What has fairness got to do with it?   Social justice and pension reform

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Documents reviewed

- *Inclusion or insurance? National Insurance and the future of the contributory principle.* By John Hills (London: Centre for Analysis of Social Exclusion, 2003. CASE paper no.68)
- *The New Old: why baby boomers won't be pensioned off.* By J. Huber and P. Skidmore (London: Demos, 2003)
- *A new social contract for the elderly*. By John Myles.   (In: Why We Need a New Welfare State. Edited by G. Esping-Andersen et al., 2002).
- *What justice requires: Pension reform in ageing societies*. By John Myles (Journal of European Social Policy, 2003, vol 13, pp. 264-270).
- *Pension reforms: key issues illustrated with an actuarial model*. By Heikki Oksanen (Brussels: European Commission, 2002).
- *The Debate on Pensions: More Rigour Needed in the Middle Field*. By Heikki Oksanen (Journal of European Social Policy, 2003, vol .13, pp. 269-274).
- *Debate on Social Justice and Pension Reform: Social Justice and the Reform of Europe's Pension Systems*. By Erik Schokkaert and Philippe Van Parijs. (Journal of European Social Policy, 2003, vol 13:45-264)
- *The Policy Challenges of Population Ageing*   By Alan Walker (McMaster University: SEDAP Research Paper no 108, 2003)
- *Old Europe? Demographic change and pension reform* By David Willetts MP (London Centre for European Reform, 2003)

Fairness as a constraint on proposals for reform and fairness as a driver for reform

Arguments about fairness enter into debate about policy reform in one of two ways – either as a constraint on policy-making - a criterion that has to be satisfied by all proposals for change – or as an essential part of the rationale for change. In the first case it is accepted that current policy has to be changed for reasons that have nothing to do with fairness; and yet we must make sure that the required changes have no undesirable effect on the fairness of the arrangements under consideration. In the second case it is argued that current policy should be changed *because*, as it stands, it is unfair.

It is easy enough to agree that fairness (i.e. *some* test of fairness) should be a constraint on any changes in pension policy that might be proposed as adjustments to population ageing – without accepting that a problem of unfairness is one of the 'main drivers' or rationales for reform. A great deal of policy debate about population ageing and pension reform does in fact proceed on the assumption that arguments about fairness are relevant mainly as constraints on policy proposals that are developed as responses or solutions to a rather different problem: the pressures that population ageing will soon be exerting on public pension systems and what this means for their continuing viability as sources of an adequate retirement income. Looked at from this point of view, it should be possible (and it is clearly desirable) to provide a consensual 'non-ideological' analysis of the problem – that is to say, we should expect experts to reach broad agreement about the nature and magnitude of the pressures that population ageing will exert on different kinds of pension systems – even if it is not possible to reach a similar kind of agreement about the fairness of different remedies or solutions.

A consensual analysis of the problem?

Is there an agreed analysis of the problems facing pension systems over the next few decades? Up to a point.

"It is now a commonplace that the unfunded pension systems of many OECD countries will run into severe financing problems in the coming decades due to declining fertility and increasing longevity and thus a dramatically increasing pensioner/worker ratio. Most experts agree that systems such as US Social Security will become "unsustainable", which means either that the average benefit level (as percentage of current wages) has to be cut or tax rates must be raised (or a combination of the two) in

order to preserve the budget balance." (Breyer, 2001)

Many of the governments of the OECD countries – certainly most of those in continental Europe – would probably be prepared to take their agreement somewhat farther than this, firstly, in their recognition that the trend towards to earlier exit from the workforce has exacerbated the problem (Casey et al, 2003), and secondly, in their insistence that they have relatively little room for fiscal manoeuvre in the matter of sustainability. What constrains them here is the belief that the level of public expenditure as a proportion of GDP is already approaching the limits of political acceptability and economic efficiency (Jackson, 2003). In other words, the problem is not just that present pension arrangements are unsustainable (in Breyer's sense) under conditions of population ageing. More importantly, there is a limit to their ability to 'fix' this problem by increasing taxes or pension contributions. They cannot (or should not) promise to maintain current replacement rates if this would require an 'unfeasibly' large increase in the rate of contributions/taxes. Nor can they realistically expect to increase public borrowing as a way of funding an increasing negative balance on the scheme[1]. This does not mean, of course, that the policy task is simply that of ensuring that these limits are not transgressed. The real problem for governments is how to ensure that people have adequate income in retirement without transgressing these limits.

There is also broad consensus that the sustainability of public pension programmes is most threatened in those parts of continental Europe which already have relatively high levels of public social welfare spending and rely most heavily on 'traditional' pay-as-you-go defined benefit pension (PAYG DB) schemes as a means of providing retirement income. These are the countries which tend to have least room for manoeuvre, though when it comes to the question of how much room for manoeuvre they really have, there is still quite a bit of disagreement. Not everyone agrees, after all, about the positioning of the limits that political acceptability and economic efficiency set to public expenditure.

Does this mean that there is no very serious problem in countries with pension systems that do not rely heavily on PAYG DB schemes? If we specify the 'problem' in terms of public finances – how population ageing affects public finances through the pension system – then it seems evident that in

[1] Members of EMU, as signatories of the Growth and Stability Pact, are committed to keep public debt below 60% of GDP and move the budget 'close to balance or surplus', which also provides them with a ready-made criterion by which to assess the economic sustainability of their pension programmes. 'Sustainability' here is used differently from the way that Breyer uses it. Disney (2003) discusses the limitations of these requirements as a true measure of sustainability.

countries which are not so heavily reliant on PAYG DB schemes (like the UK or Switzerland or Netherlands), the problem will not be too serious. If, on the other hand, we think that there is a problem here, which cannot be reduced to the requirements of maintaining sound public finances, then we may be inclined to take a rather different view of the prospects for pensions in a country like the UK.

