

The Decline of the Welfare State: Demography and Globalization

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1: OVERVIEW

In the coming decades, the population of the industrialized world is forecast to age dramatically. In the European Union, before the 2004 enlargement, old-age dependency, defined as the ratio of the population aged 60 and older to those between ages 15 and 59, is projected to rise from 35 percent in

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2000 to 66 percent in 2050. Within the European Union, aging is expected to be most pronounced in Germany, Italy and Spain, where this ratio is forecast to rise to 71, 76 and 81 percent, respectively, by 2050. Aging trends are almost as severe in Japan, where old-age dependency is forecast to rise from 36 to 70 percent over the same period. In comparison, projected population trends in the United States look almost benign. The Census Bureau currently forecasts that the old-age dependency ratio will reach 47 percent in 2050, up from 27 percent in 2000.¹

The aging of the population has far-reaching implications for national pension systems.² In the continental Europe, most state pension systems are unfunded (pay-as-you-go systems) and the benefits are quite generous. This will necessitate a sharp rise in taxes if benefits are maintained largely intact. The O.E.C.D. predicts that France, for example, will have to spend 33 percent more as a share of gross domestic product than it does now.

Similarly, in many other countries, the simulated tax contribution rates that would balance the old-age social security systems are significantly higher than the statutory rates. For example, Brugiavini (1999) reports that this simulated rate reached 44 percent for Italy in 1991.

The Economist (24th August, 2002, p.21) looks at another dimension

of the financial burden, that is the public debt:

“On some estimates, by 2050, government debt could be equivalent to almost 100 percent of national income in America, 150 percent in the EU as a whole, and over 250 percent in Germany and France.”

To put these staggering figures in a proper perspective, recall that the Stability and Growth Pact of the EU puts a 60 percent target ceiling on public debt as a percentage of national income!³

A comprehensive study conducted recently by Jagadeesh Gokhale and Kent Smetters (2003) takes into account all current liabilities and projected future expenditures of the U.S. government and compares them with all the revenues the government can expect to collect in the future. The difference (in present value) is a staggering deficit of 44 trillion dollars, an almost quadruple of GNP.⁴ Major contributing factors to this deficit are old-age social security and medicare.

Similarly, the widespread low-skill migration also puts a strain on the public finances of the welfare state. Being relatively low earners, migrants are typically net beneficiaries of the welfare state, that is, they are expected to receive benefits in excess of the taxes (contributions) they pay. For instance, a recent study, initiated by the U.S. National Research Council, estimates the

overall net fiscal burden of migrants (aged 20-40 years, with less than high-school education on arrival) at about \$60,000-\$150,000, over their own lifetime; see Smith and Edmonston (1997).

One would naturally expect that as the share of the elderly in the population rises when the population ages, their political clout would strengthen the pro welfare-state coalition. Similarly, one would expect this coalition to gain more political power as more low-skill migrants are naturalized. Thus, aging and migration seem to tilt the political power balance in the direction of boosting the welfare state, imposing a growing burden on the existing workforce. However, the theme that we put forth in this book is quite the opposite: Aging and low-skill migration generates indirectly political processes that trim rather than boost the size of the welfare state. We reach this somewhat surprising conclusion by carefully working through a conventional model of a political-economy determination of the welfare state. We also provide some supportive empirical evidence from the EU and the U.S. for this general theme.

But what if the welfare state tries to rely more heavily on capital taxes in order to finance the social benefits it provides? Recall that the old derive most of their income from capital because they retired from work. So, at first thought, it may seem that as the share of the old in an aging population

rises, then an attempt to rely more heavily on capital taxes would face a stiffer political resistance. However, after a careful scrutiny of this hypothesis we come to an unconventional conclusion: Aging plausibly tilts the political power balance in favor of larger capital-financed welfare state. We provide also supportive empirical evidence from the EU for this conclusion.

Is the latter conclusion relevant? After all, aging is not the only process witnessed nowadays. Globalization across various economies is another universal phenomena to reckon with.⁵ Can therefore high capital taxes survive international tax competition brought about by such globalization?

Evidently, in the absence of **world-wide** tax coordination and enforcement, the answer is in the negative.⁶ As put succinctly by **The Economist** (31st May, 1997, p.17):

“Globalization is a tax problem for three reasons. First, firms have more freedom over where to locate... . This will make it harder for a country to tax [a business] much more heavily than its competitors... . Second, globalization makes it hard to decide where a company should pay tax, regardless of where it is based... . This gives them [the companies] plenty of scope to reduce tax bills by shifting operations around or by crafting transfer-pricing...

. [Third], globalization... nibbles away at the edges of taxes on individuals. It is harder to tax personal income because skilled professional workers are more mobile than they were two decades ago."

Thus, we apply our political economy model again to assess the forces of globalization. The 2004 enlargement of the EU gives a stark example for the underlying downward pressure of tax competition. The new entrants have significantly lower corporate tax rates (zero in Estonia, for instance) than the original EU-15 countries (40% in Germany). It seems inevitable that the high tax countries will have to succumb to the forces of tax competition and sharply cut their corporate tax rates. The combined forces of aging, low-skill migration and globalization seem to be too strong for the welfare state to survive in its present size.

Indeed, most of the large industrialized economies have embarked in recent years on a track of trimming the generosity of their pension and other welfare-state programs. The general rules are quite straightforward: Raise retirement age and curtail benefits. Following the report of the Greenspan Committee (January, 1983), the U.S. has gradually raised the retirement age to reach 67 in the year 2027.⁷ Similarly, but much later, France decided in

July 2003 to require public sector workers (about one-fourth of the French workforce) to contribute to the state pension system for 40 years, instead of 37.5 years. Also, Germany, which already raised its retirement age from 63 to 65, has recently decided to raise it further to 67 between 2011 and 2035. With respect to curtailing benefits, this is usually accomplished by abandoning wage-indexation in favor of price-indexation (or by subjecting them to income taxation). Naturally, as real wages rise over time (due mostly to productivity increases), price-indexation is less generous to pensioners than wage-indexation; see Cogan and Mitchell (2003) for the U.S. and Thode (2003) for Europe.

This treatise studies the decline of the welfare state from a political-economy perspective. We uncover how the processes of aging and globalization (through migration, capital mobility, and international tax competition) team up together to change the political power balance and generate a public support for reforming the welfare state.

Notes

1. These numbers are taken from Brooks (2003) who reports global trends in youth and old-age dependency in greater detail.
2. Occupational pension systems do not escape some of these implications

either.

3. It is worth mentioning that the ceiling on the public deficit was in effect suspended in the November 2003 meeting of the EU ministers of finance. The ministers decided not to impose sanctions on Germany, France and Portugal for violating this ceiling. This puts doubt on whether the debt ceiling will be enforced.

4. This calculated deficit is totally different from the traditional definition of a government debt, as the latter comprises only realized liabilities (that is, those liabilities backed by explicit papers).

5. Obstfeld and Taylor (2003) attempt to explain the historical development of globalization (in particular, international capital mobility) by political-economy forces. After World War I, "newly-or better-enfranchised groups such as the working classes" contributed to severely impede capital mobility. The emerging peace and prosperity that followed World WAR II, and intensified after the end of the Cold War, unleashed political forces for freer capital mobility.

6. Sinn (1990) was one of the earliest economists to raise this issue; he expressed fears that the very foundation of the welfare state will disappear because of international tax competition.

7. This change was made before the U.S. fertility rate had recently started to rise; see also section 2.1.