Institute of Family Studies in June last year.

What is clear is that we do need to pay more attention to incentive issues. Whether this implies a major shift away from our basic system of flat-rate benefits financed from general revenue is perhaps a little more controversial.

APPENDIX A

COMPARISON OF SUPERANNUATION LUMP SUM AND INDEXED PENSION BENEFITS UNDER TAX-SOCIAL SECURITY ARRANGEMENTS APPLYING AT DECEMBER 1982

A comparison of the "value" of the benefits of a lump sum recipient and an indexed superannuation pensioner requires a range of assumptions, any set of which must involve a degree of artificiality: no individual actually behaves over many years according to any set of preconceived assumptions. The assumptions used here have therefore been chosen to allow an illustrative comparison only, from which one may then make "reasonable" speculations regarding a range of possibilities.

The basis of the comparison shown in the table is that a superannuation lump sum recipient will, for as long as he is able, maintain a constant standard of living equal to that of the superannuitant who chose to receive an indexed pension. The expected total benefit of each choice is then equal to the total real benefit received at each instant after retirement multiplied by the probability of death at that instant. In the case of the superannuation pensioner, the total real benefit received at each instant is equal to the total real disposable income received up to that instant; in the case of the lump sum recipient, it is the total real income disposed up to that instant plus the amount of real assets remaining.

For the purposes of exposition, the following key assumptions have been made:

- the initial choice between pension and lump sum is based on the conventional commutation factor of $1 indexed pension being equivalent to $10 lump sum, with the particular choice here being between a $10,000 indexed pension and a $100,000 lump sum;

- the superannuation pension is fully indexed to movements in the CPI;

- the maximum rate of age pension is fully indexed to movements in the CPI;

- the income-test-free area remains constant in money terms;

- the over-70's income-test-free pension remains constant in money terms;

- the personal income tax threshold is fully indexed to movements in the CPI, and the standard rate of tax is 30 per cent;

- the recipient of the lump sum puts aside at the beginning of each year, for as many years as possible, that part of his assets which (after tax and after taking account of the age pension to the extent that he is eligible) would provide the same real purchasing power as the initial level of indexed superannuation pension less tax. The rest of his assets are invested;

- for the superannuation pensioner, the over-70's income test-free pension provides a real increase in purchasing power but, for the lump sum recipient who can adjust his assets to take account of the availability of the income test-free pension, no increase in real purchasing power at age 70 occurs; and

- the "expected total benefit" received is equal to the sum of the real benefits received or in hand at the end of each year, multiplied by the probability of dying in that year according to **Australian Life Tables 1975-77.** (For ease of calculation, it has been assumed that a male does not live beyond age 94.)

These assumptions would, if anything, generally tend to exaggerate the benefits of the pensioner over those of the lump sum beneficiary.

The table is based on a single man aged 65 retiring in December 1982. Year 1 figures are based on the social security and personal income tax systems as at December 1982. A constant inflation rate of 10 per cent and a constant rate of return on investment of 14 per cent area assumed. Similar results have been derived for constant rates of inflation and return of investment of 10 and 1 per cent respectively and of 12 and 14 per cent respectively, and can be expected for women and for married couples.

The table shows that:

. the total expected benefit received by the superannuitant taking an indexed pension is $120,836 (Year 1 prices) while that received by the lump sum beneficiary is $131,732;

. the recipient of the lump sum is able to maintain his standard of living at the same level as the superannuation pensioner in Year 1 for 16 years, longer than the normal life expectancy of a male aged 65 (13.1 years according to Australian Life Tables 1975-1977).

These results arise despite the conservative assumptions listed above and **without the lump sum recipient resorting to any artificial income test or tax circumvention.**

SECOND DISCUSSANT: PHILLIPA SMITH

Professor Aaron's paper provides a very timely focus for discussion about what options exist today in the areas of social welfare and income security. There are a range of new challenges which have to be met if our system is going to be both effective and fair. Not least among these challenges are of course the increased demand on welfare in terms of the increased numbers of aged, disabled people and lone parent pensioners. The increased numbers of unemployed are particularly important and unfortunately won't leave us at any point. In fact the forecasts that have been made for the next year clearly show that even though the economic forecast may be good, the numbers of unemployed will remain at best fairly static. Coupled with this is the trend towards longer periods of unemployment.

The ABS statistics indicate that just under a million people were unemployed at some time during last year and about a third of those people were unemployed for more than twenty-six weeks. As Michael Keating said in a comment on the Mitchell paper, after a certain period of unemployment it becomes debatable as to whether those people will ever be able to rejoin the labour market. Coupled with this is the growing trend in the numbers of people who can only obtain part-time or casual work. The social security system at the moment treats part-time and casual workers in a particularly harsh and inflexible way.

Another current trend is towards two income families, which our current social security system really doesn't quite know how to handle. The final challenge remains in terms of the increased numbers of people who are living in poverty in our society. This is a very real factor indeed.

I would like to say at the outset that I particularly welcome Professor Aaron's comments on the importance of the taxation system and the more hidden transfers in our economy. In comparison to social welfare these transfers are rarely scrutinised. To take one example, an estimate (by the Social Welfare Research Centre, University of NSW) has been made that about five billion dollars is paid out each year in the form of non-taxable occupational fringe benefits. It is sobering to remember that is about the total amount of money paid out to all aged pensioners, yet it receives very little scrutiny in public debate. Professor Aaron noted also that the absence of any taxes on capital gains and wealth not only allows avoidance of tax, but is a very important element in the increasing inequality in Australia. Taxation reform must remain very high on our list of priorities if we are looking to where additional resources are to be found and for a fair distribution of available resources in Australia. I must admit however, that the realisation of any significant taxation reform is likely to be a very slow and painful affair. The recent example of the government's attempts to tax superannuation lump sums remains a very clear testimony to the strength and the vocal nature of the higher income groups in our society in terms of maintaining their position.

The major disappointment that I feel with the paper as presented by Professor Aaron is its lack of attention or concern in terms of the success or otherwise of our income security system in alleviating poverty. The concerns appear to be more about the protection of previous levels of income or the maintenance of those previous levels rather than evaluating whether we are achieving the much more basic task of alleviating poverty. I do not believe it is a hardline stand to say that a priority goal of the income security system and other government policies should be to ensure an adequate level of income for those with few other resources - especially when such payments are funded from consolidated revenue.

