Immigration is no way to fund an ageing population

By Martin Feldstein

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Increasing life expectancy and declining birth rates are leading to big fiscal problems throughout Europe. Without fundamental changes, the rise in the relative number of older people and the slower growth of the labour force will substantially raise government outlays for pensions and healthcare.

A common reaction to this problem is a call for increased immigration. The taxes paid by these new workers would help to finance the benefits of the aged. Although there is general discomfort with some of the social consequences of increased immigration, many have concluded that increased immigration is the only way to avoid a big increase in tax rates or a cut in benefits.

However, a little analysis shows that even a very large increase in immigration would have only a very small impact on the revenue needed to deal with the ageing population. Much of the tax paid by the new workers would be needed to finance the government benefits that they and their families consume — especially for healthcare and education. It is necessary, therefore, to ask how much net revenue is created by immigration and how that additional revenue relates to the increased number of immigrants.

Here are some simple calculations for Spain. The analysis would be much the same for other leading European countries. UN projections show that the Spanish population will remain essentially unchanged over the next 50 years while the number of working-age people per retiree will fall from 4.5 today to fewer than two in 2050. With more retirees and fewer workers, the cost of the government pension programme is projected to rise from 8.4 per cent of gross domestic product now to 15.7 per cent in 2050.

There is much talk in Spain about the possible fiscal benefits of increased immigration. Consider the potential impact of a one-time inflow to Spain of an additional 2m new workers, equivalent to a 10 per cent increase in Spain''s labour force. If this increased immigration were limited just to those who enter employment, that would be equivalent to a 54 per cent increase in the size of the foreign population in Spain. Adding their dependants would make the increase even greater.

A rise of more than 50 per cent in the number of foreign-born in Spain could have a big impact on social and political conditions. What would it mean in terms of additional net tax revenue? Since immigrants generally earn less than native Spanish workers, a rise in the number of foreign-born workers equal to 10 per cent of the labour force would raise total labour compensation by about 8 per cent or less. Since wages are only about 75 per cent of total GDP, a rise of 8 per cent in gross wages would be equivalent to a 6 per cent rise in GDP.

At least half of the additional 6 per cent of GDP would be consumed by the immigrants and their families. An additional fraction of the extra GDP would be used by the government to finance benefits for them. So the net additional revenue available to pay benefits of the original Spanish population would be only about 2 per cent of GDP or less.

This 2 per cent of GDP is very small relative to the future fiscal problem. Government spending on pensions and healthcare is now 14 per cent of GDP and is projected to rise by 2050 to 24 per cent. The 2 per cent of GDP in net revenue that would result from a 50-plus per cent rise in the foreign-born population would therefore finance less than 10 per cent of the projected pension and health benefits.

The increased immigration would, moreover, provide only temporary relief to a permanent fiscal problem. The ageing of the Spanish population and the slower growth of the labour force will persist in the long term. The extra immigrants in the next decade would provide net revenue temporarily but would eventually receive retirement pensions and healthcare that absorb the extra taxes that they pay. It would take a continuing increase in the number of immigrants to achieve even the relatively small additional revenue that I have described.

Whether or not this use of increased immigration to raise additional short- term revenue is a favourable trade-off is a decision that every country must make for itself. The US and Canada, with their histories of immigration and demographic heterogeneity, may find continued immigration less of a problem than many European countries.

There may be many reasons to favour increased immigration. The new workers would enjoy an improved standard of living for themselves and their children. They and their descendants may contribute to their new countries in many ways. But it would be wrong to advocate increased immigration as necessary to deal with the fiscal consequences of an ageing population, or as a means to avoid large future tax increases or benefit reductions.

The only way to avoid either significantly higher tax rates or substantially lower retirement incomes is to shift from a pure tax-financed system to one that supplements the tax-financed benefits with increased saving and investment. It is not too late to begin a transition from a pure pay-as-you-go system to a mixed system, but it will be progressively more difficult to do so as the population ages.

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