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Comment Alan J. Auerbach

This chapter is the latest in a series by the authors utilizing a multicountry, computable general equilibrium model that features international capital flows and a rich characterization of demographic variables. In earlier work, the model has been used to consider the macroeconomic effects of aging and the role of pension reform in improving welfare and macroeconomic performance. The present effort focuses on a related question: whether a Europe that is "old" both in history and in population can prosper even as the strong demographic transition already under way continues. The answer is a provisional "yes," and figure 5.15 shows the keys to success. The authors suggest that the following measures, in some combination, could keep per capita consumption rising even as these countries' populations age:

1. Adopt labor market reforms aimed at increasing labor force participation.
2. Adopt a funded public pension plan.
3. Force people to work.

The last prescription, of course, is problematic. A reduction in hours—among those already working—in response to labor market reforms is a natural part of the household decision-making process; there is no easy way to prevent it, and a government seeking to maximize welfare, rather than simply output, would not want to. But even the other prescriptions are not so simple. How to adopt labor market reforms that have proved so difficult in the past is certainly a challenge, and the benefits of a funded pension plan cannot be magically obtained without a painful transition to funding that has left most countries seeking other options. Let me expand a little on these points.

How can labor market reforms be adopted? The authors characterize a suite of labor market changes that might be accomplished by Old Europe, including increases in labor market participation by the elderly, the young, and women, along with a reduction in the unemployment rate. The fact that an existing advanced European country—Denmark—already has these characteristics is a good start in thinking about what might be possible elsewhere. But it is only a start. The chapter does not specify what actual policy reforms might accomplish these changes in the labor market, nor does it provide evidence that all of these reforms would be welfare-improving, even if they were feasible. For example, Italy's lower labor force participation rate among women may reflect some difference in social or cultural values,—that

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is, in preferences—and overriding these preferences could be detrimental to social welfare. Without a fuller specification of the nature of the existing constraints on labor markets and the costs of relaxing them, it is hard to know whether, and at what social cost, the labor market changes considered here could be accomplished.

Achieving pension reform. The chapter shows that the transition to an older society has less severe macroeconomic consequences when a funded pension system is in place. This is a lesson from the authors' earlier simulation studies, and it makes perfect sense. To continue servicing a pay-as-you-go (PAYG) public pension system as the old-age dependency ratio increases, a country must increase marginal tax rates on workers, thereby worsening labor market distortions. Under a funded system, of course, this will not happen, as workers provide for their own future retirement through contributions that are linked to future benefits.

But *getting* to a funded system is different from starting with one. The capital accumulation needed in transition must come at the expense of some generations, and this requirement has posed a very high political obstacle that has left countries in search of alternatives. The recent pension reforms in Sweden and Germany are illustrations of attempts to achieve greater financial stability and intergenerational equity without departing from the PAYG framework. It might make sense for the authors to consider a more achievable pension reform within the PAYG format as they search for options for Old Europe; for example, changes that would increase the linkage between an individual's taxes and benefits and thereby lessen the perceived tax burden of pension contributions.

Interpreting the Results

As already mentioned, the chapter uses a multicountry, general equilibrium simulation model the authors have developed in prior work. Because development of the model is not this chapter's primary focus, there is relatively little discussion of the various parameter choices made in the calibration process. One does not want to get bogged down reviewing all aspects of the model, but it would be useful if Börsch-Supan and Ludwig provided further elaboration as to the model's key parameters. In particular, on which parameters do the chapter's main result critically hinge, and how certain are we about the values chosen?

In qualitative terms, most of the chapter's findings make sense, although some would benefit from further elaboration. For example, one might have expected that, with a hump-shaped productivity profile, an increase in elderly workers would lead to a less productive labor force, at least relative to the productivity that one would observe if productivity profiles were flat with respect to age. As figure 5.17 shows, however, the opposite result occurs. Presumably, this is because of the shape and location of the hump—in particular, that productivity does not fall off so fast to make the declines in older age offset the increases at slightly lower ages.

Another example of at least one reader's difficulty in interpreting the results is in figure 5.10, where, as in other figures in the chapter, the authors use what might be characterized as a graphical difference-in-differences approach to report the effects of policies. I think, by the way, that this method of analysis is a useful and innovative way of looking separately at the many pieces of a complicated whole, but it does not eliminate the complexity of the results, which often must be traced to a series of interacting factors. The first lower panel of figure 5.10 shows the marginal impact on hours of having a public pension system. As discussed earlier, we would expect a favorable outcome, but this is actually what we observe only if labor market reforms are also implemented; that is, hours of work are higher for a funded pension plan than for the status quo under the labor market reform labor force assumptions, but not under the status quo labor force assumptions.

Conclusions

In summary, this is a chapter that barrages the reader with many interesting findings. Some are quite intuitive, while others are less so. Such less intuitive findings can be where the payoff lies in using such models, for by understanding where these findings come from we gain a better understanding of how different factors interact. But much of the chapter's findings derive from its assumptions, in particular those about what labor market reforms might deliver. We can see quite clearly from the chapter's results that these reforms could matter in a big way for future economic performance. But we do not know any more than before what has kept these reforms from being adopted, or how they might be achieved in the future. Thus, the chapter shows that Old Europe *can* prosper. But whether it *will* remains a very open question.