

Coming to Terms with an Ageing Europe

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DEMOGRAPHIC CHANGE AND THE WELFARE STATE

Europe's population is ageing rapidly. The consequences of this profound demographic change will pose multiple challenges for economic and social governance, particularly for the future of welfare states. Although the conception of a 'European social model' is ill-defined and there are marked differences in the mix and generosity of social policies provided in different European countries, the contrast with the very different models in most other parts of the world are nevertheless striking. Europeans expect, and are offered, adequate pensions and social care for the elderly, substantial public funding for health-care, unemployment benefits, and a range of other policies aimed at mitigating social risks.

These policies are costly and rely on a political consensus resulting from decades of accommodation between different interests in European societies about the acceptable degree of risk-sharing and redistribution. The welfare state touches everyone and, as careful research by Sir John Hills has shown, most segments of the population take as much out of the welfare state as they contribute. Only the richest decile of the population is systematically a net contributor and only the poorest decile a net recipient. Moreover, individuals will be net contributors and recipients at different times, debunking the idea that welfare states can be reduced to simplistic notions such as taxpayers versus dependents, 'strivers' versus 'shirkers', or even 'millennials' versus 'baby-boomers'. Sickness can strike or dependence can arise at any age and affect citizens in any income bracket.

Ageing potentially upsets the grand societal bargains behind European welfare states and, without efforts to reach a new consensus, could damage social cohesion. Simple statistics underline the magnitude of the challenge. On average in the EU today, the crude old-age dependency ratio is 3.38 people of working age (those aged 16–64) for each elderly person (65 years or older). By 2060 this is projected to become 1.94 : 1, having been 4 : 1 as recently as 2010. The ratios for the very old (aged 80+), who typically require

KEY INSIGHTS

RISING OLD-AGE DEPENDENCY RATIOS IN EUROPE IMPERIL THE POLITICAL CONSENSUS BEHIND WELFARE STATES.

BOTH ORTHODOX AND MORE CONTROVERSIAL SOLUTIONS ENTAIL TRICKY MORAL AND DISTRIBUTIVE TRADE-OFFS.

TO ADDRESS THE COSTS OF AGEING, THE DIFFERENT DIMENSIONS OF THE WELFARE STATE NEED RECONFIGURATION, NOT REPUDIATION.

THE FUNDAMENTAL POLICY QUESTION IS NOT THE AFFORDABILITY OF THE WELFARE COSTS OF AGEING, BUT WHO PAYS.

significantly more public support, are 12 : 1 today, falling to 4.63 : 1 by 2060. Policymakers may be broadly aware of these trends, but the detail is telling because it radically alters the arithmetic of who pays and who receives.

The increase in the implicit burden on those of working age to fund those beyond working age would be huge unless there is extensive recalibration of welfare arrangements. Many countries have already implemented pension reforms aimed, primarily, at rendering their systems sustainable. But pensions are only part of the story: the costs of ageing also encompass health, social care, and other support services hitherto met either by public budgets or the families of older people. Any plausible scenario about long-run social trends will need to introduce politically delicate measures which reconcile, on the one hand, expectations of the standard of living older people should enjoy when they become

A HIGHER TAX BURDEN COULD BOTH REDUCE INCENTIVES TO WORK AND, DEPENDING ON THE INSTRUMENTS USED TO RAISE REVENUE, DIMINISH INTERNATIONAL COMPETITIVENESS BY INCREASING EMPLOYERS' COSTS.

economically inactive with, on the other, what those paying the bills are prepared to accept.

Yet it should not be forgotten that welfare states also perform an important investment function by equipping citizens with skills and promoting higher employment rates. Over the past two decades, the 'social investment' turn in many EU countries

has seen a shift of focus from the 'compensating' and 'protective' welfare state to an 'enabling' one. By targeting and supporting groups prone to be detached from the labour market, this approach contributes to enhanced human and social capital.