"The public implications of demographic ageing have been the primary focus of entire libraries of documents prepared by international (EU, OECD) and national agencies... The risk, however, is to conclude that for nations where the public budget for retirement is large and growing that demographic ageing is a "big" problem, while in nations where the public retirement budget is modest and even stable, the problem is negligible. Our emphasis here on the total social costs and their allocation, is intended in part as an antidote to the risk of such an error…" (Esping-Andersen et al, 2002)

The point is a simple one. If the 'real costs' – the "total social costs" – of providing retirement income are set to rise as a result of population ageing, then although it may be possible for government to deal with its projected budgetary difficulties by cutting down on public pension commitments and shifting an increase proportion of the costs 'off-budget', society as a whole still has the task of (i) meeting the increase in the real costs and (ii) allocating this increase among different population and/or social groups. Although most published discussions of pension reform tend to focus on the first of these tasks as the primary problem (in which case, if fairness enters the discussion at all, it is as a constraint on proposals for reform), there is a substantial number of commentators and analysts who argue that at bottom the problem is a distributional one.

David Willetts (2003), in a paper recently published by the Centre for European Reform, shares Esping-Andersen's view that we have to look beyond the problems of public finances in order to understand the underlying nature of the problem facing pension systems under conditions of population ageing. The relatively healthy state of the UK's public finances under most projections for the next forty or fifty years does not let the UK off the hook.

"Deep down, Britain's pension crisis is very similar to those facing France, Germany and Italy. All four countries made generous pension promises without having enough future resources to meet them. The difference is that in the UK it is companies which have promised to meet the cost of retirement benefits … Mercers, a leading firm of actuaries, has calculated that British companies are facing a £270

billion pension fund shortfall – that is the gap between the cost of meeting their pension commitments and the assets in the pension funds. Companies cannot simply hope that a sustained recovery in equity prices will make good this shortfall." (Willetts, 2003)

So what kinds of policy adjustment are required to enable society to meet the projected increase in the costs of retirement provision? Although Willetts highlights the projected shortfall in pension fund assets, he is quite adamant that the problem cannot be solved simply by increasing the level of private savings. The 'underlying threat', as Willetts sees it, is not that we won't save enough, but that we won't produce enough. Pension arrangements, no matter what form they take, are ways of transferring purchasing power from people who are working to people who are not working. As such, they have less effect on the ability of our economies to provide a decent and acceptable standard of living for increasing numbers of pensioners than does the growth rate. The fundamental challenge, therefore, is to maintain a dynamic economy under conditions of population ageing. How will the European economies maintain the growth rates they need when the generations making up the future workforce are shrinking in size? What is required are policies (i) to increase labour participation, not just among older people (the 55+ age group), but also among working age women and younger people, and (ii) to increase labour productivity.

One notable feature of Willetts' discussion is that fairness really has very little to do with it. Although we can assume that fairness is there in the background as a constraint on whatever remedies are proposed (a test that is to be applied when the implications of these remedies are worked out in detail), his key point is that population ageing represents a major challenge to the ability of pension arrangements in advanced industrial economies to deliver what we all want them to deliver. This perspective on the problem stands in marked contrast with the arguments of commentators, such as Johnson (1997), or Cremer & Pestieau (2000), or Schokkaert & Van Parijs (2003), who are all quite firmly of the opinion that the 'fundamental' problem is in fact distributional or political.

"The pension problem must not be viewed as a 'demographic' or 'economic' problem, but fundamentally as a political problem, which we cannot even begin to tackle without some conception of what justice requires" (Schokkaert & Van Parijs, 2003).

"Since the proportionate size of the retired population is set to rise, future workers will inevitably have to forego a larger share of investment and consumption than do current workers in order to sustain

pensioner incomes. The only way to prevent population ageing leading to a rise in the share of national income transferred to elderly people is through a reduction in the relative income of older persons. This is why I call the future of old age income security primarily a political rather than an economic issue…"(Johnson, 1997).

Intergenerational fairness and the problem of generational equity

"Member states should undertake ambitious reforms of pension systems in order to contain pressures on public finances, to place pension systems on a sound financial footing and ensure a *fair intergenerational balance*" (European Commission, 2003).

"A strategy pursuing the *aim of equal treatment for all generations* can cope with … demographic changes only through an intergenerational redistribution i.e. a re-balancing in favour of the younger and as yet unborn cohorts" (Rürup Commission, 2003).

Both these quotations come from reports that are concerned, first and foremost, with the long-term sustainability of public pension arrangements under conditions of population ageing. They appeal to the idea of intergenerational fairness both as a constraint on reform and as a rationale for reform.

If it is accepted that retrenchment is necessary to maintain the sustainability of public pension arrangements, then we are inevitably faced with decisions about allocating the costs of retrenchment. Is it not unfair simply to cover the costs of future benefits (i.e. for the 'next generation' of pensioners) by raising the level of future contributions paid by the next generation of workers? If, however, future benefits are held down so that contributions do not have to rise, then the costs of retrenchment are pushed onto the next generation of pensioners. "The policy choice between tax increases and benefit cuts resembles a zero-sum conflict in which the benefits or taxes of one generation or group of workers must be sacrificed in maintaining the incomes of another" (Bosworth & Burtless, 2003). So what should count as a fair allocation – between different generations - of the costs of maintaining the sustainability of public pension systems? And how is this to be achieved?

It can also be argued that, in the absence of reform, the costs and benefits associated with participation in public pension schemes will be distributed in an 'unbalanced' way between different generations. Intergenerational *re*distribution is necessary in order to avert the *mal*distribution of resources between

earlier and later generations that will result if they are left unreformed. Here too, we have to ask what counts as a “fair intergenerational balance” and how it is to be achieved.

The 1994 World Bank report on pension reform supplied one controversial answer to these questions when it highlighted the problem of ‘perverse intergeneration redistribution’ inherent in traditional PAYG DB pension schemes under conditions of population ageing. On the basis of this analysis, it was argued, firstly, that it is not really possible to achieve intergenerational fairness in a traditional single pillar PAYG DB system, and secondly, that the only fair solution is to replace it with a multi-pillar system which combines a social safety net with a fully funded defined contribution (DC) scheme. Looked at from this point of view, the failure to maintain intergenerational fairness is seen to be part (and for some analysts the strongest part) of the case for the *radical* reform of public pension systems. The case is, as it were, expanded to draw not only on the argument that unreformed public pension systems will generate excessive public welfare expenditure and damage the overall efficiency and performance of the economy (e.g. Petersen, 2002), or that fully funded systems offer better rates of return and boost aggregate savings (e.g. Feldstein, 2001), but also on the argument that unreformed public pension systems – under conditions of population ageing - are unfair to successive generations.

