

Debate on social justice and pension reform

Social justice and the reform of Europe's pension systems

Erik Schokkaert*, *Katholieke Universiteit Leuven, Belgium*

Philippe Van Parijs, *Université Catholique de Louvain, Belgium*

Summary No serious discussion of possible pension reforms can dispense with some conception of what justice requires, both between and within generations. In this paper we first spell out step by step the implications for pension systems of a conception of social justice that articulates in coherent fashion the values of freedom, efficiency and solidarity heralded in the European project. We next consider in this light a number of important policy issues: Should we move towards more funding and less 'pay as you go'? Towards a more private system? Towards a more Bismarckian system? Towards a higher retirement age? Towards a more unified European system?

Résumé Il ne peut avoir de discussions sérieuses sur les possibles réformes des pensions sans que soit abordé la conception de la justice qui les sous-tendent, tant entre générations qu'à l'intérieur de chacune d'entre-elles. Dans cet article, nous développons tout d'abord pas à pas les implications pour les systèmes de pensions d'une conception de la justice sociale qui articule de manière cohérente les valeurs de liberté, d'efficacité et de solidarité dans le projet européen. Ensuite, à la lumière de ce qui précède, nous considérons différentes questions politiques importantes: doit-on aller vers plus de pré-financement et moins de répartition? Vers davantage de systèmes privés? Vers un système plus Bismarckien? Vers un âge d'accès à la retraite plus élevé? Vers un système européen unifié?

Introduction

Which way forward with our pension systems? The facts about ageing and their consequences for retirement pensions are by now well known. Possible solutions to the problem have been intensively explored. And a consensus is emerging to the effect that there is no need for panic. True, decisions cannot be post-

poned, but if they are taken now the problem is under control. However, several solutions are conceivable, and we need standards in order to assess them, and to choose on the basis of such an assessment. The discussion of possible solutions is frequently cast in a technical jargon which tends to obscure these underlying ethical choices. Policies vary along many dimensions (retirement age, benefit

* Author to whom correspondence should be sent: Dr Erik Schokkaert, Centrum voor Economie en Ethiek, Katholieke Universiteit Leuven, Naamsestraat 69, B-3000 Leuven, Belgium.
[email: Erik.Schokkaert@econ.kuleuven.ac.be and vanparijs@etes.ucl.ac.be]

levels, contribution levels, relative shares of funding and pay-as-you-go), and the policy package offered as the best (or most 'efficient') solution must therefore weight these various dimensions, which reflect value judgments about the content of and relationships between inter- and intragenerational justice.

Consequently, as persuasively argued by Cremer and Pestieau (2000), 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. Ethical arguments are needed to answer questions such as the following: What claims can citizens justly make on society? What is the scope of the social solidarity we wish to realize? What room should be left for individual responsibility? Of course, population ageing and its interaction with pension structures generate quite different problem loads in different countries and this is likely to be highly consequential in choosing concrete policy options. Nevertheless, it is essential to spell out general principles which we believe, on due reflection, to be ethically compelling. Which policy package deserves to be recommended does not hinge on whether widespread ethical views make it 'persuasive', but on whether we believe ourselves that it is just.

In particular, to tackle the issue of pensions, we need to articulate a coherent, defensible conception of 'intergenerational justice'. Such a conception unavoidably touches on issues relating to environmental effects and the depletion of natural resources. In this contribution, we shall mostly leave this dimension to one side and concentrate instead on justice issues that arise between age groups in an ageing society. These issues do not only concern the sustainability of present pension provisions. The related increase in health-care expenditures actually confronts us with harder choices than pension systems. The normative approach we shall put forward must be able to guide us in this area too, and we shall suggest how it can. Yet, in spelling out some

illustrative policy implications of our approach, we shall concentrate on pensions, by raising five central issues in today's debate about their future. Should we move towards more funding and less 'pay as you go'? Towards a more private system? Towards a more Bismarckian system? Towards a higher retirement age? Towards a more European system? Although we feel that our analysis is relevant to the present political discussions, we do not offer a full-blown package of concrete policy proposals. Our more modest aim is to state and explain the ethical principles that we believe should guide the European discussion on pension reform.

A normative standpoint

The ethical stance we propose articulates the following four convictions:

1. The ultimate unit for any sensible theory of justice is neither the generation, nor the professional category, nor the household, but the individual, not at any particular moment in time but over the whole life cycle.
2. In 'Rawlsian' fashion, we ascribe priority to the fate of those members of a society who are worst off. Taking feasibility constraints into account, this egalitarian standpoint yields a criterion of sustainable maximin.
3. The equalisandum – what it is that needs equalizing or 'maximising' – does not lie in outcomes but in opportunities. These opportunities are to be understood very broadly. Distributive justice, in our view, is about the distribution of 'positive' or 'real' freedom. Individuals have to be compensated for inequalities rooted in their endowments, as distinct from inequalities rooted in their preferences or life plans. But 'endowments' cover not only access to external resources, but also the possession of 'internal resources', i.e. any unchosen personal feature of a person with which

(unlike preferences) she does not identify. While differences in people's endowments must be corrected or compensated, people can fairly be held responsible for what follows from differences in their preferences.

4. Concern about political and social feasibility must not affect basic ethical principles. Ethical analysis must help shape public opinion, rather than subserviently reflect it. However, feasibility is important when thinking about concrete policy prescriptions. If the best is the enemy of the good, it may be advisable to go for the good in the short run; but without blinding oneself to long-run ethical challenges.

A full justification of these general convictions goes far beyond the purpose of this paper, and we shall make no attempt to provide one.¹ Instead, we shall simply ask which policy prescriptions are consistent with the broadly egalitarian standpoint these convictions express. We are not claiming that this standpoint is uncontroversial, but feel that it is of obvious relevance to Europe's social-policy debate, in which social inclusion and the reduction of inequalities often feature as top priorities.

