



Focus

III. Dealing with the economic and budgetary challenges posed by population ageing in times of crisis*

Being active and healthy well into old age is now a realistic prospect for very large numbers of people for the first time in Europe's history. But an ageing population also raises challenges for our societies and economies, both cultural, organisational and from an economic point of view. Policy-makers worry about how living standards will be affected as each worker has to provide for the consumption needs of a growing number of elderly dependents. The seriousness of the challenge depends on how our economies and societies respond and adapt to these changing demographic conditions.

Looking ahead, policy-makers need to ensure long-term fiscal sustainability in the face of clearly anticipated risks over the long-term, as well as significant uncertainty. This is all the more true as Europe is in the midst of the deepest recession in decades, which is putting an unprecedented strain on workers and companies and is set to have a major impact on the sustainability of public finances. The euro-area's ability to get out of the slump fast and to restore high and stable growth and sound public finances will depend crucially on its ability to deploy targeted and well coordinated policy responses built on structural reforms, as stressed by the European Economic Recovery Plan. Once out of the crisis, the long-term prospects will depend on the degree of determination to achieve a swift return to sound public finances and increased focus on the structural reform agenda as a key part of a credible exit strategy.

This focus section draws on joint work by the European Commission (DG ECFIN) and the Economic Policy Committee's Ageing Working Group (AWG)³⁶ and presents a new assessment of the economic and budgetary challenges posed by ageing. The assessment builds on Eurostat's most recent long-term demographic projections (Section 1), which are used to construct long-term labour force and growth projections (Sections 2 and 3). These are then used to project the budgetary implications of ageing (Section 4). An analysis of the potential impact of the current crisis on long-term trends via several alternative scenarios is also presented (Section 5).

1. Long-term demographic trends

Demographic change is transforming Europe: longer lives, low fertility and inward migration are its key aspects. The extent and speed of population ageing depend on future trends in these three factors. According to Eurostat's EUROPOP2008 projection, future demographic developments differ significantly from country to country, but the overall population size in the

euro area³⁷ is projected to remain the same in 2060 as today, thanks to a slight rebound in the fertility rate in some Member States and more dynamic immigration flows in recent years.

Only a modest recovery in total fertility rates, which remain low...

Only a modest recovery in the total fertility rate, which is the average number of births per woman over her lifetime, is assumed for the euro area, from 1.53 births per woman in 2008 to 1.65 by 2060. In all euro-area countries, the fertility rate would remain below the natural replacement rate of 2.1 births per woman needed for each generation to replace itself. This will result in slow growth and in most cases actual declines in the population of working-age.

... while life expectancy continues to increase...

Mortality risks fell dramatically during the 20th century, bringing more years of active life for both men and women. Life expectancy has been rising steadily, with an increase of two and a half years per decade in the countries holding the record for the highest life expectancy. If the pace of future progress in the reduction of mortality

* Section prepared by Per Eckefeldt.

³⁶ See European Commission, '2009 Ageing Report: economic and budgetary projections for the EU 27 Member States (2008-2060)', European Economy No 2, 2009.

³⁷ Projections for the euro area assuming unchanged membership.

remains the same as it has been over past decades, most people in the euro area will live very long lives. For the euro area as a whole, life expectancy at birth for men would increase by 7.9 years over the projection period, from 76.6 years in 2008 to 84.5 in 2060. For women, life expectancy at birth would increase by 6.7 years, from 82.3 in 2008 to 89 in 2060, implying a narrowing gap in life expectancy between men and women.

Life expectancy at the age of 65 would increase by 5.3 years for men and by 5.1 years for women over the projection period. In 2060, life expectancy at age 65 would reach 21.8 years for men and 25.1 for women.

... and inward net migration to the euro area continues, but decelerates

Over the projection period, annual net migration inflows to the EU are assumed to total 59 million people, the bulk of them (46.2 million) in the euro area. The trend is assumed to decelerate over the projection period, falling from about 1 422 000 people in 2008 (equivalent to 0.4% of the euro-area population) to some 627 000 people by 2060 (0.2% of the euro-area population). Migration already plays a predominant role in population growth today: in many Member States, the size of net migration determines whether the population still grows or has entered a stage of decline.

Net migration flows are assumed to be concentrated in a few destination countries: Italy (12 million cumulated to 2060), Spain (11.6 million) and Germany (8.2 million). According to these assumptions, the change of Spain and Italy from origin to destination countries is confirmed in the coming decades.