The argument, by now familiar enough, is that population ageing changes the terms of the ‘implicit generational contract’ that underpins PAYG DB pension schemes. Because PAYG systems rely on transfers of income from taxpayers to people who are retired, they also rely on a ‘promise’ that these same taxpayers will eventually benefit from the same system of transfers when it is their turn to retire. As successive generations live longer and shrink in size, the value of the ‘annuity’ provided under the contract diminishes. If we suppose that replacement rates and retirement age remain the same and that the scheme is kept in balance by raising the level of contributions to cover the increased aggregate cost of benefits, then the later generation will receive a poorer rate of return on their pension contributions than their predecessors. It is in this way that population ageing - working through PAYG pension systems – is the cause of a very large and unintended redistribution away from future (younger) generations to earlier (older) generations. As Johnson (1999) argues, the weakest conclusion that we might draw from this argument is that change in the terms of the contract makes it *appear* unfair – which creates a serious *political* problem for the stability of the system.

The argument here, however, is not simply that the change in the terms of contract makes it *appear* unfair to later generations, but that it actually *is* unfair and provides us with a *good* reason for

reforming the system with a view to eliminating or at least minimizing the intergenerational redistribution. Reform should aim to change from a system in which each working generation assumes the responsibility of supporting its retired contemporaries while being assured of similar treatment by the next working generation to a system in which each generation finances its own retirement – without claims against subsequent generations or obligations towards preceding generations.

This particular argument - that population ageing gives rise to a problem of generational equity for PAYG pension systems but not for fully funded systems - has been challenged on various counts; and a recent report on pensions from the International Labour Office elaborated on the most important of these in some detail (Gillion et al, 2000). From the fact that funded pension schemes do not involve any intergenerational *redistribution,* it does not follow that they involve no kind of generational inequity.

"Individual fully funded schemes do not redistribute between generations because the value of the benefits paid to an individual has to equal the value of accumulated contributions. Nonetheless, the outcome is similar in some respects to defined benefit pay-as-you-go schemes: the rates of return earned on contributions vary from one generation to the next…"

If demographic shocks can cause one generation to receive a lower rate of return on its (PAYG) pension contributions than its predecessors or successors, volatility in financial markets can have the same effect on the rate of return received by different generations on their contributions to the investment funds that underpin fully funded pension schemes. As Estelle James (1997) acknowledges, "certain types of capricious distributional effects are eliminated by the shift from a DB to a DC plan, but others are created".

Where does this leave the issue of intergenerational fairness? It certainly implies that the problem of achieving intergenerational fairness in pension policy is not to be resolved by replacing PAYG pension systems with fully funded pensions. The phenomenon of 'perverse intergenerational redistribution' cannot serve as a good reason for making such a policy change. But this does not dispose of the problem.

Is intergenerational fairness a proper goal for public policy?

But is it reasonable to expect public policy to concern itself with the intergenerational effects of pension reform in the first place? There are two arguments that have been advanced in the literature for disregarding the problem of intergenerational fairness altogether, which are, firstly, that it is swamped by what is sometimes called '*intra*generational' fairness, and secondly, that we have no workable criterion of intergenerational fairness by which to measure the success of public policies which aim to achieve it.

Consider how differently the issues of distributive justice that arise from population ageing will appear if we take the view that:

(a) the status quo distribution of income and wealth in our society is more or less satisfactory; or
(b) the status quo distribution of income and wealth in our society is unsatisfactory because there is too much interpersonal (or intragenerational) inequality.

If we think that (a) is a reasonable assessment, then it might well be asked why we should get so worked up about the problem of intergenerational fairness. In other words, if we are willing to tolerate considerable intragenerational inequalities, why not also intergenerational inequalities? If, on the other hand, we incline to (b), then it becomes plausible to argue that the problem of generational inequity is overshadowed by what is surely the more fundamental problem of social justice. What is required by way of response to this argument is a convincing account of the importance of the problem of intergenerational fairness for PAYG schemes, and this is generally given, as we have seen, in political terms. Circumstances have changed in ways that require us to take more explicit account of the effects of current policies on the living standards of future generations. The current working generation can no longer assume that economic growth will continue to deliver rising living standards (for its own retirement) as it has done in the recent past. Concern about the stock of public capital and natural resources that is being passed on to the next generation reinforces our sense of the importance of the issue intergenerational fairness. The fairness of the contract that underlies public intergenerational transfers can no longer be taken for granted. If it is conceded that a consensus over intergenerational fairness has become a condition of their stability, then we should turn our attention to laying the foundations for a 'new' consensus.

What is at issue here is the fairness of a system of intergenerational transfers with respect to the successive generations that participate in the system. If governments are going to use PAYG schemes to effect large-scale intergenerational transfers (from the working generation to its retired contemporaries), then it seems quite proper to ask whether or not these transfers have any unwanted redistributive consequences under conditions of population ageing. And to do this we must have some criterion for deciding what counts as *unwanted* redistribution from one generation to another (or 'equal treatment' for successive generations participating in the intergenerational contract) – and a way of deciding in particular cases whether or not any such redistribution has occurred (a tool for measuring the 'generation-specific' effects of a policy that makes use of intergenerational transfers). Scepticism about the availability of an agreed criterion of intergenerational fairness – or the feasibility of deciding whether or not it has been met – has led some commentators to the conclusion that this kind of intergenerational fairness should not be a concern of public policy.

