ECONOMIC POLICY COMMITTEE

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ANNUAL REPORT ON STRUCTURAL REFORMS 2005

"INCREASING GROWTH AND EMPLOYMENT"

Key Messages

This is the Ecofin Council's 2005 report on structural reforms, prepared by the Economic Policy Committee (EPC). In December 2004, the EPC conducted its annual peer reviews on the implementation of structural reforms by the Member States in the preceding 12 months. This year, these examinations have been advanced by one month to advise better the Council and the Commission ahead of the Spring European Council. This is also in conformity with the role that the Sapir group[1] recommended the EPC to seek. The report not only deals with the implementation record in the past year, but is also forward looking, signalling areas where further progress is required in Member States.

Overall, there has been some progress with structural reforms over the past 12 months, but the examinations confirmed Wim Kok's and Ecofin's assessment that much more urgency is needed with implementation. The EPC fully shares the view that a macroeconomic framework supportive of stability and growth is indispensable. Governments will reap the full benefits of structural reforms in terms of growth and employment only in an appropriate macroeconomic environment. At the same time successful structural reforms enhance the effectiveness of macroeconomic policies, ensuring long-lasting growth and the long-term sustainability of public finances.

The EPC identified seven key areas pivotal for re-focusing on the core goals of the Lisbon Strategy - higher growth and employment. These recommendations take up the priority areas which were identified by the High-level Group chaired by Wim Kok[2] and by the Ecofin Council of 16 November 2004. From the examinations, the need for urgent and intensified labour market reforms has emerged as a recurrent and particularly important theme. More action is needed to increase employment rates across all age groups. Further, the EPC stresses that all measures aiming to reform product, labour and capital markets have to be consistent with the overarching objective of fiscal sustainability.

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[1] See pp. 158 and 161 of "*An Agenda for a Growing Europe: The Sapir Report*", Sapir et al, July 2003

[2] See Chapter 2 of "*Facing the Challenge: The Lisbon strategy for growth and employment*", Report from the High Level Group chaired by Wim Kok, November 2004

1) Realising the knowledge society and boosting innovation

- **Facilitate private R&D investments** by creating the appropriate framework conditions (in particular strengthening science-industry links and ensuring affordable intellectual property rights). FDI inflows can also generate technological spill-over effects, especially if supported by education policies. Currently, there tends to be an emphasis on increasing public R&D spending. While this may reflect an appropriate redirection of public resources, it is particularly important to ensure efficient evaluation and monitoring of their effectiveness.
- **Build on the progress made in the information society**. ICT, internet and broadband are increasingly available. Yet, differences exist among Member States and there remains scope to use available technologies more effectively.
- **Improve education and training systems better to meet demands for highly skilled labour.** Educational reform (in particular tertiary education), in line with the Bologna declaration, should be geared towards promoting greater mobility of students, teachers and researchers. It should also aim at creating centres of excellence of educational and research institutions.

2) Keeping the commitments to the Internal Market

- **Integrate the markets for services**. The services sector suffers from insufficient competition in all Member States, which contributes to low productivity growth.
- **Ensure adequate resources for and independence of competition and regulatory authorities.** This is needed in order to enforce more effectively competition policy, especially following the progressive liberalisation of (network) sectors, which sometimes have a natural tendency towards monopolies or oligopolies, due to relatively high fixed costs.
- **Refrain from distortionary public intervention in the markets**. Public intervention in markets is economically sensible when used to target market failures. However, Member States should further reduce inappropriate sectoral state aid, and re-direct state aid towards horizontal objectives. Member States should also refrain from using regulations and standards in ways that constrain the Internal Market.
- **Implement the directives for the liberalisation of network industries**. In particular, the liberalisation of the energy sector still requires particular attention, including to secure effective competition.
- **Improve the transposition record.** Only six Member States have transposition deficits below the 1.5 per cent target as of July 2004.
- **Improve the effectiveness of financial markets.** Although it did not emerge as a major issue in the examinations, the continued deepening and integration of financial markets remains an important objective (e.g. to seek continued improvements of securities markets and payments, retail financial services and European financial supervision). Effective competition across Europe will help ensure that needed enterprise finance is provided and that the resilience of the European economy against shocks is improved.
- **Continue integration of labour markets in the EU.** Improve mobility by recognition of qualifications, assessing the transferability of social security/pension entitlements, and consider reducing formal barriers to mobility.

3) Creating the right climate for entrepreneurs

- **Improve the regulatory environment at the community and national level,** building on the Six Presidency Initiative to reduce administrative burdens and promote competitiveness through improvements in regulatory impact assessments and simplification of existing legislation. At present, four Member States measure the administrative burdens on business and three apply quantitative reduction targets.
- **Bring down remaining barriers to market entry.** Many Member States have established one-stop-shops and business information centres. This should, however, not substitute for more substantial improvements in the entrepreneurial climate and in public sector efficiency.
- **Develop a competitive entrepreneurial spirit**. In general, educational policies play an important role to generate dynamic entrepreneurship in the medium and long run. , So as to promote business start-ups, better conditions for the growth of existing enterprises and innovation, there is still a need to improve access to finance, even though several Member States reported improvements in the supply of risk capital.

4) Building a labour market for higher employment and stronger social cohesion

- **Drive forward the three labour market reform priorities** as endorsed by the Ecofin Council in March 2004; namely (i) increasing flexibility of labour markets in order to unlock the dynamics of employment creation, including appropriate adjustments in wage bargaining systems; (ii) modernising the concept of job security to improve employability; and (iii) taking action on benefit and tax reform to improve incentives and make work pay. A focused approach is needed to enhance employment in view of the long list of various suggestions for labour market reforms[3]. Employment is also the best way to increase social inclusion and to guarantee its sustainability.
- **Strengthen regional cohesion.** Wage flexibility and the regional mobility of labour, within and between Member States, are crucial to diminish regional disparities. In addition, infrastructure, including transport and housing, is a necessary but not sufficient condition to address this issue adequately. Higher employment is also conducive to social cohesion.
- **Stimulate social partners to co-operate** in implementing labour market reforms balancing the interests of both the insiders and the outsiders.

5) Working towards an environmentally sustainable future

- **Create win-win opportunities** such as eco-efficient innovations to strengthen the synergy effects between environmental protection and growth, which can ease the trade off between them. The wider use of market-based instruments should be pursued, also building on the experiences from the greenhouse gas emission trading scheme.

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[3] See, for example, *"Jobs, Jobs, Jobs: Report of the Employment Taskforce chaired by Wim Kok"*, November 2003

6) Ensuring long-term sustainability and quality of public finances

- **Pursue the three-pronged strategy**; namely, increasing employment rates; reducing public debt; reforming pension and health care systems[4]. Many Member States implemented or announced further measures to promote the long-term sustainability of public finances. Inadequate progress so far in increasing employment rates and reducing debt burdens remain therefore areas of prime concern. Monitoring of the quantitative impact of pension and health care reforms as well as increasing employment rates, and if necessary intensifying efforts, will now be crucial so as to alleviate fiscal pressures and the EPC Ageing Working Group will update its sustainability assessment in the course of 2005.
- **Improve the quality of public finances**. In order to re-direct public resources, both at the national and EU levels, towards growth-enhancing activities in line with the strategic Lisbon priorities, further improvement is required to ensure the effective use of public funds. Assessing this hinges upon the development of a coherent framework to assess the composition of public expenditure, including institutional approaches to support budgetary re-allocation, and the availability of detailed, reliable and comparable data in all Member States.
- **Take measures to improve public sector efficiency.** Half of the Member States report efforts including the increased use of ICT, the reduction of administrative burdens and the use of Private-Public Partnerships. But, more focus is needed on developing more user-oriented provision of public services, so as to reduce pressures for higher, unaffordable spending.
- **Efficient co-ordination between different levels of government** should also be ensured, so as not to put at risk the sustainability and quality of public finances.

7) Enhancing external openness

- **Reinforce delivery of structural reforms by increasing external openness,** also in a multilateral context. Increased trade, especially in the new Member States, has proven to be an important spur to growth, employment and productivity. Promoting external openness to the rest of the world can also increase the attractiveness for FDI inflows, which, among other tools, are instrumental for the development towards knowledge-based economies, especially if supported by policies to promote education and skills.

Strengthening governance of the Lisbon Strategy.

In 2005, the Spring Council will discuss the mid-term review of the Lisbon strategy. If the implementation gap is to be closed, the governance of the Lisbon process should be strengthened. The EPC recalls the conclusions adopted by the Ecofin Council on 16 November 2004 on the economic aspects of the Lisbon process. Ministers stressed, in particular: achieving higher growth and employment should be at the centre; reforms aimed at accelerating Europe’s employment and productivity growth; political ownership and leadership; the central role of the BEPGs and of multilateral surveillance; and, increasing accountability.

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[4] The Stockholm European Council, March 2001

PART I

REFORM PRIORITIES

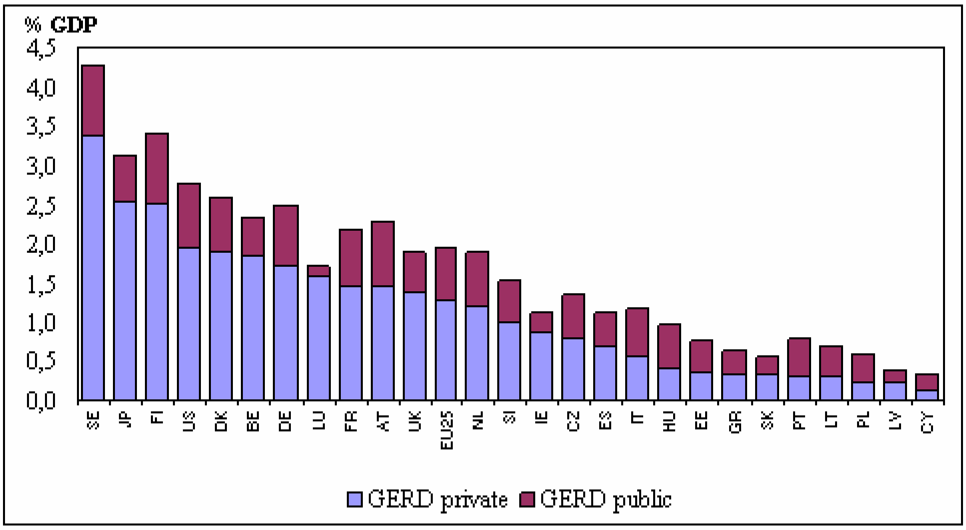
Realising the knowledge society and boosting innovation

- ***Facilitate private R&D investments*** *by creating the appropriate framework conditions (in particular strengthening science-industry links and ensuring affordable intellectual property rights). FDI inflows can also generate technological spill-over effects, especially if supported by education policies. Currently, there tends to be an emphasis on increasing public R&D spending. While this may reflect an appropriate shifting of public resources, efficient evaluation and monitoring of their effectiveness has to be ensured.*

A core element in the Lisbon strategy is progress towards the knowledge-based society. The knowledge-based society encompasses a broad array of topics and activities. During the country reviews in December 2004, most attention was given to three related elements (private) R&D and innovation, the information society and (tertiary) education, which broadly coincides with the priority reforms identified by the Kok High-level Group.

In March 2002, the European Council concluded that “there must be a significant boost of the overall R&D and innovation effort in the Union, with a particular emphasis on frontier technologies. The European Council therefore agreed that overall spending on R&D and innovation in the Union should be increased with the aim of approaching 3 percent of GDP by 2010. Two-thirds of this new investment should come from the private sector.” Only two Member States (SE and FI) currently exceed the spending target and another five (BE, DE, DK, FR and AT) exceed the 2 percent mark. On average Member States spend 1.93 percent, of which 65 percent is financed from non-public sources. Several Member States (including SK and UK) indicate that their R & D expenditure will remain below the EU target in 2010. In many Member States the absorptive capacity is insufficient to ensure an efficient allocation for the massive increase in public R&D and innovation funds. On the other hand, low levels of private R&D investments in the EU are identified as one of the main explanations for the EU-US innovation gap[5].

Figure 1 - Gross domestic expenditure on R&D in EU25, US and Japan



Source: EU structural indicators, Eurostat (no data available for MT)

[5] European Commission, *European Innovation Scoreboard* (SEC(2004)1475), 19 November 2004

Most member States emphasised the importance of creating the appropriate framework conditions to facilitate private R&D. Affordable intellectual property rights - including a Community patent - and strengthening science-industry links are perceived as key. However, for the latter it proves difficult to define the government role and appropriate public measures. Fresh views in this respect were not reported. In particular for the new Member States FDI proves a valuable source for R&D and innovation.

- ***Build on the progress made in the information society**. ICT, internet and broadband are increasingly available. Yet, differences exist among Member States and there remains scope to use available technologies more effectively.*

The information society has progressed well since the start of the Lisbon strategy. For instance in the EU15 the percentage of households who have Internet access at home increased from 18.3 percent in 2000 to 47.0 percent in 2004 (EU25: 44 percent), although large differences exist among Member States. The number of broadband lines subscribed in percentage of the EU15 population has tripled to 7.6 percent in 2004 (EU25: 6.5 percent). In the EU15 total enterprises' receipts from sales through the Internet as percentage of the total turnover doubled from 0.9 percent in 2002 to 2.0 percent 2004. In spite of these increases there is further scope for both the proliferation of ICT, and its more efficient use.

- ***Improve education and training systems better to meet demands for highly skilled labour.** Educational reform (in particular tertiary education), in line with the Bologna declaration, should be geared towards promoting greater mobility of students, teachers and researchers. It should also aim at creating centres of excellence of educational and research institutions.*

A recurrent item during this year's country reviews was the need to improve the educational system - in particular tertiary education - to ensure that it better matches skill demands. The most recent PISA study shows that in a vast majority of the Member States 15-year old on average outperform or equal reading and mathematical skills compared to US students of the same age[6]. The exceptions being EL, IT, LU and SK for reading and EL, IT and PT for mathematics. However, US students seem to overtake EU students in the tertiary educational stage, since this is identified as one of the reasons why US growth exceeded EU growth in the 1990s[7]. Similarly, the European Innovation Scoreboard claims that 26 percent of the innovation gap between the US and the EU is due to the lower share of the working population with tertiary education in the EU[8]. It is therefore encouraging that the European Education Ministers aim to increase "the international competitiveness of the European system of higher education", including through the introduction of a two-tier tertiary education system (undergraduate/graduate)[9]. Several Member States (DE, EE, IT, HU, NL and SI) report progress in this field. But to reap the full benefits of the Bologna initiative further reforms are urgently needed.

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[6] OECD Program for International Student Assessment (PISA), *Learning for Tomorrow's World*, (2004). EE, CY, LT, MT, SL and UK are not included in this study.

[7] K. Aiginger, *Growth Difference between Europe and the US in the Nineties: Causes and Likelihood of persistence*, (www.wifo.ac.at/Karl.Aiginger/publications/2002/background.pdf), November 2002

[8] European Commission, *European Innovation Scoreboard* (SEC(2004)1475), 19 November 2004

[9] *Bologna Declaration*, 19 June 1999

Keeping our commitments to the Internal market

- ***Integrate the markets for services****. The services sector suffers from insufficient competition in all Member States, which contributes to low productivity growth.*

The Kok report rightly recognises that the slowdown of activities to complete the Internal Market prevents Europe from reaping enormous potential benefits of further economic integration. The Kok report particularly emphasises the need to remove obstacles to the free movement of services, which is still far less developed. It nevertheless accounts for 70 percent of economic activity in the EU, whereas it only represents 20 percent of Europe's trade. In most service sectors, less then 5 percent of production is exported to other Member States[10]. Removal of the national regulatory barriers that for a large part cause this low trade level could result in an increase of trade in commercial services of up to 15-30 percent, and a rise of the FDI stock in services of 20-35 percent[11].

- ***Ensure adequate resources for and independence of competition and regulatory authorities.*** *This is needed in order to enforce more effectively competition policy, especially following the progressive liberalisation of (network) sectors, which sometimes have a natural tendency towards monopolies or oligopolies, due to relatively high fixed costs.*

In addition, substantial improvements are still to be made in order to increase competition in services (retail, professional services) between (potential) suppliers *within* individual Member States. Improving competition in services was explicitly identified as a key challenge in the 2003-2005 BEPGs for six Member States (BE, ES, FI, IE, NL, and the UK) and implicitly in the recommendations for DK, DE and SE. So far progress has been limited in all Member States but DK and NL, implying an urgent need for further action.

To ensure effective enforcement of competition legislation, competition and regulatory authorities need to be independent, clearly mandated to investigate specific markets and sectors, and adequately staffed. This is particularly the case following the progressive liberalisation of (network) sectors that sometimes have a natural tendency towards monopolies or oligopolies, due to relatively high fixed ("sunk") costs. Network regulators should be further strengthened in LV and AT (telecommunications). Independence needs to be enhanced in several Member States (EE, LU, HU), while in others the number of staff should be increased (SI).

