The EU's Demographic Crisis

One of the greatest, and least trumpeted, assets of the United States is its growing population. More people means a larger labor force, higher levels of production, more services, more creativity, more consumption and a larger tax revenue for governments. Of course a growing population presents challenges as well, such as stimulating enough demand in the labor market. This is, however, one of the nice problems to have as a government. For the EU the problem is exactly opposite. Over the last 25 years Europe's young population (aged 14 and under) has decreased by 21 per cent and currently more elderly than children live in the EU. The challenge of creating opportunities may be less intense, but it is more than matched by the challenge of retaining older workers, financing health care and retirement, and maintaining a dynamic economy. This is the challenge that the EU is wrestling with today. Its ability to meet that challenge will determine to a large extent what kind of EU there will be in 50 years time.

Tendencies

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

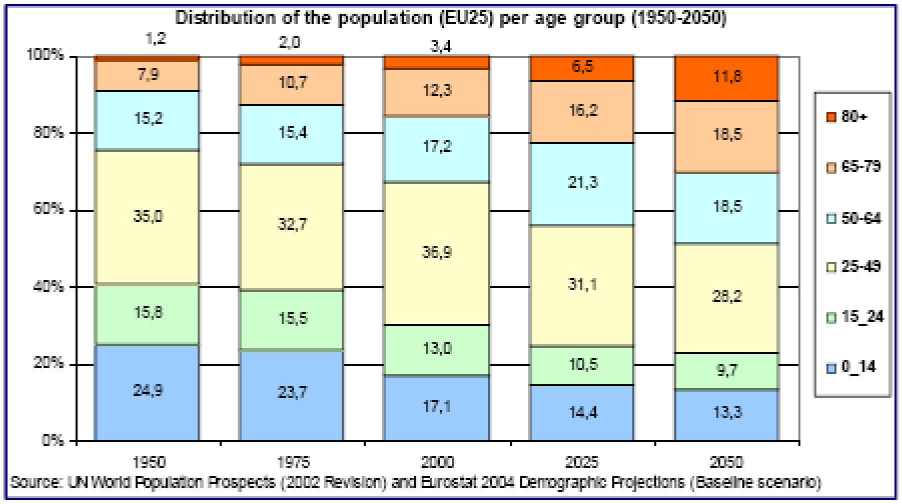
(1) Continuing low birth rates do not enable Europe to renew its population. On average, every European woman would need to give birth to at least 2.1 children to replace the population. The average EU-27's fertility rate was 1.38 in 2006 and is not likely to increase significantly (By contrast the US fertility rate in 2006 was 2.09).

(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+, a resource intensive community.

(3) With the "baby boomers" surviving longer, 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 have risen 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, dropping by 48 million or 16% by 2050.

The European Union Center of Excellence of the University of North Carolina at Chapel Hill is funded by the European Union to advance knowledge and understanding of the EU and its member countries.

GRAPH 4: THE AGEING OF THE EUROPEAN POPULATION



According to the latest estimates from EU's Economic Policy Committee, the population of the EU27 is 492.8 million and growing with a 6% growth rate in 2006. This rate is unevenly distributed across the Union, of the member states that joined the EU in 2004 and 2007, only the populations of Cyprus and Malta saw an increase as the pure result of child births. Of the older member states Ireland's population increased most from 2000-2006 (16.3 per cent), followed by Luxemburg (11.6%) and Spain (11%). Germany witnessed the lowest growth (0.8%). Breaking down these figures, it becomes clear that natural increase has stagnated, and that in 2000-2006, 83% of the population growth in the EU has been the result of immigration. Only in France and in the Netherlands were birth rates higher than immigration rates in 2006.

Low fertility rates are partly the consequence of many people placing career before children until their late 30s. At that age, they might have one child, but often no more than that. Moreover, the young generation increasingly forms a family structure with a double income and no children. The average age for women giving birth for the first time is highest in Spain (30.9 years) and lowest in Bulgaria (26.3 years). By comparison, increases in natural births were 12 times higher in the US than the EU. Estimates are that the EU population will reach a peak in 2025, and decline thereafter. In total, 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%, although this trend will likely be affected by economically driven migration trends.

The big-bang enlargement of the EU on May 1, 2004 and on January 1, 2007 has not helped to alleviate this problem. The new EU is actually aging even faster than the EU-15, with the birth rates in Estonia, Lithuania, the Czech Republic, Slovakia and Slovenia ranking among the lowest in the world. The entry of Romania and Bulgaria in 2007 will further aggravate the problem, as Romania's population is expected to decrease from 21.7

million in 2005 to 17.1 million in 2050; Bulgaria from 7.7 in 2005 to 5.1 in 2050, with both countries showing relatively low fertility rates of 1.3.