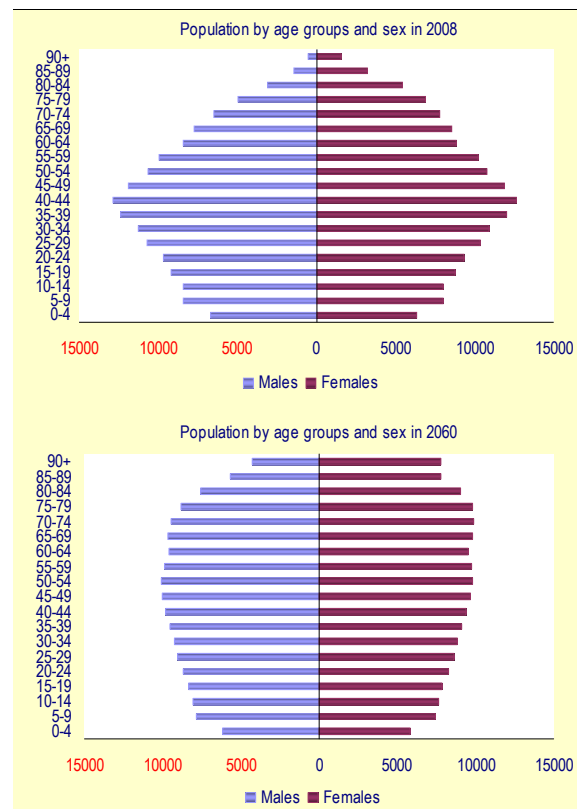
Population structures become increasingly dominated by old people rather than young

The population of the euro area as a whole would be slightly larger in 2060 than today, but much older. The population would increase (from 324.9 million in 2008) by about 6% by 2040, when it would peak (at 345.5 million). A steady decline would then take place, with the

population shrinking by nearly 3%, to 335.1 million, by 2060.

Almost half of the population today is 50 years old or more. In 2060, more than half of the population will be aged 55 or over. The number of elderly persons aged 65 or over was already higher than the number of children (below 15) in 2008, but their numbers are relatively close. In 2060, there would be nearly twice as many elderly people as children. In 2008, there were about three and two thirds as many children as very old people (above 80). In 2060, children would still outnumber very old persons, but by a small margin: the number of very old people would reach 80% of the number of children.

Graph 28: Population pyramid in 2008 and 2060, euro area (thousands)



Source: 2009 Ageing Report, Commission services.

Elderly people would account for an increasing share of the population due to sustained reductions in mortality in past and future decades. The ageing process can be described as ageing from the top, as it largely results from projected increases in longevity, moderated by



the impact of positive net migration flows and some recovery in fertility.

While the euro-area population is projected to remain the same in 2060 as it was in 2008, there are wide differences in population trends across Member States: a majority of them would gain in population numbers (Belgium, Ireland, Spain, France, Cyprus, Luxembourg, the Netherlands, Austria, Portugal and Finland,), while the population would fall in others (Germany, Greece, Italy, Malta, Slovenia and Slovakia).

The projections show a significant reduction in the population aged 15-64 ...

The working-age population, which is conventionally defined as aged between 15 and 64, would start to decline as of 2010 and, over the whole projection period, it would drop by 15% in the euro area. However, five Member States would see their working-age population expand: Belgium, Ireland, France, Cyprus and Luxembourg, mostly due to migration (except in the case of France and Ireland where fertility is relatively high). The number of children is projected to decline gradually from 2020 onwards.

... and an increase in the number of elderly persons aged 65 or more...

The number of elderly people will increase very markedly, according to the projection. It will almost double, rising from 58 million in 2008 to 101 million in 2060 in the euro area. The number of oldest-old (aged 80 years and above) is projected to increase even more rapidly, almost tripling from 15 million in 2008 to 43 million in 2060. The progressive ageing of the elderly population itself is a notable aspect of population ageing.

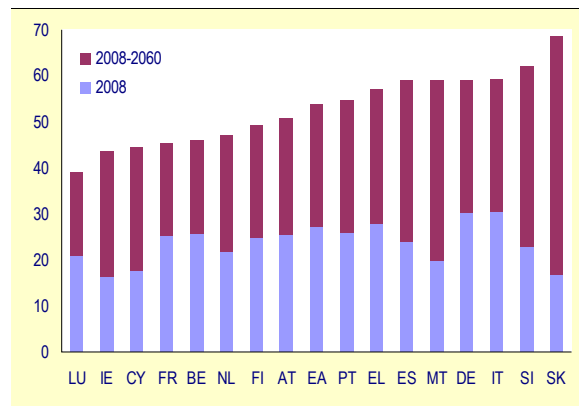
... leading to a doubling of the old-age dependency ratio in the euro area

As a result of these unprecedented demographic trends, the old-age dependency ratio, calculated as the ratio of people aged 65 or over relative to the working-age population aged 15-64, is projected to more than double in the euro area from 27% to 54% over the projection period.

