Using cheap private health insurance to avoid the Medicare Levy Surcharge

What is the cost to taxpayers?

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Andrew Macintosh[1]

Summary

The Medicare Levy Surcharge (MLS) aims to encourage greater private provision of hospital services by penalising high income earners who do not have eligible private health insurance with a registered health fund. Eligible private health insurance is defined as health insurance with an excess (known as 'front-end deductible') of no more than $500 for singles or $1,000 for couples and families. For the purposes of the MLS, high income earners are defined as a single person with a taxable income greater than $50,000 a year or a family or couple with a combined taxable income of more than $100,000 (which increases by $1,500 for each child after the first).

The health insurance industry has developed a number of low-cost health insurance products that enable high income earners to avoid the MLS. These cheap policies provide only limited cover, meaning the incentive for policyholders to actually use private health services or rely on the cover when using public services is greatly diminished. The net effect of the practice of using low-cost health insurance products to avoid the MLS is to reduce tax revenues without providing the offsetting benefit of reduced pressure on the public health system. To gauge the extent of this problem, this paper looks at the low-cost health insurance policies offered by registered health funds to high income earners and estimates the losses in tax revenues.

All registered health funds were contacted by phone and asked whether they had a cheap policy that would allow the policyholder to avoid the MLS. The vast majority of registered health funds offered a low-cost policy, with annual premiums generally ranging between $400 and $600. By taking out such a policy, most high income earners can gain a financial benefit (i.e. the cost of the policy is less than the MLS that would have been payable).

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The revenue losses from the use of low-cost policies to avoid the MLS were calculated using unpublished ABS data from the 2004/05 National Health Survey. It is estimated that this practice resulted in tax losses of between $110 and $250 million in 2004/05, with a best estimate of $230 million.

To reduce tax losses and improve the operation of the MLS, the Government should tighten the rules regarding the eligibility of private health insurance products. In particular, in order to avoid the MLS, high-income earners should be required to obtain insurance that provides cover for at least some private hospital and ancillary services (particularly ambulance). In addition, measures should be put in place to ensure high-income earners with private health insurance use the policies when they obtain services in public hospitals.

1. Introduction

The Federal Government provides a large amount of assistance to the private health insurance sector as a means of encouraging greater private provision of health services. Three main mechanisms are used to provide this assistance.

- Lifetime Health Cover. Introduced in 2000, Lifetime Health Cover is designed to encourage people to take out private health insurance earlier in life by penalising those who delay. If a person fails to take out private health insurance by 30 June in the year they turn 31, they are required to pay an additional two per cent loading on their premium. For each subsequent year they do not have private health insurance, an additional two per cent loading is applied up to a maximum of 70 per cent. Previously, the additional loading would apply for life. This has recently been changed. Now the loading is removed if a person maintains cover for ten consecutive years. There is no exemption for low income earners.

- The Private Health Insurance Rebate. This scheme was introduced in January 1999 and it enables people who have private health insurance to claim a rebate from the Government on their premiums. For those aged 70 years and above, the rebate is 40 per cent, for those aged 65 to 69 the rebate is 35 per cent and those under 65 years are entitled to a 30 per cent rebate. The object of the scheme is to increase the uptake of private health insurance by lowering premiums.

- The Medicare Levy Surcharge (MLS). The MLS is a penalty that applies to high income earners who do not have private hospital insurance. High income earners are defined for these purposes as a single person with a taxable income greater than $50,000 a year or a family or couple with a combined taxable income of more than $100,000 (which increases by $1,500 for each child after the first). People meeting this description who do not have private health insurance are required to pay an additional one per cent surcharge on their taxable income, which is on top of the 1.5 per cent Medicare Levy. The scheme is designed to encourage high income earners to take up private health insurance.

The assistance provided to the private health insurance industry is justified on the grounds that greater private provision of health services relieves pressure on the public system. For example, in 2005, the Minister for Health, Tony Abbott, stated that:

> [o]f course, every patient treated in a private hospital is one less patient on a public hospital waiting list (Abbott 2005).

