SHIPMAN: Europe's warning buzzer

We can reshape our government to avoid catastrophe

By William G. Shipman

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The near-collapse of Greece is a warning buzzer for all of Europe; the welfare model is on a collision course with forces much stronger than Europe's embrace of the utopian promise. The ensuing clash will be between those who demand that the state continue to provide much of its citizens' needs and those who argue that it can't. As the conflict plays out, Europe will have two choices. One will be to adhere to its cradle-to-grave entitlements; the other will be to replace them with efficient, market-based solutions. Which path it takes not only will form Europe's future, it also will determine ours to some degree.

The welfare model was born of the Industrial Revolution. With its premium on the strength and endurance of labor, this 19th-century economic advance devoured human resources. In response, mutual-aid societies, church groups and public/private enterprises emerged to benefit those too weak to work. These micro-responses, which sprouted in many European countries, were trumped ultimately by large government programs. Germany, for instance, introduced the Sickness Insurance Law in 1883. It added the Accident Insurance Law one year later and then in 1889 the Old-Age and Disability Insurance Law, the beginning of Social Security. It was decreed that the government must step in and protect its citizens from the difficult vagaries of life.

Having made these first experimental steps, the German government broadened its mandate. Today, it provides an old-age, disability and survivors pension. It also offers sickness and maternity benefits as well as workers and dependents medical benefits. If one is injured at work, the state pays temporary and permanent disability benefits as well as workers medical and survivor benefits. If one is unemployed, the state pays a benefit equal to 67 percent of net earnings. There also is a benefit for children younger than 18 and a child-rearing allowance for children younger than age 2. Most European governments, including Greece, provide similar benefits.

These generous benefits require generous resources, most of which come from taxing wages. Take, for instance, the following numbers in Germany: old age, disability and survivors insurance, 19.5 percent of earnings (employee and employer combined); sickness and maternity benefits, 15.9 percent; work injury, 1.33 percent; unemployment benefits, 6.5 percent. For Greece, the total payroll tax rate, insured person and employer combined, is about 35 percent.

These high payroll taxes discourage employment, which leads to lower economic growth, higher unemployment and ultimately lower wage-related tax revenues. But beyond all of this, Europe is facing a demographic monster that will rip its cultural fabric to shreds.

Across the continent, the number of young workers who pay taxes is declining relative to the population of older folks who receive benefits, because life expectancy is increasing and fertility rates are decreasing. From 1950 until now, life expectancy at birth in Germany has increased from 68 to 81 years of age while the fertility rate has fallen from 2.2 to 1.3. These trends are comparable throughout all of Europe.

The fertility rate that stabilizes a population is 2.1. Above this, populations grow, and below it, they shrink. The fertility rates in all European countries were above 2.1 in 1950; they are now all below that. There is no country in Europe in which people are having enough children to replace themselves when they die. Europe is aging, and at the same time, it's shrinking. Yet the welfare model requires that it do neither. Europe is on a collision course. How it responds will determine its future, likely for decades.

One response would be to alter fundamentally how citizens' needs are met and financed. The most efficient solution would be to provide market-based structures to health care and retirement income.

An alternative response would be to view the short-term financial challenge as simply a cash-flow problem - which it is, but only in part. From this perspective, the solution is to raise taxes further and/or cut benefits. Both responses make a bad situation worse. Tax-adjusted benefits are already low. Making them lower - as the only fix - would burden citizens and the economy even further.

As we watch the European reaction to the Greek tragedy, caused in part by its own response to the interplay of its well-established demographics and entitlements, we will learn whether European countries have finally learned that the welfare state is unsustainable. Should Europe make the wrong choice, it will suffer further and become even less important as an economic and strategic partner. The next buzzer won't be a warning.

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