The largest increase is expected to occur during the period 2015-40. This means that the euro area would move from having 4 persons of working-age for every person aged over 65 to a ratio of only 2 to 1. When adding the number of children to the calculation, the ratio of dependent to active is projected to rise by about 50%.

Graph 29: **Old-age dependency ratio, euro-area Member States**

(persons 65 and over/persons aged 15 to 64, in %)



Source: 2009 Ageing Report, Commission services.

2. Labour force projections

Labour participation rates to increase ...

For the euro area, the participation rate (of people aged 15 to 64) is projected to increase by 3½ pp, from 70.8% in 2007 to 74.4% in 2060. Almost all of the increase is projected to materialise before 2020. The biggest increase in participation is projected for older workers, aged between 55 and 64 (around 22.5 pp for women and 12.5 pp for men). The gap between male and female participation rates would gradually narrow, especially in countries where it is currently wide.

... but labour supply will decline because of the future population trends

The labour force (15-64) in the euro area would increase by almost 5% or about 7.4 million people by 2020. This is mainly due to the rise in the labour supply of women. However, the positive trend in female labour supply is projected to reverse after 2020 and, as the male labour supply drops too, the overall labour force

is expected to decrease by as much as 13% by 2060, which translates into 21 million people (14 million if compared with the number in 2007).

A majority of Member States would see their labour supply expand until 2020. However, a few countries (the Netherlands, Finland and Slovenia) will even record a reduction in labour supply over the next decade. After 2020, most countries are projected to see labour supply shrink over the period 2020 to 2060. The projected decrease in the labour force after 2020 will be due almost entirely to adverse demographic developments.

According to assumptions, the unemployment rate will drop slightly and the employment rate will increase...

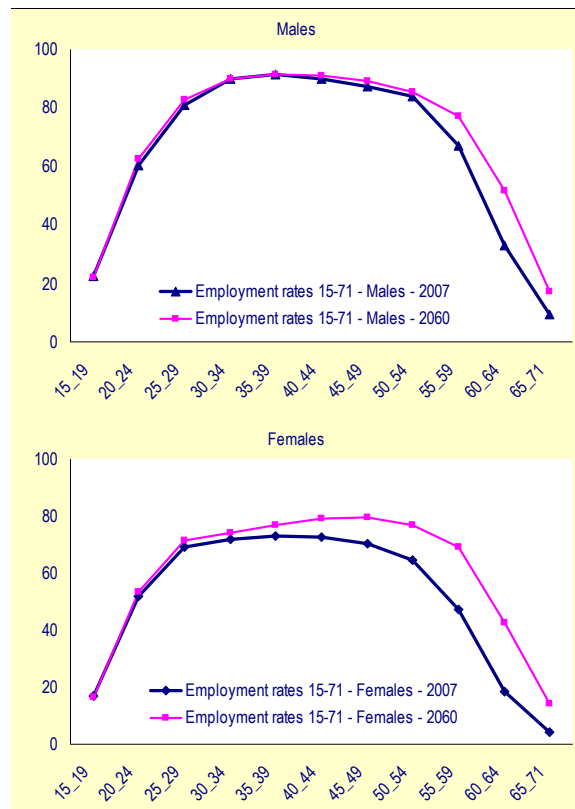
Overall, a reduction in the euro-area unemployment rate of around 1½ percentage points is assumed (from 7.6% in 2007 to 5.9% in 2020).

According to assumptions, the employment rate (of people aged 15 to 64) in the euro area will increase from 65.5% in 2007 to 70% by 2030. Reflecting recent positive trends, the employment rate of women is assumed to rise from 57.7% in 2007 to 63.4% in 2020 and to 64.9% in 2060. The increase in the employment rate will be even larger for older workers (55-64), from 42.4% in 2007 to 54.7% in 2020 and to 60.2% in 2060.

... but the number of workers will shrink

However, the number of people employed will grow by 6.7% up to 2020, before reversing and declining by 13% by 2060. Overall employment in the euro area is projected to shrink by about 10 million people over the entire projection period. Increasing labour force participation rates in most countries and rising net immigration levels in some can only moderate the fall in employment caused by the ageing of the population and the negative population growth in the period from 2020 to 2060.

Graph 30: **Employment rates in the euro area** (by gender and age group; 2007 and 2060, in %)



Source: 2009 Ageing Report, Commission services.

