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The Demographic Dividend

A New Perspective on the
Economic Consequences of
Population Change

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PREFACE

How does population growth affect economic development? Economists, demographers, and policymakers have debated this question for decades. Various studies have suggested that population growth can be detrimental to economic development, or beneficial, depending on circumstances. More recently, the neutralist view that rapid population growth neither promotes nor impedes economic growth has held sway. The emergence of this view has coincided with a declining interest in family planning as an instrument of economic development. The latest evidence suggests, however, that the debate may have been framed too narrowly. It has focused almost exclusively on population size and growth rates. Little attention has been paid to a critical variable: the age structure of the population (that is, the way in which the population is distributed across different age groups). Taking account of age structure provides powerful confirmation of the age-old view that, when it comes to the determination of living standards, population does, indeed, matter.

This report reviews the debate over the effects of demographic change on economic growth and examines the research evidence on the economic impact of changes in age structure. It also examines the relationship between population change and economic development in particular regions of the world, including East Asia, Latin America, sub-Saharan Africa, and the Middle East and North Africa. Finally, it discusses how changes in the age structure interact with labor-market, health, and education policies to contribute to economic growth.

Understanding the relationship between population change and economic growth has taken on added importance in recent years because the world's developing countries—home to the vast majority of the world's population—are in varying stages of a demographic transition from high to low rates of mortality and fertility. This transition produces a “boom” generation that is gradually working its way through each nation's age structure. As the boom generation enters working age, there is the opportunity to unleash an economic growth spurt, provided the right kinds of policies are in place to ensure the extra workers are productively employed. For this reason, policy-makers should benefit from a clearer understanding of the relationship between economic development and the changes in age structure that result from the unfolding demographic transition.

This research was conducted for *Population Matters*, a RAND project whose goal is to synthesize and communicate the policy-relevant results of demographic research. Through publications and outreach activities, the project aims to raise awareness and highlight the importance of population policy issues and to provide a scientific basis for public debate over population policy questions. *Population Matters* is part of RAND's Labor and Population Program.

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CONTENTS

Preface	iii
Figures	vii
Tables	ix
Summary	xi
Acknowledgments	xv
Acronyms	xvii
Chapter One	
THE DEBATE OVER THE EFFECTS OF POPULATION GROWTH ON ECONOMIC GROWTH	1
The “Pessimistic” Theory: Population Growth Restricts Economic Growth	2
The “Optimistic” Theory: Population Growth Can Fuel Economic Growth	15
The “Neutralist” Theory: Population Growth Has No Significant Effect on Economic Growth	17
The Importance of Age Structure	20
Chapter Two	
DEMOGRAPHIC TRANSITIONS AND THE “DEMOGRAPHIC DIVIDEND”	25
The Demographic Transition: Declining Mortality and Fertility	25
The Demographic “Dividend”	37

Chapter Three	
CASE STUDIES OF POPULATION CHANGE AND ECONOMIC GROWTH	43
East Asia	43
Japan	46
North America, Western Europe, Australia, and New Zealand	48
South Central and Southeast Asia	51
Latin America	56
Middle East and North Africa	59
Sub-Saharan Africa	60
Eastern Europe and the Former Soviet Union	65
Chapter Four	
THE IMPORTANCE OF THE POLICY ENVIRONMENT . . .	69
Health Equals Wealth	69
Population Policy and the Family	72
Policies for Labor and Financial Markets, and Human Capital	74
Policies for the Future: Planning for an Older Population	78
Chapter Five	
CONCLUSIONS	81
References	83
Additional Reading	95
Index	99
About the Authors	107

FIGURES

1.1.	Shares of the World Population by Levels of Regional Development, 1950, 2000, and 2050	13
1.2.	Economic Growth, 1820–1992 (by Major Region)	14
1.3.	GDP per Capita Growth Against Population Growth, 1965–1990	18
1.4.	Overall Population Growth Rate and the Economic Growth Residual	19
1.5.	Life Cycle Income and Consumption	21
1.6.	Population Growth and Age Structure	22
2.1.	World Population, 1750–2150	26
2.2.	Population by Region, 1950–2050	27
2.3.	Trends in the Infant Mortality Rate at Different Levels of Development	28
2.4.	Trends in the Fertility Rate at Different Levels of Development	29
2.5.	The Demographic Transition, and Population Growth Rate over the Course of the Demographic Transition	31
2.6.	Population by Age Group and Year, Less-Developed Regions	32
2.7.	Population by Age Group and Year, East Asia	33
2.8.	Population by Age Group and Year, Ireland	34
2.9.	Population by Age Group and Year, Sub-Saharan Africa	36
2.10.	Share of Working-Age Population by Region	37
2.11.	Share of Population of Working Age , Specific Areas	38

2.12.	Labor Force Participation by Age Group, in Various Regions of the World, 1990	40
3.1.	Population Share Aged 65+	48

TABLES

1.1.	World Population in Billions, 1804–2043	4
1.2.	Total Population in 2001, by Region, Subregion, and Country	4
3.1.	Annual Growth Rates of Total Population, Working- Age Population, and Non-Working-Age Population for Asia and Its Subregions	54

**DEMOGRAPHIC CHANGE AND ECONOMIC GROWTH:
THE IMPORTANCE OF AGE STRUCTURE**

For decades, economists and social thinkers have debated the influence of population change on economic growth. Three alternative positions define this debate: Population growth either (1) restricts, (2) promotes, or (3) is independent of economic growth. Proponents of each explanation can find evidence to support their cases. All of these explanations, however, focus on population size and population growth. In recent years, however, the debate has given insufficient attention to a critical issue: the *age structure* of the population (that is, the way in which the population is distributed across different age groups), which can change dramatically as fertility and mortality rates change.

