

## The Challenge of Lisbon for the European People's Party

By John Bruton



The European Council, at a meeting on 23<sup>rd</sup> and 24<sup>th</sup> March 2000, adopted what became known as the “Lisbon Strategy”. It set out to

confront what it called a “quantum shift resulting from globalization and the challenges of a new knowledge-driven economy”. It did so at a time when the Council said the Union was “experiencing its best macro-economic outlook for a generation”, but had “more than 15 million Europeans still out of work”.

The Strategy covered policy areas that were mainly within the competence of Member States, not the Union itself, and the ambitious goals set at Lisbon were to be achieved by a new open method of coordination, whereby the setting of guidelines and the exertion of peer pressure, would speed up the necessary reforms. These reforms were also spurred on by the dramatic growth in the productivity of the United States economy which, after a period of European catch up, was then powering ahead of Europe in its overall competitiveness.

Interestingly enough, this 2000 version of the Lisbon Strategy paid little attention to an issue that has come to dominate the debate in 2005 - what the Kok report has described as the “combined challenges of low population growth and ageing”. The fact that it faces up to the impact on economic growth of low population growth and ageing makes the Kok report, and the Barroso Commission’s response to it, more realistic than the original Lisbon Strategy of 2000.

In this article, I would like to offer some suggestions on how the member parties of the European People’s Party (EPP) can help achieve the Lisbon goals. I will draw on my experience of over thirty five years in Irish politics, and on my more recent studies of the United States

economy.

Speaking on the Lisbon process, Jean-Claude Juncker, Luxembourg Prime Minister, and one of our most distinguished EPP leaders, said:

“We all know what we need to do, but we don’t know how to win elections after we have done it”.<sup>1</sup>

This sums up the challenge facing the EPP. The Party must come up with a method for turning unpleasant pension, healthcare and labor market reforms into election winning strategies.

That seems like a tall order. But do we really have any choice?

### Europe’s low birth rate at the core of the problem

Between 1960 and 2000, the average dependency ratio (defined as the number of persons aged 60 or over, relative to the number aged between 15 and 59) for the EU 15 rose from 26 to 35 dependents. At the same time (thanks to more immigration and a higher birth rate) the dependency ratio for the United States remained constant at 25.

Now at 35 dependents, the dependency ratio for the EU 15 is (unless we increase our birth rate) expected to reach 47 dependents by 2020 and 70 dependents by 2050.<sup>2</sup>

Basically, fewer and fewer people of working age will have to support more and more elderly people. There will be almost as many people over the retirement age than there will be people of working age.

The problem is, of course, not exactly the same for every country. The age dependency ratio

<sup>1</sup> Financial Times, 2 February 2005

<sup>2</sup> “An agenda for a Growing Europe” Sapir Report (2003)

for Spain in 2050 will be 73.8 and in Italy 68.1, whereas it will “only” be 46.7 in France and “only” 39.9 in Britain. But present projections are that the age dependency ratio in the United States in 2050 will be 34.9, which will be little more than half the average European rate.

So even if President Bush felt he needed to devote his State of the Union address to the prospect of long-term deficits in Social Security and Medicare, we in Europe have a much bigger problem. The State of our Union, as far as ageing is concerned, is much more severe!

But, it is also worth remarking that, when one is looking as far ahead as 2050, one does have the time to do something to change the trends, and one is not confined to unpleasant welfare reforms as the only means of bridging the ageing gap. A substantial increase in the European birth rate could, even without more immigration, begin to reduce the projected dependency ratio by as early as 2025 – which is well within the expected lifetime of most readers of this paper. The relevance of achieving a higher birth rate is hardly discussed at all in the review of the Lisbon Strategy. It is almost as if it is a taboo subject. Why?

The Commission's most recent communication on the Lisbon Strategy<sup>3</sup> says “While the issue of low birth rates should be properly addressed as part of a long-term policy, raising employment levels is the strongest means of generating growth and promoting socially inclusive economics” and it goes on to add that the “huge potential” of women “in the labour market” remains to be fully “exploited”.

