

Ageing Population Puts Pressure on Social Expenditure



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A recent ETLA study shows that social expenditures will rise substantially in Finland over the next two decades as the population ages. The main reasons for this development are the growing number of pensioners and higher pensions. There will also be a sizeable rise in the need for health care and other care services. If efficiency in the provision of services is not improved, or if the growth in benefits is not reduced, the country's social expenses will remain high in relation to GDP because the change in the age structure of the population is permanent.

Social Expenditure Will Rise as the Population ages

The largest social expenditure items in Finland are pensions, health care and other care services, and various transfer payments. Certain age groups account for most of the spending. Expenditure on pensioners is typically several times greater than that on children and people of working age. Even if per capita expenditure remains stable, the rise in the number of pensioners will lead to an increase in overall expenditure. It is also expected that the replacement rates of pensioners will rise as private sector pension schemes mature. Nevertheless, greater uncertainty exists with respect to the unit costs of social and health services. If productivity in service provision does not rise as fast as the expected rise in unit costs, there will be a faster rise in social expenses than what would be expected on the basis of demographic factors alone.

The ETLA study estimates that the ratio of social expenses to GDP will rise substantially

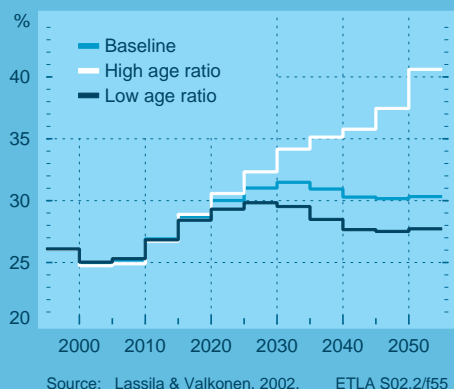
during the next twenty years. Thereafter the growth will slow down. This is the basic scenario in which current legislation regarding social expenditures remains unchanged.

Population Uncertainty a Starting Point for Policy Discussions

The study developed tools for the evaluation of future alternatives. A factor that proved to be important in the study's evaluations was uncertainty concerning population trends. This uncertainty should form a starting point for policy discussions, considering that the social security system must function in all future scenarios. Another factor with a significant impact was economic growth.

Demographic uncertainty, however, is not expected to be very high in the next twenty years, especially in comparison to expected growth in social expenses. Yet if one considers the development of social expenses after 2020, this uncertainty is a governing factor.

Social Expenditure/GDP Under Different Demographic Alternatives



The difficulty embedded in estimating future spending on social programs varies across expenditure categories. Uncertainty surrounding demographic projections and expected pension policies, as well as uncertainty over economic growth, are the main sources of uncertainty in estimating expenditure on pensions. In other income transfers, political decisions, e.g. the indexation of benefits, are the key factors alongside economic developments.¹⁾ Finally, we consider estimating trends in social and health services to be the most difficult because this involves uncertainty over both political and technological developments, which are very difficult to predict.

The Current Level of Services Can Be Financed, But Will It Be Enough?

According to our calculations, current levels of health and other care services can be financed, unless we are very unlucky with respect to de-

mographic and economic developments. If labour productivity in the provision of social services increases, it will even be possible to improve the level of services in line with the rise in productivity. This is the positive conclusion reached in the study.

However, with respect to care services, the crucial question is whether the current level of services will be a sufficient point of comparison also in the future. It is obvious that the potential supply of services will grow considerably, for instance in response to medical advances. This means that dissatisfaction over publicly funded services may rise even if the services provided are considerably better than currently. It is not a question of whether people would be unwilling to pay more for such services, but whether they are willing to do so via the tax system.

The Problem is Lack of Preparation

Longer life expectancy is a favourable phenomenon. Smaller families also free resources and time for parents and leave children with bigger inheritances. So why should one worry about the population getting older?

