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Volume Title: The Economic Consequences of Demographic Change in East Asia, NBER-EASE Volume 19

Volume Author/Editor: Takatoshi Ito and Andrew Rose, editors

Volume Publisher: University of Chicago Press

Volume ISBN: 0-226-38685-6
ISBN13: 978-0-226-38685-0

Volume URL: http://www.nber.org/books/ito_08-2

Conference Date: June 19-21, 2008

Publication Date: August 2010

Chapter Title: The Demographic Transition and Economic Growth in the Pacific Rim

Chapter Authors: Andrew Mason, Ronald Lee, Sang-Hyop Lee

Chapter URL: <http://www.nber.org/chapters/c8145>

Chapter pages in book: (19 - 55)

The Demographic Transition and Economic Growth in the Pacific Rim

Andrew Mason, Ronald Lee, and Sang-Hyop Lee

Asian countries, like other countries around the world, are in the midst of a systematic series of demographic changes known as the demographic transition, driven by declining fertility and mortality. In addition to declining fertility and mortality, the demographic transition involves changes in population size, growth rate and age distribution. Populations start and end with similar total dependency ratios, but before the transition the dependents are primarily children and at the end they are primarily the elderly.

Although children and the elderly are both referred to as *dependents*, they differ in a very important way. Children rely almost exclusively on transfers to fill the large gap between what they consume and what they earn. The elderly, in contrast, rely on a combination of transfers and life-cycle saving to fill the gap between what they consume and what they earn. Thus, aging—and the anticipation of aging—can lead to an enormous increase in transfers and/or assets.

For this reason, the shift in the structure of dependency from children to the elderly has large potential consequences for the accumulation of physical capital and human capital, as we shall consider in some detail as our

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This chapter was prepared for the East Asian Seminar on Economics (EASE), held in Seoul, Korea, June 19–21, 2008. Research was supported in part by two grants from the National Institutes of Health, NIA R01-AG025488 and NIA R37-AG025247, and by MEXT Academic Frontier Project (2006–2010). Diana Wongkaren provided excellent assistance with many of the calculations. This chapter draws on Mason, Lee, and Lee (2008), prepared for the Asian Development Bank.

main theme. Closely related to this theme is the important role of institutional arrangements governing intergenerational transfers which interact with changing population age distributions and motivation for old-age support. Depending on these institutions, population aging may either drive a vast accumulation of implicit debt in public transfer systems for health and retirement, or it may generate a greater accumulation of assets raising incomes and perhaps labor productivity depending on whether assets are accumulated domestically or abroad.

This is not the place to discuss the causes of changing fertility and mortality, but it will be helpful to begin by considering the general form of changes over a classic demographic transition, as done in figure 1.1. The figure shows actual historical and projected data for India from 1890 to 2100, along with simulated outcomes based on parameterized curves for fertility and mortality. The purpose of the simulated outcomes is to emphasize the systematic and regular aspect of the changes shown which result from the broad qualitative features of the transition and are not special to the Indian context. This stylized transition will then serve as a template for placing the transitions in Asia into a broader context.

We see in figure 1.1 that the mortality decline in India began early in the twentieth century while fertility did not begin to decline until around 1960. A lag of this sort between the inception of mortality and fertility decline is typical of demographic transitions, although the length of the lag is often shorter and there have been some exceptions. During the lag period the rate of population growth accelerates, here from less than a half percent per year to over 2 percent per year, and then decelerates after fertility begins its decline. Population size rises markedly, here by a factor of five or six from 1900 to the present, with substantially more increase yet to come.

The last panel in the figure summarizes the changes in the age distributions by plotting the youth and old age dependency ratios, defined conventionally as the ratio of the populations aged zero to fourteen years, or sixty-five and over, to the working age population aged fifteen to sixty-five. The first notable change is the rise in the child dependency ratio as mortality declines while fertility remains high. As mortality declines, more children survive raising the ratio, much as would happen if fertility were to rise. The increase is evidently quite substantial. Only when fertility begins to decline after 1960 does the youth dependency and total dependency begin to fall, and this decline continues for fifty to sixty years. This phase of declining total dependency corresponds to a rising proportion of the population in the working ages that raises per capita income, other things equal, as we will discuss at length later. This boost to per capita income is called the first demographic dividend. Around 2015 this phase comes to an end as rising old age dependency first offsets and then outweighs the decline in child dependency. Population aging now raises total dependency, which continues its ascent until 2060 or so in this simulation, which assumes that fertility declines until

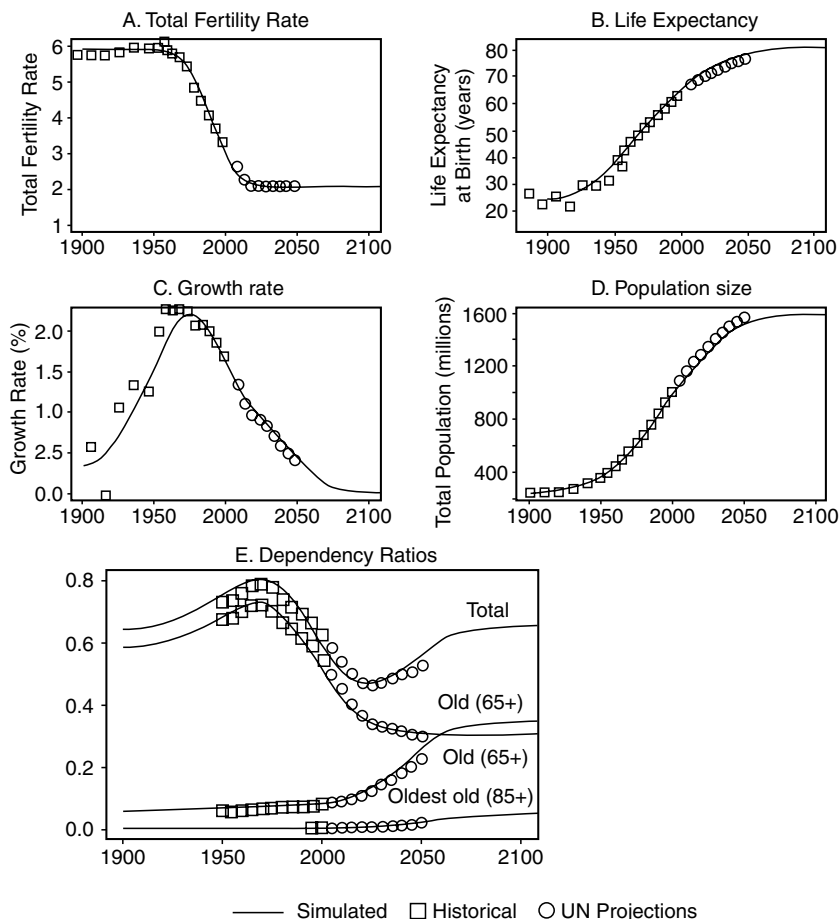


Fig. 1.1 A classic demographic transition, India 1890 to 2100, historical, projected and simulated

Notes: The simulation is based on a fertility transition in which the total fertility rate follows a quintic path declining from 5.9 in 1953 to 2.1 in 2025 and a mortality transition in which a Lee-Carter mortality index follows a sinusoidal path as $e(0)$ increases from 24.7 in 1900 to 80.0 in 2100. Actual India data for the period 1891–1901 to 1941–1951 are taken from Bhat (1989). Actual and projected data are taken from UN (2001).

replacement level at 2.1 births per woman and assumes that mortality decline ceases when a life expectancy of eighty is reached. It is entirely possible that fertility might continue to decline to the lower levels seen throughout much of East Asia, and that life expectancy may continue to rise, so that population aging continues to rise to higher levels more similar to those expected for Japan and Korea.

We will be considering some of the consequences of this series of demo-

graphic changes for economic growth. To summarize, the first dividend stage presents an opportunity to convert the transient gains into long term progress through investment. Low and declining fertility has been widely associated with increased investments in human capital, which is one such investment. In various ways, the demographic changes driving the transition should greatly increase the aggregate demand for wealth, raising saving rates and leading to increased capital intensity in the aggregate economy. However, this response is not automatic. To the extent that old age consumption is funded through intergenerational transfers—either private, through the family, or public, through pension and health care systems—this boost to capital accumulation will be diminished. Each of these points provides leverage for policy intervention.

Whether countries will rely on transfers or assets to fund the needs of a growing elderly population will depend on policies, culture, and institutions. As compared with European and Latin American countries, Asia has relied less on public Pay-As-You-Go (PAYGO) pension programs, although the situation is somewhat different in Japan (Ogawa, Mason, Chawla, and Matsukura, chap. 4 in this volume). But health care for the elderly is a large and increasing cost that is often heavily subsidized by the public sector. Moreover, familial transfers to the elderly may be very important in Asia, and these are similar to PAYGO pension programs in some important respects. Thus, aging in Asia may lead to large implicit debts that are shared by taxpayers and the adult children of elderly.

If the needs of a growing elderly population are met through greater reliance on life-cycle saving, population aging will lead to an increase both in assets and income. Previous studies and the subsequent analysis show that through this mechanism, changes in age structure can lead to a second demographic dividend—higher standards of living that persist long after the favorable effects of the first dividend have ended.

The economic effects are not confined by national borders. Divergent demographic trends in the region are likely to generate international capital flows from those countries experiencing the most rapid increase in saving rates to countries that are aging more slowly (but have rapidly growing labor forces).

Some countries in Asia have experienced very rapid transitions. Japan, Korea, China and some members of the Association of Southeast Asian Nations (ASEAN) are examples of countries in which changes in age structure are particularly dramatic. Moreover, the timing of the demographic transitions varies across the region. Japan is furthest along, while India and some ASEAN countries are relatively early in the transition. As a consequence, the impact of age structure for any particular decade varies considerably from country to country. Moreover, the differences in the transition create the demographic divergence that leads to differences in factor ratios with implications for trade, foreign investment, and immigration.

The remainder of this chapter addresses these issues in more detail. In keeping with the approach of this study, we contrast the experiences and prospects in Japan, Korea, India, ASEAN, and greater China—consisting of the People’s Republic of China (PRC), Hong Kong, and Taiwan (also referred to as “China+” in the tables and figures). Demographic trends are discussed in section 1.1.

