CENTRE FOR EUROPEAN REFORM

OLD EUROPE? DEMOGRAPHIC CHANGE AND PENSION REFORM

David Willetts MP

CENTRE FOR EUROPEAN REFORM

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Old Europe? Demographic change and pension reform

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Foreword

Dresdner Kleinwort Wasserstein is delighted to sponsor this Centre for European Reform paper.

David Willetts sets out in a very readable style the nature of our demographic problem and some of its far-reaching effects. He does not pull his punches in pointing out the complacency with which a number of the governments, not least the UK, are treating the subject. Having funded pension schemes does not exempt a country from the problem.

The implications of an ageing society are likely to be far-reaching. Economic growth will be undermined by the adverse effect on innovation and entrepreneurial attitudes. The larger numbers of older voters who tend to have a higher propensity to vote than the younger ones will make their power felt through the democratic process – a pensioner is unlikely to vote for lower pensions. Later retirement and immigration are not easy solutions either. We need to show flexibility and open social attitudes, which may not come easily to ageing and risk-averse societies.

Dresdner Kleinwort Wasserstein has rigorously pursued the implications of the pensions deficit on the balance sheets of listed companies with funded schemes, which we believe will be even more acute with the publishing of the imminent IASB guidelines. This paper broadens the debate to Europe as a whole. It shows how reliant many countries are on their fertility rate, which is continuing to fall.

We believe that the potential effects of the demographic changes may have a huge impact on consumption, economic growth and consequently the capital markets.

We welcome the contribution this paper makes to this debate.

Realising that there is a problem is the first step to finding a solution.

Alan Yarrow
Vice Chairman

Dresdner Kleinwort Wasserstein

1 Introduction

The dismissal by Donald Rumsfeld, US Secretary of Defense, of Germany and France as “old Europe” touched a raw nerve. Perhaps many Europeans feared that the US Secretary of Defense was speaking nothing less than the literal, demographic truth. After all Europe’s population is ageing much faster than the US. It seems to confirm the famous warning that Europe would become “old people in old houses with old ideas”.

But is there a new Europe as against an old Europe? Donald Rumsfeld went on to say that Europe’s “centre of gravity” was shifting to the east identifying the new members of NATO as the new Europe. There certainly is extraordinary demographic diversity within Europe, reflecting our rich cultural and social diversity. But America’s new allies are not Europe’s most youthful societies. In fact, the European countries which are ageing fastest are in the east and the south – Poland, the Czech Republic, Germany, Italy and Spain for example. Europe’s more youthful societies are in the north and the west – France, Great Britain, Ireland and Sweden. Europe’s demographic future lies on its Atlantic seaboard.

This pamphlet will contrast two countries which are ageing fast and will soon have shrinking populations – Germany and Italy – with two others which have much more favourable demographics – France and the UK. Indeed in the year 2000, for the first time since reliable records have been kept, more babies were born in France than in any other European country. France is enjoying an extraordinary demographic boom, at least by the undemanding standards of European demography.

In the first three chapters, this pamphlet will try to explain the demographic changes taking place in Europe and clear away some of the misconceptions. It will start – as it ends – optimistically. One of the most obvious benefits of living in a modern society is that we live longer, healthier lives. We lose fewer people as children or young adults through disease and disaster, and many more of us make it through to old age.

It is good news that we are living longer. The bad news is that there are not enough young people coming along behind. The problem is not life expectancy; it is birth rates. The effects of this demographic change are profound – and go well beyond the financing of our pensions.

The second half of this pamphlet will examine ways in which Europe's economies might respond to these challenges. One option is that we should all work more. But even if the EU achieved its ambitious targets for increasing employment rates, it would not fully compensate for the decline in the working age population.

Migration is another much touted solution to the demographic problem. But governments would have to permit migration on a truly massive scale to offset the demographic changes.

A third solution – in many ways the most desirable of the lot – is that we should produce more babies. But that should not mean trying to force traditional roles on women, who at last are beginning to enjoy the educational and employment opportunities that men have taken for granted. Indeed the countries with the lowest birth rates are those which retain the most traditional roles for women.

Too much writing on demographics and pensions treats Britain as somehow an exceptional case. But Britain is not exempt from the demographic and financial pressures facing other European countries. It is not the special case which some misleading international statistics might suggest. This pamphlet aims to combat such ill-justified British complacency.

One final point. This demographic problem is not the end of civilisation as we know it. The nations of Europe should still be around and functioning in fifty years time, even if they are rather older and, in many cases, rather smaller. Europe does not face a demographic crisis on the scale of, for example, that in sub-Saharan Africa as a result of the AIDS epidemic. It will adjust. The question is: how? If European countries get their policies right now they could undergo a relatively smooth demographic transition. If they do not, the social and economic strains will be far greater.

2 Demography is destiny

Some optimistic demography

The title of this chapter is attributed to August Comte – he was saying something very important.[1] Understanding demographics is essential to make sense of economic, social and, indeed, cultural changes around us. But too often demography is reduced to a discussion of the supposedly dismal consequences of living longer. Improvements to life expectancy are a great achievement. We will start by trying to analyse this achievement in a bit more detail because life expectancy is increasing in a different manner now than in the past.

[1] The quote is also sometimes attributed to the contemporary demographer Richard Easterlin.

Even for an advanced Western country, Britain has done particularly well at improving people's chances of getting to 60. In the USA, a high homicide rate reduces life expectancy – approximately 15,000 people are murdered each year in the USA against 1,000 in the UK. Continental Europe also enjoys a lower homicide rate than the US. But on the continent it is driving which is the killer of younger adults – about 8,000 people die each year in car accidents in France and Germany against under 4,000 in the UK. As a nation which neither commits much homicide nor drives homicidally, Britain does quite well on life expectancy – at least until its citizens start needing the National Health Service more.[2]

[2] A British male has a 92.3 per cent chance of reaching 60 as against 88.9 per cent in France and 88.8 per cent in the US. However, the UK under-performs compared with other advanced countries after the age of 60.

Take five people. One dies of tuberculosis (TB) aged 25. The second dies in an industrial accident aged 50. The remaining three work until they are 65 and die at the age of 75 after a year of ill health. That gives, however, those five people an average life expectancy of 60 years. Over time health reforms reduce the incidence of TB, while factories become safer. These changes help to increase life expectancy from the bottom. Now all five work until they are aged 65 and all die at the age of 75. Thus average life expectancy rises from 60 to 75. But it is not the case that every one used to die at 60 and now does so at 75. Most of the extra years of life are working years. It was tackling these killers of people in their prime which drove much of the improvements in life expectancy during the first half of the 20th century.

The next change is for those 75-year-olds to live until they are 80 instead. This is to improve life expectancy from the top and is the main reason longevity continues to increase. It is also good news, especially as these are mainly extra years of healthy life. By and large people die fitter: medical science has made more progress in tackling the diseases of morbidity than mortality. The model for this is the Victorian prime minister Palmerston, who is supposed to have died at the age of 82 on the billiard table, *in flagrante* with a maid.

The conventional wisdom is that people aged over 75 need a lot of healthcare. So if people live five years longer, the pessimists say, they are going to need five more years of expensive healthcare. But this is to misunderstand the figures. The intensive healthcare is not delivered to people because they are aged 75: it is delivered to people because they are in the last year of their lives.[3] As people live to be 80 instead of 75, they will still need expensive healthcare, but the healthcare will be needed in their last year which is five years later than before. Indeed, the real optimists would argue that greater life expectancy involves a transitional saving in healthcare costs as the final year of life is delayed.

[3] One estimate is that for people over 65, 60 per cent of medical costs are incurred in the last 12 months of life.

One reason why many experts have underestimated recent improvements in life expectancy is that they assumed it would be

harder to raise life expectancy from the top, for people who were already old, than from the bottom, by eliminating the misfortunes of youth and middle age. Many thought that humans were approaching the limits of their design life. But the evidence is of surprising stability in the rate of increase in longevity. Demographer Professor Jim Oeppen estimates that life expectancy has increased by around three months each year since 1840. Individual countries may achieve bigger or smaller improvements than this at specific periods. But the underlying pattern remains the same.

Baby boom, baby bust, and baby blip

So what is the problem? To understand this it is necessary to go back to the dismal inter-war years. I am gong to tell this as a British story, though a similar pattern applies throughout much of the Western world.

Times were hard. Birth rates had fallen to less than two children per woman. The Second World War lowered birth rates still further. Immediately after the war the birth rate briefly increased only to fall back again in the austerity of the late 1940s and early 1950s.

The Attlee government and its Conservative successor commissioned earnest reports into the problems of an ageing population and a low birth rate. Indeed one of the Treasury's main fears about the costs of the post-war welfare state was that there would not be enough workers to pay for it. A Royal Commission on population reported in 1949. A National Advisory Committee on the employment of old men and women produced a series of reports urging employers not to miss out on the talents of older people. The Phillips Committee warned in 1954 that in 25 years time the dependency ratio of pensioners to workers would become unsustainable. The Committee's main proposal was to increase the minimum pension age for women from 60 to 63 and for men from 65 to 68. More than 50 years after Phillips reported, Britain will start the slow process of equalising the pension ages for women with men at 65 between 2010 and 2020.

