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Reflections on the Political Economy of Ageing

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## **Introduction**

The recent federal election revealed a large gulf between policy and politics in the field of ageing. After more than a decade of policy aimed at addressing the longer-term budgetary consequences of ageing, our politicians engaged in a short-run bidding war to secure ‘the grey vote’. The two main victims of this profligacy were the public purse (i.e. future generations of Australian taxpayers) and good public policy.

Australia’s means-tested pension system has proved to be extremely adaptable to changes in the economic, social and demographic context. This contrasts with Europe, where social insurance provides a direct link between contributions and benefits that restricts the scope for politically motivated change. But flexibility can be dangerous if mis-used, and our politicians seem incapable of resisting the temptation it provides to buy their way into office.

Much has been written in the last decade or so about the need to structure the incentives created by public programs so that they reinforce (or at least do not impede) policy goals. We now have a better appreciation of how perverse incentive effects can lead to changes that can weaken or undermine the intended effects of policy. Yet we continue to provide our politicians with an incentive structure that allows them to buy votes in the run-up to elections and wonder why they respond by spending big!

Much of the Australian debate on ageing has failed to address one of the most important contributors to both the living standards of older people and current and future levels of public spending – the age pension. There has been inadequate attention paid to whether the current pension is adequate and whether or not there is a need for change as part of the policy response to population ageing. Although this might appear to be a narrow perspective on the impact of ageing on public spending, it provides a platform to considering the effects of a range of other public programs that also, directly or indirectly, affect the living standards of older people.

## **The Politics of Demographic Change**

Much has been written about the impact of population ageing on the age structure of the population. Ageing has important implications for public *policy*, but these should not be divorced from their more fundamental *political* impact. ABS projections imply that the proportion of the population aged 65 and over will double over the next four

decades, from around 13 per cent to 26 per cent in 2051. By 2051, the number of Australians aged 85 and over is projected to exceed the number of under-5s for the first time (currently those under 5 outnumber those aged 85 and over by almost four-to-one).

Of greater significance than this demographic shift is the fact that the proportion of *voters* who are aged 65 and over is projected to more than double, from around 21 per cent currently to over 46 per cent in 2051. Thus, by the middle of the century, almost half of the Australian electorate will be aged 65 or over and this can be expected to exert a major influence on patterns of political support for social programs, including the pension.

Three factors have the potential to offset this prediction. First, if older people congregate into a small range of localities, their electoral influence may decline as it becomes more concentrated in a small number of electorates. Second, there is the possibility that the political interest of older people may fracture as the system adjusts to ageing and other contextual changes. There are already signs of this happening, as the diverging interests of pensioners and self-funded retirees start to compete for political (and policy) attention. Finally, it is possible (though unlikely) that there will be a sharpening of generational tensions as working-age voters form a coalition to resist the pressures emerging from the larger cohorts of older people.

Paradoxically, there are fewer signs of generational conflict in Australia (where the means-tested, tax-financed pension is an explicit cross-sectional transfer between generations) than in countries in Europe (where contributory pension schemes encourage a life cycle perspective in which each generation pays while working for the benefits it receives when retired). The experience of workers striking to oppose pension reforms is commonplace in Europe but seems inconceivable in Australia. Here, pension issues are seen as the preserve of older people, and while working-age voters may resist paying taxes, they do not link this specifically to reduced spending on pensions (hence the flexibility referred to earlier).

Of course, the impact of changes on all generations must be taken into account in the context of demographic change. Expenditure projection studies have demonstrated that reduced pressures resulting from declining fertility and the smaller cohorts of younger people will offset part of the increased public spending pressures associated

with increased longevity and the growing number of older people. However, these offsets will be only partial, both because of the relative size of the demographic changes, but also because children are less costly (on a per capita basis) to the public purse than older people. Ageing will thus lead to a shift in the overall cost burden, with a reduced demand on private wallets (that largely support children's needs within the family) accompanied by an increased demand on the public purse (that pays for most of the programs for older people). Yet as Gary Burtless (2002, p. 17) has observed:

‘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.’

Timing issues are also important, since most of the gains associated with the impact of lower fertility on young-age dependency have already passed, whereas most of the old-age dependency effects still lie in the future. Trying to engineer public policy shifts in response to these trends is made more difficult by the fact that governments have used part of the ‘fiscal dividend’ associated with the decline in the numbers of children to fund tax cuts for the middle classes. If this is a crisis for government, it is entirely one of its own making.

