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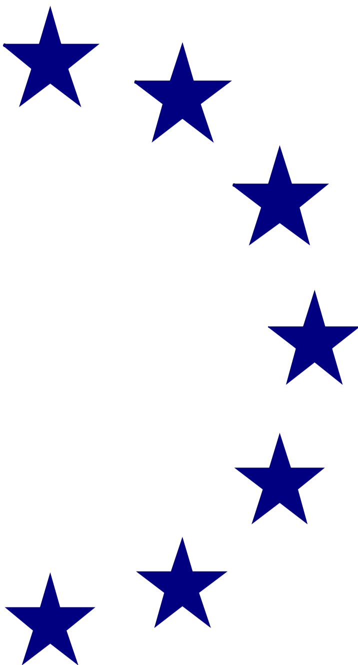

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Key structural challenges in the acceding countries: The integration of the acceding countries into the Community's economic policy co-ordination processes

by
Economic Policy Committee (EPC)

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The integration of the acceding countries into the Community's economic policy co-ordination processes

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THE INTEGRATION OF THE ACCEDING COUNTRIES INTO THE COMMUNITY'S ECONOMIC POLICY COORDINATION PROCESSES

PREFACE

In March 2000 in Lisbon, the European Union set itself the strategic ten-year goal

> "*to become the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion*".

The Heads of State and Government, meeting in Lisbon and Stockholm, called for greater efforts to speed up structural change so as to raise the growth potential, aiming at five priority areas: (i) employment, (ii) innovation and research, (iii) economic reform on product and capital markets, (iv) social cohesion and (v) sustainable development. The Member States, recognising that a marked acceleration of structural reforms is required in order to bring the strategic Lisbon goal within reach, have taken steps to implement labour, product and capital market reforms embedded in a sound macroeconomic environment. The new Broad Economic Policy Guidelines (BEPGs) for 2003-05 recognise the imperative of attaining higher and sustainable growth rates. Sound macroeconomic conditions and policies are a prerequisite for a sustainable increase in economic prosperity. Better functioning and more competitive labour, product and capital markets are indispensable in achieving a more dynamic economy and enhancing potential growth.

Enlargement in a medium- to long-term perspective is set to enhance considerably the prospects for growth of the EU economy. The acceding countries have achieved strong and solid progress with structural and institutional reforms. Progress (and the speed of structural change), however, has not been consistently strong across all countries and areas. Achieving real convergence with the EU and enhanced resilience to possible future shocks will depend on the scope and pace of progress in the implementation of the structural reform agenda.

The present Report should be a first step towards integrating the acceding countries, after enlargement, into the multilateral surveillance conducted by the Council under the Treaty, in line with the mandate given by the Ecofin ministers on 5 November 2002. The Report assesses the challenges faced by the acceding countries with regard to the Lisbon goal and the BEPGs, and identifies possible priorities for structural reforms in those countries by looking at the dynamics of a wide range of policy areas relative to the EU. The Report should also provide advice and oversight for the Council in concentrating the EU's monitoring on the priority areas where reform challenges are most evident.

The Report, which has been elaborated by a specific working group made up of experts from national administrations of the Member States, the European Commission and the European Central Bank (a list of members of the Working Group is annexed to this report), has to rely primarily on the Pre-Accession Economic Programmes and other secondary information, as the acceding countries do not yet participate in the Community's economic policy co-ordination processes. The outline of the Report follows the BEPGs and the EPC's annual reports on structural reforms. At this stage, its analytical part covers only the ten countries acceding in 2004 as the Report aims at preparing for their integration into the existing multilateral surveillance processes. Multilateral surveillance of the remaining three EU candidate countries (Bulgaria, Romania and Turkey) will continue under the Pre-Accession Surveillance procedure. Moreover, the EPC considers that the latter should be assessed in a report similar to the present one before their actual EU accession. However, for the sake of completeness the comparative tables, if data is available, also cover those three countries (albeit for Turkey most data have been lacking).

KEY MESSAGES

Structural reform challenges

The Economic Policy Committee (EPC) has analysed structural challenges in the acceding countries, on the basis of the Lisbon strategy as implemented via the BEPGs. It found that the challenges of the acceding countries do not differ fundamentally in nature from those in the present Member States. However, some challenges are more demanding for the acceding countries. Consequently, the existing framework for multilateral surveillance of structural reforms, as outlined in the general recommendations of the BEPGs, seems broadly appropriate also for the acceding countries.

The gap with the EU average is still wide and in spite of experiencing higher growth rates than EU countries over the past few years the progress in catching-up with the EU in income levels has been limited in most acceding countries. Catching-up in income levels is a long-term process, but the challenge is to speed up the narrowing of the productivity gap and the gap in employment rates between the acceding countries and the EU Member States.

The Lisbon strategic goal of "becoming the most competitive and dynamic economy remains unchanged in an enlarged Union. Yet the Lisbon targets are likely to be more difficult to achieve, simply because in most cases the average EU starting base is statistically lowered by the fact that most acceding countries are less well placed vis-à-vis the Lisbon targets than the existing Member States. It should also be recognised, though, that at least in some areas a number of acceding countries are already equally or even better placed than (some) present Member States.

Within the existing framework, the EPC considers that in the Cardiff process and the BEPGs, the focus for the acceding countries could rest more on the still incomplete structural shift. A number of product market issues, such as privatisation, administered prices and factors affecting the sectoral composition of the economy, and a number of challenges related to the knowledge-based economy, such as the performance of the education systems and R&D as well as innovation performance, need to be discussed more intensively than is currently the case for the existing Member States. A special focus for surveillance should be the institutional framework for market development and the business environment, and the effective implementation of competition policies. In the Luxembourg process, the focus for the acceding countries should, on account of the need for business restructuring, be more on the priority "promoting adaptability in the labour market". In regard of the specific elements of the Lisbon strategy and the BEPGs, the EPC would like to highlight the following priority areas:

- **Increasing employment and incentives to work**. Whilst the average employment rate in the EU has been rising, this is not the case for many acceding countries. In most of them, unemployment has remained unacceptably high. Major differences exist between the acceding countries in regard of employment rates and unemployment ratios. Even greater efforts than in the EU-15 will therefore be needed in order to achieve the Lisbon employment goals in an enlarged EU-25 as a whole. The measures that hold the key to "more and better jobs" include:
    - increasing the incentive effects of tax and benefit systems, in particular for low-wage earners by reducing unemployment traps ("increase incentives to work");
    - ensuring that wage increases remain in line with productivity gains and price stability (wage bargaining systems are key);
    - improving employment flexibility through an in-depth review of employment protection legislation;
    - improving the skill level with a focus on lifelong learning;
    - focusing on precisely targeted, effective and efficient active labour market policies.

Such reforms will speed up the acceding countries' convergence towards the EU's Lisbon employment targets.

- **Strengthening competition and efficiency in product and service markets**. While many challenges in product markets are key to both acceding countries and present Member States, the acceding countries are facing some specific challenges, especially with regard to sectoral changes in the economy, privatisation, administered prices and state aid. There are still several sectors in product and service markets, especially in the non-tradeable sector, where competition in the acceding countries seems to be lacking relative to EU-15. Across all sectors, for enterprise and entrepreneurship to thrive, measures to improve the **business environment** will be essential. The following should be priorities for further action:
  - In some countries, more progress is needed to strengthen competition rules and establish independent competition authorities. Despite good progress, significant deficiencies need to be addressed in most countries with regard to the regulatory burden on business, the effective implementation and, in some countries, the design of judicial reforms, and the quality and administrative capacity of the central and local authorities. Many segments of the public sector need to be made more efficient to facilitate the operation and growth of businesses.
  - In a number of countries, incomplete market-exit mechanisms should be addressed, in particular through the improvement of bankruptcy legislation and procedures. For network industries, it will be key to reduce potential barriers to foreign and domestic competititon and ensuring effective and transparent supervision.
  - After accession, particular attention will have to be devoted to the effective implementation of **internal market obligations**, which is a challenge notably with respect to achieving rapidly the targets for transposing EU directives, and eliminating barriers to cross-border trade.
  - In many countries, further scope exists for privatisation/restructuring. Countries which have encountered problems in devising viable strategies should reinforce and press ahead their privatisation/restructuring programmes. State aid should be reduced and overhauled with the aim to both reduce the total and to redirect this aid towards horizontal objectives.

  The implementation of competition policies should be a core focus for monitoring. Restructuring of the agricultural sector remains an urgent priority in many acceding countries.

- **Pressing ahead with financial market reforms.** Bank restructuring and privatisation have added to financial sector stability in the accession countries. Except for some notable exceptions, the privatisation process can be regarded as largely completed. As regards financial sector development, the acceding countries in transition clearly lag behind the EU average in terms of stock market capitalisation, the level of financial intermediation, and the degree of liquidity. The following reforms have been identified as being important for further action:
  - Continued reforms to deepen and widen the financial sector are required so as to avoid credit constraints. The legislative frameworks must support the development of financial markets and the institutional investor base. In this regard, the timely and effective implementation of EU financial services regulation, notably the Financial Services Action Plan is crucial.
  - The availability of low-cost loan finance and early-stage risk capital financing for SMEs is essential. The implementation of the Risk Capital Action Plan has an important role to play.
  - Whilst it appears that satisfactory progress has been made in putting into place adequate regulatory and supervisory capacities, substantial changes in the structure of financial markets create new demands for the organisation of financial supervision, which should proactively be addressed.

- **Improving the quality of public finance.** The Ecofin ministers in their meeting with their counterparts from the candidate countries on 5 November 2002 noted that reaching **sound fiscal positions** for some of the acceding countries will clearly require efforts over and above those described in the PEPs. The acceding countries, whilst after accession respecting the requirements of the Stability and Growth Pact, should enhance the efficiency of public spending and revenues by way of institutional and structural reforms. In order to foster a growth-enhancing environment providing sufficient scope and incentives for private-sector development, the structure of budget revenue and expenditure needs to be reassessed. Specifically:
  - On the revenue side, specific challenges should be addressed, such as the compared to present Member States narrow tax base with at the same time similar levels of public expenditure which characterises several acceding countries, and weaknesses in tax collection and administration.
  - On the expenditure side, the quality of services provided by the public sector and improvement of the efficiency of public administration set the framework for dynamic economic growth. Specific attention should be devoted to investment in key areas (such as R&D and innovation, public infrastructure and human capital) so as to underpin future competitiveness and growth, while the need for expenditure control rules at sub-national levels of government should be addressed.
  - It is essential that the use of **EU structural funds** will be focused on those types of investments most conducive to long term productivity gains, particularly human and knowledge capital, as well as on basic infrastructure.

- **Continuing pension and health care reforms.** Ageing populations could induce dramatic changes in potential growth rates, and a deterioration of public finances, which is the same challenge as in the present EU Member States. In the light of the Lisbon agenda:
  - In line with the three-pronged strategy developed by the Ecofin Council to prepare for the budgetary effects of ageing (i.e. debt reduction, raising employment rates and reform of pension systems) and in view of the current parameters of their pension systems, many acceding countries will have to implement comprehensive reform strategies. These will inter alia have to include initiatives aimed at offsetting the effects of ageing via reforms of the basic parameters of public pension systems (e.g. the retirement age, the replacement rate or the contribution rate), with a view to improving incentives to work and strengthening the actuarial link between contributions and benefits.
  - Due to growing GDP as well as technical progress and product innovation, health care expenditures are expected to grow fast. Containing such expenditures, while providing effective coverage, will entail steps to improve the efficiency of the health care systems.

- **Accelerating the transition to a knowledge-based economy.** The acceding countries have, in particular relative to their income levels, achieved high levels of educational attainment. However, they lag substantially behind present Member States in regard of the transition to a knowledge-based economy as reflected by lower investment in R&D. In regard of education, the lack of high skilled labour could indicate potential long-term difficulties in the light of the Lisbon agenda. To accelerate the catching-up process:
  - The acceding countries should press ahead with educational reforms and improve their education and training systems in terms of educational attainment, skilled human resources, and R&D and innovation performance.
  - They should improve the general framework conditions for R&D, including the entrepreneurial climate, access to risk capital, and the interrelationship between business and the research network.
  - In view of the technology gap of several acceding countries vis-à-vis EU-15, increased focus should be laid on technology transfer and gradual product and process improvement as well as direct public educational and research efforts to underpin this

process. The dynamics of foreign direct investment, which has a key role as mechanism of technology transfer, should be sustained.

The acceding countries, in their future Cardiff reports (and the remaining Pre-Accession Programmes in 2003), are invited to pay particular attention to the structural reform priorities identified above. The EPC considers that it is crucial for the acceding countries to maintain the current reform momentum, even in the event of lower growth performance, as some countries could face a risk of backtracking in certain areas undergoing reform. There should be a determined attempt in those countries to mobilise public opinion and build **a solid political consensus** amongst the various stakeholders backing the catching-up process.

Economic policy co-ordination processes and further work

In response to the mandate given by the Ecofin Council in November 2002 as to how the acceding countries could be integrated as early as possible into the Community's **structural reform co-ordination processes,** the EPC suggests including the acceding countries for the first time in:

- the **BEPGs** in 2004 (including in their country-specific part), taking into account their new three-year perspective (which for the current Member States is the period 2003-2005, and for the new Member States should therefore be 2004-05), and accordingly the implementation report on the BEPGs in 2005;

- the **EPC's annual report on structural reforms** in 2005 (the Cardiff report), including specific country notes. However, the acceding countries should be invited to already provide Cardiff reports in October/November 2003 and participate at the annual examinations of the EPC for the 2004 annual report on structural reforms;

- the **Luxembourg and Cologne processes** in 2004; a (possible) upcoming report on the **open method for pensions** only after long-term projections for pension expenditures are made available in 2006 (the acceding countries have already been included in the Lisbon strategy in 2003).

In terms of further follow-up, in its **comprehensive monitoring report** in the structural reform area to be provided in November 2003, and in its Lisbon reports for the Spring European Council, the Commission is invited to devote particular attention to the most urgent challenges identified in this Report. Enlargement will be a special subject in the **EPC Annual Report on Structural Reforms in 2004**. With the Lisbon targets in mind, a special annex could be devoted to the areas of critical items identified by this report for the acceding countries, (such as privatisation, the share of public enterprises, administered prices, and tertiary and vocational education). The **EPC's working groups** are invited to extend their work to cover the acceding countries, for example the EPC's Ageing Working Group to include them into their next round of common projections for public spending on pensions, health and long-term care for the elderly in 2004/5, and the EPC's Working Group on Output Gaps with a special report being submitted to the Committee by the end of 2004. The EPC's Working Group on Structural Indicators is invited to explore whether there is any need for additions to, or changes to the scope of the existing list of structural indicators. The EPC as a whole should include the issue of regional disparities, and the role that Community and national policies could play over a broad range of fields to reduce standards of living within the Community.