To apply this general conception to the intergenerational problem, it is important to define clearly what is meant by a 'generation'. The political debate sometimes gets confused because distinct notions of 'generation' are mixed up. It is essential to distinguish between 'cohorts', or categories of people born in a particular period, and 'age groups', or categories of people who have been living for a particular number of years (Daniels, 1988; Gosseries, 2003). In the real world, cohorts overlap – the aged of an earlier cohort cohabit with the young from a later one – and there is, therefore, at any particular moment, a coincidence between the earlier cohort and the older age group, between the later cohort and the younger age group. But whereas people never leave their cohort, they cannot help (short of dying) shifting from one age group to another. Remember that we take the position that what

matters to justice is the lot of individuals over the whole of their life cycle. The distribution between cohorts is therefore far more directly relevant to justice, as we conceive it, than the distribution between age groups.²

Non-overlapping cohorts and prudential life-span policies

Against this background, we shall now spell out the conception of intergenerational justice that makes most sense to us for handling issues of pension (and health-care) policy. In order to do so we assume at first, most unrealistically, that all individual members of each cohort are equally endowed in terms of both external and internal resources and that successive cohorts are equally endowed or so separate from one another that no transfer between them is feasible. Given the conception of justice sketched above, there is no injustice in this abstract world. We also abstract from the fact that in the real world cohorts are overlapping. This does not prevent the issue of pensions from arising.

From our ethical starting point, it follows that all individuals must be free to allocate their (equal) endowments over their life cycle. In general, we may expect that individuals will first invest in human capital, then have an active period in which they earn an income from their labour and finally retire and live from their savings. It also follows from our ethical stance that individuals must bear the cost of the choices they make. The allocation of their consumption over their life cycle, including the level of their retirement income, will depend on their own labour supply, savings and investment decisions. Suppose, for example, that Jane wants to retire comparatively early in life so as to enjoy, if lucky, a period of retirement in reasonably good health. This is fine, but she will then have to save more and/or work harder in her active period of life, and/or be satisfied with a lower consumption level during retirement.

Pension schemes are most likely to develop

spontaneously in this world. Since cohorts do not overlap, they will necessarily be of the funded type. And, given our conception of justice, the retirement pensions will need to be of the 'defined contribution' type, i.e. the level of one's pension benefits will be determined by the level of the contributions paid in the course of one's active life. Similarly, health insurance will develop, without any ex ante redistributive effect (all people are assumed to be equally endowed, and hence to face identical ex ante health risks), but with a breadth of coverage that will vary according to people's risk aversion and be strictly correlated with the level of the premium.

As a thought experiment, let us now compare two non-overlapping cohorts (A and B) in different situations and see how this difference in their situation would influence the decisions to be taken by them as regards transfers between age groups:

1. Suppose first that the average person in Cohort B differs from the average person in Cohort A in wanting to retire comparatively early. Because of external effects, it is reasonable to suppose that there will be some clustering of desired retirement ages in each cohort. By opting on average for a longer retirement period, Cohort B will have to work harder and/or to save more during active life and/or to accept a lower level of consumption during retirement.
2. Suppose next that life expectancy is higher for Cohort B than for Cohort A. Members of Cohort B can expect to live longer in reasonably good health. Analogously to the previous case, one can predict that in most cases the higher life expectancy will lead to a lengthening of both the period of retirement *and* the period of active employment.
3. Suppose, finally, that expected health-care costs in later periods of life are larger for Cohort B than for Cohort A. Individuals in Cohort B then face a different trade-off when deciding about their health insurance. In general, they will be willing to pay a

larger premium to compensate for the more expensive risk. But as they face a trade-off between consumption and labour when healthy, and the degree of coverage, the latter will be kept in check.

In the above, the resulting pattern of pension arrangements is the product of the aggregation of individual choices, without any need for a pension *policy*. However, even in this very simplified world, the government arguably has a role to play. For in the absence of government intervention, some individuals will save so little that their retirement pension will not be sufficient to guarantee them a decent living standard. If this is considered a problem, the government can remedy it by guaranteeing a minimum pension or by imposing a mandatory minimum level of savings during active life. Two main arguments can be used to justify this.

First, even within our freedom-oriented framework, there is room for some mild paternalism. If people are not fully aware of their probability of becoming very old or very ill, or if they do not fully realize what it means to be destitute in old age or to be unable to pay for one's medical expenses, then some of them may well insure themselves considerably less than they would do otherwise. Compulsory minimum provisions can therefore be introduced without appealing to a conception of the good life different from people's own.³ Second, it can safely be expected that a minimally humane, or misery-averse society will not tolerate the quiet starvation of some of its elderly people who failed to save enough during their active lives. However, if people know that in any case they will be helped when they are retired, even if they did not save enough, this knowledge may have an influence on their incentive to save. To avoid such free riding – which would violate our principle of justice by indulging equally endowed free-riders – some mandatory saving is required.

Hence, even in this highly artificial world of cohorts that do not overlap and that each consist of equally endowed individuals, and

hence in which no distributive injustice needs to be corrected, there would be a need for a collectively determined pension policy. Important real-world collective choices with respect to retirement age, minimum benefit levels or health insurance coverage would also arise in an abstract world in which distributive justice is assumed (freeriding aside) to be unproblematically realized.

Overlapping cohorts and the possibility of pay-as-you-go

Moving next to a world in which cohorts do overlap (i.e. in which younger age groups of a later cohort live together with the older age groups of an earlier cohort) has one crucial implication: we are no longer confined to 'funded' schemes. It is now possible to set up arrangements of the pay-as-you-go type, i.e. arrangements in which the income of the old, instead of being provided by their savings, is supplied by transfers from the young. The traditional family structure is basically a pay-as-you-go institution: parents care for their children when these are still too young to work, and, through a differed reciprocity, children take care of their parents when these have become too old to work. The long period of socialization and the substantial transfers implied by it are important characteristics of the human animal, and pay-as-you-go pension schemes may therefore be conjectured to have deep biological roots.

From an economic point of view, the most significant advantage of pay-as-you-go institutions is the possibility of risk-sharing between successive cohorts. Suppose there is still no issue of justice between cohorts because there is no predictable inequality between them, but that the economic and social environment of each cohort is subject to unexpected shocks, i.e. generates so-called collective risks. If cohorts did not overlap, each of them would have to bear the full consequences of these shocks. But since they do overlap, intergenerational transfers can be linked in one way or

another to the economic situation of the cohorts, in such a way that collective risks can to some extent be covered. It is possible for the less lucky generations, when retired, to get a larger income from the younger (fortunate) generations than the one they could have derived from their own savings. It is also possible, when the unpredictable shock hits the younger generation, for the latter to lower its transfers to the retired. Starting from the notion of an optimal life-cycle consumption pattern and taking into account that consumption needs are lower during retirement, one might suggest a specific risk-sharing rule. This rule would allocate the consequences of the unpredictable shock over the whole life cycle so as to keep invariant the ratio of the income of the retirees to the (net) income of the active working population. This criterion is essentially the one proposed by Richard Musgrave (1986) and endorsed by John Myles (2002). Under our assumption, at this stage, that cohorts are equally endowed *ex ante*, it does *not* imply a specific stance on distributive justice, but is only offered as a possible risk-sharing device, on the assumption that preferences over life-cycle allocations of leisure and income do not change significantly across cohorts.

