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Book Reviews

The Political Future of Social Security in Aging Societies. By VINCENZO GALASSO. MIT Press, Cambridge, Massachsetts. 2006. xvii + 257 pp. £22.95.

Vincenzo Galasso focuses on the funding of government-sponsored pay-as-you-go (PAYG) social security, often identified in the literature as pillar 1 of a three-pillar typology of total pension and retirement income (pillar 2 being occupational or employer-sponsored pensions, and pillar 3 being individual pension savings products). Why the author concentrates on just this pillar is not entirely clear from the book. Perhaps he believes (rightly, in my view) that pillar 1 is an essential component of many continental European national pension systems, particularly those of Germany, France, Italy and Spain. On the other hand, given the scope of his study and the implications he would wish us to seriously consider, it is arguable that a more comprehensive assessment of the issue would also focus on the prospects for pillars 2 and 3, especially in those countries most at risk of a PAYG pensions melt-down. None the less, it is easy enough to agree with the author's contention that demographic ageing is likely to make the current configuration of many PAYG systems financially unsustainable: the issue is whether these systems can be made politically sustainable in the sense of attracting the support of a majority of voters.

One attractive aspect of this book is the author's realization that an ageing population need not mean that the whole of the electorate will be held hostage to the interests of a minority. Throughout, he is sensitive to the dynamics of political coalition formation, wherein older retirees seeking to maintain expected retirement income may form coalitions with other constituents who also have a large stake in the social welfare system. By this analysis, the losers from population ageing may still be the baby-boom generation and beyond if they are unable to forge such alliances; if they are able to do so, however, the losers may be middle-class working men and women whose tax rates (social security contributions) become so large as a proportion of their total real wage that they act as a disincentive to work. The only alternative, according to the author, is to increase the age at which a full benefit retirement income can be claimed from the state. The author uses the choice between higher contribution rates and a later retirement age to structure his analytical model and its associated simulations for six countries: France, Germany, Italy, Spain, the United Kingdom and the United States.

The book is organized into 11 chapters, beginning with an introduction to the issues followed by a survey of the countries' current PAYG systems, including reference to common characteristics such as the contribution rate, benefit formula, eligibility and official retirement age. Here, as in the separate chapters devoted to each of the countries studied (Chapters 5–10), the author seeks to explain the basic elements of each country-system without being confounded by their never-ending complexities and their attendant but barely mentioned deeply entrenched linkages to aspects of national welfare states. In the main, he succeeds in this task; I was familiar with many of the countries surveyed but none the less learned new things about each. Where the book sometimes falters is when the nature and process of PAYG reforms are described, oftentimes glossing over the scope of those reforms and the subtleties of parameter reforms. It is striking, in fact, that so few people understand their own systems, let alone the niceties of other systems. If experts find it hard to understand the logic and structure of current systems, and if it is difficult to grasp the consequences of overlapping and accumulative reforms, why should those affected be expected to understand and be able to mobilize politically to protect their own interests?

Chapters 3 and 4 take the reader through the literature on positive political economy, and the structure of the author's model. Here, Galasso argues that understanding the growth of the welfare state is not sufficient for understanding the prospects for retrenchment and benefit reform. He draws on the literature across the social sciences, with brief forays into the arguments about corporatism and interest group politics, arguing that his approach—via a simple majority voting model focused on the choice between higher contribution rates and a latter retirement age—can be an effective way of understanding the political sustainability or otherwise of each country's PAYG system. I had some doubts, especially considering that recent reforms have sought to discount the benefit value of those who are able to claim the maximum entitlement of each system. None the less, this approach reaps useful insights about the characteristics of each system and sharpens the debate over the prospects for each country (as is shown in the subsequent chapters).

Basically, the simulation model for each country allows the author to evaluate whether the choice is to be resolved in favour of contributions or the retirement age. Here it is interesting to note that there are differences between countries, with the prospects for Spain being identified as 'bleak' and the probable outcome for Italy being more interesting than most. As for the United Kingdom, a country in which the effects of demographic ageing are predicted to be relatively 'mild', it was found that an increase in the retirement age would mitigate against pressure for redistribution between generations, just as an increase in average levels of education attainment (a proxy for real income) would mitigate against the need for redistribution of income at retirement. Of course, equally important, just at the moment at least, has been the massive net immigration from Europe of relatively well educated workers. This option—the import of working people through higher rates of economic growth—is not considered by the author for any country but is clearly of (potentially) great significance for the sustainability of PAYG in the United Kingdom and the United States.

Finally, I wondered about two assumptions underpinning the author's model. First, why should we assume that older people will expect their own interests to be considered as important as the prospects for the well-being of those in work? After all, those working will be their children and grandchildren: why would they be so selfish as to deny them a better chance in life than they themselves might have had? If they are altruistic, this would suggest that the trade-off between contributions and the retirement age may not be as significant as the author assumes.

Second, might not the focus on PAYG social security be misleading, in the sense that those coming up to retirement in many countries will have already realized that their retirement incomes may not be as much as anticipated and may have scaled back their expectations (as a cohort), and will also have sought (on their own account) other forms of pension savings to compensate for the anticipated shortfalls. By this argument, the trade-off is not nearly as significant as the author assumes, just as the older population affected by a discounted PAYG pension may be much smaller than anticipated. If this scenario is plausible, then the prospects for political mobilization in order to protect an already discounted expected PAYG retirement income may not be realized.

In sum, this is an interesting book with an analytical logic and economy of argument that is very stimulating. It is a significant contribution to the literature.

University of Oxford GORDON L. CLARK

The Economy as an Evolving Complex System III: Current Perspectives and Future Directions. Edited by LAWRENCE E. BLUME and STEVEN N. DURLAUF. Oxford University Press, 2005. x + 377 pp. Paperback £23.99.

This book is the third in a series of books arising from conferences at Santa Fe beginning in 1988. It is well worth reading: its contributors are top-rate, and its value per page far exceeds that of just about any—even a high-ranking—economics journal.

The three volumes together convey a sense of how Santa Fe-type ideas have become integrated into the profession. The first of these was a grandiose two-volume set; the second was a bit smaller and less grandiose, and this third volume (and the first to be published by Oxford University Press) is a still smaller paperback, which in some ways is indistinguishable from the many other recent conference volumes on complexity-related topics. That indistinguishability is itself remarkable. Twenty years ago Santa Fe ideas and approaches were considered grandiose; now they are simply part and parcel of present-day economics. The seeds sown at Santa Fe have made, and continue to make, a difference in how economics is done.

The book consists of an introduction and 13 papers, which, loosely, can be organized into four groupings. The theme of the first three papers is that the rational-expectations close of the macro model does not make much sense: a meaningful close must include a stochastic learning process of heterogeneous agents. Among the macroeconomists I talk to (admittedly, a selected sample) this is not heresy, but simply a statement of reality. The papers explore how to deal with this reality. While there is no consensus that this work has arrived at a generally accepted alternative, the approach they take represents the future of macro theory.