The finance ministries and the statistical offices in the acceding countries should devote sufficient resources to the structural indicators to ensure best possible **coverage and quality of the data** used. The information content of the Pre-Accession Programmes should be improved for example as regards the data on the quality of public finances (revenue and expenditure) and the sustainability of public finances.

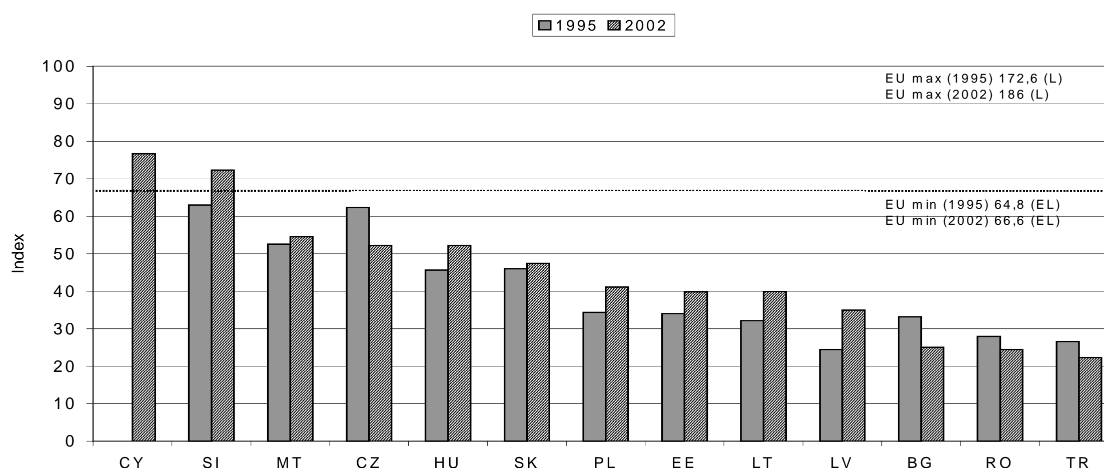
I. THE CONTEXT FOR MEETING THE STRATEGIC LISBON GOAL

1. Since the outset of transition the economies of the acceding countries have made remarkable progress in regard of **macroeconomic stability**. For several years, output growth in most countries has exceeded the EU average. A number of macroeconomic imbalances remain for some countries, and this calls for renewed vigour, e.g. with regard to current account balances, the savings rate, the sustainability of the fiscal stance over the medium term, the commitment to fiscal consolidation and the stability of price developments. Additional macro- and microeconomic reforms, together with continued fiscal consolidation, will be necessary to increase further the efficiency of economic management and domestic co-ordination and raise the growth potential of the economy while tackling medium-term challenges. Stability-oriented macroeconomic policies as well as credible and viable exchange-rate strategies will be crucial for investment and economic growth. Stable macroeconomic conditions are a precondition for the acceding countries to cope successfully with enhanced competition, increased market flexibility and the possible economic vulnerabilities associated with the ongoing catching-up process.

Real convergence

2. The main challenge that acceding countries are facing is to catch up in terms of income levels. Whilst achieving income-per-capita levels close to the EU average will be a long-term process, there are also signs that many acceding countries are slowly but steadily closing the economic gap with the EU even if, for a number of countries, some backtracking in convergence has been forecasted to take place in 2003. Despite overall progress, the gap in income-per-capita levels between the acceding countries and the EU average remains considerable. Taking account of differences in purchasing power, GDP per capita in the acceding countries is around 45% of the average EU level. This figure masks large differences between countries, as shown in Graph 1. In 2002 GDP per capita ranged from over 74% of the EU average in Cyprus to 35% in Latvia. While Cyprus and Slovenia are, in fact, as prosperous as some of the present, less affluent Member States, the Baltic countries and Poland have a GDP per capita which is less than 45% of the EU average.

Graph 1: GDP per capita in PPS in 1995 and 2002
(EU average = 100)



***Source**: Eurostat.*
***Note**: 2002: estimates. Data for Cyprus 2001 (data for 1995 not comparable for Cyprus).*

3. Looking at the future prospects for real convergence and using a stylised set of assumptions, it is for illustrative purposes possible to derive a rather mechanistic long-term outlook for convergence trends in the acceding countries towards the EU-15 average. For that purpose, real incomes as a % of EU incomes have been calculated over a longer period, assuming for the years after 2004:

- the same growth rates as in the 2004 Commission's Spring 2003 forecasts for the candidate countries (see first column in Table 1);

- an EU growth rate of 2.4% based on the 2004 growth rates in the Commission's Spring 2003 economic forecasts;[1]

- constant prices and population size.

4. According to this calculation, Hungary, the Czech Republic, Estonia, Latvia, Malta and Slovakia would join Cyprus and Slovenia to reach 75% of the EU-15 income level over the next 25 years (see third column in Table 1). For other countries the catching-up process would take much longer. Indeed, it is likely to take one or two generations in the case of some of them.[2] This is perhaps unsurprising, given the lessons from the process of convergence for accession countries in the past. Yet the most noteworthy point is the sensitivity of the results to the assumptions made. Small changes in growth rates can significantly affect the speed of convergence. The fourth column in Table 1 shows the effect of increasing the growth rate assumptions in the candidate countries by 0.5 percentage point. In the case of Poland, for example, increasing the growth assumption by that amount would reduce the period needed to reach "75% convergence" with the EU by thirteen years (from 50 to 37 years).

Table 1: Period needed to reach 75% of the EU-15 average for GDP per capita (in PPS)

	Growth rate assumption as from 2004 (% p.a.) *	**Average growth rate achieved 1995-2002 (% p.a.)**	**Period needed to reaching 75% of the EU average**	**Scenario: Period needed to reach 75% of EU average with 0.5 percentage point higher growth**	
Cyprus	3.8	3.6	1	1	(-)
Czech Rep	3.9	1.7	19	15	(-4)
Estonia	5.1	4.9	23	19	(-4)
Hungary	4.1	3.9	24	19	(-5)
Latvia	6.0	5.6	24	21	(-3)
Lithuania	5.0	3.9	28	23	(-5)
Malta	3.7	3.3	25	18	(-7)
Poland	3.7	3.9	50	37	(-13)
Slovakia	4.5	3.7	22	18	(-4)
Slovenia	3.7	3.9	7	5	(-2)
Bulgaria	5.0	0.5	40	34	(-6)
Romania	5.0	0.4	44	37	(-7)
Turkey	4.5	2.9	61	49	(-12)

***Source**: Own calculations; AMECO, European Commission, April 2003. * Commission 2004 economic forecasts.*

[1] Those figures are technical assumptions taken for purely illustrative purposes, and are not to be misunderstood as forecasts.

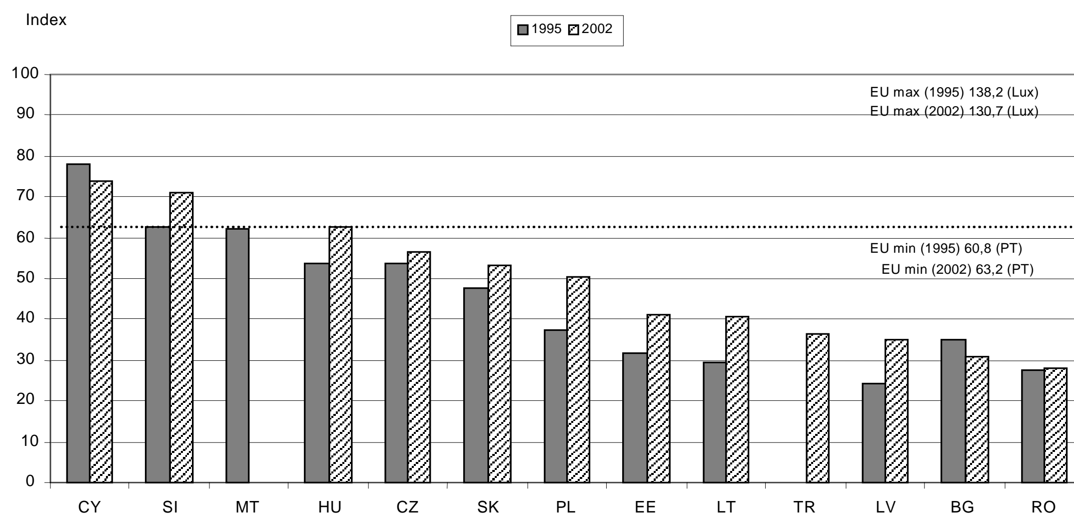
[2] See also the conclusions of the Commission's report (DG ECFIN, November 2001) on 'Real Convergence in the Candidate Countries': "*what is clear from that exercise is that for many countries catching-up even to levels of just 75% of the EU average will probably be a process spanning over more than one generation*". That paper provides also a good analysis of underlying growth-enhancing factors and an overview of the economic convergence of Portugal, Ireland, Spain and Greece before and after joining the EU.

5. The general economic developments in acceding countries in recent years permit a more general, albeit simplistic, observation regarding the role of policy: those economies which have made the strongest progress in implementing wide-ranging reforms seem to have achieved higher growth rates.

Labour productivity, wage costs and the structure of the economy

6. In order to close the income gap with the EU, it will be important for the acceding countries to increase further labour productivity and total factor productivity, along with employment. As illustrated by Graph 2, six candidate countries are below half the EU average productivity level. Only three acceding countries have a labour productivity level above the lowest productivity level among the current Member States. However, labour productivity increased steadily for most acceding countries over the period from 1995 to 2002.

Graph 2: Labour productivity per person employed in 1995 and 2002 (EU average = 100)



***Source**: Eurostat*
***Note**: 2002: estimates.*

7. Recent empirical work providing a breakdown of GDP growth into its various components for five acceding countries shows that in Hungary, Poland, and Slovenia a key driver behind cumulative output growth over the period 1991-99 was the relatively high total factor productivity growth (i.e. independent technical progress) (Table 2). In addition, fixed capital contributed strongly to the high cumulative output growth in Poland. The contribution of employment declined in all five countries, except Slovakia (however, in the late 1990s, production was catching up and the contribution of employment to growth was higher). This is also illustrated by a recent Commission analysis which highlights the essential characteristics of the economies of the central European acceding countries, featuring relatively low capital endowment and a low level of technology. It also asserts that their future speed of real convergence towards the EU average depends essentially on the rate of investment (including foreign direct investment), the growth in total factor productivity, and high labour force growth and participation[3]. In contrast, during the same period within the EU-15 the contribution of employment to GDP growth was stronger than in the acceding countries; and having a lower growth rate than the acceding countries the contribution of total factor productivity growth and capital deepening was weaker.

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[3] European Commission: The economic impact of enlargement, June 2001, pp. 27-31.

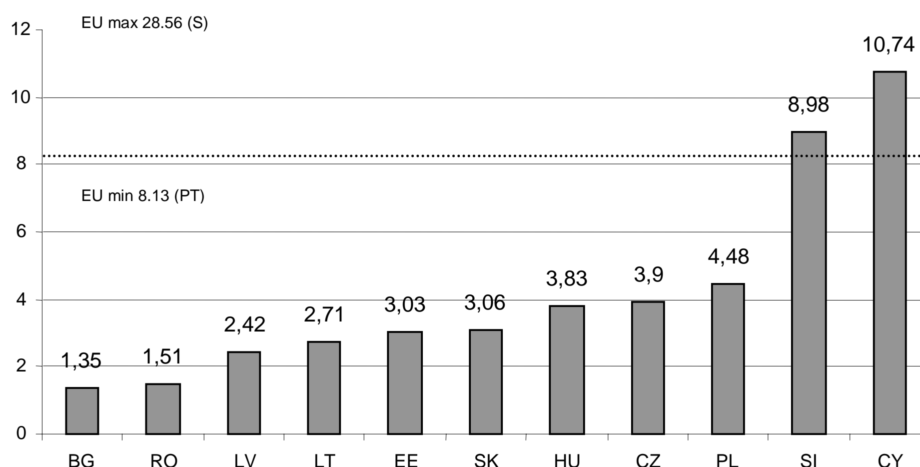
Table 2: Contributions to growth rates in central European countries 1991-99 (as %)

	Cumulative GDP growth	Contribution of TFP growth	Employment	capital
Czech Rep	9.1	4.6	-4.3	9.0
Hungary	16.6	20.2	-11.1	9.2
Poland	47.9	20.9	-1.6	24.3
Slovakia	21.8	2.0	6.2	12.4
Slovenia	25.6	21.0	-6.4	10.9

Source: *IMF (2001), 'Real Convergence to EU income levels: Central Europe from 1990 to the Long Term', Doyle P., Kuijs L., and Jiang G., Discussion Paper, p. 31.*

8. Labour costs differ markedly between the acceding countries and relative to the current Member States[4]. The level of total hourly labour costs in 2000 in industry and services ranged from 2.42 euros in Latvia to 10.74 euros in Cyprus (Graph 3). This compares with an EU average of 21.5 euros (1999 figure). In most of the acceding countries, labour costs were below one quarter of the EU average.

Graph 3: Hourly labour costs in industry and services in 2000 (in euros per hour)



Source*: Eurostat, Labour Cost Survey, Candidate Countries 2000.*

9. The developments of unit labour costs between 1995 and 2002 diverged widely between countries and was very dynamic in some of them (Table 3). At the initial stage of transition, especially in labour-intensive industries, low and falling (nominal) wages, together with undervalued currencies, constituted the key comparative advantage of acceding countries. Since then, nominal wages went up substantially, outpacing in several countries labour productivity growth. It should also be taken into account that in the period 1995-2001 real exchange rate appreciation ranged from approximately 10% to a maximum of 100% (Slovenia, Malta and Cyprus being at the lower end and Lithuania and Latvia at the upper end; the other countries moved within a band of 35-60%). Accession countries are likely to face further real exchange rate appreciation, as inflation differentials with EU-15 will not, in general, diminish completely due to catching-up price movements[5], internal market integration in association

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4 See Labour Costs Survey 2000, Eurostat Statistics in Focus 23/2002.

5 Through the so-called Balassa-Samuelson effect faster-growing countries tend to experience higher rates of inflation without necessarily suffering a deterioration in their cost competitiveness. Wage increases will, to a large extent, be determined by productivity growth in the tradable sector (c.f. manufacturing, agriculture), which is exposed to international competition.

with low initial price levels and further adjustments in administered prices. Wage increases, if not matched by gains in productivity in the longer term, pose a challenge to external competitiveness in some acceding countries and could further aggravate the existing current account deficits. Unit labour costs being a key determinant of competitiveness, it is a major challenge for the candidates to ensure that real wage growth does not exceed productivity gains. Sustained wage moderation is therefore an important precondition for easing inflationary pressures, attracting foreign direct investment inflows, boosting growth and raising employment.