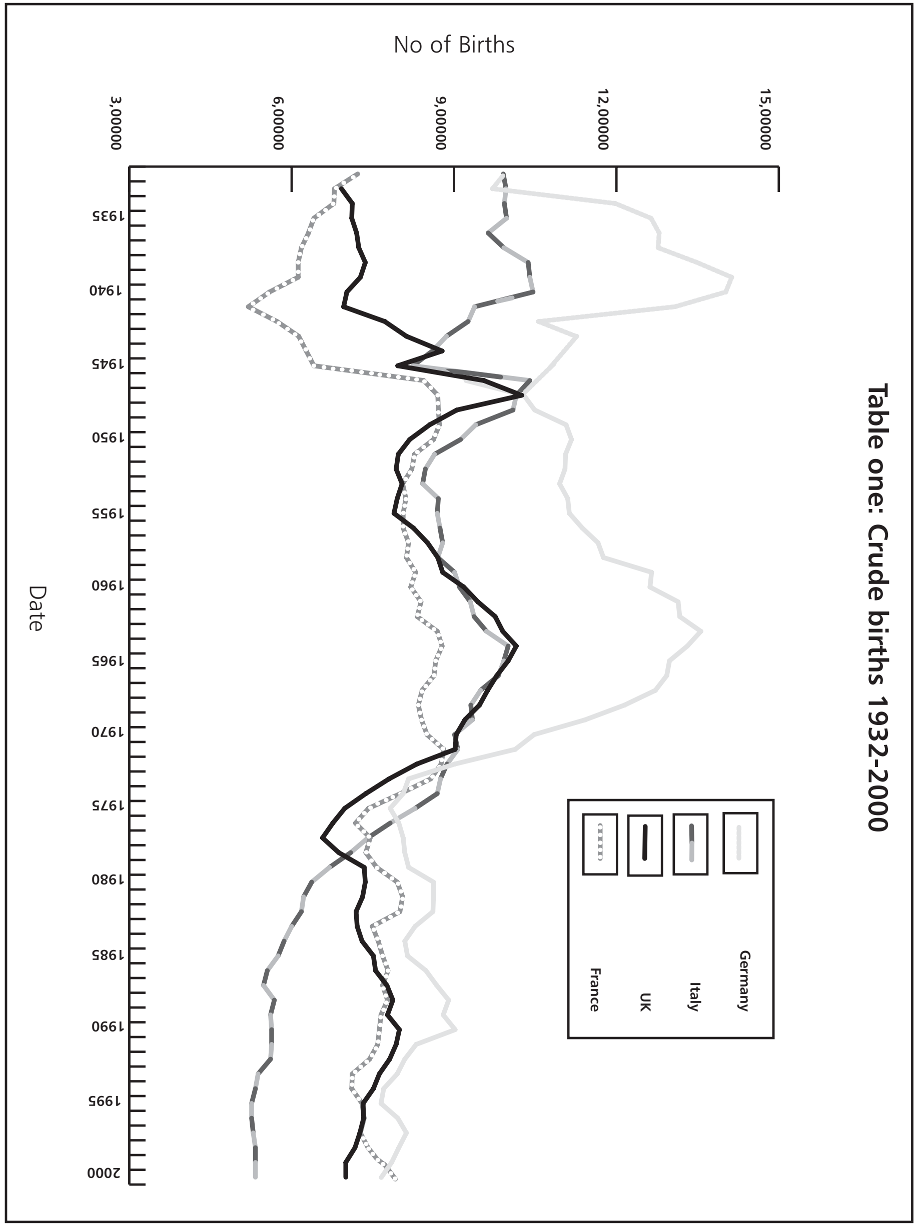
But the policy wonks of the early 1950s were caught out by a demographic change happening under their noses – birth rates started to rise. Work was plentiful. Wages were rising. The cost of living was low. Women could afford to withdraw from the workforce and have children. Harold Macmillan, the British prime minister, famously said: “Most of our people have never had it so good”. And the sexual innuendo captured exactly the mood of the times. There were more pregnant brides than at any time in the 20th century. The real baby boom was under way. Philip Larkin wrote:

> Sexual intercourse began
> In nineteen sixty-three
> (which was rather late for me)
> Between the end of the ‘Chatterley’ ban
> And the Beatles’ first LP
> (Annus Mirabilis)

He got the year exactly right. The following year British births peaked at 1.015 million – the one and only time they have exceeded 1 million since 1947.

The storm clouds started to gather after the first oil crisis of 1973, though the baby boom was already past its peak. Male wages rose at a much slower pace. Job insecurity increased. Living costs rose. More women re-entered the workforce. After the baby boom came the baby bust. In 1977, the year after the International Monetary Fund bailed out Britain, the birth rate fell to a record low of about 660,000. The UK’s birth rate then recovered modestly during the 1980s to reach a mini-peak of 790,000 in 1990. That was the baby blip. Subsequently birth rates have slowly declined, although most recently some European countries, notably France, have seen some increase in birth rates again.

This chapter will examine more closely how the birth rate is changing now – and the differences between France, Germany, Italy and Britain are explored further in chapters six and seven. The



1930s saw a big divergence with high birth rates in Germany and Italy but low rates in France as well as Britain. However, all four countries experienced a post-war baby boom which peaked in 1964, after which all four had a baby bust.

For the EU 15 the total number of live births peaked at 6.25 million in 1964. In 2002 the number of births fell below 4 million for the first time since the Second World War. The total fertility rate in the EU has declined from above the replacement rate – defined as 2.1 babies per woman – in the 1960s to only about 1.5 now.

In the 1980s and 1990s, there was a 'bulge' of young and middle-aged adults. That meant lots of productive workers and an economic golden age with strong growth and low rates of expenditure on dependents, be they young or old. The rabbit was indeed in the middle of the python. There has been virtually no increase in the number of pensioners in Britain and France for a decade because of the low inter-war birth rates. But people born in the first mini-baby boom immediately after the war reach the age of 65 in 2010. The real baby boomer generations of the late 1950s and early 1960s will reach pensionable age from 2020 onwards. That is when Europe will see large increases in the numbers of pensioners. Moreover the numbers of very old pensioners will then start to rise. The UN estimates that by 2050 more than 10 per cent of the populations of France, Germany and Italy will be over 80.[4] France and Germany will each have more than 100,000 centenarians. Meanwhile, Japan will have over 1 million centenarians, about 1 per cent of the country's population.

[4] *United Nations, 'World Population Prospects – the 2002 revision', UN, 2003.*

This increase in the number of over-60s is only half the story, however. Behind them, the number of working age adults is falling because of the lower birth rates of the 1970s and 1980s. Europe's real problem is not so much the ageing of the baby boomers as the baby bust which follows. Europe will not only have more old people but also fewer children and young adults. The number of people

Table two: Changes in composition of populations 2000-2040 (millions)

	2000	2040
France		
Under 15	11.0	8.9
15-59	36.1	31.6
60+	12.3	21.8
Age dependency ratio	0.34	0.69
Germany		
Under 15	12.5	7.8
15-59	50.2	37.6
60+	19.3	27.1
Age dependency ratio	0.38	0.72
Italy		
Under 15	8.1	4.3
15-59	35.3	21.6
60+	14.0	22.2
Age dependency ratio	0.40	1.03
UK		
Under 15	11.2	8.7
15-59	36.0	32.0
60+	12.4	20.8
Age dependency ratio	0.34	0.65

Source: CSIS ageing vulnerability index.

aged over 60 will rise and the number of people aged 15 to 59 will fall. This means that the ratio between them, the so-called age dependency ratio, shifts very dramatically. Table two (page 11) shows the dependency ratios for the four major European countries and the estimates of the absolute figures on which these ratios rest.

These figures are vital for understanding the future of Europe. What they mean precisely, how we respond to them, and whether indeed we can change them is the subject of the rest of this pamphlet.

The figures in table two are based on forecasts prepared by a Washington-based think-tank, the Centre for Strategic and International Studies (CSIS), for the Global Ageing Commission. The CSIS has commissioned a series of independent forecasts, based on the UN's 2000 revision of its World Population Prospects. The UN's 'medium case' scenario is the most widely cited, because it sounds middle-of-the-road.[5] In reality, this scenario assumes significant increases in the birth rates of low fertility countries. Table two uses the UN's alternative constant fertility assumption. The table also assumes the established rate of improvement in life expectancy carries on into the future. And it assumes that net immigration continues at its 1995-2000 averages. In other words, it assumes Europe carries on as it is today. Those governments facing a major demographic challenge are tempted to use very different assumptions – for example, that there is a recovery in birth rates and that the rate of improvement in longevity slows down. Italy and Japan, two countries which face the most dramatic demographic changes, are particularly prone to using these sorts of assumptions to underplay the changes their societies face.

[5] The UN's medium fertility assumption is that countries with low fertility rates converge on a fertility rate of 1.85 children per woman by 2045-2050. In most EU countries the fertility rate is currently below this rate.

As soon as one starts thinking about how economies and societies might respond to these changes it becomes clear that there are very few facts and many highly-charged assumptions. The pernicious

language of 'support ratios' and 'dependency ratios', for example, contains assumptions about who is in paid work and who is not – and what constitutes real work. This language and its underlying assumptions will have to change.

Governments also diminish the scale of the demographic challenge by making other helpful assumptions, such as that migration rates will continue to rise and labour market conditions improve. Governments can even 'double count' their policies by manipulating starting assumptions in this way – the favourable assumptions magically become the base case, and then it looks as if policy changes mean they can do even better.

Demographic changes shape society. But we also shape our demographics – it is not a fate fixed for us by the gods. Different structures for our labour markets, or different patterns of family life, produce very different demographic effects. Demographic change is not fixed, nor is the way in which we respond to it. In chapters five, six and seven this paper will explore three ways to respond to these changes – with more work, more migration, and more babies. But first the pamphlet will look at the economic and financial consequences of these demographic shifts.

3 Some economic consequences of a declining population

The debate about the economic impact of changes in Europe's demography is too closely focused on the cost of pensions. The enormous shift in Europe's population that is now underway will have far wider economic effects.

This chapter takes its title from a lecture by John Maynard Keynes, the economist, in 1937, which he delivered just after he had published his General Theory. The lecture began with a statement of the obvious:

> We know much more securely than we know almost any other social or economic factor relating to the future that, in the place of the steady and indeed steeply rising level of population which we have experienced for a great number of decades, we shall be faced in a very short time with a stationary or a declining level.[6]

[6] *John Maynard Keynes, 'Some economic consequences of a declining population: the Galton lecture, February 16th 1937', Eugenics Review vol. XXIX, no. 1, 1937.*

Those confident words were of course proved completely wrong. Keynes' forecast was based on the low inter-war birth rates and was then falsified by the post-war boom. It is a reminder of the need for some humility when talking of these great demographic changes.

But even if Keynes' facts were wrong – at least for the immediate post-war period – his theory might be right. His lecture boldly reversed the obvious, but incorrect, conventional wisdom that a growing population is more likely to lead to unemployment because of too many workers – the so-called lump of labour fallacy. Keynes argued the opposite: a population that was shrinking would be at greater risk of unemployment. A youthful and growing population borrowed more, consumed more, thus stimulating demand and using resources to the full. By contrast, he argued, a shrinking and ageing population saved more thus diminishing demand and leading resources to be unemployed or underemployed.

