Box 7

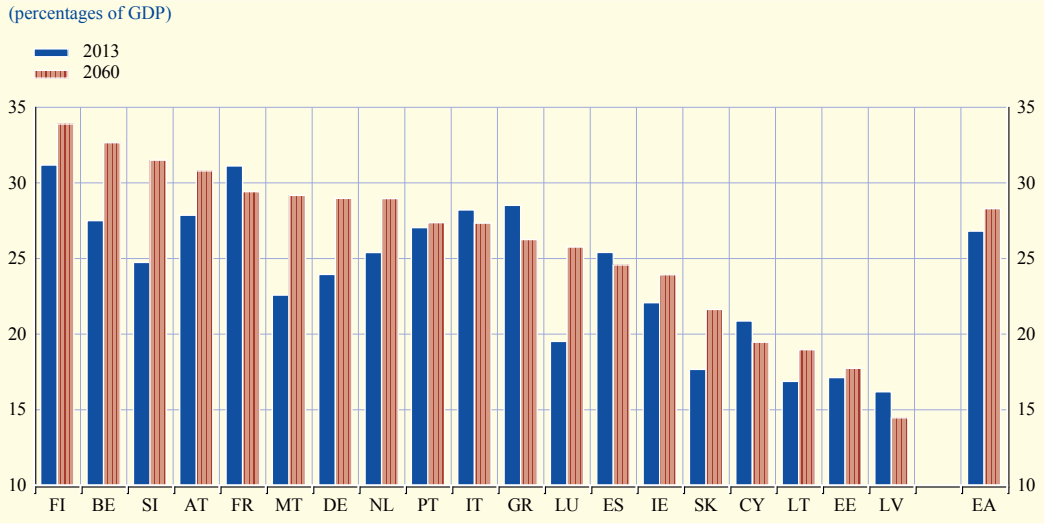
THE 2015 AGEING REPORT: HOW COSTLY WILL AGEING IN EUROPE BE?

Europe is facing a demographic challenge. The old age dependency ratio, i.e. the share of people aged 65 or over relative to the working age population, is projected to almost double in the euro area from around 29% currently to above 50% by 2060. If adequate structural reforms are not implemented, ageing will have adverse implications for the sustainability of public finances, particularly in the long run. Moreover, given that the labour force is projected to shrink, ageing is expected to dampen potential GDP growth. Owing to its adverse impact on fiscal sustainability and potential growth, ageing is also of relevance to monetary policy.

This box summarises and assesses the main projection results of the 2015 Ageing Report for euro area countries. The 2015 Ageing Report, published on 12 May 2015, is the latest of the reports prepared every three years by the Ageing Working Group of the Economic Policy Committee. The report provides long-term projections for the period 2013-60 for all EU countries of total age-related costs and their components, i.e. pensions, health care, long-term care, education and unemployment benefits. The projections are based on a commonly agreed methodology and a set of demographic and macroeconomic assumptions.

Total ageing costs in the euro area are expected to increase over the projection horizon, notwithstanding substantial cross-country differences. According to the 2015 Ageing Report, total ageing costs in the euro area are projected to increase by 1.5 percentage points of GDP, i.e. from 26.8% of GDP in 2013 to 28.3% in 2060 (see Chart A). However, developments in ageing costs are very heterogeneous across countries. While ageing costs are projected to increase substantially in Slovenia, Malta, Luxembourg, Belgium and Germany (by at least 5 percentage points of GDP), they are expected to decline in France, Italy, Greece, Spain, Cyprus and Latvia. The level of ageing costs was highest in 2013 in Finland and France (both around 31% of GDP),