If there is a chain of cohorts thus linked by pay-as-you-go schemes, each of them, when active, can reasonably be expected to accept the rules, because it knows that it could itself be hit by an unexpected negative shock later on. Such risk sharing between overlapping cohorts should therefore not be construed as truly redistributive. Like any insurance scheme, it is redistributive *ex post*, not *ex ante*, and can be justified as an *ex ante* Pareto-improving deal between cohorts which relies on nothing but self-interest. This does not extend to predictable collective risks, which can give rise to *ex ante* inequalities between cohorts and to which we shall return shortly.

Pay-as-you-go schemes need not be restricted to the intra-dynasty context. To increase the degree of risk sharing, it makes sense to set them up in a collective way, with

the government intervening to specify the rules which each active generation can expect the following one to follow as regards transfers to the elderly. We then encounter, even in the absence of any change of economic circumstances from one generation to the next, the very same policy issues that arise with funded schemes. Changes in life styles or in life expectancy of the sort considered above ('Non-overlapping cohorts and prudential life-span policies') have similar consequences for the structure of 'intergenerational' pay-as-you-go transfers. If the parents' generation wants to retire earlier in life, for example, the level of the benefit paid to them by their children's generation will need to be adjusted downwards. Both funded schemes and pay-as-you-go schemes can accommodate such variations.

Intracohort inequalities and minimum pensions

Our next step towards a more realistic description of the real world is the introduction of inequalities within cohorts. We keep assuming that there is no ex ante inequality between cohorts (or that it can be disregarded), and hence that there is no problem of intercohort justice. However, with overlapping cohorts we need to take into account that different cohorts are living together. Given our maximin perspective, justice requires us to focus on the fate of the worst-off within each cohort. Remember that we take a life-cycle perspective. Justice does not imply a comparison of annual incomes, but of the total of what individuals are given over their lifespan. Allocation of that endowment over life remains each individual's own responsibility.

Within our framework, the most straightforward and at first sight most consistent policy proposal would be to maximin people's endowments 'at the start' and then rule that individuals have to look after their own pensions. Instead, we propose that a guaranteed minimum pension be introduced and pitched

at as high a level as is sustainable, subject to whatever justice requires be done for earlier ages. There are different arguments for such a direct redistribution through a guaranteed minimum pension system.

The main one is the mildly paternalistic argument used earlier that some individuals will not save as much as they would if they were adequately informed or fully able to process the information they possess. This argument is particularly strong as regards the provision of a minimum pension to all members of a cohort, whatever career their life-time endowments enabled them to pursue. Empirical research shows that inter-temporal discount rates, although in part a matter of taste not to be interfered with, are highly correlated with internal resources and external circumstances beyond the control of the individuals concerned: people from upper classes or scoring higher on intelligence tests have a lower discount rate (Warner and Pleeter, 2001). It therefore makes sense to 'protect' individuals with an extremely high discount rate by shifting part of the redistribution to the retirement period in the form of a guaranteed minimum pension.

Should this guaranteed minimum pension be means-tested? According to our interpretation of the maximin standpoint, it should not. In part because the means test tends to trap the elderly in various ways, for example by heavily penalizing cohabitation and various types of activity and saving. In part because of the effect of means-testing on the rate of take-up, either directly because of insufficient information about entitlements or indirectly because of the stigma attached to claiming or the wish to avoid bothering one's family if the means test is understood to extend to the claimant's children's income and wealth.

Unavoidably, this guaranteed minimum pension will need to be financed by intracohort redistributive taxation. Depending on the institutional and political context of the country concerned, this guaranteed minimum pension may or may not take the form of an unconditional basic pension. In some cases, it

may be administratively more convenient or politically more astute to incorporate it into a broader public pension system. It is essential that it should be guaranteed even to those who have had no career whatever, and that its level, relative to other pensions, should be made as high as is sustainable. Introducing a guaranteed minimum pension at the level of, or slightly above, the poverty line would already be an important step forward. As argued by Myles (2002: 162–3), the financial means required for the elimination of old-age poverty are rather modest and well within the possibilities of European nations.

Finally, the provision of such a (substantial and non-means-tested) guaranteed minimum pension is meant to affect not only the options open to the worse-off in old age, but also earlier in life. Many countries have adjusted contribution periods to compensate workers for irregular work histories due to illness and unemployment, child care or care for elderly family members. A minimum pension unconditionally guaranteed to all generalizes such measures, thus contributing to the removal of gender inequalities and, arguably, to a fair and efficient form of labour-market flexibility.

Intercohort inequalities and fair generational accounting

Let us now take the last and crucial step in the analysis and introduce the question of justice between cohorts. This implies that we do not only consider the effects of unexpected shocks (for which we introduced the notion of risk sharing), but also the existence of differences in endowments (of physical or human capital) known *ex ante*. In a world with overlapping cohorts, this implies that age groups from cohorts with different backgrounds live together. More specifically, the overall economic situation of the retirees will reflect the history of the cohort to which they belong. To deal with this more realistic context, it is not difficult to extend our maximin approach. Justice requires maximizing the endowment of the

worst-off cohorts, so as to allow them to make the situation of their own worst-off members as good as possible.

The basic principle of maximizing the endowment of the worst-off cohort immediately suggests a solution to the problem of intergenerational justice in the context of the protection of the environment. What we owe to future generations is to leave them a stock of physical, human and environmental capital which is at least as valuable as the stock of capital which was at our disposal (see Gosseries, 2001; Van Parijs, 1996). This general principle also applies to the evaluation of explicit and implicit government debt. The explicit debt essentially consists of government bonds. The implicit debt essentially takes the form of pension claims by retired people in a pay-as-you-go system, the cost of which will have to be borne by later generations. Explicit and implicit government debt are added (negatively) to the stock of later cohorts and therefore redistribute in favour of earlier cohorts. As such, this is perfectly acceptable (and even desirable) in our maximin setting, if the implicit or explicit government debt bequeathed to later cohorts is compensated for by an increase in the value of their human, physical and environmental capital. If later cohorts have a better endowment, justice requires to redistribute in favour of earlier cohorts. Let us now apply these general principles to some more specific questions about retirement pensions.