### **Needs and Living Standards**

What is a pension system trying to achieve? It is useful to distinguish between the ends and means of policy: the *goal* of all pension systems is to maintain (relative to some benchmark) the living standards of people once they withdraw from the labour force; the *means* of achieving this is to provide people with income transfers (and access to other public resources) in retirement. It follows that *the achievement of the pension system should be judged by the living standards it generates (compared with what was promised) rather than the income that it delivers.*

The limitations of relying on income alone to measure living standards have long been recognised. More income, other things constant, will increase the standard of living, but the impact may be small and will depend on a range of other factors. In relation to both research and policy, we need to focus on the standard of living itself, not just on a presumed relationship between it and income.

The ability of a given income transfer to support a given standard of living will depend on what other supports are available to older people. The adequacy of a pension cannot therefore be judged in isolation from how well health care, aged care and housing provisions meet the needs of older people. For example, high rates of home ownership in Australia allow the government to provide a lower rate of pension than would otherwise be required to support older people at a given living standard (Castles, 1997).

Table I illustrates the practical importance of this issues by comparing the age-income profile with a range of direct indicators of the standard of living. The results have been derived using data from the *Community Understanding of Poverty and Social Exclusion* (CUPSE) survey that is the basis of a recent report on deprivation and social exclusion in Australia (Saunders, Naidoo and Griffiths, 2007). The second column shows mean (gross) income adjusted for need using the modified OECD equivalence scale. This indicator is commonly used in studies of poverty and income distribution to measure the adequacy of resources relative to needs (Saunders and Bradbury, 2006; ABS, 2007).

The next two columns show a measure of satisfaction with overall financial situation using a ten-point scale from very dissatisfied (scores between 1 and 3) to very satisfied (scores of 9 and 10), and responses to a question asking people to assess their current standard of living in one of five categories; very high (score = 5), fairly high (4), medium (3), fairly low (2) and very low (1). The final column shows the mean deprivation score, derived by summing the number of items regarded by a majority (at least 50 per cent) of the population as essential that each individual does not have and cannot afford and averaging across the age categories.

The age-income profile shows the familiar inverted U-shape, rising to a peak in when people are in their 50s and then declining, particularly after age 65, although there are also high levels of income experienced by people in their late-20s and early-30s.

Recall that the estimates have been adjusted for differences in need (e.g. to reflect the presence of children) and the patterns shown are more marked before this adjustment is made. The two indicators of subjective well-being (SWB) both show much less variation than mean income but each reveal that those in the older age groups (particularly those aged 65 and over) are best off in terms of the level of satisfaction with their financial situation how they assess their overall standard of living. The age

differences are confirmed by the deprivation scores, which show the opposite pattern to income, declining across the age categories and reaching a minimum for the older age group.

**Table 1: Relationship between Income and Life Satisfaction Indicators, by Age**

Age (years)	Gross income (equivalised)	Satisfaction with financial situation	Assessment of living standard	Mean deprivation score
17-24	496.8	5.54	2.69	2.13
25-29	729.4	5.53	2.79	1.75
30-34	709.1	5.59	2.71	1.97
35-39	669.7	5.63	2.80	1.74
40-44	665.7	5.55	2.83	1.83
45-49	681.6	5.79	2.77	1.54
50-54	712.4	5.88	2.77	1.25
55-59	678.4	6.06	2.77	0.83
60-64	547.7	6.12	2.85	0.99
65+	403.6	6.30	2.93	0.87

Source: SPRC Community Understanding of Poverty and Social Exclusion (CUPSE) survey

There are a number of explanations for the patterns shown in Table 1, particularly the divergence between the objective (income-based) measure and the three more subjective (non-income) well-being indicators. The indicators may be wrong, although this argument is difficult to sustain given that they all reveal a similar picture about how living standards vary with age at a point in time. It is possible that the subjective indicators reflect the lower expectations of those in the older age ranges – the idea of adaptive preferences (Sen, 1985). However, other results from the CUPSE survey indicate that older people are more likely to regard items as essential than younger people, which is contrary to what one would expect if preferences are adapting to a lower standard of living among older age groups.

Another possibility is that the equivalence scale used to adjust income for differences in need may not capture how needs vary with age. The OECD scale makes no allowance for age aside from distinguishing between children and adults (and the age at which this occurs varies between applications) and this is likely to be a source of error, potentially a substantial source. Budget standards estimates prepared by the SPRC (Saunders et al., 1998) indicate that the needs that are met out of *private* budgets decline with age. Thus, the private consumption needs of a 70 year-old Australian woman are estimated to be around three-quarters (74 per cent) of those of a 35 year-old woman. If the equivalence factor for older people was reduced by 25 per

cent, their equivalised income would increase in proportion, closing the gap with younger age groups (though not totally). The final explanation of the results in Table 1 is that income (whether adjusted for needs or not) may simply be a poor indicator of the standard of living, as was suggested earlier.

