



REVIEWING THE ROLE AND STRUCTURE OF PENSIONS IN THEIR NATIONAL CONTEXT

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Abstract

This paper reviews recent developments in pensions policy in a range of countries and identifies some of the main forces driving the policy reform agenda. The paper brings a new perspective to some familiar issues, drawing specifically on the research and policy experience of Australia, China and the United States. Its basic message is that to fully understand the forces influencing national pension systems, it is necessary to understand the forces and expectations that are specific to each country. Three main themes are addressed: demographic change; financing of pensions; and the role of politics. It is argued that all three must be included within any analysis of pension reform and that each is important – despite the emphasis given recently to the first issue. Different approaches to pension reform in different countries reflect the values and culture of each country and once these become embedded in a pension scheme, they take on their own momentum. This point is illustrated with examples drawn from Australia and China, both of which have unique pension systems compared with many other countries. The evidence discussed relates to the role of means testing and the balance between formal and informal means of support in old age. In all countries, pension reform options must address demographic changes and be financially sound, but they must also be politically sustainable. There are challenges arising from all three factors, but to portray these as a ‘crisis’ for prevailing pension systems does little to aid the search for sensible responses.

1 Introduction

The theme of this conference, the emerging long life society, provides an opportunity to reflect on the consequences of economic and social change for the nature and design of social security programs throughout the world. Trying to distill a small number of issues that are relevant to the diverse experiences of ISSA member countries is a formidable task, perhaps an impossible one. It is made more difficult by the different economic and social contexts in different countries and their different value systems and policy priorities. Nowhere is this more apparent than in relation to pension systems, where issues relating to the impact and response to demographic change and the roles of public and private sectors that are at the forefront of the international policy agenda. Is it possible to adopt a single overarching model to inform policy development in the area of pensions – as is implied in the three pillars approach of the World Bank (1994) – or is the variation within countries such as to preclude the adoption of such an approach? This is the central issue addressed in this paper, which draws on a variety of national experience to argue that the latter approach may be preferable.

While it is valuable to analyse pension systems theoretically in order to highlight key parameters and identify potential conflicts and pressures, what ultimately matters is how schemes operate in practice, and this involves taking account of many factors that cannot be adequately captured in abstract models. Included among these are the aspirations and attitudes of the population and the integration between the pension system and other key economic and social institutions. Public pension systems have not evolved independently of these other factors and they cannot be meaningfully studied without taking account of the relevant interactions, constraints and opportunities. The OECD has recently noted that despite differing public pension arrangements, the incomes of older people in OECD countries are reasonably similar, because pensioners ‘fill the gap with private savings and working income’ (OECD, 2001: 21). This observation highlights the fact that public pensions are part of a wider system and the pension reform debate must thus engage with these broader issues.

Several factors explain the central role of old-age pension systems in the contemporary social security reform agenda. First, pensions have a *long history*, being one of the first public social welfare programs introduced in most countries and they have proved to be the most enduring and popular (the former, of course, reflecting the latter). Second, old age pensions are *expensive*, accounting in 1998 for more than 9 per cent of GDP in many European countries and averaging 7 per cent of GDP across the OECD (OECD, 2003). And while pension spending represents a lower percentage of national income in many developing countries, the pension budget is also rapidly growing in many of them (Whiteford, 2003: Table 10). Third, the *sustainability* of existing pension arrangements in the face of demographic change has been questioned, giving an imperative to the reform process. Finally, pension provisions have very wide *coverage* and are thus of immediate interest to the ever-growing numbers approaching retirement age - and to the even larger numbers in the generations following along behind them.

The following discussion focuses on some of the key features of the current debate and addresses some of its principal concerns. While offering little that is original, I will try to bring a new perspective to some familiar issues, drawing on the experience of two countries with which I have some knowledge – Australia and China. Both countries lie well outside of the Euro-centric pension mainstream that is dominated by countries that rely predominantly on social insurance to achieve the ‘twin peaks’ of pension achievement: intergenerational equity and social solidarity. Yet both have distinctive pension arrangements whose structure and evolution offer a number of illuminating insights.