The indications are that Australia is becoming a much more polarised country. This view is supported by preliminary income distribution statistics from the ABS. I was interested to see some research results from the economic research group INDECS which also supported this. For example, that research indicated that in 1968-69, 12.4% of households were in the well-off category, that is where household income was more than $32,000 per annum in today's money terms, and that 12.4% of households accounted for 25% of Australia's income. This was contrasted with the period 1980-81 where it was found that the well-off group had increased to 20% of all households and that they now accounted for 48% of the nation's income. In comparison to that it was also found that the number of poor households had also increased - poor households being defined as those households where income was less than $12,250 per annum. In 1968-69 it was found that about a quarter of Australian households were below that level and accounted for about 10% of Australia's income. By 1980-81 these poor families had risen to 30% of households but their share of income had actually dropped to 8%.

The extent to which one believes in equality as a goal in itself obviously depends on one's particular political stance. However, in Australia there is no doubting the old saying that the rich are getting richer and our poor relatively poorer. The statistics also bear out the ineffectiveness of our taxation system in achieving any redistribution of income. If statistics were available on the accumulation of wealth I am sure that the results would be even more staggering. It is also apparent that the social security system and other measures have not protected a growing number of people from poverty. The latest available statistics, although not very good, would indicate that somewhere between two to three million people are living under, or very close to, the Henderson poverty line. It is worth stressing here that the poverty line bench mark is a most conservative estimate.

A 1982 study of low income families in Sydney (P. Smith, **Living On The Edge**, ACOSS, 1982) indicated that for those families whose income was just 20% above the poverty line, it was almost inevitable that sooner or later a crisis situation would occur: they would not be able to pay the rent, would have to rely on emergency relief, or some other crisis would emerge. To rely solely on current pensions or benefits is to be relegated to a situation of poverty. For example the single adult unemployed benefit of $73.60 per week is $35.50 per week below the poverty line. The unemployed, single parents, pensioner couples with children, and those renting, are clearly the groups most at risk of poverty.. Yet an examination of the pensions, benefits and social security allowances over the last ten years indicates that the standard of living of these groups has fallen behind the rest of the community. The relative value of their allowances has in fact declined either through freezing or partial freezing of those benefits. These facts are supported by emergency relief statistics which indicate an escalation in the numbers of people having to turn to this form of relief, often as an ongoing supplement to the inadequate level of pensions and benefits.

As just one example of this, the NSW government last year increased its allocation for emergency relief from 11 million to 18 million dollars, but found that demand was in fact running at double those levels. It also found that 95% of the people needing relief were already on Commonwealth pensions or benefits. I regard these statistics and facts as a basic indictment that the pension and benefit levels we have at the moment are inadequate. Professor Aaron's paper posed the question of whether poverty alleviation was the basic goal. I very much regard it as one of the priority goals. Professor Aaron however raises several options that are available to us. One is a social insurance system which is paid out of contributions. Another option is for a system of flat rate benefits that might still be paid out of consolidated revenue but are of a more universal nature.

I will make a couple of quick points and a warning about the social insurance option. The analogy with insurance can often be very misleading. In particular a conflict will often arise between what can be regarded as the individual equity of the person and their contributions and the broader goal of social equity. The more a scheme tries to redistribute to the poorest income groups, the less people are likely to see it as an insurance contribution, and the more likely they will view it as just another form of taxation. A possible reason why the analogy of insurance and earned rights might be attractive is if people are willing to pay out more in this form of contributions than they would in taxes. We have to remember however, that the poorest and most vulnerable groups are by definition groups that have least capacity to afford that protection - the groups, for example, who have not been able to get work experience, or the low wage groups who cannot afford contributions at particular life stages.

The experience of many overseas countries in using the social insurance system has been that subsidies from consolidated revenue are still required, and that the large bulk of revenue is distributed to the middle or higher income groups. The implicit danger is that a social insurance sytem may be simply justifying or perpetuating the inequalities that are present in the wage system through the social security system. In this regard I found important the comparisons Professor Aaron made, which are highlighted by his comment that one third of social security beneficiaries in the US receive lower benefits than they would in Australia. I support the use of a flat rate system - if it is both a method of redistribution and a means of ensuring adequacy. In a true philosophical sense it may be theoretically possible to pay out universal payments to all and tax it back through the taxation system. I do not believe that this is a practical option because of the massive reforms that would be required. The other political danger is if the government cannot ration expenditure by use of an income test then it would be likely to find rationing devices through other mechanisms. The crack down on invalid pensions in 1981-82 was an example of this. There was a redefinition of eligibility for the invalid pensions and the 85% incapacity for work test, and 45,000 people were taken off the pension.

The degree to which our system should be regarded as a residual model or the "State as repairman" model will in fact depend upon the meanness of the test that is involved. It will depend on the level of benefits that are paid, and on the taper of payment. As a corollary to both those points, it will also depend on the total amount of money that is available and the adequacy of payments made.

I agree very much with the points made by Professor Aaron about the important question of incentives for unemployment beneficiaries. There are certain trade-offs involved in terms of the incentives and what I have already said about adequacy is relevant here. First, there is the question of the absolute level of unemployment benefits; secondly, there is the question of the effective marginal tax rate faced by the unemployed and its effect on incentives. Professor Aaron suggests that one explanation for the weak demand for labour has been the increased value of unemployment benefits from 1970-75, I think other speakers have also mentioned this. I would like to point out that the statistics they quoted depend on the base year taken.

It should be remembered that while the value of unemployment benefits increased up to 1975 they have in more recent years dramatically declined. For example by June 1984 the real value of unemployment benefits for single people under the age of eighteen will have declined by about 48% since 1975. Unfortunately that drop in the real value of youth unemployment benefits has not improved the unemployment statistics for those people. The effect of the recession and perhaps the effect of real wages have been much more important factors than the level of unemployment benefits themselves.