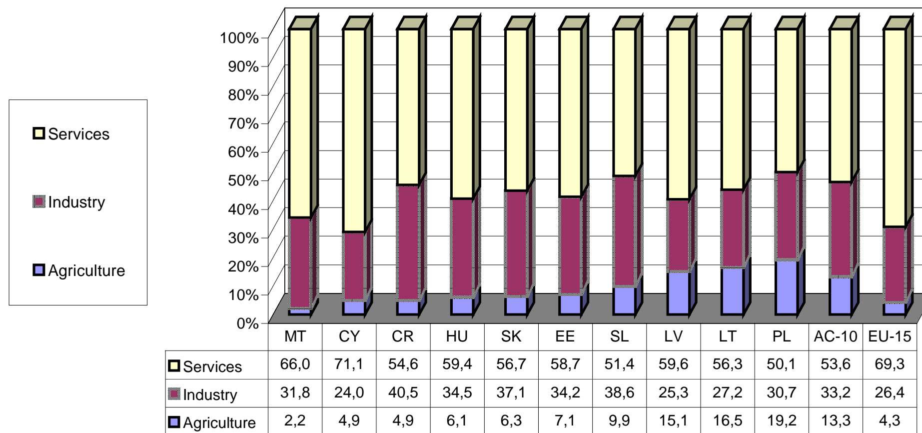
Table 3: Unit labour costs in 1995 and 2002
EUR-based, annual averages

	1995	2002	Relative change 1995-2002 (in %)
Czech Republic	110,3	202,7	+ 83,8
Hungary	110,9	187,4	+ 69,0
Poland	152,1	301,6	+ 98,3
Slovakia	93,1	120,5	+ 29,4
Slovenia	94,7	107,8	+ 13,8
Estonia	413,1	635,7	+ 53,9*
Latvia	508,2	794,7	+ 56,4*
Lithuania	472,7	997	+ 110,9*
Bulgaria	29	39,9	+ 37,6
Romania	60,8	90,1	+ 48,2

Source*: Vienna Institute for International Economic Studies (WIIW), Research Report No. 293, February 2003.*
Note*: Unit labour costs are exchange-rate adjusted, with 1989=100 for CZ, HU, PL, SK, SI BG, RO and 1992 = 100 for EE, LV and LI. 2002 data preliminary. * Note that the Baltic countries cannot be compared with the Central European countries as the base year for EE, LI and LT is 1992 instead of 1989.*

10. As regards the structure of the economy, the private sector has expanded significantly over the last decade in most acceding countries. While in EU Member States the general government sector in 2001 accounted for between 8% and 20% of GDP, in Latvia and Slovenia the public sector still accounted for a third of GDP or more. Only in Estonia, the Slovak Republic and Hungary did the private sector generate more than 80% of GDP. The relatively small private sector in some countries may indicate a lack of competition and ample room for efficiency gains. The sectoral composition of employment in acceding countries and in some countries the existence of large state-owned manufacturing companies with hidden unemployment help explain the low labour productivity (Graph 4 shows the sectoral shares of employment in 2001). Productivity growth in the acceding countries could be increased in the future by a further shift of emphasis within the sectoral composition of the economy towards sectors with a higher value added.

Graph 4: Sectoral share of employment in 2001 (%)



	MT	CY	CR	HU	SK	EE	SL	LV	LT	PL	AC-10	EU-15
Services	66,0	71,1	54,6	59,4	56,7	58,7	51,4	59,6	56,3	50,1	53,6	69,3
Industry	31,8	24,0	40,5	34,5	37,1	34,2	38,6	25,3	27,2	30,7	33,2	26,4
Agriculture	2,2	4,9	4,9	6,1	6,3	7,1	9,9	15,1	16,5	19,2	13,3	4,3

Source: *Eurostat.*

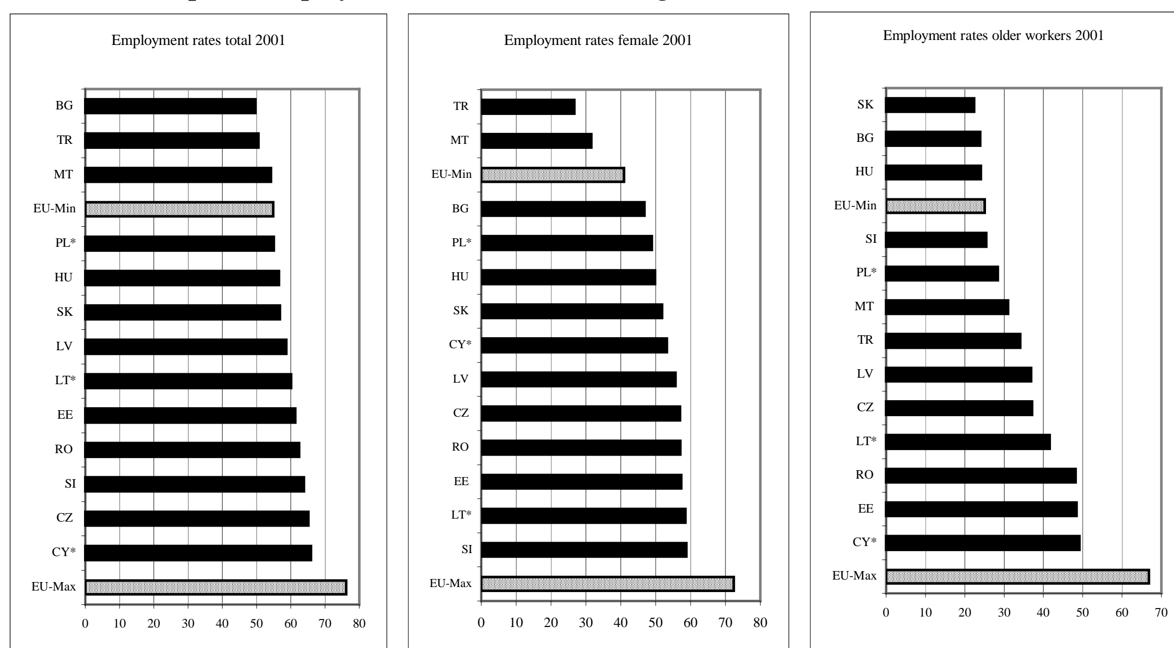
11. The sectoral composition of output and employment is still biased towards agriculture, which accounts for a high percentage of employment in most of the acceding countries. The share of the agricultural sector in terms of employment is, on average, three times higher in the acceding countries than in the EU. The employment share of agriculture in the acceding countries are much higher than GDP shares, i.e. they suffer from very low productivity. In order to foster overall productivity, in most acceding countries agriculture (farms and agro-enterprises) needs urgent restructuring.

II. LABOUR MARKET REFORMS

12. *A flexible labour market will be vital in achieving the strategic Lisbon goal. In Lisbon, viewing the EU as a whole, the EU Heads of State and Government set a 2010 target for the total employment rate of 70% and one of more than 60% for the employment rate of women. In Stockholm an overall target for the employment rate for those aged between 55 and 64 was set at 50% and intermediate targets of 67% and 57% were set for the overall employment rate and the employment rate of women respectively in 2005.*

13. As for employment, there are major differences between countries; all the acceding countries except Cyprus report lower total employment rates than the EU average (see Graph 5). In 2001 total employment rates in acceding countries ranged from 50.7% to 67.9% of the working-age population as compared with 64% on average in the EU. The employment rates of older workers were in the 22.5%-50.5% range. This relatively low employment rate is explained by, among other things, widely used and relatively generous early retirement systems. Female employment rates are less dispersed and range between 47.9% and 57.4%. The comparatively high female participation is due partly to the rather easy access to childcare facilities, which did, however, deteriorate in the post-communist period.

Graph 5: Employment rates in the acceding countries in 2001 (as %)



***Note** : * 2000 data.*
***Source**: Eurostat - Structural Indicators, April 2003.*

14. **Unemployment** remains a serious problem in most countries, ranging between 4.5% and 19.7% in 2001 (Table 4). Unlike in the EU, the female unemployment rate is lower than the male unemployment rate in about half of the acceding countries. Special attention should be paid to high rates of long-term and youth unemployment and to high unemployment among low-skilled workers. Regional unemployment is rather high in most acceding countries, with Slovakia showing the widest gap between regions.

Table 4: Unemployment rates in 2001 (as %)

	Total	Long-term	Men	Women	Youth
Cyprus	4.5	0.9	3.0	6.5	3.5
Czech Rep	-	4.1	-	-	6.7
Estonia	12.2	5.8	12	12.5	8.8
Hungary	5.7	2.5	6.3	4.9	3.7
Lithuania	16.5	9.3	19.0	13.8	10.2
Latvia	12.9	7.7	14.2	11.5	8.6
Malta	-		-	-	
Poland	18.6	9.2	17.2	20.3	15.2
Slovenia	5.9	3.6	5.6	6.3	5.7
Slovakia	19.7	11.3	20.4	18.8	17.6
Bulgaria	19.6	12.5	20.5	18.6	13.6
Romania	6.5	3.2	7.0	5.9	7.0
EU:					
Average	7.3	3.2	6.4	8.5	7.1
Maximum	10.6	5.4	8.6	15.6	10.3
Minimum	2.0	0.5	1.7	2.4	2.7

***Source**: Employment in Europe 2001 and 2002 for long-term unemployment rates of acceding countries, structural indicators for EU and total unemployment rates in acceding countries.*

15. Prospects for employment creation should, however, improve in the years to come as widespread labour shedding, which has been part of the business restructuring process, is likely to come to an end. Thus, employment could increase modestly in 2003-04. The pure statistical result for the ten acceding countries joining the EU in 2004 will increase the unemployment ratio in an enlarged EU. In the longer run, there are grounds for assuming that the positive effects of enlargement on economic growth in Europe would bring about favourable employment developments as well. However, across the acceding countries, employment rates have decreased (see Annex 1) and unemployment rates increased since 1997 which is problematic in view of the Lisbon agenda.

16. Policies to raise employment levels in the acceding countries are not very different from the range of approaches observed in the present Member States, including macroeconomic stimulus. In some countries, **tax and benefit systems** seem to be important areas for further labour market reforms so as "*to make work pay and encourage the search for jobs*". In most acceding countries the newly introduced unemployment insurance systems appear to be less generous on average than in the EU. However, they appear to be especially generous for unemployed persons with a family, which creates possible unemployment traps. Several acceding countries devote, relatively speaking, more resources to non-employment benefits than the current Member States, undermining the incentives for low-productivity workers to seek and take up employment. The relatively high tax burden on labour, especially low-wage earners, is a particular problem in some acceding countries. Early retirement systems are in some cases used as a response to the decline in employment and, as in current Member States, excessive replacement rates and generous eligibility rules might be an issue, notably for unemployment and disability schemes that often lead to early retirement.

17. The **wage bargaining systems** in the acceding countries have evolved during the transition period. Minimum wages were introduced in almost all of them and currently amount to between 25% and 42% of the average wage. Lack of regional differentiation of the nominal minimum wage is a problem in Poland, but it is not clear whether it makes up for high regional differences in the labour market situation in other countries. Tripartite bargaining was common in the centrally planned economies; bilateral bargaining has developed as the degree of corporatism has declined rapidly. Nowadays, in most acceding countries, wage negotiations at firm level predominate, facilitating wage differentiation.

18. Labour market flexibility in a number of acceding countries is hampered by relatively strict labour market regulation, especially **employment protection legislation**. However, in many current Member States restrictions are similar to, or even more binding than, those in some acceding countries. In many acceding countries, factors such as complicated administrative procedures and unduly long minimum notice periods are at play. Working-time flexibility varies between acceding countries, with an increasing share of part-time and fixed-term contracts.

19. **Active labour market policies,** such as training, employment subsidies and job search assistance, have gained in importance in labour market policies of the present Member States, but also in acceding countries. While present EU countries spend around 1% of GDP on active labour market policies, the comparable figures in acceding countries are still much lower (on average 0.2% of GDP, though the share of expenditure for active labour market policies in total labour market expenditure is higher than in the present EU Member States). Spending patterns and the efficiency of spending differ widely. Finally, human capital formation is an important challenge for the acceding countries, as the education systems in the centrally planned economies did not prepare people for lifelong adaptability of their skills and focused too much on narrow job descriptions (see Chapter VI).

20. Overall, while in the EU the average employment rate has been rising, this is not the case in many acceding countries. In most of them, unemployment has remained unacceptably high and the challenges are to reduce the high (and especially long-term) unemployment rates among certain groups, especially the young and the low-skilled, to narrow regional disparities and to increase employment rates for older workers. Institutional arrangements on the labour market in many acceding countries need to be modernised. The authorities should, however, guard against adopting more rigid labour market policies. Measures such as increasing the incentive effects of tax and benefit systems so as to restore the financial benefits associated with a return to employment, reducing early retirement by offering incentives for people opting for later retirement, enforcing sustained wage moderation to strengthen or maintain the link between productivity growth and wages, improving employment flexibility through a thorough review of employment protection legislation, improving the skills level with the focus on lifelong learning, and focusing on precisely targeted, effective and efficient active labour market policies hold the key to "more and better jobs" in the Lisbon process.

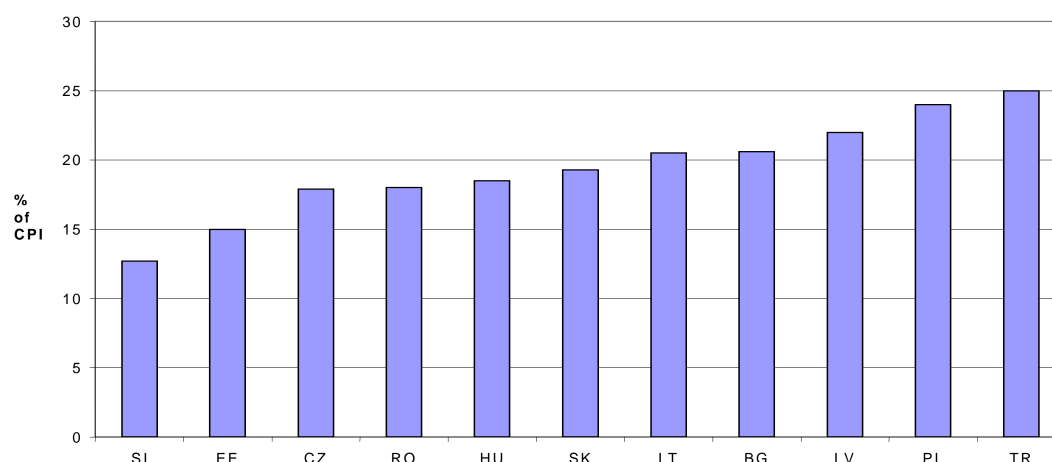
III. PRODUCT MARKETS

21. *An EU aspiring to become the most competitive and dynamic knowledge-based economy in the world needs strong competition and an effective competition policy. In the acceding countries, given their relatively low level of labour productivity, an appropriate regulatory and competition framework, including a right business environment conducive for entrepreneurship, and the liberalisation of network industries are central issues for increasing international competitiveness.*

22. The economies of the acceding countries are very open economies, well-integrated into the EU. All the acceding countries except Lithuania, Latvia, Cyprus and Poland have a greater degree of trade openness than the average of the smaller EU Member States. **Transposing internal market directives** into national legislation will be a major issue that will need to be monitored after accession to the EU. Integration is also being driven by foreign direct investment (FDI). In Estonia, the Czech Republic, Poland and Hungary annual FDI from the EU between 1996 and 2001 averaged more than 3% of GDP. This is considerably more than Slovenia and Latvia managed to attract; their average annual inflow of FDI from EU Member States was below 1.6% of GDP. As a comparison, FDI flows to EU Member States from other Member States during this period averaged 3%.