The paper is organised around three main themes. The first relates to demography and is discussed in Section 2. Section 3 reviews some of the issues in financing that have so dominated the recent pension reform debate, while Section 4 discusses the politics of pension reform and examines how pension systems relate to other socially endorsed distributional mechanisms. Section 5 provides a brief summary of the main themes and arguments.

2 Demographic Pressures

The pension reform debate has been dominated by the view that projected changes in demographic structure require a policy response to maintain the longer-term sustainability of pension systems. Even a rudimentary grasp of basic arithmetic suggests that there is an element of truth in this proposition. If people, on average, are going to live for longer, then it is going to cost more to support them at a given standard and someone will have to pay, or the standard they are provided with will have to decline. Yet much of the pension reform debate has been driven by a largely manufactured ‘funding crisis’ which asserts that the population ageing will not only cause pension systems to *cost more*, but that this increase is *not affordable* given the existing structure of pension entitlements and community expectations.

Over the last two decades, many countries have examined their pension arrangements to assess the relevance of these arguments and have taken action to address identified weaknesses. Governments have understandably wanted to reform their pension systems to make them compatible with their broader fiscal objectives. But even in industrial countries, pensions are only part of a broader structure that determines how resources are used to support the living standards of different generations. The social norms, customs and institutions that comprise that broader structure of support in old age (the ‘non-pension’ system) is also affected in many ways by demographic change and these changes also need to be acknowledged and reviewed.

This proposition can be illustrated with the help of some recent research undertaken by Gary Burtless (2002) who shows that the *total* dependency burden in the US – defined as the portion of the wage that each active worker must sacrifice in order to support the consumption needs of dependent adults and dependent children – would have *declined* slightly between 1950 and 2000 if 1950 activity rates had remained unchanged throughout the period. It would have been even lower if activity rates had been at their year 2000 level, and on this assumption would still be well below the 1950 figure by 2050 (Burtless, 2002: Table 2). An implication is that changes in economic activity rates can more than offset the impact of changes in fertility and mortality on projected fiscal burdens.

The modelling on which these projections are based assumes that all adults have the same consumption needs, while the consumption needs of children (inclusive of education spending) are assumed to be just below three-quarters (72 per cent) of adult consumption needs. On the basis of his analysis, Burtless (2002: 15) concludes that ‘the extra burdens connected with population aging are considerably smaller than commonly supposed’. However, this optimistic conclusion must be tempered by several factors. The first is the fact that many of the gains associated with the impact of lower fertility on young-age dependency have already come and gone, whereas most of the old-age dependency effects are yet to emerge. Furthermore, in federal countries like Australia, the public support burden of young and old has been split between national and sub-national governments, so that the budgetary impacts are not only segmented over time, but also across jurisdictions.

But the issue that Burtless focuses on is the difference in *attitudes* to the tax contributions that support people during their retirement years and the predominantly private transfers that support children. Support for the aged in industrial countries like the US has largely been arranged through public schemes (pension and aged care programs), whereas support for children has been primarily left to families. Demographic change is thus shifting the way that the total level of support is financed, away from private wallets and towards the public purse. Trying to engineer such a shift through public policy is difficult because governments have been moving in the opposite direction, cutting spending in order to fund tax cuts for the middle classes.

However, the key point is that the nature of public support and the balance between public and private forms of support *become embedded in community attitudes* and this affects what reform options are practical in response to demographic (or other) changes. As Burtless (2002: 17) puts it: 'Even though breadwinners in rich countries have enjoyed sizeable consumption gains from lower fertility, they do not view these gains as an offset to the higher taxes they must now pay to support the retired elderly'.