The economic implications of demographic changes are addressed in section 1.2 following the broad outlines discussed in the introduction. We discuss research on the relationship between population and economics and we present a new analysis of how demographic change will influence key macroeconomic variables in ASEAN, greater China, India, Japan, and Korea.

1.1 Demographic Change in Asia

1.1.1 Demographic Transition and Population Growth

In the middle of the twentieth century birth rates were high in every Asian country but Japan. Death rates had begun to decline in a number of Asian countries, leading to more rapid population growth and to increasing proportions of children because the declines in mortality were concentrated at young ages. In terms of the transition shown in figure 1.1, some of these countries in 1950 were in the late stages of rising youth dependency, and others were in the stage of fertility decline and the first dividend.

Except in Japan, birth rates were generally around forty births per 1,000 population between 1950 and 1955, while death rates were as low as ten per 1,000 population in Japan, and as high as twenty-five per 1,000 in China and India (United Nations 2007). The rate of natural increase (RNI), the difference between the birth rate and the death rate, is the rate at which the population would grow with no net immigration. The RNI was high between 1950 and 1955, varying from around 20 to 25; that is, 2 to 2.5 percent per year (see figure 1.2).

During the next fifty years death rates declined very substantially. By the period from 2000 to 2005, the death rate was near or below ten per 1,000 in every country, while birth rates also declined. In some countries the birth rate declined by more than the death rate, slowing population growth, but growth rates remained near 2 percent per year or more in many countries between 1975 and 1980. Between 2000 and 2005, however, further declines in the birth rate are apparent in figure 1.2. In Japan, births and deaths were nearly equal during this period. In other countries, population growth ranged from near 0 to almost 2 percent per year.

Figure 1.2 also shows United Nations (UN) medium projections through 2050, which assume that in countries with very low fertility—for example, Japan, Korea, Taiwan, Hong Kong, China, and Singapore—it will rise in the future, and that in countries with relatively high fertility, such as the

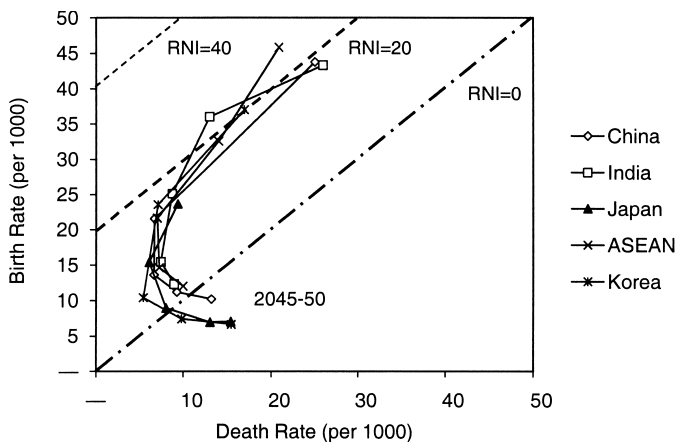


Fig. 1.2 Birth rates and death rates for ASEAN and selected Asian countries, 1950–1955, 1975–1980, 2000–2005, 2025–2030, and 2045–2050

Source: Based on data from United Nations Population Division (2007).

Notes: The RNI is rate of natural increase per 1,000 persons. ASEAN is a simple average of country values.

Philippines and India, it will decline further (UN 2007). The implied variation in population growth rates lies between minus and plus 1 percent per year. Death rates will rise moderately in many countries as their populations age.

The broad outlines of the demographic transition are similar across Asia, but speed and timing vary. The transition began first in Japan, then in other East and Southeast Asian countries, and more recently in some ASEAN countries and India. It has been very rapid in Korea and China as compared with countries elsewhere in Asia, other parts of the developing world, or in Western countries.

Population growth rates are reported for ASEAN, greater China, India, Japan, and Korea in table 1.1. Between 2000 and 2005, Japan's population growth was almost zero. The PRC and Taiwan had population growth rates well below 1 percent per annum. Among the ASEAN countries, only Thailand and Myanmar were growing at less than 1 percent per annum. Two Asian countries had growth rates that would have been well below 10 were it not for substantial rates of immigration—Singapore and Hong Kong, China. The population growth rates between the years 2000 and 2005 of other ASEAN countries vary from 1.3 percent in Indonesia to 2.3 percent in Brunei. India's growth rate is moderately high at 1.6 percent per year for the period from 2000 to 2005.

Because of differences in population growth rates, the populations of ASEAN and India are increasing relative to China, Japan, and Korea.

Table 1.1 Population growth rates (%), 1950–2050

	1950–1955	1975–1980	2000–2005	2025–2010	2045–2050
ASEAN	2.10	2.14	1.39	0.69	0.19
Brunei Darussalam	5.56	3.65	2.29	1.28	0.78
Cambodia	2.15	-1.01	1.76	1.26	0.77
Indonesia	1.67	2.20	1.31	0.61	0.10
Lao PDR	2.73	1.30	1.62	1.08	0.50
Malaysia	2.72	2.32	1.95	0.87	0.41
Myanmar	1.96	2.19	0.89	0.47	0.01
Philippines	2.99	2.70	2.08	1.09	0.50
Singapore	4.90	1.30	1.49	0.38	-0.37
Thailand	2.84	2.08	0.76	0.12	-0.27
Viet Nam	1.87	1.99	1.45	0.75	0.21
CHINA +	1.90	1.49	0.67	0.17	-0.32
China, People's Rep. of	1.87	1.48	0.67	0.17	-0.32
Hong Kong, China	4.64	2.73	1.15	0.54	0.11
Taiwan	3.63	1.95	0.54	-0.06	-0.89
India	1.73	2.30	1.62	0.79	0.32
Japan	1.43	0.93	0.14	-0.56	-0.78
Korea, Rep. of	2.55	1.55	0.46	-0.25	-0.89

Source: United Nations Population Prospects, 2006. Taiwan: Council for Economic Planning and Development, China, "Population Projections for Taiwan Areas: 2008–2056."

Notes: Values for ASEAN and China + are for the combined populations, not simple average across the group members.

India's population is projected to exceed greater China's population by 2030 (figures 1.3 and 1.4).

1.1.2 Population Age Structure

Population age structure changes in a very predictable way over the demographic transition. Early in the transition, the percent of children increases as infant and child mortality declines, as we saw in figure 1.1. Later, the child share declines and the percent in the working ages increases. In the final stages, the share of the working age population declines while the share at old ages increases.

The rise in the child share of the population occurred in ASEAN, China, and India between 1950 and 1975. In ASEAN, for example, the percent under age twenty increased from 49.0 percent to 53.0 percent (table 1.2). The decline in the proportion under age twenty has been extraordinarily rapid in some Asian countries such as greater China and Korea. In 1975, just over 50 percent of Korea's population consisted of children under the age of twenty. The projected value for 2025 is 16.8 percent.

The low level reflects the fact that Korea has among the lowest total fertility rates of any country in the world. Other countries in which the child share

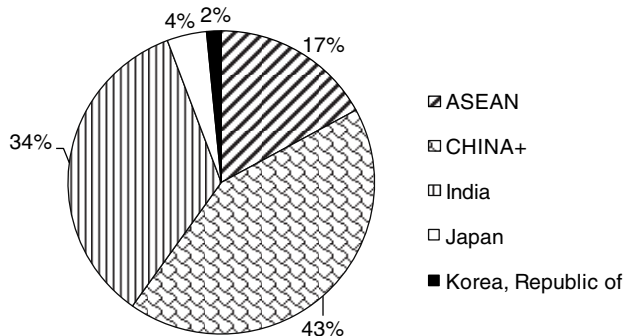


Fig. 1.3 Regional distribution of population for major country groupings, 2000

Source: See text.

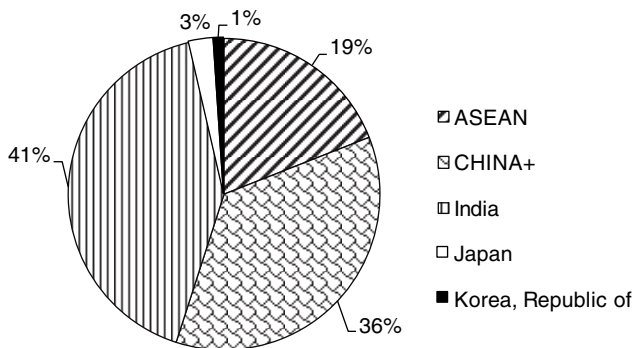


Fig. 1.4 Regional distribution of population for major country groupings, 2050

Source: See text.

is expected to drop to very low levels over the coming decades are Singapore, China, Hong Kong, China, Taiwan, and Japan.

The percentage of the population in the working ages, defined here as those between ages twenty and sixty-four inclusive, increased between 1975 and 2000 in every member of greater China, India, Japan, Korea, and every ASEAN country but Cambodia and Lao People’s Democratic Republic (PDR). The percentage reached 60 percent or more in Singapore, Thailand, greater China, Japan, and Korea. These countries are at or near the peak and will not experience any substantial change in the share of their working-age population between 2000 and 2025. Japan is an exception and it will experience a significant decline in the working-age share and size (table 1.3).

The largest increases in the working-age populations are occurring in ASEAN and India. Between 2000 and 2025 the working-age share will increase 7 percentage points in ASEAN and almost 9 percentage points in

Table 1.2 Percentage of population under age twenty, 1950–2050

	1950	1975	2000	2025	2050
ASEAN	49.0	53.0	41.8	30.3	24.1
Brunei Darussalam	46.0	50.5	40.0	29.6	24.7
Cambodia	52.6	52.8	54.3	39.0	29.4
Indonesia	50.0	52.3	40.6	28.9	23.6
Lao PDR	49.5	54.3	54.1	38.7	26.9
Malaysia	50.4	53.2	43.6	31.7	24.5
Myanmar	44.3	51.7	40.4	27.9	23.0
Philippines	53.7	55.4	48.4	37.3	26.6
Singapore	50.0	45.7	28.1	16.4	15.5
Thailand	53.0	53.3	32.1	24.4	21.4
Viet Nam	41.9	53.8	44.1	29.4	23.1
CHINA +	43.4	48.8	32.8	23.7	20.5
China, People's Rep. of	43.3	48.9	32.9	23.8	20.5
Hong Kong, China	41.2	42.3	23.7	15.7	15.2
Taiwan	52.5	47.4	29.7	20.6	18.6
India	47.7	50.6	45.1	33.3	24.4
Japan	45.8	31.5	20.5	15.5	15.3
Korea, Rep. of	51.7	50.3	28.9	16.8	14.2

Source: United Nations Population Prospects, 2006. Taiwan: Council for Economic Planning and Development, "Population Projections for Taiwan Areas: 2008–2056."