23. Accession countries made considerable progress in bringing high and volatile CPI inflation rates down from double to single-digit numbers and, thus, closer to EU-15 levels. In 2002, CPI inflation rates amounted to between 0.4% in Lithuania to 7.5% in Slovenia, compared to 2.1% in EU-15. Inflation differentials with EU-15 are related to the Balassa-Samuelson effect or to specific transition factors, such as deregulation, indirect tax harmonisation or relative price changes. **Consumer price levels** in most acceding countries are low compared with the EU. In 2001 the consumer price level, expressed in a common currency, was less than half the EU average in five acceding countries. This may be attributed in part to relatively low wage and income levels as well as to a residual need to liberalise administered prices (Graph 6 illustrates that in four acceding countries regulated prices account for more than one fifth of the CPI). Several acceding countries are undertaking reforms to reduce price controls (which, however, might also affect inflation) and to open up markets to competition.

Graph 6: Administered prices in 2001 as a share of CPI



Source: *Commission regular reports.*
Note: *Data for PL, SI and SK from 2000. No data for CY and MT.*

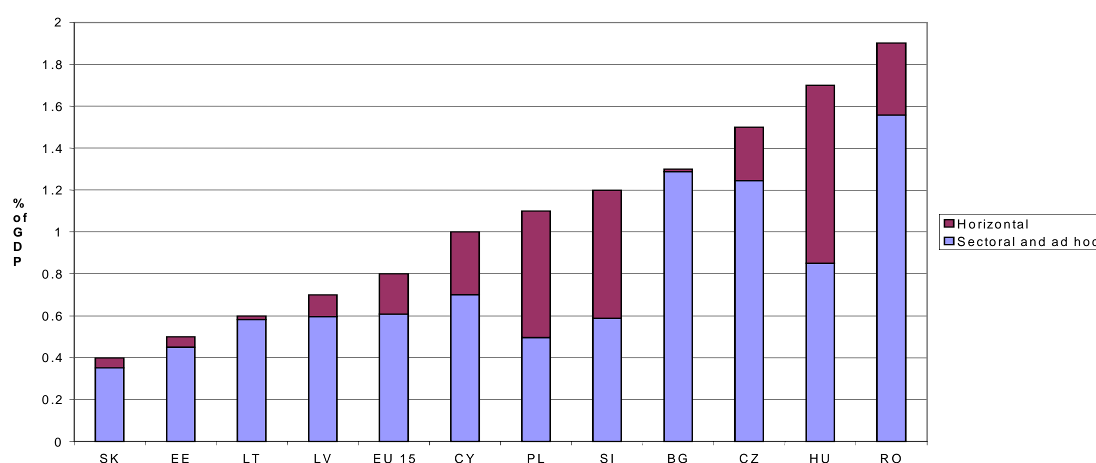
24. A specific challenge on product markets for the acceding countries arises from the shift in the sectoral composition of output. Business **privatisation and restructuring** have made huge advances in most countries. Annual average privatisation receipts for the period 1994-99 in the acceding countries ranged from less than 1% of GDP to almost 4.5% of GDP. In a few countries, the privatisation process has been practically completed. In others, the public enterprise sector is still large (accounting for more than 25% of GDP in five acceding countries) and privatisation remains high on the structural reform agenda. Privatisation is an important element in raising economic efficiency further and in attracting sorely needed foreign capital and knowledge. A few countries have encountered problems devising viable privatisation and restructuring strategies for some sectors (e.g. steel in Poland). In this regard, it will be important to reinforce and press ahead forcefully with the privatisation programmes. Restructuring of the agricultural sector remains a major task. Agricultural modernisation is hindered notably by the lack of employment opportunities in other sectors. In many countries subsistence farming, developed during transition as a form of social safety net, dampens the productivity. Generally, income on subsistence farms does not derive from the sale of agricultural products but from welfare payments, which provides no incentive for change. In some countries, the functioning of land markets needs to be improved.

25. In many acceding countries **competition in product and service markets**, which is a key driver of growth, productivity and job creation, is still relatively weak, especially in the non-tradable sector. This potentially holds back real income convergence. In most countries, the effective implementation of the legal framework for market entry and exit of companies should be further enhanced. Measures to liberalise, open up and increase competition in product and service markets should be key policy priorities. Many acceding countries have made encouraging headway in strengthening competition rules and establishing independent competition authorities, but in some countries more progress will be needed if EU competition policy is to be fully and effectively enforced. The **liberalisation of network industries**, which is important in view of its contribution to raising growth potential and lowering inflation, appears to vary considerably between acceding countries. Too little information is available, but it appears that in many countries impediments to market entry remain in certain industries and that regulation needs to be improved. Viable tariffs need to be in place to induce private sector investments. As in current Member States, it will be crucially important to improve market contestability by reducing (potential) barriers to foreign and domestic competition and by ensuring effective and transparent monitoring structures. In terms of the degree of energy market openness, progress has to date been fastest in Slovenia. For electricity, many acceding

countries have already gone further than the current minimum requirements. For gas, very few measures have been taken in most countries to support competition and there is a problem of concentration of gas supply sources. Unbundling requirements are currently minimal.

26. A major issue in the acceding countries is the quantitative impact of **ad hoc state aid**[6], which has a distorting effect, deters new entrants and prevents the reallocation of resources to more competitive enterprises, thereby slowing down the restructuring of the economy. Total state aid in acceding countries, excluding aid to agriculture and fisheries, ranged from 0.4% of GDP in Slovakia to 1.7% of GDP in Hungary in 2000 (EU average: 0.8% of GDP) (Graph 7). Whilst Slovakia, Estonia, Lithuania and Latvia recorded lower total state aid than the EU average, in Hungary state aid was more than double the EU average. However, there might be some underestimation of state aid attributable to indirect state aid such as soft budget constraints for state-owned companies and tax exemptions. State aid in the acceding countries should therefore be analysed with caution. In several of them a large share of the aid was sectoral or ad hoc aid used for specific industries (notably for the steel and coal industries), which can have a particularly distorting effect on the economy. In a number of acceding countries it will be necessary to overhaul state aid with a view to both reducing total state aid and redirecting state aid towards horizontal measures.

Graph 7: State aid in 2000 (% of GDP)



Source: State Aid Scoreboard special edition.
Note: Figures exclude aid to fisheries and agriculture. Data not available for MT.

27. A necessary component of strategies to accelerate real convergence is reforms improving the efficiency of the institutional framework, including **measures to improve the business environment**. The 2002 Regular Report[7] by the Commission states that the acceding countries have made good progress in institutional and legal convergence but also that significant deficiencies still have to be addressed in most countries. This particularly concerns the regulatory burden on business, the effective implementation and, in some countries, the design of judicial reforms, and the quality and administrative capacity of the central and local public sectors. There is a widespread perception that many segments of the public sector remain highly inefficient, creating obstacles to the operation and growth of businesses. According to the assessment made in the Commission's Regular Report, corruption remains a matter of serious concern in several of the acceding countries. In a number of countries incomplete

6 which is subject to transition regulation until 2011.

7 Strategy Paper and Report by the European Commission on progress towards accession by each of the candidate countries (COM(2002)700) of 9 October 2002. On the business environment in the acceding countries, see also, in particular, Chapter 2 of the 2002 EBRD transition report.

market exit mechanisms should be rectified, in particular by improving bankruptcy legislation and procedures. Market entry and exit mechanisms are an area where additional analysis would be warranted.

28. Overall, EU accession will increase the pressure for further structural reforms in product markets for the acceding countries. While many challenges in product markets are common to both acceding countries and EU Member States, the acceding countries are facing specific challenges, especially with regard to sectoral changes in the economy, privatisation, administered prices and state aid. Reforms of product and service markets, including a strengthening of competition, measures to streamline the business environment, continuous reform in public administration and improvement of the entrepreneurial climate, are necessary. For countries which have encountered problems in devising viable privatisation and restructuring strategies, it will be important to reinforce and press ahead forcefully with the privatisation programmes. For network industries, as in current Member States, it will be key to improve market contestability by reducing potential barriers to foreign and domestic competititon and ensuring effective and transparent supervision structures. Together with the ongoing shift in the structural composition of the economy from agriculture and heavy industry to services and capital- and technology-intensive industries, these reforms will provide a basis for productivity growth in the acceding countries. Sufficient inflow of capital will be critical to unlock the possible potential in higher tech industries for those countries in which the specialisation structures are dependent on the labour-intensive, low-skill sectors. After accession, particular attention will have to be devoted to complying with internal market obligations, notably with respect to the targets for transposing EU directives and eliminating barriers to cross-border trade. A specific focus of monitoring should be the implementation of EU competition policies (actual compliance and appropriate administrative capacity). The efforts by many acceding countries to undertake additional important reforms in those areas, as evidenced out in the Pre-Accession Economic Programmes, are to be welcomed.

IV. FINANCIAL MARKET REFORMS

29. *Financial markets have an important role to play in achieving the Lisbon objectives. Financial sector development may stimulate real convergence via the mobilisation of savings, which is vital in view of high investment needs, and via the monitoring function as a key element of corporate performance. The full integration of the acceding countries' capital markets into the EU is a key issue.*

30. As regards financial sector development, the acceding countries in transition clearly lag behind the EU average in terms of stock market capitalisation, the level of financial intermediation, and the degree of liquidity. The institutional investor base is weak. This points to the enormous potential for financial sector growth in these countries. Only Cyprus and Malta have a domestic financial sector that, in size, broadly resembles that of the EU Member States. The financial sector of the eastern European acceding countries has undergone major changes since the beginning of the transition. At present, it is characterised by strong dominance of the generally well-capitalised banking sector on capital markets, a still relatively low level of financial intermediation and a relatively low degree of liquidity in many market segments. Capital ratios exceed the Basle recommendation of 8% in all countries. Domestic credit at the end of 2000 represented on average 60% of GDP (euro area: close to 140%). The average interest rate spread in 2002 in the accession countries was 5.8%, as compared to 3.5% in the euro area. Access to bank financing (i.e. by foreign parent banks) and capital markets abroad may somewhat alleviate domestic financial constraints, particularly after having become part of the EU Single Market.

31. Ownership of banks in the acceding countries has been largely converted from public to private and from domestic to foreign. Except for a few cases, the **privatisation** process can be regarded as largely completed, thanks to major efforts and funds from public authorities to

consolidate and re-capitalise the banking system. Notable exceptions to private ownership of banks are Poland, where the government controls the largest bank, and Slovenia, where the government controls the second-largest bank and holds a significant share in the largest bank. Moreover, acceding countries have, in individual cases, retained interests in privatised banks by offering guarantees to cover future losses. The further consolidation and efficiency improvements in the banking sector remain a challenge.

32. Starting from a low level, lending to individuals in many acceding countries represents one of the fastest-growing areas of the banking system, as illustrated in Table 5 below. This largely reflects a catching-up phenomenon; in Hungary, for example, the level of gross debt of individuals (around 7% of disposable income in 2002) falls far short of the average figure of 50% in the EU. The availability of risk capital and low cost debt finance for small and medium-sized firms (SMEs), especially at the earliest stages of their life cycle, is important for funding innovation and development. Although some progress has been made here, it remains inadequate and risk capital is -by and large- too expensive.

Table 5: Commercial bank lending to households* (% of total at year-end)

	1998	**2000**	**2001**
Czech Rep	6	9	12
Estonia		20	22
Hungary		8	12
Latvia	10	15	15
Lithuania	11	10	11
Poland		24	27
Slovakia	8	14	21
Slovenia	22	30	27
Bulgaria	10	7	8
Romania		4	4
Euro area*	*42*	*43*	*42*

***Source**: National data, IFS, ECB staff calculations.*
***Note**: * As % of total loans of euro-area residents excluding MFI.*

33. Rapid integration of the acceding countries into the **single market for financial services** has an important role to play in achieving the Lisbon objectives. While many acceding countries have already addressed a few issues that are also dealt with under the Financial Services Action Plan, such as supervising capital-based pension funds, substantial challenges remain. For example, many countries still need to implement changes to the legislative frameworks for securities, pension and investment funds and life insurance. It would be useful if the newly created Financial Services Committee monitored effective implementation.

34. Progress on **financial sector regulation and supervision** remains uneven between countries and between different sectors but important progress has been achieved. The substantial changes in the structure of financial markets impose new demands on the organisation of financial supervision (including cross-border co-operation) which should be addressed pro-actively by acceding candidates, as they seek fast integration into the single market for financial services. Maintaining the level playing field for institutions in an enlarged EU will be crucial for both current and future EU Member States with a view to preserving overall financial stability. Once they have joined the EU, acceding countries will face further challenges in regard to the regulatory framework.

35. Overall, EU accession represents an important structural challenge for both the banking and the non-banking sector. Financial markets in the acceding countries continue to be underdeveloped relative to the EU. Integration is viewed as speeding up the pace of concentration, boosting competition, adding to efficiency incentives, promoting the range of financial services available (e.g. mortgages, consumer credit, SME finance) and strengthening

the competition for deposits. It can also be expected to provide an impetus for further liberalisation, fostering better regulation and imparting momentum especially for retail and insurance banking, which makes closer co-operation between national and foreign supervisors important. The legislative frameworks must support the development of financial markets and the institutional investor base. Timely and effective implementation of the Financial Services Action Plan will play a key role. The availability of risk capital and loan finance for small and medium-sized firms (SMEs), especially at the earliest stages of their life cycle, remains inadequate and mostly too expensive. The implementation of the Risk Capital Action Plan has an important role to play. The process of adjusting acceding countries' market infrastructure seems particularly challenging against the background of a continuously evolving market infrastructure within the euro area - this is relevant notably for payment systems.

V. IMPROVING THE QUALITY AND SUSTAINABILITY OF PUBLIC FINANCE

36. *Public expenditure and taxes account for significant proportions of national income. With a view to raising the growth potential of the EU economies in conformity with the Lisbon agenda, the quality and sustainability of public finances in recent years have become key policy objectives within the EU.*

37. All Member States must **achieve and sustain sound budgetary positions**. In this respect, the Ecofin ministers, at their meeting with their counterparts from the candidate countries on 5 November 2002, already noted that a number of Pre-Accession Economic Programmes fall short on policy commitments that credibly underpin a medium-term path of fiscal consolidation and do not envisage sufficient efforts to correct the major imbalances and to meet the potential costs of structural reforms. Achieving sound fiscal positions for some of the acceding countries will clearly require efforts over and above those described in the Pre-Accession Economic Programmes (see Table 6 for fiscal developments). In line with the goals agreed in Lisbon and Stockholm, also referred to in the Broad Economic Policy Guidelines, public finances should maximise the contribution of public finances to growth and employment.