The fundamental policy question is not so much one of affordability in the narrow sense of whether resources for a system of social transfers can be found, but rather of burden-sharing and the political appetite for altering it. Already, in the years of economic crisis, the tensions around cuts in welfare entitlements have been politically divisive and provided one explanation for the proliferation of populist responses. Policymakers will be anxious to avoid more conflict between social groups over the costs of ageing.

WHAT CAN BE DONE?

There are three main strategic approaches to confronting the direct costs of ageing, whether to the public purse or to society more generally. One is to counter the rise in the elderly dependency ratio, the second is to reduce the provision of money and services to the elderly, and the third is to raise the contributions or other resources going to older people. In practice, any credible strategy will require elements of all three approaches.

The menu of solutions, then, comprises three main orthodox options and two more contentious ones. The first orthodox approach, which many EU countries have already adopted, is raising the retirement age. The straightforward reasoning is to yield more years of contributions and fewer years of payment of pensions, thereby altering the ratio of working population to dependent population.

Complications arise in the transition, especially if a segment of the current working population has to pay twice (or believes it must do so) because of the need to pay for current pensions while also postponing its own. A gender dimension may arise if women, who in many systems have traditionally had lower retirement ages, are asked to move to the higher male retirement age. It is important to note, too, that raising the retirement age does not necessarily alter the non-pension costs of ageing, notably for health and social care.

Second, the costs of ageing could be met by increasing taxes or exploiting other revenue sources. The obvious drawback of taxing the working population more heavily is the apparent unfairness of the increased burden. However, the wider ramifications also need to be taken into account. A higher tax burden could both reduce incentives to work and, depending on the instruments used to raise revenue, diminish international competitiveness by increasing employers' costs. An alternative is to impose more of the costs on the elderly, either by shifting to tax bases where they are over-represented, such as housing or financial wealth, or by charging them directly for care and other services.

A third solution is to curb the flow of benefits to the elderly. This can be directly orchestrated through formulae linking public pension entitlements to the strength of the economy, so as to limit the share of pensions in gross national income. A few of the many options for doing so are to index pensions to the growth of the lower of consumer prices or real wages, to

adjust pensions (as in Germany) in line with the old-age dependency ratio, or to relate outlays on pensions to the growth of GDP.

What such reforms cannot so easily do, however, is to reduce the future care costs of ageing. Unless society is prepared to offer less care to the elderly, there is likely to be a rising cost of coping with chronic age-related conditions, such as dementia. Instead, solutions may have to come from taxing the income or, sometimes more plausibly, the wealth of the elderly. The elderly can, however, justifiably claim they contributed during their working lifetimes and are therefore entitled to the benefits. Taking this route has therefore proved to be very tricky for political leaders and can also affect younger generations, if it reduces inter-generational wealth transfers.

MORE CONTROVERSIALLY...

The two, more controversial, means of dealing with the costs of ageing have very different features. One is to increase the working population by boosting immigration of younger workers. The other is to build up a stock of foreign assets in the form of a sovereign wealth fund (SWF) able to generate a flow of income to be used to meet social policy costs. Intriguingly, both can be viewed as consequences of globalisation and, from this perspective, should be interpreted with subtlety, including in relation to the morality of the solution.

If they achieve a high employment rate, immigrants will typically be net contributors to the public finances, more so if they possess skills which attract higher salaries. But as work by the Dahrendorf Forum working group on 'society, populism, and electoral trends' shows, migration on a scale capable of altering the arithmetic of ageing has societal and political consequences. For European countries, the potential economic benefits have to be set against adverse effects on social cohesion.

Migration also means a brain drain from the countries of origin to the host country, to the extent that the former paid for the education of the migrant. At the same time, migrants often remit income to their home countries and, if they return to their country of origin, boost the stock of human capital there through the experience they gain while abroad. An example of this dynamic is Ireland, long a country of emigration, which became a magnet for returning émigrés during its boom years. Over the long term, immigrants and their families will—self-evidently—also age and expect to receive the same

benefits as the indigenous population. But in the medium term, the direct fiscal effects should be positive, so long as immigrants (and their families) are integrated into the host country's labour market.