Another great economist, Franco Modigliani, provides a useful framework for thinking about these economic effects. On his lifecycle hypothesis, we spread our patterns of borrowing, saving and dissaving to even out our consumption throughout life. It is an economist's version of the different ages of man. We borrow during the early parts of our working life. Then we repay our borrowings and build up our savings in our 50s after our children have left the nest. Then we run down our savings in our old age.

Modigliani's theory predicts that asset prices, such as houses or shares, should have surged during the 1990s and that they should still be rising as the baby boomers build up their savings prior to retirement. But when the baby boomers begin to run down their savings, asset prices should fall – we cannot all sell our houses to finance retirement without prices falling.[7] Optimists cited this theory as evidence that the bull market of the 1990s would carry on rolling. However, the recent collapse of equity prices has, to say the least, come rather earlier than this theory predicted.

[7] *A recent assessment by the Bank of England concluded that there are so many other factors affecting asset prices it is difficult to link them to changes in composition of the population. See Gary Young, 'The implications of an ageing population for the UK economy', Bank of England Working Paper no. 159, July 2002.*

Such economic theories help to explain how, for example, interest rates redistribute income across generations. Young people are borrowers who gain from low interest rates and high inflation to erode their debt. Older people are savers who gain from the opposite: high interest rates and low inflation. There used to be a rule of thumb in the Treasury that for every letter welcoming a cut in interest rates, there were forty letters of complaint from savers. The consumers and borrowers in a society are young and middle-

aged. Inflation distributes resources to them. It is older voters, the savers, who want low inflation. One might predict that as the average voter gets older, the electorate is more likely to vote for low inflation to protect the value of savings. Japan, the fastest ageing country, is the first to suffer from serious deflation. This deflation has raised the real incomes of Japanese pensioners – not least because there has been no reduction in the cash value of their pensions, even though prices are falling.

Demographic change does not just affect the demand side of the economy, it also has important supply-side effects. Syl Schieber, vice-president of Watson Wyatt Worldwide, has looked at the links between entrepreneurship and population ageing. He bases his work on the London Business School's total entrepreneurial activity index, which measures the proportion of the labour force involved in starting new ventures. He relates this to the youthfulness of populations. There is a clear pattern. Japan and Germany have the highest ratios of older people and the lowest levels of entrepreneurial activity. The UK is in the middle. The United States and China do best.[8]

[8] *Syl Schieber, presentation at EU Conference, Brussels, March 3rd 2003.*

One way to offset the economic impact of ageing is for older societies to become much more productive so that they grow despite having fewer workers. But this is easier said than done. Older people do indeed provide wisdom and experience and this could help raise productivity rates incrementally. But new entrants to markets are responsible for 40 per cent of productivity improvements, because they look at the problems afresh and do things differently. Syl Schieber's analysis suggests youthful countries will have more new businesses and will benefit from that important aspect of productivity improvement. Ageing societies are most unlikely to enjoy a better productivity performance.

A professor at Chicago University, David Galenson, helps explain this dilemma. He has undertaken an ingenious research project comparing the ages of great artists when they painted the works which now command the highest prices and the most references in books of art history. For Picasso the peak age is 26. He is the artistic equivalent of the new entrant, breaking with convention and tradition. For Cézanne the peak age is 67. He was an artist endlessly wrestling with the same problem as he strove to get to the truth. That is the incremental improvement that comes with growing experience. An ageing European society may offer us more Cézannes but we will have fewer Picassos – that is a grievous loss.[9]

[9] David Galenson, 'The life cycles of modern artists', National Bureau of Economic Research, <http://papers.nber.org/papers/w9539.pdf>.

The population of the EU 15 is likely to shrink modestly from 2020 onwards. The official projections from the European Commission show an increase from 376 million in 2000 up to a peak of about 386 million in 2020, after which it will decline to 364 million by 2050. But this headline figure conceals far greater changes in the composition of the population. The Commission estimates that the number of people aged 15 to 64 will decline from 243 million in 2000 to 203 million in 2050, an 18 per cent decline. The number of people aged over 65 will increase by 40 million, or 60 per cent, to 103 million by 2050. That means the proportion of people aged over 65 compared to those aged 15 to 64 will double from 24 per cent now to 49 per cent by 2050. These demographic changes will transform the EU's relationship with the USA. In 1950, the population of the USA was approximately 150 million and the population of the EU 15 was 300 million. Even now the population of the EU 15 is about 90 million greater than the USA. But the US population is projected to increase by 130 million between now and 2050. The US will overtake the EU 15 at some point after 2030. By 2050 the population of the USA could well be 60 million larger than the EU 15.[10]

[10] The 2002 revision of the UN's World Population Prospects shows, on its medium variant, the EU 15 population at 370 million and the US at 409 million. That projections change by such large amounts with small changes in assumptions within two years is a reminder to treat all such projections with care.

Table three: Populations of the EU and the USA 1950-2050 (millions)

	1950	2000	2025	2050
EU 15 population	300	377	371	339
USA	150	285	347	397

Source: UN World Population Prospects – the 2000 Revision.

The US has a higher fertility rate than the EU and projections assume continuing high levels of immigration. As a result it will have a higher proportion of young workers. Its median age – the age of the middle person in the population – will be much lower than Europe's. The UN estimates the median age in the EU 15 will rise from 38 in 2000 to 49 in 2050. By contrast in the US it will rise from 35 to 39. In fact, most of the rest of the world ages more than America over the next fifty years. For example, the effect of China's one child policy means that by 2050 the average age will be higher than America at 44. China's problem is that it grows old before it grows rich. India has much more favourable demographics.

In 1950 all four major European countries were among the twelve most populous in the world. That is one of the many reasons why they were so well represented in the structures of the post-war world. By 2000 Germany alone remained just within the top 12. By 2050 it will have disappeared from the list as well as Japan, leaving the USA as the only developed country in the top 12.

These demographic changes will have enormous economic effects. As America's workforce continues to grow so does its economy – at an underlying rate that remains about 2.5 per cent a year. But the European Commission estimates that the decline in Europe's working age population could reduce its underlying growth rate from 2.1 per cent to just 1.3 per cent by 2050. That means that by 2050 Europe's share of the world's output will have fallen to 10 per cent, from 18 per cent today. By contrast, the US will increase its share of global output from 23 per cent today to 26 per cent in 2050.

By 2050 Europe will have a shrinking population, a low underlying growth rate, and a falling share of world output. By contrast the USA will have a strongly growing population, it will still be relatively youthful, and if anything its share of world output will be rising.

There are many more important things in life, even in economics, than simply being big. However, the idea that Europe has a viable long-term option of becoming a cultural or economic alternative to America in these circumstances is pure fantasy. To understand the USA's future as the world's hyper-power you do not have to look far beyond these demographic facts.

4 Promises to pensioners: savings paradoxes

The resources we are going to live on when we retire do not exist yet. We are not squirrels, setting aside food now for the future. What we have instead are claims on future resources. These claims can take different forms. They can be claims registered via the government, which has promised us benefits in the future. Ultimately, these rest on the government's power to collect taxes and social security contributions to transfer money from workers to pensioners. Alternatively, these claims on future resources can be registered via private contracts, giving us ownership of some of the resources that will be generated in the future through holding shares, for example. The first model is pay-as-you-go; the second is funded. British politicians and commentators used to congratulate themselves on the apparent success of funded pensions compared with the pay-as-you-go models on much of the continent.

But Britain now faces a crisis in funded pensions. Put simply, British companies may no longer be able to pay the pensions they have promised their workers. Deep down, Britain's pension crisis is very similar to those facing France, Germany and Italy. All four countries made generous pension promises without having enough future resources to meet them. The difference is that in the UK it is companies which have promised to meet retirement benefits (although sometimes as a result of government legislation). In continental Europe, governments are committed to generous retirement payments through the social security system.

Mercers, a leading firm of actuaries, has calculated that British companies are facing a £270 billion pension fund shortfall – that is the gap between the cost of meeting their pension commitments and the assets in their pension funds. Companies cannot simply hope that a sustained recovery in equity prices will make good this shortfall. The UK must devise new policy measures to help tackle the crisis. Otherwise workers could face the nightmare choice of either their employers being forced into bankruptcy because of their pension liabilities, or having to accept a less generous renegotiation of their pensions. Nearly three-quarters of British companies have closed their final salary pension schemes – that is where the company pays a pension based on salary level and length of service – to new members. Over the next few years they may close their pension schemes to existing members as well.

The conventional celebration of the great British success of funded pensions led to extraordinary complacency about future public expenditure on benefits for pensioners. Forecasts suggest that Britain will maintain public spending on pensions at around 5 per cent of GDP from now until 2050. The conclusion is always that UK public spending on pensions is "sustainable", but that every other European country has a problem. The Treasury's recent study of Britain's long-term expenditure trends purported to show this.[11] The OECD and the European Commission use similar figures.

[11] *HM Treasury, 'Long term public finance report: an analysis of fiscal sustainability', November 2002.*

Table four: Spending on public pensions as a percentage of GDP, 2000 and projections for 2040.

	2000	2040
France	12.1	15.9
Germany	11.8	16.6
Italy	13.8	15.7
UK	5.5	5.0

Source: European Commission, European Economy No. 3, 2002.

However, the official British figures do not reflect the true state of the country's pension burden. Britain's demographic problem may not be as severe as some other countries, but even so the number of pensioners is going to rise from 10.8 million to 15.1 million between now and 2050.

The number of retired people receiving income-related (means-tested) state benefits, in addition to their state pensions, is also set to increase – from 52 per cent of pensioners now to 82 per cent by 2050, according to the Institute for Fiscal Studies.[12] Logically, Britain should be facing a substantial rise in public expenditure to pay for the increase in the number of pensioners and greater proportion of means-tested benefits. Yet these pressures do not show up in the figures. How can we explain this puzzle?

