THE DESTINY OF DEMOGRAPHIC CHANGE

RAFAEL GOMEZ and DAVID FOOT

Changing population trends lie behind our diminished prospects for economic growth. If we understand the demographic facts we'll be able to come up with the right policies to deal with the economic challenges.

Les faibles perspectives de croissance économique s'expliquent par les tendances démographiques. Il nous faut donc mieux comprendre l'évolution de la démographie pour définir les politiques qui stimuleront notre économie.

The March 2013 issue of *Policy Options* included a series of articles focusing on how Canadians need to adjust to the reality of a slower-growing economy and how we may even benefit from the end of our addiction to faster growth and ever-greater accumulations of gross domestic product. This attention is warranted primarily because it is based on a development only hinted at in many of those submissions: the roots of slower growth lie in our changing demographics. Three population-related developments point to trouble ahead for our 20th-century model of postwar economic growth. First, we will face a slowing of overall population growth by the middle of this century. Second, the coming years will see the beginning of a 30-year decline in the ratio of the working-age population to seniors. And finally, we will see a decline in the ratio of prime-age workers (ages 35-54) to the rest of the working-age population.

These demographic realities require our policy-makers and the media to acknowledge that the causes of this latest downturn lie in a set of long-run factors of which demography is the major — if not the only — cause. Good policy can come only from understanding that our current economic hardships are not a function of skills shortages, tweaks to training programs, tax credits for employers or better job-matching efforts. Though these can be part of a more ambitious solution to mitigate the worst effects of slower growth, the time for seeing solutions in these microeconomic miracles is long past. Only when we recognize the following inevitable and incontrovertible demographic facts will we be able to adjust the expectations of consumers, workers, entrepreneurs, corporations, trade unions and especially governments to the reality that in the coming years our growth potential will be substantially reduced.

Fact one: The first demographic reality is rather obvious to anyone witnessing the replacement of maternity wards with geriatric clinics in many of our hospitals: we stopped having children in numbers sufficient to maintain the replacement rate of the population after the mid-1960s. Without immigration, Canada's population would actually be facing a natural decline by 2026.

Even if current international migration rates remain at 2012 levels, Canada's population is projected to grow by only a minuscule 18.5 percent between 2016 and 2056. This is not an annualized population growth rate. It is the total growth of the population during that projected 40-year period. Contrast that with the doubling of the population that occurred between 1951 and 1991, when Canada's population went from 14 million to 28 million people, and you get a better handle on the true source of our underlying economic potential during the so-called golden era of postwar prosperity.

The idea that population growth — with its associated supply and demand side effects — drives economic expansion is not new. It was received wisdom among economists up until the early postwar period, when many regarded slowing population growth as one of the major contributing factors behind the long-run stagnation of the 1930s. Indeed, there were great fears that such stagnation would return soon after the end of the Second World War. The fundamental relationship between demography and economic growth was pointed out most notably by John Maynard Keynes, who in *General Theory* raised the now famous rhetorical question: "What will you do when you have built all the houses and roads, town halls and electric grids and water supplies and so forth which the stationary population of the future can be expected to require?"

And no less an authority than Nobel laureate J.R. Hicks noted in his 1939 *Value and Capital* that "one cannot repress the thought that perhaps the whole Industrial Revolution has been nothing else but a vast secular boom, largely induced by the unparalleled rise in population. If this is so, it would help explain why, as the wisest hold, it has been such a disappointing episode in human history." In

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the latter half of this quote, Hicks is acknowledging how much more could have been done to alleviate poverty and reduce unemployment when times were good if only policy-makers had truly grasped the significance of their once-in-a-generation demographic opportunity.

There is evidence that population change has had similar effects in 20th-century Canada. Between 1951 and 1991, the share of Canadian 15-64-year-olds grew at its fastest rate, and this coincided with the period of fastest economic growth and material improvements to standard of living in Canada's history. The question is, could we have done more to secure our future prospects during this near half-century window, given that our baby-boom-induced growth was also nearing an end?

To those who contend that our economic fortunes have shifted from domestic supply-demand conditions to export markets, consider this: Household purchases fuel \$6 out of every \$10 created in the aggregate economy. As households begin aging (and even reduce in number as deaths outpace births by mid-century), the Canadian economy will inevitably start to produce and consume less. At that point Canada's economy will have to rely on other levers, such as technological change, entrepreneurial effort and smarter management, to improve overall economic output. That's a tall order even in the best of times.

Fact two: Because of either legal restrictions, social expectations or the inevitability of our biology, our working years typically range from ages 15 to 64. Even if we play with the tail margins a little and assume that by mid-century people will work into their late 60s (say, to 68 or 70 instead of the average retirement age today, which is roughly 63), we get only a half decade of respite from declines in the size of our working-age population.