Table 1 suggests that the living standards of older people, on average, compare favourably with those of other age groups, at least when examined using a cross-section snapshot. The Australian age pension delivers a *relatively low income* (a claim that is confirmed by international comparisons produced by the OECD (Förster and d’Ercole, 2005)), but appears to do much better at *supporting the living standards* of older people relative to people of working-age.

The sustainability of any pension system depends upon the strength and consistency of its political support. This in turn depends on how well its benefits conform with community perceptions of need (the standard of living that the pension can support) and the values that underpin social justice (the relative living standards of older people and other groups in society). Research has a role to play in informing adequacy issues but politics has a more fundamental role to play in shaping pension policy.

The nature of public support and the balance between public and private forms of support *become embedded in community attitudes* and this constrains the reform options that are practical in response to demographic change (the notion of path dependence highlighted in the work of Pierson, 1997 and Bonoli, 2000). The difficulties associated with switching attention away from income relativities onto the living standards that can be supported by different income levels at various points in the life cycle (including at older ages) should not be under-estimated, but such a switch would contribute to a more informed debate on the political economy of pensions.

### **Inequality and Older People**

Growing inequality has been a feature of Australian economic and social change over the last three decades, and these trends (though difficult to document because of numerous changes to the ABS income distribution data) seem set to continue. There are three reasons why growing inequality might be of concern for older people. First, increasing inequality may be driven by forces that have undesirable effects on older

people. Second, growing inequality may give rise to undesirable social outcomes that impact disproportionately on older people. Third, older people may be more egalitarian than others in the population, and thus more concerned about growing inequality.

An example of the first argument is that inequality may be bad for older people, not because of the undesirability of growing inequality *per se*, but because the values and policies that have produced more inequality involve cutbacks in the public programs that older people tend to rely on more heavily than others in the population.

Growing inequality may also be of specific concern to older people because it produces undesirable social outcomes that are particularly harmful for older people. The adverse effects of inequality on health (morbidity and mortality), the level of criminal activity, and community cohesion and connectedness are all central here, although the evidence is mixed about the size and robustness of many of the effects. We are a long way from demonstrating convincingly that the effects exist in the aggregate, and even further from showing that they have a particularly strong impact on older people.

This brings me to the third argument, which relates to the idea that older people are more resistant to, and hence more adversely affected by, the growth in inequality than other age groups. Age differences in attitudes to inequality can be examined using the CUPSE data, and some of the results are summarised in Table 2. Respondents were shown the four statements about inequality shown in the first column of Table 2 and asked to indicate the strength of their agreement with each of them. The figures shown refer to the percentage of each age group who indicated that they ‘strongly agree’ or ‘agree’ with each statement.

The results are somewhat mixed, although there is no clear pattern confirming that older people are more egalitarian than younger groups. Those aged 65 and over tend to be more likely to agree that inequality is too high and should be reduced, but they are also more likely to oppose income redistribution because of its harmful economic effects. Most striking of all, those aged 65 and over are three times more likely than those under 30 to think that inequality is too low and needs to be increased in order to improve incentive structures. A note of caution should be applied to these findings, because other research (in Australia and overseas) suggests that many people have

views about inequality that differ greatly from the true situation, although this should not necessarily affect the age differences shown in Table 2.

**Table 2: Attitudes to Inequality, by Age (percentages)**

	Total	Under 30	Age: 30-64	65 and over
<i>Inequality is too high and should be reduced</i>	60.8	56.1	62.3	59.6
<i>Inequality is too high, but cannot be reduced without harming the economy</i>	16.1	22.3	16.1	12.2
<i>Inequality is about right in current circumstances</i>	17.1	17.4	17.0	17.2
<i>Inequality is too low – more inequality creates more incentive to work</i>	6.0	4.2	4.7	11.0

Future trends in inequality is an issue that many people express concern about (as evidenced by the resistance to Work Choices), although the evidence does not show that inequality is of any more concern to those aged 65 and over than to those in younger age groups. Even so, the political economy of inequality and redistribution is likely to exert an important influence on the future of public policy and will thus play an important role in affecting –directly and indirectly – the future living standards of older people.