[12] *Tom Clark and Carl Emmerson, 'The tax and benefit system and the decision to invest in a stakeholder pension', Institute for Fiscal Studies, Briefing Note no. 28, August 2002.*

International figures for public expenditure on pensions measure the classic contributory benefits for pensioners, what most countries would call social security. They usually exclude means-tested payments to people with a low income. Most countries classify such payments, which are not age-dependent, as social assistance or welfare. Social assistance is anyway an insignificant element of pensioner income in most countries as social security payments – state pensions – are so generous. The UK is an exception. Because the UK's basic contributory social security benefit for pensioners is so low, the government also pays a significant proportion of support to pensioners through means-tested welfare. But important British benefits for pensioners – such as the minimum income guarantee, housing benefit, council tax benefit or benefits for disabled people – do not appear in all the pension expenditure forecasts. In most countries public expenditure on pensions and public expenditure on benefits for pensioners mean the same thing. In Britain it does not. Unless forecasts explicitly state that they include all benefits for pensioners they are likely to significantly underestimate British expenditure trends.

The European Commission recently asked the British government to supply figures which include means-tested welfare payments to pensioners as part of their expenditure forecasts. The UK Treasury reluctantly agreed. But it made another adjustment to offset this: it excluded payments of disability benefits from their expenditure forecasts to cut the overall spending figure. This change is estimated to have removed 0.8 per cent of GDP from the UK government's spending forecasts.[13]

[13] *For the Treasury definition of public pension spending see 'Long term public finance report: an analysis of fiscal sustainability', footnote 4, page 42, November 2002.*

This is not the end of the story. The UK government must also make assumptions about how much income pensioners will earn from other sources. If pensioners enjoy a buoyant income from other sources, such as private pensions or property income, then the government will not need to spend so much on means-tested benefits. But if the government used more credible assumptions about pensioners' future income, forecast expenditure on means-tested benefits would be much higher. This is not so much an issue on the continent where it is the contribution formula for building up benefits which matters. As the British system is so means-tested, exact assumptions about the level of income from other sources matter a lot.

Treasury forecasts of future expenditure on benefits for pensioners assume that their income from funded savings – private pensions – is buoyant, rising in line with average earnings. However, if instead one assumes that income from private pensions grows at a more modest rate – say in line with prices rather than earnings – projections of public expenditure on means-tested benefits become much higher. Indeed, this author's own provisional estimate is that on current policies expenditure on benefits for pensioners could well be more like 10 per cent of GDP in 2050 – double the official forecast.[14]

[14] *The effect of using prices rather than earnings increases public expenditure on the pension credit alone by two full percentage points of GDP by 2050. See the parliamentary answer to author, Hansard, col 391, June 3rd 2003.*

Thus British public expenditure on pensions is likely to converge with continental levels. It is one of the strange paradoxes of the Blair government that it has made an explicit objective of policy to converge on continental levels of health spending. In reality its policies on pensions involve a similar convergence on continental levels of spending but the government is strangely reluctant to admit that this is the direction of policy.

Anglo-Saxon commentators react with horror to the idea of heavy dependence on pay-as-you-go funding, because it means workers have to pay taxes and social security contributions to pensioners. But it is important to clarify exactly what the problem is. We need some mechanism for transferring the resources that an economy is generating to pensioners who are not working. Workers can transfer money to pensioners by paying the taxes which fund state benefits, or workers can sacrifice wages to higher company profits which then pay dividends to the retired. The two models work the same way by transferring resources from workers to pensioners. There is no automatic reason why funded schemes are affordable – as we are discovering in Britain – nor that pay-as-you-go schemes should be unaffordable.

One common misconception is that funded pensions increase the total amount of national savings. The evidence does not bear this out. If anything, it is the opposite: countries like the UK and the US with more funded pensions have lower savings rates than most continental countries. Funded pensions may not increase overall savings, but they do help raise returns to capital by ensuring savings are invested better. The UK and the US do not need to save as much as continental economies, because they achieve higher rates of return.

Funded pensions do however have three distinct and very important advantages. First, they are more transparent, and open to commercial and legal scrutiny, because these pensions are mediated via private contracts rather than via the state. Britain is facing many difficulties in trying to resolve its funded pensions crisis. But at least the problem is already in the public domain. A new accounting standard FRS 17 has forced companies to take action. The standard requires corporations to show more openly the assets and liabilities of their pension fund. By contrast, reform is much more difficult in those countries where excess pension promises are registered via the state. As one expert observed to a minister, "I can tell you how to reform your state benefits for pensioners, but I can't tell you how to win the election afterwards".

Second, pay-as-you-go systems are inherently prone to excess promises. Politicians find it far too tempting to promise generous benefits in the future based on an optimistic forecast of economic growth. And paradoxically, as the financial position deteriorates, the pressures to make such promises increase. The immediate way of solving financial pressures in a state pay-as-you-go scheme is to bring in more contributors today. And you can bring in more contributors and extract higher contributions from them by promising even better benefits in the future. A good example is the German government's decision to increase social insurance contributions while promising free nursing home care in the future.

Third, policy-makers find it much more difficult to adapt pay-as-you-go systems to the dramatic demographic changes outlined in chapter two. Governments can only tax their own population. Consequently, a shrinking number of workers would have to pay ever higher contributions for a growing number of pensioners. In contrast, private pension funds can allocate their assets around the world. If workers build up sufficient savings during their working lives it does not matter if there is a smaller workforce when they retire. They will instead have a claim on the resources generated by more dynamic economies. Funded pensions enable affluent Western economies to export capital to developing countries. You cannot tax people in other countries but you can invest in their industries.

France, Germany and Italy have all cut back on future pension promises and made modest steps to encourage funded pension savings instead. However, some important differences persist between the three countries.

France

France is the high priest of pay-as-you-go financing of pensions. Funded pensions are seen as pernicious examples of Anglo-American capitalism. Sophisticated French *Enarques* – elite civil servants – will explain the logic of the intergenerational contract in a pay-as-you-go system. Indeed, the great French thinker Condorcet first argued the case for a state system of 'social insurance' while in hiding during the French Revolution. British thinkers, such as Burke and Malthus, dismissed his '*Esquisse d'un Tableau Historique*' as hopelessly fanciful. In his 'Essay on the Principle of Population', Malthus summarised the proposition only to reject it:

> By the application of calculations to the probabilities of life and the interest of money, he proposes that a fund should be established which assures to the old an assistance, produced, in part, by their own former savings, and in part, by the savings of individuals who in making the same sacrifice die before they reap the benefit of it. ...Such establishments and calculations may appear very promising upon paper but when applied to real life, they will be found to be absolutely nugatory.

When Michael Portillo, as Treasury minister, predicted that the basic state pension would become 'nugatory', he used exactly the same word as Malthus some 200 years earlier. France does not just have a pay-as-you-go basic pension, it also has a pay-as-you-go system of occupational pensions – AGIRC and ARRCO. In 1993 the Balladur Government attempted to reduce the spiralling costs of these schemes by increasing the contribution period to earn a full pension from 37.5 years to 40 years. The French government also tied the value of the pension to prices not earnings. But these reforms only applied to the private sector – the nearly 50 per cent of the French workforce in the public sector escaped. Only now does the French government appear intent on reducing the generosity of its public sector pensions – not least because private sector employees will no longer support special privileges for the public sector.

The French pension problem is intimately tied up with the challenge of reforming its public sector. This is another respect in which the UK is converging on Europe. The closure of so many corporate final salary schemes in the last few years means there are now more such schemes in the public, rather than private sector. Many of these are unfunded and even those, which are funded, such as local authority schemes, are ultimately backed up by the taxpayer. The UK has just gone through the significant cross-over point where there are now more active members of final salary pension schemes in the public sector than in the private sector. Soon generous final salary schemes will be the almost exclusive preserve of the public sector. A gap is opening up in pension provision in the UK just as the French government is trying to close it.

Funded pension assets in France amount to approximately 7 per cent of GDP, according to the European Commission. In Britain the figure is 81 per cent of GDP. For Italy it is 3 per cent and for Germany 16 per cent. A superficial analysis of these figures would conclude that Britain has far greater retirement savings. But in the year 2000 an average French household saved 10.8 per cent of its income, according to the 2002 OECD Economic Outlook. In the UK, by contrast, the figure was 4.2 per cent. Household savings totalled 9.8 per cent in Germany and 12.3 per cent in Italy. Britain is not a nation of savers, despite the importance placed on funded pensions.

What happens to these French savings? Many of them go into money market funds and life insurance policies. In practice, older French people draw on these funds to finance their retirement. But

such savings are not specifically linked to retirement or an age limit. As a result they are excluded from international statistics for pensions savings. This is a further and significant distortion to the way in which statistics are presented.

We can see the significance of this if we look at the actual sources of pensioner incomes. The chart below shows the figures for the middle quintile, that is the middle 20 per cent of pensioners by income, in France, Germany, Italy and the UK.[15]

[15] The middle quintile is often very different from the average income of pensioners, which can be distorted by a small number of very well off pensioners.

Table five: Sources of income for the middle quintile of people aged over 60 as percentage of total income

	Private pension income	Asset income	Unfunded benefits	Earnings
France	0.4	18.0	78.2	3.4
Germany	2.5	10.2	84.3	3.0
Italy	3.1	10.0	82.7	4.3
UK	11.3	10.8	74.8	3.1

Source: CSIS ageing vulnerability index.

The table shows that French pensioners draw very little income from funded pension savings, but do have an unusually large amount of income from other assets. In fact, if income from these savings is included, French pensioners rely on a similar mix of unfunded state benefits and private savings as their British counterparts. Equally, in Germany and Italy general savings far outweigh funded pension savings.

Thus the UK's position is flattered by the way international economic statistics are compiled. On the one hand, the full cost of future expenditure on state benefits for pensioners is excluded from most pensions data, because not all these payments are linked to age. On the other, private savings in the UK are linked to age so they are all included as retirement income. In contrast, most continental European countries are doing better than the statistics initially suggest. More of their state benefits are contributory and age-related and therefore fully counted in the statistics, but their savings are less likely to be linked to an age condition so more of them are excluded.

There might even be a causal connection here between the UK's pension rules and the low overall savings rate. The British government's focus on encouraging people to save for retirement may discourage general savings. If you are saving for your retirement you cannot access the money until you have reached pension age. By contrast, if you can save in products that can be accessed more flexibly you might well save more in total. The option of drawing down savings may increase the likelihood of saving more in total. This is part of the thinking behind the Conservative Party's proposal for a new flexible lifetime savings account, which could be accessed throughout an individual's working life. It might be a better basis for encouraging people to save than to restrict savings so they cannot be touched until pension age.