Hours of work (labour input) are projected to decline too

The total hours of work in the euro area will fall by 5.7% between 2007 and 2060 over the entire projection period. In annual average growth rates, hours of work are projected to fall by 0.1% in the euro area over this period. These figures reflect projected employment trends and a composition effect, due to the increasing share of employed persons working part-time (mainly due to the increase in women in employment, who are more likely to work part-time).

In line with different demographic trends, a reduction in labour input is projected in most countries over the period between 2007 and 2060, with drops of 20% and more in Germany, Slovenia and Slovakia. By contrast, a few will see an increase in hours worked (Belgium, Ireland, Spain, France and Luxemburg).



The ratio of elderly non-workers to workers will rise steeply

It is important to consider the ratio of elderly non-workers to workers, or the effective economic old-age dependency ratio, when assessing the impact of ageing on budgetary expenditure, above all for public pension schemes. For the euro area, the ratio is projected to rise sharply from 39% in 2007 to 73% in 2060. Hence, the euro area would move from having a ratio of 4 elderly non-workers to 10 workers in 2007 to a ratio of more than 7 to 10. Extremely high values are projected in some countries. In Slovakia and Malta, for example, the projections point to a situation where, by 2060, there will be almost as many inactive old persons as people working (the ratio will be more than 90%). By contrast, the ratio is projected to be under two thirds in Ireland, France, Cyprus, Luxembourg, the Netherlands, Austria, Portugal and Finland.

A retirement, not an ageing problem

Ageing is a dynamic process, and the policy challenge is to develop labour market and welfare-state policies that are adaptable and sustainable in the face of uncertain economic and demographic developments.

Table 9: Retirement problem or ageing problem in the euro area?

	Men		Woman	
	2008	2060	2008	2060
Average exit age	61.7	63.4	61.2	63.1
Life expectancy at the time of withdrawal	14.9	21.1	21.1	25.9
% of adult life spent in retirement	19%	25%	26%	29%
Exit postponement, in years		4.7		3.1

Source: 2009 Ageing Report, Commission services.

In the euro area, the average exit age from the labour market was 61.7 for males and 61.2 for females in 2008. By 2060, this is projected to have risen to 63.4 and 63.1 respectively, in part due to the reforms enacted (see Table 9). This implies an increase in the share of adult life spent

in retirement, from 19% to 25% for males, and from 26% to 29% for females. In order to keep the share of adult life spent in retirement constant at its 2008 level, the average retirement age would need to rise by an additional 3 to 5 years, i.e. a considerably larger increase than projected. A priori, there is no economic rationale for favouring a constant share of adult life spent in retirement, and indeed a preference for a longer period of leisure time in retirement could be justified on the basis of rising living standards. However, retirement decisions need be economically and financially viable.

3. Labour productivity and potential growth

Total factor productivity is assumed to converge to 1.1%

Total factor productivity (TFP) drives labour productivity growth in the long run. A cautious assumption was set of Member States' TFP growth rates converging to a long-term historical average in the EU of 1.1%, as was seen over the period from 1970 to 2004, which is close to productivity growth in the US over the same period. The speed of convergence is determined by the relative income position of the Member States. Specifically, the lower the current GDP per capita, the higher the real catching-up potential, which will materialise through a period of higher TFP growth.

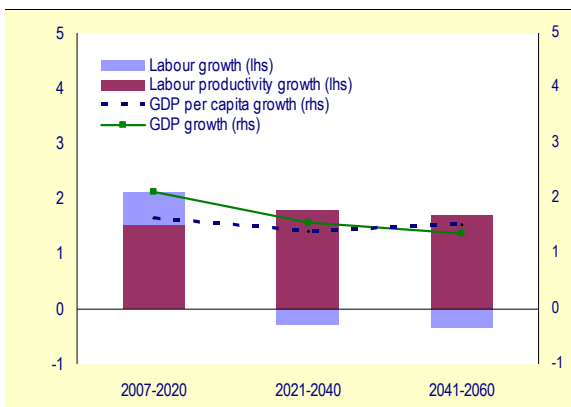
A decline in potential growth rate is projected...

Even without incorporating the potential negative impact of the current economic crisis, the annual average potential GDP growth rate in the euro area is projected to fall from 2.2% in the period 2007-2020, to 1.5% in the period 2021-2030 and to a meagre 1.3% in the period 2041-2060. While all euro-area Member States would experience a slowdown in their future potential growth rates, owing to the adverse impact of demographic trends, growth rates would differ substantially from country to country.