Table 1.3 Percentage of population aged twenty to sixty-four, 1950–2050

	1950	1975	2000	2025	2050
ASEAN	47.2	43.4	53.3	60.6	58.3
Brunei Darussalam	49.2	46.0	57.0	62.8	60.5
Cambodia	44.7	44.4	42.7	56.0	60.9
Indonesia	46.1	44.4	54.5	62.1	57.8
Lao PDR	48.4	42.7	42.5	56.5	62.5
Malaysia	44.6	43.0	52.5	59.6	59.2
Myanmar	52.3	44.0	54.1	62.9	58.1
Philippines	42.7	41.6	48.0	56.3	60.4
Singapore	47.6	50.1	64.8	60.8	51.7
Thailand	43.8	43.1	61.2	60.7	55.3
Viet Nam	53.9	41.3	50.5	61.9	57.7
CHINA +	52.1	46.8	60.3	62.5	55.7
China, People's Rep. of	52.2	46.7	60.3	62.5	55.8
Hong Kong, China	56.3	52.3	65.4	62.6	52.1
Taiwan	45.0	49.2	62.1	62.3	55.5
India	49.2	46.0	50.3	58.9	61.1
Japan	49.3	60.6	62.2	55.1	47.0
Korea, Rep. of	45.2	46.1	63.7	63.6	50.6

Source: United Nations Population Prospects, 2006. Taiwan: Council for Economic Planning and Development, "Population Projections for Taiwan Areas: 2008–2056."

India. Within ASEAN, the gains will be dramatic in Cambodia (13 points), Lao PDR (14 points), and Vietnam (11 points).

Population aging is coming very rapidly to the countries of East Asia. Japan, with the percentage of people aged sixty-five and older increasing from 17.2 in 2000 to 29.5 in 2025, has the oldest population in the world. The percentage sixty-five and older will double between 2000 and 2025 in greater China, from 6.9 percent to 13.8 percent, and in Thailand, from 6.7 percent to 14.9 percent. Even more rapid aging will occur in Singapore and Korea where 22.8 percent and 19.6 percent of the populations are projected to be sixty-five and older by 2025 (table 1.4).

Elsewhere, the share of the population aged sixty-five and older will not reach 10 percent until after 2025. By 2050, however, the ASEAN share is projected to reach 17.7 percent and India's share 14.5 percent. At first glance demographic characteristics in 2050 may appear to be remote to the economic concerns of today. Nothing could be further from the truth, however. The elderly population of 2050 is the working population of today. The prospect of old-age and retirement will influence current behavior—with respect to saving, for example. Moreover, policies implemented by governments today will determine the success with which the working population of today can adequately prepare for an extended period of old age, and the ways in which they prepare.

Table 1.4 Percentage of population sixty-five and older, 1950–2050

	1950	1975	2000	2025	2050
ASEAN	3.8	3.6	4.9	9.1	17.7
Brunei Darussalam	4.9	3.5	2.9	7.6	14.8
Cambodia	2.7	2.8	2.9	5.0	9.8
Indonesia	4.0	3.3	4.9	9.0	18.6
Lao PDR	2.2	3.1	3.4	4.7	10.6
Malaysia	5.1	3.7	3.9	8.7	16.3
Myanmar	3.4	4.2	5.5	9.3	18.9
Philippines	3.6	3.1	3.5	6.5	12.9
Singapore	2.4	4.1	7.2	22.8	32.8
Thailand	3.2	3.6	6.7	14.9	23.3
Viet Nam	4.2	4.9	5.5	8.7	19.2
CHINA +	4.4	4.4	6.9	13.8	23.8
China, People's Rep. of	4.5	4.4	6.8	13.7	23.7
Hong Kong, China	2.5	5.4	11.0	21.7	32.6
Taiwan	2.4	3.4	8.1	17.2	25.9
India	3.1	3.4	4.6	7.7	14.5
Japan	4.9	7.9	17.2	29.5	37.7
Korea, Rep. of	3.0	3.6	7.4	19.6	35.1

Source: United Nations Population Prospects, 2006. Taiwan: Council for Economic Planning and Development, "Population Projections for Taiwan Areas: 2008–2056."

1.1.3 Role of Immigration

Immigration plays a relatively modest role in determining population growth and age structure in Asia as compared with births and deaths. Immigrant flows are heavily regulated and limited—mostly by receiving countries. With a few exceptions, the countries of Asia have not opened their borders to immigrants, and there is little to suggest that will change soon irrespective of economic or demographic pressures that may emerge in the coming years.¹

Asia's largest countries are net sending countries. Net migration from India, China, Indonesia, and the Philippines has consistently been negative (outward). The rate of net migration is quite small in India and China and, thus, has little effect on the size of their national populations. Between 2000 and 2005, for example, China lost 0.03 percent per year of its population, and India lost 0.02 percent per year of its population due to immigration. The rate of out-migration from Indonesia and the Philippines is relatively great as compared with most other countries, at -0.09 percent per year in Indonesia and -0.22 percent per year in the Philippines. But even in these two countries, the impact on the growth of the population in any year is modest (table 1.5).

These four countries do contribute relatively large shares to global migration flows because their populations are so large. For 2000 to 2005 the annual net numbers of immigrants were 390,000 from China, 280,000 from India, 200,000 from Indonesia, and 180,000 from the Philippines. Combined, they contributed just over one million net immigrants a year to the global flow. This compares with a total outflow of 2.6 million per year from the less developed regions to the more developed regions of the world during the same period.

For the most part these immigrants were not moving to other Asian countries. Total net inflows, including immigrants from outside Asia, were approximately 100,000 immigrants per year to the net receiving countries of ASEAN, 60,000 per year for Hong Kong, and only 54,000 per year for Japan.

For a few countries in the region migration is significant relative to their domestic populations. The Philippines has sustained immigrant outflows at a significant level for many years. As a consequence, remittances are currently about 13 percent of gross domestic product (GDP). Hong Kong, Brunei, and Singapore have actively encouraged immigration to their countries. Over 40 percent of Hong Kong's and Singapore's populations, and one-third of Brunei's population are immigrants.

Japan falls at the other end of the immigration spectrum with its relatively closed borders. Given the high wages of its workers relative to those

1. Estimates presented in this section are all drawn from two sources: United Nations (2006, 2007).

Table 1.5 Annual net migration rate (net migrants per thousand population)

	1950– 1955	1955– 1960	1960– 1965	1965– 1970	1970– 1975	1975– 1980	1980– 1985	1985– 1990	1990– 1995	1995– 2000	2000– 2005
ASEAN											
Brunei Darussalam	18.0	13.6	11.0	17.3	13.6	10.9	2.5	4.7	2.6	2.2	2.0
Cambodia	-0.0	-0.0	-0.0	-0.1	-12.8	-3.6	—	3.4	2.8	1.3	0.2
Indonesia	-0.0	-0.0	-0.1	-0.1	-0.0	-0.1	-0.1	-0.5	-0.8	-0.9	-0.9
Lao PDR	-0.0	0.0	0.0	0.0	0.0	-13.2	-2.1	0.0	-1.4	-3.5	-4.2
Malaysia	1.9	1.3	1.0	-1.5	-1.6	1.5	-0.3	1.8	3.0	4.5	1.2
Myanmar	—	—	—	—	—	—	-0.3	-0.7	-0.6	0.0	-0.4
Philippines	—	—	—	-0.7	-1.1	-1.6	-3.0	-2.7	-2.8	-2.5	-2.2
Singapore	15.0	11.6	1.1	0.4	1.3	0.9	11.7	9.7	15.4	19.6	9.6
Thailand	—	—	—	—	0.4	0.9	0.0	0.0	0.6	1.7	0.7
Viet Nam	—	—	—	—	—	-3.2	-0.9	-0.8	-0.7	-0.5	-0.5
China + China	-0.1	-0.1	-0.2	—	-0.2	-0.1	-0.0	-0.1	-0.2	-0.2	-0.3
China, Hong Kong SAR	17.4	13.0	9.5	-5.0	7.3	15.1	5.1	0.9	10.1	9.3	8.7
Taiwan	—	—	0.1	-0.0	-0.5	-0.4	-0.4	-0.3	-0.2	-0.2	-0.2
Japan	-0.0	-0.1	-0.0	-0.1	-0.1	-0.0	0.0	0.3	0.4	0.4	0.4
Korea, Rep. of	5.4	-0.0	-0.2	-0.2	-0.8	-1.0	-1.0	-0.9	-0.5	-0.3	-0.3
India	-0.0	-0.0	-0.0	-0.1	-0.1	-0.1	-0.1	-0.1	-0.2	-0.3	-0.2

Sources: UN 2007 World Population Prospects; Taiwan-Fuchien Demographic Fact Book, various years.

Note: Dashed cells indicate that data not available.

of its neighbors and the declining numbers in the working ages, one might well expect substantial immigration into Japan. Currently about two million immigrants live in Japan or, 1.6 percent of its population. This compares with an immigrant share for the more developed regions of the world of 9.5 percent and a figure of 12.9 percent for the U.S. population.