Why scepticism? The 1994 World Bank report on pensions recognised that 'lifetime return on pension contributions' provided a rather a crude yardstick for comparing the treatment (the 'deal') that successive generations received from PAYG schemes. The yardstick was able to measure the 'lifetime net benefit' of participation in the scheme only by taking a very narrow view of intergenerational transfers, and of the costs and benefits that are to be entered into the account. After all, governments use revenues raised from the working generation in general taxation (as well as pension contributions) to make such transfers and they make them to the 'pre-work' generation as well as to the 'post-work' generation. And if we accept that we cannot sensibly assess the 'lifetime deal' that each generation receives as a result of a public system of intergenerational transfers without taking the whole system into account, we have a good reason for moving to generational accounting in order to compare the 'lifetime net tax burden' on successive generations – which is precisely what the World Bank recommended that governments do. They should compile sets of generational accounts in order to assess the generation-specific effects of their tax-and-transfer policy.

Narrowness, however, is also the main burden of many of the criticisms brought against generational accounting. As the basis for a test of intergenerational fairness, it seems, according to some critics, to take an excessively narrow view of (i) the ways in which different generations are affected by government fiscal policy and (ii) intergenerational transfers. The only benefits, for example, which are included in the preparation of the accounts (i.e. are attributed to a particular generation), are income

transfers. All other benefits of government public expenditure (which might include e.g. a large expansion of higher education) are considered non-attributable to particular generations. And, as Guillemard (1999) argues in considering the generational incidence of the adverse effects of changes in the labour market, an analogous problem occurs on the cost side of the accounts. A rather different line of criticism depends on the hypothesis that increases in the level of public transfers from taxpayers to pensioners are to some extent offset by increases in the level of private transfers going in the other direction (De Bourg, 2003). In other words, generational accounts are defective to the extent that they ignore *private* intergenerational transfers. Until we know something about the size of this offsetting effect of private transfers from the pensioner population to their children and grandchildren, we have a very incomplete picture of the generational effects of government fiscal policy.[2]

What conclusions can be drawn from these criticisms? If is accepted that generational accounts are indeed inadequate to the task in hand – because of the sheer complexity of the various factors that should be taken into account – then we may incline to the view that *net* intergenerational transfers are quite simply too complex to measure (Guillemard, 1999). And even if we suppose that the attempt to assess the intergenerational fairness of pension policy is not undermined by the difficulties of the task of measurement (so that we can agree on the procedures for determining the size of any *net* intergenerational transfer), it still remains for us to determine whether or not this redistribution is undesirable or unfair. If we think that *this* judgement is especially problematic, perhaps because our ideas about what is required by justice do not stretch far enough to cover this sort of case, or perhaps because the judgements involved are too controversial to serve as a basis for public policy (Agulnik, 2000), then we still have no workable criterion by which to assess the intergenerational fairness of pension policy, which means that it should not be a goal for public policy.

Building a new consensus

This scepticism about the availability of a workable criterion by which to assess the intergenerational fairness of pension policy is shared neither by the Rürup Commission, nor the European Commission (see above). It has also been explicitly rejected in a number of recent discussions of the importance of

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[2] Lee (2002) argues that this offsetting effect must be small. The net direction of *private* transfers in advanced industrial societies may be downwards (from elderly to children), but “transfers [to the elderly] through the public system overwhelm these downward private transfers, so that the net direction of transfers [is] upwards”.

intergenerational fairness to the debate on pension reform (Oksanen, 2002, 2003; Myles, 2002, 2003; Schokkaert & van Parijs, 2003). All these authors accept that European (and Canadian) welfare systems have to be seen to pass a test of intergenerational fairness if they are to be preserved. Governments have to respond to the widespread perception that existing policy commitments will impose an excessive burden on future generations.

For Oksanen the choice of test is relatively unproblematic, and the policy response is fairly clear. An unfair burden will be placed on future generations of pensioners if, as a result of demographic change, it costs them more than current pensioners to secure the same benefits.

"As a benchmark [for intergenerational fairness] it is required that all generations with the same longevity and fertility should pay the same proportion of wage to pensions to earn the same replacement rate and retirement age" (Oksanen, 2002).

Oksanen then, like the World Bank (1994), argues that the kind of single pillar PAYG DB schemes that are found in continental Europe should be reformed because they are unfair to future generations. It is unfair for the baby boom generation to shift the costs of their increased longevity and declining fertility onto future generations. Unlike the World Bank, however, Oksanen does not think it necessary to confine the role of government in pension provision to poverty alleviation – the provision of a (preferably minimal) safety net – nor to hand over the task of smoothing the distribution of income across the life cycle entirely to funded schemes administered through the private sector. Fairness requires *either* that current contribution rates be raised quite drastically to allow for the accumulation of a substantial reserve fund *or* that future replacement rates and/or retirement age have to be changed in a way that will allow for considerable cuts in future pension expenditure. But, "as it seems that people still want to preserve relatively high benefits and do not want to work many years more, some degree of funding should be part of the reform package" (Oksanen, 2003). Note that this argument for pre-funding is quite independent of the view that a switch to funding will reduce the "total social costs" of providing retirement to future generations. All that matters for Oksanen's argument is that it reallocates the costs of provision between generations[3]. Notional accounts – which revalue contributions and index benefits according to a formula which explicitly incorporates demographic

[3] Lindbeck (2003), along with many other analysts, favours partial funding not so much because it remedies an injustice but rather because it spreads the risks between a system which is vulnerable to shocks in financial markets and a system which is vulnerable to stagnation or decline in the tax base.

change and labour productivity growth – are another way of achieving the same goal of intergenerational fairness, since the return on individual contributions should be approximately equal across generations (Disney 2003).

Oksanen is less interested in the justification of his chosen test of intergenerational fairness than in the detail of the reform proposals that will satisfy the test under conditions of population ageing. Van Parijs (2003) and Myles (2002), on the other hand, are much more interested in the test itself. Granted that we can determine whether or not the pension system has resulted in a large net redistribution from later to earlier generations, it still remains to be decided whether or not the redistribution is fair. It is not enough to fix on the terms of a 'deal', which future generations of workers or taxpayers can regard as fair because they will not lose out. Where Oksanen starts out with a strong presumption against the fairness of intergenerational redistribution, Van Parijs starts out with a strong presumption in its favour – by analogy with the circumstances in which other kinds of interpersonal redistribution might be justified. In other words, it seems reasonable to expect future generations to bear a higher tax burden than current generations because they will be richer – especially when this is done with the aim of improving the position of the most disadvantaged members of the earlier generation. It should also be born in mind that future generations will owe some of their wealth to the investments made by current generations. Only if all the appropriate factors are taken into account, which include the depletion of environmental capital, as well as the improvement of physical and human capital, are we engaging in what Van Parijs calls "fair generational accounting".