In terms of the adequacy of benefits, we have to remember that the level of unemployment benefits discussed is not just about the incentives but the level of income that people have to live on. It would be a cruel hoax to set benefits at a level which ensured people would have to work to survive if there was no work available for them. The main psychological effects of unemployment also provide a clear testimony that unemployment benefits are not a preferred form of income. It has been suggested that, in particular, the waiting periods for youth unemployment benefits should be increased. Professor Aaron notes for example, that under the Australian system no employment history is necessary and that there is no limit on the length of time that people can be on unemployment benefits. While both these points may be true and these features appear generous in terms of the U.S system I do not regard them as being generous overall. The existing waiting periods for unemployment beneficiaries, combined with the payment of benefits in arrears for unemployment beneficiaries, are factors which contribute to force people to seek emergency relief.

Secondly when talking about longer waiting periods or lower benefits for youth, we cannot assume that the unemployed youth are living at home. One Victorian study indicated that about 35% of youth are living away from home. Other studies have indicated that unemployed youth often come from low wage families and from families where multiple unemployment exists. The last point I would like to make is about the marginal tax rates that are faced by the unemployed. These problems are important and are not easily resolved. They are important both because of the increasing average duration of unemployment, and because part-time work or casual work may be the only way back into the labour market for these people. It is important also because of the trend towards the availability of part-time work versus full-time work.

The income test for unemployment benefits means that anyone with an income over ten dollars per week (or twenty dollars from March 1984),or if the combined income of the husband and wife is over that ten dollars, their benefit will be reduced by fifty cents per dollar up to an income of to sixty dollars per week. After that point their benefits are reduced dollar for dollar. For example, a married couple with one child will currently receive unemployment benefits of $155.20 a week. If the breadwinner has, say, two days employment per week and earns $100, the operation of the incomes test means that after two days work that family will be about $25 better off, less personal income tax which might be in the order of about six dollars. Thus the family will still be at or about the poverty line, without taking account of the extra, possibly quite substantial, costs of going to work. The harshness of the marginal tax rate faced occurs through the combination of a social security taper and the personal income tax. It is obvious that in some situations the effective marginal rate is over 100%. There does not seem to me to be an easy way in which this "poverty trap" can be resolved. For example, if you reduce the social security taper to a uniform 50% as in other cases, personal income tax still has to be added, so you are still looking at very high marginal taxes. The dilemma also exists as to whether it is better to have an extremely high financial disincentive over a short band of income or a lesser disincentive that is still high over a broad band of income. In fact a net pension in some situations would be up to or over the average weekly earnings figure. Cost considerations of course must figure in whichever option you take.

One option which could be readily taken immediately is to increase the permissible income limits, thus allowing people to earn more than the currently permissible $10 (or $20 from March) before the social security taper comes into effect at all. The growth of part-time work is the only available work option.

Concern about the role of real wages in causing unemployment also raises important questions as to what the appropriate methods should be for supplementing the income of the working poor. Clear distinctions do not exist between what is unemployment, under-employment, and what is part-time employment. The differences are becoming blurred and the social security system will need to move towards the payment of income supplementation for the working poor, but again those disincentive and incentive problems will raise their heads.

Money incentives are not the only incentives that should be considered. For example if you look at the unemployment benefit system there are clear disincentives through the work test arrangements for people taking on study. Under the old rule anyone who studied for more than eight hours in a week was not eligible for unemployment benefits. That strict rule is no longer in place. However, in the situation where a person studies for a considerable number of hours in the week, and if there is a certificate at the end of the course, the Department of Social Security might assess that the person is not "ready and available for work". Therefore that person may fail the work test and will be taken off unemployment benefits. Clearly if the unemployment benefit was needed for survival, and if other options are not available, the unemployed cannot afford to undertake training or study, which might better equip them to return to the work force. Equally the same sort of problems arise for people who think that undertaking voluntary work might be one way of making a step back into the workforce. Undertaking voluntary work may also be taken as an indication that a person is not ready and available for full time work.

The suggestion by Andrew Podger that we might consider a work test for lone parents once their children reach a certain stage may sound sensible. However, that would work only if there were training options and an income support mechanism available for those women during their training period. This is not the case now. Many women when they look at training find that there are no education allowances available for them during the period of training and only a slim chance of employment at the end of that training. We should consider these aspects much more carefully when discussing the incentives for training.

Another concern relates to the focus given to provision of opportunities for training of young people. When you look at the manpower programmes in Australia at the moment there is a sad dearth of programmes and allowances available for adult unemployed people, even though they constitute over half of the unemployed. Only about 10% of the expenditure on training programmes goes to the adult unemployed. One possibility that deserves further exploration is guarantees of social credits for training for any person, which can be used at any stage in their life, as opposed to youth guarantees or allowances for universal youth guarantees.

Finally I would like to concur with what I think was the sentiment of Professor Aaron's paper. The time has passed when we could think in terms of certain ideological stances when we talk about social welfare. We need to be looking for practical reforms that can be achieved to assist people who are disadvantaged.

REPLY BY PROFESSOR AARON

This may have become a ritual, but I do think we, as your guests, have been blessed by very considerate, intelligent and thoughtful comments. I certainly have been.

This is a peculiar subject which in varying degrees is unlike all the others discussed at this conference. There is some economics in the questions that are raised, there is also a lot of political philosophy. It is awfully hard to keep those two very different modes of thought straight in discussing social welfare programmes. My reply may be a good example of how difficult, if not impossible, it is to do that.

Ian Manning wrote me a note which I think summarises a fair amount of what people emphasise when addressing the Australian social welfare system. He thought I had paid insufficient attention to the frequently made point that a flat benefit income or means tested programme is much more efficient than a social insurance system in dealing with the problems that income security programmes are meant to deal with. All of you with sharp ears should bridle at the sentence that I just uttered because it is a very vague and intentionally weazel worded sentence. What I would like to do is indicate why I think that the term "efficiency" needs a fair amount of attention, since it is subject to a whole range of different interpretations. One interpretation is that income tested programmes are a good deal more efficient than social insurance type programmes in terms of what we in the United States have christened "target efficiency". For each dollar of public expenditure the direct impact on the welfare of poor people is greater through income tested programmes than through those available as a matter of right without an incomes test. I think that is undoubtedly correct in the sense that there is no doubt the system of the kind you have here is more efficient.