Consider first the question of how to adjust retirement pensions if there is an increase in the productivity of the active generations.⁴ Of course, if the changes in productivity are ‘unpredictable’, we find ourselves in the risk-sharing context discussed above (‘Overlapping cohorts and the possibility of pay-as-you-go’) and the Musgrave rule provides guidance for prudent risk sharing between different generations.

The analysis needs to be different, however, if the changes in productivity are not due to unpredictable shocks. Suppose, for example, that the increase in the productivity of the

younger generations is due to the investment by the older generation in the physical or, more importantly, human capital of their children – and that this increase in the value of the endowment is not offset by a shrinking of environmental capital. It is then in principle justified for the investing generations to improve their own position through the accumulation of government debt and/or pension wealth. On the contrary, if the increase in the productivity of younger generations is the outcome of their own savings choices (different from the savings choices of the previous generation), there is no reason to increase the retirement pension. However, it is far from easy to evaluate these different effects and/or to incorporate them in a stable intergenerational contract. It may therefore make sense to return to the Musgrave rule as a kind of litmus test, as an attractive and transparent compromise solution. This rule has the advantage that whatever burden needs bearing is shared by the different cohorts and that such burden sharing may increase social cohesion. Note, however, that in this new context its rationale is that of a mere rule of thumb, and hence that it will be comparatively easy to come up with compelling reasons to depart from it.

More important still are the challenges that stem from increases in the dependency ratio. If such an increase could be construed as an ‘unpredictable’ shock and hence as a collective ‘risk’, the Musgrave rule would be applicable without qualification. However, is the increase in the dependency ratio really a collective ‘risk’? Consider the two different demographic forces causing it. The increase in longevity is not really a problem of intergenerational justice and we have suggested already that the obvious response to it is an increase in the age of retirement. We return to this point below. The second factor is the decrease in the birth rate. Can this decrease be seen as a collective risk? If so, the Musgrave rule applies. Must it rather be interpreted as a deliberate choice? If so, it would be unfair for the less procreation-prone generation to shift part of the burden to the following one. As Sinn (2000: 405) puts it:

Burden smoothing in the presence of the 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.

If one follows Sinn’s line of reasoning, a shift in the distribution of the tax burden – and a departure from the Musgrave rule – can be justified. It is of course debatable whether a cohort can be held ‘responsible’ for its average reproductive behaviour. Moreover, reproductive behaviour is not homogeneous within a cohort.⁵ In this context, too, the Musgrave rule makes sense as a kind of litmus test. But, again, our endorsement of the rule is not based here on a ‘hard’ efficiency reasoning about risk sharing, but it is contingent on the evaluation of a set of specific factors and there is room for a broader social debate.

Against the background of our set of ethical convictions, we endeavoured to give a specific content to the idea of intergenerational justice. Our approach goes beyond safeguarding the sustainability of the present pension arrangements. It is also broader than the popular economic approach of ‘intergenerational accounting’ and its spirit is completely different. Intergenerational accountants calculate the ratio of benefits to contributions for cohorts born at different moments in time and (implicitly or explicitly) take for granted that fairness requires these ratios to be equal. Such accounting exercises give useful insights, but as a theory of justice this approach is a non-starter. It concentrates exclusively on the inter-cohort transfers through the government budget. It neglects the crucial problem of intracohort distribution. Most importantly, it builds on the implicit normative assumption that generations have the right to a ‘just return’ on their contributions to the government. From the standpoint presented above,

however, net transfers to a cohort that is characterized by an unfavourable endowment (or unfavourable circumstances) are no more problematic, ethically speaking, than net transfers to a poorer region.

Five issues

On this simple normative background, let us now consider five salient policy issues regarding the future of European pension systems.

Go funded?

The distinction between 'funded' and 'pay-as-you-go' does not coincide with the distinction between 'private' and 'public' arrangements. Public pensions can be funded. Private pensions can have pay-as-you-go features, e.g. when they are of the defined benefit type. For the time being, however, let us consider whether there is any general case for shifting drastically the current balance between pay-as-you-go and funded pension systems.

The main advantage of pay-as-you-go systems is that they allow for intercohort sharing of collective risks and are therefore *ex ante* Pareto-improving. At the same time they allow for some intergenerational redistribution, which may be required by justice considerations. Recognizing these potential advantages does not imply that there is no room for funding in the overall structure of retirement pensions. On the contrary, each cohort remains free to set up new retirement arrangements which will often take the form of funded schemes. There is, moreover, an efficiency case for combining pay-as-you-go and funding. Over the long run, there is a negative correlation between the trends in the returns on capital and on human capital, and hence between the trends in the yield of pension funds and the rate of growth of real wages, which form the basis of pay-as-you-go social-security contributions. As the efficient financing of retirement pensions requires the pooling

of risks, a mixture of funding and pay-as-you-go is therefore appropriate.

Does this presumption in favour of a mixed system cease to be relevant in the context of an increase in the dependency ratio? A longer life expectancy has similar consequences for both funded and non-funded pension systems. And a falling birth rate implies a decrease in the active population, which in turn can be expected to lead to a change in the relative prices of labour and capital and hence to a relative decrease in the interest rate and to a lower return for the pension funds. In the long run this effect may be empirically important.⁶ However, it remains true that the sustainability of pay-as-you-go arrangements is more directly threatened by the increase in the dependency ratio.

