



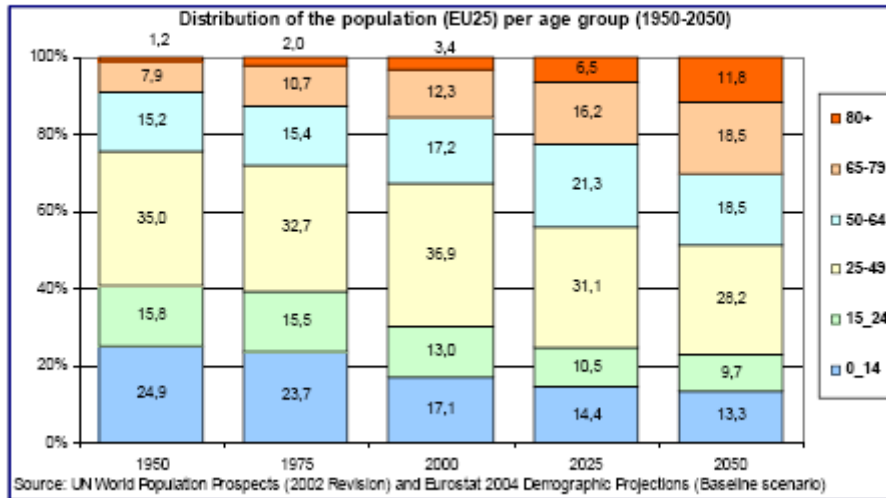
The EU's Demographic Crisis

One of the greatest, and least trumpeted, assets of the United States is its growing population. More people mean more workers, more production, more services, more creativity, more taxes and more consumption. Of course a growing population presents challenges as well, like creating enough opportunities for all those seeking employment. But the opposite situation is much worse. When populations decline, they must make do with fewer workers, less production, fewer services, and so on. The challenge of creating opportunities may be less intense, but it is more than matched by the challenge of holding onto older workers, financing health care and retirement, filling vital positions, and maintaining a dynamic economy. This is the challenge that the European Union (EU) must wrestle with today. Its ability to meet that challenge will determine to a large extent what kind of EU we have tomorrow.

Tendencies

Three demographic changes lie at the core of the European dilemma:

- (1) Continuing low birth rates do not enable Europe to renew its population. On average, every woman would need to give birth to at least two children to replace the population, but EU's fertility rate fell to 1.48 in 2003 and is not likely to increase significantly.
- (2) Since 1960, average life expectancy in Europe has risen by 8 years, and is projected to rise a further 6 years by 2050. With fewer children being born, increased life expectancy results not only in an increase of the elderly population, but more critically in the proportion of those aged 80+.
- (3) With the "baby boomers" growing, the ratio of the older to the younger generation grows. In 2004, working age people were in the majority, with 39-year olds as the largest cohort. By 2050, the number of persons aged 65+ will rise by 58 million (77%). Moreover, the segment aged 80+ will be the fastest growing, rising by almost 32 million (174%) by 2050. After 2010, the working-age population (aged 15-64) will start to fall, and will drop by 48 million or 16% by 2050.

GRAPH 4: THE AGEING OF THE EUROPEAN POPULATION

Overall, according to the latest estimates from EU's Economic Policy Committee, the population of the 25 EU countries is projected to rise from 457 million in 2004 to a peak of 470 million in 2025, and thereafter decline to 454 million in 2050. Ireland is predicted to see a 36%-increase in its population, with Belgium, France, Sweden and the UK also witnessing some upward trends. By contrast, the populations of Poland, Germany and Italy are estimated to decrease by approximately 7%.

The big-bang enlargement of the EU on May 1, 2004 has not helped to alleviate the problem. Although the average age of the ten new EU members' populations is lower than in the old EU with 15 member states, it will increase faster than in the old EU and overtake it around 2035. In other words, the new EU is actually ageing even faster, with the birth rates in Estonia, Lithuania, the Czech Republic, Slovakia and Slovenia ranking among the lowest in the world. Not only in the new EU countries but also elsewhere in Europe many pursue careers until their late 30s when they might have one child, but in many cases they do not have any more. Moreover, the young generation increasingly forms family structures with two incomes and no kids.

Consequences

The threat to Europe's standard of living caused by a reduction in the proportion of the working-age population was noted in 2004. That year, a high-level working group was commissioned to assess the EU's fulfillment of its strategic objective to build the world's most competitive and dynamic knowledge based economy by 2010. The group's chairman, former Dutch Prime Minister Wim Kok, issued a damning report, citing demographic change as being among the many challenges yet to be faced. The report said that "the pure impact of ageing populations will be to reduce the potential growth rate of the EU from the present rate of 2–2.25% to around 1.25% by 2040. The cumulative

impact of such a decline would be a GDP per head some 20% lower than could otherwise be expected.”

