

Inequality, Aging and Capital Mobility: Implications for Fiscal and Monetary Policy

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The Setting: Three Phenomena

- Increasing economic inequality
- Population aging
- Increasing international capital mobility

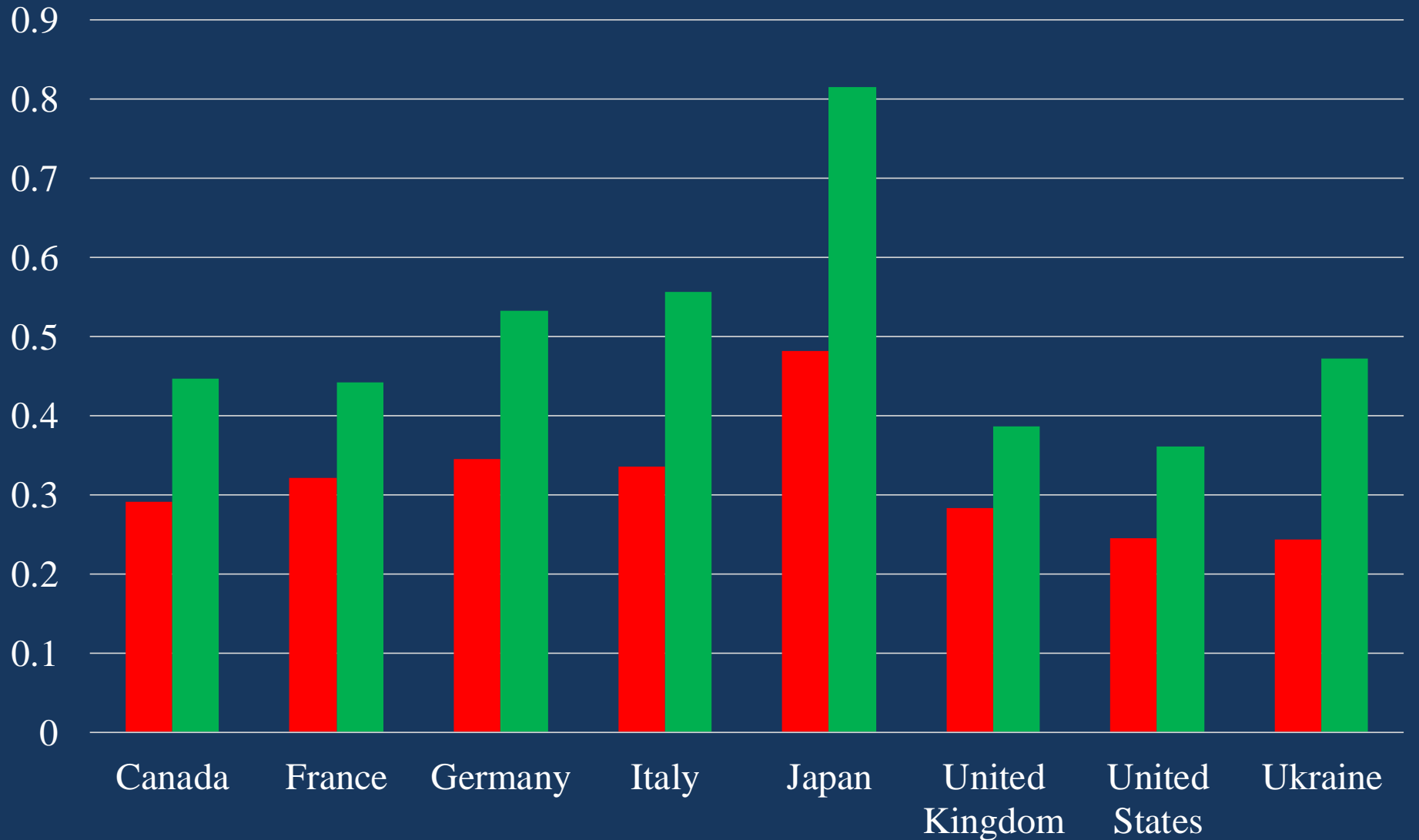
First two put pressure on fiscal policy

Third limits scope for fiscal policy responses

Also, direct and indirect implications for monetary policy

Population Aging

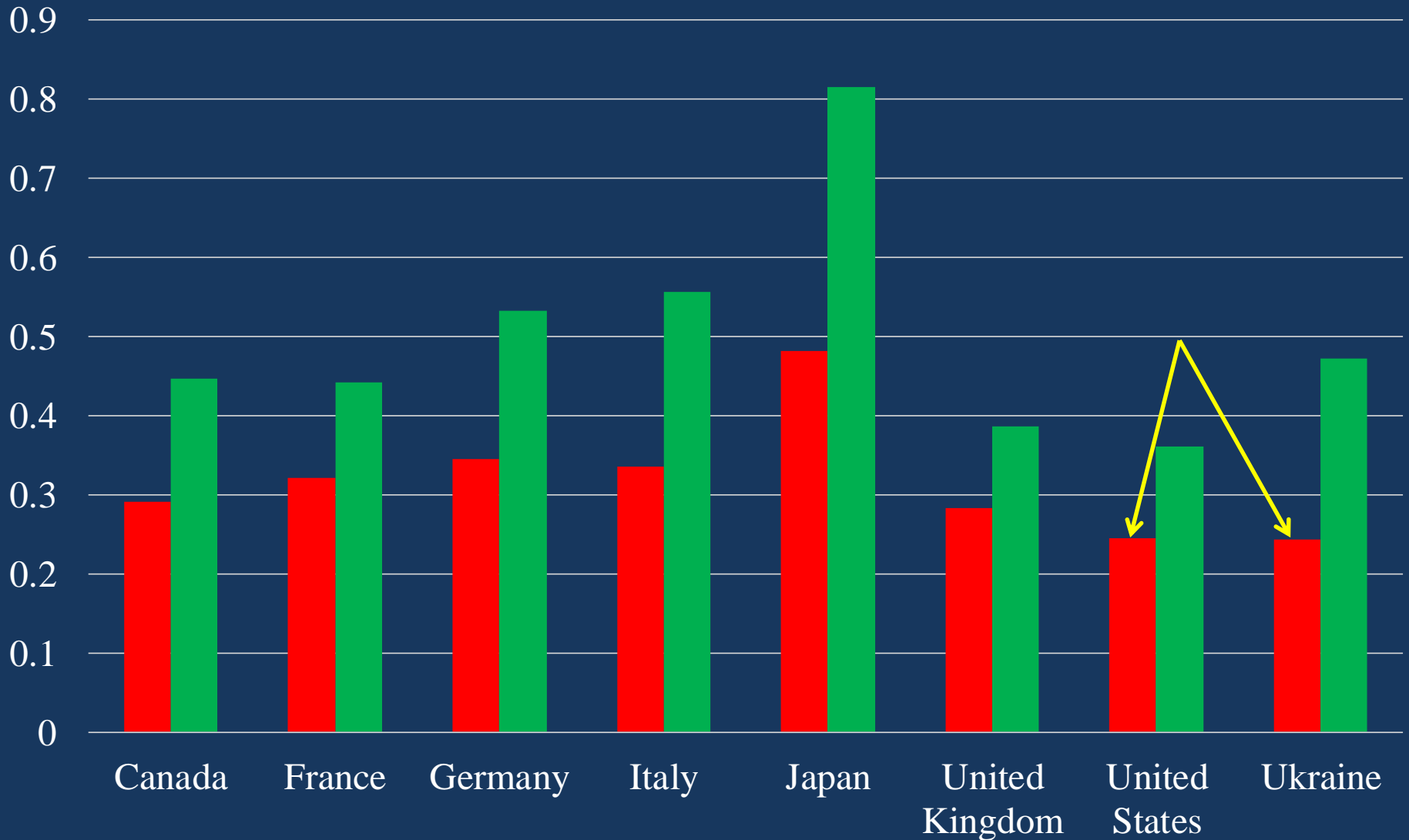
Old-Age Dependency Ratios



Source: US Census Bureau,
International Data Base

■ 2018 ■ 2050

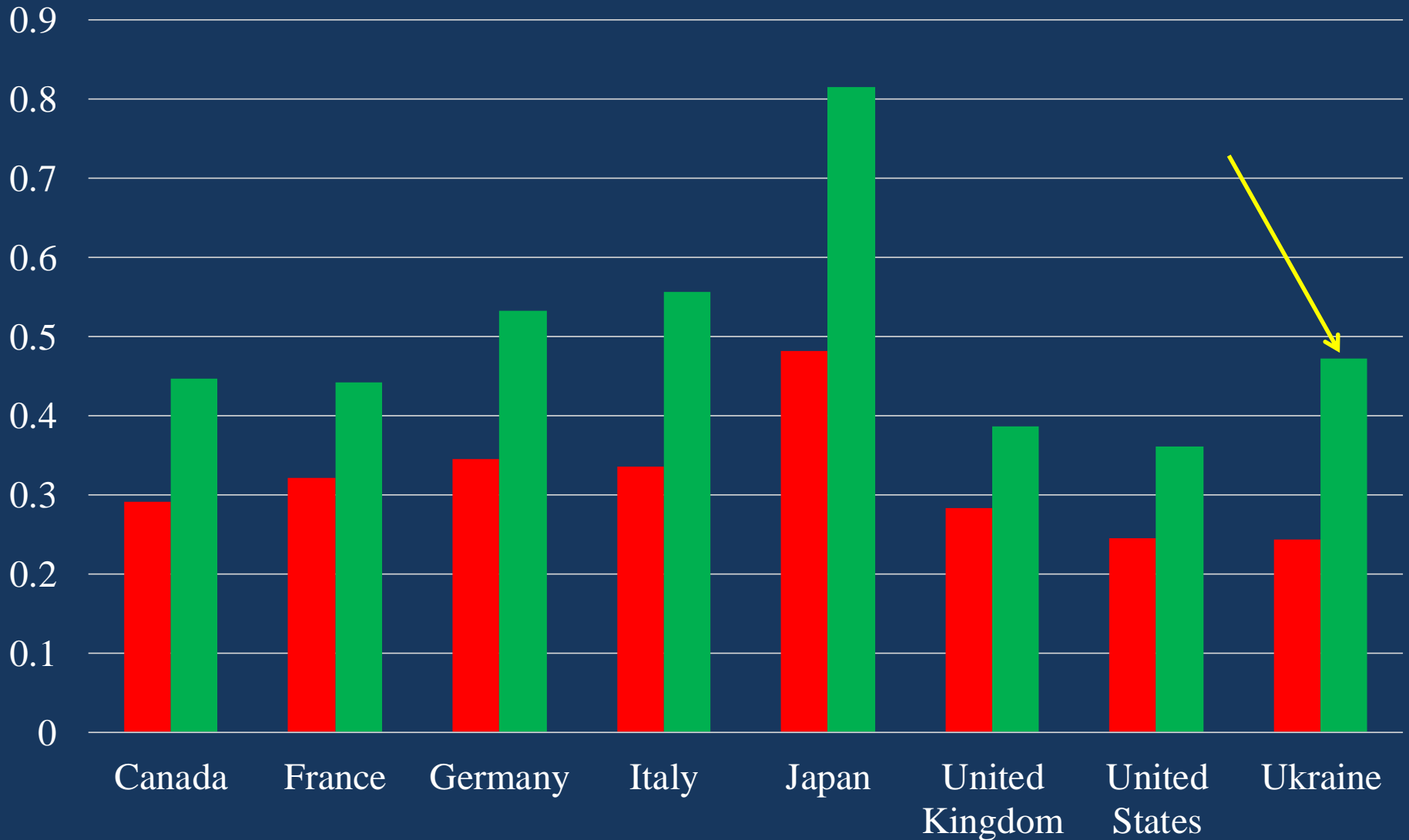
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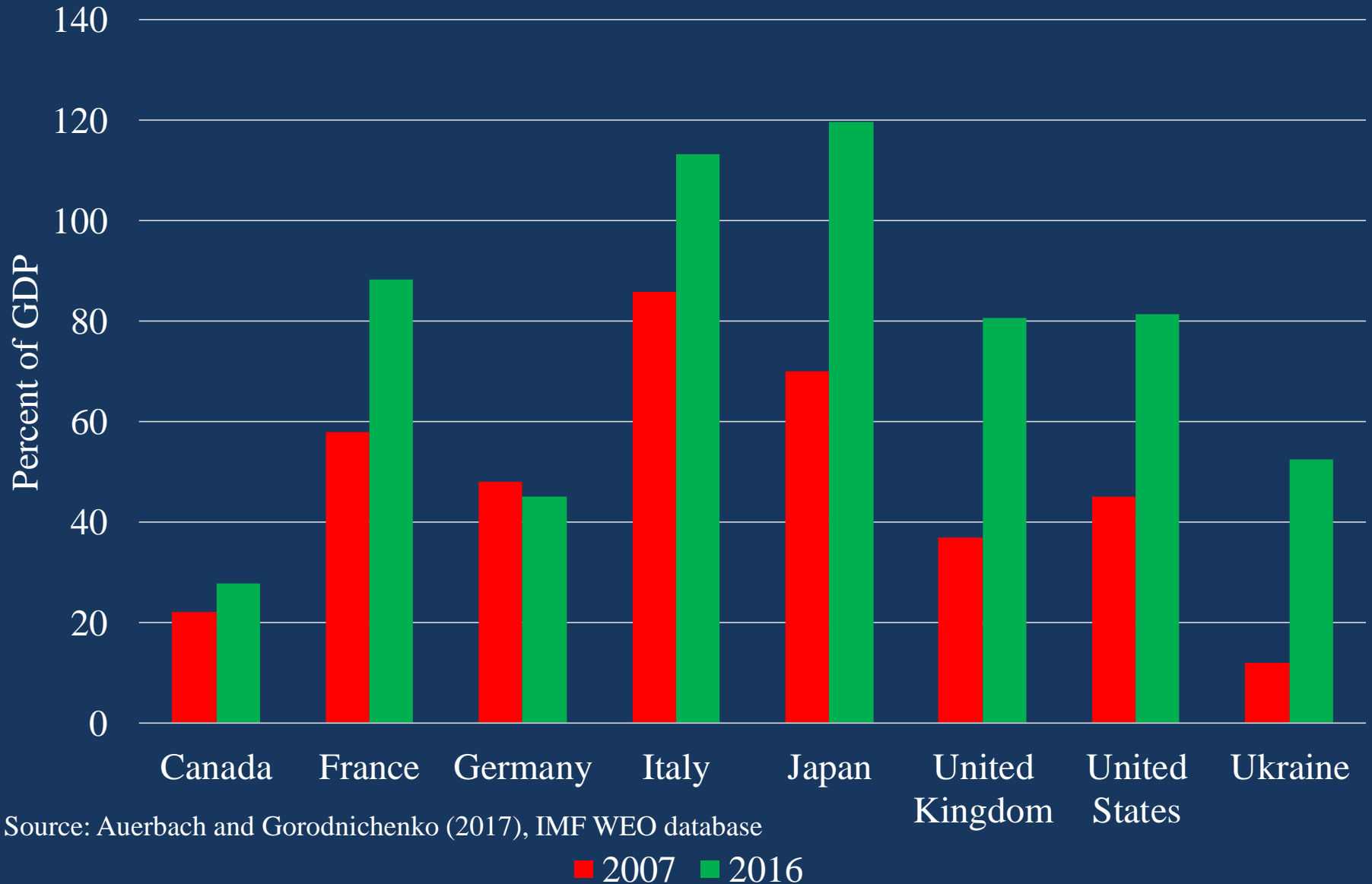
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■ 2018 ■ 2050

Net General Government Debt



Fiscal Sustainability

- How to summarize necessary adjustments?
