

# The political economy of social security: a survey

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Received 1 October 2000; received in revised form 1 May 2001; accepted 1 May 2001

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## Abstract

This paper surveys the literature on the political economy of social security. We review models that address the following questions: (i) Why do social security programs that transfer resources from young and middle-aged workers to the elderly exist? (ii) What are the economic and political interactions between social security systems and other redistributive programs of the welfare state? (iii) How does political sustainability shape social security systems in a dynamic economic and demographic environment, and which social security reforms are politically feasible? We characterize this literature along two lines: economic factors and political institutions. We then assess the empirical relevance of the models by comparing their implications to stylized social security facts. © 2002 Elsevier Science B.V. All rights reserved.

*JEL classification:* H53; H55; D72

*Keywords:* Redistribution; Multidimensional voting; Political pressure; Political sustainability; Social security reforms

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## 1. Introduction

All developed countries have a social security system. An overwhelming majority of these systems is unfunded (or pay-as-you-go). The systems are financed through a payroll tax levied on current workers' labor income, and provide a pension benefit to retirees, i.e.,

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former workers, who have reached retirement age and have exited the labor market with an entitlement to an old-age pension.

The size of these unfunded social security systems has increased over the last few decades. In 1995, they absorbed 4.5% of GDP in the US, 13% in Italy, 16.5% in France, and over 20% in Sweden. There has been a wide body of literature on the economics of social security (see, among many others, Diamond, 1996; Gramlich, 1996). However, decisions on social security policy, from the initial design of the system to later modifications, go beyond economic theory into the realm of politics. Contributions to political campaigns, lobbying, votes of vested interest groups influence career-oriented policy-makers to sacrifice economic principles for political objectives.

This paper surveys the main contributions in the literature of political economy models of social security. We first review models that analyze the institution of the unfunded social security systems and their development into the most widespread instrument of social insurance. The challenge common to this line of research is to understand why there exist social security programs that transfer resources from young and middle-aged workers to the elderly. We highlight the empirical implications of the stylized models, and compare them to the social security “facts”, that emerge from the empirical literature. Many of the elderly political economy models used unidimensional voting models, and thus at most accounted for a single social security feature, typically the size of the system. This is a significant limitation, since social security systems are known to have several features.<sup>2</sup>

We then turn to a recent body of literature that applies multidimensional voting models to the analysis of social security systems. These models examine the interactions between social security and other redistributive programs of the welfare state, or among the different characteristics of the social security system. An insight of the multidimensional models is to recognize that the different programs of the welfare state may be economic and political complements or substitutes. These aspects are crucial in determining the size and composition of the welfare state.

Finally, we consider the theoretical contributions to the more heated topic of the current social security debate. We review the literature that studies the response of the current social security systems to changes in the economic and demographic scenario, and the models of social security reforms. In particular, we focus on the following questions: How does political sustainability shape the social security system in a dynamic economic and demographic environment? Which social security reforms would be politically feasible?

We characterize the political economy models of social security by political institutions and economic factors.

Agents' individual preferences over the social security system can be aggregated through several political mechanisms. The political institutions encountered in the literature in the case of a one-dimensional issue space can be classified in three broad

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<sup>2</sup> See Mulligan and Sala-i-Martin (1999b,c) for a review of the main characteristics of these systems around the world.

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