Tax Policy Options for Aging Societies

Alan J. Auerbach
University of California, Berkeley
June 10, 2015
Societal Aging

Lower birth rates, increased life expectancy
What are the implications for tax policy?
Societal Aging

Lower birth rates, increased life expectancy
What are the implications for tax policy?

1. Need to finance unfunded age-based programs
Societal Aging

Lower birth rates, increased life expectancy

What are the implications for tax policy?

1. Need to finance unfunded age-based programs

2. Shifts in composition of budgets and voters
Societal Aging

Lower birth rates, increased life expectancy
What are the implications for tax policy?

1. Need to finance unfunded age-based programs
2. Shifts in composition of budgets and voters
3. Changing effectiveness of different taxes
Societal Aging

Lower birth rates, increased life expectancy
What are the implications for tax policy?

1. Need to finance unfunded age-based programs
2. Shifts in composition of budgets and voters
3. Changing effectiveness of different taxes
4. Influences on conduct of stabilization policy
Budget Stress

• Not a consequence of aging *per se*, but of aging *plus* practice of using PAYG finance for age-based programs (e.g., pensions, health care, etc.)

• A big problem for most developed countries
Budget Stress

• Not a consequence of aging *per se*, but of aging *plus* practice of using PAYG finance for age-based programs (e.g., pensions, health care, etc.)

• A big problem for most developed countries

• Implications for tax policy:
  – Increasing revenue/GDP ratio, even with reforms
  – A greater importance of limiting economic distortions – concerns for economic efficiency compete with and partially crowd out redistribution
Budget Stress

• Not a consequence of aging *per se*, but of aging *plus* practice of using PAYG finance for age-based programs (e.g., pensions, health care, etc.)

• A big problem for most developed countries

• Implications for tax policy:
  – Greater attractiveness of tax systems that have limited scope for redistribution but greater economic efficiency; e.g., VAT
  – No reason to limit funding to “dedicated” revenues
Shifting Budget Composition

• Even with fiscal balance, make-up of public spending will change markedly as population ages, from discretionary to old-age entitlement
Shifting Budget Composition

• Even with fiscal balance, make-up of public spending will change markedly as population ages, from discretionary to old-age entitlement.

• Consequences:
  – Short-run spending adjustments more difficult for economic reasons (affect long-range decisions).
  – Longer-run spending adjustments may also be more difficult, for political reasons (a growing coalition of support for status quo).
Shifting Budget Composition

• Even with fiscal balance, make-up of public spending will change markedly as population ages, from discretionary to old-age entitlement

• Tax policy implications:
  – Need for a more flexible tax system, to absorb budget shocks coming from the expenditure side
  – Want taxes for which tax rate variations over time do not cause major economic damage (e.g., for which timing of decisions not sensitive)
Impacts on Tax Effectiveness

- Obvious impact – tax bases will shift relative to GDP, and so will composition of revenues
  - Consumption higher (if old-age consumption taxable)
  - Labor income lower
Impacts on Tax Effectiveness

• Obvious impact – tax bases will shift relative to GDP, and so will composition of revenues
  – Consumption higher (if old-age consumption taxable)
  – Labor income lower

• More subtle effect – attractiveness of different tax reforms may change, too, because of varying efficiency of different tax components
  – Consumption taxes become more attractive relative to labor taxes in promoting growth
Stabilization Policy

• Lower birth rate means slower economic growth, but slower growth has no obvious implications for *stabilization* policy

• However, aging may influence stabilization policy through other channels
Stabilization Policy

Automatic stabilizers:

• Changing cyclical responsiveness of revenues and spending, although direction of net impact unclear:
  – Entitlement programs more important; could make automatic spending responses more counter-cyclical
  – Consumption tax revenues smoother over the cycle than other revenue sources; but elderly response to tax payments likely more sensitive
Stabilization Policy

Discretionary policy:

• Impact of policy changes could be higher if higher responsiveness among elderly

• If consumption taxes grow in importance, a stronger potential lever for price-based discretionary policy (e.g., tax rate variations)
  – An advantage of such policies is that temporary policies are stronger, not weaker
Conclusions

• Increasing budget stress, due to unfunded old-age programs, will crowd out tax progressivity.
• Shifts in spending composition and voting population may make expenditure changes more difficult, requiring more tax flexibility.
• The “optimal” tax system changes as well.
• Ambiguous effects on the practice of stabilization policy.