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Second report on the implementation of the 2003–05 broad economic policy guidelines

European Economy appears six times a year. It contains important reports and communications from the Commission to the Council and the Parliament on the economic situation and developments ranging from the *Broad economic policy guidelines* and its implementation report to the *Economic forecasts*, the *EU economic review* and the *Public finance report*. As a complement, *Special reports* focus on problems concerning economic policy.

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Second report on the implementation of the 2003–05 broad economic policy guidelines

(presented in accordance with Article 99(3) of the EC Treaty)

Abbreviations and symbols used

Member States

BE	Belgium
CZ	Czech Republic
DK	Denmark
DE	Germany
EE	Estonia
EL	Greece
ES	Spain
FR	France
IE	Ireland
IT	Italy
CY	Cyprus
LV	Latvia
LT	Lithuania
LU	Luxembourg
HU	Hungary
MT	Malta
NL	The Netherlands
AT	Austria
PL	Poland
PT	Portugal
SI	Slovenia
SK	Slovakia
FI	Finland
SE	Sweden
UK	United Kingdom

EUR-12	European Union Member States having adopted the single currency (BE, DE, EL, ES, FR, IE, IT, LU, NL, AT, PT, FI)
EU-25	European Union, 25 Member States
EU-15	European Union, 15 Member States before 1 May 2004 (EUR-12 plus DK, SE and UK)
AC-10	European Union, 10 Member States that joined the EU on 1 May 2004 (CZ, EE, CY, LV, LT, HU, MT, PL, SI, SK)

Currencies

EUR	euro
ECU	European currency unit
DKK	Danish krone
GBP	Pound sterling
SEK	Swedish krona
CAD	Canadian dollar
CHF	Swiss franc
JPY	Japanese yen
SUR	Russian rouble
USD	US dollar

Other abbreviations

SCPs	Stability and convergence programmes
PEPs	Pre-accession economic programmes
NMS	New Member States
SGP	Stability and Growth Pact

Contents

([1]) Commission communication.
([2]) Working document of the Commission services.

Executive summary

Second assessment of progress made in implementing the broad economic policy guidelines …

… providing input for the 2005 spring report

This communication reviews progress made in implementing the EU's medium-term economic policy strategy as set out in the 2003–05 broad economic policy guidelines (BEPGs) ([1]). Having been adopted in 2003 and updated in 2004 ([2]) to take account of the Union's enlargement, the guidelines focus on the contribution that economic policies can make to the Lisbon strategy, both through the pursuit of sound macroeconomic policies and vigorous economic reform. This communication summarises the main findings of the implementation report on the BEPGs that the Commission services have prepared as part of the 'implementation package', also comprising the draft joint employment report and the implementation report on the internal market strategy. The implementation package provides essential background to the Commission's 2005 spring report and the mid-term review of the Lisbon strategy.

Shift of focus towards policy measures

Compared with the preliminary assessment made last year ([3]), this implementation report has stepped up the assessment to identify clear progress made, or lack thereof. Thus, to some extent, the focus has shifted from policy intentions to policy measures. The assessment takes, however, due account of the limited time the newly acceded Member States have had to follow up on the guidelines.

Moderate economic recovery with subdued domestic demand

Shortly after the adoption of the 2003–05 BEPGs, the economy started to turn around in the second half of 2003. The recovery developed further in 2004 supported by a favourable global economic environment. However, with an estimated growth rate for the EU of 2.5 % in 2004 (and around 2 % for the euro area), the economic recovery is rather moderate and has yet to be consolidated by a strengthening in domestic demand. Some improvements can be noted in the labour market where employment growth recovered to 0.4 % in 2004 supported by moderate wage developments. Inflation is projected to have increased only slightly compared with 2003 to 2.2 % in both the EU-25 and the euro area, despite developments in energy prices that have been mitigated in the euro area by an appreciation of the euro.

Macroeconomic policies remained accommodative

In a context of persistent uncertainties concerning the strength of the recovery and rising energy prices, macroeconomic policies remained accommodative in 2004. The European Central Bank (ECB) maintained its key policy interest rates unchanged. Some central banks in the Union raised interest rates to contain inflationary pressures. Overall, fiscal policies in the EU-15 remained broadly neutral in 2004 as indicated by the only minimal change in the discretionary component, while automatic stabilisers generally played freely to support economic activity. In some new Member States, the consolidation of public finances has contributed to a more accommodative monetary policy stance than otherwise would have been the case.

Persisting budget deficits

Only limited progress was made in 2004 in reaching sound budgetary positions in several Member States, which recorded high budget deficits in 2003. Coupled with still below-potential growth in 2004, this implied that the average nominal deficit increased to nearly 3 % of GDP in the euro area and remained unchanged at a marginally lower level in the EU as a whole. Behind this there are, however, sizeable differences across Member States: the lacklustre performance of some Member States contrasts with the sound positions of 'close to balance or in surplus' reached or maintained by a number

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([1]) Council Recommendation 2003/555/EC of 26 June 2003 on the broad guidelines of economic policies of the Member States and the Community (for the 2003–05 period) (OJ L 195, 1.8.2003, p. 1).
([2]) Council recommendation of 5 July 2004 on the 2004 update of the broad economic policy guidelines for the period 2003–05.
([3]) Commission communication 'First report on the implementation of the 2003–05 broad economic policy guidelines' (COM(2004) 20 final, 21.1.2004).

of other Member States in 2003 or 2004 (Belgium, Denmark, Estonia, Spain, Ireland, Luxembourg, Finland and Sweden).

In 2004, around one third of the Member States had deficits exceeding 3 % of GDP

Nominal budget balances deteriorated in more than half of the Member States: a surplus turned negative in four Member States and the deficits worsened in 10 more and markedly so in Greece and Poland. On the basis of the Commission's autumn 2004 economic forecasts, nine Member States are expected to have had deficits exceeding the 3 % of GDP ceiling by a wide margin in 2004. This also reflects the initial budgetary position in several of the new Member States, reflecting the ongoing transition process and the different challenges facing fiscal policies.

Excessive deficits have already been identified for Portugal in 2002, and Germany and France, both in 2003, while eight more countries were found to be in an excessive deficit situation in 2004, namely Greece and the Netherlands and, following accession, the Czech Republic, Cyprus, Hungary, Malta, Poland and Slovakia. While the excessive deficit situation was abrogated in 2004 in the case of Portugal, and the deficit in the Netherlands is estimated to have returned to just below 3 % of GDP in 2004, Germany, France and, above all, Greece (among the EU-15 Member States) still struggle with high deficits. However, implementation of fiscal consolidation efforts in countries under the excessive deficit procedure (EDP) seems broadly on track, with the exceptions of Greece and Hungary.

Maintained pace of labour market reforms

The pace of labour market reforms appears to have been maintained in 2004, above all reflecting the measures recently adopted in Germany, as well as significant progress in Denmark, the Netherlands, Ireland and Austria (see also the draft joint employment report 2004–05). In general, there is a tendency for many measures to remain focused on tax cuts, lifelong learning strategies or active labour market policies (ALMPs), while fewer initiatives (or less comprehensive proposals) are related to benefit systems, wage bargaining and employment protection legislation.

Measures to enhance work incentives continued to focus on tax reforms

Several Member States adopted tax reforms to increase incentives to enter or stay in the labour market and some Member States (e.g. the Czech Republic, Denmark, Germany, France and the Netherlands) also lowered the duration of unemployment benefits and/or tightened eligibility and job-search criteria.

A few Member States took measures to enhance adaptability

Labour markets must be made more flexible while providing workers with appropriate levels of security. In 2004, only a few Member States took measures to increase the adaptability of work organisation. Notably, in Germany, employment protection legislation loosened for small firms, fixed-term contract duration was increased and the trend of reduced working time in specific branches started to reverse. France amended the redundancy legislation. However, no other Member State tackled the sometimes overly strict employment protection legislation on permanent contracts or the segmentation of the labour market across different types of contracts. In Italy, while reforms were introduced to support a rise in labour force participation, the increased variety of labour contracts may further increase the already visible segmentation of the labour market.

Most Member States continued to foster occupational mobility through lifelong learning strategies and active labour market programmes. Regional mobility was addressed in some Member States by improving incentives in tax–benefit systems, or, as in the case of Spain, by reducing rigidities in the housing market.

Progress is clearly insufficient to reach all employment targets set for 2005–10

Recent progress notwithstanding, it is increasingly unlikely that the Union will reach the Lisbon and Stockholm employment targets (possibly with the exception of the female employment rate target) unless further and comprehensive reforms are swiftly implemented by all Member States. A sustained improvement in economic dynamism would also foster future employment growth.

Unfavourable developments in productivity growth

Reforms to improve the productivity performance of the EU are as equally important as labour market reforms. Since the turn of the century, hourly labour productivity growth has slowed down further in a number of Member States, going into negative territory in 2003 in Italy, the Netherlands and Portugal. It can be partly related to a lower level of investment per employee as a result of the higher rate of job creation in the second half of the 1990s. However, this can only explain a small share of the observed productivity slowdown. More important is the slowdown in the rate of technological progress stemming from the slow reorientation to high productivity growth sectors, the relatively small size of the EU's information and communication technology (ICT) production industry, and its apparent slowness in reaping the productivity-enhancing benefits of ICT in a range of ICT-using industries.

The pace of internal market integration has slowed down …

Raising productivity levels requires the implementation of a vigorous and comprehensive set of reforms to fully reap the benefits of economic integration. However, as already observed in the first implementation report on the 2003–05 BEPGs, the record is mixed. Several indicators (e.g. intra-EU trade and price convergence) show that the pace of internal market integration has slowed down, in part as a result of lower economic activity. Transposition of internal market directives is behind schedule and only Spain and Lithuania have managed to bring down the percentage of non-transposed directives below the agreed 1½ %. The high level of infringement cases in Germany, Greece, Spain, France and Italy is also a source for concern. In the area of public procurement, the value of openly advertised projects continues to increase, but still accounts for only 16 % of the total value of public procurement.

… while liberalisation of network industries progressed and competition policies became more effective

Fostering competition in network industries remains a continuing task. Further steps were taken in 2004 towards the liberalisation of network industries, but effective competition is not always ensured as the still very high market share of incumbents seems to indicate. With the implementation of the new regulatory framework, competition in the e-communications services sector is intensifying in most markets, bringing increased benefits to consumers. Eight Member States made further steps towards full liberalisation of the energy market (Belgium, Denmark, France, Ireland, Italy, Luxembourg, the Netherlands and Portugal). In many new Member States, competition in network markets is also increasing as their economies have been opened up to international competition. The effectiveness of competition policy has been enhanced by the modernisation of the Community antitrust and merger regimes and a, albeit modest, strengthening of the Commission's investigative powers. Related to this development, which implies more responsibility for national competition authorities, Member States (notably Spain, Ireland, the Netherlands and the United Kingdom) made a welcome step by providing additional resources.

Progress made in financial market integration

In 2004, significant steps were made in providing the appropriate regulatory framework for more efficient capital markets and further financial integration in the EU. The implementation phase of the risk capital action plan (RCAP) has led to a well-developed buyout market, but venture capital investment for early-stage companies remains weak. As the legislative phase of the financial services action plan (FSAP) draws to an end, the focus has started to shift to the transposition of adopted measures into national law. Rates of transposition of directives continue to vary widely across directives and Member States, even if transposition appears sufficient in 2004.

With the Commission's May 2004 communication on clearing and settlement and the setting-up of the Clearing and Settlement Advisory and Monitoring Expert Group, some progress has been made towards fostering an integrated, safe and efficient post-trading environment for EU securities markets. Progress has also been made in strengthening corporate governance, with the adoption of EU-level as well as domestic initiatives in this respect. Reflecting market developments, Member States have continued to improve their cross-sectoral arrangements for supervision while significant steps have been taken to improve cross-border cooperation.

Improved climate for doing business

Business framework conditions appear to be improving, even if entrepreneurial activity is still less dynamic than in the United States. Governments are making an effort to reduce the time and costs required for setting-up a company and to provide services via the Internet (e.g. Belgium, France, Hungary, Poland and Slovakia). Greater attention to regulatory reform is also visible at the European level. Measures are being implemented in Member States to reduce the costs of complying with corporate tax requirements (which can be very high for SMEs). In addition, measures have been taken to widen the corporate tax base, which may increase the scope for a reduction in tax rates.

Only gradual progress towards the knowledge-based economy …

… with Lisbon target on R & D at risk

Despite different measures taken to enhance the transition towards a knowledge-based economy, the progress is only gradual. The EU continues to substantially lag behind the United States in research and development (R & D) and innovation. The last cyclical slowdown in business investment and foreign direct investment (FDI) hampered knowledge and technology diffusion, which is particularly important for the new Member States. R & D expenditures increased only marginally to 2 % of GDP in 2002, making the target for R & D investments of 3 % of GDP by 2010 (of which two thirds are to be financed by the private sector) virtually unattainable, without major initiatives. Some Member States (Finland and Sweden) have high R & D ratios, whereas others have experienced declining ratios since 1999 (Greece, Ireland and the Netherlands). Nearly all Member States have adopted national targets for increased public and private investment in research and an increasing number of them are indirectly supporting business R & D through fiscal incentives. The new Member States should benefit from knowledge transfer via foreign direct investments. This transfer is essential for a process of catching up in these Member States in order to increase their specialisation in higher value added activities. Public investment in human resources shows a slight increase and varies considerably between Member States. Despite encouraging progress, further efforts will be necessary to achieve the 2010 targets for adult participation in lifelong learning and early school-leavers. Little progress has been made in increasing the share of 22-year-olds who have completed upper-secondary-level education. To sum up, while Member States are making efforts to reform research, innovation, education and training systems, there is a risk that the current pace of reform will not enable the Union to attain the objectives set at Lisbon and Barcelona regarding the knowledge-based economy.

In general, gross public investment (as a percentage of GDP), which had been on a downward path since the 1970s, stabilised at around 2½ % of GDP between 2000 and 2004. The European growth initiative stressed the role of public investment in key transport infrastructure to strengthen the dynamics of the internal market. A quick-start list was identified and is now part of the trans-European network (TEN) priorities approved by the Union in April 2004. In addition, the EU budget is significantly financing investments in, for example, infrastructure, R & D and education, with the aim of contributing to raising both productivity and employment.

Long-term sustainability of public finances not yet secured in the majority of Member States

Besides achieving higher employment and potential growth rates, the agreed policy strategy to address the economic and budgetary consequences of ageing also hinges on reducing debt levels and reforming pension systems. No significant progress has been made in recent years in the reduction of public debt, which remained above the reference value of 60 % of GDP in 2004 in both the EU as a whole and in the euro area. The continuing high debt is due to the low priority given in a number of Member States to budgetary consolidation and the weak economic growth environment. After major pension reforms in 2003, notably in France and Austria, important measures were taken in 2004 in, for example, Italy and Slovakia, while others took more limited action (e.g. Latvia raised the minimum retirement age and Portugal introduced a penalty for civil servants retiring early) and sometimes with the aim of softening the impact of earlier reforms. Analysis shows that, despite recent efforts to ensure the long-term sustainability of public finances, it remains an important issue in the majority of Member States, notably in Belgium, the Czech Republic, Germany, Greece, Spain, France, Italy, Cyprus, Hungary, Malta, Poland, Portugal, Slovenia and Slovakia.

Social sustainability hampered by labour market situation

Progress in improving social sustainability continued to be limited in 2004. Above all, the relatively weak labour market performance, with slow employment growth in 2003–04, continues to hamper overall progress, as employment plays a major role in lifting people out of poverty and social exclusion. Recent measures taken by the Czech Republic, Estonia, Hungary, Slovenia and Slovakia aim at modernising tax–benefit systems or facilitating employment for vulnerable groups. It is thus important to strengthen the mutually reinforcing effect of policies promoting economic growth, employment, and economic and social cohesion.

Better progress made in taking action to improve environmental sustainability

Compared with 2003, better progress was made in 2004 in taking action to improve environmental sustainability. In the area of climate change, the preparations for the Community trading scheme for greenhouse gas emissions were finalised in 2004 allowing the scheme to start on 1 January 2005. Some Member States, however, did not notify their complete national action plans for emission allowances in time and were therefore not able to participate in the scheme from the start. Russia's ratification of the Kyoto Protocol means that it will enter into force from 2005, increasing the pressure to implement effective policies to reduce greenhouse gas emissions. So far, reduction in greenhouse gas emissions has not been sufficient to put the EU-15 on a linear path to meeting its Kyoto commitments. Several Member States took market-based measures to encourage energy efficiency (e.g. Belgium and Italy) or to support the use of alternative fuels (e.g. France, Austria, Sweden and the United Kingdom); however, others weakened the price signal of higher energy prices by lowering fuel taxes. In the transport sector, a few Member States (e.g. Belgium, Cyprus and Austria) joined the group of those which have adjusted their vehicle taxation systems to take into account carbon dioxide and/or particulate emissions. Furthermore, road pricing measures for heavy lorries entered into force in Austria and finally in Germany, which are useful to achieve a better intermodal balance. Regarding the progress on electricity from renewable energy sources, four countries have made important efforts through application of feed-in tariffs (Denmark, Germany and Spain) and through a de-taxation of renewable energy sources (Finland).

Efforts to increase the efficiency of the whole energy supply and demand chain should be pursued in order to reduce European energy dependency and ensure affordable prices to all end-consumers (both industries and households), as well as to comply with international obligations under the Kyoto Protocol.

Mixed progress in the euro area where budget policies continue to disappoint …

… but where economic management will benefit from a two-year presidency of the Eurogroup

Progress in response to the guidelines for the euro area remains mixed. While the macroeconomic policy mix continued to be supportive to growth — with a growth-supportive monetary stance accompanied by a broadly neutral fiscal stance — the need for further and comprehensive economic reforms is illustrated by a sluggish and belated recovery in comparison with other industrialised economies. Further reforms that reduce structural rigidities and the attainment of sufficient margins for automatic stabilisation through the budget are still required in order to strengthen the capacity for adjustments to shocks. The lack of significant progress on budgetary consolidation by any of the seven Member States that had not achieved a position of 'close to balance or in surplus' in 2003 is, also in this respect, a particular source for concern. Although some improvement in the cyclically adjusted budget deficits was recorded in France and the Netherlands, the situation further deteriorated in Germany, Greece, Italy and Austria. More positively, there appears to have been a narrowing of inflation differentials in the euro area for a second consecutive year. The decision in 2004 to create a stable two-year presidency for the Eurogroup as of 2005 should benefit its functioning and result in continuity in the euro-area attendance at international meetings. This can be viewed as an important first step in strengthening the voice of the euro area on the world stage.

Overall, progress in implementing the 2003–05 BEPGs leaves much to be desired

Summing up, the overall conclusion from this second implementation report on the 2003–05 BEPGs is that progress continues to be mixed. Some Member States are making better progress than others. For instance, a relatively good follow-up of the country-specific recommendations has been given by Belgium, Denmark, Ireland, the Netherlands, Finland and the United Kingdom, while progress can be considered limited in several Member States. Concerning the recommendations to the new Member States, addressed just half a year ago, the assessment of their implementation indicates that, albeit with different speeds, it is going in the right direction, notably in Cyprus and Slovakia. Alternatively, when focusing on the development by sector, relatively good progress has been made in making the overall business environment more favourable, in enhancing the effectiveness of competition policies and in improving environmental sustainability. The pace of labour market reforms, which was stepped up somewhat in 2003, appears to have been maintained. Progress, however, has been limited as regards the ongoing transition to a knowledge-based economy where a substantial gap remains between the EU and the United States. The pace of internal market integration also appears to have slowed down, with limited progress noted on the transposition of internal market directives and a continued high level of infringement cases. Furthermore, the limited progress in several Member States to reach a sound budgetary position and/or correct an excessive deficit continues to be a source of concern. Although some progress was made in improving fiscal sustainability with, *inter alia*, pension reforms in some Member States, debt ratios remain high and long-term sustainability is not yet secured in 14 of the Member States in 2004. Taken together, the overall pace of reform remained unchanged in 2004. It is clear that, with the current reform pace, full implementation of the 2003–05 BEPGs will not be secured, making it difficult to fulfil the Lisbon ambitions.

Part I

General assessment

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1. Introduction

The timely and effective implementation of the European Union's medium-term policy strategy is of the highest importance for fulfilling the Union's ambitions as regards sustainable economic growth, employment and social cohesion. This annual implementation report reviews the progress made by Member States and the Union in implementing the economic policy strategy as laid down in the 2003–05 broad economic policy guidelines (BEPGs) ([1]). It provides a key input for the multilateral surveillance of the economic policies of the Member States and the Union as envisaged by the Treaty. It is presented as part of the 'implementation package', together with the draft joint employment report and the implementation report on the internal market strategy. Together, they give essential background information to the Commission's 2005 spring report. In turn, the 2005 spring report, together with the recent report of the high-level group chaired by Mr Wim Kok, the former Dutch Prime Minister, prepares the ground for the forthcoming mid-term review of the Lisbon strategy.

The BEPGs set out the contribution economic policies can make to the Lisbon strategy through a comprehensive strategy concerning macroeconomic policies, economic reforms and sustainability. Whereas last year's implementation report ([2]) (i.e. the 2004 report) focused to a great extent on policy intentions, this second implementation report on the 2003–05 BEPGs shifts the attention to policy measures taken and/or envisaged. Rather than limiting the assessment to policy actions in 2004, an incremental approach is used, by reviewing and assessing policy measures since the adoption of the guidelines in 2003.

The 2004 update of the BEPGs confirmed the validity and relevance of the general guidelines, also for the new Member States, and updated the country-specific budgetary recommendations to seven Member States ([3]). The main focus of the 2004 update was the integration of the recently acceded Member States into the existing framework for economic policy coordination. Country-specific challenges and recommendations for 2004 and 2005 were established, taking due account of the individual performances, prospects, structures and institutions of the new Member States.

This working document of the Commission services starts with a review of the follow-up given to the 23 general guidelines applicable to all Member States and to the Union, followed by the assessment on the implementation of the five guidelines specifically directed to the euro area. Subsequently, there is a summary assessment of the implementation of the country-specific recommendations. The second part of this document provides a detailed assessment of the implementation of the recommendations given to address the individual challenges on a country-by-country basis. The assessment takes into account the limited time that newly acceded Member States have had to follow up on the guidelines.

([1]) Council Recommendation 2003/555/EC of 26 June 2003 on the broad guidelines of economic policies of the Member States and the Community (for the 2003–05 period) (OJ L 195, 1.8.2003, p. 1).

([2]) Commission communication 'First report on the implementation of the 2003–05 broad economic policy guidelines' (COM(2004) 20 final, 21.1.2004).

([3]) Council recommendation of 5 July 2004 on the 2004 update of the broad economic policy guidelines for the period 2003–05.

Box 1: Progress in delivering on the three priorities of growth, labour market flexibility and sustainable public finances

When the Economic and Financial Affairs (Ecofin) Council adopted the 2003–05 broad economic policy guidelines in June 2003, it identified three main priorities for policy action: growth, labour market flexibility and sustainable public finances. Against the background of an economic recovery lagging behind the global pace, the Council paid considerable attention in 2004 to the first priority. This box gives only a broad overview of the measures taken in response to these three key priorities. More detail is to be found in the full report.

1. Promoting economic growth. Looking at the last two years, macroeconomic policies have been supportive to growth. Monetary policies in most Member States have been accommodative. Since the cut in interest rates in June 2003, the ECB has kept its key interest rate at the historically low level of 2 %. The budgetary stance in both 2003 and 2004 remained broadly neutral. In addition to sound macroeconomic policies, the Council called for higher investment in human and physical capital and the completion of the internal market. While public investment in education seems to have stabilised, public investments in physical capital have increased slightly. Over the last few years, public investment ratios have increased significantly in new Member States such as the Czech Republic, Malta and Poland but also in, for example, the United Kingdom. At the European level, the European growth initiative, aimed at investments in key infrastructural projects, was launched in 2003, but, so far, only one transport infrastructural project and one energy project have actually started. The pace of internal market integration appears to have slowed down, but financial market integration has progressed further with the legislative phase of the financial services action plan now nearly completed.

In 2004, Eurogroup ministers had discussions on the assessment of the structural weaknesses of the euro area in the light of the growth performance and discussed how growth could be enhanced in a budget-neutral way. Options in this regard related to reducing the administrative burden, improving the quality of public finance and stimulating competition in sheltered sectors. These options underline the importance of a timely implementation of all the guidelines aimed at raising Europe's growth potential.

2. Increasing labour market flexibility. The Ecofin Council specifically called for tax–benefit reforms and greater incentives to take up employment in most Member States. After a slight improvement in 2003, the pace of labour market reforms appears to have been sustained in 2004 reflecting above all the substantial measures proposed in Germany in 2004. In most Member States, good progress has been made over the last two years in cutting taxes or providing lifelong learning strategies, but the objective of achieving a 12.5 % rate of adult participation in lifelong learning remains difficult. Fewer, or less comprehensive, measures relate to benefit systems, wage bargaining and employment protection legislation (and, in particular, for permanent contracts) that can affect labour market participation to a greater extent. Some Member States have implemented measures in the area of active labour market policies to increase the role of incentives and targeting on specific groups.

3. Ensuring sustainable public finances. Besides further consolidating public finances and raising employment rates, most Member States needed, according to the Ecofin Council, to engage in far-reaching pension and healthcare reforms. Whereas substantial pension reforms were implemented in 2003 and 2004 in France, Italy, Austria and Slovakia, progress in a number of other Member States with unsustainable public finances was limited. Healthcare reforms were implemented in Germany, France, Portugal and Slovakia, but these were exceptions among the 25 Member States. As most of these healthcare reforms were aimed at containing rising healthcare costs, they constitute welcome steps in timely addressing the pressures on healthcare expenditures stemming from ageing populations.

2. Implementation assessment of the general guidelines

2.1. Growth- and stability-oriented macroeconomic policies

2.1.1. Economic background: moderate economic recovery in 2004

The implementation of the 2003–05 BEPGs started in the year that recorded the lowest economic growth since 1993. In 2003, economic growth in the Union dipped to just 1 %, while growth in the euro area barely exceeded ½ %. On the back of a strong surge in world trade, the EU economy started to recover in the second half of 2003, and strengthened during the first half of 2004. Data for the third quarter of 2004 are consistent with earlier projections of an average growth rate of 2½ % for the EU-25 and around 2 % for the euro area. While this performance was markedly better than during the period 2001–03, it was mainly driven by buoyant external demand. Domestic demand (notably investments), on the other hand, stayed below what might be expected at this stage of the recovery. This suggests that the combination of supportive financial conditions, improving profit margins and accommodative macroeconomic policies has not yet been able to boost confidence, to accelerate investment expenditure and to trigger a pick-up in private consumption.

The economic slowdown of 2001–03 did not affect the labour market to the same extent as earlier slowdowns, as witnessed by, for example, the more limited rise in unemployment. The unemployment rate rose gradually to about 9 % in 2003 in both the EU-25 and the euro area, and it is expected that it would have stabilised on that level in 2004. The faster pace of economic growth has translated into a gradual, albeit still modest, growth in employment. Job creation of around ½ % in 2004 corresponds to 0.8 million jobs in the EU-25, of which 0.5 million are in the euro area.

Inflation did not come down significantly despite the weak economic growth over recent years. In 2003, inflation remained close to 2 % in the EU and the euro area, partly due to adverse shocks such as the acceleration in food prices. Another relevant factor was the upward pressure from increasing unit labour costs. For 2004, inflation is estimated at 2.2 % in the EU and the euro area.

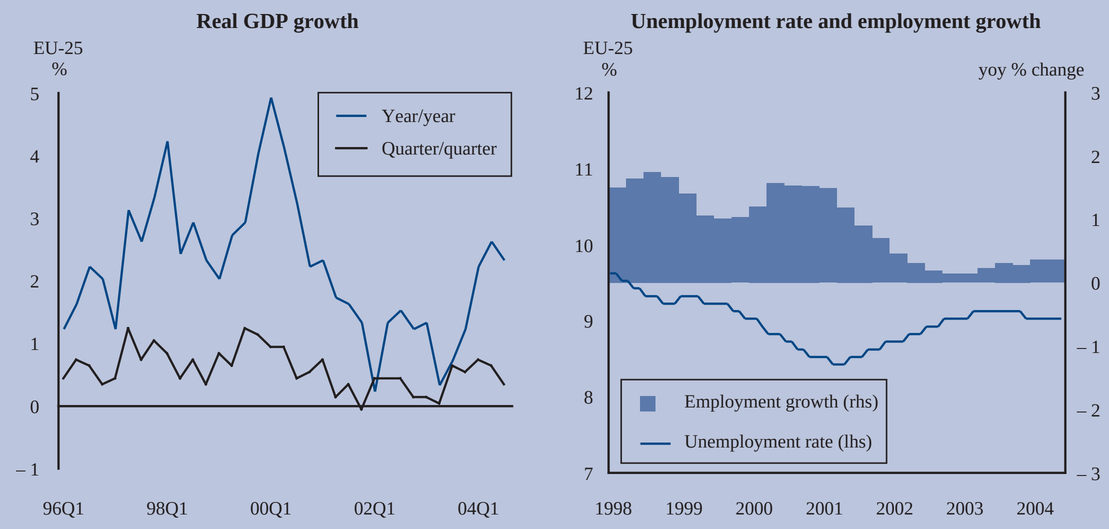
Headline inflation has been pushed up by higher energy prices while core inflation has remained sticky as a result of high services inflation and increases in indirect taxes, particularly on tobacco, in several Member States. For the euro area, the appreciation of the euro provided some counterweight to the rising commodity prices but the adjustment of consumer prices resulting from downward pressures on import prices seems to have been slow.

Macroeconomic policy conditions remained conducive to economic growth

The macroeconomic policy stance remained broadly accommodative as the recovery gradually gained pace in 2004.

Following the 50-basis-point cut in interest rates to the historically low level of 2 % in June 2003, the ECB left policy rates unchanged throughout 2004 against the background of limited inflationary pressures. The positive influence of low interest rates on economic activity was mitigated by the rise in the nominal effective exchange rate, which appreciated on average in 2004 by 4 % compared with the average over 2003. Taking the short-term interest rates and real effective exchange rates in this period together, monetary conditions have loosened slightly. With inflation staying close to 2 % in both 2003 and 2004, the monetary authorities in the euro area succeeded in maintaining price stability.

Graph 1: **Economic developments in the EU**



Source: Commission services.

Table 1

Short-term and long-term interest rates in the EU in 2004

	EUR-12	CZ	DK	EE	CY	LV	LT	HU	MT	PL	SI	SK	SE	UK
Short-term nominal interest rates	2.1	2.4	2.2	2.5	4.7	4.2	2.7	11.4	3.0	6.0	4.7	4.8	2.3	4.6
Change from 2003	– 0.2	0.1	– 0.2	– 0.4	0.8	0.4	– 0.1	2.9	– 0.3	0.3	– 2.1	– 1.4	– 0.9	0.9
Long-term nominal interest rates	4.2	5.0	4.5	4.5	5.8	5.0	4.6	8.4	4.7	7.2	4.8	5.1	4.6	5.1
Change from 2003	0.1	0.9	0.2	– 0.8	1.1	0.1	– 0.7	1.6	– 0.3	1.4	– 0.6	0.1	0.0	0.5

NB: Nominal short-tem interest rates are defined as the three-month interbank rates. Nominal long-term interest rates are defined as the central government benchmark bond of 10 years.

Source: Commission services' autumn 2004 economic forecasts.

Elsewhere in the EU, several central banks have raised policy rates in the last two years. Anticipating emerging price pressures, the Bank of England started to raise interest rates in November 2003 followed by a cumulative 1-percentage-point rise in 2004 to a level of 4.75 %. The monetary authorities in some of the newly acceded Member States have adopted a different monetary policy stance during the last two years. The Hungarian central bank, in particular, maintained a tight monetary policy resulting in a very steep increase in interest rates by 600 basis points in the second half of 2003. In 2004, it eased interest rates gradually by a total of 300 basis points.

The fiscal policy stance in the euro area and the EU-15 was broadly neutral in 2004 as was also the case in 2003. The fiscal stance is measured by changes in the cyclically adjusted primary balance ([1]). The pick-up in economic activity in 2004 is not yet visible in the nominal budget balance, which is estimated to have remained

([1]) Due to the absence of cyclically adjusted balances for the new Member States, no assessment can be made for the Union as a whole. However, based on the development of the nominal balances of the 10 new Member States, in combination with their growth performance, it seems unlikely that the picture of the EU-25 would be different.

unchanged for the EU-25 and to have increased to just below the 3 % ceiling for the euro area.

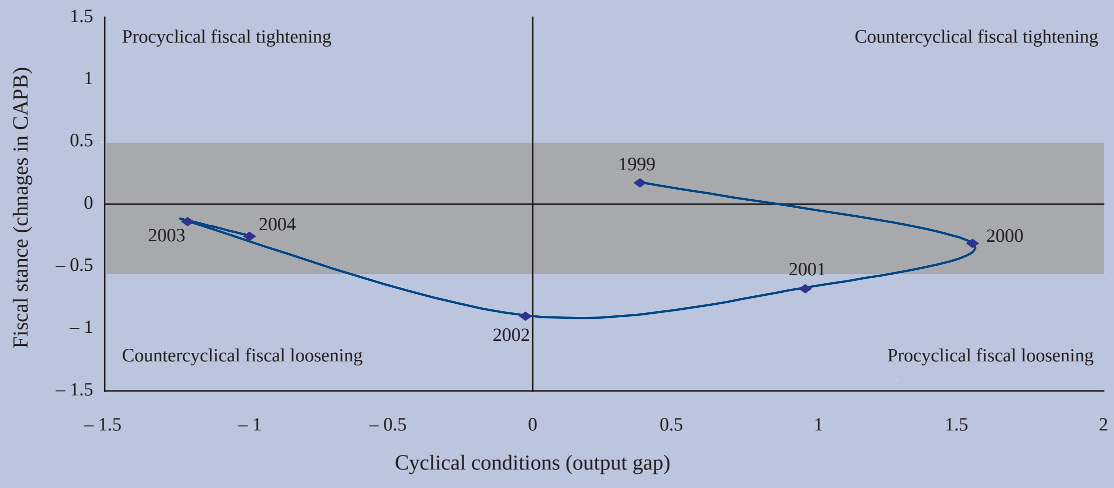
Wage developments are also crucial in determining overall macroeconomic conditions. While slow to come down early in the cycle, and thereby having put upward pressure on unit labour costs and inflation, steady and moderate wage growth over recent years has, in the light of a cyclical recovery in productivity, contributed to keeping a lid on inflationary pressures. In the euro area, wage growth dropped from 2.6 % to 2.2 %, although inflation remained unchanged. Given the cyclical increase in labour productivity growth, nominal unit labour costs decreased in 2004 to 0.6 %.

2.1.2. Budgetary developments: a majority of Member States are struggling with high deficits

Following a surplus in 2000, reflecting the economic upswing and the receipts arising from the allocation of mobile phone licences, the budget balance in the EU turned negative again to a deficit of more than 2 % of GDP by 2002. This was due to both the play of automatic stabilisers and discretionary policies, but with sizeable differences recorded across Member States. Budget deficits were substantial, and in some cases above the 3 % of GDP excessive deficit ceiling, while only three Member States recorded a considerable surplus. Public finances continued to deteriorate in 2003 due to the lacklustre growth, with an almost unchanged cyclically adjusted budget balance, while net borrowing increased, narrowing further the distance to the deficit ceiling. For the EU as a whole, the budget deficit is expected to have remained unchanged in 2004.

While the economic cycle has been the main factor behind the deterioration in public finances in recent years, some of the deterioration has also stemmed from a discretionary loosening of fiscal policy. However, differences are notable across Member States. Almost all Member States that had already sizeable nominal deficits further loosened their fiscal stance, whilst Member States with small deficits or surpluses maintained a broadly neutral stance. Public finances continued to deteriorate in 2003 due to the lacklustre growth, with an almost unchanged cyclically adjusted budget balance, while net borrowing increased to 2.7 % on average, both in the EU-15 and the euro area. Against this background, it was deemed appropriate to keep the general budgetary guidelines unchanged in the 2004 update of the BEPGs. On the other hand, the lack of improvement and/or the rapid deterioration noted in some countries triggered updates of the budgetary country-specific recommenda-

Graph 2: **Fiscal stance and cyclical conditions in the EU-15**



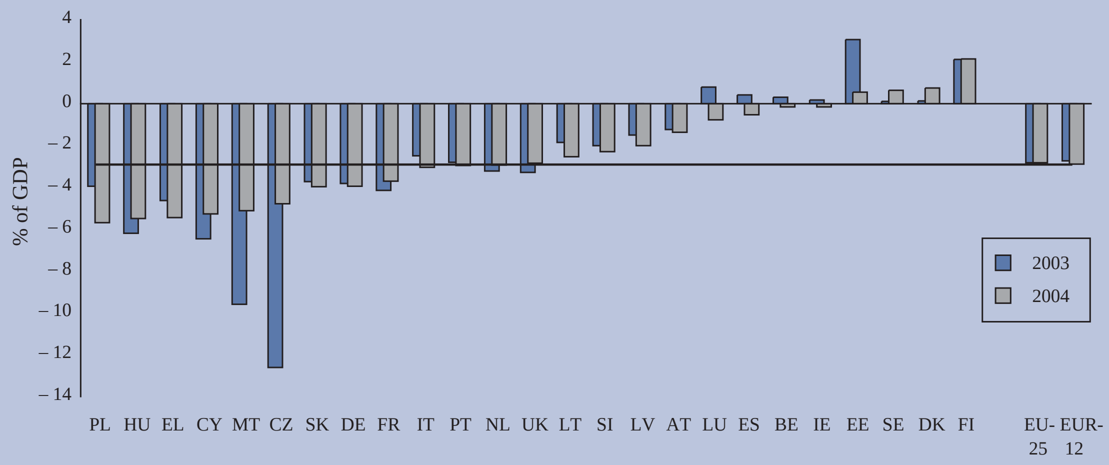
([1]) The 10 Member States are not included because comparable data do not yet exist. The shaded area represents a broadly neutral stance.
Source: Commission services.

Against this background, the 2003–05 BEPGs recommended Member States to:

1. reach or maintain budgetary positions of close to balance or in surplus throughout the economic cycle; to correct excessive deficits in line with the Stability and Growth Pact;

2. subject to (1), avoid procyclical policies, in particular in economic upturns.

Graph 3: **General government balances by Member State, the euro area and for the EU-25**



Source: Autumn 2004 Commission forecasts.

tions to Germany, Greece, France, Italy, the Netherlands and Portugal and a new challenge was introduced in the case of the United Kingdom.

The 2004 update of the BEPGs found that the existing economic policy strategy was broadly appropriate for the 10 new Member States that entered the Union on 1 May 2004. However, as regards the need to 'reach or maintain sound budgetary positions', it was felt that an appropriate time path had to be found to balance the speed of the necessary budgetary consolidation and a fiscal stance supporting the ongoing structural adjustment of their economies. Therefore, a multiannual adjustment period was allowed for some of these countries with a deficit above 3 % of GDP. With the general budgetary guidelines in mind and while taking due account of differences in their economic performances, prospects, structures and institutions, country-specific budgetary recommendations were issued to almost all new Member States.

According to the Commission's autumn 2004 economic forecasts, in 2004 the fiscal deficit for the euro area is expected to have increased for a fourth consecutive year and the deficit is projected to be 2.9 % of GDP, whereas it is projected to decline to 2.5 % of GDP in 2005. For the EU as a whole, the nominal aggregate deficit in 2004 is projected to stay at 2.8 % of GDP (as in 2003) and to decline to 2.4 % of GDP in 2005. Against this background, a further rise in the debt to GDP ratio is projected in 2004.

In 2003, the budget deficits in four euro-area Member States (Germany, Greece, France and the Netherlands) were equal to or above 3 % of GDP. In 2004, the Netherlands is projected to have reduced its budget deficit to below the reference value, while Italy is expected to reach it. The abovementioned overall improvement in 2005 relies strongly on the expected budgetary consolidation in Germany and France. Nevertheless, apart from the

Table 2

Cyclically adjusted budget balance in the euro area and the EU-15 (in % of GDP)

	Cyclically adjusted budget balance (CABB) (1)			Change in CABB (1)	
	2003	2004	2005	2004	2005
BE	1.1	0.4	0.0	– 0.7	– 0.4
DE	– 3.0	– 3.4	– 2.9	– 0.4	0.5
EL	– 5.1	– 6.1	– 4.4	– 1.0	1.7
ES	0.2	– 0.7	– 0.1	– 0.9	0.6
FR	– 3.8	– 3.5	– 2.8	0.3	0.7
IE	0.1	0.1	0.0	0.0	– 0.1
IT	– 1.9	– 2.4	– 2.6	– 0.5	– 0.2
LU	1.7	0.4	0.3	– 1.3	– 0.1
NL	– 1.8	– 1.4	– 1.0	0.4	0.4
AT	– 0.8	– 1.0	– 1.9	– 0.2	– 0.9
PT	– 1.9	– 1.9	– 2.7	0.0	– 0.8
FI	2.8	2.8	2.3	0.0	– 0.5
Euro area	– 2.2	– 2.5	– 2.1	– 0.3	0.4
DK	1.2	1.5	1.8	0.3	0.3
SE	1.4	0.7	0.4	– 0.7	– 0.3
UK	– 2.9	– 2.7	– 2.4	0.2	0.3
EU-15	– 2.2	– 2.3	– 2.0	– 0.1	0.3

(1) On the basis of the production function method, except in the case of Spain where the Hodrick–Prescott (HP) filter method has been used. For the new Member States cyclically adjusted balances are not yet available.

Source: Commission services' autumn 2004 economic forecasts.

Netherlands, none of the countries currently in the excessive deficit procedure is expected to have the deficit below the reference value in 2005, unless further consolidation measures are adopted. In addition, of the 10 new Member States, six had deficits higher than 3 % of GDP in 2003. In 2004, only Poland and Slovakia are not expected to improve their nominal deficits and the deficits in all six are projected to stay above the reference value (1).

When making comparisons between Member States, due notice should be taken of one-off operations influencing the overall picture. In Spain, one-off measures (consisting mainly of the assumption of the railway network company's debt by the central government amounting to 0.7 % of GDP) taken by the new government in 2004 caused the balance to turn into a deficit in 2004. One-off measures were instrumental in achieving a balanced position in Belgium in 2003 and 2004, but will cease to influence the budget as of 2005. In Italy, one-off measures amounting to more than 2 % of GDP helped contain the deficit in 2003 and in the autumn 2004 forecast such measures are projected to reduce the budget deficit by 1½ and ½ % of GDP in 2004 and 2005, respectively. In Portugal, two one-off measures (worth more than 2 % of GDP) contributed to bringing the budget deficit below 3 % of GDP in 2003. For 2004, the Portuguese government is planning further one-off operations worth 2 % of GDP and additional one-offs are envisaged for 2005 (some of these are pending a final decision of Eurostat). A significant part of the deficit reduction projected for 2005 in France stems from one-off revenues amounting to ½ % of GDP (transfer of the responsibility to the social security sector for the payment of pensions to EDF–GDF employees). One-off measures were also important in the Czech Republic (where the 2003 deficit includes a State guarantee of some 7 % of GDP) and Malta (where the restructuring of the shipyard industry added more than 3 % to the 2003 deficit).