Given that the time available is finite and people have to make choices, the “exploitation” of this “potential” of women in the labour market could well have the effect of preventing them from having as many children as they themselves would otherwise wish. That could even further reduce the birth rate. It would further worsen, in the medium term the dependency ratio. Fewer children today would mean fewer workers tomorrow and fewer workers tomorrow

would mean fewer contributors to the costs of caring for the elderly.

In promoting higher labour force participation rates among those of childbearing age, a choice arises between short and medium term social benefits. This choice needs to be honestly debated, even if that debate could be a contentious and difficult one which called some well established social goals into question.

The Lisbon Strategy seeks to increase what it calls the “participation rate”. “Participation” is defined as taking part in paid work. A parent at home, looking after a number of small children, is arbitrarily deemed not to be “participating” in society in accordance with the measure used by economists. But that is a very narrow and economic measure of “participation”. A new broader measure of participation is needed which would place a higher social valuation on parenting, and this new valuation should be explicitly included among the Lisbon goals.

If the tax code is altered, as it has been in some countries, artificially to discourage a choice to stay at home and look after children in order to promote “participation”, then the birth rate will fall still further.

In the short run, that may save money on the schooling of extra children. But, in the long run, it will deprive society of the young workers who will be needed, sooner or later, to pay the taxes to finance their parents' and grandparents' pensions and nursing home care.

The need to devote more time to paid work is not the only possible obstacle to having more children. Indeed some countries with high female participation rates in paid work, have higher birth rates, than other countries which have both lower paid work participation rates and lower birth rates.

Other factors play a part. High housing costs and unduly prolonged third level education may postpone the time when a couple can afford to come together to have children. Avail-

<sup>3</sup> “Working together for growth and jobs – a new start for the Lisbon Strategy” (COM(2005)24)

ability of childcare may also be a factor, but the data is ambiguous on this. Taking a prolonged period of parental leave may interrupt the accumulation of pension rights or progress along a chosen career ladder. Anything that adds to the high cost on a decision by either a father or a mother to take responsibility for having children deserves to be examined if we want to give Europe a more balanced demographic structure. There is an incentive distortion if the cost of rearing children is imposed mainly on families, and the cost of caring for the elderly is mainly taken over by the State.

From an accounting point of view, Philip Longman says:

“Older citizens consume far more resources than children do. Even after considering the cost of education, a typical child in the United States consumes 28% less than the typical working age adult, whereas elders consume 27% more, mostly in health related expenses”.<sup>4</sup>

On the basis of such figures, there is a very strong economic case in terms of maintaining Europe’s stock of human capital for giving substantial family allowances to European families who are willing to have more children.

### **Can difficult choices be sold to the electorate?**

But, whatever way you look at it, this is a problem that can only be solved in the medium term. A higher birth rate next year will make no difference before 2025 or later. In the shorter term, difficult choices also have to be made. These choices include liberalising the labour market, reducing the reservation wage, postponing retirement and restricting health benefits. And, as Jean Claude Juncker points out, these choices have to be made by politicians, most of whom face the need to be re-elected within the next three years, not the next twenty!

How do you sell unpleasant policies to an unwilling electorate?

I make no claims to special expertise in this matter, but I do have some experience derived from my time in Irish politics over thirty-five years.

My own experience, as Irish Finance Minister who introduced very tough budgets in the 1981-82 period, is that when the public sense there is a national crisis requiring unpleasant action by the Government, they will support their Government, so long as the necessity for the action is explained to them in clear language by a united team that has its full heart in the job in hand. Half-hearted, divided, or unconvinced Government leadership will convince nobody. Half-hearted, divided or unconvinced implementation of the Lisbon Process will go nowhere.

Another problem that a reformist leadership will face is a demand from party supporters when asked to support sacrifices now, that they be shown “light at the end of the tunnel”. In other words, party supporters want firm assurances that, if the unpleasant medicine is consumed today, there will be a complete cure within at least a week! While it is easy and sometimes necessary to give such assurances, they do not always turn out to be true. An unexpected change in global conditions – such as a rise in international interest rates or a fluctuation in currency values – can postpone the arrival of the benefits of even the best designed reform programme. This happened in Ireland in the 1980’s.

Some of the reforms that will need to be undertaken – reducing job security or raising the retirement age – will eventually increase employment and reduce taxes or deficits. But that may not happen until well after the next election. And that is simply too late for today’s Prime Minister!