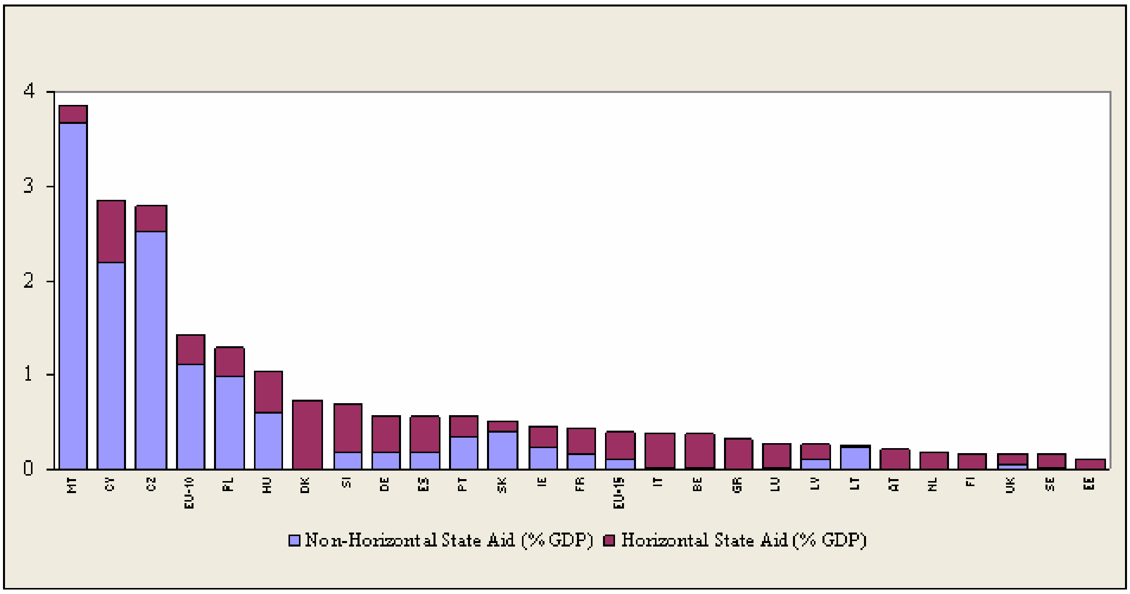
- ***Refrain from distortionary public intervention in the markets****. Public intervention in markets is economically sensible when used to target market failures. However, Member States should further reduce inappropriate sectoral state aid, and re-direct state aid towards horizontal objectives. Member States should refrain from using regulations and standards in ways that constrain the Internal Market.*

[10] Lejour and Montizaan, *Intra-EU trade and investment in service sectors and regulation patterns*, CPB Memorandum No. 101 (2004), The Hague.

[11] Kox, Lejour, and Monitzaan, *The free movement of services within the EU*, CPB Document 89 (2004), The Hague

Member States comply with the European Council's renewed call in Barcelona (2002) to decrease the level of state aid, and to redirect aid towards horizontal objectives. As is illustrated in graph 2 both the level (in terms of GDP), and the share of horizontal subsidies varies considerably among Member States.[12] The level of state aid in the new Member States is expected to drop by more than 50 percent as a significant number of aid measures is being phased out. Nonetheless, the combined aid level in the new Member States as a whole will remain well above the EU15 average (whereas EE, LT, and LV are characterised by aid levels that are among the lowest of the EU) without additional reductions. The Member States that currently grant the highest shares of state aid to non-horizontal objectives (MT, CZ, CY, PL, HU), are encouraged to further reduce these levels, whereby it is noted that these reductions should not unduly interfere with objectives such as the facilitation of necessary structural reforms. Among the EU15, IE and PT substantially decreased their level of state aid over the past years, but still face the biggest challenge of the EU15 to redirect aid towards horizontal objectives.

Figure 2 - State aid (% GDP)



Source: State Aid Scoreboard 2004, European Commission

- ***Implement the directives for the liberalisation of network industries****. In particular, the liberalisation of the energy sector still requires particular attention, including to secure effective competition.*

The Lisbon Strategy calls for progressively liberalising network industries. In particular, the liberalisation and securing of effective competition in the energy sector still requires attention. When comparing regional European markets, competition constraints persist on the West Continental, the Iberian, and the Italian markets, while competition is stronger on the Central and Eastern European, Nordic and UK markets. NL and PT fully liberalised their electricity markets in 2004, HU and LT liberalised energy markets for non-household users, and in SI Transmission System Operators in electricity and gas were legally unbundled. However, the overall picture is that competition remains restricted, also after liberalisation, resulting in persisting market dominance of one or

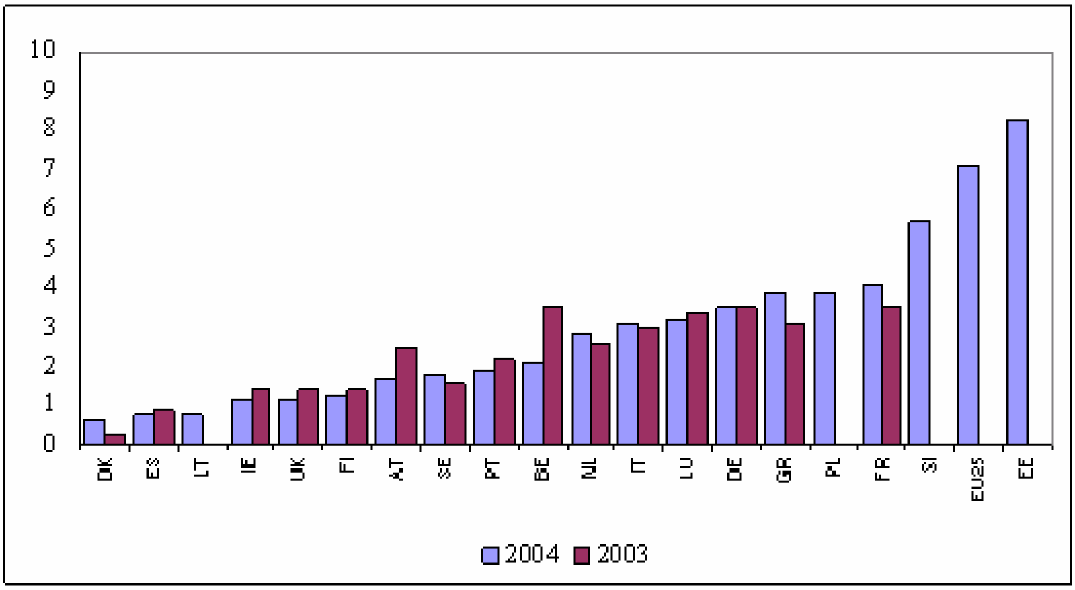
[12] European Commission, *State Aid Scoreboard 2004*, Brussels, (europa.eu.int/comm/competition/state_aid/scoreboard/index_en.html)

few generators and higher prices for end-users. Member States that are lagging in taking measures to increase competition include BE, EE, FI, FR, EL, IT, LV and PL.

- ***Improve the transposition record.*** *Only six Member States have transposition deficits below the 1.5 per cent target as of July 2004.*

At the September Competitiveness Council, Ministers agreed to step up efforts to reduce the Internal Market transposition deficit to 1.5 percent or below as requested by the Stockholm European Council (2001). As an operational follow-up, the Presidency requested Ministers in a letter dated 11 October 2004 to set target dates for meeting the European Council's twin objectives (the 1.5% deficit and the 0% deficit for directives overdue more than two years) and to undertake an internal screening of internal transposition systems (best practices).

Figure 3 - Transposition rates



Source: Internal Market Scoreboard N° 13, July 2004, European Commission

Only six of the EU25 already have transposition deficits below the 1.5% target (DK, ES, IE, LT, FI, UK). Among the last-placed states are CZ, CY, LV, HU, MT, and SK with significant deficits (not in figure).[13] CY, HU and SK set their target date for meeting the 1.5% transposition deficit on 31 December 2005. The CZ set its target on 30 June 2006. Most Member States are either in the process of evaluating their internal procedures and mechanism with the aim of improving their transposition records or have recently done so and are now working on the basis of improved transposition systems.

- ***Improve the effectiveness of financial markets.*** *Although it did not emerge as a major issue in the examinations, the continued deepening and integration of financial markets remains an important objective (e.g. to seek continued improvements of securities markets and payments, retail financial services and*

[13] However, according to preliminary Commission data of November 2004 it would seem that all these countries now have a transposition deficit below 10%, while CY, HU and MT are even substantially below this threshold.

European financial supervision). Effective competition across Europe will help ensure that needed enterprise finance is provided and that the resilience of the European economy against shocks is improved.

An effective, integrated financial services market would deliver significantly lower costs to business and consumers and help to drive growth in all other sectors of the economy. 39 of the 42 measures proposed in the Financial Services Action Plan (FSAP) have now been completed. However, it is still too early to make a final evaluation to what extent it has achieved its stated objectives. Many of the FSAP measures have only just entered into force, while others still need to be transposed in the Member States. The national implementation of all the FSAP measures to ensure a level playing field across Europe is therefore an important priority, as is their subsequent enforcement.

While the impact of the FSAP will only become apparent over the medium-to-longer term, financial market integration in the EU is progressing. In wholesale markets in particular there is evidence that European markets are beginning to integrate. In contrast, there has been less integration in retail financial services, which are still segmented along national lines. The EU needs to consider what action may be necessary to facilitate further integration, analysing where the remaining barriers exist and tackling them where appropriate.

As the EU's financial markets become more integrated, consideration also needs to be given to the need for enhanced convergence in supervisory practices. Closer supervisory cooperation and convergence of practice will help to address supervisory concerns about the changing nature of risks in the financial sector, to deliver a more streamlined approach to cross-border financial supervision and increase confidence in the financial products of cross-border firms. This closer cooperation should be based on the new Lamfalussy arrangements, which are now in place to supervise financial services across the EU.

More generally, the integration of labour markets in the EU should be continued (see also below). This calls for improving mobility by recognition of qualifications, assessing the transferability of social security/pension entitlements, and consider reducing formal barriers to mobility.

Creating the right climate for entrepreneurs

- ***Improve the regulatory environment at the community and national level,*** *building on the Six Presidency Initiative to reduce administrative burdens and promote competitiveness through improvements in regulatory impact assessments and simplification of existing legislation. At present, four Member States measure the administrative burdens on business and three apply quantitative reduction targets.*

In its 21 October conclusions, the Ecofin requested the Commission to continue work on a methodology to measure the administrative burden of EU legislation and regulation, and to set up pilot projects in order to test the methodology. Ministers agreed that a common European methodology should be based, inter alia, on the recommendations by the EPC and that the method could be similar, but not necessarily identical, to the Standard Cost Model (SCM) that is already in use in SE, DK, NL and BE. It called on the Commission to present and implement the methodology as soon as possible in 2005 after completion of the pilot phase.

BE, DK and NL have set up quantitative targets, committing themselves to reducing administrative burdens on enterprises by 25 percent. These three countries have estimated the total administrative burden on enterprises in order to be able to measure performance against the targets. In the case of DK and BE, the target should be met in 2010, while the NL intends to reach the target already in 2007.

The Competitiveness Council of 25-26 November welcomed the progress achieved since its session in May 2004 in identifying, on the basis of contributions from the Member States, individual legal acts which seem to offer a particular potential for simplification from the point of view of competitiveness. The Council also stated its intention to pursue work on identifying priorities for simplification as a continuous process in the broader framework of better regulation.

Together with administrative simplification programmes, consultation and e-government (see Public Sector Efficiency), impact assessment is an important element in the efforts to achieve better regulatory and administrative environment for enterprises. Five Member States (BE, IE, SK, SE, UK) have adopted targets stating that they will submit to impact assessment all new regulations relevant to the business sector by 2006. SE would already have achieved this goal.

Building on this progress, at the December 2004 Ecofin, the Six Presidencies of IE, NL, LX, UK, AT, FI, outlined a shared vision for further reform over the next two years. The joint statement calls for new proposals for competitiveness testing of EU regulations; agreement on further simplification of existing EU laws; and agreement to measure and control the administrative burden imposed by EU regulations.

- ***Bring down remaining barriers to market entry.*** *Many Member States have established one-stop-shops and business information centres. This should, however, not substitute for more substantial improvements in the entrepreneurial climate and in public sector efficiency.*

One of the key recommendations of the Kok report is the drastic reduction of duration, effort and costs of setting-up a business. Barriers to business start-ups vary widely among Member States, as do governments’ activities to reduce them. ES, EL and PL are among the Member States where the scope for progress is largest in terms of number of procedures, costs and minimal capital requirement. However, effective progress in improving these obstacles to entrepreneurship in these Member States seems limited.

A large number of Member States set up one-stop shops or are in the process of establishing them. Notwithstanding that one-stop shops can make an important contribution to the improvement of the regulatory business environment, these organisations should not substitute for more substantial improvements in the entrepreneurial climate and in public sector efficiency such as enhancing access to finance, improving the quality of regulation, providing a national taxation system that underpins entrepreneurship and, from a broader point of view, strengthening the judiciary and the rule of law.

- ***Develop a competitive entrepreneurial spirit**. In general, educational policies play an important role to generate dynamic entrepreneurship in the medium and long run. So as to promote business start-ups, better conditions for the growth of existing enterprises and innovation, there is still a need to improve access to finance, even though several Member States reported improvements in the supply of risk capital.*

Entrepreneurship is also determined by less tangible variables such as a ‘fear of failure’ culture, and a low drive for independence relative to the preference for the security of a fixed income. Several Member States (such as FI, LU, UK and SE) initiated education and awareness campaigns to promote the entrepreneurial spirit, particularly among the young. Other Member States, particularly those with relatively low growth business birth-rates of enterprises (such as BE, LV)[14], could also consider including attention to the cultural constraints of self-employment in their efforts to promote business start-ups.

Finally, access to risk capital is essential in promoting business start-ups and facilitating expansion of innovative enterprises. In line with the Lisbon Strategy, access to low cost finance must be facilitated within the framework of measures to create a business climate that is conducive to investment, innovation, and entrepreneurship. Over the past years, investments in venture capital are clearly on the rise in a large number of Member States. In 2003, substantial increases occurred in the UK and NL, which are also the two Member States with the highest level of risk capital investments. In CZ, the increase in risk capital investment was so substantive, that this country ranked among the main EU venture capital investors in 2003, while in 2000 it had the lowest level of investment of all (acceding) Member States of which data are available.[15] This might be considered a promising signal for SI, SK and, to a somewhat lesser extent, AT, where both the level and growth rate of venture capital investments are low. Although AT and SK report (intended) measures to increase the availability of risk capital, efforts should be intensified drastically to catch up with the other EU Member States.

Building a labour market for higher employment and stronger social cohesion

- ***Drive forward the three labour market reform priorities** as endorsed by the Ecofin Council in March 2004; namely (i) increasing flexibility of labour markets in order to unlock the dynamics of employment creation, including appropriate adjustments in wage bargaining systems; (ii) modernising the concept of job security to improve employability; and (iii) taking action on benefit and tax reform to improve incentives and make work pay. A focused approach is needed to enhance employment in view of the long list of various suggestions for labour market reforms[16]. Employment is also the best way to increase social inclusion and to guarantee its sustainability.*

[14] European Commission, *Benchmarking Enterprise Policy: Results from the 2004 Scoreboard* (2004), Brussels. Data CY, MT n/a.

[15] European Commission, *Benchmarking Enterprise Policy: Results from the 2004 Scoreboard* (2004), Brussels. Data EE, CY, LV, LT, LU, MT n/a.

[16] See, for example, *“Jobs, Jobs, Jobs: Report of the Employment Taskforce chaired by Wim Kok”*, November 2003

- ***Continue integration of labour markets in the EU.*** *Improve mobility by recognition of qualifications, assessing the transferability of social security/pension entitlements, and consider reducing formal barriers to mobility.*

At the request of the 2003 Spring European Council, Mr Kok chaired the European Employment Taskforce which identified practical reform measures to promote employment growth[17], because - despite overall progress - the intermediate targets are out of reach. In *Facing the Challenge*, the Kok High-level Group reiterates its commitment to the recommendations of the Employment Taskforce. In addition it stresses the need for lifelong learning and active ageing.

Table 1 - Employment rates and targets in the EU25

	2000	2003	2005 (target)	2010 (target)
Total (aged 15-64)	62.4	63.0	67	70
Women (aged 15-64)	53.6	55.1	57	60
Older workers (aged 55-64)	36.6	40.2	-	50

Source: EU structural indicators, Eurostat

The Ecofin Council deemed necessary a further prioritisation, and concluded in March 2004 that "Each Member state should commit in specific terms to implement measures which will:

1. Increase flexibility of labour markets in order to unlock the dynamics of employment creation, including appropriate adjustments in the wage bargaining systems;
2. Modernising the concept of job security to focus on improving employability; and
3. Take action on benefit and tax reform to improve incentives and make work pay."

2004 was a year in which Member States have made only limited progress in these specific areas. Despite progress in some Member States, overall the need for urgent and intensified labour market reforms emerged as a recurrent and particularly important theme in the country examinations. The reported labour market reforms relate in most cases to improving active labour market policies and reducing the tax wedge on labour. Action is also needed to ensure a regulatory climate that supports job creation.

- ***Strengthen regional cohesion.*** *Wage flexibility and the regional mobility of labour, within and between Member States, are crucial to diminish regional disparities. In addition, infrastructure, including transport and housing, is a necessary but not sufficient condition to address this issue adequately. Higher employment is also conducive to social cohesion.*

- ***Stimulate social partners to co-operate*** *in implementing labour market reforms balancing the interests of both the insiders and the outsiders.*

In particular the need for flexible wage bargaining systems that allow wage developments to reflect changes in productivity are crucial for reducing regional disparities. National wage arrangements typically have a tendency to rigid elements. In addition, wage differentials also prove a powerful incentive for labour mobility both among and within countries. Nevertheless, improvements in the flexibility of wage

[17] *Jobs, jobs, jobs: Report of the Employment Taskforce chaired by Wim Kok*, November 2003

bargaining has been limited in the Member States in which specific problems in this area have been detected (ES, EL, IT, PT, and FI). Looking ahead, a number of Member States urgently need to make progress with increasing regional wage flexibility, especially in several New Member States . Further progress on wage flexibility depends to an extent on the approach of the social partners. For instance in Italy, talks with social partners to explore possible changes were initiated, but abandoned by the largest trade union, which strongly opposed regional wage agreements. In Finland, the outcome of the next (centralised) wage agreement will possibly provide further scope to reflect productivity differences.

Working towards an environmentally sustainable future

- ***Create win-win opportunities*** *such as eco-efficient innovations to strengthen the synergy effects between environmental protection and growth, which can ease the trade off between them. The wider use of market-based instruments should be pursued, also building on the experiences from the greenhouse gas emission trading scheme.*

There are win-win opportunities such as eco-efficient innovations whereby environmental policies can contribute to growth. It is important to seize this opportunity to foster a sustainable development.

