

**COMMENTS ON SESSION III:  
PUBLIC DEBT, AGEING AND FISCAL SUSTAINABILITY**

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All of the authors in this panel are to be complimented for providing well researched and thought provoking papers. This panel contains four papers on country studies, one paper on the saving effects of tax-favored saving plans, one paper on dynamic deficit impulses, and one on the policy implications of fiscal imbalances. The last paper by Charles Steindel extensively refers to my paper with Kent Smetters (published in this volume as the last one of the first session). Hence, much of the discussion is devoted to addressing the issues raised by Dr. Steindel. I also discuss the papers on deficit dynamics by Köhler-Töglhofer and Zagler, and the paper on tax-favored saving by Antolín, de Serres and de la Maisonnette.

The question posed by Steindel's paper is: "Is there evidence of a connection between the prospect of future rapid debt growth arising from entitlement payments and higher current levels of consumption (and reductions in saving and capital formation)?"

The argument is constructed as follows: if economic agents anticipate more in public retirement and health care benefits than their cumulative payroll tax payments, they would consume more today, eroding saving and capital formation. This would reduce the economy's output potential and the ability to continue paying benefits in the future. In turn, this could trigger entitlement reforms to reduce future debt. Steindel remarks that the standard tax-smoothing argument justifies an earlier implementation of fiscal reforms. However, he argues, if there is no evidence of a positive link between high anticipated debt and high current consumption, reforms will not release investible resources at the margin, detracting from their urgency.

Steindel notes, correctly, that mere existence of a large fiscal imbalance alone is not sufficient to trigger a change in current consumption-saving behavior. Economic agents' expectations about how and when the imbalance will be resolved matter as well. Steindel examines whether past policy changes that presumably induced large changes in the federal fiscal imbalance prompted large changes in aggregate U.S. consumption. He finds that although prospective Social Security benefits were increased substantially in 1972, the share of consumption in GDP showed no change. Social Security reform in 1983, when future benefits were retrenched significantly, was also not associated with a large decline in the consumption-to-GDP ratio.

Although I agree with Steindel's reasoning, I find his methodology questionable and therefore, disagree with his conclusions. First, a closer examination of the precise sequence of events suggests that the absence of a correlation between

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aggregate consumption and the two fiscal policy episodes cited by Steindel is not surprising. As already noted, expectations about how credible or permanent those policy changes are, would also affect agents' consumption behavior. During the 1972 Social Security episode, benefits were increased immediately by 20 per cent but the indexation of benefits to inflation – which was *the* major element of that legislation – was not to become operative until after 1975. Inflation, however, increased soon after 1972 and was running at an annual rate of almost 10 per cent by 1974, quarter II. Hence, prior to 1974, inflation indexation of benefits was not in effect and high inflation was continuing to erode real benefits. Hence, the announced policy of indexation may not have been credible prior to 1974 and the fact that total consumption was not stimulated immediately after the law was changed is not surprising.

The opposite change in Social Security benefits was enacted in 1983: benefits were made subject to income taxes, the normal retirement age was increased, and payroll taxes were hiked. However, the benefit cut did not undo the ongoing resource transfers toward the elderly. Indeed, immediate hike in payroll taxes on employers and employees – which rose from 11.4 per cent in 1980 to 12.4 per cent in 1983 in two steps – probably confirmed that such transfers would continue. In addition, the increase in normal retirement age was not to commence for two more decades, diluting any effect on current consumption. Hence, again, the absence of a contemporaneous consumption effect is not remarkable.

Steindel also suggests, correctly, that to properly analyse these questions, one should focus on the responses of different age cohorts to large changes in government programs. However, he incorrectly reports the lack of appropriate data sources. I coauthored two studies some years ago which implements precisely the cohort-based approach that Steindel suggests (Gokhale, Kotlikoff and Sabelhaus, 1996, and Auerbach, Gokhale, Kotlikoff, Sabelhaus and Weil, 2001).