A separate report prepared for the EU’s Economic Policy Committee in 2006 confirms these trends. The fifteen old EU countries are expected to see the annual average GDP growth rate fall from 2.2% in the period 2004-2010 to 1.3% between 2031 and 2050. What is more, the ten new EU members will face an even steeper decline, with annual GDP growth rates converging with the economic performance of the old EU, decreasing from 4.3% in the period 2004-10 to 0.9% GDP growth between 2031 and 2050.

This means that smaller working-age population will translate into lower economic growth. Moreover, smaller working-age population will translate into smaller contributions to the state coffers (unless taxes are increased). At the same time, a larger proportion of older generations would mean higher public expenses on health care and long-term care for the old, because frailty and disability rises sharply for that age group, especially for the very old (aged 80+).

Yet pension systems are affected the most. The Netherlands, the UK, Ireland, Sweden, the three Baltic States, Poland, Slovakia and Hungary are increasingly switching to private pension funds. However, they are only supplements in pension systems that are still heavily influenced by the public sector. More precisely, most EU countries still rely on the so-called pay-as-you-go pension schemes that force today’s workers to finance yesterday’s workers’ pensions.

These pension systems are based on the assumption that workers hugely outnumber retirees. In other words, the young can afford to support the old. However, with the demographic situation changing quite radically, this assumption is no longer true. The current worker-pensioner ratio in Europe of four workers for each pensioner will fall to a ratio of two workers for one pensioner by 2050. To put it simply, an ageing population in Europe means fewer workers to support the old. This means that the current public pension schemes will no longer be sustainable. They will either need to be revised to include higher social security contributions or lower pension levels. Nevertheless, either of the two moves would probably face loud criticism from both the contributors (who do not want to pay higher taxes) and the “extractors” (who do not want smaller pensions). If all European governments fail to change the current practice and neither taxes nor welfare provisions are reformed, governments will be forced to borrow and increase public debts to pay for social benefits, pensions and care for the elderly. However, that scenario is not sustainable either, given that European countries will soon have smaller working-age populations to pay off these debts. Introduction of higher taxes to finance the rising public spending is not a viable option as that is likely to enhance outward migration of capital and skilled labor, endangering the sources of growth and fiscal revenue.

So what would happen if no policy change occurs? The 2006 report of the EU’s Economic Policy Committee analyzing public spending based its conclusions on such an

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assumption, i.e. that the pensioning age, fertility rates, employment rates, immigration tendencies and public spending policies would stay as they are today. As a result, the report predicted that the biggest increase of public spending will be on pensions, health care and long-term care, while spending on education and unemployment allowances is unlikely to be affected significantly.

Overall, the problem of ageing populations is projected to lead to increases in public spending in most EU countries by 2050, with the old EU forced to pay more – increasing public spending by about 4% of GDP between 2004 and 2050. The only exception is Austria (with a mere 0.2% increase), where necessary pension reforms were adopted in 2000. Italy and Sweden are expected to see only minor increases since their pension benefits are based on effective working-life contributions. Other old EU countries will face relatively moderate changes with public spending increasing by less than 3.5% of GDP. Ireland, Spain, Luxembourg and Portugal will have to spend the most in comparison to their current public spending.

At the same time the increase for the ten new EU countries is expected to be a relatively small 1.5% of GDP, mainly due to a sharp drop in public pension spending replaced by a switch to a privately funded scheme in Poland (the biggest of the new EU countries). Apart from Poland, Estonia and Latvia are also expected to see a decreasing public spending trend, while Lithuania and Slovakia will see only a minor increase. At the same time Cyprus, Slovenia, Hungary and the Czech Republic have one of the biggest problems in the EU because their pension reforms have yet to be significantly reformed. With the exception of Poland, age-related spending in the other nine new EU countries is expected to increase by over 5% of GDP on average. The public spending of Cyprus is projected to grow by almost 12% by 2050.

2010 is the year when the budgetary impact of ageing in most EU countries will start to become apparent, the report stresses, although the most striking increases in spending will take place between 2020 and 2040.

Solutions

There is some positive news. Total fertility rates in the EU are projected to rise from 1.48 children per woman in 2004 to 1.60 by 2030, staying at a constant level until 2050, but nevertheless remaining well below the natural replacement rate.