...and the sources of growth are also projected to change, with labour productivity becoming the key driver

For the euro area, labour productivity growth is projected to remain fairly stable at close to 1.7%. A small increase in the growth rate is expected up to the 2030s as a result of the higher productivity growth assumed in Member States that are catching up. Total hours of work –labour input – are projected to increase up to the 2020s. Thereafter, demographic ageing, with a reduction in the working-age population, is expected to act as a drag on growth. Over time, labour productivity will become the only driver of growth in the euro area.

Graph 31: **Components of potential GDP, euro area** (annual average growth rate in %)



Source: 2009 Ageing Report, Commission services.

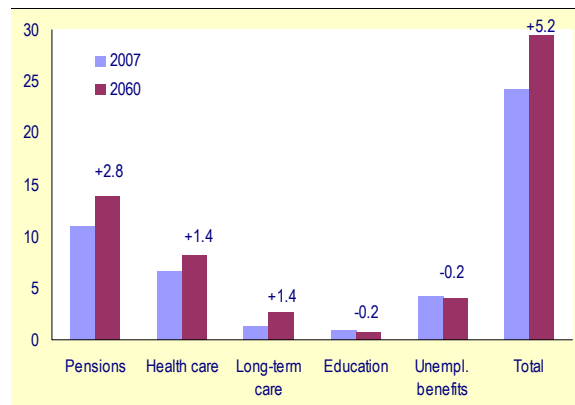
4. Budgetary projections

Results of long-term, age-related public expenditure projections

The budgetary projections point to sizeable fiscal challenges coming from the higher share of the total population in older age cohorts and a decline in the economically active share of the population. The fiscal impact of ageing is projected to be substantial in almost all euro-area countries, with effects already becoming apparent during the next decade. On the basis of current policies, age-related public expenditure is projected to increase on average by 5.2 pp of GDP by 2060 in the euro area. Most of the projected increase in public spending over the

period 2007-2060 will be on pensions (+2.8 pp of GDP), healthcare and long-term care (+1.4 pp of GDP each). Potential offsetting savings in public spending on education and unemployment benefits are likely to be very limited (-0.2 pp of GDP each).

Graph 32: **Age-related expenditure components, euro area** (% of GDP, 2007-2060)



Source: 2009 Ageing Report, Commission services.

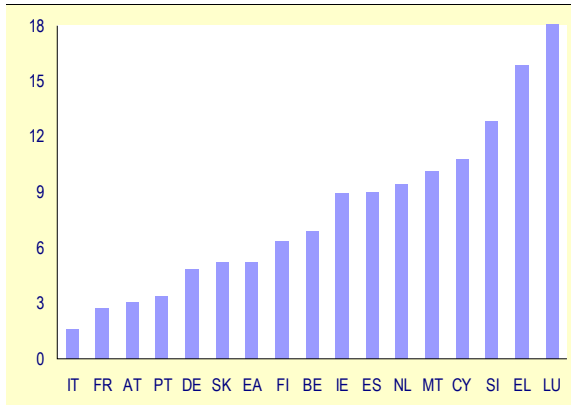
In terms of country-specific situations, the following points can be made:

- The age-related increase in public spending will be very significant in eight countries (Luxembourg, Greece, Slovenia, Cyprus, Malta, the Netherlands, Spain and Ireland), with a projected increase of 7 pp of GDP or more, although for some countries the large increase will be from a fairly low level. These countries have so far made only limited progress in reforming their pension systems or have maturing pension systems.
- For a second group of countries – Belgium, Finland, Slovakia and Germany – the age-related increase in public spending is more limited, ranging from 4 pp to 7 pp of GDP. Several of these countries have taken significant steps to reform their public expenditure systems that contribute to limit the increase in future expenditure.
- Finally, the increase is more moderate, 4 pp of GDP or less, in Portugal, Austria, France and Italy; this is also thanks to the implementation of substantial pension reforms. For many of them, the projected increase in expenditure on healthcare and



generally on long-term care is higher than the increases in pensions.

Graph 33: Age-related expenditure in the euro area
(projected change in pp of GDP, 2007-2060)



Source: 2009 Ageing Report, Commission services.

The highest increase is projected for public pension expenditure...