38. General government balances continue to be mostly negative in the acceding countries, but there are major differences among countries. For the acceding countries as a whole, aggregate general government deficits (in ESA 95 terms) reached 5.3% of GDP in 2002, mainly due to the sharp increase of the deficit in Hungary. In a context of declining privatization receipts and some take over of private sector liabilities (in particular from the financial sector), debt developments should continue to be closely monitored. A detailed discussion relative to the Maastricht deficit and debt criterion is within the competence of the Economic and Financial Committee, and is therefore not elaborated here.

Table 6: Fiscal developments (percentage of GDP)

	Government deficit				Gross debt ratio	
	2001	2002	2003	2004	2002	2004
Cyprus	-3.0	-3.5	-4.0	-3.5	55.9	52.4
Czech Rep.	-5.5	-6.5	-6.3	-5.9	25.6	31.3
Estonia	0.5	1.3	-0.5	-0.6	4.4	3.9
Hungary	-4.2	-9.1	-4.9	-3.7	52.9	51.4
Lithuania	-2.3	-1.8	-1.9	-2.0	23.6	23.4
Latvia	-1.9	-2.5	-2.9	-2.6	16.8	18.6
Malta	-7.0	-6.1	-5.2	-4.1	64.9	62.8
Poland	-3.1	-4.2	-4.2	-4.0	43.3	46.0
Slovenia	-2.5	-1.8	-1.5	-1.2	27.9	25.2
Slovakia	-5.4	-7.7	-5.3	-3.8	39.3	38.8
Bulgaria	0.4	-0.7	-0.6	-0.5	59.2	50.2
Romania	-3.3	-2.6	-2.7	-2.7	24.6	26.4
Turkey	-28.9	-13.7	-9.8	-6.9	99.6	79.6
EU-15	-0.9	-1.9	-2.3	-2.2	62.7	63.2

Sources*: Commission Spring 2003 Economic Forecast; Fiscal Notifications 2002.*

Quality of public finances

39. The overall **level of expenditure and, to a lesser degree, revenue** in the acceding countries broadly resemble those of the present Member States, although significant differences for individual countries exist (Table 7). In most of the acceding countries, the ratio of public expenditure to GDP was above 40% of GDP in 2001. However, total government expenditure fell by several percentage points of GDP in the countries in transition from a centrally planned to a market economy in the late 1990s. The scale of government activities was reduced, state-owned enterprises were privatised to a varying degree, and complex systems of subsidies designed to equalise incomes between different enterprises and sectors were reformed or dismantled. As the large share of the public sector in the economy hampers the convergence process of these catching-up economies, most acceding countries envisage a continuing decline in GDP ratios for both public expenditure and public revenue in the medium term in the PEPs 2002, via overall spending restraint and tax cuts.

Table 7: Size of general government spending (% of GDP)

	Revenue		Expenditure	
	2001	2005	2001	2005
Cyprus	40.5	42.2	43.5	42.5
Czech Rep.	42.1	41.3	47.1	46.8
Estonia	38.6	38.4	38.4	38.4
Hungary	46.1	42.5	50.2	45
Lithuania	34.2	36.1	36.1	37.6
Latvia	41.4	38.6	43	40.6
Malta	37.4	35.8	44.4	38.8
Poland	41.8	42.2	45.3	44.5
Slovenia	43.1	42.5	45.6	43.3
Slovakia	41.2	39.8	46.6	41.8
Bulgaria	40.6	35	40.3	35
Romania	36.7	34.6	40.1	37
Turkey	42.1	40.1	57.2	40.6
EU-15	46.4	-	47.2	-

Source*: 2002 PEPs.*

40. Table 8 presents the structure of **general government revenue** in the acceding countries. Total tax receipts in the acceding countries averaged about 35% of GDP in 2000, compared with 45% in the euro area. Financing the existing scale of public expenditure imposes a heavy burden on the tax base, which is much narrower in the acceding countries than in the present

Member States. Nominal tax rates for earned and capital incomes are rather high (according to indications from the International Bureau of Fiscal Documentation), while many exemptions and tax evasion reduce effective rates. Social security contributions as a share of labour costs are also high. According to the IMF and the Commission, the distortions caused by high rates of taxation on labour may be a serious impediment to a job-intensive growth strategy in several acceding countries[8].

Table 8: Structure of general government revenue in 2000 (% of GDP)

	Czech Rep	Estonia	Hungary	Latvia	Lithuania	Poland	Slovak Rep.	Slovenia	Euro area
Current revenue	39,2	38,7	41,8	36,8	30,4	41,6	36,6	41,5	45
Tax revenue	36,7	35,8	36,2	31,3	28,5	39,9	34,1	39,2	44,9
Personal income tax	5	7,8	7,2	6	7,8	4,6	4,6	7,6	9,9
Corporate income tax	3,9	1	2,2	1,7	0,7	2	3	-	3
Social security contributions	14,7	12,4	9,8	10,7	7,1	8,7	13	13,6	15,6
Property tax	0,5	0,4	0,9	1	0,6	-	-	2,3	1,5
Indirect tax	12,6	14,2	16	11,9	11,7	11,4	13,5	15,7	13,6
Total public revenue	40,6	-	44,5	-	-	41,6	46,1	-	-

Source: *IMF/EU, OECD, Finmin of Poland.*

41. There is a general intention, as spelt out in the 2002 PEPs, to gradually shift the tax burden from labour towards consumption. However, as nominal VAT rates are already close to or at EU levels, boosting effective consumption tax revenue should take place through a broadening of the tax base and through higher excise duties and eco-taxes. Furthermore, tax administration and the effectiveness of tax collection need to be improved significantly. According to the PEPs, a significant lowering of company taxation is planned in many countries.

42. As for the **expenditure side of budgets**, government consumption and social transfers as a percentage of GDP is comparable to that in the present Member States (Table 9). The World Bank estimates that up to 80% of all government expenditure in these countries – as in most present Member States - is **mandatory and quasi-mandatory expenditure** in the sense that it is determined by rules outside the budgetary process. These are mainly expenditures in the areas of defence, old-age and disability pensions. The corresponding expenditure rigidity is often compounded by indexation clauses for pensions and public-sector wages. Moreover, the widespread lack of clear frameworks defining the fiscal relations between the state and sub-state levels is a challenge for delivering the medium-term adjustment efforts needed in many cases. As a result, spending at the lower levels of government is difficult to control. Some acceding countries apply budgetary rules and procedures to improve public expenditure efficiency and control, such as multi-annual budgets, expenditure rules with explicit limits on the annual growth rate and agreements between different levels of government. In some countries, these rules should be improved, both in design and/or enforcement as there continue to be large spending slippages.

43. In the 2002 PEPs public investment expenditure is set to be maintained at a level of 3% of GDP on average. The acceding countries are characterised by a relatively **low stock of public infrastructure**, which is often ill suited to the needs and standards of market economies. They face considerable challenges in replacing old technology and building new infrastructure networks, including through public-private partnership (PPP) arrangements (the implementation of which depend on viable tariffs). The sections below provide information on investment in human capital (health care, education).

[8] See European Commission: Public finances in EMU 2002, European Economy No 3 2002, pp. 114 ff.

Table 9: Structure of general government expenditure in 2000 (% of GDP)

	Czech Rep	Estonia	Hungary	Latvia	Lithuania	Poland*	Slovak Rep.	Slovenia	Euro area
Current expenditure	38,4	36,3	39,9	36,6	30,4	-	38,2	39,2	43,8
Government consumption	8,7	24,6	14,4	16,1	16,6	15	17,6	17,6	19,8
Interest payments	1,1	0,3	6,1	1,1	1,7	3	2,7	1,5	3,7
Subsidies and current transfers	28,6	11,4	19,4	18,9	12,1	-	17,9	20,1	19,8
Subsidies	8,1	0,8	2,8	5	0,2	-	4	1,5	1,4
Current transfers	20,5	10,6	16,6	13,9	11,9	-	13,9	17,9	18,4
Capital expenditure	5,9	3,2	7,1	4	1,9	2,8	3,9	4,1	1
Total public expenditure	46,1	40,1	47,5	40,6	32,3	45,5	52,2	43,3	44,8

***Sources:** IMF/EU, OECD, Finmin of Poland; *Year 2001.*

44. It is critical to use the **EU's Structural and Cohesion Funds** efficiently in the interest of long-term sustainable economic growth. The acceding countries are currently preparing their national development strategies for EU part-financing of public investment and it is essential that these are focused on those types of measure most conducive to long-run productivity gains, particularly human and knowledge capital, as well as on basic infrastructure. Mechanisms must be put into place to ensure efficient implementation.

45. Overall, if fiscal policy is to play its role in supporting rapid and sustainable real convergence, further improvement in the quality of public finances will be crucial in a number of acceding countries. Given the still limited availability of data on the quality of public finances, urgent steps should be taken to improve data compilation and reporting to allow for a more detailed assessment. The following key issues can be identified. On the revenue side, the tax base in most acceding countries is narrow. The tax burden on labour is relatively high, and this is a challenge in light of the Lisbon agenda aimed at making tax and benefit systems more employment-friendly. Weaknesses in tax collection and administration should be addressed urgently so as to achieve an efficient and fair fiscal system, including a broader tax base. On the expenditure side, the quality of services provided by the public sector and improvement of the efficiency of public administration set the framework for dynamic economic growth. However, tackling the rapidly increasing nominal expenditure pressure on public services and fulfilling the higher EU standards for these services will be further challenges also on the financing side. It can be expected that social security expenditure (and public sector wages) will also rise in tandem with the gradual convergence of prices and wages towards EU levels. There is a need to control spending at all levels of government, which too is a challenge given the widespread lack of frameworks determining the fiscal relations between the state and sub-state levels. The need for public investment expenditure will remain high in the foreseeable future in the light of the development and convergence of the acceding countries. Some countries should devote particular attention to public spending on human capital in order to catch up with the present Member States. In sum, sound public finances should be achieved via spending restraint and growth friendly tax systems, with clear priorities on the composition of public expenditure.

The sustainability of public finances: pension and health care reforms

46. *In view of the demographic challenges posed by ageing populations and the goal of the Lisbon strategy to ensure that public finances contribute to growth and employment, the sustainability of public finances within the EU has become a core policy objective in recent years. The Ecofin Council developed a three-pronged strategy to address the budgetary implications of ageing: raising employment and participation rates, reducing public debt and reforming pension and health care systems. This was endorsed by the Stockholm European Council and subsequently incorporated into the Broad Economic Policy Guidelines.*

47. The already observed population decrease in the acceding countries will reinforce the diminution of the population of the present Member States foreseen in twenty years from now (after 2020). Most acceding countries have very low fertility rates, lower life expectancies at birth than the present Member States and in many cases strong negative migration balances. In most of them, the working-age population (aged between 20 and 64), the number of elderly persons aged over 65 and the old-age dependency ratio are expected to follow broadly similar trends as in the present Member States[9]. The dependency ratio is expected to surpass EU levels by around 2040 (see Table 10).

Table 10: Old-age dependency ratio (persons aged 65+ as a percentage of persons aged 15-64)

				Change 2000/50	
	2000	**2025**	**2050**	**Absolute**	**%**
Czech Rep	20	36	61	41	207
Cyprus	18	29	39	21	119
Estonia	21	30	47	26	122
Hungary	21	33	51	30	139
Latvia	22	31	50	28	128
Lithuania	20	29	51	31	156
Malta	18	37	47	28	154
Poland	18	31	50	32	180
Slovakia	17	27	50	33	200
Slovenia	20	38	66	46	233
Bulgaria	24	31	54	30	127
Romania	19	26	45	25	130
EU-15	24	36	49	24	100

Source: *UN population projections 2002. AMECO for the EU-15.*
Note*: The old-age dependency ratio is defined as persons aged over 65 as a percentage of the working-age population (aged 15-64). Similar trends are expected for the economic dependency ratio, which expresses the population aged 15 and over not employed as a percentage of the number of persons employed.*

48. The projected decline in the size of the active labour force involves a strong risk of lower economic growth, even under reasonable assumptions concerning the increase in total factor productivity. In the Lisbon agenda, the goal of higher factor productivity goes hand in hand with that of higher **participation and employment**. Higher participation rates, among men as well as among women and especially at older ages, and lower unemployment rates can help mitigate the challenges of ageing populations.

49. As regards the **size of current public spending on public pensions**, public pension expenditure in several countries is close to or above 10% of GDP (Cyprus, Latvia, Poland and Slovenia). Ageing populations could lead to a substantial increase in public expenditures in many acceding countries as long-term projections, where available, point to a sharply rising expenditure trajectory (see Table 11)[10]. This development may make it more difficult to finance the impact of an ageing population on public spending on pensions. On the basis of the scenarios set out in the 2002 PEPs, six out of ten acceding countries have a debt level below 40% of GDP. Several acceding countries, with relatively low debt levels, and gradual build-up of assets in funded schemes, appear in a good position to cope with the budgetary impact of ageing populations. However, this could be very different for those acceding countries that have not yet proceeded with the introduction of a comprehensive reform of their first-pillar pension schemes. Given the fact that long-run budgetary projections are only available for a number of countries, and their limited comparability, a detailed case-by-case analysis by the

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9 See EPC report on budgetary challenges posed by ageing populations of 24 October 2001: http://europa.eu.int/comm/economy_finance/epc_en.htm

10 It should be borne in mind, though, that public debt ratios in the acceding countries are at present generally lower than in the present Member States.

EPC's Ageing Working Group seems warranted on the impact of population ageing on public expenditure on pensions.

