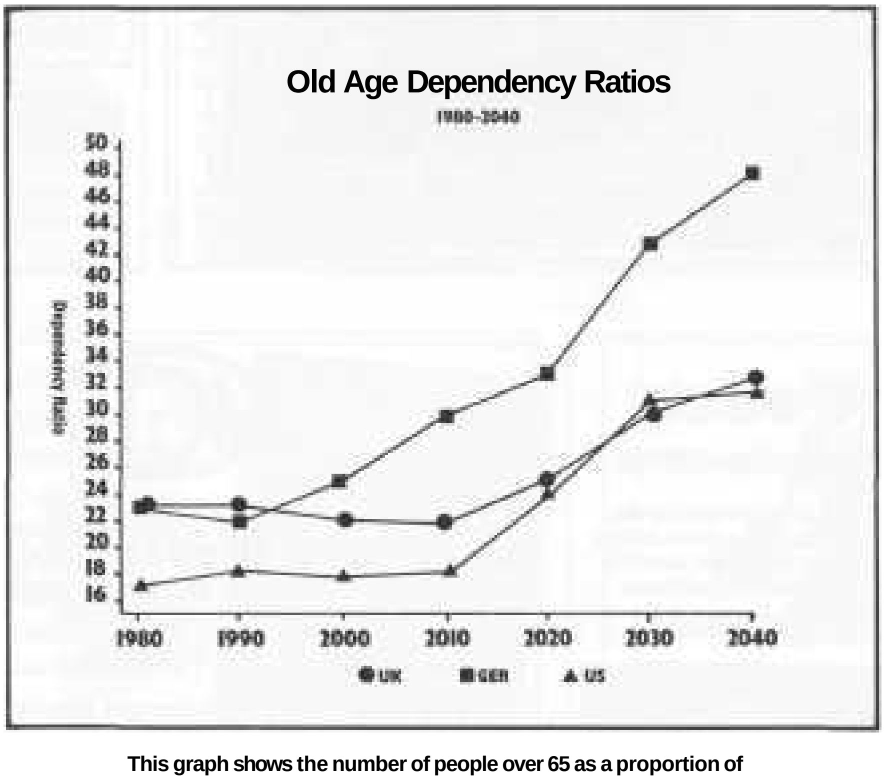
Old Age Creeps Up

The great economic and social problem of the next four decades will be the ageing of Britain's population. The recent row over Lawson's pensions leak is small beer compared with what is to come. This is going to be a big one. **Paul Johnson** peers into the future



This graph shows the number of people over 65 as a proportion of those aged 15-64 over the next 50 years.

The rapid ageing of the populations of all industrial countries over the next 40 years will be an economic and social transformation of vastly greater magnitude than the 1970s' oil price shock or the 1980s' recession. Unlike the economic difficulties of the last two decades which arose suddenly and with little warning, the problem of population ageing is almost entirely predictable, because we know within narrow boundaries how many people of working age and how many elderly will be alive in 20 or 30 years' time.

This process of population ageing will have a profound impact on many established social customs and institutions such as the pattern of work and retirement, the functioning of welfare systems, and the nature of family relationships. Yet these consequences of population ageing have to date attracted little public attention, perhaps because the issues are unfamiliar, but also because politicians and others concerned with public policy seldom have the opportunity or the desire to look more than a few years ahead.

In this article, however, I will suggest that altering welfare systems will have only a limited and transitional impact on the economic cost of population ageing, and that if we are to face up to the long-run costs of this demographic change, we need to think of policy options that extend well beyond the boundaries of the welfare state. In order to explain why the issue is much broader than a simple concern with welfare policy, I will first sketch in some familiar detail about demographic trends, then place these trends in the context of current welfare and labour market structures, before going on to consider the range of policy options which governments need to consider now.

