From Red to Grey: a Third Transition

The combination of rapidly aging and relatively poor populations exists only in transition countries

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In 2025, more than one in five Bulgarians will be more than 65 years old — up from just 13% in 1990. Ukraine's population will shrink by a fifth between the years 2000 and 2025. And, also in 2025, the average Slovene will be 47.4 years old — among the oldest in the world.

Populations have been aging quite rapidly in many countries; yet the unique conjunction of rapidly aging and relatively poor populations exists only in transition countries. Indeed, because of this demographic "third transition" following the political and economic transitions, the only countries in the world with population declines of more than 5,000 people between 2000 and 2005 were 16 countries in Eastern Europe and the former Soviet Union — led by Russia, Ukraine, Romania, Belarus, and Bulgaria. No country faces as big an aging crisis as Georgia which is set to lose 800,000 people over the next two decades. And no other countries in the world face the dual challenges of a rapidly aging population and an incomplete transition to mature market institutions to deal with the adverse economic consequences of aging.

The economic impact of aging will be felt most through the rising proportion of the elderly — those aged 65 and older. The old-age share of the population will increase beyond 15% in 2025 in all but seven transition economies and Turkey.

Growing Older Does Not Have to Mean Growing Slower

Will the changing demographics in the region mean a halt to economic growth, because older populations have shrinking labor forces and save less, with negative consequences for investment and capital accumulation?

Not necessarily, as in labor markets the reality is less demographically deterministic:

- The growth in labor productivity, which has been the single greatest contributor to increases in per capita income in the region, could swamp any effects of smaller labor forces;
- The impact of aging on the labor supply can be partially offset by increases in the labor force participation rates. Increasing the retirement age close to OECD levels (which, on average, are higher by four years for men and five years for women) and improving the ability to do more flexible, part-time work could increase the quantity of the labor supply;
- Intraregional migration from younger countries can augment the labor forces of the aging countries, if political resistance is overcome.

In aging populations, aggregate saving — the key ingredient in creating capital and a key determinant of growth — is likely to decline because people save less as they grow older. However, the available data suggest that households and firms in transition countries in Eastern Europe and the former Soviet Union may eventually want to increase their savings as:

- The average saving rate declined in the late 1990s and early 2000s to about 15%. Convergence toward Western European levels of 24% would then imply the growth of future saving in the region;
- The share of both household and corporate savings is unusually low — or even negative, as in Bulgaria — compared with OECD countries. Most likely, this reflects an incomplete economic transition. Eventually, households and firms will stop running down assets and will want to replenish their savings to provide for retirement and to build precautionary cushions.

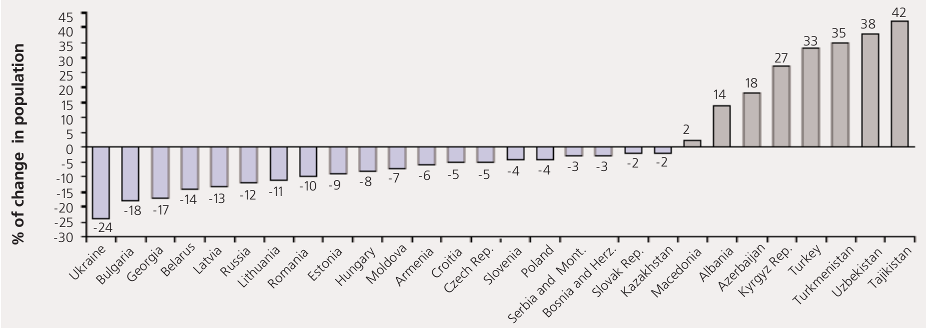
Besides, corporate and foreign savings should remain largely unaffected by aging. As financial markets, which are currently shallower than in OECD countries, deepen and the number and variety of savings instruments increase, individuals and corporations are likely to receive greater opportunity for formal savings matching their individual time horizons and risk profiles. Moreover, financial deepening and increased flexibility are also likely to boost overall productivity.

Sensible Policies Can Ease Aging Spending Impact

There are widespread concerns that aging populations in ECA countries will exert new pressures on public spending, especially for pensions and health care. In addition, aging populations would have significantly higher health needs, simply because the greatest demand for medical care occurs in the later years of life. Another critical issue is long-term care for the very old, which either becomes costly as informal, family-based care declines or imposes opportunity costs if younger people have to spend time on care that they would otherwise spend working.

- *Reforming pension systems:* Under the simplest assumption that pension spending will go up in proportion to the rise in the percentage of the population older than age 65, pension spending by 2025 in Croatia, Hungary, Poland, Serbia, Slovenia, and Ukraine will rise above that of Italy (the highest OECD pension spender). Poland could have pen-

Populations in Most Countries Will Decrease between 2000 and 2025



sion spending as high as 22% of GDP, with Ukraine not far behind at 19%.