A key feature of Burtless' model is the assumed ratio of the consumption needs of children and adults, which determines how sensitive the dependency burden is to changes in demographic structure. If the assumed ratio is too high, the estimated gains from the decline in fertility will be over-stated and the change in the overall dependency burden will be correspondingly under-estimated. In practice, this ratio will vary across countries according to how public and private support for children and the aged is structured. Australian research on household budget standards suggests that the *private* costs of a 6 year-old girl lie between 30 per cent and 45 per cent of the *private* costs of a 35 year-old woman – the difference reflecting whether the adult is assumed to live alone or with a partner (Saunders et al., 1998). UK research reported by Bradshaw (1993) produces broadly similar findings.

However, budget standards research also indicates that costs vary substantially with the age of adults, which may be even more important in the present context. Thus, the private consumption needs of a 70 year-old Australian woman are only around three-quarters (74 per cent) of those of a 35 year-old woman. In terms of their implications for *private household budgets*, the costs of meeting the consumption needs of aged adults are therefore higher than the costs of meeting the consumption needs of children, but well below the costs of meeting the needs of non-aged adults. However, private consumption needs are only part of the picture. As noted earlier, most industrial societies have chosen to fund a large proportion of the cost of meeting the needs of aged adults from public budgets, whereas the bulk of children's needs are met from household budgets. It is on this point that Burtless' remarks on prevailing attitudes to these different forms of support are so important.

However, pension schemes are designed to redistribute income to private households so that they can afford to meet their consumption needs. The fact that many of the health and social care needs of the aged are funded by government insulates pension systems from these effects, even though the adequacy of pension benefits depends on how these care needs are paid for. However, this line of argument has implications for how we should

think about the income replacement goal of pensions. *If the goal of pensions is to provide an income stream that can support a constant level of private consumption in retirement*, then the fact that consumption needs decline with age should be reflected to some degree in the level and time profile of pension benefits. The case is even stronger in countries where home ownership receives favourable tax treatment, since reduced housing costs associated with home ownership is the main reason why consumption needs decline in old age.

The traditional separation of the life cycle into three stages – inactive young-age dependency, active adulthood and inactive old-age dependency - is an oversimplification, as Burtless model demonstrates. Many people now face a more complex and fluid set of transitions into and out of the active (labour force) phase that has become more uncertain and volatile. Increasingly, the period of working-age activity is bracketed between a lengthy transition out of the education system and an even longer transition into retirement. During both transitions, increasing numbers of people combine part-time work with study, and part-time work with partial retirement, respectively, blurring the boundaries between study, work and retirement. The work-to-retirement transition may begin when people are in their 50s and extend until they are well into their 70s, and this has implications for the labour market, but also for how pensions are organised and delivered.

These shifts raise questions about how to think about the income replacement role of the pension system. If labour market income is increasingly uncertain and variable for many people, a pension system that provides a constant income stream from an arbitrary fixed age may not meet either immediate or longer-run income replacement needs effectively. The budget standards estimates suggest that *a pension payment structure that declines with age would not affect the ability of pensioners to sustain their private consumption in retirement*. Given the very large increases that have occurred in the life spans of those who reach the conventional retirement age of 65 – a key feature of the long life society - there seems little justification in maintaining a system of pension entitlements that treats all people aged over 65 as if they have the same needs. The needs of the increasingly frail old-old and those who live alone are different from those who are able (and often want) to lead more active lives. Greater differentiation of age pension benefits along these lines would provide pension systems with increased flexibility and relieve some of the cost pressures, without disturbing the underlying *consumption maintenance* (as opposed to *income maintenance*) objective.

A recent OECD study shows that the ‘quasi replacement rate’ ratio of the (need-adjusted) disposable income of older (65+) to working-age (18-64) people in nine OECD countries is similar despite the differences in pension arrangements (OECD, 2001: Table 2.1). Income replacement rates are high - generally around 80 per cent (even before taking account of housing assets and reduced work expenses) - but decline slightly after the age of 75 (OECD, 2001: Table A.7). Background research undertaken as part of the OECD study indicates that the (need-adjusted, non-housing) *consumption* levels of older couples actually exceed those of younger couples (Yamada and Casey, 2002: Table 2.3). These results support the need to differentiate between the income and consumption needs of

older people, and to recognise how needs change with age and the specific vulnerabilities facing older people who are living alone.

