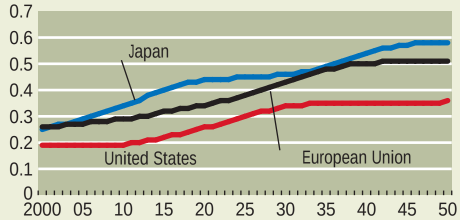
PICTURE THIS

Can Europe Afford

OVER THE coming decades, an increasing share of the European Union's (EU's) population will turn elderly as baby boomers reach retirement age and life expectancy rises. This is true of both the 15 original members and the 10 new ones. Enlargement will, at best, have a brief rejuvenating effect, given the current, much younger age profile of the new members. Projections indicate that, by 2020, the share of older people in the EU-25 will approach that of the EU-15, reflecting a plunge in these new members' fertility rates over the past decade or so. In fact, the onset of serious population aging in the EU is no longer a distant event, as it will start as early as 2010.

Across major industrial countries, populations are aging.

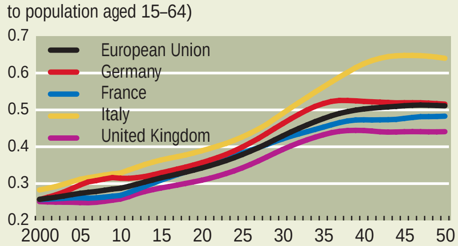
(elderly dependency ratio; ratio of population aged 65 and over to population aged 15–64)



Sources: European Union Economic Policy Committee 2001; *UN Population Prospects Publication* (Revision 98); and IMF staff estimates.

In the European Union, the share of the elderly in the population will double by 2050 . . .

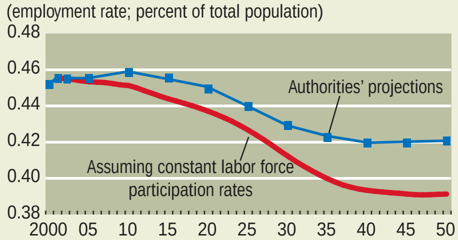
(elderly dependency ratio; ratio of population aged 65 and over to population aged 15–64)



Sources: European Union Economic Policy Committee, 2001; and IMF staff estimates.

and the share of the employed in the population will decline sharply.

(employment rate; percent of total population)



Sources: European Union Economic Policy Committee, 2001; and IMF staff estimates.

to Grow Old?

For most EU countries, aging populations will cause major fiscal headaches—chief among them, fiscally unsound pension systems. Europe recognizes that dramatic pension reforms are urgently needed. Currently, public pensions financed on a pay-as-you-go (PAYG) basis dominate in most countries. These schemes pay pensions out of current contributions or taxes. The problem with PAYG systems is that they are in danger of becoming massively underfunded when the number of people drawing pensions begins to markedly increase relative to the number in the active labor force paying into the systems. By contrast, prefunded pensions—both private and public—play a subordinate role in most countries. These schemes make pension payments from a fund that is an accumulation of financial assets built up over a period of years from its members' contributions.

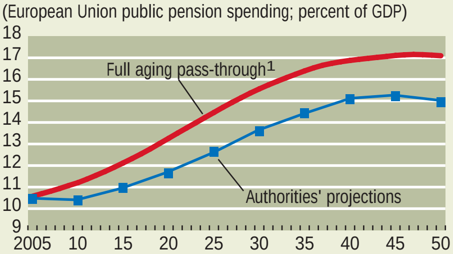
So what are Europe's options? Three stand out:

- *Closing PAYG financing gaps* on a year-by-year basis through "parametric" reforms that boost pension revenue (increasing pension contribution rates or the number of contributors) or cutting pension spending (reducing benefits or the number of pensioners), or both.
- *Shifting to public prefunding of pensions,* which would imply running surpluses in the public pension system, at least over the next two decades or so.
- *Shifting to private prefunding of pensions,* which would lead to deficits in the public pension system during the transition period as contributions are diverted to private pension accounts (assuming the diversion of contributions cannot be fully offset by parametric reforms).

So far, different EU members favor a range of strategies that embrace all of these options. Some member countries plan to cut public debt and use the resulting interest savings for extra aging-related spending; adopt labor market reforms to raise employment rates, especially for older workers and women; and, particularly among the new member states, rebalance the public-private pension mix by shifting to private prefunding. However, the reality is that, given the size of the problem, public pension benefits will also need to be cut—and substantially—which, at the political level, would require a graying electorate to accept an erosion of its promised benefits. No doubt then, resolving these tensions in a forward-looking way would require more reliance on option three—that is, starting to build up a *private* pension component now so that it will eventually help to compensate for the unavoidable future cutbacks in public pension benefits without pitting younger and older generations against each other. ■

The growing number of elderly threatens to undermine the financial sustainability of the welfare state . . .

(European Union public pension spending; percent of GDP)

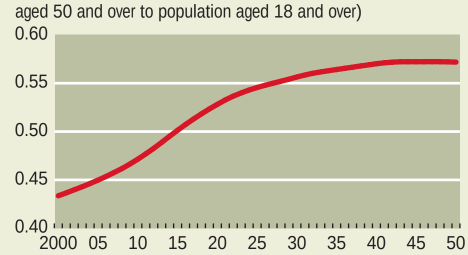


Sources: European Union Economic Policy Committee, 2001; and IMF staff estimates.

[1]That is, all pension system parameters—such as generosity and eligibility—and the employment rate are left unchanged; only the change in the dependency ratio is reflected in public pension spending.

while boosting the political power of its main beneficiaries.

(share of older voters in voting-age population; ratio of population aged 50 and over to population aged 18 and over)



Sources: European Union Economic Policy Committee, 2001; and IMF staff estimates.

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