Fortunately, this is only a potential scenario. A recent EU study found that, on average, 47% of the projected demographic change could be mitigated by changes in policy, primarily raising and equalizing the retirement age between men and women and using consumer price inflation — rather than wage inflation — to index pensions after retirement. Calculations by the World Bank have produced similar results.

• *Affordable health care and long-term care*. The magnitude of medical and health cost increases will depend on whether longer life spans add healthy years or years of illness and dependency. We find that the use of health services will increase as populations age but that the increase will, in most countries, be largely due to factors unrelated to aging, such as growth in GDP per capita, changes in the level of service, technological innovation, quality of services, and productivity.

At current benefit levels, public spending on health will increase significantly by 2020 (compared with 2005) only in Tajikistan and Uzbekistan, both young countries. Spending will modestly increase — by 2% of GDP — in Belarus, Bulgaria, Estonia, Poland, Romania, and Russia, and will actually fall in Armenia, Bosnia and Herzegovina, Croatia, and Turkmenistan.

However, new pressures on the provision and use of long-term care services will be very difficult to face for most ECA countries. Using a conservative assumption that only 5% of the elderly with disabilities will receive formal institutionalized care, and 5% will receive informal care (10% for new EU member states), expenditures on long-term care will double in almost all countries and will account for between 0.5% and 1% of GDP. If institutionalized care extends to 20% of the elderly with disabilities, expenditures will consume between 2% and 4% of GDP.

How, then, should policy makers respond to this public expenditure shock? Perhaps the most effective way to ensure better health and lower expenditures is by promoting healthier elderly populations. These measures include changes in lifestyle, especially promotion of regular exercise and control of diet and weight; design of substantially less expensive public services; and support to informal caregivers, predominantly women, including provision of cash and service benefits to them.

• *Providing for lifelong learning*: Aging will exert at least two different pressures on education, with potentially opposite budgetary consequences. The shrinking school-age population will make some cost savings possible. If current trends continue, by 2025 all the countries except Tajikistan will have smaller school-age cohorts — by 30-50%.

A closer look, though, reveals that the savings may not be as large or as universal, because current coverage in education leaves significant room for improvement. For example, the large declines in primary school coverage in Armenia, Bosnia and Herzegovina, and Turkmenistan have pulled gross enrollment rates in primary education well below 90%. So, improving coverage will lead to very fast growth in education enrollments in countries with young populations.

The aging, late reformers in the former Soviet Union and the western Balkans face the greatest challenge

The second factor that can help to counteract the expected decline in expenditures is the imperative to invest in lifelong learning practices to improve productivity and better meet the needs of dynamic and flexible economies. The transition led to a serious disconnect between the skills provided by education systems and the skills needed by the market economy.

Education quality across region is not high. As measured by the OECD's PISA assessment, only some of the countries, such as the Czech Republic, Hungary, Latvia, and the Slovak Republic, have somewhat decent rankings, whereas the aging, late reformers, such as Russia and Serbia, do less well.

Moreover, formal programs of lifelong learning are almost nonexistent in the region. In principle, economic liberalization policies strengthen the incentives for employers to provide training for their employees, whereas productivity-related earnings dispersions strengthen incentives for individuals to seek training. However, legal proscriptions and onerous certification requirements — as well as the absence of positive inducements such as tax benefits — inhibit the development of lifelong learning programs by private providers.

In summary, the blow to public expenditures coming from aging can be fairly small — if well-understood policy measures are put in place for pensions, if proactive measures are undertaken for financing long-term care, and if savings in public education expenditures are reoriented toward initiatives that boost productivity.

The Different Paths Ahead

The requirements for reform on these issues vary for different countries in Eastern Europe and Central Asia. They depend on each country's individual aging profile and on the reform paths and timing that the countries choose in the decades ahead. The challenge is to be proactive in undertaking the particular reforms that are essential for meeting the shocks caused by aging populations.

• *The young, late reformers in Central Asia* — the Kyrgyz Republic, Tajikistan, Turkmenistan and Uzbekistan — have the easiest paths in dealing with aging: although they will need to face adjustments in education and, to some extent, in pensions because of population aging, their large pool of young residents will ease the pressure. Their major task is to complete the economic transition and further develop institutions.

• *The aging, early reformers of the European Union and Croatia* (and, to some extent, Albania) will find that the reforms already undertaken by them and their better-developed institutional capacity will help them deal proactively with the pressures of aging populations. But much will still depend on whether they have the political will to undertake difficult future reforms in pensions and long-term care.

• The greatest test is for the *aging, late reformers of the former Soviet Union and the western Balkans*. They face the twin problems of significantly aging populations and relatively underdeveloped institutions, with action needed on both.

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