One useful approach, which was found to be particularly effective in Ireland in the late 1980’s, is that of getting opposition parties and social partners to buy into the reform programme, at least in part. Then, even if one does not win the next election, one has at least got the satisfaction of seeing their programme implemented.

<sup>4</sup> “The Global Baby Bust” by Philip Longman in *Foreign Affairs*, May/June 2004

And, who knows, you may get the credit for the results of your reforms in the next election after that.

This was our experience in Ireland with the budgetary policies of 1982. The budget was defeated in Parliament, and an election ensued which the Government lost. The new Government that came into office put through 90% the budget they themselves had voted against a few months before. Then they, in turn, lost an election quite soon afterwards, and the original Government was re-elected.

Some EPP parties are now in opposition and are facing a Government of the left which is trying to implement Lisbon reforms. Should an EPP party adopt the tempting opposition tactic of destructively criticising what the Government is doing, or should it, on the other hand, adopt a policy of qualified support for what its political opponents are trying to do?

I think qualified support is the best tactic. Ireland's painful decade of fiscal correction lasted from 1980 to 1989 and in the last two years of that time my party, Fine Gael, was in opposition.

In 1987 our then party leader, Alan Dukes, adopted a policy that was without precedent in Irish political history. He said that if the Government continued on a path of fiscal correction, we would not vote against its measures in Parliament. He got a lot of grief from his party supporters and parliamentary backbenchers for taking this course. He was told that the party would lose its identity and would disappear because its policies would be indistinguishable from those of its main political opponents.

His critics were proved completely wrong. When the election came round in 1989, Fine Gael actually increased its representation, notwithstanding its qualified support for the policies of, what had by then become a rather unpopular Government. Fine Gael was seen by the electorate as being sincere rather than opportunistic, and it was rewarded rather than punished when the

votes were counted.

Political sincerity and personal conviction will be essential to the success of any drive by EPP parties to implement the Lisbon Strategy and make Europe a more competitive and knowledge-based economy.

As I said earlier, we will convince no one else unless we are convinced ourselves! Given the ageing profile of our European workforce, it would be unconvincing for an EPP party simultaneously to oppose immigration of appropriately skilled people to Europe, while at the same time claiming that it wants to keep costs down and enhance the flexibility and effectiveness of our workforce. Notwithstanding the superficial popular support that an anti-immigration stance might attract, the underlying inconsistency would penetrate into the public consciousness and undermine its legitimacy. Integration and the creation of a positive European allegiance amongst immigrant families is another matter and is something about which we can learn from American experience.

### **Retirement or renewal – the choice for Europe's "baby boom" generation**

The Lisbon Strategy, in its present form, will not change Europe's demography. That is a fact. Perhaps not a very palatable one. But a fact, nonetheless.

As a result of demography, German public spending on pensions, even after accounting for a reduction in future benefits written into current law, is expected to swell from an already staggering 10.3% of GDP today, to 15.4% in 2040, while the number of workers available to support each retiree will shrink from 2.6 workers to only 1.4 workers per retiree.<sup>5</sup>

Raising the retirement age would, to some extent, ease this burden of old age health and pension benefits. But a rapid decline in physical fitness among the population could make a policy of later retirement harder to sustain.

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<sup>5</sup> Longman op.cit.

In the United States, declining fitness among the general population already causes this problem. Increases in obesity and sedentary life and work styles are causing disability rates to rise even among the population who are 59 or younger. Researchers estimate that this trend will cause a 10% to 20% increase in demand for nursing homes and home care over and above the increases that otherwise would have occurred. In the case of European men, the percentage who are overweight ranges from 40% in France to 70% in Germany. Reversing this trend would contribute to the Lisbon goals, because it would reduce long-term health costs and would make later retirement more feasible.

But Europeans should not feel that they are alone in facing a problem of how to maintain economic dynamism, while supporting an ageing population.

For example, the U.S. Defence Department already spends 84 cents on pensions, for every dollar it spends on basic pay. In 2000, the cost of military pensions amounted to 12 times what the military spent on ammunition and more than 5 times what the U.S. Air Force spent on new planes and missiles.