(1) For more detailed information, see also Box A1 in the annex, which contains an overview of measures taken by Member States in response to country-specific recommendations in this area.

Of the seven EU-15 Member States that had reached or maintained a budgetary position of close to balance or in surplus in cyclically adjusted terms in 2003 (see Table 2), the Commission's autumn 2004 economic forecasts project that they maintained such a position also in 2004 and 2005, though with recourse to considerable one-off measures in some Member States (and with the exception of Spain in 2004), as noted above. As regards the new Member States, the lack of cyclically adjusted budget balances hampers the comparison with the EU-15 Member States ([1]). Estonia had achieved a fiscal surplus in 2003 and a lower surplus is projected in 2004 and 2005, alongside a widening of the negative output gap in both these years. Of the eight EU-15 Member States not yet having achieved a balanced budgetary position in 2003, three improved their cyclically adjusted budget balance (CABB) in 2004, namely France, the Netherlands and the United Kingdom. By contrast, a deterioration in the CABB is projected in Germany, Greece, Italy and Austria in 2004. In 2005, an improvement in the CABB is projected (on current policies) in most of these countries. However, a deterioration is projected in Italy, Austria and Portugal.

Nine of the new Member States had a deficit in 2003. It is projected to decline in the Czech Republic, Cyprus, Hungary and Malta in 2004, aided by growth above potential in the first three. By contrast, a higher deficit is projected in 2004 in five countries, despite improved cyclical conditions. In 2005, fiscal consolidation is projected in all nine countries, except in Latvia and Slovakia, and, in general, in combination with a smaller effect of the cycle.

Overall, on the basis of the budgetary projections in the Commission's autumn 2004 economic forecasts, further budgetary consolidation is of utmost importance for a number of Member States, not least in view of the prospects of putting an end to the excessive deficits prevailing in several Member States.

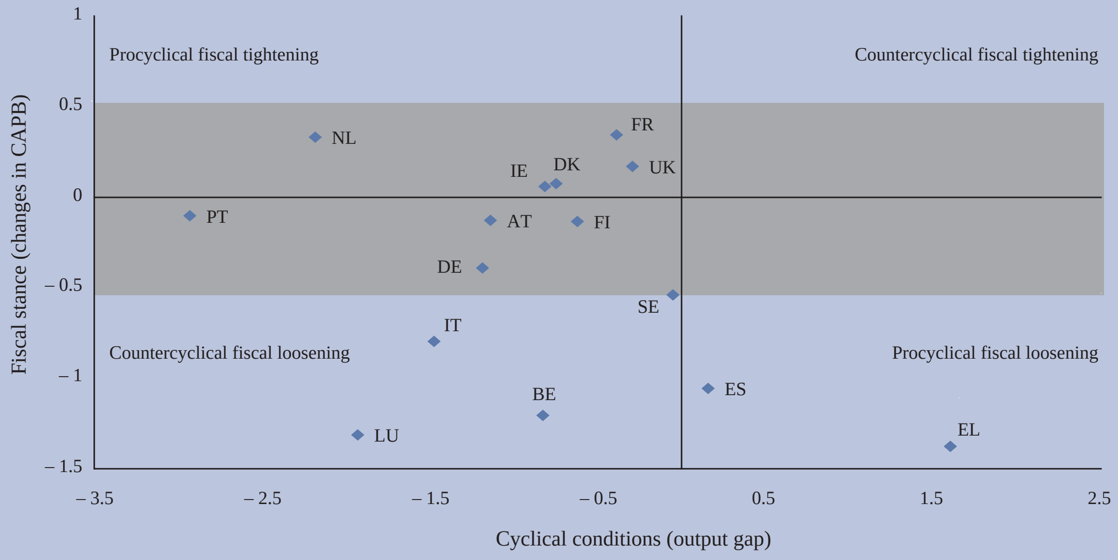
Excessive deficits were identified in Portugal (in 2002), Germany and France (both in 2003). With the deficit outcome for 2003 below 3 % of GDP, the excessive deficit procedure for Portugal was abrogated by the Council on 11 May 2004; however, a renewed breach of the 3 % limit cannot be excluded. In Germany and France, the deficit remained well above 3 % of GDP in 2004. In Germany, the deficit widened marginally with cyclical conditions partly to blame as the composition of growth was tax unfriendly. By contrast, the deficit in France could have narrowed more significantly if the additional revenues from higher-than-expected growth had been allocated in full to deficit reduction.

In 2004, eight more Member States were found to be in excessive deficit, namely the Czech Republic, Greece, Cyprus, Hungary, Malta, the Netherlands, Poland and Slovakia. The Council recommended that Greece, Cyprus and the Netherlands correct their excessive deficit by 2005; for Greece, this now looks particularly challenging in view of the recent, substantial upward revision of the deficit. The remaining five countries were requested to pursue fiscal consolidation in line with their convergence programme, with the excessive deficits to be corrected by 2006 (Malta), 2007 (Poland and Slovakia) or 2008 (the Czech Republic and Hungary) and, with the exception of Hungary, implementation of the fiscal consolidation efforts seems broadly on track. As regards Italy, which was recommended in the 2004 update of the BEPGs 'to take appropriate measures' in response to the possible existence of an excessive deficit, the Council decided not to issue the early warning recommended by the Commission in view of the savings package announced by the Italian authorities in July 2004. However, there is still a risk that the 3 % of GDP ceiling was breached in 2004 or will be breached in 2005.

The overall fiscal stance (approximated by the changes in the cyclically adjusted primary balance — CAPB) was estimated to be broadly neutral in 2003 and 2004 in the euro area and EU-15 and seen in relation to cyclical conditions (measured with the level of the output gap). The aggregate fiscal stance results from quite diverse fiscal stances across Member States, despite fairly similar cyclical developments (see Graph 4). For instance, several Member States are expected to run somewhat procyclical policies, reflecting the further consolidation efforts needed to fulfil the guideline on sound budgetary positions (e.g. France and the Netherlands), although this could not explain the procyclical fiscal stance noted in Greece. As regards the new Member States, the fiscal stance in Hungary, Latvia and Lithuania requires attention: fiscal policies in 2004 seem to have been either

([1]) Work is currently ongoing in the OECD and the EPC to allow for calculations of budgetary elasticities and thereby of cyclically adjusted balances (CABs) for the new Member States. This work was, however, not finished in time for the publication of the present report. The lack of cyclically adjusted budget data makes it impossible so far to include the new Member States in a fully systematic and comparable way in the follow-up to guidelines 1 and 2.

Graph 4: **Fiscal stance and cyclical conditions in the EU-15 in 2004**



(1) The new Member States are not included because comparable data do not yet exist. The shaded area represents a broadly neutral stance.
Source: Commission services.

loosened or exhibiting a lack of consolidation efforts in response to higher-than-expected revenues, despite the country-specific recommendation to avoid procyclical policies. In general and in view of the lack of action already mentioned, it appears vital that the fiscal stance is tightened when economic conditions improve in several Member States in order to ensure sufficient room for the automatic stabilisers to operate fully in the next economic downturn.

Overall, the lack of resolve to address and/or avoid the (excessive deficit) situation in some Member States continues to be a source of great concern. In the light of the experience of the multilateral budgetary surveillance and with a view to strengthening economic governance and clarifying the implementation of the Stability and Growth Pact (SGP), the Commission adopted two communications in 2004 (1), advocating better interlinking of the instruments for EU economic governance (BEPGs and the SGP) in order to enhance the contribution of budgetary policy to economic growth. The Commission also proposes that the SGP would benefit from an increased focus on the sustainability of public finances and increased recognition of the different economic situations in an enlarged Union of 25.

(1) COM(2004) 425 final of June 2004 and COM(2004) 581 final of September 2004. The Council held a first discussion on 10 September 2004 on how to strengthen and clarify the pact and ensure better implementation.

2.1.3. Wage developments: now better tuned to support employment creation

While wage hikes declined less than productivity during the recent prolonged period of slow growth …

Wages have responded only modestly to the protracted slow growth in recent years, partly reflecting a greater resilience in the labour market during this slowdown. Nominal wage growth fell gradually from 3½ % in 2000 to around 3 % in 2003 in the EU-15, while it remained relatively stable at around 2¾ % in the euro area during the same period. Unit labour costs increased, however, as labour productivity growth declined sharply early in the slowdown reflecting mainly labour hoarding in several Member States.

... labour cost pressures have eased with the recovery

Overall, nominal wage increases eased very slightly in 2004 in the EU-25 and the EU-15 (to 3 and 2¾ %, respectively), and somewhat more in the euro area (to

Against this background, the 2003–05 BEPGs recommended Member States to:

3. ensure that nominal wage increases are consistent with price stability and productivity gains.

Table 3

Wage developments in 2004

	Nominal compensation per employee	Real wages ([1])	Labour Productivity	NULC ([2])	RULC ([3])
BE	2.7	0.7	2.1	0.6	– 1.4
DE	0.0	– 1.0	1.8	– 1.7	– 2.7
EL	6.5	2.8	2.0	4.4	0.8
ES	3.7	– 0.1	0.6	3.1	– 0.7
FR	3.3	1.4	2.7	0.6	– 1.2
IE	5.4	2.3	2.7	2.6	– 0.4
IT	3.4	0.5	0.5	2.9	0.1
LU	3.3	1.0	1.9	1.3	– 0.9
NL	2.4	1.5	3.2	– 0.8	– 1.6
AT	2.5	1.4	1.4	1.1	0.0
PT	3.1	1.1	0.9	2.2	0.2
FI	4.1	3.7	3.5	0.6	0.2
Euro area	2.2	0.3	1.6	0.6	– 1.3
CZ	6.4	1.6	4.7	1.7	– 3.0
DK	3.3	1.4	1.9	1.4	– 0.4
EE	8.6	4.6	5.6	2.9	– 0.9
CY	4.0	1.0	2.4	1.6	– 1.4
LV	14.0	6.8	6.7	6.9	0.1
LT	7.8	6.0	5.5	2.2	0.5
HU	8.8	2.5	3.4	5.2	– 0.9
MT	0.6	– 2.7	0.4	0.2	– 3.1
PL	4.7	1.8	6.0	– 1.3	– 4.0
SI	6.0	1.8	3.8	2.2	– 1.9
SK	9.9	5.7	5.0	4.7	0.7
SE	3.4	2.3	4.3	– 0.9	– 1.9
UK	5.2	2.8	2.6	2.6	0.2
EU-25	3.0	0.9	2.1	0.9	– 1.1

([1]) Nominal compensation adjusted by the GDP deflator.
([2]) Nominal unit labour costs.
([3]) Real unit labour costs.

Source: Commission services’ autumn 2004 economic forecasts.

2¼ %). Such wage increases are generally in line with price stability in the medium term. Moreover, the strengthening of the economy has resulted in a cyclical recovery of labour productivity, clearly up from the depressed levels of the preceding three years. As a corollary, the rise in unit labour costs decelerated below 1 %. This reduction in domestic price pressures is particularly beneficial at times of heightened external risks to price stability.

Furthermore, the advances in productivity also allowed, for the first time since 1998, a noticeable easing in real unit labour costs, which should underpin a rebound in investment (see Table 3 above).

The picture is more diverse at the country level. Within the euro area, nominal wage increases were relatively high in Greece, Ireland and Finland, i.e. countries with comparatively strong economies and/or tight labour markets while wage growth was subdued in Germany where still weak labour market trends triggered agreements on cost reductions. Cost-competitiveness in terms of unit labour costs decreased above all in Greece, Spain and Italy, but improved in Germany and the Netherlands. This extends recent trends, except for Greece, where the improvement seen in 2003 was discontinued with the 2004 two-year wage agreement, and the Netherlands, where a turnaround was reached after the preceding dip in activity.

Wage-related country-specific guidelines were addressed to two euro-area countries. In Ireland, the fairly moderate private sector wage settlements of summer 2004 are reassuring in terms of price competitiveness, notwithstanding faster public sector pay awards, reflecting a gradual adjustment in pay scales relative to the private sector. In Portugal, wage growth clearly decelerated in the aftermath of the 2003 recession, supported also by a partial wage freeze in the public sector, thereby containing the erosion in competitiveness.

Outside the euro area, nominal wage growth began to pick up in the United Kingdom, reflecting the tight labour market situation. A higher pace of wage increases prevailed in 2004 in most of the recently acceded Member States. Generally, good advances in productivity were achieved, but nominal unit labour costs still rose quite fast in Latvia and Slovakia. A deceleration, in continuation of what had already occurred in Hungary and Slovakia relative to 2003, would sustain the currently good export performance.

Country-specific recommendations were also addressed to two of the new Member States. In Estonia, wage growth eased somewhat in 2004, and unit labour costs clearly decelerated, supported by stronger productivity growth, ensuring that wage developments were compatible with employment growth. Hungary was recommended to encourage a reform in wage setting and promote multiannual agreements. While there were no systemic reforms, progress was made as regards wage moderation, helped by a slowing in public sector wage rises from the rapid pace of the preceding years.

2.2. Economic reforms to raise Europe's growth potential

Living standards in the EU remain well below those in the United States

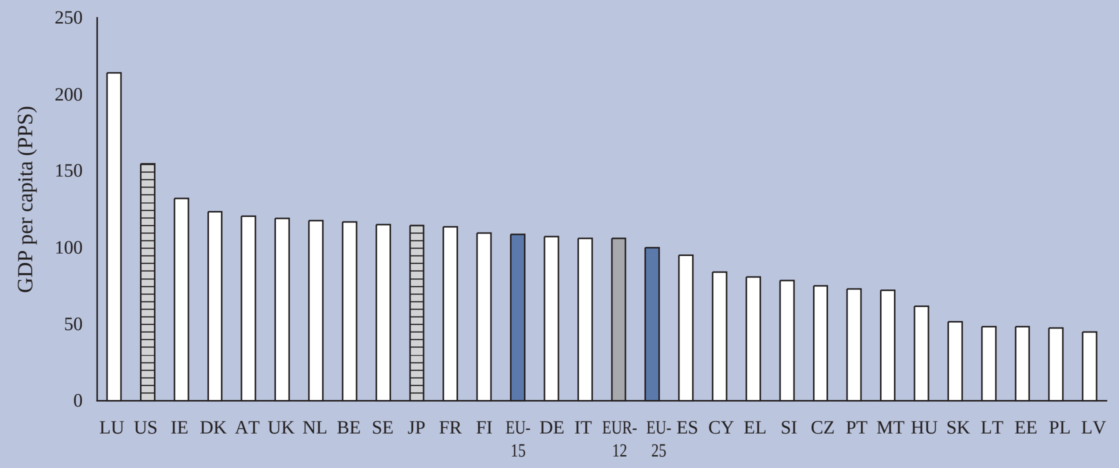
Over the past three decades, living standards in the EU-15 (approximated by GDP per capita in purchasing power parities) appear to be stuck at around 70 % of the US level. Taking the new Member States into account, EU GDP per capita drops to 65 % of the US level. Graph 5 illustrates the still substantial differences in living standards between EU countries, with GDP per capita in Luxembourg exceeding that of the United States and that in Poland and the Baltic States not yet reaching one third of the US level. However, the new Member States generally enjoy growth rates well above those of the EU-15 Member States and contribute to an overall dynamism of the EU economy.

The increased contribution of employment to EU GDP growth since the mid-1990s has been offset by a reduction in the contribution from labour productivity. Over the period 2000–03, the EU-15 increased both its labour productivity per hour worked (albeit by less than in previous years) and the total number of hours worked. This was not the case in Denmark, France, Germany, Japan, the Netherlands, Sweden, and the United States where the total number of hours worked declined.

In Belgium, Italy, Luxembourg and Portugal, on the other hand, the number of hours worked increased, but hourly productivity declined (see Graph 6). Currently, one third to one half of the differential in living standards between the EU and the United States can be associated with differences in hourly productivity, while the remainder is related to a difference in the number of hours worked (including differences in the employment rate as well as the hours worked per worker).

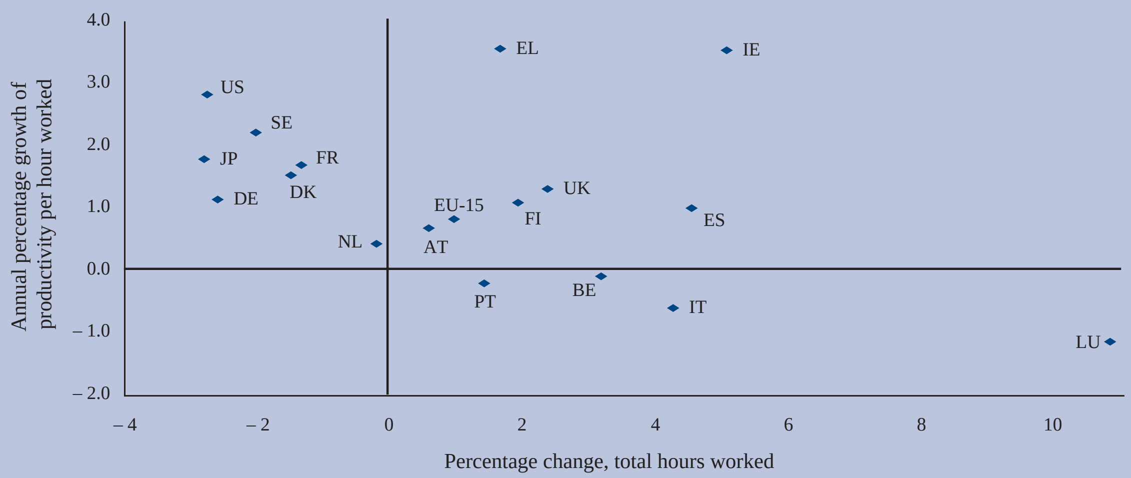
The combination of a productivity slowdown and the low employment rate, against the background of the challenges stemming from globalisation and ageing, indicates the need to vigorously pursue economic reforms. The recent report 'Facing the challenge' of the high-level group on the mid-term review of the Lisbon strategy reiterates this need.

Graph 5: **GDP per capita, 2004 (EU-25 = 100)**



Source: Commission services (Eurostat, structural indicators).

Graph 6: **Evolution of productivity and total hours worked, 2000–03**



Source: Commission services.

Box 2: The report of the high-level group on the mid-term review of the Lisbon strategy: 'Facing the challenge'

The 2004 spring European Council invited the Commission to establish a high-level group headed by the former Dutch Prime Minister, Mr Wim Kok, to prepare an independent contribution to the mid-term review of the Lisbon strategy to be held in the spring of 2005. The mandate of this group was to identify the measures required to achieve the Lisbon goal and to assess the effectiveness of the instruments of governance.

The group delivered its report in early November 2004. Its assessment is that, while some progress has been made since Lisbon, the pace of reform needs to be significantly stepped up if the Lisbon goal is to be achieved. Slow implementation of the measures foreseen within the context of the Lisbon strategy have been at the heart of the problem. The report proposed refocusing the Lisbon strategy on a limited set of concrete reform measures, which should benefit from a supportive macroeconomic framework, with a view to stimulating growth and employment creation. It highlighted five traditional Lisbon areas with recommendations — namely, the knowledge-based society, the internal market, the establishment of a favourable business climate, the creation of a more adaptable labour market, and the promotion of leadership in eco-innovation. The 14 specific recommendations regarding these areas cover issues such as how to attract world class scientists and researchers, a European Research Council, adoption of the Community patent, transposition of directives, integration of services and follow-up to the financial services action plan, reduction in administrative burden, reduction in time and cost to set up a business, implementation of the labour market recommendations of the European Employment Task Force, national strategies for lifelong learning, a comprehensive ageing strategy and greening of public procurement.

To make the Lisbon strategy a success, the group proposes to increase ownership by introducing national action programmes in which Member States formulate their plans to achieve commonly agreed targets. As regards the BEPGs and employment guidelines, it recommends the adoption of new guidelines for a period of four years by July 2005, reflecting the focused objectives of growth and employment. Finally, the report identifies a need to increase peer pressure on Member States and to improve the communication of the Lisbon project to European citizens.

2.2.1. Halfway through the first decade of the Lisbon strategy, the EU is failing to reach the employment targets

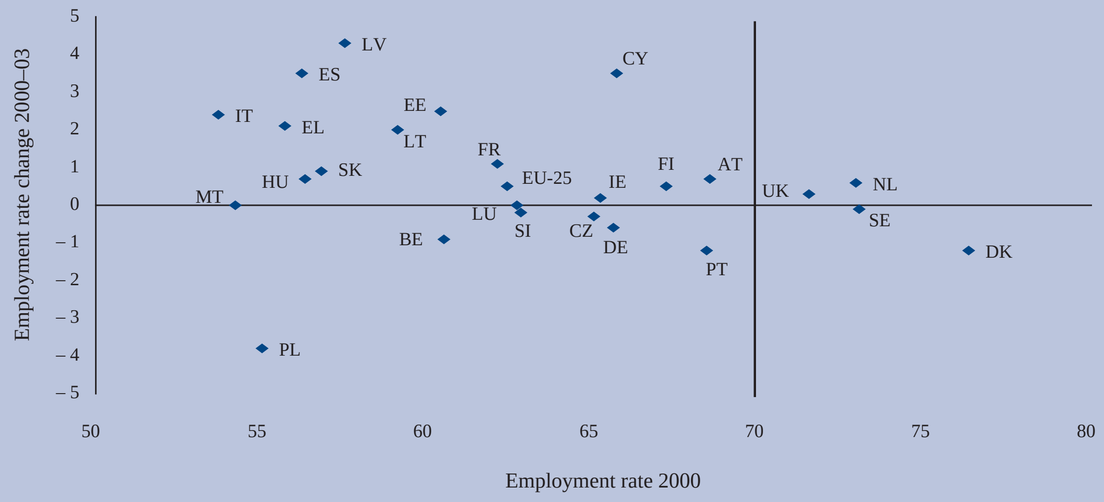
The Lisbon and Stockholm employment targets now look markedly more challenging, if not unattainable, than they did in 2000

Employment growth has declined markedly in recent years, due, *inter alia*, to the previous economic slowdown. Although an economic recovery is now under way, its impact on the labour market is expected to remain relatively modest in 2004 and 2005 (with employment growth estimated at 0.4 and 0.7 % in the EU-25, respectively, according to the Commission's autumn 2004 economic forecasts).

At the Member State level, the development is diverse, with, on the one hand, a relatively dynamic employment growth noted in, for example, Greece, Spain, Italy and the smaller new Member States since 2000. On the other hand, employment growth was relatively weak in most other countries and even turned negative in Belgium, the Czech Republic, Denmark, Germany, Poland, Portugal, Slovenia and Sweden during the period 2000–03 (see Graph 7).

In the 2000–03 period, the overall employment rate for the EU-25 increased by a total of 0.8 percentage points, bringing it to 62.9 % in 2003 on average (still far from the intermediate target of 67 % to be achieved by the end of 2005 or the 70 % target by 2010). Differences are substantial across Member States, with employment rates ranging from 51.2 % in Poland to 75.1 % in Denmark in 2003, and with employment growth generally being slower in some of the larger Member States.

The female employment rate rose to 55.1 % on average in 2003 (varying from 33.6 % in Malta to 71.5 % in Sweden). The female employment rate also remains below the intermediate target of 57 % or the 60 % target to be achieved by 2010, although these still appear to be within reach. For instance, the female employment rate rose almost twice as fast as the total employment rate (see Graph 8). The increase was particularly rapid in Cyprus, *Graph 7:* **Total employment rate**



NB: Lisbon target for total employment is to achieve 70% on average by 2010.
Source: Commission services (Eurostat, structural indicators).

Graph 8: **Female employment rate**

NB: Lisbon target for total employment is to achieve 60% on average by 2010.
Source: Commission services (Eurostat, structural indicators).

Greece, Spain, Italy, Latvia and Austria, reflecting both labour market reforms to dismantle barriers to female participation and cultural change. As mentioned in last year's implementation report, the overall development is also due to an age cohort effect, as younger cohorts are more likely to participate in the labour market.

In contrast, the employment rate of older workers (aged 55–64), which amounted to 40.2 % in 2003 (ranging from 23.5 % in Slovenia to 68.6 % in Sweden), has the greatest distance to cover towards the 2010 target of 50 %.

The unemployment rate for the EU-25 continued to increase somewhat in 2003 to 9.1 % and is expected to have stabilised around that level in 2004. By the last quarter of 2003, unemployment rates ranged from 3.9 % in Luxembourg to 19.2 % in Poland. Moreover, youth unemployment remains very high, over 18 %, while long-term unemployment is over 44 % of total unemployment in the EU-25.

Summing up, the employment targets look more challenging at mid-term than they did in 2000, when the EU-15 employment rate stood at 63.4 % and employment growth was strong. The macroeconomic slowdown can partly explain the disappointing performance over the past few years. The current economic recovery will help in moving towards the targets, but the recovery of employment once growth picks up is expected to be modest. Some labour hoarding appears to have been taking place during the economic slowdown, as suggested by a relatively low cyclical level of labour productivity recorded recently, which is likely to cause subdued employment growth in the recovery. More importantly and up to 2001, there were signs that some structural reforms of product and labour markets, together with wage moderation, were beginning to pay off. Thereafter, progress in labour market reforms seems to have levelled off. Without swift implementation of comprehensive labour market reforms, the Union will fail to reach the Lisbon and Stockholm employment rate targets by 2010, except possibly for female employment rates.

Overall, the pace of labour market reforms needs to accelerate if the Lisbon targets are not to be missed by a large margin

In general, the pace of reforms on the labour market has improved slightly since 2003. This follows, above all, from the recent measures adopted and/or proposed in Germany as well as from significant progress in Denmark, Ireland, the Netherlands and Austria. However, several Member States are still in the process of adopting reforms. Overall, reform efforts have concentrated on the areas of labour tax cuts, active labour market policies and strategies for lifelong learning, while fewer measures have been taken in the areas of wage bargaining, benefit systems and employment protection legislation (in particular, permanent contracts) which would influence labour participation and unemployment more ([1]).

Tax and benefit reforms continue: Member States tend to start reforms by reducing labour taxes, but few countries are taking measures to reform unemployment and related benefit schemes

Improving incentives to work, particularly in the design of unemployment and related benefit schemes, remains a serious challenge in most Member States. Indeed, recommendations to address disincentives to work were given to 18 Member States.

([1]) In Box A2 in the annex, the main reform measures undertaken in 2003 and 2004 in response to guidelines 4 to 8 are summarised by Member State.

Against this background, the 2003–05 BEPGs recommended Member States to:

4. improve the combined incentive effects of taxes and benefits and reduce high marginal effective tax rates;
5. ensure that wage bargaining systems allow wages to reflect productivity differences;
6. review labour market regulation and promote more adaptable and innovative work organisation;
7. facilitate labour mobility;
8. ensure efficient active labour market policies.

Graph 9: **Older workers employment rate**

NB: Lisbon target for total employment is to achieve 50 % on average by 2010.
Source: Commission services (Eurostat, structural indicators).

In general, measures adopted or announced in 2003 focused on reducing taxes with little action to reform benefit systems, although it is the combined effect of taxes and benefits that contributes to the risk of unemployment and inactivity traps. Several Member States adopted tax reforms to increase the incentives to enter or stay in the labour market, primarily for low wage earners, even if these measures are relatively costly to public finances.

In 2004, Germany, France and the Netherlands took measures to lower the duration of unemployment benefits, combined with stricter eligibility conditions and job-search requirements. Denmark also tightened job availability criteria. Portugal amended the sickness benefit system to eliminate disincentives to work. Sweden implemented measures to raise the levels of certain social insurance benefits, while tightening the enforcement rules related to sickness insurance. Finland announced mandatory participation of persons in active measures in order to receive unemployment benefits.

In the new Member States, there is a widespread need to lower the tax burden on labour, especially at the lower end of the wage scale. Ambitious efforts are needed to redesign benefit systems with a view to making the transition from welfare to work easier. In practice, this is a considerable challenge given the heavy reliance of certain groups of the population on social assistance as their primary source of income. Introducing in-work benefits might be usefully considered, although these policies tend to have a high fiscal cost. Hungary has started to reduce labour taxes and to reform healthcare contributions, and Slovakia has adopted measures regarding social assistance. The Czech Republic has taken action in reforming its unemployment benefit systems, by increasing the level of benefits while introducing more stringent conditions of eligibility and work availability requirements. Furthermore, it has cut the sickness benefit system while rendering stricter enforcement. Slovakia has introduced benefits to increase work incentives. Slovenia has enacted its tax reform to reduce labour costs and, in particular, the burden on lowest wages.

Very little has been done to ensure that wages better reflect productivity and local labour market conditions

In the context of a monetary union and with large regional disparities within several Member States, as well as large differences in unemployment across skills, 12 Member States were specifically recommended to allow for a greater wage differentiation to better reflect productivity differences across industries, regions and skills. Public sector wage settlements may also play an important role in a number of countries.

Last year's implementation report highlighted an informal trend towards more flexibility at the firm level, as variable forms of pay, related to individual achievements and to the situation of the company, are becoming more widespread. In many new Member States, wage negotiations at firm level predominate.

In 2004, the most noticeable measures focused on minimum wages. The introduction of a statutory minimum wage is being discussed in Germany, while a minimum wage for 15–17-year-olds was introduced in the United Kingdom. In Spain, the minimum wage was increased and in Finland the government proposed making tax cuts conditional on a moderate wage settlement. National minimum wages, if high relative to average wages, tend to compress the wage distribution and could price workers out of the labour market. In Germany, the government has encouraged social partners to make greater use of opening clauses in collective agreements.

In some Member States, work organisation is becoming more adaptable; however, very few initiatives in employment protection legislation are being taken to foster job creation

A flexible regulatory framework and work organisation are necessary to support change and facilitate adjustment. In 2003, Germany, Greece, Spain and Italy started to take action to respond to recommendations received. In 2004, Germany started to reverse the trend of reduced working time in specific branches.

France amended the redundancy legislation to loosen employment protection and Germany also increased fixed-term contract duration and loosened employment protection legislation for small firms by raising the threshold to apply provisions against dismissal from 5 to 10 employees. However, no other Member State has taken significant action to tackle 'overly strict' employment protection legislation, nor to reduce the segmentation of the labour market across different types of contracts. The activation of more flexible labour contracts in Italy may actually increase segmentation of the labour market.

Some Member States are encouraging geographical mobility, and the majority are promoting occupational mobility

Regional disparities in several Member States, often with simultaneous unemployment and skill shortages, continue to point to the need to foster geographical and occupational mobility. A recommendation to eliminate barriers to geographical mobility was addressed to Spain.

Insufficient wage differentiation or some features of the unemployment benefit systems also appear to be inhibiting geographical labour mobility by providing incentives for the unemployed to remain in rural areas. In 2003, some Member States introduced changes in the tax–benefit system, in order to improve incentives to mobility (i.e. Germany, Greece, Spain, France and Sweden). Spain continued to address rigidities in the housing market. A majority of Member States continued to foster occupational mobility, for example through lifelong learning programmes. Indeed, participation rates in lifelong learning in the EU-25 have seen a steady increase since 2001 (7.9 %) to the current level of 9 % (2003); however, it remains particularly low in many Member States (notably in the Czech Republic, Greece, Italy, Malta, Portugal and Slovakia) and varies widely according to age and attainment level.

In 2004, the dissemination of information on vacancies continued to improve through the cooperation of Member States and the use of information technology, notably through the development of a European job mobility portal (EURES).

Some Member States have taken measures in the area of labour market policies to favour labour market participation, but the redesign of policies following their evaluation remains exceptional

The role of both incentives and targeting of active labour market policies (ALMPs) has been highlighted by many countries to improve their efficiency. Germany received a specific recommendation to increase the efficiency of ALMPs.

In 2004, Germany stepped up its evaluation effort, as public employment services defined performance targets for local offices and intend to regularly control their placement performance. Moreover, ALMPs in general no longer lead to requalification for unemployment benefits. Finally, the design of individual action plans will become mandatory and some programmes will be discontinued in 2005 following poor results of an evaluation. Denmark and the Czech Republic have taken action to target ALMPs to specific groups. The Netherlands is strengthening the evaluation through development of performance-based ALMPs, while Greece and Finland have improved their public employment services.

2.2.2. Addressing the underlying causes of the slowdown in EU labour productivity growth

Hourly labour productivity growth in the EU has fallen behind …

For the first time in decades, hourly labour productivity in the EU-15 is on a trend growth path which is lower than that of the United States. This productivity slowdown culminated in negative growth rates in 2003 for Italy, the Netherlands and Portugal. For most of the new Member States, no data on hourly productivity are currently available in the structural indicators. Nevertheless, since 1996, growth in labour productivity per person employed in the new Member States overall has consistently been above that of the EU-15 Member States. However, even among the new Member States, country performances may differ substantially. In 2004, labour productivity growth varied from less than 1 % in Malta to more than 5 % in Lithuania, Latvia and Poland.

… due to a lack of investment and a slowdown in technological progress

The slowdown in EU labour productivity growth rates since the mid-1990s can be attributed in equal parts to a lower investment per employee and a slowdown in the rate of technological progress. The former can be partially explained by a higher rate of job creation, as those who enter employment from either unemployment or inactivity have below-average productivity. However, this explains only 30 % of the productivity slowdown. The latter has been associated with: (i) the difficulty of the EU in reorienting its specialisation towards sectors with high productivity growth prospects; (ii) the poorer productivity performance and smaller size of ICT-producing industries (including office equipment and semiconductors) in comparison with the United States; and (iii) the lower productivity growth of the EU than that of the United States in ICT-using services (such as wholesale and retail trade, and financial services) due to a slower diffusion of new, more knowledge-based, technologies.

Product market reforms may result in substantial productivity gains …

Additional product market reforms are required in order to transform the EU into a more competitive and dynamic economy. This can be achieved by improving the framework conditions in which business operates. Beyond the direct impact of a decrease in the costs of doing business, well-designed product market reforms can indirectly contribute to increasing productivity by creating incentives for a reallocation of resources within and amongst firms and sectors towards more productive activities and by stimulating innovation and the use of new technologies. Research shows that reforms facilitating market entry and raising the level of competition on goods and services markets may result in substantial productivity gains ([1]). Productivity gains tend to be concentrated in high-tech sectors and it is in these sectors that new firms make the most significant contribution to productivity growth. The provision of high-quality scientific, technical and managerial education is essential to the development and diffusion of innovative production technologies.

… but the pace of internal market integration appears to have slowed down

In order to make the EU economy more competitive and dynamic, it is essential to ensure that the internal market is well functioning and undistorted by sectoral and ad hoc State aid. However, many indicators point towards a slowdown in EU product market integration. Partly as a consequence of slower economic growth, trade amongst the EU-15 Member States has stalled, growing by only 0.6 % in 2002 and then shrinking by 0.3 % in 2003.

These figures are little different from developments in extra-EU trade, even when there are signs that intra-euro-area trade has developed more favourably. Moreover, following years of strong convergence, price dispersion across the EU as a whole (as measured by the coefficient of variation of consumer price levels) has stabilised at 29 %. For comparison, the coefficient of price variation in the euro area is 14 %.

Even though some EU-15 Member States (Germany, France, the Netherlands and Austria) have made progress in transposing the Community's internal market directives into national law, only Spain has managed to keep or bring the implementation gap below the Lisbon strategy target of 1.5 %, which had been set initially for March 2002. For the EU-15 Member States taken together, the progress achieved in closing the gap during the first years

([1]) European Commission (2004), 'The link between product market reforms and productivity: Direct and indirect impacts', Chapter 5 in 'The EU economy: 2004 review', *European Economy*, No 6, 2004.

Against this background, the 2003–05 BEPGs recommended Member States to:

9. foster competition in goods and services markets;

10. accelerate the integration of EU capital markets by *inter alia* ensuring consistent enforcement of EU rules and removing barriers to efficient cross-border clearing and settlement;

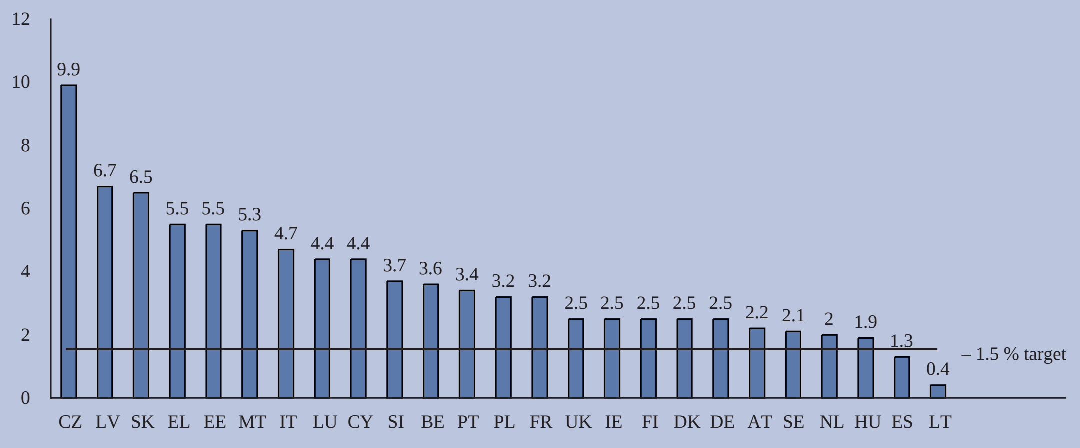
11. generate a supportive environment for entrepreneurship and for small and medium-sized enterprises (SMEs) to start up and grow;

12. agree on and implement measures to strengthen corporate governance and further improve arrangements at national and Community level to deliver efficient cross-sector and cross-border cooperation in financial supervision and financial crisis management;

13. take active steps to promote investment in knowledge, new technologies and innovation and make progress towards the 3 % of GDP objective to total R & D investment by *inter alia* developing framework conditions conducive to R & D and innovation, promoting access and use of ICT and improving the quality and efficiency of education and training systems;

14. enhance the contribution of the public sector to growth by *inter alia* redirecting public expenditure and increasing the efficiency of the public sector.

Graph 10: **Transposition deficits (percentage of directives not notified), November 2004**



Source: Commission services.

of Lisbon (from 3 % in 2000 to 2 % in 2001) has been reversed as transposition in the last two years has been extremely sluggish. In fact, the EU-15 transposition deficit returned to 3 % in November 2004. For the new Member States, reaching the 1.5 % target posed an even greater challenge. Lithuania, however, has delivered an outstanding performance by bringing the transposition deficit down to 0.4 % in November 2004.

The number of infringement cases against Member States also remains at an unsatisfactorily high level. The value of public procurement that is openly advertised continues to increase, but still accounts for only 16 % of the total value of public procurement. It is clear from persistent differences between Member States in the value of openly advertised public procurement as a percentage of GDP that there is considerable scope for further improvements, particularly in Germany, Italy, Luxembourg, Austria and Finland. The public procurement legislative package was adopted by Parliament and the Council in early 2004. In Spain, Finland and Sweden, committees were set up to improve public procurement practices.

The elimination of tax-related obstacles to cross-border activities …

The results of a recent survey of over 700 European companies show large tax-related obstacles to cross-border activities. Companies with subsidiaries or permanent establishments in another Member State face significantly higher tax compliance costs than companies with domestic subsidiaries only. Especially for small and medium-sized companies, this is an important trade barrier as the costs of complying with VAT and corporate tax requirements have been estimated to represent 1.9 % of tax collected for large companies and 30.9 % of tax collected for SMEs. In 2004, a number of directives related to company taxation and VAT rules were adopted, which, if properly implemented, should contribute to a better functioning internal market. Although there is evidence of corporate tax competition amongst some countries with similar characteristics (such as the Baltic States), there is no evidence of a general race to the bottom. The new Member States have generally lower statutory rates, but their level of effectively paid taxes is not very different from that in the EU-15 countries. Finally, the level of State aid (excluding aid to agriculture, fisheries and transport) in the EU-15 appears to have stabilised at 0.4 % of GDP. For the 10 new Member States as a whole, such State aid was significantly higher, amounting to 1.4 % of GDP over the period 2000–03. However, the average conceals wide variations between the new Member States, ranging from 0.1 % in Estonia to 3.9 % in Malta. Furthermore, if certain measures which are in the process of being phased out are excluded, the average for the new Member States drops to 0.7 %. The State aid given in most new Member States (e.g. in Malta and Poland) is still largely sectoral in nature.

… and the creation of an internal market for services carry important benefits …

The proposed directive on the internal market for services foresees the free movement of services by ensuring that service providers only have to comply with the national law of their home country when they want to provide their services across borders on a temporary basis (eliminating the requirement to set up shop in the Member State concerned). Opening up trade and cross-border activities in services would have a considerable impact on growth because of the large and growing share of this sector in the economy. A recent study [1] estimates that adoption of the service directive would raise the GDP level by 0.6 to 0.7 %.

… as does the liberalisation of network industries provided that effective competition is ensured

Market opening in the network industries continues to progress, leading, in general, to productivity gains and price reductions. In 2004, further steps towards a full liberalisation of the energy market were taken in Flanders in Belgium and in Denmark, France, Ireland, Italy, Luxembourg, the Netherlands and Portugal. In many new Member States, the framework for competition in network markets is also increasingly well developed, as their economies have been opened up to international competition. However, this process does not necessarily guarantee effective competition. Many Member States have yet to communicate the national measures required for the transposition of the two energy directives. The effective implementation of these directives and improved cross-border transmission networks are essential conditions for the creation of a single energy market. The target of 10 % of import capacity compared with the installed generation capacity will not be achieved in 2005 by Spain, Ireland, Italy and the United Kingdom. Greece and Portugal will only reach the target in 2005 if the projects under construction are completed on time. Latvia and Lithuania have initiated efforts to improve interconnections with European networks and the creation of an Iberian electricity market in June 2005 has been announced.

In liberalised markets, the market share of the incumbent remains high. In fixed telephony, for example, the market share of the incumbent in the EU-15 Member States was 77 % for local calls, 67 % for long-distance calls and 60 % for international calls in 2003. With the implementation of the new regulatory framework, competition in the e-communications services sector is nevertheless intensifying in most markets, bringing increased benefits

[1] Copenhagen Economics (2004), 'Economic assessment of the barriers to the internal market for services', study commissioned by the Enterprise and Industry DG of the European Commission.

to consumers. Prices of long-distance and international calls, for example, have continued to decline. However, at the end of 2004, five Member States had not yet notified measures transposing the regulatory framework for electronic communications.

Rail freight market opening began in March 2003 on the majority of the international lines. However, Community legislation in this domain is not yet fully implemented by all Member States and a number of rail companies still need to be restructured. Effective competition in the rail freight market only exists in Denmark, Germany, Italy, the Netherlands, Sweden and the United Kingdom.