Environmental policy needs to take all costs to society into account. Getting prices right enforcing the polluter pays principle remains a key challenge in order to foster effective resource allocation. Evidence indicates that economic instruments are often more effective than command-and-control instruments, and should therefore always be considered when environmental policy instruments are assessed. A suitable approach to improve the effectiveness in environmental policy is therefore to encourage the use, where appropriate, of economic instruments such as tradable permits and national environmental taxes. Some MS (SE, HU, FR, FI, DK, DE, ES, UK) have made progress in this area, but especially in a EU-wide perspective, market based instruments still provide a largely untapped resource.

Ensuring long-term sustainability and quality of public finances

- ***Pursue the three-pronged strategy****; namely, increasing employment rates; reducing public debt; reforming pension and health care systems*[18]*. Many Member States implemented or announced further measures to promote the long-term sustainability of public finances. Inadequate progress so far in increasing employment rates and reducing debt burdens remain therefore areas of prime concern. Monitoring of the quantitative impact of pension and health care reforms as well as increasing employment rates, and if necessary intensifying efforts, will now be crucial so as to alleviate fiscal pressures and the EPC Ageing Working Group will update its sustainability assessment in the course of 2005.*

[18] The Stockholm European Council, March 2001

Over the last few years, many Member States have made substantial efforts to reform their pension and health care systems, and introduce other structural reforms, including those that help to raise the potential trend rate of growth of the economy. Despite these efforts the long-term sustainability of the public finances cannot be guaranteed yet across the European Union. As the long-term sustainability of the public finances is a prerequisite to achieving high and stable rates of long-term economic growth, further reform efforts are therefore required. In many Member States these reforms should be complemented by the consolidation of public debt to prepare the public finances for the future fiscal impact of an ageing population.

However, Member States will need to go beyond establishing policies that are fiscally sustainable today. The ageing of the population is a gradual and long-term process, and our understanding of this and other long-term socio-economic trends might evolve in the future. All long-term projections are subject to degrees of variability around the key assumptions and therefore it is important to produce projections around a number of scenarios. For example, over the past few decades, demographers have raised gradually their assumption of increases in life expectancy and it is possible that these will increase further. As such, even those Member States that, to the best of our current knowledge, pursue policies that are long-term fiscally sustainable, ought to monitor future developments and be in the position to implement further reforms if necessary.

- ***Take measures to improve public sector efficiency.*** *Half of the Member States report efforts including the increased use of ICT, the reduction of administrative burdens and the use of Private-Public Partnerships. But, more focus is needed on developing more user-oriented provision of public services, so as to reduce pressures for higher, unaffordable spending.*

The use of information and communications technologies and Private-Public-Partnerships are priorities in increasing public sector efficiency.

Since the 1990s, the introduction of information and communication technologies has been an important tool to improve the performance of the public sector. The introduction of information and communication technologies, together with the associated changes in working methods (e-Government) offers the potential for improvements in the quality of information, time savings, and increased speed of response in interaction with citizens and businesses; it promotes the establishment of common standards across public agencies, and encourages the elimination of redundant systems. *e*Europe 2005 Action Plan and the subsequent e-Government policy put forward measures to speed up the development of e-Government in the EU. The European Commission identifies SE and IE as leading countries in the introduction of e-Government.

The involvement of the private sector can yield benefits by bringing the projects closer to the market in terms of risk-sharing, management skills and the quality of public services. Private-Public-Partnerships aim at combining the best of the public and private sectors.

- ***Improve the quality of public finances****. In order to re-direct public resources, both at the national and EU levels, towards growth-enhancing activities in line with the strategic Lisbon priorities, further improvement is required to ensure the effective* *use of public funds. Assessing this hinges upon the development of a coherent framework to assess the composition of public expenditure, including institutional approaches to support budgetary re-allocation, and the availability of detailed, reliable and comparable data in all Member States.*

The European Council in Lisbon identified the improvement of the quality of public finances as an important prerequisite for promoting long-term growth and employment in Europe. The Lisbon strategy and the BEPGs ask for '*redirecting, i.e. while respecting overall budgetary constraints, public expenditure towards growth-enhancing cost-effective investment in physical and human capital and knowledge'*. Whereas important Lisbon strategy elements like R&D, knowledge based economy and education with their growth potential can be supported by high quality public spending, quality cannot be reduced purely to investment. Therefore, all expenditure items (including tax expenditures) are to be assessed with respect to their quality dimension, i.e. their contribution to potential growth.

It will be necessary, but difficult to create room for redirecting public expenditure towards high priority areas while respecting overall budgetary limits. Therefore, the Lisbon strategy and the BEPGs ask for *'increasing the efficiency of the public sector, inter alia, by introducing mechanisms to assess the relationship between public funds and policy objectives and to help control spending'*. Improving the governance of public sector institutions and the management of public budget re-orientation holds the potential to raise the quality of public finances and hence the growth potential of the EU economies. The surveys of the national setups clearly back the call for a look at Member States´ experience with instruments for evaluating and assessing public expenditure, including "best practice" comparisons as well as the need for specific impact assessments of single components of the public budget.

Institutional reforms in the budgetary process can facilitate 'high quality' budgetary adjustment while at the same time increasing the efficiency of public spending. Some Member States have introduced frameworks for expenditure control and reforms to the budgetary re-allocation process with the aim of linking public expenditures to policy outcomes (performance budgeting). These experiences should be used to initiate a process of mutual learning and exchanging "best practices" at EU level. In this field there is an urgent need for improvement, e.g. by installing an "institutional data set", and the scope for learning from international experiences is large.

In sum, an in depth empirical analysis on the basis of a reliable data base is called for, in order to develop a coherent framework for analysing the dynamics and the composition of total public expenditures and thus gain a more comprehensive understanding of their impact on the growth potential.

- ***Efficient co-ordination between different levels of government*** *should also be ensured, so as not to put at risk the sustainability and quality of public finances.*

When assessing the sustainability of the public finances, it is important to consider a wide measure of government. Experience has shown that ultimately all tax payers may have to bear the cost of unsustainable finances in one part of government, and therefore it makes sense to focus on this wider measure when assessing sustainability. However, the way in which different Member States operate their fiscal frameworks and take account of sub-national tiers of government differs significantly, reflecting the different political and constitutional arrangements of those countries

Enhancing external openness

- ***Reinforce delivery of structural reforms by increasing external openness,*** *also in a multilateral context. Increased trade, especially in the new Member States, has proven to be an important spur to growth, employment and productivity. Promoting external openness to the rest of the world can also increase the attractiveness for FDI inflows, which, among other tools, are instrumental for the development towards knowledge-based economies, especially if supported by policies to promote education and skills.*

Increasing EU openness to trade and FDI could be a valuable tool for the achievement of the Lisbon targets. The Spring European Council 2004 noted that "*increasing external openness globally and improving the dynamic economic relationships between trading partners will enhance growth prospects*". More recently, the Ecofin Council conclusions stated "*that continued efforts are also necessary to increase external openness, also in a multilateral context, as an important spur to growth, employment and productivity by increasing competition and lowering barriers to entry and increasing incentives for innovation.*"

Many Member States have benefited economically from external openness. Trade has proven to be an important spur to growth, employment and productivity in a large number of MS. In their national Cardiff reports and during the country examinations most MS stressed the economic importance of trade for their economic development.

Trade barriers still constitute an obstacle for fully realising the economic gains of global trade. Further increasing the EU openness to trade and FDI would be a forceful instrument towards the achievement of the Lisbon targets. No specific targets exist in this area. It is important that Member States acknowledge the importance of open trade and investment in this context. Reducing EU's external barriers as well as ensuring a strong and unified EU in pursuing trade liberalisation in the forthcoming WTO negotiations and other international organisations would be beneficial for the economic prospects of the EU. It would also promote economic cohesion by boosting living standards in regions of EU Member States on the EU's external borders. A number of them rank among the EU's poorest regions, and would benefit if there was an effective liberalisation of trade with the EU's Near Neighbours.

External openness has also been an important factor to attract FDI. In most Member States FDI has been a driving force behind technological development and knowledge dispersion. Still, in many MS FDI is hampered by barriers to entry and bureaucracy. Eliminating barriers to FDI and promoting favourable framework conditions for FDI could facilitate the transition to the knowledge-based economy.

PART II

COUNTRY NOTES

BELGIUM **(BE)**

Challenges identified in the 2003-2005 Broad Economic Policy

Belgium was requested to:

- Ensure the continuation of the budgetary adjustment in the forthcoming years, in particular in view of ensuring the long-term sustainability of public finances in the face of population ageing.
- Increase the low participation and employment rates, especially for older workers and women, and improve incentives to work.
- Enhance competition in certain services sectors and continue to increase the efficiency of public administration and to improve the business environment.

Developments over the last year

- The debt ratio stays on a downward path, but the primary surplus has also been decreasing.
- A low employment rate especially among older workers is a major structural problem. Measures were adopted to stimulate employment in the age group over 50 and reduce access to benefits for early retirement. However, limited progress was made in increasing activity and employment rates.
- Further measures have been taken to make work pay. Personal income tax has been lowered and social security charges have been reduced. The Government decided to introduce "work bonus", an increased rebate of social security contributions for low-income workers. Moreover, measures have been implemented to re-attach the newly unemployed to the labour market after company restructuring.
- Measures have been adopted to enhance competition and the liberalisation of network industries is progressing through the transposition of the EU legislation. Since July 2004, approx. 90% of the energy market is open to competition.
- Good efforts have been delivered to cut the administrative burden for businesses. The Government has pursued and strengthened its general policy of better regulation. The reform of public administration has also been pursued further.

Areas where further progress is still required

In order to keep track with the Lisbon Strategy, Belgium should:

- Continue its efforts to ensure long-term sustainability of public finances, particularly by implementing the agreed health care and pension system reform measures and taking due account of future liabilities.
- Strengthen initiatives targeted at increasing the employment rate. A particular focus should be to the activation of the older workers and the reform of the early retirement schemes should be pursued further. Continue efforts to reduce non-wage labour costs and facilitate more wage differentiation across sectors.
- Further reduce administrative burdens, in order to improve the overall business environment.
- Pursue efforts to liberalize network industries.

CZECH REPUBLIC (CZ)

Challenges identified in the 2004 update of the Broad Economic Policy Guidelines

The Czech Republic was requested to:

- Urgently ensure a further reduction of the general government deficit on a sustainable basis and the long term sustainability of public finances.
- Continue to address the structural problems in the labour market.
- Improve conditions for an accelerated productivity growth.
- Promote entrepreneurship and SMEs.

Developments over the last year

- As regards the long term sustainability of public finances, the Government recently set up an experts' group to prepare different proposals of pension reform and intends to decide on one of the proposals before the 2006 parliamentary elections. The health-care reform was put on hold and also the contingent liabilities linked to the indebtedness of public hospitals and to the "environmental clean-up guarantees" granted to privatised industrial firms by the National Property Fund remain outstanding.
- On 1 October 2004, a new Employment Law entered into force. However, many of structural shortcomings, such as low labour force mobility, have not yet been tackled.
- In order to improve the business environment, several proposals to tackle barriers to market entry and exit and to reduce administrative burden are being discussed. Also, a completely new Bankruptcy Act is being prepared. However, very few measures have actually been implemented.
- A new Education Act covering the primary and elementary education has been approve, which should bring about more flexibility and adaptability of skills and competencies. However, a reform of tertiary education was postponed. Several measures have been taken to stimulate R&D activities and more measures to promote private spending on R&D are being considered.

Areas where future progress is still required

In order to keep track with the Lisbon Strategy, the Czech Republic should:

- Take a more determined approach to restore public finance long-term sustainability, also given the need for a substantial increase in infrastructure investment.
- Continue with the reform of the pension system on the time schedule as envisaged. The reform of the health system should be addressed urgently and measures should be taken to reduce the fiscal risk from the rising stock of contingent liabilities.
- Restart the process of deregulation of housing prices and improve the transport infrastructure in order to tackle the structural weaknesses in the labour market. Also, a firm commitment to reform of the tertiary education sector is warranted.
- Start to implement as soon as possible the proposed measures to improve the business environment. Also, further progress on the envisaged new Bankruptcy Act would be a positive development. Shorten the implementation of the proposed measures.

DENMARK (DK)

Challenges identified in the 2003-2005 Broad Economic Policy Guidelines

Denmark was requested to:

- Ensure an adequate labour supply in view of the ageing of the population.
- Enhance competition in certain sectors and improve the efficiency of the public sector.

Developments over the last year

- Further measures were introduced to increase labour supply and to lower unemployment. The recent tax reform, fully implemented in 2004, lowers marginal taxes for many workers to raise the incentives for workers to work more hours and introduces an earned income tax credit to enhance incentives for low-wage earners to stay in or enter the labour market. However, additional measures will be necessary in order to reach the medium term targets of labour supply.
- The targets for public expenditure growth have been exceeded but with a downward trend. In 2004, real public consumption is expected to have grown only modestly, which could indicate that a more effective control of public expenditure across all government levels has been established. Next to budget agreements across government levels, the tax freeze aiming at preventing local governments from raising taxes to finance increased spending seems to be working.
- Prices in Denmark remain the highest in the EU. In 2004, the Competition Authority published a report which identified sectors, such as the legal profession, the housing sector, and taxi services, where competition is distorted by regulations.
- A decision was made to overhaul completely the municipal system of government with the aim of improving efficiency. Also, a cross-government initiative was launched to investigate how public sector roles can be modernised and where possible delegated to the private sector.

Areas where future progress is still required

In order to keep track with the Lisbon Strategy, Denmark should:

- Formulate further reforms to reach the medium term target for the labour supply.
- Focus on the implementation of the changes of the municipal system of government.
- Make an extra effort to achieve the targets for public expenditure restraint in the future. This is important for the medium-term fiscal targets as well as the strategy of the long-term fiscal sustainability and debt reduction.
- Further examine the causes of the high price level, and to take remedial action accordingly.
- Continue to intensify competition in sectors with higher than average EU-price levels. Adequate follow up should be given to the findings in this years report from the Competition Authority.

GERMANY (DE)

Challenges identified in the 2003-2005 Broad Economic Policy Guidelines

Germany was requested to:

- Promote job creation and adaptability and mobilise the unutilised employment potential.
- Increase productivity through improvements in the business environment and the efficiency of the education system.
- Secure the long-term viability of pension and health-care systems.

Developments over the last year

- Important steps have been taken to increase the flexibility of the labour market. Germany has since March 2003 been passing legislation to reform the labour market, with implementation taking place over 2003 – 2005. The reforms comprised the four laws on "modern services in the labour market" ("Hartz I to IV"), modifying the framework and the instruments of labour market policy in a fundamental way. 2004 saw the implementation of these measures and they succeeded in bringing the overall decline in employment to a halt.
- Incentives to take up work are strengthened by the reorganisation of the benefit structure in 2005 ("Hartz IV"), which involves stricter rules and eligibility criteria for transfer payments.
- Measures taken to encourage businesses to invest and grow have had little effect thus far. However, the Government has pledged to remove further the remaining barriers to the Internal Market.
- Germany continued to overhaul its pension system with three laws in 2004. Incentives for later retirement were strengthened. In the health sector and also to a limited extent in the education system progress in structural adjustment has been made in 2004. The Act on Modernisation of the Health Care System involved among other measures a better incentive structure to raise cost-awareness with patients and providers, and some steps to strengthen competition in the sector.

Areas where future progress is still required

In order to keep track with the Lisbon Strategy, Germany should:

- Continue with the implementation of all four Hartz laws, and labour market reform efforts should be further strengthened, for instance in the area of job security. Social partners should be encouraged to promote further wage flexibility to ensure that wages better reflect productivity differences.
- Monitor closely the results of active labour market programmes and especially the results of the so-called "one-euro jobs" scheme.
- Further reduce the number of barriers remaining to the Internal Market, and further remove barriers for entry in the craft trades.
- Building on the measures that have been taken, continue efforts to secure the long-term sustainability of the pension system. As for health care reforms, steps already been taken to increase competition and strengthen economic incentives should be carefully evaluated and, where necessary, further efforts should be made.

ESTONIA (EE)

Challenges identified in the 2004 update to the Broad Economic Policy Guidelines

Estonia was requested to:

- Address the sizeable current account deficit, to which an appropriate fiscal policy should contribute.
- Address the structural problems in the labour market.
- Improve conditions for increasing productivity.
- Develop effective competition in network industries.

Developments over the last year

- A legal package addressing structural problems in the labour market, such as bringing down the high rate of long-term unemployment, was adopted by the Government in 2004. Plans are underway to replace unemployment benefits and subsistence allowance for people of working age and capacity with job-seeking allowance in order to increase incentives to work.
- In 2004, a new vocational education development plan for 2005-2008 was prepared for the future use of EU structural funds. Actions include the assessment of businesses' needs and demands for vocational training and maintaining the school network.
- The introduction of number portability for fixed lines in 2004 and for mobile lines in 2005 should help to increase competition in telecommunication.

Areas where further progress is still required

In order to keep track with the Lisbon Strategy, Estonia should:

- Monitor measures taken in order to bring down the high rate of long-term unemployment and focus on avoiding economic and social exclusion.
- Ensure that the current account deficit does not become unsustainable.
- Take further measures in order to improve the education system.
- Speed up the liberalisation process in the electricity sector, preferably faster than the schedule foreseen in the transitional period agreed in the accession treaty.
- Pursue efforts to increase R&D spending, in particular in the private sector.

GREECE (GR)

Challenges identified in the 2003-2005 Broad Economic Policy

Greece was requested to:

- Ensure the long-term sustainability of public finances in the face of population ageing, in particular in view of the high government debt ratio.
- Increase the low level of productivity, which is associated with problems in the functioning of the labour and product markets, low investment in human capital, and the late development of the knowledge-based society.
- Reduce the high rate of structural unemployment, and increase employment rates, particularly for women.