Germany

Germany has twice greatly extended the scope of its state pensions benefits – in 1957 and 1972. The German government made both sets of reforms during the golden years of strong economic growth and as a result they are exceptionally generous. In 1992 the German

government made the first reductions to the system of state benefits. In 2001 Walter Riester, labour minister in the first Schröder government, introduced a more radical set of reforms which will ultimately reduce the state pension by 10 per cent. But the most eye-catching feature of the Riester reforms was that they included modest tax incentives for people to take out personal pension savings for the first time. By 2008 workers can contribute up to 4 per cent of their pay to a variety of funded pension schemes. The German government will also provide a contribution, based not on income levels but on the number of children – an ingenious pro-natalist measure. However, some experts have criticised the reforms as a "typical over-engineered German product", and their sheer complexity has resulted in a disappointing take-up rate. Most recently, the Rürup Committee has proposed an increase in the pension age and a formula to limit the proportion of GDP spent on the state pension.

Germany also has generous company pensions – provided you have worked with the employer long enough to build up pension rights. German companies use an accounting system in which their obligation to pay employee pensions in the future is shown explicitly on the balance sheet as a liability of the company. Sometimes these reserves are invested in independent funds but more often they are held internally as a source of capital for the company itself. Indeed, many Germans believe this source of internal working capital drove their growth rates during the post-war period. However, this system of reserves makes it hard to measure the rates of return achieved by German industry, and could be a contributing factor to the feeble returns on capital accepted for far too long as a feature of German capitalism. These pension arrangements, however, do have two conspicuous advantages. First, pension costs for companies are completely transparent. They have always been shown on the company's balance sheet. Consequently, the requirement of the International Accountancy Standards Board to show pension costs in full, which is due to be adopted by all European businesses in 2005, should not cause significant problems for German businesses. Second, Germany has tackled the obvious weakness of its book reserve system, which is that the pension fund could go bust with the company. Germany has an insurance scheme to protect company pensions although, like a similar American insurance system, it is now facing serious financial pressure.

While France's pension problem is its bloated public sector, Germany's is closely linked to its inflexible labour market. The German state pension scheme offers particularly generous rewards for early retirement. The recent CSIS report on Germany states that in 1998 only one quarter of new pensioners in the basic public pension scheme retired with a standard pension: the other three-quarters qualified for one of the special early retirement plans. Moreover, workers who move jobs can lose much of their entitlement to a company or public sector pension, and therefore job mobility is heavily penalised (even after the Riester reforms a worker needs to be at least 30 years old and have 10 years of service before they acquire vested pension rights). The worst aspects of the German pension scheme are the rewards for early retirement and the penalties for job mobility. This is something we will look at further in chapter five.

Italy

Italy grants very generous pension benefits. However, the Italian government has undertaken several major pension reforms over the past 10 years as part of its efforts to prepare for membership of the single currency. In 1992 the government of Giuliano Amato introduced reforms designed to reduce long-term pension costs by about 25 per cent. Then in 1995 Lamberto Dini pushed through a more radical reform with benefits linked to lifetime contributions and held in national personal accounts. The savings from this reform are theoretically very large, but are to be introduced after such a long delay that they affect virtually no adult Italian. This is a classic example of that well-known principle – 'God give me virtue, but not yet'.

What really makes Italy unique is the interaction of its pension system with its traditional family structure. The Italians have very generous state pension benefits, but they have virtually no other welfare benefits. Italy's total benefits bill is therefore comparable with other western countries, even if its expenditure on pensions is much greater. Half of all members of Italian trade unions are retired. Giuliano Amato has observed that "Young Italians believe the unions only represent their fathers." This is something we will look at in chapter seven.

Konrad Adenauer, the former German Chancellor, is supposed to have remarked that Germany would always be able to afford its pay-as-you-go system because Germans would always have children. That was a shrewd remark which is now far from true. The best way of ensuring that pensioners have a decent income in the future is to have a strong and growing economy with lots of workers producing the output on which pensioners can draw. This is the real way of underpinning the finances of any pension system, be it pay-as-you-go or funded. The second half of this pamphlet will examine three main ways of increasing the size of the workforce: encouraging more of the existing population into work; bringing in more migrant labour from abroad; and producing more babies.

5 More work?

The simplest way for governments to begin to tackle the looming demographic crisis is to get more adults into work. Even if the total number of people of working age is falling, perhaps a higher proportion can be in paid work, to maintain the size of the active workforce. Many European countries have low rates of adult employment at present. Indeed, the European Council, meeting in Lisbon in March 2000, set a target of raising the EU's adult employment rate from 64 per cent to 70 per cent in 2010. But only recently Pedro Solbes, the economic and financial affairs commissioner, warned of a serious gap between the commitments to prepare for ageing populations and the actual reform measures that are being taken, "the Lisbon targets are therefore in jeopardy of not being met."[16]

[16] *Pedro Solbes, 'Is Europe facing up to the challenge of ageing populations', Speech, Brussels, March 4th 2003.*

Europe should seek to draw on at least five different sources of labour.

First, the most obvious pool consists of those who are officially unemployed. After all, they are available to work. Mistakes in macro-economic management and problems in the operation of the labour market have left the four countries we are studying with combined unemployment of over 8 million, according to the harmonised International Labour Organisation survey measure. Almost half of these unemployed are in Germany.

Second, more women could enter the workforce. The EU has set a specific target of raising the female employment rate from 55 per cent to 60 per cent. Across the EU the employment rate for women is on average 18 percentage points lower than for men. But this average masks considerable diversity in the female employment rate: for example in Italy only around 40 per cent of women are employed compared with nearly 70 per cent of men.

Third, Europe could encourage older workers to remain in employment longer. Several countries have actively introduced incentives to early retirement – most notably Germany with its disastrous benefit changes of 1972. Twenty years ago experts were concerned that workers were hardly any better off in work than claiming unemployment benefit – now they worry that workers are hardly any better off working rather than taking early retirement. It is no surprise therefore that so many people aged over 50 have withdrawn from the labour force. Again, the EU has set a specific target of raising the employment rate for workers aged 55 to 64 from 39 per cent now to 50 per cent. The table below shows the scale of the problem:

Table six: Percentage employment rates of older male workers (55-64)

	1980	2000
France	65.3	38.5
Germany	64.1	48.2
Italy*	49.0	40.9
UK	62.6	59.8

Source: OECD Economic Outlook No. 72, December 2002.
**For Italy, the data is for 60-64.*

Fourth, and closely related to the disengagement of older workers, Europe should tackle the problem of the number of people of working age on disability benefits. Well-intentioned attempts to get people off unemployment benefits and into work can sometimes have the perverse effect of moving them out of the labour market altogether, notably onto disability benefits. As there is no specific employment assistance for people on such benefits, it is even harder to get them into work than if they are officially unemployed.

Finally, EU member-states should be much more open about a ‘hidden’ labour market problem – that of young people delaying their entry into the workforce. The loss of working years by delaying first paid employment is at least as significant a trend in Europe over the past 30 years as that from early retirement. This delay is valuable if students are acquiring a worthwhile education or training. But if it takes longer for people to reach a given level of education because of declining school and university standards, then it becomes an economic problem which should be tackled. Only Germany, where many students stay at university until they are nearly thirty, has seriously debated this problem.

EU member-states already assume significant improvements in labour market participation rates in their official forecasts. But the question remains whether governments are willing to take the action necessary to meet the Lisbon targets. The evidence to date suggests they do not. This may be because of the convenient, but false, assumption that this agenda is just a matter of technocratic changes to labour market policies. In reality much deeper social and cultural changes are needed. High employment societies are very different from low employment ones. A society with higher rates of labour force participation is going to be one where paid work replaces what was previously unpaid work done informally within the extended family. The cash economy grows relative to unpaid ‘social’ work.

Diversity

European countries will have to change radically the structure of their labour markets to meet the Lisbon objectives. Many of the people coming into the labour force – women, people with disabilities, people aged over 50 – might not be willing or able to do a conventional 40-hours a week job. A diverse labour force requires a similarly wide range of employment opportunities. Yet all too often regulations are constructed around a model of what a job ought to be like, and it is still far too difficult to move into non-standard employment.

Highly regulated, standardised labour markets exclude people. Loosely regulated, diverse labour markets are inclusive. One simple measure of the degree of standardisation in labour markets is the number of hours worked. One study showed that in Germany 28 per cent of employees worked exactly 38 hours, and 28 per cent worked exactly 40 hours. In France 49 per cent of the workforce worked 39 hours. In Italy 20 per cent worked 36 hours and 45 per cent worked 40 hours.[17] In Britain the picture was very different. The number of hours most frequently worked was 40 hours – but only by 10 per cent of employees. UK employees work a much wider range of hours. This diversity helps to explain why the UK has higher rates of employment than France, Germany or Italy.

[17] *Catherine Hakim, 'Models of the family, women's role and social policy: a new perspective from preference theory,' European societies (1), 1999.*

EU member-states need fundamentally to overhaul their labour markets, a fact which has not yet been appreciated by all policy-makers. Parts of the European Commission are still busy producing new labour market regulations such as the agency workers directive, which seeks to give part-time agency workers similar rights to full-time members of staff. This directive is inconsistent with the aim of increasing flexibility and thus employment rates. Member-states should instead focus on fostering greater diversity in their labour markets.

Retirement

An increase in the age at which workers retire is a particularly effective means of easing pressure on public expenditure and private pensions – it means greater tax income and contributions while delaying the payment of retirement benefits. The European Commission estimates that if member-states succeeded in raising the average retirement age by five years – without also increasing the level of pension benefits – public expenditure on pensions would remain stable despite the demographic changes. For years policymakers have talked about the importance of firms not missing out on the talents and experience of older workers, but the trend continued in the wrong direction as Table six shows. The average retirement age is now at least rising in a number of countries. But the overall figures often hide a marked difference between the sexes, with increasing rates of employment amongst older women off-setting continuing declines among men.

