Population Aging and Tax Policy

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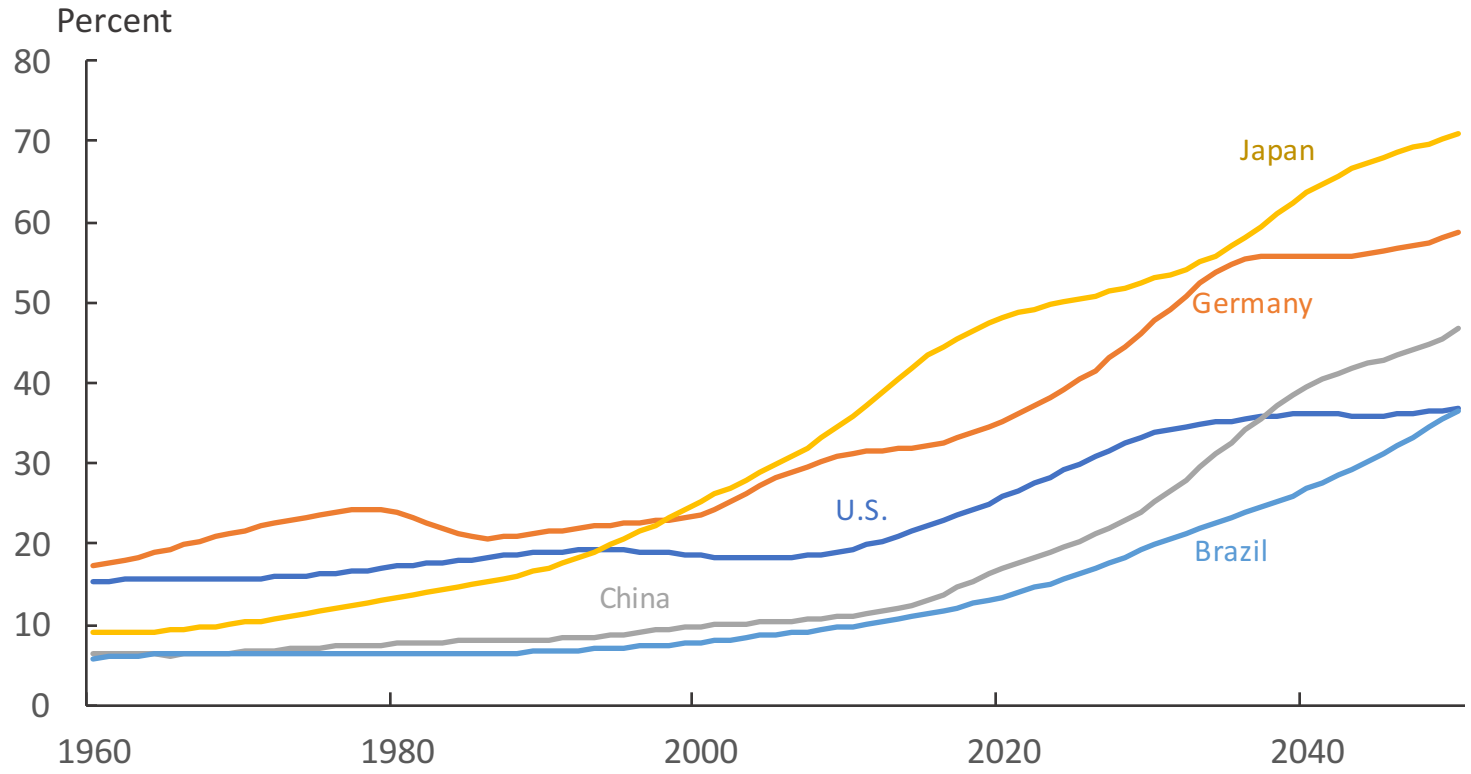
Notes for the slides can be found at the end of the presentation.

How should policymakers change tax systems given population aging and its economic effects?

[a particularly relevant question given heightened attention to tax reform]