Similarly, when the MLS was first announced in 1996, the then Minister for Health, Dr Michael Wooldridge, argued it would ‘relieve some of the pressure on the public hospital system’. He also stated it would relieve the ‘service strain’ on Medicare and

public hospital waiting lists (Wooldridge 1996).[1] The same sentiments are expressed on the Department of Health and Aging website.

> The aim of the Medicare Levy Surcharge is to encourage high-income earners to take out private hospital cover and, where possible, to use the private system to reduce the demand on the public system (DHA 2007).

Opponents claim that the assistance provided to the private health insurance industry does very little to reduce pressure on the public system and that the savings achieved by the redirection of patients to the private sector are outweighed by the costs of the policies. Consequently, the financial assistance provided to private health insurance industry would be better spent on the public health system (Davoren 2001; Sullivan *et al.* 2002; Segal 2004; Hall and Marnard 2005).[2]

This paper seeks to contribute to this debate by evaluating the extent to which low-cost health insurance products are being used by high income earners to avoid the MLS. Under the rules applicable to the MLS, high income earners are exempt from the surcharge if they have eligible private health insurance with a registered health fund. Eligible private health insurance is defined as health insurance that covers hospital costs with an excess (known as 'front-end deductible') of no more than $500 for singles or $1,000 for couples and families. The excess requirements were introduced in May 2000 in response to information that large numbers of high income earners were buying cheap insurance products with large excesses in order to avoid the surcharge.

If large numbers of high income earners are using low-cost insurance products to avoid the MLS, the program is unlikely to achieve its objective of reducing pressure on the public system. This is a result of the fact that people with low-cost insurance products are less likely to rely on the private sector for health services because they will shoulder a substantial proportion of the costs of the service.[3] As a result, they are more likely to use the public system, where they may or may not be treated as a private patient. Due to this, high income earners purchasing low-cost insurance products to avoid the MLS reduce tax revenues without necessarily providing the offsetting benefit of reduced pressure on the public system.

Where a patient presenting at a public hospital declares that they have private health insurance the loss to the state is reduced as the insurer will pay a proportion of the cost of the service. However, there is evidence that a significant proportion of people with private health insurance are not declaring their insurance status when they present to public hospitals (Sullivan *et al.* 2002; Hamilton and Denniss 2002).[4] In doing so, they deny the public system an important source of revenue.

To gauge the extent of the problem associated with the use of low-cost health insurance to avoid the MLS, Section 2 evaluates why people take up low-cost health insurance and the types of low-cost health insurance products that are available. In

[1] Similar statements were made by Dr Wooldridge's successor, Kay Patterson. See, for example, Patterson (2002).
[2] See Pratt (2005) for a brief overview of the debate.
[3] The cost to the patient could be in the form of a large excess, co-payments or direct payment to the private hospital in cases where the policy does not provide cover for the relevant services.
[4] See also Moorin and Holman (2006).

Section 3, unpublished Australian Bureau of Statistics (ABS) data are used to estimate the amount of tax revenue that is lost as a result of the use of low-cost health insurance to avoid the MLS.

2. Cheap health insurance

There are three main reasons why people purchase health insurance: better health services, to obtain a sense of security and to obtain a financial benefit. The immediate financial benefits relate primarily to the avoidance of the MLS.

If a person can purchase an eligible private health insurance product for less than the additional tax they will pay as a result of the operation of the MLS, they will be better off financially. Hence, the financial benefit obtained from purchasing private health insurance in relation to the MLS is a function of the size of the premium and the income of the person, couple or family.

A single person with a taxable income of $50,000 will be better off financially if they can purchase an eligible private health insurance product for less than $500 per annum. The potential financial benefit increases as the person's income increases. For example, a single person with a taxable income of $75,000 will be better off if they can obtain health insurance for less than $750 a year.

A similar situation applies to couples and families. For a one-child family with a taxable income of $100,000, they will obtain a financial benefit if they can purchase health insurance for less than $1,000 a year. With a taxable income of $150,000, the family will be better off if they can acquire health insurance for less than $1,500.

