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Fiscal policy in the longer term

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Saving, wealth and government debt

- Fiscal policy problems may be the result of flaws in the financial regulatory structure
  - Defaults on government debt held abroad
- National wealth has to be evaluated along with government debt
  - Are national savings adequate for plans?
  - What is the nature of the market failure?
- Wealth exists for retirement
  - Rising life expectancy is a fiscal problem
  - Gains from extending working lives

Default and financial regulation

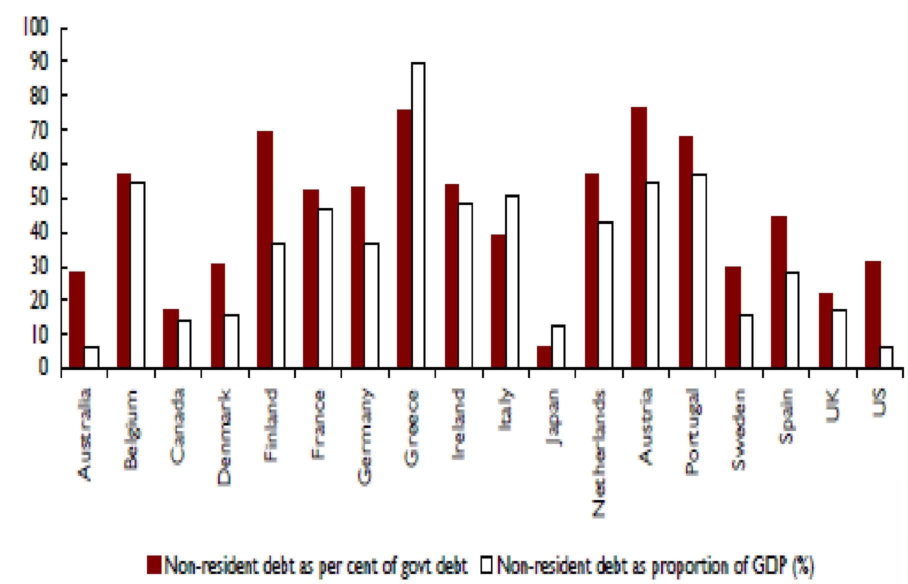
Table 1. The evolution of government debt held abroad

	Austria	Canada	Denmark	Finland	France	Spain	Sweden	UK
Proportion of government debt held abroad								
1995	0.36	0.28	0.42	0.53	0.25	0.23	0.41	0.20
2009	0.78	0.14	0.43	0.96	0.67	0.47	0.40	0.23
Gross government debt as a percent of GDP								
1995	66.7	99.6	79.5	65.3	62.6	65.7	81.2	56.3
2009	69.4	79.7	48.6	53.2	86.7	57.1	51.9	74.2
Shift in fiscal exposure (change in debt held abroad as per cent of GDP)								
2009–1995	30.0	–16.2	–12.5	16.1	42.8	11.2	–12.9	5.7

Source: OECD Debt Statistics and NIESR database.

- A (partial) default on debt held at home is a tax on wealth
- The SMFS and EMU led to major foreign holdings of debt

Figure 1. Foreign country holdings of government debt, end 2009



Source: Bank for International Settlements.