The problem is that the public sector has not planned for the increase in these expenditures sufficiently in advance. Unless the efficiency of the social security system is improved, or unless growth in benefits is reduced, the funding of social expenditures will require a higher overall tax rate. This taxation would target labour income. Pension contributions would rise and the municipalities would also raise local taxes. There will be some room to reduce state taxes on earned income and other social security contributions.

The pressure to increase taxation will be constrained by a rise in education levels, which also has a favourable impact on economic growth and the tax base. It is difficult, however, to solve tax rate problems resulting from the ageing of the population with education because social expenditures largely depend on incomes.

What Can Be Done?

Strengthening the link between contributions and benefits in the income transfer system will

¹⁾ The computation assumes that non-earnings-based income transfers are indexed fifty-fifty between price and wage developments. With this assumption (often used in long-term predictions) the cost burden of these expenses falls substantially in the long run. However, the history of income transfers shows that the tendency to make itemised increases and offer greater eligibility to services has raised actual expenses faster than expected.

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lower the tax-like nature of the contributions and increase the incentive to work. Also, the level of income transfers should be tied to the economy's capability to pay taxes. With regard to the pension system, this means that life expectancy and the size of the working-age population should be taken into account when determining the size of pensions or the retirement age. With regard to other income transfers, benefits could be tied to an index that takes the size of the tax base into account. In comparison with the current way, where benefits are determined in annual political squabbles, such a system would better anticipate future benefits and costs.

With respect to the provision and funding of public services, various financing alternatives, a division of labour between private and public institutions and ways of improving the efficiency of public service provision could be considered.

Covering the rise in pension expenditures with a higher pre-funding rate is a favourable option to consider, as is the amortisation of government debt. However, there is not much time left in which to accrue additional funds through saving before expenditures start to rise. Furthermore, tax competition and tax incentive problems call for an immediate reduction in taxation.

Uncertainties surrounding the magnitude of future expenditures also make it difficult to plan for future spending in advance. Though demographic developments can be anticipated with reasonable accuracy for the next twenty years, the trend growth of the economy and the return on capital are more difficult to predict. Managing such risks would require new preemptive rules governing the size of government debt and pension funds. Research on the development of such rules is advancing: examples of such measures include tying pension benefits to life expectancy, tying pension funding to birth rate developments and studies that consider ways to fund future care expenditure in advance.

The table below summarises developments in the share of social expenditures to GDP in some future scenarios. Last autumn's pension decisions have not been factored into the analysis.

The table shows that the social expenditure-to-GDP ratios vary only slightly under different scenarios. The exception is the scenario in which the age distribution is highly skewed towards a higher age ratio. In this case pension levels rise considerably even though the wage bill falls. This means that social expenditures and their funding base grow in different directions, ultimately leading to considerably higher tax rates.

Social Expenditure/GDP

	2000-2004	2020-2024	2050-2054
Baseline	24.9	30.0	30.3
Demographic alternatives			
High age ratio	24.7	30.6	40.6
Low age ratio	25.0	29.3	27.7
Economic alternatives			
Lower interest rates	25.0	30.2	30.7
Slower labor productivity growth	24.8	30.6	31.5
Higher level of education	24.9	29.4	28.2
Lower unemployment	24.9	29.4	29.8
Social policy alternatives			
Higher demand for care services	25.1	30.9	31.8
Higher demand for care services, high age ratio	25.0	31.8	42.6
Indexation of benefits to changes in earnings	24.9	31.4	32.5

Source: Lassila & Valkonen, 2002.

The scenario would be even gloomier if wages would not adjust downwards as employer contributions rise. In such a case the outcome is a permanently higher level of unemployment, even though the labour force would simultaneously contract.

The least desirable scenario occurs when a higher age ratio is combined with higher service demand per capita. In this case the ratio of social expenditures to GDP would rise by 18 percentage points. The realisation of political risks is represented by the alternative in which basic social security benefits are tied to earnings.