Demographics and the Economy

An Interview with David K. Foot, PhD, Professor of Economics, University of Toronto

Interviewed by Peter O'Brien, CIMA®, CFP®, ChFC®

What do demographics tell us about the economy? Can they predict future trends? In a wide-ranging discussion in August 2012, Peter O'Brien, CIMA®, CFP®, ChFC®, a wealth advisor with Morgan Stanley Smith Barney in Jacksonville, Florida, and a member of the *Investments & Wealth Monitor* editorial advisory board, posed these and other questions to David K. Foot, professor of economics at the University of Toronto. Foot, who last shared his insights in the *I&WM* January/February 2009 issue, earned a B.Ec. from the University of Western Australia and MA and PhD degrees from Harvard University.

Peter O'Brien: In *I&WM's* 2009 article, you commented on the amazing accuracy of demographic models over long periods. Do you still hold that view?

David Foot: I've always said that demographic models explain about two-thirds of everything, but never everything. Demographics are a great place to start in understanding medium- to long-term economic trends. Short-term trends in the economy, on the other hand, are not affected by demographics. They are affected by government policies, private sector spending policies, banking policies, etc.

Peter O'Brien: What medium- and longer-term trends are you seeing?

David Foot: Globalization for one. Companies and organizations are no longer restricted to the demographics of their own countries. They can also look at the demographics of other countries, which helps moderate the effects of domestic demographics.

Technology is another important longer-term trend, which can sometimes ameliorate, but seldom offset, the effects of demographics. Finding new uses for technology and replacing people with machines naturally have implications for unemployment.

A third trend has violently erupted on the scene during this decade and is about to have a major impact around the world, particularly in North America. This is the trend toward increasing income inequality. Income is being captured by very few—the one-percenters as popular lingo describes them—which is having a long-term impact on the spending patterns of the vast majority of the population.

In addition, an aging population inevitably means slowing economic growth.

Peter O'Brien: Is that a truism or a prediction?

David Foot: It's a prediction, but it's validated all over the place. An aging population means reduced fertility and therefore slower labor force growth. And labor force is two-thirds of the input into output growth.

Peter O'Brien: Do you agree, however, that we're also seeing long-term increases in productivity?

David Foot: In the United States, we still see some productivity growth, partly due to U.S. businesses investing in new technology. But here in Canada and in many countries in Europe, productivity growth slows as labor force growth slows despite advances in technology. Also remember that the United States has the highest fertility rate in the developed world. You are replacing yourself with 2.1 children per family, so you don't have the same issue with slowing labor force growth that we see in Canada and Europe.

Peter O'Brien: Is less labor force mobility another trend?

David Foot: It depends on the age demographics of a country. People generally are not mobile when they are raising a family. So if most of a country's labor force is in its 30s and 40s, there will be a decrease in labor force mobility. Add to this people in their 50s and 60s, who have raised their kids and are mobile again, but may not have jobs, and that leaves young people in their 20s as the only mobile labor force. If that age group is a smaller percentage of the population, we will see a gradual decline in labor mobility.

Peter O'Brien: Does that concern you?

David Foot: I don't think it's bad, although economists would say it's terrible. However, economists are wrong all over the place these days, and I'm an economist.

In my opinion, the point of an economy is to provide people with income so they can live, raise families, and be social beings. Staying in one place so kids can have a stable schooling is probably a very good thing.

Peter O'Brien: Has negative equity in housing affected labor force mobility?

David Foot: If you can walk away from your mortgage, negative home equity should not impact labor mobility. If you can't walk away, it has a major impact. In Canada, Japan, and most of Europe, a homeowner's wages can be garnished to pay a mortgage—people can't get out of it. In some states in the United States (non-recourse states), people can walk away from their mortgages.

Peter O'Brien: The single European market heralded a new era in the free movement of goods, services, capital, and people. What trends have you noticed in Europe in terms of labor mobility?

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David Foot: We see a wonderful example of lifecycle labor mobility. As I mentioned, people tend to move in their 20s, after they've completed their education and before they have a family. Poland, which had a large number of people in their 20s during the 1990s and early 2000s, experienced a lot of labor mobility at that time. But now these young people are in their 30s, and many are returning home to raise families. When looking for sources of in-migration, look for a country with open borders and many young people in their 20s.

Peter O'Brien: What does this mean for countries with high youth unemployment such as Greece and Spain?

David Foot: Relatively speaking, there actually are very few young people in Greece and Spain in their teens and early 20s because of low fertility. That's why these countries are in so much trouble. They have much lower labor force growth and much slower economic growth. They are never going to grow out of their deficits.

Peter O'Brien: Do periods of weak economic performance have a discernible impact on fertility rates?

David Foot: It has a very minor impact, and the impact can go either way. Let me explain. Economists would say that the demand for children depends on income and price. If you have a lower income, the demand for children goes down, and fewer children are born. So in soft economic times, you can expect a minor decline in fertility rates.