The demographic problem

The essence of the demographic problem is quite simple - the proportion of old people in the population of industrial societies is increasing and the proportion of people of normal working age is falling. All developed countries have seen an increase in average life expectancy over the course of the 20th century as nutrition has improved and medical advances have increased the survival chances of the young. In the UK, for instance, life expectancy at birth for males in 19S0 was 66.5 years; by 1979 this had risen to 70.7 years; for females the figures rose from 71.3 to 77.5 over the same period. Furthermore, life expectancy among the elderly has also increased so that more 70 year olds now survive to 80 and more 80 years olds live to 90 than ever before. Yet despite these impressive increases in longevity, the root cause of population ageing lies not in our success in extending the life course, but in our failure to produce enough children.

In 1950 the total fertility rate, which measures the expected number of births per woman aged 15-44, was well over 2.1 (the population replacement rate) in all the countries of Western Europe and North America. Today only Ireland continues to experience above-replacement fertility, while in West Germany and Denmark total fertility has fallen to the unprecedented level of 1.4. Large changes in fertility rates have been experienced before - the baby boom' of the 1950s followed two decades of low fertility during the 1930s depression and the second world war - and the very low fertility rates evident in some countries today are not expected to continue indefinitely, although few population projections suggest a return to above-replacement fertility rates in the foreseeable future.

Even if fertility does return to something approaching the replacement rate by the year 2000 or shortly after, there will nevertheless be an enormous transitional problem by the third decade of the next century as the 'baby boom' generation enters retirement and turns to the small cohorts of working age adults for economic support. In Britain, the projected old age dependency ratio (the number of persons aged 65+ to those aged 15-64) is stable at around 23:100 until 2010, but then rises sharply to reach 33:100 by 2040. The pattern is similar in the US, but in West Germany the low fertility rate will cause the old age dependency ratio to begin its rise in 1990 and to reach a much higher level of around 48:100 by 2040.

Whatever the reason for the fertility decline - and there is no consensus - its effect will be to increase sharply the proportion of older people over 65 in the populations of developed countries. It is anticipated that the percentage of the population in the OECD countries aged 65 and over will rise from 12.2% in 1980 to 21.9% in 2040. Why does this matter? An increase in the average age of the population need not engender any economic problems. There is nothing sacrosanct about the age 60 or 65 to make it the dividing line between productive and unproductive phases of life. Indeed, the long-run improvements in nutrition and health care that have worked to increase life expectancy over the course of this century suggest that on average a 65 year old man today is likely to be physically more capable of sustaining employment than a somewhat younger man 60 or 70 years ago.

However, increased longevity has not been matched by an extension of the working phase of life; the trend has been for the age of retirement to fall rather than rise. Furthermore, the typical age for commencement of work in the labour market has risen over the last century as a larger proportion of children have been educated for a

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This graph gives the percentage of men aged 55-64 who do paid work.

greater number of years. These long-run changes in the nature of the employment contract, with work starting later and finishing earlier, have led to a shortening of the productive phase of life despite the improvement in health and extension in lifespan which together have worked to increase the productive potential of the individual.

An inevitable corollary of this reduction in the number of years spent in work is an increase in the length of life spent dependent on the effort and output of that section of the population currently engaged in what is normally defined as productive work. Many mechanisms have evolved to ensure that resources are redistributed from the working to the non-working sectors of society - the family and the private savings market being two obvious ones - but in most developed countries it is the state pension and welfare system that has assumed the primary role in this process of redistribution.

This is a recent phenomenon. These state welfare and pension systems evolved during the 1950s and 60s when economic growth was high and when the immediate cost of increasing benefits or including more beneficiaries was slight. The postwar experience of a cheap and generous state pension system forged a popular perception of the welfare contract as an unbeatable bargain where the payout was much larger than the input. But the ageing of the population, a (possibly temporary) brake to the rate of economic growth, and changes in the nature of the employment contract that have resulted in a reduction in the length of the average working life, together serve to make expectations of the welfare contract derived from the experience of the recent past no longer viable. To see exactly why these expectations cannot be fulfilled, we need to examine more closely the nature, function and evolution of both the welfare contract and the employment contract in modern industrial societies.