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## Reflections on the Political Economy of Ageing

SPRC

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## The Context

SPRC

'The *Intergenerational Report* ... provides a basis for considering the Commonwealth's fiscal outlook over the long term, and identifying emerging issues associated with an ageing population'

'The interest of the pension issue ... stretches more broadly than the questions of who should pay, at what level and by what means. It should go along with rethinking what old age is and how changes in the wider society affect the position of older people ... it isn't enough to think only in terms of economic benefits.' (Anthony Giddens, *The Third Way*)

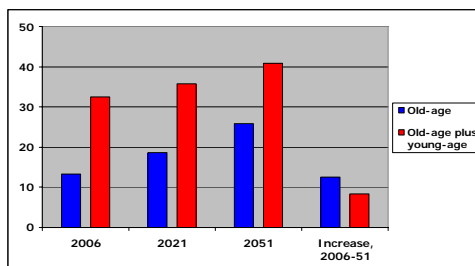
## Scope of this Presentation

SPRC

- x Modelling the impact of demographic change
- x Pensioner needs, incomes and living standards
- x Inequality and older people

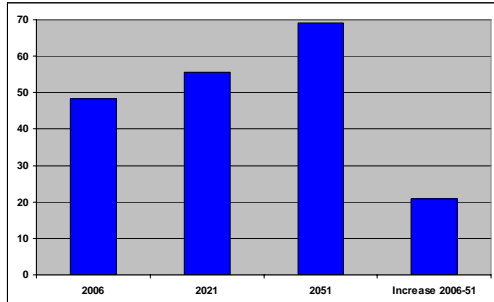
## Changes in Demographic Structure (% of total population)

SPRC



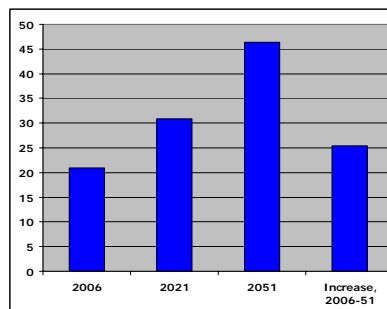
## Changes in Dependency Ratio (0-14 plus 65+ as a % of population aged 15-64)

SPRC



## Changes in the Age Composition of the Electorate (age 65+ as a % of age 18+)

SPRC



### The Ageing Debate: Neglected Factors



- × The **sequencing** of demographic change is important: the decline in young-age dependency proceeds the increase in old-age dependency
- × Ageing is an issue of **national** importance – the States need to be involved in modelling efforts
- × The **pension** will remain the cornerstone of the retirement income system, but the ageing debate provides an opportunity to re-consider its role, purpose and structure
- × While most of the costs of supporting older people are borne by the public purse, the costs of **children** are met from private wallets:
 

‘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’ (Burtless, 2002)
- × Path dependence is an important constraint on the feasibility of pension reform (Pierson; Bonoli; Saunders)

### Political Factors



- × Demographic change will have a profound impact on the **age composition of the electorate** adding to the political influence of existing constituencies (particularly under compulsory voting)
- × Current attitudes, vested interests and mobilised support will affect what is **politically** viable, yet few modelling studies include these variables
- × Under European social insurance systems, the political power of workers has constrained government action on long-term pension reform
- × Australia’s non-contributory system has given government the flexibility to increase benefits for older people, but this has been exploited for short-term political gain (both are examples of path dependence)

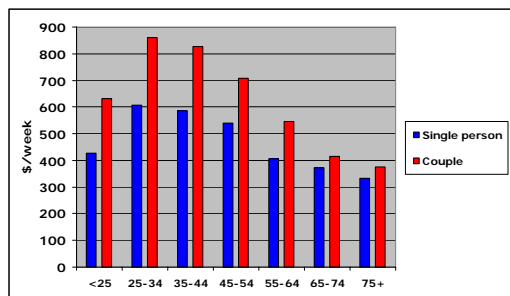
### Pensioner Incomes and Living Standards Indicators



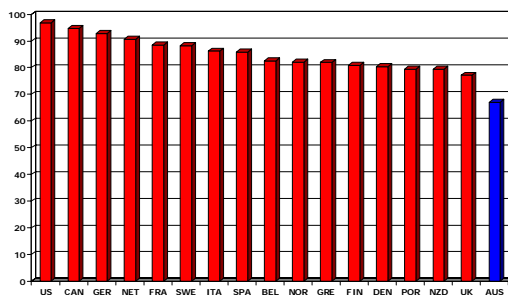
Age (years)	Gross income (equivalised)	Satisfaction with financial situation	Assessment of living standard	Mean deprivation score
17-24	496.8	5.54	2.69	2.13
25-29	729.4	5.53	2.79	1.75
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40-44	665.7	5.55	2.83	1.83
45-49	681.6	5.79	2.77	1.54
50-54	712.4	5.88	2.77	1.25
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60-64	547.7	6.12	2.85	0.99
65+	403.6	6.30	2.93	0.87