Competition policy has been modernised

The entry into force of the 'modernisation package' for the enforcement of the Community antitrust rules on 1 May 2004 will enhance the effectiveness of competition policy by clarifying rules and streamlining procedures. The Commission's powers of investigation and the penalties for anticompetitive behaviour have been strengthened. More responsibility has been devolved to national competition authorities and courts, since many cases may be more effectively dealt with at the national level, but a system has been put into place to ensure a consistent approach is adopted at the Community and national levels. Over the past year, Spain, Ireland, the Netherlands and the United Kingdom have significantly increased the resources (staff and budget) of their competition authorities. While the new Member States have made encouraging headway in strengthening competition rules and establishing independent competition and regulatory authorities, there is still some way to go.

Denmark has stepped up its efforts to strengthen competition in certain sectors where it was still inadequate, but progress in countries such as Spain, Ireland, Finland and Sweden was more limited.

The risk capital action plan has delivered positive results …

The risk capital action plan (RCAP) was launched in 1998 with the objective of eliminating barriers impeding the creation of an integrated single market in risk capital by 2003. In this period of five years, considerable progress was made, with all political as well as many technical objectives attained. The European risk capital industry is now much larger and more mature and professional than before the RCAP was launched. The European risk capital markets can now be considered strong as far as the buyout segment is concerned, but venture capital in early-stage investment still requires attention.

… and the financial services action plan nears completion

By the end of 2004, the legislative phase of the financial services action plan (FSAP), aimed at completing the internal market for financial services, was nearly completed. Of the 42 original legislative and non-legislative measures, 39 have now been adopted at EU level. Two of the three remaining measures (the third capital adequacy directive and the 10th company law directive on cross-border mergers) are under discussion in the Council and the Parliament, while a proposal for the third measure (14th company law directive on transfer of seats) is under preparation. Of the FSAP measures already adopted, 23 are directives that have to be transposed into national laws. The deadline for full transposition has passed for 13 of them and infringement procedures have been launched in some cases. The rate of transposition has varied by directive and by Member State. Some of the early FSAP directives are close to full transposition, while the directives with the greatest problems in terms of transposition include those relating to the reorganisation and winding-up of insurance undertakings and money laundering. Overall, the transposition rate of the directives has been sufficient, with some countries (notably Denmark, Italy and Austria) doing relatively well.

Special mention should be made of the efforts made in the new Member States in the area of regulatory reform of the financial sector. These Member States were required to adopt the EU *acquis* before 1 May 2004; almost full compliance was achieved in respect of the free movement of capital and company law, while some of these Member States have retained specific transitional arrangements in relation to the freedom to provide financial services. It should be noted that many of the new Member States have also worked very hard to ensure timely transposition of FSAP directives.

With the FSAP near completion, the focus is now turning to the next phase of EU financial integration. The Commission has launched a wide consultation exercise to take stock of the progress made in financial integration and to identify remaining gaps. Meanwhile, the Council has provided an indication of its priorities for the next phase of financial integration. Alongside the input from the Council and the recommendations made

Box 3: **Progress in developing the risk capital market**

In November 2003, on the occasion of the discussion on the final RCAP progress report, the Ecofin Council requested to be informed about the progress in developing the risk capital market 'in the context of the annual Commission report to the spring European Council'.

In 2004, the Commission made further steps in support of the development of the European risk capital market.

Firstly, in view of the possible implications of the proposed recast capital adequacy requirements for banks and investment firms, the Commission presented a proposal fully taking into account the concerns of risk capital providers. The proposal acknowledges the benefits from diversification inherent in venture capital and private equity funds and proposes accordingly lower capital requirements. The implications of the implementation of the international accounting standards (IAS) on risk capital providers are also being assessed.

Secondly, in the context of identifying possible obstacles for investments by institutional investors (pension funds) in venture capital funds, research carried out by the Commission services showed clear differences in the profitability of venture capital investment in Europe and the United States. The lower European profitability than in the US venture capital industry is particularly notable in the case of early-stage investing.

Thirdly, the Commission is preparing a proposal for the successor programme to the multiannual programme (MAP) for enterprise and entrepreneurship containing also Community financial support for investments into early-stage SMEs and innovative as well as high growth potential companies in their expansion phase. The measures of the new programme will aim to support innovation and enterprise competitiveness.

Furthermore, it should be noted that the Commission communication on State aid and risk capital is in the process of being evaluated as to the appropriateness of State aid rules in relation to early-stage venture capital investment. A revised communication is scheduled to be presented in 2005.

by the high-level group on the mid-term review of the Lisbon strategy (the so-called Kok group), the consultation exercise will help the Commission in the choice of priorities for the future which it is to present in the first half of 2005.

Clearing and settlement systems are still to become better integrated …

In line with the high priority assigned to improving clearing and settlement systems in the EU, the Commission issued a communication in May 2004 presenting proposals on how to foster an integrated, safe and efficient post-trading environment for EU securities markets. Further to this, a high-level group of experts ([1]) has been established to advise the Commission and to coordinate action by the private sector on removing the so-called Giovannini barriers for which the private sector would bear responsibility. Meanwhile, further initiatives were taken in 2004 by Member States which should improve the effectiveness of their clearing system (Italy) and settlement systems (improvement of operations on the dematerialised securities system (Greece), introduction of a new electronic settlement system (Italy) and a new securities register (Poland), and efforts to establish central securities depositories (CSDs) (the Czech Republic and Slovakia), as well as open their systems to outside links (Slovenia)). In addition, consolidation among EU clearing and settlement providers continued in 2004 with the merger of the Swedish and Finnish CSDs.

… while various targeted domestic measures have been taken to improve markets' efficiency

These measures have been complemented by various Member States' initiatives to increase the efficiency of their financial sectors. Measures have been taken, for instance, to support financial innovation (e.g. measures to support the development of hedge funds, mortgage bonds or commercial paper issuance (Germany and France,), facilitate securitisation (Germany, France and Luxembourg), and reform savings schemes (the Czech Republic and France)), to improve competition (measures to abolish banks' monopoly in accepting deposits

([1]) The so-called Cesame group (Clearing and Settlement Advisory and Monitoring Expert Group).

and new legal framework for covered bonds (Sweden)), and to improve efficiency (rationalisation of the stock exchange (Cyprus), launch of its privatisation process (Poland), gradual withdrawal of illiquid securities from the stock market and relicensing of securities brokers (Slovakia)). However, further reforms are necessary, particularly in several of the less developed financial sectors of the new Member States.

Business investment has suffered a cyclical decline and …

Recent developments in business investment seem to indicate that the environment for enterprises has not improved as business investment declined from 18.4 % of GDP in 2000 to 16.8 % in 2003. Due to the economic catching-up and inflows of FDI (foreign direct investment), the level of business investment in 2003 was marginally higher in the new Member States. Those countries also experienced lower declines over the period 2000–03, with Estonia, Latvia and Slovakia even increasing their levels of business investment.

This was also the case in Greece, even though 2003 inflows of FDI were relatively limited (0.3 % of GDP). The 2004 update of the BEPGs emphasised that, for the new Member States, sustaining a high level of FDI is an essential element of the transition towards higher value added activities, as it encourages knowledge and technology diffusion. In 2003, FDI inflows as a percentage of GDP were relatively high in Estonia (9.9 %), Cyprus (6.6 %) and Malta (7.9 %).

… regulatory reform can contribute to its recovery

The purpose of regulations is to correct market failures and/or to protect the interests of individuals, businesses, government and society as a whole. Labour and environmental regulations, for example, are important to protect consumers and vulnerable social and economic groups and preserve the environment. Nevertheless, the cumulative impact of such regulations may impose substantial economic costs, at least in the short run. In order to avoid too high a regulatory burden on business, it is essential that regulations are well designed and proportionate.

The four presidencies' initiative ([1]) has made regulatory reform a priority over the course of 2004–05. The initiative is aimed, in particular, at simplifying regulations and reducing the administrative burden on business. The Commission and the European Council are supporting the development of a common approach to measuring administrative burden, which could be used to assess the national and Community regulations.

Business framework conditions appear to be improving

Economic regulations that act as a barrier to market entry can be especially damaging. The observation that it is easier to start a new business in the United States than in most EU Member States (even if the situation has improved markedly over recent years) is particularly relevant in this respect. In the United States, entrepreneurial activity is more dynamic than in the EU.

According to the World Bank, it takes five days to start a business in the United States, while in the EU it takes an average of 36 days. However, business framework conditions in the EU appear to be improving as governments (in countries such as Belgium, France, Hungary, Poland and Slovakia) are making an effort to reduce the time and costs required for setting up a company, to streamline corporate taxation and to provide services via the Internet. A recent study identifies the Nordic countries as leaders in e-government with, for example, Italy and Portugal lagging behind ([2]).

Further steps made to strengthen corporate governance …

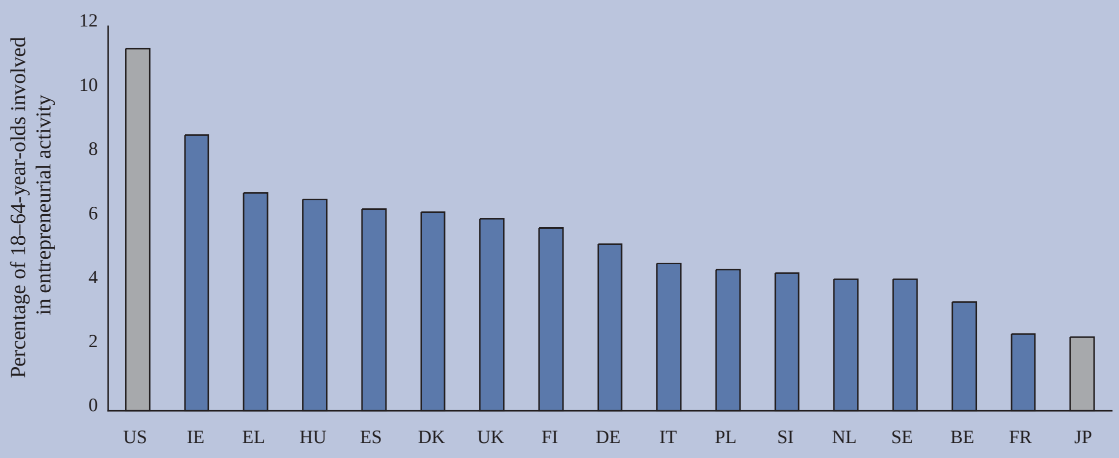
Several corporate scandals in the last few years have underlined the need to have clear and appropriate corporate governance arrangements both at national and at EU level. After the publication of the action plan on corporate governance in 2003, the Commission took several initiatives in 2004:

- adoption of recommendations on the role of (independent) non-executive or supervisory directors in listed companies and on the remuneration of directors;
- launch of a public consultation on the issue of shareholder rights;
- adoption of a proposal for a directive to modernise statutory audits within the EU, introducing new

([1]) On 26 January 2004, the Irish, Luxembourg, Dutch and UK presidencies launched a joint initiative on regulatory reform with a letter from their finance ministers (http://www.finance.gov.ie/documents/pressreleases/2004/janmcc12462.pdf).

([2]) Accenture (2004), 'E-government leadership: High performance, maximum value', May.

Graph 11: **Total entrepreneurial activity, 2003**



Source: Global entrepreneurship 2003.

requirements on how audits are conducted and on the structures needed to ensure audit quality and trust in the audit function;

- proposals for revisions to directives to establish collective board responsibility for financial and key non-financial statements and to enhance overall transparency in financial reporting;

- creation of a European corporate governance forum to encourage the coordination and convergence of national codes. The forum will meet for the first time in early 2005.

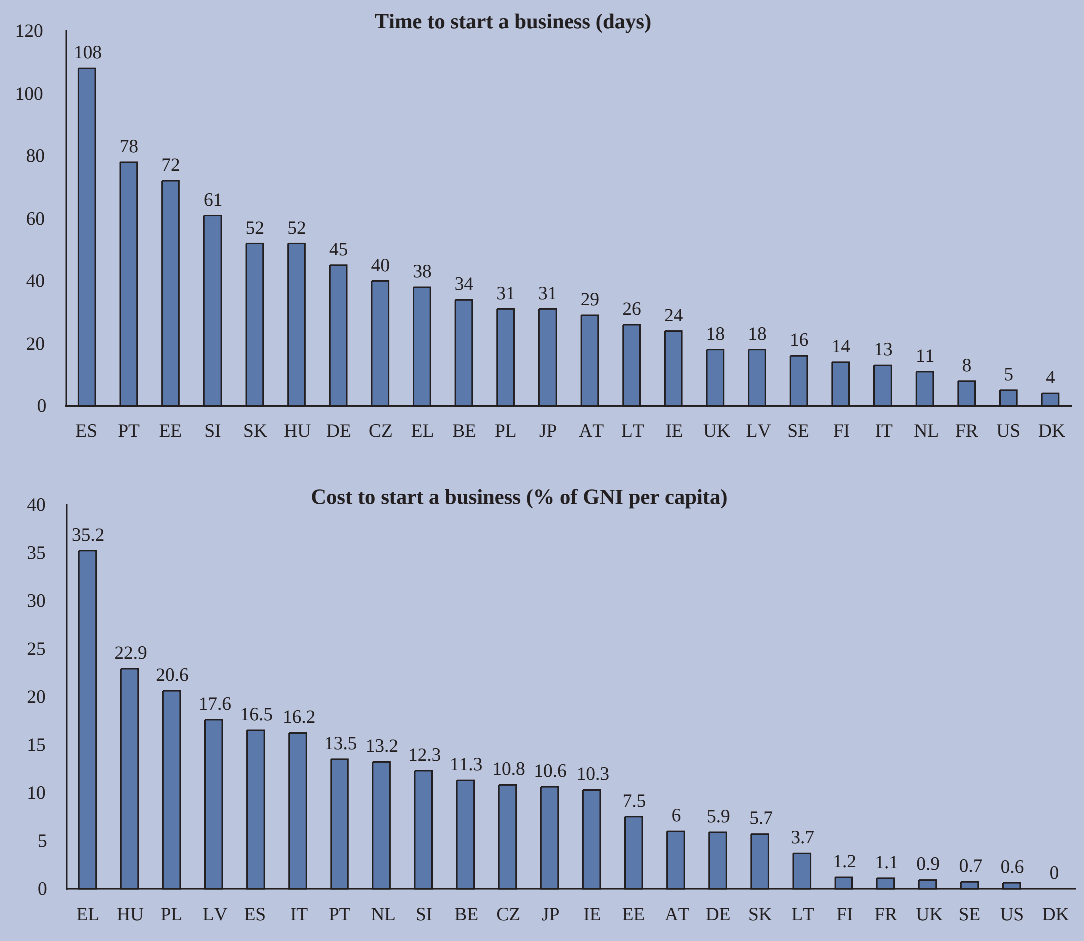
Member States have also taken further steps to strengthen their corporate governance arrangements. Among these initiatives are measures to improve the general standards for corporate governance and transparency (the Czech Republic, Spain, Ireland and Cyprus) as well as more targeted measures focusing on investor protection and independence of supervisory board members and/or auditors (Germany, France, the Netherlands and Poland).

... and financial supervision

Reflecting the progressive blurring of activities conducted by various sectors of the financial system, several Member States have continued to improve cross-sectoral arrangements for supervision. In 2004, the Czech Republic and Slovakia began vesting all competences for supervision of financial markets and institutions in a single authority, in line with the model already adopted in 10 of the other Member States ([1]). The Netherlands has carried on with the adoption of the legislative framework necessary for its new cross-sectoral functional supervisory model (one institution responsible for macro- and micro-prudential supervision, and one responsible for all conduct-of-business supervision). Belgium has merged its banking and insurance supervisors, while an advisory Financial Services Authority Supervisory Board was set up in March 2004. In Portugal, the National Council of Financial Supervisors extended its responsibilities with respect to cross-sectoral cooperation. In Cyprus, the memorandum of understanding between the banking, securities and insurance supervisors was extended to the supervisor of cooperative societies. France has carried on with the streamlining of its sectoral supervisory system. Several Member States (Germany, Greece and Sweden) have strength-

([1]) The 10 Member States concerned are Denmark, Germany, Estonia, Ireland, Latvia, Hungary, Malta, Austria, Sweden and the United Kingdom. Arrangements are not strictly uniform, as major differences remain among these countries in terms of relationship with the central bank and in-house organisation.

Graph 12: **Business start-up conditions in 2004**



Source: World Bank, 2004.

ened their supervisory arrangements in respect of the insurance and re-insurance sectors, including with respect to improved cross-border cooperation (Poland).

Further progress was made in cross-border supervisory cooperation, with the signature of a cooperation agreement between the Bank of Lithuania and the Swedish financial supervisory authority, the strengthening of common Nordic supervision, and the signature of cross-border cooperation agreements between the Austrian financial markets authority and its Slovak and Czech counterparts. In addition, both the Slovenian securities market agency and the Hungarian supervisory authority have concluded cooperation agreements with several of their counterparts. Significant steps were taken at EU level, in particular the extension to all financial sectors of the so-called Lamfalussy approach.

A widening gap between the EU and the United States in terms of R & D and innovation …

There remains a substantial gap between the EU and the United States in terms of innovative capacity as measured by R & D spending, the number of patent applications, venture capital and IT expenditures. Since 1999, R & D expenditures in the EU-15 Member States have increased only marginally, only approaching 2 % of GDP in 2002, which makes the Barcelona target of 3 %

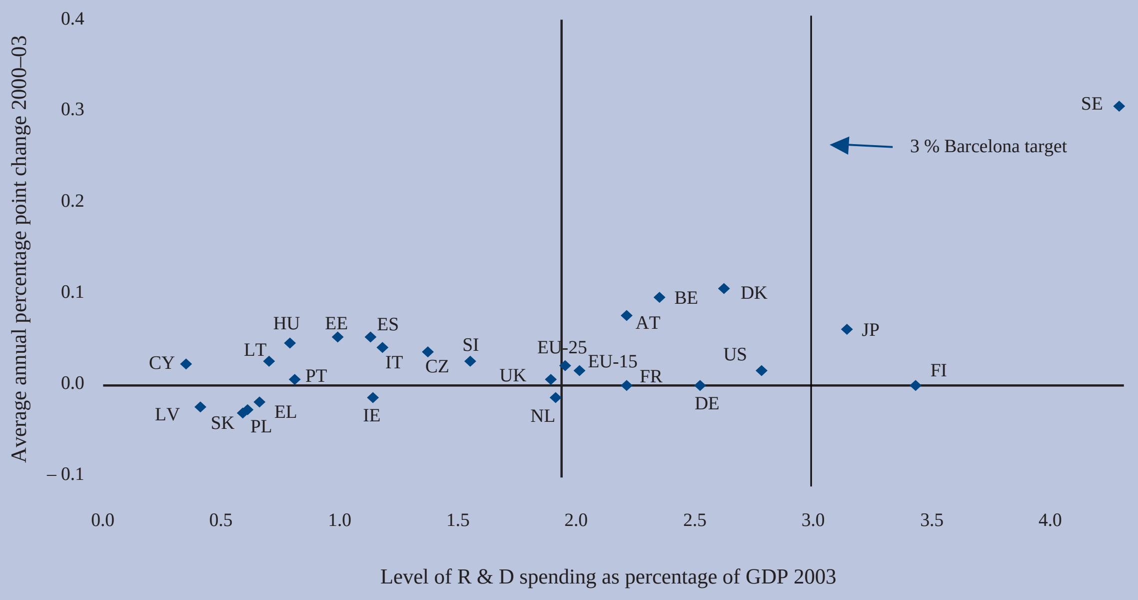
virtually impossible to meet. Greece, Ireland and the Netherlands, however, have even recorded a decline in R & D spending since 1999. In Finland and Sweden, on the other hand, R & D expenditures as a percentage of GDP remain above that in the United States. Since the Barcelona summit, nearly all Member States have adopted national targets for increased public and private investment in research. In response to the 2003–05 BEPGs, Greece, Spain, Ireland, the Netherlands, Austria and Portugal have taken measures to improve the framework conditions for business investment in R & D and innovation, but progress in Italy has been more limited. The new Member States spend less on R & D (0.8 % of GDP) than the EU-15 members, but may make up for this disadvantage by benefiting from knowledge diffusion through FDI or innovation networks.

Several factors appear to have played a role in the widening gap between the EU and the United States in R & D and innovation: a shortage of government and EU funds for research and postgraduate education, which, moreover, is very dispersed across the different fields; a fragmented, less competitive and less than stimulating environment for researchers; an insufficient focus on excellence in research and education; a lack of mobility of researchers, and insufficiently attractive European career perspectives for researchers; insufficient science–industry links; the absence of an affordable and legally certain Community patent; and a relative shortage of risk capital in the euro area. All these factors make the United States a more attractive place to do research.

… but rapidly rising Internet access and use

The *e*Europe action plan has been instrumental in raising Internet access and use. The percentage of EU households with Internet access at home rose from 18 % in 2000 to 41 % in 2003 with Denmark, the Netherlands and the United Kingdom leading the ranking and Greece, Spain and Portugal being at the bottom. Moreover, 87 % of enterprises with more than nine employees had Internet access in 2003, which was a 17-percentage-point increase over the last two years. Similarly, broadband Internet access per 100 inhabitants has increased significantly, reaching 6.0 % in 2004. This is, however, still less than in the United States which recorded 8.7 %. Amongst EU Member States, the highest access rates were recorded in Belgium, Denmark, the Netherlands, Finland and Sweden.

Graph 13: **Evolution of R & D spending, 2000–03 (or latest available period)**



Source: Commission services (Eurostat, structural indicators).

Mixed messages on education and training

The latest statistics for 2001 indicate a slight increase in public spending on education and training in the EU, but levels vary significantly between countries (from over 7 % of GDP in Denmark and Sweden to under 4 % in Greece and Luxembourg). Private spending is important in only a few Member States (Germany, in particular), and overall it is low compared with that in the United States and Japan.

When looking at rates of participation in education and training, a somewhat more positive message emerges. Adult participation in lifelong learning has seen a steady increase since 2001 (7.9 %) to the current level of 9 %. Nevertheless, the 2010 objective of achieving a 12.5 % rate of adult participation remains difficult. Moreover, participation remains low in many Member States (the Czech Republic, Greece, Italy, Lithuania, Malta, Portugal and Slovakia), varying widely by age and attainment level. The target set for the EU for 2010 that 85 % of 22-year-olds should have completed upper-secondary-level education also represents a major challenge. The EU average (76.7 % in 2003) has hardly progressed since 2000 and wide disparities exist between Member States (see Graph 14). Women generally have higher attainment levels than men.

Despite recognition of the importance of reducing the number of early school-leavers, action is often piecemeal. Most policies consist of special measures to support the most vulnerable students outside the mainstream education system. The proportion of early school-leavers decreased slightly to 16 % in 2003, which is still well above the 2010 target of 10 %. In eight Member States (the Czech Republic, Germany, Estonia, Spain, France, Cyprus, Hungary and Slovakia), rates have increased since 2002. Progress towards the EU target depends critically on progress in Spain, Italy and Portugal, where levels are significantly above the EU average. Significant falls occurred in the Member States with the highest rates, notably Portugal and Malta (with levels still above 40 %).

Creating room for manoeuvre to redirect expenditure requires further reforms to face the budgetary impact of ageing

One of the ways to strengthen the public sector contribution to growth is by redirecting spending towards growth-enhancing, cost-effective investment in physical and human capital. However, changes in the composition of public finances are difficult to achieve in the short term. Table 4 presents the data currently available for the functional classification of public expenditure

Graph 14: **Youth educational attainment level, 2004**

NB: Lisbon target for total employment is to achieve 70 % on average by 2010.
Source: Eurostat.

Table 4

Composition of public expenditure (percentage of overall public expenditure), EU-15 excluding Spain

	1995	2000	2002
Economic affairs (1)	13.0	8.2	8.4
Education	9.8	10.8	10.8
Health	11.6	13.5	13.9
General public services (2)	15.5	13.9	14.3
Social protection (3)	38.0	41.2	40.7
Others (4)	12.0	12.4	11.9

(1) Includes agriculture, industry, energy and transport.
(2) Includes interest payments.
(3) Includes pensions.
(4) Includes defence, public order and safety.

Source: Commission services.

for the EU-15 excluding Spain. It shows that social protection is the largest expenditure category, followed by general public services and health. Changes for the period 2000–02 are relatively small. For the period 1995–2002 as a whole, the figures show an increased share of expenditure on social protection and health, while expenditure on economic affairs and general public services decreased its share in total expenditure. Agreed long-term projections on the impact of ageing, which are based on a no-policy-change scenario, imply further relative increases in public expenditure mainly on pensions and health. Therefore, in order to create room for redirecting public expenditure towards high-priority areas, expenditure control and further reforms to face the budgetary impact of ageing are essential (1).

An integrated approach towards the contribution of public finances to growth requires that tax structures should also be directed towards strengthening the growth potential by promoting employment creation and investment.

Empirical analyses suggest that the long-term trends in tax revenues and current spending (especially welfare spending) are to some extent both driven by the same demographic factors, namely dependency ratios. In other words, taxes have been increased to finance increasing levels of spending and, in particular, labour taxes appear to have been rising steadily in industrial countries in order to finance welfare spending, especially pensions, healthcare and other social benefits. The tendency, however, has been reversed in the EU-15 Member States since 1996. In recent years, the overall tax revenues as a percentage of GDP have also declined slightly (see Table 5).

Long-term decline in public investment appears to have ended

Analysis of public investment should focus on the evolution of expenditure on growth-enhancing extensions of the public capital stock (net investment). However, data is presently only available for gross public investment expenditure, which is a crude measure of investment in physical capital while ignoring the importance of human capital. For the Union as a whole, gross public investment (as a percentage of GDP) — having been on a downward path since the 1970s — was largely stable between 2000 and 2004 at around 2½ % of GDP. Over the period 2000–04, however, public investment increased significantly (more than 0.2 % of GDP) in 10 Member States (see Graph 15). Related to the process of ‘catching-up’, increases of over 1 % of GDP were recorded in the Czech Republic, Malta and Poland, while a large increase is also visible in the United Kingdom, albeit from a relatively low base. In contrast, public investment as a percentage of GDP decreased in some Member States, most importantly so in Portugal (– 1.4 % of GDP) and Germany (– 0.4 % of GDP).

(1) Monitoring the functional composition of public expenditure is hampered by the lack of detailed (and actual) data also covering categories such as R & D and pensions. In 2004, a project started in cooperation with Eurostat to improve data collection. This will allow further analysis of trends in public expenditure.

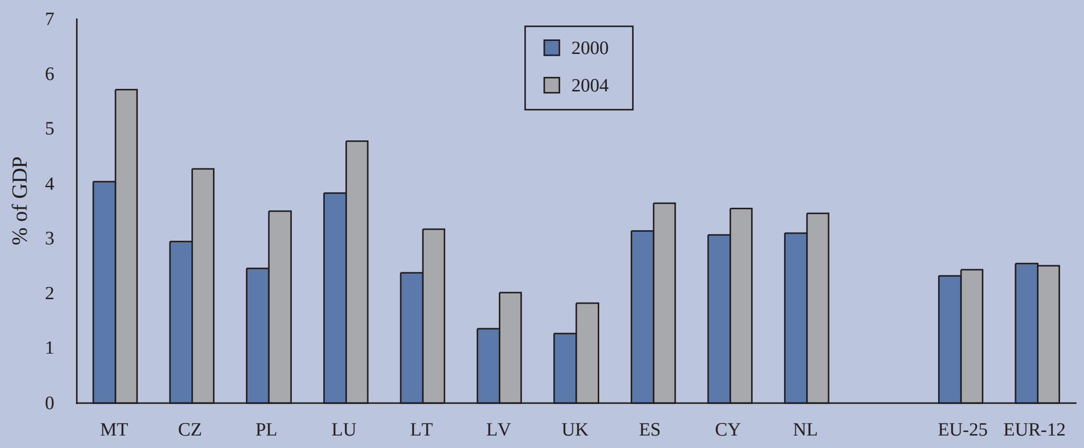
Table 5

Composition of total revenues as a percentage of GDP

	EU-25		US		JP	
	2000	**2004**	**2000**	**2004**	**2000**	**2004**
Direct taxes	14.0	12.7	15.4	11.4	8.6	7.6
Indirect taxes	13.7	13.6	7.3	7.2	8.4	8.1
Social contributions	14.3	14.2	7.2	7.0	9.8	10.2
Other	4.5	4.7	4.4	4.2	5.3	5.3
Total revenues	**46.5**	**45.1**	**34.2**	**29.8**	**32.2**	**31.1**

Source: Commission services.

Graph 15: **Increases in public investment, 2000–04 (ranked by percentage point of GDP increase in investment)**



Source: Commission services.

Increasing efficiency and controlling expenditure: still room for improvement

In order to enhance public sector efficiency, several Member States have introduced mechanisms for controlling public expenditure and reforms to the budgetary process that aim at better linking public expenditure to policy outcomes.

Expenditure rules can help Member States to respect the budgetary requirements of the EU fiscal framework, by better controlling expenditure categories that are subject to overruns, while at the same time reallocating expenditure towards high-priority items. The effective control of aggregate categories of expenditure is a precondition for reforms of performance budgeting that shift the focus from money spending to policy outcomes. Such reforms may improve the efficiency and effectiveness of the use of scarce resources so that savings can be achieved, while at the same maintaining improved performance in achieving policy objectives. In this respect, the available empirical data indeed confirm that countries with more effective medium-term expenditure frameworks are also more advanced in introducing institutional reforms related to perform-

Box 4: **Progress in implementing the European growth initiative**

The European growth initiative, endorsed by the European Council in December 2003, stressed the role of public investment in key transport infrastructure to strengthen the interconnectivity of networks and thus the dynamics of the internal market. It includes, *inter alia*, accelerated public investment in a quick-start list of 30 more or less mature transport projects of European relevance, which are part of the TEN transport priorities approved by the Union in April 2004. The information available shows that national public investment plans have been unevenly affected, though it is still too early to have a complete view of the impact of the initiative. While there is little evidence of an overall acceleration in investment, the implementation of transport projects in the quick-start list in 2004 proceeded more or less in line with plans. In most cases, it consisted more of upgrading existing national infrastructure (mainly railway lines) than starting construction work for new infrastructures; only one new TEN transport infrastructure project actually started in 2004 (the Perpignan–Figueras railway line) as well as a new TEN energy project concerning the reinforcement of electric interconnections between France and Belgium (Avelgem–Avelin). In some cases, notably for large-size cross-border projects such as the Brenner tunnel and the Lyon–Turin rail link, which were put on top of the agenda by the quick-start list, implementation has proceeded less quickly than initially planned due to technical delays, ambitious time frames or difficulties in mobilising the necessary funding.

ance budgeting ([1]). Recommendations to ensure or improve expenditure control were addressed in the 2003–05 BEPGs to Denmark, Greece and Finland, while Ireland and the United Kingdom were requested to ensure or enhance public sector efficiency.

Ireland extended the system of multiannual spending envelopes from public transport to all areas of capital spending and adopted measures to improve the efficiency and control of expenditures notably in health and infrastructure spending.

2.3. Strengthening sustainability

2.3.1. Economic sustainability: three-pronged strategy only partly implemented

Government debt ratio has not started to decline

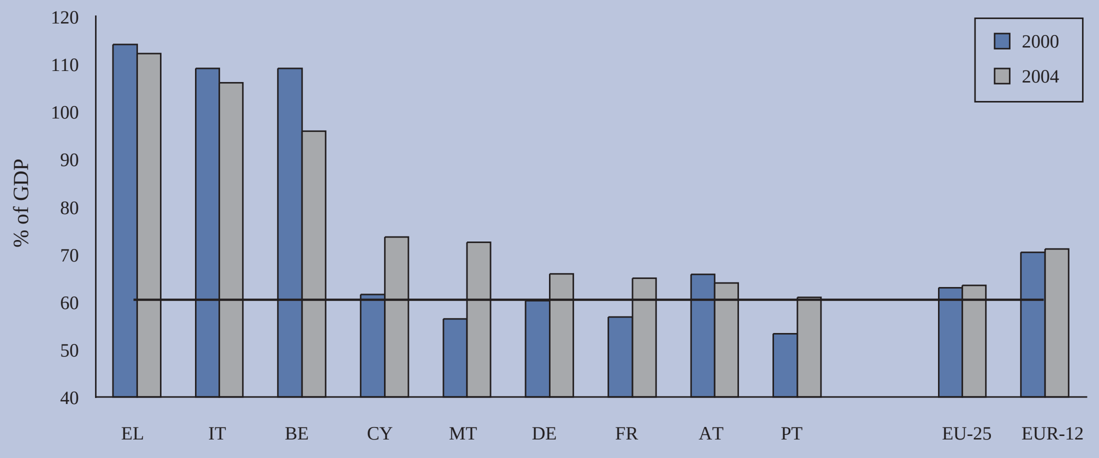
After a small decline at the beginning of the decade, government debt (as a percentage of GDP) has increased again since 2002 and remains, on average, above 60 % of GDP. According to the Commission's autumn 2004 economic forecast, nine Member States are expected to have had debt ratios exceeding the 60 % reference value in 2004 (see Graph 16). The debt level in Greece, Italy and Belgium stands out in the EU-25, although Belgium achieved a strong decline in the period 2000–04 by almost 15 percentage points. In the same period, debt also declined significantly in Spain and Ireland, while strong increases occurred in the Czech Republic, Germany, France, Portugal, Malta and Poland.

This development should be seen in the context of the pressures on public finances stemming from ageing populations. According to the recent Eurostat 2004 population projections, already in the period 2003–25 the working-age population is estimated to decline by 10 million persons or 3 %, although the total population is expected to increase by 17 million persons or almost 4 %. After 2025, the total population would start to fall from 468 million in 2025 to 447 million by 2050, while the working-age population would decrease from 295 million to 252 million by 2050. At the same time, the population aged 65 and above would double in size from 76 million in 2003 to 135 million in 2050.

As a result, the old-age dependency ratio (persons aged 65 or above to persons of working age 15–64) is projected to double from 25 % in 2003 to over 50 % in 2050. This development is expected to result in a substantial burden on public spending on age-related items, in particular on pensions, healthcare and long-term care. To address the economic and budgetary consequences of ageing, the Stockholm European Council decided that a three-pronged strategy should be followed, focusing on increasing employment rates, reduction of public debt, and reforming pension and healthcare systems.

([1]) See European Commission (2004), 'Public finances in EMU — 2004', Part IV 'The quality of public finances', *European Economy* No 3.

Graph 16: **Government debt ratio for Member States exceeding the 60 % reference value**



Source: Commission services.

Against this background, the 2003–05 BEPGs recommended Member States to:

15. ensure a further decline in government debt ratios;

16. design, introduce and effectively implement reforms of pension systems.

So far, the sustainability of public finances in view of the ageing population is far from secured in the majority of the Member States, notably in Belgium, the Czech Republic, Germany, Greece, Spain, France, Italy, Cyprus, Hungary, Malta, Poland, Portugal, Slovenia and Slovakia.

A stronger commitment to reduce debt ratios is needed in several Member States

In 2004, the debt ratio declined or was kept unchanged in almost half of the Member States. On the basis of unchanged policies, the Commission's autumn 2004 economic forecast projects that over the period 2004–06 not one of the nine Member States exceeding the 60 % of GDP reference value in 2004 will achieve this reference value. Further significant declines are foreseen in Belgium and Spain, while in most Member States the debt ratio is either declining slightly or even showing a moderate increase (see Part II for further details). As a result, the debt ratios in some countries, such as Hungary and the Netherlands, are increasing towards the 60 % of GDP reference value.

In the EU as a whole, the current trends show an unsatisfactory rate of reduction of debt ratios. No progress has been made in bringing debt ratios down sufficiently before the full impact of ageing takes place. While the development of the debt ratios is linked to weak economic growth in recent years, it is also a reflection of the lack of progress made in reducing budget deficits (as was already noted in Section 2.1.2).

Pace of pension reform has varied substantially across the Member States concerned

Although major pension reforms have already been adopted in some Member States and further reforms are heavily debated in a number of countries, additional measures are required in many Member States. It is essential to move away from offering generous early-retirement pathways, especially so in economic downturns or to cope with economic restructuring, in order to tackle reforms of the standard retirement age, and replacement rates of pension entitlements, as well as adjusting pension benefits in case of early retirement in a way that ensures a better linking of benefits to contributions over the whole life cycle. In total, 11 Member States received country-specific recommendations concerning the reform of their pension systems (Belgium, the Czech Republic, Germany, Greece, Spain, France, Italy, Austria, Poland, Portugal and Slovakia) ([1]).

Compared with the assessment in the first implementation report when significant progress was noted, the record of the efforts to implement reforms of pension systems in 2004 is mixed. In several countries (e.g. France and Austria), where important pension reform measures were implemented in 2003, supplementary measures were introduced in 2004. In some countries, reforms were aimed broadly at monitoring and adjusting the implementation of the reforms. At the same time, however, further pension reform measures in some countries introduce long transition periods; moreover, newly finalised measures still provide incentives to retire early.

While in some countries, pension reform measures are under way …

Italy made an important step in 2004 towards securing a more sustainable pension system. However, while the reform will tighten the eligibility criteria for pensions, the development of the privately funded pension pillar will require stronger incentives. Germany continued to overhaul its pension system by improving the financial balance of its public pension scheme and increasing incentives for retirement saving. Nevertheless, incentives for later retirement were only partially strengthened and an increase in the statutory retirement age beyond 65 was postponed. In Austria, the ambitious reform law of 2003 was modified by the new draft in several aspects. This modification includes new provisions which, contrary to the previous objectives of the reform, (i) do not result in a harmonised pension system and (ii) introduce the possibility for early retirement.

([1]) Box A5 in the annex provides an overview of the measures adopted and proposed in 2004 as regards these country-specific guidelines.

In France and Portugal, the implementation of the reform measures introduced in 2003 continued, and, in the latter, this included fine-tuning of some measures or extending the coverage of others. In Slovakia, where major reform measures were adopted in 2003, a sizeable funded pension pillar was introduced at the beginning of 2005. In Poland, in addition to close monitoring of the pension system that underwent reform in 1999, additional incentives are being planned for encouraging later retirement. Similar measures were recently adopted in Spain.

In 2004, the retirement age was raised to 62 in Slovakia, and a few Member States (Belgium, Germany and Finland) raised or plan to raise the minimum age of retirement, albeit gradually. Portugal introduced a penalty for civil servants who retire early, and the Czech Republic plans to eliminate further early-retirement pathways in 2006 (see also the follow-up to guideline 16). The Netherlands decided to end fiscal facilities for early retirement in 2006 but, partly due to the long transition period granted, there is a risk that early retirement might not be reduced appreciably in the meantime. However, Austria plans to introduce a ‘corridor’ for early retirement beginning at 62.

… in others, little progress has been made

Pension reform measures that are currently being implemented in Greece seem insufficient for appropriate containment of the budgetary burden related to the budgetary costs of population ageing and should be complemented by additional efforts to reform the pension system. In the Czech Republic, the pension reform plans are only in the initial stage. On the basis of the proposals tabled by an experts’ group, the government plans to make a decision on pension reform by 2006.

2.3.2. Social sustainability

There is a substantial need for both higher (potential) growth and social cohesion in an enlarged EU.

In particular, the necessary restructuring process may have a significant impact on the most vulnerable parts of the population in most of the new Member States.

Poverty and social exclusion across the Union are significant, with more than 15 % of the EU-15 population living below the poverty threshold in 2001. The risk of poverty rate in many of the new Member States is broadly in

Table 6

Selected measures of risk of poverty rates in some new Member States and the EU-15, 2001

(%)

	After social transfer	Before social transfer (1)	Employed	Unemployed
EU-15 (2)	15	24	7	38
CZ	8	18	3	30
EE	18	25	10	47
LT	17	24	14	41
HU	11	17	5	33
PL	15	31	11	37

(1) Pensions excluded from social transfers.
(2) Weighted population average.

Source: Commission services.

line with that of the EU as a whole (see Table 6) [1]. However, the risk of poverty rate masks differences in living conditions across countries.

There is also a wide variation in the risk of poverty rate across countries, ranging from 10 % or less in the Czech Republic, Sweden, Denmark, Hungary and Slovenia to 20 % or more in Ireland, Slovakia, Greece and Portugal.

A strong downward pressure on income differences is exerted by social transfers in all Member States, which reduce the poverty rate by 7 to 10 percentage points on average and even more in Poland. As evidenced in Table 6, employment plays a major role in lifting people out of poverty and social exclusion. Overall, unemployment has tended to rise since 2000 but with diverse evolutions across Member States. Unemployment rose sharply in, for example, Poland (reaching 19.2 % in 2003), whereas it tended to decrease in several of the other new Member States and especially in the Baltic States. These evolutions are mirrored in the long-term unemployment rates, which nevertheless remain relatively high in most new Member States, and in the population in jobless households, although the latter is lower than the EU-15 average in six of the new Member States (see Table 7). Since shifting from unemployment to employment considerably lowers the likelihood of being exposed to the risk of poverty, measures that can facilitate better access to employment, in particular in the fields of education and housing, should be strengthened.

Regional income inequalities have also widened in the enlarged Union. For instance, the 10 richest regions have a GDP per capita which is more than five times larger than that of the 10 poorest regions (compared with an average income which is 3.2 times higher in the 10 richest regions within the EU-15) [2]. Over the period 1995–2001, all the new members experienced a substantial rise in regional inequalities as measured by GDP per capita, largely due to catching-up and the economic restructuring process through a (re)allocation of physical and human capital across regions, while the situation remained broadly unchanged in the EU-15. However, it has not been translated into higher disparities in terms of disposable income, as tax–benefit systems (excluding pensions) tend to play a major role in reducing income disparities. Regional inequalities in household income were reduced by approximately 27.6 % for the EU-25 (see Table 8). While this redistribution effect tends to be larger for the EU-15 countries (– 28.2 %), it is still sizeable for the new Member States (– 24.9 % on average), and in particular for Slovakia (– 35.8 %).

Reforms of social protection systems still piecemeal in most cases

Measures addressing the tax–benefit systems in order to improve participation continued to concentrate on taxes in 2004 (e.g. in Belgium, Denmark, Austria, Slovenia, Finland and Sweden) (see also the follow-up to

(1) The risk of poverty rate measures the share of the population (in per cent) living in households with a disposable income below 60 % of the national median. Thus, the absolute value of the poverty line differs between countries.

(2) Figure for 2001, NUTS 2 regions.

Table 7

Unemployment and population in jobless households

(%)

	Total unemployment (1)		Long-term unemployment (1)		Population in jobless households (2)	
	2000	2003	2000	2003	2000	2003
EU-25	8.7	9.1	4.0	4.0	—	10.2
EU-15	7.8	8.1	3.5	3.3	9.9	9.8
CZ	8.6	7.8	4.2	3.8	7.8	7.7
EE	12.5	10.2	5.7	4.6	9.6	10.9
CY	5.2	4.4	1.3	1.1	5.6	5.2
LV	13.7	10.5	7.9	4.3	15.0	8.7
LT	16.4	12.7	7.6	6.1	9.2	7.4
HU	6.3	5.8	3.0	2.4	13.5	11.6
MT	6.8	8.2	4.6	3.5	7.4	7.9
PL	16.4	19.2	7.6	10.7	—	14.8
SI	6.6	6.5	4.1	3.4	9.0	8.7
SK	18.7	17.5	10.1	11.1	10.9	10.1

(1) Eurostat labour force survey and Economic and Financial Affairs DG.
(2) People aged 18–59 living in jobless households.