The demographic transition to an older population is the main driver behind the projected increase in public pension expenditure. This effect alone would push up expenditures very significantly in all countries. However, a number of factors, also related to past reforms of pension systems, are expected to mitigate the increase:

(a) tightening eligibility for public pensions (through higher retirement ages and/or reduced access to early retirement and better control of alternatives to early retirement like disability pensions) would constrain public pension expenditure in nearly every country. In the large majority of countries, this reflects implemented pension reforms, often phased in over a long period, which lead to higher participation rates of older workers during the projection period. For example, pension reforms that have strengthened the link between pension benefits and pension contributions (or raised the threshold for qualifying for a 'full' pension), can also contribute to raising the retirement age. Trend increases in female labour force participation also lead to an increase in the effective retirement age in a large majority of countries;

(b) higher employment rates are projected as reforms that provide stronger work incentives reduce structural unemployment rates in a number of countries;

(c) the generosity of pensions relative to wages is projected to decrease. It is captured at an aggregate level by the pension benefit ratio, i.e. the average pension as a share of the average wage. This effect shows very considerable differences across Member States. In some (Ireland, Greece and Cyprus) average public pensions relative to wages remain unchanged or even increase over the projection period, while in most others, and especially in France, Italy, Austria, Portugal and Slovakia, they are projected to have fallen significantly by 2060. While resulting in budgetary savings, the adequacy of pensions should be kept under review. Inadequate pension levels may lead to future demands for ad hoc government intervention to address declines in public pensions relative to wage developments and the risk of poverty of pensioners.

Generally, several related issues merit attention:

- (i) removing supply-side barriers to allow people to continue to work as they grow older;
- (ii) putting in place flexible mechanisms that allow older people to choose to retire even beyond the statutory retirement age and affect the size of their eventual pension benefit;
- (iii) introducing incentives for employees/employers to prolong their working lives/retain older workers in the workforce;
- (iv) allowing part-time old-age retirement, as a way of combining adequate incomes for older persons with improving the labour supply in the economy, as well as making the continued contribution of older workers more attractive;
- (v) providing relevant and accessible information on the need for people to rely on a range of different income sources once retired. Incentives for private savings can take many different forms, ranging from making contributions to private pensions schemes compulsory to providing tax breaks for regular private pension savings.

...but healthcare costs rise too...

Healthcare systems in the euro area are expected to face substantial challenges in the future. The baseline projection includes an increase in healthcare expenditure of 1½ percentage points of GDP by 2060. Healthcare spending is also strongly related to income growth and technological progress. Newly developed methods for early diagnosis and treatment contribute significantly to growth in spending. An analysis of past trends in healthcare expenditure suggests that technological developments – new and better treatment – are responsible for a significant part of overall costs growth, which may result in a sizeable increase in spending that is not captured in the projection. Healthcare spending as a share of GDP could be three and even four times higher than in the AWG baseline projection by 2060 if technological progress is assumed to continue as in the past and these costs are not contained. However, technological advancement may also have positive effects on reducing the costs of medical treatment through efficiency gains (faster and better treatment). Investment in prevention and health technologies offers instruments for the population to stay healthy and productive for longer. The effective management of technology is therefore a major determinant of future spending.

...as does long-term care spending...

An ageing population will also require increased public spending on **long-term care**. Based on current policies, public spending on long-term care is projected to increase by 1½ pp of GDP by 2060 due to the fact that the very old (aged 80+) will be the fastest growing age class in the population. Again, demographic factors will not be the only drivers. Currently, care for the frail elderly is provided to a very large extent on an informal basis by relatives. Changes in family structures, higher labour force participation of women and increased geographical mobility could reduce the availability of informal care. For countries whose formal care systems are less developed, the projected increase in public spending on long-term care could underestimate future pressure on public finances, due to the likely need for increased formal care provision.

...with limited, if any, offsetting effect from education spending

In terms of public **education** spending, despite the decreasing number of children over the coming decades, the current objectives and targets of education policy in the euro area, and a substantial improvement in the quality of education, may well require higher educational expenditure in the future. Investing in the human capital of young people and the adult workforce will be crucial to future productivity growth. Hence, the small decrease in the public education expenditure ratio over the projection period, which results solely from changes in the demographic composition (fewer children in the future), may not materialise.

5. The potential impact of the economic crisis on long-term budgetary projections

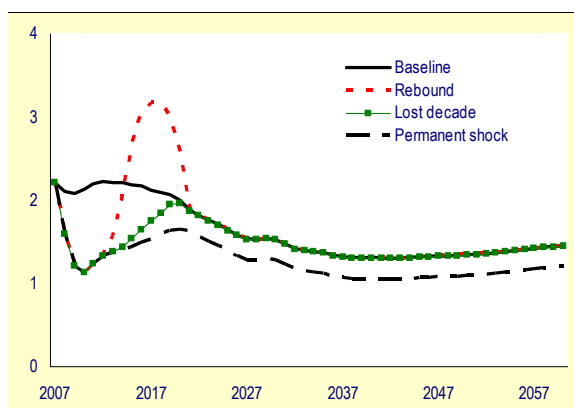
Drastically worse macro-economic developments – and prospects – than expected last year add to the uncertainty as regards the buoyancy of economic growth in the medium to long term. The economic crisis that took hold in 2008 has led to an unusually sharp and rapid deterioration in economic activity. The current slowdown has gradually transformed into a world recession. This has prompted the question of the extent to which the worsened short-term outlook also has implications for the medium and longer term.