This argument in favour of a shift to funding is sometimes strengthened by referring to the fact that the real rate of return in a pay-as-you-go system is equal to the growth rate of the economy, which is, under present circumstances, much lower than the real interest rate, i.e. the rate of return in a funded system. It is wrong, however, to conclude that moving towards funding would imply an unambiguous efficiency gain, in the sense of a Pareto-improvement. The additional burden imposed on participants in an existing pay-as-you-go system cannot fully be ascribed, if at all, to the inefficiency of the system. It should rather be viewed as a tax which is needed to service the implicit government debt created with the gift to the first generation at the time the system was introduced (Breyer, 2001; Orszag and Stiglitz, 1999; Sinn, 2000). The transition to a funded system does not remove this tax burden; a drastic shift towards funding implies a drastic shift in the distribution of this burden at the expense of today's active generation (see Miles and Timmermann (1999) for some illustrative figures). We do not want to enter the intense technical debate among economists about the magnitude of this burden shift. For present purposes, the key point is that a move towards funding will always raise a problem of intergenerational

distributive justice. If there are good justice arguments to increase the burden of today's active population, one may advocate a move towards partial funding. Such a shift is advocated (on justice grounds) by Oksanen (2001). However, against the ethical background sketched above, there is no way one could justify the drastic shift in the burden of tax that would be implied by the transition to a completely funded system.

What are we to think, however, about the gift to the first generation of retirees at the time Europe's pay-as-you-go systems were introduced after the Second World War? Was this an unjustified 'free lunch' for a generation that received a pension without having contributed to it? We think that the pejorative connotation usually associated with this notion is altogether unwarranted here. The 'free lunch' offered to the retirees of the time was rather a well-deserved modest supper for a cohort that lived through the Great Depression and the War and had to cope, moreover, with a considerable depreciation of its savings. The implicit tax that travelled through time all the way to us is not the product of an original sin which we should resent, but a sound implication of intergenerational justice.

To sum up, a strong pay-as-you-go component in the pension system remains desirable from the point of view of intergenerational justice. However, this pay-as-you-go component should be adapted to the increase in the dependency ratio. First, it makes sense to reshape it using the Musgrave rule as a handy risk-sharing device and an 'automatic stabilizer', which should improve the transparency and flexibility of the system. The rule cannot stipulate categorically what intergenerational justice requires, but it offers a useful baseline when debating transfers across cohorts. Second, the desirability of a strong pay-as-you-go component does not exclude some shift in the direction of more funding. Such a shift, however, need not entail greater reliance on private arrangements. The setting-up, within the government sector, of earmarked trust

funds to pay for future pensions is also a form of funding. From an economic point of view, they are equivalent to a reduction of the government's explicit debt, but adopting the formula of earmarked funds may increase the political feasibility of ethically commendable debt reduction. Referring to these alternative ways of 'going funded' takes us straight to our second issue.

Go private?

Although conceptually a distinct issue, the choice of the public-private mix has strong implications for the issue of intergenerational risk sharing. Privately funded schemes do not share the risk-sharing potential of a pay-as-you-go scheme. This is obvious in the case of *individual* privately funded schemes (often referred to as the 'third pillar'), which leave the greatest scope for freedom. These schemes necessarily belong to the 'defined-contribution' category, i.e. to a type of pension scheme in which the benefit is actuarially equivalent to the yield of the contribution, i.e. to the return on the capital accumulated (interest or return on equity). They are therefore intrinsically unable to achieve intergenerational risk sharing.

Since it is more difficult for individuals to hedge against the risk of uncertain returns on capital, funded schemes often take the form of mandatory collective savings through pension funds at the level of branches or firms (often referred to as the 'second pillar'). By pooling risks, such funds have the advantage of facing a far more advantageous trade-off between risk and expected return on capital. These *collective* private pension funds can in principle set up a reserve fund and propose 'defined benefit' schemes, i.e. schemes in which the benefit level of a retired person is not strictly determined by the contributions that person paid. If the level of pensions is indexed to prices or to earnings, for example, the risk is shifted away from pensioners to the active population. Of course, like pay-as-you-go

schemes, such funded 'defined benefit schemes' will also have difficulty coping with an increasing dependency ratio. More importantly, if these collective private funds are subjected to unregulated market competition, their risk-sharing potential will be severely limited. For in the case of a negative shock, the existing funds which intend to keep the promises they made will have to raise their contributions. And newcomers to the market will then be in a position to offer far more attractive conditions to the active population.

Obviously, the government does not face this constraint. It can set up its own (legal) pay-as-you-go system (or 'first pillar'), or so strongly regulate the collectively funded schemes in the second pillar that they are forced to integrate an intergenerational risk-sharing element. It follows that, even strictly on efficiency grounds, at least part of the pension system will have to be either explicitly of the publicly organized pay-as-you-go type or incorporate pay-as-you-go features through a strong public regulation of funded schemes.

Once intragenerational justice considerations are brought in, and hence the need for a guaranteed minimum pension, the case for an explicit 'first pillar' government component in the pension system is made much stronger. For government regulation of the 'second pillar' could conceivably require a minimum pension but could not reach those left uninsured by their labour-market history. Even with a guaranteed minimum pension, different individuals may of course opt for different life-cycle allocations. Some may work harder and earn and save more. A just and efficient overall pension system will therefore contain more than the provision of a minimum pension. The risk-sharing advantages of pay-as-you-go remain relevant, also, for these additional components. Hence, there is no a priori reason to suppose that the minimum pension must be the only pay-as-you-go component in the whole system. However, the minimum pension must be given a privileged status. In applying the Musgrave rule to regulate intergenerational risk sharing through pay-as-you-

go transfers, the downward adjustments must not indiscriminately affect all pension levels. Priority must be given to the safeguarding of the minimum pension at the highest sustainable level, and it is therefore to be expected that a negative shock will lead to a compression of the pension structure.

While government intervention is necessary to guarantee distributive justice and intergenerational risk sharing, supplementary private pension arrangements are perfectly legitimate from our normative standpoint. To a large extent, individuals can be held responsible for the allocation of their endowment over their life cycle. Against the background of a just distribution of endowments, a restriction of individual freedom as to the allocation of a person's endowment over the life cycle is only justified if the efficiency gains generated for everyone's benefit are such that it is reasonable to suppose that all would agree ex ante to the restriction. Therefore, there is room for third-pillar pensions. And second-pillar pensions may contribute to reach an appropriately balanced mix of funded and pay-as-you-go financing. While some balance between the different 'pillars' needs to be found, there is, however, no sound ethical reason for stimulating second or (a fortiori) third-pillar savings by granting them tax advantages.

Go Bismarckian?

