Tackling the economic consequences of ageing

Ignazio Visco
Chief Economist, OECD

In 1930 – a period of numerous technical innovations – John Maynard Keynes wrote a thoughtful essay imagining the economy 100 years hence. He predicted substantial improvements in living standards stemming from capital accumulation and technical change. And he even concluded that mankind's adjustment to productivity increases will ultimately imply a need to work only a 15-hour week in order to meet economic needs!

Today his essay would still be appropriate for a story on the new economy. And even if Keynes was correct on capital accumulation and technical innovations, as well as on the substantial improvements in our standard of living, his conclusion about the working week reminds us all how wide of the mark bold predictions can turn out to be. Nevertheless, my focus in this article is on the possible long-run implications of what appears to be a rather certain demographic prospect: the ageing of OECD populations.

Improvements in living standards, healthcare and nutrition have led to an increase in life expectancy. In 1960, average life expectancy in the OECD area was 66 years. Today it is 76. Moreover, an increasing number of years in retirement are disability-free and retirement income levels are enabling the elderly to enjoy their latter years more fully. Longer life expectancy and improved retirement incomes over the past 30-odd years are probably the largest such changes ever registered over any comparable period. And looking forward over the next 30 to 50 years, "new economy" innovations in biotechnology and microchips with medical applications, currently at an experimental phase, offer the prospect of extending life expectancy further, some say by 10 years or more.

But ageing populations are also linked to low fertility rates (see graph 1). On average each woman in the OECD area has 1.6 children and in countries such as Italy, Spain and the Czech republic the average is about 1.1-1.2 children; these are well below the 2.1 children required to maintain a stable population. Together, increased life expectancy and low fertility rates – even if the latter may recover to an extent in the years to come – will result in a smaller proportion of the population being of working age, particularly in the years after 2010. For the OECD area as a whole, the number of people aged 65 years and over relative to the number aged between 20 and 64 years – the dependency ratio – is expected to double in the next five decades to reach almost 50%. Considerably sharper increases are expected among some of the major European countries and Japan (see graph 2).

While living longer and in good health is obviously a marvellous achievement, especially if one has the resources to enjoy it, a consequence of a contracting labour force (in particular associated with low fertility rates) might, all things being equal, be to undermine improvements in material living standards. Furthermore, under current institutional arrangements where public pensions are paid out of the contributions of today's workers, fewer workers supporting more and older retirees will put budgetary positions in OECD countries under increasing pressure. In particular, public pension payments will rise and absorb a growing proportion of total social outlays. Moreover, healthcare spending, an important component of public expenditure, is also likely to increase, especially since the share of the very old (80 years old and above) is expected to rise from less than 3% to more than 8% of the OECD population over the next 50 years, and this age group is one of the biggest users of healthcare services. A recent OECD study concluded that budgetary pressures from ageing populations in OECD countries could add on average some 6% of GDP to government outlays on the aged (for pensions and health care) between now and 2050. In my view this may turn out to be a conservative estimate, as it is based on relatively optimistic assumptions concerning dependency rates, productivity and labour market developments.

Adjustment to an older and slower-growing population is one of the major structural changes facing OECD economies. It raises a number of policy issues that will require imagination and courage to deal with, not least how public pensions and health care obligations will be paid for. The OECD has extensively analysed the forces behind ageing populations, their likely impacts on living standards and budgetary positions and the policy challenges caused by these structural shifts. Space is too short here to explain in detail, but one conclusion is clear: maintaining the status quo is not an option. Under no circumstances would this ensure an adequate retirement income for the aged and at the same time limit the burden on taxpayers. It is inevitable that as we live longer we will need to work longer (and therefore retire later). At the same time a rise in labour force participation rates, especially among elderly workers and females, which in certain countries are very low, will be needed. Such messages need to be broadly recognised and require policy responses. Otherwise, budgetary restraint could become necessary for an extended period to avoid spiralling levels of public debt, putting sustained pressure on other important areas of government expenditures or raising the tax burden, possibly compromising future growth prospects and therefore the material living standards of future generations.

However, no single policy initiative can redress the fiscal pressures of ageing populations. The OECD emphasises the need for action on many fronts, cutting across traditional boundaries of economic, financial and social disciplines. Specifically, responses need to focus on achieving an increase in the average number of years individuals actively spend in the labour force. In this context financial incentives to early retirement or disincentives to later retirement, such as laws which forbid combining work with the receipt of old-age pension, should be removed and ways to enhance job opportunities for older workers and improve their skills and competencies should be found. Public pension benefits should be reduced, for given contributions, to ensure budgetary control and lower the public debt burdens caused by ageing populations. At the same time the sources of retirement income should be diversified, with a mix of tax-and-transfer systems, funded systems and private savings, which also demand strengthening of financial market infrastructures. Finally, efforts should be pursued to make health and long-term care more cost effective.

Such reforms require advance notice and gradual implementation to minimise their distributional impact. They should leave no room for complacency. Indeed this is a major challenge for policymakers, as they need to anticipate problems and build support for reforms, even though the effects are only likely to be seen one or two decades down the road. This is no easy task, as all options for reform bring different costs and benefits and have important distributional consequences, both within the current population and between generations. Nevertheless, some progress has been made, for instance, towards encouraging an increase in the average number of years worked. Improvements are, however, uneven across countries and in many cases more reforms are required.

