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How to grow old without going bust: the need for efficient EU labour markets

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Background

Much of the debate to date about how to respond to the ageing of Europe's population has focused on the need to reform pension systems. Far less attention has been paid to the changes which will be needed in the labour market to mitigate its impact.

The EU's population is forecast to shrink from just under 490 million now to 472 million by 2050. Even more striking is the change in the make-up of the population by age: today there are just under 81 million Europeans aged over 64; by 2020, there will be 102 million and, by 2050, more than 141 million – around 30% of the population and almost double the current level. The number of Europeans under 15 is also likely to shrink from just under 80 million to less than 74 million in 2020 and just over 63 million (only 13% of the population) by 2050.

There are, of course, significant variations across Europe. In Ireland, the over-64s account for around 11% of the population, compared with 18% in Germany and 19% in Italy. However, by 2050, more than 25% of the population in most countries will be in this age group, with over 35% in countries such as Italy and Spain.

While those with the highest rates are facing particular problems, ageing populations are clearly a Europe-wide challenge, and will have a significant impact on societies and economies, including labour markets.

The inevitable ageing of the workforce will require a re-think by employers, as the fall in the number of young workers will reduce the new knowledge injected into the economy and put greater reliance on older workers' experience. Making it easier for workers to change career path late in their working lives, and easing the integration of migrant workers into the labour market, will become critical. Furthermore, highly-skilled and qualified young workers will become relatively scarce and their wages may rise disproportionately.

For governments, one of the key questions will be how to finance the welfare state as the burden of supporting an ageing population increases. Europeans tend to support – and expect – a high level of social security, but many question whether this will be affordable with fewer payers (those in work) and a disproportionate rise in the number of recipients of, in particular, pensions and health care.

What is being done?

A range of policies are already being implemented in individual EU Member States. These include reforming pension systems by:

- Shifting responsibility for pensions away from public provision to individuals and companies through measures such as subsidised savings for retirement, encouraging private pension provision and occupational pensions (such as in the UK).
- Limiting individual pay-outs by only providing a minimum state pension or reducing the level of pay-out. Significant progress has been made on this in most OECD countries, with an average 22%

reduction in the 'pension promise' in recent years.

- Public pre-funding, such as investment in a public pension fund (as, for example, in Ireland, which is setting aside 1% of GNP annually for this purpose).
- Changing the conditions under which individuals receive a full pension by, for example, increasing the minimum pension age or indexing it to life expectancy. (Italy is considering increasing the pension age – albeit from a very low level – and Germany will raise it to 67 by 2012.)

Other measures include balancing government expenditure and revenues by reducing *per capita* public expenditure and/or increasing taxes. This can help to reduce future liabilities by, for example, reducing national debt (and interest payments) in relation to assets held (as has been done, for example, in Scandinavian countries).

Improving competitiveness by ensuring high productivity *per capita*, so a smaller working population can generate more wealth which can be redistributed, is also key. This requires significant investment in education and research, as well as policies designed to create conditions which enable European firms to compete internationally. This is already a key element of the EU's Lisbon Agenda.

Other countries have sought to influence underlying demographic trends by increasing the incentives to have children through child-friendly family policies (tax credits and direct payments in France, and flexible childcare and education in Scandinavian countries). However, even if these incentives are effective, any impact on the economy is delayed and, in many countries, it is difficult to keep women in the labour market after they have children.

Clearly, easing restrictions on the number of immigrants could also be part of the answer (as demonstrated by the recent experience in Ireland and the UK, where an influx of young workers from the accession countries has boosted the economy). Immigrants not only fill existing gaps in the labour market, but also tend to be younger and have higher fertility rates. Immigration is, however, politically controversial and it is doubtful whether the likely scale of migration would be sufficient to address the underlying issue.

Where do we go from here?

While progress has been made, many countries are only just embarking on the road to reform. The economic and public finance situation is already beginning to deteriorate in countries where reform is politically unfeasible, and the scale of the challenge means that more decisive action will be required in almost all countries.