Increased recognition of the growing diversity of the consumption needs of older people must be accompanied by greater efforts to respond to the labour market needs of older workers. Income from work contributed a declining proportion to the overall income package of people aged 65 and over in many OECD countries between the 1970s and the 1990s – although the level of that contribution varies greatly, from around 55 per cent in Japan to around 10 per cent in Finland, Germany and the Netherlands, to only 5 per cent in Sweden. It seems difficult to believe that these differences do not reflect different pension arrangements and attitudes towards the role of older people in society. Reversing the trend to early retirement (often used as a form of disguised unemployment) is an important goal of the pension reform agenda.

While pension reform can play a role in this process, attitudes are also important. As Schultze (2002: 94) has argued:

[T]he most serious barrier to the re-employment of older workers today is the attitudes of the workers themselves and their potential employers – especially with regard to the issue of productivity and the ability to train older workers.

Research by my colleagues supports the relevance of this claim to Australia (Bittman, Flick and Rice, 2001). It is hard to escape the conclusion that these attitudes reflect the existence of pension systems that implicitly condone inactivity among those who reach a pre-determined retirement age.

In China where pensions are relatively under-developed, older people have very different attitudes to employment. Data from the survey on *The Sampling Survey of the Aged Population in Urban and Rural China* conducted in 2000 indicates that the percentage of older people who want to work is close to two-fifths (38.6 per cent) for those aged 60-69, less than one-fifth (18.7 per cent) for those aged 70-79, and just below one-tenth (8.9 per cent) for those aged 80 and over (China Research Centre on Ageing, 2002). Even though the percentage who were *actually* working is much lower (at 1.4 per cent overall), it is clear that the work ethic is alive and well among older Chinese urban residents! The contrast with Europe is partly attributable to different cultural expectations, but the role of pensions is another major factor. The bottom line is that if increased economic activity can offset the impact of demographic change on pension budgets, then pension reform must surely seek to bring about such a change.

3 Financing Issues

Nicholas Barr (2002) has recently noted that there are only two ways to seek consumption security in old age. The first involves storing current production for future use, and the second involves exchanging current production for a claim on future production. Of these, Barr argues that the former approach ('storing current consumption') is not very promising because it cannot deal with changing tastes, nor can it be applied to services such as transport, social or medical care that cannot be stored. The 'establishing future claims' approach is thus the only practical alternative and this forms the basis of pension schemes, whether or not they are funded on a pay as you go (PAYG) basis.

However, while it is true that storing current production gives rise to a number of practical problems, there are alternative ways of establishing claims on future production than through legislated pension schemes. One such strategy is to buy a house while working and rely on the services it provides to meet housing needs in old age. (Thus, while Barr (1999) has argued that storing current production in a hole at the bottom of the garden is not a practical option, using the house that is at the top of the garden to establish a claim on future production makes a lot more sense!). Although the house may need to be modified to better suit increased frailty in old age, as a general strategy it makes good sense, and many countries have encouraged home ownership for precisely this reason.

Another strategy involves having a family, in the expectation that one's children will provide parents with the care and resources they need in old age (and the revenue needed to fund pension commitments). This approach is also subject to risk because the level of support (or even its existence) is not guaranteed. But if there are strong social pressures on children to support their parents in old age – buttressed by laws that allow this to be enforced – then family support may be no more uncertain than the implicit promises contained in unsustainable public or enterprise-based pension schemes. The key point is that in order to be effective, a system of implicit intra-generational support requires a set of social norms and customs that make it difficult to avoid assumed responsibilities. This explains the important role of Confucianism in preserving the traditions that nurture such responsibility under the 'welfare orientalism' approach adopted in many East Asian countries (White and Goodman, 1998: 8-9).

