“THE END OF THE AGE OF ENTITLEMENT”
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Introduction

I wish to thank my friends at the Institute of Economic Affairs for the opportunity to discuss an issue that has been the source of much debate in this forum for sometime….that is, the end of an era of popular universal entitlement.

There is nothing much new in the debate other than the fact that action has now been forced on governments as a result of the recent financial crisis. Years of warnings have been ignored but the reality can no longer be avoided.

Despite an ageing population and a higher standard of living than that enjoyed by our children, western democracies in particular have been reluctant to wind back universal access to payments and entitlements from the state.

As we have already witnessed, it is not popular to take entitlements away from millions of voters in countries with frequent elections.

It is ironic that the entitlement system seems to be most obvious and prevalent in some of the most democratic societies. Most undemocratic nations are simply unable to afford the largesse of universal entitlement systems.

So, ultimately the fiscal impact of popular programs must be brought to account no matter what the political values of the government are or how popular a spending program may be.

Let me put it to you this way: The Age of Entitlement is over.

We should not take this as cause for despair. It is our market based economies which have forced this change on unwilling participants.

What we have seen is that the market is mandating policy changes that common sense and years of lectures from small government advocates have failed to achieve.

And we have subsequently witnessed over the last twelve months a raging battle. This has been a battle between the fiscal reality of paying for what you spend, set against the expectation of majority public opinion that each generation will receive the same or increased support from the state than their forebears.

The entitlements bestowed on tens of millions of people by successive governments, fuelled by short-term electoral cycles and the politics of outbidding your opponents is, in essence, undermining our ability to ensure democracy, fair representation and economic sustainability for future generations.

Perhaps we could re-apply noted British philosopher, AC Grayling's words on liberty to our debate by declaring that we may record that the age of entitlement might have passed its best point, "after so brief a period of flourishing…"[1]

And flourish it did.

Government spending on a range of social programs including education, health, housing, subsidised transport, social safety nets and retirement benefits has reached extraordinary levels as a percentage of GDP.

However an inadequate level of revenue has forced nations into levels of indebtedness that, in an age of slowing growth and ageing population, are simply unsustainable.

The social contract between government and its citizens needs to be urgently and significantly redefined. The reality is that we cannot have greater government services and more government involvement in our lives coupled with significantly lower taxation.

As a community we need to redefine the responsibility of government and its citizens to provide for themselves, both during their working lives and into retirement.

As part of this process, we must emphasise that government spending should be funded from revenue rather than by borrowing from future generations in whatever form that may take.

The Problem

Entitlement is a concept that corrodes the very heart of the process of free enterprise that drives our economies.

All of us would agree that there are some basic community entitlements. For generations we have all sought to define those basic rights.

For example, in the United States constitution the founding fathers determined that citizens are entitled to life, liberty and the pursuit of happiness.

You will remember it was Margaret Thatcher who interpreted community entitlements as the right for our children to "grow tall and some taller than others if they have the ability in them to do so".[2]

This broader and timeless conservative definition of our end game lays down some foundations for the role of government.

Equality of opportunity rather than equality of outcome is my preferred model for contemporary society.

Thankfully the modern capitalist economy is centred around the satisfaction of personal wants and needs. Commercial transactions are at the core of the system.

And it is a simple and proven formula for willing buyers to engage with willing sellers. If we want a product or service we go and buy it with the dividend from the fruits of our own labour. The producer is happy and the customer is satisfied.

[2] Speech to the Institute of Socio Economic Studies "Let Our Children Grow Tall" September 15, 1975

The problem arises however when there is a belief that one person has a right to a good or service that **someone else will pay for.** It is this sense of entitlement that afflicts not only individuals but also entire societies. And governments are to blame for portraying taxpayer's money as something removed from the labour of another person.

In our collective effort to win votes, political leaders deliberately portray a new spending commitment as if it is coming out of their own personal bank account. Political leaders rarely thank taxpayers for their funding of the policy.

To pay for all these good policy initiatives, governments have taken the easy option and borrowed money from that mysterious and amorphous group defined as "bondholders".

We all know this is simply a case of borrowing money from the taxpayers of tomorrow for spending initiatives of today. Of course I say with irony, it gets even better when some governments borrow more money to pay the interest on current debt so existing taxpayers and voters will never notice the pain. This is the public sector equivalent of those much maligned ponzi schemes.