Source: Commission services (including Eurostat, structural indicators).

Table 8

Regional inequalities in household income: Gini index using primary and disposable income, average 1995–2001

	(1) Gini index Primary income	(2) Gini index Disposable income	Percentage change (2) – (1)
EU-25	0.098	0.071	– 27.6
EU-15	0.097	0.069	– 28.2
CZ	0.088	0.067	– 23.1
PL	0.102	0.079	– 23.3
SK	0.142	0.091	– 35.8
HU	0.139	0.105	– 24.9

NB: Country groups are weighted (population) averages Gini index computed using average household income in NUTS 2 regions by country. EU-25 excludes Denmark, Estonia, Ireland, Cyprus, Latvia, Lithuania, Luxembourg, Malta, Portugal and Slovenia. Data for the Czech Republic and Hungary concern the years 2000–01, for Poland, 1999–2001.

Source: Commission services (including Eurostat).

guideline 4). In some Member States, changes have also recently been introduced that will reduce non-wage labour costs (Estonia, Hungary, Latvia and Slovakia).

Reforms of the unemployment and welfare-related benefit systems have been less comprehensive. Some Member States have tightened, or will tighten, conditions for the eligibility or duration of benefits (the Czech Republic, Germany, France, Lithuania, the Netherlands, Slovenia and Slovakia). In some cases, the provision of social assistance has been limited (the Netherlands) or reformed to improve work incentives (Slovakia).

Efforts to facilitate access to the labour market of those at a disadvantage are ongoing. Measures to foster the employment of persons with disabilities were either rein-

Against this background, the 2003–05 BEPGs recommended Member States to:

17. take steps to modernise social protection systems and to fight poverty and exclusion with a view to supporting the broad Lisbon objectives;

18. improve the functioning of markets so that they are conducive to private investment in regions lagging behind, particularly by allowing wages to reflect productivity differences;

19. ensure that public support in regions lagging behind is focused on investment in human and knowledge capital, as well as adequate infrastructure, and that investment programmes are designed and administered efficiently.

forced or introduced in 2004 in many Member States (the Czech Republic, Germany, Estonia, Spain, Hungary, Portugal and Slovenia). Pilot schemes are being tested in the United Kingdom. A reform of the disability scheme in 2006 has been decided in the Netherlands.

Other vulnerable groups such as young job-starters or the long-term unemployed are often targeted by changes in tax and social security systems (e.g. Hungary and Slovenia) or by specific packages (e.g. in the Czech Republic and Estonia) or in the French social cohesion plan.

Little action noted to allow wage differences to better reflect productivity and local labour market conditions in order to tackle regional labour market differences

Less policy consideration has been given to regional disparities in labour markets although high regional unemployment and long-term unemployment rates entail risks of social exclusion. Regional differences in both employment and unemployment rates decreased slightly between 2000 and 2003, from 13.4 % to 13 % for the EU-25 and from 13.5 % to 12 % for the EU-15. Disparities in terms of employment and unemployment rates are still sizeable across EU regions, however. For instance, the two regions with the lowest unemployment rates, namely Bolzano (Italy) and Salzburg (Austria), had unemployment rates equal to 2 and 2.3 %, respectively, in 2003, while regions such as Dolnoslaskie and Zachodniopomorski, both located in Poland, had unemployment rates equal to 26.0 and 25.5 %, respectively.

Regional dispersion in long-term unemployment rates varies greatly across countries. Countries such as Greece and Poland, where the national rate of long-term unemployment is relatively high, have, in contrast, lower regional dispersion in long-term unemployment compared with the EU average. In other countries, long-term unemployment seems to be much more concentrated geographically, such as in Belgium, the Czech Republic, Germany and Italy, pointing towards region-specific problems within the domestic labour market.

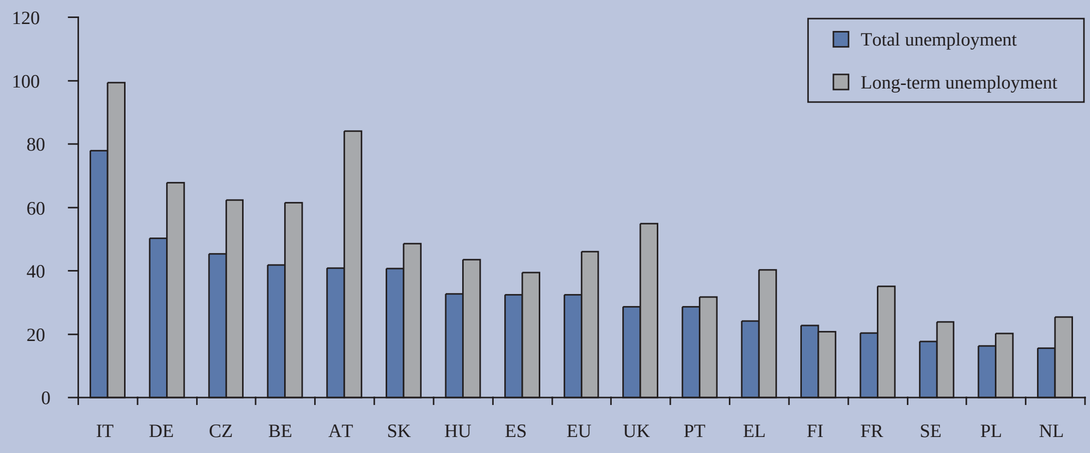
No major initiative was taken in the Member States most concerned to allow wages to better reflect differences in regional and local labour market conditions in 2003 or 2004. In Spain, the interconfederal agreement that allows for elements of flexibility based on sectoral and company conditions was extended to 2004. The government has also announced its intention to strengthen collective bargaining so as to better reflect local as well as firm-specific conditions. In Italy, social partners started talks in 2004 with a view to exploring possible changes to the wage setting mechanism.

Measures taken at both EU and national level to enhance the effectiveness of investments

Steps have been taken by the new Member States to give their public investment mix a more Lisbon-oriented profile. On aggregate, spending on human resources will attract a growing share of total public spending in the period 2004–06, while the share of basic infrastructure will decline ([1]). However, due to the important needs of the new Member States, the latter will still represent more than 50 % of public investments. The EU Structural and Cohesion Funds will contribute some EUR 24 billion at current prices to the '2004–06 economic and social development pro-

(1) According to data on national public structural support including the EU assistance in the so-called lagging Objective 1 regions available from the *ex ante* additionality assessments for the period 2004–06. These data allow for a comparison with recent years (1999–2002).

Graph 17: **Regional unemployment dispersion in EU countries, 2003 (coefficient of variation across NUTS 2 regions)**



Source: Commission services.

grammes' of the new Member States that were formally adopted in June 2004, following an agreement on their content concluded in December 2003.

In the EU-15, some Member States are taking steps to improve the design and management of public investment programmes. In Ireland, a five-year capital investment programme has been introduced from the 2004 budget and the government also continues to encourage public–private partnership. In the United Kingdom, a new strategy is being devised, following a major review in 2004, to increase public sector efficiency: an input-oriented approach should complement the existing focus on output and results. In Denmark, a reform of the structure and allocation of responsibilities in the public sector implies fewer and larger municipalities and the replacement of counties by five regions is being prepared.

In the context of the Structural Fund programmes for 2000–06, two instruments were implemented that aimed at ensuring that resources were spent as effectively as possible. Firstly, mid-term evaluations were carried out and their recommendations considered in the usual mid-term reviews of the Structural Funds. Secondly, the performance reserve linked for the first time performance to financial allocations when national authorities, in close cooperation with the Commission, used a set of indicators targeting effectiveness, management and the take-up of funds as a basis for the allocation. Both instruments contribute to more results-oriented management of the Structural Funds.

As a follow-up to the third report on economic and social cohesion, legislative proposals for the post-2006 Structural and Cohesion Funds were presented in July 2004, which aim at further supporting the Lisbon strategy and at simplifying the Community assistance.

2.3.3. Environmental sustainability

Maintaining a high level of environmental quality may have wider benefits

Environmental policy has as its first goal the safeguarding of the natural environment which is a key determinant of quality of life. Environmental policies can also be a source of competitive advantage for Europe, but this is not automatic. They are more likely to increase competitiveness if they get prices right and so provide opportunities for innovation and the creation of new markets and investment opportunities.

Market-based instruments such as emissions trading schemes, or taxes and charges that internalise the external costs of pollution also help to do this. In this way, they can support structural reforms in other areas as well as yielding environmental benefits.

Against this background, the 2003–05 BEPGs recommended Member States to:

20. reduce sectoral subsidies, tax exemptions and other incentives that have a negative environmental impact and which are harmful for sustainable development. Ensure, *inter alia* through the use of taxes and charges, that pricing of the extraction, the use and, if applicable, the discharge of natural resources, such as water, adequately reflects their scarcity and all resulting environmental damage;

21. reduce subsidies to non-renewable energy and promote market instruments, further broaden the coverage, and ensure appropriate differentiation of energy taxation;

22. adjust the system of transport taxes, charges and subsidies to better reflect environmental damage and social costs due to transport, and increase competition, for example through accelerated regulated market opening, in transport modes such as freight railways;

23. renew efforts to meet commitments under the Kyoto Protocol and implement the EC greenhouse gas emissions trading scheme and set up systems to report on those policies and measures and their prospective effects on emissions. Take measures to reach the targets set by subsequent European Councils, notably on energy efficiency, renewable energy and biofuels.

Mixed progress has been recorded in using market-based instruments such as taxes and charges to give price signals regarding pollution and the use of natural resources …

The Netherlands will launch, in mid-2005, a trading system to cut industrial emissions of nitrogen oxides (NO_x) by over 55 % by 2010. It will be a ‘dynamic baseline-and-credit system’ which will fix a relative ceiling ([1]) for NO_x emissions per unit of energy. This ceiling will be progressively tightened to meet the targets of the NEC directive ([2]) by 2010. Companies that overachieve their relative ceiling can sell emission rights to those that have difficulties in achieving it. The trading system ensures an overall compliance and provides a cost-effective incentive to reduce emissions. However, it remains to be seen how high the transaction costs of the Dutch system are.

In some cases, instruments to pursue other policy objectives induce environmental benefits. An initial analysis of the charging scheme to reduce congestion in central London, which had been introduced in 2003, shows that NO_x and particulate matter emissions from vehicles fell by 12 % in 2004 in that area. The United Kingdom has announced real increases in its landfill tax over the coming years, while Ireland, following the success of the ‘plastic bag’ tax, is considering similar instruments to address other forms of litter. However, Ireland also abandoned its planned carbon tax, apparently because of fears about the impact on poorer households. Portugal has postponed the introduction of such a tax.

… but high oil prices have sent a strong signal to improve energy efficiency and to further develop the market for alternative fuels

The transport sector remains highly dependent on oil — in the case of road transport, almost entirely so, notwithstanding Community targets to increase the use of biofuels. Pure or blended with petrol or diesel, they are a first step to reduce the dependence of the sector on hydrocarbons. Nevertheless, several Member States, including France, Austria, Sweden and the United Kingdom, have adopted tax reductions on biofuels in order to promote their use as road fuels. Although most of the price of petrol and diesel at the pump is made up of taxes, the rise in oil prices has nevertheless had a marked impact on road fuel prices, which should encourage more fuel-efficient vehicles. Some Member States have chosen to reinforce this impact. First analyses from the United Kingdom indicate that modifications in the taxation of company cars that were introduced in 2003 have led to reductions in carbon dioxide (CO_2) emissions of about 200 000 tonnes. Furthermore, Belgium has introduced fiscal incentives to encourage the purchase of cars with low levels of CO_2 emissions per kilometre, while the Netherlands and Aus-

(1) Referred to as performance standard rate (PSR).
(2) Directive 2001/81/EC (OJ L 309, 27.11.2001).

tria have decided to introduce tax incentives for diesel cars that achieve 80 % reduction of particulate matter compared with the current standard. Other Member States are considering similar schemes. Road pricing measures for heavy lorries remain implemented in a poor and fragmented way due to delays in setting up a Community framework for infrastructure charges that would encourage the integration of external costs.

More generally, the high oil prices experienced during 2004 will — if sustained — help encourage greater energy efficiency and boost investment in low-carbon energy sources provided that Member States do not react by adjusting fuel taxes, so weakening the price signal. However, a number of Member States have reacted in precisely this way, in spite of the Commission's opposition. Hungary and Slovenia have reduced excise duties, while Latvia and the United Kingdom have delayed previously foreseen duty increases. Other Member States have announced support for specific sectors (fishermen and farmers in France and Spain) and households in Belgium.

Market-based measures taken to encourage energy efficiency include increased income tax rebates in Belgium for investments in energy efficiency in the household sector, while Italy has introduced a system of tradable 'white certificates' for energy efficiency improvements, analogous to the 'green certificates' that some Member States have already introduced in favour of renewable energies.

Denmark has restructured its support for renewable energy sources, replacing obligations for the purchase of renewable energies with a system of subsidies specific to different types of renewable energy. In its recent communication ([1]), the Commission concluded that unless more active and effective policies are put into place, the indicative target on electricity from renewable energy sources will not be achieved. Four countries — Denmark, Germany, Spain and Finland — are on track for achieving the non-binding renewable electricity targets.

Market opening is gaining ground and making freight railways more competitive

Rail freight market opening began in March 2003 on the majority of the international lines. Regulated competition will increase quality and will raise confidence in railways among industrial users. All new Member States have notified implementation measures except for Slovakia and the Czech Republic (only partly). Infringement procedures for non-communication of implementation measures are under way against Germany, Greece, Luxembourg and the United Kingdom. Infringement procedures for non-conformity of the implementation measures have been started against Belgium, Spain and the Netherlands. Effective competition on the rail freight market exists in Denmark, Germany, Italy, the Netherlands, Sweden and the United Kingdom.

Preparations to tackle climate change intensified in 2004 …

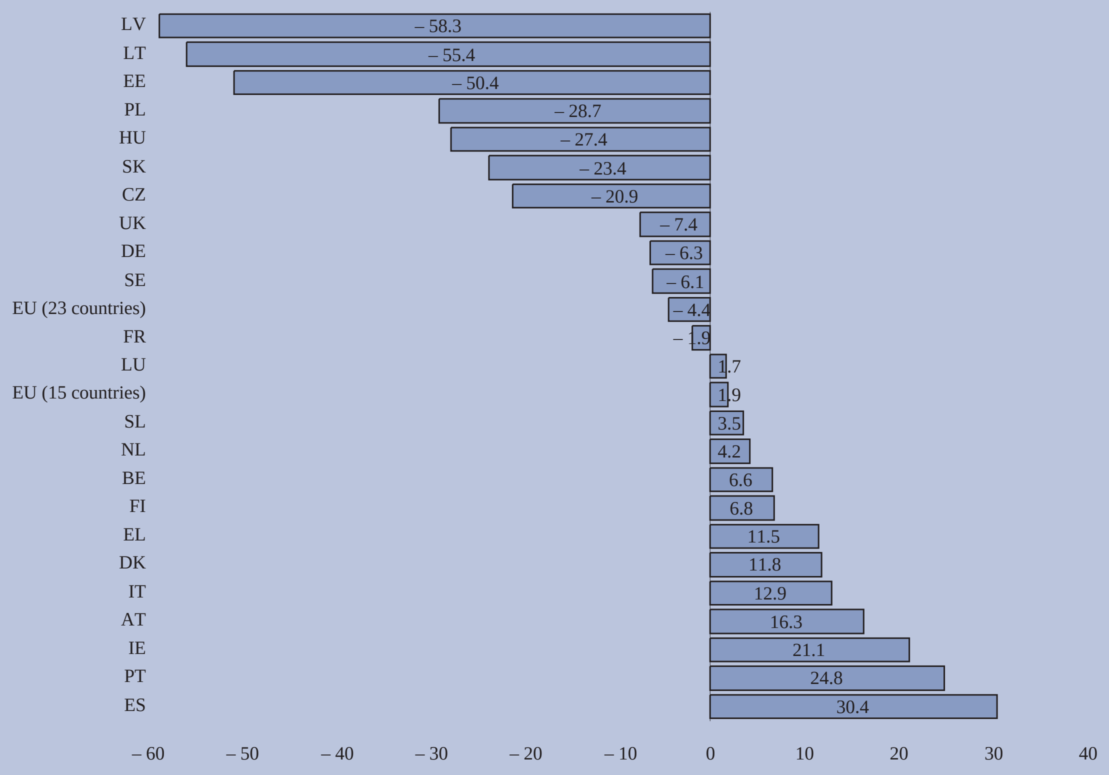
Russia's decision to ratify the Kyoto Protocol to the UN Framework Convention on Climate Change — essential for the protocol to take effect following the United States' withdrawal from the protocol — has added urgency to the EU's efforts to put into place effective policies and measures to reduce greenhouse gas emissions, as it removes any residual doubts about the existence of internationally binding greenhouse gas emission constraints.

Considerable efforts have been made to ensure that the Community greenhouse gas emissions trading scheme started on 1 January 2005. In particular, although few Member States had met the legislative deadline of 31 March for submitting their draft national allocation plans under the Community greenhouse gas emissions trading scheme, nevertheless, by the end of 2004, all Member States had submitted plans, and the Commission had approved the allocation plans of 21 Member States. Combining the figures from these plans sets the overall limit on the quantity of carbon dioxide which the companies covered by the directive can emit. All these companies — covering some 40 to 45 % of Community greenhouse gas emissions — will regularly have to surrender emission allowances corresponding to their actual carbon dioxide emissions. Ahead of this date, an active forward market in emission allowances had already emerged.

Several Member States have also advanced their preparations to acquire additional tradable units under the Kyoto Protocol thus substituting reductions via domestic policies in the first commitment period by funding greenhouse gas abatement projects in other countries, under the so-called 'clean development' and 'joint

([1]) Communication from the Commission to the Council and to the European Parliament 'The share of renewable energy in the EU' (COM(2004) 366 final).

Graph 18: **Distance-to-target indicators for the Kyoto Protocol and the burden-sharing targets of EU Member States**



Explanatory note : the distance to target indicator measures in percentage points how close current emissions are to a hypothetical linear path to the Kyoto target for 2008–12, assuming only domestic measures are used and taking base year emissions as the emissions of the year 1990. A negative value indicates emissions are ahead of target; a positive value indicates that the country is not on track to meet its Kyoto commitment.
([1]) Malta and Cyprus do not have targets under the Kyoto protocol.
Source: Commission services.

implementation' mechanisms established under the Kyoto Protocol.

In this context, the Council and the European Parliament adopted the directive to allow companies covered to acquire and use Kyoto units in the EU emissions trading scheme ([1]). Furthermore, the Council reached political agreement on measures to reduce emissions of fluorinated greenhouse gases, for example by better servicing and by phasing out such gases in the air-conditioning systems of motor vehicles.

… although much remains to be done in most of the EU-15 Member States

There is a strong contrast between the new Member States and most of the EU-15 Member States as regards the scale of efforts that are needed to meet the Kyoto commitments.

In the new Member States ([2]), the economic restructuring that has been part of the transition to a market economy has typically resulted in steep falls in greenhouse

([1]) Directive 2004/101/EC (OJ L 338, 13.11.2004).

([2]) Except Cyprus and Malta, which do not have commitments under the Kyoto Protocol.

gas emissions, so that their emissions are well below the levels allowed under the Kyoto Protocol (except for Slovenia). With a few exceptions (Germany, France, Sweden and the United Kingdom), the EU-15 Member States are off track, and need to accelerate their emission reductions if they are to meet their Kyoto commitments. Several of the EU-15 Member States have not met their obligations to transpose the emissions trading directive into national law in order to implement it. The Commission has started legal action against those Member States. However, it should be noted that difficulties with the compliance with legal reporting requirements in a number of Member States continues to hamper the evaluation of actual and projected progress.

3. Euro-area specific challenges

Economic growth recovered in 2004 but remains subdued

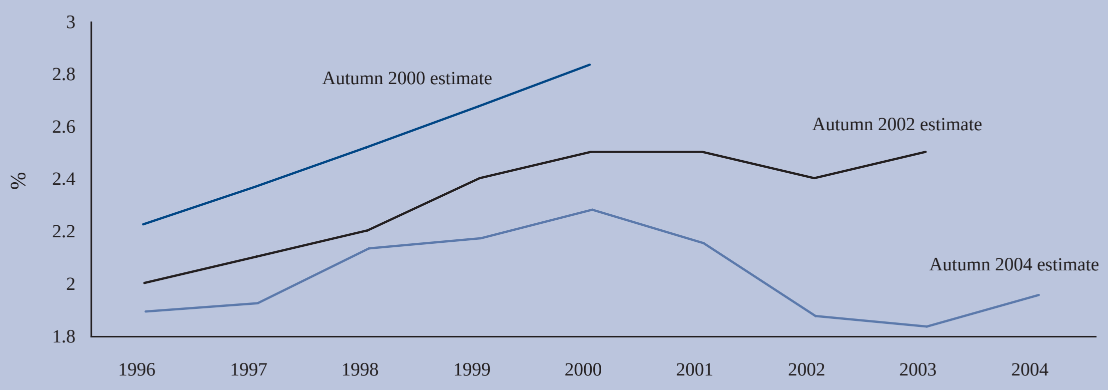
Growth in the euro area began to slow down in 2000 amidst a deceleration in the global economy in the context of global uncertainties and falls in asset prices. With domestic demand insufficient to provide a buffer from the global downturn, GDP growth fell from 3.5 % in 2000 to a mere average of 1 % over the period 2001–03. The failure of growth in the euro area to pick up rapidly highlighted the fact that economic growth remained below its potential. Moreover, potential growth itself remained weak. In recent years, Commission estimates of potential growth in the euro area have been revised downwards significantly (see Graph 19) and the current estimate for potential growth in 2004 is now around 2 %.

These downward revisions are partly related to a smaller contribution of labour to growth, but mainly reflect the slowdown in actual labour productivity growth. This productivity slowdown can be decomposed into a slightly lower contribution of capital deepening (due to a cyclically-related lower investment ratio) and a lower contribution from independent technical progress or total factor productivity, which is the main cause of the revision ([1]).

Economic activity remained subdued in 2003, with annual GDP growth slowing to just 0.6 % and unemployment increasing by almost 0.5 % to 8.8 %. Euro-area growth finally strengthened in 2004, supported by buoyant global growth. GDP growth increased to around 2 % in 2004, building on the pick-up in activity that emerged in the second half of 2003. Nevertheless, in

([1]) The sensitivity of the calculation method of potential growth to actual developments implies that potential growth estimates could return to higher rates if labour productivity growth picks up.

Graph 19: **Estimate of the rate of potential growth, euro area**



Source: Commission services.

Against this background, the 2003–05 BEPGs identified four challenges facing the euro area:

- strengthen potential growth,
- cater for balanced macroeconomic policies,
- monitor inflation differences,
- strengthen economic policy coordination;

and therefore recommended policy actors at national level to:

24. contribute to a policy mix that is compatible with price stability and with economic growth close to potential in the medium term;
25. maintain budgetary positions of close to balance or in surplus throughout the economic cycle in cyclically adjusted terms and, if needed, take all the necessary measures to ensure an annual improvement of at least 0.5 % of GDP. Countries with excessive deficits need to correct them;
26. analyse the causes of inflation differences to identify instances when they are undesirable;
27. deepen the analysis of economic developments and policy requirements, focus more on implementation, and strengthen the external representation of the euro area;
28. improve the efficiency of the existing coordination procedures in the area of structural reforms; intensify structural reforms.

The 2004 update of the BEPGs reconfirmed that economic policy needs to be much more focused on sustained growth without hampering further budgetary consolidation.

comparison with other industrial countries, the economic recovery in the euro area was sluggish and late starting. Amidst world trade growth estimated to have reached almost 10 % in 2004, the United States registered GDP growth of above 4 %, while growth in Japan is estimated to have been around 3 %.

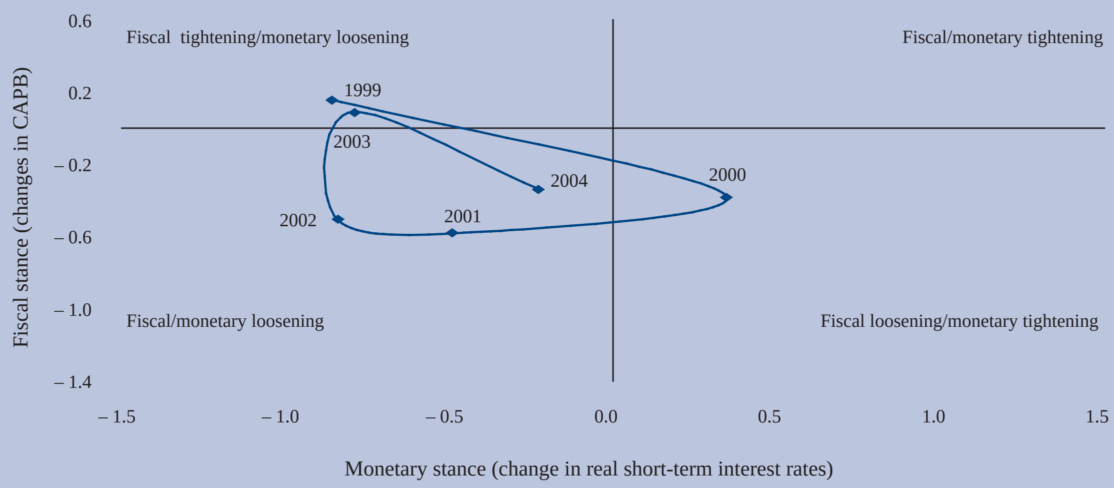
The pick-up in GDP growth in the euro area has so far not led to a significant increase in employment. Employment growth is estimated to have picked up only slightly on the 0.2 % growth seen in 2003, to reach 0.5 % in 2004. The increase in unemployment is likely to have come to a halt in 2004 at a level of 8.9 %.

Looking forwards, euro-area growth is expected to continue at around 2 % in 2005, despite higher oil prices taking their toll. Growth will be supported by a strong acceleration in investment expenditure, and reinforced by a more gradual pick-up in private consumption. Employment growth is expected to increase to almost 1 % in 2005, while the unemployment rate remains unchanged.

Policy mix continues to be supportive to growth

Macroeconomic policy remained accommodative in 2004, with a broadly neutral fiscal stance accompanied by a monetary stance which continues to be supportive to the recovery (see Graph 20). The ECB left nominal interest rates unchanged throughout 2004, with the minimum bid rate remaining at 2 %; real short-term and long-term interest rates remained at historical lows. Real short-term interest rates even became negative in several months. This accommodative monetary stance is visible in the financial system in a rise in bank loans to the private sector. In 2004, the nominal effective exchange rate of the euro appreciated by 3.8 % on average compared with the average in 2003. This appreciation of the euro provided some downward pressure on external demand but also acted as a counterweight to the rising commodity prices. Both in 2003 and 2004, the fiscal policy stance, measured by the change in the cyclically adjusted primary balance, was broadly neutral. This neutral discretionary fiscal policy provides room for automatic fiscal stabilisation.

Graph 20: **Policy mix in the euro area**



Source: Commission services.

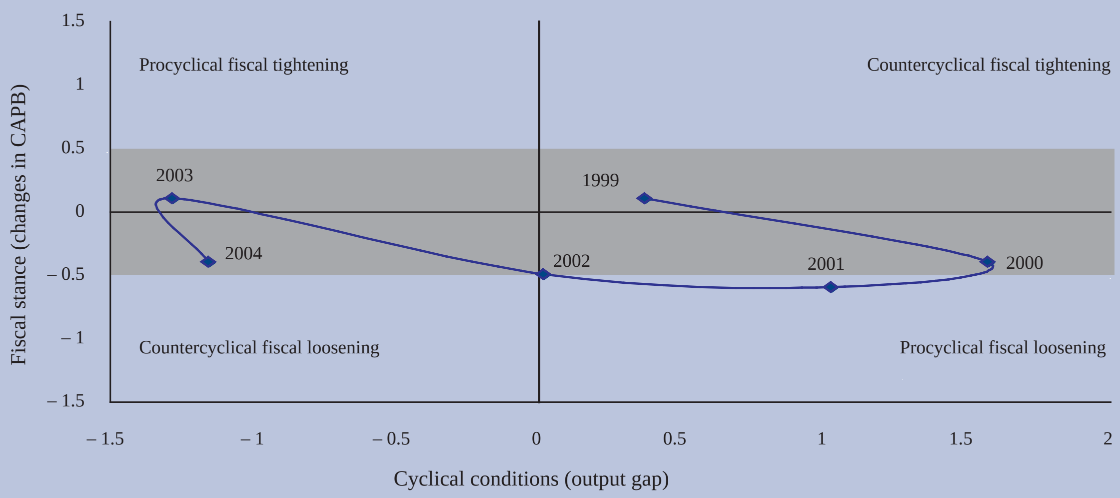
Insufficient budgetary consolidation in the Member States with high deficits in 2004

The fiscal position deteriorated somewhat in the euro area in 2004 with general government net borrowing increasing to just below the 3 % of GDP ceiling, while the cyclically adjusted deficit rose to 2.5 % of GDP. However, differences are substantial across Member States. Four of the five countries with a close to balance budgetary position in 2003 (measured as a broadly balanced budget or in surplus in cyclically adjusted terms) managed to maintain such a position in 2004, namely Belgium, Ireland, Luxembourg and Finland, whereas one-off measures taken by the new Spanish government caused their balance to turn into a deficit. According to the Commission's autumn 2004 economic forecasts, the deterioration noted in Spain in 2004 will be temporary. Of the seven Member States that had not achieved a position of close to balance in 2003, none undertook sufficient efforts to ensure an improvement in the cyclically adjusted balance of at least 0.5 percentage points of GDP in 2004, although a certain improvement was noted in France and the Netherlands. The cyclically adjusted budget deficit actually deteriorated for all the other Member States in question (i.e. Germany, Greece, Italy and Austria). Based on the changes in the cyclically adjusted balance, not one single Member State managed to comply with the agreed minimum improvement in 2004. Four Member States show an adjustment of 0.5 % of GDP or more in 2005 (Germany, Greece, France and — nearly — the Netherlands). The broad picture would not change much even allowing for a correction in the change in the cyclically adjusted balance to account for the impact arising from growth surprises (i.e. potential growth different than forecast) ([1]).

Of the three euro-area Member States in an excessive deficit situation in 2003, Portugal managed to bring its deficit below 3 % of GDP in 2003 and its excessive deficit procedure was consequently abrogated on 11 May 2004. However, according to the autumn 2004 forecast, the deficit in Portugal again risks exceeding the 3 % of GDP ceiling in 2005. The deficits recorded for Germany and France both remained well above 3 %

([1]) The assessment of the fiscal effort of countries was discussed in the context of a revision of the SGP along the lines proposed by the September 2004 Commission communication 'Strengthening economic governance and clarifying the implementation of the SGP'. It was concluded that a correction of the CABB to account, *inter alia*, for the impact of growth surprises could improve the assessment of the path of Member States towards the medium-term objective and that the assessment should also be complemented by a bottom-up approach aimed at evaluating the budgetary impact of the discretionary fiscal measures taken. The 2004 public finance report provides a description of a methodology for correcting the change in the CABB for growth surprises. The analysis contained in the 2004 public finance report shows that such a correction would, in general, have a quite limited impact on the CABB changes, and that a significant effect would arise only in the case of actual growth being substantially lower than potential.

Graph 21: **Euro-area fiscal stance and cyclical conditions, 1999–2004**



NB: The shaded area represents a broadly neutral stance.
Source: Commission services.

of GDP in 2004. Continued subdued domestic demand in Germany and a large reduction in income tax rates, which was only partly financed by a broadening of the tax base, both contributed to a certain widening of the deficit. As indicated above, the general government deficit in France improved somewhat in 2004 also in view of the higher-than-expected growth. However, the deficit could have narrowed more significantly had the automatic stabilisers been allowed to play fully. The Commission's autumn 2004 economic forecasts, based on unchanged policies, project an improved budgetary position in Germany and France to 3.4 and 3.0 % of GDP, respectively, in 2005.

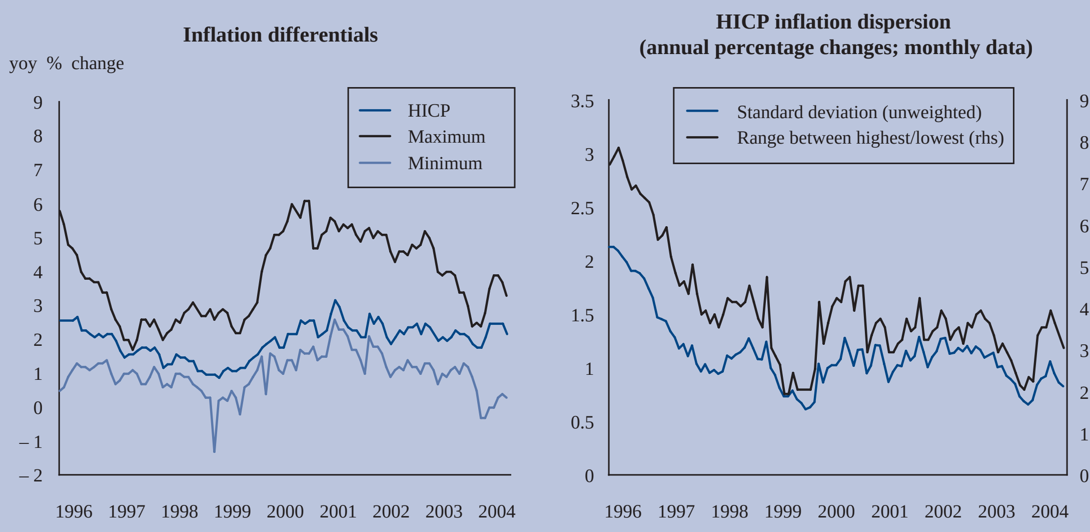
In 2004, Greece and the Netherlands were also found to be in an excessive deficit situation. In the case of Greece, the deficit for 2003 has been revised upwards repeatedly to around 4½ % of GDP highlighting the recent expansionary, procyclical (looking at the positive output gap) fiscal policies. In the Netherlands, and despite a substantial package of fiscal savings, the sharp economic downturn caused the deficit to exceed the 3 % of GDP ceiling in 2003. A clear improvement is expected in both cases, even if it appears unlikely (assuming no policy changes) to be sufficient to reduce the Greek deficit to below 3 % of GDP by 2005 if no further measures are taken. As regards Italy, which was also recommended 'to take appropriate measures' in response to the possible existence of an excessive deficit in the 2004 update of the BEPGs, the Council decided not to issue an early warning as recommended by the Commission following the announcement of a savings package by the Italian authorities in July 2004. According to the Commission's forecast, however, a deficit of 3 % of GDP appears likely in both 2004 and, under the assumption of unchanged policies, in 2005.

Inflation differences are narrowing

Inflation differences in the euro area, as measured by the difference between the Member States with the highest and the lowest HICP inflation rates and by the unweighted standard deviation, fell for the second consecutive year in 2004, although they remain above the levels seen in the early years of economic and monetary union (EMU). However, indirect tax cuts have kept inflation in Finland unusually low, and, if Finland is excluded from the calculations, inflation differences are smaller than five years ago.

From a historical perspective, the inflation dispersion in the euro area seems low, although, given the relatively short experience with it, a degree of caution is required in interpreting results from such comparisons.

Graph 22: **Inflation differences and dispersion, euro area**



Source: Commission services.

Since the start of Stage III of EMU, some countries have registered persistent differentials relative to the euro-area average. Temporary differences in inflation rates may arise from price shocks such as temporary rises in oil or food prices, given different consumption patterns in Member States. Price changes may also be policy induced, arising, for example, from changes in indirect taxation or differences in the pace of deregulation of utilities. But as Table 9 shows, even after the effects of changes in energy prices and unprocessed food have been removed as measured by core inflation, significant inflation differences remain between Member States. Core inflation does not exclude changes in indirect taxes, which in 2004 took place primarily in relation to alcohol and tobacco. The low inflation rate in Finland can be accounted for by cuts to indirect taxes on a number of consumer goods, including alcohol, whilst large increases in tobacco taxes in France, the Netherlands and, to a lesser extent, Germany and Italy placed upward pressure on overall inflation in those countries.

Even differences in core inflation can to some extent be considered a normal adjustment mechanism in a monetary union. Given that, by definition, the nominal exchange rate instrument is no longer available for national purposes, required national adjustments in a monetary union fall on relative price and wage movements. In particular, according to the Balassa–Samuelson (BS) model, inflation may be higher in catch-up economies. This arises from the fact that catch-up economies may enjoy relatively high productivity growth in the tradable (predominantly manufacturing) sector, forcing up wages (but not the price of tradable goods). Higher inflation comes through price rises in the non-tradable sector, as labour mobility ensures that wages rise at the same rate as in the tradable sector, despite lower productivity growth.

Table 10 shows that in the early years of EMU variations from the euro-area average in Spain, Ireland, the Netherlands and Portugal all significantly exceeded what might have been expected, taking into account an average of estimated BS effects (in view of the fact that some of the Balassa–Samuelson effects use data from the 1970s, it could be expected that the effect is smaller now, given that real convergence has taken place between euro-area members) ([1]). But in 2004, the difference in inflation decreased in the majority of countries and, in particular,

([1]) In addition, the removal of one particular study from the average reduces the expected BS effects in Greece and Finland by 0.6 and 0.2 percentage points respectively.

Table 9

Euro-area inflation: annual change to November 2004 (percentage weights in parentheses)

	HICP	Industrial goods (excluding energy)	Energy	Unprocessed food	Processed food (including alcohol and tobacco)	Services	Core inflation
BE	2.3	0.1 (33)	12.7 (9)	1.0 (8)	2.1 (12)	1.9 (38)	1.2 (82)
DE	2.0	0.8 (30)	7.0 (10)	– 2.4 (5)	2.6 (11)	2.0 (44)	1.7 (85)
EL	3.2	2.5 (31)	12.7 (7)	– 4.4 (9)	3.7 (14)	3.6 (39)	3.2 (84)
ES	3.5	1.3 (30)	9.9 (9)	2.7 (13)	4.2 (13)	3.8 (36)	2.9 (78)
FR	2.2	0.4 (30)	10.9 (8)	– 0.9 (9)	1.7 (12)	2.7 (42)	1.7 (84)
IE	2.8	– 1.1 (23)	15.3 (7)	– 1.0 (7)	1.7 (17)	3.7 (46)	2.0 (86)
IT	2.0	1.6 (34)	6.0 (6)	– 2.1 (8)	2.6 (11)	2.6 (40)	2.2 (86)
LU	4.0	0.6 (35)	21.1 (9)	– 0.2 (5)	5.4 (20)	2.5 (32)	2.4 (86)
NL	1.5	– 0.4 (33)	6.5 (8)	– 5.1 (5)	0.4 (11)	3.1 (42)	1.4 (86)
AT	2.4	– 0.1 (30)	12.9 (7)	– 1.8 (6)	1.0 (11)	3.1 (46)	1.7 (87)
PT	2.6	0.9 (32)	10.8 (8)	– 1.3 (11)	1.6 (11)	3.7 (38)	2.3 (81)
FI	0.2	0.0 (30)	8.5 (7)	– 1.4 (7)	– 5.1 (16)	1.4 (40)	– 0.3 (86)

Source: Commission services.

Table 10

Actual inflation differentials and implied inflation differentials due to Balassa–Samuelson (catch-up) effects

	BE	DE	EL	ES	FR	IE	IT	NL	AT	PT	FI
Average estimated BS inflation differential ([1])	0.6	– 0.6	1.6	0.5	0.1	1.3	0.5	0.1	0.2	0.7	0.5
Average HICP differential 1999–2002	– 0.0	– 0.6	1.1	1.0	– 0.4	2.1	0.3	1.3	– 0.3	1.2	0.2
HICP differential 2003	– 0.5	– 1.0	1.3	1.0	0.0	1.9	0.7	0.1	– 0.7	1.1	– 0.7
HICP differential 2004	0.1	– 0.2	1.0	1.3	0.0	0.6	– 0.2	– 0.7	0.2	0.4	– 2.0

([1]) Average of six studies, taken from ECB, *Inflation differentials in the euro area*, September 2003. No data for Luxembourg available.

Sources: Commission services; ECB.

fell below what would have been expected as a result of BS effects in both Ireland and Portugal. Whilst inflation differentials in Germany are now slightly above what would be expected due to BS effects, the difference is only marginal, suggesting that the picture regarding inflation differentials has improved somewhat in recent years. Only in Spain, where service sector inflation remains particularly strong, have inflation differentials exceeded the expected amount in all three periods.

The persistence of inflation differentials may possibly indicate that structural rigidities are continuing to impede a smooth adjustment. While some structural differences across countries, such as energy's share of consumption and size and export-orientation of the industrial structure, must be seen as a given, there may be institutional barriers that reduce the speed of adjustment of prices and wages over the business cycle and to economic shocks. Inflation appears particularly persistent in the service sector, with the lower degree of competition in the service economy, the relative importance of labour costs and the relatively low exposure of the sector to external competition likely to be contributors to price stickiness. To the extent that agents still form inflation expectations on the basis of domestic rather than euro-area inflation trends, persistent differences in real interest rates, which seem to have aggravated remaining growth and therewith also inflation differences, are likely to persist. While structural reforms may ameliorate country-specific inflation differentials, it should be recognised that, in the short-term, differences in the speed and magnitude of implementation of structural reforms may temporarily accentuate inflation dispersion among Member States.

First step made in strengthening the voice of the euro area on the world stage

Progress is being made with regard to the internal coordination of common positions in international issues of particular relevance for EMU. For example, during the last episode of euro appreciation, the Eurogroup expressed to the outside world a coordinated view on exchange rate issues, which has supported the credibility of EMU's policy framework. The EU representatives in the International Monetary Fund (IMF) have also stepped up their efforts to coordinate their positions ahead of the Executive Board meetings by creating a troika including the representatives of the previous and next EU presidencies. By acting as a systematic and recognisable interlocutor with the IMF management and the staff, this troika is expected to enhance the continuity and visibility of EU common positions.

The need to ensure a proper and appropriate external representation of the euro area in the relevant international institutions and forums remains, however, a crucial challenge. The launch of the euro has not yet strengthened the representation of the euro area in international forums, which is still fragmented and incomplete and not commensurate to its economic weight. Ad hoc arrangements continue to prevail with regard to different institutions, making it difficult for the euro area to speak with one voice at the international level. A noteworthy development is that, in September 2004, the Eurogroup agreed on a new set of working methods, which included the creation of a stable presidency for a two-year term that can be renewed one time only. It was agreed that, as of 2005, Jean-Claude Juncker, Prime Minister and Finance Minister of Luxembourg, would serve as the inaugural president. The switch to a stable presidency will improve the functioning of the Eurogroup and bring greater coherence and continuity to its dealings with international organisations like the IMF and G7 finance ministers' meetings. Overall, this reform can be viewed as an important first step in ensuring that the interests of the euro area are properly represented on the world stage.