It is also possible to establish a claim on future medical services by exerting political pressure for a state-funded health system that will provide universal access to health care facilities on the basis of assessed health needs. There is uncertainty surrounding whether the system will exist in the future, what level of service it will provide, and at what cost to users, but if the system has universal coverage, there will be considerable political resistance to any major changes. Health systems are at least as resilient to change as pension systems – and for similar reasons. People can thus seek to store medical services for their future use by supporting a universal public health care system whose future, barring a major economic or political crisis, is virtually guaranteed. It has long been recognised that broadly based support for collective provisions ('middle class welfare') is

one means by which today's generations can ensure that public schemes are there to meet their future needs (Le Grand, 1982).

These examples highlight the role of custom and culture in influencing how social support for older people is designed and delivered. Many developing countries have relied on family support for the elderly, not just because of the immature state of their public pension schemes, but also because of the integral role of the family in the 'welfare society' approach that is favoured over the western welfare state model.

The role of formal and informal support systems for the elderly in China illustrates how the structure of provisions and the social attitudes that sustain them differ from those that exist in many industrial countries with mature pension schemes. Of course, one has to be careful when applying western analytical frameworks, value systems and assumptions to a country like China that has, for the last two decades been developing 'a new socialist social security system with Chinese characteristics' (Chow, 2000: 10). And as others have pointed out, many western social security ideas make no sense in the Chinese context, where social solidarity is seen as an 'empty ideological slogan' and where the idea that ordinary people should have to pay taxes to fund universal benefits is still rejected by the vast majority of the population (Ka, 2001). These attitudes obviously place limits on the pace of pension reform and what can realistically be achieved.

Data from the Chinese survey referred to earlier show that the option for 'establishing non-pension claims on future production' has considerable relevance to the urban aged in China. Thus, over three-quarters (75.5 per cent) of those aged over 60 own their own homes and a further 18.5 per cent rent from the government at heavily subsidised rates. Housing accounts for a very small proportion (4.4 per cent) of the average household budget of old people, and even less (3.2 per cent) if personal expenditures are included. The largest single item in the budgets of older people is spending on cash gifts, which accounts for virtually half (49.6 per cent) of total personal expenditure. At the same time, income from private transfers represents a not insignificant proportion (6.2 per cent) of the average older person's budget: as with the work ethic, private (primarily intra-family) redistribution is alive and well in China!

Shared living arrangements also serve an important support function for many older people in China, where more than half (58.6 per cent) live with their children (many of them in three or four generation households) in houses that are often owned by the parents themselves. In contrast, only 40.4 per cent live in one-generation households, either alone or with their spouse. These patterns are similar to those shown in earlier research to exist in Taiwan (Chang, 1999). But they are very different to living arrangements among older people in many European countries where multi-generational households are relatively rare, and where they do exist, they involve parents living in their children's homes, not *vice versa* (Smeeding and Saunders, 1999). Reducing housing costs through the sharing of accommodation is an important part of the retirement support package in these countries.

Given the rapid economic and social transformation that is taking place in China, one might have expected the growing importance of pensions to result in a greater degree of

financial autonomy and hence in the incidence of independent living arrangements among the elderly. The fact that this has not yet occurred to any great degree in part reflects the enduring nature of the attitudes and values that support the role of the extended family.

The 2000 survey indicates that almost half (47.8 per cent) of the Chinese elderly agree with the statement that: ‘The elderly are the burden of the family’, with support stronger among women than men and increasing with age. At the same time, slightly more than half (52.0 per cent) agree with the statement that: ‘The elderly are the burden of the society’, with support again stronger among women than men and increasing with age. Thus, while a majority of the Chinese elderly see their support as a social responsibility, there is also strong support for the view that the family should also play a role. There are also signs that society is not living up to the responsibility expected of it – at least in the area of pensions – with a substantial proportion (41.0 per cent) indicating that they are ‘fairly’ or ‘very’ worried that ‘The pension is not enough to live on’. A similar proportion (39.6 per cent) are worried that ‘There is no one to care for you when needed’, while 29.3 per cent worry that ‘Children are not filial’.