Some SWFs can be enormous: for example, the main Norwegian fund—much of it invested abroad—is valued at close to three times the country's GDP and the return it generates, after deducting administrative and other costs, is around 4 percent per annum. This means an annual flow of around 12 percent of GDP, equivalent to around half of Norway's entire social protection budget.

However, building up an SWF is controversial in a different sense. The return on investment transfers resources away from the countries where the fund invests, lowering their income, to the country of origin which benefits from higher income. Intriguingly, while immigration imports labour directly, a sovereign wealth fund does the same thing indirectly insofar as it invests in host countries with younger populations.

Still, by raising the rate of investment in the host country, the SWF can contribute to the host country's economic development, with gains for both sides.

Wealth funds require the current generation to save more, and thus reduce

their consumption, to build up a fund which benefits subsequent generations, with implications for inter-generational fairness. This is especially contentious in the aftermath of the years of crisis when so many citizens had to endure sizeable cuts in their standard of living. SWFs are also usually outside direct democratic control, raising questions about their legitimacy. But if it is a path countries choose to follow, they can adopt regulations for the fund that enshrine national preferences, be it on the ethics of its investment decisions, as Norway currently does, or on how revenues are used.

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OTHER POLICY CONSIDERATIONS

The ageing of a population has a number of other ramifications. The first concerns the supply of labour. Older people tend to consume a higher volume of care services, requiring a sizeable increase in the jobs which provide such services. In EU countries, these jobs tend to be poorly paid and, especially for those funded

predominantly by public money, will continue to be subject to cash constraints. This is not a conjunction likely to attract the increased number of care workers needed, although labour scarcity would be expected to induce higher wages.

In many EU countries, too, the existing labour force of care providers disproportionately consists of older female workers who will exit the labour market relatively soon. Coping with care demands will become doubly difficult because of the need to replace the existing workforce as well as meeting new demand. Increased investment in labour-saving technologies could alleviate the problem.

Second, the overall mix of public expenditure matters. Action to improve the long-run sustainability of fiscal policy can free resources to cover the costs of ageing. In particular, avoiding high interest payments on public debt can be crucial. According to Eurostat data, 2017 interest payments on public debt (as a proportion of GDP) ranged

IN MOST EU COUNTRIES, THE PENSIONER POVERTY OF EARLIER GENERATIONS HAS BEEN REPLACED BY PENSIONER PROSPERITY, DESPITE THE PERSISTENCE OF POVERTY AMONG CERTAIN GROUPS OF THE ELDERLY.

from almost zero in Estonia and 0.35 percent of GDP in Sweden to close to 4 percent in Portugal and Italy, with Spain (at 2.5 percent) and the UK (2.7 percent) among those where a pronounced increase followed the crisis years.

A policy answer is to have medium- to long-term targets for debt reduction, although the distributive impact of doing so cannot be ignored because it means the economically

active generation has to pay even more tax to help run down public debt. In practice, too, debt reduction requires governments to adopt and (often more importantly) respect suitable fiscal rules. For example, Sweden had a target of running a public surplus of 2 percent of GDP, which meant more rapid debt reduction, although it has since made the target less demanding.

Housing is a third structural challenge. Ageing can be expected to increase the number of households, especially of single pensioners, requiring additional housing tailored to their needs including care homes, possibly in locations different from those of the working population. If new retirement communities become

the answer, they will have to be complemented by housing for the army of care workers and the provision of infrastructure such as health-care facilities. Land-use planning will, therefore, have to adapt, as will infrastructure provision.

Fourth, there will be awkward questions around wealth and how it is taxed or passed on. In most EU countries, the pensioner poverty of earlier generations has been replaced by pensioner prosperity, despite the persistence of poverty among certain groups of the elderly. Wealth taxes, including those payable on death, are an emotive subject. Moreover, as the share of the elderly in the voting population grows, they may use their political power to oppose such taxes, especially as they have a higher propensity to vote than the young.