Analysis of economic developments and discussions on the euro area have deepened

The dialogue among euro-area policy actors has gradually advanced over the years going beyond actual economic developments to discuss structural issues and economic mechanisms in the euro area to a greater extent. In 2004, the Eurogroup ministers had, for example, discussions on the assessment of structural weaknesses of the euro area in the light of the growth performance and also discussions on budget-neutral measures to strengthen growth, including by reducing the administrative burden weighing on the business sector. Ministers also discussed, in view of EU enlargement, a framework for analysing the readiness of Member States to enter ERM II. Moreover, the Eurogroup discussed a coordinated policy response to rising oil prices in marked contrast to the divergent policies adopted in earlier years clearly showing that economic policy coordination is evolving ([1]).

Report of the Kok group stresses the importance of national ownership, benchmarking and communication

In terms of the governance of the Lisbon strategy, the high-level group on the mid-term review of the Lisbon strategy (the Kok group) made a number of recommendations to improve the coordination of structural reforms (see Box 2). These recommendations, while made for the EU-25, are equally valid for the euro area. The report underlined the need to ensure commitment and ownership at the level of individual Member States. This can be done through national strategies with clear road maps and through enhanced involvement of national parliaments, the European Parliament and social partners in the process. In order to ensure more coherence and consistency of the reform efforts, the broad economic policy guidelines and the employment guidelines should provide the basic directions for the national strategies.

The report also recommended that the central elements of the open method of coordination (peer pressure and benchmarking) be strengthened by presenting to the Heads of State or Government and the wider public annual updates on countries' performances, praising good performance and castigating poor performance. Finally, the report stressed the importance of clear com-

([1]) An example of the deeper analysis of economic developments and policy requirements can be found in an assessment made by the Commission services on the first five years of EMU, 'EMU after five years', 2004.

munication to a wider public of the potential benefits of the reform effort. The Commission and Member States will work together to ensure that the report's recommendations are taken up by the 2005 spring European Council. The Commission will shortly put forward its proposals in the 2005 spring report.

4. Summary of the degree of implementation by Member States

Part II of the report contains a detailed analysis of how economic policies in the Member States have responded to the challenges and country-specific recommendations contained in the 2003–05 BEPGs. The main focus of this analysis is on the policy actions taken in the course of the year 2004. For the new Member States, this allows a preliminary assessment of the degree of implementation of the recommendations, which were adopted by the Council only half a year ago. For the EU-15 Member States, the analysis in Part II complements the previous implementation report allowing for a more in-depth assessment of the degree of implementation of the recommendations, which were adopted one and a half years ago.

This section summarises the degree of implementation for each country, focusing on the degree to which each country is responding to the policy challenges identified for it. Even if the wording of these assessments is standardised, the difficulties surrounding a cross-country comparison of the state of implementation should be borne in mind. First and foremost, the EU-15 Member States have had more time to give an adequate follow-up to the recommendations than the new Member States. Second, the challenges identified for the different Member States differ not only in number but also in scope, i.e. some challenges are clearly more demanding than others.

Summing up and on the basis of the assessments in Part II, a relatively good follow-up of the country-specific recommendations has been given by Belgium, Denmark, Ireland, the Netherlands, Finland and the United Kingdom, while progress can be considered limited in several EU-15 Member States. Concerning the recommendations to the new Member States, addressed just half a year ago, the assessment of their implementation indicates that, albeit with different speeds, it goes in the right direction, notably in Cyprus and Slovakia.

4.1. Belgium

After one and a half years of implementation, Belgium has in general made good progress in addressing the three policy challenges that were identified in the country-specific part of the BEPGs. In particular, progress has been made on the challenge of public finance sustainability, as the reduction in the debt ratio has continued, although primary surpluses are diminishing and the decline in interest payments is slowing down. Regarding the recommendation to limit the yearly real increase in expenditure of Entity I (federal government and social security) to 1.5 %, progress was limited in 2004; measures to control public expenditure were relatively successful, even if a substantial overrun in healthcare spending occurred. The government complied with the specific recommendation to allocate the proceeds from the higher-than-expected economic growth to improve the budgetary position. Some progress has also been made in preparing for the budgetary implications of population ageing, by reducing debt or financing the ageing fund, but the low effective retirement age remains largely unaddressed.

Some progress has been made in addressing the challenge of increasing participation and employment rates, especially of older workers. Some limited measures have been taken to stimulate employment in the over 50 age category, but no new measures have been taken to limit the access to the system of early retirement and extend further effective working life. Some progress has been made with the elimination of major distortions to work incentives, mainly through reductions in social security contributions targeted at the low-paid.

Finally, some progress has been made in addressing the challenge and recommendations on productivity and business dynamism. Good efforts have been made to reduce the administrative burden at all administrative levels and the reform of the public administration has been pursued, although more modestly. Improvements were made in liberalising network industries in 2004 although not further than the minimum requested by EU directives. However, no specific action has been taken to enhance effective competition in other local services.

4.2. Czech Republic

After half a year of implementation, the Czech Republic is making some progress in addressing the four policy challenges that were identified in the country-specific part of the BEPGs. In particular, progress is being made in addressing the challenge regarding public finances. As a step towards correcting excessive deficit by 2008 at the latest, the government has implemented reforms on both the expenditure and the revenue side, including the introduction of medium-term expenditure ceilings for central government. However, action to address the long-term sustainability of public finances has been much more limited, in particular in the fields of pension and healthcare policy.

Some progress is being made in addressing the challenge on the labour market. Measures have been introduced to reduce disincentives to work and to enhance occupational mobility, but little action has been taken to address the problems of regional mobility and skill mismatches.

Limited progress is being made in addressing the challenge of improving the conditions for an accelerated productivity growth. Despite some measures to reform the elementary and secondary schooling which should bring about a reform of the curriculum, the overall reform of the education system and, in particular, tertiary education is still outstanding. On the other hand, several measures to support R & D and innovation through, for example, investment incentives have been adopted and others are in the pipeline.

Finally, limited progress is being made in addressing the challenge on entrepreneurship and SMEs. Several important proposals to improve the business environment are being discussed although the actual implementation remains a challenge.

4.3. Denmark

After one and a half years of implementation, Denmark has in general made good progress in addressing the two policy challenges that were identified in the country-specific part of the BEPGs. Progress has been good in addressing the challenge of ensuring an adequate labour supply in view of the ageing of the population. As regards the recommendation to make work pay, the labour market initiative implemented in 2003 included more result-oriented activation measures as well as tightened availability and willingness-to-work criteria, while the tax reform, which lowers marginal tax rates for medium-income earners, was fully implemented in 2004 instead of gradually as originally envisaged. Concerning the recommendation to ensure expenditure control at all levels, although the overall targets so far have been exceeded, the measures adopted seem to have been effective in setting public consumption growth at local government level on a downward trend.

Good progress has also been made in addressing the challenge of enforcing competition in certain sectors and of improving public sector efficiency. As regards the recommendation to step up competition in sectors where this is inadequate, long-term targets have been set for reducing the number of such sectors and by conferring extra powers on the Danish competition authority. As a step towards meeting the recommendation on increasing the efficiency of the public sector, an initiative was launched to investigate how public sector functions can be modernised and where possible delegated to the private sector.

4.4. Germany

After one and a half years of implementation, Germany has in general made some progress in addressing the four policy challenges that were identified in the country-specific part of the BEPGs. In particular, good progress has been made in addressing the challenge of promoting job creation and adaptability and mobilise unutilised employment potential. Significant action was taken to reform the tax–benefit system to strengthen incentives to take up work, notably through implementing the various Hartz labour market reforms, which have started to show the first measurable results. Good efforts have also been made to improve the efficiency of ALMPs and of job-search assistance through the reform of the labour agency. No significant action, however, has been taken by the government to ensure that wages reflect productivity differences across skills and regions, besides encouraging social partners to make greater use of opening clauses in collective agreements.

Limited progress has been made in addressing the challenge of increasing productivity through improvements in the business environment and the efficiency of the education system. The ban on special sales in the retail sector was lifted and German competition law was brought into line with European legislation. However, there is little visible progress in the reduction of the regulatory and administrative burden or in reducing employment protection. In the education system, some measures were taken to provide for more all-day schools and through the introduction of assistant professorships at universities.

Limited progress has been made in addressing the challenge on public finances, in particular by keeping the general government deficit below 3 % of GDP. The government deficit in 2004, projected at close to 4 % of GDP, remains well above that mark. It also means that the cyclically adjusted deficit actually deteriorated in that year, albeit for reasons mostly outside government control.

Some progress has also been made in addressing the challenge to secure the long-term sustainability of public finances, in particular by promoting the take-up of supplementary pension schemes and improving the efficiency of the healthcare system. While the law on sustainable funding of the pension system effectively leads to a lower annual increase in public pensions, the incentives for later retirement were only partially strengthened, in particular as the statutory retirement age was not increased. Healthcare reforms introduced some modest incentive to rein in consultation of doctors through the introduction of a small co-payment.

4.5. Estonia

After half a year of implementation, Estonia is making some progress in addressing the four challenges that were identified in the country-specific part of the BEPGs. In particular, limited progress is being made in addressing the challenge of the sizeable current account deficit, including through an appropriate fiscal policy stance. While remaining in a position of budgetary balance or in surplus over the foreseeable future, the reduction in public savings in 2004 might not have sufficiently supported the correction of the external imbalance. The current account deficit is projected to remain virtually unchanged at around 13 % of GDP in 2004, and to start declining only gradually thereafter on the back of an improving trade balance.

Good progress is being made in addressing the challenges on the structural problems in the labour market, namely to adopt policies with particular emphasis on reintegrating the long-term unemployed and to encourage social partners to ensure that wage developments do not hinder employment growth. An active labour market policy package, funded also by EU transfers, was approved by the government in autumn 2004, which aims at increasing the incentive for the long-term unemployed to actively look for jobs. Employment ratios should be increased both by reforms to the vocational training system, and by a reduction in taxes and social charges on labour. The fairly flexible labour market is characterised by a small role for collective wage bargaining. The minimum wage, however, is set at national level. In 2004, it stood at just 32 % of the average national wage. Major income tax cuts and a stepwise increase to the threshold for income tax exemption will reduce non-wage labour costs considerably, thus taking pressure from gross wage settlements. Consequently, labour market conditions are set to continue to improve gradually.

Limited progress is being made in addressing the challenge of improving conditions for increasing productivity. Efforts have been made to promote R & D but overall levels, especially the business share of R & D, remain low. Important efforts are being made to improve the vocational training system, but few new measures have been taken to improve the education system over the past six months.

Good progress is being made in addressing the challenge of developing effective competition in network industries. Some efforts have been made to further open up the electricity market to competition, and competition is effectively improving in the telecommunications market. So far, no measures have been announced to strengthen the independence of regulators.

4.6. Greece

After one and a half years of implementation, Greece has in general made only limited progress in addressing the three policy challenges that were identified in the country-specific part of the BEPGs. In particular, no progress has been made regarding the challenge of the long-term sustainability of public finances. Despite strong economic growth, no actions were taken by the government to reduce the debt ratio at a satisfactory pace and to correct the excessive deficit, in response to Article 104(7) of the Treaty adopted by the Council on 4 July 2004. In cyclically adjusted terms, Greece moved further away from a budgetary position of close to balance or in surplus. The impact of measures aiming to improve labour productivity and enhance the working capacity of the unemployed is as yet unclear, while measures undertaken by the government in the framework of the reform of the social security system are insufficient to avoid budgetary strains in the future due to the problem of an ageing population.

Some progress has been made in addressing the challenge of increasing the low level of productivity. Initiatives to encourage the transition towards a knowledge-based society have been pursued. However, effective competition in the electricity market is not yet secured despite steps in the right direction. In addition, while efforts have been made to simplify the business and taxation environment, the transposition rate of internal market directives has decreased.

Finally, limited progress has been made in addressing the challenge of reducing the high rate of structural unemployment, and increasing employment rates, particularly for women. Measures to ensure that wages reflect productivity differentials in the framework of the wage bargaining process are insufficient as benchmark wages are still linked to the announced income policy in the public sector and to inflation prospects. The impact of the measures that the government has undertaken to promote part-time work and to promote flexibility and much better demand and supply is as yet unclear, given the still high barriers to entry and the strong rigidities in the Greek labour market.

4.7. Spain

After one and a half years of implementation, Spain has in general made some progress in addressing the three policy challenges that were identified in the country-specific part of the BEPGs. In particular, some progress has been made in addressing the challenge of raising the low employment rates. Although tax incentives were introduced in 2003 to promote female participation and provision of childcare as well as geographical mobility, only limited measures on housing were implemented in 2004. Moreover, the wage bargaining system remains broadly unchanged and no reform of employment protection legislation so as to reduce labour market segmentation has been undertaken.

Some progress has been made in addressing the challenge of increasing the low level of productivity. Initiatives have been taken to encourage R & D investment and ICT take-up, but additional action will be needed to improve the education system. Efforts have been made to reduce the administrative burden on businesses but the measures taken so far to further enforce competition in certain sectors, namely retail and electricity, have been insufficient.

Finally, limited progress has been made regarding the challenge of the long-term sustainability of public finances. Measures aiming to increase employment rates and the endowments to the pension reserve fund are expected to amount to 2.9 % of GDP in 2005 and the fast reduction in public debt to below 50 % of GDP are positive steps so as to tackle the budgetary impact of ageing. However, no reform of the public pension system, strengthening the link between contributory efforts and pension benefits, is envisaged.

4.8. France

After one and a half years of implementation, France has in general made some progress in addressing the four policy challenges that were identified in the country-specific part of the BEPGs. Limited progress has been made in addressing the challenge of reducing rapidly the general government deficit to below 3 % of GDP and keeping government finances on a steady consolidation path. However, while the deficit is likely to be brought to 3 % of GDP in 2005, this is due mainly to a better macroeconomic environment than initially envisaged and to the implementation of one-off measures amounting to ½ a percentage point of GDP in 2005. Despite these one-off measures, the cumulated reduction in the cyclically adjusted deficit over 2004–05 will be lower than recommended. Finally, efforts envisaged by the French authorities for the medium term, although consistent with the minimum of 0.5 percentage points of GDP per year, will not be sufficient to bring government finances to a close to balance or in surplus situation in 2008, the end-year of the projection period.

Limited progress has been made in addressing the challenge on labour market participation and structural unemployment. Despite the implementation of the pension reform, incentives to work remain relatively weak for people at or above the legal retirement age, which is, moreover, at 60 amongst the lowest in the OECD. In addition, incentives to job search remain relatively low, and little has been done so far to alleviate employment protection legislation, which is particularly strict in France.

By contrast, good progress has been made in addressing the challenge of the long-term sustainability of public finances. After the implementation, in 2003, of a comprehensive reform of the pension system, a reform of the health insurance system was introduced in 2004, with the aim of balancing its budget. Although the precise budgetary impact of the reform remains uncertain, especially on the expenditure side, this reform constitutes a clear step in the right direction.

Finally, there has been some progress in addressing the challenge on productivity and business dynamism. Measures have been taken to reduce and simplify business regulations. Efforts have been made to increase competition in energy markets but effective competition remains limited. Further progress should also be made to raise the transposition rate of internal market directives and to bring down the number of infringement proceedings.

4.9. Ireland

After one and a half years of implementation, Ireland has in general made good progress in addressing the policy challenge that was identified in the country-specific part of the BEPGs regarding the achievement of a smooth transition to lower sustainable growth levels in the years ahead. In particular, further efforts have been made to improve control and efficiency of public expenditure, especially by extending multiannual budgeting and by reforms in the health sector. As regards wage developments, relatively moderate provisions were agreed by the social partners in June 2004 in the new 18-month national wage agreement. Efforts have been pursued to improve infrastructure and to raise the level of R & D. However, action has been more limited with regard to increasing competition in network industries and certain other sectors of the economy.

4.10. Italy

After one and a half years of implementation, Italy has in general made limited progress in addressing the five policy challenges that were identified in the country-specific part of the BEPGs. In particular, limited progress has been made in addressing the two challenges on public finances. While narrowly avoiding the occurrence of an excessive deficit, the underlying budgetary position worsened in 2004 and the Italian government continued to rely mainly on temporary measures. Attempts to strengthen the policy coordination continue to show mixed results on different levels of government. The planned reduction in the tax burden for 2005 and 2006 is not fully financed because of structural cuts in current primary expenditure.

Progress in addressing the long-term sustainability challenge on public finances was also limited. Specifically, the efforts made to ensure a satisfactory pace of debt reduction proved insufficient in 2004, in spite of sizeable privatisation proceeds. Conversely, Parliament adopted a pension reform applying stricter provisions yet taking effect only in 2008.

Some progress has been made in addressing the challenge on labour market and regional development. Action was taken to increase labour force participation mainly via the introduction of additional, more flexible labour contracts. Very modest provisions for childcare facilities were blocked by the Constitutional Court. As a step towards a more decentralised wage setting mechanism, the government has supported dialogue among social partners. By contrast, no measures were taken to further reform employment protection legislation and to improve the efficiency of the unemployment benefit and social assistance system.

Limited progress has been made in addressing the challenge on the knowledge-based economy. Although some reforms of the school system and universities have been implemented, the education and skills statistics still place Italy below the EU average. Similar conclusions hold for innovative capacity. Furthermore, ICT use and diffusion, in particular for small and medium-sized firms, have not been sufficiently promoted.

Some progress has been made in improving the business environment. Efforts initiated in 2003 have been continued to simplify the regulatory framework and the access to finance improved procedure. However, progress has been more limited with regard to increasing effective competition in the service and energy sectors, and the transposition rate of internal market directives has decreased. The electricity sector has been the subject of some reforms; however, the competition in both the electricity and gas sectors is not yet effective.

4.11. Cyprus

After half a year of implementation, Cyprus is making good progress in addressing the two policy challenges that were identified in the country-specific part of the BEPGs. In particular, good progress is being made in addressing the challenge of ensuring a reduction of the general government deficit on a sustainable basis, namely through the implementation of the convergence programme, which, given the positive results in the development of government revenues and expenditure in the first eight months of 2004 and the measures included in the 2005 budget, has so far been more or less on track.

Good progress has also been made in addressing the challenge of increasing the diversification of the economy towards higher value added activities. Several initiatives to improve the adequacy of skilled human capital and to promote R & D, innovation and ICT diffusion in order to encourage the transition towards a knowledge-based society have been launched. Furthermore, efforts have been made to simplify the business and taxation environment, through the implementation of e-government services, by shifting the tax burden from direct to indirect taxes (in line with the *acquis*), and reducing entry barriers in several sectors.

4.12. Latvia

After half a year of implementation, Latvia is making limited progress in addressing the four policy challenges that were identified in the country-specific part of the BEPGs. In particular, no progress is being made in addressing the challenge on the sizeable current account deficit, to which an appropriate fiscal policy should contribute. Although general government budget revenues, due to strong growth achieved in 2004, have been better than foreseen in the 2004 budget, no effort seems to have been made to reduce the general government deficit, notwithstanding the recommendation in this regard: August 2004 budget amendments provided for additional expenditure worth nearly 1 % of GDP, while the deficit target for 2004 remained unchanged.

Some progress is being made in addressing the challenge to improve conditions for increasing productivity. Regarding the recommendation to improve the education and training systems, some plans have been issued but without focusing on the key problem of responsiveness to labour market needs. Significant efforts are being made to promote R & D and innovation and to support the use of new technologies. However, the encouragement of entrepreneurship still faces administrative, financial and cultural barriers.

Some progress is also being made as regards the challenge to address structural problems in the labour market. The tax and benefit system is being revised to make work pay more, most notably via an increase in the minimum tax-free threshold. However, there has been limited effort to strengthen labour supply by pursuing measures to better adapt the qualifications of the workforce to the requirements of the labour market and by facilitating labour mobility.

Finally, some progress is being made to address the challenge to develop effective competition in network industries. Latvia is late in implementing the EU energy directives, effective competition in the energy market remains low and the role of the regulator still needs to be strengthened. Nevertheless, announced plans for interconnections with other European networks are a positive step.

4.13. Lithuania

After half a year of implementation, Lithuania is making some progress in addressing the four policy challenges that were identified in the country-specific part of the BEPGs. In particular, good progress is being made in addressing the structural problems in the labour market, namely through the implementation of active labour market policies and infrastructure development. Several measures to improve the combined incentive effects of taxes and benefits are under preparation, and other key measures are expected to have been taken in the remainder of 2004.

Some progress is being made in addressing the challenge on public finances. The general government deficit in 2004 was slightly below the government target presented in Lithuania's first convergence programme. Additional revenues were used to finance further expenditure, but this happened in the first half of the year.

Some progress is being made in addressing the challenge and recommendations on productivity and business dynamism. Important efforts are being made to improve vocational training, although few new measures have been taken to improve the education system. Actions have been taken to promote R & D and innovation and to support the use of new technologies.

Finally, good progress is being made in addressing the challenge of developing competition in the network industries. Reforms have been undertaken to further liberalise network industries, and projects are starting to improve interconnection capacities.

4.14. Luxembourg

After one and a half years of implementation, Luxembourg has made some progress in addressing the two policy challenges that were identified in the country-specific part of the BEPGs. Progress made in addressing the challenge of increasing the activity and employment rates of the resident population by drawing inactive people, especially older ones, into the labour market has been limited. The main measures in this field had already been taken in 2002, with little further progress recorded since then. The Luxembourg pension system continues to provide few incentives to older workers to remain in work when they have reached an age where they are entitled to a complete pension.

Good progress has been made in addressing the challenge of improving the business environment and encouraging entrepreneurship. The modernisation of the legislative framework for competition policy was finalised in May 2004. However, it is important to continue to monitor its implementation. Efforts to reduce the administrative burden on business have been pursued.

4.15. Hungary

After half a year of implementation, Hungary is making limited progress in addressing the five policy challenges that were identified in the country-specific part of the BEPGs. In particular, insufficient progress is being made in addressing the challenge of ensuring a reduction of the general government deficit on a sustainable basis. Despite some consolidation, the deficit target in 2004, which was to be the anchor of the fiscal adjustment until 2008, has been missed. Also, the reform measures included in the 2005 budget do not seem to be sufficient to achieve the path towards the deficit reduction specified in the convergence programme and endorsed by the Council.

Some progress is being made in addressing the challenge posed by structural problems in the labour market. As a step towards the improvement of the mobility of the labour force, the enhancement of the motorway network should improve the accessibility of the eastern regions of the country in the medium term. However, it remains to be seen to what extent the changes in the housing policy will contribute to higher mobility. Furthermore, the authorities have adopted several measures in order to integrate disadvantaged persons into the labour market, although a consistent framework for such employment policy measures is not yet evident. While there has been only limited progress in ensuring that the tax and benefit system supports employment and entry into the labour market, further efforts have been made with the changes in the tax wedge, which will come into force in 2005. Limited progress is being made in addressing the challenge on policies inducing wage moderations. In 2004, the slowdown in real wage growth below productivity growth was largely induced by strong demonstrative effects from public wage growth. However, no progress was made to enforce central-level social dialogue.

Some progress is being made in addressing the challenge on productivity and business dynamism. Measures have been taken to create a business environment more supportive to entrepreneurship, and, in particular, measures to reduce the administrative burden and to facilitate access to credit have been taken in favour of SMEs. The education system is improving but is not yet efficient enough. Further efforts have also to be made to speed up the movement towards the knowledge-based economy.

Finally, limited progress is being made in addressing the challenge of developing effective competition in network industries. Competition has improved, but the market is still dominated by incumbents and the independence of the regulator in the energy market is not guaranteed.

4.16. Malta

After half a year of implementation, Malta is making limited progress in addressing the three policy challenges that were identified in the country-specific part of the BEPGs. In particular, good progress is being made in addressing the challenge of putting public finances on a sustainable basis. The measures adopted in the 2004 budget are likely to have reduced the general government deficit to 5.2 % of GDP in 2004, in compliance with the target set in the May 2004 convergence programme.

Limited progress, however, is being made in addressing the challenge of increasing employment rates, especially among women. While no actions have been taken to streamline tax–benefit system interaction and to facilitate the return to work of middle-aged women, the results of the measures undertaken to improve the quality of secondary education and vocational training are not yet visible.

Limited progress is also being made in addressing the challenge of encouraging effective competition, namely in sectors such as network industries, food industries, and shipbuilding. The government has continued to pursue efforts to provide the right environment for competition to develop, but progress is slow.

4.17. The Netherlands

After one and a half years of implementation, the Netherlands has in general made good progress in addressing the three policy challenges that were identified in the country-specific part of the BEPGs. In particular, very good progress has been made in addressing the challenge on budgetary adjustment, where corrective measures of a mainly structural nature have been taken in order to correct the excessive deficit that arose in 2003.

Good progress has also been made in addressing the challenge of drawing inactive people into the labour market, namely through a far-reaching overhaul of the social security and pension systems, with, however, some doubts remaining on the effectiveness of certain measures in actually raising the participation rate.

Finally, some progress has been made in addressing the challenge of tackling the relatively slow productivity growth. Measures have been taken to strengthen the Dutch competition authority and to address competition problems in some sectors of the economy. Quantified targets for a reduction in the administrative burden will be set in 2005. In an attempt to increase business investment in R & D, some efforts have been made to stimulate the links between industries and universities. Science and technology education has been promoted by different programmes.

4.18. Austria

After one and a half years of implementation, Austria has in general made some progress in addressing the three policy challenges that were identified in the country-specific part of the BEPGs. Some progress has been made in addressing the challenge on the long-term sustainability of public finances, namely through reform of the pension system. Ambitious reforms were implemented in 2004, but adjustments to be implemented in 2005 appear to negate some of the effects. Insufficient progress has been made in achieving expenditure savings across various levels of government, notably as the granting of a fiscal investment premium has led to slippage from expenditure targets. The ongoing tax reform is therefore not financed by structural measures on the expenditure side.

Good progress has been made in addressing the challenge to improve the technology base and to encourage business R & D. The initial results of a streamlined government support system seem to show that Austria is closing the innovation gap vis-à-vis the EU average.

Limited progress has been made in addressing the challenge of strengthening the development of effective competition in some sectors. Despite measures to increase effective competition in, for example, the retail sector and falling mark-ups in network industries, barriers to entry in the electricity market seem to remain. Also, staffing of the competition authority has been insufficient. The law on telecommunications adopted in August 2003 has strengthened the position of the telecommunications authority.

4.19. Poland

After half a year of implementation, Poland is making some progress in addressing the five policy challenges that were identified in the country-specific part of the BEPGs. In particular, limited progress is being made in addressing the challenge regarding the labour market. Some measures have been taken to reduce the disincentives to work associated with the current benefit systems but they need to be complemented by more substantial reforms, and no progress has been made in lowering the high tax burden on labour. As a first step towards increasing the flexibility of the wage setting process, the government has introduced a measure allowing firms to hire job-starters at a rate below the minimum wage, but more needs to be done to allow the minimum wage to decline relative to average wages so as to reduce the cost to firms of hiring low-skilled workers. Furthermore, while further efforts have been made to improve the education and training system, little action has been taken to remove the barriers to labour mobility.

Some progress is being made in addressing the challenge on public finances. Good progress is being registered in reducing the general government deficit in the context of the budgetary surveillance exercise in line with the decisions taken by the Council on 5 July 2004. Only limited progress, however, has been achieved in addressing the issue of long-term sustainability of public finances. The implementation of the reform of the pension system is being constantly monitored. Still, important risks remain, stemming from the rising stock of contingent liabilities.

Some progress is being made concerning the challenge of improving the conditions for increasing productivity. Good progress is being made to adapt the education and training system to labour market requirements, namely by promoting investment in training and lifelong learning, and developing entrepreneurial potential and ICT skills. However, further effort is necessary to improve R & D and innovation, despite some measures aiming at the transfer of knowledge via information technology (IT) and some targeted projects to spur the implementation of R & D results in the economy.

Regarding the challenge of speeding up the restructuring of the economy and privatisation in industry, limited progress is being observed. On the one hand, no progress has been made to reduce the overall level of State aid and reorient it towards horizontal aid. On the other hand, limited progress is being made to encourage effective competition in network industries and speed up economic restructuring, except for the announced acceleration of privatisation in 2005.

Finally, good progress is being made in addressing the challenge on business dynamism. Legislative measures have been pursued to reduce the administrative burden and improve the business environment, although their implementation has been delayed.

4.20. Portugal

After one and a half years of implementation, Portugal has in general made some progress in addressing the three policy challenges that were identified in the country-specific part of the BEPGs. In particular, limited progress has been made in addressing the challenge on consolidation of public finances. In 2004, the Portuguese authorities succeeded in keeping the general government deficit below 3 % of GDP; however, Portugal relied, for the third consecutive year, on the raising of sizeable revenues from one-off operations to meet that objective. Despite some improvement in the underlying deficit, it seems that the measures taken in 2004 have been insufficient to avoid expenditure slippages in various subsectors of the general government. However, the programmes of structural reforms in areas such as public administration, education and healthcare have proceeded broadly as planned and are expected to support the intended medium-term budgetary consolidation.

Some progress has been made in addressing the challenge of increasing the overall competitiveness of the economy, namely through improving the education system, promoting investment in R & D, improving the business conditions of firms and enhancing competition in the energy sector. However, it remains uncertain whether the measures taken are sufficient to improve significantly the efficiency of the education system and to catch up in terms of business R & D spending and innovation as well as ICT diffusion; also, the rate of transposition of internal market directives has decreased.

Good progress has been made in addressing the challenge of long-term sustainability of public finances. The reform of the health sector is being implemented in line with plans. As a step towards reforming the pension system for civil servants, in 2004 the government made early retirement more costly and pension benefits less generous for new pensioners.

4.21. Slovenia

After half a year of implementation, Slovenia is making some progress in addressing the four policy challenges that were identified in the country-specific part of the BEPGs. In particular, good progress is being made in addressing the challenge of lowering inflation in a sustainable way, especially through applying forward-looking wage indexation schemes in both the public and the private sector while only little action has been taken to step up structural reforms aimed at liberalising administered prices.

Limited progress is being made in addressing the challenge of increasing employment rates for older workers. As a step towards facilitating the participation of groups furthest from the labour market, which include the older, long-term unemployed and young people, the government has introduced several changes to the tax system but has taken no measures to address the imbalance between temporary and permanent working conditions. Further improvement is required in developing a comprehensive active ageing strategy consisting of financial incentives, flexible work arrangements and access to lifelong learning activities for older workers.

Some progress is being made in addressing the challenge to improve conditions for sustained productivity growth. Steps have been taken to reduce the administrative barriers facing new businesses, including the partial completion of the one-stop shop service for small businesses. In 2004, tax incentives encouraging investment were introduced, in particular for firms that hire Ph.D. graduates and invest in equipment for research and technological development. In addition, the decision was taken to establish eight or nine centres of research excellence.

Limited progress is being made in addressing the challenge to promote the development of effective competition in the economy, notably in network industries. The Competition Protection Office is still understaffed and fines for anticompetitive behaviour are too low to act as a deterrent. Liberalisation of the network industries continues but at a different intensity across sectors. Limited steps have been taken to facilitate the purchase of land for industrial use.

4.22. Slovakia

After half a year of implementation, Slovakia is making good progress in addressing the four policy challenges that were identified in the country-specific part of the BEPGs. In particular, good progress is being made in addressing the challenge regarding the further reduction of the general government deficit on a sustainable basis. Effective action has been taken to achieve the 2005 deficit target of the May 2004 convergence programme and to implement with vigour the measures envisaged in the programme, including those related to a systemic pension reform, further healthcare reforms and public sector rationalisation. However, the authorities would seemingly have had some additional opportunities to accelerate the fiscal adjustment and should demonstrate a strong commitment to seize such opportunities in the future, in particular as growth will possibly be more favourable than expected in the convergence programme.

Good progress is being made in addressing the deep-seated structural problems in the labour market, although unemployment remains high as economic restructuring continues. Further efforts have been made to strengthen labour supply, including by removing obstacles to regional mobility and reducing skill mismatches (e.g. through continued improvements to the transport infrastructure and the functioning of the housing market and through active labour market policies). Steps have been taken to generate additional labour demand, including by allowing for more flexibility in wage setting (e.g. limited increase in minimum wages). Steps have also been implemented to create conditions for an affordable reduction in the healthcare and social contribution rates (e.g. healthcare and pension reforms).

Good progress is being made in addressing the challenge on the business environment and entrepreneurship. The legislative framework has been improved. In particular, new bankruptcy legislation has been introduced and a reform of the tax system has led to a decrease in the corporate tax rate. However, weak legal enforcement remains a problem.

Limited progress is being made in addressing the challenge of improving conditions for increasing productivity. The education reform is in its early stages with reforms of the tertiary education still being discussed. Progress on R & D and innovation and transfer of knowledge, despite significant FDI inflows, has been limited. However, the government has recently approved a strategy to speed up the transition to the knowledge-based society. Also, information technologies are spreading.

4.23. Finland

After one and a half years of implementation, Finland has in general made good progress in addressing the two policy challenges that were identified in the country-specific part of the BEPGs. Some progress has been made in addressing the challenge on the labour market, but progress on the tightening of the eligibility criteria and improvement of the administration of benefit systems is still lacking. Also, no progress has been made on improving incentives in benefit systems. On the positive side, taxes on income have been cut and the employment rate of older workers has risen. Moreover, the measures introduced in the government's inter-sectoral employment programme have produced some early results. Allowing wages to better reflect productivity differences depends on the outcome of the new wage agreement.

Good progress has been made in addressing the challenge to enhance competition in certain sectors and improve the efficiency of the public sector. In 2004, Finnish competition law was brought into line with the new EU rules and a Research Institute on Competition was created. However, no measures have been taken to deal with the excessive market concentration in the electricity sector. The action plans to improve both the efficiency of the public services sector and of the public procurement process are being implemented. In addition, mechanisms to help control public spending have been put into operation. On the central government level, multiannual spending limits have helped to control spending and ensure the compliance of expenditure rules. In their first year in operation (2004), final expenditure remained below the spending limit, and also the 2005 budget proposal is within the ceiling.

4.24. Sweden

After one and a half years of implementation, Sweden has in general made limited progress in addressing the two policy challenges that were identified in the country-specific part of the BEPGs. Limited progress has been made in addressing the challenge on labour supply through pursuing further reform of the tax and benefit systems to improve work incentives. Measures to promote participation for certain groups have been taken, although other initiatives may have a negative effect. As regards tax and benefits, a mixed picture emerges, notwithstanding further steps to complete the income tax reform taken in the budget bill for 2005.

Limited progress has also been made in addressing the challenge of enhancing competition in certain sectors and improving the efficiency of the public sector. Despite some efforts in the right direction, there is little evidence of increased efficiency in the public sector or of measures taken in order to improve competition in non-tradable sectors.

4.25. United Kingdom

After one and a half years of implementation, the United Kingdom has made good progress in addressing the four policy challenges that were identified in the country-specific part of the BEPGs. Some progress has been made in addressing the challenge to improve the relatively low level of productivity. While competition in specific sectors such as professional bodies has improved, less progress has been made in the deregulation of pharmacies and the liberalisation of postal services. Official evaluation of efforts to boost both public and private R & D and innovation has been limited. Work is ongoing to improve basic workforce skills, with initiatives to strengthen apprenticeships and facilitate adult learning.

Good progress has been made in addressing the challenge of reducing the high numbers claiming sickness and disability benefits and sustaining longer-term labour supply. The government has recently announced a major extension of existing pilot projects to support the return to work of benefits' claimants.

Good progress has also been made in addressing the challenge to improve the quality and efficiency of public services. Reforms are being undertaken to ensure that increased public spending is used efficiently and cost-effectively, building on the existing output-focused role of public service agreements.

Finally, limited progress has been made in addressing the challenge added in 2004 of strengthening the budgetary position so as to avoid emerging budgetary imbalances. Notwithstanding some signs of budgetary improvement relative to the deficit of 3.4 % of GDP in 2003, substantial uncertainties exist and it remains too early to conclude that imbalances are being avoided.

Box A1: **Follow-up to country-specific recommendations related to public finances**

Country-specific recommendations (as an extension of general guidelines 1, 14 and 15)	Significant reform measures in 2004: Adopted	Significant reform measures in 2004: Proposed
GUIDELINE 1: Reach or maintain budgetary positions of close to balance or in surplus throughout the economic cycle (*); correct excessive deficits in line with the Stability and Growth Pact *(*) Euro-area Member States were recommended to improve their cyclically adjusted balance by at least 0.5 % of GDP annually in case the medium-term objective had not yet been achieved.*		
CZ: Reduce the general government deficit in a credible and sustainable way within a multiannual framework.	The deficit targets for 2004 and 2005 are likely to be achieved. A law on new budgetary rules which introduced fiscal targeting based on medium-term expenditure ceilings for central government adopted in summer 2004.	
DE: Achieve an annual reduction in the cyclically adjusted deficit of 0.6 % of GDP in 2004 and of at least 0.5 % in 2005 to ensure the general government deficit is brought below 3 % of GDP in 2005; should the recovery be stronger than expected, allocate revenues to deficit reduction ([1]).	Despite expenditure being kept under firm control, the cyclically adjusted deficit is estimated to have widened by 0.4 % of GDP in 2004, reflecting weak tax revenues. In 2005, a decline in the cyclically adjusted balance by 0.5 percentage points of GDP is expected, though, under current policies, Germany is unlikely to bring its deficit below 3 % of GDP in 2005. In 2006, the deficit is expected to fall below 3 % of GDP on current policies.	The German authorities have recently announced additional savings for 2005, which could bring the general government deficit below 3 % of GDP in 2005.
EE: Avoid procyclical fiscal policies that may exacerbate the external imbalance; promote the reduction of the gap between domestic savings and investment.	The fiscal expansion was untimely in view of accelerating activity in 2004. For 2005, the authorities plan a balanced budget implying further, albeit much lower, fiscal loosening.	
EL: Respond appropriately to possible excessive deficit; move towards medium-term budgetary position close to balance or in surplus by improvements in the cyclically adjusted budget balance of at least 0.5 % of GDP per year.	No effective action has been taken to correct the excessive deficit in 2004, reflecting the procyclical expansionary nature of Greek fiscal policies. The cyclically adjusted budget balance is projected to improve significantly in 2005 as the government is expected to control — but insufficiently — current primary spending.	

([1]) Recommendation 7 bis to Germany also referred to budgetary consolidation after 2005.

Box A1 (continued)

FR: Achieve an annual reduction in the cyclically adjusted deficit of 0.8 % of GDP in 2004 and at least 0.6 % in 2005 to ensure the general government deficit is brought below 3 % of GDP in 2005; should the recovery be stronger than expected, allocate higher revenues or savings from lower-than-expected expenditure to deficit reduction ([2]).	The improvement in the cyclically adjusted balance in 2004, of 0.3 % of GDP, reflects no additional measures taken in 2004, despite a stronger-than-expected economic recovery. In 2005, an expected decline in the cyclically adjusted balance by 0.7 percentage points of GDP is influenced significantly by one-off revenues. This contributes to a projected reduction of the deficit to 3.0 % of GDP in 2005. In 2006, a deficit higher than 3 % of GDP is expected on current policies.	
IT: Move towards a close to balance or in surplus position by reducing the cyclically adjusted deficit by at least 0.5 % of GDP per year, replacing one-off measures with more permanent measures.	The worsening of the fiscal position, at 3.0 % of GDP in 2004, results from a gradual reduction in one-off measures, coupled with no adjustment to the primary expenditure to GDP ratio. The cyclically adjusted budget balance worsened by 0.5 percentage points of GDP in 2004 and is projected to worsen further in 2005.	
CY: Reduce the general government deficit in a credible and sustainable way within a multiannual framework.	The 2004 deficit target is likely to have been met and Cyprus is broadly on track to reach the target for 2005.	
LV: Reduce the general government deficit in a credible and sustainable way within a multiannual framework.	The deficit target for 2004 remained unchanged at 2.0 % of GDP, despite significantly higher output growth and tax revenues, which should have led to a tighter target.	The rejection of the 2005 budget caused the government to resign in October; hence, the future direction of fiscal policy is uncertain.
LT: Reduce the general government deficit in a credible and sustainable way within a multiannual framework; avoid procyclical policies, in particular budget amendments allocating additional expenditure in response to higher-than-expected revenues.	The deficit for 2004 is likely to have been lower than targeted and the target for 2005 is likely to be met. A budget amendment allocating additional expenditure (0.3 % of GDP) was adopted in June 2004 and no major budget amendments have been made since July 2004.	
HU: Reduce the general government deficit in a credible and sustainable way within a multiannual framework.	Corrective measures taken in 2004 were insufficient to reach the agreed deficit target of 4.6 % of GDP, and the failure to achieve the target cannot be attributed to unexpected unfavourable economic circumstances. The agreed target for 2005 is not expected to be reached, indicating a significant departure from the agreed adjustment path.	

([2]) Recommendation 7 bis to Germany also referred to budgetary consolidation after 2005.

Box A1 (continued)

MT: Reduce the general government deficit in a credible and sustainable way within a multiannual framework.	The deficit for 2004 is likely to have been lower than targeted. New measures in the 2005 budget to increase fiscal stringency suggest that Malta is broadly on track to reach the target for 2005.
NL: Stand ready to take the necessary measures in response to the existence of an excessive deficit, while continuing to contain government expenditure within clearly defined ceilings set in real terms, consistent with a medium-term budgetary position close to balance or in surplus.	In order to reduce the deficit, a supplementary package of savings equivalent to 0.6 % of GDP was implemented in April 2004; around half of these measures were of a one-off nature. As a consequence, the general government deficit is expected to have fallen to 2.9 % of GDP in 2004. The 2005 budget contains consolidation measures equivalent to around 0.5 percentage points of GDP.
AT: Achieve structural expenditure savings, also at lower levels of government, to lower the high tax burden, while securing a cyclically adjusted budgetary position close to balance.	The rise in the deficit in 2004 was mainly due to lower-than-planned expenditure restraint at both central and lower levels and was also influenced by the first stage of an income tax reform. The second stage of the tax reform in 2005, costed at 0.8 percentage points of GDP, is not offset in the budget and will contribute to a significant deterioration in the cyclically adjusted balance in 2005.
PL: Reduce the general government deficit in a credible and sustainable way within a multiannual framework.	The deficit for 2004 is likely to have been lower than targeted, with higher-than-expected revenues used to consolidate the fiscal position. The draft budget for 2005, adopted by the government at the end of September, incorporates several measures included in the Hausner plan, suggesting that Poland is on track to meet the target for 2005.
PT: Avoid the deficit breaching 3 % of GDP again; move towards a medium-term close to balance or in surplus position by ensuring an improvement in the cyclically adjusted budget balance of at least 0.5 % of GDP per year, replacing one-off measures by measures of a more permanent character.	The deficit for 2004 is likely to be below 3 % of GDP, influenced by sizeable one-off measures (of 2 % of GDP). The cyclically adjusted deficit was unchanged in 2004. On current policies, a worsening of the cyclically adjusted, as well as the nominal, balance is likely in 2005.
SK: Reduce the general government deficit in a credible and sustainable way within a multiannual framework.	The deficit for 2004 is likely to have been lower than targeted and the target for 2005 is likely to be met.