The welfare contract

Any tax-funded welfare system operates on the basis of an implicit contract between generations which involves people paying contributions during the productive phase of their life-cycle, and drawing benefits during childhood, in periods of sickness, and after retirement. This is analogous, at a societal level, to the implicit contract that exists within families, with working age adults providing care and support both to their children and to their elderly parents. These implicit contracts work in the long run only if each generation is prepared to honour its moral obligations to both the preceding and succeeding generations. If the contract is broken by one generation that refuses to pay during its productive phase, there is then a strong incentive for succeeding generations to break the contract and put their faith in self-help.

The scale and direction of welfare transfers between generations that is projected for the early years of the next century is a cause for concern, because the coincidence of adverse demographic trends and the maturing of many Western welfare systems means that tax contributions from workers will need to rise sharply in order to sustain the welfare systems. In Britain the ratio of national insurance contributors to pensioners is expected to fall from its current level of 2.3:1 to around 1.6:1 by the third decade of the next century, which implies that total national insurance contributions will have to increase from the present level of 12.5% of the wage bill to 18% by 2030. The additional cost in the future of accumulated pension rights under the state earnings related pension scheme (SERPS) will almost certainly force this national insurance figure upwards. In the country with the most unfavourable demographic structure, West Germany, it is projected that the payroll tax needed to sustain the current pension system will have to rise from its current level of 18.5% to around 42% by 2030. If, as seems almost certain, real expenditure on health care for an ageing population increases over the same period, then the necessary redistribution of income from workers to non-workers will become even more pronounced.

It seems inevitable that the interaction of current demographic trends and current welfare policies will impose a large, growing and possibly unsustainable fiscal burden on the productive populations in developed nations. Since there can be no immediate change in the population age structure, it may seem that an obvious way to cope with the rising financial burden of an ageing population is to alter in some fundamental way the welfare contract that operates to transfer resources from the young to the old. This is what was hinted at in the Green Paper on Social Security in 1985, and what has been recommended in a recent OECD report on *Ageing Populations*. Such a redrawing of the welfare contract is certainly possible, but it is far from clear that this sort of reform is alone sufficient to restrict the economic costs of population ageing.

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Whether retired people receive income from the state via the tax transfer system or whether they live off the interest and dividend payments from their past savings, the goods and services they consume are part of the current output of the currently employed population. A doubling in the size of the elderly population will, other things being equal, double the financial burden of support on the working population regardless of how the retired population exercises a claim on current output. A sudden curtailment of state support for the elderly would reduce tax burdens at the cost to the retired population of an immediate decrease in welfare, but in the long run if private income rose to replace the diminished state pension, there would be no net change in the proportion of current output consumed by the non-productive elderly.

An immediate reduction in state support for the elderly would, therefore, relieve the short-run problems of a heavy fiscal burden on one particular generation, but it would do little to solve the long-term economic problems of population ageing. To do this, it is necessary to change patterns of work rather than welfare, and the scope for action here is determined by the nature of the labour contract.

The labour contract

It has already been noted that the extension of the physical lifespan in the 20th century has been accompanied by a contraction of the productive lifespan because the average age of entry into the workforce has risen as educational opportunities and requirements have increased, and the average age of labour-force exit has declined. In Britain the proportion of men aged 55-64 in work has fallen from 93% to 67% in the 20 years from 1965, and this trend towards earlier retirement has been common to all developed countries. The change has occurred independently of any alteration in the age limits for the receipt of state old-age pensions or other welfare benefits. If this trend towards earlier retirement could be reversed the effect on inter-generational transfers between working and non-working sections of the population would be immediate and significant, because the additions to the working population would also be subtractions from the dependent population.

To see what scope exists for reversing the trend towards early retirement, we need to examine the factors influencing the labour force participation of older people. People may opt for early retirement because they no longer need or want to work, or they may be forced into retirement because they lose the mental or physical capacity for employment. Improvements in the fitness and nutrition of the population over the course of the 20th century indicate that the reduction in the average age of retirement has not occurred because of an absolute decline in the health of older people.