This paper focuses specifically on what impact more efficient and flexible labour markets can have and demonstrates why, in most countries, further labour market reform is required to increase the sustainability of the public sector.

State of play

Dependency ratios are often used to predict the likely impact of demographic trends on welfare systems. They measure what proportion of the population are able to work and how many are dependent on social security. Generally they focus on the ratio between the elderly and those of working age (the number of over-65s divided by the population aged 15-64).

In 2004, there were about four people of working age for each person of pension age in the EU-27; i.e. an average dependency ratio of 24%. By 2050, the situation is expected to have deteriorated dramatically, with the average rate more than doubling to 53% (i.e. fewer than two people of working age supporting every one of pension age).

But this is not the whole story. This measurement ignores the fact that many people of working age are not in work. They could be unemployed, suffer long-term illness, be in full-time education or caring for children or elderly relatives, or have taken early retirement. Furthermore, more people of pension age are likely to remain in employment for longer in future. For this reason, the old-age dependency ratio alone does not give an accurate picture of the situation.

A different measure…

EU Member States generally have generous welfare systems, with a wide range of benefits for those unable to work, and publicly-financed education systems which encourage young people to continue studying for longer.

As a result, in countries with relatively high levels of economically inactive people and extensive welfare states, real dependency is much more usefully measured by calculating how many people are actually in work as a proportion of the total population. An analysis of this type of ratio shows that in addition to the demographic trends, the functioning of the labour market has a critical impact.

Across Europe, only around 38% of people actually work, with even lower figures in countries such as

Bulgaria and Slovakia (around 33%) and Poland (which has the lowest ratio at below 30%).

On this measure, Ireland, which performs best using the old-age dependency ratio, no longer tops the league because of its lower employment rates. Instead, the Netherlands and Denmark perform best, with almost one person employed for each person not working. Sweden, the UK, Slovenia and Portugal have rates above 45% and this success is driven by the labour market rather than demography (the Netherlands, Sweden and Denmark, in particular, have high employment rates across all age groups).

Looking ahead, the total employment rate will deteriorate in line with demographic trends. If current employment ratios (i.e. the proportion of people working in each age group) remain constant, Europe's overall employment rate will decline by around 1.5 percentage points by 2020.

Finland and the Netherlands will experience the greatest falls (4 and 3 percentage points respectively), followed by Slovenia, France, Belgium and Italy (with fewer than one in three people in work in both France and Italy).

Although the situation will improve between now and 2020 in some new Member States, thanks to a more favourable demographic outlook, by 2050 all countries will see a significant deterioration. Across the EU-27, an average of just one in three people (32.2%) will be working, with less than 30% in Bulgaria, Greece, Spain, France and below 25% in Italy, and Poland.

... and a different outlook

These figures clearly show that the situation is critical across Europe. More and more people outside the labour market will depend on fewer and fewer people working. This threatens the core principle of the European welfare state and raises a key question: how far can solidarity between those who are in work and those who are not be strained before reaching breaking point?

However, if Europe could reform its labour markets, it could buy itself significant breathing space.

This is demonstrated by using average employment rates (by age group) in Europe to assess future dependency. If every Member State had the current average European employment rate in 2050, countries like Poland and Slovakia (where rates are currently lower than the EU average) could improve by 7.6 and 6.8 percentage points respectively.

This becomes even clearer when we use the employment rates of the best-performing labour market, currently Denmark. If all countries had employment rates as high as those in Denmark now, none would have a total employment rate below 40% by 2020 and only three would fall below 40% by 2050 – Bulgaria at 39.5%, Italy 39.3% and Spain 38.9% – and even these would be an improvement on the current situation.

Higher employment rates would also make a significant difference (an improvement of more than 10 percentage points) in other countries such as Greece, France, Poland and Slovakia, which are likely to struggle with rates below 30% by 2050 if no action is taken.

This shows that, with healthier labour markets, most countries could postpone many of the negative impacts of population ageing way into the future.

Prospects

A well-functioning labour market is clearly crucial to address the negative implications of an ageing society for public-sector sustainability.