Because people's economic behavior and needs vary at different stages of life, changes in a country's age structure can have significant effects on its economic performance. Nations with a high proportion of children are likely to devote a high proportion of resources to their care, which tends to depress the pace of economic growth. By contrast, if most of a nation's population falls within the working ages, the added productivity of this group can produce a "demographic dividend" of economic growth, assuming that policies to take advantage of this are in place. In fact, the combined effect of this large working-age population and health, family, labor, financial, and human capital policies can effect virtuous cycles of wealth creation. And if a large proportion of a nation's population consists of

the elderly, the effects can be similar to those of a very young population. A large share of resources is needed by a relatively less productive segment of the population, which likewise can inhibit economic growth.

After tracing the history of theories of the effects of population growth, this report reviews evidence on the relevance of changes in age structure for economic growth. It also examines the relationship between population change and economic development in particular regions of the world: East Asia; Japan; North America, Western Europe, Australia, and New Zealand; South Central and Southeast Asia; Latin America; the Middle East and North Africa; sub-Saharan Africa; and Eastern Europe and the former Soviet Union. Finally, it discusses the key policy variables that, combined with reduced fertility and increases in the working-age population, have contributed to economic growth in some areas of the developing world.¹

THE DEMOGRAPHIC TRANSITION AND THE “DEMOGRAPHIC DIVIDEND”

The relationship between population change and economic growth has taken on added salience in recent years because of demographic trends in the developing world. At varying rates and times since World War II, developing countries have been undergoing a demographic transition, from high to low rates of mortality and fertility. This transition is producing a “boom” generation—a generation that is larger than those immediately before and after it—that is gradually working its way through nations’ age structures. The East Asian nations were at the forefront of this transition; other regions, including Latin America, began their transitions later, in the 1960s and ’70s. Yet

¹The text, tables, and figures for this paper draw heavily on data from a recent CD-ROM published by the United Nations (United Nations, 2001). Unless otherwise noted, we use the UN’s “medium variant” for all data. The UN’s methodology has been criticized for its reliance on the assumption that all countries will converge to a fertility rate of 2.1 children per woman. The concern here is that this suggests fertility will rise in quite a few countries where the total fertility rate is currently below the replacement level of 2.1. Regardless of the merits of this critique, we note that most of the results presented in this paper are qualitatively insensitive to the difference between the “medium-” and “low-fertility” variants of the data.

other areas—notably some countries in the Middle East and Africa—have not yet fully begun, or are in the early phases of this transition.

THE ESSENTIAL POLICY ENVIRONMENT

Nations undergoing this transition have an opportunity to capitalize on the demographic dividend offered by the maturing of formerly young populations. The demographic dividend is not, however, automatic. Given the right kind of policy environment, this demographic dividend can help to produce a sustained period of economic growth, as it did in several East Asian economies. The critical policy areas include

- public health
- family planning
- education
- economic policies that promote labor-market flexibility, openness to trade, and savings

Policymakers in developing countries have a window of opportunity for exploiting the maturation of previously young populations. Policymakers should consider how to maximize and capture this dividend by accelerating the demographic transition, and allowing extra labor to be absorbed productively in the market. Finally, policymakers must plan for the future health care and pension-income needs of this baby-boom generation when it ages. The demographic transition offers policymakers a window of opportunity. Seizing it could prove vital to the economic and social development of their countries.

Note that policies that enhance the free operation of markets are frequently referred to throughout the report. In most simple economic models, such policies will tend to promote a country's ability to take advantage of the demographic dividend. However, two caveats are in order.

First, policy reforms that make labor markets more flexible are not unambiguously beneficial, especially in the short run. Political feasibility can also be an issue. Although social protection programs can, in principle, ease the impact of labor market reforms, workers

who suffer pay reductions, who are displaced, or who fear these outcomes can be a potent political force resisting change. Furthermore, capture of the potential demographic dividend can be impeded by labor market rigidities that pervade many developing countries. These include rules governing the hiring and firing of individuals that prevent employers from taking risks and thus deter investment; minimum wages that exceed market rates and thereby discourage hiring and training; government pay practices that are grossly out of line with the market; and labor market inertia caused by labor-management bargaining.

Second, similar issues arise with respect to free trade, since it is well established that trade liberalization creates both winners and losers. Openness to trade can provoke economic adjustments that lead to unemployment and poverty. There are also some important issues about the fundamental fairness of outcomes that result when countries become more integrated into the world economy. These questions relate, for example, to intellectual property rights, immigration restrictions, and developed country protectionism.

Devising economically and politically realistic programs to deal with these challenges is hugely important, though beyond the scope of this report.

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ACRONYMS

FDI	foreign direct investment
GDP	gross domestic product
MENA	Middle East and North Africa
NAS	U.S. National Academy of Sciences
UN	United Nations
WHO	World Health Organization