A second possible element of efficiency was suggested by Andrew Podger, namely that an income tested system may be more sensitive and flexible - more easily adjusted in response to external economic change. That may be the case, though I am not sure that recent Australian experience supports this. In my paper I have a table in which I present, both in nominal and real dollars, expenditures in recent years on a fairly broad range of social welfare programmes. Even if one allows for the fact that a large part of that growth is due to unemployment benefits there still is a significant real growth in social welfare expenditures right through up to the projections for the 1983-84 budget. Looking at U.S experience I might be sympathetic to Andrew Podger's point. I think that in its efforts to cut domestic expenditures, the Reagan administration has so far been more successful with income tested programmes than with the social insurance programmes. Whether that is an advantage or disadvantage seems to me to be an open question. These programmes by and large supply resources to groups within societies that are peculiarly illsuited to deal flexibly with the shocks of external economic events, notably the aged, the disabled and the sick. For that reason it seems to me that there is a strong case for setting up an institutional framework which discourages budgetary responsiveness to external economic events with these groups. You can see my point on political philosophy. In any event it seems to me that this is not an open and shut question and I am not even sure of the underlined facts which were suggested.

There are some other senses in which the term efficiency might be used. One is that used by Beckerman in his study of welfare programmes in Australia and three other countries, and that is in terms of the total effect of welfare programmes on the economic state of the poor; the total effect on poverty. By this criterion the Australian system does not come out with quite as high marks as it does on effectiveness per dollar spent. I am not sure which of these two approaches, even if one wants to use them at all, is preferable.

The essence of the social insurance approach is not solely an economic one. It is also a political position and it affects the debate within a society. Specifically it co-opts in support of transfer payment programmes, those groups who under an incomes tested or a means tested programme would probably be neutral or critical of the programme. Specifically, relatively well to do working class people whose tenure on the job is well established under an incomes tested programme really do not stand to gain a great deal from it. They are not likely to be threatened by unemployment unless there is an economic catastrophe and they may indeed be covered by private benefits of some sort. Under a social insurance approach those are your strongest supporters for the programme and consequently the whole political setting, the whole political climate of debate is altogether different. Consequently I think the budget constraint has shifted even if one is looking solely at the resources which a society is willing to allocate through the test.

For economists I think there is another meaning for efficiency and that is in the terms of a dead weight loss that a system produces overall. I don't know of anybody that has tried very hard to make such estimates for social insurance systems. I only know that in looking at social insurance systems it would be a mistake solely to look at the height of taxes that is necessary to finance them for purposes of calculating dead weight loss. The wrongness of that approach is apparent if one considers the conversion of a voluntary private insurance system into a mandatory public one. Surely to the extent that the insurance was purchased on a voluntary basis privately there is no dead weight loss, the premiums were paid, benefits are going to be received at some time in the future. If one now converts that into a public programme, then to the extent that somebody is paying those premiums and receiving those benefits, to the extent that those taxes are in effect replacing previous premiums there is no dead weight loss from the imposition of those taxes. The imposition occurs to the extent that private decisions are distorted relative to what they would have been in the absence of the system.

Another issue is that much of the rhetoric lying behind the Australian system rejects market outcomes and wants to use the social welfare system ideally as a means of replacing the undesirable outcomes of a market system. The fact of the matter is that the Australian system as it is structured is a very residual system - one that really has the effect of allowing the market system to operate and then stepping in only to correct or to set a floor on the lowest incomes.

Let me turn briefly to the health issues and say something about those aspects that are generally upsetting economists. I really feel that in this area Australia is in a good position to deal with the problem that is emerging in all developed countries. Every developed country in the world has acquired some institutional mechanism for insulating people from the cost of health care at the time they need to get it. If you are seriously ill you do not have to pay the full costs of health care in any developed country in the world. The comprehensiveness of coverage varies of course, but even in a country like the United States 90% of hospital bills are paid by people other than the patient - either by insurers or by government programmes. The same thing is true and has been true for a number of years in Australia through an evolving system that seems to change annually or bi-annually. The point is that nobody pays for the high cost of the big ticket items in medical care at the time they need it. That is one point.

The corollary is of course that nobody has an incentive to economise - at least once you get beyond a certain margin. The patient does not have an incentive to economise, the physician surely does not have an incentive to economise - the hospital administrator I would like to leave out of the equation for the time being.

The second fact is the technology which is proceeding at really an extraordinary pace in the medical area with the development of procedures that bring miraculous cures or diagnostic accuracy in a number of cases , but that also have the capacity to be used in a virtual infinity of cases where the benefits are much smaller. There is a steady continuum from the miracle cure to the marginal gain of a small bit of information or the slightest improvement in the probability of a desirable medical outcome. The cost however, of doing the given procedure will be the same whether the expected benefit is very great or very small. Put those two things together of course and you have the makings of an industry in which it is in everybody's interest to spend as much as possible, at least up to the point where benefits are zero. It gets progressively more costly to do so as time goes by, purely as a result of technological advance. We are all grappling with this problem in one way or another in virtually every developed country.

I suggest in my paper that Australia happens to have in place a system relatively well suited to dealing with that problem. Specifically, the funding of hospitals through State budgets is especially well suited since the Grant formula was changed from a margin formula to a closed-ended lump sum payment from the Commonwealth to the States. I think Australia is in good shape on those grounds. In most countries I would like to see more use of market forces in the demand for medical care than they now have. That is a personal view though. We economists who may have a bias in that direction are in a demonstrably small minority on that question so I think that this budgetary control mechanism that you have is something that you should treasure.

I will turn now to some of the specific comments made by Andrew Podger and Philippa Smith. The first one is about superannuation. It seems to me that the importance of this issue is difficult to exaggerate. It is potentially a gaping loophole in the personal income tax system. People are able to save, accumulate non-taxable assets and capital income that is non-taxable and then receive payment which is not taxable. This is a situation that vitiates any taxation norm whether you believe in a comprehensive income tax or a consumption tax. It is also a loop hole for labour income of course, since there is a strong incentiive for those who have discretionary income to try and lock it away in the form of a superannuation plan. I recognise the institutional rigidities and the difficulties of making arrangements with employers. The important thing to recognise is that there is a very strong incentive to move in that direction and I think over time one is going to see a tendency to shelter increasing amounts of income in that fashion unless that loop hole - one might call it a garage door - is closed or at least narrowed.