Developments over the last year

- The budget deficit reached 4.6% of GDP in 2003 and is expected to increase further to 5.5% of GDP in 2004. The widening of the deficit took place in spite of strong economic growth, though there were some non-recurrent factors (e.g. organisation of the Olympic Games, electoral cycle). As a result, the government debt ratio is expected to increase to 112.2% of GDP in 2004, the highest in the Union.
- Hourly labour productivity remains at the second lowest level in the EU-15 and its growth slowed down in recent years.
- The situation in the labour market has improved somewhat in the recent period, but the youth unemployment rate is still higher then the EU average and the gap in the unemployment rate between men and women is significant. Although a number of measures aimed at increasing incentives to work and improving the qualifications of the unemployed have been implemented in 2004, the overall progress is relatively slow.
- Initiatives launched to improve the business environment and to encourage R&D activities, innovations and ICT diffusion, as well as to improve human capital have accelerated. They focused on promotion of ICT in schooling, professional training and the business sector, and on strengthening links between enterprises and universities.

Areas where further progress is still required

In order to keep track with the Lisbon Strategy, Greece should:

- Take measures to repair its public finances with vigour. Step up effort to implement pension reform measures.
- Take urgent measures to promote sustained and firm productivity growth in the future. Pursue efforts to enhance competition, particularly in the energy sector. Continue to simplify the business and taxation environment and promote the knowledge-based society.
- Address rigidities in the labour market; improve work incentives, particularly by reducing non-wage costs and easing the employment protection legislation.
- Evaluate the outcomes of the measures that have already been taken and strengthen efforts in areas where insufficient progress has been achieved
- Increase the transposition rate of Internal Market Directives

SPAIN (ES)

Challenges identified in the 2003-2005 Broad Economic Policy Guidelines

Spain was requested to:

- Raise the low employment rates, especially among women, and reduce wide regional labour market disparities.
- Increase the low level of productivity, including by strengthening the knowledge-based economy in terms of educational attainment and skill levels, investment in IT, R&D and innovation performance.
- Ensure the long-run sustainability of public finances in the face of population ageing.

Developments over the last year

- Although Spain has continued to maintain a positive growth differential with respect to the euro area, the gap has narrowed significantly in 2004, mainly due to the recent recovery in the euro area. Moreover, growth has been largely driven by domestic demand and investment in dwellings and equipment, whereas the external sector is increasingly dragging on real GDP growth.
- The employment and labour participation rates are on an upward trend in Spain, but remain significantly below the EU average. The unemployment rate, although falling, remains the highest in the euro area.
- Several actions have been taken to increase female employment and participation rates, inter alia through the improvement of family support measures. A number of initiatives to foster employment opportunities for people with disabilities have been introduced.
- Spain has introduced several measures to address the rigidities in the housing market, particularly to encourage the development of a rental market.
- Some steps have been taken in an attempt to ensure effective levels of competition in key strategic sectors, as well as to enhance the economy’s capacity to innovate.

Areas where further progress is still required

In order to keep track with the Lisbon Strategy, Spain should:

- Take further measures to increase employment and participation rates, notably among females, and to reduce the high unemployment rate. Moreover, reform the wage bargaining framework and phase-out indexation provisions in collective agreements. A further revision of employment protection legislation is needed.
- Facilitate labour and geographical mobility by, amongst other steps, promoting the rental market for housing and taking further steps to increase the availability of land for development.
- Intensify efforts to increase the low level of productivity, by improving levels of educational attainment and further encouraging the development of a knowledge-based economy. Take additional steps to increase effective competition in some sectors, such as electricity and retail distribution, and further reduce barriers to entry to these markets.
- Take further steps to achieve a major reform of the public pension system in order to ensure the long-run sustainability of public finances. This requires, inter alia, strengthening the link between contributions and benefits, and controlling the long-term increases in pension expenditure in the face of population ageing.

FRANCE (FR)

Challenges identified in the 2003-2005 Broad Economic Policy Guidelines

France was requested to:

- Reduce rapidly the general Government deficit to below 3% of GDP and keep government finances on a steady consolidation path.
- Increase labour market participation and reduce structural unemployment.
- Ensure the long-term sustainability of public finances in the face of population ageing.
- Ensure competition in the network industries and accelerate the adoption of Internal Market measures, in order to create a level playing field.

Developments over the last year

- In 2004, the French authorities adopted a major reform on the health system with the aim of bringing the health insurance system to budgetary balance in 2007 while preserving the quality of health services.
- In 2004, the unemployment insurance system and eligibility conditions for unemployed benefits were tightened and their duration was reduced in order to enhance job search.
- Concerning young people and people excluded from the labour market, the Government adopted a "social cohesion plan" in 2004 foreseeing a significant increase in subsidised jobs, public employment, and training and apprenticeship.
- Measures have been taken to open up the energy market for competition through the implementation of the European Directives on Energy and the EU recommendations governing the transport and distribution of energy.

Areas where further progress is still required

In order to keep track with the Lisbon Strategy, France should:

- Pursue efforts to increase participation rates and to reduce structural unemployment, in particular of older and low-skilled workers in order to increase productivity and the level of hours worked per capita. Ensuring proper monitoring and intensify measures, if and as necessary.
- Ensure long-term sustainability of public finances by vigorously implementing and closely monitoring the effects of the 2003 pension reform and the recent reform of the health insurance system. Stand ready to effect further reform if they prove insufficient.
- Pursue efforts to increase competition, especially in energy markets. Reduce barriers to new entrants.
- Improve transposition and implementation of Internal Market Directives.

IRELAND (IE)

Challenges identified in the 2003-2005 Broad Economic Policy Guidelines

Ireland was requested to:

- Achieve a smooth transition from double-digit economic growth in the late 1990s to lower, sustainable growth in the years ahead by ensuring stable macroeconomic conditions and by strengthening the supply side of the economy.

Developments over the last year

- The Government has taken a number of further initiatives to improve efficiency and the control of public expenditure, especially in high priority areas such as health and infrastructure. Measures include the extension of multi-annual spending envelopes to all areas of capital spending and the introduction of the limited carryover of these envelopes from one year to the next.
- The second phase of the national pay agreement was negotiated, providing for a 5.5% pay increase over the 18-month period in question, compared to the 7% increase agreed in the first phase. For the public service, as was the case in the first phase, the general round pay increases and the payments under the benchmarking process are conditional on verifiable progress on public sector modernisation and flexibility as well as maintenance of industrial stability.
- Efforts have been pursued to increase competition in network industries, particularly in postal services, electricity and gas sectors.
- Various measures to improve capital spending under the National Development Plan 2000-2006 and to increase the level of R&D, including by businesses, have been implemented: e.g. investment in roads, public transport, social housing; increased funding to research, technological development and innovation; and tax breaks for R&D expenditure. An investment programme for water and sewage infrastructure has been agreed.

Areas where further progress is still required

In order to keep track with the Lisbon Strategy, Ireland should:

- Pursue efforts to foster competition in sectors such as professional services, retail distribution and insurance. Build on measures already taken to strengthen the administrative capacity of competition authorities.
- Improve the effectiveness of R&D expenditure, including by businesses.
- Continue to monitor wage competitiveness in the public sector.
- Continue to monitor the housing market and pursue efforts to moderate house price increases.

ITALY (IT)

Challenges identified in the 2003-2005 Broad Economic Policy Guidelines

Italy was requested to:

- Rapidly consolidate public finances.
- Ensure the long term sustainability of public finances in the face of population ageing.
- Raise the low employment rate, especially among women and older workers, and reduce the wide North-South economic disparities.
- Strengthen the knowledge-based economy in terms of educational attainment and skill levels, investment in IT, R&D and innovation performance.
- Continue to improve the business environment and to enhance competition in the energy and service sectors.

Developments over the last year

- Significant privatisation took place in the previous year, but public debt remains high and the pace of debt reduction is slow. The Parliament approved the pension reform. However, the mandatory provisions, aiming inter alia at postponing exit from labour market, rising the retirement age and long-term fiscal stability, will apply from only 2008 onwards.
- Developments in the labour market are positive, mainly due to the implementation of the first part of the labour market reform. Change in the centralised wage setting mechanism, taking into account regional differences in both productivity and cost of living, is being discussed.
- A comprehensive reform of the school system is now under way and is showing positive results. Steps were taken to stimulate spending on R&D and an institute was created with a mandate to stimulate research and scientific competition. Limited progress has been made regarding IT use and diffusion.
- Several measures have been taken in order to foster entrepreneurship and to improve the business environment, such as introduction of new corporate income tax system and improved access to finance for businesses. As regards liberalisation of the energy sector, measures were taken to improve competition.

Areas where further progress is still required

In order to keep track with the Lisbon Strategy, Italy should:

- Pursue reform of the pension system and reduce the long transition period to the new contributions-based system.
- Strengthen efforts to increase labour market participation and reduce regional differences by increasing productivity and labour force participation in the South, by encouraging greater wage differentiation and by lowering employment legislative protection.
- Continue to pursue efforts on the reform of the education system, to address low educational attainment, and on encouraging R&D and innovation.
- Continue to take measures to increase effective competition in the energy sector and in professional services and improve the rate of implementation of Internal Market directives.

CYPRUS (CY)

Challenges identified in the 2004 update of the Broad Economic Policy Guidelines

Cyprus was requested to:

- Ensure a reduction of the government deficit on a sustainable basis.
- Increase the diversification of the economy towards higher value added activities.

Developments over the last year

- After the slippage in fiscal consolidation in 2003, when the budget deficit increased to 6.3% of GDP, in 2004 the deficit is expected to be reduced below 5% of GDP. In 2004 the revenue side benefited from a broadening of the VAT tax base and an increase in indirect tax rates. The gross government debt ratio is expected to increase to 74.9% of GDP in 2004.
- The completion of the liberalisation of the utilities and the air-transport sectors, along with the price liberalisation in key sectors, has been concluded upon the accession to the EU in May 2004, though full efficiency gains have not materialised yet.
- R&D expenditure as a percentage of GDP remains the lowest in the EU, though it is estimated to have increased in recent years. A number of measures to encourage R&D activities and promote innovation and ICT diffusion have been implemented in 2003 and 2004. In addition, measures to upgrade human capital have been promoted.
- New legislation on e-commerce has been introduced in May 2004 and the number of e-government applications has been increased.
- In general, financial markets are well developed and related legislation has been strengthened. Dismantling of exchange rate controls was completed in May 2004.

Areas where further progress is still required

In order to keep track with the Lisbon Strategy, Cyprus should:

- Implement the ongoing fiscal reform, to contain government expenditure, and secure long-term sustainability of the public finances.
- Building on the measures already taken, continue with engineering diversification of the economy.
- Further increase expenditure on R&D and innovation, focused mainly on applied research. Encourage especially private investment in R&D. Take measures to increase ICT diffusion and improve digital skills.
- Increase further labour market flexibility, particularly by overhauling the indexation mechanism (COLA).

LATVIA (LV)

Challenges identified in the 2004 update of the Broad Economic Policy Guidelines

Latvia was requested to:

- Address the sizeable current account deficit, to which an appropriate fiscal policy should contribute.
- Improve conditions for increasing productivity.
- Address the structural problems in the labour market.
- Develop effective competition in network industries.

Developments over the last year

- Labour productivity growth is increasing and is among the fastest in the EU. However, nominal wage growth exceeds the productivity growth. The unemployment rate is decreasing, but still remains high and is accompanied by a relatively low participation rate. Labour mobility is limited, while important elements of the reform are still pending.
- The reform of the basic education system was completed, while the reforms of secondary and tertiary education are ongoing. Actions have been taken through the "National Innovation Programme" to promote R&D and innovation. To encourage the contribution of the private sector in R&D, a special programme was developed in 2003.
- Considerable progress has been achieved in building a favourable entrepreneurial culture with improvements in company registration procedures, tax policy and in access to capital for entrepreneurs.
- Changes in the tax and social security system were adopted and they may contribute to higher motivation to enter the labour market. Completion of social security reform may, inter alia, increase disincentives towards the informal sector.
- Reforms to liberalise network industries have been of a different intensity across sectors. Projects to improve interconnection capacities are getting under way.

Areas where further progress is still required

In order to keep track with the Lisbon Strategy, Latvia should:

- Continue with developing a favourable entrepreneurial climate.
- Improve productivity as a key issue by further improving the efficiency and targeting of education and by encouraging R&D and innovation.
- Address structural problems in the labour market, especially long-term unemployment and youth unemployment.
- Pursue reforms to reduce regional disparities and increase labour mobility.
- Pursue liberalisation of network industries and strengthen the regulator's power.

LITHUANIA (LT)

Challenges identified in the 2004 update of the Broad Economic Policy Guidelines

Lithuania was requested to:

- Address the structural problems in the labour market.
- Maintain low general government deficits.
- Improve conditions for increasing productivity.
- Develop effective competition in network industries.

Developments over the last year

- Structural problems in the labour market are being addressed and several measures were implemented to improve regional mobility in the medium term. New measures aimed at reducing skill mismatches were taken in 2004 and should contribute to better meeting the growing demand for labour in the private sector, especially through the promotion of the vocational training.
- Public spending on education is above the EU average. Lithuania has also improved its youth education attainment level. Nevertheless, the system of vocational training is deficient with an inadequate responsiveness to labour market needs. However, actions have been taken to improve vocational training. In response to low R&D performance, the Government adopted a new strategy to promote R&D and innovation and to increase the cooperation between research and business. IT penetration is still low, mainly owing to inadequate infrastructure and low awareness.
- A set of reforms have been taken to further liberalise network industries. Network industries are mostly deregulated and energy markets have been opened, though effective competition remains weak.
- Considerable progress has been made in the Lithuanian financial sector in regulation and transparency, as well as in the restructuring and privatisation of the banking sector.

Areas where further progress is still required

In order to keep track with the Lisbon Strategy, Lithuania should:

- Keep on addressing the structural problems in the labour market, in particular to tackle the high unemployment rate, both total and long-term, and to improve regional disparities.
- Take measures to improve productivity, in particular by improving the efficiency of the education and training systems and their adaptation to the needs of labour market. The promotion of R&D and innovation, especially through new technologies, should continue to be a priority.

LUXEMBOURG (LU)

Challenges identified in the 2003-2005 Broad Economic Policy Guidelines

Luxembourg was requested to:

- Increase the low national participation and employment rates, especially for older workers.
- Improve the business environment and encourage entrepreneurship in order to achieve a more balanced economic structure.

Developments over the last year

- The modernisation of the legislative framework for competition policy was finalised in 2004. The introduction of new competition law will eliminate the shortcomings of the existing body of legislation such as the regulation of fixed and monitored prices. An independent Competition Council has been set up whose duties include supervising the application of the new national legislation and the enforcement of EU law where applicable.
- The implementation of initiatives to reduce the administrative burdens on businesses and on SMEs in particular has continued. New measures were announced such as the generalisation of audits of the effects of new legislation and regulation on the business environment, with particular emphasis on SMEs. In 2004, a risk capital enterprise (SICAR) was launched to foster access to venture capital. This will contribute to improving business conditions for SMEs.
- The action plan "Entrepreneurship au Luxembourg- *Entreprendre pour reussir*" was launched to coordinate all initiatives in the development of business entrepreneurship. Activities with the direct involvement of schools, businesses and Chambers of Commerce as well as awareness campaigns are among the measures directed at the young.

Areas where further progress is still required

In order to keep track with the Lisbon Strategy, Luxembourg should:

- Increase the employment rate of its residents, especially of marginal groups, and take further measures to reduce incentives for early retirement.
- Increase competition in the service sector, focusing particularly on implementation of existing measures.
- Fully implement the reform of the legislation on competition and increase the rate of transposition of the Internal Market directives.
- Continue efforts to reduce the administrative burden for SMEs and the development of business entrepreneurship.
- Reform the education system, to ensure it delivers higher educational attainment and supplies the skills the economy need.

HUNGARY (HU)

Challenges identified in the 2004 update of the Broad Economic Policy Guidelines

Hungary was requested to:

- Ensure a further reduction of the general government deficit on a sustainable basis.
- Increase employment rates and address the structural problems in the labour market.
- Enhance cost-competitiveness by pursuing policies that induce wage moderation.
- Improve conditions for increasing productivity.
- Develop effective competition in network industries.

Developments over the last year

- Although several measures were taken to strengthen fiscal discipline, and the deficit/GDP ratio is expected to improve, the fiscal deficit needs further adjustment.
- The participation rate remains low - around 60% in 2003, but several measures were taken to encourage the integration of disadvantaged groups into the labour market. The recent changes in the tax and social security system, coming into effect in 2005 seem to decrease the tax wedge on labour, thereby increasing motivation to enter the labour market.
- Real wage growth became moderate in 2004; the slowdown was induced by a significant moderation of public sector wage growth. Despite impressive productivity growth, the level of productivity is still low and the tax wedge on labour is high. Measures have been taken to develop vocational training and the new act on higher education also encourages positive developments in the educational field.
- SMEs are supported through grants for investment projects, improved access to finance and tax policy measures. The simplified entrepreneurial tax available for small enterprises has been a positive development in the reduction of administrative burdens.
- As required by the European Directives on Energy, measures have been taken to open up the energy market for competition (e.g. the gas and electricity markets were liberalised for non-household users).

Areas where further progress is still required

In order to keep track with the Lisbon Strategy, Hungary should:

- Take additional measures to ensure a sustainable reduction of the fiscal deficit, while further reducing the high tax wedge.
- Continue with the measures to improve the participation rate. Remove obstacles to regional mobility, inter alia by developing the transport infrastructure and taking appropriate measures in respect of housing.
- Take steps to increase productivity, by promoting investment in R&D, reforming the education system to better respond to labour market needs, and create a business environment that is more supportive of entrepreneurship.
- Proceed with the liberalisation of network industries, and increase the effectiveness of competition particularly in the electricity sector.
- Persist with implementing measures to lower regional disparities.

MALTA (MT)

Challenges identified in the 2004 update of the Broad Economic Policy Guidelines

Malta was requested to:

- Ensure a reduction of the general government deficit on a sustainable basis and the long-term sustainability of public finances.
- Increase employment rates, especially among women.
- Encourage effective competition taking into account the specific characteristics of the small domestic economy.