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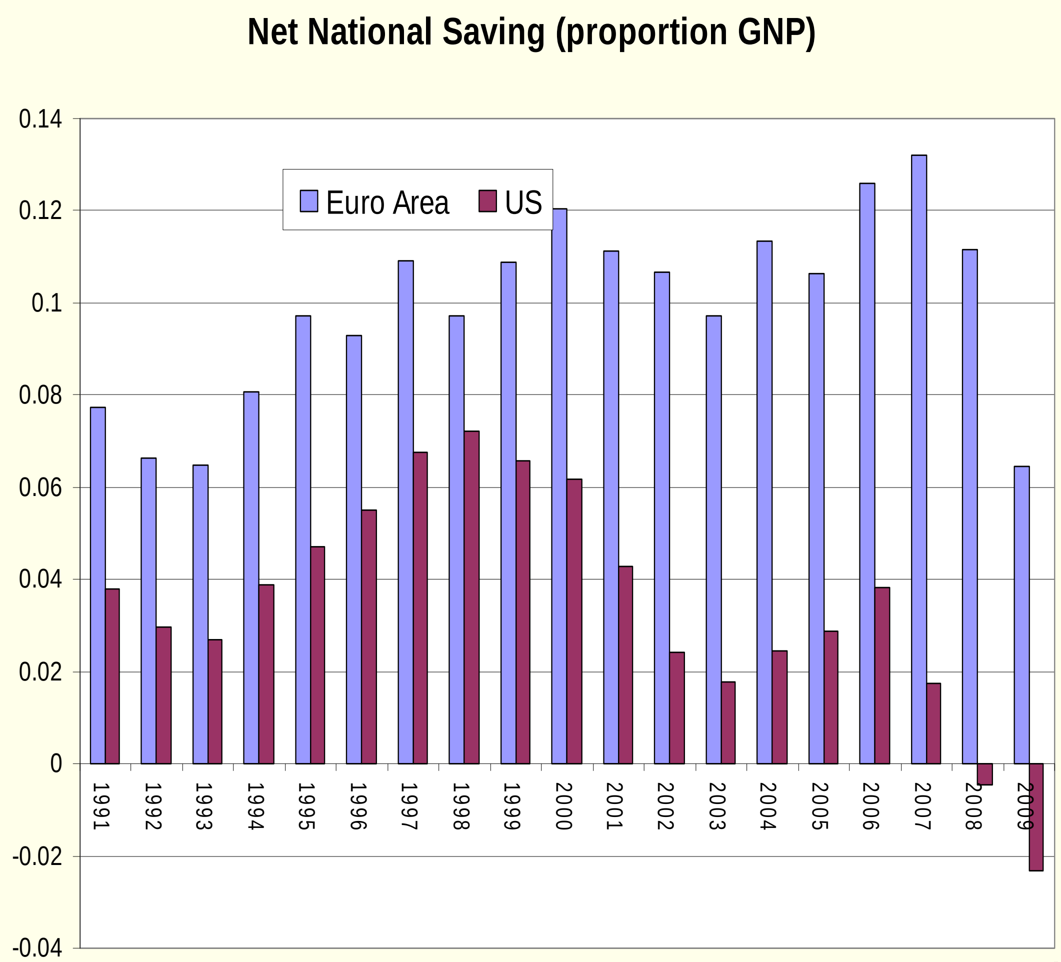
What determines saving needs?

- National saving is investment minus depreciation and the current account
  - Steady state national wealth is the net saving rate divided by the growth rate
  - Steady state national wealth ought to be related to retirement incomes less transfers from workers
- If saving is not high enough then pensions or pensioners have to be reduced
- These are problems for long term fiscal policy setting as in Auerbach

Net National Saving

- Wealth is not adequate for current plans/life expectancy
  - US, UK, Italy net saving should rise by 3-5% of GDP
  - Euro Area saving needs to rise marginally
- Either taxes must rise, people work longer or pension replacement rates fall in the US and UK



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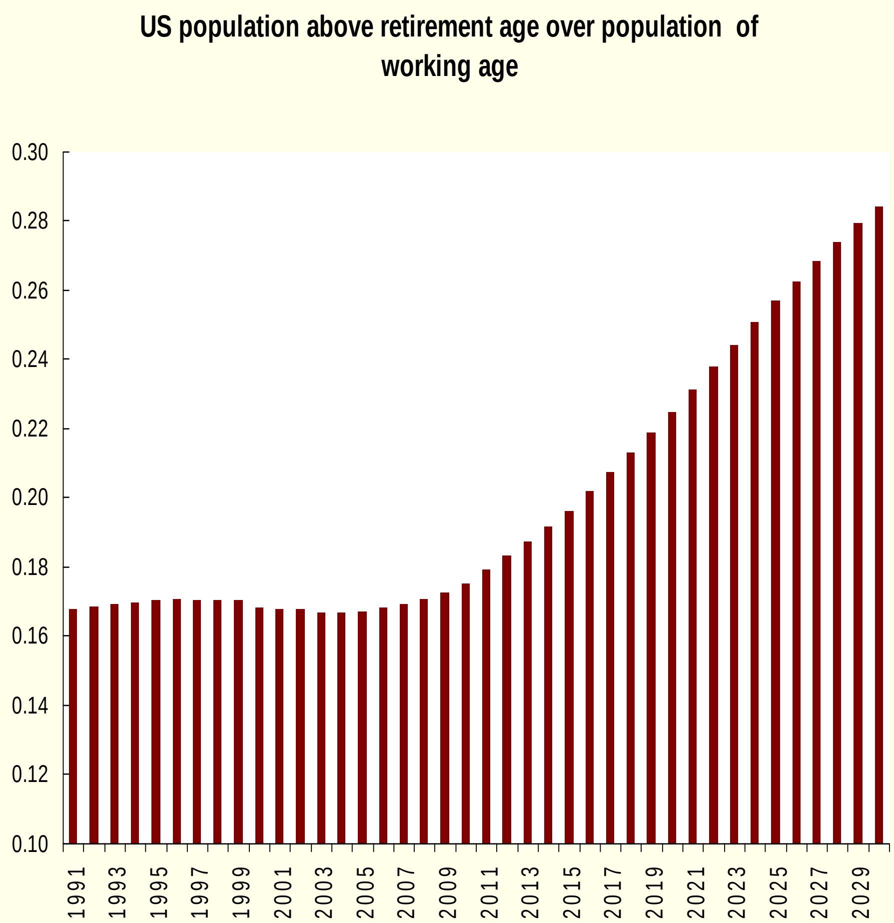
Savings needs of the US economy