This is highly relevant to economic growth prospects. For almost two decades, economists have been poring over periods of transformational growth and so-called economic miracles in various countries (Japan, 1950-80; West Germany, 1960-90; South Korea, 1970-2000; China, 1990-2010) and in each case have found a striking correlation: the boom years coincide with sharp rises in the share of working-age people in the population. Those spikes were themselves rooted in dramatic rises and subsequent falls in birth rates that occurred many years earlier.

In other words, a baby boom provides the impetus for stimulating economic growth some 15 to 20 years beyond its end, when a country enters a period of rapidly declining dependency ratios. This "demographic dividend" gives rise to other positive conditions, such as the rise in the share of prime-age workers, between the ages of 35 and 54, the age range in which worker productivity — and hence wages, consumption and later savings — rises fastest and peaks.

The pattern occurs across nations. And no nation facing simultaneous declines in working-age and prime-age people has managed to produce growth rates above the smallest of single digits. That's where a growing sample of countries, from Japan to much of Western Europe, is quickly heading.

Fact three: As Japan and Western Europe show us, Canada's demographic transition to a smaller working-age population and older society is not unique. Japan is 20 years ahead of us; continental Europe about a decade or so. China, thanks to being in the fourth decade of a one-child policy, is keeping pace. The one outlier in the Western world is the United States, which, due to its at-replacement-level birth rates through the 1990s and 2000s, has forestalled the kind of fast-paced demographic maturation occurring in almost all its OECD counterparts.

Yet the company is no comfort. It means we cannot depend on the rest of the world for an endless supply of new immigrants to ease our shortfalls in labour and youth, because they too will be aging. Most migration decisions are made by individuals between the ages of 20 and 40, after which migration plummets. Moreover, because other countries (notably China) will soon be on the demand side of the migration equation, Canada will be competing for the same pool of immigrants. We will have to work harder as a nation to attract and keep the best and brightest from moving — or remaining — abroad.

The fact that most of the developed and soon-to-be-developed world is aging alongside us also means that we should expect less (not more, as current budgetary forecasts presume) foreign demand for our commodity sector, especially from China. China has had pronounced declines in birth rates since the 1980s. From 1990 to 2010, it benefited from a "double demographic dividend" as the increase in the share both of the working-age population and the prime-age workforce played out. But this period is ending and will be followed by a steep decline in both demographic age groups, starting in 2015 for the working-age share and followed by the prime-age share in 2020. Though personal income gains and growing purchasing power in China may help moderate some of the demographic drag, there is no getting around the fact that the engine of global output gains for the past two decades is switching to a slower track. Canadians need to adjust expectations in anticipation.

Demographic realities require a new but no less bold policy agenda built on realistic estimates of economic growth. Simply achieving any net positive gain in output may become a significant achievement in the 21st century (ask post-1990 Japan how hard it is to grow when you have more centenarians in the population than newborns). Indeed, even if a country has zero real economic growth but a declining population — as we see in Japan, Russia, Germany and soon Italy, Greece and others — per capita incomes can still rise. As long as declining population growth exceeds declining economic growth, standards of living will increase.

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Indeed, we need look no further than to the words of Keynes on the subject. Apart from pointing out the obvious effects of a fall in population on aggregate demand, in 1937 Keynes offered policy-makers a solution, suggesting that the worst effects brought about by demographic decline can be avoided with progressive policies and gradual (as opposed to short-term) adjustments in expectations. In "Some Economic Consequences of a Declining Population" he stated that if there emerges "a gradual evolution in our attitude towards accumulation, so that it shall be appropriate to the circumstances of a stationary or declining population, we shall be able, perhaps, to get the best of both worlds." This is the case for full employment of economic resources and a proper reordering of priorities away from growth at all costs toward other socially rewarding objectives.

Unlike Japan and most of Europe, we are in the fortunate position of still enjoying a relatively long 15-to-20-year window of baby-boomer transitions to retirement. That gives us the opportunity to be forward looking and prepare for the end of what has been a huge demographic windfall. Adjusting economic growth expectations downward to more accurately reflect 21st-century demographic realities, as well as enacting policies (like an affordable universal national daycare program) that encourage natural increases in fertility rates, could help Canada mitigate the inevitable economic decline that comes from falls in the share of working- and prime-age populations. Public and private investments that seek to improve health care and urban infrastructure (most boomers live in urban areas) and that shift retirement and consumption patterns to accommodate an older population can also bolster aggregate demand and extend the working life of our population. An agenda built on demographic realities would also take advantage of the historically low inflation and public borrowing rates to invest in needs that we know will grow in an aging society.

We have a history in Canada of embarking on bold paths. While the global economy was mired in stagflation during the 1970s, Canada outperformed almost every jurisdiction in the Western world, and its unemployment rate remained at or below 6 percent. Sadly, almost three decades of neglect has significantly eroded much of our capacity to meet the economic and social needs of the 21st century. The global growth slowdown, now reaching its fifth year, is only unmasking what has been at the root of our collective woes. But demography is not our entire destiny. We can still shape our future. And a new economic policy, built on adjusted expectations of growth in an era of aging boomers and labour force declines, is the place to start. ■