The sovereign debt problems we are seeing in Europe and the US today are the outcome of countries wanting a lifestyle they cannot afford but are quite happy to borrow from others to pay for.

Of course in recent months in some countries in Europe the "borrowings" have turned into permanent transfers of wealth as those countries have become unable – or unwilling – to repay the loans.

Richer countries are either writing off the debt of poorer countries or they are subsidising the debt repayments with sophisticated transfer payments.

As a parent I want to give my children everything they wish for.

As a democratically elected legislator I want to give my constituents everything they wish for.

The hardest task in life is to say NO to someone you care about.

So perhaps what we are witnessing is a chronic failure of the democratic process.

A weak government tends to give its citizens everything they wish for. A strong government has the will to say NO!

Being profligate is easy and politically popular in the short term, particularly when the political cost of raising sufficient revenue is avoided by resorting to debt.

But painless revenue makes for reckless spending.

Whether it is defence, law and order, income support, social programs and so on, the outcome is the same. Eventually the piper has to be paid.

Since World War 2 western communities have enjoyed prosperity that has exceeded all expectations. This has been fuelled by innovation, materialism, globalisation, free trade and debt.

Of course these are not malevolent developments. Rather they are the lauded natural outcomes of a free and successful society.

Moreover these initiatives, which have fuelled a massive improvement in global economic productivity, have driven the age of prosperity. Arguably this has delivered the most dramatic improvement in the material quality of life since the beginning of humanity.

In effect the rapid rise in private prosperity has been matched with demands for an equal improvement in state provided prosperity.

This is understandable. We all want the best available health care, the best education, the best pharmaceuticals and so on.

The difference is that the handbrake on private demand is income.

Unless a consumer can borrow money, it is their income and wealth which determines whether they can buy a new television or renovate the family home.

But for governments with seemingly unlimited capacity to borrow money, that handbrake on expenditure is not real.

While the Keynesian model of Government-led stimulus during the inevitable downturns in the economic cycle is well documented, governments who have turned on the fiscal tap seem completely incapable of turning it off when the cycle turns upwards.

So we have witnessed a continual over-commitment in many countries, funded by the lure of cheap and easily obtainable debt.

It is a problem which is not new. We might think by now we would have learnt the lessons. But clearly that is not the case**.**

A Tale of Two Systems

In September last year I travelled to Hong Kong – a city of 7 million[3] - which sits at the edge of the Pearl River Delta - home to over 100 million additional residents. As a Special Administrative Region, Hong Kong is now serving as a conduit between China and its global trading partners, particularly those with business directly to the north.

So even though its destiny has changed, Hong Kong continues to maintain its own currency, laws and Parliament but is now totally wed at the hip to Beijing.

[3] World Bank

Without a social safety net, Hong Kong offers its citizens a top personal income tax rate of 17% and corporate tax rates of 16.5%. Unemployment is a low 3.4%[4], inflation 4.7%[5] and the growth rate still respectable at over 4%[6]. Government debt is moderate[7] and although there is still poverty, the family unit is very much intact and social welfare is largely unknown.

The system there is that you work hard, your parents look after the kids, you look after your grandkids and you save as you work for 40 years to fund your retirement. The society is focussed on making sure people can look after themselves well into old age.

The concept of filial piety, from the Confucian classic Xiao Jing, is thriving today right across Asia. It is also the very best and most enduring guide for community and social infrastructure.

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[4] February 2012
[5] ibid
[6] GDP year to Q3 2011
[7] Gross debt of 33.8% GDP in 2011, IMF World Economic Outlook Database, September 2011

The Hong Kong experience is not unusual in Asia. Characteristics such as low inflation, low unemployment, modest government debt, minimal unfunded benefits and entitlements, and significant growth are powering a whole range of emerging markets and developing an Asian middle class that will grow to some two and a half billion people by 2030[8].

The sense of government entitlement in these countries is low. You get what you work for. Your tax payments are not excessive and there is an enormous incentive to work harder and earn more if you want to.

By western standards this highly constrained public safety net may, at times, seem brutal. But it works and it is financially sustainable.

