Book Review

DOI 10.1007/s00712-007-0303-1

Galasso, V.: *The Political Future of Social Security in Aging societies*. XVII, 257pp. The MIT Press, Cambridge, MA, London 2006. Hardcover £ 22.95.

It is a well-known fact that aging populations in industrialized countries are the main factor which undermines the financial stability of the social security systems and, at the same time, are the reason why those unstable systems are not subjected to suitable reforms. From an economic perspective, the shift of the age composition of generations towards higher ages increases the number of retirees who receive social security benefits and decreases the number of working individuals who pay contributions to the system. In the predominant pay-as-you-go pensions system worldwide where the pensions are financed by contributions of workers living concurrent to the retirees either contribution rates have to be increased or benefits must fall in order to balance the pension budget. But both measures have natural limits. This financial crisis reaches its peak in the years between 2030 and 2040 when the baby boom generations in the different countries are in retirement. From a political economy perspective, in democratic societies the necessary reforms to heal these financial crises like reductions in the generosity of benefits or the postponement of retirement ages are blocked by the voters because the fraction of older voters increases. Pensioners and older workers who view their past contribution payments as sunk cost are inclined to favor the extension of benefits. They vote for larger unfunded pension schemes.

This book adopts a politico-economic approach by using a median voter model to simulate the political support for social security systems in democratic societies. The focus is to explain how pension systems will evolve until 2050 when the electorates voting for the systems grow older. This quantitative analysis is performed for six countries with aging populations: France, Germany, Italy, Spain, the United Kingdom, and the United States. The selection of the countries is not entirely transparent. So it would have been a valuable addition if a Scandinavian country had been included exemplifying the Nordic type of very comprehensive pension schemes covering not only workers but all citizens.

After an introduction in the first chapter the institutional and parametric characteristics of pension schemes and recent reforms are presented in Chap. 2. Moreover, the demographic and labor market trends of the six countries are described showing that the demographic problem of aging societies for the long-term financing of pensions is exacerbated by early retirement tendencies. Due to those developments the ratio of retirees to contribution paying workers increases much faster than the old-age dependency ratio of persons aged above 65 years and persons aged between 20 and 64 years. This observation already hints to the main conclusion of the book that raising the effective retirement age is one of the most promising and viable reform steps to be undertaken in aging societies to alleviate the pension crisis. Finally, this chapter shows that the demographic aging implies a rise of the median age among voters.

Chapter 3 provides an overview about theories explaining the existence and expansion of welfare states. Here the book mixes normative justifications with positive explanations of public pension systems. From a normative point of view the chapter reflects individual myopia and missing private insurance markets as reasons for public pension systems. Another important argument, the "rational prodigality argument", is missing here: in the presence of means tested basic income rational households may save too little because they can rely on the transfers of other altruistic agents in their old age. Compulsory public pension schemes may cure this free-riding behavior (see Lindbeck and Weibull 1988; Fenge and von Weizsaecker 2001). In line with the politico-economic approach of the book the author argues in this chapter that the economic factors in those efficiency considerations fail to explain the actual expansion of public pension systems in the last decades. Instead political determinants are seen as the driving factors of increasing pension systems. It is argued that economic factors have an impact on the preferences of voters for social security systems. Retirees have a preference for larger pension systems because they bear no costs and favor contribution rates that maximize their current pension benefits. Middle-aged and older workers prefer larger pension systems because they do not consider the entire cost of their pensions but focus only on their remaining time horizon. Even younger workers with low incomes may support pension spending because of the existence of within-cohort redistribution elements in the system. Building on those "vested interests" of voters of different ages a model is formulated which characterizes the individual preferences over social security. The book explicitly refrains from modeling the political impact via veto players and interest groups, the so-called corporatist view. Although it is conceded that unions, parties and lobbies may play a crucial role in the decision process over welfare state policies the author argues that the impact is not long-lasting. In the long run governments are more concerned with winning a majority of the electorate than pleasing particular interests. Retrenchment policies are tailored to split the electorate into a large group of winners and a small group of losers which means for example to introduce long transition periods for reforms. In confirming this view it may be added that governments appear to conceal retrenchment measures. In Germany, for example, the statutory retirement age is increased successively up to 67 years by 2029 which represents effectively a cut of future pensions. Another example is that the change to a deferred taxation of pensions is phased in by taxing 50% of the pensions of current retirees – although their contributions have been already paid out of taxed income. Thus governments seem to seek hidden ways in cutting the benefits in order not to repel their voters.

