Withholding versus withdrawing

The political difficulty of withdrawing privileges, especially those long expected by the public, will create fundamental uncertainty for years to come, argues ***David Rowe***

Most of us learned about the fallacy of composition in our economics courses. In times of crisis, it is natural and logical for individuals, households and businesses to cut back on their spending where possible. This increases their reserves and improves the chances of weathering an unexpectedly severe setback without financial embarrassment.

For the system as a whole, however, this reaction can magnify an economic contraction and worsen financial stress. It is largely on this basis that governments have, for at least the past 50 years, expanded public budget deficits to offset cyclical declines in private demand. The basic argument is that the real long-term burden of an economic contraction is to pass a smaller and less productive capital stock on to future generations.

The applicability of the fallacy of composition in some contexts should not, however, blind us to the relevance for public policy of some other lessons we learn in our personal lives. One of the most important management lessons I learned the hard way was that it is 10 times harder to withdraw than to withhold. When people are denied benefits they have never enjoyed, they may grumble and complain but their reaction will generally be constrained. When benefits have been enjoyed for some time, they become expectations. They even tend to be regarded as rights. If such benefits are subsequently withdrawn, the reaction is inevitably more extreme than if they were never granted in the first place.

Consider a situation where a company is expanding and has acquired more open office space to accommodate additional employees to be added over the next year. Initially, when the space is largely empty, it is tempting to allow the first occupants to use a greater area per person than will be available once the space is filled. Logically, it seems sensible to give temporarily greater comfort to some staff while the extra space is available. Unfortunately, it is likely this will create a significant morale problem later when the layout must be reconfigured and the additional space is withdrawn.

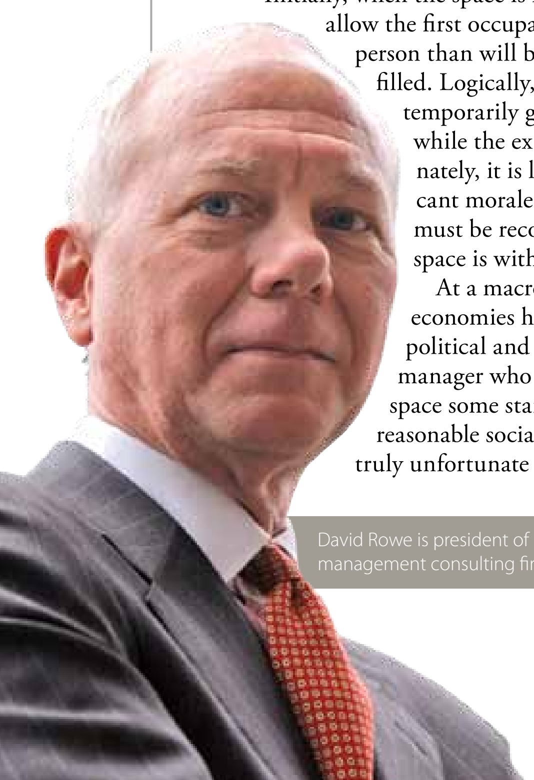
At a macro level, the developed industrial economies have worked themselves into a political and sociological bind similar to the manager who must withdraw the additional space some staff have come to expect. A reasonable socially funded safety net for the truly unfortunate is an understandable goal as a country becomes richer. For example, socially funded medical coverage for catastrophic illness is certainly sensible. This entails limited moral hazard, since few people will be encouraged to increase their risk of serious illness as long as the deductible amount they must meet themselves is substantial.

In most developed countries, however, socially provided benefits go well beyond such a basic safety net. Qualification for many benefits is based strictly on age with no reference to fundamental need. This is particularly true of old-age pension and medical coverage schemes. Since such programmes are largely funded on a pay-as-you-go basis, they are vulnerable to age imbalances within the population that imply a significant decline in the ratio of working contributors to beneficiaries.

In many ways, the political bind is worse than that of the manager who must withdraw extra office space. First, the social benefits that have been implemented over the past 75 years were never presented as temporary. Indeed, they are referred to as entitlements in the US, a term that reinforces the sense they are fundamental rights. Second, restricting such entitlements must be done through a political process in which the beneficiaries have a strong presence at the ballot box.

Accommodating the growth in beneficiaries relative to contributors as populations age would have been difficult in any case, but the problem has been aggravated by the global competitive environment. As China and India allowed greater freedom for individual initiative, they have created a massive increase in the competitive global labour force. This has been bolstered by the growing ease of global communication that facilitates management of geographically dispersed organisations. These countries also have the advantage of only needing to withhold social benefits to maintain fiscal sustainability rather than having to withdraw them.

Retreating behind tariff barriers will not solve the problem facing developed Western democracies. Like Australia prior to the reforms of the Bob Hawke government in the 1980s, this is a prescription for developing an increasingly uncompetitive domestic economy. One classic means of resolving this dilemma that cannot be ruled out is devaluing the currency through inflation. If markets suddenly became convinced this was the strategy, however, a sudden spike in interest rates would be inevitable. Unfortunately, no-one has a crystal ball that can reveal how all this will unfold. Suffice to say, the way major industrial democracies restore sustainable fiscal circumstances, given the global competitive pressures and strong public resistance to withdrawal of long-enjoyed entitlements, will be one of the abiding sources of economic and financial uncertainty for the coming decade. ■



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