So what, for Myles and Van Parijs, is the workable criterion by which we can assess the intergenerational fairness of pension policy? They both appeal to the work of political economist Richard Musgrave for a 'rule-of-thumb' which goes some of the way towards answering this question, namely that levels of pension contributions and benefits should be adjusted to ensure that population ageing does not bring about any significant change in the ratio of pensioner benefits to worker income *net of contributions* – so the *relative* living standards of the working population and their retired contemporaries stay more or less the same.

But why only "some of the way"? Because we have to ask whether or not departures from the Musgrave rule are justified by the demographic or economic circumstances.

One clear implication of the rule is that the economic benefits of growth in labour force participation

and productivity (if it happens) should be shared out equally between workers and pensioners. As a distributive rule, and the point is conceded by a recent report on pensions prepared for the World Economic Forum (2004), this might seem to be the only fair way of allocating gains (or losses) between these two segments of the population. Should this rule be relaxed, however, if we think that gains in prosperity are conditional upon a significant expansion of labour force participation which in turn might require additional wage incentives to the working population (i.e. a larger proportion of the benefits of increased productivity goes into increased wages than the rule would demand)? Where the Forum report sees a trade-off – relaxation of the rule might be necessary to increase the size of the cake that is to be divided between workers and pensioners – Schokkaert & Van Parijs see an inequitable division of the cake.

What about demographic circumstances? Does the shift to lower fertility, for example, justify departure?

"Burden smoothing in the presence of demographic crisis requires the imposition of an extra tax primarily on the current working generation, *because* this generation saved on child rearing expenses. Thus the pensions to be expected by the current working generation would have to be cut in line with the lower number of their children without alleviating their own pension contributions accordingly" (Sinn, 2000, my italics).

According to Sinn, therefore, (and Oksanen agrees), the benefits that accrue to the generation with lower fertility would justify some redistribution in favour of their children – a departure from the Musgrave rule. A similar conclusion is supported by a suggestion of Lee (2002), namely that we regard public pensions as a way of compensating parents for the taxes which finance an extended period of public education for their children. When governments increase taxes on worker-parents to pay for a socially optimal amount of investment in children, they deprive the parents of the ability to provide for their own old age – hence the pensions. To the extent that a working generation with lower fertility saves on child rearing expenses, then the system of public intergenerational transfers will move 'out of balance'. Public pensions will 'over-compensate' the working generation. Van Parijs and Myles, on the other hand, take a quite different view of the significance of the drop in fertility. Because "the rising retirement costs produced by the baby dearth" are like other exogenous shocks such as natural disasters or recessions, they constitute a collective risk, and are therefore "an appropriate target for intercohort risk-sharing" (Myles, 2003). It would be unjust to place

responsibility for the shift to lower fertility on any particular generation because this is not the sort of happening for which people should be responsible. Departure from the Musgrave rule is not justified by this kind of 'demographic shock'.

A rather different angle on the significance of the consumption gains that households make as a result of lower fertility is examined by Burtless (2002). Although the consumption of retired adults in many wealthy industrial countries is financed mainly out of public transfers, this is not the case with dependent children, whose consumption is financed mainly from parental income. This is part of the reason why the higher tax burden required as a result of increasing old age dependency ratios will be only partially offset by the lower tax burden that will result from decreasing youth dependency ratios. But it still remains to ask to what extent the higher tax burden will be offset by a lower level of private expenditure on children. Burtless presents some stylised calculations of the net effect of lower fertility and increasing longevity on the proportion of lifetime income that goes towards the support of dependent (i.e. non-working) people of all ages. "Under plausible assumptions, the trend towards an older population may actually reduce the lifetime consumption sacrifice that each generation must make in order to support other generations". When the consumption gains (to working adults) that result from lower fertility are taken into account, the balance of advantage between successive generations under conditions of population ageing may be quite changed - and would presumably (though Burtless does not consider the question) no longer justify redistribution from earlier to later generations. The picture that results from this approach to the measurement of the lifetime net benefits that individuals derive from membership in relatively large or small generations is quite different from that we obtain by attempting to measure 'lifetime net tax burden'.

Equality and the economic position of older people

These arguments about intergenerational fairness and the problem of generational equity are by no means the only way in which the value of social justice enters the debate about pension reform. If, on one side of the debate, it is argued that reform is necessary to deal with an approaching problem of generational equity, there is another side of the debate, which argues that many of the proposed reforms will have the effect of making our societies less fair than they are now. The problem is in fact often presented as one aspect of a much wider debate about the affordability of 'European-style' welfare systems as national economies become increasingly integrated into a single global economy (e.g. Buti et al, 1999). Critics argue that exaggerated and unbalanced claims about the costs to the wider

economy of high levels of public welfare spending are used to justify measures to 'roll back the welfare state' (e.g. Mishra, 1999), and in the matter of pensions these claims are seconded by what may be regarded as questionable arguments about intergenerational fairness. Looked at from this point of view, there is one central and powerful reason for opposing proposals that would weaken systems for social protection in advanced industrial societies, namely that they threaten the achievement of the egalitarian objectives that underpin (or should underpin) these systems. What makes the arguments of Myles and Schokkaert & Van Parijs interesting is that they combine an explicit commitment to these same objectives with a sense of the importance of the problem of intergenerational fairness. It is necessary to find a solution to the problem, but any acceptable solution must be shaped and constrained by the principles, which underpin this commitment.

As far as older people are concerned, there are three yardsticks which are standardly used to measure the progress towards a more equal distribution of resources in society, and may also be used to illustrate the threat which is judged to be implicit in proposals to shift responsibility for provision of retirement income from government to the private sector: poverty rates, income inequality, and replacement rates. These measures are of particular importance for the debate on pension reform in the UK, since this country usually comes out quite badly in international comparisons of the economic position of older people in advanced industrial societies.