With respect to the unemployed there are a couple of comments I would like to make. The first is a kind of instinctive reaction against the gloomy view of the prospects for unemployment in Australia. I recognise the problems that have been sketched in the last two and a half days and I have been listening carefully. However, one would have heard exactly the same stories in many economies in the midst of previous recessions and in particular one heard very much the same kind of story in the United States as briefly as a year or eighteen months ago. We have had a remarkable decline in unemployment. I have a principle which is that economists consistently underforecast turning points and the magnitude of them. I would be willing to take bets against the large scale econometric models here that if the economy begins to recover, it will recover better than people are forecasting and that would include on unemployment front.

With respect of the treatment of unemployment in two income families, I will throw just one issue on the table which it seems to me something needs to be done about. You have a fundamental discrepancy between the relevant units used for your tax system and those used for your unemployment system and indeed for many other aspects of your income support system. You have a real individual income tax, but for many aspects of the income transfer system the family unit is used - and indeed it is that which is relevant - I think that is going to create increasing difficulties for you.

Philippa Smith quoted some really striking statistics on the trends in the numbers of people who are well off and poor, and the shares of income that they receive. I would like to see those statistics as they are very interesting. However, they are subject to a number of possible interpretations and one of those, I think, is adverse to the expansion of social welfare programmes. One possible interpretation - I have no reason to think it is necessarily the right one, but it is not logically excluded - is that the expansion of social welfare programmes has had a catastrophic effect on incentives. That would be suggestive if the data being presented referred to before-transfer income. That would suggest that there had been a large swing, a dispersion in the degree of work effort away from those who stand to benefit from large transfer payments and face the very high marginal tax rates that Philippa referred to and towards those who are able to shelter themselves effectively from the ostensibly high marginal tax rates under the personal income tax through one or another of the devices for tax avoidance.

I have two final points. The first is inspired by some of the previous discussion on Dan Mitchell's paper and also by some remarks made by Philippa Smith. One is prone to look at the long duration of unemployment and the very high numbers of unemployed and infer the need for generous benefits that continue without limits. There is clearly an incentive question here and in particular one incentive that is relevant concerns the duration of unemployment itself.

I have a table in my paper that points out that the periods of extended unemployment suffered by some of the unemployed in Australia are a good deal longer than in the United States. It is just a plain table with simple data, it does not provide any of the numerous possible explanations for what is going on. But I would like to suggest, for the reasons suggested by Philippa Smith, that this means the unemployment problem is a good deal less serious in the United States. To the extent that the structure of unemployment insurance in the United States contributes to that, it is producing a beneficial side effect that has to be weighed in the balance along with the rather cruel denial of benefits under the U.S programme in a number of specific cases. To put it bluntly if we convert the labour market systems of both countries into systems in which queue-shuffling was absolute to the extent that 10% unemployment meant that we were all unemployed 10% of the year, then we would not have a major social problem with unemployment. We would have an economic problem to be sure because production would be reduced, but we would have very little need for income transfers as a result of unemployment and the whole issue would be a good deal more tractable. Now, table three of my paper is presented to provoke people into addressing with research the question of whether the structure of unemployment benefits may contribute to the rather unshuffled queue of unemployed that seems to characterise the Australian labour market.

The last point concerns the one that Philippa Smith raised about marginal tax rates. I have lived through this issue for a long time both inside government and as an analyst. I think that the economists' emphasis on marginal tax rates has been overdone. The reason I think so is captured in the results of some research that has come out in the last three or four years as a result of the income maintenance experiments. It can be summarised most simply in the following way. Consider two income transfer programmes with the same guarantee, one with a high benefit reduction rate and one with a low benefit reduction rate. The fact of the matter is, at least given the United States labour supply elasticities, the disincentive effects from a high benefit reduction rate are much smaller than those in a system with the low benefit reduction rate. The reason quite simply is the one that Philippa Smith cited, that the high benefit reduction rate system applies to a much smaller proportion of the income distribution than does the low benefit reduction rate system. Hence many fewer people are subject to the extra tax rate that the benefit reduction rate brings with it. The Reagan administration carries that policy almost to it's logical extreme and after a few months of work you lose your benefits completely if you have any earnings at all. That sounds very cold and draconian and unquestionably it is for some people. But it minimises the total work disincentive effect. It is something that I think almost none of the economists who started the income maintenance experiment in the United States back in the 1960's and 70's anticipated. But nonetheless that's where the results seem to have led.

My purpose in the paper and indeed in these remarks is really not to take hard positions about Australian social welfare policy. I don't know that a social insurance system has sufficiently great advantages to outweigh the disadvantages referred to by both Andrew Podger and Philippa Smith. I do know that there is an issue that is not addressed by the Australian system which emphasises the anti-poverty objective, and that is the question of what sort of income protection should be provided for middle class people as they move into the retirement years. I don't mean to take a firm position on either the disincentive effects of any of these programmes, with respect to saving or labour supply, I couldn't take a firm position because for the most part the research is insufficient to enable us to argue dogmatically about it. There is a dearth of data for reasons that may be good and sufficient. Data are much more expensive to gather in a small country, you have to get almost as many observations, but the cost is spread over many fewer people, so it's really very expensive to get good data sufficient to support research in a country the size of Australia. Nonetheless I really meant my paper by and large as a plea to take a hard look at incentive effects, to take account of other objectives than just the anti-poverty objectives and to try to do so in as non-ideological a way as possible.

DR NEVILLE NORMAN, University of Melbourne:

I would like to join with those who are impressed with the way in which Professor Aaron has come to grips with the Australian social welfare system, and in so doing raise some points that may appear to be of detail but which are so frequently misrepresented by Australian economists.

As Professor Aaron correctly observed, social welfare exists not simply at the Commonwealth level but also at the State level and through the many voluntary and charitable organisations. Notwithstanding this, his table one is restricted only to Commonwealth Government outlays. Secondly, a reference that Australia has never taxed capital gains, while technically incorrect by virtue of Section 26 of the Australian Income Tax Assessment Act, is for all practical purposes correct in this context.