1.2 Economic and Social Implications

Demographic change in general, and the demographic transition in particular, has three broad kinds of economic consequence. First, the support ratio is altered, such that output produced by the working age population must be shared with differing numbers of children and elderly. During the phase of the transition when fertility is falling, rising support ratios boost the growth rate of per capita income or consumption, other things equal, and this is called the “first demographic dividend.” Second, the process of capital accumulation is affected, since both longer life and fewer children lead to higher savings in preparation for retirement, while population aging increases the relative number of wealth-holding elderly in the population. The combined effect raises the aggregate capital-labor ratio and therefore labor productivity, generating the so-called “second demographic dividend.” However, the extent to which this happens depends on the extent to which income of the elderly is derived from public or familial transfers, rather than private saving, and the degree of openness of the economy influences the extent to which labor productivity is raised domestically or in other countries. In any event, although the capital-labor ratio increases, the rate of saving out of GDP may decrease as populations age. Third, both lower fertility and higher survival lead to increased human capital investment per child. While the support ratio falls, rises, and then falls again over the demographic transition, the accumulation of physical and human capital per capita rises permanently, at least once fertility begins to fall. We will consider each of these three kinds of effects in more detail, drawing on information about the economic life cycle for various Asian countries from the National Transfer Accounts (NTA) project.²

Population change has important implications for individual countries, but also for regional economies and regional integration. First, national and regional populations are growing at very different rates, with India and ASEAN increasing relative to greater China, Japan, and Korea. Inevitably changes in the size of populations influence the size of regional economies. More people means more consumers, more workers, and more savers and

2. The National Transfer Accounts (NTA) project uses new methods to construct measures of the flows of resources across ages through the public sector and through the private sector, including within families. Estimates are consistent with National Income and Product Accounts. Currently, twenty-eight countries in Asia, the Americas, Europe, and Africa are participating in the project. More information is available at www.ntaccounts.org.

investors. The extent to which larger populations result in greater aggregate consumption, aggregate earners, aggregate saving, and investment will be influenced by a host of factors beyond the size of national and regional populations. Nonetheless, population size is an important consideration.

National and regional differences in the growth of consumer demand, labor forces, and aggregate saving and investment will influence international flows of workers, goods and services, and capital. The classic approach to this issue is that international flows arise in response to international differences in relative factor endowments (Deardorff 1987). In this context a key issue is whether divergent population trends lead to divergent factor endowments.

The impact of divergent factor endowments will depend to a great extent on the institutional context. Divergent capital-labor ratios can lead to immigration, capital flows, and/or trade depending on the policy context. As should be clear from the brief description in the preceding section, international labor flows are relatively limited in Asia. In the absence of radical changes in policy, population aging is more likely to influence international capital flows and trade than immigration.

1.2.1 The Economic Life Cycle

The economic life cycle is fundamental to understanding the relationship between population age structure and the economy. In all populations there are extended periods of dependency. Children consume more resources than they produce through their own labor and must rely heavily on intergenerational transfers from their parents (and grandparents), and from taxpayers. The elderly also consume more than they produce. They rely on intergenerational familial and public transfers, but also on personal assets to fill the gap between what they consume and what they produce through their own labors.

Figure 1.5 is an estimate of the economic life cycle based on analysis of consumption and labor income data for four developing economies. The figure is a cross-sectional profile constructed from per capita measures of labor income and consumption by single year of age. The values are normalized on average labor income of adults aged thirty through forty-nine. Labor income includes all pretax returns to labor: earnings, benefits, and self-employment income estimated as a proportion of the operating surplus or mixed income of the household sector. The age profiles are based on nationally representative household surveys of income and adjusted to match National Income Account data.

Labor income is a composite. It includes the labor income of both men and women. It is influenced by labor force participation rates, by variation in hours worked, and by variation in wages for employees and productivity for the self-employed. Earnings, which can be measured with relative accuracy, is a dominant share of labor income in developed countries. However,

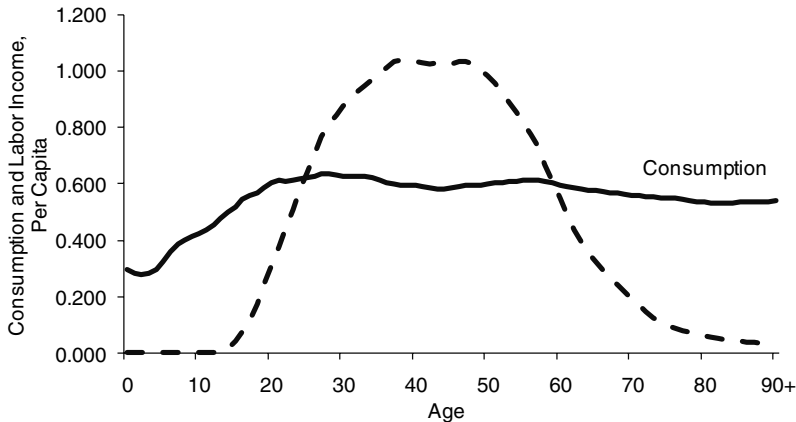


Fig. 1.5 The economic life cycle, developing world profile

Source: Lee and Mason (2007).

self-employment income, which is poorly measured, is a substantially large share of labor income in low-income countries.

Consumption includes both public and private consumption. Private consumption of health, education, and other goods and services has been estimated separately using nationally representative surveys of consumption. Public consumption has also been estimated separately for education, health, and other publicly provided goods and services. Private and public consumption have also been adjusted to match National Income and Product Accounts (NIPA) values.³

One must avoid interpreting these figures as longitudinal or cohort profiles rather than as cross-sectional profiles. In a growing economy with these cross-sectional profiles, labor income will rise more steeply for young cohorts, peak at a later age, and decline more slowly for the elderly. Consumption will not be flat for a cohort—rather it will rise with age at a rate roughly equal to the rate of aggregate per capita consumption growth.

The age at which children become economically independent is surprisingly old. Children under age twenty-five are producing less than they consume. Likewise, old age dependency occurs at a surprisingly early age. Those aged sixty and older are producing less from their labor than they consume. The life-cycle surplus is confined to thirty-four years—from ages twenty-five to fifty-nine.

The extent of dependency varies across the dependent ages, however. Those in their early twenties are producing almost as much as they consume; as are those in their early sixties. Young children produce nothing, but they also consume much less than a teenager or someone over the age of sixty.

3. Detailed information about the methodology is available in Lee, Lee, and Mason (2008).

An important issue is whether the economic life cycle is changing over time, how it is changing, and whether it is susceptible to policy. The potential for policy intervention is discussed in the conclusion to the chapter. An important possibility that is widely discussed is that the age at retirement will increase as health improves and life expectancy rises. This may happen, and in a few industrial countries—including the United States—labor force participation rates have risen slightly at older ages in recent years. For the most part, however, the age at retirement has declined dramatically around the world, although Japan has been different. The labor income profile for the United States and Taiwan have become increasingly concentrated, declining for both the young and the old relative to prime age adults. Another possibility is that the consumption side of the economic life cycle will change. Our preliminary analysis suggests that this may be occurring—consumption is rising most steeply at older ages in the industrial countries and particularly in the United States, consumption of the elderly has increased very sharply. In the following analysis we abstract from these changes. If we were to incorporate them, however, they would reinforce our conclusions.

The subsequent sections will make extensive use of the economic life cycle to provide a more refined measure of how changes in population age structure will influence trends in consumption, labor, and their magnitudes relative to one another.

1.2.2 The First Dividend

Recent studies on the macroeconomic effects of population age structure are based on growth models that explicitly incorporate population age structure. The simplest form for these models distinguishes two components of per capita income:

$$(1) \quad \frac{Y}{N} = \frac{L}{N} \frac{Y}{L}.$$

The exact definitions of the terms vary across studies, but broadly speaking Y/N is per capita income, L/N is the share of the population in the working ages—also called the support ratio, and Y/L is income per worker or working age person. Letting gr represent the growth rate, equation (1) can also be expressed as:

$$(2) \quad gr \left[\frac{Y}{N} \right] = gr \left[\frac{L}{N} \right] + gr \left[\frac{Y}{L} \right].$$

Equation (2) identifies two channels through which population can influence per capita income. First, the support ratio varies with changes in the population age structure. Given the rate of growth in Y/L , a 1 percentage point increase in the support ratio yields a 1 percentage point increase in per capita income. This effect is referred to as the accounting effect or the first dividend. Note that equation (2) is an identity and, hence, given output per

effective producer, changes in the support ratio must produce point-for-point changes in output per effective consumer. A comprehensive understanding requires that we explore the second channel, as well: how changes in population age structure, other population changes, and nondemographic factors influence productivity growth, in other words, the growth of Y/L .

Elaborations on this simple formulation have been used to study population and economic growth using three approaches. First, aggregate panel data have been used to estimate growth models, usually adapting equation (2) to a Barro-type growth framework (Kelley and Schmidt 1995; Bloom and Williamson 1998; Bloom and Canning 2001; Kelley and Schmidt 2001; Kelley and Schmidt 2007). A second approach relies on growth accounting methods (Mason 2001). A third method uses simulation modeling (Cutler et al. 1990; Mason 2005; Attanasio et al. 2006; Mason and Lee 2006; Mason 2007).

A simple refinement of this formulation incorporates the age variation in the economic life cycle into the calculation of the support ratio. In this formulation, L is the effective labor force calculated using the age-profile of labor income to weight the population age distribution. The effective labor force then incorporates age variation in labor force participation, hours worked, and productivity. The denominator N should also incorporate age variation in consumption to measure the effective number of consumers. Thus, if income per effective consumer, Y/N , increases by 1 percent, the per capita age profile of consumption in figure 1.5 can increase by 1 percent holding the consumption ratio (the ratio of aggregate consumption to national income) constant. To be explicit, the effective number of producers, L , and the effective number of consumers, N , are defined to be:

$$(3) \quad L(t) = \sum_x \gamma(x)P(x, t)$$

$$N(t) = \sum_x \alpha(x)P(x, t),$$

where $P(x, t)$ is the population aged x in year t , $\gamma(x)$ is the age-profile of labor income, and $\alpha(x)$ is the age-profile of consumption. Both age-profiles are held constant over time.⁴ The support ratio is defined as the ratio $L(t)/N(t)$.

The economic support ratio for five countries/groups from 1950 to 2050 is plotted in figure 1.6. Japan's support ratio has peaked and is beginning to decline, but for all others in Asia the economic support ratio is rising and thus contributing to more rapid growth in income per effective consumer. The impact of the economic support ratio does not depend on its level; its effect on income per effective consumer—the first dividend—is equal to the growth rate of the support ratio (figure 1.7).

Figure 1.7 presents the first dividend for 1990 to 2025. In the early 1990s

4. An interesting and important question is how the economic life-cycle changes over time and how that will influence the analysis presented here.