Let us define a 'Bismarckian' system as one in which the level of the benefit to which a person is entitled is sensitive to the level of the contributions that person paid, and a 'Beveridgean' system as one in which it is not. Our option for a 'first pillar' (i.e. a government-organized pay-as-you-go component), and more specifically for one that incorporates a (non-means-tested) guaranteed minimum pension, does *not* settle the choice between a 'Bismarckian' and a 'Beveridgean' public retirement insurance system. By incorporating more-than-minimal pensions into a government-organized pay-as-you-go system, one

may opt for 'Bismarck' against 'Beveridge' on the basis of second-order considerations related to efficient intergenerational risk sharing of the sort hinted at above ('Go funded?'). However, even if one is primarily interested in the level of the minimum pension, this is not the sole argument.

A second argument emphasizes that the level of the minimum pension will be set through the political process. As a first approximation, we could say that the generosity of the pension system will be determined by the position of the median voter. It is conceivable that this median voter will opt for a public pension system that guarantees a higher minimum pension if a link is retained between contributions and benefits: under such a ('Bismarckian') system, the median pensioner is entitled to considerably more than the minimum pension, while also paying higher contributions than would be the case if public pensions reduced to the minimal one. (See Casamatta et al. (2000) for an elegant theoretical analysis of this phenomenon.) This enhanced political support may be due in part to an illusion about how much of a difference social contributions make to the level of their pensions. But it may also derive from the income security which above-minimal pensioners owe to such a Bismarckian system: arguably, the safer one feels, the more altruistic one becomes (Goodin, 1993) and therefore also the more favourable to political programmes that include a generous minimum pension.

Whatever the exact reason, there is empirical evidence that workers and their organizations are more willing to accept a lower net wage as a result of higher taxes if there is a perceived link between contributions and benefits (Gruber, 1994; Montgomery et al., 1992; Ooghe et al., forthcoming; Summers et al., 1993). If taxes on labour income are used for benefits whose levels are unrelated to the taxes each pays, they are perceived as a real burden, shifted, if at all possible, onto the employer and hence incorporated into an enhanced wage cost. By contrast, if higher

contributions translate into higher benefits, they are to a larger extent 'internalized'. In this case, distortions are therefore less pronounced and the optimal level of taxes/contributions can be higher.

From our maximin standpoint, the best way for the government-organized pension system to combine Beveridgean and Bismarckian features will therefore be contingent upon the specific circumstances of the country considered, in particular on the way in which its labour market responds to different ways of structuring the system. The current situation, sometimes quite intricate, as developed out of an idiosyncratic national history, will always need to be a crucial point of reference. Transparency is desirable, but we need not be purists. Improving the system so as to sustainably maximize the minimum might mean putting up forever with a significant level of complexity and misperception.

Get people to work longer?

We argued before that an increase in longevity is bound to alter the desired allocation of consumption and labour supply over the life cycle. In a hypothetical world with identical individuals and equally endowed cohorts – where there is by definition no problem of distributive justice – some increase in the retirement age is a predictable reaction to the increase in longevity. While the real world is of course more complex, the prima facie case for such an increase in the present economic circumstances is very strong and almost self-evident.

However, this is not what we observe. The population is fiercely opposed to any increase in the retirement age and most Western countries have been characterized by a trend towards earlier retirement. This need not be a problem, from our standpoint, if these trends reflect genuine preferences of the population. Concern for real freedom for all makes flexibility with respect to the retirement age a crucial feature of policy. Individuals must be

able to choose their pattern of life, while bearing the predictable consequences of their savings and retirement decisions. The latter condition is crucial: it implies that working until later in life leads, *ceteris paribus*, to a higher retirement pension, while retiring earlier should mean a lower pension. More flexibility is desirable only if individuals take their retirement decisions against an institutional background that presents them with a realistic trade-off between the level of the pension and the duration of the period of retirement. Such a realistic trade-off will have to incorporate considerations about the long-run sustainability of the pension system.

This latter condition, however, is not at all fulfilled in the current situation. Empirical evidence shows that the trend towards early retirement is partly (or even largely) induced by the tax incentives created through government intervention (Gruber and Wise, 1998; 2001; Pestieau, 2001). From our standpoint, these distortions must be removed, while at the same time arrangements for part-time working by aged people must be fostered (see also Gallie, 2002).

There are, however, some issues about the age of retirement which cannot be handled by a right to a guaranteed minimum pension from a certain age combined with supplements whose levels depend, *inter alia*, on how early or late one retires. First, because of differences in their talents, some individuals will have to accept jobs involving worse working conditions and yielding less job satisfaction. Arguably, they should have the possibility of retiring earlier without having to pay a cost in terms of a lower pension. However, if an adequate labour-market policy – arguably including as a key component the introduction of a form of universal basic income – succeeds in widening the range of occupational choice for those who have least of it, the hardship of one's job and its impact on one's life expectancy can be treated (no less but also no more than the level of one's wage and the latter's derived impact on pension benefits) as a matter of choice. This reasoning, needless to

say, must operate against the background of insurance institutions covering illness and disability, whether work-related or not.

This may go some way towards reducing or compensating the overall inequality in life expectancies, but is most unlikely to make the gender gap insignificant along this dimension. This raises a tricky issue. As long as men can expect to live less long, or less long in reasonably good health, would it not be fair to allow them to retire earlier than women, or to pay lower contributions, or to receive higher pensions? As things stand, it can sensibly be argued that the inequalities suffered by women in many other respects (not least those affecting pension levels) easily earn them the modest privilege of enjoying their pensions for a longer time, and making this sort of proposal in today's circumstances could therefore readily be rejected as despicable on the basis of our ethical premises.⁷ But this is too easy a way out. If present trends continue, especially as regards gender-based educational inequalities, vigorous policies may one day put an end to these inequalities, or even invert them. Unless driving up the presence and status of women in working life to the level of men's miraculously drives up men's life expectancy to the level of women's (or, in a grimmer scenario, drives down women's to the level of men's), a concern for justice will not allow us to evade the tricky issue just raised.

Suppose then that men and women work on average for the same length of time, retire at the same age, earn the same wages and pay the same social-security contributions at the same rate, while women keep living five years longer than men, owing, say, to their hormonal system protecting them better against cardiovascular diseases. Were such a situation to arise, would it be unjust from our ethical standpoint? No and yes. Part of what pensions schemes cover is the risk of poverty in old age. Whether or not this risk materializes more often for women than for men, men and women can fairly be expected to contribute equally to the provision of a decent minimum pension for all, just as all can be fairly

expected to cover adequate health care for diseases whose probability varies greatly, and predictably, from one category to another. But beyond this basic level, pension schemes are also a way of spreading throughout one's lifetime the comforts and amenities of life. Those are privileges which can only be enjoyed by the lucky who live long enough, and fairness requires that they be paid for by those who will enjoy them or, given the uncertainty, in proportion to the likelihood of enjoying them, assessed as precisely as possible. If women's life expectancy after retirement is, say, 30 percent higher than that of men, it is fair that they should pay 30 percent more in contributions for the part of the pension that exceeds the minimum guaranteed to all.