Table 11: Public pension expenditures in 2000-50 (% of GDP)

	2000	2030	2050	Change 2000-50
Cyprus	8	11.9	14.8	+6.8
Czech Republic	7.8[5]	-	14.6[5]	+6.8
Estonia	6.9 [2.4]	-	-	
Hungary	6.0[5]	-	7.2[5]	+1.2
Latvia	9.8 [4]	-	-	
Lithuania	5.3	6	7	+1.7
Malta	5.4 [2.4]	-	-	
Poland	10.8	9.6	9.7	-0.9
Slovakia	7.9 [4]	-	-	
Slovenia	13.2	19.7	18.1	+4.9
Bulgaria	9.1 [2.4]	-	-	
Romania	6.4	7.8	8.2	+1.8
EU-15	10.4	13.0	13.3	+2.9

Notes: *-: not available; [1)]2002; [2)]2001; [3)] 2000; [4)] According to Gesellschaft für Versicherungswissenschaft und -gestaltung e.V. (which in turn draws on national statistics). [5] OECD. Since definitions of public pension expenditures are not identical for each country, caution is warranted when making comparisons.*
Sources: *If not explicitly indicated, data are based on the 2002 Pre-Accession Economic Programmes.*

50. In several acceding countries **funded schemes** within the publicly financed pension systems have gradually become more prominent in recent years. Cyprus, Estonia, Hungary, Latvia and Poland have introduced a three-pillar pension system (compulsory and non-funded/compulsory and funded/voluntary and funded) and Lithuania and Slovakia are planning to do so in the near future. Funding does not by itself reduce future pressures on public expenditure; its benefits are in entrenching long-term budgetary consolidation efforts, by building reserves for the future pension liabilities of governments and introducing a flexible and long-term instrument of budgetary discipline to help to respond to the expected additional budgetary cost of ageing. Benefits of funding in the first pillar in the existing PAYG schemes include strengthening the financial basis of pension systems, increasing the security of future pension provision, and enhancing intergenerational equity in public finances. However, it should be recognised that, if funding is to make a meaningful contribution towards financing age-related expenditures, considerable resources will need to be devoted.

51. Recent pension reforms in the acceding countries have also focused on increasing the effective **retirement age,** which in most countries is relatively low. In addition, the legal retirement age in several countries appears too low and is, in many cases, several years lower than in most EU countries (it is close to 65 for men in most Member States[11], whilst it is two to five years lower in several acceding countries). It should be recalled here that the Barcelona European Council called for an increase in the effective average retirement age in the EU by some five years. Other challenges facing pension systems in the acceding countries, quite similar to those facing EU Member States, may include the dynamics of early-retirement arrangements (in some countries these have been introduced in response to the increase in unemployment), expenditure pressures due to indexation rules[12], and striking the right balance between contribution rates and the level of benefits paid out.

52. Comparable information on **health care spending** is available for only four acceding countries. Public expenditure on health care in 2000 amounted to 6.6% of GDP in the Czech

[11] See EPC report on reform challenges facing public pension systems: the impact of certain parametric reforms on pension expenditure of 5 July 2002: http://europa.eu.int/comm/economy_finance/epc_en.htm.

[12] For example, with pensions indexed to wages, gains in total factor productivity will not have a large beneficial impact on pension expenditure.

Republic, 5.1% in Hungary, 4.2% in Poland and 5.3% in the Slovak Republic[13]. Public health care expenditure has increased sharply since the start of transition in some of the countries. It can be expected that, owing to general increases in welfare, technical progress and product innovation in the coming years, public health care expenditures will converge on EU levels (EU-15: 5.9% of GDP in 1998), which for certain countries implies a significant increase in such expenditure.

53. Overall, a decline in the size of the active labour force may dampen growth and thereby slow down the catching-up process, since it may not be possible to maintain the increase of total factor productivity continuously at a level which would offset the impact of a declining labour force. Higher employment and participation rates are necessary to mitigate the challenges of ageing populations. Many acceding countries have already introduced a wide range of pension reforms, including the introduction of a three-pillar system. However, in order to counter longer-term spending trends in line with the three-pronged strategy for tackling the budgetary implications of ageing populations, further reforms seem to be needed in some countries before the projected decline in the size of the active labour force fully materialises. Such reforms need to focus on raising the employment rate of older workers and the effective retirement age. In a number of countries, scope for further improvements is to be found in reforming pension systems in the direction of better financial sustainability (e.g. by moving towards actuarial neutrality). The EPC considers that a further case-by-case analysis is warranted on the impact of population ageing on public expenditure on pensions. Health-care expenditure is also likely to be severely affected by increasing life expectancy and associated improvements in the health of elderly persons, whilst other factors come into play such as technological developments. Containing future expenditure growth while providing effective coverage will necessitate steps to raise the efficiency of health care systems (several countries have to contend with over-capacities and face an urgent need for modernisation).

VI. FOSTERING THE KNOWLEDGE-BASED ECONOMY

54. Within manufacturing, most acceding countries are experiencing a rather dynamic process of integration into the European division of labour. But all acceding countries except Malta, Estonia and Hungary have considerably lower levels of high-technology exports as a share of total manufactured goods than the EU average. The gap in export structures between most acceding countries and current Member States has narrowed considerably over the past decade, however, and the adjustment process out of commodities and labour-intensive products and into capital- and technology-intensive products is continuing at a fairly fast pace. In a few acceding countries dependence on labour-intensive branches in their export structures has increased since the late nineties[14]. While its share in the total economy has been increasing steadily, the service sector is generally less developed than manufacturing.

Education and training systems

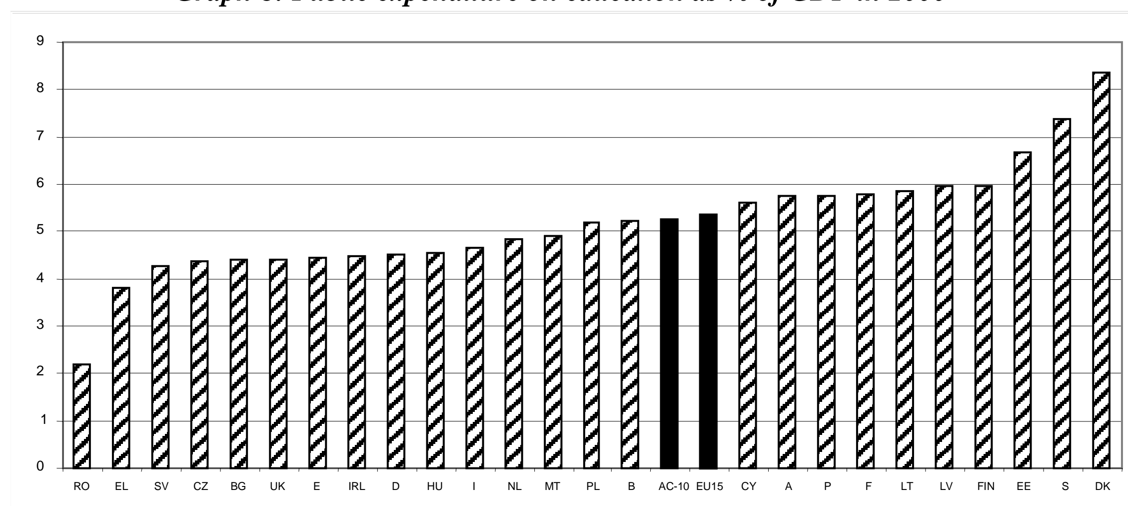
55. *The education systems in not only the present Member States but also the acceding countries face similar challenges: to raise the quality of education and to ensure that the population is provided with skills adapted to the needs of working life and market requirements. The Lisbon strategy set several goals in education and training, including much higher per capita investment in human resources, access for all schools in the EU to the Internet and a halving in the number of 18 to 24 year-olds who have not completed at least secondary education.*

[13] For the other candidate countries, the Gesellschaft für Versicherungswissen-schaft und -gestaltung e.V. (2001) indicates health care expenditure as follows: Cyprus 5.7% of GDP in 2000, Estonia 5.5% in 2001, Latvia 3.5% in 2000, Lithuania 4.4% in 2000, Malta approximately 8% in 2000, Slovenia 7% in 2000, Bulgaria approximately 10% in 2001, Romania 4.1% in 2000, and Turkey 4.8% in 2000.

[14] See e.g. Michael Landesmann, Structural features of economic integration in an enlarged Europe: patterns of catching-up and industrial specialisation, European Economy, January 2003.

56. Graph 8 shows that **public funding of education** in acceding countries is, on average, somewhat lower than the EU average of 5.3% of GDP. Two groups among the acceding countries can be identified: the Baltic States (Estonia, Latvia and Lithuania), with expenditure levels above 6 % of GDP, which are higher than the EU average and rank them with the EU countries that have the highest levels of expenditure; and the Czech Republic and Slovakia, which have the lowest ratios of public expenditure not only relative to the EU-15 average but also on an EU-25 comparison. In Poland, the Czech Republic and Slovakia, public spending on education has registered a marked drop during the 1990s. In contrast, public spending has risen steadily in Estonia, Slovenia, Lithuania and Cyprus. No information is available on private funding, which for some countries might make a difference.

***Graph 8: Public expenditure on education as % of GDP in 2000*[15]**



***Source**: Structural Indicators, New Cronos, Eurostat.*

57. In terms of the **efficiency of education spending**, in some acceding countries there appear to be certain cost inefficiencies related to overstaffing, a duplication of facilities, inefficient class sizes, inefficiencies in available equipment and overemphasis on non-essential services, which push up the costs of education.

58. As regards the quality of the educational systems, curricula may be outdated in several respects, e.g. in terms of management skills or flexibility/adaptability more generally. With regard to output, available information suggests that many acceding countries share the common problem that the education system does not meet the needs of the private sector, in terms of the knowledge produced and adaptability of the labour force.[16] As a consequence, a sizeable proportion of workers in the acceding countries may not be sufficiently well prepared to meet the needs of the labour market.

59. Educational attainment of the population in acceding countries is high when measured as a proportion of the adult population that has completed at least **secondary education**. On average, a larger proportion of 25 to 64 year-olds in the acceding countries have completed at least upper secondary level than in the EU (the average in the acceding countries is 77%, compared to some 64% in the EU, with a number of acceding countries scoring higher than the

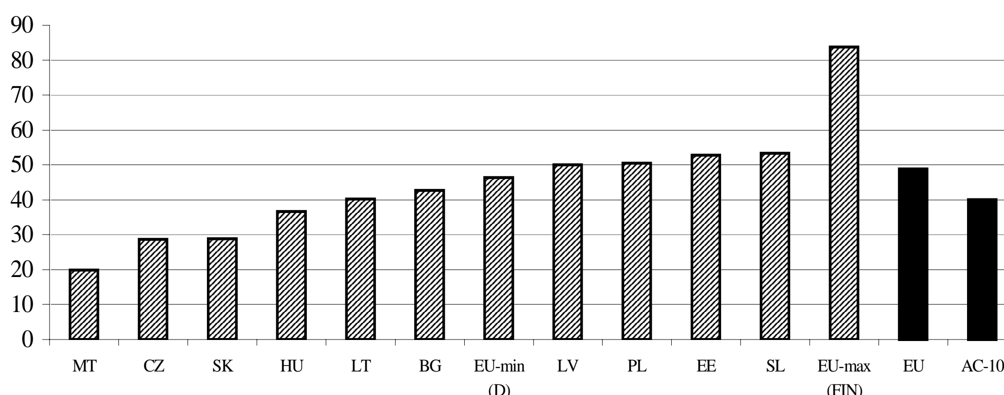
[15] It should be noted, though, that these figures are difficult to compare as they have not been adjusted for differences in demographic developments. Data comparability may be further impeded by differences in the efficiency of resource input.

[16] In terms of broader reforms to the education system, the literature has highlighted factors such as the decentralisation of schools or broader pedagogical aims of the educational system. See, for example, Andreas Ammermüller, Hans Heijke and Ludger Wössmann, Schooling Quality in Eastern Europe: Educational Production During Transition, Kiel Working Paper No 1154, March 2003. http://www.uni-kiel.de/ifw/pub/kap/kap.htm.

EU countries). Similarly, the gross enrolment rate in secondary education exceeds that in most EU countries (the exception being Malta).

60. However, the situation is different as regards **tertiary education**, which in the acceding countries has been completed on average by only 19% of the 25 to 64 year-olds (compared with 22% in the EU). Only Lithuania, Estonia and Cyprus are above the EU average. Moreover, the situation is certainly less advanced than suggested by the quantitative indicators, as attainment levels do not usually differentiate between the narrow, often outdated, qualifications used in the former centrally planned economies, and the new, broad-based qualifications needed for the knowledge-based economy. In over half of the central European acceding countries the proportion of persons having completed tertiary education is lower in the younger age groups than in the older age groups. Graph 9 shows that the average gross enrolment ratio in the EU is 49% of the age group eligible for tertiary education[17] (ranging from 46% in Germany to 84% in Finland). Only four acceding countries (Poland, Latvia, Estonia and Slovenia) exceed the EU average gross enrolment ratio.

Graph 9: Gross enrolment ratio at tertiary level in 1999



***Source**: UNESCO.*

61. Recent reforms in education systems show increasing awareness of these issues, and in particular the need to boost participation at tertiary education level to satisfy the demand for high skill workers. As a result, almost all acceding countries are undertaking major efforts to catch up with the EU level of participation in tertiary education. Poland and Hungary had the highest percentage increase in enrolments in higher education between 1995 and 1999 in all OECD countries. Estonia also shows a significant increase (80%) in this same respect. Other countries also recorded large, albeit less marked increases.

62. The proportion of **tertiary graduates in science and technology** per 1000 persons in the age group 20-29 in the accession countries appears lower than in the EU Member States, even if it has increased considerably, especially in Estonia, Lithuania and Poland. The number of persons in 2000 ranged from 3.3 persons in Cyprus to 12.1 persons in Lithuania, compared with a range of between 23.2 persons (in Ireland) and 5.7 (in Italy) in the EU in 2000. On the basis of available information, however, it is not clear whether the ratio of tertiary graduates in science and technology to *all* tertiary graduates in the acceding countries is lower than the same ratio in the present Member States.

63. The number of **dropouts and early leavers**, another indicator of the output of the education system, has substantially increased in accession countries, but it is still lower than in

[17] A subgroup of university-age population.

the EU countries (12.9% on average as against 19.3%). However, dropouts remain a major problem (notably in vocational education and training).

64. Especially serious is the situation of **low-skilled workers**, who are in a much more disadvantaged situation than their high-skilled counterparts and even more so when compared with the EU. While unemployment rates of high-skilled workers in candidate countries are comparable to those in the EU (differences reflect mainly higher unemployment rates), the situation of the low-skilled is rather different. Unemployment rates are higher than in any EU country and the gap between high- and low-skilled workers is wider, reflecting a more pronounced dual labour market. This conclusion is reinforced when taking into account the extremely low employment rates for the low-skilled.

65. Education and training systems need to be better adapted to the needs of lifelong learning, and the capabilities of those systems to respond adequately to changes in skill requirements need to be enhanced. In this respect, in terms of participation in **continuing vocational education and training** in general for the 25 to 64 year-olds, data from the Labour Force Survey show large disparities between acceding countries and EU countries (3.6% on average in the accession countries compared with 8.4% on average in the EU).