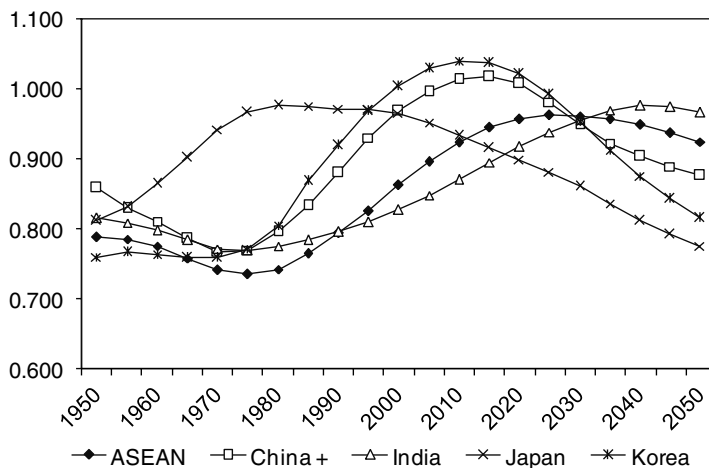


Fig. 1.6 Economic support ratio, country groupings, 1950–2050

Source: Calculated by authors.

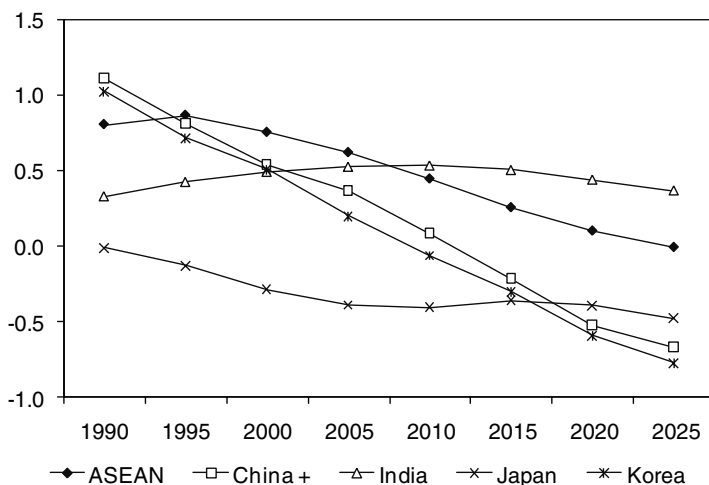


Fig. 1.7 The first demographic dividend (%), 1990–2025, country groupings

Source: Calculated by authors.

the first dividend was turning negative in Japan, increasingly so as time progressed. By 2025 the decline in the economic support ratio will be depressing growth in income per effective consumer by 0.5 percent per year.

The experiences of greater China and Korea are similar with the first dividend, marginally larger in greater China in each year. In the early 1990s, the first dividend added about 1 percent per year to growth in income per effective consumer. The impact has declined steadily. It is still positive, but

will soon disappear and after 2020 will depress growth by 0.5 percent per year. In India and ASEAN the dividend is positive for the entire thirty-five year period. Currently, the increase in the economic support ratio is adding approximately 0.5 percent per year to growth in income per effective consumer. Over the period 1990 to 2025, the first dividend has raised income per effective consumer in total by 21 percent in ASEAN and by 18 percent in India.

Changes in the economic support ratio emphasize the implications of population age structure for per capita values. The changes in total number of effective consumers and producers are also of interest because of their implications for trade, capital flows, and immigration. The most rapid growth in the effective number of consumers is in ASEAN and India. For the period from 2005 to 2010, the annual growth rate in the effective number of consumers is 1.4 percent per annum in ASEAN and 1.7 percent per annum in India. The effective number of consumers is growing much more slowly in China and Korea and declining slowly in Japan (table 1.6).

Currently, the effective number of producers is growing more rapidly than the effective number of consumers except in Japan. The growth rate is about 2 percent per annum in ASEAN and India, 1 percent in greater China, 0.7 percent per annum in Korea, and declining by 0.4 percent per annum in Japan.

The regional differences in growth rates may seem small but their cumulative effect is not because they are persistent. The coming decades will see a significant shift to the West and to the South. India will supplant China as the largest country in terms of effective number of consumers and effective number of producers. The ASEAN's share will grow to approach about 20 percent by 2050. Japan and Korea will shrink relative to their neighbors. Korea's share of effective producers will be cut in half by 2050, and Japan's by over 60 percent (table 1.7).

Table 1.6 Annual growth rates (%), effective numbers of consumers and producers

	1990	1995	2000	2005	2010	2015	2020
Effective consumers							
ASEAN	2.0	1.8	1.6	1.4	1.2	1.1	0.9
China +	1.3	1.1	0.9	0.7	0.6	0.5	0.3
India	2.2	2.0	1.8	1.7	1.5	1.3	1.1
Japan	0.5	0.3	0.1	-0.1	-0.2	-0.3	-0.5
Korea, Rep. of	1.1	0.9	0.7	0.5	0.3	0.1	-0.1
Effective producers							
ASEAN	2.8	2.7	2.3	2.1	1.7	1.3	1.0
China +	2.4	1.9	1.4	1.1	0.7	0.3	-0.2
India	2.5	2.4	2.3	2.2	2.0	1.8	1.6
Japan	0.5	0.2	-0.1	-0.4	-0.6	-0.7	-0.8
Korea, Rep. of	2.2	1.6	1.2	0.7	0.2	-0.2	-0.7

Table 1.7 Distribution of effective consumers and producers

	1990	2025	2050
Effective consumers			
ASEAN	16.4	18.0	19.0
China +	45.3	39.5	36.0
India	31.7	37.8	41.4
Japan	4.9	3.3	2.6
Korea, Rep. of	1.7	1.3	1.1
Total	100.0	100.0	100.0
Effective producers			
ASEAN	15.4	18.1	19.1
China +	47.2	40.5	34.3
India	29.9	37.0	43.5
Japan	5.7	3.0	2.2
Korea, Rep. of	1.8	1.4	0.9
Total	100.0	100.0	100.0

The first dividend depends entirely on changes in the size of the effective workforce relative to the population (or the effective number of consumers). Output and income per working-age adult are held constant and, hence, the possible effects of population growth or changing age structure on the second component in the basic growth identity, equation (2), are set aside. In the next sections we explore the possibility that demographic trends are influencing income per effective worker.

There are many potentially important channels through which productivity may be influenced by population. We will consider two important ones: the accumulation of human capital and the accumulation of physical capital, with our emphasis on the latter.

Human Capital Formation

In Becker's quantity-quality trade-off theory (1991), one possible explanation for fertility decline is that rising incomes lead couples to choose to invest so much more per child that they also choose to have fewer children. But within that theory there are also other possibilities. Newly available contraceptives raise the price of quantity by disconnecting fertility from sex, and could thereby reduce fertility and raise investments per child through a complex interaction. New public education or cheaper transportation to existing schools could reduce the price of quality, raising investments and reducing numbers of children. Mortality decline or economic development would both raise rates of return to education and thereby could lead couples to choose quality over quantity. In all these cases we would expect to observe an inverse relationship between quantity and quality reflecting movements along the hyperbolic budget constraint, although the causal forces at work would be quite different.

Some theories assign a central role to human capital. For example, Becker, Murphy, and Tamura (1990) make output of consumption goods proportional to the stock of human capital (constant returns), and human capital per child proportional to the human capital of the parent generation. If this growth model escapes a Malthusian trap, then it converges to a steady state growth path with constant fertility, growing human capital per person, and a growing rate of return to human capital.

Using data from National Transfer Accounts, we have constructed a measure of investment in children’s human capital. We begin with measures of public and private spending on children’s health and education at each age. We then sum these across age up to eighteen years for health and up to twenty-six years for education. This sum measures total human capital investment per child, in a cross-sectional synthetic cohort sense. To normalize these measures to facilitate comparison across countries, we then divide by the average level of labor income from ages thirty to forty-nine, as before. The natural logarithm of this ratio is then compared to the logarithm of the Total Fertility Rate, which is also a cross-sectional synthetic cohort measure.

The result is plotted in figure 1.8, which shows a strong inverse association across countries between human capital investment per child and the level of fertility. The elasticity is -1.3 , indicating that couples in countries with lower fertility actually spend a higher proportion of their labor income on human capital investments than do couples in the countries with higher fer-

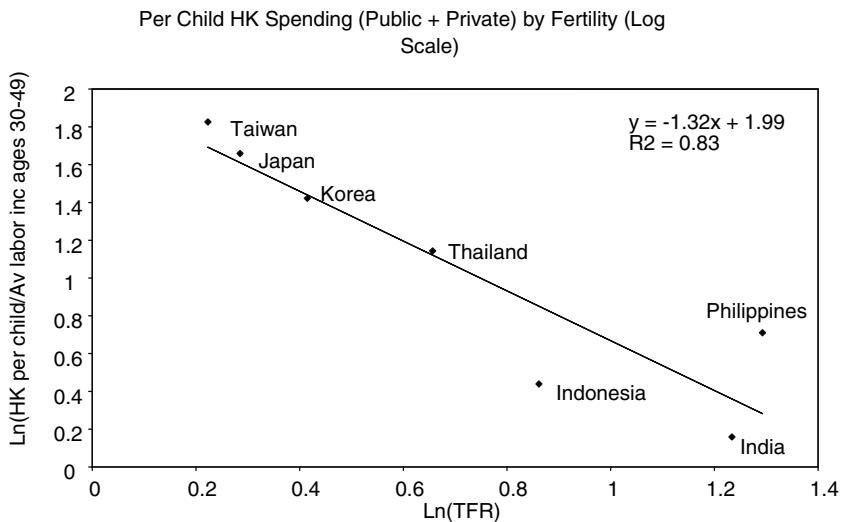


Fig. 1.8 Total human capital spending per child on health up to age eighteen and education up to age twenty-six, public and private, divided by average labor income ages 30–49

tility. When countries outside of Asia are included, however, this elasticity is indistinguishable from unity (Lee and Mason 2009). The inverse association displayed in figure 1.8 can be viewed as a kind of meta budget constraint for quantity-quality, an interpretation developed in Lee and Mason (2009).

