

In the coming decades, the population of the industrialized world is forecast to age dramatically. In the European Union (EU), before the 2004 enlargement, old-age dependency—defined as the ratio of people age sixty and older to people age 15 through 59—is projected to rise from 35 percent in 2000 to 66 percent in 2050. Within the European Union, aging is expected to be most pronounced in Germany, Italy, and Spain, where this ratio is forecast to rise to 71, 76, and 81 percent, respectively, by 2050. Aging trends are almost as severe in Japan, where old-age dependency is forecast to rise from 36 to 70 percent over the same period. In comparison, projected population trends in the United States look almost benign. The U.S. Census Bureau currently forecasts that the U.S. old-age dependency ratio will reach 47 percent in 2050, up from 27 percent in 2000.¹

The aging of the population has far-reaching implications for national pension systems.² In continental Europe, most state pension systems are unfunded (pay-as-you-go systems), and the benefits are generous. Dramatic increases in old-age dependency will necessitate a sharp rise in taxes if benefits are maintained largely intact. The Organization for Economic Cooperation and Development (OECD) predicts that France, for example, will have to spend 33 percent more, as a share of gross domestic product (GDP), than it does now. The income and payroll taxes that support Europe's large welfare states drive a deep wedge between a worker's take-home wage and the much higher costs of employing her.

Similarly, in many other countries, the simulated tax-contribution rates that would balance the old-age social security systems are significantly higher than the statutory rates. For example, Agar Brugiavini (1999) reports that this simulated rate reached 44 percent for Italy in 1991. Another dimension of the financial burden is the public debt (*The Economist*, 2002, p. 22): “On some estimates, by 2050, government debt could be equivalent to almost 100 percent of national income in America, 150 percent in the EU as a whole, and over 250 percent in Germany and France.” To put these staggering figures in perspective, recall that the European Union’s 1997 Stability and Growth Pact puts a 60 percent target ceiling on public debt as a percentage of national income!³

A comprehensive study conducted recently by Jagadeesh Gokhale and Kent Smetters (2003) takes into account all current liabilities and projected future expenditures of the U.S. government and compares them with all the revenues that the government can expect to collect in the future. The difference (in present value) is a staggering deficit of \$44 trillion—almost quadruple the U.S. gross national product (GNP).⁴ Major contributing factors to this deficit are old-age social security and medical care.

Similarly, widespread low-skill migration also strains the public finances of the welfare state. A recent estimate of the likely inflow of immigrants from the 2004 entrants to the EU (excluding Malta and Cyprus), Bulgaria and Romania, put the figure for gross inflows at 340,000 immigrants per year (see Hille and Straubhaar [2001]). Being relatively low earners, migrants are typically net beneficiaries of the welfare state—that is, they are expected to receive benefits in excess of the taxes (contributions) they pay. For instance, a recent study initiated by the U.S. National Research Council estimates that the overall net fiscal burden of migrants (age twenty through forty years, with less than high school education on arrival) is about \$60,000 to \$150,000 over their lifetimes (see Smith and Edmonston, 1997).

As the share of elderly people in the population rises when the population ages, their political clout would be expected to strengthen the pro-welfare-state coalition. Similarly, this coalition would be expected to gain more political power as more low-skill migrants are naturalized. Thus, aging and migration seem to tilt the political power balance in the direction of boosting the welfare state, imposing a growing burden on the existing workforce. However, the theme that is put forth in this book is quite the opposite: aging and low-skill migration generate indirectly political processes that trim rather than boost the size of the welfare state. We reach this somewhat surprising conclusion by carefully working through a conventional model of a political-economy determination of the welfare state. We also provide some supportive empirical evidence from the European Union and the United States for this general theme.

But what if the welfare state tries to rely on capital taxes to finance the social benefits that it provides? Recall that the old derive most of their income from capital because they retired from work. At first, it may seem that as the share of the old in an aging population rises, an attempt to rely on capital taxes would face stiffer political resistance. However, after carefully scrutinizing this hypothesis, we come to an unexpected conclusion: aging plausibly tilts the political-power balance in favor of a larger capital-financed welfare state. We provide supportive empirical evidence from the European Union for this conclusion.

Is this conclusion relevant? Not entirely. After all, aging is not the only process witnessed nowadays. Globalization across various economies is another universal phenomenon that must be reckoned with.⁵ Can high capital taxes survive international tax competition brought about by such globalization? Evidently, in the absence of worldwide tax coordination and enforcement, the answer is no⁶ (*The Economist*, 1997, pp. 17–18):

Globalization is a tax problem for three reasons. First, firms have more freedom over where to locate. . . . This will make it harder for a country to tax [a business] much more heavily than its competitors. . . . Second, globalization makes it hard to decide where a company should pay tax, regardless of where it is based. . . . This gives them [the companies] plenty of scope to reduce tax bills by shifting operations around or by crafting transfer-pricing. . . . [Third], globalization . . . nibbles away at the edges of taxes on individuals. It is harder to tax personal income because skilled professional workers are more mobile than they were two decades ago.

The 2004 enlargement of the EU gives a stark example for the underlying downward pressure of tax competition. The new entrants have significantly lower corporate tax rates (zero in Estonia, for instance) than the original EU-15 countries (40% in Germany). It seems inevitable that the high-tax countries will have to succumb to the forces of tax competition and sharply cut their corporate tax rates.

Thus, we apply our political-economy model again to assess the forces of globalization. The combined forces of aging, low-skill migration, and globalization seem to be too strong for the welfare state to survive in its present size.

Indeed, most of the large industrialized economies have embarked in recent years on a track of trimming the generosity of their pension and other welfare-state programs. The general rules are quite straightforward: raise the retirement age, and curtail benefits. Following the report of the bipartisan Greenspan Committee (January 1983), the United States has gradually raised the retirement age so that it will reach sixty-seven in the year 2027.⁷ Similarly but much later, France decided in July 2003 to require public-sector workers (about one-fourth of the French workforce) to contribute to the state pension system for forty years instead of 37.5 years. Germany, which has already raised its retirement age from sixty-three to sixty-five, recently decided to raise it further to sixty-seven between 2011 and 2035. With respect to curtailing benefits, this is usually accomplished by abandoning wage indexation in favor

of price indexation (or by subjecting benefits to income taxation). Naturally, wages typically rise faster than prices (due mostly to productivity increases) so that each new cohort of retirees gets a starting benefit level with greater purchasing power than the previous cohort's starting benefit level. Thus, price indexation is less generous than wage indexation to pensioners (see Cogan and Mitchell, 2003, for the United States and Thode, 2003, for Europe). With respect to tax increases, currently in the United States only the first \$87,900 of annual wages is subject to the social security tax. The social security tax, as it stands now, is regressive. At the center of the public debate is correcting this aspect as a way to strengthen the social security trust fund, to pay benefits once the baby boomers retire. A favored solution among conservatives is to allow individuals to invest part or all of the tax they would have to pay in private investment accounts instead.

As we examine the decline of the welfare state from a political-economy perspective, we uncover in this book how the processes of aging and globalization (through migration, capital mobility, and international tax competition) team up to change the political-power balance and generate public support for reforming the welfare state.