Contrast this with what we find in Europe, the UK and the USA.

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[8] *Can the Asian Middle Class Come of Age*?, Homi Kharas, The Brookings Institution, 12 June 2011

All of them have enormous entitlement systems spanning education, health, income support, retirement benefits, unemployment benefits and so on. Some countries are more generous than others and in many instances the recipients of the largest amount of unfunded entitlements are former employees of the Government.

In all these areas people are enjoying benefits which are not paid for by them, but paid for by someone else – either the taxes of those who are working and producing income, or future generations who are going to be left to pay the debt used to pay for these services.

Despite tax rates much higher than in Hong Kong, government revenue in these economies still falls well short of meeting current government spending initiatives.

The difference is made up by the public sector borrowing money. And more often than not we are borrowing money from people such as the citizens of Hong Kong.

You would have to say that this is a flawed formula. For western democracies the party is over.

Our most deeply exposed western economies can no longer continue to accumulate debt without constraint. The ongoing credit crisis in Europe seems a very long way from resolution. Ultimately, spending on entitlements becomes a structural problem for fiscal policy.

In the United States for example, the excess of government expenditure over receipts is enormous. The Government has $15 trillion of Federal gross debt and it's going up by $1.5 trillion a year because expenditure is $6.2 trillion a year and receipts $4.8 trillion[9]. Obviously with interest rates at near zero levels the cost of debt is limited but sooner or later it must end in tears.

So why is it that western nations are so deeply indebted and so tragically unfunded when it comes to meeting their future obligations in the face of an ageing demographic and longer life expectancies?

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[9] IMF, World Economic Outlook, September 2011

Both sides of the western political spectrum are to blame.

As the electoral pendulum has swung between socialist and conservative sides of politics, the socialist governments, often winning electoral success thanks to the funding from unions, have created a huge array of entitlements for selected classes of individuals, particularly and ironically employees of government and members of unions.

These entitlements have now begun to hang like a millstone around the neck of governments, mortgaging the economic future of many Western nations and their enterprises for generations to come.

I will give you a classic example. In Boston USA, there's a certain former police captain who retired aged 55 some 20 years ago after a 32 year career on the force. During that period he managed to contribute some $73,000 to his defined benefit pension plan, a plan which gives you a percentage of your salary for life when you retire. On retirement he started receiving 100% of his retirement salary, namely $55,000.

He is now 75, which means he has collected some $1.1 million in benefits. And it looks like he'll live until he's at least 90 or even older, so that's almost another $1.0 million over 15 years. It's more than he earned in 32 years and he contributed just $73,000 to help pay for it. Either taxpayers pay the bill or the government has to borrow to pay for the entitlement.

When the electoral pendulum swings, conservative governments have come in promising to fix the problem but in most instances have just trimmed around the edges without addressing the real problem of the growing entitlement burden.

And the greatest Catch 22 of modern democratic politics is that socialist governments are blindly wedded to increases in expenditure while conservative governments are blindly wedded to not increasing taxes. So once the cycle of economic growth comes to its inevitable end, the problem is exacerbated.

Perhaps the real problem is the exuberant excesses of politicians who do not seem to understand or care about the fact that like a household, a nation needs to balance its budget over time and needs to make sure it can cover its future commitments.

This has already reached dangerous levels with some OECD countries like France spending close to 30% of their GDP on public social expenditure.

Other countries get by with much less. Korea only spends 10% of GDP on public social expenditure with Australia at 16% of GDP, the USA at 20% and the United Kingdom at 23%.[10]

The bottom line is that our communities need to make a tough decision. We cannot choose both higher entitlements and lower taxes. We must make a decision one way or the other. We can take more and more of our citizen's money and spend it for them, or we can take less of it and rationalise government services.

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[10] OECD Social Expenditure Database, estimates for 2012

But it is a decision that must be made …and soon.

This challenge is compounding in scale as an ageing population in many industrialised countries is making even further demands on the entitlement system.

Europe for example, has the highest proportion of over 60s of any region in the world. And while 22% of the population in Europe is currently over 60, this number is forecast to rise to 35% by 2050.

Plans for the future of Europe have assumed strong economic growth, but it is highly uncertain how growth will be achieved as the fiscal burden associated with rising health and aged care costs, as well as a generous pension scheme, continues to grow.