There's a counter argument, however. If the recession is expected to be short, people might look at it as an opportunity cost. For example, a woman might lose her job during a recession and decide to have a child because she won't lose much economically. We see that phenomenon among very well-educated women. Bottom line, a recession has a minor impact on fertility based on current data.

Peter O'Brien: What did you learn from the 2010 U.S. census? Any surprises?

David Foot: There were no surprises to me. The census confirmed ongoing trends. Nevertheless, I believe that it is very important to maintain a good census. In Canada, by the way, the government tried to cancel our census to save money.

The U.S. census did show that the Hispanic population is now larger than the African American population and is growing faster than many predicted. In some school districts, Hispanics represent 50 percent of the school population even though Hispanics are just 17 percent of the population overall. This has all sorts of implications down the road. We also see that the United States is rapidly becoming a bilingual country.

Peter O'Brien: Demographic analysis has largely been confined to broad categories of age, gender, income, race, and ethnicity. In the Facebook age, are we going to see more granular analyses of public and private data? How do you view the proliferation of demographic data coming out of the private sector?

David Foot: I see it as a worrying trend. Data from private sources may not be gathered from random samples, which leads to biased results. In contrast, governments use sound sampling techniques to get a stratified, random sample and ensure that results are representative of the population at large. It would be a disaster if governments tried to cut costs by relying on private sector data to determine public policy.

Peter O'Brien: What lessons can economists and investment advisors learn from the accuracy and robustness of demographic models?

David Foot: One lesson is the incredible importance of factoring in the lifecycle stages of human behavior. Take the baby boomers as an example. Because of their large numbers, they have had a huge impact on the economy as they have moved through the different stages of their lives—on spending, types of spending, saving, and so on. Economic models talk about the lifecycle, but then they collapse it with a big integration term and it disappears. I recommend building the age structure of the population into economic models when looking at things like consumption behavior.

Peter O'Brien: Do econometric models have too many variables? Should they be simplified?

David Foot: Not necessarily. We should certainly simplify the message. Science tells us that the world is complex, interacting, and nonlinear; yet most economic models are linear. We can deal with small variations around the status quo, but we can't deal with large variations. However, the existing frameworks of economic models are probably bankrupt anyway, so putting more nonlinearity into those models isn't necessarily going to solve the problem.

Peter O'Brien: What problem are you referring to?

David Foot: When we look at the economy in North America, income distribution is a residual—it falls out of the bottom of models. There's no feedback from income distribution to consumption behavior and all the rest. Today, with the increase in income disparity, it's more important than ever to get this feedback, but it doesn't exist in the models.

Peter O'Brien: Do you foresee that economic and taxation policies will address the issue of income inequality in the United States and elsewhere?

David Foot: If anything, it's going in the opposite direction. Tax policies are encouraging more income inequality, with the rich paying ever fewer taxes because they get their income from dividends and the like, which are taxed at a lower rate.

Governments in the United States, United Kingdom, and Canada talk about solving our terrible deficit problems, but they keep cutting tax rates. The deficit problem is solved by raising taxes, not cutting them. Yet, people vote for tax cuts, disaster looms down the road, and I see no changes in that trend.

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Peter O'Brien: The strains on federal, state, and municipal budgets in the past few years have brought the heavy cost of public sector pension obligations into sharp focus. What do you see in this respect?

David Foot: It's a big issue in the private sector, too. One of the biggest costs companies talk about is their legacy costs—the pension and healthcare costs of an aging population.

In my view, the objective of a decent society should be a good pension for everyone. Otherwise, poverty becomes rampant among seniors, and there's a huge increase in pressure on healthcare spending. If you want to see higher healthcare spending, reduce pensions among seniors—and that seems to be the way we are going in the capitalist world. Companies argue that they can't afford defined benefit pensions, senior executives take defined benefit pensions away from their employees, and then they keep them for themselves. It's amazing.

When people accept a job at an agreed-upon wage, they've factored in future wages as part of that agreement. To take away from seniors a promise that was made to them is immoral and should be illegal.

Peter O'Brien: What's the solution?

David Foot: For municipalities, the choice is to raise taxes or issue more bonds. Raising taxes won't happen, so they issue more municipal bonds and get ripped off coming and going, which is why they are going bankrupt. Municipalities are charged to put bonds onto the market and are charged a higher interest rate than they should have to pay given the risk embodied in the bonds. Then those extra interest costs—and we're talking about hundreds of millions of dollars—get creamed off by issuers and become huge windfalls for the financial sector and Wall Street. When are we going to wake up?

Peter O'Brien: But at the same time, will investors want to buy bonds from an entity that cannot afford its pension obligations?

David Foot: Municipalities are paying the price of previous management decisions and increasingly are caught between a rock and a hard place.

Peter O'Brien: Let's take the discussion from local municipalities to countries such as Italy and Greece in terms of those countries' pension obligations.

David Foot: Don't forget to also look at the life expectancy and health of seniors in those countries. They have a significantly higher life expectancy than in the United States. Seniors with a good income live longer and are healthier. If you don't want them to live longer, you take away their pensions, and they die earlier.