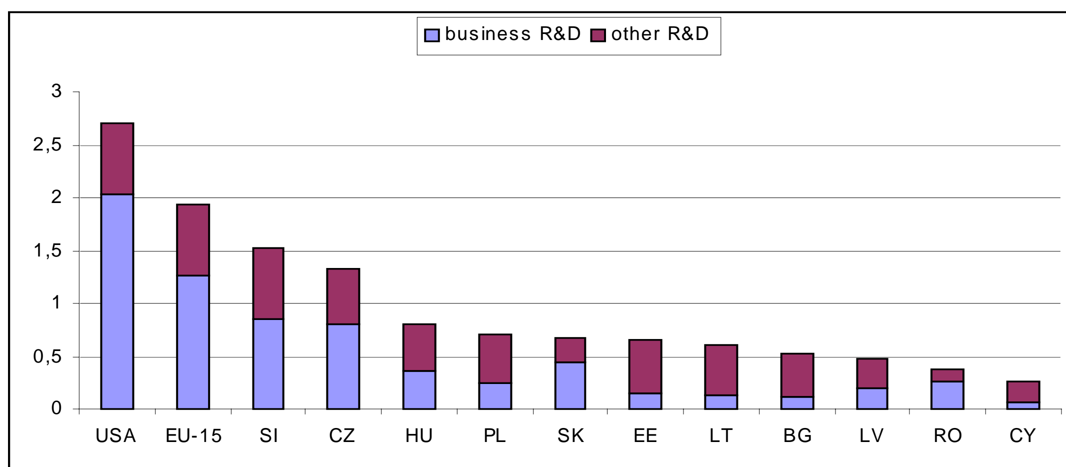
66. Overall, the acceding countries have made major efforts to reform their education systems and to adapt them gradually to the challenges posed by a knowledge-based economy. On balance, people in the acceding countries have a high literacy rate and the educational infrastructure is well developed. Spending on human capital is higher than the EU average in several acceding countries. In some countries, however, spending on human capital has registered a marked drop during the 1990s. Some important challenges remain for the education systems in the acceding countries, in terms of preparedness of the workers to meet the demands of the labour market, participation in tertiary education and cost-inefficiencies when compared with EU Member States, and in terms of the progress to be made if the Lisbon objectives are to be met. In certain areas and countries a gap might emerge in regard of the quality and output of education systems since educational attainment does not fully meet the needs of the private sector. This is of particular concern in terms of the knowledge and skills being produced and the adaptability of the workforce, notably for high skilled workers. Many members of the labour force might require time and investment to develop new skills needed for prospering in a knowledge-based economy. This could indicate potential long-term difficulties in the light of the Lisbon agenda.

R&D and innovation

67. *The Barcelona European Council set the goal of raising overall spending on R&D so as to approach 3% of GDP by 2010. Two thirds of this investment should come from the private sector. This input indicator implies inter alia improved incentives for firms to invest in R&D.*

68. Acceding countries spend relatively little on both **total and business R&D** as a share of GDP. In 2000 total R&D spending for those countries averaged well below 1% of GDP, compared with an average of almost 2% of GDP in the EU (Graph 10). This poor record was matched by weak business R&D investment in 2000, which was equivalent to less than 0.4% of GDP, i.e. not even a third of the EU average. Moreover, business expenditure on R&D in the acceding countries, expressed as a percentage of GDP, did not increase between 1995 and 2000. There is therefore no sign that this large gap in business R&D expenditures between those countries and the EU is about to disappear. The low level of R&D expenditure is also reflected in low patenting activities in the acceding countries.

Graph 10: R&D expenditure in 2000



***Source**: Eurostat.*
***Note**: *Estimated value for EU-15. No data available for Malta and Turkey.*

69. The EPC's 2002 report on research and development[18] can provide a useful framework for comparing the situation in the acceding countries with that in the EU. It identified as key drivers of innovation activities a well-educated workforce, a strong climate for entrepreneurship, easy access to risk capital and other finance, infrastructure for research networks and co-operation between the private and public sector, an appropriate intellectual property regime and macroeconomic stability. It showed that the improvement of the **general framework conditions**, and above all a highly competitive environment, is vital. This means not only having the appropriate competition rules in place but also creating an environment in which smaller firms are able to grow extremely quickly and challenge less innovative incumbents to improve their performance. According to the Commission's 2002 Regular Report, the implementation of competition policies in several acceding countries was found to be insufficient, which also affects innovation. Many firms face disadvantageous conditions for financing innovation, either in terms of obtaining access to finance or in terms of its cost. One of the most important policy challenges for boosting innovation, not only in the present but also in the future Member States, is the overall governance of public research institutions and grant mechanisms and their responsiveness to the needs of their private counterparts. It may make sense for some of the acceding countries to focus more on technology transfer and gradual product and process improvement as opposed to large-scale, long-term and risky industrial and public research investment.

70. Three acceding countries, the Czech Republic, Hungary and the Slovak Republic, invested more in **information and communication technologies** (ICT) in 2000 than the EU average (7.4% of GDP). However, no acceding country except the Czech Republic could match the growth of ICT investments in the EU during the last six years (1995-2000). This trend points to a further widening of the gap in ICT maturity between the EU Member States and many acceding countries.

71. Overall, acceding countries lag substantially behind EU Member States in the transition to the knowledge-based economy. Low levels of investment in R&D and IT may hamper their catching-up with the EU mainstream and any improvement in their productivity levels. Present levels of spending on R&D in the acceding countries fall well short of the Lisbon objective, notably in the private sector. Those countries may well benefit most from continuing their reforms of educational and research institutions, raising the educational attainment in the areas most relevant for innovation performance and aim for gradual but steady progress towards the

[18] http:www.europa.eu.int/comm/economy_finance/epc/documents/rdfinal_en.pdf.

Barcelona target of 3% of GDP expenditure on R&D and innovation. It may make sense for some of the acceding countries to focus more on technology transfer and gradual product and process improvement. Measures should be taken to improve the general framework conditions, including the entrepreneurial climate, the efficiency of the education system, access to risk capital, the education of the workforce and the interrelationship between business and the research network so as to make them more responsive to private firms looking for partners. The effective implementation of competition policies should be a key priority with a view to fostering innovation.

VII. ENVIRONMENTAL AND SOCIAL SUSTAINABILITY

72. *Sustainable development is defined by the conclusions of the Gothenborg European Council as "to meet the needs of the present generation without compromising those of future generations" ... which "requires dealing with economic, social and environmental policies in a mutually reinforcing way". The Commission proposes to "focus on a small number of problems which pose severe or irreversible threats to the future well-being of European society", namely (1) global warming, (2) threats to public health, (3) poverty, (4) ageing of the population, (5) loss of bio-diversity and (6) transport congestion. The question of population ageing was addressed above.*

Environmental sustainability

73. The 2002 Broad Economic Policy Guidelines state that the "*protection of environmental resources such as clean air, water and soil, maintaining biodiversity and reducing environmental threats to public health require an active environmental policy in order to ensure a responsible use of scarce natural resources and development which is economically, environmentally and socially sustainable in the long run. Commitments undertaken at international level, notably in the area of climate change, also call for policy action."*

74. The **energy intensity** of the economy is more than three times higher in the acceding countries than the EU average (708.8 gross inland consumption of energy divided by GDP as opposed to 193.9 on average in the EU). Almost all accession countries exceed the figure of the EU Member State with the highest energy intensity. Urban air quality seems to be a major problem in the acceding countries. Freight transport volumes are about the same as the EU average. Freight transportation by road in all eastern and central European acceding countries plays a smaller role than in the EU as a whole. The same seems to be true for passenger transport.

75. **Greenhouse gas emissions** are much lower in the acceding countries than in the EU and are characterised by a decreasing trend in the accession countries as a whole. Several countries show, however, increasing emissions. It is likely that the declines observed in emissions are part of the sectoral shift away from heavy industry, and the increases in some countries are an indication that the transition process is substantially completed, so that increases in emissions due to rising levels of economic activity are now the dominant factor. The share of renewable resources, which must be seen in relation to the existing indicative target of 22% of gross electricity consumption by 2010, is on average lower in the acceding countries than in the EU. In 2000 it ranged from 0.2% in Estonia to 31.2% in Slovenia (average EU: 14.7%). As in the EU, no clear trend has been discernible in recent years.

Social cohesion

76. Data on social cohesion in the accession countries are particularly scarce. Nevertheless, one can draw some conclusions from the employment situation. According to the 2002 Broad Economic Policy Guidelines, "… *jobs are the best protection against poverty and social exclusion.*" The unemployment and employment rates discussed above demonstrate that there is scope for improving social inclusion. The high long-term unemployment rate in the

accession countries, which ranges from 1.2% in Cyprus (in 2000) to 11.3% in the Slovak Republic (2001), further underpins this argument. However, the share of the population in a jobless household falls perfectly into the range recorded for EU countries.

77. Regional income dispersion does not seem to pose a greater problem than in the EU. The same is true for the share of early school-leavers. Generally speaking, those leaving the education system without sufficient skills are at a high risk of poverty and social exclusion.

VIII. IMPLICATIONS FOR THE LISBON STRATEGY AND INTEGRATION OF THE ACCEDING COUNTRIES INTO EU STRUCTURAL REFORM PROCESSES

The Lisbon strategy

78. The Lisbon strategic goal of "becoming the most competitive and dynamic economy" remains unchanged in an enlarged Union. Yet the Lisbon targets are likely to be more difficult to achieve, simply because in most cases the average EU starting base is statistically lowered by the fact that most acceding countries are less well placed vis-à-vis the Lisbon targets than the existing Member States (for a summary of main Lisbon targets, see Annex 2)[19]. It should also be recognised, though, that at least in some areas a number of acceding countries are already equally or even better placed than (some) present Member States. Given the data collected recently and the specific characteristics of the accession countries, quantitative assessments should, however, be treated with care.

79. As regards the Lisbon and Stockholm targets for **employment rates**, the total employment rate in an EU-25 would have been some 1.5 percentage points lower than in the EU-15 in 2001 (62.6% compared with 64%). The female employment rate in an EU-25 would have been 54.1% (compared with the actual female employment rate in the EU-15 of 54.9%). The employment rate of older workers would have been 37.2% in an EU-25 (compared with the actual employment rate of older workers in the EU-15 of 38.6%). Challenges facing labour markets in the acceding countries do not differ fundamentally in nature from those in the EU Member States, but the problems are often more severe.

80. Integration implies the full transposition of internal market directives in the area of **product markets**, and the removal of other barriers to trade and services, which is a challenge. The acceding countries face more severe problems than the present Member States as regards their efforts at reform intended to strengthen competition in several product markets, including the need to enhance the general business environment, to lower barriers imposed by market entry and exit mechanisms, and to reduce significantly sectoral or ad hoc state aid. In many acceding countries, the administrative capacity of the public sector also needs to be urgently enhanced. Many segments of the public sector are perceived as remaining highly inefficient which creates obstacles to the operation and growth of businesses. Necessary improvements particularly concern the regulatory burden on business, the effective implementation and in some countries the design of judicial reforms, and the quality and administrative capacity of the central and local public sectors. For network industries, it will be key to improve market contestability by reducing potential barriers to foreign and domestic competititon and ensuring effective and transparent supervision structures. A specific challenge is posed by the large share of employment represented by the agricultural sector in several countries, the modernisation of which is hampered by a lack of employment opportunities in other sectors.

81. **Financial markets** in the acceding countries continue to be underdeveloped relative to the EU. The legislative frameworks must support the development of financial markets and the institutional investor base. Challenges may arise from the adjustment process of acceding

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[19] The complete Lisbon targets can be found in the Commission staff working paper in support of the Report from the Commission to the Spring European Council in Brussels ("The Spring Report"), SEC(2003) 25 of 14 January 2003.

countries' market infrastructure, and the access to and cost of loan and risk-capital finance for SMEs. In line with the Financial Market Action Plan, continued reforms to deepen and widen the financial sector are required so as to avoid credit constraints. In addition, progress with financial sector supervision and regulation remains uneven between countries.

82. As regards the **quality of public finances**, there is a need in many acceding countries to reassess the structure of budget revenue and expenditure in order to foster a growth-enhancing environment providing sufficient space and incentives for private sector development. Sound public finances should be achieved via spending restraint and growth friendly tax systems. On the revenue side, specific weaknesses may stem from the narrow tax base in several acceding countries, from the lack of a clear definition of fiscal relations between the national and sub-national level in terms of public expenditure control, and from tax collection and administration. On the expenditure side, challenges exist in the shape of the ever-rising needs of public-sector services and the need to improve the efficiency of public administration. Specific attention should be devoted to investment in key areas (such as R&D and innovation, public infrastructure and human capital) so as to underpin future competitiveness and growth.

83. In view of the current parameters of their **pension systems** (e.g. effective retirement ages, employment rates of older workers, contribution and replacement rates), many acceding countries in addition to reforms already introduced will have to implement comprehensive reform strategies. The goal of an increase in the effective retirement age is difficult to assess, as no reference point exists (there is probably no data on the retirement age in the EU-25 as a whole in 2002 - the reference year for which the goal was set at the European Council in Barcelona). However, the statutory retirement age in several acceding countries is two to five years lower than in present Member States which points to a problem.

84. Acceding countries lag substantially behind EU Member States in the **transition to a knowledge-based economy**. The industrial base of most of the acceding countries is still biased towards low to medium-technology sectors. The Lisbon target of R&D investment rising by 2010 to 3% of GDP, of which two thirds should come from the business sector, is likely to be somewhat more difficult to achieve in an enlarged Union (rough estimates suggest that the total R&D figure in EU-25 would be around 1.8% of GDP and the business R&D figure around 1.1% of GDP – as opposed to 1.9% in EU-15, of which 1.1% from business). In regard of education, the lack of high skilled labour could indicate potential long-term difficulties in the light of the Lisbon agenda. The acceding countries have to take steps to improve their education and training systems in terms of educational attainment, skilled human resources as well as R&D and innovation performance. More attention should be drawn onto technology transfer and gradual product and process improvement – this is often spurred by foreign direct investment.

EU structural policy co-ordination processes and further work

85. Within the EU, a number of economic policy co-ordination processes have been developed to foster economic reform and provide for appropriate peer pressure:

- the **Broad Economic Policy Guidelines**, which are at the centre of economic policy co-ordination and which reflect and guide all other co-ordination activities at EU level. They are specific about misalignments, structural imbalances and issues of competitiveness. The Council in December 2002 decided that in the future the BEPGs should focus on the medium-term economic policy strategy and should be reviewed only every three years (see Annex 3 for the set-up of the new economic policy co-ordination cycle). In the intermediate years, the focus is on implementation of the key recommendations.

- **other policy co-ordination processes** which deal with specific economic policy areas, such as employment (the Luxembourg process), structural reforms and competitiveness

(the Cardiff process/report), the macroeconomic dialogue with the social partners (the Cologne process) and pension reforms (the open method of co-ordination on pensions).

- the **Lisbon strategy** with the Commission's annual synthesis report leading to the Spring European Council on economic reform.

86. The existing policy co-ordination processes, notably the Cardiff report, the Luxembourg process, the Lisbon strategy and the BEPGs, cover all economic aspects which are relevant for the present and the future Member States. It appears that the specific challenges facing the acceding countries can be dealt with within the existing multilateral surveillance framework. However, in their future Cardiff reports (and the remaining Pre-Accession Economic Programmes), the acceding countries should pay particular attention to the challenges spelt out above; there is sufficient leeway for them to do so under the current reporting priorities.