According to a study commissioned by the European Central Bank[11], 19 EU countries had almost 30 trillion Euros of unfunded entitlement obligations for their *existing* populations. Of this 30 trillion Euros, France has liabilities of 6.7 trillion and Germany 7.6 trillion.

These liabilities will continue to grow without significant reform. And, by the way, I don't see how a debate in France about lowering the retirement age from 62 to 60 will help address these challenges.

A lower level of entitlement means countries are free to allow business and individuals to be successful. It reduces taxation, meaning individuals spend less of their time working for the state, and more of their time working for themselves and their family.

An economy that impedes individual ambition - whether through higher taxation, the lack of opportunity in employment, or restricted social mobility - is one that enforces the barriers of class, rather than reduces them.

[11] Pension obligations of government employer pension schemes and social security pension schemes established in EU countries, Final Report, European Central Bank, January 2009

Governments should ensure that the actions they take will leave their citizens better off because, naturally, that will reduce the desire for ‘entitlements’. The role of government must be to help people to the starting line, while accepting that some will then run faster than others.

Everyone should know that they grow up in a country where it is possible, through hard work and diligence, to achieve their dreams.

Naturally the Americans call this the American Dream, but it is similarly played out across the globe, including in emerging economies in Asia.

The Australian Experience

As the child of a father who came to Australia in 1948 as a refugee from Palestine and built himself into a successful businessman, I know that being successful in Australia is not the product of belonging to rich and prosperous families, but rather is the result of hard work and diligence.

In fact those stories are most often repeated in countries without extreme interventionist governments. For example, over 80 per cent of the millionaires in the United States are the first generation in their family to be millionaires.

But Australia has had its fair share of irresponsible governments. In 1996 the incoming conservative government inherited a budget in a weakened state. The previous Labor administration had racked up a succession of budget deficits and \$96bn of net debt, about 17% of GDP. (I know that figure is not large by the current experience of most countries in Europe, but trust me, the repayment task was a challenge.)

It took nine years of budget surpluses and asset sales to repay the debt. That is three election cycles in Australia.

It took another two years of hard fiscal rectitude to build up a stock of net assets equivalent to 4% of GDP. In total that is a long period of sustained fiscal austerity.

Australia has not completely avoided the problems of other western democracies because it still has a lot of spending by government which many voters see as their entitlement.

However, over the years there have been a number of key decisions to reduce spending to manageable levels.

Australia has sought to reduce the burden on government of providing aged pensions through a compulsory system of savings for retirement. Retirees must rely first on the benefits they have accumulated rather than on government income support. And retirement benefits to government employees and politicians are no longer provided on a defined benefit basis but on a contributions basis so they only get back the principal and earnings on what they have put in.

The government is also gradually raising the age at which government benefits can be accessed, from 60 to 67 for women and from 65 to 67 for men from 1 July 2023.

Most importantly, the net government assets of $45 billion arduously built up by the previous conservative government were set aside into a Future Fund. The funds cannot be touched by the government for everyday expenditure. Rather, the fund can only be accessed to pay for the previously unfunded entitlements of federal public servants so as to reduce the burden on taxpayers.

That was an initiative of great foresight. It is, if you like, Australia's sovereign wealth fund with the explicit purpose of boosting the sustainability of the budget through time.

The Road Back

So where do we go from here?

There is really only one solution in the long term, and that is for countries to live within their means.

We must rebuild fiscal discipline. Budget surpluses must be restored, ideally until the debt is repaid.

This can only be achieved by cutting spending or by raising taxes. And given the general acceptance that the increased drag from higher taxes would compromise economic growth, the clear mandate is to lower expenditure.

This is lovely rhetoric but to actually do it needs some very harsh political and social decisions.

To be bold, I have some suggestions.

The first is that people need to work longer before they access retirement benefits. When the age pension was introduced in Australia at age 65, life expectancy was 55. Today life expectancy is in the 80's.

So you can understand how I was shocked to hear that one of the policy promises of one of the main French Presidential Election candidates, François Hollande, is to bring the official retirement age back down to 60 from 62.

Second, there have to be universal compulsory retirement schemes into which employees and employers must contribute so that after a man or woman has worked for 40 or more years they have set aside an amount that can provide them with a reasonable income for a further 15-20 years at least.