- Calculate a country's fiscal gap to determine how much need to reduce primary deficit annually to achieve some target debt-GDP ratio at the end of some period
 - Express fiscal gap as a share of GDP

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 1. Past deficits, which sum to current level of debt, and which require resources for debt service and, possibly, to hit a more ambitious debt target
 2. Current deficits, i.e., the current pattern of spending and revenues, if continued into the future as a share of GDP
 3. Future deficits, i.e., growth relative to GDP under current policy due to demographics and rising costs of government services, notably health care

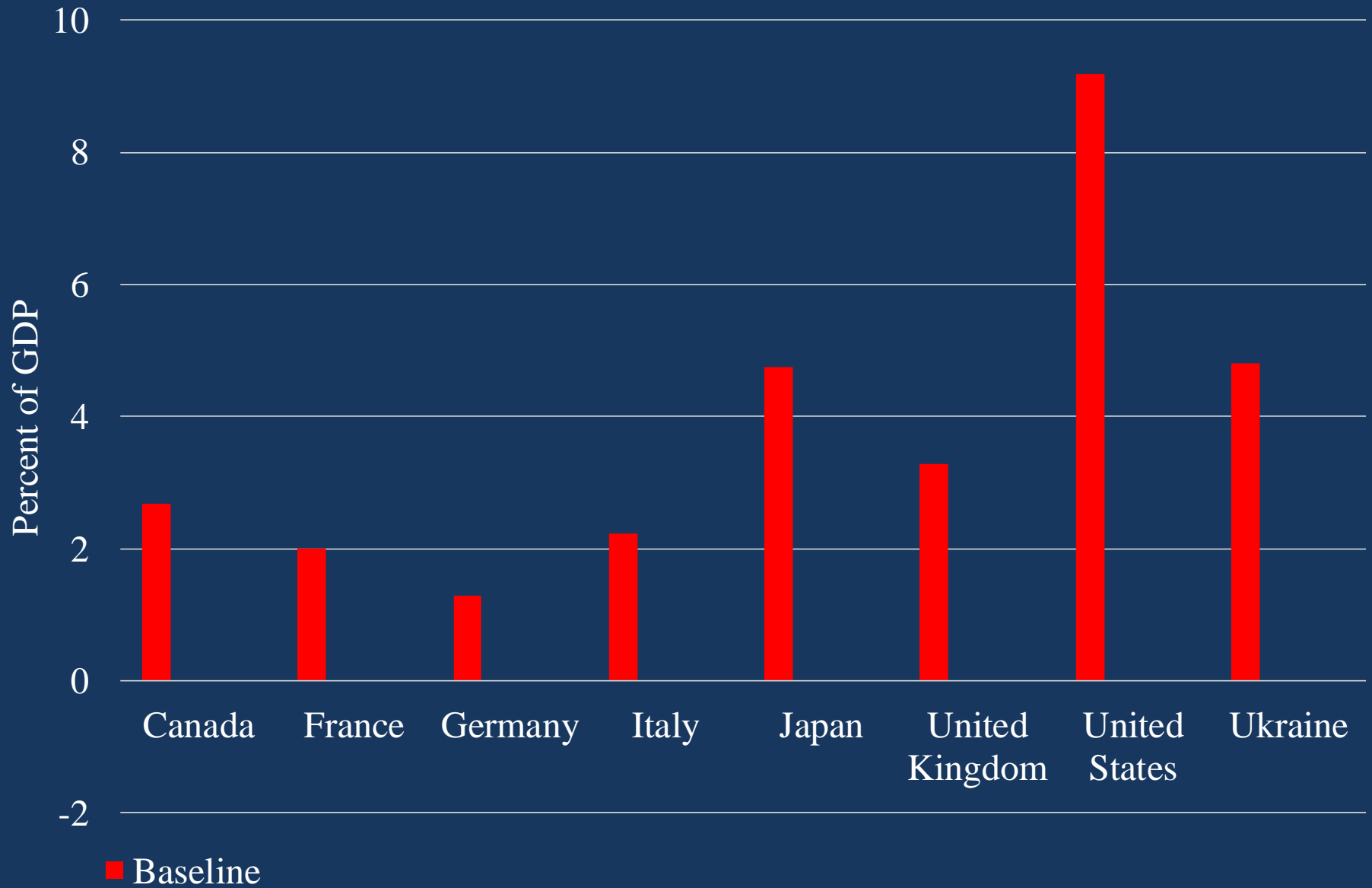
Example: the US Now and in 1946

- In 1946, federal debt-GDP ratio = 110%
 - But current primary deficits were small, as were future commitments for old-age spending
- In 2017, federal debt-GDP ratio = 75%
 - But current primary deficits and, especially, future commitments for old-age spending massive

How Big are the Fiscal Gaps?