Developments over the last year

- The 2004 budget laid the foundations of strengthened fiscal discipline, envisaging an increase in public revenues coupled with public expenditure tightening.
- The Government has recently announce a package of fiscal incentives aimed at increasing female labour market participation, while attention will continue to be devoted to the contribution which the promotion of childcare provision can make towards this aim. Another contributor is the National Commission on the Promotion of Equality between Women and Men, which helps the setting and achievement of strategic priorities in this area for the years 2004-2006.
- In 2004, measures to increase competition have continued in the electricity and transportation sectors. Furthermore, the Government published a White Paper on a new framework for the electronic communications market.
- The Government's privatisation programme has continued. For example, the privatisation process for Sea Malta, the commercial national shipping line, is under way.

Areas where further progress is still required

In order to keep track with the Lisbon Strategy, Malta should:

- Increase further the efforts to achieve a higher employment rate, and in particular female and older workers employment. This should include reforms to ensure that the tax and benefit interaction has a favourable impact on those furthest away from the labour market.
- Strengthen further the initiatives already taken by the government to reduce the high rate of early school leavers and encourage higher education, in particular in science and technical areas.
- Take measures to safeguard the long-term sustainability of public finances. Reforms of the pension and health systems should be addressed.
- Improve transposition and implementation of Internal Market Directives.
- Closely monitor initiatives announced in the government budget for the fiscal year 2005 to encourage firms to engage in research and development and to recruit highly-trained personnel, and stand ready to take further measures as necessary.

NETHERLANDS (NL)

Challenges identified in the 2003-2005 Broad Economic Policy Guidelines

The Netherlands was requested to:

- Pursue budgetary adjustment in the coming years in the face of weaker potential growth, and the budgetary costs of ageing.
- Draw currently inactive people into the labour market.
- Tackle the relatively slow productivity growth, stemming, inter alia, from the low level of competition in some sectors, and insufficient business investment, particularly in R&D.

Developments over the last year

- The Netherlands is pursuing a deep-rooted overhaul of the social security and pension systems. Measures include a limitation of the maximum duration of unemployment benefits, a phasing out of subsidies on low-paid labour by 2006, a reform of the disability scheme, applying new rules of financing for child care as of 2005, putting end fiscal facilitation of pre-pension and early retirement schemes in 2006 and the introduction of a fiscal savings scheme to facilitate career breaks.
- The Netherlands experienced high wages and price increases in recent years. In this respect, for the 2nd year in a row co-operation with the social partners has resulted in a moderate wage agreement, which should improve the external competitiveness of the economy.
- A bill strengthening the Dutch Competition Authority (NMa) and broadening its competences came into force on 1 August 2004. In the energy sector, markets have been fully liberalised since July 2004.
- Despite reforms undertaken to strengthen the innovative capacity of the Dutch economy, the share of R&D financed by the industry is below the EU-15 average and shows a negative trend. Another negative trend is in the number of students in science and technical courses, although also here measures have been taken.

Areas where further progress is still required

In order to keep track with the Lisbon Strategy, the Netherlands should:

- Implement the planned reforms of social security and pensions systems as quickly as possible, closely monitor the effects of the measures that were already taken and strengthen efforts in areas where insufficient progress has been achieved.
- Make sure that the quantified targets for the reduction of the administrative burden for 2005 are met.
- Implement further measures to increase innovation capacity, e.g. to stimulate private investment in R&D and to support growth of young dynamic high tech companies and high tech start-ups. Continue efforts to increase the number of science and technical graduates and to monitor closely the trend in R&D.

AUSTRIA (AT)

Challenges identified in the 2003-2005 Broad Economic Policy Guidelines

Austria was requested to:

- Ensure the sustainability of public finances in the face of population ageing.
- Continue to improve the weak technology base, and encourage business R&D and innovation.
- Strengthen the development of effective competition in some sectors.

Developments over the last year

- In 2004, implementation of the substantial pension reform passed in 2003 continued. The 2004 law partly undo front-loading effects of the 2003 law.
- Austria continues to increase spending on R&D with additional increases expected over the period 2004-2006. The Government has also continued to rationalise and streamline its R&D and innovation support. The business environment is improving due to measures taken to support entrepreneurship and SMEs and to the reduction of the corporate tax rate.
- The Government is preparing to introduce the second stage of the far-reaching tax reform in 2005. The reform should lead to a significant tax reduction.
- Measures to increase effective competition continued in 2004.

Areas where further progress is still required

In order to keep track with the Lisbon Strategy, Austria should:

- Remove restrictions that continue to impair effective competition in services, particularly in the liberal professions. Efforts are also needed to increase competition in network industries, especially in the energy sector.
- Ensure long-term sustainability of public finances by vigorously implementing and vigilantly monitoring the effects of the pension reform.

POLAND (PL)

Challenges identified in the 2004 update of the Broad Economic Policy Guidelines

Poland was requested to:

- Urgently address the deep-seated structural problems in the labour market.
- Ensure a reduction of the general government deficit on a sustainable basis and the long-term sustainability of public finances.
- Improve conditions for increasing productivity.
- Speed up the restructuring of the economy and accelerate privatisation in industry.
- Improve the business environment.

Developments over the last year

- Despite robust GDP growth, the labour market situation has little improved so far, underscoring the structural nature of Polish unemployment. However, the authorities adopted last year, or are considering, a number of initiatives outlined in the Hausner plan, designed to reduce the inactivity traps associated with the current benefit systems, although some of these proposals have been watered down or abandoned.
- Poland implemented a pension reform in 1999. At present, the system is stable, functioning well and under constant monitoring. On the other hand, important risks remain for the long term sustainability of public finances, stemming inter alia from the rising stock of contingent liabilities.
- Several useful initiatives have been taken to improve the education and training system, but little progress has been made in removing barriers to labour mobility.
- Poland has made considerable efforts to reduce the administrative burden and to improve the business environment. However, the State continues to hold an important share of the economy and the privatisation process lacks public support, although there are plans to step up the privatisation process in 2005.

Areas where future progress is still required

In order to keep track with the Lisbon Strategy, Poland should:

- Continue to fight the large unemployment problem, inter alia by reducing the high tax wedge on labour, proceeding with reform of the benefit system, allowing the minimum wage to decline relative to average wages so as to reduce the cost to firms of hiring unskilled workers and to allow for more regional differences in minimum wages. Also, additional steps should be taken to improve the functioning of the housing market and remove transport barriers to labour mobility.
- Step up efforts to reduce the risk from the contingent liabilities for the long term sustainability of public finances, by ensuring for example that the law on the reform of health care units is dealt with.
- Pursue further efforts to remove the remaining barriers that still hinder entrepreneurship such as: lack of infrastructure, high prices of telecommunication services, weak incentive packages in comparison to other EU countries, a still relatively high administrative burden and a lack of transparency in the tax system.
- Pursue further efforts to raise productivity, in particular by further encouraging private R&D expenditures and innovation. Also, privatisation, in particular in the coal and energy sectors, should be accelerated, while taking into account also competition issues.
- Reduce the overall level of State aids, whilst reorienting aid towards horizontal objectives.

PORTUGAL (PT)

Challenges identified in the 2003-2005 Broad Economic Policy Guidelines

Portugal was requested to:

- Accelerate the consolidation of public finances and address the strong dynamics of Government expenditure.
- Increase overall competitiveness, which is at risk from the low efficiency of the education system, low R&D spending, a low degree of competition in certain sectors, and high nominal wage growth.
- Ensure the long-term sustainability of public finances in the face of population ageing.

Developments over the last year

- Reform of health care and pensions were introduced, and changes to the rules governing the retirement and assessment of pension rights of civil servants came into force in 2004.
- The labour productivity growth is still very low. Private sector wage increases slowed substantially in the past year. The new labour code is expected to enhance labour market adaptability, in particular by allowing for greater flexibility for work arrangements.
- The strategy initiated last year to encourage the transition towards a knowledge based society has continued to be implemented, but important human capital insufficiencies remain. Measures were taken to improve the education system and curricula, to decrease school dropouts and to improve the involvement in the lifelong learning activities. Several measures and programmes have been adopted to stimulate investments in R&D, and foster the cooperation between business and R&D institutions.
- Some competition enhancing reforms, particularly in network industries, have been taken and the resources and independence of the Competition Authority were strengthened, though barriers to entry remain in the energy sector.
- Measures were taken to improve the business environment such as administrative simplification, a reform of the Bankruptcy law, new industrial licensing rules and a reduction of the basic rate of the corporate income tax.

Areas where further progress is still required

In order to keep track with the Lisbon Strategy, Portugal should:

- Ensure the long-term sustainability of the public finances and continue the pension, health care and social security system reforms.
- Intensify measures, and monitor the implementation of the initiatives already taken, to increase productivity. Pay particular attention on improving the efficiency of the education system and to promoting life-long learning, and pursue efforts to reduce school dropouts.
- Continue improving the business environment by further strengthening and closely monitoring the implementation of measures already taken.
- More efforts to increase the rate of transposition on Internal Market Directives.

SLOVENIA (SI)

Challenges identified in the 2004 update of the Broad Economic Policy Guidelines

Slovenia was requested to:

- Lower inflation in a sustainable way.
- Increase employment rates, especially for older workers.
- Improve conditions for sustained productivity growth.
- Promote the development of effective competition in all segments of the economy, notably in network industries.

Developments over the last year

- Inflation has continued to decrease rapidly in 2004. Nevertheless, it still remains above euro-zone levels. A new wage agreement was concluded in the private sector in 2004 to cap pressures to push up wages by limiting backward looking indexation. However, inflationary pressures still persist due to structural rigidities.
- Measures have been adopted aimed to increase low employment levels of older workers and to decrease the large share of long-term unemployment.
- Slovenia has completed a number of reforms to promote entrepreneurship. Two new Acts were adopted to reduce the administrative burdens facing new businesses. The one-stop-shop system for SMEs has been partially completed.
- R&D expenditures are the highest among the new Member States (at 1.5% of GDP in 2003), but still remain below the EU average. The business sector represents 60% of R&D. To promote business investment in R&D, new tax incentives to companies investing in new equipment, especially equipment for research and technological development, were approved.

Areas where further progress is still required

In order to keep track with the Lisbon Strategy, Slovenia should:

- Take measures to remove remaining structural rigidities in order to keep disinflation sustainable in the long-run.
- Continue to address the structural problems in the labour market, especially to reduce long-term unemployment and increase employment of older workers. Take further measures promoting lifelong learning and increasing the retirement age.
- Continue efforts to ensure productivity growth, particularly by promoting entrepreneurship, reducing the administrative barriers for SMEs and further encouraging investment in R&D and innovation.
- Pursue efforts to foster effective competition in product markets, notably in network industries. Strengthen the administrative capacity of the Competition Protection Office and further promote the inflow of FDI.

SLOVAKIA (SK)

Challenges identified in the 2004 update of the Broad Economic Policy Guidelines

Slovakia was requested to:

- Ensure a further reduction of the general government deficit on a sustainable basis.
- Continue to address the deep-seated structural problems in the labour market.
- Improve the business environment and support entrepreneurship.
- Improve conditions for increasing productivity.

Developments over the last year

- Unemployment remains high, though efforts have been made to tackle the structural shortcomings in the labour market. The Government is trying to strengthen the incentives for job creation in particular in regions affected by high unemployment. Specific measures to dismantle obstacles to regional mobility and to reduce skill mismatches are being implemented.
- Significant progress has been made with the reform of the pension system.
- The Government has been stepping up its efforts to create the conditions for an affordable reduction in contribution rates. The introduction of a flat corporate and individual income tax rate is set to motivate both job creation and willingness to work. Nevertheless, the total health and social contribution rates still remains at a high level.
- There has been significant progress in improving the business environment. Measures to enhance the business climate were aimed at improving the entry to and exit from the market and easing the administrative burden on business. However, weak enforcement remains a problem as changes are slow.
- The education reform is in its initial stages. The first stage of the primary and secondary schooling system reform has started and a major reform of the curriculum is only now being prepared.

Areas where further progress is still required

In order to keep track with the Lisbon Strategy, Slovakia should:

- Continue to address structural problems in the labour market, notably the high level of unemployment and long-term unemployment. Foster regional mobility among the active population.
- Tackle remaining weaknesses in the business environment, in particular in terms of strengthening the judicial and law enforcement systems.
- Focus on strengthening regulatory capacity, in particular with respect to the telecommunication market.
- Pursue efforts to increase the innovative capacity of the economy, in particular by encouraging R&D activities, and to reform tertiary education.

FINLAND (FI)

Challenges identified in the 2003-2005 Broad Economic Policy Guidelines

Finland was requested to:

- Reduce the high level of structural unemployment and increase the employment rate of older workers.
- Enhance competition in certain sectors and improve the efficiency of the public sector.

Developments over the last year

- Finland introduced further income tax cuts equalling approximately 0.5% of GDP. Combined with tax cuts introduced in 2003, Finland fulfils the target set by the Government of tax cuts on labour especially targeted on small and medium income earners of 0.8% between 2003-2007.
- Some early results of the employment programme introduced in 2003 with emphasis on the reduction of the high level of structural unemployment and to boost labour supply are apparent. Some 29 new labour force service centres for the most difficult-to-place job-seekers were opened, and the activation rate of unemployed rose by 1 percentage point to 24% in 2004.
- In 2004, the Finnish Parliament passed the Act on Competition Restrictions, which harmonises Finnish competition law with the modernised EU competition law. The Competition Institute was set up to carry out research into competition and educate businesses and consumers about the benefits of competition. The Finnish Competition Authority has been given additional powers, which will enhance its ability to uncover and prosecute illegal agreements in cartel cases.
- An advisory board was founded jointly by central government and the association of local municipalities to increase understanding and expand the use of public procurement. A legislative reform aiming at improving competition in public procurement is currently being drafted.

Areas where further progress is still required

In order to keep track with the Lisbon Strategy, Finland should:

- Intensify efforts, including strengthening of monitoring mechanisms, to reduce the high level of structural unemployment, to reach the Government's target of creating 100,000 new jobs by the end of 2007 and the objective of raising the employment rate to 75% by 2011. Progress is needed in improving incentives in benefit systems as well as tightening the eligibility criteria and improving the administration of benefit systems.
- Enhance competition in those sectors where it is still weak. Progress needs to be made concerning excessive concentration in the electricity sector.
- Continue efforts to improve the efficiency of public services.
- Pursue further reforms, especially in health care and public sector services, to ensure the long-term sustainability of the public finances.

SWEDEN (SE)

Challenges identified in the 2003-2005 Broad Economic Policy Guidelines

Sweden was requested to:

- Ensure an adequate labour supply in view of the ageing of the population.
- Enhance competition in certain sectors and improve the efficiency of the public sector.

Developments over the last year

- Although Sweden took several measures to reduce unemployment (for instance through further reduction of labour taxes), according to the Budget for 2005 the Swedish authorities do not expect to have reached their nationally set target of an 80% employment rate by 2004. In fact, employment rates, while remaining high and well beyond the Lisbon targets, fell further in 2004 in spite of strong economic activity.
- On the benefits side, Sweden showed a mixed performance with reforms to improve work incentives. On the one hand, additional measures to reduce the number of sick days, including enforcement of the rules for receiving sickness insurance, were implemented in 2004. On the other hand, the authorities announced plans in the 2005 Budget bill to raise certain social insurance benefit levels and the cut in the sickness insurance benefit level introduced in 2003 will be reversed as from 1 January 2005.
- Prices in Sweden remain among the highest in the EU, with high prices in sectors such as retailing, construction, housing, and non-tradable services, and so far there are few signs of increased competition. However, some measures have been taken in 2004, including the coming into force of a new law intending to increase price transparency. There has also been some increase in competitive pressure within the retailing and construction sectors due to the establishment of international discount stores and new rules to fight cartels more effectively.
- There is still little evidence of increased efficiency in the public sector, although some proposals to that effect are expected for 2005.

Areas where further progress is still required

In order to keep track with the Lisbon Strategy, Sweden should:

- Noting the decreasing employment rate of 2004, make further efforts to increase labour market participation and monitor progress on reducing the number of sick days.
- Enhance competition in those sectors where it is still weak (e.g. housing, construction, retailing, and non-tradables) and thereby lower the high price level.
- Take steps to increase efficiency in the public sector, not least by gaining more experience with outsourcing and establishing best practices.

UNITED KINGDOM (UK)

Challenges identified in the 2003-2005 Broad Economic Policy Guidelines

The United Kingdom was requested to:

- Improve the relatively low level of productivity.
- Address the high numbers of working-age people claiming sickness and disability benefits and sustain labour supply in the longer term.
- Improve the quality and efficiency of public services.

Developments over the last year

- The United Kingdom implemented a number of measures to improve skills among young people and the adult workforce in order to improve the productivity performance. The UK took further initiatives in this area, including a strengthening of apprenticeship schemes and a facilitation of adult learning.
- Measures to promote competition have been taken, but progress has varied across sectors. Since 2003, a number of restrictions on competition in professions such as accountancy have been removed. However, in pharmacies and postal services the made progress is more limited.
- The UK's expenditure on R&D is similar to the EU-15 average. The Government has been using inter alia R&D tax credits and project-specific grants to boost R&D spending. The UK published a ten-year Science and Innovation Investment Framework in July 2004 which set an ambition for public and private investment in R&D to reach 2.5% of GDP by 2014, together with policies to achieve this.
- A review of public sector efficiency was published. Building on this, government departments have submitted plans to achieve significant annual efficiency gains over the medium term. Measures include a reduction in administrative costs and civil-service employment by 2008. Significant efforts have also been made to improve the measurement of public sector output.
- The UK has announced an extension to its Pathways to Work pilots for incapacity benefits claimants, extending the approach to around one-third of claimants.
- A new statutory regime for the regulation of mortgage lending came into force on 31 October this year. As a result, the Financial Services Authority (FSA) became responsible for the regulation of the selling of first charge residential mortgages in the UK. The new regime will improve the standard of information and advice received by consumers.