Box A1 (continued)

UK: Avoid the occurrence of an excessive deficit; improve the cyclically adjusted position to consolidate public finances, consistent with a position of close to balance or in surplus in the medium term.	The deficit for 2004 is likely to have been lower than in 2003 and below 3 % of GDP. A further reduction in the deficit is projected for 2005. An improvement in the cyclically adjusted balance is foreseen in 2004 and 2005.
GUIDELINE 14: Enhance the contribution of the public sector to growth	
CZ: Reform the healthcare system.	
DK: Ensure expenditure control at all levels of government.	Targets for public expenditure growth have been exceeded but there are indications that a more effective control of public expenditure has been established.
EL: Ensure effective control of government current primary spending; use public resources more effectively.	
FR: Curb the dynamics of spending in the health sector.	Reform adopted, with the aim of bringing the health insurance system into balance in 2007 while preserving the quality of the health service.
IE: Enhance public expenditure efficiency; improve medium-term revenue and expenditure planning.	Initiatives to improve efficiency and control of expenditures.
PT: Obtain deficit reduction through expenditure side; increase healthcare system efficiency.	Draft budget for 2005 will rationalise and retrench public expenditure.
SK: Continue additional health system reform and public sector rationalisation.	The 2005 budget incorporates the last tranches of the current healthcare reform agenda and further measures for public sector rationalisation.
FI: Improve spending control; ensure compliance with expenditure rules.	Mechanisms to help control public spending are being implemented.
UK: Ensure efficient and cost-effective delivery of public services.	Building on publication of a major review of public sector efficiency, government departments have submitted plans to achieve significant annual efficiency savings.
GUIDELINE 15: Ensure a further decline in government debt ratios	
BE: Ensure a sustained declining trend of the debt ratio by maintaining high primary surpluses.	The primary surplus, while decreasing over the last few years, remains high and contributes to a decline in the debt ratio, being 95.8 % in 2004.

Box A1 (continued)

EL: Ensure a sustained declining trend of the debt ratio by maintaining high primary surpluses.	The primary surplus has declined over the past five years and reached its lowest level in 2004. Despite strong economic growth, the debt ratio is estimated to have increased in 2004 to 112.2 % of GDP. A decline in the debt ratio in 2005 will be influenced by the success of the privatisation programme.
IT: Ensure that the debt ratio is diminishing at a satisfactory pace towards the 60 % of GDP threshold.	The primary surplus has been on a declining trend over the past five years and reached its lowest level in 2004. The still very high debt to GDP ratio continues to decline at a slow pace, to 106.0 % of GDP in 2004, largely explained by the high levels of the cash borrowing requirement, which since 1999 has consistently exceeded the Maastricht definition of general government deficit.
PL: Reduce the risk from the rising stock of contingent liabilities.	The pension reform was implemented in 1999 and the pension system is stable. Limited progress has been made in other areas, such as healthcare, education and transport.

Box A2: **Follow-up to country-specific recommendations related to labour markets**

Country-specific recommendations (as an extension of general guidelines 4 to 8)	Significant reform measures in 2004 — Adopted	Significant reform measures in 2004 — Proposed
GUIDELINE 4: Improve the combined incentive effects of taxes and benefits and reduce high marginal effective tax rates		
CZ: Enhance incentives to work and lower high social security contribution rates; reform tax–benefit systems to eliminate disincentives to work.	Higher unemployment benefits coupled with stricter eligibility conditions and work availability requirements; cut in sickness benefits coupled with stricter enforcement.	
BE: Reduce distortions to work incentives in tax–benefit systems.	Revised system of service vouchers; increased control on work availability requirements.	
DK: Improve labour supply incentives, in particular tax reform and eligibility rules.	Earned income tax credit, income tax reform lowering marginal tax rates for many workers; tightened job availability criteria.	
DE: Continue tax–benefit reforms to work incentives, enforce job-search conditionality.	Reduced benefit duration; end adjustment of benefits to wage increases; new benefit with strict work availability requirements.	
EE: Set up an effective institutional framework that supports job creation.	Reduction of taxes and social charges on labour.	
EL: Improve formal work incentives, including part-time, through reduced non-wage costs and pension rights transferability.	Replacement of unemployment benefits with employment subsidies.	Subsidised employment.
FR: Implement new unemployment insurance system, including effective job-search incentives.	Tightened eligibility conditions for unemployment benefit and reduced duration.	
IT: Increase labour force participation of women and older workers; increase resources and efficiency of unemployment benefit and social insurance system.	Mandatory participation in active measures to receive unemployment benefits.	
LV: Review the tax–benefit system in order to make work pay; increase the efficiency of social spending.	Action plan to combat undeclared work (2005–09).	
LT: Improve the combined incentive effects of taxes and benefits.	Overhaul of the unemployment benefit system; reduction of labour taxation.	

Box A2 (continued)

MT: Streamline the tax–benefit system to strengthen incentives to work.		
HU: Ensure that the tax–benefit systems provide incentives to enter or remain in the labour market; reduce the high tax burden on labour.	Reduction in labour taxes; reform of health contribution; measures on disability schemes envisaged.	
NL: Continue benefit reforms, particularly eligibility and conditionality and reform disability system.	Reduced benefit duration; job-search requirement for older unemployed people.	Fiscal facilities for early retirement to end in 2006 but early retirement might not be reduced appreciably in the meantime.
AT: Improve pension contributions–benefits link and improve older worker participation.	Statutory retirement age is gradually raised, extension of the period over which individual benefit entitlements are calculated.	Provisions of the 2004 draft law constitute a step backwards, *inter alia* due to facilitation of early retirement.
PL: Lower the tax burden on labour, reform the tax–benefit system to eliminate financial disincentives to work, and to increase the efficiency of social spending.	Steps to limit early retirement; new rules for sickness benefits and family allowances.	
SI: Review the tax–benefit systems with a focus on participation of older workers.	Tax exemptions and subsidies to encourage employment of older workers.	
FI: Improve tax–benefit incentives and eligibility criteria, particularly for older workers.	Income tax cuts.	
SK: Lower the very high combined health and social contribution rates, while observing the overall budgetary consolidation constraints.	Benefits introduced to increase work incentives for successful job-seekers; reduction in employer contribution rate.	
SE: Pursue reforms of tax–benefit systems to improve work incentives.	Labour income tax cuts and stricter enforcement rules for sickness insurance; increase in social benefit levels and extension of 'free-year' initiative.	
UK: Improve work incentives, particularly by reforming sickness and disability benefits.	Extension of pilot schemes for support of disabled workers' integration into the labour market.	Reform of policies after assessment of pilot schemes.
GUIDELINE 5: Ensure that wage bargaining systems allow wages to reflect productivity, taking into account productivity differences across skills and local labour market conditions		
DE: Reform wages to reflect productivity differences through reviewing the *Günstigkeitsprinzip*.	Relaxation of 'favourability' principle under consideration.	

Box A2 (continued)

EE: Ensure that wage developments, including changes to minimum wage legislation, do not hinder employment growth.		
EL: Reform wage bargaining to reflect productivity differences.	Increase in minimum wage above expected inflation and productivity.	
ES: Reform wage setting to reflect productivity differences and phase out indexation provisions in collective agreements.		
IE: Social partners to allow wages to adapt to productivity and skill differences.	Fairly moderate pay provisions agreed, increasing use of benchmarking in setting wages for the public sector.	
IT: Encourage more decentralised wage setting to better reflect productivity and skills.		
HU: Encourage a reform of wage setting (including multiannual agreements with social partners) which allows wages to better reflect productivity and promotes low inflation.	Freezing of minimum wages and public sector wage moderation.	
PL: Increase the flexibility of wage setting to ensure wages better reflect productivity differences.		
PT: Encourage wage moderation to allow increases to take into account productivity and skills.		Social pact on pay moderation and collective agreements.
FI: Reform wage bargaining to reflect productivity differences.		
SI: Liberalise administered prices and advance further with de-indexation, in particular with the wage setting mechanism.		
SK: Allow more flexibility in the wage setting mechanism.		

Box A2 (continued)

GUIDELINE 6: While respecting the role of social partners according to national practices, review labour market regulations notably by relaxing overly restrictive employment protection legislation (EPL) and addressing those relating to employment contracts, and promote more adaptable and innovative work organisation		
DE: Further reduce regulatory and administrative burden, *inter alia* by lowering effective degree of employment protection.	Maximum duration of temporary contracts raised; higher threshold to apply provisions on protection against dismissal.	
EL: Improve flexibility and security balance; modernise work organisation; review labour market regulations.	PES upgraded; creation of job centres and a centralised information system; measures to extend part-time employment.	
ES: Further reform EPL to reduce labour market segmentation across different types of contract.	New social accords to modernise the public administration.	
IT: Further reform EPL and reduce labour market segmentation across different types of contract and firm size.	Increased variety of labour contract, which may heighten labour market segmentation; employment services sector is opened and liberalised to private firms.	
SI: Address the imbalance between temporary and permanent work conditions.		
GUIDELINE 7: Facilitate labour mobility, both geographical (within as well as across countries) and occupational, especially by promoting the recognition of qualifications and the transfer of social security and pension rights, by eliminating obstacles to mobility related to the housing market, and by promoting lifelong learning		
CZ: Enhance occupational and regional mobility by deregulating the housing market and improving transport infrastructure.		
EE: Promote vocational training and lifelong learning.		Vocational education development plan for 2005–08.
ES: Continue to facilitate geographical mobility, *inter alia* by removing fiscal distortions and improving rental market conditions and availability of land for development.	Measures to ease housing search and change of residence; 2002–05 housing plan continues to be implemented.	
LV: Facilitate labour mobility by improvements in transport infrastructure.		
LT: Enhance regional mobility.	Improved transport infrastructure and quality of public transport.	

Box A2 (continued)

HU: Remove obstacles to regional mobility through appropriate housing and transport policy.	Tightening of the housing loan scheme.	Eligibility for new house purchases somewhat broadened.
PL: Remove obstacles to regional mobility, especially through reform of the housing market and improvements in transport infrastructure.	Mobility grants for certain groups of persons.	Improve the regional passenger transport network.
SI: Reassess lifelong learning activities.		
SK: Remove obstacles to regional mobility and reduce skill mismatches, whilst ensuring the efficiency of retraining measures.	Financial support for commuters; continued improvements in the transport infrastructure including public transport; housing benefits and measures.	
GUIDELINE 8: Ensure efficient active labour market policies (ALMPs) with special attention to people facing the greatest difficulties in the labour market, according to rigorous impact evaluations		
DE: Continue to improve efficiency of ALMPs, in particular job-search assistance; improve cost-effectiveness and targeting.	End of ALMPs leading to requalification to unemployment benefits.	Design of individual plans mandatory.
EE: Adopt policies with particular emphasis on reintegrating the long-term unemployed.		
LT: Ensure the efficiency of education, retraining and other ALMPs.	Promotion of vocational training.	
HU: Encourage disadvantaged groups to enter the labour market.	Grant scheme to promote (re)integration of women into the labour market; medium-term action plan initiated to promote education and training of the Roma minority.	
MT: Strengthen retraining, particularly in relation to labour shedding and returning middle-aged women to work.	Increased opportunities for lifelong learning.	Improvement of provision of grants to firms that train their workers.
SK: Ensure the efficiency of retraining measures and other ALMPs.	Ongoing reform of the education system.	Evaluation methodology for ALMPs under preparation.

Box A3: **Follow-up to country-specific recommendations related to product markets**

Country-specific recommendations (as an extension of general guideline 9)	Significant reform measures in 2004	
	Adopted	**Proposed**
GUIDELINE 9: Foster competition in goods and services markets		
BE: Enhance effective competition in network industries and in local services.	Transposition of EU directives in telecommunications, energy, postal services and railways.	
DK: Enforce competition in sectors where it is inadequate.	Competition Act was updated to bring it into line with the modernisation of EU competition law.	Recommendations made to increase competition in some sectors (legal profession, housing sector, and taxi services) where it is ineffective.
DE: Create a more competitive environment.	Lifting of existing ban on special sales in the retail sector; partial liberalisation of entry into handicraft trades.	Alignment of German competition law with EU legislation on 1 January 2005; creation of a regulator and unbundling in energy sector.
EE: Liberalise electricity market, strengthen independence of regulator and ensure competition in telecommunications.	Introduction of number portability in fixed telecommunications.	Legal unbundling of the transport system operator in energy; connecting the electricity network with the Finnish one.
EL: Enhance competition in the energy sectors.	Licences to independent power generators were granted in 2004; amendments to the legislation to fully transpose the EU energy directives.	Expected interconnection between the Greek and Turkish gas networks.
ES: Enforce effective competition in retailing and monitor developments in the electricity market.	Draft law approved encouraging higher flexibility for shop opening hours across all Spanish regions.	The creation of the Iberian integrated electricity market is set for 30 June 2005; preparation of a White Paper on the reforms of the competition framework.
FR: Ensure competition in energy markets. Raise the transposition rate of internal market directives and reduce number of infringements.	Liberalisation of the gas and electricity markets for non-household users. Law to allow the government to accelerate the transposition of directives; decree to organise the follow-up to the transposition at ministerial level.	
IE: Increase competition in network industries and certain other sectors.	In postal services, outbound cross-border mail services fully opened to competition; liberalisation of electricity supply for all large customers and many SMEs; liberalisation of gas supply for all non-household customers.	Legislative proposals to remove a limited number of restrictions on pharmacies and to liberalise liquor licensing; a competition report on the auctioneering and estate agency professions is expected in early 2005.
IT: Increase effective competition in the service sector, widen the opening of the energy markets, and improve the implementation of internal market directives.	Creation of the electricity power exchange, Marzano law and decree of May 2004 on the transmission network.	Ongoing discussion at the Parliament on proposals to increase competition in the professional services sector.

Box A3 (continued)

LU: Fully implement the reforms of the competition law and ensure that competition and regulatory authorities have sufficient independence, resources and power to fulfil their tasks.	The modernisation of the legislative framework for competition policy was finalised.	
LV: Enhance effective competition in network industries and strengthen role of the regulator; increase physical interconnections with other European networks.		Draft law to transpose EU energy directives; move to one-tier State-level regulation instead of the current two-tier State- and local-level system; creation of a modern and high-speed interconnection between the Baltic States and Poland; creation of a common Baltic electricity market and projects to connect the electricity network with those of Poland and Finland.
LT: Increase liberalisation and competition in energy, telecommunications and railway markets; create and improve interconnection capacities with neighbouring EU Member States.	Transposition of EU energy directives; number portability and digitalisation of fixed telecommunications lines; unbundling in railways sector.	Creation of a modern and high-speed interconnection between the Baltic States and Poland; creation of a common Baltic electricity market and projects to connect the electricity network with those of Poland and Finland.
HU: Proceed with liberalisation of the network industries, increase effectiveness of competition and independence of the network regulators.	Liberalisation of the gas and electricity markets for non-household users; reduction in sunk costs relating to long-term contract agreements; Act on electronic communication has entered into force; Postal Act has entered into force.	
MT: Increase competition in certain sectors, including network industries, food industries and shipbuilding.	Continuation of privatisation programme (Sea Malta); regulations for the licensing of activities in the electricity sector and relating to electricity tariffs; dismantling of levies on agriculture and agro-food products finalised by Malta's accession to the EU.	Announced privatisation for a number of State-owned holdings (Bank of Valletta and Maltacom).
NL: Improve the regulatory framework as well as its implementation.	Strengthening of the Dutch competition authority (NMa) and concentration of its action on the sector featuring weak competition.	
AT: Increase resources of the competition authority and enforce decisions of the telecommunications regulator.	Slight increase in the number of competition authority staff.	
PL: Reduce overall State aids and reorient towards horizontal objectives; encourage market entry and effective competition in network industries while pursuing a greater connectivity of national markets.	Application of the EU regulation for telecommunications (telecommunications law stimulating competition).	Announced privatisation in the energy sector in 2005.

Box A3 (continued)

PT: Enhance effective competition in liberalised utilities and increase the transposition rate of internal market directives.	Liberalisation of fuel prices; eligibility to freely choose the electricity supplier has been extended to all consumers.	The creation of the Iberian electricity market was announced for 30 June 2005.
SI: Improve competition through strengthening administrative capacity of the Competition Protection Office, easier entry into network industries and facilitating the purchase of land for industrial use.	Amendments to the Energy Act, allowing non-household users to choose their electricity supplier; use EU Structural Fund subsidies for renovation of public and utility infrastructure aimed at increasing the supply of land for industrial use.	Plans to increase staff to at least 37 but no clear timescale; new act will confer direct responsibility for issuing fines on the competition authority.
FI: Enforce competition in network industries and non-tradable services.	Harmonisation of Finnish competition law with the modernised EU competition law; set-up of a competition institute.	Implementation of the EC directive on the regulation of access to communications networks into Finnish legislation.
SE: Enforce competition in sectors where it is inadequate.	A law is expected to increase price transparency for all goods, services and utilities marketed to consumers; some suspected cartels in the construction sector are currently being investigated by the competition authorities.	Project to increase competition and trade in the construction sector involving the Nordic and Baltic countries and Poland; investigation in order to improve the implementation of competition policy; a commission will present measures on how to increase competition in the foodstuffs and construction sectors.
UK: Improve competition in sectors like the professions, postal services and pharmacies.		The government is considering reform of the regulatory framework for legal services; further investigation into the matter of public sector procurement in a number of sectors; full liberalisation of postal services, by abolishing all restrictions on market entry, by January 2006.

Box A4: **Follow-up to country-specific recommendations related to product markets and knowledge-based economy**

Country-specific recommendations (as an extension of general guidelines 11, 13 and 14)	Significant reform measures in 2004 — Adopted	Significant reform measures in 2004 — Proposed
GUIDELINE 11: Generate a supportive environment for entrepreneurship and for SMEs to start up and grow		
CZ: Remove administrative burdens, improve and enforce the legal framework and increase access to finance.	Merger of agencies for support of businesses to better integrate EU funds.	New bankruptcy legislation; better operation of the commercial register; one-stop shops for businesses.
BE: Improve public administration and pursue the reduction of administrative burden for companies.	Follow-up to the Copernicus reform; 'Kafka plan' to cut red tape; implementation of the single database for company data.	
DE: Reduce the regulatory and administrative burden.	Of 74 projects, 14 are foreseen have been implemented; two new venture capital funds for high-tech start-ups.	
EL: Simplify the business and taxation environment and raise the transposition rate of internal market directives.	New legislation to reduce bureaucratic and legal obstacles to setting up a new company; measures to increase the efficiency of the public administration; tax reform.	
ES: Reduce the administrative burden on business.	Opening of more one-stop shops; extended availability of firm-support online facilities; changes to the accounting regime for SMEs to simplify compliance with tax and accounting obligations; new insolvency law.	
FR: Reduce and simplify business regulations.	Measures have entered into force (following the 2003 economic initiative law) to stimulate business creation, and to simplify business regulation and administrative burdens; development of e-government; innovation plan.	Law to further develop and reduce obstacles to entrepreneurship; tax reforms.
IT: Reduce the administrative burden on business.	Simplification law voted in 2003; automatic cancellation from the register of closing businesses.	
CY: Continue to simplify the business and taxation environment.	Implementation of e-government services; a scheme to support youth entrepreneurship in the manufacturing sector and e-commerce as well as activities related to services in tourism; compliance with the VAT rate.	
LV: Encourage an entrepreneurial culture.	Guidelines to promote entrepreneurship; decrease in corporate tax rate to 15 %; State-guaranteed loans.	

Box A4 (continued)

LU: Encourage the creation of SMEs and help those to access venture capital.	A risk capital enterprise was launched to foster access to venture capital; action plan 'Entrepreneurship au Luxembourg — Entreprendre pour réussir'.	Generalisation of audits of the effects of new legislation and regulation on the business environment, with particular emphasis on SMEs.
HU: Ensure stability of legislation and government policies to create a business environment more supportive to entrepreneurship.	Act on Electronic Business Registration; amendment to the Act on Bankruptcy procedures; the simplified business tax system has been extended to more businesses; reduction in corporate income tax rate; extension of the four-stage credit programme.	
PL: Reduce administrative burden, simplify regulations and improve access to finance.	Law on freedom of economic activity; amendment of the law on the national criminal register.	Creation of the one-stop shop for business registration in 2007.
SI: Reduce time and costs to set up a new company and simplify administrative procedures affecting businesses.	Two new acts passed designed to increase support for small businesses and simplify licensing rules; information and business support elements of the one-stop shop system implemented.	Implementation started on third element of one-stop shop system to allow registration of a business in 14 days; other regulatory decrees to eliminate unnecessary administrative barriers for small businesses being drafted.
SK: Strengthen legislative framework, particularly through adopting new bankruptcy legislation and improving the judicial system.	Improved operation of the commercial register and estates register; reduction in the corporate income tax rate and simplification of the tax system; an institute of court administrators responsible for acts of an administrative nature has been introduced to speed up the court proceedings; new bankruptcy legislation.	Online communication with the commercial register, unified forms, one-stop shops for entrepreneurs, online submission of tax declarations, and better transmission of information within the administration.
GUIDELINE 13: Take active steps to promote investment in knowledge, new technologies and innovation and make progress towards the 3 % of GDP objective of total R & D investment		
CZ: Improve the education and training system and its responsiveness to changing skills requirements; improve R & D and innovation activities' knowledge transfer through R & D and support knowledge diffusion.	Reform of elementary and secondary schooling was adopted; investment incentives for strategic services and technological centres introduced; tax deductibility of R & D expenditures.	Reform of tertiary education.
DE: Reform education and training system.	National agreement to increase number of training places on offer over the next three years; update of occupational profiles for vocational training; EUR 4 billion federal grant to create all-day schools.	Creation of assistant professorships without *Habilitation*.

Box A4 (continued)

EE: Improve the education system and vocational training (including lifelong learning); implement the 2001 R & D strategy including promoting involvement of business sector in R & D spending.	Estonian national development plan 2004–06.	Vocational education development plan for 2005–08.
EL: Increase the availability of skilled human capital, promote business involvement in R & D and innovation, and improve ICT diffusion.	Actions promoting the development of information technology in schooling and professional training; actions to promote the use of ICT within business communities ('Go electronically' and 'e-business development') and by the public sector; links between universities and enterprises further strengthened through initiatives supporting the establishment of spin-off firms.	
ES: Increase skilled human capital, investments in R & D and innovation, and ICT diffusion.	Measures taken to develop further the national system of qualifications and vocational training; the 2004–07 national R & D+I plan; additional initiatives to foster e-government.	Changes announced to the legislative framework of the education sector.
IE: Prioritise roll-out of infrastructure and raise the level of R & D.	Completion of a number of broadband projects and road bypasses; introduction of a 20 % tax credit for incremental R & D expenditure announced in the 2004 budget.	EUR 5 billion investment programme for 2004–06 in new water and sewerage infrastructure announced in May 2004.
IT: Raise the education and skill base of the population; increase investment in R & D and innovation; promote ICT take up, in particular through measures targeted at SMEs.	Reform of the school system and universities; creation of the Italian Institute of Technology; R & D support through tax incentives.	
CY: Increase skilled human capital, promote R & D and innovation, and improve conditions to facilitate ICT diffusion.	Measures towards the development of information technology in schooling; a scheme to promote innovative projects and the adoption of new technologies.	Preparation of a national strategy for the development of the information society (including e-government services and e-commerce).
LV: Improve education and training systems and their responsiveness to labour market needs; encourage R & D and innovation, particularly in the business sector.	Multiannual plan for education; national innovation programme to promote R & D and innovation.	
LT: Improve education and training systems and their responsiveness to market needs; promote R & D and innovation; strengthen business–research institute links and support knowledge transfer through FDI and higher IT penetration.	Lifelong learning strategy for vocational training; financial actions to promote R & D, IT and innovation.	

Box A4 (continued)

HU: Promote involvement of private sector in R & D and innovation; strengthen business–research institute links; ensure sufficient resources to improve research quality and support knowledge transfer through FDI; improve education and vocational training systems to better enable them to adapt to skill needs of the market.	Modernisation of the regulation on vocational training; grants to educational institutions through the national higher-education strategy to encourage research and educational attainment; increase in support for adult education; launch of the national research and technology office; launch of the research and technological innovation fund; launch of a scheme to strengthen the link between research and businesses; Bill on R & D and Technical Development.	Reform of the system of secondary school-leaving examination.
MT: Improve the quality of secondary education and vocational training.	Plans to review and improve the provisions of the Business Promotion Act.	
NL: Promote technology-oriented education and strengthen science–industry links.	Techno partner action programme to stimulate the university–industry links; programmes aimed at increasing the number of science and technology students and boosting entrepreneurial potential.	
AT: Encourage business research and innovation, especially for SMEs.	Creation of the Austrian Research Promotion Company; reform of the fund providing resources for scientific research (FWF) in order to modernise the organisational structure and increase transparency; creation of the National Foundation for Research and Development.	
PL: Improve the education and training system and its responsiveness to changing skills requirements; promote R & D and innovation, in particular in the business sector, and support knowledge transfer through FDI.	Law of 20 April 2004 promoting investment in training and lifelong learning; general education reform to develop entrepreneurial potential; ‘*e*Poland’ (strategy for 2004–06); pilot programme for knowledge transfer through IT for SMEs; targeted projects towards implementation of R & D results in the economy.	
PT: Promote stronger involvement of the business sector in R & D, innovation and ICT; improve the efficiency of spending in education.	Citizen’s portal launched to provide electronic access to various public services; transposition into national law of EU directive on electronic commerce; legislative reforms implemented to regulate the use of electronic documents; reforms to the education system have continued to modernise curricula, promote the use of IT and vocational education; new plan for the prevention of school dropout introduced to cut early school-leaving by half by 2010.	A new science and innovation action plan is due to be implemented soon; a new Vocational Training Bill was proposed by the Council of Ministers.

Box A4 (continued)

SI: Promote R & D and innovation in the business sector and improve tertiary education.	Tax incentives for companies investing in equipment for R & D; substantial tax relief to companies who hire Ph.D. graduates; new laws adopted on higher education and post-secondary education (Bologna and Bruges–Copenhagen processes).	Decision to finance the establishment of eight or nine centres of excellence, co-financed by EU Structural Funds.
SK: Improve the education and training system and its responsiveness to changing skills requirements; encourage R & D and innovation and knowledge transfer through FDI.	Reform of elementary and secondary education.	Reform of tertiary education introducing tuition fees.
UK: Monitor closely existing measures to promote R & D; review and strengthen policies aimed at improving basic skills in the workforce.	Some steps taken to monitor science and innovation investment framework; increased take-up of the employer training pilot scheme; reform of the apprenticeship schemes including young apprenticeships for 14–16-year-olds.	Plans to introduce trials of apprenticeship programmes for adults.
GUIDELINE 14: Enhance the contribution of the public sector to growth		
DK: Increase the efficiency of the public sector.	Investigation into the modernisation of public sector roles and where possible delegation to private sector; requirement to test all public sector building and construction projects for their appropriateness as public–private partnerships.	Decision to completely overhaul municipal system of government by 2007 to improve efficiency; transfer to central government of responsibility for tax collection and recovery of debts owed to public authorities.
FI: Increase the efficiency of the public sector.	Further implementation of the 2003 action plan on improving efficiency of the public sector both at national and municipal levels; advisory board founded to increase understanding and use of public procurement.	Legislative reform aimed at improving competition in public procurement is currently being drafted.
SE: Increase the efficiency of the public sector.		Project on the terms of implementation of the EC directives on public procurement in Swedish law; report of the Council for Municipal Analysis on the development of indicators for public sector efficiency assessment.

Box A5: **Follow-up to country-specific recommendations related to pension systems**

Country-specific recommendations (as an extension of general guideline 16)	Significant reform measures in 2004 — Adopted	Significant reform measures in 2004 — Proposed
GUIDELINE 16: Design, introduce and effectively implement reforms of pension systems		
CZ: Reform pension system.		
BE: Reinforce measures to postpone retirement from the labour force.		
DE: Promote supplementary pension schemes, and strengthen incentives for later retirement.	Gradual introduction of taxation for pension benefits, coupled with tax exemptions for retirement contributions; indexation formula linking benefits to the system dependency ratio; support for financial products eligible for subsidised fully funded supplementary private pension income through trimming of red tape; early retirement for previously unemployed persons and those previously in a gradual retirement schemes (*Altersteilzeit*) postponed from 60 to 63 years as of 2006.	
EL: Pursue reforms of the social security system, and, in particular, the pension system.	Incentives provided for the prolongation of working life beyond the statutory limit of 35 years; mobility of social security rights between funds; amendments of the legislation related to persons with disabilities, farmers, professionals and civil servants.	
ES: Strengthen link between contributions and benefits and control the long-term increases in pension expenditure.	Setting-up of a pension fund to complement civil servants' pensions; further endowments to the pension reserve fund amounting to EUR 9 billion in the course of 2004.	Further endowment to the pension reserve fund of EUR 5.3 billion (0.6 % of GDP) in 2005 to reach EUR 24.2 billion (2.9 % of GDP).
FR: Undertake comprehensive reform of the pension system.		
IT: Address long transition period to the new contributions-based system, and promote supplementary privately funded pension schemes.	Tightening of the eligibility criteria to qualify for a seniority pension after 2008; privately funded schemes promoted by enabling employees to divert the annual flow of funds currently accounted by employers as *trattamento di fine rapporto* — the implementation of this measure requires secondary legislation, which is expected to be adopted in 2005.	

Box A5 (continued)

AT: Reform public pension system; increase low average effective retirement age and ensure incentives to work are enhanced.	New regulation regarding harmonised pension system refers only to persons becoming civil servants after the law enters into force. Possibility for early retirement at 62 years of age for employees made redundant and workers having done heavy-duty manual labour. Formula for annual adjustment of pension levels without automatic adjustment for demographic change.
PL: Monitor implementation of pension reform.	
PT: Adopt further reforms to the pension system for workers in general government.	
SK: Greater effort to ensure effective and functioning implementation of the new pension system.	Ongoing measures and introduction of a sizeable funded pension pillar.

Part II

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1. Belgium

After a prolonged slowdown in economic activity between mid-2000 and mid-2003, real GDP growth picked up in the second half of 2003. GDP is likely to have risen by 2.5 % in 2004. For 2005, similar growth figures are expected. The Belgian government debt remains one of the highest among the EU States (95.8 % of GDP in 2004), although it has been falling steadily since 1993. Unemployment is a second major economic challenge for Belgium also in view of the sustainability of public finances ahead of the ageing impact on pensions. Employment started to pick up again in 2004 with 0.4 % growth and further growth is expected in 2005. The low activity rate remains an important structural weakness of the Belgian labour market (66.9 % in 2004 compared with 72.1 % for the EU-25), particularly for older workers. The government has taken some measures to improve incentives to work in 2004. However, after the adoption of some measures in 2002 and 2003, progress in preventing early retirement remained limited in 2004. Belgium has a high level of hourly labour productivity. Competition from abroad allows Belgium to sustain below-average price levels. A serious effort is being made to increase R & D expenditure and to enhance the innovative capacity of the economy through education and training in the light of a long-term deficit of skilled R & D personnel. In network industries, the transposition of European legislation could ease the high Belgian prices. Continued efforts are being made to improve the business environment but the reform of the public administration has been pursued more modestly. A detailed assessment of recent developments in addressing Belgium's key policy challenges is presented in the following sections.

1.1. Long-term sustainability of public finances

The debt ratio stays on a downward path but primary surpluses diminish and the decline in interest payments slows down

In 2004, Belgium posted a slight deficit in its general government accounts (0.1 % of GDP). This was the fifth consecutive year with the government accounts in slight surplus or close to balance, whereas the debt ratio fell below the 2003 level of 100 % of GDP for the first time since the early 1980s (95.8 % of GDP in 2004). This was achieved despite lower one-off positive measures than in 2003 (0.6 % of GDP compared with 1.5 % in 2003) partly owing to higher-than-expected real GDP growth. Indeed, the economic recovery contributed to higher increases in direct and indirect taxes than in the previous years. Lower interest payments contributed to improving the government accounts, but a strong overrun in healthcare pushed up primary expenditure in 2004 and also appears to be a major problem for the years ahead.

The primary balance has been decreasing over the last few years (from 7.2 % of GDP in 2001 to 4.8 % in 2004) and is forecast to fall further to 4.2 % of GDP in 2005. The cyclically adjusted primary surplus decreased from 6.5 % of GDP in 2002 to 5.3 % in 2004 and is forecast to decrease to 4.5 % in 2005. Interest payments fell further to 5.0 % of GDP in 2004. All in all, Belgium needs to maintain high primary surpluses.

Continued overrun in health expenditures is a serious problem

The government has been relatively successful in controlling public expenditure with one important exception: healthcare spending. In the 2004 budget, expenditures have been allowed to increase only in a few areas, including health, justice and investment. Given past overruns, the government decided to set new and higher targets on healthcare spending of 4.5 % in real terms. This turned out to be hardly compatible with the recommendation to limit the yearly real increase expenditure of Entity I (federal government and social security) to 1.5 %. Correcting for the one-off transfer in subsidies for the railway company SNCB from 2004 to 2003, Entity I expenditure rose above 3 % in real terms. This is mainly the result of a substantial overrun in healthcare spending, which is estimated to have increased by around 6 % in 2004 (compared with the target of no more than 4.5 %). Further measures are clearly needed

Ensure the continuation of the budgetary adjustment in the forthcoming years, in particular in view of ensuring the long-term sustainability of public finances in the face of population ageing	Assessment
Under this challenge, Belgium was requested to:	
1. ensure that the government debt ratio is kept on a sustained declining trend at a satisfactory pace by maintaining high primary surpluses (GL 15);	In progress
2. limit the real expenditure increase in Entity I (federal government and social security) to 1.5 % and allocate proceeds stemming from higher-than-expected economic growth to improve the budgetary position as a matter of priority;	Limited
3. strengthen the existing strategy in order to prepare for the budgetary implications of population ageing: in particular by reducing the debt level, better addressing the low effective retirement age, pursuing the reform of the pension systems, and strengthening efforts to finance the ageing fund (GL 16 and E-REC 2).	In progress

Bearing in mind the three-year period available for implementation, the degree of implementation since 2003 is indicated as: 'Complete' for (practically) complete; 'In progress' where progress is well advanced; 'Limited' where the recommendation is only partially addressed; and 'Insufficient' where no substantial measures going in the right direction have been taken.

to curb real expenditure in this area. As to proceeds stemming from higher economic growth in 2004, the government respected recommendation 2 (E-REC 2) as the cyclically adjusted budgetary surplus (after correcting for the impact of one-off measures) barely changed from 2003 to 2004.

Budgetary implications of population ageing: government accounts in the right direction but with some qualifications

In view of population ageing, the challenges for Belgium are twofold. First, there is the issue of sustainability of public finances. Second, there is the issue of increasing the activity rate and the employment rate, which will be addressed in the next section. As regards public finances, the debt to GDP ratio has been falling steadily as mentioned above and should continue to go down further. The slightly worrying development is that the primary surplus, although still at 4.8 % of GDP in 2004, has been on a steady downward path. As to reforming the pension system, the authorities have taken a number of measures in 2003 such as the increase in the number of participants within the second pillar in the pension system (see the 2004 BEPG implementation report). The extension of a complete working career for women from 40 to 45 years corresponds to the finalisation of the progressive implementation of the 1997 reform. Against this background, no further steps were considered necessary.

With a view to meeting the challenges of population ageing, the Belgian authorities have followed a two-way approach of reducing the debt and building an ageing fund using budget surpluses and non-recurring receipts. This fund is meant to be used in the period 2010–30. By the end of 2004, the ageing fund had accumulated assets worth EUR 11.9 billion (4.2 % of GDP). However, in 2003 and 2004, a substantial part of the non-recurring receipts came from the taking-over by the government of the Belgacom pension fund (EUR 1.4 billion), which improved the government accounts but also had a counterpart effect of increasing government pension liabilities. The authorities justified the recourse to these one-off or temporary measures with the need to keep the debt to GDP ratio on a downward trend at a time of slow economic growth. However, focusing only on the positive side of those transactions gives a biased view of their long-term impact. Now that the cyclical developments are roughly neutral (GDP growth near potential), the government should refrain from using further one-off measures, which actually seems to be the case.

1.2. Labour market and regional development

Measures to postpone early retirement taken in the last few years are gradually implemented, but further progress remains limited

A low employment rate especially among older workers (28.1 % compared with an EU average of 40.2 % for the age group 55–64) is a major structural problem of the Belgian labour market. Some limited measures were approved in 2002 and 2003 to stimulate employment in the age category above 50, including taxing complementary pensions and raising the age until which older unemployed people have to search for a job (stepwise to 56 years in 2002, 57 in 2003, and 58 as from 2004), reducing social security contributions for older workers (started to be applied in 2004), applying financial stimuli for older workers who remain part-time employed, and promoting a reduction in working hours for that same category of workers carrying out physically demanding work. These measures have been adopted in agreement with employers and the trade unions.

In 2004, no new measures were adopted but tripartite negotiations took place to prepare agreements with the social partners to limit the access to the system of early retirement and extend further the effective working years. The government aims to carry out all these measures on the basis of social agreements. The authorities do not intend to change the legal retirement age while there is consensus on giving priority to early retirement of workers with long careers or subject to hard physical work, instead of, for example, workers in restructuring companies. All in all, although there is a slow process towards removing incentives to early retirement, so far little progress has been registered in increasing activity and employment rates, which remained broadly unchanged in 2004 and remain among the lowest in the EU.

On top of ongoing implementations of tax reform, some further measures have been taken to make work pay

The ongoing direct tax reform (approved in 2001 for progressive implementation until 2006) reduced the tax burden on labour by 0.2 % of GDP in 2004. After full implementation, the tax reform should result in a total tax alleviation of 1.6 % of GDP by 2007. Lower social security contributions (decided in 2003 and progressively implemented until 2005) further reduced the tax burden on labour by some 0.1 % of GDP in 2004. In addition, in 2004 the government decided to introduce a 'work bonus' (for progressive implementation in 2005–07) which is an increased rebate of social security contributions for low-income workers. The objective of the work bonus system is to stimulate employment by lowering labour costs, to make employment more attractive for low-income workers and to avoid 'unemployment traps'. Moreover, measures were also implemented in 2004 to quickly reactivate newly unemployed persons after company restructuring. These measures include the sponsoring of employment cells responsible for out-placing laid-off workers and temporary reductions in social security contributions for companies rehiring unemployed persons.

Employment has been promoted through the implementation of a revised system of service vouchers decided at the end of 2003. In this system, the government sponsors officially registered workers in certain household services which otherwise are often performed through the informal economy. Although the government's funding of these services has been reduced in the 2005 budget, the authorities are maintaining its initial target of

Increase the low participation and employment rates, especially for older workers and women, and improve incentives to work	Assessment
Under this challenge, Belgium was requested to:	
4. take further steps to reinforce measures to postpone retirement from the labour force, in particular by combining a removal of incentives to early retirement (GL 16) with enhanced prevention and activation measures for older workers;	Limited
5. continue progress in making work pay by eliminating the major distortions to work incentives arising from the interaction of the tax and benefit systems (GL 4).	In progress

creating 25 000 part-time jobs by 2007. Finally, measures have been taken to gradually step up controls on the availability of the unemployed for accepting a job offer, particularly as regards the long-term unemployed receiving unemployment benefits.

1.3. Productivity and business dynamism

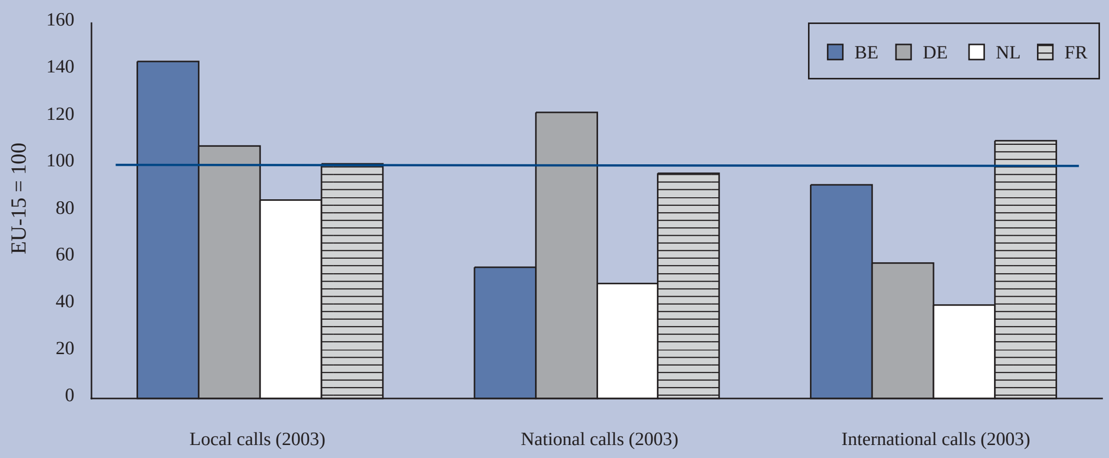
Transposition of EU legislation is slowly enhancing effective competition in network industries …

Liberalisation of network industries is progressing through the transposition of the EU legislation. In telecommunications, a draft law to transpose the EU package will enhance the powers of the regulator and will introduce a tendering procedure for the provision of universal service obligations.

Although favourable developments have been registered in the number of unbundled lines and in the penetration of mobile and broadband communications, prices in the fixed-lines segment have had a tendency to increase and prices for local calls remain amongst the highest in the EU. The full liberalisation of energy supply in Flanders in 2003 and the compliance with EU directives concerning market opening for non-household users in the Brussels Region and Wallonia have increased the number of active players and led to price reductions, renegotiations of contracts and consumers switching in the competitive segment. Globally 90 % of each — electricity and gas — market is open to competition. Legislation in postal

Enhance competition in certain service sectors and continue to increase the efficiency of the public administration and to improve the business environment	**Assessment**
Under this challenge, Belgium was requested to:	
6. take measures to enhance effective competition in network industries and in local services (in line with GL 9);	Limited
7. improve public administration in the context of the ongoing reform and pursue the reduction of administrative burden for companies (GL 11).	In progress

Graph 1.1: **Relative prices in telecommunications**



Source: Commission services.

services and railways is being brought into conformity with EU legislation. However, no specific concrete action has been taken to enhance effective competition in other local services.