These studies show that over longer horizons, fiscal policy's differential tax treatment of cohorts affects their consumption in the expected direction. Specifically, they show that:

- a) the cross-cohort distribution of consumption is strongly dependent on the cross-cohort distribution of resources;
- b) the theoretical prediction that the propensity to consume out of resources rises with age is confirmed by the data;
- c) the secular decline in U.S. national saving coincides with a significant, secular increase in the lifetime resources available to current retirees relative to those available to younger workers;<sup>1</sup>

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<sup>1</sup> A cohort's resources are measured as the sum of its human wealth (present value of future earnings), non-human wealth (financial and non-financial assets including cash value of life insurance and balances in defined contribution retirement accounts), pension wealth (present values of private-sector defined benefit pension benefits), and their generational account – the present value of prospective taxes net of transfers *vis-à-vis* federal and state governments.

- d) that most of this resource transfer toward the elderly can be traced to growth in Social Security and Medicare.

This transfer occurs in two ways:

- i) directly by providing retirees more by way of benefits than their past payroll tax contributions and
- ii) via the forced annuitization of benefits which, by insuring retirees against outliving their resources, enables them to consume at a faster rate and reduces involuntary bequests.

The study also confirms that retirees have not undone their forced annuitization of resources via Social Security and Medicare by increasing their purchases of life insurance.

Other studies that are also relevant are those by Altonji *et al.* (1992, 1997) and Hayashi *et al.* (1996). These studies suggest that the distribution of intra-extended-family consumption follows the distribution of intra-extended-family income and that a transfer of resources from children to parents prompts a very small reverse private transfer. Given that a positive fiscal imbalance implies operative public transfers from younger workers and future generations toward retirees, these studies imply that much of the resources transferred toward the elderly would be consumed rather than saved and bequeathed to their children and grandchildren.

To me, these studies constitute more substantial and credible evidence favoring the hypothesis that the current generational stance of U.S. fiscal policy provides dependable resource transfers toward retirees and prompts higher consumption. This evidence appears more credible to me than the casual empirical correlations of aggregate U.S. consumption offered in the paper.

Based on the literature, I draw the following conclusions: a large fiscal imbalance implies an ongoing transfer toward current generations, especially retirees. Credibility that the current generational stance of fiscal policy will be maintained appears to be quite high: witness the recent passage of a Medicare prescription drug benefit in the United States that substantially increases the government's commitment to make such transfers. Large and credible transfers induce more consumption by the cohorts that receive them and, all else equal, reduces national saving. Hence, reforms that terminate such transfers would stem the decline in national saving and a larger share of U.S. domestic investment would be financed out of domestic saving. Output growth may be faster and more of it would be preserved for use by U.S. citizens. Although the standard tax smoothing argument suffices for justifying an earlier correction of fiscal imbalances, the likely positive impact of such reforms on national saving implies they should be implemented immediately.

The paper by Köhler-Töglhofer and Zagler on dynamic deficit and debt impulses builds on the literature developed after Alesina and Perotti's (1995) study on the same topic. The idea is to decompose debt expansions and contractions according to their driving components – whether taxes or expenditures, whether on

pensions, health care, government consumption or investment, etc. to identify changes that lead to sustained vs. temporary debt reductions, and long-lasting versus fleeting debt expansions.

This paper focuses on the impact of a current debt reduction or increase on future debt levels. It is not directly concerned with the impact of current debt change and the manner of its achievement on real economic variables. This is a significant omission because of the well known result that there is no necessary one-to-one relationship between explicit debt impulses and real economic outcomes. A simple policy change whereby both taxes and outlays are increased equally in all future periods could alter real economic outcomes but also leave the levels of annual deficits and debt unchanged.<sup>2</sup> The most well known applications of this type of policy are pay-as-you-go pension programs – used by many countries. However, tax funded welfare programs qualify as well if, over the long haul, their revenues and outlays balance out in present value. All that's needed to associate a given set of deficit and debt series with different real outcomes is to use the government as a redistributive agent – to reallocate resources among population sub-groups with different propensities to consume out of their resources.

The converse is also true: a given time path of real economic outcomes could be associated with several different debt and deficit impulses. For example, Smetters (2001) shows that government investment in private assets (setting up enterprises that are partly publicly and partly privately owned with a variable share of public ownership, or investing pension fund surpluses in private securities) can deliver this result. It occurs because government ownership of private sector securities is an alternative to capital income taxation, which also gives the government a “stake” in private sector profits. In such a regime, the government could increase its investment in private securities and simultaneously impose a symmetric cut capital income taxes (that results in lower revenue when capital income is positive and provides a smaller credit against capital losses).

