Ageing in the Netherlands

van Dalen, H.P.

Published in:
CPB Report

Publication date:
2000

Ageing in the Netherlands: should we trust the generational accountant's view of the world?

Harry van Dalen*

The fiscal consequences of ageing have been on the agenda of economists for a considerable time now, and most of the issues of fiscal policy have also been discussed at length in the literature and generally contain few surprises for the informed reader. CPB's *Ageing in the Netherlands* is in that respect no exception: it is one big generational accounting exercise with no major surprises that are not already apparent in the work of Bovenberg and Ter Rele. If you read enough generational accounting work you know that these calculations are quick-and-dirty, that they are first approximations and certainly not the final word on the subject, and I wonder why CPB did not invest some more time in underpinning the generational accounts with a dynamic general equilibrium model like the ones constructed by Peter Broer[1] and Leon Bettendorf.[2] Considering the intellectual background of the authors, I would have expected a more creative report on ageing, as there is so much more to say about ageing populations than this generational accounting exercise suggests. My role as a discussant is therefore more akin to that of a film critic who has to write about Jaws III: when you saw and enjoyed Jaws I (Kotlikoff) you know that Jaws II and Jaws III will be of less quality and also contain fewer surprises – no matter how good the reputation of the cast is. The script demands sharks. In order to change the script of future ageing studies, I would suggest the following points of discussion:

1. Why smooth tax rates? The authors use throughout the paper the assumption of constant tax rates. These constant tax rates can easily be defended on the ground that government smooths or should smooth tax rates in order to minimise the deadweight loss associated with distortionary taxation. What is odd about the use of the tax rate smoothing assumption is that there is no reason at all for using this assumption – taxes in the present set-up have no distortionary consequences, as the model has no microeconomic underpinnings. Sure, if you stall raising tax rates now you will have to raise them more later, but perhaps that may be the efficient way to go about dealing with ageing populations. I say 'perhaps' because you cannot answer this question as long as you leave preferences undefined. Moreover, as long as you don't underpin your policy scenarios microeconomically, your policy evaluations will be biassed towards the view shared by generational accountants. In short, there are no costs, but also no benefits, to keeping the tax rate constant across the generations, so: why smooth tax rates? (or related: why back off from general equilibrium modelling?)
2. Why is the sustainable policy solution unique? Anyone who reads his fair share of Dutch newspapers must be under the impression that there is only one way to solve the Dutch budgetary problems and there is only one optimal debt time path. CPB gives us the same impression, although they make quite clear why this is so: the way CPB presents sustainable deficit and debt paths is so narrow because its definition of sustainability is equally narrow. The solvency condition necessarily holds with equality. Otherwise, one leaves tax resources unused, government spending is left unchanged, and solving the model for an indirect tax (t) increase is a simple problem – since there is only one equation with one unknown: $B^f(t) + B^c(t) + D = 0$, where $B^f(t)$ represents the net benefits of future generations, Bc (t) that of current generations, t is the endogenous tax rate and D is the initial government debt. One can also see why taxes need to be constant – not because of the tax smoothing argument, but simply because the accounting framework does not allow any other choice. Any deviation from this equilibrating tax rate will lead to exploding debt (or asset) paths. My point with respect to the uniqueness of this sustainability solution is that it is an artificial sense of sustainability. Sustainability is a poorly understood and larger concept than CPB suggests, and it does not imply some unique time path of public debt (as presented and readily accepted by policy makers). As sustainability plays such a large role in this report, I would therefore have expected a link to the large literature on testing sustainability of fiscal policy and using these insights in constructing time paths. There is an infinite number of sustainable fiscal policies, making the CPB choice perhaps plausible within the world of the generational accountant – but outside that particular world it seems rather arbitrary.
3. Fixed factor prices are a fiction. As the large fluctuations in interest rates in the recent past have shown, any assumption of constancy is unrealistic in the medium-term, and certainly in the long run. The idea that interest rates are fixed is hard to swallow if you think that the industrialised world is ageing, and this is bound to have an effect on the world interest rates. Furthermore, assuming a fixed interest rate does not necessarily mean that the wage rate is also fixed (p. 18). Of course, predicting the interest rate is almost an impossible job, but it is better to model this crucial variable as stochastic and time-varying than to assume that nothing will happen.