As the baby boomers grow older the number of potential early retirees grows. So if the percentage of men in their 50s taking early retirement remains stable, the cost in terms of lost GDP will grow. A recent study by Watson Wyatt showed that the level of labour force participation by 55 to 64 year olds across the OECD would have to rise from 51 per cent now to 56 per cent in 2010 just to hold the economic cost constant at 7.3 per cent of GDP. [18]

[20] *Watson Wyatt, 'The early retirement burden', 2003.*

In some countries, such as Germany, generous early entitlements to state pensions create clear incentives for people to stop work. Moreover, 'Bismarckian' welfare states require that people are fully retired to receive a state pension. So state pension rules drive people into retirement. But this is not the story everywhere. In one of the most important but unremarked reforms of the Thatcher years, the so-called earnings rule was abolished so that people could carry on working after the age of 65 without losing any state pension. There is no state retirement age in Britain, because there is no retirement condition for receiving the state pension. But Britain has also had an early retirement problem. The British example shows that if we are to understand why people retire we cannot just look at rules for state benefits, we have to examine company behaviour as well.

[19] Edward P Lazear, 'Why is there mandatory retirement?' Journal of Political Economy, Vol. 87 No.61, 1979 and 'Agency, earnings, productivity, and hours restricted', the American Economic Review. Vol. 71, issue 4, 1981.

Retirement, like unemployment, was invented as part of 19th century industrial capitalism. Professor Edward Lazear has shown how companies underpay younger workers but with the prospect of future increases in their pay as a reward for loyalty and improved performance.[19] Lazear argues that younger workers are underpaid and older workers are overpaid. The retirement age is the point at which these periods of 'underpayment' and 'overpayment' net out at zero. Companies that underpay their young workers as part of a seniority system need to set a defined retirement age to fix a limit to the period of 'overpayment' of older workers. If competition increases the wages of young workers to something close to their real economic value, and seniority systems 'overpaying' older workers break down, then compulsory retirement ages become unnecessary. The evidence is indeed that retirement ages are particularly important in companies with long-term and hierarchical employment structures. Self-employed people carry on working for much longer. This helps explain why the early retirement problem is particularly severe in Germany – it has more large companies with traditional seniority systems than other European countries.

Conventional final salary funded pensions made the problem worse. They provided a pot of money which companies could raid if they needed to shed staff. During Britain's two recessions of the early 1980s and the early 1990s, companies that were shedding staff found it easiest to get rid of older workers and make them a charge on the pension fund. These workers were then lost to the labour force forever, whereas younger workers could have got another job. One expert has found clear evidence that: 'being in a job with an occupational pension significantly increases your chances of

being displaced if you are in the top half of the wage distribution, often by 10 percentage points or more. Men in their early fifties with an occupational pension and in the top quartile of the wage distribution are 50 per cent more likely to be displaced than a man with the same age and hourly wages but no occupational pension.'[22]

[22] Nigel Campbell, 'The decline of employment among older people in Britain', London School of Economics, case paper, January 19th 1999.

EU member-states need to change this state of affairs. The EU has made a start by passing a directive banning age discrimination from 2006. There is considerable scope for countries to interpret it as they wish. But the UK government has made it clear that it is likely to make company retirement ages, at least under 70, unlawful. There is a straightforward legal device to implement this. At the moment the retirement age is exempt from unfair dismissal legislation. This exemption could be removed. Such a reform would provide a practical legal example of an underlying change in social attitudes: making someone redundant just because they are aged 60 or 65 should be as unacceptable as getting rid of someone for being female or black or gay. Very few British companies seem to have fully adjusted to the significance of this forthcoming change.

The move from defined benefit to defined contribution schemes will also reduce the incentives for early retirement. A defined benefit pension is often fixed as a proportion of one's final salary, so there is little or no incentive to work after reaching peak earnings. A defined contribution scheme by contrast builds up a personal pot of money: the more years an individual works and the bigger the contributions they build up, the greater the pension that they will receive. As defined contribution pensions are worth so little people are going to have to carry on working anyway to build up an acceptable pension fund. Workers are not going to leave so readily, especially with the legal protection provided by the EU age discrimination directive.

Several EU countries are moving their state benefits system to a defined contribution model as well – notably Sweden and France. The new Polish system is a particularly radical reform along these lines. This means citizens build up bigger and bigger pension entitlements the longer they make contributions. It strengthens incentives to carry on working.

The European Commission forecasts the number of people aged between 15 and 65 in the EU 15 will fall by 40 million over the next 50 years. The most optimistic forecasts from the European Commission suggest that labour market reforms could encourage a further 30 million people into the workforce. But that means Europe's working population would still shrink by 10 million after decades of growth. Even if the EU reached its target of a 70 per cent employment rate by 2010 the size of its working population would still decline from that point on. Policies to raise labour force participation are desirable but they are running hard to stand still. Ultimately, even if we all work until we drop, the total size of the workforce is going to decline as the overall population falls. That is, unless we either bring in more workers from abroad or produce more children ourselves. Those are the subjects of the next two chapters.

6 More migration?

Just as nature abhors a vacuum so does demography. Countries that cannot generate enough workers themselves will suck them in from outside. The United Nations estimates that 175 million people – 1-in-30 of the world's population – are migrants.

The period 1870-1914 also saw mass movements of people from the poor, high birth-rate countries of southern Europe to the USA. Our new global economy can expect to see more of such mass migrations in the future. The population of Italy will not really fall to 40 million by 2050 – migrants will fill at least some of the gaps. The UN's baseline projection is that the EU will attract a net 600,000 migrants per year up to 2050. This figure was included in the population projections contained at the end of chapter two and is high by post-war standards.

The UK and Germany are the largest recipients of migrant workers in Europe. The UN assumes this pattern will continue. Germany's net inward migration rate is projected at 211,000 per annum and the United Kingdom's at 136,000 per annum. Some 9 per cent of Germany's residents are non-citizens – the same rate as the USA.[21] Germany's birth rate is as low as Italy's but its higher migration rate ensures it is not facing the same scale of demographic change. The other reason is a less happy one – the German life expectancy is projected to be 82.9 years in 2050 as against 86.5 years for Italy.

[21] *However, non-citizens might nevertheless have been born in Germany whereas many citizens in the US are foreign born. It is easier for a foreigner to become an American citizen than a German one because of very different models of citizenship. See David Coleman, '2 and 1/2 Cheers: a review essay on the International Migration Report 2002', Population and Development Review, Vol. 29 (2), June 2003.*

This is the difference between bratwurst and pasta. Sushi should raise Japanese life expectancy to 91.9 years by then.

However, migration rates do not correlate precisely with demographic pressures. The fact that more migrants go to Germany than Italy, and more to the UK than France, suggests there is no clear link between demographic changes and migration rates within Europe.

First, migrants have more difficulty finding jobs in countries with heavily regulated labour markets. A flexible labour market is both better able to employ women and over-50s from the existing workforce and is also more receptive to migration from abroad – so migrants tend to go to high employment societies, because they are more liberal. In Italy and France labour rules are much stricter, although this might drive many immigrants into the black economy.

There is also a second possible explanation. Economically speaking, it appears obvious that a low birth rate country should suck in migration from abroad. But if we look at the problem sociologically, the picture becomes rather different. A country with a low birth rate is failing to produce sufficient people to carry its culture forward into the future. Consequently, many low birth countries are resistant to migration for fear of the different cultures brought by immigrants. By contrast, countries with high birth rates are ones that have confidence about their future. For them migration is less of a threat. So countries with high birth rates might be those with high rates of migration as well.

The links between demographic change and migration are not at all straightforward. The economic impact of high migration rates is mixed too. Migration can raise the underlying growth rate of an economy by increasing the number of workers. This is the case in the UK over the past few years. In the 2002 budget, the British Treasury raised its estimate of the underlying growth rate of the economy from

2.5 per cent to 2.75 per cent per year. The Treasury justified the revision in part due to the impact of higher assumed growth in the working age population due to migration.[22] Gordon Brown's success in apparently raising the growth rate could thus result from the failure of David Blunkett, the Home Secretary, to restrict migration.

[22] *HM Treasury, 'Financial statement and budget report', page 3, March 2002.*

It is easy to increase the total output of the economy by bringing in other workers. But the problem is that output per head may not grow. Large-scale migration of relatively unskilled people drives down average productivity growth. In Britain the growth in output per worker is falling just as rates of migration strengthen. Even if total GDP is rising, per capita GDP may not.[23]

[23] *The UK figures on migration have been frequently revised. The latest estimates from the Office of National Statistics in June 2003 suggest net migration at an average of 60,000 per annum 1994-97 surging to an average of 159,000 per annum 1998-2001. At the same time annual growth of productivity has fallen to an historic low of 1.3 per cent since 1997.*

Low-skilled, low paid migrants can also widen income differentials. Professor Layard, the Labour Peer, made the point in a letter to the Financial Times in May 2002:

> For European employers and skilled workers, unskilled immigration brings real advantages. It provides labour for their restaurants, building sites and car parks and helps to keep these services cheap by keeping down the wages of those who work there. But for unskilled Europeans it is a mixed blessing. It depresses their wages and may affect their job opportunities. Already unskilled workers are four times more likely to be unemployed than skilled workers and it is not surprising that they worry. Although the total size of the labour force has no effect on the unemployment rate its structure does; and a rise in the proportion of workers who are unskilled does raise overall unemployment. By the same token, we do need more immigration of skilled workers to rebalance our workforce.

This author demonstrated in a recent pamphlet that the number of economically inactive adults in the UK has not fallen in the past five years, despite a range of welfare-to-work schemes.[24] The employment rate in Britain has risen in recent years due to migration, rather than because vulnerable groups have found jobs.

[24] *David Willetts, Nicholas Hillman, and Adam Bogdanor, 'Left out, left behind: the people lost to Britain's workforce', Policy Exchange, July 2003.*

Moreover, migration does not provide a full solution to demographic problems which result from a fall in the birth rate, but migrants do provide a temporary boost to the labour force. But then they themselves grow old and their own birth rates decline towards that of the prevailing culture – a process that takes around 15 years.[25] A low birth rate society thus needs continuing flows of migrants just to maintain the size of its workforce, and it would need even larger numbers to keep the ratio of workers to retired stable.

[25] *This is the estimate used by the UK government's actuaries department in their population projections. An interesting exception to this rule is the Bangladeshi community which has a higher birth rate in the UK than in Bangladesh.*

The UN has done some modelling which shows just how many migrants would be needed to resolve Europe's demographic problems. Take Germany with a population of 82 million. If Germany has zero net immigration, its population falls to 51 million by 2050 and 24 million by 2100. If Germany continues with the current high level of net immigration, its population would still fall by 2050, by around 14 million to 68 million and to 39 million by 2100. Germany would need to attract 188 million migrants, or 80 per cent of its total population by 2050, to maintain the current ratio between workers and pensioners. Italy would need 120 million migrants by 2050. The EU as a whole would need 700 million migrants. These figures show migration cannot keep ageing populations young.