If the primary motivation for purchasing private health insurance is to obtain a financial benefit, the price of the product is likely to be the issue of greatest concern to the purchaser. The quality of the cover provided under the policy is likely to be a secondary issue or even irrelevant. This appears to be reflected in certain types of low-cost private health insurance that are offered by registered health funds.

There are three main types of low-cost private health insurance that have been developed to accommodate those seeking a financial benefit from the operation of the MLS.

Public hospital cover

Public hospital cover provides cover for treatment and accommodation as a private patient in a public hospital. Cover is not provided for treatment in private hospitals, or for any ancillary services (for example, ambulance, dental or physiotherapy). If the patient states that they have private health insurance when they are admitted to a public hospital, they will be required to pay any excess under the policy. However, if they do not identify as being privately insured they will not have to pay the excess. Apart from the tax saving, the only potential benefit to the consumers from holding public hospital cover is the capacity to choose their doctor.

Public hospital cover with limited ancillary cover

This type of policy provides the same benefits as those described in relation to public hospital cover, only some ancillary cover is included. In most cases, the ancillary cover is limited to things like ambulance services.

Hospital and ancillary cover with high excess

This type of low-cost private health insurance provides public hospital cover and limited private hospital and ancillary cover. The private hospital cover is generally subject to a wide range of exclusions and the ancillary cover is fairly limited, although it may include cover for services like dental care and physiotherapy. Premiums on these policies are kept low by the limits on the services and large excesses and/or so-called 'co-payments', which deter people from making insurance claims.[5]

To determine the extent to which registered health funds are offering low-cost private health insurance to enable people to avoid the MLS, we contacted all registered health funds over the period 14 to 15 June 2007 and asked the following question.

> I was speaking to my accountant and he said I could save a lot of tax if I got myself a cheap health insurance policy. I don't really need health insurance, I just want the cheapest policy that will allow me to avoid the Medicare Levy Surcharge. I am a single male, aged 29 with no dependents living in New South Wales. Have you got something that would suit me?

Details of the policies recommended by the funds are presented in Table 1.

Almost all registered health funds offered a low-cost private health insurance product priced around the $500 per annum mark. In several cases, the annual premiums are well below $500, ensuring that all high-income earners with these policies will be better off financially than if they did not have any cover. However, even where the annual premiums exceed $500, in most cases, high-income earners will obtain a financial benefit from purchasing these policies because the price of the policy is likely to be less than the MLS that would otherwise by payable. Further, a number of the policies with annual premiums above $500 have high excesses, which are designed to act as a deterrent to potential claimants. Examples include HBA's Hospital Saver, GMF Health's Bronze Cover, Health-Partners' Excess 500 , Latrobe Health Services' X3, NIB's Basic Saver and NRMA Health's Hospital Select Value.

The types of low-cost products that were suggested by the sales consultants varied. Several funds suggested policies covering public hospital services only. A number of the funds also recommended the use of cheap hospital with limited ancillary cover or hospital and ancillary cover with high excess policies. However, not all of the recommended policies could be described as low-cost insurance. For example, the policy recommended by St Luke's Medical and Hospital Benefits Association Ltd has an annual premium that is more than $1,500. Only very high income earners would be able to gain a financial benefit by purchasing this policy. Given the other options in

[5] Co-payments require the holder of the policy to contribute to the cost of health services. They are effectively an excess payment, only health insurance providers call them co-payments to ensure their products still meet the requirements to enable policy holders to avoid the MLS.

the market, it seems unlikely that anybody would purchase this policy solely to gain a financial benefit through the operation of the MLS.