Would this be an unacceptable form of discrimination? Not if you share our intuitions about the following analogous situation. Take a person with a genetic disease such that she can live a normal life except that she will certainly have died by the age of 50. Is it fair that this person should pay contributions towards a pension she knows she will never enjoy? It is for the part that covers a level of pension that protects people against destitution and indignity in old age, since being in that situation would be regarded by that person, along with everyone else, as highly undesirable. But it is not for what covers the remainder, as that would amount to making the unlucky subsidize the lucky. If you share our judgement about this case, you must regard the gender differentiation of contributions in the situation sketched above as legitimate, unless you want to contemplate the following possibility. Suppose medical technology is now such that men can safely absorb female hormones of a quality and quantity that will endow them with an extra five years of life expectancy, together with (and, sadly for some, inseparably) a number of other female attributes. If this possibility exists (cheaply enough), yet is turned down by men, the latter would arguably lose their entitlement to lower contributions. But as long as it does not exist, our opportunity-based conception of justice could

not endorse a system that organizes net transfers to those lucky enough to enjoy for longer the most fundamental resource of all: life.

Go European?

In today's European Union, pension institutions differ widely from one member state to another. They reflect a complex and subtle balance between the various considerations introduced in this paper. Homogenizing these systems within a foreseeable future is out of the question. And even if it were not, from our normative standpoint, it should be. For national (possibly even subnational) differences provide one way of helping to realize, as far as is feasible, each group's freedom to design its solidarity institutions in accordance with its conception of what each stage of life requires, while bearing responsibility for the consequences of its choices.

This does not imply that national decisions have to be made in isolation from one another. Like individuals, countries can learn from one another's experiences and from the relative successes and failures of different policy measures. We therefore believe that an open method of coordination between the different member states of the European Union makes a lot of sense. This method can be defined as 'a process where explicit, clear and mutually agreed objectives are defined, after which peer review enables European Union Member States to examine and learn from good practice' (Frank Vandembroucke in Esping-Andersen et al., 2002: xix). It is an 'open' method in that it allows each member state to choose its own instruments in the light of its own specific circumstances.

In this process, one should not underestimate the importance of the first step: the formulation of a set of explicit and clear objectives. This creates room for explicit ethical discussion about basic policy issues at the European level. It creates the opportunity to think explicitly about what could be the

content of the 'European social model' – if such a model were to exist. Coordination is particularly useful between partners who share a broadly similar perspective on the importance of 'social cohesion' and, more specifically, on the set of objectives which pension systems are meant to serve. We believe that the core of this vision is encapsulated in the conception of justice spelled out above.

This process of European coordination need not remain stuck at the level of abstract principles, however. It can and must give priority to the objective of safeguarding a high minimum pension in all countries. There are at least two good reasons for giving priority to this concern. The first one is directly ethical. Many of the reforms discussed in connection with pensions aim to improve the efficiency of the system as an insurance device. The exact nature of the risks that are to be covered and the relative importance attached to them depend on the preferences of citizens. From our point of view, there is then scope for variation in order to best track these preferences. This does not hold for components of the overall system that are directly justice-driven. Justice comes first. And it naturally takes a transnational dimension, especially in an emerging polity such as the European Union, within which European citizens can move freely and whose national components have become mutually dependent in countless ways. The introduction across Europe of a guaranteed minimum pension, of an (unconditional) income floor for the elderly, would in this view be an important step forward. The second argument is of an instrumental nature. A pension system that incorporates an income floor for all the elderly is necessarily redistributive *ex ante*. Such a redistributive system is most likely to be considerably more vulnerable to international tax competition than arrangements of the social insurance type. International coordination in this area is therefore particularly important.

We do not go into the details of the introduction of such minimum income guarantee.

Can the European Union content itself with defining common targets, or should it help the poorest countries to achieve them by contributing to the funding of the schemes, and, if so, to what extent and according to what sort of formula? Should the target be defined with reference to an absolute (European-wide) or to a relative (country-specific) poverty line? Should one coordinate on a specific type of measure or on specific objectives, as captured by appropriate social indicators? Several of these important issues are discussed in Atkinson et al. (2002). For our purposes, it is sufficient to emphasize the priority to be given to the fight against poverty among the retired through comprehensive, non-means-tested schemes that incorporate a substantial minimum pension, while at the same time giving the individual states the freedom to devise their own pension institutions. Even if one were to opt for the most ambitious version of this programme – the introduction of an unconditional basic pension fixed and funded at the European level – the aim would not be to build a giga-welfare state, a huge substitute for national welfare policies. It would rather be to restructure the transfer to the elderly so as to fit, under the national systems, a firm European floor that would enable these to be less vulnerable and do a better job.

Conclusion

While we have deliberately remained at the level of general principles, the contours of what we believe to be an ethically adequate system of retirement pensions should be clear enough. By way of conclusion, we shall briefly restate the picture that emerges and discuss its political feasibility and economic sustainability.

As far as pensions are concerned, government intervention is needed, in our view, for two main reasons. First, justice requires that priority be given to the introduction of a guaranteed minimum pension, at a level that is as high as is sustainable, subject to whatever is required to sustain a corresponding minimum

for earlier stages in life. Some European coordination is desirable here. By no means does this imply that government pensions in the various member states should be confined to the universal provision of this minimum. Depending on the historical circumstances of each member state, there can be ample room for Bismarckian features. Second, the pension system has to contain a pay-as-you-go component for efficiency reasons, namely to permit the intergenerational sharing of collective risks. Moreover, once a pay-as-you-go component is in place, it also allows for intergenerational redistribution, if justice requires it. For the intergenerational arrangement to be stable and socially and politically sustainable, it must be based on a flexible and transparent distribution rule. The Musgrave proposal is an attractive baseline. Considerations of risk-sharing efficiency may strengthen the case for incorporating Bismarckian features into the public pension system. Alternatively, they may provide an argument for a significant government regulation of second-pillar pensions.