Source: SPRC Community Understanding of Poverty and Social Exclusion (CUPSE) survey

### Mean Equivalised Disposable Incomes by Age, 2003-04



### International Comparison of Relative Aged Incomes (aged 66-75 as a % of overall mean; circa 2000 – Source: OECD)

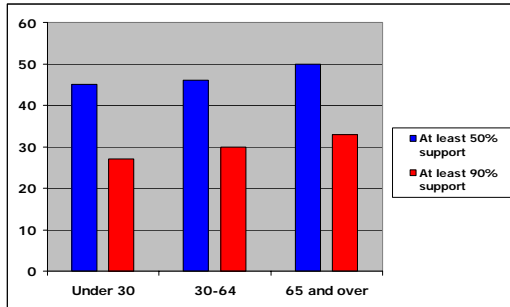


### Preference Drift/Adaption



- × ‘The depth interviews also showed that older people who had lived on low incomes all their lives had never been able to afford these items and over the years had lowered their expectations. This was especially true of holidays away from home, replacing worn-out furniture, saving for a rainy day and personal spending money’ (DWP Research Report No. 363)
- × This issue needs to be examined using longitudinal data (e.g. HILDA)
- × Some striking results have emerged from recent UK research using panel data (DWP Research Report No. 364)

**Support for Items Being Essential – Things That No-one Should Have To Go Without Today (percentages)**



**Future Inequality Among Older People**



- × **Inequality between retirees will increase because:**
  - (a) The maturing of the SCG scheme will shift more older people onto a part-rate pension/superannuation package
  - (b) Greater earnings inequality will eventually produce in increased inequality in superannuation benefits
  - (c) Reforms announced in 2006 Budget provide huge benefits to those with large superannuation entitlements
- × These effects are likely to weaken political support for the pension, which may decline in relative terms, exacerbating the above effects

**What Does Increased Inequality Imply for Older People?**



**1. The Inequality Ethos**

Where growing inequality reflects an increased role for markets, this may be accompanied by increased individualism and reduced commitment to pay the taxes that fund public programs like pension schemes – there is some evidence to support this

**2. Inequality has Harmful Social Effects for Older People**

Increased inequality may produce adverse social effects (e.g. crime rates; reduced life expectancy; increased morbidity; weakened sense of community) that will indirectly affect older people - the evidence is mixed on many of these effects (including the negative impact of equality and redistribution on economic growth)

**3. Older People May be More Opposed to Inequality**

Older people may be more concerned about inequality than other groups in society – not much is known about this issue

**Attitudes to Inequality by Age (percentages)**



	Total	Age		
		<30	30-64	65+
Inequality is too high and should be reduced	60.8	56.1	62.3	59.6
Inequality is too high, but cannot be reduced without harming the economy	16.1	22.3	16.1	12.2
Inequality is about right in current circumstances	17.1	17.4	17.0	17.2
Inequality is too low – more inequality creates more incentive to work	6.0	4.2	4.7	11.0

**In Summary**



- × Mean income (adjusted for need) declines with age after about age 30, initially because of the presence of children, then because of labour market withdrawal and retirement
- × There is no cross-section evidence that hardship declines with age – quite the contrary (although declining aspirations may play a role)
- × The (limited) Australian evidence suggests that older people do not have lower expectations about consumption needs
- × A pension that varies with age, marital status and other factors (e.g. housing tenure) may be more adequate in terms of consumption support, more equitable among groups of older people, and no less affordable
- × Inequality within older age groups is likely to increase
- × Older people do not appear to be more supportive of inequality than younger people

**Assessing the Adequacy of the Pension: Methods**



**Objectively:**

- against an external benchmark (e.g. 25% of MATWE – the Henderson poverty line!)
- against a relative income target (e.g. a statistical poverty line set at 50% of median income)
- against a normative standard (e.g. a budget standard)
- using external evidence on living standards (e.g. deprivation rates)

**Subjectively:**

- using perceptions and attitudinal information derived from social surveys and/or qualitative information obtained from focus groups and in-depth interviews

**Real and Relative Movements in Maximum Rate of Age Pension, 1965-2006 (June each year: 1974 = 100)**

