



Intergenerational risk shifting through social security and bailout politics

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Abstract

This paper adopts a stochastic overlapping generations framework to analyze the allocation of aggregate financial risks under different social security systems and a majority voting rule. We study whether there will be switches between pay-as-you-go (PAYG) and fully funded (FF) systems in such an economy. We show that in case of a negative aggregate shock, low-income young individuals will form a political coalition with the elderly to implement a PAYG system. PAYG scheme is shown to persist even after a good aggregate shock if the system is redistributive enough.

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1. Introduction

The design of old age insurance through social security and, in particular, through a pay-as-you-go (PAYG) system has been widely discussed since the ‘Beveridge Report’ was written in Britain during the second World War period (Beveridge, 1942). Recently, reform proposals regarding the social security systems are at the

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heart of the public policy debates in all the major industrialized countries. In most of these countries, aging of the population has led to higher costs associated with the PAYG systems. This financial burden has boosted the fraction of public opinion, policy makers, and economists that view a private alternative to the existing public arrangement not only as feasible but also as desirable.

Currently, almost all of the publicly defined benefit systems follow a PAYG scheme, that is, current benefits paid to the elderly are financed by current contributions from workers (and employers). The private system alternative is based on the simple idea that workers, instead of contributing to the PAYG retirement scheme, could put their savings in individually owned private accounts and withdraw these funds from the account when they reach the retirement age. In the rest of the paper, we will refer to this ‘individually funded’ alternative as the fully funded (FF) system. In many privatization plans, workers would be free to decide how to invest their own savings. The clear economic advantage of such a system is that individual accounts would allow workers to tailor their investment and saving decisions concerning their retirement funds to their degree of risk aversion. In a PAYG scheme, instead, workers are forced to accept the ‘portfolio allocation’, so to speak, of the public system.

A classic and recurrent argument in favor of the introduction of a private social security system claims that it could enhance the growth rate through the effect on the saving rate. In other words, a worker could obtain higher rates of return by managing his individual account and investing appropriately in securities. Geanakoplos et al. (1999), however, disagree with this ‘investment illusion’ and show that once the ‘legacy debt’ from the first generation of retirees is incorporated into the computations, a privatized system may not necessarily yield a higher rate of return in the U.S. Furthermore, higher rates of return would embed a higher risk. In fact, many of the central issues in the debate over reforms relate to uncertainty.

Proposals to privatize Social Security in the U.S. and to invest a portion of the Social Security Trust Fund in equities have drawn attention to the risk aspects of a reform.¹ Once uncertainty considerations are incorporated, the analysis of social security reforms becomes more complicated. This is because, even leaving aside the important efficiency considerations, risk-sharing issues naturally arise. A defined contribution system allocates risk in a very different way than a publicly financed defined benefit system does: a PAYG system has a fundamental advantage in this sense over a system of individual accounts. Its future benefits are backed by the government’s power to tax, which will be exerted if this is what the majority of voters want. Consequently the public system can spread the risk across different cohorts of the population, including future (unborn) workers. The risks associated with holding capital assets, instead, can be shared with others alive at the same time, but they cannot be shared with future generations. Under an FF system, each worker’s pension depends largely on how successful the individual investment decisions have

¹Lindbeck and Persson (2003) provide an extensive taxonomy of how alternative pension systems distribute various types of risk along several dimensions. See also Feldstein and Liebman (2002) for an overview of the discussion.

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