Although figure 1.8 shows a cross-sectional rather than a longitudinal relationship, it suggests that fertility decline in Asia has been accompanied by a sharp increase in investment per child relative to family resources. We would expect an increase of this sort to raise labor productivity and contribute powerfully to economic growth, a process that is modeled and explored in Lee and Mason (2009). Here, however, we will simply note that this rising level of investment may have been rooted in declining fertility and must surely have contributed importantly to rising labor productivity and economic growth.

Physical Capital Accumulation and the Second Dividend

A fundamental result that follows from the neoclassical growth model is that for a given saving rate, slower population growth or slower growth in the effective labor force leads to capital deepening and an increase in output per worker (Solow 1956). When the workforce grows more rapidly, a larger share of current investment must be devoted to providing capital to new workers (capital widening). Less is available for increasing capital per worker (capital deepening). The steady state capital output ratio (K/Y) depends only on the saving rate (s), the rate of population growth (n), and technological change (λ) (if we ignore depreciation): $K/Y = s/(n + \lambda)$. Any decline in the population growth rate leads to a rise in the capital output ratio.

This is an important point because the decline in the economic support ratio at the end of the demographic transition is a direct result of slower growth in the labor force. The first dividend turns negative, but, given a constant saving rate, output per worker will rise. Hence, population aging may lead to higher—not lower—per capita income. Indeed, this was the conclusion reached by Cutler et al. (1990) in their analysis of U.S. aging.

Given the objective of this analysis, two assumptions underlying the simple neoclassical growth model are unattractive: that the saving rate is exogenous and that the economy is closed.

The life cycle saving model is widely used to analyze the effects of population and other factors on saving (Modigliani and Brumberg 1954; Modigliani 1988) and capital (Tobin 1967). In the classic life cycle model, individuals save when they are young and dissave during their retirement years. Thus, given the age profile of saving, an increase in the old-age population leads to lower aggregate saving. A lower saving rate does not unambiguously lead to a decline in capital because of the capital deepening effect. If n and s both decline, K/Y may increase or fall.

The validity of the life cycle model is widely debated. Factors other than the desire to provide for old age may motivate saving. The bequest motive

may influence saving, in addition to life cycle saving, but neither we nor others know how the motivation to bequeath varies with fertility or other demographic factors. Hurd (1987) finds that the bequest behavior of individuals with and without children is similar, suggesting either that bequests are mainly unintended or that saving for bequests may be motivated by others besides one's own children (Kuehlwein 1993). Old age support may be provided through public or through familial support. Models estimated using aggregate data support very large effects of age structure (Kelley and Schmidt 1996; Higgins and Williamson 1997; Williamson and Higgins 2001). Models based on survey data suggest more modest influences from age structure (Deaton and Paxson 2000). Simulation models imply that age structure has an important effect, but one that is smaller than found in aggregate empirical work (Lee et al. 2000).

A potentially important elaboration on the life cycle model incorporates the effects of life expectancy on the age profile of saving in addition to the composition of the population. People are living longer and, hence, the duration of their retirement is longer. Although a possible response would be to retire at a later age, this has not occurred for reasons that are not entirely understood. Several recent studies have found support for a strong positive life expectancy effect on aggregate saving rates (Bloom et al. 2003; Kinugasa 2004; Kinugasa and Mason 2007). Fertility decline may also have a significant effect on saving. A number of studies have concluded that populations with high child dependency have lower saving rates (Mason 1987; Higgins 1994; Kelley and Schmidt 1996).

Transfers also play an important role. In principal, old age consumption can be financed entirely through intergenerational transfers, as in Samuelson's consumption-loan economy (Samuelson 1958). More realistically, intergenerational transfers vary in their importance from country to country. Some countries rely heavily on PAYGO public pension programs. Other countries rely heavily on familial support systems, although much less is known about this form of intergenerational transfer and its implication for saving.

A high percentage of elderly and adult children live together in most Asian countries. In Japan and Korea the extent of coresidence has declined substantially in recent decades. Moreover, young adults have much lower expectations about receiving old-age support in the future than was previously the case (Ogawa and Retherford 1993). Coresidence, however, does not provide a clear guide to the magnitude or direction of familial transfers.

National Transfer Accounts provide comprehensive estimates of the importance of assets and intergenerational transfers, both public and familial, for a few countries. Figure 1.9 provides estimates for Japan, Taiwan, Thailand and the United States of the fraction of the life cycle deficit (consumption less labor income) of those sixty-five and older funded by familial transfers, public transfers, and assets (asset income and dissaving combined). The

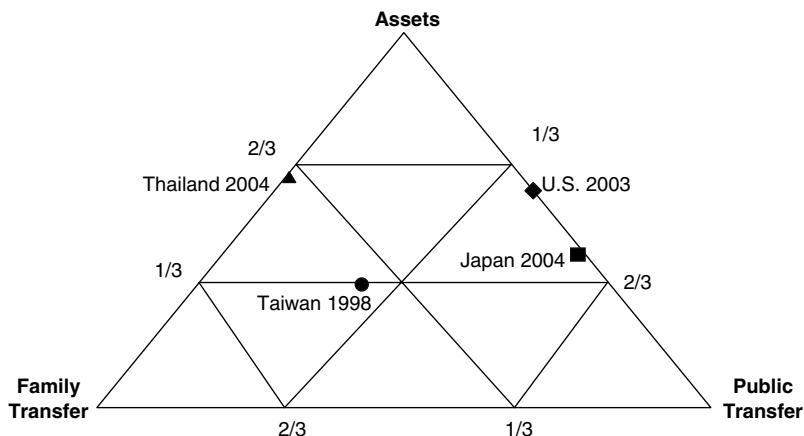


Fig. 1.9 Proportion of life cycle deficit of those sixty-five and older funded through familial transfers, public transfers, and asset-based reallocations (asset income and dis-saving)

Notes: Selected Asian countries and the United States. Computational details available at www.ntaccounts.org. Estimates from the National Transfer Accounts Project. Japan estimates constructed by Naohiro Ogawa, Rikiya Matsukura, and Amonthep Chawla. Thai estimates constructed by Chawla. Information about Taiwan and U.S. estimates available in Mason et al. (2009).

elderly in Taiwan and Japan both depend heavily on transfers—covering almost two-thirds of their life cycle deficits. Taiwan is much more heavily dependent on family transfers and Japan on public transfers, but in total they rely heavily on combined transfers. They rely on assets to cover roughly one-third of their life cycle deficits. In contrast, the United States and Thailand depend on transfers for roughly one-third of their life cycle deficit. Thailand depends more on family transfers and the United States on public transfers, but their total dependence on combined transfers is similar. Thailand and the United States rely much more on assets to cover their life cycle deficits than do Japan and Taiwan.

That U.S. elderly depend more on assets for their retirement than Japanese elderly may seem surprising given that Japanese saving rates are higher than U.S. saving rates. The estimates are constructed to insure consistency with NIPA estimates of saving. There are many possible explanations of the seeming inconsistency, however. This is a snapshot of the use of assets to support retirement by the elderly. Aggregate saving rates also depend on the saving behavior of nonelderly adults. Moreover, the estimates presented in figure 1.9 address only the life cycle use of saving and not other motives; for example, the bequest motive.

Because comprehensive measures of familial transfers are just becoming available, there are no empirical studies of their effect on aggregate saving rates. But Lee, Mason, and Miller (2000, 2002, 2003) use a simulation model

to explore their potential effect on aggregate saving. In their analysis of Taiwan, they find that changes in age structure and life expectancy alone can account for only a portion of the rise in aggregate saving rates that accompanied its demographic transition. However, demographic change combined with a widespread abandonment of familial support systems can explain the boom in saving that occurred there.

The results presented here make use of a similar simulation model to assess the implications of population change for wealth and income. The details of the model are described in Mason and Lee (2007) and only its key features are sketched out here.

The economy is assumed to be completely open to international capital flows and interest rates, so domestic wages and interest rates are unaffected by the supply of capital by residents. The age profile of labor income is fixed; for example, relative productivity and labor force participation rates do not change over time, but the labor income profile shifts upward in response to technological growth, which is exogenously determined. These aspects of the model are relatively conventional. However, the treatment of consumption and saving in the model is distinctive.

The model used here implicitly assumes that intergenerational altruism is a pervasive feature of the society. We assume that the cross-sectional age-consumption profile incorporates those preferences for the well-being, for example, of children and the elderly. The shape of this age profile is assumed not to change over time but it shifts upward (or downward) depending on the accumulation of assets, technological progress, and changes in the support ratio driven by changing population age structure. Individual consumption is determined only indirectly by the individual's economic success, since there is extensive sharing of income through public and private intergenerational transfers. Likewise, total consumption by a cohort at each age is only indirectly influenced by the lifetime economic success of that cohort. This approach is far more consistent with the consumption patterns observed in Asia, which in each year are quite constant across all adult ages, regardless of the income histories of each generation.⁵

Consumption at older ages is realized through a combination of intergenerational transfers and life cycle saving. The importance of transfers relative to life cycle saving is exogenously determined and treated in this model as a policy variable or a feature of each society. The economy is subject to an aggregate budget constraint on flows that, along with other features of the model, determines the time path of assets, transfer wealth and implicit debt, and income.

In each period, t aggregate wealth is equal to the present value of current and future consumption of all individuals who are adults in year t , less the

5. Models based on the standard life-cycle theory or the Ramsey approach produce broadly similar results.

present value of current and future labor income of all individuals who are adults in year t . Wealth (W) defined in this way is a broad measure of wealth that includes both real assets (A) and the present value of current and future net transfers to year t adults, called transfer wealth (T). Transfer wealth consists of two components: child transfer wealth and pension transfer wealth. Child transfer wealth is the present value of transfers from year t adults to living dependent children and to children who will be born in the future. Child transfer wealth is negative and it is equal to the present value of the future cost of children to those who are adults in year t .

Pension transfer wealth is the present value of net transfers that year t adults will receive from year t children and from future generations. These transfers may be familial transfers or public transfers. Pension transfer wealth is the counterpart of implicit debt—the transfer wealth of those who are adults today is equal in magnitude to the implicit debt of future generations. Implicit debt as calculated here is not limited to public transfers programs; for example, PAYGO pension programs. It includes all intergenerational transfers whether public or private (familial).

