# COMMENTS ON SESSION 2
# SUSTAINABILITY ASSESSMENT AND POLICY IMPLICATIONS

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I would like to thank Daniele Franco and Banca d'Italia for inviting me to this milestone 10th Public Finance Workshop in Perugia. Long-term fiscal sustainability is a pressing public policy issue that deserves discussion and debate to evaluate potential solutions. The organizers should be commended for picking such an important topic for this year's Public Finance Workshop. All the presentations so far have been very insightful and interesting. I will be commenting on the last two papers presented in this session. The first one is on generational accounting for Italy and the second is on the long-term sustainability of public finance in Japan.

The paper by Rizza and Tommasino represents an interesting application of generational accounting for Italy with the objective of providing a current assessment of the Italian public finances based on generational accounting methodology. The paper begins with a good description of the generational accounting methodology. Similar to other country experiences, the rapidly-aging population is challenging the viability of Italy's pension-centered welfare state.

Generational accounting provides a comprehensive framework for undertaking long-term fiscal planning and analysis by considering how much current and future generations will have to pay in net taxes (taxes net of transfer payments) over time, to pay for the government's current and future spending, all in present value terms. This framework also identifies the changes in fiscal policies needed to alter the distribution of intertemporal burdens to promote generational equity.[1] The Rizza and Tommasino paper computes two indicators using the generational accounts – the intertemporal budget gap (IBG) and the generational balance gap (GBG) – to shed light on the extent of the fiscal adjustment needed to achieve generational balance. The paper does a good job of summarizing the history of generational accounting in Italy and the major developments in the Italian public finance policies and outcomes since the early nineties, including a discussion of the problematic legacy of the previous consolidation process, which consisted of several pension reforms in Italy. The paper provides a good backdrop as to why a new look to the country's generational accounts is important, especially after Italy was admitted to join the European Monetary Union in 1998, which led to changing goals of Italian budgetary policy.

Due to time constraint, I will not be discussing the general limitations associated with generational accounting[2] such as the difficulty of computing the present value of government revenues and its obligations over time due to future uncertainty. As noted in the writings on the subject,[3] computations are based on highly sensitive assumptions regarding variables such as the discount rate and the growth rate of labor productivity while holding policies constant. As noted in the paper, if a different discount rate is used (5 per cent instead of 3 per cent) in conjunction with the baseline labor productivity growth of 1.5 per cent, the IBG is projected to increase from 179 to

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The views expressed are personal comments and do not necessarily represent the views of the New Jersey Department of Treasury or the National Tax Association Taxation.

[1] Refer to Auerbach, A.J., J. Gokhale and L.J. Kotlikoff (1991), "Generational Accounts: A Meaningful Alternative to Deficit Accounting", in D. Bradford (ed.), *Tax Policy and the Economy*, Cambridge (MA), MIT Press for the National Bureau of Economic Research.

[2] For a summary of issues with generational accounting see The Tax Policy Center (2007), *The Tax Policy Briefing Book*, The Urban Institute and Brookings Institution, Washington (D.C.).

[3] See *The Tax Policy Briefing Book*.

242 per cent of GDP. I will instead point out certain issues specific to the paper and provide a few suggestions.

The Rizza and Tommasino paper focuses primarily on three spending programs: education, health care and social security, which account for two thirds of the current primary expenditure but the remaining third is not assigned to any particular age cohort. As noted in the paper, the intergenerational gap between newborns and future generations would depend on the selected allocation strategy of these expenditures. It may be useful to extend the analysis to include these spending items to get a more complete measure of generational accounts.

Some explanation of why the period through 2050 is being considered would be helpful. It would be interesting to know how the results may change if, say, a longer time horizon is considered.

In the construction of old-age pension and social contribution profiles, the authors model entry into the labor market at age twenty-five and continuous employment is assumed till retirement. This assumption seems rather simplistic as it is unable to account for other labor force participation scenarios, including: (a) younger entrants (below age 25); (b) interim periods of unemployment; (c) temporary "out-of-job" situations such as during job switching, maternity and child care, temporary disabilities, or for the pursuit of higher education. Also, it is not clear if the assumption regarding retirees can be relaxed in the model to incorporate post-retirement participation in the labor force.

Rizza and Tommasino correctly point out that the sole focus on debt can be highly misleading in assessing a government's generational policy. They suggest exploring other policy measures such as restraining the growth of current primary expenditure to reduce the intergenerational imbalance. Their analysis of reform options concentrates primarily on expenditure reduction policies of both age- and non-age-related spending. The discussion highlighting how such reductions can be generated (through, say, administrative or management reform, technological advancement and other factors) would be useful to policy makers. It is also important to examine the issues relating to tax expenditures vs. direct government spending to understand the future impact of current government policies in the context of the generational accounting framework. The emphasis should be on constraining real public spending, a point not made clear in the section on reform options.