Defined benefit schemes need to be phased out worldwide, including in Australia, whether they are for public servants or private sector employees. In addition, all government funded pensions and other such payments must be means tested so that people who do not need them do not get them.

Third, there needs to be clear thinking about which services should be provided by governments and whether government funded services should be entirely free or have some affordable co payment. Many will argue that certain government services should be free and universal but the problem with any free good is that it will be overconsumed and underappreciated.

For example, in Australia, health services are partly funded through compulsory levies, paid either to the government or to private health insurers.

Across the Western world we have saddled our nations and our children with a debt burden that is simply unsustainable. It is time for strong political and economic leadership to clean up this mess properly, not with a series of band aids and political spin but with genuine economic and social reform.

The age of unlimited and unfunded entitlement to government services and income support is over. It’s as over in Greece as it is in Italy, in Spain, and in the USA.

There also needs to be a rethinking of government borrowing. Some might argue that some low level of debt is not a bad thing. I believe that is a dangerous proposition. Once some level of debt is accepted it becomes too tempting to opt for just a little more. Pretty soon a little debt becomes a big problem.

Also, there is a significant cost to servicing debt. Even in Australia, where net debt as a percentage of GDP is lower than in Europe, interest costs on net debt are approaching $7 billion a year. That is enough to build 7 new teaching hospitals every year.

The message is that every dollar of debt has an opportunity cost.

Another aspect of the problem is that credit is no longer easily accessible for the private sector or the public sector.

And the credit market no longer automatically favours the public sector. Ironically more and more sovereigns are seen as a greater credit risk than many international companies. I would think the experience of the past few years has been something of a reality check. Lenders now know that even today advanced western economies can default on their debts.

In today's global financial system it is the financial markets, both domestic and international, which impose fiscal discipline on countries. A country which is viewed as approaching its safe limit for debt will find it increasingly difficult to borrow additional funds at an affordable rate. Eventually the capital markets will close.

We are now in an era where lenders are much more wary about credit risk. I view this as a healthy development.

Lenders have a more active role to play in policing public policy and ensuring that countries do not exceed their capacity to service and repay debt.

This is playing out most dramatically in Europe where the European Commission and the European Central Bank are either directly or indirectly heavily influencing public policy in Greece, Italy, Spain and Portugal to name a few.

It is also worth noting that the system of regulation of banks and other deposit taking institutions is artificially boosting demand for sovereign credits with mandated liquidity requirements generally emphasising a prominent role for government securities.

Governments have been too prepared to exploit the resultant lower borrowing costs.

And whilst securities issued by sovereigns have traditionally been viewed as the safest and most liquid assets, I am not sure that it is still the view of investors in Europe today.

Concluding Comments

The road back to fiscal sustainability will not be easy.

It will involve reducing the provision of so called "free" government services to those who feel they are entitled to receive them.

It will involve reducing government spending to be lower than government revenue for a long time.

It is likely to result in a lowering of the standard of living for whole societies as they learn to live within their means.

The political challenge will be to convince the electorate of the need for fiscal pain and to ensure that the burden is equally shared.

Already in the UK and parts of Europe we have seen the social unrest that can result when fiscal austerity bites.

But the alternative is unthinkable.

The Western world cannot continue on its current path of borrowing to fund its excessive lifestyle. The problem of fiscal sustainability will only get worse.

Eventually lenders will cry enough is enough and turn off the credit tap. And when that happens the economic, financial, social and political dislocations are likely to be catastrophic.

The Western world is at the most important economic cross road in its history - Governments must accept their responsibilities to fiscal discipline and the prudent use of their citizens hard earned monies, or they need to accept that the demise of western economies will be forced upon them in a dramatic, unpredictable and possibly violent way.

Adam Smith's free hand is perfectly capable of forming a fist to punish nations who ignore the fundamental rules. Unfortunately I think Adam's down at the gym right now and in training for one almighty whack.

Restoring fiscal credibility will be hard. But it is essential we learn to live within our means.

The Age of Entitlement should never have been allowed to become a fiscal nightmare. But now that it has, Governments around the world must reign in their excesses and learn to live within their means. All of our futures depend on it.