Areas where further progress is still required

In order to keep track with the Lisbon Strategy, the United Kingdom should:

- Continue its focused approach to tackle the structural problem of low productivity. A large number of measures have been taken already, but they need perseverance and their effectiveness needs to be monitored carefully and corrective action should be taken, if needed.
- Continue efforts to increase the percentage of GDP spent on R&D. This should include regular monitoring and evaluation of the effectiveness of R&D and the policies outlined in the ten-year framework.
- Devote continued specific attention to the high number of people claiming sickness and/or disability benefits.

Monitor the long-term sustainability of the private sector pension position

Monitor the impact of the new regulatory regime and its effect in improving consumer capability in the mortgage market, and stand ready to take further measures as necessary.

ANNEX

STRUCTURAL INDICATORS

Annex on structural indicators: Individual headline indicators and summary progress by countries

This annex illustrates the progress which has been made by the EU and the Member States towards the key Lisbon objectives according to the headline list of structural indicators adopted in the General Affairs Council Conclusions (15875/03) on 8th December 2003. The data source is Eurostat.

Structural indicators should not be used mechanically:

- The relationship between the numerical values of an indicator and the achievement of the Lisbon policy goals is often not straightforward and requires further interpretation, e.g. to take account of the institutional context, the general level of development or the cyclical position of the economy.
- Furthermore, attention should be given to both the levels of the indicators and the rate of change.
- Moreover, by definition, indicators relate only to the past and often are available only with a time lag. They cannot, therefore, pick up current initiatives, as they will have effect only with time.

Nevertheless, bearing in mind these qualifications, the indicators remain an invaluable starting point or tool for the assessment of Member States' structural position and policies.

To show the extent to which the various European economies are converging or diverging, for each of the headline indicators, this annex compares the EU average with the simple averages of the highest and lowest quintile of Member States. As far as possible, this comparison has been made on an EU-25 and an EU-15 basis. However, the data coverage of the ten new Member States has not always been sufficient for an EU-25 comparison.

Furthermore, as a benchmark for assessing the progress made by the EU relative to that of other leading industrialised economies, the EU's performance for each of these headline indicators has been measured against that of the US and Japan, where data are provided by Eurostat.

The annex is divided into two sections. The first section presents a series of charts corresponding to the headline set of fourteen structural indicators. In accordance with the conclusions of the General Affairs Council (15785/03), the charts relating to employment are broken down by gender. Hence, a total of eighteen charts are shown.

The second section presents a set of summary tables showing the relative performance of the Member States on each of the fourteen headline indicators. The first table identifies, on the basis of levels, those countries in the highest and lowest performing quintiles. The second table compares the progress made by the Member States on each of the headline indicators over the period 1999 – 2003[1], where data is available.

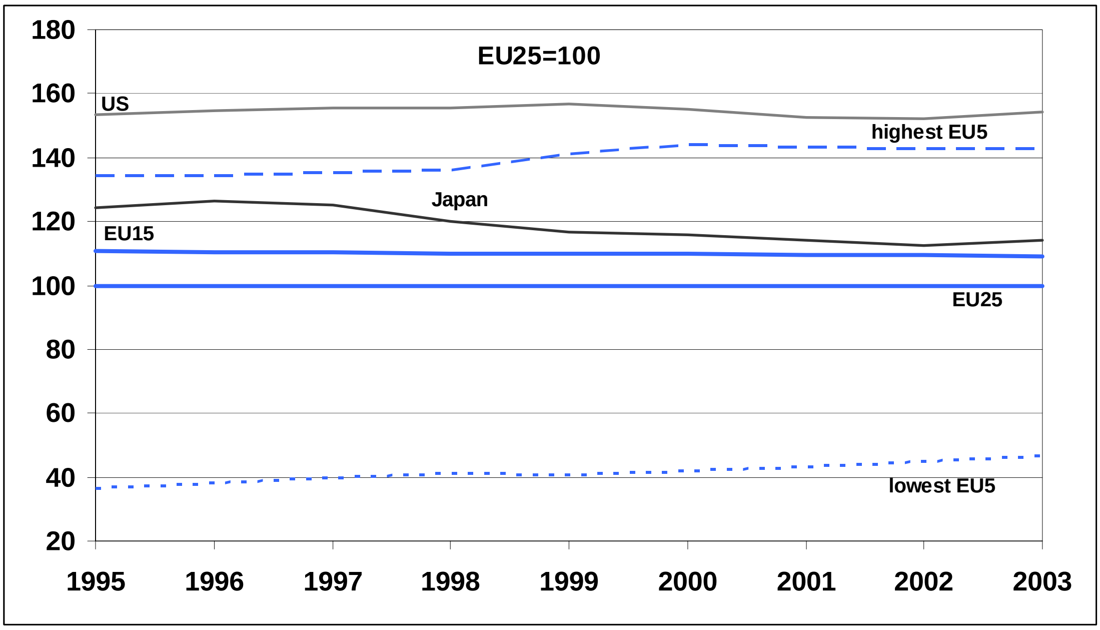
[1] The conclusions of the General Affairs Council (15875/03) on 8 December 2003 stated that, "both levels and changes in recent years should whenever appropriate, be presented for indicators."

PART 1

HEADLINE STRUCTURAL INDICATORS

GDP PER CAPITA IN PPS

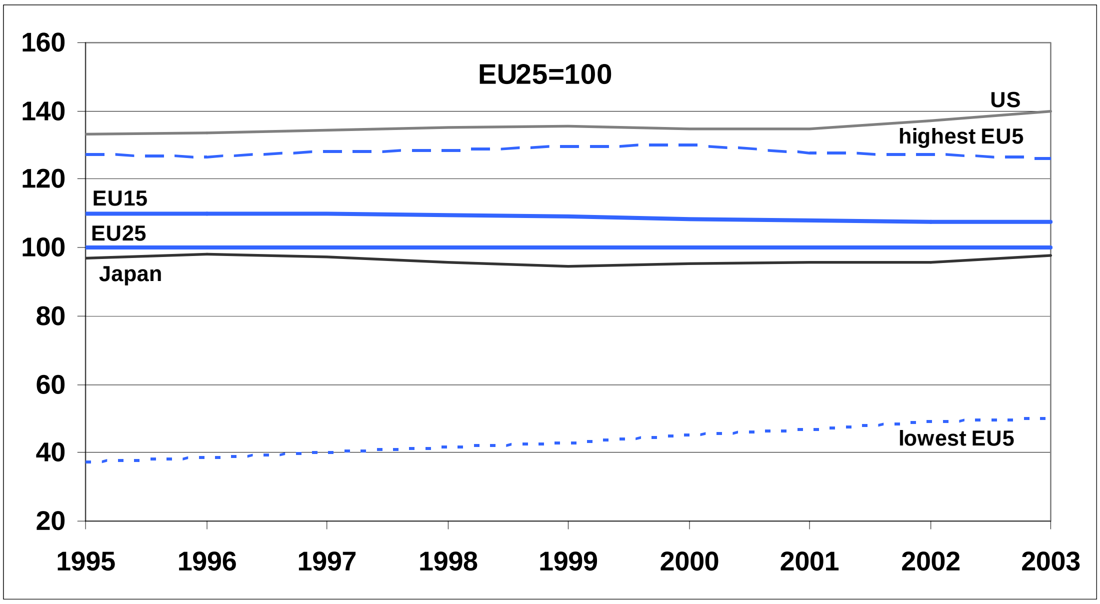
There remains a large gap between the EU25 and the US that has widened slightly over the last year.



eb011 a1: GDP per capita in PPS - GDP per capita in Purchasing Power Standards (PPS), (EU-25=100) *
Includes forecast data: 2003 - eu15, dk, es, it, se, uk & jp; 2002 - dk, it, se, uk & jp; 2001 - it & jp.

LABOUR PRODUCTIVITY (per person)

The gap with the US in terms of labour productivity per worker has continued to widen and Japan has continued to catch up.

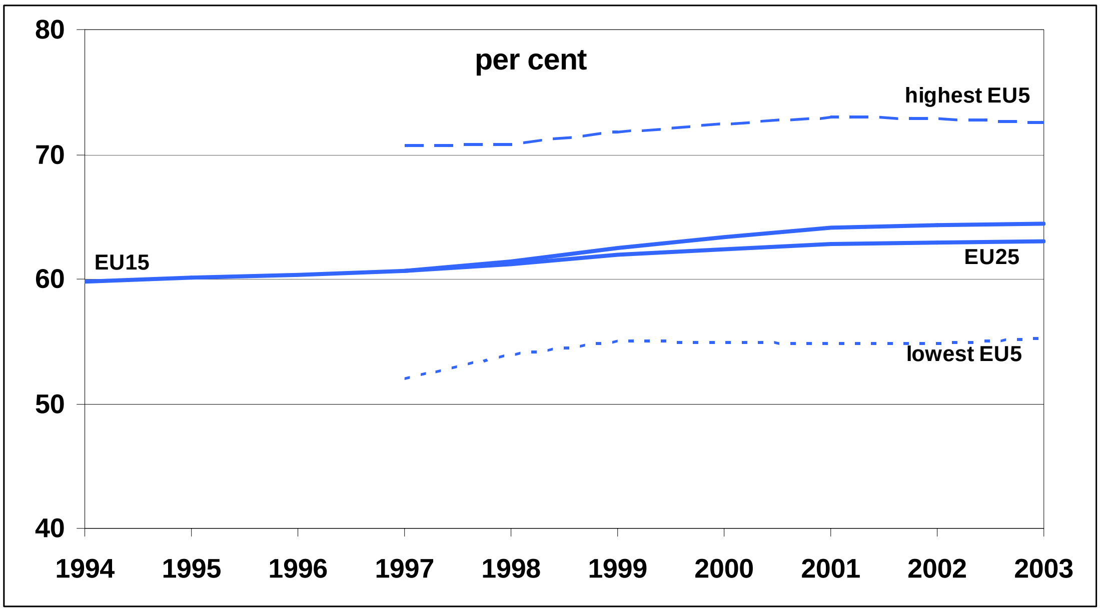


eb021 b1: Labour productivity per person employed - GDP in PPS per person employed relative to EU-25 (EU-25=100)
Includes forecast data: 2003 - eu15, eu25, dk, fr, ie, cy, mt pl, pt se, uk & jp; 2002 - dk, se & uk.

* Coding and full name of indicator as found in the Eurostat Structural Indicators database.

TOTAL EMPLOYMENT RATE

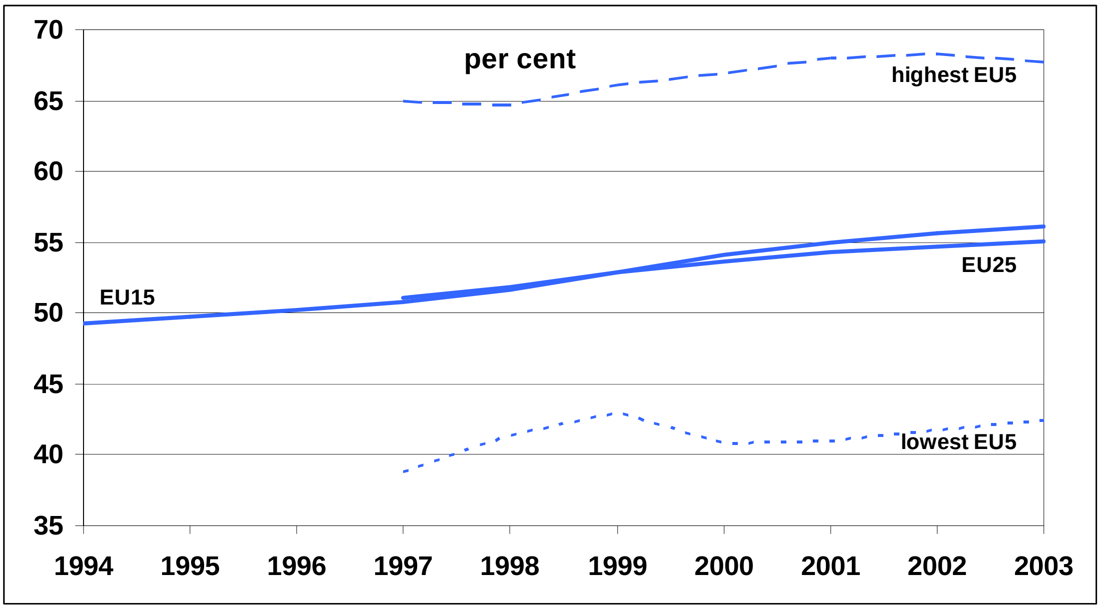
The total employment rate has continued to rise but at a slower pace, with the top quintile experiencing a decrease.



em011 I.1.1: Total employment rate - Employed persons aged 15-64 as a share of the total population of the same age group.
Data missing: cy & mt (1997-99); cz, ee, lv, lt & sk (1997).

EMPLOYMENT RATE (female)

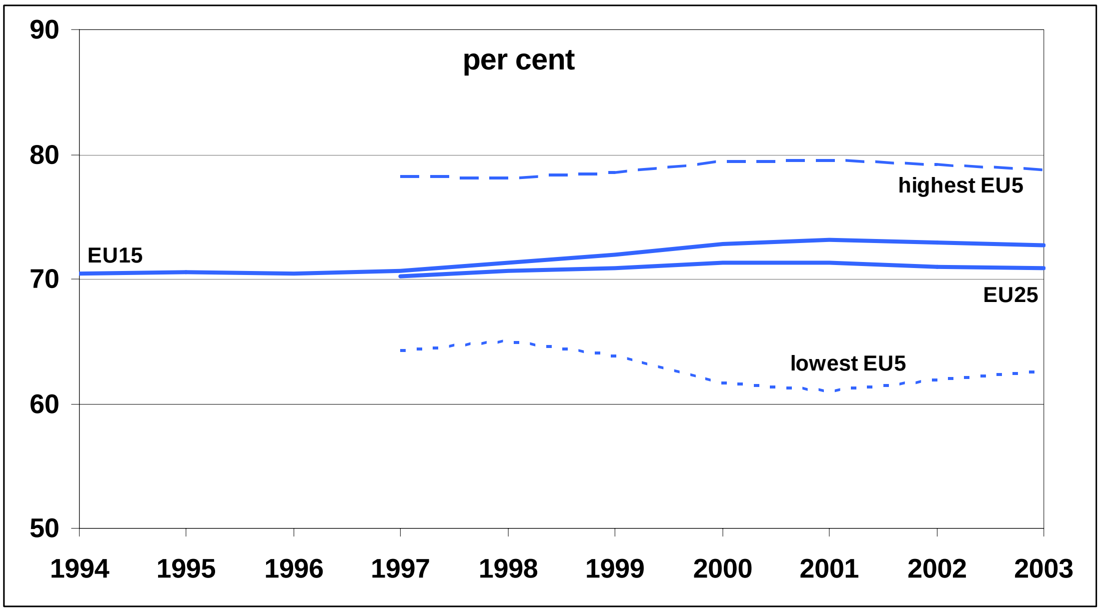
The female employment rate has continued to rise, though at a slower rate in the EU25 than in the EU15.



em012 I.1.2: Employment rate - females - Employed women aged 15-64 as a share of the total female population of the same age group.
Data missing: cy & mt (1997-99); cz, ee, lv, lt & sk (1997).

EMPLOYMENT RATE (male)

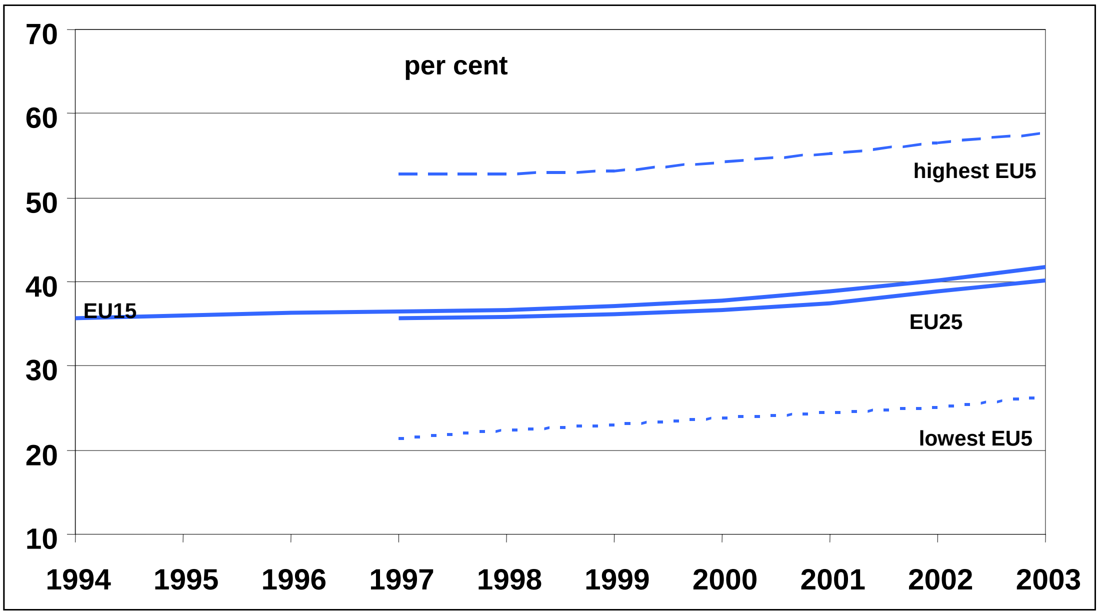
Overall, the male employment rate has continued to fall (though slightly) but for countries in the bottom quintile the rate has continued to rise.



em013 I.1.3: Employment rate - males - Employed men aged 15-64 as a share of the total male population of the same age group.
Data missing: cy & mt (1997-99); cz, ee, lv, lt & sk (1997).