This evidence re-affirms the reality and the perception of the pluralistic nature of support for the elderly in China. The key point is that the pension system is part of an overall system that is not only pluralistic but also segmented (Shang, 1999). With pensions now at the centre of the social reform agenda in China, there are many indications that ‘storing up current production’ is still widely perceived as capable of delivering good outcomes for future generations. However, it is likely that as economic freedom increases and the population shifts from rural to urban areas following the abandonment of the household registration system, the willingness and ability of the family to fulfil these implicit inter-generational obligations will be eroded. The key issue is how well public pensions can fill the resulting support vacuum, in terms of both the level of support and its reliability.

Barr notes that the key variable that affects the adjustment of pension systems to external demographic and economic shocks is *output*. The consumption of those who are not contributing to current output must be met by that part of current output that is not consumed by those who have produced it. Whether pensions are financed on a PAYG or funded (individual account) basis is of secondary importance. The basic pension financing relationship is expressed as:

$$c.W.L = P.N \quad (1)$$

where c = the contribution rate, W = the average wage, L = the number of workers, P = the average pension, and N = the number of pensioners. This can be reduced to the expression $s = c / r$ where s = the support ratio (N/L), c = the contribution rate and r = the replacement rate (P/W).

The ‘funding crisis’ perspective on pensions promoted by the World Bank (1994) is predicated on the observation that if s rises (as a result of demographic change associated with the long life society), this must be offset by some combination of a higher contribution rate (c) and a lower replacement rate (r). The policy challenge is to select the

contribution rate/replacement rate combination that will achieve an optimal outcome given projected demographic developments.

The first point to emphasise about this framework is that it is a highly simplified representation of an extremely complex reality. It has already been argued that the notion of a demographic support ratio is an over-simplification that can produce misleading conclusions, and that the relevance of the replacement rate to current realities has also been compromised by labour market and demographic changes. There is a need to bring pension systems more in line with what labour markets can now deliver to workers as earnings during their working lives, which raises the issue of the role of pensions.

The three principal roles of pensions are poverty relief, consumption smoothing and insurance (Barr, 2002). The multi-pillar approach assigns a separate scheme to each objective, with poverty relief addressed by a publicly-managed defined-benefit scheme, consumption smoothing achieved by a mandatory, privately-managed, individual account, defined contribution scheme, and private insurance provided commercially (McGillivray, 2000; Holzmann, 2000). Since there is virtual unanimity on the need for some kind of first pillar and for the inevitability of a third (voluntary) pillar, much of the debate has concentrated on the role of the second pillar.

The Australian experience provides an illustration of how the emergence of a strong second pillar pension can balance the tensions that result from relying solely on the first and third pillars. Australia has traditionally relied on a means-tested approach that combines high pension coverage with relatively low benefits that were restricted to those on low and middle incomes. Since the 1970s, pensions have been tied to a poverty line set at around 25 per cent of average earnings, with parity maintained through automatic indexation to consumer price movements and, more recently, to earnings growth. Pension coverage reached a maximum of around 83 per cent of the eligible population in the late-70s (Whiteford, 2000: Figure 14) but even then the pension budget was well below the OCED average (OECD, 1985). A series of cost saving measures introduced in the 1980s saw the coverage rate decline from 83 per cent to 64 per cent between 1979 and 1989.

A decline of this magnitude over such a short period would not be achievable under a second pillar social insurance style of pension scheme because of the nature of its entitlements. To understand how it was achieved in Australia, it is necessary to understand the role that public attitudes played in defining the pension reform agenda. While most Australians believed that their taxes provided them with the right to an age pension, there was broad agreement with the principle of means-testing, and virtually no one argued that the government should provide higher benefits to those who had contributed more in higher taxes. Vertical equity (or income support) among the aged thus dominated over life cycle equity (or income replacement) considerations – at least in relation to the role of public pensions.