Alternative scenarios for GDP growth potential in the aftermath of the crisis...

The AWG/EPC baseline long-term macro-economic projections for potential growth are based on the Commission's forecast made in Spring 2008. Since then, the economic outlook has deteriorated sharply, with potential adverse consequences on potential growth. In an effort to simulate the order of magnitude of the long-term risks connected with the ongoing economic crisis, alternative scenarios have been run. In view of the considerable uncertainty regarding the length of the slump in economic activity, three scenarios may be contemplated: (i) a pessimistic scenario: "permanent shock"; (ii) a less pessimistic scenario: "lost decade", and; (iii) an optimistic scenario: "rebound".



Graph 34: Alternative crisis scenarios for potential GDP (annual % change)



Source: 2009 Ageing Report, Commission services.

More specifically, the three scenarios are based on the following assumptions:

- In the 'rebound' scenario, *labour productivity* is assumed to reach the AWG baseline level in 2020. *Labour input* (total hours worked) is also assumed to reach the baseline level in 2020.
- In the 'lost decade' scenario, *labour productivity* is assumed to reach the AWG baseline growth rate in 2020. *Labour input* (total hours worked) is assumed to reach the baseline growth rate in 2020.
- In the 'permanent shock' scenario, labour input growth (total hours worked) and labour productivity growth will reach: (i) the *labour input* growth rate assuming that the unemployment rate is permanently 1 pp higher than in the AWG baseline from 2020 onwards; and (ii) the *labour productivity* growth rate assuming that it is 0.25 pp lower than in the AWG baseline from 2020 onwards.

The impact of the crisis on wealth creation depends on its duration and on the extent to which policies are put in place that successfully enhance the growth potential once out of the crisis. The impact of the crisis is at its strongest in the 'permanent shock' scenario, but also the 'lost decade' scenario has an adverse impact on the long-term growth potential. In the 'rebound' and the 'lost decade' scenarios, potential GDP growth for the euro area coincides with the

AWG baseline from 2020 on. Up to 2020, the downward revision of potential GDP growth is noticeable in the euro area, 0.6 pp lower on average in the 'lost decade' scenario, and 0.7 pp in the 'permanent shock' scenario. Over the entire projection period 2007-2060, the average revision of potential GDP growth in the 'lost decade' scenario is 0.2 pp per year for the euro area. In the worst case 'permanent shock' scenario, a larger downward revision of the average annual GDP growth of 0.4 pp over the whole projection period would materialise.

All scenarios show a reduction in GDP per capita over the medium term, of between 5 and 7% by 2015 already. In the 'rebound' scenario, this would be recuperated by 2020, as the slump would be fully reversed. The 'lost decade scenario' implies a reduction in the per-capita GDP level in 2060 compared with the baseline, which mirrors the lower expected potential growth in the decade up to 2020. This period is 'lost' in terms of accumulated wealth creation.

Table 10: GDP per capita, euro area (difference from baseline, in %)

	2010	2015	2020	2040	2060
Rebound	-3	-5	0	0	0
Lost decade	-3	-7	-8	-8	-8
Permanent shock	-3	-7	-10	-14	-18

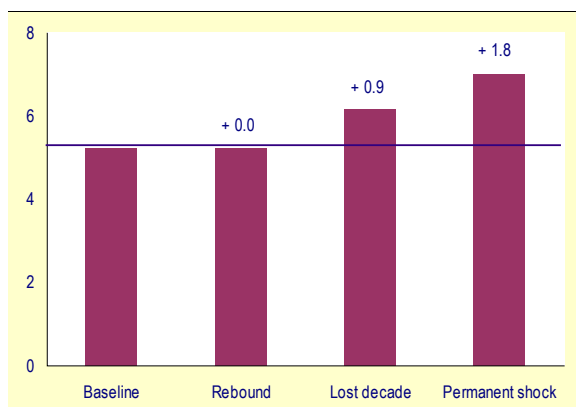
Source: 2009 Ageing Report, Commission services.

The loss in GDP per capita in the euro area is around 8% in 2020 in the 'lost decade' scenario, and this loss is carried over the rest of the projection period, since the growth projection remains broadly unchanged between 2020 and 2060. In the 'rebound' scenario, the GDP per capita by 2060 is the same as in the AWG baseline (the deterioration relative to the baseline up to 2014 is offset by the improvement between 2015 and 2020). Finally, a more marked reduction in the GDP per capita level is observed in the 'permanent shock' scenario, where GDP per capita is 10% lower than in the AWG baseline in 2020, 14% lower in 2040 and 18% lower in 2060, reflecting lower growth throughout the projection period up to 2060.