TOTAL EMPLOYMENT RATE OF OLDER WORKERS

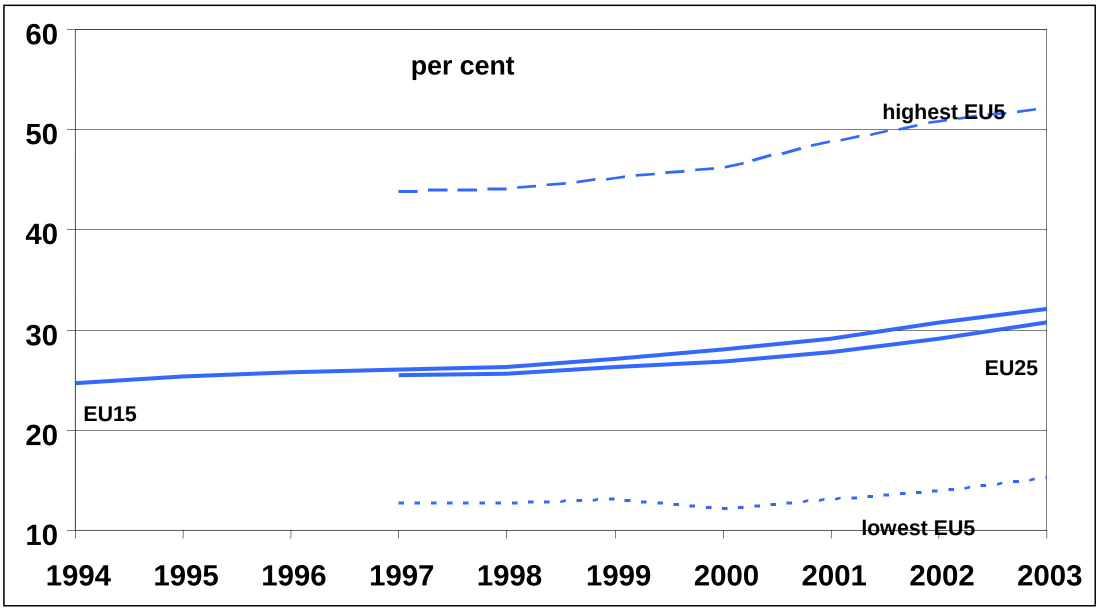
Progress has been made across the EU25 as the employment rate for older workers has continued to rise.



em014 I.1.4: Total employment rate of older workers - Employed persons aged 55-64 as a share of the total population of the same age group.
Data missing: cy & mt (1997-99); cz, ee, lv, lt & sk (1997).

EMPLOYMENT RATE OF OLDER WORKERS (female)

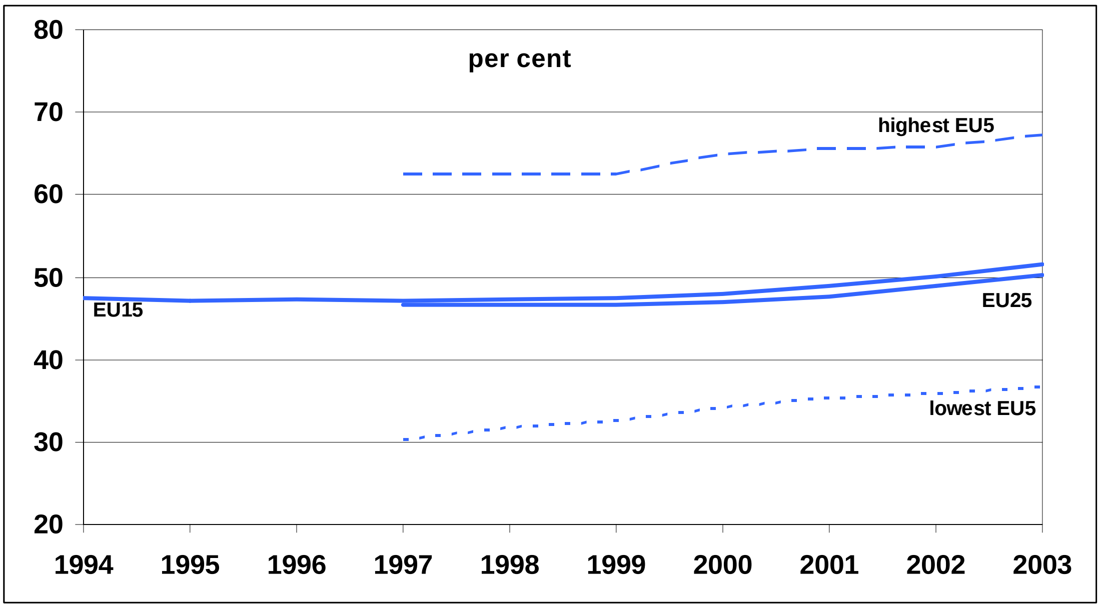
The employment rate for female older workers has continued to rise.



em015 I.1.5: Employment rate of older workers - females - Employed women aged 55-64 as a share of the total female population of the same age group.
Data missing: cy & mt (1997-99); cz, ee, lv, lt & sk (1997).

EMPLOYMENT RATE OF OLDER WORKERS (male)

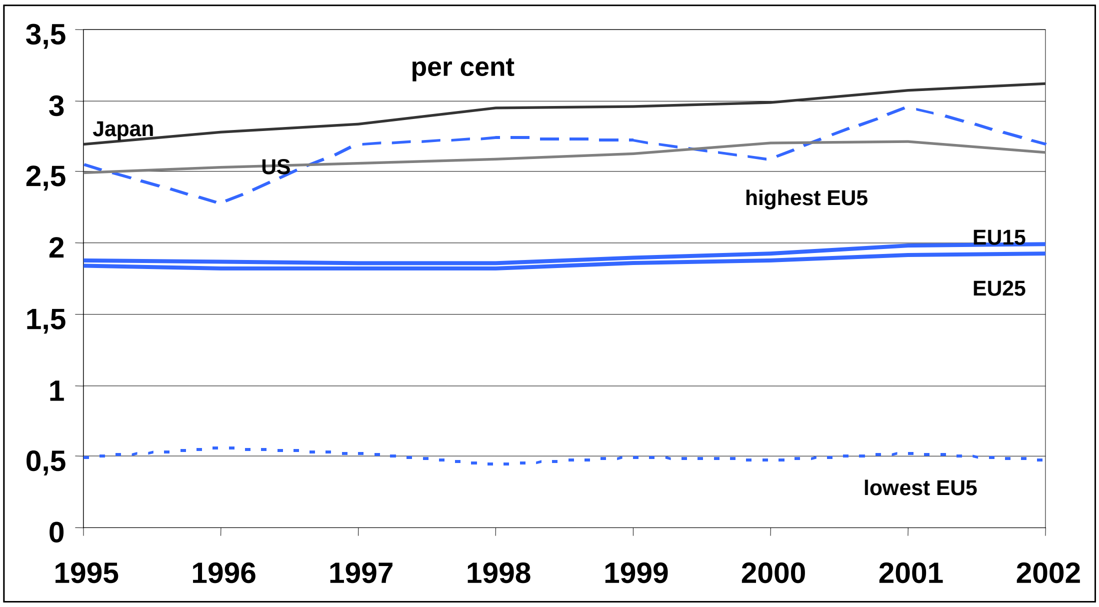
The employment rate for male older workers has continued to rise.



em016 I.1.6: Employment rate of older workers - males - Employed men aged 55-64 as a share of the total male population of the same age group.
Data missing: cy & mt (1997-99); cz, ee, lv, lt & sk (1997).

TOTAL R&D EXPENDITURE

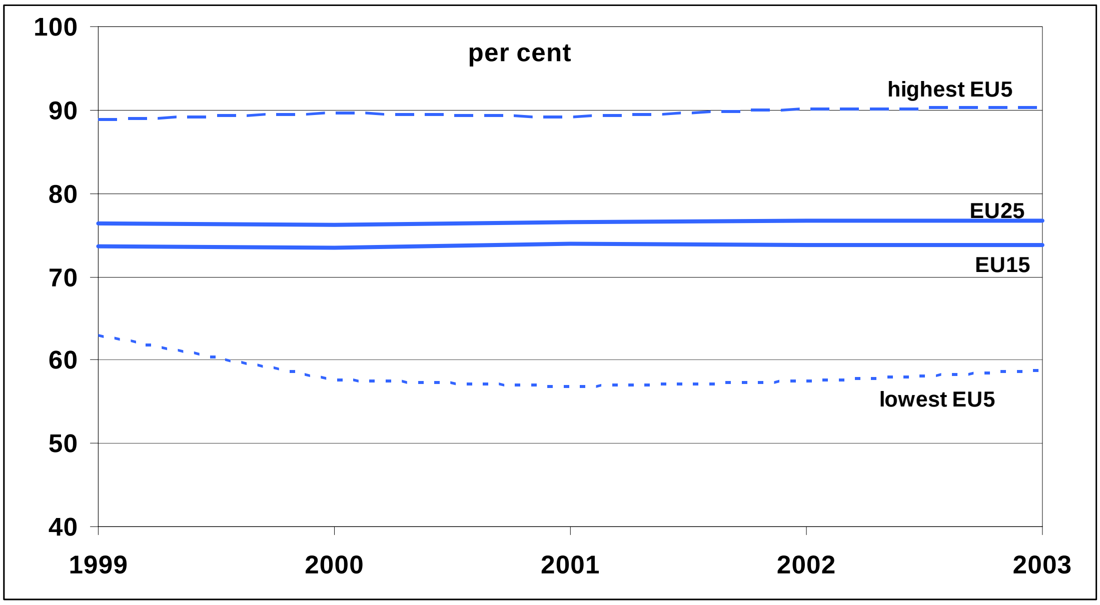
Overall R&D expenditure has remained stable although expenditure by the top quintile fell back in 2002.



ir021 II.2.1: GERD (Gross domestic expenditure on R&D) - as a percentage of GDP.
Missing data and extensive use of estimates; for details see Eurostat website.

YOUTH EDUCATION ATTAINMENT LEVEL

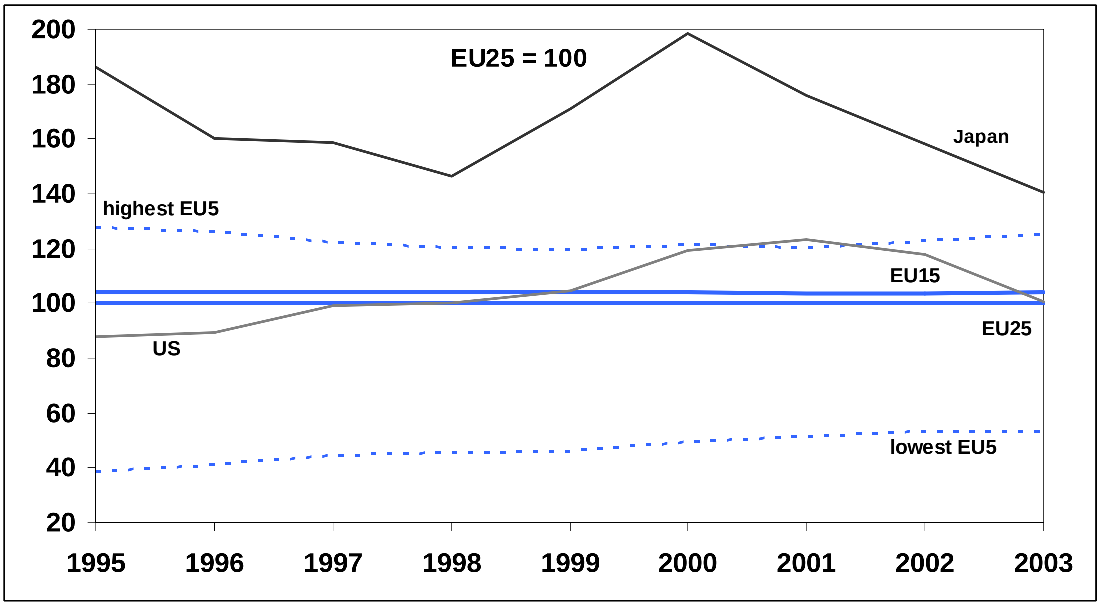
Youth educational attainment across the EU overall has remained unchanged, although there has been a slight improvement in the bottom quintile.



ir091 II.9.1: Youth education attainment level - total - percentage of the population aged 20 to 24 having completed at least upper secondary education.
Breaks in series and use of provisional and forecast data. For details see Eurostat website.

COMPARATIVE PRICE LEVELS

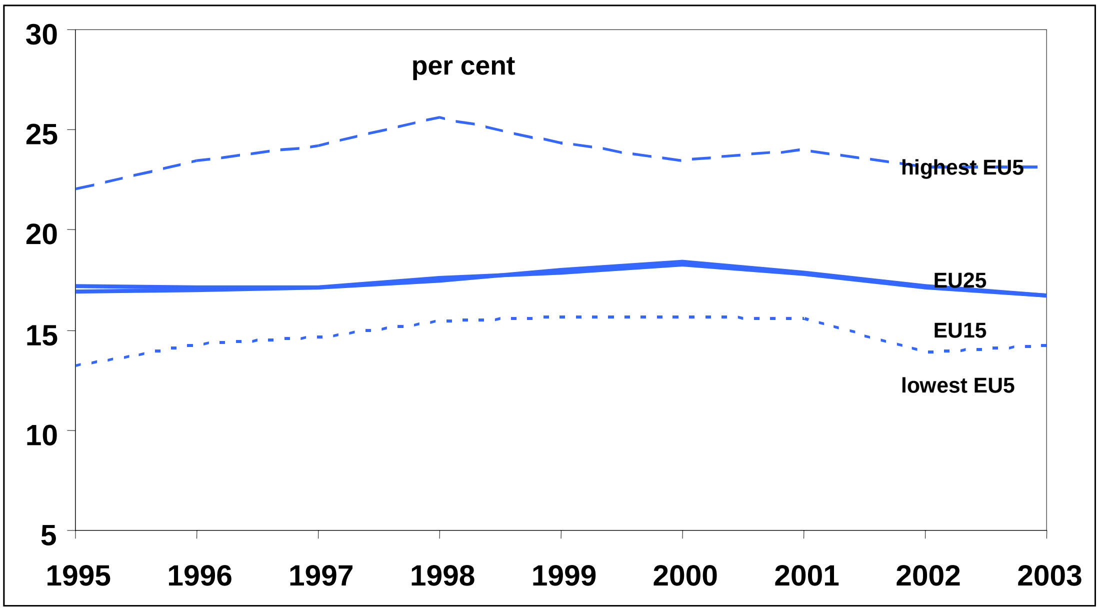
Price convergence has changed little over the last year, whereas, prices in the Us and Japan have moved closer to the EU25 average.



er011 III.1.1: Comparative price levels - comparative price levels of final consumption by private households including indirect taxes (EU-25=100).
2003 EU data are provisional; us & jp data includes estimates (2000-03). No data for mt before 1999.

BUSINESS INVESTMENT

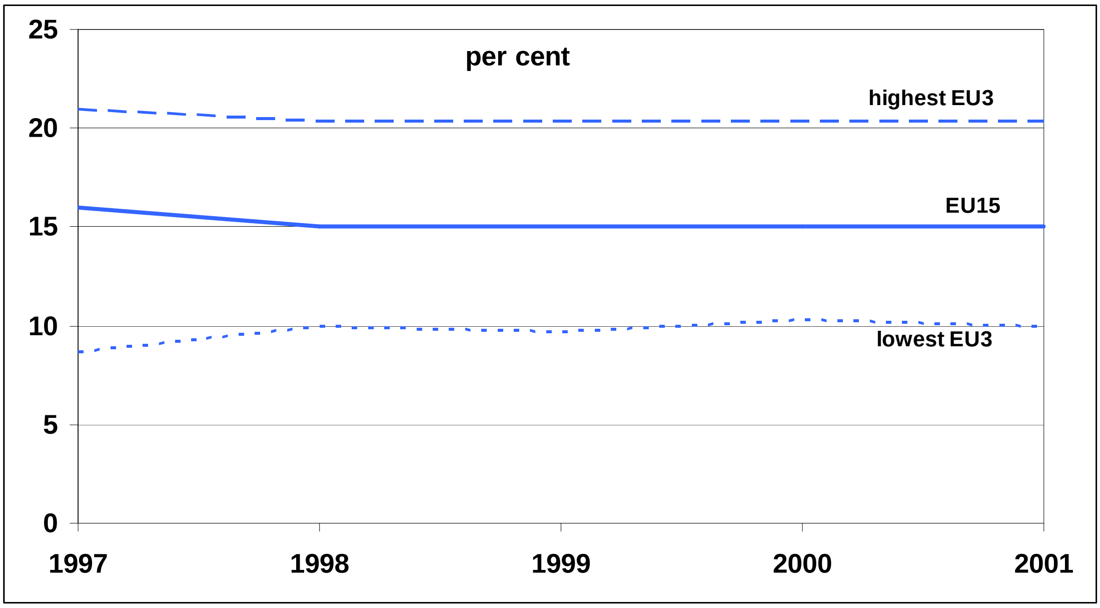
Overall business investment has continued to decline from a peak in 2000.



er070 III.7: Business investment - gross fixed capital formation by the private sector as a percentage of GDP.
Missing data: cy (1995-97); hu (2002-03); mt (1995-98).