Where in the world will the migrants come from?

Immigration alone will not resolve Europe's demographic crisis, although some migration may help mitigate it. But it is worth

thinking about where these migrants will come from, because that may have implications for cultural and social changes in Europe.

The obvious assumption is that the migrants will come from Donald Rumsfeld's new Europe, especially the countries of the former Soviet bloc, which are now joining the EU. But the UN estimates that the working age population (15 to 59 years) of the ten EU accession countries will fall from 48 million in 2000 to 30.2 million in 2050, an even greater decline than the average fall across the EU 15. Eastern Europe is enduring a demographic crisis of its own. Birth rates in Poland, the Czech Republic, and Hungary, for example, have fallen to catastrophically low levels. The UN expects Poland's population to fall from 38.6 million to 33 million by 2050; the Czech Republic's to fall from 10.3 million to 8.6 million; and Hungary's from 10 million to 7.6 million. Of the 20 countries predicted to record the largest population decline over the next 50 years, 15 are from the former Soviet bloc. These countries do not have a big future supply of young workers. Recruiting migrants from them is more a matter of "hurry now while stocks last".

Moreover, emigration will make what is an already difficult demographic problem in eastern Europe even worse. Because of their plummeting birth rates, several of the accession countries are already facing shifts in their dependency ratios as severe as Italy or Spain. If one adds that to a large exodus of workers to the west their position could catastrophic. Donald Rumsfeld's new Europe has a birth rate as bad, if not worse, than old Europe's. Expanding to the EU 25 therefore exacerbates Europe's demographic problem, it does not help to solve it.

Europe will have to look elsewhere for a sustained source of immigrants. There are young countries with high birth rates on its doorstep – in the Middle East and North Africa. It is from these countries that workers will be sucked in to run the nursing homes and the shops of old Europe. The UN estimates that by 2050 Turkey's population will be over 100 million, far greater than any country in the EU 15. Its working age population will be 57 million, a third of the entire EU 15's working population.

As well as looking east, Europe will also find itself looking to the Muslim south. In contrast, the main source of migrant labour in the US is Christian Hispanics. This scenario, of more interest to the strategic planners in Washington than in Brussels at the moment, means that by the end of the 21st century Europe could well have an increasingly Muslim south and east. A demographic shift of this nature could mean Europe's religious and cultural map more closely resembles that of the early Medieval period. Europe is going to have to think much more carefully about relations with an Islamic population that is growing, while birth rates in southern Europe collapse.

7 More babies?

People are living longer – that is a great human achievement. The demographic challenge facing much of Europe is not life expectancy but low birth rates. Governments can buy time by squeezing more work out of the adult population and by importing more workers from abroad. But the source of the problem is the low birth rate. As people live longer you would need very large increases in the birth rate to keep the same ratio between the generations – a rate that would lead to stupendous population growth. A replacement rate of 2.1 births per woman would at least avoid absolute falls in the number of children while the ratio of younger to older people would continue to rise. There is no right figure. But if we had more children it would certainly help.

Government attempts to encourage people to have more children – pro-natalism – come with dreadful associations. Pro-natalism is linked in many people's minds with a traditional role for women, if not the out-and-out fascism of '*Kinder, Kirche, Küche*'. Many people doubt whether governments can or should affect birth rates. That is why the best starting point is to consider whether people are having as many children as they say they would like. A gap between these expectations and outcomes suggests that people are finding it difficult to fulfil their aspirations. The challenge is then to see whether policymakers can help remove the obstacles that frustrate the aspirations of contemporary women and men. This is a question which has been almost entirely ignored in post-war Europe: now it must enter mainstream political debate.

Birth rates peaked across Europe in the mid-1960s, as we saw in chapter two. The baby boom generation entered their most fertile years in the 1980s, so one might have expected to see an echo of the

1950s baby boom then. In fact, the birth rate only increased modestly in most European countries. The total fertility ratio remains way below replacement rates across most of Europe as the table below shows.

Table seven: Total fertility rates averages for 1960-65, 1995-2000, and 2000-2005

	1960-65	1995-2000	2000-2005
France	2.9	1.76	1.85
Germany	2.5	1.34	1.35
Italy	2.5	1.21	1.23
UK	2.8	1.70	1.60

Source: UN World Population Prospects – the 2000 & 2002 revisions.

Most population forecasts assume birth rates will rise in the future. The argument is that women are delaying childbirth to complete higher education and begin their careers, so the current low birth rate reflects a change in the timing of childbearing, not the overall number of births. Whether or not Europe's birth rate recovers is the single most important question affecting its future demographic shape. However, there are two important reasons why we should not assume that such a bounce back would resolve all the problems, or even that it necessarily is going to happen at all.

First, tempo matters. Delayed childbirth leads to a widening in the gap between generations which lowers population and increases the average age, even with no fall in the overall fertility rate. Second,

delayed childbirth can easily become childlessness. The decline of fertility after the age of 30 is dramatic and may be underestimated – leaving people with fewer children than they hoped for. A recent British survey showed 20 per cent of women aged 36-38 were childless but one in four of them were still intending to have a first birth.[26] Another study estimated that if fertility rates do not recover "each additional decade that fertility remains at its present low level would imply a further decline in the European Union of 25-40 million people."[27]

[26] *Smallwood and Jefferies, 'Family building intentions in England and Wales, trends, outcomes and interpretations', Population Trends 112, Summer 2003.*

[27] *Wolfgang Lutz, 'Europe's population at a turning point', Science Magazine, March 28th 2003.*

Birth rates shape, and are sensitive to, economic, social and cultural changes. Low birth rates are not inevitable. Italy and Germany currently have low birth rates whereas Britain and France have rather higher birth rates, at least relative to the rather unambitious standards of European demography. This is a direct reversal of the position in the 1930s. Then Britain and France had low birth rates whereas Germany and Italy were in an altogether different league. Fortunately, the sort of social conditions needed now to support people who wish to have children may be very different from the inter-war period.

Many people still assume traditional Roman Catholic societies must have high birth rates, whereas the reality is the exact opposite. In Italy, the total fertility rate now stands at about 1.3 children per mother, way below the replacement rate. Japan is the only other major advanced economy with a rate as low. The Italian population on these trends will shrink from 57 million now to 44 million by 2050, and perhaps 30 million by 2100. Unless there is a dramatic change in Italian fertility rates, the Italian people are at risk of dying out.

The interaction of Italy's labour markets, its family structure, and its housing market is the clue to all this. In Italy, jobs are still dominated by the *pater familias*. Traditional male employment is quite high, but there are much lower rates of employment among women and young people, so the total employment rate is low. The traditional extended family is held together by dependence on the male breadwinner. Dependence on the father of the family continues even after retirement, as the main Italian social security benefit is the pension. Benefits for families or unemployed people are low or non-existent. Extended families thus face huge financial pressures to stick together. Hence the paradox that Italy has low rates of employment but also low rates of workless households. This is because the households are large and the male head of the household (an expression which still applies there) will be in work, or on a pension following early retirement, and then distributing his income to the rest of the family.

Young people stay at home for much longer than in just about any other advanced European country. A recent survey by Data Monitor showed that 95 per cent of Italian 18 to 24 year olds lived at home, the highest rate of any European country. In Sweden just 46 per cent of 18 to 24 year olds live at home. Yet Sweden has one of Europe's highest birth rates and Italy has one of the lowest. Living at home with your parents is a very powerful contraceptive. In Italy it is not until nearly 30 that half of all men have left home.[28] One reason for staying at home is that young Italians are more likely to be financially dependent on their parents. Another factor is the unusual structure of housing finance – mortgages are complicated and expensive in Italy. It is hard to borrow and takes a long time to build up the savings needed. This reinforces the delay for young Italians in creating a home of their own.

[28] *Maria Iacovou, 'Leaving home in the European Union', ISER Working Paper 2001.*

Italian women do not just undertake most of the housework and child care, they also care for elderly parents and parents-in-law. Italy has the highest proportion of elderly parents living with their adult children in Europe. The only other advanced economy with anything like the same rate of intergenerational cohabitation is Japan – another country with a very low birth rate. If women are busy caring for elderly people they are less likely also to take on

the responsibility of raising children as well. And a traditional role for the man – not helping with domestic tasks – may make the problem worse.

The evidence from Italy, and indeed Spain, is that a traditional family structure now leads to very low birth rates. 'Traditional roles' within the home do not encourage women to have more babies – rather, it may lead to very low birth rates.

Germany also has a very low birth rate, although not quite as low as Italy's. However, German families are smaller and more individualistic, and the country does not have the same traditional family structure as Italy. Instead the German educational system and its labour market are the main cause of the low birth rate.

Germans spend longer in higher education than students in just about any other advanced economy. Young German adults are at home because they are studying at university. Some 60 per cent of 18 to 24 year old Germans live at home – higher than France and the UK, although much lower than Italy. Young Germans delaying the formation of the new family unit helps explain the low birth rate, but the structure of the German labour market is also important. The problems of the over-regulation of the German labour market are almost always discussed in terms of their effect on production. But the real losers are consumers. The restrictions on shop hours in Germany, for example, make life far more difficult for working women who also take on most of the domestic responsibilities. Many working couples with children in Britain do their shopping at times which would be illegal in Germany – although recent reforms might help.

It is not just shopping hours which makes it difficult to combine children and work. The school hours are also a major obstacle as most children start at school early but finish at lunchtime. All this makes life very difficult for the working mother. More women in Germany are in work than in Italy because of far more liberal social attitudes. However, they then find enormous practical obstacles in combining that with having children. German labour market regulations and the accrual of pension rights are based on the model of a standard full-time job. Thus Germans have a strong incentive to work full time, although the inflexible education and retailing arrangements make it extremely difficult to combine this with having children.

The latest UN projections show that Europe does not just face big changes in its total population, as the number of elderly people rises and the number of younger workers fall. It also faces great shifts in the relative size of different national populations.

