Will the Pension Time Bomb Sink the Euro?

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The population in Europe is aging and declining. A trend that could have been perfectly manageable with foresight could turn into a catastrophe given the increasing unfunded liabilities arising from pay-as-you-go (PAYGO) public pension programs, now more than 200 percent of GDP in France and Italy, and more than 150 percent of GDP in Germany. This situation is especially difficult in a continent where entitlements are deeply entrenched in a welfare state culture.

The European Commission recently stated, "There is a risk of unsustainable public finances in some half of EU countries. Belgium, Germany, Greece, Spain, France, Italy, Austria and Portugal are on this black list." Furthermore, the monetary affairs commissioner of the European Union warned, "There is only a limited window of opportunity for countries to get their public finances in order before the budgetary impact of aging takes hold as of 2010" (EUobserver.com, May 21, 2003).

So, the PAYGO pension system could turn out to be one of the gravest threats to the single European currency. As Niall Ferguson and Larry Kotlikoff (2000) argue,

> The bottom line is that generational imbalances across the eurozone gravely threaten the single currency's medium-term viability [111]. . . . [C]ountries with the most severe generational imbalances may exert pressure on the ECB to loosen monetary policy. For most of the twentieth century, after all, printing money was often the line of least resistance for governments having fiscal difficulties [117]. . . . History therefore suggests that asymmetric

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> fiscal problems—often generated by war—quickly cause monetary unions between fiscally independent states to dissolve. The fiscal problems caused by bloated social security and pension systems could have a similar centrifugal effect on EMU, with welfare substituting for war as the fatal solvent [120].

Parametric Pension Reform Is Not the Solution

Some European countries have begun to recognize the fiscal consequences of these demographic imbalances. But regrettably they seem to believe that changing some key parameters of the PAYGO pension system will solve the crisis. In June 2003, France's Prime Minister Raffarin eloquently spoke to his country's National Assembly of the need for "*lucidité demographique*" and managed to eliminate some blatant privileges of the public workers pension system. These measures partially correct the abuses of the system but not its flawed roots. The recent German pension reform, basically tax credits for supplementary savings, were a failure because too many people simply cannot save extra money after paying huge payroll taxes. Now Chancellor Schröeder has launched his "Agenda 2010," but it basically entails tampering, not reforming, the PAYGO pension system. Italy, the country with the lowest fertility rate in the world, has annual public pension outlays of around 14.5 percent of GDP. Italians, who already face 33 percent payroll taxes for pensions, would need to increase those taxes to 48 percent to pay the benefits promised to the elderly.

Even though European leaders seem to believe that so-called parametric pension reforms will be sufficient to solve the crisis, there are three main reasons that conspire against that goal. First, the political viability of some of these reforms among members of the European Monetary Union is clearly asymmetrical. For example, it may be possible to raise substantially the legal retirement age across the board in a corporatist country like Germany once consensus is reached at the top. But in France, where the recent attempt at marginal adjustments in this area for government employees led not only to long and crippling strikes but even to the support of a majority of the population, that may prove impossible.

Second, it is probable that the most decisive "parametric" change—postponing the age that makes a worker eligible for full state pension benefits—will have unintended consequences. For example, it may induce changes in the behavior of those workers asked to extend their working lives. In countries with extensive welfare programs and lax

disabilities procedures, that would simply mean shifting the source of state expenditure to another program or ministry. It must be kept in mind that the rigid European labor laws not only keep the unemployment rate high overall, but also make it especially difficult for older people to retain their jobs, or get new ones, since wages cannot adjust downward to keep pace with declining old age productivity.

Finally, measures like postponing the retirement age, reducing benefits, or increasing payroll taxes entail a decrease in the already minimal "rate of return" for these contributions, thus leading eventually to a young worker revolt, through voice (strikes, etc.) or exit (leaving the system or even the country). Those measures mean an increase in the existing "rate of return gap," making PAYGO systems even less favorable when compared with private savings alternatives.

Since, in 30 years, one worker will support each retiree in Germany, the following nightmare scenario describes, in a fictional way, the degree of coercion that this may entail: "In 2050, to save money and free precious workers, the Bundestag votes to abolish the pension bureaucracy. From now on, each retiree will be assigned his or her working-age slave, who will hand over half his salary" (Theil 2003).