Third, in relation to the superannuation proposals currently being discussed in Australia, one frequently hears Australian economists speak of a 5% superannuation tax under the existing arrangements whereas in fact 5% of the vestable sum is included. On this matter Professor Aaron is absolutely correct. However, on two other matters there are technical corrections to be made. The 30% tax under the new proposal is in fact only a 15% tax up to a threshold value of $50,000 of the terminable lump sum. More to the point, the sum that will now be in the base for the new superannuation lump sum tax is not the actuarial sum accumulating after the effective date, which is the 1st of July 1983, but the ratio of the period of time from that date until terminationto the total period of superannuation. In an age of inflation this makes quite a lot of difference. This is a concession made by the government recently, partly because under promissary benefits schemes you just simply could not work out the actuarial basis otherwise. This is a concession which has not, if I may say so, been very much appreciated or acknowledged.

Very few Australian economists really understand the mechanics of the system as well as Professor Aaron does, and yet many will rather glibly favour slashing government expenditure whilst failing to recognise that there is a sort of "political lower bound" operating in this process. Equally, economists should not flinch from pointing out to the social welfare people that acquiesence to these pressures has economic costs. Potentially, these substantial economic costs may alternately rebound on the very disincentives to which Professor Aaron has correctly drawn our attention. If one were not much in favour of numerical projections and had acquiesced literally to these social welfare arguments and then approached all elements of Commonwealth government spending in the same way, there would be a huge problem looming, not only for Australia but for many other countries. I think that this focus is one of the most important elements that will drive the economic and governmental environment for Australia in the rest of the 1980's.

DR OWEN DONALD, Dept of Social Security:

One of the concerns that I have derives from Professor

Aaron's resurrection of the debate on the potential for unemployment benefit conditions and levels to increase perhaps the volume but more commonly the longevity of unemployment, and the peculiar distribution of unemployment longevity that appears to exist in Australia by comparison to that in the U.S.. Emerging from the paper is a fairly strong suggestion that unemployment benefit conditions in Australia have contributed to increased longevity of unemployment. Professor Aaron addressed himself to this issue just a few minutes ago. Perhaps it should also be said that the present rates and conditions of unemployment in the absence of more appropriate forms of assistance (for those in educational institutions, other forms of training or long term redundancy) may draw one to this conclusion. I would not want to argue too much at the youth level, although obviously a good deal of debate has occurred in relation to whether unemployment benefits levels for youth in Australia have actually affected school retention rates. Certainly in the absence of either financial incentives to remain at school and/or more appropriate forms of youth training, it is quite conceivable that unemployment benefits, even at a relatively meagre level, might contribute to youth unemployment.

There are however, a number of reasons for suggesting that unemployment benefit is perhaps not as attractive a device for long term income support as Professor Aaron surmises. Firstly his paper does not directly mention that unemployment is work tested to the extent of ensuring fortnightly - or at least six monthly - that the person involved has in fact been actively seeking work. Secondly, it was stated that virtually all the unemployed in Australia qualify for unemployment benefits. But, as also pointed out, unemployment benefit is family income tested (actually, income tested on the basis of the couple's combined income). Unlike the situation in some other places, the spouse of an employed person does not attract unemployment benefit in this country.

At this point I will raise a tangential issue relating to comments made in respect of the Mitchell paper. It was commented this morning that in 1971, 14% of the unemployed were in receipt of unemployment benefits whilst at the end of the decade the figure approached 80%. It was suggested this could possibly indicate some major structural changes in both the unemployment problem and the nature of the benefit being received. What was not emphasised was that the increasing longevity of unemployment throughout that period contributed very substantially to the demand for unemployment benefits.

Certainly there were also changing social attitudes but these particularly related to the increasing commonness of unemployment and the increasing perception that, as I too could be unemployed perhaps I should look on beneficiaries in a somewhat different way. The major factor must surely be that under periods of full employment with very short term unemployment and high job turnover there is relatively little incentive to apply for unemployment benefits. But when vacancy rates are very low, when unemployment is very high and prospects of getting jobs are very low, clearly people have got very little choice but to go onto benefits. I think that fact predominately explains the dramatic increase in the proportion of the unemployed receiving benefits.

Turning to the paper more specifically, there has been a good deal of Australian debate on the impact of unemployment benefits on the longevity of unemployment. That debate,as Professor Aaron has highlighted, is based on very poor evidence and has at best been inconclusive. But it is worthwhile stating the simple arithmetic of the problem. While the level of unemployment benefit may have an influence on the longevity of unemployment, the key factor is clearly that while we now have 600,000 unemployed, we only have something like 20,000 job vacancies.

On the question of incentives, Professor Aaron leaves out a potentially very significant new benefit in Australia called family income supplement (FIS). This is geared quite specifically to addressing the problem of work incentives among low income people with families. Thus the problem that we face, or used to face, of unemployment beneficiaries being able to claim more income through benefits than they could receive through employment, by and large no longer exists. Although FIS would be generally described as a meagre programme at present, there are indications that it will be more significant in the future. It is certainly an attempt to address a major incentive problem in relation to unemployment benefits that has arisen in recent years.

I would add that it is not quite true that early retirees, aged 55, who go onto unemployment benefits receive just as large a pension as an age pensioner. Firstly those who are single in fact get a lower benefit, and secondly, those who are married receive a lower benefit in the form of additional benefits. They are not eligible for rental assistance, they are also not eligible for fringe benefits which can be quite significant on low incomes as an income supplementation device. I would suggest that overall the attractiveness of unemployment benefits has been overstated, as has the suggestive conclusion that unemployment benefits in Australia have contributed to the longevity of unemployment. Admittedly it is very easy to come to that conclusion in a comparison with unemployment benefits insurance in the United States, but it may nonetheless have been overstated.

MR JOHN MACLEOD, CRA:

I would like to support what Neville Norman has said - that we should be careful not to think of welfare only in terms of Commonwealth government payments. Not only do we have to consider the the State level, but we also have to think of the local government level. To give an example of the local government in my own area: 15% of the rate payers pay more than 50% of the rates. This means they subsidise garbage and water supply services to that area. We should also think about private sector contributions. The most important one that is missing is workers compensation. I have referred to this previously so I will say no more about it here, except that if we are not careful it will become a monster that will overwhelm us. Secondly, I think the other part of the private sector that should have been commented on is the role of charities and the rapid pace at which Australian families have departed from the welfare responsibilities that they had a few decades ago.

