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Political complements in the welfare state: Health care and social security ☆

Carlos Bethencourt [a,b], Vincenzo Galasso [c,d,e,*]

[a] *Universidad La Laguna, Spain*
[b] *CAERP, Spain*
[c] *IGIER, Italy*
[d] *Università Bocconi, Italy*
[e] *CEPR, United Kingdom*

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Abstract

All OECD countries target a large majority of their welfare spending to the elderly, through public pensions and health care programs. Spending in both programs has largely increased in the past decades — often more than the share of elderly in the population. We suggest that these phenomena may be due to political complementarities between these two transfer programs. We show that these two programs may coexist, because public health care may increase the political constituency in favor of social security, and vice-versa. Specifically, public health decreases the absolute longevity differential between low and high-income individuals, therefore rising the retirement period and the total pension benefits of the former relatively to the latter. This effect increases the political support for social security among the low-income young. We show that in a political equilibrium of a two-dimensional majoritarian election, a voting majority of low-income young and retirees supports a large welfare state; the composition between public health and social security is determined by intermediate (median) income types, who favor the contemporaneous existence of these two programs, since public health increases their longevity enough to make social security more attractive. Technological improvements in health care strengthens this complementarity and lead to more welfare spending.

JEL classification: H53; H55; D72
Keywords: Intergenerational transfer; Endogenous longevity; Subgame perfect structure induced equilibrium

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* Corresponding author. IGIER, Università Bocconi, via Salasco 5, 20136, Milano, Italy. Tel.: +39 02 5836 5319; fax: +39 02 5836 3332.
E-mail addresses: cbethenc@ull.es (C. Bethencourt), vincenzo.galasso@uni-bocconi.it (V. Galasso).

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1. Introduction

In all OECD countries, the two major welfare state programs – public pensions and health care – target mainly the elderly. Unfunded pension systems use current contributions from the workers to finance current pension benefits to the retirees. Public health care programs may instead be financed through general taxation or earmarked labor taxes, but provide most of their benefits to the elderly. As a result, in the US, people aged 65 to 74 receive five times more benefits than individuals with less than 64 years (see Hagist and Kotlikoff, 2005). Similar, yet less extreme, patterns apply to other OECD countries. Furthermore, in the last few decades social security and public health care spending has dramatically increased in all developed economies. Aging has typically be identified as the major culprit of this spectacular raise in public spending, due to the increase in the share of beneficiary from these programs. Yet, social security and health care spending has often increased more than the share of elderly in the population, thereby suggesting that pension and health care benefits per each elderly individual have also increased.

Public provision of health care and pension transfers have traditionally been justified because of inefficiency in some relevant markets – such as annuity and private health care – due to asymmetric information. Recently, the health care literature has emphasized the relevance of technological progress, and the adoption of new, more expensive medical treatments (see Newhouse, 1992) to explain the raise in health spending. Yet, why are these new technologies so massively used in spite of their cost? In a recent paper, Hall and Jones (2004) argue that health care is a superior good: as individuals get richer they choose to spend a larger proportion of their income on health care. Policy-makers are thus merely adjusting public health spending to individual preferences. Analyzing the political support to social security and medicare, Bohn (1999) forecasts a further increase in spending driven by the change in the age profile of the electors. Galasso and Profeta (2004) concentrate on social security, and reach as similar conclusions: aging will lead to a further increase in the share of social security spending over GDP.[1]

This paper presents an additional explanation of the contemporaneous existence of these two large welfare state programs – health care and social security – mainly targeted to the elderly, based on a notion of political complementarity among welfare programs.

We show that more health care may increase the political constituency in favor of social security, and viceversa. There may be several channels of political complementarities, as one program may modify some relevant characteristics of the voters — thereby changing their preferences over the other welfare program. Here, we concentrate on how health care policies may affect the redistributiveness of social security.

The seed of this intuition was in Philipson and Becker (1998), who argued that social security induces the elderly to increase their private investment in health care, because the existence of an annuity – the old age pension – raises the value of longevity. Here, we identify a new link that goes from (public) health care to social security. Expenditure in public health care increases longevity in a non-linear way, since its effect tends to be larger among low-income individuals than among well-off people. However, richer individuals tend to live longer. Thus, for a given income distribution, expenditure in public health contributes to decrease the longevity differential between rich and poor individuals. As a result, the retirement period, and thus the total pension benefits, increases more for low-income than for high-income individuals, therefore rising the returns on social security for the low-income workers, as opposed to high-income ones.[2]

The main contribution of the paper is to show that, for a sensible – yet stylized – representation of the two separate programs, some political complementarity between social security and public health care emerges. This political complementarity justifies the use of two welfare programs to transfer resources to the elderly and helps to explain the large government spending in health care and social security. Social security and public health care are sustained as a politico-economic equilibrium outcome of a majoritarian voting game. A voting majority of low-income young and all retirees supports a large welfare state, as in Tabellini (2000) and in Conde-Ruiz and Galasso (2005). Its composition between public health care and social security is determined by intermediate (median) income types, who favor a combination of the two programs, since public health care increases their longevity enough to make social security more attractive. Additionally, we show that an improvement in the health care technology that increases the effectiveness of public health care in raising longevity strengthens this political complementarity and thus increases welfare spending.

[1] See Galasso (2006) for a detailed discussion of the political economy of social security.

[2] Borck (2003) also emphasizes the importance of the link between income and longevity in pension policy decisions.