In response to the mandate given by the Ecofin Council as to how the acceding countries could be integrated as early as possible into the Community's **structural reform co-ordination processes,** the EPC suggests including the acceding states for the first time in:

- the BEPGs in 2004 (including in their country-specific part), taking into account the new three-year perspective of the BEPGs (which for the current Member States is the period 2003-2005), and accordingly the implementation report on the BEPGs in 2005;

- the EPC's annual report on structural reforms in 2005 (the Cardiff report), including specific country notes. As the acceding States will be observers in the EPC from 2004, they should be invited to already provide national Cardiff reports by October/November 2003 to allow them to already participate at the annual examinations of the EPC for the 2004 annual report on structural reforms[20];

- the Luxembourg and Cologne processes in 2004; and a (possible) upcoming report on the open method for pensions only after long-term projections for pension expenditures are made available in 2006. The acceding countries were already included in the Lisbon process in 2003.

87. Within the existing framework, the EPC considers that:

- in the Cardiff report and the BEPGs, the focus for the acceding countries could rest more on the still incomplete structural shift. A number of product market issues, such as privatisation, administered prices and factors affecting the sectoral composition of the economy, and a number of challenges related to the knowledge-based economy, such as the performance of the education systems and R&D as well as innovation performance, need to be discussed more intensively than is currently the case for the existing Member States. A special focus for surveillance should be the institutional framework for market development and the business environment, and the effective implementation of competition policies;

- in the Luxembourg process, the focus for the acceding countries should, on account of the need for business restructuring, probably be more on the priority "promoting adaptability in the labour market"[21].

88. In view of the challenges outlined above, the **structural indicators** adopted under the Lisbon process appear generally adequate. The EPC Working Group on Indicators should explore whether there is any need for additions to, or changes to the scope of the existing list of

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[20] In this context, it might be interesting to note that the Commission also already receives Cardiff reports from Norway.

[21] As proposed by the European Commission in COM(2003)6 final, 14.1.2003.

structural indicators, e.g. in the areas of employment (tertiary education) or economic reform (privatisation/share of public enterprises, and administered prices).

89. The statistical offices of the acceding countries need to devote enough resources to the structural indicators to ensure the best possible **coverage and quality of the data** used in the structural indicators. For example, in order to allow for a thorough assessment of the quality of public finances, the acceding countries should aim at improving data quality on public revenue and expenditure; future updates of the Pre-Accession Economic Programmes, and indeed the first Convergence Programmes in 2004, would benefit from (i) a more extensive description of the pension reforms under way, (ii) the indication of available long-term projections for pension expenditures, and (iii) a description of the precise role of funding and the pace of asset accumulation in the funded pension systems.

90. The following recommendations are made for **further work in the EPC**:

- Enlargement will be a special subject in the **EPC Annual Report on Structural Reforms in 2004**. With the Lisbon targets in mind, a special annex could be devoted to the areas of critical items identified by this report for the acceding countries, (such as privatisation, the share of public enterprises, administered prices, and tertiary and vocational education).

- Taking account of the close linkages between employment policies and productivity growth, the EPC's **wage monitoring exercise and the Working Group on Labour Market Issues** should be called on to pay particular attention to the labour market challenges in acceding countries;

- So as to produce comparable long-term projections for pension expenditures for the convergence programmes, the acceding countries should be included in the next round of common projections for public spending on pensions, health and long-term care for the elderly by the EPC's **Ageing Working Group** in 2004/05;

- The methodological work on potential output and the computation of cyclically adjusted budget balances by the EPC's **Working Group on Output Gaps** should be extended to cover the acceding countries, with a report being submitted to the Committee by the end of 2004.

- The EPC's **Working Group on Structural Indicators** should explore whether there is any need for additions to, or changes to the scope of the existing list of structural indicators.

- The EPC as a whole should include the issue of regional disparities, and the role that Community and national policies could play over a broad range of fields to reduce standards of living within the Community.

Annex 1:

Employment rates in the acceding countries
(as % of age-specific groups)

Male

	15-64						55-64					
	1996	1997	1998	1999	2000	2001	1996	1997	1998	1999	2000	2001
Bulgaria	--	--	--	--	56,1	53,6	--	--	--	--	34,9	34,2
Czech R.	--	77,1	76,1	74	73,1	73,2	--	38,5	37,5	37,6	36,1	36,9
Cyprus	--	--	--	78,7	78,9	79,7	--	--	--	66,3	67,1	67,9
Estonia	--	69,7	70,3	66,3	64,3	65,6	--	59,6	60,9	59,2	50,2	57,1
Hungary	59,4	59,6	60	62,4	62,7	63,3	27,1	27,1	26,3	29,3	33	35
Latvia	--	--	63,5	65,2	62,3	61,9	--	--	49,2	50,2	48,3	44,8
Lithuania	--	--	67,6	68,9	61,8	59,8			57	56,7	52,2	48,6
Malta	--	--	--	--	--	--	--	--	--	--	--	--
Poland	--	66,2	66,3	63,6	61,2	59,2	--	44,5	42,7	41,8	37,4	38,3
Romania	--	73,4	71,9	70,4	69,5	68,6	--	62,8	61,9	59,4	57,4	56
Slovakia	--	--	--	64	61,6	61,8	--	--	--	36,4	35,2	37,7
Slovenia	66	67,1	67,5	66,8	66,7	68,5	28,1	29,8	32,8	32,2	31	33
EU-15	**70,1**	**70,3**	**71**	**71,7**	**72,5**	**73**	**47,2**	**47,1**	**47,3**	**47,5**	**48**	**48,6**

Female

	15-64						55-64					
	1996	1997	1998	1999	2000	2001	1996	1997	1998	1999	2000	2001
Bulgaria	--	--	--	--	47,2	47,9	--	--	--	--	11,2	11,4
Czech R.	--	60,2	58,9	57,4	56,8	57	--	24	23,2	23,6	22,1	23
Cyprus	--	--	--	50,2	52,5	56,5	--	--	--	28,8	31,9	32,6
Estonia	--	60,6	60,7	58	57,1	56,9	--	40,5	42	39,3	37,5	41,9
Hungary	45,1	44,8	46,8	48,8	49,4	49,6	10,2	10,7	9,3	11,1	13	14,6
Latvia	--	--	54,2	54,1	53,5	56,1	--	--	28,1	26,4	25,9	30,1
Lithuania	--	--	58,5	61,4	58,5	57,4	--	--	27,4	31,8	34,5	31,8
Malta	--	--	--	--	--	--	--	--	--	--	--	--
Poland	--	51,6	52,2	51,6	49,3	48,4	--	27,7	25,2	24,5	21,8	23,8
Romania	--	61,1	60,1	59,7	59	58,2	--	48,2	48,4	47,3	47,3	45,8
Slovakia	--	--	--	52,1	51,1	51,8	--	--	--	10,6	10,2	10
Slovenia	57,5	58,4	59,5	58,1	58,5	58,6	12,9	16,4	19,4	14,9	14,3	14,4
EU-15	**50,1**	**50,6**	**51,5**	**52,8**	**54**	**54,9**	**25,8**	**26,1**	**26,3**	**27,1**	**27,9**	**28,8**

Male and female

	15-64						55-64					
	1996	1997	1998	1999	2000	2001	1996	1997	1998	1999	2000	2001
Bulgaria	--	--	--	--	51,5	50,7	--	--	--	--	22,1	23,9
Czech R.	--	68,6	67,5	65,6	64,9	65	--	54,8	53,4	53,2	51,6	52,4
Cyprus	--	--	--	64,2	65,5	67,9	--	--	--	47	49	49,8
Estonia	--	64,9	65,3	62	60,6	61,1	--	48,9	50,2	47,9	43	48,6
Hungary	52	52	53,2	55,4	55,9	56,3	17,6	17,9	16,7	19,1	21,9	23,7
Latvia	--	--	58,6	59,4	57,7	58,9	--	--	37	36,6	35,4	36,4
Lithuania	--	--	62,9	65	60,1	58,6	--	--	40,2	42,6	42,2	39,1
Malta	--	--	--	--	--	--	--	--	--	--	--	--
Poland	--	58,8	59,2	57,5	55,1	53,8	--	35,5	33,3	32,5	29	30,5
Romania		67,2	65,9	65	64,2	63,3	--	55	54,7	52,9	52	50,5
Slovakia	--	--	--	58	56,3	56,7	--	--	--	22,2	21,4	22,5
Slovenia	61,7	62,8	63,5	62,5	62,7	63,6	19,9	22,7	25,9	23,4	22,3	23,4
EU-15	**60,1**	**60,5**	**61,2**	**62,3**	**63,2**	**63,9**	**36,2**	**36,3**	**36,6**	**37,1**	**37,8**	**38,5**

Source: *Employment in Europe 2002 - European Commission and EPC Ageing Working Group 2001.*

Annex 2: Summary of main Lisbon targets and objectives

The Lisbon strategy entails a variety of targets and objectives, agreed not only at the Lisbon Council itself (March 2000) but also at Stockholm (March 2001), Göteborg (June 2001) and Barcelona (March 2002). Not all are quantified or time-specific, but those which are include:

Employment

- an overall employment rate of 67% in 2005 (Stockholm) and 70% in 2010 (Lisbon);
- a female employment rate of 57% in 2005 (Stockholm) and 60% in 2010 (Lisbon);
- an employment rate for workers aged 55-64 of 50 per cent in 2010 (Stockholm);
- an increase of five years by 2010 in the average effective retirement age (Barcelona); and
- available childcare by 2010 for 90% of pre-school children over three and for 33% of children under three (Barcelona).

Research and innovation:

- R&D spending equivalent to 3% of GDP by 2010, with two thirds of the total coming from business (Barcelona);
- 100% of schools to be connected to the Internet by 2002; and
- All teachers to have training in digital skills by 2003.

Economic reform

- full implementation of the Risk Capital Action Plan by 2003 and of the Financial Services Action Plan by 2005 (Lisbon);
- a transposition rate into national law for internal market directives of 98.5% (Stockholm);
- no internal market directives to be more than two years overdue in their transposition (Barcelona);
- open energy markets for business customers in 2004 and subsequently for domestic users (Barcelona);
- cross-border energy transmission capacity equal to at least 10% of installed production capacity by 2005 (Barcelona); and
- a single European sky by 2004 (Barcelona).

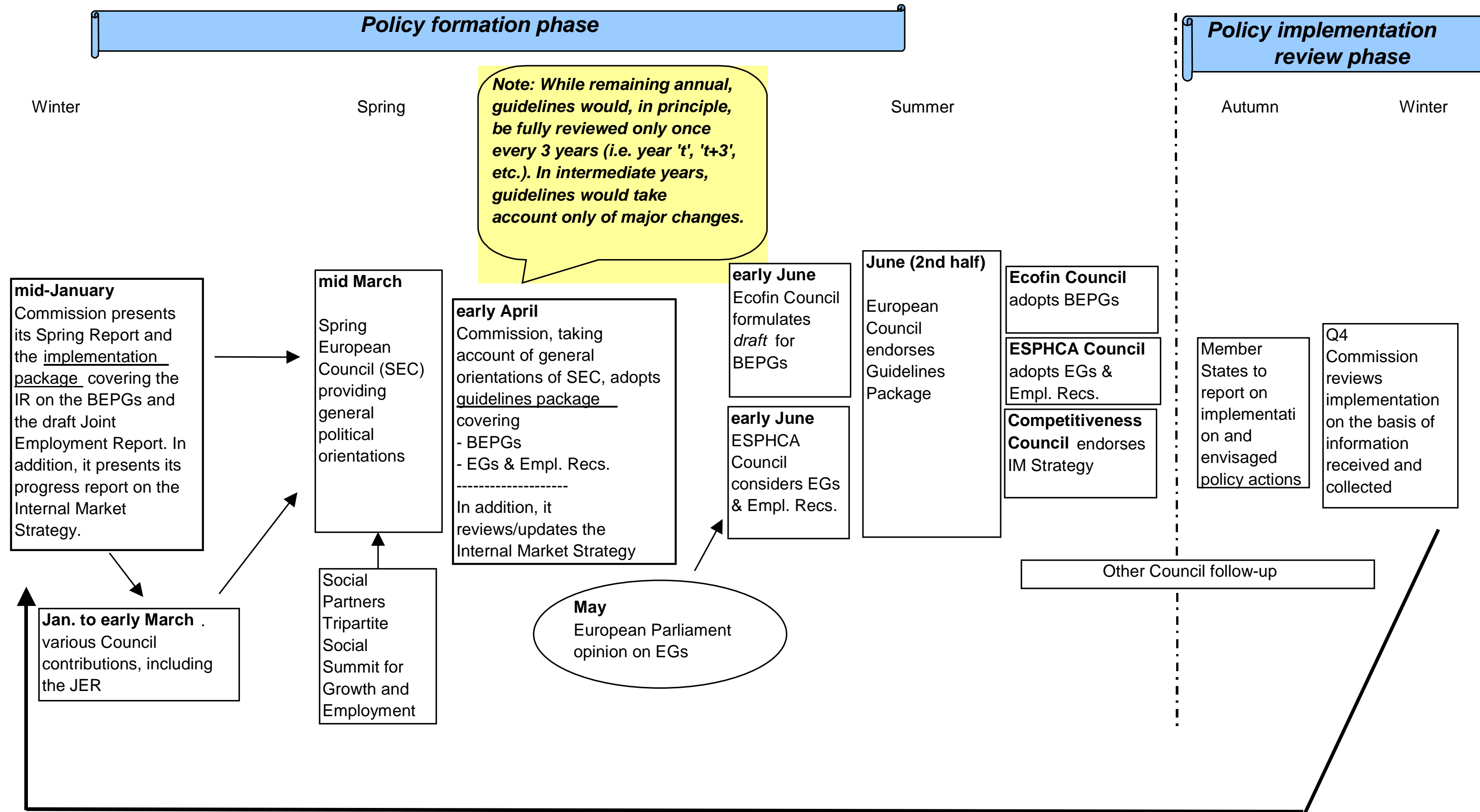
Social cohesion

- to halve by 2010 the number of early school-leavers not continuing with further education (Lisbon); and
- to reduce by 2010 the numbers living at risk of poverty (Barcelona).

Environment/sustainable development

- visible progress on reducing greenhouse gas emissions by 2005 (Göteborg);
- an indicative target for electricity generated from renewable sources of 22% of gross electricity consumption in 2010 (Göteborg); and
- Combating Climate Change: meet the indicative target of 22% for the contribution of electricity produced from renewable energy sources to gross electricity consumption by 2010 (Gothenborg).

ANNEX 3: FLOWCHART OF THE IMPROVED ECONOMIC POLICY COORDINATION CYCLE



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