The crisis may have a considerable adverse budgetary impact if its effects on medium-term growth are not reversed

In terms of budgetary impact, the question of whether the shock is temporary or permanent determines its potential magnitude. An assessment of the public budget impact of these alternative scenarios has been carried out on the basis of the elasticities calculated for the sensitivity analysis. This provides only a preliminary indication of the impact of the alternative crisis scenarios.

Graph 35: **Potential budgetary impact of the crisis, euro area** (projected change in the total cost of ageing, pp of GDP, 2007-60)



Source: 2009 Ageing Report, Commission services.

The 'lost decade' scenario reveals that the age-related government expenditure increases faster over the first decade of the projection period, and then stabilises relative to the AWG baseline. Between 2007 and 2020, the total increase in age-related expenditure would be 0.9 pp of GDP higher than the AWG baseline and would then remain stable through to 2060. The 'permanent shock' scenario shows a constant widening of the expenditure-to-GDP ratio compared with the baseline. Between 2007 and 2020, age-related public expenditure would increase by 1.2 pp of GDP more than the AWG baseline. Over the entire projection period, however, the public age-related spending-to-GDP ratio would be 1.8 pp of GDP higher than the AWG baseline.

6. Policy implications

The slowdown in the GDP growth potential is already projected to happen in the next decade in the euro area on account of demographic trends, and the economic crisis aggravates the slowdown in a no-policy change scenario. The euro-area working-age population is assumed to start to decline early next decade, and employment growth is projected to turn negative as from the 2020s. In the medium term, the potential persistence of the economic crisis may lead to subdued potential growth due to sluggish job and productivity growth already, implying a risk of a lost decade in terms of wealth creation in the euro area.

These long-term simulations illustrate that at this juncture, marked by very subdued economic activity and exceptional uncertainty in terms of prospects, there is a very real need to put policies in place that prevent the current financial crisis from turning into a permanent shock to the key determinants of potential growth (employment and labour productivity), as this would have a serious negative impact on future GDP, per capita income levels and budgetary conditions. The euro-area's ability to emerge from the slump fast and restore high and stable growth and sound public finances will depend essentially on its ability to deploy targeted and well coordinated policy responses built on structural reforms, as stressed by the European Economic Recovery Plan³⁸ and illustrated by the 'rebound' scenario.

Once out of the crisis, the long-term prospects will also depend on the degree of determination for a swift return to sound public finances, as recommended in the EERP, and the pursuit of structural reforms required by demographic change, which will now be all the more important to build confidence as part of the exit strategy from the crisis. Equally importantly, the structural reform agenda designed to tackle the demographic challenge needs to be strengthened. This means raising employment rates substantially and, in particular, helping and encouraging the ageing baby-boomers to stay in the labour market rather than retire early, as previous generations have tended to do. The euro-area's best chance of ensuring that ageing

³⁸ COM (2008) 800 final, 26 November 2008.



will not be perceived as a threat, but as a historic achievement, lies in not wasting the potential of these baby-boom generations.

These points of reference confirm the validity of the three-pronged strategy to cope with the economic and budgetary challenges posed by ageing populations, as adopted by the Stockholm European Council in 2001, namely, (i) reducing debt at a fast pace; (ii) raising employment rates and productivity; and (iii) reforming pension, healthcare and long-term care systems.

The Commission stressed in its Communication on population ageing of 29 April³⁹ the need for resolute and determined efforts from the Member States to put in place all the policies needed to ensure that the euro area emerges from the financial and economic crisis with solid growth potential and the ability to make full use of its human resources. Expanding the degree to which existing factors of production have been

used so far is the key to getting the euro-area economies back on a path of solid long-term growth. For this to happen, a comprehensive exit strategy built on structural reforms will be essential. In particular, this will involve prolonging working life and increasing the participation of youth, women and older workers, reforming tax and benefit systems to make work pay along the flexicurity principle, reforming pension systems and making health and long-term care systems more efficient, alongside the necessary investment in education and research. Putting the emphasis on these policies at the present juncture will help the euro area both to emerge more resiliently from the current recession and to address the challenges of an ageing society. By vigorously pursuing the reform agenda, by investing massively in the quality of human resources and by removing barriers to the full use of its labour force, the euro area can emerge stronger from the current economic crisis.

³⁹ COM (2009) 180, 29 April 2009.