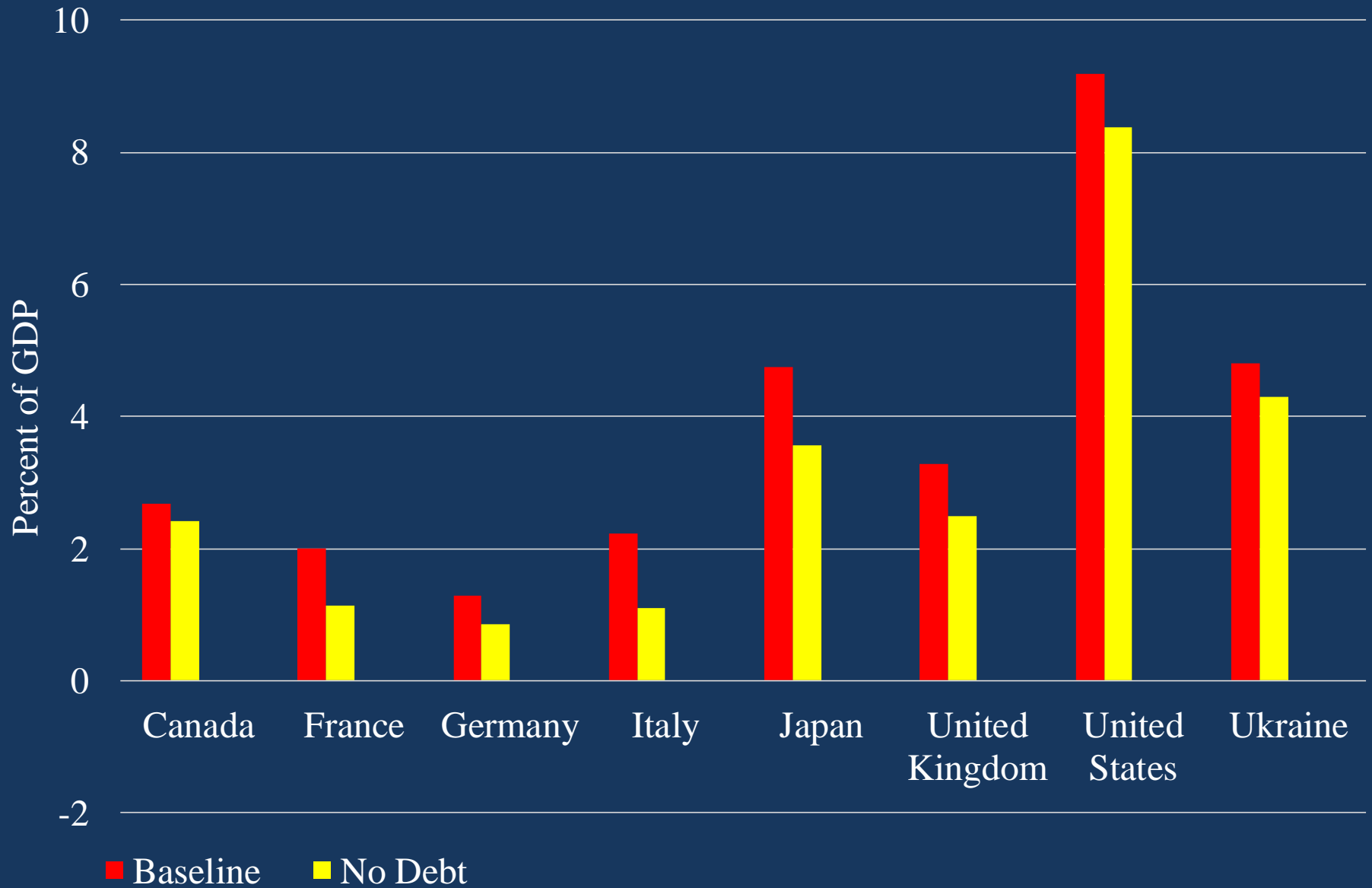
- Calculate through 2050
- Aim for a terminal debt-GDP ratio equal to current one
- Use IMF projections for short-term primary deficits and old-age spending growth
- Assume a real government interest rate of 3% and a real growth rate of 2%

Fiscal Gaps (through 2050)



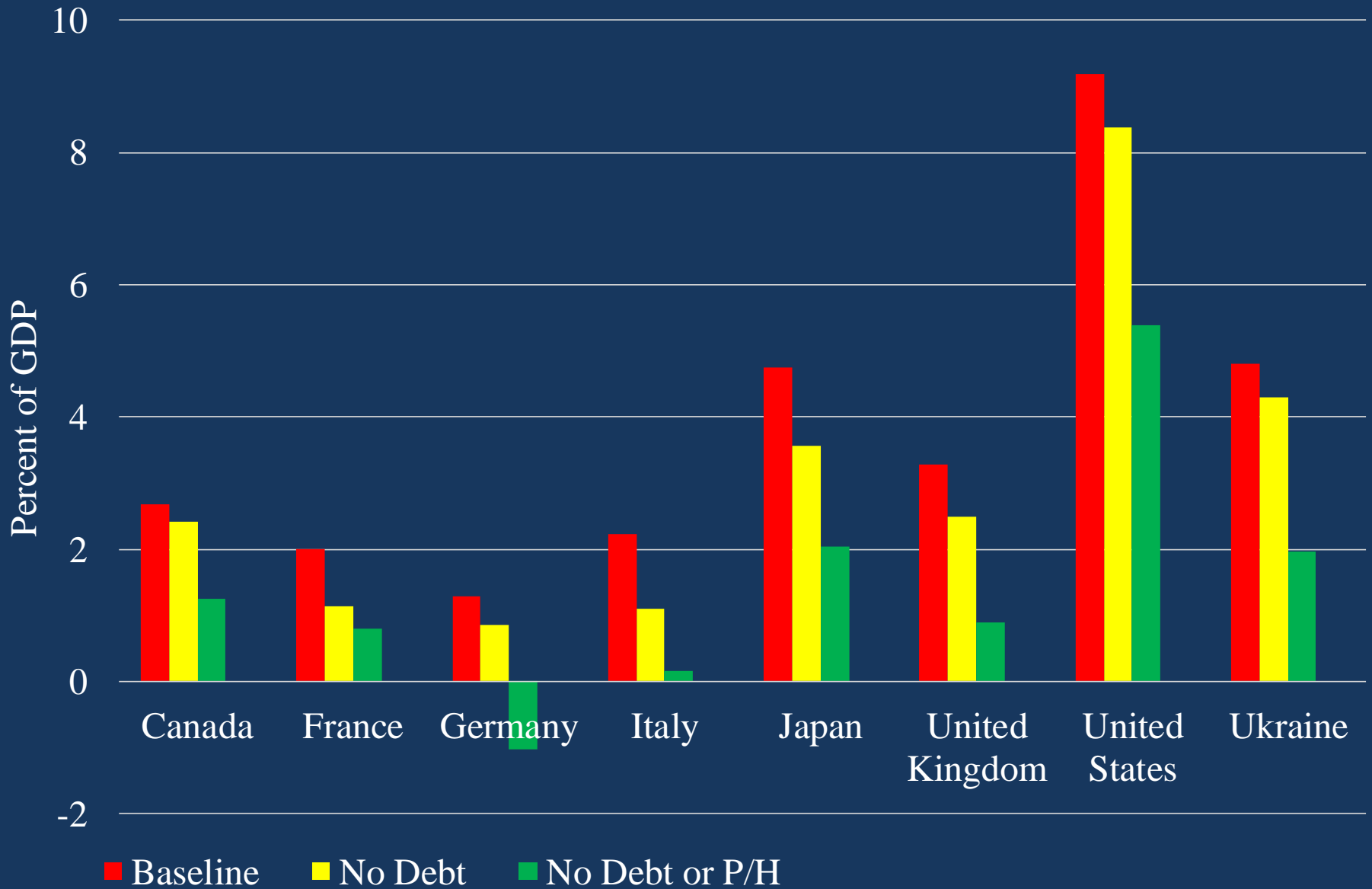
Source: Auerbach and Gorodnichenko (2017), IMF WEO database

Fiscal Gaps (through 2050)