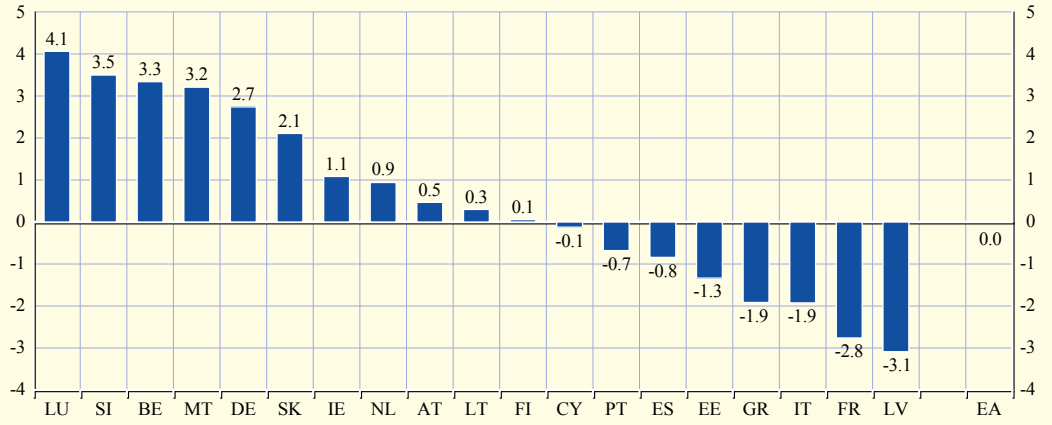
Chart A Total ageing costs



Source: 2015 Ageing Report.

Chart B Change in pension costs

(percentage points of GDP, 2013-60)



Source: 2015 Ageing Report.

as well as in Greece and Italy (both above 28% of GDP). By 2060 Finland, Belgium and Slovenia are expected to be the countries with the greatest ageing challenge in the euro area, with total ageing costs of well above 31% of GDP.

Pension expenditure, which is the largest component of total ageing costs,[1] is projected to remain flat relative to GDP on average over the projection horizon. In fact, pension expenditure in the euro area is projected to return to its 2013 level of 12.3% of GDP by 2060 (see Chart B). The dynamics in pension costs, however, differ substantially across countries. In the majority of euro area countries, pension expenditure is expected to increase (in particular in Luxembourg, Slovenia, Belgium and Malta, where it is projected to increase by more than 3 percentage points of GDP), while it is projected to decrease in eight euro area countries (Cyprus, Portugal, Spain, Estonia, Greece, Italy, France and Latvia). By contrast, the cost of health and long-term care is projected to increase in all euro area countries.

Compared with the 2012 Ageing Report[2], the projected increase in total ageing costs has been considerably revised downwards from 3.5% to 1.5% of GDP over the projection horizon. Ageing cost projections for Luxembourg, France and Greece in particular have been substantially revised downwards (by at least 4.5 percentage points of GDP over the period 2013-60). A similar picture emerges for the change in pension costs, which have been revised downwards by 1.2 percentage points of GDP for the euro area compared with the previous report.[3]

The downward revision of pension cost projections seems to be largely driven by the more favourable demographic and macroeconomic assumptions, rather than genuine reforms. While the underlying assumptions explain up to two-thirds of the revisions, the impact of new

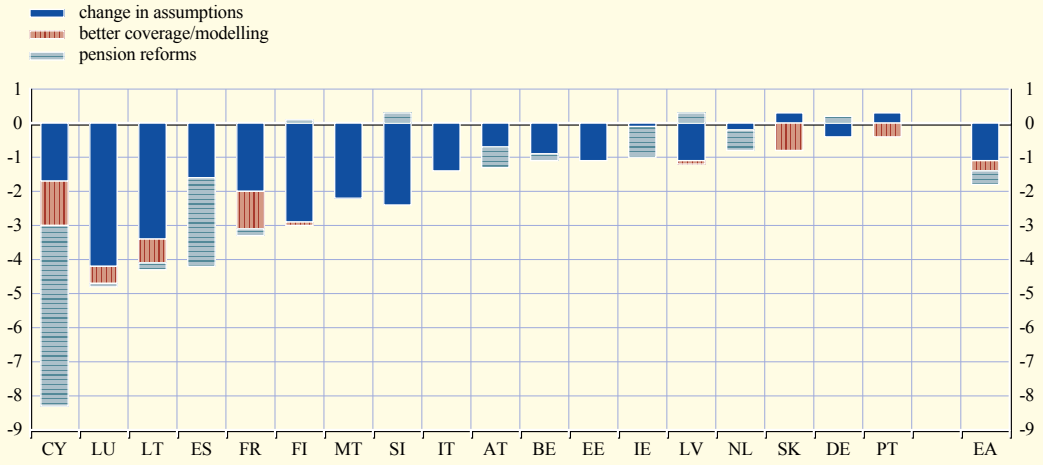
1 Pension expenditure accounts, on average, for almost half of total ageing costs, followed by health care (one-quarter) and education (one-fifth), while the relative weights of long-term care and unemployment benefits are more limited.

2 See also the box entitled "Fiscal challenges from population ageing: new evidence for the euro area", *Monthly Bulletin*, ECB, Frankfurt am Main, July 2012.