The paper needs to consider reform options on the revenue side as well, by explicitly considering tax reform measures. Given the large size of the underground economy in Italy, it would be beneficial to explore compliance and enforcement reform options to reduce tax gaps. Tax base modernization efforts to address issues of tax base erosion due to technological and other structural changes is also essential. It is important to note that the revenue side composition and distribution has clear implications in the general accounting context in terms of how it could change the generational gap between newborns and future generations. The brief discussion of switching from decreasing social security contributions by 10 per cent to balancing by increasing the VAT rate by 12 percentage points illustrates this point (a switch to VAT, as noted by the authors, tends to improve the generational accounts of currently living young and middle-age generations as compared to the old-age population).

Regardless of what reform options are being considered to address "… the crucial challenge of Italy's public finances of simultaneously bringing down the debt ratio and reducing the fiscal burden on the economy", the intergenerational trade-offs and tough policy choices that need to be made today to ensure long-term fiscal sustainability should be spelt out clearly. For the policy maker it would be helpful to know if certain tax or revenue structures make it more vulnerable to economic cycles. Similarly, a discussion of such characteristics for major expenditure items would also be helpful.

The problems associated with long-range predictions due to uncertainty and sensitivity to assumptions are well known, including some technical problems related to generational accounts, but it would be useful to have a discussion of alternative measures in the Italian context. The paper is successful in identifying areas of further research after reviewing some of the limiting assumptions that were used, such as assuming that the age distribution of Italian population reaches a steady state by 2050. Using detailed consumption data for the construction of relative age profiles for indirect taxes, providing a more detailed breakdown under the pension simulation model and using consistent macroeconomic scenarios are steps in the right direction. In addition, it would be useful to extend the analysis to account for spatial differences in fiscal characteristics on generational equity.

The paper by Oshika and Shibasaki offers a good review of Japan's current fiscal position as compared to other countries. Japan's fiscal condition has worsened and the most rapidly aging population is contributing to exacerbate fiscal stress in Japan. The paper lays out major factors that have contributed to the increase in general bonds outstanding, including both expenditure side and revenue side factors. Following the discussion of Japan's fiscal problems, the authors examine various options to address the issues concerning the long-term fiscal sustainability. Like Italy and other nations, Japan faces fiscal challenges due to the accelerated aging of its population. For instance, the ratio of people above age 65 to total population is expected to increase in Japan at the fastest pace; this ratio nearly increased five-fold since 1965, from single to a double-digit ratio of 30.5 in 2025 and is expected to keep growing through the projection period.

The paper includes a good chart showing the forecasts for social security benefits through FY2025 and the distribution by major program categories. Overall, social security benefits are expected to increase by 56.7 per cent (1.6 times or by 50 trillion yen), while national income is projected to grow at 43.6 per cent (1.4 times). Welfare and long-term care represent the fastest growing component, but together they account for below one-tenth of the national income in FY2025. Although pension accounts for a larger share of national income, medical care is projected to grow at a much steeper pace.

The paper provides a detailed road map and targets for fiscal consolidation and summarizes the 2006 basic policies for economic and fiscal management and structural reform by distinct phases. After making efforts to advance fiscal consolidation under the concept of the integrated reform of the economy and public finance (phase I), the goal is to achieve surplus in primary balance as a first step toward fiscal consolidation (phase II) and finally decrease the debt-to-GDP ratio at a steady pace along with ensuring the surplus in the primary balance of the central and local governments (phase III). There is a detailed breakdown of expenditure reductions slated for FY2011 with the biggest reductions in public investments and other non-social security and personnel-related expenses. The paper provides a discussion of central and local government interactions and highlights the relationship of these two levels of government in the ratio of primary balance to GDP. Some additional details would be helpful while discussing intergovernmental relationships to improve primary balance conditions.

In the long-term fiscal projections section, the analysis provides a comparison between two alternative scenarios. Under one alternative, the focus is on the sustainability of public finance and determining the size of adjustment, one-time and permanent adjustments required at the present time to reach the targeted 60 per cent of GDP ratio in FY2050. In contrast, the second alternative considers multiple options of social security benefits and tax burdens. Unlike the first one, the accumulated annual tax increase to FY2025 is computed as the adjustment required to maintain the debt-to-GDP ratio compared to FY2011.