Table 1 Recommended low-cost health insurance products

Registered health fund	Product name	Product type[a]	Excess	Co-payment	Premium[b]
Australian Health Management Group Ltd	Basic Hospital	Pub/Pr/A	No	Yes	$536.85
Australian Unity Health Ltd	Smart Start Singles	Pub/Pr/A	$100 one off	No	$597.60
BUPA Australia Health Pty Ltd (trading as HBA)	Hospital Saver	Pub/Pr/A	$500	No	$508.80
Cessnock District Health Benefits Fund Ltd	Basic Cover Smart Cover	Pub/A Pub/Pr/A	No	No No	$665.60 $624.00
Credicare Health Fund Limited	B100	Pub	No	No	$430.80
GMHBA Ltd	Better Singles Saver (EE) Public Hospital Cover	Pub/Pr/A Pub/A	$250 $100 one off	Yes No	$523.80 $535.80
Grand United Corporate Health Ltd	Only provides cover for corporations.				
HBF Health Funds Inc.	Young Single Saver (Hospital Only)	Pub/Pr	No	Yes	$451.90
Health Insurance Fund of W.A.	Gold Starter	Pub/Pr	$200	No	$349.40
GMF Health	Young Singles Choice Bronze Hospital Cover	Pub/Pr/A Pub/Pr/A	$150 $200 up to limit of $400	Yes Yes	$796.25 $582.40
Health-Partners Inc.	Excess 500	Pub/Pr/A	$500	Yes	$599.88
Hospitals Contribution Fund of Australia Ltd (HCF)	Hospital Advanced Savings	Pub/Pr/A	$50 per night for a max of 8 nights	No	$478.80
Latrobe Health Services Inc.	Top Hospital with CoverWise (X3) Healthy Start	Pub/Pr/A Pub/Pr	$500 No	No No	$711.24 $631.56
Lysaght Peoplecare Ltd	Public Hospital Cover	Pub/A	No		$589.20
Manchester Unity Australia Ltd	Healthmate	Pub/Pr/A	$200 for first two admissions in calendar year	No	$754.20
MBF Australia Ltd	Budget Hospital	Pub/Pr/A	$500	No	$483.00
Medibank Private Ltd	First Choice Hospital Saver	Pub/Pr/A	$250	Yes	$462.00
Mildura District Hospital Fund Ltd	Basic Hospital Cover	Pub	No	No	$449.50

NIB Health Funds Ltd	Basic Saver	Pub/Pr/A	$500	No	$517.70
NRMA Health	Hospital Select Value	Pub/Pr/A	$500	No	$538.65
Queensland Country Health Ltd	Public Hospital	Pub	No	No	$629.40
St Luke's Medical & Hospital Benefits Association Ltd	Hospital 500	Pub/Pr/A	$500	No	$1,588.90
United Ancient Order of Druids Friendly Society Ltd	Gold Cover H1	Pub/Pr/A Pub	$250 No	No No	$555.60 $583.80
Westfund Ltd	Value Sports	Pub/Pr/A	No	No	$655.20

a. Pub = cover as private patient in a public hospital; Pr = cover for treatment in a private hospital; A = ancillary cover.

b. After the 30 per cent rebate and any deductions for making payments via direct debit.

3. Revenue losses

The ABS has conducted six nation-wide health surveys since the late 1970s. The surveys aim to provide national benchmarks on a wide range of health issues, including private health insurance. The most recent of these surveys was undertaken between August 2004 and June 2005 and was conducted in a randomly selected sample of 19,501 private dwellings, yielding a total sample of 25,906 persons from across Australia.

Amongst other things, respondents to the 2001 and 2004/05 surveys were asked not only whether they had private health insurance but also why they obtained it. Table 2 presents the weighted data from these surveys on the reasons why people obtain private health insurance.

Table 2 Reasons for obtaining private health insurance

Reason for obtaining private health insurance*	**2001 National Health Survey (per cent)**	**2004/05 National Health Survey (per cent)**
Security/protection/peace of mind	41.3	42.5
Shorter wait for treatment/concerned over public hospital waiting lists	18.9	22.5
Always had it/parents pay it/condition of job	21.5	22.5
Provides benefits for ancillary services or extras	18.4	22.1
Allow treatment as private patient in hospital	21.6	21.1
Choice of doctor	21.9	20.9
To gain government benefits/avoid extra Medicare levy	**9.6**	**9.7**
Has condition that requires treatment	5.8	7.7
Elderly/getting older/likely to need treatment	6.4	7.0
Lifetime cover/avoid age surcharge	**9.6**	**5.5**
Other financial reasons	**6.1**	**3.8**
Other reasons	8.6	6.1

Source: ABS (2006a).
* Respondents can report more than one reason for obtaining insurance. As a result, components may not add to 100.