It seems more likely that the labour force supply of older people has fallen over time because their increasing wealth and pension entitlements have reduced their need for an employment income. What proportion of the retired population has consciously opted-out of the labour market because of relative affluence is difficult if not impossible to determine, but it can be said with confidence that not all retired people have left employment from choice. High rates of unemployment among older workers who have not reached retirement age are a sure sign that the declining labour force participation of the elderly is in part a consequence of a fall in the demand for older workers.

Why have employers curtailed their demand for older workers? Recent research into the inter-industry labour force participation of older workers suggests that employers shed older workers because of rigid pay scales. In large, modern corporations the fixed costs associated with hiring and training a worker are substantial and in order to minimise these costs employers attempt to restrict staff turnover. One effective way to do this is to pay seniority increments to staff with a certain number of years service. These bonuses are not related to the specific job done by the worker or to his or her productivity - their purpose is to establish an earnings gradient which will provide an incentive for workers to stay with their employer.

However, the very nature of seniority payments means that at some point an older worker is likely to be paid a wage or salary greater than his or her marginal product - in other words s/he will be a net cost to the employer. At this point the employer needs to shed the worker, but dismissal of older workers would serve to undermine the employee loyalty which it is the purpose of the earnings gradient to promote. The socially acceptable way to shed older workers is, therefore, to offer them early retirement with an advantageous pension arrangement. As long as the cost to the employer of the early retirement settlement is less than the cost of the continued employment of the unproductive worker up to normal retirement age, early retirement is the employer's preferred choice.

Early retirement seems, therefore, to be in the interest of everyone directly involved in it, if not for the bulk of the working population who have to support the cost of generous pension arrangements either through increased taxes, increased private pension contributions, or increased prices for the products of the companies that promote these expensive early retirement policies. Greater labour force participation among older people, which would appear to be in the long-run interest of all Western societies now facing the problems of population ageing, seems not to be in the short-run interest of any of the parties involved in the decision - a clear case of the public good and individual self-interest in conflict.

Policy options

The working of both the welfare contract and the employment contract in modern industrial societies serves to exacerbate the economic and social problems that are a concomitant of population ageing. Low fertility will produce a declining population and a small workforce in the early part of the next century, the spread of early retirement will further diminish the size of the available workforce, and the scale of welfare transfers will impose high tax burdens on those in work. The problems are manifest and obvious, the solutions are less straightforward.

If no action is taken to deal with the incipient crisis of population ageing, then it seems certain that Western societies will experience major social and economic dislocation, and they may experience it relatively soon. Although demographic ratios and welfare systems may in aggregate change relatively slowly over two or three decades, the practical consequences of these changes are already noticeable in the education and health services as we become over-supplied with schools and under-supplied with nursing homes. The time lag on new investment in these areas means that planning for future changes needs to begin now.

There is a further reason for action to be taken now, even if the most pressing economic consequences of population ageing do not emerge until the next century. As life insurance and pension companies always stress in their advertising, it is never too early to start thinking about and planning for retirement. Few people have the opportunity and resources to change their pension plans and pattern of asset accumulation after their mid-forties, so their social and economic expectations of retirement tend to be set at least 20 years before normal retirement age. If new attitudes to retirement will be needed by the third decade of the next century to cope with the cost of an ageing population, then it is the expectations and actions of today's 20 and 30 year olds that should be the focus of attention.

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The most obvious area for immediate government action is the welfare contract. Changing the nature of this contract will not reverse the long-term problem of a relative decline in the productive capacity of the population, but it can ease some of the transitional problems associated with unfair fiscal burdens. There can be little justification for a pension scheme that takes from poor parents and children and gives to rich pensioners. Of course, many of today's pensioners are poor, and there will be poor pensioners in 50 years' time, but current trends indicate that pensioners as a whole are getting wealthier. A move in the future from a universal to a needs-related pension system would seem to be both fair and efficient; fair in the sense that it could reduce the burden of taxation on the abnormally small (and fiscally disadvantaged) working population, and efficient in that it could direct higher pensions to poorer pensioners. But because selective benefits have a notoriously poor take-up rate the best way to achieve effective targeting is by universal pensions coupled with a negative income tax scheme operating within an integrated tax and benefit system. Everyone would receive the basic state pensions, but this together with other incomes would be taxable.

