

Demographic dangers for growth

The UK economy has performed impressively for an extended period of time and the Treasury has received praise for this achievement. There has been much debate about the underlying causes of this sustained growth and whether it really is evidence of prudent economic management, but one factor which has not been greatly explored is the contribution of demography. In fact, the economic effects of demographic trends are worth more serious consideration.

During the 1980's and 1990's, the economy benefited from a significant rise in the number of people of working age. At the same time, the birth rate fell sharply so there were fewer children to support. In addition, the number of pensioners has been relatively stable. The fall in number of dependents and rising numbers of workers helped sustain consumption and bolster growth, giving a very favourable underpinning to economic performance.

This demographic boost, however, is soon set to unwind. As Chart 1 shows, we will shortly enter a period in which the old-age dependency ratio suddenly starts to soar. From 2010 or so, the number of pensioners will increase sharply, while the number of workers falls, so the proportion of the population in employment is forecast to decline. As more people try to live on pension income, rather than earnings, consumption is likely to fall and the burdens on working taxpayers will rise. Thus, the slowdown in the growth of the workforce and the increase in spending on age-related support, mean demographic trends will have adverse effects on economic growth after 2010.

These changes pose many economic challenges. Of course, the trends have been in place for many years, so has the Government been taking advantage of these 'good years' to lay the foundations of a meaningful response to dealing with the sudden rise in old-age dependency, thereby minimising the negative impact of the 'demographic drag'? Sadly, it seems to have squandered this opportunity.

There are ways in which we could have prepared the economy for a forthcoming rise in pensioner numbers. Some of the most obvious would include introducing meaningful incentives to encourage people to save and to work longer. However, instead of enhancing such incentives, the Government has actually introduced significant disincentives, in the form of mass means-testing of pensioners as a fundamental part of the state pension, which penalizes those who have private sources of income.

Another important element of preparing for the demographic challenges is a sustainable pension system, which should be simple enough for people to be able to plan their future income needs. Unfortunately, however, we have the most complex pension system in the world, which no-one can really understand and almost no-one has confidence in. Our state pension is also one of the lowest in the world, so we are heading for a situation in which an

increasing proportion of the population has very low income (far lower than in other countries) which will damage growth prospects. The recent White Paper on pension reform has missed a golden opportunity to simplify and increase the level of state pension support and establishing a pension system that could form a solid basis on which to plan for the future. Instead, the Government is proposing to maintain most of the complexity and inadequacy of current arrangements. The table below shows the position of the UK against some other OECD countries and it is clear that the UK pension is well below average.

INCOME OF PENSIONERS RELATIVE TO AVERAGE EARNINGS IN 10 COUNTRIES

<u>rates</u>	<u>Gross replacement rates</u>	<u>Net replacement</u>
income from security by older people)	(Pension entitlement as share of individual lifetime average earnings)	(takes account of tax and social contributions paid
Italy	78.8	88.8
Netherlands	68.3	84.1
Germany	45.8	71.8
Poland	56.9	69.7
France	52.9	68.8
Japan	50.3	59.1
Czech Republic	44.4	58.2
Australia	40.0	52.4
US	38.6	51.0
UK	37.1	47.6
Mexico	36.0	45.1
OECD average	57.2	69.1

Source: OECD 2005

So, if our pension system is not well structured for the demographic challenges, has the Government perhaps been preparing the economy in other ways for this looming problem? For example, has the fiscal situation been reined in, building up surpluses to prepare for the forthcoming strains on public spending? Sadly not. Even though taxation has increased, public spending has increased even faster, so the budget deficit has worsened.

Since 1997, the contribution to economic growth from both central and local government spending has risen enormously, while gross fixed capital formation and savings levels have declined. Local and central government consumption spending rose sharply after 1998, outstripping total GDP growth every year by a substantial margin (see Table below). Since 2000, over half the new jobs created have been in the public sector and the long-term pension spending commitments from unfunded public sector schemes are also enormous. A strongly expanding public sector, with sharp rises in public (and private sector) borrowing has sustained economic activity until now. Yet, the forthcoming demographic shift would suggest that we actually needed increased saving, not increased borrowing, to prepare for future needs.

**GROWTH RATE OF GROSS DOMESTIC PRODUCT AT MARKET PRICES
1993-2004**

	Total GDP	Central Gov	Local Gov	Gross Fixed	
Household		consumption	consumption	capital formation	
	<u>Mkt prices</u>	<u>consumption</u>	<u>consumption</u>	<u>capital formation</u>	<u>consumption</u>
1993	5.0	3.8	-1.9	0	5.8
1994	6.0	3.1	3.7	7.3	5.0
1995	5.7	2.9	4.4	8.8	5.1
1996	6.3	5.1	2.2	7.3	7.2
1997	6.0	1.5	0.9	5.6	6.0
1998	6.1	3.5	4.6	13.1	6.6
1999	5.3	6.6	11.3	3.5	6.3
2000	5.1	7.0	7.7	3.3	5.8
2001	4.6	7.2	6.6	2.5	5.3
2002	5.2	9.7	8.4	4.9	5.1

2003	5.9	9.4	9.6	3.0	4.9
2004	6.0	6.8	9.2	8.8	5.1

Source: UK Input-Output Analysis, ONS

From around 2010 there will be increasing numbers of people not working, an increasing proportion of the population who are not economically productive, fewer workers to create new wealth and a sharp rise in the numbers of pensioners struggling to manage on the inadequate level of UK state pensions and dwindling private pensions. As a larger proportion of the population has lower incomes, consumption is likely to fall, and growth will suffer.

During years when the economy should have been building up national savings to prepare for the forthcoming demographic drag, the Government has actually presided over a sharp drop in saving and huge rises in borrowing. Economic policy has focused on sustaining growth in the short-term, by spending and borrowing, and has squandered the demographic boost that should have enabled more saving to prepare for the ageing population. Far from prudent management, this suggests a short-sighted agenda of going for growth now and leaving the next administration to cope with the consequences of demographic inevitability.