Ageing, even the ageing that takes place long before reaching retirement age, may also adversely affect the rate of technological and organisational innovation.

Older people, with family responsibilities, are less likely to take risks or move to a new workplace than are young, unattached people in their 20's or early 30's. The older people get, the more they value security. And those who value security are less comfortable with the process of "creative destruction" that, according to Schumpeter, is inherent in economic growth. For example, the ageing of the Japanese workforce during the 1990's has undoubtedly contributed to Japan's declining growth, by comparison with the enhanced growth of the much more youthful population of China. The older a population gets the more inclined it becomes to use its political influence to resist change.

In truth, the achievement of the Lisbon goals requires a radical reappraisal of the expectations people in Europe have about "what I am going to do when I retire".

The goal of "retirement" may have to be replaced by goals like "retraining", "reorientation" and "renewal" for people who are approaching their 65<sup>th</sup> year. What will be required will be a change in social psychology, as well as, a change in social policy. Older people will have to come to enjoy a life of renewed challenge and change, rather than the present expectation of quiescence and routine. Mentalities will have to change.

### **What Europe can learn from America**

I would now like to turn to what Europeans might learn, in seeking to implement the Lisbon Strategy, from the historical experience of the United States of America.

The first lesson we should learn is to keep a sense of proportion.

According to US economist Robert J. Gordon European output per head was 5% higher than American output per head was in 1820.<sup>6</sup> Then, thanks to the expansion of the US frontier and to immigration, European output per head fell back to 93% of the US level by 1870. By 1913, Europe had fallen even further behind – to just 74% of the US level of output per head. And then, thanks to two world wars initiated by Europeans, European output per head fell even further again to 56% of the American level in 1950. The "American challenge" is nothing new! We have been losing ground since 1820!

Since 1950 Europe has, more or less, been catching up. By 2000, West European output per head had reached 77% of the American level which is considerably better than where Europe was in 1950! We had got back to where we were, in relative terms, in 1913.

There has, indeed, been a falling back in Europe's relative output per head in very recent

<sup>6</sup> "Two centuries of Economic Growth : Europe chasing the American Frontier" by Robert J. Gordon – Centre for Economic Policy Research (2004)

times in the 1990's, thanks to the much more rapid application of information technology in the United States.

### **The number of hours we work**

But a good part of this difference is explained by the fact that Americans work more paid hours than Europeans do – more hours per week, more hours per year and more hours per lifetime. Some might say that Americans live to work, while Europeans work to live!

But this trend for Europeans to work fewer hours than Americans is a fairly recent one. Between 1979 and 2001, the average annual number of hours per year worked by Americans remained more or less stable at 1820 hours. In the same period, the number of paid hours worked in France fell from 1800 hours in 1979 to 1532 hours in 2001 – a drop of almost 300 hours work in the year. In Germany the annual number of hours worked also fell by around 300 hours and in Italy, the U.K. and Sweden, the annual number of hours worked fell about one hundred hours a year.<sup>7</sup>

In theory at least, it should be possible for Europeans to increase their incomes and output by reverting to the number of hours they worked in 1979. That is a choice that should at least be considered as one means of achieving the Lisbon goals.

### **The influence of geography and housing policy**

The difference in productivity between Europe and the United States may also be partially explained by factors that cannot be changed at all. For example, America has more space.

The more space you have the more productive you can be, especially in activities like retailing, wholesaling and farming. Lower productivity in retailing and wholesaling accounts for over a third of the productivity gap between the UK and the US, and for well over half the productivity gap between Germany and the US. Efficient

retailing and wholesaling is much easier if you can have wide aisles in shops and warehouses and can have customised out-of-town locations for shopping malls. It is much more difficult to achieve maximum retail and wholesale efficiency, and consequently lower prices, in a store in the centre of a medieval European city!

Likewise, it is much easier to achieve high productivity per farm worker on the rolling cornfields of the United States, than it is in the small fields on the small farms of Europe.

Adair Turner estimates that US productivity in retailing and wholesaling has been growing at a dramatic 6% per annum, while the typical European growth rate in these fields has been only 1%.<sup>8</sup>

There are, however, a number of things that the United States does that Europe should reasonably be expected to imitate if it wants to achieve the Lisbon goals.