Over time, occupational superannuation schemes emerged to supplement the public age pension and although they attracted considerable tax concessions, coverage was concentrated on a relatively small number of public sector and white-collar employees. As these schemes expanded, concerns over the need for improved integration with the

age pension and over the inequitable distributional consequences of the superannuation tax concessions led to the introduction in 1992 of a mandatory ‘second pillar’ scheme in the form of the Superannuation Guarantee (SG). This will over time, provide an earnings-related contributory pension that will, through the income-test claw-back, ease the financial burden on the age pension, although the decline in spending will partly be offset by the growing cost of tax superannuation-related concessions (Commonwealth of Australia, 2002: 42)

Even so, the SG scheme has brought about a major shift in the structure of Australian retirement income provision. Could a similar outcome have been achieved by expanding the existing public pension scheme? Almost certainly not. First, because the ethos of means-testing has become so ingrained into the Australian psyche that a public scheme that provided higher benefits to those with higher incomes would not have been politically feasible. Even though much the same effect is produced by the favourable tax treatment of superannuation (which cost around 58 per cent of pension spending in 2001-02), the fact that these are concessions (and hence far less visible) has been integral to their acceptance. Secondly, expanding the old age pension scheme would have involved raising taxes, and although Australians are resistant to increased general taxation, they are more willing to pay higher charges that fund earmarked benefits of the form provided under the SG scheme (Saunders, 1995).

The Australian pension experience highlights both the strengths and limitations of the means-tested approach. Its main strength lies in its ability to provide high coverage at a relatively low cost, even though this can give rise to poverty traps and associated disincentive problems. But the means-tested approach has limited ability to provide an adequate pension to middle class workers because it reinforces notions of low taxable capacity that prevent its expansion beyond subsistence levels. Above all, the means-tested approach reinforces notions of ‘fairness as poverty relief’ that make it more difficult to achieve broader income maintenance or redistributive objectives through public actions. As in the case of the examples from China cited earlier, traditions that are bound up with (and reflect) the nature of current pension arrangements constrain the scope of reforms designed to overcome existing weaknesses.

One of the key policy issues facing countries with less developed pension systems revolves around the *sequencing* of reforms. In this regard, the Australian experience is salutary. The successful establishment of a strong and effective first pillar scheme that addresses poverty relief can defer the need for a second (funded) pillar for a very long time - particularly if its mean-tested safety net philosophy is accepted and endorsed by the community. If a second pillar is introduced too soon, it can undermine middle class support for the first pillar and prevent the development of a vibrant commercial sector, thus undermining the role of the third pillar. The resulting dynamics may in turn produce an unbalanced system that is low on both coverage and equity, yet highly resistant to change – as many developing countries have discovered. It is far easier to develop a second pillar after the first pillar is in place than it is to underpin a structure built around the second pillar with a new (or greatly expanded) first pillar.

4 Political Forces

The impact of political culture or the ‘politics of pensions’ underlies many of the arguments developed so far. Ross (2000: 4) defines political culture as ‘the manners of thought, and practices of communities or nations that govern behaviour in the political system [that is] the product of both the collective history of a political system and the life histories of the members of the system’. He goes on to argue that any social security system must be realistically based on the economic, social, and political conditions of a particular country, and that a key task of the reform process is to strengthen the political mechanisms that can produce needed change. Issues of political culture, and the constraining influence of democratic and legislative processes – what Barr refers to as ‘governance’ – are critical.

Politics can play a positive role in the pension reform debate by making the underlying issues more transparent to those affected by change. It is important to acknowledge, however, that individuals cannot be assumed to act rationally when it comes to retirement income planning. Most individuals adopt a myopic view when they are young, heavily discounting the benefits arising from consumption smoothing – as long as the current tax implications are bearable. By the time they start to think seriously about these issues – when they are well into middle-age – most of their taxpaying history is already behind them and they face a future in which the generosity of the pension now looms much larger than the contributions (or taxes) that they will have to pay to fund it.