3 The figures reported for the 2012 Ageing Report are shown for the same time period (2013-60) and include the impact for several countries (Belgium, Spain, Cyprus, Latvia, the Netherlands, Slovenia and Slovakia) of the peer-reviewed pension reforms conducted after the finalisation of the 2012 report. Thus, without the updated figures from the 2012 report, the difference to the previous report would have been even larger.

Chart C Breakdown of revision to pension cost change

(percentage points of GDP; change between 2012 and 2015 Ageing Reports)



Source: 2015 Ageing Report.
Notes: 2012 Ageing Report projections have been updated with the peer-reviewed projections of those euro area countries that have conducted pension reforms in the past three years (Belgium, Latvia, the Netherlands, Slovenia and Slovakia), with the exception of Spain and Cyprus, for which only the original 2012 report figures are available for this breakdown. Figures are based on European System of Accounts 1995 (ESA 95) data. The breakdown for Greece is not available. "Change in assumptions" refers to changes in pension costs owing to different demographic and macroeconomic assumptions. "Better coverage/ modelling" refers to changes in pension costs owing to improved coverage of the national pension projections and/or improved modelling techniques.

pension reforms seems to be rather limited on average (see Chart C).[4] The new demographic assumptions seem, on average, to be responsible for around one-third of the downward revisions of pension dynamics, as suggested by, among other things, a sharp downward revision to the change in the old age dependency ratio (of almost 4 percentage points between 2013 and 2060) compared with the previous report.[5] This factor seems to be particularly relevant for Lithuania, Latvia, Luxembourg, Malta and Slovenia. Furthermore, the better macroeconomic assumptions compared with the previous report – in particular the more pronounced decline in the unemployment rate (of 2.4 percentage points compared with the 2012 report) – seem to strongly contribute to the downward revision of the pension projections (see Chart D). The labour market effect is particularly pronounced for Spain, Italy, Cyprus, Greece and Portugal.

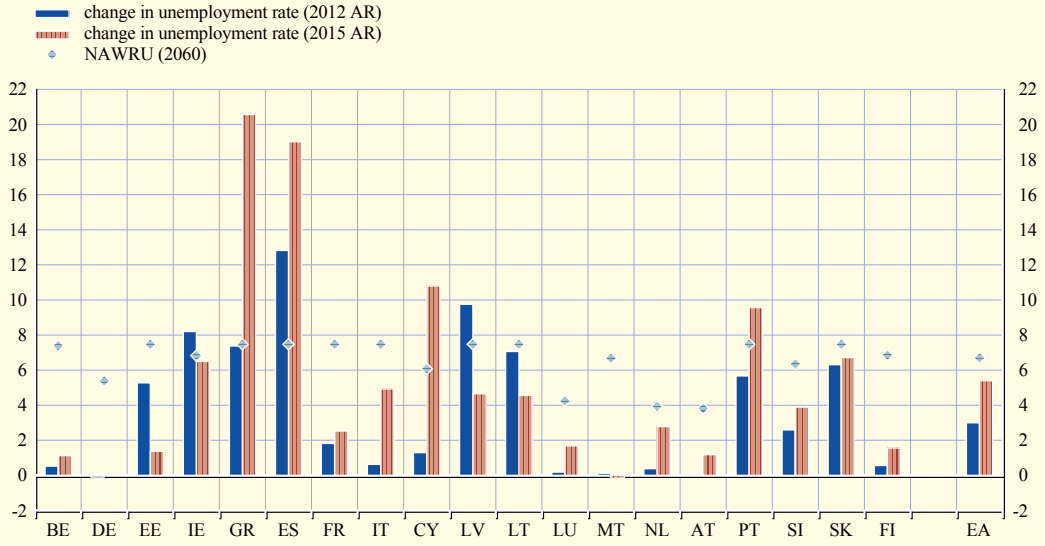
The new ageing cost projections for several countries are exposed to substantial adverse risks as they rely on favourable underlying macroeconomic assumptions. In particular, the assumption that total factor productivity (TFP) growth, which has fallen substantially during the crisis, will recover to a growth rate of 1% in the long run appears optimistic for several countries in the absence of substantial growth-enhancing reforms. This also holds from a historical perspective. During the period 1999-2012, TFP growth was on average around 0.7%, with considerably lower TFP growth rates in Belgium, Spain, Italy, Cyprus, Luxembourg and Portugal (see Chart E). Moreover, the assumption that the unemployment rate will converge downwards to a long-run EU average of not more than 7.5% by 2060 (the average euro area unemployment rate is projected to be 6.7% in 2060) is only plausible if substantial labour market

4 For Cyprus and Spain Chart C shows a significant fall in pension costs due to pension reforms. In contrast to the other euro area countries which have conducted pension reforms in the past three years (Belgium, Latvia, the Netherlands, Slovenia and Slovakia), the peer-reviewed, updated projector are not available for Cyprus and Spain for the breakdown shown in Chart C.