The initial purchase of private securities would be balanced by the initial outlay on that purchase leaving the initial net debt unchanged. The reduced capital income taxes, however, would register as changes in future deficits and debt levels. Smetters (2001) demonstrates that this policy change could be designed such that every current and future private agent remains in exactly the same real economic position – implying that the government also remains in exactly the same real economic position. Hence, there will be no change in real economic outcomes. It is important to note that this result holds in a fully specified Arrow-Debreu world, including the case where some agents are borrowing constrained.

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<sup>2</sup> This is not strictly true because post-policy changes in real economic outcomes will have a second-order impact on future outlays and revenues. However, marginal adjustments to outlays and revenues could be made to hold deficit and debt levels equal to those projected without the policy change. Despite these adjustments, real economic outcomes would be different from those projected to occur without the policy change.

These observations compel the conclusion that deficit and debt impulses are neither necessary nor sufficient as measures of the real impact of fiscal policies on the economy. Hence, assessing the impact of various components of government spending and taxes on future debt levels and their sustainability appears to be an uninformative exercise since, ultimately, we really care about real outcomes and not the time paths of explicit debt and deficits. To capture the argument in a nutshell, examining the impact of various types of policies on explicit debt and deficits are insufficient. Implicit debt levels could be changed independently and could influence real economic outcomes.

The paper by Antolín, de Serres and de la Maisonneuve investigates the impact of tax-favored plans on saving. There is a long standing debate about how much net new saving tax-favored saving plans generate. This debate remains in a stalemate (at least in the U.S) and disagreements continue to erupt on occasion about the impact of specific tax-saving plan proposals. Recently, the focus has been on the future revenue impact of tax-favored saving plans. Boskin's (2003) suggests that the asset accumulations in such plans would spur future U.S. federal tax revenues on account of both, future account withdrawals and higher corporate and personal capital income taxes. However, Auerbach, Gale, and Orzag (2003) suggest that the revenue impact would be modest.

The current paper implements a detailed analysis to estimate the net revenue impact of tax-saving incentive plans in 17 OECD countries. The revenue impact depends on several factors: the differences in tax rates during contribution and withdrawal phases, the marginal tax rates that would be applicable during the accrual phase were accruals subject to taxation, and the extent of new saving spurred by the plans.

The authors' successfully undertake a massive task in analyzing tax incentive plans' fiscal impacts for 17 OECD countries. To do so they must calibrate and project values of key determinants of contributions and withdrawals – the number of participants, initial assets, earnings, contribution rates, income accruals, and withdrawals. Also, they must make assumptions about average marginal tax rates applicable today and in the future on contributions (to estimate lost revenues due to plan participation), income accruals on plan assets, and on withdrawals.

The authors' implementation probably cannot be improved upon, given the limited sources of information on each country's economy, demographics, and plan performance to date. The authors take great pains to achieve accurate estimates – especially with regard to lost revenues on income accruals within tax-favored accumulations.

The authors main results are that most countries face significant tax losses as a result of offering tax-saving incentive plans. These losses would be mitigated if introducing tax-favored plans generated net new saving. However, how much new savings are generated is not easy to estimate. To the extent that such schemes are mostly utilized by upper-income individuals, the likelihood of generating new savings remains low.

One avenue for more accurate estimates not considered in the paper is the possibility of tax interactions. For example, in the United States, larger taxable withdrawals from tax-favored accounts could potentially expose a larger amount of retirees' Social Security benefits to income taxation. Such interactions could magnify (or reduce, depending on the type of interaction) the fiscal impact of such plans over the next two decades as large cohorts of baby-boomers, who own substantial tax-favored assets, retire and begin to draw their Social Security benefits.

Second, the exercise assumes that current fiscal policies will continue indefinitely. However, it is well known that the fiscal policies of many OECD economies are unsustainable. All countries with unsustainable fiscal policies must soon begin to adjust them to bring future outlays and revenues back toward balance. If these adjustments involve higher future income taxes, they will reap much larger revenues than those estimated by the authors. Any future income tax hikes will essentially be "non-distortionary" *vis-à-vis* the asset accumulations: once accumulated, the assets cannot be rapidly decumulated to avoid the new higher tax rates. Hence, the size of country-specific "fiscal assets" could be considerably understated. Notwithstanding these observations, the authors are to be commended for a significant contribution to the literature on the revenue effects of tax-favored saving plans.

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