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Public pensions, unemployment insurance, and growth

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Abstract

We develop an overlapping-generations model that highlights the interaction between an unfunded pension program and an unemployment insurance program in the presence of a labor market with union wage-setting. Both programs are financed by earmarked proportional wage taxes levied on firms and their employees. The equilibrium path entails endogenous growth and involuntary unemployment. The presence of spillovers between pension programs and unemployment insurance programs has striking implications for growth policy, efficiency issues, and the transition to a fully-funded pension system. © 2000 Elsevier Science S.A. All rights reserved.

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1. Introduction

Plagued by high unemployment rates and slow economic growth, several European countries have started re-examining the role of their extensive social security system in this state of affairs as well as looking for suitable reforms in major branches of it. The current paper contributes to these efforts by offering a model of the social security system that incorporates some important institutional

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features of European welfare states and labor markets. Thereby it provides an analytic framework in which relevant policy issues are addressed.

We develop an overlapping-generations model with endogenous growth that highlights the interaction between public pensions and unemployment insurance programs in the presence of a labor market with union wage-setting. Hereafter we refer to the combination of public pensions and unemployment insurance programs as the social security system (SSS) of the economy. As a first step, the pension system, in the form of the pay-as-you-go (PAYG) system, is modeled as a merely intergenerational redistributive device, whereas the unemployment insurance is modeled as an intragenerational redistributive device. Each program is supposed to be financed by earmarked proportional wage taxes paid by both firms and their employees.

In our framework a number of clear-cut results can be obtained. First, the contribution rates to the SSS, by firms as well as by workers, are shown to have no influence on the level and path of the unemployment rate in the economy. This result parallels the type of results obtained in static models of unionized labor markets and imperfectly competitive product markets, in which the unemployment benefit is proportional to earnings (e.g. Malcomson and Sartor, 1987; Lockwood and Manning, 1993; Corneo, 1994). From an empirical viewpoint, the long-run employment neutrality of proportional payroll taxes has received some supportive econometric evidence by Cotis and Loufir (1990) for France and by Padoa-Schioppa (1990) for Italy.¹

Second, the contribution rates to the SSS are shown to exert growth effects, which are negative for the contributions to the pension system and positive for those paid to the unemployment insurance. The result about a possible negative influence of the PAYG system on long-run growth has already been put forward in some former studies, e.g. Saint-Paul (1992). The empirical magnitude of this effect is the object of much debate. The finding that the unemployment insurance is beneficial for growth is, to the best of our knowledge, a new one.

Third, we consider the possibility of a Pareto-improving reform of the pension system, from an unfunded to a fully-funded system. We take as our starting point the proposal made by Belan et al. (1998) for full-employment economies. We show that there is a suitable modification of this proposal which makes an efficient transition possible for economies with equilibrium unemployment.

Fourth, we shed light on the issue of the optimal formal incidence of contributions, i.e. whether workers or firms should finance the SSS. We establish that there is no financing method that dominates another one on pure efficiency grounds. Thus, any change of contribution rates adversely affects at least one

¹The theoretical literature quoted above has also analyzed the role of tax progressivity and pointed out the beneficial employment effects of increases in the marginal rate of income tax within static models. By contrast, the present paper studies the implications of earmarking proportional wage taxes to the social security system in a dynamic general equilibrium setting.

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