5 The demographic assumptions are based on the EUROPOP2013 population projections, which were published by Eurostat in April 2014.

Chart D Change in the unemployment rate

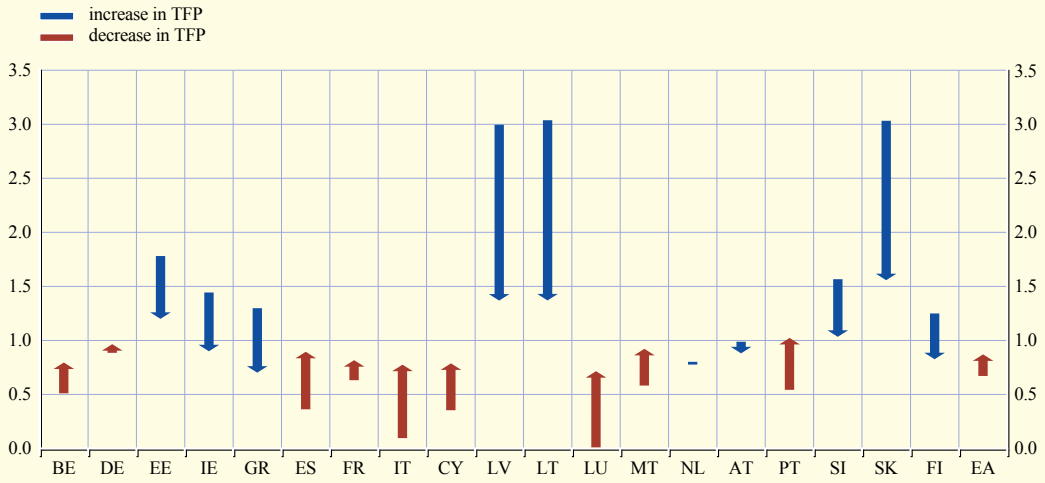
(percentages, 2013-60)



Source: 2015 Ageing Report.
Notes: A positive value for the change in the unemployment rate indicates a decline in the unemployment rate between 2013 and 2060. The values shown from the 2012 Ageing Report are recalculated for the period 2013-60. The diamonds indicate the non-accelerating wage rate of unemployment (NAWRU) level in 2060 (maximum level at 7.5%).

Chart E Change in total factor productivity growth

(percentage change between 1999-2012 and 2013-60 averages)



Sources: 2015 Ageing Report and Eurostat.
Notes: Change in TFP growth rate between historical averages (1999-2012) and projection averages (2013-60). Blue arrows indicate a decline in TFP growth compared with historical averages, whereas red arrows indicate an increase in TFP growth compared with historical averages.

reforms are enacted. The decline in unemployment assumed in the report is particularly strong for Greece, Spain, Cyprus and Portugal (around 10 or more percentage points between 2013 and 2060) (see Chart D). With these assumptions, which are prone to a high degree of uncertainty,

the Ageing Report deviates from the standard (prudent) practice of basing projections on "no policy change" assumptions. In fact, if these assumptions did not materialise as expected, this could result in substantially higher ageing costs for the countries concerned.

There are also risks relating to the reversal of implemented pension reforms. The report assumes that all pension reforms that have been legislated for in recent years will be fully implemented. However, a reversal of past reforms cannot be ruled out, as indicated by recent discussions in some countries.

Overall, despite the more favourable ageing cost projections for many countries, further reform efforts are needed to curb the increase in the costs of ageing. The new ageing cost projections for several countries are exposed to adverse risks, as they depend on very optimistic assumptions for productivity and labour market developments. Without reforms to reduce structural unemployment and raise potential growth, ageing costs for these countries would be substantially higher. Thus, it would be misleading to interpret the new ageing cost projections as a sign of less urgency to foster countries' reform efforts.