As shown in Table 2, the seventh most cited reason for obtaining private health insurance in both the 2001 and 2004/05 surveys was to gain government benefits or

avoid the MLS (hereafter referred to as 'avoiding the MLS').[6] Between 2001 and 2004/05, the proportion of people reporting avoiding the MLS as a reason for purchasing private health insurance was virtually unchanged, rising only slightly from 9.6 and 9.7 per cent.

In order to estimate the amount of tax revenue lost due to the purchase of low-cost private health insurance, we obtained unpublished data from the ABS's 2004/05 national health survey on the number of Australians with private health insurance who obtained it to avoid the MLS, by type of insurance and income. The relevant weighted data are presented in Table 3 below.

Table 3 Number of people with private health insurance to avoid the MLS, by income unit (gross cash income) and type of private health insurance (2004/05)

	Type of private health insurance membership					
Income unit (gross cash income)[a]	**Hospital cover only ('000)**	**Average income ($'000)**	**Hospital and ancillary cover or ancillary only ('000)**	**Average income ($'000)**	**Total with private health insurance ('000)[b]**	**Average income ($'000)**
Single						
More than $50,000	40.8	81.2	119.5	97.9	160.9	93.6
Family/sole parent						
More than $100,000	39.6	147.8	130.6	142.0	170.1	143.3
Couple						
More than $100,000	13.7*	156.0	34.3	157.3	48.7	156.8

Source: ABS (2006b).
a. Excludes persons where income was not reported.
b. Includes persons who were insured but type of cover was not known.
* Estimate has a relative standard error of 25 to 50 per cent and should be used with caution.

As Table 3 shows, an estimated 160,900 single taxpayers earning more than $50,000 a year had private health insurance for the purpose of avoiding the MLS in 2004/05. Of these, 40,800 had hospital cover only and 119,500 had either hospital and ancillary cover or ancillary cover only.

Approximately 218,800 families (including sole parents) and couples had private health insurance for the purpose of avoiding the MLS in 2004/05. Of these, 53,300 had hospital cover only and 164,900 had either hospital and ancillary cover or ancillary cover only.

[6] Avoiding the MLS and obtaining the rebate are the only 'government benefits' available to high income earners if they obtain private health insurance.

To obtain a conservative estimate of the revenue losses, we included only the singles and families/couples with hospital cover only. It is assumed that people with hospital cover only whose motivations in purchasing the insurance include gaining government benefits or avoiding the MLS have obtained a substandard, low-cost policy.

The revenue losses were calculated by multiplying the number of people who took out hospital cover only to avoid paying the MLS in each relevant income group by the average surcharge payable by high income earners in the group who did not have private health insurance. This is represented in the following equation.

Revenue loss = [(Single HCO average income x 0.01) x Single HCO] +
[(Family HCO average income x 0.01) x Family HCO] +
[(Couple HCO average income x 0.01) x Couple HCO]

Where:

- Single HCO means singles with hospital cover only;
- Family HCO means families (including sole parents) with hospital cover only; and
- Couple HCO means couples with hospital cover only.

The results are presented in Table 4.

Table 4 Revenue loss in 2004/05 due to use of low-cost private health insurance (those with hospital cover only)

	Average levy avoided ($)	Number with hospital cover only	Revenue loss ($)
Single	812	40,800	33,129,600
Family	1,478	39,600	58,528,800
Couple	1,560	13,700	21,372,000
Total	**n/a**	**n/a**	**113,030,400**

Source: ABS (2006b).

The above method suggests the use of low-cost private health insurance to avoid the MLS cost taxpayers approximately $113 million in 2004/05.