Policies aimed at raising fertility rates are essential for Europe in the long run. Many experts think that one of the main obstacles is a choice that many women face between having a career and having children. Experts stress that removing obstacles to simultaneous parenthood and pursuit of a career – through tax system, employment law changes and childcare alternatives – would not only help parents and their children, but also their own parents and grandparents as well.

Such moves, however, will not be able to offer a real solution to the imminent crisis, because they are simply delayed. The damage has been done, i.e. for several decades too few babies were born and this gap will evidently remain, no matter how many children the current and the next generations produce.

It would also be wrong to hope for miracles from the possible EU accession of Turkey – a country with currently over 70 million inhabitants. Pension systems and public spending in general are likely to remain in the national domain of each EU country. Therefore, the accession of such a big state as Turkey with predicted demographic growth tendencies different from the ones observed elsewhere in Europe would not be a solution. Furthermore, data suggests that immigrants tend to adopt the life choices of their host country, with immigrants' offspring having as few children as the rest of the society. As a result, even Turks or any other people immigrating to European countries are not likely to make a significant change, unless they move to the EU permanently with their children and grandchildren. In that case they would all contribute to the host country's fiscal systems and as a result their pensions would also be financed by their own children. However, most immigrants return home after some time. More than half of them leave within ten years of immigration, while four out of five immigrants return home within 25 years. That leaves a host country with only one permanent immigrant and significantly smaller advantages for the local pension systems, because immigrants who have returned to their home country get their pension payments paid by collective domestic contributors of their host country.

This might lead to a suggestion that more permanent immigration is needed. However, if the notion of fertility rates converging is indeed true, immigration is not likely to help. The immigrants will also age without enough children to support them. Moreover, the Rand Corporation's report for the European Commission has stated that the number of immigrants required to offset population ageing in the EU "would be unacceptable in Europe's current socio-political climate". As an example, according to United Nations' estimates, Germany would need an average immigration of 3.6 million people a year from 2000 till 2050 to prevent dependency ratios from rising. For comparison, annual net migration inflows to the whole EU currently amount to 1.3 million people or 0.35% of the population.

Some have suggested that higher employment rates could ease the situation, and indeed projected data suggest that positive employment tendencies will cushion the economic effects of ageing for a short while. The Lisbon Strategy goals of 70% employment will be reached in 2020, with a 10-years delay. However, the ageing effect will become dominant from 2018, when both the size of the working-age population and the number of persons employed will decrease. That is also the time when economic growth rates are set to decline the most.

The employment rate of older workers is also projected to rise sharply, from 40% in 2004 to 59% in 2025. Half of this increase is due to the positive effects of already enacted pension reforms motivating the older generation to keep working longer. But increasing

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the formal retirement age alone will not help significantly because, according to calculations by the United Nations, it would have to be raised from 65 to 76 years if pensions relative to gross earnings in 2050 were to remain at 1995 levels. This is not politically feasible; yet increasing the retirement age by 2 years would not be enough.

As a result, experts agree that the main key to success is a radical reform of pension systems. Retirement age might have to be increased by at least five years, as to reduce the projected increase in pension spending by delaying it for some years. More importantly, pension systems should be privatized, abandoning the collectivist traditions that have been dominant in Europe until now. This means that governments should reduce the scope of the core pay-as-you-go public pension system, at the same time encouraging the policy of channeling savings into private retirement accounts.

Frits Bolkestein, former EU Internal Market Commissioner has said that “if pension spending were not reformed, but led to higher deficits, some countries would not respect their obligations under the growth and stability pact [setting a 3% of GDP limit for public deficits]; which in turn could lead to inflationary pressures; which in turn would result in the ECB [European Central Bank] having to set higher interest rates with negative impact not only on investment, but also on growth and employment, which are the basis of sustainable pension systems... Clearly the reply to these questions – ‘pay more, work longer, get less,’ is not an easy message to sell.”

Privatizing pension schemes will not be popular. However, several European governments have already taken the first steps in the right direction. As noted above, some countries have started painful pension reforms and are, as a result, facing relatively better public spending trends, setting an example for those governments who have demonstrated less political courage until now.

Experts say that a window of opportunity for pursuing structural reforms is open right now (between 2004 and 2011), due to positive employment and demographic tendencies whereby the total number of persons employed is projected to increase until 2017. From the political standpoint, this might be the right window of opportunity too. As the number of elderly as a proportion of the electorate increases steadily, pension reforms are likely to face increasing resistance. Thus, the longer these reforms are postponed, the more difficult it will become to push them through.

Europe’s shrinking population is a big problem now, but it will only become more intractable in the future. The United States should take more time to celebrate that it does not share the same fate.