… and good efforts have been made to cut the administrative burden for businesses

The Copernicus reform to improve federal public administrations has been pursued under new labels, although more modestly. Most reforms concern additional training possibilities and measures to improve the service to the public. The implementation of a new performance-based remuneration system has been completed for all civil servants. Good efforts have been made to reduce the administrative burden with a focus on the reduction of administrative barriers for new businesses. The estimated burden stood at around 3.4 % of GDP in 2002, virtually unchanged compared with 2000, with a disproportionate weight on SMEs. To decrease this burden, 61 projects of the 100 contained in the 'Kafka plan' to cut red tape are expected to have been implemented by the end of 2004. The number of days needed to set up a new business has been dramatically cut from an average of 56 to 11. The long-term objective is a smooth three-day procedure for setting up new businesses. The final implementation of the single database for company data will make contacts between companies and administrations easier. In the context of a federal State, the reduction in administrative burden at the regional level is very important. Initiatives to measure benchmarks and reduce the administrative burden, to carry out impact assessments of new legislation and to introduce one-stop shops have been implemented to various degrees in the three regions.

Table 1.1

Economic indicators for Belgium

	Belgium				EU-25			
	2001	2002	2003	2004	2001	2002	2003	2004
General economic background								
Real GDP growth (1)	0.7	0.9	1.3	2.5	1.8	1.1	1.0	2.5
Inflation (2)	2.4	1.6	1.5	2.0	2.5	2.1	1.9	2.2
Labour productivity growth (3)	– 0.7	1.2	1.2	2.1	0.8	0.9	0.9	2.1
Employment growth (1)	1.5	– 0.3	0.0	0.4	1.0	0.3	0.3	0.4
Nominal wage growth (4)	3.6	3.7	2.5	2.7	4.0	3.2	3.1	3.0
Current account (5)	4.5	5.8	4.4	4.5	:	:	:	:
Unemployment (6)	6.7	7.3	8.0	8.2	8.5	8.9	9.1	9.1
Public finances								
General government balance (5)	0.6	0.1	0.4	– 0.1	– 1.2	– 2.3	– 2.8	– 2.8
Primary balance (5)	7.2	6.1	5.7	4.8	2.4	1.0	0.3	0.2
Cyclically adjusted balance (5)	0.2	0.6	1.1	0.4	:	:	:	:
Gross government debt (5)	108	105.4	100.0	95.8	62.1	61.6	63.2	63.5
Employment								
Employment rate (7)	59.9	59.9	59.6	:	62.8	62.9	63.0	:
Female employment rate (8)	51.0	51.4	51.8	:	54.3	54.7	55.1	:
Employment rate for older workers (9)	25.1	26.6	28.1	:	37.4	38.8	40.2	:
Long-term unemployment (10)	3.2	3.5	3.7	:	3.8	3.9	4.0	:
Tax rate on low wage earners (11)	49.1	48.5	47.5	:	37.2	37.1	37.4	:
Unemployment trap indicator (12)	88.8	91.3	90.3	:	78.8	78.5	78.3	:
Product market reforms								
Hourly labour productivity (13)	120.2	119.8	120.9	:	:	:	:	:
Total trade to GDP ratio (14)	:	97.5	94.8	:	:	58.8	57.2	:
Internal market directives (15)	97.7	98.0	96.5	96.4	:	:	:	96.3
Business investment (16)	19.3	18.2	17.9	:	17.9	17.2	16.8	:
Knowledge-based economy								
Total tertiary graduates (17)	53.4	55.9	:	:	46.8	:	:	:
Spending on human resources (18)	6.1	:	:	:	5.1	:	:	:
R & D expenditure (19)	2.2	2.2	2.3	:	1.9	1.9	:	:
Expenditure on IT (20)	3.4	3.1	2.9	2.9	3.1	2.9	2.9	2.9

(1) Growth rate in per cent.
(2) Annual average rate of change in harmonised index of consumer prices in per cent.
(3) Growth rate of real GDP per occupied person in per cent.
(4) Growth rate of compensation per employee.
(5) As a percentage of GDP.
(6) Number of unemployed as a percentage of the labour force.
(7) Employed persons aged 15–64 as a share of the total population of the same age group.
(8) Employed women aged 15–64 as a share of the total female population of the same age group.
(9) Employed persons aged 55–64 as a share of the total population of the same age group.
(10) Long-term unemployed (over 12 months) as a percentage of the total active population aged 15–64.
(11) Income tax plus employer/employee contributions as a percentage of labour costs of a single earner at 67 % of the average production worker wage, no children.
(12) Effective tax rate on labour income taking into account the combined effect of increased taxes and benefits withdrawal as an individual moves from unemployment back to work earning 67 % of the average production worker wage, measured at the first month of unemployment (after any 'waiting period' if applicable).
(13) GDP per hour worked in PPS, EU-15 = 100.
(14) Percentage, average value of imports and exports of goods and services divided by GDP, multiplied by 100; for DE, ES, FR, IT, PL and the UK, the value for the EU-25 is the total for the large Member States; for all the other States, the value for the EU-25 is the total for the small Member States.
(15) Percentage implemented in November 2004.
(16) Gross fixed capital formation by the private sector as a percentage of GDP.
(17) Total tertiary graduates (ISCED 5–6) per 1 000 of population aged 20–29.
(18) Public expenditure on education as a percentage of GDP.
(19) GERD — gross domestic expenditure on R & D as a percentage of GDP.
(20) Expenditure on information technology as a percentage of GDP.

Source: Commission services (including Eurostat, structural indicators). The data for 'general economic background' and 'public finance' are taken from the Commission's autumn 2004 economic forecasts.

2. Czech Republic

In 2004, the Czech Republic experienced a strong economic performance driven mainly by buoyant investment and strong, but weakening, consumption. The outlook for economic activity remains favourable over the medium term. The key policy challenge for the Czech economy is sustainable public finances. Despite the strong GDP growth, the general government deficit remains well above 4 % of GDP. The Czech economy also displays a number of structural weaknesses. The labour market is rigid and it has so far been slow to react to the pick-up in economic activity. There are imperfections in the business environment and productivity growth per person employed over the period 2000–03 was relatively low at around 2.5 %, which was one of the lowest growth rates among the new Member States. Nevertheless, productivity growth rates in 2003 and especially in 2004 seem to be encouraging. The key reform area in 2004 was to start the process of consolidation of public finances. After the nearly two-month-long government crisis, a new government was confirmed by Parliament in August 2004. It consists of the same parties and it is again supported by the narrowest possible majority (101 of 200 seats in the Parliament). The new government mostly reaffirmed the priorities of the previous one: to accelerate economic growth, to reduce unemployment, to support families with children, to fight against corruption and to continue the consolidation of public finances. The new government has also stressed its commitment to proceeding with structural reforms. There are several proposals in the pipeline to deal with the outstanding weaknesses of the business environment. Furthermore, reform of the education system is being discussed and the government is in the process of formulating its R & D and innovation policy and the appropriate measures to implement it. A detailed assessment of recent developments in addressing the Czech Republic's key policy challenges is presented in the following sections.

2.1. Public finances

A successful beginning of the medium-term fiscal consolidation …

On 5 July 2004, the Council decided that the Czech Republic was in excessive deficit and recommended that this be corrected by 2008 at the latest. Specifically, the Czech Republic was required to implement with vigour the measures envisaged in the May 2004 convergence programme, in particular to introduce fiscal targeting based on medium-term expenditure ceilings, to design effective rules to reduce the risk of increasing indebtedness of regions and municipalities and to allocate higher-

Urgently ensure a further reduction of the general government deficit on a sustainable basis and the long-term sustainability of public finances

Under this challenge, the Czech Republic was requested to:

1. reduce the general government deficit in a credible and sustainable way within a multiannual framework in line with the decisions to be taken by the Council in the context of the forthcoming budgetary surveillance exercise (GL 1);
2. reform the healthcare and pension systems to ensure their financial sustainability, in particular to counter the expected increase in the old-age dependency ratio and take measures to reduce fiscal risk stemming from the rising stock of contingent liabilities; and to ensure that incentives to work are enhanced and the high social security contribution rates are lowered (GLs 4, 14 and 16).

than-budgeted revenues to deficit reduction. Several laws were passed in the second half of 2003 and in April 2004, for instance the law on changes in VAT and in excise duties and the laws introducing savings in pension and sickness expenditures. Reforms of expenditures and revenues were accompanied by the creation of a new institutional framework for budgetary planning. In summer 2004, the Czech Parliament passed a law on new budgetary rules which introduced fiscal targeting based on medium-term expenditure ceilings for central government. With each annual budget for year *n*, the Parliament will approve nominal expenditure ceilings for years *n* + 1 and *n* + 2. Any later review of the ceilings is allowed only in situations explicitly mentioned in the law on budgetary rules. However, the medium-term ceilings apply only to the central government expenditure. As regards regional governments and municipalities, legal constraints on their indebtedness may not be sufficient to discourage them from excessive deficits and debt. The 2004 deficit target of 5.3 % of GDP is likely to be achieved, despite an imputation of a State guarantee of about 0.8 % of GDP. Without the imputed State guarantee, the deficit target would be overachieved, mainly due to higher-than-expected revenues against the backdrop of a strong economic performance. The expenditure ceilings will become legally binding only in 2006, but the 2005 State budget to a large extent respected them and the deficit target for 2005 of 4.7 % of GDP is likely to be met as well. Although the strong economic performance makes fiscal consolidation easier, the government should stick to its original plans and concentrate on expenditure cuts. Important savings, particularly regarding government consumption, still need to be agreed upon to comply with the deficit target for 2006 of 3.8 % of GDP.

… but important decisions concerning the long-term sustainability are still pending

The Czech Republic faces serious risks of budgetary imbalances in meeting the cost of an ageing population. So far, policy measures have concentrated on parametric changes of the pension and healthcare systems. Those measures are insufficient to secure the long-term sustainability of public finances and further measures are needed. The government recently set up an experts' group to prepare different proposals of pension reform. The government is determined to choose one of the pension reform proposals and to decide on it before the 2006 parliamentary elections. On the contrary, the healthcare reform which was started by the previous government was put on hold. Contingent liabilities linked to the indebtedness of public hospitals and to the 'environmental clean-up guarantees' granted to privatised industrial firms by the national property fund remain.

2.2. Labour market

Several steps in the right direction adopted …

The main structural weaknesses of the Czech labour market are low mobility of the labour force between jobs and regions, a too generous social benefit system, high taxation of labour and an inadequate system of higher education. As part of the fiscal consolidation package, replacement rates of sickness benefits were cut in the first three days of sickness and the obligation of doctors to make responsible decisions when granting sick leaves was reinforced. A new Employment Act which entered into force on 1 October 2004 introduced several positive changes into the labour market policy. For instance, there is a new regulation of private unemployment agencies and the law introduces the possibility of 'partial unemployment.' Registration as unemployed and provision of unemployment benefits become stricter. On the other hand, the new law introduced a prolongation of unemployment benefits from six to nine months for those older than 50 years and to 12 months for those older than 55 years. The new Employment Act also includes several changes in the active labour market

Continue to address the structural problems in the labour market

Under this challenge, the Czech Republic was requested to:

3. strengthen labour supply by reforming tax–benefit systems to eliminate disincentives to work and enhance occupational and regional mobility by reducing skill mismatches, whilst ensuring the efficiency of retraining measures and other active labour market policies, deregulating the housing market, and improving transport infrastructure (GLs 4, 7, 8 and 13).

policy such as training of employees if it is necessary for them to keep the job, investment subsidies for employers creating new jobs, subsidised public works, additional support for workers with disabilities, bridging subsidy for newly self-employed persons who have been registered as unemployed, etc. On 1 May 2004, the rules for granting investment incentives were changed in such a way that entrepreneurship in the structurally weak regions with high unemployment should be better promoted. Moreover, the government adopted a programme to promote the creation of new jobs in districts where the rate of registered unemployment exceeds 14 %. To combat youth unemployment, the government has launched a special programme for young job-seekers to increase their employability.

… but more profound measures still remain to be taken

However, many of the causes of structural shortcomings in the labour market have not yet been tackled. The system of social benefits is still too generous and contributes to inactivity, particularly of low-wage workers. The highest negative impact of parenthood on the employment of women in the EU (38.9 %, compared with the EU average of 13.6 %) has remained unaddressed. The process of deregulation of housing rents was put on hold due to the lack of political consensus. In the short period of time, very little progress has been achieved in improving transport infrastructure which remains a serious constraint both for labour force mobility and for settlement of new businesses in structurally weak regions.

2.3. Productivity

A profound reform of the education system is still lacking …

The progress in reforming the education system has been very limited. The resources for education remain at very low levels. The overall public education expenditures fluctuate at around 4.5 % of GDP and there is no prospect of significant increases in the near future.

Parliament has approved a new Education Act covering primary and secondary education which should bring about a reform of the curriculum. The act should increase the autonomy of schools and shift emphasis towards flexibility and adaptability of skills and competences. Due to the lack of financial resources the government has postponed a reform of tertiary education. The proposed reform was intended to increase the number of tertiary graduates, improve their practical skills, support research at the universities and increase the expenditures on tertiary education from 0.9 % of GDP to 1.2 %. The new government refused to open a debate on the introduction of university fees.

… and the progress on R & D and innovation is piecemeal

The authorities recognise that the effectiveness of R & D activities and the diffusion of know-how continue to be a problem. The overall spending on R & D reached 1.3 % of GDP in 2003. The government is considering ways to boost private spending on R & D. The main tool is intended to be the tax deductibility of R & D expenditures. The volume of public spending (excluding the tax expenditure on R & D) is not expected to exceed 0.6 % of GDP in the next two years. In 2004, the government adopted the national R & D policy for 2004–08 and the national innovation policy. The implementation plan is to be discussed by the government in the first half of 2005. Furthermore, legislation improving the institutional framework for public research institutions was adopted.

The Czech Republic has enjoyed significant FDI inflows which have probably contributed to knowledge transfer.

Improve conditions for an accelerated productivity growth

Under this challenge, the Czech Republic was requested to:

4. improve the efficiency and quality of the education and training system and its responsiveness to changing skills requirements (GL 13);
5. improve the efficiency of R & D and innovation activities, foster the transfer of knowledge through FDI and support the diffusion of knowledge (GL 13).

In order to attract investments into advanced technologies and high value added activities, the government has adopted a programme of investment incentives for technological centres and strategic services (e.g. call centres, headquarters). This project has received a good response and is thought to generate further pressure on enhancing the quality of human capital.

2.4. Entrepreneurship and SMEs

Measures to improve the business environment are in the pipeline …

The Czech government seems determined to promote entrepreneurship and improve the business environment. As regards the institutional set-up, the investment and business development agency, CzechInvest, was created by merging several existing agencies in order to increase the effectiveness of the support for entrepreneurship and the use of EU funds. Furthermore, the Business Environment Development Council was founded with the aim of proposing measures to improve the business environment. As regards the concrete measures, there are proposals to tackle barriers to market entry and exit and to reduce administrative burden. Parliament is discussing legislative proposals to speed up the registration of companies by setting strict time limits and introducing unified forms. Parliament is also considering amendments to the bankruptcy legislation aimed at improving the position of creditors. At the same time, a completely new Bankruptcy Act is being prepared which should significantly shorten the bankruptcy proceedings, strengthen the position of creditors and allow, if still viable, for restructuring of the troubled company. A project to introduce one-stop shops for entrepreneurs is being finalised. It should be fully operational as of 2006. The general rate of corporate income tax is being gradually reduced from 31 % in 2003 to 24 % in 2006.

… but the implementation is rather slow, and …

However, besides the institutional changes and some reported improvements in the operation of the commercial register which have resulted in some reduction in the time needed to complete a registration, very few measures have actually been implemented.

… the situation of SMEs has not yet changed significantly

The valued added generated by SMEs continues to slightly exceed 52 % of the total output compared with 57 % for the EU. The system of SME support has been somewhat adjusted to accommodate the resources from the EU funds. Additional impetus is expected to be given by the government's innovation strategy. The functioning of the credit register has improved the access of businesses to finances. On the other hand, the introduction of the minimum compulsory tax for entrepreneurs seems to have reduced the number of self-employed somewhat.

Promote entrepreneurship and SMEs

Under this challenge, the Czech Republic was requested to:

6. improve the business climate by, in particular, removing administrative burdens, improving and enforcing the legal framework and increasing access to finance (GLs 11 and 12).

Table 2.1

Economic indicators for the Czech Republic

	Czech Republic				EU-25			
	2001	2002	2003	2004	2001	2002	2003	2004
General economic background								
Real GDP growth (1)	2.6	1.5	3.1	3.8	1.8	1.1	1.0	2.5
Inflation (2)	4.5	1.4	– 0.1	2.8	2.5	2.1	1.9	2.2
Labour productivity growth (3)	2.2	0.0	3.3	4.7	0.8	0.9	0.9	2.1
Employment growth (1)	0.4	1.5	– 0.2	– 0.9	1.0	0.3	0.3	0.4
Nominal wage growth (4)	7.6	6.2	6.7	6.4	4.0	3.2	3.1	3.0
Current account (5)	– 5.4	– 5.6	– 6.2	– 6.1	:	:	:	:
Unemployment (6)	8.0	7.3	7.8	8.3	8.5	8.9	9.1	9.1
Public finances								
General government balance (5)	– 5.9	– 6.8	– 12.6	– 4.8	– 1.2	– 2.3	– 2.8	– 2.8
Primary balance (5)	– 4.8	– 5.2	– 11.3	– 3.6	2.4	1.0	0.3	0.2
Cyclically adjusted balance (5)	:	:	:	:	:	:	:	:
Gross government debt (5)	25.3	28.8	37.8	37.8	62.1	61.6	63.2	63.5
Employment								
Employment rate (7)	65.0	65.4	64.7	:	62.8	62.9	63.0	:
Female employment rate (8)	56.9	57.0	56.3	:	54.3	54.7	55.1	:
Employment rate for older workers (9)	37.1	40.8	42.3	:	37.4	38.8	40.2	:
Long-term unemployment (10)	4.1	3.7	3.8	:	3.8	3.9	4.0	:
Tax rate on low wage earners (11)	41.6	41.8	42.0	:	37.2	37.1	37.4	:
Unemployment trap indicator (12)	67.2	67.0	66.3	:	78.8	78.5	78.3	:
Product market reforms								
Hourly labour productivity (13)	44.7	45.5	48.9	:	:	:	:	:
Total trade to GDP ratio (14)	67.7	62.5	63.4	:	:	58.8	57.2	:
Internal market directives (15)	:	:	:	90.1	:	:	:	96.3
Business investment (16)	24.3	22.9	22.4	:	17.9	17.2	16.8	:
Knowledge-based economy								
Total tertiary graduates (17)	25.4	25.7	:	:	46.8	:	:	:
Spending on human resources (18)	4.2	4.4	:	:	5.1	:	:	:
R & D expenditure (19)	1.2	1.2	1.4	:	1.9	1.9	:	:
Expenditure on IT (20)	3.3	3.1	3.4	3.4	3.1	2.9	2.9	2.9

(1) Growth rate in per cent.
(2) Annual average rate of change in harmonised index of consumer prices in per cent.
(3) Growth rate of real GDP per occupied person in per cent.
(4) Growth rate of compensation per employee.
(5) As a percentage of GDP.
(6) Number of unemployed as a percentage of the labour force.
(7) Employed persons aged 15–64 as a share of the total population of the same age group.
(8) Employed women aged 15–64 as a share of the total female population of the same age group.
(9) Employed persons aged 55–64 as a share of the total population of the same age group.
(10) Long-term unemployed (over 12 months) as a percentage of the total active population aged 15–64.
(11) Income tax plus employer/employee contributions as a percentage of labour costs of a single earner at 67 % of the average production worker wage, no children.
(12) Effective tax rate on labour income taking into account the combined effect of increased taxes and benefits withdrawal as an individual moves from unemployment back to work earning 67 % of the average production worker wage, measured at the first month of unemployment (after any ‘waiting period’ if applicable).
(13) GDP per hour worked in PPS, EU-15 = 100.
(14) Percentage, average value of imports and exports of goods and services divided by GDP, multiplied by 100; for DE, ES, FR, IT, PL and the UK, the value for the EU-25 is the total for the large Member States; for all the other States, the value for the EU-25 is the total for the small Member States.
(15) Percentage implemented in November 2004.
(16) Gross fixed capital formation by the private sector as a percentage of GDP.
(17) Total tertiary graduates (ISCED 5–6) per 1 000 of population aged 20–29.
(18) Public expenditure on education as a percentage of GDP.
(19) GERD — gross domestic expenditure on R & D as a percentage of GDP.
(20) Expenditure on information technology as a percentage of GDP.

Source: Commission services (including Eurostat, structural indicators). The data for ‘general economic background’ and ‘public finance’ are taken from the Commission’s autumn 2004 economic forecasts.

3. Denmark

After the subdued economic activity in 2003, GDP growth should be some 2¼ % in 2004 and 2005, mainly driven by domestic demand. In particular, in 2004 private consumption was boosted by direct and indirect tax cuts as well as the suspension of contributions to a mandatory pension savings scheme. As part of the spring 2004 fiscal package, the income tax cuts of the tax reform were accelerated and fully implemented in 2004. The labour market turned in 2004, with employment recovering modestly after the marked fall in 2003. Overall, economic policy remains focused on medium-term objectives, addressing the broader challenge of ensuring the financing of the expected future increase in net public expenditures due to ageing, without the need for a fiscal tightening at some later point. The strategy pursued consists of reducing the public debt ratio substantially by 2010, through running significant general government surpluses while at the same time lowering the tax burden with a view to increasing labour supply and output potential. The fiscal targets are overall being met and Denmark's public finances are thus sound. The medium-term fiscal projections, however, assume significant increases in the labour supply and this challenge has so far been less forcefully addressed. To present reform proposals related to the future financing and design of the welfare system, the so-called Welfare Commission was set up in 2004. In recent years, productivity per hour in Denmark has been generally above the EU-15 average, both in terms of level and growth. However, according to an OECD survey carried out in July 2004, Denmark continues to have the highest prices in the EU. There are likely to be numerous factors behind the sustained high price level, but one element may be weak competition in some sectors of the economy. In 2002, the government set a target of halving the number of markets with competition problems by 2010. It has already made some progress towards this target and proactive efforts by the Danish competition authority should help the situation to improve further, not least in the area of government regulations that distort competition. A detailed assessment of recent developments in addressing Denmark's key policy challenges is presented in the following sections.

3.1. Long-term sustainability of public finances

Measures to enhance labour supply have been taken in recent years …

As reviewed in the 2004 implementation report, earlier reform efforts have gone in the right direction and should have a positive effect on labour supply. The 2003 'More people into employment' initiative includes more results-oriented activation measures and strengthened economic incentives for groups benefiting from social assistance. In addition, availability and willingness-to-work criteria have been tightened. The recent tax reform, fully implemented in 2004, lowers marginal taxes by approximately 6 percentage points for about a quarter of the workforce by raising the threshold for the medium tax bracket which should raise the incentives for many to work more hours. In addition, an earned income tax credit has been introduced to enhance incentives for low wage earners to stay in or enter the labour market. Even after the recent reform, however, the top marginal rate of 63 % still applies to around 40 % of full-time workers. Moreover, while contributing to raising labour supply, the tax cuts are not self-financing and thus do not per se improve long-term fiscal sustainability. The agreement to lower taxes was financed within the framework of the original 2010 plan (dating from January 2001), partly by making use of the built-in room for tax reductions, and partly by lowering expenditure targets.

… but the needed future reforms have yet to be specified

The effects of already implemented measures take time to come through and it is too early to fully evaluate their impact. In spite of earlier reforms, the unemployment benefit duration remains long in an EU context. This could reduce the effectiveness of active labour market policies. Although activation does not provide entitlement to new benefit periods and willingness-to-work criteria are strict, the remaining duration of unemployment benefits has provided an easy return to benefit recipiency, often resulting in only short employment periods

Ensure an adequate labour supply in view of the ageing of the population	**Assessment**
Under this challenge, Denmark was requested to:	
1. continue efforts to increase labour supply notably by efforts to make work pay by increasing incentives to join and remain in the labour force and to postpone retirement, in particular by ensuring the implementation of the tax reform and by considering additional steps to tighten eligibility rules and reduce marginal taxes within a framework of sound public finances (GL 4);	In progress
2. ensure expenditure control at all levels of government so that the multiannual targets for public consumption growth are respected (GL 14).	In progress
Bearing in mind the three-year period available for implementation, the degree of implementation since 2003 is indicated as: 'Complete' for (practically) complete; 'In progress' where progress is well advanced; 'Limited' where the recommendation is only partially addressed; and 'Insufficient' where no substantial measures going in the right direction have been taken.	

for low wage earners. Regarding older workers, the 1999 reform of the voluntary early-retirement benefit scheme is having some positive effects on the labour supply of persons aged 60–62 years. However, by reducing or delaying entry via economic incentives rather than restricting access, the reform was limited and the scheme thus remains an obstacle to raising labour market participation for the over-60s. All in all, as recognised by the Danish authorities, further efforts will be needed to reach the medium-term targets for labour supply. The content of further reforms has not yet been spelled out.

The targets for public expenditure growth have been exceeded …

Over the last decade, the average growth of public consumption expenditure in real terms has been some 2 %. The target set for 2002 and 2003 was an average growth of 1 % over the two years. The outcome, however, was 2.1 and 1.0 %, respectively, thus in excess of the target but with a downward trend. The target for 2004 was 0.7 % and from 2005 still stricter at ½ %. Achieving the targets for public expenditure restraint is important for the medium-term fiscal targets in general, and also for the credibility of the strategy of income tax reductions, as the potential fiscal leeway for the tax cuts has been created in part by lowering the projected future growth of real public consumption expenditure in 2004 and 2005.

… but public expenditure control is becoming more effective

As the largest share of public consumption is the responsibility of the counties and municipalities, fulfilling the targets for the general government finances will require discipline in adhering to the agreements across all government levels. In addition to the budget agreements across government levels, the tax freeze is a key factor in this respect. Local governments have autonomous taxing powers but are restricted in raising capital via loans. In this perspective, the tax freeze aims at preventing local governments from raising taxes to finance increased spending. In 2004, real public consumption is expected to have grown only modestly, which could indicate that a more effective control of public expenditure has been established. Moreover, the local government budgets for 2005 imply that the tax freeze is respected overall. In view of past trends, however, the target of ½ % growth of real public consumption remains ambitious.

3.2. Productivity and business dynamism

Efforts are being made to improve competition in sectors where there are problems …

Prices in Denmark remain the highest in the EU and this may be due in part to weak competition in some parts of the economy. The Danish government has made clear its commitment to improving competition throughout the economy by setting long-term targets for reducing the number of sectors with competition problems and by conferring extra powers on the Danish competition authority. Since 2002, the competition authority has had the power to impose fines large enough to have a deterrent effect on undertakings in breach of competition law and in 2004 the Danish Competition Act was updated to bring it into line with the modernisation of EU competi-

Enhance competition in certain sectors and improve the efficiency of the public sector	Assessment
Under this challenge, Denmark was requested to:	
3. step up efforts to enforce competition in sectors where it is inadequate (GL 9);	In progress
4. continue efforts to increase the efficiency of the public sector, *inter alia* by improving framework conditions for increased competition, promoting the benchmarking of public sector efficiency, and by increasing public tendering (GL 11).	In progress

tion law. The competition authority has been proactive in identifying markets where problems exist. In 2004, a report was published which identified sectors, such as the legal profession, the housing sector and taxi services, where competition is distorted by regulations. The report makes recommendations for change in some sectors, and suggests further investigation in others.

… and moves to increase public sector efficiency are continuing

In 2004, the decision was made to completely overhaul the municipal system of government with the aim of *inter alia* improving efficiency. The implementation of the changes is planned to take place in 2007. The number of municipalities is expected to be reduced from 271 to around 100. The new larger municipal units should allow the exploitation of scale efficiencies. Significant efficiency gains are expected by the Danish authorities from the transfer to central government of the responsibility for tax collection and recovery of debts owed to public authorities. However, some concerns might be raised as to whether the increased decentralisation might ultimately reduce efficiency in certain areas if new administrative units are created to replace the present county administrations.

Also in 2004, a cross-government initiative was launched to investigate how public sector roles can be modernised and where possible delegated to the private sector. As part of its action plan for public–private partnerships, the government has introduced a requirement to test all public sector building and construction projects for their appropriateness as public–private partnerships.

Table 3.1

Economic indicators for Denmark

	Denmark				EU-25			
	2001	2002	2003	2004	2001	2002	2003	2004
General economic background								
Real GDP growth (1)	1.6	1.0	0.5	2.3	1.8	1.1	1.0	2.5
Inflation (2)	2.3	2.4	2.0	1.1	2.5	2.1	1.9	2.2
Labour productivity growth (3)	1.3	1.4	1.4	1.9	0.8	0.9	0.9	2.1
Employment growth (1)	0.3	– 0.4	– 0.9	0.4	1.0	0.3	0.3	0.4
Nominal wage growth (4)	4.6	3.2	3.6	3.3	4.0	3.2	3.1	3.0
Current account (5)	3.1	2.0	2.9	3.2	:	:	:	:
Unemployment (6)	4.3	4.6	5.6	5.8	8.5	8.9	9.1	9.1
Public finances								
General government balance (5)	2.1	0.7	0.3	1.0	– 1.2	– 2.3	– 2.8	– 2.8
Primary balance (5)	5.4	3.6	2.9	3.3	2.4	1.0	0.3	0.2
Cyclically adjusted balance (5)	0.9	0.5	1.2	1.5	:	:	:	:
Gross government debt (5)	49.2	48.8	45.9	43.4	62.1	61.6	63.2	63.5
Employment								
Employment rate (7)	76.2	75.9	75.1	:	62.8	62.9	63.0	:
Female employment rate (8)	72.0	71.7	70.5	:	54.3	54.7	55.1	:
Employment rate for older workers (9)	58.0	57.9	60.2	:	37.4	38.8	40.2	:
Long-term unemployment (10)	0.8	0.9	1.1	:	3.8	3.9	4.0	:
Tax rate on low wage earners (11)	40.6	39.9	39.9	:	37.2	37.1	37.4	:
Unemployment trap indicator (12)	93.7	93.1	92.7	:	78.8	78.5	78.3	:
Product market reforms								
Hourly labour productivity (13)	101.7	99.9	101.9	:	:	:	:	:
Total trade to GDP ratio (14)	44.1	44.6	42.4	:	:	58.8	57.2	:
Internal market directives (15)	99.2	99.3	99.7	97.5	:	:	:	96.3
Business investment (16)	18.4	18.9	18.2	:	17.9	17.2	16.8	:
Knowledge-based economy								
Total tertiary graduates (17)	55.2	:	:	:	46.8	:	:	:
Spending on human resources (18)	8.5	8.5	:	:	5.1	:	:	:
R & D expenditure (19)	2.4	2.5	2.6	:	1.9	1.9	:	:
Expenditure on IT (20)	3.8	3.5	3.4	3.4	3.1	2.9	2.9	2.9

(1) Growth rate in per cent.
(2) Annual average rate of change in harmonised index of consumer prices in per cent.
(3) Growth rate of real GDP per occupied person in per cent.
(4) Growth rate of compensation per employee.
(5) As a percentage of GDP.
(6) Number of unemployed as a percentage of the labour force.
(7) Employed persons aged 15–64 as a share of the total population of the same age group.
(8) Employed women aged 15–64 as a share of the total female population of the same age group.
(9) Employed persons aged 55–64 as a share of the total population of the same age group.
(10) Long-term unemployed (over 12 months) as a percentage of the total active population aged 15–64.
(11) Income tax plus employer/employee contributions as a percentage of labour costs of a single earner at 67 % of the average production worker wage, no children.
(12) Effective tax rate on labour income taking into account the combined effect of increased taxes and benefits withdrawal as an individual moves from unemployment back to work earning 67 % of the average production worker wage, measured at the first month of unemployment (after any 'waiting period' if applicable).
(13) GDP per hour worked in PPS, EU-15 = 100.
(14) Percentage, average value of imports and exports of goods and services divided by GDP, multiplied by 100; for DE, ES, FR, IT, PL and the UK, the value for the EU-25 is the total for the large Member States; for all the other States, the value for the EU-25 is the total for the small Member States.
(15) Percentage implemented in November 2004.
(16) Gross fixed capital formation by the private sector as a percentage of GDP.
(17) Total tertiary graduates (ISCED 5–6) per 1 000 of population aged 20–29.
(18) Public expenditure on education as a percentage of GDP.
(19) GERD — gross domestic expenditure on R & D as a percentage of GDP.
(20) Expenditure on information technology as a percentage of GDP.

Source: Commission services (including Eurostat, structural indicators). The data for 'general economic background' and 'public finance' are taken from the Commission's autumn 2004 economic forecasts.

4. Germany

In 2004, GDP grew at a solid pace of nearly 2 %, thus bringing a long period of stagnation to an end. However, the recovery has so far relied almost exclusively on external demand. Domestic demand even shrank, reflecting weak business and consumer confidence as well as stagnating wages. As a result of this lopsided demand pattern, public finances failed to improve substantially with the deficit in 2004 barely below 4 % of GDP, practically unchanged from 2003. The reluctance of German households and companies to spend contrasts with the far-reaching structural reform programme launched by the government in March 2003, which in the medium term should improve Germany's growth potential. Since the reform programme is largely addressing the labour market and social security systems, public controversies over implementation details overshadowed the progress of reform. Public finances benefited from the reform, in so far as nominal expenditure remained flat in 2004. Based on the additional measures adopted by the government in late 2004, it may be expected that, despite revenue shortfalls, the deficit can be brought below 3 % of GDP in 2005. No significant action has been taken by the government to ensure that wages reflect productivity differentials across skills and regions, besides encouraging social partners to make greater use of opening clauses in collective agreements. Only some progress has been made in the health sector and in the education system. Also, the blurred allocation of decision powers between different levels of government often impeded finding a common approach on reform progress between the different levels of public authorities. The delays in the transposition of internal market (IM) directives into national law and the different approaches taken to address the weaknesses in the German education system are examples. Nonetheless, the majority of the recent reforms go in the right direction, and it is reassuring that the authorities are ready to review policy settings on a broad front, for example, with active labour market policy. A detailed assessment of recent developments in addressing Germany's key policy challenges is presented in the following sections.

4.1. Labour market and regional development

Implementation of a large reform programme …

As reviewed in the 2004 implementation report, Germany has since March 2003 been passing legislation to reform the labour market, with implementation taking place over 2003–05. The reforms comprised the four laws on 'modern services in the labour market' (Hartz I to IV), modifying the framework and the instruments of labour market policy in a fundamental way. Furthermore, the law on labour market reforms relaxed slightly the dismissal protection rules, and a reform of the regulation of crafts eased the qualification requirements needed to open up a business. The year 2004 was characterised by the implementation of these measures. Labour market reforms already implemented are showing first effects, with the rapid increase in low-skilled jobs subject to reduced social security contributions, bringing the overall decline in employment to a halt (see Graph 4.1). Between mid-2001 and mid-2003, employment in Germany fell by half a million from 38.9 million to 38.4 million.

Recently, the figure has edged up by some 100 000 from a low in autumn 2003, in spite of still subdued GDP growth. By contrast, over the same three years, the number of employees paying social security contributions dropped by one and a half million with no indication of bottoming-out. The fall in the number of persons paying social security contributions is one of the reasons for the deterioration in public finances. The government has commissioned a comprehensive evaluation of the individual measures and of their overall effects — to be undertaken by independent research institutes by 2006 — with first results expected before the end of 2005.

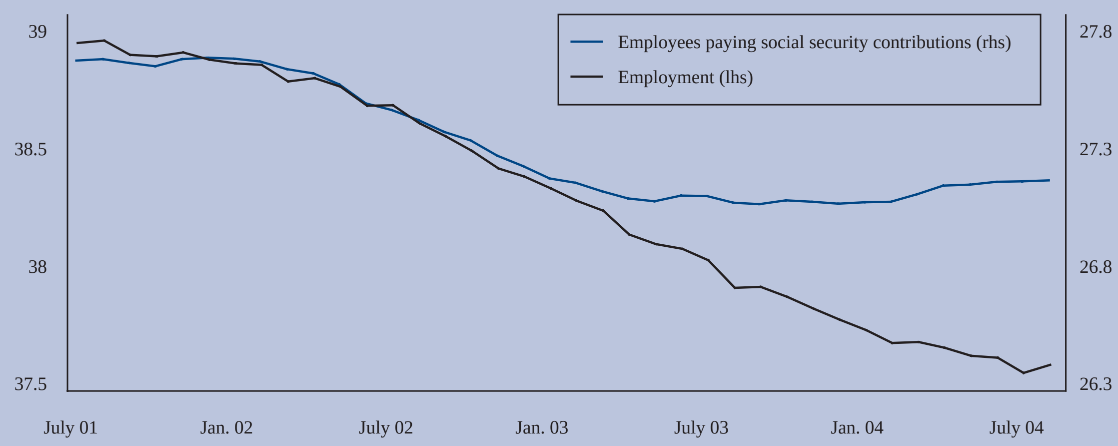
… but incentives could be strengthened further

The recommendation to reform the tax–benefit system addresses two issues in particular. First, persons not in

Promote job creation and adaptability and mobilise the unutilised employment potential	**Assessment**
Under this challenge, Germany was requested to:	
1. continue to reform the tax–benefit system (GL 4), in order to ensure sufficient incentives to take up work or to move into a higher income bracket, and firmly enforce the conditionality of benefits upon active job search;	In progress
2. take measures to ensure that wages reflect better productivity differences across skills and regions (GL 5), notably by reviewing the *Günstigkeitsprinzip*, allowing temporarily lower payments for job-starters;	Limited
3. carry forward the reforms to improve the efficiency of ALMPs, in particular of job-search assistance. Further reform ALMPs according to cost-effectiveness criteria and target them better towards those persons most prone to the risk of long-term unemployment (GLs 8 and 13 iv).	In progress

Bearing in mind the three-year period available for implementation, the degree of implementation since 2003 is indicated as: 'Complete' for (practically) complete; 'In progress' where progress is well advanced; 'Limited' where the recommendation is only partially addressed; and 'Insufficient' where no substantial measures going in the right direction have been taken.

Graph 4.1: **Employment and employees paying social security contributions (million persons)**



Source: Commission services.

the labour force find it unattractive to take up low-paid work due to high contribution rates to social security. Second, social transfers are usually tied to the recipient being out of work, and thus the unemployed face high marginal tax rates upon taking up a job. The 2004 data seem to show that the first problem has been addressed by recent reforms, whereas this was less the case for the second (and more important) problem. So-called *Minijobs*, paying up to EUR 400 a month, exempt the worker from social security contributions, while *Midijobs*, paying between EUR 400 and EUR 800, only 'phase in' social security contributions. Since their introduction on 1 March 2003, their number has been rising. However, the number of employees paying social security contributions has fallen and unemployment has not changed much. This indicates that these jobs may have proved largely attractive to persons outside the labour force. There is no clear evidence that this trend is coming to a halt. Whether *Minijobs* crowd out regular jobs or whether they create additional job opportunities cannot yet be determined on the basis of existing studies. Since they are subject to reduced social security contributions and unemployment is hardly declining, *Mini-/Midijobs* may aggravate the funding problems of social security systems. With the new social benefit (ALG II) in 2005, the opportunities for earning income in addition to transfers are being extended. Although between 70 and 85 % of the transfer income is still being withdrawn upon taking up low-paid work, the level of income at which transfers are withdrawn entirely has been raised considerably.

Despite the transfer trap, incentives to take up work will be strengthened by the reorganisation of the benefit structure in 2005 (Hartz IV), which involves some expenditure cuts (e.g. for housing aid) and stricter rules for transfer payments. Although the reform was legislated at the end of 2003, the organisational aspects of this reform were fixed only late in 2004, which is likely to result in administrative problems at the time of introduction in 2005. The reduction in the benefits will not eliminate the unemployment trap fully, but will improve incentives to take up work paying marginally above the transfer income. In particular, workers will be forced to accept any job offer paying up to 30 % less than the prevailing local wage; otherwise, they stand to lose their benefit entitlement eventually.

Progress was made in 2004 regarding the reduction of active labour market programmes with poor results from evaluation. Also, employment in the secondary labour market no longer creates further claims to unemployment benefits. A different type of secondary employment, but without the same benefits as regular employment, is being substantially extended in 2005. Such so-called ‘one-euro-jobs’ are unskilled jobs against an expense allowance for their holders, which are not meant to replace jobs offered on the market. These jobs can be offered on a compulsory basis to recipients of ALG II by their local counsellor; if declined, the social assistance is eventually lost. These jobs may reinforce incentives for the unemployed to seek regular work, if the local job centres indeed use them in this ‘workfare’ manner. However, there are grave risks of inefficiency. Although ‘one-euro-job’ holders remain liable to accepting any regular job, they will often disappear from the unemployment statistics, improving ‘the record’ of their local counsellor. Both the job-holders and the local governments that offer such jobs are fully compensated for their expenses by the Federal Employment Agency. The agency does not require the employer to assume part of the social benefits that it continues to fully pay to the job-holder.

Evidence on two further measures from the Hartz package aiming at the primary labour market, both introduced on 1 January 2003, became available in 2004. As of end-November 2004, 870 *Personal-Service-Agenturen* (PSAs), which are temporary employment and training agencies taking on for 12 months unemployed persons who are difficult to integrate into the labour market, had been established, employing around 36 400 formerly unemployed persons (against a target of 50 000). Since their creation, about 67 000 persons have left the PSAs, of which about 20 000 have found regular work. The number of people in ‘Ich-AGs’, a scheme providing subsidies to unemployed persons when becoming self-employed, had risen to 181 000 in November 2004. However, the scheme was criticised for the unconditional approval of applications. From November 2004 onwards, the business plans submitted by new applicants are being scrutinised more closely. It remains to be seen whether this will make this start-up scheme more efficient.

No reform of wage bargaining

Wage agreements were moderate in 2004, accompanied by a negative wage drift. Encouraged by the government, wage agreements increasingly contain opening clauses that allow for de facto wage cuts in exchange for job guarantees. These are, however, most often conditional on the agreement by social partners at the industry level. Several large firms with a firm-level wage agreement also concluded such deals. Moreover, especially in eastern Germany, wage contracting is losing importance as the social partner organisations are losing members. This is evidence for the pressure for greater wage differentiation at the firm level. Notably, the recent behaviour of social partners can be seen as the first practical deviation from the prevailing interpretation of the *Günstigkeitsprinzip*, which, according to the union wage contract law (*Tarifvertragsgesetz*), allows deviations from the union wage contract only if this is to the worker’s benefit. In the past, courts had interpreted this rule such that firm-level agreements on wage cuts against job guarantees do not warrant a deviation from the industry-level union wage agreement. The labour market developments in 2004 support the recommendation to clarify the *Günstigkeitsprinzip* in the *Tarifvertragsgesetz*, together with providing for opening clauses at the firm level in the *Tarifvertragsgesetz* as a complementary means to ensure that wages better reflect productivity differences. Germany, however, did not review existing legislation in this respect.

4.2. Productivity and business dynamism

Measures taken to encourage businesses to invest and grow have had little effect thus far

Business investment as a percentage of GDP declined from 18.5 % in 2001 to 16.3 % in 2003. This decline was steeper than that in other Member States, indicating it was not a pure business-cycle effect. The creation of a more attractive business environment was hindered by remaining barriers to a truly integrated internal market. The transposition rate of internal market directives in 2004 (97.5 %) remained below the EU target of 98.5 %. The federal government has pledged to achieve the target by the end of 2005. Although the statutory corporate tax rate was reduced from 45 % (of retained earnings) in 1998 to 25 % in 2004, nominal taxation of profits at the level of corporations remains relatively high because of the additional burden imposed by the local trade tax.

