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The Political Future of Social Security in Aging Societies. By Vincenzo Galasso. Cambridge and London: MIT Press, 2006.
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How much social security benefits can you expect when you retire? Questions about social security are important not only for economists, but central to financial planning for virtually everyone in the developed world. Vincenzo Galasso focuses on the political sustainability of social security, the question what economic incentives a country's voters have to maintain or to modify their social security systems. This is indeed the key question in wealthy democracies where transfers are more a question of politics than of resources.

While population aging is a global phenomenon, social security is structured quite differently in different countries. Appropriately therefore, the book includes a general part (chapters 1–4, 11) and a series of country studies (chapters 5–10). The general part includes an introductory chapter, an insightful cross-country comparison, a survey of relevant economic and political theories, and a chapter explaining the author's preferred voting-theoretic framework. The country studies examine France, Germany, Italy, Spain, the United Kingdom, and the United States, thus sampling both continental welfare states and two notable exceptions. Each country chapter presents institutional and historical facts, followed by an economic analysis of voter preferences over the size of the country's social security system. A concluding chapter compares results across countries and presents additional results about voter preferences over the social security retirement age.

I recommend the book for anyone interested in social security. Most of it is readable for nontechnical audiences, but some of the voting theory is laid out with equations, which may limit accessibility for policy makers and other laypeople.

My assessment differentiates somewhat between the narrative sections, the voting analysis, and the conclusions. Galasso's presentation is outstanding with regard to the countries' institutional features, the demographic trends, and the history of social security. These narrative sections are comprehensive, detailed, and insightful. The voting analysis uses the right approach and yields an abundance of interesting results. The numerical tax rate predictions rely on a few questionable assumptions, however, and are perhaps more instructive for making comparisons than as forecasts in levels.

The book yields two important conclusions that are well supported by historical and voting-theoretic evidence. First, despite the rising cost, aging voter populations tend to favor expanded social security systems—higher taxes rather than lower benefits. Second, an increased retirement age is a promising way to shrink social security, especially if it is phased in slowly so that a voting majority of current median-age and older voters remains untouched. The prediction that voters will reject a scaling-down of social security is not new (see Henning Bohn 1999 for the United States), but the book provides significant new evidence—not only voting analyses for six different countries, but also strong historical evidence. The prediction of voter support for an increased retirement age is more novel and also presented convincingly, providing a ray of hope for economists and policymakers keen on cost-reducing reforms.

The narrative presentation of the six countries' social security systems alone makes the book worth buying. Particularly insightful is Galasso's review of how politicians have tried to reform social security since the 1970s. This includes not only the successful reforms—the ones found in official records—but also reform attempts that failed, and it includes comments about the various proposals' supporters and opponents. The historical review suggests three generalizations that foreshadow the voting analysis: (1) Reforms attempts fail if they impose significant burdens on voters at or above median age (about age 45); (2) Reforms can be successful if they are phased in slowly, in a way that middle-aged and older voters are effectively exempt and the burden falls on younger cohorts; (3) A simple cost-reducing measure is to increase the retirement age, and it is politically viable if implemented with suitable delay.

A neglected issue is perhaps the legal status of social security. In the United States, for example, the Supreme Court has ruled that social security benefits are paid at the discretion of Congress, whereas the German Supreme Court has recognized social security benefits as constitutionally protected property. One may wonder to what extent such legal differences will become important for how political systems can respond to population aging.

The heart of the book is the voting analysis. Galasso follows an established literature by modelling voters as forward-looking and weighting the expected present value of benefits against the expected present value of their own future contributions. Voters disregard past contributions as sunk cost. Because future contributions decline with age, net benefits are increasing as voters approach retirement age, and they are positive in retirement. If one abstracts from other voter characteristics, net benefits are positive for a majority of voters if and only if they are positive for voters of median age. Galasso derives predictions about the future of social security by estimating costs and benefits for voters in different countries and at different times—years 2000 and 2050.

This approach to thinking about social security is sensible and has a long tradition. But there are problems in the application. Galasso assumes that voters choose a social security tax rate (and implied replacement rate) by comparing steady state allocations resulting from alternative tax rates. Voters are also assumed to regard their economy as closed, so that due to crowding out, a higher tax rate reduces wages and increases the return to capital. A steady-state starting point, one-time voting, and single-issue voting are perhaps acceptable simplifications, all meant to capture the essence of a more complicated dynamic voting game. But crowding out introduces dynamics that are not adequately modeled.

To see the problem, consider the simpler case of a small open economy where wages and the return to capital are exogenous. Individual social security benefits and cost are then proportional to the tax rate, as in partial equilibrium. If net benefits for the median voter are positive at any tax rate, they are positive at all tax rates and strictly increasing; and if net benefits are negative, they are negative at all rates. Voting over tax rates would yield extreme solutions—zero or 100 percent. The location of interior solutions in Galasso's model—the numerical predictions—is therefore determined by auxiliary assumptions, notably about crowding out and about labor supply distortions. Wage and interest effects are problematic in this context not only because the countries in question are open, but because voters who recognize the general equilibrium effects of their votes cannot rationally ignore the dynamics. These dynamics tend to favor higher tax rates than in steady state (perhaps much higher ones; see Bohn 1999) because median-age voters have typically accumulated wealth. They benefit more from rising interest rates than they are harmed by slowly declining wages.

Despite these concerns, Galasso's voting predictions are highly informative because one can interpret them as partial equilibrium calculations (small open economy) plus a consistently applied "size penalty" (motivated by general equilibrium effects). The finding of positive tax rates in all countries documents that median-age voters individually expect positive net benefits. The higher tax rates predicted for 2050 indicate rising margins of benefits over cost, i.e., voter support for expanding social security. The differences across scenarios indicate under which conditions the expansionary pressures are stronger or weaker. Moreover, because lack of openness and lack of dynamics bias the calculations in opposite directions, Galasso's size penalty is not necessarily unreasonable.

Overall therefore, quibbles about the calculations should not distract from the value of Galasso's projections. His prediction of rising tax rates in all six countries—and this at different rates—and his finding of voter support for an increased retirement age are important and valid insights that deserve broad professional and public recognition. Most valuable for Americans is perhaps the insight that we are less affected by population aging than the European countries and that by raising the retirement age from 65 to 67, we have responded better than the Europeans.

References

Bohn, Henning. 1999. "Will Social Security and Medicare Remain Viable as the U.S. Population Is Aging?" *Carnegie–Rochester Conference Series on Public Policy*, 50: 1–53.

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