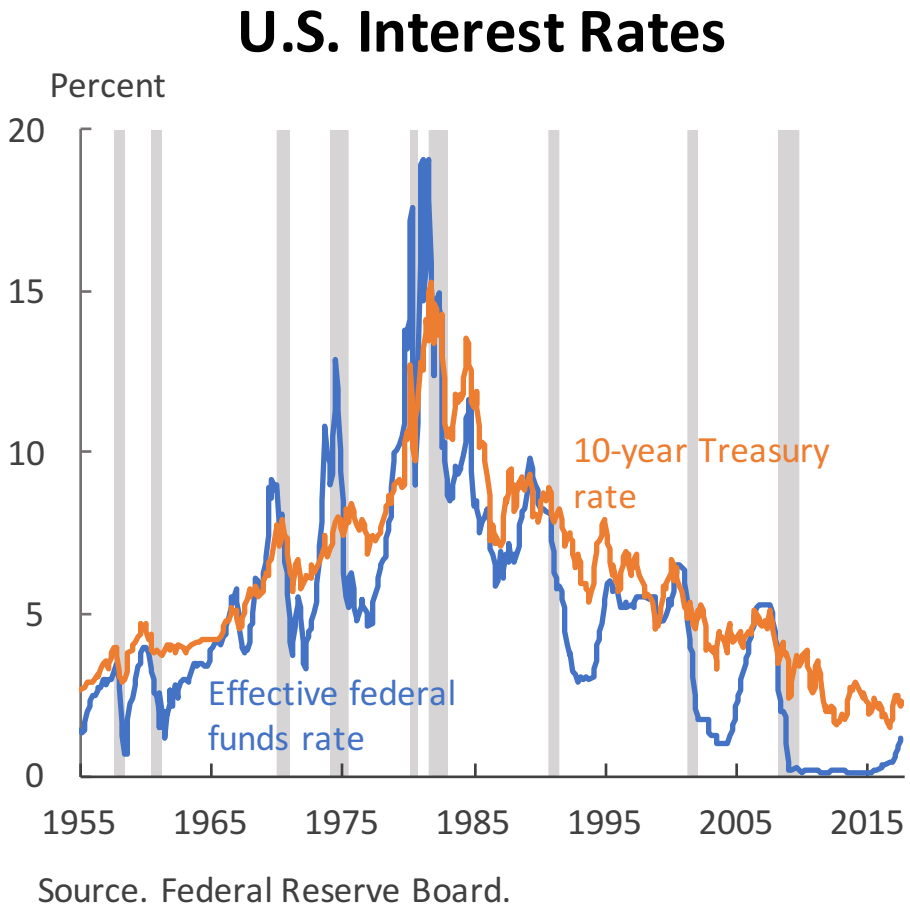
Population aging is increasing dependency ratios

Population 65+ Relative to Working-Age Population



Source. World Bank.

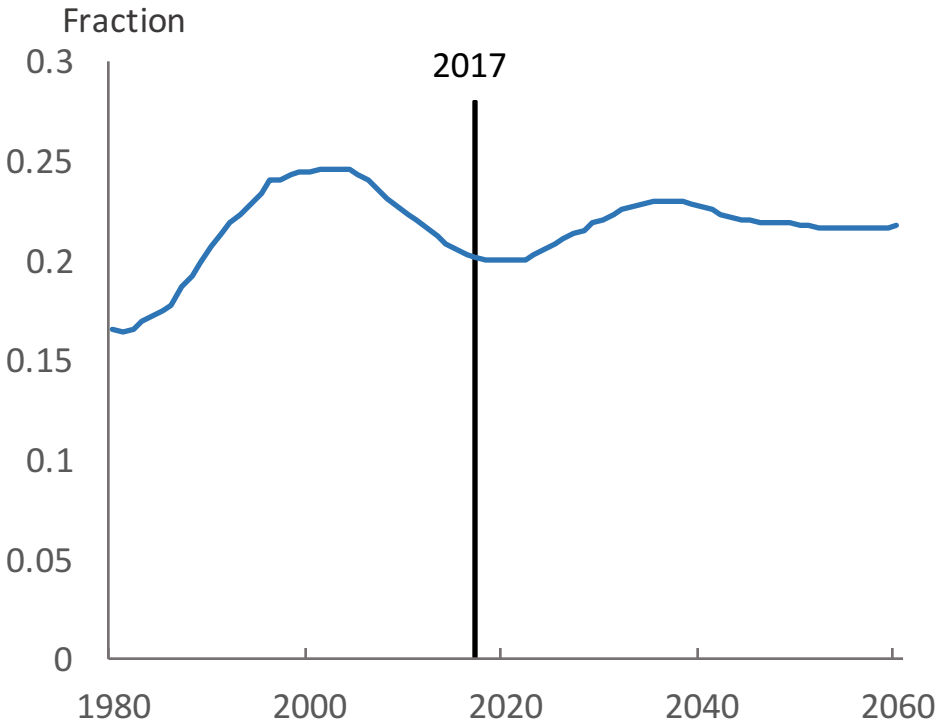
Population aging has contributed to lower interest rates



Gagnon et al 2016 argues that demographics account for 1.25pp of the decline in the equilibrium real interest rate since 1980.

Population aging *might* have lowered productivity

People between Ages 40 and 49 as a Share of the U.S. Working-age Population



Source. U.S. Census Bureau.