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. In 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 [economic] 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 of 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 EU-15 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 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. Put simply this means a smaller working-age population will translate into lower economic growth. Furthermore, this diminished population will translate into decreased contributions to the state finances (unless taxes are increased to compensate). 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 those aged 80+. In 2006 1/6 of the EU population was 65+ and the number of people aged 80+ increased by 84%, from 10.2 million to 18.8 million. Overburdened European pension systems are affected the most by these trends. The Netherlands, the UK, Ireland, Sweden, the three Baltic States, Poland, Slovakia and Hungary are increasingly switching to private pension funds. However, private pensions are merely supplementing 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 in exchange for similar support in their old age. However, with the demographic situation changing quite radically in the last 20years, 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 aging population in Europe means fewer workers to support the growing demands on pensions resulting in unsustainable public pension schemes. They will either need to be revised to include

The European Union Center of Excellence of the University of North Carolina at Chapel Hill is funded by the European Union to advance knowledge and understanding of the EU and its member countries.

higher social security contributions or lower pension yields. Either of these two moves would 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 unsustainable too, given that European countries will soon have smaller working-age populations to pay off these debts. The introduction of higher taxes to finance the increases to public spending levels is not a viable option as it is modeled to result in the 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 assumption, i.e. that the pensionable 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, but as an overall picture this is a dramatic change to public finances.

Overall, the problem of aging populations is projected to lead to increases in public spending in most EU countries by 2050, with the EU-15 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 EU-15 countries will face relatively modest 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 twelve 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 deflationary 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 yet to reform their pension systems and therefore present significant challenges. 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 and the overall public spending of Cyprus is projected to grow by almost 12% by 2050. The budgetary impact of aging in most EU countries will start to become apparent in 2010, the report stresses, although the most striking increases in government spending will take place between 2020 and 2040.

The European Union Center of Excellence of the University of North Carolina at Chapel Hill is funded by the European Union to advance knowledge and understanding of the EU and its member countries.

Solutions

Amongst all of this gloom there is some positive news however. Total fertility rates in the EU are projected to rise from 1.48 children per woman in 2004 to 1.60 by 2030, remaining at this 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 their career and having children. Experts stress that removing obstacles to simultaneous parenthood and successful 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 the problem has a well-established long lead-in time by very nature of generational reproduction. Even if birth rates were to instantly increase the relief of this problem would still be 30years away, because of the generational dynamic.

It would also be wrong to hope for miracles from the possible EU accession of Turkey – a country with currently over 70 million inhabitants and a very small 5.9% of the population being 65+ (2006 figures). 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 present a solution to the rest of the Union. 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, the evidence is that 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 out of five and significantly smaller advantages for the local pension systems, because immigrants who have returned to their home country get their pension payments paid by the collective domestic contributors of their host country.

This might lead to a suggestion that more permanent immigration is needed. However if fertility rates do continue to converge, immigration is not likely to help. The immigrant communities 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 aging in the EU "would be unacceptable in Europe's current socio-political climate". As an illustrative example, and according to the United Nations, Germany would need an average immigration of 3.6 million people a year from 2000 till 2050 to prevent dependency ratios from rising whilst the annual net migration inflows to the whole EU currently amount to 1.3 million people or 0.35% of the population a year.

The European Union Center of Excellence of the University of North Carolina at Chapel Hill is funded by the European Union to advance knowledge and understanding of the EU and its member countries.

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

The employment rate amongst older workers is 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 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 – something that is not electorally tenable.

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 expenditure 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, whilst encouraging the policy of channeling savings into private retirement accounts, through making it tax efficient.

The penalties for continuing not to reform were set out by Frits Bolkestein, former EU Internal Market Commissioner, who 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."

But privatizing pension schemes will not be popular. However, several European governments have already taken the first steps in this 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 lacked the political courage to do so.

Experts say that the EU is already in a window of opportunity for pursuing structural reforms (between 2004 and 2011), due to positive employment and demographic tendencies where the total number of people employed is projected to increase until 2017.

The European Union Center of Excellence of the University of North Carolina at Chapel Hill is funded by the European Union to advance knowledge and understanding of the EU and its member countries.

From the political standpoint, this might be a good moment as well. 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 major challenge now, but it will only become more intractable in the future, if concrete measures are not implemented. The United States should take more time to celebrate that it does not share the same fate.

The European Union Center of Excellence of the University of North Carolina at Chapel Hill is funded by the European Union to advance knowledge and understanding of the EU and its member countries.