There are four problems with this estimate.

- It assumes the use of low-cost cover to avoid the MLS is confined to those with hospital cover only. As discussed in Section 2, there are many low-cost hospital plus ancillary policies that appear to be designed primarily to allow people to gain a financial benefit by avoiding the MLS. By excluding this category of policies, we have underestimated the revenue losses.
- The method that was used assumes there is an even distribution of people reporting taking out private health insurance for the purpose of avoiding the

MLS across the relevant income levels (i.e. above $50,000 for singles and above $100,000 for families and couples). In reality, it is likely that a larger proportion of people in higher income groups will use low-cost policies to avoid the MLS than in lower income groups because higher income earners have a greater financial incentive to engage in this practice. By assuming an even distribution across the income levels, we have underestimated the revenue losses.

- The ABS figures use gross income, while liability to pay the MLS is based on taxable income (i.e. gross income less allowable deductions). The use of gross income will increase the estimate of revenue losses.

- Respondents in the national health survey can give one or more reason for obtaining private health insurance. Consequently, the number of people who reported obtaining private health insurance to avoid the MLS in the survey may be greater than the number who acted on this by obtaining a substandard policy. This suggests we may have overestimated the revenue losses.

- The ABS estimate of the number of couples with hospital cover only who obtained the policy to avoid the MLS has a relative standard error of 25 to 50 per cent. As a result, the ABS advises that the estimate be used with caution.

Another estimate of the revenue losses that accounts for those with low-cost hospital and ancillary cover can be obtained by assuming that one third of those in Column 4, Table 3 use substandard policies to avoid the MLS. The exclusion of two-thirds of this group is intended to account for those with appropriate hospital and ancillary cover and those with ancillary cover only (people with ancillary cover only are required to pay the MLS). The one-third/two-third division is an educated (but conservative) guess based on the number of people reporting that they obtained private health insurance to avoid the MLS and the availability of low-cost policies that have seemingly been designed to assist high income earners to avoid the surcharge.

The results of this method are presented in Table 5.

Table 5 Revenue loss in 2004/05 due to use of low-cost private health insurance (hospital cover only and hospital and ancillary cover)

	Hospital cover only revenue loss ($)	**Hospital and ancillary cover revenue loss ($)**	**Total revenue loss ($)**
Single	33,129,600	38,958,326	72,087,926
Family	58,528,800	61,755,800	120,284,600
Couple	21,372,000	17,966,806	39,338,806
Total	**113,030,400**	**118,680,932**	**231,711,332**

Source: ABS (2006b).

Without additional information, it is difficult to accurately determine the magnitude of the revenue losses associated with the practice of using low-cost health insurance to avoid the MLS. However, the unpublished ABS data presented here suggest the

annual losses are likely to be between $110 and $250 million, with a best estimate of $230 million.

4. Policy responses

The evidence suggests low-cost health insurance products are often used to avoid the MLS and obtain a financial benefit for the purchaser. This practice reduces the Federal Government's tax revenues and undermines the capacity of the MLS to ease the pressure on the public hospital system.

Previous research by the Australia Institute suggested the revenue losses associated with this issue were in the order of $99 to $180 million in 2002 (Hamilton and Denniss 2002). The best estimate for 2004/05 is $230 million, with a range between $110 and $250 million. The increase in the estimate is due to a rise in the number of high income earners reporting taking out private health insurance to avoid the MLS and the use of an alternative method to estimate the revenue losses.

To reduce revenue losses and relieve pressure on the public hospital system, the Government could consider the following.

- Tighten the rules regarding the eligibility of private health insurance products. In order to avoid the MLS, high-income earners should be required to obtain insurance that provides cover for at least some private hospital and ancillary services (particularly ambulance). Co-payments should also be brought within the $500/$1,000 limit that currently applies to the front-end deductible.

- Put in place reforms to ensure high-income earners with private health insurance use the policies when they obtain services in public hospitals. This could be done by establishing a database to enable public hospitals to check peoples' insurance status.

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