In Chap. 4 the theoretical framework for the analysis of economic and political decisions is introduced. The methodology proceeds in two steps. First, the political economy model is calibrated to match the main economic, demographic and political characteristics and the features of the social security systems for each country around the year 2000. The individual and production parameters are chosen so that the equilibrium social security contribution rate voted for by a median voter corresponds to actual rates in 2000. Starting from this initial steady state the impact of aging electorates on the shape of social security systems is analyzed in step two by retaining the calibrated parameters and feeding the model with forecasted economic, demographic, and political variables for the year 2050.

Chapters 5–10 present the analysis of each of the six countries. All chapters contain a historical introduction, a very detailed description of the current social security system, a discussion of recent reforms or such under consideration, and an illustration of the country-specific demographic dynamics. The chapters about Italy, Spain, the United Kingdom and the United States also provide the specific pension benefit formulas of the current systems and explain very carefully the sometimes complex features of how to calculate the pension entitlements. For all readers who are interested in the mechanics of pension schemes and the economic effects embedded in the details of pension formulas this part of the book allows a good update of knowledge. But also readers who want to obtain a general impression of the present state of pension systems in the countries considered here can learn a lot of interesting features.

The simulation results of the social security contributions voted for by the electorates in 2050 and the resulting replacement rates are shown under the assumption of different effective retirement ages. The central outcome and the resulting political message are the same for all countries: postponing the retirement age represents a crucial measure to limit the political incentives towards more pension spending. Higher effective retirement ages in the year 2050 help to restrain the median voter's preference for higher social security contribution rates. Since the working life is prolonged and the retirement period shrinks, the returns from the pension system decrease which induces the median voter to vote for a lower contribution rate. At the same time and despite the drop in the contribution rate the generosity of the pension system in all countries except the USA increases. Postponing the retirement age reduces the ratio of retirees to workers which counterbalances the population aging with the effect of higher replacement rates. This straightforward result holds also when labor market distortions are considered where workers react to increasing contribution rates by reducing their working hours. Since this outcome is not so surprising it would have been a valuable addition if the range of policies had been extended to other instruments than the retirement age. Further retrenchment policies like the direct cut of pension benefits or the reduction of pay-as-you-go systems in favor of an extension of fully funded schemes are reform routes that can be observed in some countries. For the case of Germany the latter reform type has been analyzed by Sinn and Uebelmesser (2002).

An increase in the retirement age yields a rise of the replacement rates but this comes at the cost of reducing the retirement period. In Chap. 11, the question is analyzed whether voters would support a higher retirement age. The political regime of majority voting is extended by letting the voters determine the social security contribution rate, but also the effective retirement age. A bi-dimensional voting game is adopted where individuals vote for their most preferred contribution rate, for any given retirement age, and their most preferred retirement age, for any given contribution rate. Since median voters may be different for each issue the pair of contribution rate and retirement age supported by a majority of the voters represents the equilibrium of this voting game. The result which arises in four countries where the equilibrium exists is very interesting: the future voters in 2050 would support an increase in the retirement age. Thus postponing the retirement age would be a politically feasible reform step to mitigate the rise in the social security contribution rates. The reason for this result is that voters would be more concerned with receiving lower pension benefits at earlier retirement ages than with accelerating their retirement time. This is good news and may encourage policy makers to engage in such a reform. Finally, Chap. 11 briefly discusses the suggestion to delegate pension policies to the European Union in order to circumvent the dependency of national governments from their aging electorates. The author rightly views such a delegation as a wrong way. It would harm the EU institutions and a majority of voters might oppose the delegation of pension policies to the EU. Moreover, national governments would forego the long-term political gains of successful reforms.

This book is certainly a valuable contribution for all readers interested in political economy approaches to public pension issues. It can help young researchers to understand the mechanics of such models and to apply them to other issues of pension schemes or welfare states. More policy-orientated readers can learn a lot in general about pension schemes in different countries and specifically about the economic and political effects of pension reforms advocating higher retirement ages.

References

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