Population aging, fiscal balance, and inflation

Mitsuru Katagiri
Hosei University
Population aging and fiscal balance

• Population aging generally worsens fiscal balance due to:
  – Increases in social security spending like pension, and
  – Declines in labor supply which shrink the tax base.

• Japan is one of the most aging societies in the world.
  – The ratio of people older than 65 is 28.4% in 2019.

• Asian countries will experience a rapid population aging in the future (See Table 2.1 and Fig. 2.1 in Chapter 2).
Ways of ensuring fiscal sustainability

To ensure fiscal sustainability under population aging, the fiscal authority needs to:

1. **Decrease fiscal expenditure**
   - Particularly, it is necessary to reduce social security spending.

2. **Raise fiscal revenue, and/or**
   - In addition to taxes, they can raise social security burdens.

3. **Increase inflation to reduce the debt-to-GDP ratios.**
   - Public debt is mostly nominal domestic bonds in many countries.
Main arguments

- **The political economy** of aging is key to understanding its effects on fiscal policy.
  - Aging increases the political power of older generations.
  - Hence, a government tends to increase taxes and social security burdens but hesitates to cut social security spending.
  - Also, inflation is difficult to raise, as older generations who rely on nominal assets dislike inflation *(Katagiri et al., JME, 2020).*

- Low interest rates induced by population aging may help a government reduce interest payments.
  - Population aging lowers growth, and so the natural interest rate.
1. Reduction in fiscal expenditure

• Population aging inevitably raises fiscal expenditure for medical care, pension, etc., but...

• ...population aging increases the voting power (= political power) of older generations.

• Thus, it is difficult to cut the social security expenditure under population aging.
  – In many countries, raising the age to start receiving a pension is necessary but very difficult.
  – In Japan, public insurance is too generous for those older than 75, covering 90% of medical expenses.
2. Increase in fiscal revenue

- Social security expenditure is financed by taxes and the social security burden on younger generations.

- Given the increasing political power of older generations, a government tends to increase those burdens.
  - "Worsening support ratio will increase fiscal expenditure needs, pushing governments to seek for more fiscal revenues." (Ch. 2)
  - Japan increased the consumption tax rate from 3% -> 5% (1997) -> 8% (2014) -> 10% (2019), mainly for social security.

- High taxes and social security burdens distort economic behaviors and make a welfare loss in general.
Social security burden in Japan

- The social security burdens are rapidly increasing in Japan.

Note: The figure shows the ratios of security burdens to national income.
3. Inflation and fiscal sustainability

• Given that most public debt is nominal domestic bonds, (unexpected) inflation lowers the debt-to-GDP ratios.
  – When inflation is expected, it is reflected in a higher interest rate.

• In history, unsustainable fiscal balance often causes high inflation, but...

• ...population aging makes it politically difficult to raise inflation, as old generations rely on nominal assets.
  – "Aging caused by increase in longevity is deflationary, however, aging caused by decline in birth rate is inflationary" (Chapter 2).
Interest rate and fiscal sustainability

• Population aging lowers the natural interest rate because it lowers the growth rate.
  
  – “Referring to the case of Japan, most likely the richest source of information and experience on aging in the world, aging will push down the natural interest rate. ... Lower natural interest rates bring relief to debt sustainability concerns.” (Chapter 2)

• A low interest rate helps a government maintain its fiscal sustainability by reducing interest payments, but....

• ...in the face of high inflation after the Covid-19 pandemic, many countries are forced to raise interest rates.

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Low interest rates and fiscal balance

• Despite the increasing debt in Japan, interest payments do not increase due to low interest rates.
Concluding remarks

- Population aging increases social security expenditure and shrinks the tax base, thus worsening fiscal balance.

- Due to the increasing political power of older generations, it is hard to cut social security spending or raise inflation.
  - Most older people rely on nominal assets and hate inflation.
  - Instead, taxes and social security burdens tend to increase.

- Considering the fiscal benefit of low interest rates, raising interest rates is a tough decision.
  - Financial repression by low interest rates is one of the options.