I will turn quickly to Professor Aaron's discussion about incentives, where he refers to the effects of savings and the aged pension. While there might not be much economic literature on this there certainly has been quite a considerable debate. The Liberal Party for example debated it ad nauseam and continues to actively debate it. There are a number of very important issues here and they come back to those old, old points which Russell Matthews and others have been making repeatedly - that it is the result of our crazy taxation system. It is crazy in the sense that the marginal personal tax rates at 46% and 60% cut in at far too low levels and therefore encourage all sorts of anti-social behaviour and secondly the capital gains that we have already discussed. The real question is about funded or unfunded superannuation funds. It is one thing to provide for your superannuation by collecting stamps or antiques or whatever; it is a totally different thing to pay into a funded scheme. In my opinion one of the important side issues in this country is the question of Australian ownership. If it really is an important political issue - I do not understand why it should be - then we have got to find out where that equity comes from and the best source of equity investments of this kind are long term savings managed by people with long term funds.

PROFESSOR JOHN NEVILE, Univ of New South Wales:

I want to talk about the comparison of the length of time people have been receiving unemployment benefits and the conclusion drawn from it, that the availability of unemployment benefits for a longer period also causes longer stretches of unemployment than otherwise would occur. The conclusion may well be true but for a number of reasons I don't think that it can be deduced from from Table 3 of Aaron's Survey paper (reproduced next page). If in America unemployment benefits cut out earlier, there are going to be more people who receive benefits for shorter periods of time. Thus if people cease to receive benefits after a certain length of time, there will not be so many at the bottom end. But quite apart from that these things add up to 100%. If there are a group of people who are eligible for unemployment benefits in America and who are ineligible for unemployment benefits in Austraiia and who tend to have relatively short terms of unemployment then this will produce this result in any case. For example, if wives tend to be unemployed when they cannot find relatively convenient jobs and return to employment when they can find relatively convenient jobs, they show up in the American statistics as short term unemployed people whilst in Australia they will not appear in this category because they are not eligible for unemployment benefits.

Finally, Professor Aaron says that differences in the demands for labour do not explain the striking contrast in duration, as in 1983 unemployment rates in Australia and the United States were similar. Unfortunately I don't think we know whether they were similar, because the definition of unemployment I think is still quite different in the two cuntries. The last

Table 3.* Comparison of Insured and Uninsured Unemployment in Australia and the United States

	Australia	United States	
		Insured	Total
	(February 1983)	(February 1983)	
	Percentage of total unemployed		
Duration of benefit or unemployment			
13 weeks or less	39.6	-	77.1
13 to 26 weeks	20.6	-	77.1
More than 26 weeks	39.7	-	22.9
More than 52 weeks	20.0	-	11.7
Age of recipient -- percent			
Under 18 years	11.0	16.2	37.2
18-24 years	40.7	16.2	37.2
55 years and older	5.1	13.4	7.7

Source: United States total unemployment data: Employment and Earnings, March 1983, U.S. Department of Labor, Bureau of Labor Statistics, Washington, D.C., 1983, p. 31 and 44; insured unemployment data: unpublished data, Employment and Training Administration, U.S. Department of Labor.

* Reproduced from the paper by Henry Aaron "Social Welfare", presented to the Brookings Survey of the Australian Economy Conference, January 1984 (p.28).

time I looked at this was 15 years ago. Just on definitional differences 2% unemployment in Australia was the same as 4% unemployment in America. I don't imagine that means that 10% in Australia is 20% in America, but there still are differences in definitions and I think it is a pity that Dan Mitchell's paper did not look at this.

MR OWEN WEST, MIM Holdings:

Many of the public debates about social welfare policies both in Australia and overseas often concern forecasts of the growing in the community requiring social benefits - especially in proportion to the numbers employed in the work-force. Philippa Smith has mentioned this. As the relative number of welfare recipients is important to the debate about particular policies and the costs of those policies and whether Australia can fund a particular welfare system, I was surprised to find no such forecast or substantial comment in the paper. I wonder whether that was a deliberate omission. Was such an analysis seen as irrelevant to a survey of the Australian welfare system?

MR DARYL DIXON, Social Welfare Policy Secretariat:

As the last commentator pointed out, this paper gets us to where we are at the moment. However the real problem - what social security is really about - is how we distribute the cake. What I have found while working in the area of financing of social welfare is that we do not really have a decent set of accounts by which we can assess the existing distribution. Until recently taxation expenditures were treated quite differently to direct expenditures. Nor do we know the accumulated unfunded liabilities of the commitments of government in this country and there is very little understanding of the long term nature of commitments in the welfare area. At the moment, for example, the pension for a female aged sixty is payable on average for 22 years. It is a payment that cannot be turned off and on. A decent set of accounts is required. If you look at it in the way that Henry Aaron has done in his paper. some of the most challenging and interesting economic problems are apparent.

PROFESSOR WOLFGANG KASPER, Univ of New South Wales:

I would like to draw attention to the subsidies that supplement welfare payments to the poor in this country. If they are reasonably agile "welfare takers", a husband, wife and one child will not only receive $155.00 cash payment per week as unemployment benefit but can additionally get housing, medical, and transport subsidies that easily amount to another $50 to $75 per week. I make the point because this is important with regard to the marginal tax incentive. We can easily arrive at marginal tax rates on transit into work of 150% or more. These non-cash subsidies are also important when we make judgements about the level of poverty and the importance to budget costs that poverty and welfare creates.

DR GLENN WITHERS, Australian National University:

I want to comment briefly on the sins of omission. Henry Aaron did dip his toe into the area of disability and injury compensation payments and spent some paragraphs talking about it. It appeared he then decided to back out before he got too far in. He particularly talked about the several billion dollar amount of payments that are now made annually for workers' compensation. If you add into that total the much greater payments paid out under compulsory third party motor vehicle insurance for injury and disability, the total adds up to an amount that is well over the Australian defence budget. I believe that where numbers of that scale are concerned, either a more comprehensive and analytic treatment should be given, or the subject should be dealt with elsewhere.