Poverty rates. Smeeding (2001) used data collated by the Luxembourg Income Study to compare the adequacy of 'income maintenance benefits' or 'social transfers' for retired people (by which he means *both* 'universal' benefits from public contributory schemes *and* income-tested benefits) across 8 OECD countries, including the UK. As he says, "the primary measure of benefit adequacy for [these] systems is the fraction of the population who are still poor after receipt of benefits". The comparison shows that income poverty rates among older people (measured in this case as the proportion of pensioners with incomes below 50% of the national median income) are relatively high in the UK, as they are in the USA , Australia and Israel. His conclusion - that the countries with lower poverty rates tend to spend more on social transfers to the elderly (as a % of GDP), have a more generous minimum safety net, and target benefits more effectively – is explicitly intended to supply us with a constraint on the fairness of proposals for pension reform: whatever they are, they should be compatible with effective measures to reduce poverty rates among older people.

A recent report from the Institute of Fiscal Studies (Goodman et al 2003) brings the LIS data up to date

for the UK. Since 1996-1997 (Smeeding's cut-off date) there has been a very small drop in this particular measure of income poverty among UK pensioners (i.e. the % of pensioners with incomes below 50% of the national median income). Although the poorest pensioners have received substantial income gains over this period, the measure tells us how pensioner incomes have moved *relative* to the median in the population as a whole – and the population median income has been growing quite fast. As Goodman et al show, periods of relatively strong economic performance tend to be associated historically with increases in relative pensioner poverty, which in their view makes it "all the more remarkable" that pensioner incomes have kept in line with general household incomes over the last 6 or 7 years.

And if we ask why the proportion of UK pensioners below the poverty line remains comparatively high by international standards, the explanation lies in a combination of factors: the benefits from the universal contributory scheme are not very generous, and a substantial proportion of pensioners with low incomes do not receive means-tested benefits. The means-test for benefits includes an asset test – and some pensioners with low incomes have enough savings either to make them ineligible for benefits or to reduce their entitlement. Official statistics also suggest that between one-fifth and one-third of all pensioners entitled to MIG did not claim in 1999-2000.

Income inequality. It should come as no surprise to find that there is a strong relationship between income inequality at working age and pension age (Disney & Whitehouse, 2002). The incomes of both pensioners and workers are considerably more equal in the Nordic countries than in the USA , where pensioners in the top decile of the income distribution have incomes more than five times larger than those in the bottom decile. In the UK the value of the same 90/10 ratio is about 3 (with 1994/5 data). The effects of the more egalitarian policies pursued by the Nordic governments are felt by workers and pensioners alike.

We should also expect – and do indeed find – that the pattern of income inequality among pensioners is quite closely related to the structure of pension systems. Just as benefit adequacy for pensioners in different countries varies according to national policies on retirement income, so do income inequalities in old age. Brown & Prus (2003) use the same dataset as Smeeding to show that "there is a strong positive correlation between the level of income transfers provided by government-sponsored social security and means-tested welfare benefits and the income inequality experienced by those age 65 and over". They also suggest that in those countries, which rely most heavily on social transfers as the

main source of retirement income, the income distribution in retirement tends to be less highly skewed than the income distribution among the working age population. The pension system makes the income distribution more equal for people of pensionable age than for people of working age. In those countries, however, where a substantial proportion of pensioners rely quite heavily on private sources of retirement income, the pension system tends to reproduce (or even widen) the pattern of inequality that is found in the working age population among the retired population. Disney & Whitehouse, on the other hand, emphasise a rather different contrast: what makes for a more equal income distribution among the pensioners is the amount of redistribution built into the pension system. Comprehensive social insurance schemes (such as Italy and France) where pension benefits are closely related to previous earnings are less redistributive than the mean-tested public pension in Australia or the mainly flat-rate benefits in the Netherlands or the UK. In the countries with the less redistributive pension systems, the transition to retirement status has less effect on the income distribution.

For the UK, the trend data presented by Goodman *et al* adds another dimension to the cross-sectional data analysed by Disney & Whitehouse (2002) and Brown & Prus (2003). Both pensioner and non-pensioner income inequality rose quite steadily in the UK between the mid-1970s and the early 1990s. Since about 1992, however, pension income inequality has remained fairly stable, despite continuing inequality growth in non-pensioner incomes. Pensioner incomes are now considerably less unequal than non-pensioner incomes.

If we think that the income distribution in the working population is so unequal as to be unfair, and the pension system does nothing to reduce this inequality, we will also think that the income distribution in old age in unfair. And even if, as in the UK (or Australia), the pension system does have the effect of reducing income inequality, the effect may be deemed too small to remove the sting from the charge of unfairness.

Replacement rates. Replacement rates – or quasi-replacement rates as they are sometimes called – provide the simplest measure of the relative economic well-being of older people. Their average incomes are expressed as a percentage of the average incomes of the population as a whole. For the 15 countries included in a recent OECD study which included *all* sources of income and not just pensions, the average replacement rate is just above 80% - ranging from about 72% in Denmark to more than 95% in Canada. Replacement rates in the UK are slightly below this OECD average at about 77% (the basic state pension does of course provide a *much* lower replacement rate than this). If we want to see

an improvement in the relative economic position of retired people, trend data for replacement rates would be the simplest way of deciding whether or not the situation really had improved.

As Disney & Whitehouse (2002) point out, there are a number of reasons for supposing that a replacement rate of 100% would make pensioners 'better off' than non-pensioners. Retired people no longer face the costs (e.g. commuting) that are often associated with work; they have increased leisure time; and, more controversially perhaps, it seems likely that advanced age makes it more difficult to extract utility – satisfied desires - from increments to our income. A great deal depends however – as far as this last supposition is concerned – on the costs that have to be met out of income. The ability to reduce consumption of some goods and services without loss of welfare (as a result e.g. of increasing disability) has to be balanced against a growing requirement (also as a result of increasing disability) for other goods and services as a means of maintaining welfare – such as long term care.

