1 Introduction

When I think about economic policy, I draw on my understanding of economic theory. Indeed, I draw on it in two distinct ways. First is the general underpinning of economic analyses that influences how economists approach questions generally. This underpinning includes both respect for the importance of incentives and awareness of the constraints that inhere in the notion of equilibrium. While these underpinnings are widespread among economists, my particular perspective also includes a large dose of second-best welfare economics, which is not so widely shared, particularly outside public economics. Second, when I think about specific policy design issues, I draw on models meant to illuminate specific economic forces that seem likely to be important for the questions at hand. This book is meant to illustrate how I approach some social security policy questions.

The book contains three very distinct types of chapters; introductions to parts of economic theory generally underpinning my approach, analyses of several formal models, and a discussion of some issues directly relevant for policymaking. I have tried to make each chapter self-contained even though they hang together overall.

Chapters 2 and 5 discuss critical general underpinnings for my thinking. Chapter 2 is an introduction to optimal income taxation, an introduction that is highly relevant since I analyze social security as a particular example of the approach of optimal taxation. While the chapter contains equations, the equations allow me to be specific about the models being discussed, rather than being bases for analytical reasoning. Chapter 5 discusses the incompleteness of markets (and contains no equations). These two chapters encompass two of the central underpinnings of my thinking about social security (which also reflects the inadequacy of individual savings decisions (Diamond 1977)). Chapter 2 highlights the impossibility of designing social security systems that do not have economic distortions. The goal, central to public finance analysis, is to portray the balance between distortions on one hand and providing insurance and raising and redistributing revenue on the other. Chapter 5 starts with the widely held awareness of economists who study insurance markets that these markets are very incomplete. This is in sharp contrast with, for example, many finance economists who study asset pricing while relying on an assumption of complete markets. Complete markets may (or may not) be an adequate basis for thinking about the prices of widely traded assets in organized markets. But complete markets do not seem an adequate basis for thinking about individual outcomes for workers, particularly for the large mass of families who have limited financial assets as they go through their life cycles.

Chapters 3, 4, 6, and 7 are totally different in style and intent. They contain models and analyses meant to illuminate particular facets of social security policy. While highlighting one issue, each of these models excludes

other issues that also matter for social security policy. These simplifications are not meant to diminish the importance of omitted issues, but just to make progress in understanding by focusing on one issue at a time. Chapter 3 extends the widely studied one-period optimal income tax model to a two-period setting, one of work and one of retirement. Two questions are explored. One is the extent to which one wants to tax or subsidize savings, rather than relying on taxation (and retirement benefits) based solely on earnings. Second is the question of how the relative distribution of consumption among the elderly should differ from that when the elderly were young workers. That is, what pattern of consumption-replacement rates would occur at an optimum of this sort of model? Chapter 4 also considers this latter question. But it does so in a significantly changed environment—with an assumption that the labor supply decisions of the young are myopic, ignoring the effects of their current efforts on the retirement benefits they will receive when they are older. The two chapters together illustrate the effect on optimal policy of a change from assuming fully rational, forward-looking, time-consistent workers to assuming myopic, time-inconsistent ones.

Chapters 3 and 4 use models of varying skills, without variation in the length of working life. In contrast, chapters 6 and 7 consider why workers retire at different ages and how these underlying reasons should affect the incentives for retirement. This is analyzed in models where workers do not differ in their skills. Chapter 6 focuses on differences in the disutility of labor, while chapter 7 adds variation in the length of expected life. Both chapters find a role for positive implicit taxation of continued work beyond the age of earliest eligibility for

retirement benefits. And both find that the return to continued work should happen not just in larger future benefits, but also in larger net pay while continuing to work.

In contrast with these discussions of underlying theory, chapter 8 is a discussion of issues directly relevant for policymaking, with a focus on issues of general interest that were of particular importance in Germany when I delivered these lectures in November 2000. As a public lecture, it is self-contained and math-free, in fact very close to the version originally presented.

Chapter 9 is a coda, discussing some issues in the relationship between economic theory and policy analysis. The discussion highlights the attention economists pay to incentives and their effects and the awareness of economists of general equilibrium and its constraints. The chapter also touches on political economy.