The impact of demographic change on capital accumulation and economic growth depends on the extent to which the economy in question relies on pension transfer wealth versus capital accumulation to support consumption in old age. We treat this as an exogenous variable rooted in each country's institutions, but changeable through policy. Thus we specify the relative shares of assets and pension transfer wealth. Two sets of results are presented following. In one, a very low percentage of pension wealth is transfer wealth (35 percent) with assets accounting for the other 65 percent. In the alternative simulation, transfer wealth is 65 percent of pension wealth and assets are 35 percent.

Before we turn to the results it should be clearly stated that the model is not intended to be a complete and comprehensive model of the economy. Its purpose is quite specific to showing how demographic changes are likely to influence wealth and assets, and with what implication for economic growth. There are three ways in which demographic change will influence wealth in our model. First, changes in the support ratio influence consumption at each age. If the support ratio is high, perhaps due to low fertility, then higher consumption at every age is possible. Anticipated higher consumption at old age means that more wealth (assets plus pension transfer wealth) must be held at every age to finance that consumption. Second, people are living longer. To support consumption over an extended period of retirement, they must accumulate more wealth during their working years. Third, given the age profile of wealth holdings, changes in the population age structure influence aggregate wealth. Up to a point, wealth rises with age and, hence, a population concentrated in the late working years and early retirement years has greater wealth, in one form or the other.

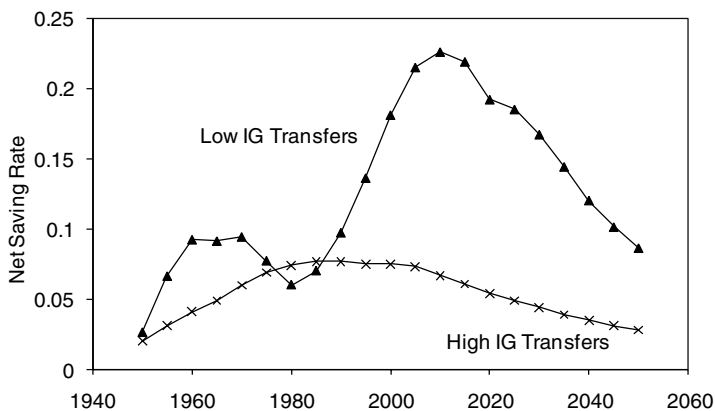


Fig. 1.10 Net saving rate simulations, ASEAN population, 1950–2050

Note: Low (high) IG transfer assumes that transfer wealth is 35 percent (65 percent) of pension wealth.

1.2.3 Simulation Results for ASEAN

Simulated net saving rates in ASEAN for 1950 to 2050 are shown in figure 1.10. Comparative results will be presented in the next section. Productivity growth is assumed to be 2 percent per annum here and in all other results presented. The high intergenerational (IG) transfer simulation gives the saving rate if 65 percent of the wealth required to support consumption in old age is provided through public and familial transfer programs. The low intergenerational (IG) transfer simulation gives the saving rate if intergenerational transfers cover only 35 percent of the consumption needed during retirement.

Changes in age structure lead to a rise and then to a decline in net saving rates. One might incorrectly infer from the pattern that population aging is leading to a decline in saving rates, but this is not correct. Saving rates are rising in anticipation of population aging. The change in saving rates is transitory, however. As the population stabilizes at an older age structure, saving rates decline to levels closer to their pretransition level.

Saving rates are strongly influenced by the size of intergenerational transfers. If transfers play a modest role in supporting the consumption of older adults, changes in age structure have a very substantial effect on net saving rates, which rise from about 3 percent of national income in 1950 to peak at 23 percent of national income in 2010.

If intergenerational transfers play a dominant role in providing support to the elderly, then the effect of age structure on saving is moderate. Net national saving rates rise from 2 percent in 1950 to peak at around 8 percent in 1985 before gradually declining.

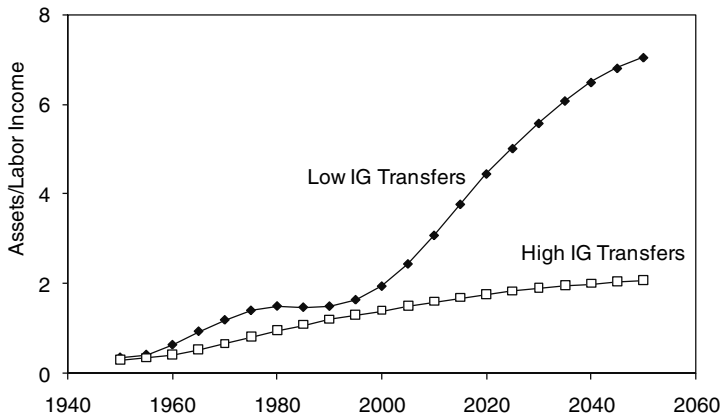


Fig. 1.11 Asset/labor income, ASEAN population, 1950–2050

Note: Low (high) IG transfer assumes that transfer wealth is 35 percent (65 percent) of life cycle pension wealth.

The impact of age structure on assets is substantial (figure 1.11). In 1950 the ratio of total assets to total labor income is about 0.3 for both intergenerational transfer systems. By 1990 assets have increased to 1.5 times labor income for the low IG transfer case and to 1.2 times labor income in the high IG transfer case. After 1990, the systems diverge with assets relative to labor income increasing to 7 in 2050 for the low IG transfer case, but only to 2 in 2050 for the high IG transfer case. Total wealth in 2050 in the low IG transfer case is also 350 percent greater than in the high IG transfer case in 2050.⁶

As compared with 1950, changes in age structure lead to about a 30 percent increase in consumption per equivalent consumer in 2030 given the high IG transfer policy (figure 1.12). Using the low IG transfer policy, changes in age structure lead to an increase in consumption per equivalent consumer of about 50 percent in 2050. Note that the higher consumption after 2025 for the low IG transfer policy comes with a cost. The higher saving rates and lower consumption rates necessary lead to lower consumption between 1995 and 2020 under the low IG transfer policy than under the high IG transfer policy. Consumption remains permanently higher under the low IG transfer policy. Over the next 100 years (not shown) consumption is 20 percent higher on average given the low IG transfer policy. In a closed economy these differences would be larger.

The simulations presume that the economic life cycle itself does not respond to changes in age structure and, hence, the gains (or losses) in consumption are equally shared by all age groups. Of course, other outcomes are

6. Because a small open economy assumption is used, labor income growth is the same in either case. The greater wealth is accumulated as foreign assets in the low IG transfer economy.

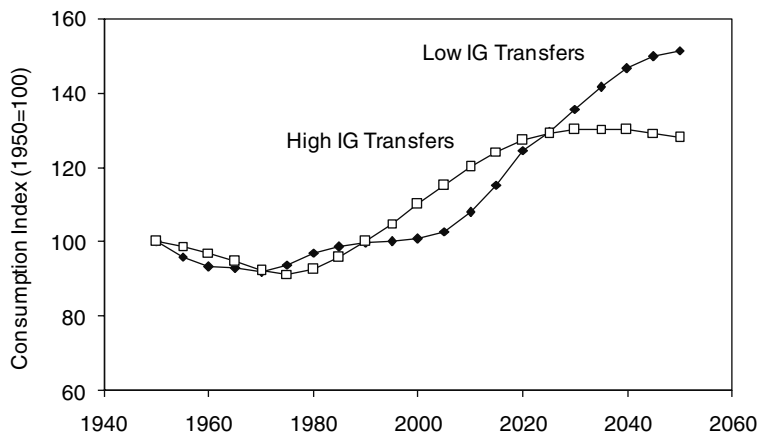


Fig. 1.12 Consumption index, ASEAN, 1950–2050

Notes: Low (high) IG transfer assumes that transfer wealth is 35 percent (65 percent) of life cycle pension wealth. Consumption index equals 100 in 1950. Effect of age structure only; effect of productivity increases not included.

possible. The elderly might flex its political power and increase its consumption relative to younger generations. Or young generations may rebel if IG transfers are too burdensome to the detriment of the elderly.

1.2.4 Comparative Results

The results presented in this section focus more narrowly on two periods: from 1995 to 2005, and from 2005 to 2020. The effects of changes in age structure on saving rates depend on the importance of intergenerational transfers to the elderly (table 1.8). Given low reliance on intergenerational transfers, net national saving rates reach very high peaks in 1995 in greater China, Japan, and Korea. In these countries saving rates decline to intermediate levels in 2005, and to much lower levels in 2025. In India and ASEAN, the saving effects are somewhat more modest and are delayed reflecting the slower and later changes in age structure.

If intergenerational transfers play a very important role, the effects of age structure on saving are muted.

Accumulated assets are reported in table 1.9. Age structure has a substantial influence on the life cycle demand for assets if intergenerational transfers are low. In this case, the ratio of assets to labor income in 1995 ranges from 1.1 given the demography of India, to 10.2 given the demography of Japan. The demand for life cycle assets grows in all cases between 1995 and 2005, and between 2005 and 2025. By 2025, Korea is approaching the simulated level of assets for Japan. Percentage growth rates are very strong in ASEAN and India. Between 1995 and 2025, assets relative to labor income increase threefold in both cases.

Table 1.8 Net saving/national income (%), country groupings

	IG trans share low (0.35)			IG trans share high (0.65)		
	1995	2005	2025	1995	2005	2025
ASEAN	13.6	21.5	18.5	7.5	7.3	4.9
China +	32.4	21.6	6.5	7.6	5.3	2.8
India	7.0	15.0	21.6	7.1	7.6	5.7
Japan	38.6	15.9	3.5	4.5	2.9	1.4
Korea, Rep. of	52.9	32.4	2.6	7.9	4.7	1.4

Note: IG = intergenerational.