Some studies (e.g. Feyrer, 2007) suggest productivity is highest for the 40-49 age group.

But, **note that any such effects are now behind us.**

Another channel is that older households do more consuming from lower-productivity sectors.

Objectives of tax policy

Collect revenue to finance government services and benefits

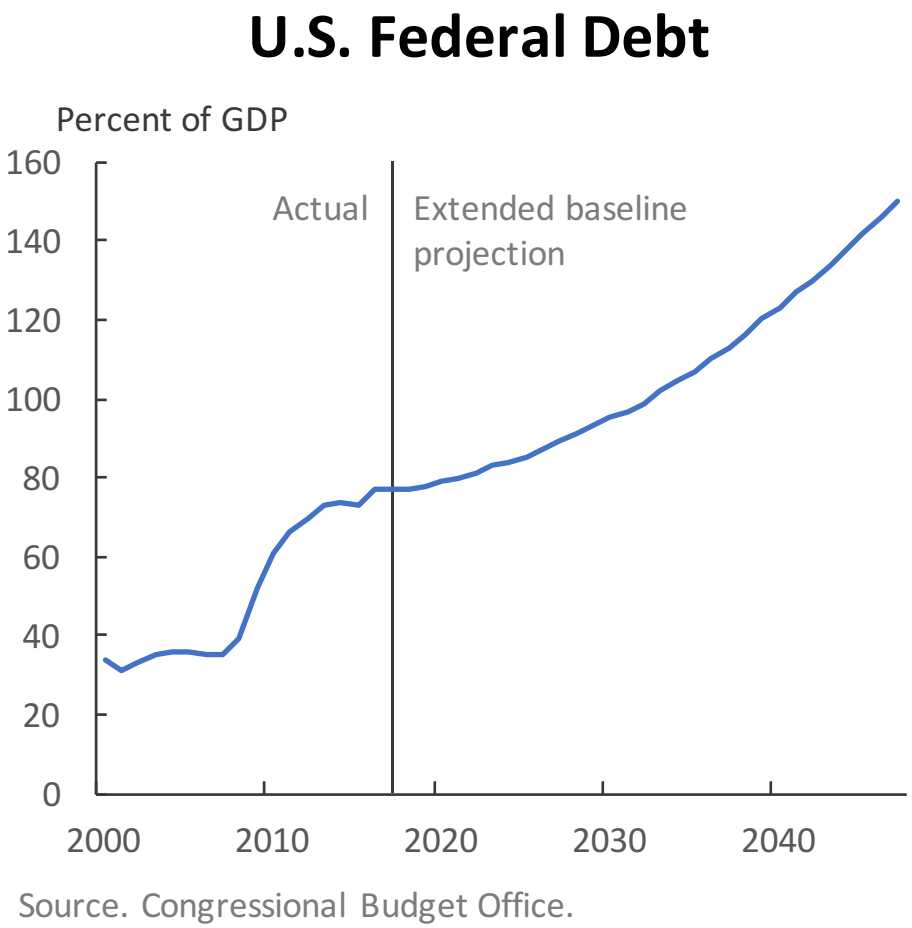
Incentivize saving and work

Mitigate business cycle fluctuations

Improve resource allocation in other ways (e.g. correct for externalities or other distortions)

Redistribute income

Collecting revenue



Population aging is contributing to a significant worsening of the budget situation—even accounting for lower interest rates.

So we are going to need **more tax revenues** (spending cuts too).

Incentivizing saving and work

Population aging heightens the need to **encourage retirement saving** given difficulties many people have saving.

> Behavioral literature (e.g. Chetty et al, 2014) => most important way to change tax policy is to provide **more incentives for firms to set up plans**.

Budget strains associated with population aging mean addressing the downtrend in working-age labor force participation is even more important.

> So **tax incentives for work should be increased**, with focus on groups with the most elastic labor supply (child care subsidies to encourage second earners, EITC expansion to encourage less-skilled men).