To achieve this, employment rates need to increase across the board, including among women, carers, older workers (pre- and post-retirement age), ethnic minorities (often second/third generation migrants), those with work-limiting illnesses or disabilities, and those with low skills and qualifications.

This has been recognised by the EU, with the European Commission arguing in 2002 that immigration alone could not entirely offset the impact of Europe's ageing population, and that: "We still need radical reform, with a focus on increased participation rates for women and older workers, if we are to achieve sustainable labour markets and pension systems."

Strong, unambiguous financial incentives and a clear responsibility on those receiving benefits to seek employment are needed to encourage those currently outside the labour market to join.

Tax and benefit systems must show a clear bias towards supporting employment and sufficient support should be given to remove barriers to labour-market participation, such as support for job-search activities, lifelong learning, flexible healthcare and childcare. Companies will need to adapt their workplaces and practices radically to accommodate these workers.

For those already in the labour market, unambiguous incentives to remain in employment are needed. Early retirement is far too common across the EU, with less than half of those aged 55-59 – and fewer than one in four in the 60-64 age group – currently working.

Early retirement schemes are often introduced to circumvent rigidities in the labour market for older workers rather than tackling the issue head on. They not only increase the overall financial burden on those in work, but also fail to provide companies with the right incentives to employ those with the highest relative productivity.

Widespread early retirement schemes need to become a thing of the past. Recent figures from the European Foundation for Living and Working Conditions show that around half of all European establishments – especially in the education, health care and financial intermediary sectors – offer early retirement schemes.

Strong incentives to stay in the labour market should apply equally across the economy, with an end, for example, to more favourable retirement conditions for civil servants or those in particular sectors.

Work longer – and better

Policies are needed to address the specific needs of older workers in order to engage them in the labour market, and raising the retirement age would reduce the number of recipients and increase the number of people paying into the system.

It is, however, unrealistic to expect that, without reform, this will result in high employment rates among the over-65s. These are already far too low among 60-64-year-olds, so any change in the retirement age must be accompanied by pro-active policies geared towards addressing the specific needs of older workers (for example, flexible working arrangements and the possibility of changing careers) to boost employment rates in these age groups.

New technologies can contribute to keeping older workers in the labour market, but are not enough on their own. If employing older workers is more expensive for companies or limits the value-added a worker can provide, this will influence firms' employment decisions.

To ensure that older workers continue to be attractive to employers, wages must correspond to productivity. Seniority can not be a decisive factor in wage setting and there must also be downward flexibility if productivity declines.

Those who continue working right up to and beyond the pension age should not be 'punished': pension systems must be linked to lifelong contributions, not final salary levels, to allow older workers to continue working for less pay. For those above pension age, continuing to work to supplement pension provisions should be encouraged.

Consideration should also be given to how to marry the need for more lifelong learning with the length of time young people now spend in formal education. More must be done to ensure that studies are as productive as possible and to reduce the time spent in full-time education, while investigating opportunities to combine education and work across all age groups rather than doing one or the other exclusively.

Welfare states and labour markets

Governments must also ensure that the right framework conditions are in place to generate sufficient new jobs. Markets must work efficiently and labour-market rigidities must be reduced so that companies can select the optimum workforce size and composition.

Sectoral shifts are inevitable as part of globalisation and companies need flexibility to alter employment levels according to market conditions. A safety net is crucial, but the key is to ensure high levels of employability in all groups in society to enable individuals to get back into employment rather than becoming dependent on social security benefits.

At the EU level, the National Reform Programmes enable the Union to work with Member States in setting overall employment policy, which should highlight the link between demography, competitiveness, sustainable welfare states and labour-market reform. The EU can also continue to highlight good practice in countries with successful employment policies (such as the flexicurity system in Denmark).

Healthy labour markets alone are by no means a sufficient answer to Europe's demographic challenge – no policy on its own constitutes a 'silver bullet' against population ageing.

However, effective labour markets can have a big impact and provide the breathing space needed to introduce the necessary reforms across all policy areas. Without high employment rates across all groups in society, most European countries will soon reach a painful limit on the finances available for their pension and healthcare systems.

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