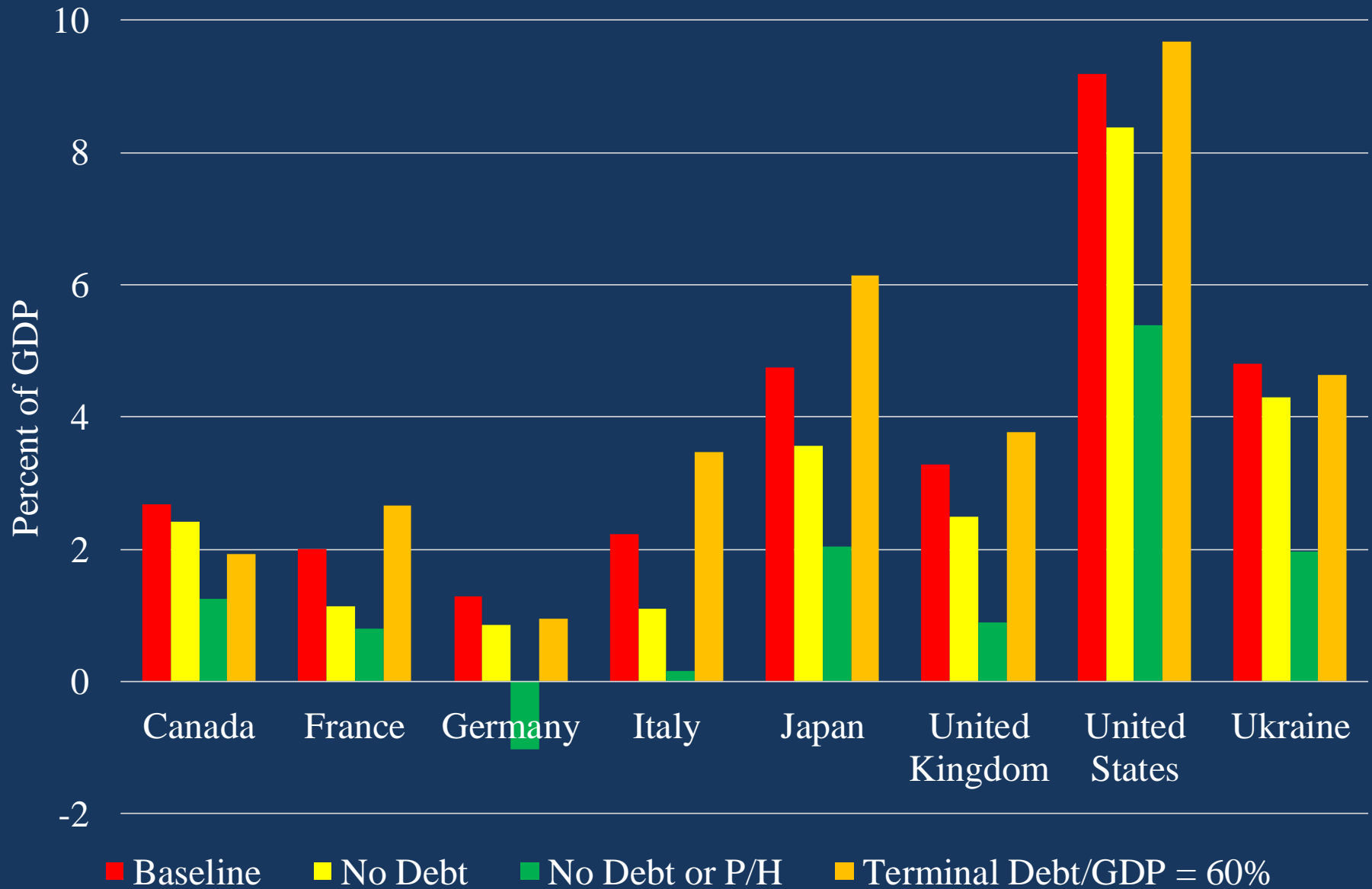
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Fiscal Gaps (through 2050)



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Fiscal Gaps (through 2050)



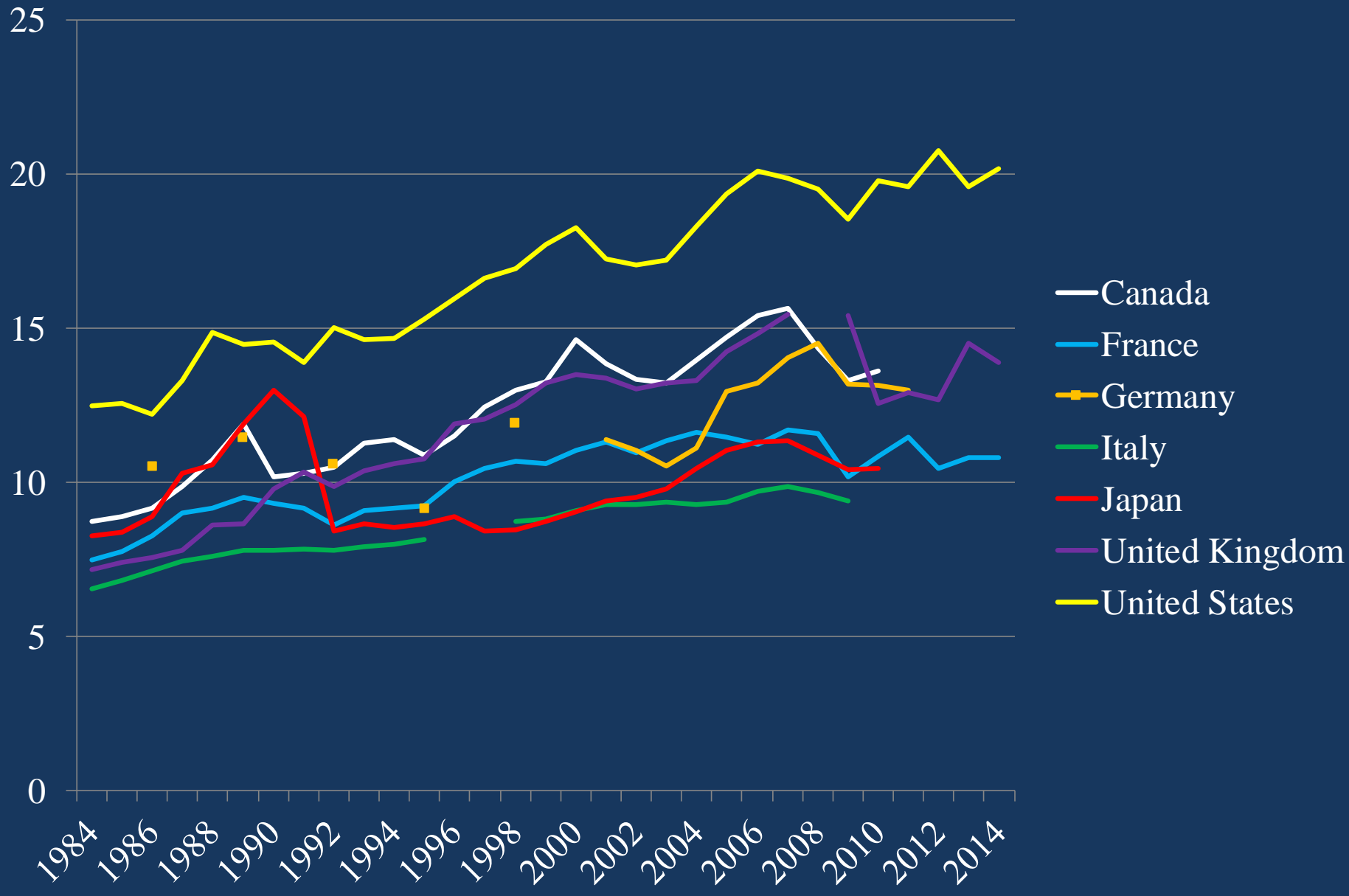
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Fiscal and Monetary Policy Implications

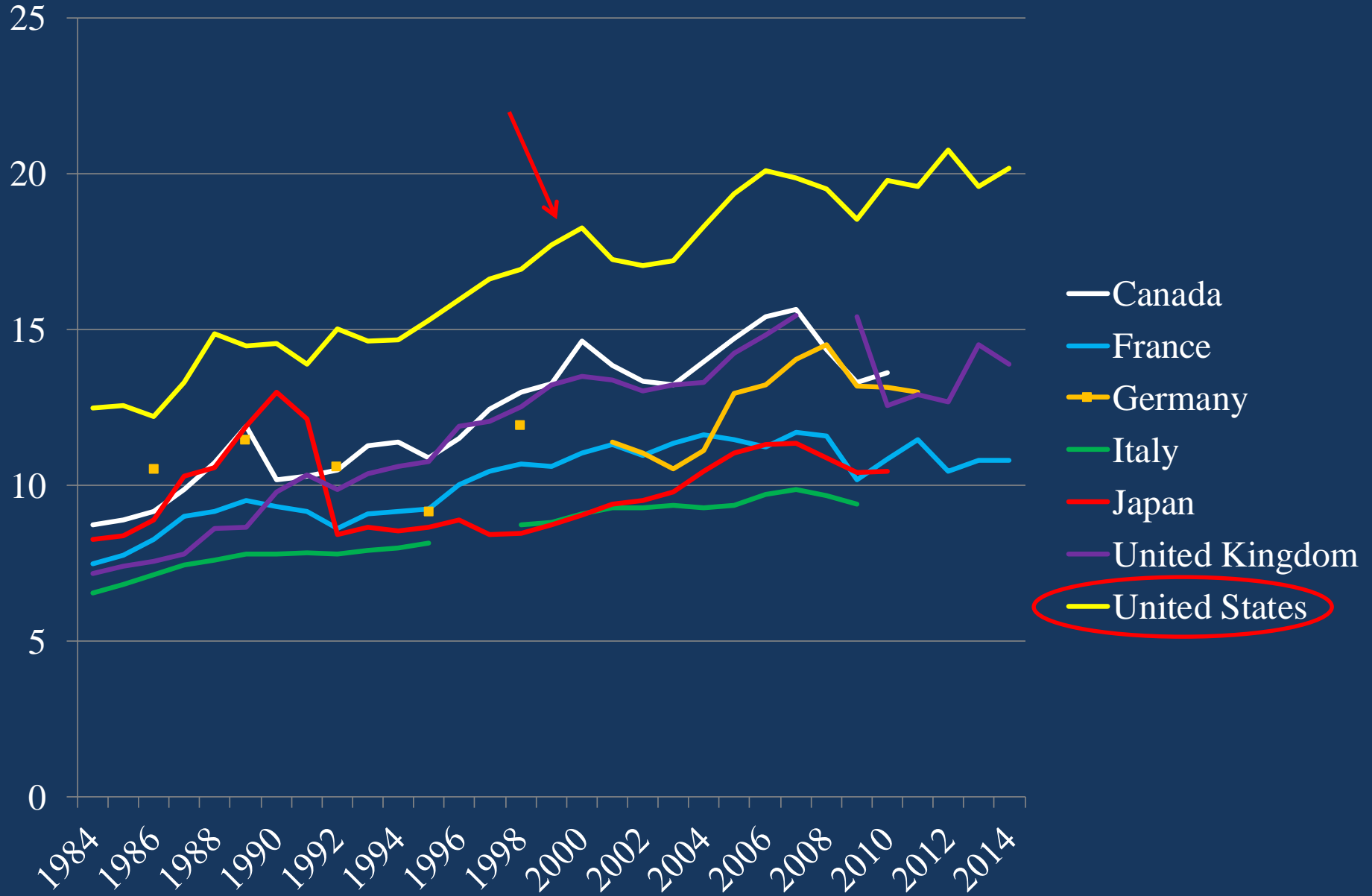
- Tax increases an obvious policy path, but...
- Are there other paths?
 - Migration
 - Inflation
 - Pension reform