It is sometimes argued that harnessing the “new economy” – higher output levels and faster productivity growth – would offer a substitute response and relax the need for difficult decisions now, as future generations will be richer and thus more able to pay the economic consequences of currently ageing populations. But as with the option for increased immigration into OECD countries, which is often advocated, higher growth would only provide a rather partial offset. To illustrate, under current institutional arrangements for a sample of OECD countries, which includes most of the large economies, 1% a year higher output growth over the next 50 years might ease the increase in the level of pension expenditures to GDP by only about three quarters of a percentage point. Hence, very substantial increases in economic growth (through higher productivity) would be needed to significantly offset the increased costs of ageing. The need for continuing on the politically difficult road of substantial reforms should therefore be reaffirmed. However, insofar as higher rates of economic growth imply an improvement in material living standards and increased government revenues, they will certainly help to increase the scope – as well as providing a window of opportunity – for major public pension reforms, while reducing their burden on the people at large.

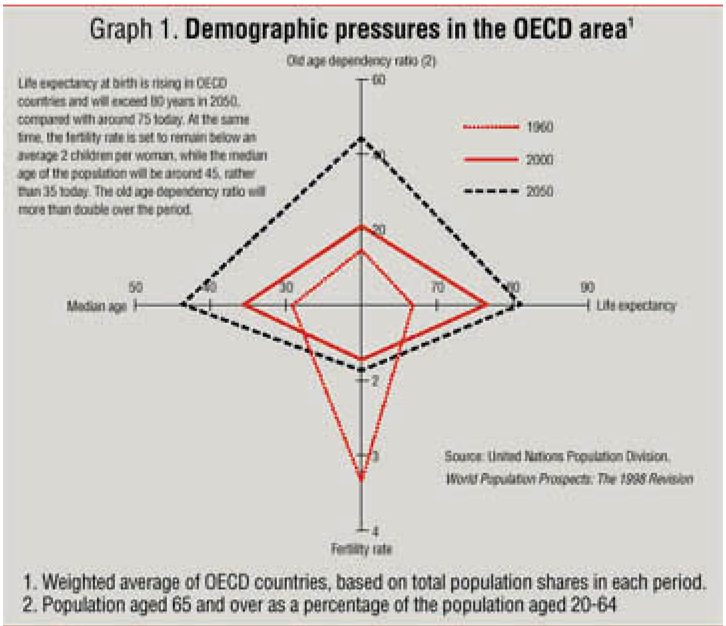
Following the remarkable US performance of the last decade, opportunities for higher growth rates are certainly present in other OECD countries, though to realise them will still require important policy decisions and institutional changes. Thus, while possible higher output growth should not be seen as a reason for complacency about future pension obligations, it should still be pursued both on its own merits and to reduce the burden of necessary reforms. The historical record offers a rich testimony of mankind's ability to change when faced with the prospect of burdening future generations. Even if some of Keynes' specific predictions about the long-run future were evidently wrong, he was certainly correct to stress the adaptability of the human race. I share his optimism.

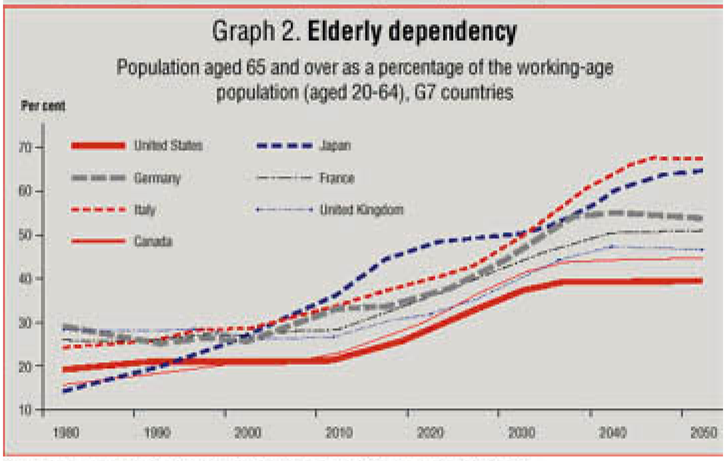
References

•"Economic possibilities for our grandchildren" in J.M Keynes (1933), Essays in Persuasion, MacMillan and Co, London.

•"Fiscal implications of ageing: projections of age-related spending" chapter in the forthcoming June 2001 edition of the OECD Economic Outlook.

Ignazio Visco, Chief Economist, OECD





Source: Eurostat; United Nations Population Division, *World Population Prospects: The 1998 Revision.*

Graph 1 shows that life expectancy at birth is rising in OECD countries and will exceed 80 years in 2050, compared with around 75 today. At the same time, the fertility rate is set to remain below an average 2 children per woman, while the median age of the population will be around 45, rather than 35 today. The old age dependency ratio will more than double over the period. *Graph 1: Source: United Nations Population Division, World Population Prospects: The 1998 Revision; Graph 2: Source: Eurostat; United Nations Population Division, World Population Prospects: The 1998 Revision.*