PRESIDENCY ISSUES NOTE

WORKING SESSION II:

ADDRESSING THE FISCAL CHALLENGES OF DEMOGRAPHIC CHANGE IN EUROPE

INTRODUCTION

The EU Member States, similarly to other nations, are profoundly concerned about the complex matter of the demographic changes impacting long-term economic prosperity and public debt sustainability in recent years. We share the major concerns of Member States regarding this issue and as the Hungarian Presidency of the EU Council, addressing it is as a key element among our priorities.

Increased longevity is one of the greatest achievement in human history. However, coupled with **declining birth rates and shrinking skilled workforce, ageing population presents significant challenges to the competitiveness and collective fiscal health of the EU.** Bruegel's paper[1] on the effects of demographic changes on public debt sustainability discusses the channels through which demographic developments impact public finances and presents the impact of alternative demographic scenarios on fiscal trajectories. The impact of current demographic trends on European competitiveness largely depends on how business circles and national economies respond. Consequently urgent policy measures are essential to address the adverse implications of demographic developments.

The EU population is expected to rise from 449 million people in 2022 to a peak of 453 million in 2026, followed by a gradual decline towards 432 million by 2070. Old age dependency ratio, which is the ratio of the old-age population to the working-age population, is expected to rise sharply, without exception, in all Member States in the coming decades. For most Member States, the total cost of ageing will substantially increase between 2022 and 2070, according to the 2024 Ageing Report. Increment in the pension expenditures is the largest contributor to the overall change in the total cost of ageing for Member States, followed by the increase in spending on long-term care and then health care.

[1] *The effects of demographic changes on public debt sustainability* – Bruegel background document

CHANNELS THROUGH WHICH DEMOGRAPHIC DEVELOPMENTS IMPACT PUBLIC FINANCES

Demographic changes affect public finances differently through several channels in various regions. They alter the labour force both in terms of the number of people of working age and their participation rates across different age cohorts. With a shrinking working-age population, labour shortages become a pressing issue, impacting productivity, economic growth and prosperity. The current activity level can still be slightly increased in Europe. In many countries, the activity rate is rather low, but it can be improved with appropriate measures, such as targeted tax incentives or pension bonuses, which have proven already successful in several EU countries recently. Certain regions in some Eastern and Southern European Member States are confronted with the combined challenges of ageing population and the outward migration of young and skilled workforce. Moreover, this phenomenon is also pronounced in predominantly rural areas, even if working from home has become more common in recent years.

Ageing population affects not only the labour market and productivity, but also consumption and investment patterns. The consumption habits of the older generations differ from those of the younger generation, and changes in the consumption patterns can have a negative impact on the growth of the economy, and consequently on the fiscal stance.

We are in a process where a shrinking proportion of the working-age population supports a growing number of elderly people. Increase in the ratio of the elderly population significantly influences pension, healthcare, and long-term care costs. These rising costs place additional pressure on public finances and necessitate new measures to ensure fiscal sustainability. This could lead to higher taxes and social contributions, which would negatively impact both competitiveness and growth.

Demographic trends can drive real interest rates. Population ageing might encourage greater savings by the working age cohorts for their future retirement, which increases savings and can reduce the real interest rate. However, dissaving by pensioners reduces savings.

QUANTIFYING THE IMPACT OF ALTERNATIVE DEMOGRAPHIC SCENARIOS ON FISCAL TRAJECTORIES

Public debt sustainability is a multifaceted issue, often defined by compliance with EU fiscal rules. The EU's new fiscal framework utilizes debt sustainability analysis as a key tool for guiding fiscal policy. Bruegel's paper compares the 2024 Ageing Report baseline scenario to six alternative scenarios: lower fertility, higher employment rates among those aged 55-74, higher life expectancy, higher immigration, higher total factor productivity (TFP) growth, and higher healthcare and long-term care costs.

The fiscal impact of these alternative demographic scenarios is measured through changes in the structural primary balance (SPB) up to 2052 for the EU27. This includes both medium-term impacts (up to 2028 or 2031) and long-term impacts (2025-2052). Differences between the SPB sequences under the baseline and alternative scenarios provide insights into potential fiscal adjustments needed to maintain sustainability.

Results show that a lower fertility rate is associated with less child-related costs in the early years. However, lower labour force later shrinks GDP, requiring more fiscal adjustment. A higher employment rate is expected to result in higher GDP and less fiscal spending in the first decade, but later the relative increase in ageing costs/GDP requires more fiscal adjustment than in the baseline scenario. In the case of higher life expectancy, the pension effect dominates, necessitating more fiscal consolidation. Additionally, internal migration could play a key role in shaping GDP growth. The adequate amount of skilled labour force which reflects the demand of the thriving and changing economy varies by region and it can substantially moderate the economic and social outcomes. Designing the appropriate cohesion policy can be a substantial tool of policy responses in addressing the territorial dimension of demographic shift. Similarly, higher TFP and increased competitiveness will result in higher GDP, which is expected to reduce the ageing costs/GDP ratio, allowing for less fiscal consolidation. Higher ageing costs require more consolidation.

POLICY RESPONSES TO DEMOGRAPHIC CHALLENGES

Demographic change has a powerful and wide-ranging impact on our everyday life and consequently requires a holistic approach. Hungary, as an EU Member State, is committed to continue the implementation of comprehensive strategies to address these issues, including a more decisive role for Cohesion Policy funds, focusing on increasing birth rates, improving workforce participation, and improving productivity making use of all available economic incentives. To address the adverse implications of demographic changes, several policy measures are essential:

1. **Boosting fertility rates** can be achieved through comprehensive family support measures, such as supporting young parents, prenatal baby loans, home creation programs, increased childcare facilities, flexible maternity leaves, and financial incentives for childbirth and child-raising.

2. **Increasing labour force participation** is another key strategy. This can be done by implementing policies that encourage higher participation rates and decreasing the proportion of inactive workers by supporting lifelong learning and skills programs, active labour market policies, tax incentives, social benefit systems, and pension and retirement regulations.

3. **Managing healthcare and long-term care costs** is vital. Implementing measures to control healthcare expenditure and align long-term care cost profiles will be necessary.

4. **Reforming pension and healthcare systems** is a priority. Adjusting retirement ages and promoting private savings schemes can help ensure the sustainability of pension systems. Enhancing healthcare efficiency to manage costs while maintaining quality care is also crucial.

5. **Promoting total factor productivity (TFP) growth** is essential for sustaining economic growth amid demographic shifts. Investing in innovation and competitiveness can achieve higher TFP growth.

Overall, these measures can help address the challenges posed by demographic changes and support long-term economic sustainability.

QUESTIONS FOR DEBATE

1. How can the EU enhance cooperation among Member States to address the fiscal challenges posed by demographic changes?

2. What specific policy measures should be prioritized to increase labour force participation among inactive, older workers and women and how should digitalization, innovation and technological advancements can be leveraged to mitigate the economic impacts of an ageing population?

3. How can the sustainability of pension and healthcare systems be ensured without overburdening future generations?