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Political Equilibria with Social Security[1]

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We model pay-as-you-go social security systems as the outcome of majority voting within a overlapping generations model with production. When voting, individuals make two choices, pay the elderly their pensions or default, which amount to promise themselves next period. Under general circumstances, there exist equilibria where pensions are voted into existence and maintained. Our analysis uncovers two reasons for this. The traditional one relies on intergenerational trade and occurs at inefficient equilibria. A second reason relies on the monopoly power of the median voter. It occurs when a reduction in current saving induces a large enough increase in future return on capital to compensate for the negative effect of the tax. We characterize the steady state and dynamic properties of these equilibria and study their welfare properties. *Journal of Economic Literature* Classification Numbers: C72, C78, © 2000 Academic Press

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1. INTRODUCTION

We are aging, and this may be more than just our personal and unavoidable experience. Indeed around the world, and particularly in the

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most advanced countries, the average citizen is becoming older. A sharp increase in the population's proportion of elderly and retired individuals has occurred in the last 20 years. An even more drastic shift in the same direction will take place in the near future, should the current demographic trends continue. At the same time, the growth rate of labor productivity has begun to decrease.

These two phenomena compound into a drastic drop in the growth rate of the total wage bill. This has caused the political debate to move from the previous concentration on expanding the social security system to concerns about the future viability of the system itself. Substantial reforms have already been implemented in some countries (Chile, Argentina, Mexico, Sweden, and Italy) or are being proposed and starting to be implemented elsewhere. It is very likely that in the next 20 years similar phenomena will spread around the globe and that we will be facing the necessity to introduce drastic modifications in the way in which our social security systems (SSS) are organized and run.

Evaluating the social and economic impact of these predictions requires more than an examination of the demographic assumption from which they are derived. It also requires an understanding of the process of collective decision making through which social security systems are shaped and managed.

In the literature one can find a variety of different explanations for why social security systems have been introduced (e.g., Becker and Murphy, 1988; Diamond, 1977; Kotlikoff, 1987; Lazear, 1979; Merton, 1983; Sala-i-Martin, 1992, to name but just a few). They seem to concentrate around the idea that public pension systems are efficiency enhancing, either because of the overaccumulation of capital that would occur without them, or because they provide for efficient risk-sharing in the presence of incomplete annuities markets and adverse selection, or because they are a way around the lack of efficient intergenerational credit markets, or because they help reducing global externalities.

While we find many of these motivations compelling, we believe a clearer theoretical understanding of the nature of modern social security systems requires an explicit consideration of three simultaneous features. Public pension systems redistribute wealth intergenerationally, they are implemented sequentially by each generation, and they are sustained by the consensus of the majority of the working-age population. This is particularly true for pay-as-you-go (PAYG) systems (as opposed to fully funded ones), which are currently the rule in almost all advanced countries.

We are far from being the first to claim that PAYG SSSs redistribute income between generations. This was made clear by Edgar Browning a while ago with two important articles (Browning, 1973, 1975). He also

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