Peter O'Brien: Will people have to work longer and save longer because they are living longer and because pensions—whether from defined benefit plans, defined contribution plans, or Social Security—won't be there for them?

David Foot: This question is tied to longevity risk. The life expectancy of someone who is 60 years old today has gone up at least a decade over his or her lifetime. That's huge. One reason is the reduction of poverty among seniors. But we're about to reverse that. If we default on pensions and increase poverty, life expectancy will go down. Maybe we'll solve the problem that way.

Peter O'Brien: Is there a less dire solution?

David Foot: We should do a better job of indexing retirement age to life expectancy and take that calculation out of the political arena. The age of eligibility for Social Security has been raised in the United States, but it's only going up two years (65 to 67) over 24 years.

We also know that baby boomers would like to work part-time in retirement. I'd like to see more flexibility built into the system, so retirees could continue to work part-time, pay taxes, and contribute to Social Security and their retirement plans when they worked. Then, on days when they don't work, they could withdraw from Social Security.

Countries are beginning to eliminate some of the penalties for working in retirement, but they still make people retire and then add their work income on top of it. Flexible retirement, which allows people to gradually ease into retirement, is a short-term solution to a worldwide problem. And with computers, it would not be hard to do.

Peter O'Brien: I saw a statistic recently that showed the average 50-year-old American has less than $50,000 in retirement assets.

David Foot: Again, look at lifecycles. People have their maximum debt around age 50 because they still have kids at home or in college. On average, however, debt levels plummet over the next 20 years. In addition, people often start accumulating more assets in their 50s. Breaking down both assets and debts over the lifecycle is an important analysis that I recommend doing more often.

Peter O'Brien: In addition to longevity risks, are there other major demographic issues that we as financial and investment advisors are ignoring?

David Foot: We are ignoring fraud in the financial sector.

Peter O'Brien: That's a demographic issue?

David Foot: No. You're right. Longevity risk is a demographic issue. But you asked what issues investment advisors are ignoring. We're ignoring fraud in the financial sector. No one has gone to jail over the 2008 debacle even though it took the world down with it. After the savings and loan meltdown in the 1980s and early 1990s, hundreds ended up in jail. But today, people are slicing and dicing ETFs (exchanged-traded funds) like they sliced and diced mortgages.

The point I'm making is that companies said two things to two different clients—they bet against one outcome by shorting on the other side. By the common person's standard, that's fraud. Even if it's not fraud legally, it's fraud. It's wrong.

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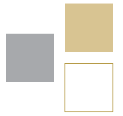

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The result is that people saving for retirement don't know what to do. Should they put their money in their house? Should they put their money into certificates of deposit, which have a lower return than inflation? Should they put their money into stocks and bonds? They don't trust the financial sector, inflation is eating away at their savings, and they are totally lost.

Peter O'Brien: In our work, we help people do just that—organize their retirement using a variety of tools, techniques, and insights.

David Foot: But I'm talking about the average person out there today who doesn't necessarily have access to people like you.

Peter O'Brien: Bringing us back to demographics, what demographic risks are we ignoring besides longevity?

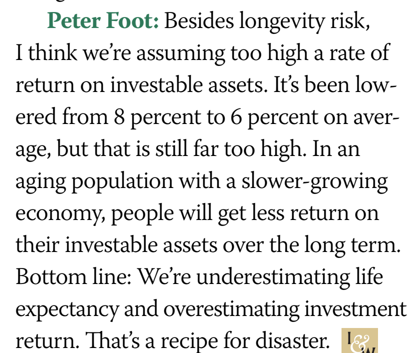
David Foot: We seem to ignore demographics when we do global analyses. For example, the one-child policy in China has resulted in many fewer people under age 25 in the Chinese workforce, which means that economic growth in China inevitably will slow. I don't see that analysis anywhere. In contrast, India has a much higher fertility rate and many young workers, but people are poor and wages are low.

Peter O'Brien: China seems to be the most-researched country in the world right now, but many question the reliability of government data coming out of China especially in regard to population and politically sensitive issues such as the one-child policy.

David Foot: I agree. My point is that foreign policy should be informed by demographics. As another example, look at the Middle East. I don't see any analysis of the demographics of Iran, Saudi Arabia, etc. In my opinion, we backed all the wrong sides—the sides that penalize women and therefore have higher fertility and therefore have a huge youth population that is not getting jobs, leading to the Arab Spring. The countries that supported women were Iran and Tunisia, and we did not support them.

Peter O'Brien: This has been an illuminating conversation. Is there anything we've missed?

Peter Foot: Besides longevity risk, I think we're assuming too high a rate of return on investable assets. It's been lowered from 8 percent to 6 percent on average, but that is still far too high. In an aging population with a slower-growing economy, people will get less return on their investable assets over the long term. Bottom line: We're underestimating life expectancy and overestimating investment return. That's a recipe for disaster. I&W



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