AT RISK OF POVERTY RATE (after social transfers)

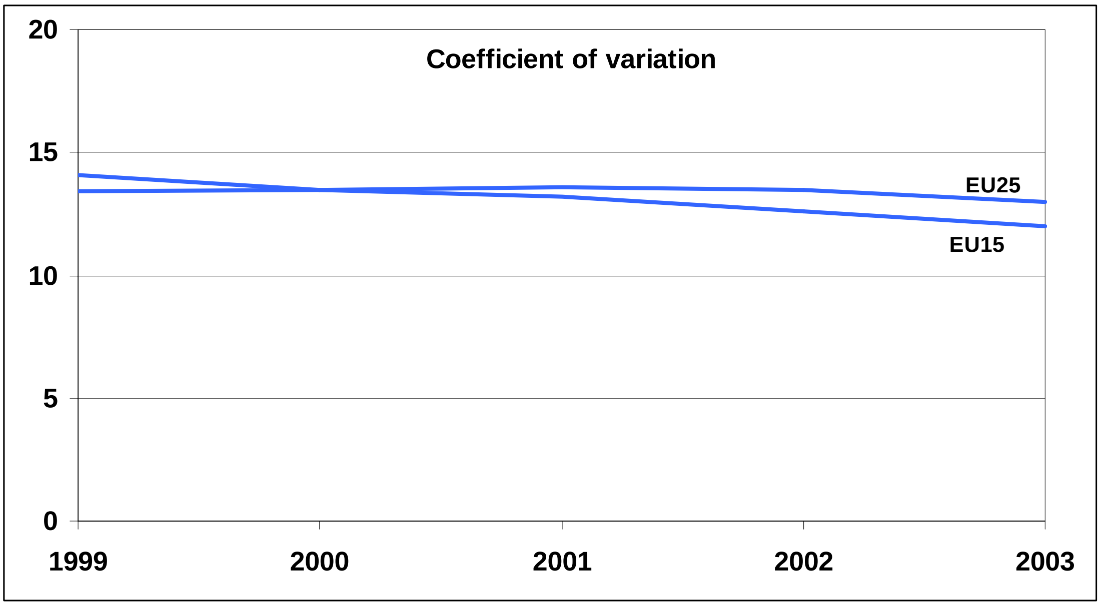
The at-risk-of-poverty rate (after social transfers) has continued to exhibit little change, as it has done since 1998.



sc022 IV.2.2: At-risk-of-poverty rate after social transfers - total - the share of persons with an equivalised disposable income below the risk-of-poverty threshold, which is set at 60% of the national median equivalised disposable income.
There is insufficient data for an eu25 figure and that for eu15 data is an estimate. For details see Eurostat website.

DISPERSION OF REGIONAL EMPLOYMENT RATES

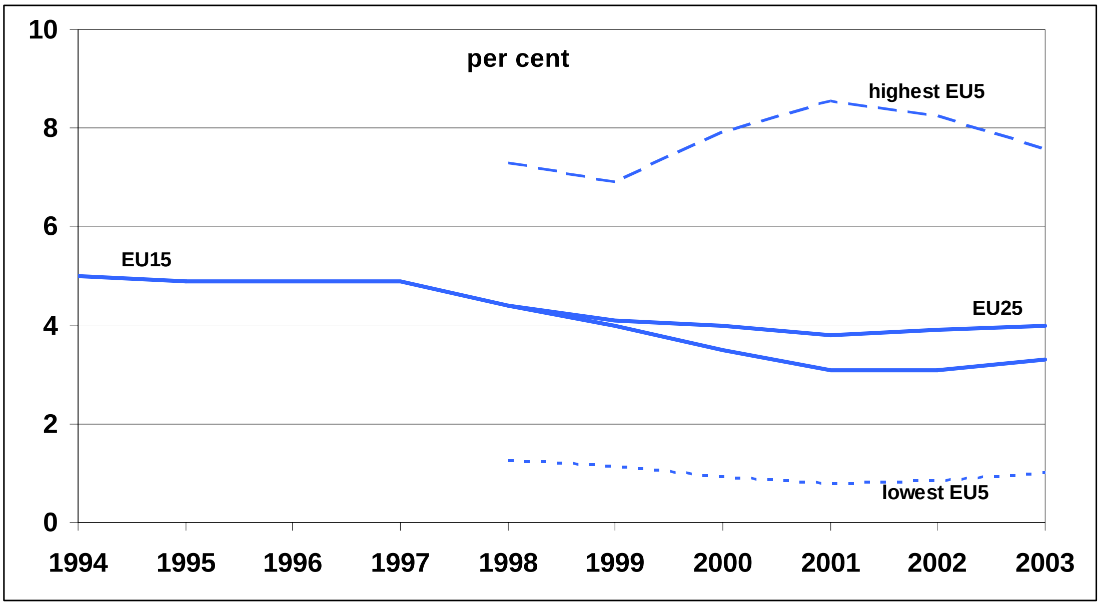
The dispersion of regional employment rates has continued to decrease, indicating convergence across the EU25 and EU15.



sc041 IV.4.1: Dispersion of regional employment rates - total - coefficient of variation of employment rates (of the age group 15-64) across regions (NUTS 2 level) within countries.
National data not applicable to dk, ee, ie, cy, lv, lt, lu, mt & si, as they are comprised of less than three NUTS 2 regions.

LONG TERM UNEMPLOYMENT

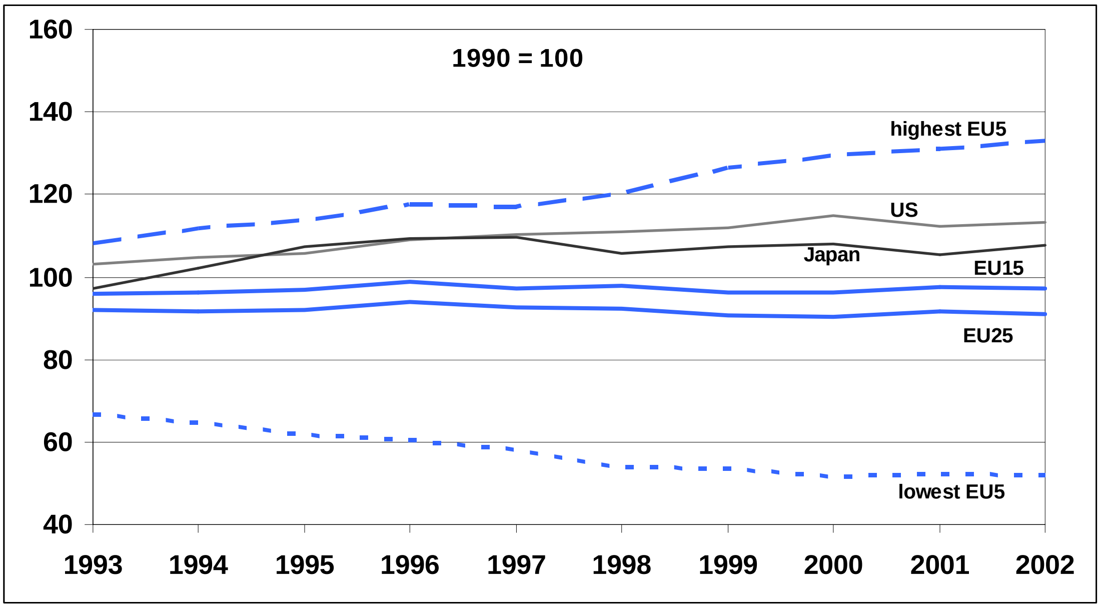
Overall the long-term employment rate in the EU25 and EU15 has continued to rise slightly, however, countries with the highest levels have continued to make reductions.



sc061 IV.6.1: Total long-term unemployment rate - long-term unemployed (12 months and more) as a percentage of the total active population.
Missing data: cy (1998-99), mt (1998-99), sk (1998) and fi (1994-96).

GREENHOUSE GAS EMISSIONS

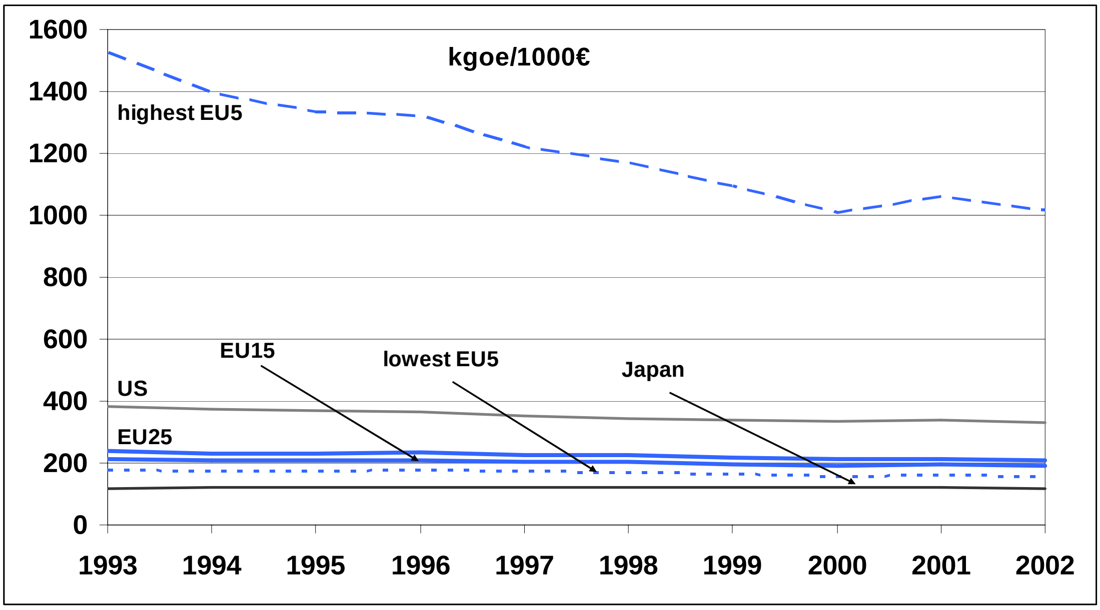
The EU25 last year and over the last decade has seen a very small decrease in greenhouse gas emissions but countries in the worst performing quintile have seen their emissions continue to rise.



en010 V.1: Total greenhouse gas emissions - percentage change since base year and targets according to Kyoto Protocol/EU Council Decision for 2008-2012 - (in CO2 equivalents) indexed on actual base year = 100.
No data available for cy; eu25 data are estimates.

ENERGY INTENSITY OF THE ECONOMY

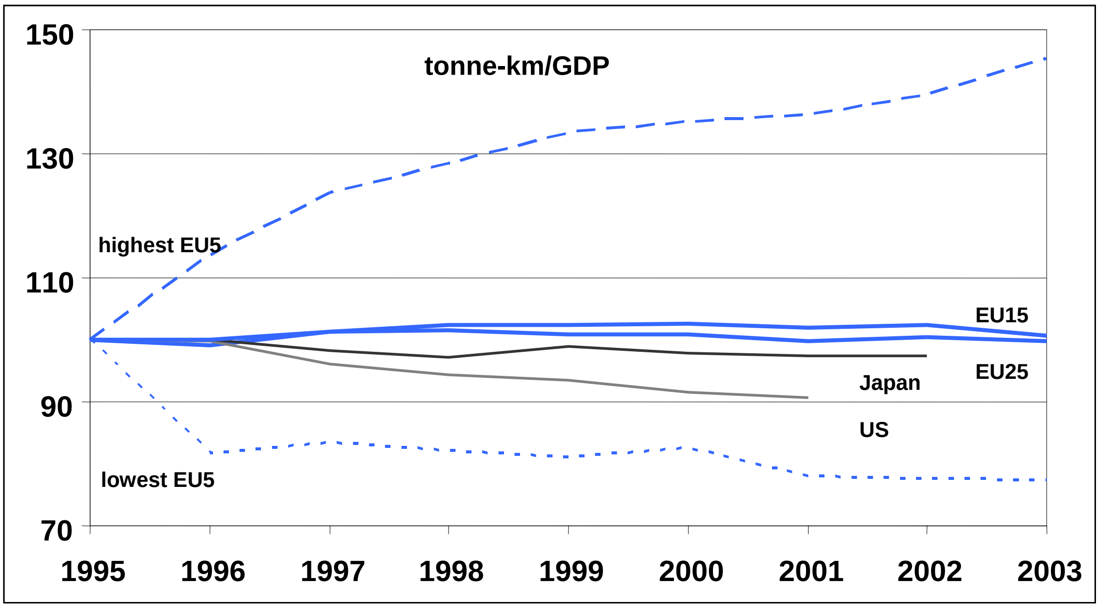
The energy intensity of the EU overall remained broadly stable, although the worst performing quintile of countries have made significant cuts.



en020 V.2: Energy intensity of the economy - gross inland consumption of energy divided by GDP (at constant prices, 1995=100) - kgoe (kilogram of oil equivalent) per 1000 Euro.

VOLUME OF FREIGHT TRANSPORT RELATIVE TO GDP

The volume of freight transport has fallen slightly over the last year. Top and bottom quintiles have continued to exhibit divergent trends.



en031 V.3.1: Transport - Volume of freight transport relative to GDP - index of inland freight transport volume relative to GDP; measured in tonne-km / GDP (in constant 1995 Euro), 1995=100.
Missing data: mt (1995-2003), us (2003-03) & jp (2003).

PART 2

SUMMARY OF MEMBER STATES' RELATIVE PERFORMANCE

<u>Table 1: Summary of Member State performance against Headline Structural Indicators</u> <u>(levels)</u>

Indicator	Report year	Reporting states	at	be	cy	cz	de	dk	ee	es	fi	fr	gr	hu	ie	it	lt	lu	lv	mt	nl	pl	pt	se	si	sk	uk
1. GDP per capita in PPS	2003	25	+					+	-						+		-	+	-		+	-				-	
2. Labour productivity per person employed	2003	25		+					-			+			+	+	-	+	-			-				-	
3a. Total employment rate	2003	25			+			+						-		-				-	+	-		+		-	+
3b. Employment rate – females	2003	25						+		-	+		-			-				-	+	-		+			+
3c. Employment rate – males	2003	25	+		+			+						-			-		-		+	-				-	+
4a. Total employment rate of older workers	2003	25		-				+	+					-								-	+	+	-	-	+
4b. Employment rate of older workers – females	2003	25		-				+	+		+					-				-				+	-	-	+
4c. Employment rate of older workers – males	2003	25		-	+			+						-	+			-				-		+	-		+
5. GERD (Gross domestic expenditure on R&D)	2002	20			-		+	+			+	+	na					na	-	na	na	-		na		-	
6. Youth education attainment level – total	2003	25				+				-					+	-		-		-		+	-		+	+	
7. Comparative price levels*	2003	25				+	-	-			-				-		+		+			+		-		+	
8. Business investment	2003	24			-	+			+	+				na				-	+			-		-		+	-
9. At-risk-of-poverty rate after social transfers*	2001	21			na	+	+	+		-	+		-	+	-	-			na	na	+		-	+	+	na	
10. Dispersion of regional employment rates - total	2003	16	+		na			na	na	-			+	-	na	-	na	na	na	na	+				na		
11. Total long-term unemployment rate*	2003	25			+			+					-			-	-	+			+	-		+		-	+
12. Total greenhouse gas emissions	2002	24			na				+	-			-	+	-		+		+	-		+	-				
13. Energy intensity of the economy	2002	25	+			-	+	+	-						+	+	-		-							-	
14. Volume of freight transport relative to GDP	2003	24						+	-	-			-	+	-				-	na		+				+	+

***** See notes for Table 1 ‘**na**’ – data not available from Eurostat Structural Indicators. ‘+’/’**-**‘ – best/worst performing quintiles.

Table 2: Summary of Member State performance against Headline Structural Indicators (progress since 1999)

Indicator	Report years	Reporting states	at	be	cy **	cz	de	dk	ee	es	fi	fr	gr	hu	ie	it	lt	lu	lv	mt **	nl	pl	pt	se	si	sk	uk
1. GDP per capita in PPS **	1999 - 2003	25					-	-	+						+	-	+	+	+		-		-				
2. Labour productivity per person employed**	1999 - 2003	25							+	-					+	-	+	-	+		-	+	-				
3a. Total employment rate	1999 - 2003	23			+ **	-		-		+			+			+	-		+	**		-				-	
3b. Employment rate – females	1999 - 2003	23			+ **	-		-		+					+	+	-		+	**		-			-		
3c. Employment rate – males**	1999 - 2003	23	-		**		-	-	+	+		+	+			+		-	+	**		-					
4a. Total employment rate of older workers	1999 - 2003	23	-		- **						+	+		+					+	**	+	-	-		-		
4b. Employment rate of older workers – females	1999 - 2003	23			- **				+		+			+					+	**	+	-	-		-	-	
4c. Employment rate of older workers – males	1999 - 2003	23	-		**				-	+	+	+		+			-			**	+	-	-				
5. GERD (Gross domestic expenditure on R&D)	1999-2002	20	+	+				+					na	+	-			na		na	na	-	na	na		-	-
6. Youth education attainment level – total	1999 - 2003	24		+			-		-	-	-				+			-		na		+	+		+		
7. Comparative price levels**	1999-2003	25		+		-	+	-				+	+	-	-							-		+			
8. Business investment	1999 - 2003	24						+	+	+			+	na				-	+			-	-		-	-	
9. At-risk-of-poverty rate after social transfers	1999-2001	15			na	na			na				+	na	-	-	na	+	na	na		na		-	na	na	+
10. Dispersion of regional employment rates - total	1999 - 2003	16	-		na		-	na	na	+		+	+		na		na	na	na	na		-			na		
11. Total long-term unemployment rate	1999 - 2003	23		+	**	-			+				+			+	-		+	**		-	-			-	
12. Total greenhouse gas emissions**	1999-2002	24	-		na			+		-	-	+	-	+			+	-				+					+
13. Energy intensity of the economy	1999-2002	25	-	+					+	-				+	+			-		+			-			-	
14. Volume of freight transport relative to GDP	1999-2002	24							-	-		+	+	+	-		-	-		na	+					+	

****** See notes for Table 2 ‘**na**’ – data not available from Eurostat Structural Indicators. ‘+’/’-‘ – best/worst performing quintiles.

**** Notes for Table 1***

Indicator 7	'+': quintile with lowest price levels; '-': quintile with highest price levels.
Indicator 9	Five countries were joint fourth best (de, fi, hu, nl & si).
Indicator 11	Three countries were joint fourth best (cy, dk & uk).

***** Notes for Table 2***

Indicator 1	Average of annual real GDP growth rate was used.
Indicator 2	Average of (real GDP growth rate – employment growth rate) was used as a proxy.
Indicator 3c	Two countries were joint fifth best (ee & fr).
Indicator 7	'+': quintile with largest price falls, '-': quintile with largest price rises.
Indicator 12	Two countries were joint fifth best (fr & uk).
cy & mt	For indicators 3, 4 & 9 progress has been measured over the period 2000-03 due to an absence of 1999 data in Eurostat Structural Indicators database.