We’ll worry about that when we get there
- the misplaced belief in,
and the cost of, Entitlement

September 2012
Entitlement – A History

The concept of a social safety net or a large scale (national) social insurance system has its historical beginnings over a hundred years ago, and is explored by Niall Ferguson in his insightful book, The Ascent of Money. The social safety net concept that we are familiar with today that backstops residents of many nations, in particular Western-based societies, can be traced back to Britain following World War II. Due to the trauma, cost and national effort of the war, Britain faced massive social issues of poverty and disease, unemployment and a lack of education. To address these issues, the Attlee Labour government implemented a policy in which each and every citizen would be entitled to free education, basic healthcare, an employment safety net (unemployment benefits) and a pension when they retire – in other words, everyone was eligible for entitlements. Thus, the UK became what was known as a Welfare State.

The Welfare State

Many nations soon also adopted similar Welfare State systems. Over time the concept of a Welfare State system developed into an ingrained belief system. Unfortunately, as Ferguson points out in The Ascent of Money, while the concept was very effective in building modern civilized societies, the problem was that no one could predict how much it would cost, and therefore, how it could be paid for or who would pay for it.

From the beginning, and indeed for many years to come, these benefits or entitlements would be paid for with the use of current system tax revenues. In other words, the retirees of today would rely on the tax collections of today’s workers (someone else’s taxes) to pay for their pensions and healthcare rather than use funds that had been put aside for these purposes throughout their working careers. That is, paid for by themselves from their accumulated tax payments while they were in the workforce. This funding method is also known as ‘pay as you go’.

The Welfare State utilising a ‘pay as you go’ payment method developed and fostered a deep and wide sense of entitlement – a belief that each individual would be entitled to a comfortable retirement with health care. After all they had worked hard, paid their taxes, done their bit, and above all, they deserved it. Individuals need not worry about how it was paid for, as paying for it was always someone else’s problem, usually a corporate pension plan or the government.

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Brett is Head of Fixed Income & Currency and is responsible for Macquarie’s Australian based cash, credit, fixed interest and currency portfolios which amount to approximately $A30 billion of assets. Brett’s primary investment and portfolio management focus is credit markets and he is responsible for the management of credit across all Macquarie’s investment solutions totalling around $A9 billion in assets under management. Brett and the credit team have delivered significant outperformance of peers throughout the credit crisis and in doing so have grown assets under management during a period where markets contracted significantly.

Brett joined Macquarie in May 2003 and became senior credit portfolio manager in August 2004, and has been responsible for the management of the credit portfolios since this time. Prior to joining Macquarie, Brett was at BT Funds Management for nine years, having joined BT as a graduate. Brett performed a number of roles in the Fixed Income team at BT including portfolio construction and portfolio management. During this period Brett was also admitted to the David Williams Fellowship program, which is designed to develop select young high achievers.
The great mismatch

Unfortunately, the Welfare State became a victim of its own success. Baby boomer demographics (encouraged by the Universal Child Benefit), longer life expectancy with advances in medicine (encouraged by universal health care), and a constant push for greater benefits, saw liabilities to entitled citizens grow astronomically. It has recently become clear that the cost of these liabilities has far outstripped the pool of available assets, and the ability of the tax system, to pay for them. By way of example, the chart below shows the cost of US health care programmes - Medicare and Medicaid. As a reference point, US tax revenue has been stable at around 18% of GDP over this time. When introduced in 1965, the cost of health care was approximately 5% of US government expenditure. Today it is approximately 40% of US government expenditure, dragging money away from other public services and programs. When Britain introduced their National Health Scheme in 1948, they expected health care costs to drop because it would promote better health!

As Ferguson notes in The Ascent of Money, entitlement has negative social implications. He states “Entitlement is rooted in the false misconception of how human beings behave. It destroys, at the individual level, the link between contributions and benefits. In other words it destroys the link between effort and reward. Whenever that happens on a massive scale and over a long period, the final result is a disaster.” As is increasingly coming to light, the broad scale and long period of entitlement that has been culminating to this point is beginning to reveal significant inadequacies.

To complicate the picture further:

- add the bursting of an enormous global credit bubble in 2007 this caused a deep financial crisis
- the financial crisis has since evolved into a sovereign debt crisis
- the sovereign debt crisis is placing enormous strain on governmental finances
- this has resulted in a long and drawn out deleveraging, which has barely begun
- this will likely result in an environment of lower economic growth and lower investment returns as evidenced by lower bond yields.

With all this considered, it is clear that the retirement cost and funding model assumptions of old now appear very unrealistic.

What has built up over many years is an asset liability mismatch of epic proportions. This mismatch is so large that most societies, which for many years have engendered a sense of entitlement, are in for a very rude shock. Furthermore, this mismatch continues to grow.

Michael Lewis in his Vanity Fair article California and Bust highlights the enormity of this issue in the US, which is best encapsulated in a quote from the Governor of New Jersey Chris Christie. In response to suggestions that state finances could be worse than estimated Christie asks “At this point, if it’s worse, what’s the difference?”. The liability relating to committed pensions and health care in the US is now irrelevant, as it is far beyond anything the US will ever be able to pay. Because of unrealistic expectations of investment earnings on pension assets, between 2002 and 2008 the debt of pension plans from US State Governments almost doubled. Estimates of the unfunded liabilities for promised future health care and pensions in the US now total $61 trillion, or just over $500,000 per household. Either entitlements will need to be cut significantly, or people will need to adjust down their living standards and/or work longer to maintain them. None of these options will sit well with the public - just ask any peripheral European how they are enjoying this new reality!