Increasing Inequality

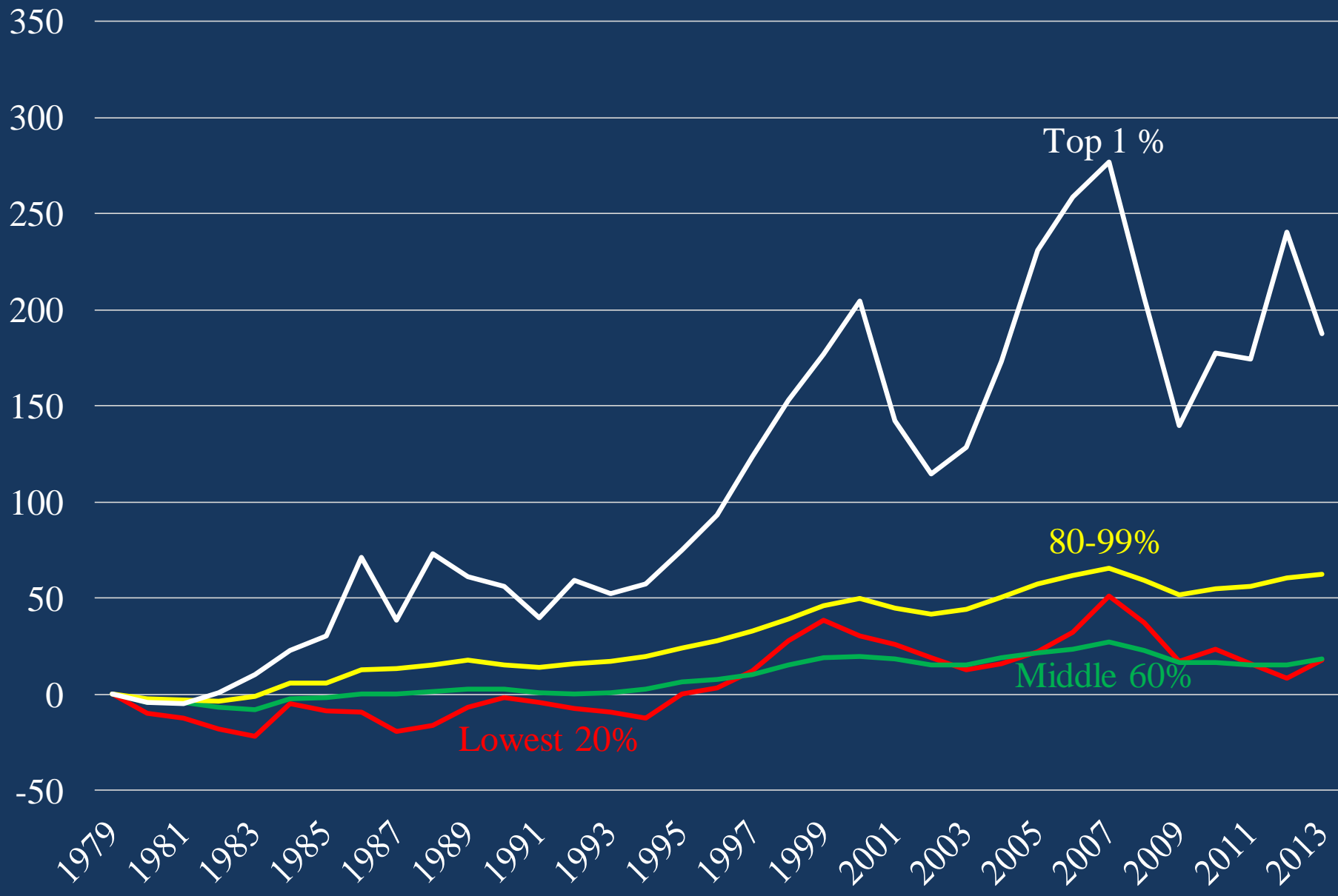
Top 1% Income Share of Total Income (Percent)



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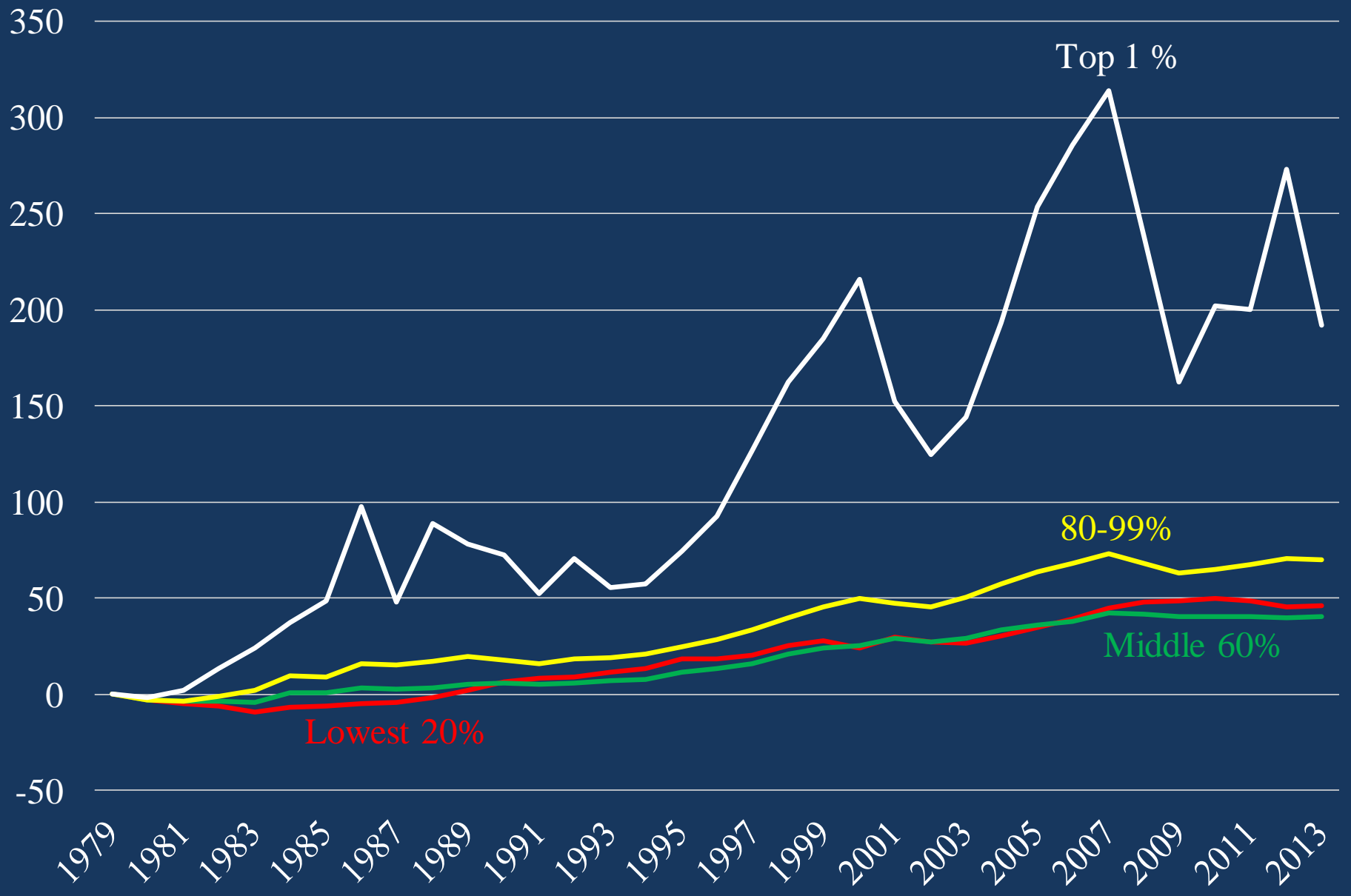