Equality of access to modern retirement

These uncertainties about measuring the relative economic well-being of older people say nothing against the view that we *should* be aiming to equalize the relative economic positions of pensioners and workers so that the transition from a wage income to retirement income is not accompanied by any significant drop in economic well-being. They serve rather to underline the point that the replacement rate has its limitations as a way of determining whether or not this transition tends to make people significantly 'worse-off'. The point Disney & Whitehouse are making is that if anything should stay the same over this transition, it is the utility or welfare that an income is able to secure, not the income itself.

Does fairness require us to allocate resources in a way that guarantees this condition of approximate equality, or what amounts to the same thing, 'income security in retirement'? Most commentators, irrespective of their position on the political spectrum, insist that what fairness or justice demands is a collective guarantee of a minimum retirement income at a level which is sufficient to sustain a decent standard of living [4]. 'Income security in retirement' (or 'income protection') is something different from this. It is what we want for ourselves – the ability to maintain more or less the same standard of

[4] But see Shapiro, 1997.

living as we had before retirement – the protection of accustomed living standards - and it constitutes, in aggregate, a greater claim on society's output than what justice demands as a minimum (though there is a strong tendency in mainland Europe to regard income security not only as a proper objective for public policy, but also as a policy objective justified by equity considerations). This does not mean, however, that what we want for ourselves in retirement necessarily constitutes an *excessive* claim on society's output. To finance our consumption in retirement, we have to be willing to forego consumption in our working years. And if we want to allocate our 'lifetime income' in a way that maintains patterns of working-life consumption into retirement, then approximate equality – income security in retirement - is what we are aiming for, and it is a perfectly reasonable goal. What matters is that we make the appropriate decisions in an informed way and recognise the constraints, and it is these that different analysts and commentators construe differently.

Lee (2002), for example, chooses to highlight the level of public intergenerational transfers to children - our 'investment' in developing the 'human capital' of the next working generation - as a major constraint on the allocation of resources for consumption in retirement. There must be an optimal allocation of resources across the life cycle which will maximise the welfare (i.e. the lifetime welfare) of each successive generation, and if, as research by Gruber and Wise (2001) suggests, "recent increases in transfers to the elderly" have been matched by "equal and opposite reductions in spending elsewhere", we may be getting it wrong. Moreover, as Esping-Andersen *et al* (2002) make clear, there is more at stake here than economic efficiency – for the simple reason that disagreement about what counts as socially optimal 'investment' in the next generation is bound to raise questions about *intra*generational fairness. If, for example, we think that there is a lack of fair equality of opportunity for children and adolescents in a country like the UK, then we will also think that public spending on this stage of the life cycle is less than optimal. Also to be taken into account is the way in which trends in the labour market and in family life are combining "to focus the long-term risks of disadvantage and poverty on children and adolescents in remarkably concentrated ways" (Skidmore & Huber, 2003). Advanced industrial societies are witnessing a big change in the structure of risk and need across the life cycle – and there are other driving forces behind this change than population ageing – which suggests that the patterns of expenditure required for an optimal allocation of resources across the life cycle are also changing.

"If conflicts over public spending and political prioritisation of public resources loom, then this is probably the greatest and most difficult balancing act: how to develop more concentrated and proactive

strategies for investing in children to help break the cycle of disadvantage and exclusion and create the conditions under which productive and fulfilling adult lives are possible for all, while simultaneously coping with the growing pressure for current spending to reflect the needs of a growing and vociferous older population." (Skidmore & Huber, 2003)

For Oksanen, as we have seen, the really important constraint is intergenerational redistribution, as measured by the cost of securing a given level of consumption in retirement. No generation should finance its consumption in retirement at the cost of the ability of future generations to finance *their* consumption in retirement. Myles' and Van Parijs' arguments, on the other hand, imply that some intergenerational redistribution can be justified, especially when it is intended to even out gross inequalities in progress towards the ideal of 'modern retirement' [5].

'Modern retirement' is the idea that Myles (2003) uses to spell out what justice requires by way of transfers to the retired population. What individuals should be guaranteed in retirement – as of right – is an income sufficient to support the ideal of modern retirement. This is the minimum below which no one should fall, and it is of course the same for everyone, unlike 'income security in retirement', which must vary according along with pre-retirement incomes. Modern retirement is something that occurs in advance of physiological decline. Individuals are able to withdraw from the labour force because they have accumulated sufficient 'retirement wealth' (either as entitlements to public benefits or capital accumulation) to make work unnecessary, rather than required to withdraw from the labour force because of their incapacity for work. This means that retirement brings a gain in leisure that is accompanied by an income sufficient to allow individuals to make positive use of it. It has to be a period of opportunity, more than a mere respite from work. It is perhaps an inevitable consequence of income inequality in retirement that some individuals will be able to take advantage of a wider range of opportunities than others. The point to make, however, is that some minimum range of opportunities must be genuinely open to everyone, if everyone is to have access to modern retirement [6].

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[5] Whether or not such redistribution would be justified to bring us all closer to 'income security in retirement' is a different matter. This is perhaps the crux of the disagreement between Oksanen and Van Parijs. Why should we think it fair to ease 'our' path to income security in retirement if this makes it more difficult for the next generation to achieve the same goal?

[6] Although Myles is largely silent on the content of this range of opportunities, it has evident affinities with attempts to conceptualise the condition of poverty for older people through (i) the specific meaning of social exclusion for older people (e.g. Patsios, 2001) or (ii) the application to later life of the ideas of Amartya Sen and Martha Nussbaum on the flourishing of human capabilities (e.g. Lloyd-Sherlock, 2002).