PROFESSOR JOHN HELLIWELL, University of British Columbia:

I have noted from a number of people here the idea that the Australian tax system may rely too heavily on income tax relative to expenditure taxes. What I would like to point out is that the tax free accumulation and superannuation funds when viewed in this light can represent a valuable element of a reformed tax system and not simply a tax expenditure that works to the benefit of the wealthy. There are several possible advantages of that scheme rather than a direct introduction of an expenditure tax. One, it solves the tricky problem of inflation indexing of capital income - that is done automatically through that process. Two - and the obvious point -is that to the extent this process is taken up, it shifts you from an income tax to an expenditure tax. Three, it can introduce an element of progressivity into the expenditure tax by putting limits on the amount of funds that can be put in to this tax free accumulation. Four, it is administratively far simpler than an expenditure tax. Five, it does not raise any new State-Commonwealth complications in the system. In order to achieve these advantages of course it is necessary to go the whole way. The existing reforms towards the treatment of the lump sum payments have only gone part way, you have to go the whole way and make sure that all withdrawals from that system after retirement are properly put through the income tax system.

MR PADDY MCGUINNESS, Australian Financial Review:

It should be emphasised that this paper, and all the comments except those of Wolfgang Kasper, have overlooked the importance of non-cash benefits in the Australian social welfare system. Welfare housing for example, is a very significant part of total expenditure by the federal government. There is educational expenditure - free schooling, free universities, there are telephone concessions for old age pensioners, there are travel concessions, local government grades concessions, there are meals on wheels, services provided by private charity and all the other voluntary services, there is child care. There are the interest rate controls, which are very important, which are imposed on housing lending for welfare purposes. There is the Arbitration Commission which sets minimum wages - effectively for welfare purposes. When all that is taken into account, one must remember that social welfare is the sole justification for the enormous network of regulations in Australia. They are always defended because of their impact on social welfare and their presumed redistributive effect in favour of the poor. It has been pointed out often enough by economists that often they favour the relatively well off rather than the poor, but the justification for intervention and regulation is always in terms of the welfare system and the welfare impact. The tariff is justified on welfare grounds; farm product stabilisation is justified on welfare grounds, as are interest rate controls. Under the Whitlam government there was a joke that there were twenty seven ministers and twenty seven ministers for social welfare. This is something which this whole conference should face up to - the fact that the Australian social welfare system is pervasive throughout the Australian economy.

PROFESSOR AARON:

Just a very few replies. Owen Donald stressed the fact that I paid relatively little attention to the new family income supplement scheme. That is true. I did so on the Willie Sutton principle because of its present status. However,I believe he drew an incorrect inference that the family income supplement is somehow going to take care of the incentive problem. I think it will make it worse. For the reasons that I stated before, counterintuitive though it may be, a very high benefit reduction rate which focuses the tax rate inherent in any welfare programme on a small population, produces less total work disincentive effect than does the apparently more encouraging low benefit reduction rate that extends benefits to the thick portions of the income distribution. I also think that the example, the differentiation between the benefits that older workers can receive, older unemployed persons can receive from unemployed benefit and old age pension, really goes to reinforce the point that I made rather than to under cut it. The point I was trying to make was that an older worker with an unattractive current job can find a way to retire de-facto because of the fact that unemployment benefits are available without limit of time.

He will not receive quite as much to be sure, but he will receive what unemployment benefit does provide. I think the work test in the current environment for such workers is likely not to be a very stringent hurdle for people to clear.

John Nevile raised a point about insured unemployment and total unemployment, suggesting that if I was referring to insured unemployment then the difference between the U.S and the Australian statistics really had an obvious explanation. That may be, but I am referring to total unemployment not insured unemployment in the rightmost column of Table 3.

Owen West raised a query about the relative lack of demographic analysis in the paper and that I think is a fair comment. I believe it would have been very difficult to have done much beyond the quite superficial prior to completion of a study done through Darryl Dixon's office. That study, which has just come out, was an attempt to look at the aged pension from an actuarial stand point and to project costs under various rules. I did cite that study in my paper and I will develop that section - provided that Larry Krause and Richard Caves are not too ruthless in cutting my number of pages.

Glenn Withers points to the very serious omission of an adequate discussion of disability injury, workers' compensation and so on. John Harper pushed very hard for me to make that a prominent part of the paper during the time I spent in Melbourne and what little I learned, I learned as a result of his pushing me. But what I learned was that there is so much institutional diversity across the States particularly in the area of workers' compensation, that any adequate treatment for non-Australian readers would have required by itself a paper nearly as long as the one I had. So my decision not to address that more thoroughly was a calculated one; I knew I was not going to learn enough in the time I had and even if I did learn enough I would not have been able to keep the written piece within the limits. However, it was so important that I could not entirely neglect it, so I fell between the two stools, neither ignoring it nor covering it adequately.

John Helliwell, I think, overstated the case (if he was stating a case) for the current treatment of superannuation. Surely what he was arguing for was consistent expenditure tax treatment. That is the direction in which the proposals of the Hawke government moved partially, but that is not where the system is right now. Right now it is just a big loop hole, it makes the income tax worse not better because it narrows the base and requires higher rates to achieve a given amount of revenue and we all know the dead weight losses rise roughly with the square of rates. So the current treatment of superannuation from a tax policy stand point is just pure bad news.

Paddy McGuinness raises a point that I tried to address in the paper but I reached a different conclusion than he wanted me to reach. The fact of the matter is that virtually everything the government does affects income distribution. Certainly enough people are aware of the effects of agricultural subsidies and tariffs and even rules regarding contract law and indeed legislation regarding sex discrimination. All of those things affect the distribution of income in a major way. So if you

6HC8
:D57
B. 8/1985

wish to write a comprehensive paper on programmes that affect social welfare you will need to write an encyclopaedia not a sixty page, soon to become fifty or forty five page paper. I left tariffs to Larry Krause and agriculture did not get covered. I will have a harder time I suspect in defending the slighting of fringe benefits, but again I have been confronted by the editorial problem. There are dozens of separate programmes which are just words to non-Australian readers. I tried to allude to them and suggest their importance. I did not get statistics on total costs under all of those programmes and if anybody can tell me how to get them I would love to include those and broaden Table 1 as various people have suggested. I would like to get State and local data.

Again, thank you for your comments.