Cumulative Growth in Real Market Income

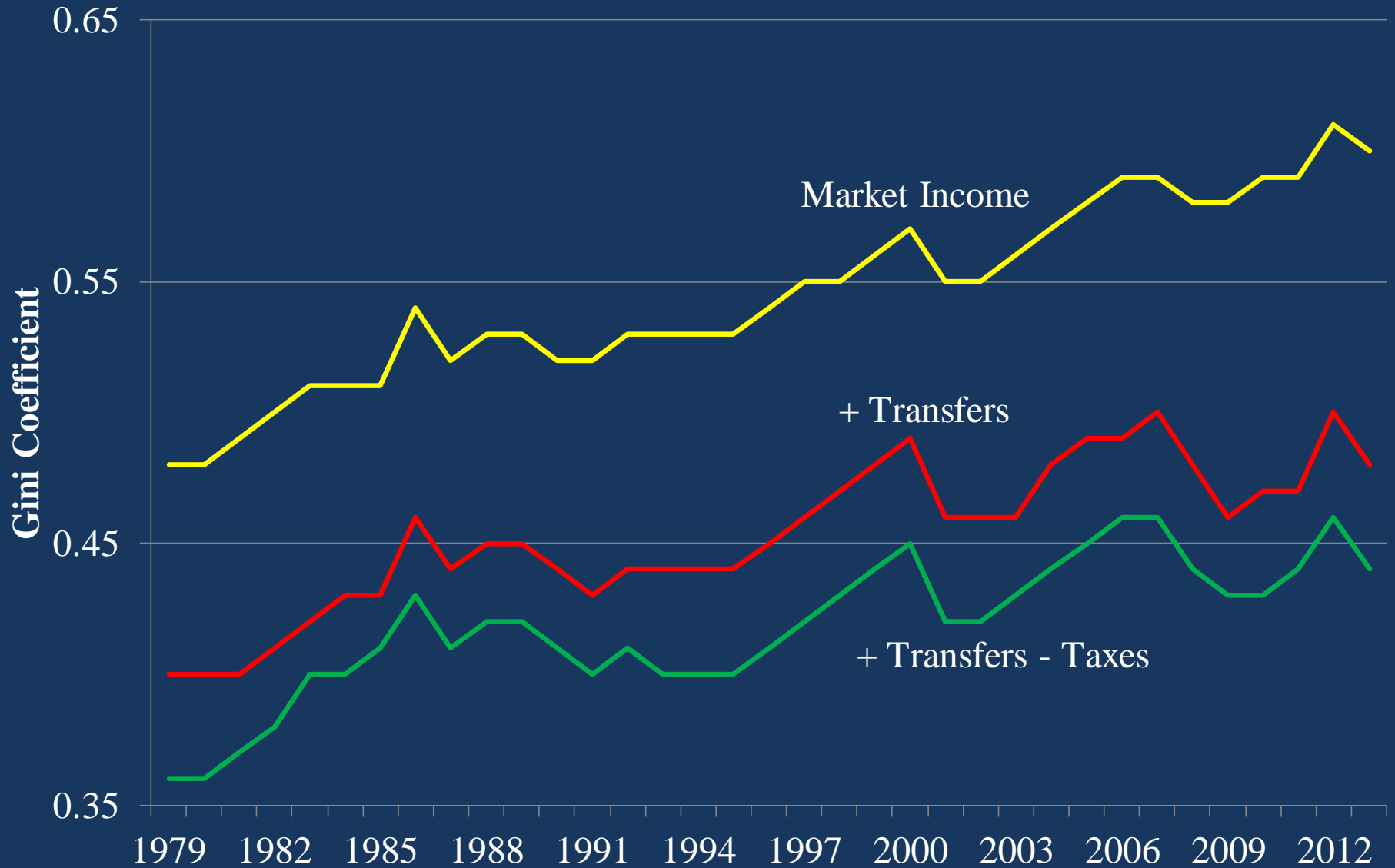


Source: CBO (2016)

Cumulative Growth in After-Tax Income

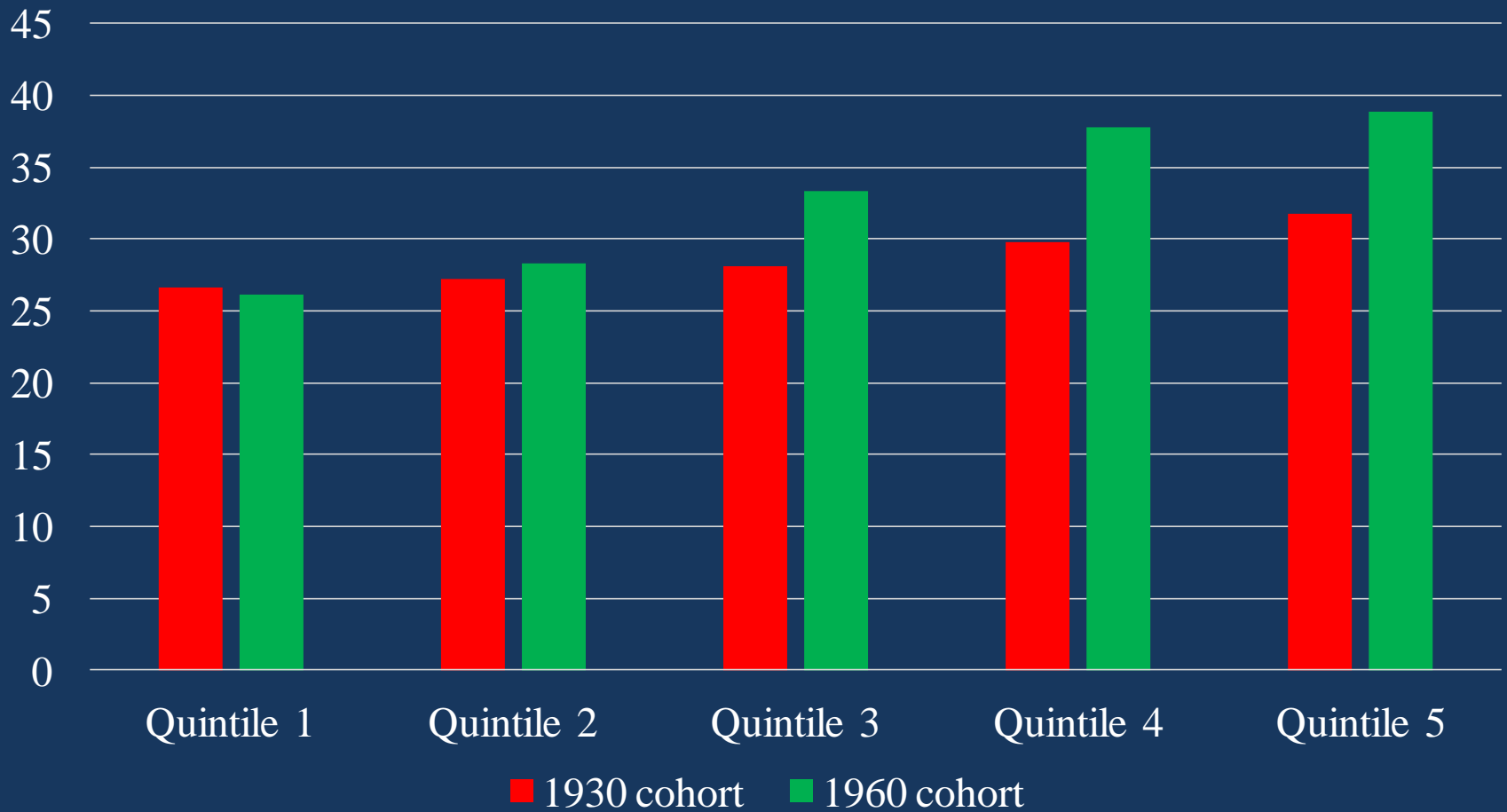


Inequality and Effects of Taxes and Transfers



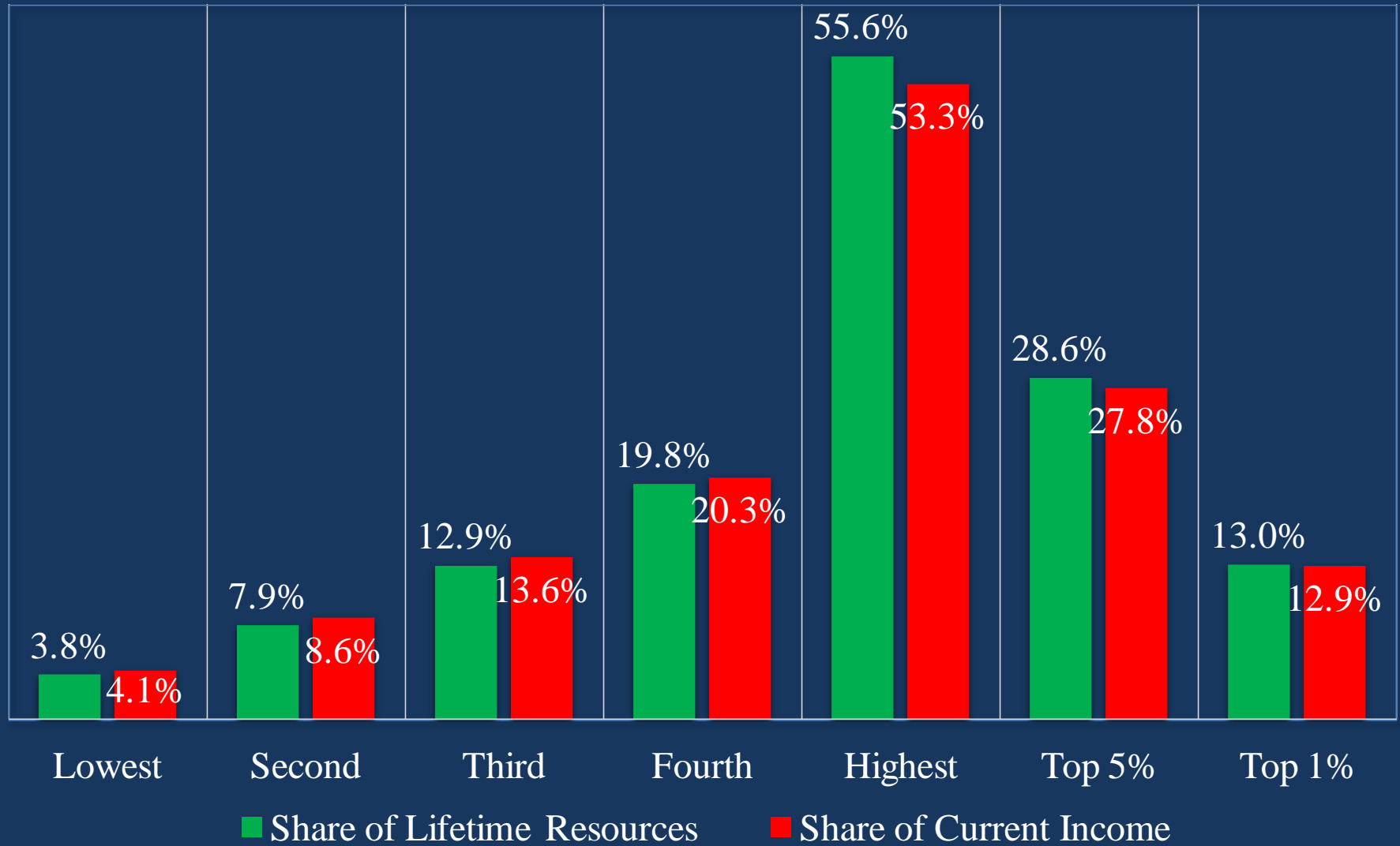
Are We Measuring Inequality
Correctly?