Funded versus Unfunded Europe

So, a division is emerging between what can be termed a "Funded Europe" and an "Unfunded Europe." The first group comprises countries with large private pension systems (Britain and The Netherlands), those that have recently introduced personal retirement accounts and could go even further (Sweden and Poland), and those with such sound public finances that are able to "fund" the PAYGO system with general tax revenues (Ireland and Luxembourg). The second group comprises the four big countries that concentrate the bulk of EMU population and GDP—France, Germany, Italy, and Spain—and all the rest with unfunded PAYGO systems.

The first skirmishes have already begun around compliance with the Maastricht rules. While Belgium's prime minister says the rules on deficits are "our bible" (*The Economist*, October 4, 2003), the French prime minister retorts, "My duty is not to solve mathematical problems to please a particular office or country" (*The Economist*, September 13, 2003). "Unfunded Europe" leaders may want to follow the old Latin American recipe—namely, devaluation, so that the ensuing inflation reduces the purchasing power of benefits. But "Funded Europe" will probably oppose devaluing the euro. A clash may ensue amidst the centers of decisionmaking in Europe, especially within the board of the European Central Bank. Of course, this

perspective may be behind the reluctance of increasingly "funded" countries like Britain, Denmark, and Sweden to join the eurozone.

More than renewed armed conflicts among European countries, as Martin Feldstein (1977) has envisioned, I believe that the prospects are for intense, exacerbated, maybe even violent, age wars: the young resenting the confiscation of a substantial part of their hard-earned salaries; the old living in permanent fear of the growing budget deficits and the possibility of substantial benefits cuts, either directly or through inflation.

It cannot be denied that European workers in the PAYGO pension system are like passengers on the Titanic. By destroying the essential link between effort and reward, between contributions and benefits, this collectivist system encourages what Bastiat called "legal plunder." And by making the finances of the system dependent on fertility rates and life expectancies, it has been relegated to the wrong side of the European demographic megatrend of the 21st century toward aging and declining populations.

Some people think that massive immigration into Europe could postpone or even solve the problem. That is not so for several reasons. First, an economic one. Massive immigration of low-paid workers would exacerbate the unemployment problems and reduce wages, diminishing the possible tax collections from payroll taxes. Second, the reckoning problem. Those workers will pay more taxes during their working lives, but they will live to collect benefits, so it is a postponement of the pension time bomb. Third, since the great wage differentials are with North Africa, it is impossible to disregard the problems of assimilation and religious tensions between largely Islamic immigrants and the rest.

Paradigmatic Pension Reform Is the Way Out

The way out is to introduce personal retirement accounts that reestablish that essential link between effort and reward and move toward defined-contributions rather than defined-benefits pension systems. Already 15 countries have followed this path, including important European ones like Poland and Sweden (Piñera 2001).

William Shipman (2003: 1) contends that "transition financing would be a complex issue," but that "it is cheaper to move to market-based systems than to continue current PAYGO systems." Indeed, he thinks that "it is possible to design a transition scenario that is a win-win situation for all generations." A gradual and economically feasible transition to a private system has already been identified for Spain (Piñera 1996).

A system of personal retirement accounts would also improve labor mobility, another key to a well-functioning monetary union. And, if complemented with a reform of the disability system, it would enlarge the available labor force and reduce wasteful government spending.

The prospects of the euro, and of European integration, would be much better if one of the big countries of the eurozone were to begin a transformation in this direction, leading the way for the rest to follow (Piñera 1998). Ultimately, if Europeans, Americans, or Japanese do not want to have enough babies, they will have to accumulate enough euros, dollars, or yen in personal retirement accounts.

European Integration versus the Bismarckian Welfare State

One of the most important figures of the last 200 years was the Prussian Iron Chancellor, Otto von Bismarck. He instituted two political changes of great consequence for our civilization. The first was the unification of Germany through, in his words, "iron and steel." The consequences of that marked the 20th century in ways that we all know well.

The second was the institution of compulsory state pension systems. He stated that, just as soldiers in the army were entitled to their pensions for services to the state, so all employees were to be considered "soldiers of labor," entitled to a state pension and, as he explained so clearly, thus "easier to handle" than those with private pensions. Today the state has moved far beyond compulsory old-age insurance. The welfare state is highly visible, as every politician tries to win elections by taking money away from those less able to defend their hard-earned wages in order to transfer it to those with the ability to mobilize votes and street power.

Whatever the merits of its introduction, the euro is already a fact and its demise could weaken the noble and visionary effort of a common economic space in Europe that has brought prosperity and ensured peace. If Europeans want to keep their common currency, they will have to abandon the Bismarckian pension paradigm and, while keeping a government-financed safety net, begin moving toward a comprehensive retirement system based on ownership, individual freedom, and self-reliance.

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