These circumstances generate pressures to expand the pension system beyond its socially optimal level, since those who have most to gain from increased provision are not only more numerous (given historical demographic patterns), they also tend to have the loudest political voice. Once established, overly generous pension schemes become very difficult to reform because their promises become embedded in other decisions. Politicians also have little incentive to support reforms that trade-off increased current costs against longer-term benefits. Furthermore, as Holtzmann (2000: 17) has argued, pension reform faces a severe credibility problem, since the electorate will be reluctant to accept the argument that major reform is needed now in order to place the system on a sound financial basis, when they have no guarantee that further changes will not be introduced in the future. If past political promises cannot be sustained today, why should today’s promises be any more sustainable tomorrow? Far better to resist any change and try to hold the political system accountable for its past decisions.

Although there is an element of truth in these propositions, they are not entirely convincing. They rest on a simplistic political analysis that contrasts starkly with the sophisticated economic and financial arguments that are used to demonstrate that pension reform is needed in the first place. If myopia is a justification for public intervention, should it also not influence the reactions (or lack of them) among those who will be affected by subsequent reforms? The view that politicians rarely look beyond the next election when deciding on matters of policy may run well in the tabloid press, but this does not make it a respectable or compelling argument.

Having said this, there is a good deal of common sense in Ross' view that political culture has an important influence on policy, particularly in the area of pensions. In countries like China, the continued reliance on the family and other informal support mechanisms in old age not only reflects the values of Confucianism, but an underlying distrust of the ability of government to honour the claims contained in state-run pension schemes. This results in an unwillingness to commit funds to the State (through taxation or social security contributions) giving rise to the emergence of mechanisms that rely instead on support provided by the family or local communities.

This lack of confidence in the machinery of government is one of the factors behind the low coverage of social security schemes in many developing countries. Overcoming this resistance will not only require more efficient legislative and administrative structures, but greater trust in government itself. Improved governance requires both. Too many developing countries have introduced 'second pillar' pension systems before the structures were in place to guarantee certainty and credibility and are now struggling to reform a system that has privileged many of those who are driving the reform process.

5 Concluding Remarks

The introduction and development of pension schemes is one of the crowning achievements of the welfare state. Ignatieff's (1994) image of the transfer of income between strangers standing in line in the post office queue 'through the numberless capillaries of the state' is a powerful evocation of a 'solidarity among strangers' that has been a product of the welfare state.

The fact that pension schemes are under attack is no surprise. Any scheme that redistributes resources between rich and poor and across the life cycle must be constantly monitored and evaluated to reflect changing patterns of inequality and life course histories. The fact that pension reform has attracted so much attention in the last two decades reflects the impact of these changes on schemes that were originally designed in a very different set of circumstances. The structure of pension systems may need to change, as well as how they achieve their objectives, but the idea itself is enduring.

Existing pension systems vary greatly, in terms of their maturity, complexity and coverage, as well as in the relative roles of public and private sectors. All countries still rely to some degree on informal structures to meet the consumption and support needs of older people. While pension schemes have largely replaced private inter-generational transfers in industrial countries, they still play a subservient role to informal family-based support in many developing countries. But whatever the mix between public and private provision, the structure of support reflects prevailing values and customs in ways that constrain the reform process.

Many of the examples cited in the paper illustrate the general proposition that *when it comes to pension reform, attitudes matter*. Specific examples include the differences in attitudes to paying for the support of older people and children in the US, the widespread acceptance of means-testing and of redistribution as poverty relief in Australia, and attitudes to working in old-age, perceptions of the role of family responsibility and the perceived unreliability of government pensions in China. These attitudinal effects illustrate how the cultural values and assumptions that underpin pension policies become embedded in individual actions and community expectations and constrain the reform process in ways that can never be adequately captured in abstract models.

The recent pension reform literature has identified a number of important features of sustainable pension systems, but there is still enormous scope for difference – as the OECD pension experience demonstrates. Differences in approach reflect the values and culture of specific countries which, once embodied in a pension system, take on a momentum of their own. The reform options available to any country must ultimately reflect the principles of sound finance, but they must also be *politically* sustainable. Each country's pension system will thus respond differently to the challenges brought about by the emergence of a 'long life society'. Portraying these challenges as a 'crisis' does little to aid the search for sensible responses.

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