Whether any Western government has either the will or the strength for this move towards a targeted system remains to be seen. Recent retrenchment in welfare spending has impinged little on the retired population, despite the fact that pension expenditure is the most costly element in all Western welfare states, and the furore about the means-testing of pensions created by Nigel Lawson's notorious press briefing shows how difficult it will be to promote considered discussion of this issue.

Any action to alter the nature of the employment contract will be even more difficult, because, as explained above, all parties concerned with the decision seem to prefer early retirement. The legislation enacted in the United States by President Reagan to raise in steps the normal age of receipt of the OASI pension from 65 to 67 by the year 2027 does not seem to have had any effect on the downward trend in the actual age of retirement from paid work. It may be possible to encourage the employment of older workers through tax concessions to companies who take on people over the age of 55, but these would have to be large to overcome the effect of the earnings gradient. This widespread prejudice against the employment of older people is at odds with the findings of industrial psychologists that in many types of work older people are as reliable, efficient and productive as younger employees. Perhaps the shortage of young workers over the next decade will begin to undermine ageist employment policies, and force employers to adopt a more open attitude to job sharing and flexible retirement, both of which are clearly favoured by many older people.

It might be argued that there will be no real economic problem if a high rate of economic growth can be sustained - when there is more in the pot for everyone, there are fewer squabbles about how the contents of the pot are divided - but growth prospects themselves are limited by the projected decline in the size of the workforce. This shortage of young workers, the essence of the demographic problem, could also be affected by government policy. A short-term response to labour shortage would be immigration, but governments are now more aware of attendant social costs of immigration than they were during the postwar years of labour shortage, so it is unlikely to become a widely adopted policy.

An alternative long-term approach is to attempt to raise the domestic fertility rate. Again it is 20 and 30 year olds who would be at the forefront of any such policy, and until the reasons for the fall in fertility are fully understood, any pro-natalist policy must be somewhat speculative. However, the high rates of married female labour force participation mean that childbirth and care involve a substantial and immediate cost in terms of lost earnings for many women. Financial compensation for this loss, or free and comprehensive childcare facilities, would be two possible ways of raising fertility from the disastrously low levels of today. While the private cost of having children remains so high, there is little likelihood of active citizens responding in sufficient numbers to the public need for a rise in the fertility rate.

The expected decline in the proportion of the population of working age also makes it imperative that Western countries make use of this human capital in the best way possible. In less developed countries demographic trends of a different sort mean that the early decades of the next century will see a sharp increase in the proportion of their populations of working age. In less developed countries, unskilled labour will be cheap and plentiful. If Western countries are to compete in international markets, they will have to ensure that their small labour force is highly skilled and highly adaptable. This implies that more effort and resources will need to be devoted to education, training and retraining.

The economic and social problems associated with population ageing in industrial societies are not short-run phenomena like balance of payments crises or periods of inflation which can be corrected with a touch of monetary or fiscal policy. Even if fertility rates could be brought back towards the replacement level in all countries within a decade, the problems of population ageing would still be apparent in our demographic structure for the next 50 years. It is this long-term aspect which makes population ageing such an unpalatable issue for governments and administrations which are interested in solutions rather than problems, and which like to parade the effectiveness of their solutions at appropriate points in the electoral cycle.

Yet it is the long-term nature of the problem that makes it imperative that action is taken now to cope with the costs of population ageing that will become most apparent in 30 years time. If no action is taken, the competition for resources between workers and pensioners may break the fiscal basis of modern welfare systems. I fear, however, that policymakers here and in other countries may follow the line of David Stockman, Director of Reagan's Office of Budget and Management in 1981 when he said, 'I'm not going to spend a lot of political capital solving some other guy's problem in 2010'. This is a very dangerous stance, because the solutions to the problems outlined here become less palatable and more costly the longer they are delayed. •