* Scientific Council for Government Policy, The Hague, and Erasmus University Rotterdam, email: dalen@wrr.nl

4. Government expenditures have no effect, increase in line with growth, and are apparently provided in an efficient manner. If I understand the authors correctly, government expenditures like infrastructure investment or education have no real effects on the productivity or welfare of the Dutch citizens. The authors also assume that government spending is indexed to the rate of productivity growth and although it "doesn't necessarily have to be true, it corresponds with long-term empirical evidence." My experience is that this unitary income elasticity does not really show up in the data, but the authors may of course have different empirical sources (although they do not mention them explicitly). Last but not least, government expenditures are left untouched in the fiscal policy analysis by which authors implicitly are saying that government spending is done efficiently and does not need to be scrutinised. This is odd, as ascertaining the efficient level of government expenditure goes right to the heart of a discussion about sustainability in the political arena. CPB has thereby missed an essential point of the public debate of today.

Wrapping up, Ronald Coase once defended the modest successes of economists by saying that "An economist who, by his efforts, is able to postpone by a week a government program which wastes $100 million a year (what I would consider a modest success) has, by his action, earned his salary for the whole of his life." I hope the policymakers who take this CPB study seriously will think for an extra week, because there is more to ageing than meets the eye, and *Ageing in the Netherlands* is a report of a generational accountant. No more, no less.

Notes

[1] D.P. Broer, 1999, Growth and Welfare Distribution in an Aging Society, OCFEB no. 9908, Rotterdam.

[2] L.J.H. Bettendorf, A.L. Bovenberg and D.P. Broer, 2000. The consequences of ageing for economic development (in Dutch: De gevolgen van vergrijzing voor de economische ontwikkeling). *OCFEB Studies in Economic Policy*, Rotterdam.

In reply

Casper van Ewijk and Ed Westerhout (CPB)

Harry van Dalen seems to have had little pleasure in reading the CPB study on ageing. He found that it contained too few surprises and too many of what he calls 'wonder points'. We appreciate the opportunity to respond to these two comments. Let us explain why.

Too few surprises?

Van Dalen considers the CPB study 'one big generational accounting exercise with no major surprises'. In response, we should stress that our primary aim was exactly that: to provide policymakers with an update of generational accounting that would be useful both at the national and international (EU, OECD) level. That does not mean that – apart from the updating of figures – we just copied earlier exercises. Rather, we improved earlier studies on several points. For example, we took more seriously the device of unchanged policies in assessing future flows of public expenditure and tax revenues, and worked through a detailed sensitivity analysis. Moreover, the CPB study, more than earlier work, stresses that tax smoothing can be motivated from considerations of economic efficiency. Furthermore, the study breaks the link that was forged in earlier work between the concept of sustainability of fiscal policies and that of tax smoothing. That our results then replicate some of the results in earlier exercises may look surprising, but is pure coincidence.

Too many 'wonder points'?

Van Dalen stresses the non-uniqueness of policies that restore the sustainability of public finances. We agree. Indeed, the intertemporal budget constraint of the government leaves room for immediate action or delay for any number of years policymakers would find attractive. It also leaves unspecified whether taxes or public expenditure (or any combination of the two) should be used to ensure solvency of the public sector, and which type of tax or expenditure item should be adjusted.

From this, it follows that tax smoothing is just one of the many options that can be used to restore the solvency of the public sector. However, it is a very particular option. It relates to microeconomic theory that indicates that the welfare loss from distortionary taxation is quadratic in the tax rate. Tax smoothing thus appears to be the solution that invokes the smallest welfare loss.

Van Dalen's argument that tax smoothing fails to be attractive in our model because we did not model the distortionary effects of taxation is not convincing. Tax smoothing is optimal because taxes are distortionary in the real world, not because they are (not) in our model. Moreover, we did calculate the additional welfare losses that the economy would suffer if policies were to deviate from the prescription of tax smoothing (see pp. 82-83 of the study). The effects turned out to be very small. We considered this, actually, to be an intriguing result. At a later stage, however, we found out that it is not that surprising. Ageing in the Netherlands is a manageable problem; the necessary adjustment in net primary expenditure to restore sustainability is small, and deviating from tax smoothing comes at a low price. Somehow, these results are related.

Finally, van Dalen criticises our assumption on public expenditure. We have taken the view that public expenditure may increase in line with GDP. To us, this seems a rather obvious benchmark assumption that fits in rather well with historical evidence and the concept of genera-

tional accounting. But not more than that. We refer to the sensitivity analysis in the study, which serves to illustrate that we can put the best of our knowledge into making future projections, but will never succeed in entirely eliminating forecast errors.