The Oshika and Shibasaki paper discusses the underlying assumptions relating to nominal GDP growth rate, nominal long-term interest rate and inflation rates under two particular cases. It would be helpful to clearly discuss why the rates fall after 2011 and why the rates are higher under Case 2 for the year 2012 and beyond. In addition to the baseline, a mid-term scenario is explored and the sustainability gap calculations are presented for the high- and low-growth scenarios.

A detailed discussion of underlying assumptions and results under alternative policy scenarios – current benefit scenario and benefit reduction scenario – are presented for both the low- and high-growth assumptions. I found the following results to be very interesting: the primary balance improvement as share of GDP is the highest (4.6 per cent) under the low-growth current benefit scenario while the same is the lowest (1.5 per cent) under the high-growth assumption under the benefit-reduction scenario. It would be useful to discuss the main results in a user-friendly manner. A clearer and more detailed explanation of the numeric results relating to the sustainability gap calculations would be beneficial to the policy makers.

The analysis implies that Japan should aim at decreasing the debt-to-GDP ratio and aim to achieve fiscal balance, following the EU countries' example, at the earliest possible. In addition, the paper indicates that a rise in taxes is inevitable. Their results suggest that if we can achieve high rates of GDP growth, the size of adjustment would be significantly smaller.

An interesting conclusion for Japan is that the historically high level of the debt-to-GDP ratio does not necessarily imply that sustainability problems will arise in the near future, due to the high levels of domestic savings and the continued current account surpluses. The paper suggests that there is no consensus on the definition of what a sustainable fiscal position means and it would tend to vary depending on the specific circumstance of each country. The authors suggest adopting a step-by-step approach with a goal of steady advancement by establishing a mid-term objective scenario with periodic reevaluations. They indicate the need for long-term commitment and strong efforts of the government to lower the costs. Finally, I agree with the authors that it is important to consider economic growth and fiscal policy in their totality.

To address the obstacles to fiscal consolidation in Japan, I would like to suggest that efforts be made to educate the public about the gravity of the fiscal crisis and how it is likely to grow beyond repair if immediate attention is not paid to the issues of fiscal imbalance and long-term fiscal sustainability. The "Fiscal Wake-up Tour" undertaken by David Walker[4] of the Peter G. Peterson Institute to educate the American public about the hard choices and economic sacrifices that need to be made now to save the nation's future may be a model for the Japanese policy makers to consider.

## Conclusion

There is no simple solution to attaining fairness in the intergenerational distribution of net tax burden and trade-offs need to be recognized explicitly.

One can't agree more with the authors that more work needs to be done and generational accounting should be used with other measures. The problems associated with long-range

4 David Walker, the President and CEO of the Peter G. Peterson Institute, and Concord Coalition are trying to educate the American public about public debt burden and how tough economic choices need to be made now to save the nation's future.

predictions due to uncertainty and sensitivity to assumptions were pointed out earlier, including some technical problems related to generational accounts, but it would be useful to have a discussion of alternative measures in the Italian context.[5] I don't know how much complexity would be introduced but it would be useful to extend the analysis to incorporate the impact of spatial differences in fiscal and economic circumstances. For instance, in the second paper it was reported that the frustration among the Japanese people is intensifying because the recent economic recovery has been limited to specific regions, specific industries and specific income brackets.

I would like to recommend the analysis in both papers be extended to consider inter linkages between changes in the real economy and changes in the financial markets;[6] linkages between national economy and global economy; and linkages between national economic policies and international macroeconomic and financial developments. The analysis should be extended to discuss the role of timely and targeted fiscal stimuli and stable and supportive monetary policy and examine the role of the International Monetary Fund and the World Bank in helping countries out of fiscal crises; explore the role of cooperative efforts in the area of tax administration and enforcement to enhance the fiscal situation. Another suggestion would be to conduct future work to study how structural breaks may impact generational and other types of long-term accounting. It is very important to examine the role of rainy day funds or other contingency funds in the context of long-term fiscal planning and analysis. It is important to incorporate a clear discussion of underlying policy trade-offs and indicate the tough sacrifices we may have to make in addressing the problem of fiscal imbalance, achieving long-term fiscal sustainability and addressing intergenerational equity.

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[5] Goode, R., and C.E. Steuerle, "Generational Accounts and Fiscal Policy", *Tax Notes*, November 21, 1994.

[6] International Monetary Fund (2008), "IMF Head Urges Global Action to Counter Slowdown", in *IMF Survey Magazine: In the News*, February.