Americans are more productive because they are more willing to move house to a new job. Europeans are much less willing, it appears, to do so, even within their own country. Many zones of high unemployment in Europe are located just outside commuting distance from areas of labour shortage.

In the United States you can easily buy a new house without even having a deposit. Banks are much more cautious in Europe. The hidden charges – legal fees and taxes – imposed on people buying a house are much higher in Europe. Increasing mobility and reducing costs in the housing sector should be one of the goals of the Lisbon Strategy.

### **Competition and Higher Education**

One of the reasons for US dynamism is the high level of competition between businesses. Underperforming companies in the United States are much more liable to be taken over, and their management replaced. One third of the companies in the Fortune 500 today will have lost

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<sup>7</sup> "What's wrong with Europe's economy" by Aidair Turner, London School of Economics (2003)

<sup>8</sup> Adair Turner. Op.cit.

their place within the next three years. There is no room in the United States system for complacent “national champions”. The watering down of the EU takeover directive means that top management in a large European company can rest much more easily on their laurels than can top management in a similar United States company.

Another area where Europe lags behind the United States is in higher education.

The US spends a higher share of its GDP on higher education from public sources than does the average EU country. When you add to that the financing that comes from private sources (student fees and charitable donations), the US spending on higher education surpasses that in Europe by a very large margin. It is no wonder then that talented European researchers are attracted to work in US universities, contributing thereby to the US economy. US universities can afford to pay them better, and offer them better and more exciting working conditions.

In the United States, 37% of the working age population has a third level educational qualification. In the EU 15, on average only 24% of our working age population have a third level qualification. There is, of course, wide variation within the average.

In Ireland 35% of the work force have a third level qualification, in Finland 32.3% and in Sweden 31%. In contrast, only 10% of the Italian work force and 13% of the Austrian have such a qualification.<sup>9</sup>

Tables published in the Sapir report show that there is a surprisingly small relationship between the number with third level qualifications, and the amount spent by Government on third level education. Perhaps it takes an inefficiently long time to get a marketable third level qualification in some countries.

Austria spends 1.7% of its GDP on third level education as against 1.6% spent in Ireland, but the proportion of the workforce qualified at

third level in Ireland is three times that in Austria. This may be partly explained by the older age structure of the Austrian population, but it is a discrepancy that deserves further study.

Productivity within higher education is important. If salary levels of academics do not vary in accordance with effort and achievement, there may be less effort and achievement. The US academic world is highly competitive and this is something from which Europe could learn.

### Supporting innovation

Why is it that Europe produces nearly twice as many science and engineering graduates per capita as the United States, and yet remains far behind the US in the number of patents obtained in the fields of science and engineering? The European Union creates only a quarter as many patents per million people as the US.

A small part of the explanation for this must be the failure, after so much effort, to bring the European Community Patent into operation. The fact that this long overdue help for scientific innovation is being held up because of a dispute about language is emblematic of Europe's problems. As a businessman said in Davos in 2003 “National culture is an asset: nationalism is a disease, ... and Europe has that disease”.

Innovation in the United States is greatly assisted by the fact that Americans are not afraid to fail. Risk-taking means being willing to fail, and to try again. Europe's banking system, and Europe's people, are far too intolerant of the businessman or woman who has failed. As the Kok report pointed:

“Despite the evidence that failed entrepreneurs learn from their mistakes and perform better in their next business, customers and financiers are reticent to place orders (with them). Honest bankruptcy still carries too many severe legal and social consequences”.

A political party, like the EPP, can do a lot to change the perverse and unproductive hostility

<sup>9</sup> Sapir. Op.cit. (2003)

to those who have failed in business.

On a wider scale, this is the political challenge facing the member parties of the European People's Party. Are we prepared to take risks?

Implementing the Lisbon Strategy involves taking real political risks. There is every possibility that we will fail, at least in narrow political party terms. We are asking people to change their lifestyles and their life expectations. We are not doing so in order to achieve some consumerist goal or to accumulate more money. We are asking people to change now so that, as Europe gets older, it will be able to afford to preserve the essentials of what previous generations of Europeans have built – a caring model of society that is the envy of the rest of the World.

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