US Life Expectancy at Age 50 by Lifetime Earnings, Males



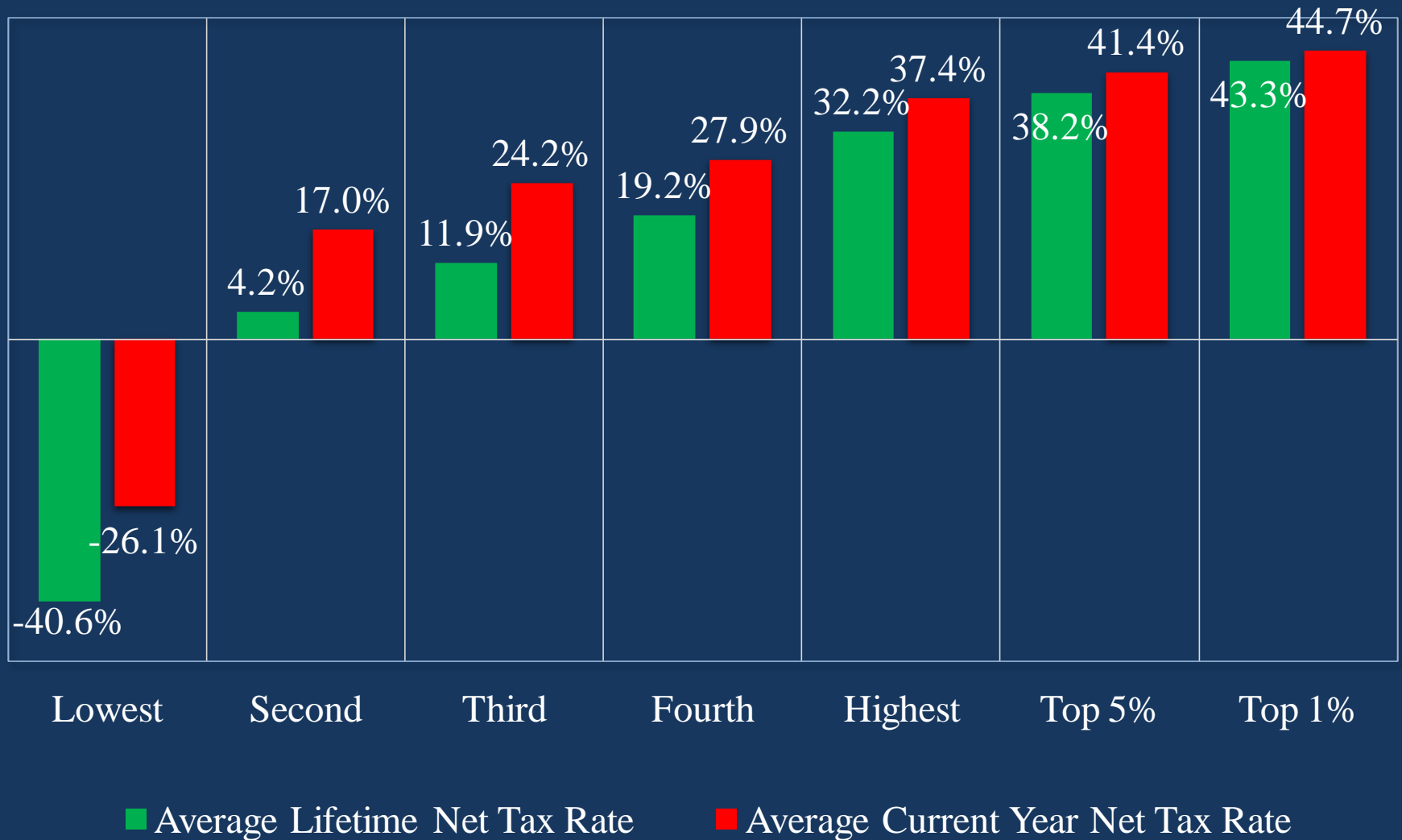
Source: Auerbach et al (2017)

Lifetime Resources and Current Income by Resource Percentile Range, Ages 40 - 49



Source: Auerbach, Kotlikoff and Koehler (2016)

Average Lifetime and Current Year Net Tax Rates by Percentile Range, Ages 40 - 49



Source: Auerbach, Kotlikoff and Koehler (2016)

Increased Fiscal Pressure

- To deal with inequality
- To deal with fiscal imbalances

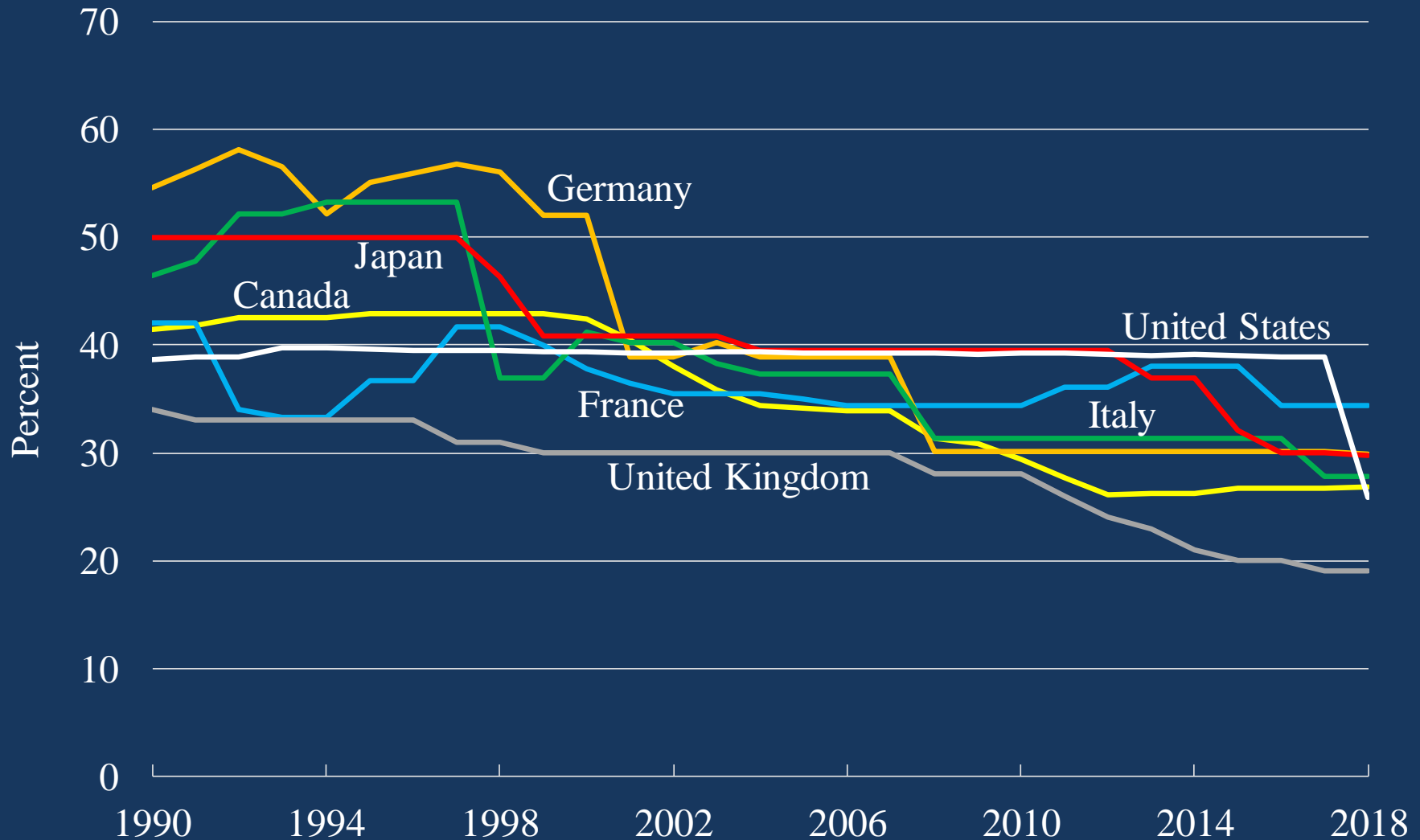
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- A logical solution: progressive tax increases and expenditure reductions