The essence of the position shared by John Myles, Van Parijs, Alan Walker (2003) and many others is that it is wrong to think that the process of aligning the standards of living for pensioners and workers has gone “too far”. There is in fact a substantial minority of the population for whom the process has not gone far enough. It may indeed be true that a majority of pensioners in the wealthier OECD countries are very close to a condition of ‘income security in retirement’, but it is also true that many pensioners do not have access to that minimum range of opportunities associated with modern retirement. Not only that, but there are some clearly identifiable socio-economic trends which look set to exacerbate existing inequalities in this regard. It is highly unlikely, furthermore, that this problem will be alleviated by economic growth alone – by the percolation of wealth down to the most disadvantaged groups in society. On the contrary it will probably require deliberate redistributive effort on the part of government. This is one of the reasons why Myles (2002) describes the threat of reform proposals which imply some retrenchment in public expenditure as one of "diminished democracy in the allocation of retirement opportunities"[7]. Universal pension schemes operating through a system of public intergenerational transfers are the instruments which wealthy industrial countries have used to “democratise access to modern retirement”; and if we think that these countries have some way to go before they can guarantee *universal* ‘access to modern retirement’, then we also have good reason not to reform public pension schemes in any way which might limit or undermine their redistributive function.

The danger is that the least advantaged members of society will lose out disproportionately as a result of reforms which aim to maintain the viability of pensions systems – even if the costs of retrenchment are shared fairly between different generations by some mix of proposals for increasing the level of contributions, cutting benefits and raising the retirement age. These are the people whose lifetime earnings are so low that that they would gain nothing or very little from participation in any kind of contributory pension scheme; they are least able to forego consumption during their working lives in order to finance consumption in retirement; and with lower life expectancy, they have most to lose from an increase in retirement age. Granted a fair sharing of the burden between successive generations, it still remains to ensure a fair sharing of the burden *within* any given generation – which would not be a problem if we thought that the distribution of income and opportunities within our society were satisfactory.

[7] The other is that public control of the pension system is the best way of ensuring that national gains in prosperity (due to productivity growth etc) are shared out equitably between workers and pensioners.

What are the policy implications of this analysis of the problem? Firstly, the system of public transfers to retired people should be sufficiently redistributive to guarantee that no-one has a standard of living below the threshold set for the ideal of modern retirement. Secondly, policies should be implemented which would improve opportunities for the most disadvantaged members of society to accumulate enough retirement wealth to minimise the need for redistribution – and the main barrier to be overcome here is not so much non-participation in a contributory pension scheme (to be corrected by tweaking the structure of incentives and disincentives attached to the scheme), but the low lifetime earnings. It is for this reason that David Miles (2002) argues that we have a "crisis of inequality in the UK" rather than a pensions crisis. If the ability to accumulate retirement wealth is an important measure of inequality and the level of lifetime earnings is the crucial determinant of this ability, then fairness demands more than that the pension system should make good the shortfall. Thirdly, there is a very strong case for extending the goals of policy beyond whatever is required to narrow inequalities in lifetime earnings. The argument turns on the identity of the factors that condition the range of opportunities that is genuinely open to people in retirement. If we think that fair equality of opportunity in retirement requires a minimum not only of accumulated retirement wealth, but also of non-financial 'resources' such as health and educational attainment, then universal access to modern retirement would seem to demand policies to increase what might be described as the human capital which the most disadvantaged members of the community bring to retirement[8].

Solidarity, self-respect and the contributory principle

One outstanding policy issue that remains to be decided even if it is accepted that more redistribution is necessary to guarantee universal access to modern retirement concerns the nature of the fit between policies that are intended to guarantee access to modern retirement and policies that are intended to provide income security in retirement – between the system of transfers that guarantees a minimum income and the system that pays out earnings-related benefits as a result of participation in some form of contributory pension scheme. Proponents of Bismarckian-style social insurance want these two kinds of public transfer to be joined seamlessly together in one single pension scheme. Critics of these systems, at least in their unreformed condition, highlight the distortions that are introduced by the

[8] This argument is developed in considerable detail by Robert Fogel (2000) who links what he calls the new egalitarian agenda with inequity in the distribution of non-material (or 'spiritual') resources. He is also explicit about the relevance of this agenda to expectations of retirement.

inevitable lack of 'actuarial fairness' in any such scheme. Better to keep the two functions separate and bring 'transparency' to the contribution-based scheme.

How does a commitment to principles that argue for a more generous income guarantee in retirement tie in with an assessment of the merits of a contributory principle in public pensions? As John Hills (2003) argues in a recent paper, which looks at this question from a UK perspective, the merits of social insurance seem clear enough, and were indeed fully endorsed by the founders of the present system of National Insurance. The system is a manifestation of social solidarity, through pooling of risks. Benefits are received as of right, as an entitlement that comes with the payment of contributions, and in no way rely on the admission or proof of poverty. The system is a way of enacting welfare rights into law without undermining norms of self-respect. Disincentives to additional self-provision are minimised. And it is also sometimes suggested that systems of this kind, to the extent that they are seen as a form of insurance rather than taxation, make redistribution more acceptable. Will not a system of transfers which aims to guarantee income security in retirement *as well as* a minimum income generate more political support than a system which only guarantees the latter? Looked at from the perspective of continental Europe, whose public pension systems are strongly contributory, these arguments may seem persuasive enough (Schokkaert & Van Parijs, 2003). What distinguishes the UK from much of continental Europe, however, is the weakness – and the progressive weakening - of the contributory principle underlying National Insurance.

Is this a development which supporters of a more egalitarian style of government should seek to reverse? Should income security/income protection become for the UK what it is in Europe – an explicit and accepted objective of public policy? Hills thinks not, and is quite happy to see government pull back from the attempt to provide income security in retirement (see also Agulnik, 2000). The fact that "contribution-based entitlements have [in the past] excluded too many" helps make the case for concentrating efforts on the provision of adequate non-contributory benefits. What would distinguish these non-contributory benefits from the kind of first pillar pension advocated by the World Bank (1994) is, firstly, their level (generous rather than minimal), and secondly, the absence of a means test. One way of doing this is to provide a flat-rate non-contributory pension as a right of citizenship financed out of general taxation (i.e. do away with a separate 'insurance' fund). Hill, however, prefers a system, which would combine generous flat-rate non-contributory benefits with

some of the positive elements of social insurance. We should be wary of sweeping away institutions, which help to promote social solidarity and maintain self-respect. Entitlements would still be 'earned', but by 'participation' rather than contributions made through a payroll tax. The aim is to base pension rights on an idea of 'active citizenship' that requires more than mere residence and yet does not insist on paid employment.

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