Conditional on the justice requirements and on the implementation of an efficient intergenerational risk-sharing device, individuals are free and they are responsible for the allocation of their endowment over their life cycle. Consequently, there is a good case for allowing the development of second- and third-pillar pensions, but there is no sound reason to grant them tax privileges. A second crucial consequence is the importance of a flexible retirement age. Individuals have to take their retirement decisions in the light of a realistic trade-off between the level of their pensions and the duration of the period of retirement.

Are these proposals acceptable for the largest part of the population? In Western Europe there is now a wealth of survey material on public opinion relating to this question.⁸ Without delving deeply into the empirical material, let us briefly sketch some ideas about the *social feasibility* of our proposals. First, although the introduction of a minimum pension at European level will no doubt require a fair amount of political

courage, acumen and vision, the idea of a guaranteed minimum for the elderly is widely supported by the population. Second, a transparent reform of first-pillar pensions and of the regulation of second-pillar pensions should be acceptable to the bulk of the citizenry. Even though most have a preference for the status quo, they are worried about the future of the pension system and are willing to accept changes. It is crucial, however, that the rationale of the reforms should be explained carefully and didactically. A well-structured ethical framework can be very important for the formulation of this rationale. Third and last, such a framework may also help to implement what is no doubt the least popular of the directions of change we advocate: the increase of the average effective retirement age, either through a rise of the mandatory retirement age, or, better, through the introduction of greater flexibility on economically realistic terms. On this issue, one may expect fierce opposition from the population. However, on the background set out above, the introduction of such responsible flexibility is among the most obvious and ethically least debatable policy options. Public opinion should not be taken as dictating to us the right answer to our basic policy questions. This answer must be based on an objective analysis of the situation and on a coherent conception of what justice requires.

The emphasis in our analysis was not on the *economic sustainability* of the pension arrangements. Yet it is obvious that long-run sustainability is a necessary requirement for any pension system. Sustainability can be achieved in many different ways, and again a comprehensive ethical framework should give us some guidance about which of them should be preferred and which should be avoided at any price. In our normative framework, the most appropriate response to the challenge of the increasing dependency ratio consists of the following package: (a) increasing the retirement age or lowering the pensions of those who are not disabled and who prefer to retire early, with an emphasis on flexibility rather

than on mandatory retirement; (b) in order to accommodate unexpected shocks, lowering the pensions and/or increasing the contributions of the active population in line with the Musgrave rule, but with a special concern for the minimum pension guarantee; (c) introducing more funding in predominantly pay-as-you-go systems, either through creating a public trust fund or through the development of second-pillar pensions, while keeping a sizeable pay-as-you-go component. Taken together this package of measures looks very much like the moderate proposals which have been put forward to restore the sustainability of the system. We feel, however, that an offensive and creative focus on social objectives is a more attractive and no less responsible way of thinking about the future. It offers a stronger promise to mobilize European citizens than a mere concern for a sound government budget. There is no contradiction between social and economic objectives. The economic side constraints can be integrated into a realistic and coherent way of thinking about and fighting for more social justice.

Last but not least, we must emphasize that by concentrating on pension systems, we only considered one component of the global package that is called in response to the rising dependency ratio. Parental leave, child care, schooling, training and retraining, work conditions and rhythms, housing and transportation, immigration and integration, must all enter the comprehensive re-thinking of the current division of tasks between age groups which is structurally demanded by the joint challenge of rising life expectancy and falling fertility. Most regrettably, perhaps, we barely touched the distinct but closely related challenge generated by the ever growing cost of care and health care for all, and particularly the elderly. The issue of social justice, intra- and intergenerational, which is raised by this growing cost is by no means less acutely politically or less tricky intellectually than the one raised by pensions. Quite the contrary. It is less hard to work out what we should fairly be given by way of an income in case we happen

to be alive, than to work out how much we can fairly ask should be spent on keeping us alive and well. And it is also less hard to accept, out of fairness, a lower income if we are lucky enough to be alive, than it is to accept, out of fairness, an earlier death.⁹

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Notes

- 1 See Van Parijs (1995) for a developed argument, and Reeve and Williams (2003) for a comprehensive set of critical essays.
- 2 Collard (2001) offers an illuminating visual representation of cohorts and generations, and uses it to structure many intergenerational issues which go beyond the pension problem.
- 3 Empirical work suggests that individuals tend to save too little according to their own preferences if they are left completely free (Banks et al., 1998; Diamond, 1977). And in the opinion survey by Boeri et al. (2001), many respondents who would be inclined to opt out of the legally imposed pay-as-you-go system prefer a situation in which pension contributions are mandatory over a situation in which they are left completely free.
- 4 In technical terms, the adjustment of pensions for changes in productivity is determined by the choice of defined benefit versus defined contribution, and within defined benefit for the specific choice of indexing rule (varying from pure price indexation to linking the pension to the real wage development).
- 5 Sinn (2000: 406) accepts this point and draws from it the following implications: 'Some households have a sufficient number of children, others have none, some invest in human capital, others

- don't. It would be in the logic of the burden smoothing argument to cut a household's PAYGO pension in line with the number of children who are missing relative to some target number and to ask this household for compensatory savings to secure its living standard in old age with a self-financed funded pension, without alleviating its contributions to the PAYGO system.' This measure would clearly improve the incentive structure for individual fertility choices. However, the ethical case implicitly assumes that fertility choices are completely free and that all households face the same opportunity set for these choices. Esping-Andersen et al. (2002) convincingly show that this is far from being the case.
- 6 This is illustrated convincingly in the simulation results of Bettendorf et al. (2000) for the Netherlands.
- 7 In February 2002, Fernando Fernandez de Troconiz, member of the Spanish national Parliament for the governing party PP (Partido Popular) had to resign as chairman of the 'Permanent Commission of the Toledo Pact', in charge of looking after the sustainability of the Spanish pension system. His resignation was brought about by the (justified) uproar that followed his declaration that women's longer life expectancy implied (even under present circumstances of inequality in other respects) that they should be getting lower pensions (*El Pais*, 4 and 11 February 2002).
- 8 A particularly interesting study is the one by Boeri et al. (2000) who compare public opinion in France, Germany, Italy and Spain.
- 9 See e.g. Van Parijs (1996: Ch. 3) for a discussion of this issue on the background of the same ethical perspective.

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