This raises another issue: now that the enormity of the problem is beginning to be recognised, how will policy makers and the public react?

Lewis explains that as state based pension schemes fell behind their earnings assumptions, the money they did have was invested in ever riskier assets. “In 1980 only 23 per cent of state pension money had been invested in the stock market; by 2008 the number had risen to 60 per cent.” As a case in point, the California teachers’ pension scheme assumption has been that its equity investments will earn 8% per annum, and still do. This led to the contribution rate on California teachers’ pensions being underestimated, and it needs to be increased – by $4.5 billion a year! California Governor Jerry Brown recently proposed state tax increases of $7 billion. Under California law, 40% of this, or almost $3 billion, will go to schools.
Were they wrong?
Looking back 70 years, do we now conclude that the Welfare State and the belief in entitlements was an ill conceived concept? Well, no; the safety net addressed many social issues and enabled considerable social and economic development. The problem was that it wasn't funded correctly – and still isn’t. And the problem looms larger and larger.

However, not a cent will actually end up in schools. The entire increase in tax revenue, and more, will be used to pay benefits to teachers who have already retired. Indeed, cuts will need to be made in schools to redirect money to pay for this! This is an incredible misallocation of resources and a very short sighted one. Rather than invest in education for the future, California is paying even more for the education of the past.

Another common response has been to simply ignore the problem, and hope it will become someone else’s (or someone else’s children's). Elected government representatives often do this on behalf of their constituents, because cutting benefits and increasing taxpayer contributions is poor politics, even in the face of mounting shortfalls. To circumvent these political issues, in November 2005, Governor Schwarzenegger put a special election to the people of California asking them to vote directly for reduced spending and benefits for State entitlements to address the State’s mounting debt and funding problem. All the reforms were soundly defeated. People want their ‘entitlements’. They just don’t want to pay for them.

Source: Centers for Medicare and Medicaid Services, August 2012
**THE LUCKY COUNTRY**

**What about Australia?**

As Dean Stewart explores in his recently published paper *Trends in superannuation and some implications* – Australia had the foresight 25 years ago to forecast that an asset liability mismatch associated with the aging baby boomer bracket would occur in a magnitude that the Australian Government would not be able to pay for. As a result the government implemented a compulsory superannuation system, to make Australians more responsible for saving for their own retirement.

Currently Australians are required to put 9% (soon to be 12%) of their salary into a superannuation scheme and are given choice about how these savings are invested for their retirement. This leaves Australia in a far better position than most Western nations, but as Stewart points out, 9%, even 12%, is nowhere near enough to accumulate sufficient savings to maintain their quality of life in retirement.

Further, this scheme has not removed Australians’ sense of entitlement. They just switched beliefs from relying on the government to believing that their superannuation would provide the retirement that they feel they deserve. But the reality is most Australians take little or no interest in the sufficiency of their superannuation and what it is invested in. The attitude seems to be “We’ll worry about that when we get there”.

And why not, when retirement is, in most cases, many years away?

One answer is that at some point even putting off the problem until you get there no longer delays it. Many people (the baby boomers) are there now! A second reason is that if you wait, once you get there, there are no options available to address it.

The Australian Government has outsourced the responsibility for saving for retirement back to individuals, but are individuals saving enough? Are their savings invested in a risk appropriate manner? Do they have the tools to manage their own retirement savings? These questions require their own dedicated investigation, and are explored in Stewart’s *Trends in superannuation and some implications*. Stewart’s paper considers the risks that individuals face when saving for their retirement, such as investment risk, inflation risk, longevity risk, portability, solvency and salary risk.

**Are individuals saving enough?**

Like the pension schemes in the US, Australians have been underestimating the contributions needed for decades. While many Australians have been saving 9% of salary in superannuation for the past 20 years, to self-fund retirement, the average wage earner will need to contribute approximately 18% of salary, for 40 years. And even then, this assumes that over half their retirement income comes from the old age pension.

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**Percentage of Salary Required to be Saved to Maintain Living Standard**

![Percentage of Salary Required to be Saved to Maintain Living Standard](chart.png)

Source: Macquarie, December 2011
Are Australians’ savings invested in a risk appropriate manner?

Like the teacher’s pension schemes in California, Australians have generally held a more risky asset allocation stance than traditional balanced funds or offshore equivalents (see chart below) for a variety of reasons and, in our view, not all of them sound. One of the reasons given for this general pro-growth asset stance is that without this risk there will not be enough to retire on. As Stewart’s Trends in superannuation and some implications paper highlights, and what the entitlement attitude refuses to consider, is that if savings are insufficient to retire on, then what is required is an increase in savings contributions, not an increase in risk.

The problems that some ‘entitled’ systems are facing are enormous, and will present challenging economic consequences moving forward. Australia does not have the acute problems that are surfacing in places like the US. Nonetheless, Australians do face the same low return environment and the challenges this environment will bring to the task of accumulating adequate savings for retirement. And the Australian system won’t deliver the retirement Australians think they are entitled to, unless contributions rise very significantly. While this may surprise many, Australians should adopt an approach of more short term pain for longer term gain.

The good news is that for most Australians, unlike the residents of many countries, it’s not too late to address the problems. By contributing more, and adopting a sensible balanced and age appropriate investment strategy, along with an adjustment to their entitlement expectations, Australians can better prepare for retirement. However, even in Australia, the financial future will still be starkly disappointing if the population sits idle and just expects the retirement they believe they are entitled to.
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