'Old Europe' and getting older
By William G. Shipman

During the diplomatic run-up to the war with Iraq, Defense Secretary Donald Rumsfeld introduced the term "Old Europe" to punctuate the opposition of Germany and France to the use of force in the impending conflict. In retort, French government spokesman Jean-Francois Cope offered: "An 'old' Continent -- a continent somewhat ancient in its historical, cultural, political, economic traditions -- can sometimes be infused with a certain wisdom, and wisdom can sometimes make for good advice."

The epithet "Old Europe" has another meaning, one that will be more determinate of the Continent's future than any perceived cultural advantage or inherited wisdom. Europe's population is aging: People are living longer, women are having fewer children, and the number of workers relative to retirees is shrinking. These trends will cause their Social Security systems and, more generally, the welfare state -- part of Europe's DNA -- to collapse. Old Europe, as we know it, is dying.

The beginnings of the welfare state were introduced by Germany's Chancellor Otto von Bismarck in 1889 when he adopted what is now called Social Security. Over the following years and decades many other nations, including the United States, followed his lead by also offering government benefits in large part to replace income lost to old age, disability, sickness, death, work injury and the like. As time progressed, the benefits became significant as did their costs.

In most cases these benefits are financed with a payroll tax, using what is often referred to as pay-as-yougo financing. In such systems benefits for today's elderly are paid by taxing today's young. And benefits to be paid to today's young will be financed by taxing tomorrow's young. This system is a simple transfer of wealth from young workers to older retirees. There is no saving or investment of resources for future economic growth.

For both taxes and benefits to remain reasonable, for the financial structure to remain stable, it is necessary that there always be many workers to tax relative to those who are benefit-eligible. This ratio of workers to beneficiaries is determined mainly by two variables: life expectancy and the birthrate. In Old Europe, both are moving in a direction that upsets this stability.

Throughout the Continent people are living longer. This is a result of, amongst other variables, better living and working conditions, better nutrition and health systems and greater wealth. According to the United Nations, life expectancy at birth in Germany, France and Italy is about 78 years of age; in the 1950s it was about 67.

And throughout much of Europe families are having fewer children. The birthrate that ultimately stabilizes a population is called zero population growth or ZPG for short. It is about 2.1 births per woman of childbearing age. Forty years ago most of Europe experienced birthrates well above ZPG. No more. Today, the birthrates are for France 1.7, Germany 1.4, Italy 1.2 and Spain 1.16, the lowest ever recorded for the human race. As has been reported before, "There is no single country in Europe where people are having enough children to replace themselves when they die."

The combination of rising life expectancy and falling birthrates results in a fall of workers relative to benefit-eligible retirees. According to the IMF, the ratio of contributors to retired beneficiaries in 1995 for France and Germany was 2.5 and 2.3, respectively. They have been on a steady decline and over the next five decades they are expected to drop to 1.4 and 1.2.

The political response to such a demographic squeeze has often been an increase in the payroll tax rate on the shrinking -- relatively, that is -- work force.

In the United States, for example, the employee and employer combined Social Security tax in 1950, when there were 16 workers per beneficiary, was 3 percent on a wage limit of $3,000. This year, with only 3.3 workers per beneficiary, it is 12.4 percent on $87,000. The maximum tax has jumped from $90 to $10,788. By European standards, however, it is low. The payroll tax in France is 49.3 percent, Germany is 40.9 percent, Italy and Spain are 42.5 and 37.8 percent, respectively. And unlike the United States, in many cases, but not all, the tax applies to all earnings. Yet, these numbers actually understate the burden placed on European workers for in each country the payroll tax revenue is not enough to finance benefits. Additional taxes are levied to make up the difference.

For many Western European countries, the shortfall of prospective taxes to benefits, the result of demographics, is greater in present value terms than the total value of government bonds outstanding in each country. Government debt including unfunded pension liabilities in some cases is multiples of commonly measured sovereign debt.

How "Old Europe" deals with these realities will largely determine its destiny. The elderly are absolutely dependent on institutions that are fundamentally, and demographically, unsound. The tax burden on workers is prohibitive causing avoidance in many forms including earlier retirement that further stresses the system.

Europe's economies and institutions are at risk. And yet, part of Europe's culture, the welfare state broadly defined, is a hard-wired reality of the region. Something will have to give.

Mr. Rumsfeld's characterization, "Old Europe," raised the ire of some of our European partners who responded that Europe's long history gave it a wisdom that a relatively young United States could not yet have acquired. Maybe so. If that is the case, it will need to harness that wisdom to solve an extraordinary challenge it can no longer avoid.

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