Table 1.9 Assets/labor income, country groupings

	IG trans share low (0.35)			IG trans share high (0.65)		
	1995	2005	2025	1995	2005	2025
ASEAN	1.6	2.4	5.0	1.3	1.5	1.8
China +	2.6	4.4	7.1	1.5	1.7	2.0
India	1.1	1.5	3.9	1.0	1.2	1.7
Japan	10.2	13.6	14.9	2.5	2.6	2.8
Korea, Rep. of	5.2	8.9	12.7	2.1	2.2	2.3

The complexities of the relationship between age structure and consumption growth are apparent in table 1.10. Consumption growth changes because of changes in income per effective consumer and changes in the ratio of consumption to national income that underlie the second dividend. If the consumption ratio changes very little, the trend in consumption is dominated by changes in the support ratio; for example, the first dividend. Thus, consumption per equivalent consumer will grow more rapidly during the dividend period and then decline as population aging dominates the support ratio.

However, if there is a strong response in the consumption ratio the outcome is more complex. Rapid accumulation of capital is realized through a decline in the consumption ratio and slow growth in consumption per effective consumer. As the consumption ratio rises from low levels, however, consumption growth can be very rapid.

Consumption growth in ASEAN shows this pattern. Given a strong saving response (low intergenerational transfers), consumption growth is slow from 1995 until 2005, but very substantial from 2005 to 2025. In contrast, given a modest saving response (high intergenerational transfers), consumption growth is more rapid from 1995 to 2005, and dissipates between 2005 and 2025.

The situation in India is somewhat different. From 1995 to 2005, con-

Table 1.10 Annual growth in consumption due to age structure (%), country groupings

	IG trans share low (0.35)		IG trans share high (0.65)	
	1995–2005	2005–2025	1995–2005	2005–2025
ASEAN	0.3	1.2	0.9	0.6
China +	3.0	1.4	1.0	0.1
India	-0.2	0.7	0.6	0.7
Japan	4.1	0.5	0.0	-0.3
Korea, Rep. of	5.9	2.6	1.0	0.0

sumption is actually declining modestly (relative to productivity gains) as a result of a decline in the share of national income consumed. Consumption rebounds after 2005. For the two decades taken as a whole, consumption growth rates are the same given either policy, but more detailed results show that consumption growth is substantially more rapid given the high saving scenario after 2015.

Greater China, Japan, and Korea are in similar situations given a low level of intergenerational transfers. For the period from 1995 to 2005, consumption growth is very rapid—ranging from 3 percent to nearly 6 percent above the assumed rate of productivity growth of 2 percent per year. During this period saving rates are declining from the high levels of 1995 and earlier, and income growth is strong leading to rapid growth in consumption. After 2005, consumption growth rates are well above those possible in the absence of a strong saving response.

A note of caution is in order here. The very large simulated effects are conditioned on low intergenerational transfers. The evidence from Japan, Taiwan, and preliminary estimates for Korea not presented here indicates that intergenerational transfers to the elderly were closer to the high IG transfer scenario than the low IG transfer scenario. Hence, the second dividends realized in East Asia were probably well below the possible gains that could have been realized. Estimates of the contribution of changes in age structure to growth in per capita income in East Asia range from about one-third to one-quarter of actual growth (Bloom and Williamson 1998; Mason 2001). The simulated impact on consumption is substantially greater than the simulated effect on per capita income, because of the rapid increase in consumption rates for Korea, Japan, and greater China.

1.3 Discussion and Conclusions

Declining mortality followed by declining fertility leads to a roller coaster of changes in dependency with initial increases in child dependency, then a period of improving support ratios spanning about fifty years and generat-

ing the first dividend, and finally population aging. Asian countries have all entered the first dividend phase, with India and ASEAN midway through it, China and Korea near its end, and Japan well past it and into population aging.

Population aging is the inevitable last stage of the demographic transition, and the costs of supporting the consumption of a large dependent elderly population, reflected in falling support ratios, lead to concerns by policymakers, the media, and the public. The declining support ratios due to population aging are a predictable and very concrete aspect of the complex constellation of economically important changes occurring over the course of the demographic transition, and it is therefore tempting to view population aging separately from these other changes that result from the same basic causes. Earlier we have highlighted the relation of the demographic transition and population aging to increased investment in human capital and physical capital. Both raise productivity and incomes far more significantly than declining support ratios diminish them.

The changes in age structure that accompany the demographic transition are emphasized here because of their importance particularly in countries that have experienced rapid fertility decline in East Asia and elsewhere. The post-World War II baby booms of the United States and other Western countries have also produced significant changes in age structure and demographic dividends. These are qualitatively similar to those experienced in East Asia but are smaller in scale. Although Japan experienced its own post-war baby boom, it was short-lived with little discernable effect.

We will now briefly consider some policy issues related to these themes.

As noted, population aging will lead to substantial declines in support ratios from their peaks at the culmination of the first dividend phase of the transition. Assuming that the shapes of the age profiles of consumption and labor income do not change, we can calculate the size of these declines. In Japan, the support ratio will decline by 25 percent between 2008 and 2050, or at 0.7 percent per year. In Korea, the decline will be by 22 percent, or 0.6 percent per year. In China, the decline will be only 14 percent, and in India and ASEAN the support ratio will rise.

The projected declines in support ratios have occasioned deep concerns in many countries, since they imply an increased dependency burden on the working age population and threaten fiscal instability. They depend on both demographic trends and on the age patterns of consumption and labor income. Some governments have considered policies to reduce the pace and depth of future population aging by raising fertility. The past experience of European nations with pronatalist policies has not been encouraging in this regard, however. Another possibility is immigration, but this seems unlikely to play a significant role in ameliorating population aging in the Asian context, since Asia is a major net supplier of migrants to other parts of the world, and the more highly industrialized countries like Japan and

Korea have a history of highly restrictive immigration policies (Mason and Lee 2008).

Another way to reduce the projected declines in support ratios is to modify the age patterns of consumption and labor income in a way that raises support ratios for a given demographic structure. Policies to encourage later retirement have not drawn much attention in Asia; indeed many countries have mandatory retirement laws (see Mason and Lee 2008), but later retirement could moderate the decline in support ratios, as could increases in female labor supply. The incentive structure created by public pension programs can have an important effect on retirement behavior (Gruber and Wise 1999) and the design of any new pension programs could be shaped accordingly. Turning to the consumption age profiles, Japan (Ogawa et al., chap. 4 in this volume) and Western industrial countries have experienced disproportional increases in consumption by the elderly relative to younger adults in recent decades, and such changes exacerbate the costs of population aging and its effects on support ratios. Some of this increase in old age consumption appears to be driven directly by the structure of public transfers to the elderly for pensions and health care. It is possible that declines in elder coresidence with adult children are in part an indirect consequence of these public transfers, and this decline may also have contributed to the increases in old age consumption by reducing family level income pooling.

The great increase in human capital investment over the course of the demographic transition has surely played an important role in economic development. Both theory and empirical analysis suggest that the increased human capital investment is closely tied to fertility decline and, to a lesser degree, mortality decline. However, the direction of causality is not entirely clear, leaving some uncertainty about whether policy driven changes in fertility, for example through pronatalist policies, would lead to opposite changes in human capital.

In the global context, East Asia stands out as investing particularly heavily in children's human capital, but in our analysis (Lee and Mason 2009) the level of investment is to be expected, given the exceptionally low fertility in East Asia. The strong role for private spending on education, complementing public education, is also distinctive in East Asia. Given this already strong pattern of human capital investment, the main policy concern appears to be that new policies not interfere with this existing tendency. It is also possible that the demand for a high level of human capital investment is itself a driving force behind the very low levels of fertility in East Asia.

Our final point is the need for governments and societies to consider carefully the arrangements supporting consumption by the elderly, and potential changes in these arrangements. Should continuation of familial support for the elderly be encouraged by policy? Or should governments move toward public pension programs, and should any new pension programs be funded or PAYGO?

A switch from familial support to public PAYGO pensions may entail less change than it appears, since both accumulate implicit debt as the population ages, and both entail increasing dependency burdens on the working age adult. However, public sector pension programs spread the support costs more evenly across the population while altering the incentives of the elderly and adult children in various ways. In either case, it should be kept in mind that the transfer wealth generated by familial support or PAYGO pensions is likely to substitute for capital in individual's retirement plans. Transfer programs of these kinds likely diminish the promotion of capital accumulation by population aging, the second dividend. Policies that encourage life-cycle saving and personal retirement accounts, whether public or private, would enable countries to harness the power of population aging to generate increased capital per worker.

There are trade-offs between the benefits and drawbacks of familial, PAYGO, and funded old age support programs, and each society may choose a different mix. The key point is that most but not all of the countries of Asia are still at an early enough stage in the transition that they have options that are no longer open to Japan and the other industrial nations. For these countries to transit from their PAYGO programs to funded programs would entail very heavy costs amounting to a year or several years' worth of GDP. For countries earlier in the transition that do not yet have comprehensive PAYGO programs, steps to encourage individual responsibility for own retirement are much more feasible and less painful.

Population aging and the forces leading to it produce not only frightening declines in support ratios, but also very substantial increases in productivity and per capita income. Low fertility and low mortality are associated with large increases in human capital investment in children, and they also cause large increases in the accumulation of physical capital. Together, these positive changes will likely outweigh the problems of declining support ratios. Population aging brings economic benefits as well as costs, and we should view this package of consequences as a whole, while developing policies to minimize the costs and amplify the benefits.

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Comment Jocelyn E. Finlay

In their chapter, Mason, Lee, and Lee explore the macroeconomic implications of the decline in fertility and mortality over the past fifty years with a particular focus on the Asian region.

During the demographic transition there is a decline in the mortality rate followed (often much later, as in the case of India) by the decline in the fertility rate. In the early stages of the demographic transition when mortality rates fall but the fertility rate remains high, population growth is very strong. In India, during this window of time the population growth rate hiked from 0.3 in 1900 to 2.2 around 1980.

The economic implications of the demographic transition have long been an avenue of enquiry. It was the work by Kelley and Schmidt (1995) which showed that population growth as a single variable did not have a significant effect on economic growth, but rather the components behind population growth were considered empirically important and theoretically interesting.

In addition to their effect on population growth, changes in mortality and fertility rates also have an effect on age structure of the population. With people living longer, the number of people in the older age groups increases. Couple this with the decline in fertility and the proportion of youth relative to the elderly declines.

One striking demographic feature that has come about during the demographic transition is the rise in the working-age share. When the fertility rate declines, the number of youth-age individuals declines relative to the number of working-age individuals. The working-age share increases. The