Mitigating business cycle fluctuations

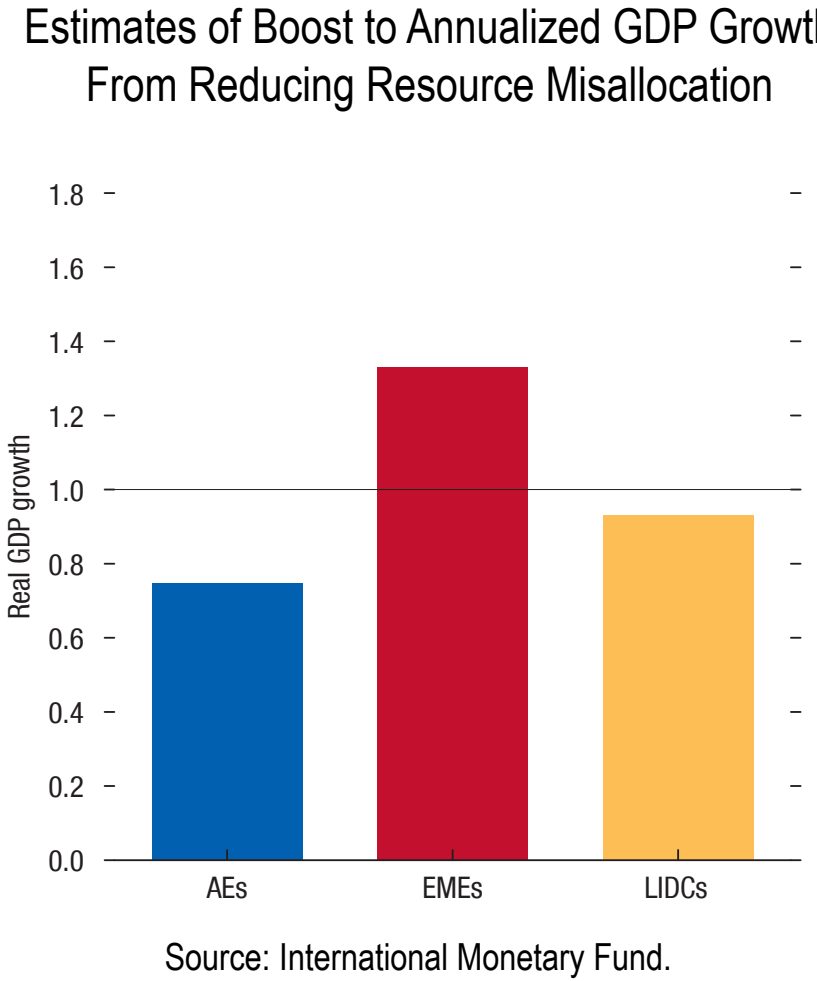
Lower real interest rates mean central banks will hit the effective lower bound more frequently (see, for example, Kiley and Roberts, 2017).

> **Monetary policy less potent** as a countercyclical force.

So need **stronger automatic stabilizers** in the tax system.

> E.g. automatic adjustments in payroll tax rates when the unemployment rate crosses a given threshold (coupled with automatic general revenue contributions to Social Security to make up for the foregone revenue).

Improving resource allocation in other ways



IMF research suggests distortions in tax systems weigh significantly on productivity.

Coming fiscal strains from population aging, coupled with global decline in productivity growth, make **removing distortions and correcting for spillovers / externalities an even higher priority**.

Redistributing income

[Obviously] more transfers to the older population because of population aging.

Other implications **less clear**:

Less potent monetary policy might argue for stronger safety net programs.

Greater need to enhance productivity might argue for more transfers to families with children that have been demonstrated to lift the adult earnings of the children.

But **need to think about traditional efficiency trade-offs** associated with more redistribution.

Summary

Tax policy objective	Implication of population aging
Collecting revenue	Will need to collect more revenue
Incentivizing saving and work	More subsidies for saving needed More incentives for work needed
Mitigating business cycles	More automatic stabilizers needed
Improving resource allocation	More important than ever
Redistributing income	No strong argument for increasing redistribution broadly but maybe selective steps

Endnotes

Slide 2: Data source—World Bank. Working-age population includes people 15-64 years old.

Slide 3: Data source—Federal Reserve Board. Study cited is: Gagnon, Etienne and Johannsen, Benjamin Kramer and Lopez-Salido, David, Understanding the New Normal: The Role of Demographics (2016-09-28). FEDS Working Paper No. 2016-080.

Slide 4: Data source—U.S. Census Bureau. Data beyond 2014 projected. Study cited is: Feyrer, James (2007) "Demographics and Productivity" *The Review of Economics and Statistics* vol. 89, issue 1, 100-109.

Slide 6: Data source—Congressional Budget Office. The long-term budget projections were last updated in March 2017 and can be found in a spreadsheet here.

Slide 7: Study cited is Chetty, Raj, John N. Friedman Søren Leth-Petersen Torben Heien Nielsen, Tore Olsen (2014) "Active vs. Passive Decisions and Crowd-Out in Retirement Savings Accounts: Evidence from Denmark" *Quarterly Journal of Economics* vol. 129, issue 3, 1141–1219.

Slide 8: Study cited is Kiley, Michael T. and John M. Roberts (2017) "Monetary Policy in a Low Interest Rate World" *Brookings Papers on Economic Activity.*

Slide 9: See International Monetary Fund, *Fiscal Monitor April 2017*.