Table eight: Total population by country (millions)

	1950	2000	2050
France	41.8	59.3	64.2
Germany	68.4	82.3	79.1
Italy	47.1	57.5	44.9
UK	49.8	58.7	66.2

Source: UN World Population Prospects – 2002 revision, medium fertility variant.

This is the real two-speed Europe: France and Britain are in the fast lane, Germany and Italy in the slow lane. The populations of France and the UK will grow while those of Germany and Italy decline.

Britain has always had one of Europe's most individualistic family systems: young adults leave home in order to set up house with a partner independently of their parents. Recent economic and social

changes have reinforced this pattern. Traditional male employment declined most rapidly during the heavy restructuring of manufacturing industry in the 1980s. The new jobs in the service economy tended to go to women and young people. Moreover, women found it easier to combine work and children in a flexible labour market. At the same time Britain had relatively low rates of higher education, meaning that young people were earning a wage and starting families younger than in many continental countries. Britain offers strong evidence that higher birth rates do not come from forcing women to adopt traditional roles. High birth rates can be associated with flexible labour markets, relatively high rates of female employment and liberal social attitudes.

However, Britain's birth rate is now falling. Britain, Germany and Austria are the only three EU countries to have recorded a decline in their birth rates for each of the past five years. The era of early independence – and early household formation – for Britain's young people may be coming to an end. The crucial factor behind this is that young Britons are maybe becoming more dependent on their parents, which reduces the birth rate. Higher rates of participation in higher education, together with tuition fees and student loans, enforce dependence on the family for longer. British students may also be studying for longer. The annual UK graduate career survey showed 22 per cent of students expecting to get a full-time graduate job and 24 per cent planning postgraduate study. Many young cohabitations break up and often at least one partner returns to the parental home after the break-up.[29]

[29] *For someone leaving home at 21, 28 per cent of men and 21 per cent of women will return to the parental home. See Ermisch and Francesconi, 'Patterns of household and family formation: seven years in the lives of British families', edited by Berthoud and Gershuny, the Policy Press, 2000.*

Above all, rising property prices are reducing Britain's birth rates. The birth rate rose in the early 1990s, when house prices were cheap. Now house prices have risen so high that the average age of the first time buyer has reached 32. Expensive housing delays the creation of a family. Young adults are delaying having children because of high house prices, extended periods of higher education and a longer period spent looking for the right partner (what the author has termed 'the Bridget Jones effect'). The birth rate trend in Britain is now declining and could well decline further. The number of live births is nearly down to the record low of 1976, and the total fertility rate is down to 1.6 children per woman. The surge in immigration is the main source of population growth.

That leaves France, the home of pro-natalist thinking. Throughout much of the late 19th and early 20th century France had one of Europe's lower birth rates and conducted an anguished debate about "*natalité*" as it watched its population overtaken by Britain and Germany (it would even have been overtaken by Italy's but for the mass emigration from Italy to America in the early decades of the 20th century). Now France has raised its birth rate to the highest level in Europe. In 2000, for the first time since the French Revolution, more babies were born in France than in any other European country. This fact is of enormous significance for the future of Europe because it means that, in every sense of the word, France is going to be a big European power. France is not part of old Europe.

How has France succeeded in raising its birth rate relative to other advanced European countries so it is close to replacement levels? The French provide explanations which are distinctly uncomfortable to Anglo-Saxon economic liberals. One argument is that the 35-hour working week has helped because it enables women, in particular, to combine work and family responsibilities. Some experts also claim that men are now liberated by the shorter working week to make a bigger contribution to domestic work and child care. Anglo-Saxons create opportunities for modern families with a host of part-time jobs and non-standard hours to help women who wish to work. But France achieves a similar effect by the heavy regulation of its labour market, reducing hours of work for both men and women so they have more time for their families.

The financial incentives for children in the French system are also very strong. In particular the French reward parents for having a third child. Many women will remain childless, so the government is encouraging others to have three (or more) to ensure the overall birth rate is above the 2.1 replacement rate.

Third, the French talk vaguely about 'optimism' for the future. Periods of optimism do not exactly correlate with high birth rates, but there is something in the point. High birth rates in Britain and Germany in the 1950s and early 1960s were linked to periods of rising real incomes and optimism for the future. The French economy has performed relatively well in recent years, with overall levels of unemployment declining and living standards improving. This is the right environment for encouraging people to have children. The French are literally delivering the most important single element of the inter-generational compact to underpin pay-as-you-go pensions – they are producing successive generations of workers to pay the taxes.

Both the Dini pension reforms in Italy and the Riester pension reforms in Germany included measures to try to stimulate the birth rate. So far, however, neither set of reforms has had any significant effect. Both countries are close to the point where deaths exceed births, and population goes into decline.

A brief tour of birth rates in four European countries helps demonstrate what modern family policy must be about. It has nothing to do with enforcing traditional roles on women. Feminism is the new natalism. In most of Europe women still aspire to having two children but in Italy and Germany it is very difficult to combine this with women's other aspirations. We can see what a better environment for raising children might look like:

- ⋆ We should not expect the extended family to provide most childcare, but encourage external support, whether through the public or commercial sectors.

- ★ We should make it easier for younger people to create their own nests by enhancing employment prospects and ensuring that housing is not too expensive. The longer young adults remain at home, the lower the birth rate.

- ★ We should reform labour markets to make it easier for people to combine work and families. Flexible access to goods and services matters too.

Finally, there is the question of money. Several European countries are now experimenting with a variety of financial incentives for children. Many European countries have socialised the cost of old age while privatising the cost of children. Taxpayers bear the costs of providing for older people, but individual families bear the costs of raising children. Governments which spend heavily on older people, but offer little for families – of which Italy is the most extreme example – will not encourage a higher birth rate. The best way of aiding pensioners is to help families, so the contract between the generations can be maintained.

8 Conclusion

Europe's population will age dramatically over the next 50 years, with its median age rising by 11.8 years. We should celebrate the fact that people are living longer. It is a great human achievement – especially as we are fitter for longer. The problem is that behind the baby boom there is a baby bust. That in turn means that the EU will face a 20 per cent decline in the size of its working age population, from around 230 million now to 190 million in 2050.

The USA faces very different demographics. Its birth rate is higher and it can take many more migrants. Its working age population could well grow from 180 million now to 230 million by 2050. The share of the EU in world GDP could well halve from 18 per cent to 10 per cent, while America's could, if anything, grow from 23 per cent to 26 per cent. To its credit the European Commission recognises the enormous economic significance of the demographic challenge facing Europe, as does the European Central Bank due to the implications for the strength and significance of the euro.

Most experts focus on the implications of these demographic changes for the financing of pensions. All the major EU countries face the problem of finding ways to meet costly pension promises. In Britain's case, companies rather than governments have made these promises. Conventional statistics have understated the problem Britain faces in meeting its pension commitment, because they only count dedicated spending on pensions and not other welfare payments to pensioners. Conventional statistics have also overstated the problem faced by continental European countries, most notably France, by excluding those savings which are not specifically linked to age even if they are run down in retirement. The European Commission and the OECD should radically overhaul their statistics and confirm that British complacency is not justified, and that France is not in as bad a fix as is believed.

The pensions crisis takes a very different form in the different countries studied in this pamphlet. The private sector in Britain is the vehicle for delivering pensions, and it is now struggling to bear the costs. Thus in the UK the pensions crisis is a long-term threat to corporate profitability. On the continent it is a long-term threat to fiscal stability. In France, the pensions problem is tied up with the challenge of reforming the public sector because it is here that pension costs are highest. In Germany, cumbersome rules on pension entitlements are a barrier to labour mobility and an incentive to early retirement. In Italy, the focus of the welfare state on pensions rather than family support, together with a heavy bias in employment towards men, reinforces a very traditional family structure.

That is why tackling the pensions problem is not some narrow exercise, but must be part of a fundamental process of economic reform in each country. Continental Europe does not need more savings. It needs more consumption, more spending and more borrowing. Keynes warned in the 1930s that ageing societies with high levels of saving, and not many investment opportunities, face a deflationary nightmare.

But there is far more to demography than pensioners. This pamphlet has examined three ways in which Europe might adjust to demographic change. None of these potential solutions would be neat technocratic exercises – they would involve profound changes in the shape of European societies.

One option is to encourage the existing population to work harder. Are the extra years of higher education really worthwhile? Can we expect women to do as much paid work as men? Can we all carry on working when we are older? Economies that absorb 75 per cent of adults into paid work are very different from those that absorb

only 50 per cent. As ‘unpaid’ social functions enter the cash nexus, societies become more commercial. You can only increase employment in this way by also embracing labour market diversity. Standardisation and regulation are the enemies of inclusion. However, even very large increases in labour force participation would not, after 2020, offset the likely decline in the absolute size of the workforce.

Migration is another option. But Europe is already attracting migrants at historically high levels. Migration cannot offset underlying demographic change. At some point however, the shrinkage of the populations of eastern and southern Europe will create a vacuum into which will flow the rapidly growing and youthful populations of the Middle East and North Africa. In some ways, we could see a return to early Medieval Europe when Islam was at its most expansive. Europe will face new challenges in managing relations with the growing Muslim populations.

Finally, we should begin a debate on ways of raising the birth rate. People cannot be forced to have more children than they want to. Nor should women return to the traditional roles from which, in some societies at least, they are escaping. But there is evidence that the countries where women enjoy the greatest economic freedom also enjoy higher birth rates. Here begins the outline of a 21^{st} century agenda for families. In the years ahead it will move much higher on the policy agenda. The best way to discharge our responsibilities to the older generations is to raise the young generations.

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CENTRE FOR EUROPEAN REFORM
NEW IDEAS FOR A NEW EUROPE

OLD EUROPE? DEMOGRAPHIC CHANGE AND PENSION REFORM

David Willetts MP

Europe must get to grips with the problems posed by an ageing population, or face a declining economic growth rate and ever increasing pension liabilities. David Willetts MP exposes the myth that Britain is better prepared to face the problems of an ageing population than continental Europe. He argues that while France and Germany must reform their state pensions systems, Britain needs to tackle a low savings rate and the crisis in company pension funds. Willetts also explores which family friendly and immigration policies could reverse Europe's demographic decline. He concludes that Europe's changing demographic structure will alter the balance of economic power within the EU and the world at large.

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