Then there is the impact on economic growth. There are two plausible reasons for the underlying growth rate to fall because of ageing: first, an older workforce is likely to have a lower propensity to innovate and take risks; and second, older consumers are less attracted to innovative products and services, coupled with a tendency to demand low productivity services. Growth could also be undermined if investment in public goods is crowded out because of demands for current spending to cope with ageing.

CONCLUSIONS AND RECOMMENDATIONS

Europe's demographic challenges are formidable and will test the ability of political systems to respond effectively because the economic, social and political consequences of ageing are profound and likely to be disruptive for prevailing economic models.

Many policy dilemmas nevertheless have to be confronted. Bringing in migrants may ease the fiscal burden, but can lead to pressure on certain public services and has often inflamed the social tensions behind populism. Over-burdening the current working-age group through higher taxation may result in reduced motivation to work, further shrinking the tax base. Curbing benefits may ease the burden on public finances, but undermines the implicit contract between the state and those who have contributed during their working lifetimes. In short, dealing with the costs of ageing requires difficult moral and distributive trade-offs to be resolved, none of which offer easy choices.

Nevertheless, credible solutions are available and well understood. What they need is a new grand bargain

between different strata of society, alongside the political courage to act decisively to implement it. The required transformations will be shaped both by the social traditions of each country and by actions already taken or reforms in the pipeline, hence neither a one-size-fits-all formula nor a check-list of best practices will be appropriate. But there are also common pathways.

Welfare states will need reconfiguration and coherent strategies. Dealing with ageing is neither a problem of affordability nor of the inability of the welfare system to adapt. It is, above all, a matter of mobilising the required coalitions and having the political will to introduce optimal reforms. Yet political and societal leaders are reluctant to draw the inevitable conclusions for policy development and firm action, generally preferring to ‘kick the can down the road’.

Eventually, they will find the road blocked and nowhere for the can to be kicked. How then can timely responses be achieved? To conclude this policy brief, four linked policy recommendations aimed at dealing with the financial strains of ageing in a fair way are put forward for the EU level and national governments in Europe to consider:

- First, the balance between the protective, distributive, and investment dimensions of welfare states has to be rethought. Although some of the criticisms of the social investment approach are undoubtedly valid, facilitating a higher employment rate should be an imperative. It can be achieved through measures that boost human capital and overcome the detachment of disadvantaged groups from the labour market.
- In parallel, the much-touted concept of active ageing has to be turned into tangible and novel policy initiatives. It has huge potential for win-win outcomes by adding to the supply of labour while contributing

to the well-being of the elderly. A glide-path out of full-time employment in the transition from work to retirement, rather than an abrupt change of status, should become the norm, rather than the exception.

- Third, pension fairness deserves to be revisited and cannot be limited to years of contributions to pension schemes. More diverse trajectories for working lives and new forms of working arrangements, together with greater longevity, have to be accommodated. They include the rise of part-time work, varying hours and periods of work, and employment contracts different from the standard models of the past. A combination of the sort of pension guarantee offered to all citizens in Sweden, irrespective of their work history, and an earnings-related component is needed.
- A fourth area for change is to reconsider the funding models for welfare states. With a few exceptions, the main source of revenue for welfare states in the EU has been social charges—in effect taxes on employment—topped-up by contributions from general taxation. However, with the elderly often capital rich (even if sometimes income poor), the base for funding age-related welfare spending should shift to taxes on wealth. Despite the resistance of many finance ministries to hypothecated taxes, there is also a compelling case for ring-fenced funds, such as the Dutch *Algemene Ouderdomswet (AOW)*, used to provide for non-contributory pensions.

A complementary fifth recommendation is to promote thorough and open debate on the policy options, their costs and trade-offs, and their ability to contain the financial burden of ageing. Without better public understanding of the tensions inherent in welfare state recalibration, arriving at enduring, politically acceptable solutions will become an even bigger challenge. ■

FURTHER READING

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