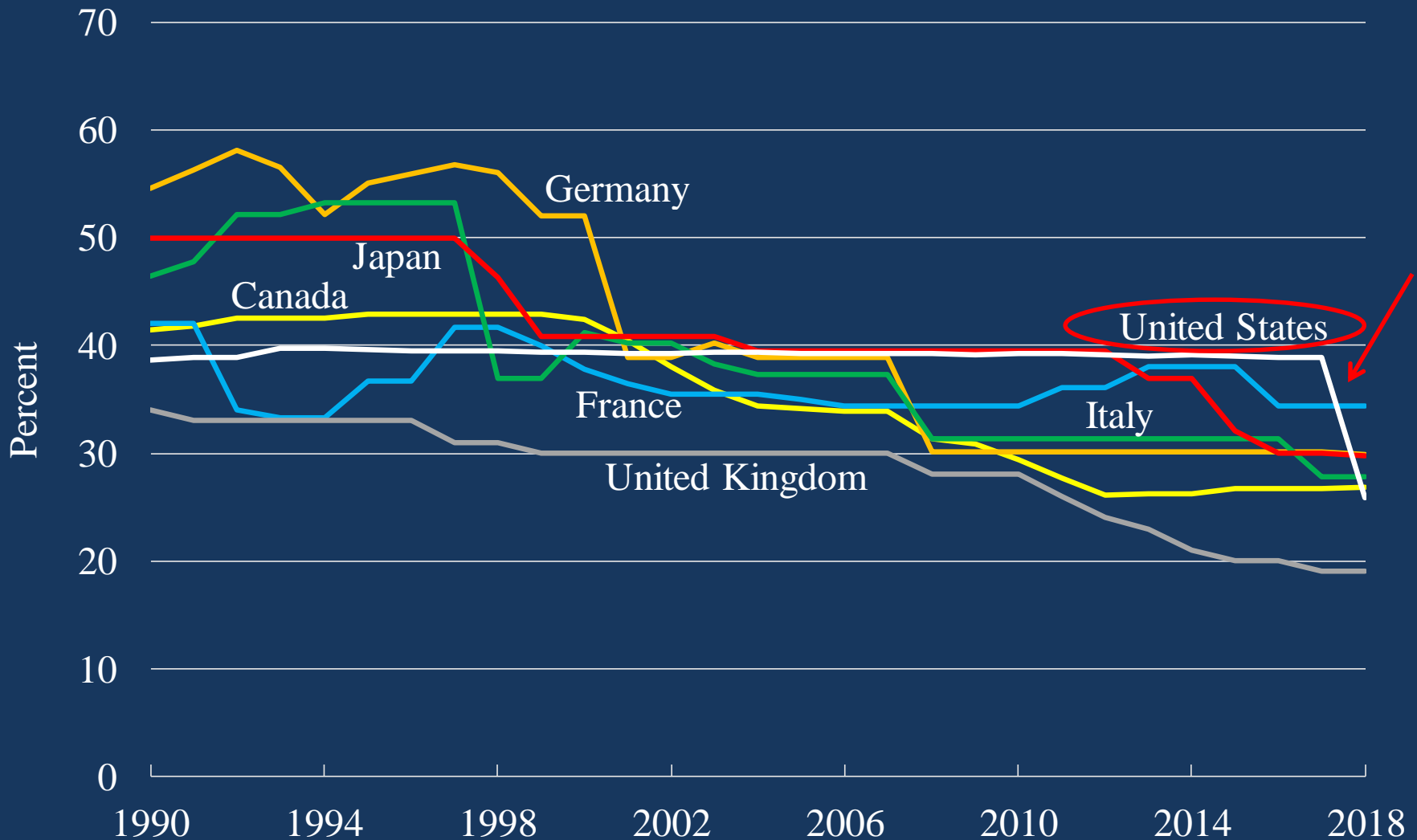
Increased Fiscal Pressure

- To deal with inequality
- To deal with fiscal imbalances
- A logical solution: progressive tax increases and expenditure reductions
- But another major challenge stands in the way

G-7 Corporate Tax Rates



G-7 Corporate Tax Rates



Options

1. Initiatives to resist corporate tax avoidance
 - OECD Base Erosion and Profit Shifting (BEPS) project
 - Problems:
 - Can lessen profit shifting, but not capital mobility
 - Weak incentives for many countries to participate, including those seeking to attract foreign direct investment

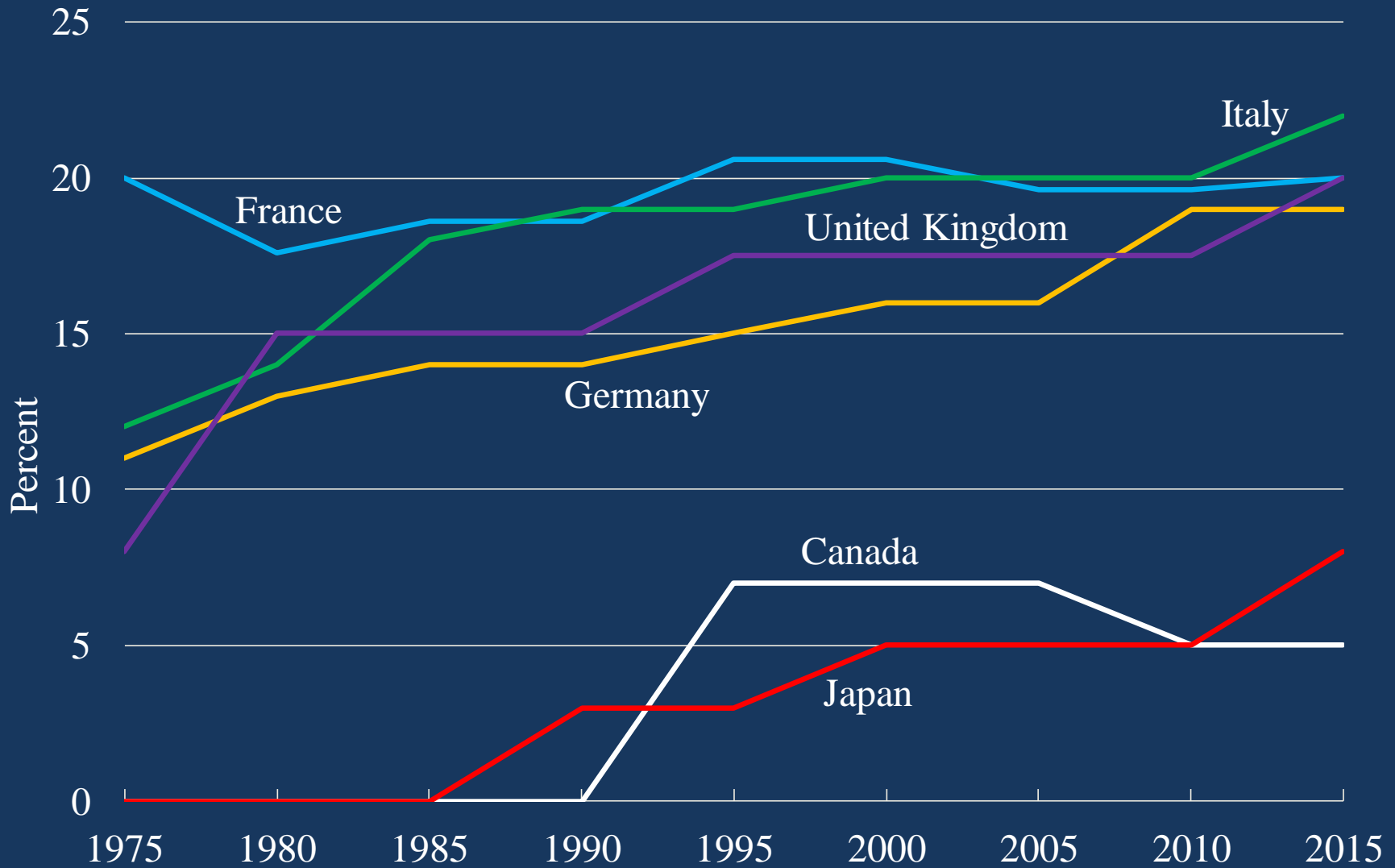
Options

2. New taxes, targeted toward the wealthy
 - Financial transactions taxes
 - General wealth taxes
- Problems:
 - Ultimate burden of such taxes may fall elsewhere
 - Mobility/observability of wealth and transactions make administration and enforcement difficult

Options

3. Rely on taxes on less mobile activities, such as consumption-based taxation
 - Attractive from an enforcement perspective, since easier to track and measure than capital income or wealth
 - In the form of a VAT, has been growing in use

G-7 VAT Rates



Source: OECD Tax Database

Options

3. Rely on taxes on less mobile activities, such as consumption-based taxation
 - Attractive from an enforcement perspective, since easier to track and measure than capital income or wealth
 - In the form of a VAT, has been growing in use
 - But a VAT doesn't get at the problem of inequality

Consumption-Based Taxation

- Can also use as a model for corporate tax reform: A destination-based corporate cash-flow tax (DBCFT), as considered by US
 - Border adjustment eliminates business opportunities to shift profits
 - Does not require international cooperation
 - Progressive (no tax on labor or shifting to labor)
 - Encourages domestic investment and production

US Experience

- Ultimately, US did not adopt DBCFT
 - Fiscal devaluation (border adjustment taxes imports and subsidizes exports) led to concerns about dollar appreciation and trade disruptions
- But US reform did include smaller provisions affecting exports, imports in same direction
- Implication – as other countries move in this direction, exchange rate movements

Monetary Policy

- With challenges facing fiscal policy, more pressure on monetary policy; however, monetary policy ill-suited to deal with these challenges
 - Fiscal gap
 - Inequality
- Strengthens argument for CB independence