- Our estimate of national wealth falls but the retired population is likely to rise markedly
  - National wealth is the stock of produced assets
  - BEA estimate has large revaluations which may it rise in 2006 and 2007 as a share of GNP
  - It should exclude land prices underlying property prices
- Probably a noticeable shortfall as in the UK

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Extending working lives

- Pension dependency is at the heart of long term fiscal dependency
  – Costs of retirement depend on state pensions
  – Inadequate savings will produce political pressure for tax based transfers from workers to retired
- Gains from extending working lives
  – Higher output in the medium term
  – Higher direct and indirect tax receipts (65% of total after 10 years)
  – Lower transfers to the retired (25% of total)
  – Lower interest payments or tax rates

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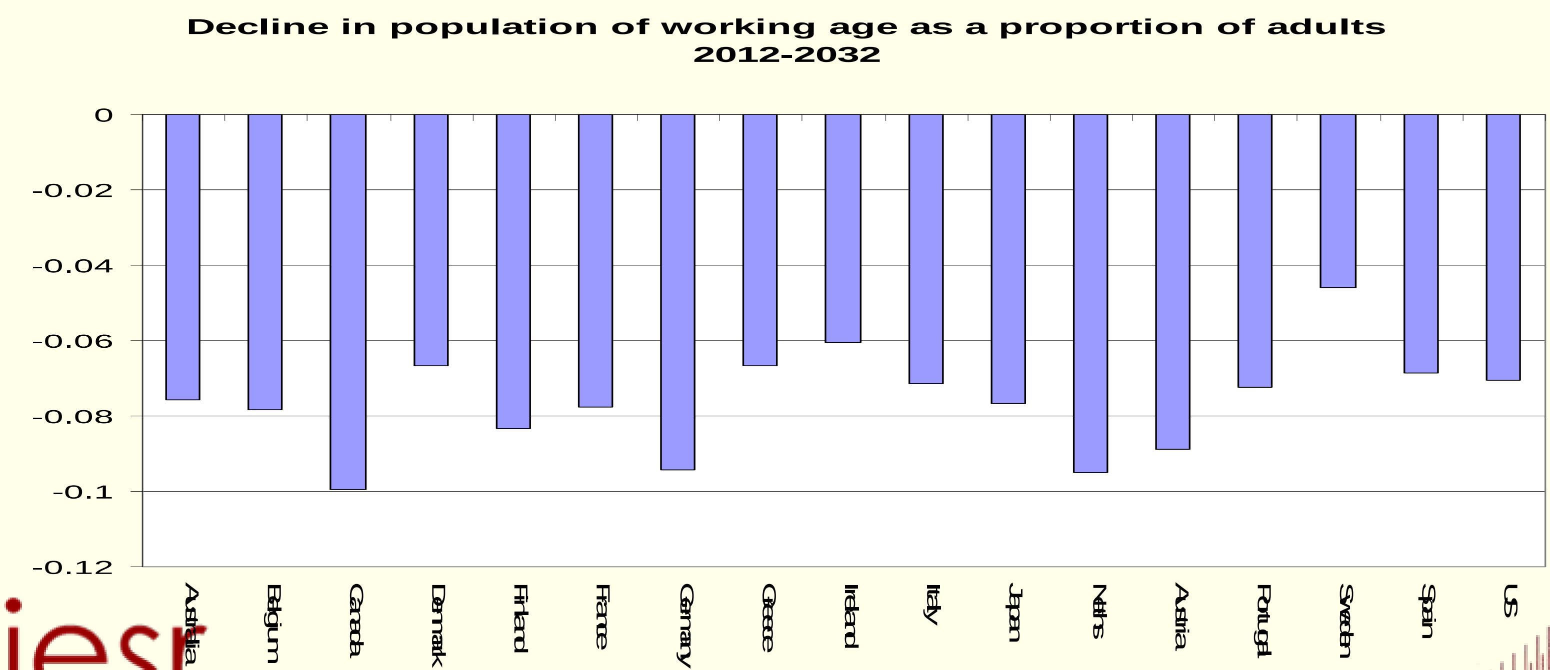
An experiment on working lives

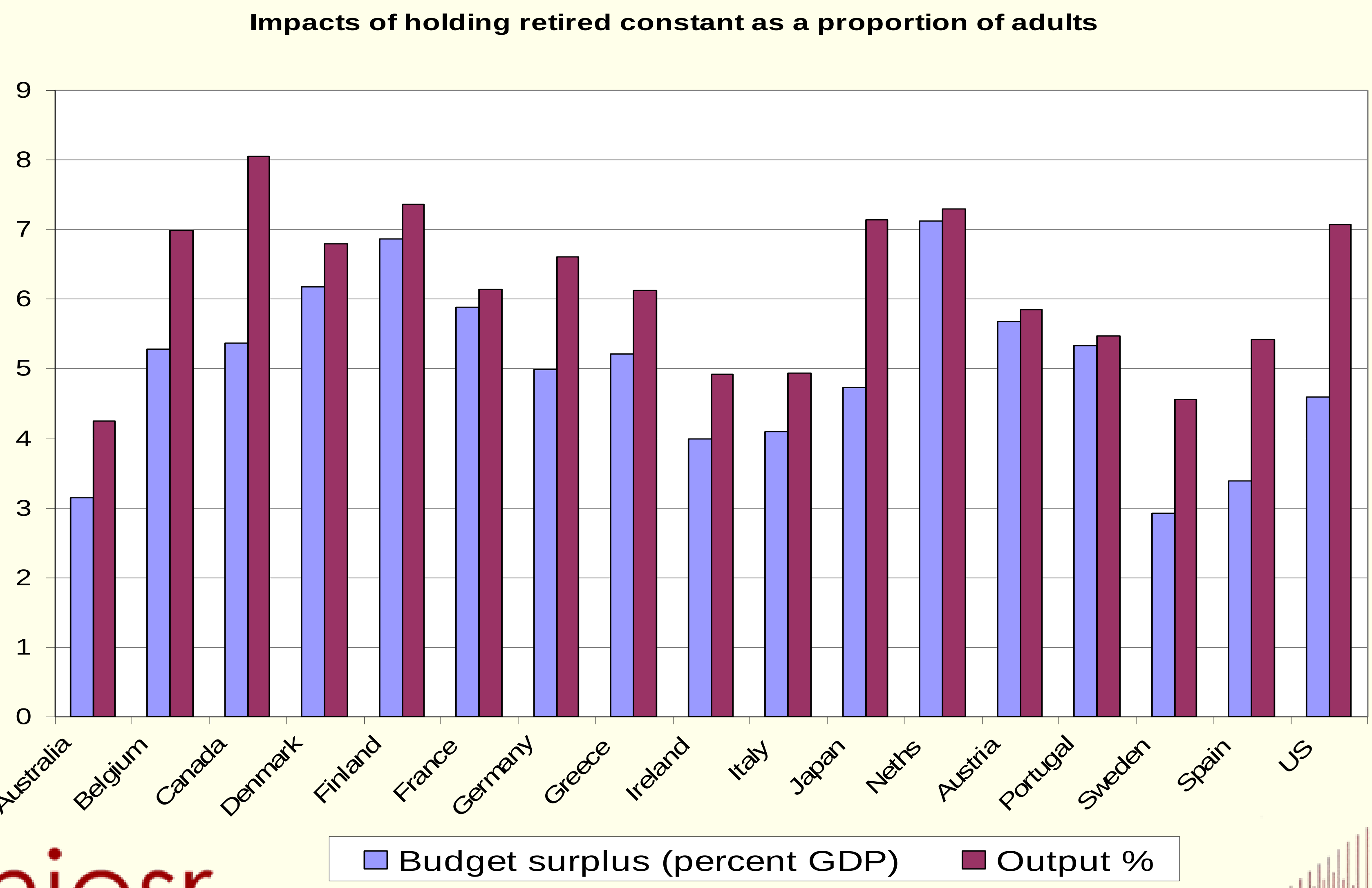
- Look at projected retired population relative to working age population or 18 OECD countries on NiGEM baseline
- Raise working age population and reduce retired to hold it constant at 2011 level
  - Hold tax and benefit rates constant
  - Hold government consumption constant
  - Run model with forward looking investment, financial markets and consumers
  - Older workers have 70% average productivity
- Unemployment returns to baseline in 5 years – market work

Who has an aging problem?

- If retirement ages do not rise dependency rates will increase in all countries
- US has begun to address the problem, but it has a similar problem to other G7 countries but lower saving



Impacts of extending working lives



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