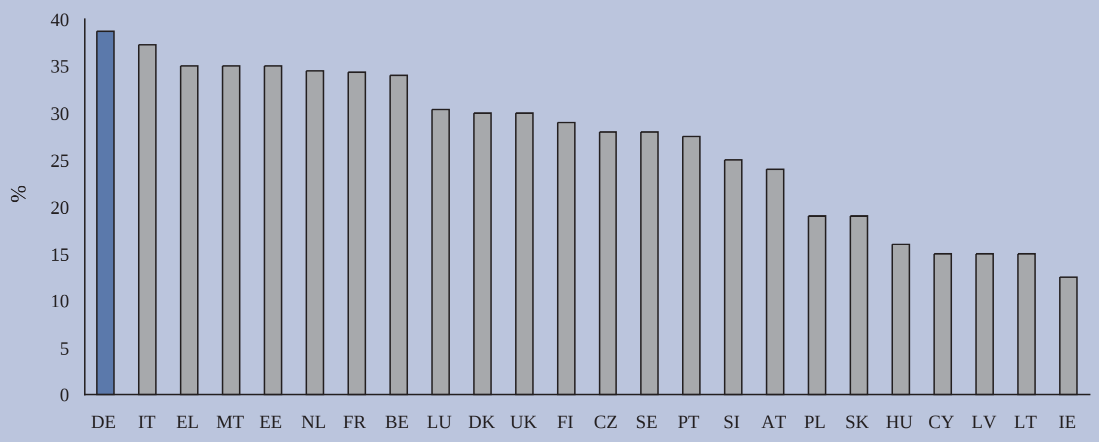
However, most German companies are partnerships, subject to personal income tax with an effective tax burden that is lower than that of corporations. The government appears to be making a serious effort to broaden the tax base. Sectoral and ad hoc State aids continued their slow decline. By the end of 2005, all federal government departments will be obliged to post their public procurement notices on a common Internet portal. This obligation does not apply to *Land* and local administrations. With the entry into force of the reformed Act on Unfair Competition on 8 July 2004, the existing ban on special sales in the retail sector was lifted. The amended competition law aligning German law with European legislation is scheduled to come into force on 1 January 2005. In 2004, the federal government launched two funds to help young high-tech start-ups gain access to venture capital. In 2004, 16 of the 74 projects foreseen in the government initiative to reduce bureaucracy and over-regulation were successfully implemented. In 2004, Germany relaxed the dismissal regulation to its pre-1998 state, notably by exempting small enterprises of at most 10 employees from the dismissal protection law for newly hired persons, and by streamlining the criteria for lay-offs for operational reasons. A high-level commission to review the constitutional allocation of powers between the different levels of government (*Föderalismuskommission*) was set up in 2003, but terminated its work at the end of 2004 without having reached a final agreement.

Only 10 % of German schools offer all-day education

In the summer of 2004, the federal government and the largest business associations launched a national agreement for training and promoting young skilled workers in Germany, with both sides pledging to increase the number of training places on offer over the next three years. Occupational profiles for vocational training are continuously being updated, especially in the light of the needs of SMEs, and new vocations are being created primarily in order to better take into account the individual demands and skills of school-leavers. In 2002/03, only 9.6 % of German schools offered all-day education, which may be considered as a tool to improve the educational attainments of students and to diminish the negative correlation between social background and scholastic success. As a result of a EUR 4 billion grant from the

Increase productivity through improvements in the business environment and the efficiency of the education system	Assessment
Under this challenge, Germany was requested to:	
4. encourage businesses to invest and grow by creating a more competitive environment (GL 9) and by further reducing the regulatory and administrative burden (GL 11), *inter alia*, by lowering the effective degree of employment protection (GL 6);	Limited
5. carry out further reforms contributing to improved educational achievements and the elimination of persistent skill shortages (GL 13).	Limited

Graph 4.2: **Statutory corporate tax rates (including local taxes and surcharges), 2004**



Source: Commission services.

federal government, around 3 000 schools more did so in 2004. The *Länder* set up a joint institute to work on education standards. However, the suggestion from the federal government to reconsider the current education system based on early selection has met resistance at the *Land* level. The federal government is resisting attempts by the *Länder* to introduce tuition fees that are aimed at limiting the duration of tertiary education. A proposal to create assistant professorships without *Habilitation* (a specific qualification for university lecturers) has been presented to the Federal Parliament, in order to improve and accelerate the process of qualification and training of young researchers.

4.3. Public finances

Expenditure restraint, but shortfalls in tax revenue

With additional budgetary measures adopted in late 2004, Germany can be expected to bring its general government deficit to just below 3 % of GDP in 2005. Augmenting its autumn 2004 forecast by these measures, the Commission projects the deficit at 2.9 % in 2005. Although the cyclically adjusted deficit is estimated to have widened by 0.4 % of GDP in 2004, with the additional measures an improvement by 1 % of GDP in 2005 and by 0.3 % of GDP in 2006 is projected. Although real GDP growth in 2004 at 1.9 % turned out to be stronger than expected by the Commission and by the German authorities in spring 2004, public revenues nevertheless fell short of expectations.

The reason for the revenue shortfall lies to a large extent in the composition of GDP growth, which was driven almost exclusively by buoyant export demand, resulting in value added taxes and excise duties below expectations. Stagnating real wages and uncertainty about the effects of the structural reform process, but also restraint on the part of corporate investors, dampened domestic demand. Yet, the budgetary authorities managed to keep expenditure under firm control. In nominal terms, public spending stagnated in 2004, including with the additional measures, and is projected to do so again in 2005. The weakening of the cyclically adjusted balance in 2004 mechanically reflects the tax-unfavourable growth composition (but also discretionary tax cuts); this effect is expected to reverse with domestic demand picking up in 2005 and 2006, which should enable the cyclically adjusted balance to improve in these years. However, none of the additional measures taken in late 2004 contributes to long-term sustainability. Indeed, some of the expenditure relief in the short run will lead to higher expenditure in the future. According to the 2004 update of the stability programme, a position of government finances close to balance or in surplus is not achieved in the medium term.

Reduce rapidly the general government deficit to below 3 % of GDP and keep government finances on a steady consolidation path	Assessment
Under this challenge, Germany was requested to:	
6. achieve an annual reduction in the cyclically adjusted deficit of 0.6 % of GDP in 2004 and of at least 0.5 % of GDP or a larger amount in 2005 so as to ensure that the general government deficit is brought below 3 % of GDP in 2005 (GL 1);	Limited
7. should the recovery in economic activity be stronger than currently expected, allocate any higher-than-expected revenues to deficit reduction and accelerate the reduction in the cyclically adjusted deficit;	n.a.
8. ensure that the budgetary consolidation continues in the years after 2005, namely through a steady reduction in the cyclically adjusted budgetary deficit by at least 0.5 percentage points of GDP per year or more if necessary to achieve the medium-term position of government finances close to balance or in surplus and bring back the debt ratio to a declining path (GL 1).	Insufficient

4.4. Long-term sustainability of public finances

Pensions: striving for sustainability, but incentives are yet too weak

Germany continued to overhaul its pension system with three laws in 2004. The law on sustainable funding of the pension system (*RV-Nachhaltigkeitsgesetz*) modifies the annual adjustment for public pensions according to the rise in gross wages through a 'sustainability factor', which takes into account the ratio of contributors to benefit recipients. Incentives for later retirement were partially strengthened. On the one hand, the earliest possible retirement age for previously unemployed persons and persons in a gradual retirement scheme (*Altersteilzeit*) will be raised gradually from 60 to 63 years from 2006 onwards. In addition, the labour market reform legislated in 2003 foresees a reduction in the maximum unemployment benefit duration of persons above 55 years of age from 32 to 18 months from 2006 onwards. On the other hand, the pension system still provides incentives to retire early, as the present value of retiring one year earlier is greater than the present value of the pension with one additional year of contributions (discounted by the individual time preference rate). Despite this, the discount to early retirement is actuarially fair in the sense that such behaviour does not additionally burden the contribution base. A decision on the increase in the statutory retirement age beyond 65 was postponed.

The old-age income law (*Alterseinkünftegesetz*) provides for the gradual introduction of taxation of pension benefits, coupled with tax exemption for retirement contributions. Due to the progressive income tax schedule, incentives to increase retirement saving are enhanced. In addition, the portability of occupational pensions was

Secure the long-term viability of pension and healthcare systems	Assessment
Under this challenge, Germany was requested to:	
9. promote the take-up of supplementary pension schemes and strengthen incentives for later retirement (GL 16);	In progress
10. increase the efficiency in the healthcare sector by introducing economic incentives for healthcare providers and recipients.	Limited

improved. The bureaucracy related to the financial products eligible for subsidised fully funded supplementary private pension income (*Riester-Rente*) was trimmed, but consumers should receive more guidance in the choice of such complex financial products. A third law unified the various public pension insurers into a more efficient administration.

Health sector: efforts at cost containment and some efficiency gains

As mentioned in the 2004 implementation report, legislation to contain the costs in the public healthcare sector entered into force in January 2004. It involved cuts in the catalogue of goods and services refundable by the system, a better incentive structure to raise cost-awareness among patients and providers, and some steps to strengthen competition in the sector. In the public health system, expenses for medical treatment are usually fully settled between service providers and insurers without the involvement of the patients. To mitigate disincentives, a fixed quarterly fee for ambulatory health services was introduced and patients were given the opportunity to ask for a ‘virtual’ bill to increase transparency. In addition, patients were offered the choice to switch to a system in which they receive the bill first and get reimbursed by the public insurer. Although the number of medical consultations was falling in 2004, the two other measures met with a faint response. Without some financial participation of patients for each ambulatory treatment, incentives do not seem strong enough to review the doctor’s bill.

Co-payments to medication were increased and the price regulation on prescription medication extended. Also, the remuneration of chemists was altered such as to provide incentives to sell lower-priced medication of the same class. Yet, despite permitting mail-order and small chains of pharmacies, barriers to entry into the retailing of medication remain. A newly established institute will provide producer-independent benefit analysis of medication and guidelines for treatment.

The public health system is still characterised by collective contracting of fees between insurers and service provider organisations. Although a fair amount of competition takes place between public health insurers, it is almost absent between service providers. Individual contracting has now been permitted in limited areas, but this is only a first step in the right direction. In the first three quarters of 2004, expenditure in the public health sector fell remarkably by about EUR 3.4 billion year-on-year (about 0.2 % of GDP for the same period). A reduction in medication expenditure by over 10 % provided the largest contribution, reflecting both cost-cutting measures and reduced demand due to co-payments. Expenditure on ambulatory treatment declined by 5 %, reflecting the positive allocation effect of the fixed quarterly fee. The cost-cutting measures reduced the level of expenditure. However, in order to contain the growth rate of expenditure, further efficiency-enhancing measures are necessary in the medium term, not only for patients but also for healthcare providers and insurers.

Table 4.1

Economic indicators for Germany

	Germany				EU-25			
	2001	2002	2003	2004	2001	2002	2003	2004
General economic background								
Real GDP growth (1)	0.8	0.1	– 0.1	1.9	1.8	1.1	1.0	2.5
Inflation (2)	1.9	1.3	1.0	1.7	2.5	2.1	1.9	2.2
Labour productivity growth (3)	0.4	0.7	0.9	1.8	0.8	0.9	0.9	2.1
Employment growth (1)	0.4	– 0.6	– 1.0	0.1	1.0	0.3	0.3	0.4
Nominal wage growth (4)	1.7	1.5	1.6	0.0	4.0	3.2	3.1	3.0
Current account (5)	0.4	2.4	2.4	4.2	:	:	:	:
Unemployment (6)	7.8	8.7	9.6	9.7	8.5	8.9	9.1	9.1
Public finances								
General government balance (5)	– 2.8	– 3.7	– 3.8	– 3.9	– 1.2	– 2.3	– 2.8	– 2.8
Primary balance (5)	0.4	– 0.5	– 0.7	– 0.8	2.4	1.0	0.3	0.2
Cyclically adjusted balance (5)	– 3.1	– 3.5	– 3.0	– 3.4	:	:	:	:
Gross government debt (5)	59.4	60.9	64.2	65.9	62.1	61.6	63.2	63.5
Employment								
Employment rate (7)	65.8	65.4	65.1	:	62.8	62.9	63.0	:
Female employment rate (8)	58.7	58.9	59.1	:	54.3	54.7	55.1	:
Employment rate for older workers (9)	37.9	38.9	39.5	:	37.4	38.8	40.2	:
Long-term unemployment (10)	3.8	4.1	4.7	:	3.8	3.9	4.0	:
Tax rate on low wage earners (11)	45.5	45.8	46.7	:	37.2	37.1	37.4	:
Unemployment trap indicator (12)	87.9	88.4	88.8	:	78.8	78.5	78.3	:
Product market reforms								
Hourly labour productivity (13)	102.8	103.0	103.4	:	:	:	:	:
Total trade to GDP ratio (14)	34.5	34.1	34.3	:	:	58.8	57.2	:
Internal market directives (15)	97.4	97.3	96.5	97.5	:	:	:	96.3
Business investment (16)	18.5	16.9	16.3	:	17.9	17.2	16.8	:
Knowledge-based economy								
Total tertiary graduates (17)	31.0	30.9	:	:	46.8	:	:	:
Spending on human resources (18)	4.6	:	:	:	5.1	:	:	:
R & D expenditure (19)	2.5	2.5	2.5	:	1.9	1.9	:	:
Expenditure on IT (20)	3.3	3.0	3.0	2.9	3.1	2.9	2.9	2.9

(1) Growth rate in per cent.
(2) Annual average rate of change in harmonised index of consumer prices in per cent.
(3) Growth rate of real GDP per occupied person in per cent.
(4) Growth rate of compensation per employee.
(5) As a percentage of GDP.
(6) Number of unemployed as a percentage of the labour force.
(7) Employed persons aged 15–64 as a share of the total population of the same age group.
(8) Employed women aged 15–64 as a share of the total female population of the same age group.
(9) Employed persons aged 55–64 as a share of the total population of the same age group.
(10) Long-term unemployed (over 12 months) as a percentage of the total active population aged 15–64.
(11) Income tax plus employer/employee contributions as a percentage of labour costs of a single earner at 67 % of the average production worker wage, no children.
(12) Effective tax rate on labour income taking into account the combined effect of increased taxes and benefits withdrawal as an individual moves from unemployment back to work earning 67 % of the average production worker wage, measured at the first month of unemployment (after any ‘waiting period’ if applicable).
(13) GDP per hour worked in PPS, EU-15 = 100.
(14) Percentage, average value of imports and exports of goods and services divided by GDP, multiplied by 100; for DE, ES, FR, IT, PL and the UK, the value for the EU-25 is the total for the large Member States; for all the other States, the value for the EU-25 is the total for the small Member States.
(15) Percentage implemented in November 2004.
(16) Gross fixed capital formation by the private sector as a percentage of GDP.
(17) Total tertiary graduates (ISCED 5–6) per 1 000 of population aged 20–29.
(18) Public expenditure on education as a percentage of GDP.
(19) GERD — gross domestic expenditure on R & D as a percentage of GDP.
(20) Expenditure on information technology as a percentage of GDP.

Source: Commission services (including Eurostat, structural indicators). The data for ‘general economic background’ and ‘public finance’ are taken from the Commission’s autumn 2004 economic forecasts.

5. Estonia

Economic activity gained further momentum in 2004. GDP growth of nearly 6 % was underpinned by robust domestic demand, a positive contribution from net exports and a strong fiscal stimulus stemming from the unwinding of the high 2003 fiscal surplus. Developments were also marked by various EU accession effects. Consumer price inflation accelerated, to an annual rate of over 3 %. The higher inflation led to a squeeze in real wage gains, which over the medium term are expected to remain in line with productivity increases. Labour market conditions continued to improve in 2004, as reflected by moderate employment growth, rising labour supply and a further decline in unemployment, a development which is expected to broadly continue over the medium term. A legal package addressing the structural problems in the labour market was adopted by the government in late 2004. The general government surplus, which had widened to 3.1 % of GDP in 2003, was reduced in 2004 to an estimated 1 % of GDP (according to the latest convergence programme). Public finances are likely to remain in balance or surplus over the foreseeable future. The correction of the external balance has been delayed, with the current account deficit remaining virtually unchanged around 13 % of GDP in 2004. Estonia's growth rates of labour productivity and GDP per capita are set to remain amongst the highest in the EU. Estonia offers a good business climate and measures to increase the currently low level of competition in network industries have been taken. The level of R & D remains low, and the pending changes to the education system will affect the country's competitiveness only over the medium term. A detailed assessment of recent developments in addressing Estonia's key policy challenges is presented in the following sections.

5.1. Current account deficit

Correction of the current account deficit delayed beyond 2004 ...

The high current account deficit remains the main economic imbalance in Estonia. While the trade balance improved somewhat in 2004, the major contributor to the deficit was the increasingly negative income balance, including huge interbank operations between the dominant Scandinavian banks and their Estonian branches. Overall, a reduction of the deficit starting already in 2004, as envisaged in the Estonian convergence programme of May 2004, has not materialised, with the external deficit remaining around 13 % of GDP. Moreover, a reduction of public savings, deriving from a reduction of the budget surplus from 3.1 % of GDP in 2003 to, according to the latest official forecast, an estimated 1 % of GDP in 2004 has not sufficiently supported the correction of the external imbalance. With a view to the high level of the current account deficit, a more gradual unwinding of the comfortable budgetary surplus would have been advisable. In addition, private savings in 2004 have not recovered as quickly as projected, with rising company profits countervailed by a decrease in house-

Address the sizeable current account deficit, to which an appropriate fiscal policy stance should contribute

Under this challenge, Estonia was requested to:

1. implement a fiscal policy that is in line with the decisions to be taken by the Council in the context of the forthcoming budgetary surveillance exercise (GL 1), and which is consistent with the objective of avoiding procyclical policies that may exacerbate the external imbalance and promotes reduction of the sizeable gap between domestic savings and investment (GL 2).

hold saving. As pointed out in the Council opinion on the Estonian convergence programme, the de facto fiscal expansion might prove untimely in view of accelerating activity in 2004, even if it is difficult to determine the country's position in the business cycle. For 2005, the authorities plan a balanced budget implying further, albeit much lower, fiscal loosening. The current account deficit is expected to come down to below 12 % of GDP in 2005, according to the Commission's forecast, thanks to an improvement in the trade balance.

… whereby external imbalance should be put into perspective

The reasons for the external deficit are to a large degree 'normal' transitional effects in a rapidly catching-up economy that is expanding its productive potential. While gross external debt has increased to sizeable levels, net debt remains relatively low. Foreign liabilities are mostly denominated in euro, which mitigates the exchange rate risk, given the stable currency board maintained within ERM II. A considerable share of the current account deficit is financed by FDI, which in turn includes a large amount of reinvested earnings. A high level of public sector reserves, to the tune of over 10 % of GDP, which was set aside over the past few years from budget surpluses, can also be considered as a stabilising — and confidence-enhancing — factor. While such considerations on the external sustainability put the current account deficit into perspective, the further trend of both public and private net saving as well as developments in competitiveness and FDI need to be closely watched.

5.2. Labour market

Important labour market reforms are under way …

Labour market conditions continued to improve in 2004. The unemployment rate, according to the harmonised EU definition, declined by 0.4 percentage points to 9.7 % of the labour force, while employment steadily increased, and is set to rise further in 2005. Also, regional disparities in unemployment rates have started to diminish. Despite these overall positive developments, a number of specific problems of a predominantly structural nature prevail to this date, many of which date back to the transition process from a planned to a market economy. An active labour market policy is designed to bring problem groups of the workforce back into jobs. To that end, a legal package was adopted by the government in autumn 2004. The authorities plan to replace unemployment benefits and subsistence allowance for people of working age and capacity with a 'job-seeker's allowance', aiming at increasing the incentive for the long-term unemployed to actively look for jobs. The draft law foresees both reforms to the vocational training system, through gearing training towards skills in high demand in order to increase employment ratios, and a reduction in taxes and social charges on labour, thereby increasing the incentive to take on low-wage jobs. EU funds will be used to implement some of these measures.

… while wage increases have moderated

Wage pressures in Estonia moderated in 2004, following an overshooting of real wages over productivity gains in 2003. The fairly flexible labour market is characterised by a small role of collective wage bargaining. Mostly, wages are set at the enterprise level, and tend to react swiftly to changes in the economic environment. The minimum wage, however, is set at national level. In 2004, it stood at 32 % of the average national wage, and thus was the lowest among the new Member States. A medium-term rule for the path of minimum wage increases was agreed last year by the Tripartite Social Partner Council, stipulating an annual increase of 1.5 percentage points as related to the average national wage

Address the structural problems in the labour market

Under this challenge, Estonia was requested to:

2. adopt policies with particular emphasis on reintegrating the long-term unemployed, particularly in regions worst hit by the restructuring of the economy, by promoting vocational training and lifelong learning, and by setting up an effective institutional framework that supports job creation (GLs 4, 6 and 8);

3. encourage social partners to ensure that wage developments — including changes to the minimum wage legislation — do not hinder employment growth, and hold up the recovery in the labour market (GLs 3 and 5).

over the period 2005–08. Apart from the minimum wage, only a limited number of sectors such as central government, transport, education and healthcare are subject to central wage bargaining. In the context of a major income tax cut, taking effect in three steps in 2005, 2006 and 2007, non-wage labour costs will be reduced by a total of 6 %. In addition, a stepwise increase to the threshold for income tax exemption which started already in 2004 and will continue to 2007 is neutralising the bracket creep effect. Both measures have a net-earnings-enhancing effect, and thus take pressure from gross wage settlements. In the Commission's autumn 2004 economic forecasts, it is assumed that wage moderation will continue in 2005. In an environment of stable prices, with CPI inflation around 2.5 to 3 % throughout the forecast period, along with income tax cuts, real wages per capita are expected to advance below productivity increases.

5.3. Productivity

Modernisation of vocational education is continuing …

Over recent years, Estonia has pursued a strategy of modernisation of its vocational education policy, notably to bring down the very high 18 % dropout rate during the first year of secondary school education. This policy also aims at increasing education's responsiveness to labour market needs. In 2004, a new vocational education development plan for 2005–08 was elaborated and Estonia has prepared for the future use of EU Structural Funds to meet this goal.

Current and future actions include the assessment of businesses' needs and demand for vocational training, as well as maintaining the school network, but few measures have been taken to improve the education system per se.

… and efforts pursued increase R & D, albeit slowly

At around 0.8 %, the ratio of R & D expenditure to GDP has slightly increased but still remains far below the EU average. In addition, the share of R & D financed by industry is low at just 30 % and the number of researchers per 1 000 labour force has even decreased over the recent period (see Graph 5.1). The limited scope of the local market, the low number of large companies and the lack of cooperation between research and businesses contribute to a low level of innovation, as reflected in a low level of patenting activity. Making use of future EU Structural Funds, the Estonian national development plan 2004–06 focuses on the pooling of research activities, the increase in the financing of R & D and innovation by businesses, the developing of cooperation between researchers and entrepreneurs, and the boosting of awareness and knowledge of innovation.

5.4. Productivity and business dynamism

Reforms to increase effective competition in network industries progress at slow pace

Under the EU Accession Treaty, Estonia has been granted a transitional period for the opening-up of its electricity market. According to this, 35 % of the electricity market should be opened to competition by the end of 2008, and full opening should follow by the end of 2012. The current degree of openness stands at around 10 % for electricity whilst the gas market for non-household users has been made contestable in line with EU directives, corresponding to a 95 % degree of market opening. Despite the transition period, legal unbundling of the electricity transport system operator will occur in 2005, and plans are being developed to connect the Estonian electricity network to the Finnish one. Following liberalisation in 2003, the telecommunications market has experienced rapid expansion. The

Improve conditions for increasing productivity

Under this challenge, Estonia was requested to:

4. improve the efficiency and quality of the education system and vocational training in order to reduce the mismatch on the labour market (GL 13);
5. implement the R & D strategy approved in 2001 and, in particular, promote the stronger involvement of the business sector in R & D spending (GL 13).

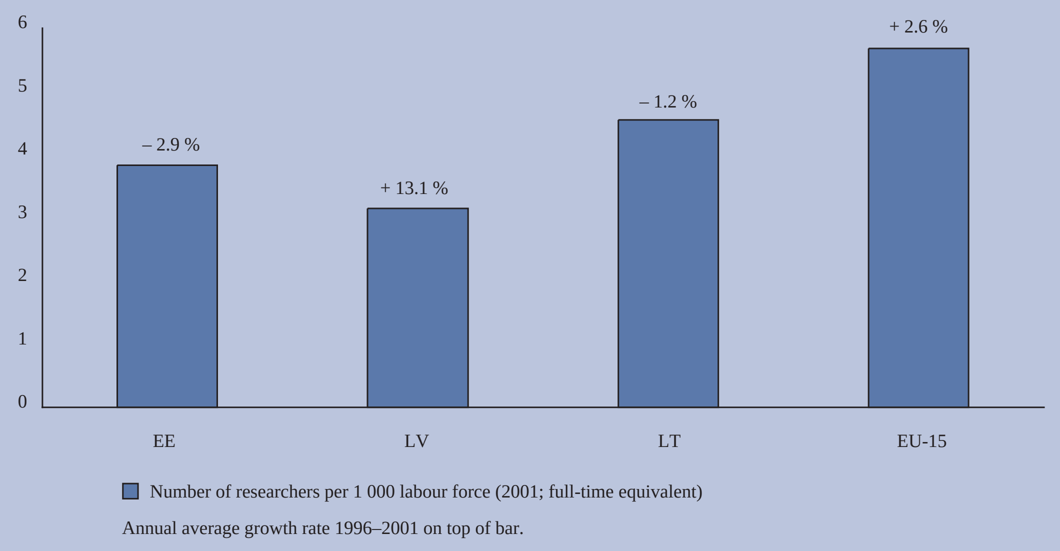
introduction of number portability for fixed lines in 2004 and for mobile phones in 2005 should further increase competition in a market where the incumbent is steadily losing market shares. No new measures have been announced to strengthen the independence of regulators.

Develop effective competition in network industries

Under this challenge, Estonia was requested to:

6. proceed with the liberalisation of the electricity market, strengthen the independence of the regulator and ensure effective competition in telecommunications (GL 9).

Graph 5.1: **Number of researchers per 1 000 labour force**



Source: Commission services.

Table 5.1

Economic indicators for Estonia

	Estonia				EU-25			
	2001	2002	2003	2004	2001	2002	2003	2004
General economic background								
Real GDP growth (1)	6.4	7.2	5.1	5.9	1.8	1.1	1.0	2.5
Inflation (2)	5.6	3.6	1.4	3.4	2.5	2.1	1.9	2.2
Labour productivity growth (3)	5.6	5.6	4.3	5.6	0.8	0.9	0.9	2.1
Employment growth (1)	0.8	1.5	0.8	0.3	1.0	0.3	0.3	0.4
Nominal wage growth (4)	7.7	10.2	8.9	8.6	4.0	3.2	3.1	3.0
Current account (5)	– 5.6	– 10.2	– 13.2	– 13.0	:	:	:	:
Unemployment (6)	11.8	9.5	10.1	9.7	8.5	8.9	9.1	9.1
Public finances								
General government balance (5)	0.3	1.4	3.1	0.5	– 1.2	– 2.3	– 2.8	– 2.8
Primary balance (5)	0.5	1.7	3.3	0.8	2.4	1.0	0.3	0.2
Cyclically adjusted balance (5)	:	:	:	:	:	:	:	:
Gross government debt (5)	4.4	5.3	5.3	4.8	62.1	61.6	63.2	63.5
Employment								
Employment rate (7)	61.0	62.0	62.9	:	62.8	62.9	63.0	:
Female employment rate (8)	57.4	57.9	59.0	:	54.3	54.7	55.1	:
Employment rate for older workers (9)	48.5	51.6	52.3	:	37.4	38.8	40.2	:
Long-term unemployment (10)	5.7	5.0	4.6	:	3.8	3.9	4.0	:
Tax rate on low wage earners (11)	37.4	37.4	:	:	37.2	37.1	37.4	:
Unemployment trap indicator (12)	:	:	:	:	78.8	78.5	78.3	:
Product market reforms								
Hourly labour productivity (13)	32.9	33.7	:	:	:	:	:	:
Total trade to GDP ratio (14)	85.6	77.6	79.0	:	:	58.8	57.2	:
Internal market directives (15)	:	:	:	94.5	:	:	:	96.3
Business investment (16)	22.9	24.0	25.0	:	17.9	17.2	16.8	:
Knowledge-based economy								
Total tertiary graduates (17)	40.1	40.9	:	:	46.8	:	:	:
Spending on human resources (18)	5.5	:	:	:	5.1	:	:	:
R & D expenditure (19)	0.7	0.8	0.8	:	1.9	1.9	:	:
Expenditure on IT (20)	2.7	2.7	2.7	2.6	3.1	2.9	2.9	2.9

(1) Growth rate in per cent.
(2) Annual average rate of change in harmonised index of consumer prices in per cent.
(3) Growth rate of real GDP per occupied person in per cent.
(4) Growth rate of compensation per employee.
(5) As a percentage of GDP.
(6) Number of unemployed as a percentage of the labour force.
(7) Employed persons aged 15–64 as a share of the total population of the same age group.
(8) Employed women aged 15–64 as a share of the total female population of the same age group.
(9) Employed persons aged 55–64 as a share of the total population of the same age group.
(10) Long-term unemployed (over 12 months) as a percentage of the total active population aged 15–64.
(11) Income tax plus employer/employee contributions as a percentage of labour costs of a single earner at 67 % of the average production worker wage, no children.
(12) Effective tax rate on labour income taking into account the combined effect of increased taxes and benefits withdrawal as an individual moves from unemployment back to work earning 67 % of the average production worker wage, measured at the first month of unemployment (after any 'waiting period' if applicable).
(13) GDP per hour worked in PPS, EU-15 = 100.
(14) Percentage, average value of imports and exports of goods and services divided by GDP, multiplied by 100; for DE, ES, FR, IT, PL and the UK, the value for the EU-25 is the total for the large Member States; for all the other States, the value for the EU-25 is the total for the small Member States.
(15) Percentage implemented in November 2004.
(16) Gross fixed capital formation by the private sector as a percentage of GDP.
(17) Total tertiary graduates (ISCED 5–6) per 1 000 of population aged 20–29.
(18) Public expenditure on education as a percentage of GDP.
(19) GERD — gross domestic expenditure on R & D as a percentage of GDP.
(20) Expenditure on information technology as a percentage of GDP.

Source: Commission services (including Eurostat, structural indicators). The data for 'general economic background' and 'public finance' are taken from the Commission's autumn 2004 economic forecasts.

6. Greece

Economic activity in Greece remained strong in 2004 benefiting from a series of factors some of which were related to the Olympic Games. Due to the sharp acceleration in exports of services, the negative contribution of the external sector narrowed in 2004. However, despite the temporarily favourable domestic conditions, the Greek economy continued to suffer from its chronic structural problems notably the external imbalance pointing to weak international competitiveness and the recently increasing fiscal imbalances that reveal a lack of decisiveness in implementing the necessary measures to control and streamline government spending. The control on a more permanent basis of fiscal imbalances is of primary importance as Greece has made little progress in reducing the still high government debt and deficits. Although the situation in the labour markets has improved lately, the implementation of measures aiming at rendering employment conditions more flexible resulted in slow progress. Some signs of improvement with respect to the employment participation rate, and the long-term unemployment rate and the youth unemployment rate have recently become evident. Conversely, the gap between the male and female rate of participation and unemployment has hardly narrowed. Greek hourly labour productivity growth has slowed in recent years and remains the second lowest in the EU-15. This is partly due to low levels of investment in R & D, and the still low — albeit fast-growing — level of ICT diffusion. Limited competition in certain network industries and a lack of business dynamism, due to a complex regulation and taxation system, could also be part of the explanation. A detailed assessment of recent developments in addressing Greece's key policy challenges is presented in the following sections.

6.1. Long-term sustainability of public finances

Measures have not been taken to reduce the debt ratio at a satisfactory pace

The government debt ratio in Greece is, according to the latest EDP notification, the highest in the EU. After the corrections in the treatment of some financial operations requested by Eurostat, the EDP notification of September 2004 indicated that the debt figures have been revised upwards by 7 to 9 percentage points of GDP over the period of notification. In 2003, the debt ratio decreased temporarily by 2.6 percentage points and reached 109.9 % of GDP. Despite strong economic growth, the debt ratio is estimated to have increased again in 2004 by 2.3 percentage points, implying that the Greek government did not succeed in reducing the debt ratio at a satisfactory pace. The general government primary surplus, which has been declining over the past five years, reached its lowest level in 2004. As the primary surplus is expected to improve in 2005 according to the Commission services' autumn 2004 economic forecasts, the debt ratio is projected to decline slightly by 0.3 percentage points. According to the 2005 draft budget, in 2005 public debt will reach 109.5 % of GDP (versus 112.1 % in 2004).

Still far away from the budgetary position of close to balance or in surplus

The Commission activated the excessive deficit procedure (EDP) for Greece on 19 May 2004. At that time, the expected general government deficit for 2004 was 3.2 % of GDP, unchanged compared with 2003. The EDP notification of September 2004, as validated by Eurostat, indicated that Greece has been in excessive deficit since 2000. After reaching 4.6 % of GDP in 2003, the general government deficit is estimated by the Commission services to have increased further in 2004 to 5.5 % of GDP. The increase in the deficit between 2003 and 2004 suggests that the budgetary situation in Greece has significantly worsened compared with what had been expected at the time of adopting the EDP report. Also, no effective action has been taken to correct the excessive deficit, in response to the July 2004 Council recommendation for the correction of the excessive deficit. The considerable widening of the deficit compared with 2003 in spite of a positive output gap reflects the procyclical, expansionary nature of Greek fiscal policies. In cyclically adjusted terms, Greece moved further away from a budgetary

Ensure the long-term sustainability of public finances in the face of population ageing, in particular in view of the high government debt ratio	**Assessment**
Under this challenge, Greece was requested to:	
1. ensure that the government debt ratio is kept on a sustained declining trend at a satisfactory pace by maintaining high primary surpluses (GL 15);	Insufficient
2. take appropriate measures in response to the possible existence of an excessive deficit; move towards achieving a medium-term close to balance or in surplus position by ensuring an improvement in the cyclically adjusted budget balance of at least 0.5 % of GDP per year, including through effective control of government current primary spending (GL 1);	Insufficient
3. use public resources more effectively with the aim of improving labour productivity and enhancing the working capacity of the unemployed (GL 14);	Insufficient
4. continue reforms of the social security system, and, in particular, the pension system (GL 16), in order to avoid budgetary strains in the future due to the problem of the ageing population.	Insufficient

Bearing in mind the three-year period available for implementation, the degree of implementation since 2003 is indicated as: 'Complete' for (practically) complete; 'In progress' where progress is well advanced; 'Limited' where the recommendation is only partially addressed; and 'Insufficient' where no substantial measures going in the right direction have been taken.

position of close to balance or in surplus. According to the Commission services' autumn 2004 economic forecasts, the deficit for 2005 will narrow to 3.6 % of GDP. Also, the cyclically adjusted budget balance is projected to improve by 1.7 % of GDP in 2005 as the government is expected to control — but possibly insufficiently — the current primary spending in its effort to reduce the deficit to below the 3 % of GDP reference value.

Labour productivity decelerated and measures to reduce unemployment have not yet delivered the expected results

Labour productivity growth slowed down in 2003 and in 2004 but is likely to pick up slightly in 2005. A series of measures aimed at increasing the incentive to work as well as measures aimed at improving the qualifications of the unemployed are being implemented with the financial support of government agencies. In particular, legislation which was enacted in 2004 to replace the unemployment subsidies with employment subsidies provides incentives to work for women, young people and the elderly. Also, legislation was enacted in 2004 to permit the State, the local administrations and public law institutions to employ certain categories of workers, namely unemployed women, persons with more than three children, and the long-term unemployed, with fixed-term contracts. The Ministry of Employment and Social Protection promoted the direct connection of vocational training activities with employment while the public employment service (OAED), which is the basic implementation body of the active employment policies, has been upgraded and reformed. However, there is yet no clear evidence as to the effectiveness of these measures. The youth unemployment ratio is still higher than the corresponding European average while the gap between men and women is still significant in the unemployment rate.

No follow-up foreseen on reforms in the social security system

The implementation of legislation enacted in 2002 lies at the heart of efforts to reform the pension system, with an emphasis on the introduction of new instruments that add credibility and flexibility to the system. In this legislation, however, the government has not taken into account sufficiently the current trends in public finances and especially the high level of government debt. As the budgetary costs from population ageing are expected to rise significantly in the future, the sustainability of the Greek public finances will be at risk if no structural measures are taken. According to legislation recently enacted, provision has been made for the transfer of social security rights when moving from one fund to another and incentives have been provided for the prolongation of working life beyond the statutory limit of 35 years. Distinguishing auxiliary from primary pensions, through the creation of separate auxiliary funds and the consolidation of various funds, remains a major priority and specific steps have been taken in this direction. New measures were adopted in 2004 with the aim of amending various aspects of existing legislation, particularly as far as persons with disabilities, farmers, professionals and civil servants are concerned. Also, considerable effort is being made to combat the evasion of contribution, *inter alia* through the establishment of a special force which monitors healthcare payments made by social insurance institutions. There is yet no clear evidence as to the effectiveness of these new measures.

6.2. Productivity and business dynamism

Initiatives to encourage the transition towards a knowledge-based society launched in 2003 have been pursued

Initiatives launched in 2003 to improve the availability of skilled human capital and to promote R & D, innovation and ICT diffusion have been pursued. First, further actions promoting the development of information technology in schooling and professional training were taken in 2004. Second, the links between universities and enterprises were further strengthened through initiatives supporting the establishment of spin-off firms. For example, 25 cooperation activities between firms and R & D centres, universities and training institutions were partially funded by the Greek government in 2004. Third, within the framework of the operational programme for the information society, the implementation of actions aimed at promoting the use of ICT within business communities (the actions 'Go electronically' and 'e-business development') and by the public sector has started.

Steps in the right direction are being taken, but effective competition in the electricity market is not yet secured

Apart from interconnections already in place, with Albania, Bulgaria, the Former Yugoslav Republic of Macedonia (FYROM) and Italy, the interconnection between the Greek and Turkish gas networks is expected to be in operation by the end of 2006. In addition, a feasibility study on the interconnection with Italy is expected to be delivered in December 2004. In the electricity sector, several licences have been granted to independent power generators. Greece is currently finalising the amendment of its legislation to fully transpose the EU energy directives. However, the infringement procedure relating to the unbundling of the incumbent company is still pending and the Commission decided to refer the case to the Court of Justice of the European Communities.

Efforts have been made to simplify the business and taxation environment but the transposition rate of internal market directives has decreased

New legislation to reduce bureaucratic and legal obstacles to setting up a new company has been prepared. Moreover, measures to increase the efficiency of the public administration have been taken. For example, interconnections between various points within the public administration have been created and new one-stop shops for citizens have been set up. The government has

Increase the low level of productivity, which is associated with problems in the functioning of the labour and product markets, low investment in human capital, and the late development of the knowledge-based society	**Assessment**
Under this challenge, Greece was requested to:	
5. step up efforts to increase the availability of skilled human capital, continue to promote business involvement in R & D and innovation, and improve ICT diffusion (GL 13);	In progress
6. enhance particularly competition in the energy sectors (GL 9);	Limited
7. continue to simplify the business and taxation environment and raise the transposition rate of internal market directives (GLs 9 and 11).	Limited

launched a new tax reform aimed at both a reduction in corporate taxes and a simplification of the tax audit procedure.

Finally, Greece's transposition rate of internal market directives has decreased from 96.9 % to 94.5 %, and is still amongst the worst in the EU-15.

6.3. Labour market

Efforts to promote part-time work continue but without producing an impact on non-wage costs

Despite some improvement and efforts undertaken in the past to promote part-time work, its share has stagnated at low levels. The implementation of legislation enacted in 2004, which extends part-time employment in both the public and the private sector, has not yet delivered the expected results. Incentives in the form of subsidising social security contributions for certain categories of the labour force and for specific sectors have been introduced since 2002. The government in its effort to promote active employment policies announced in 2004 plans of subsidised employment. So far, the reaction of the private sector has not been very encouraging. Furthermore, there seems to be no focus on the reduction of non-wage costs. As mentioned above, the government has introduced changes to the 2002 legislation in order to ensure social security rights when moving from one fund to another.

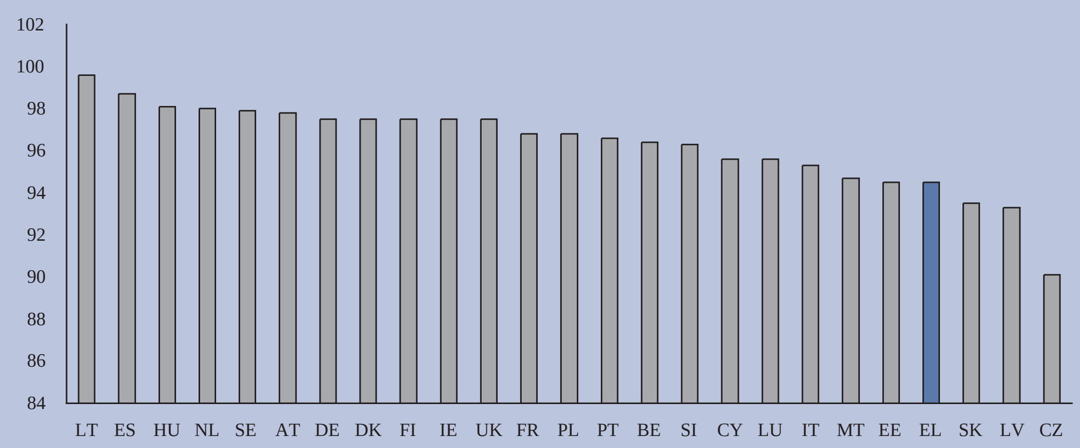
Social dialogue is put forward but wage bargaining is hardly modified

Enhancing the social dialogue has been among the priorities of the former and new government with wage bargaining being among the core issues. The private sector is bound by two-year wage agreements negotiated at the national level, setting the minimum wage for general and sectoral agreements. The benchmark wage in the private sector is linked to the announced income policy in the public sector and to inflation prospects rather than to productivity differentials. The previous agreement, signed in 2002, secured social peace until the end of 2003, while limiting the impact of higher-than-expected inflation on wage formation. A new two-year wage agreement was concluded on 13 May 2004. It implies an increase in the minimum wage above the expected inflation and productivity in 2004 and 2005.

New institutions to promote flexibility and to better match demand and supply

The restructuring of public and private employment services has not yet sufficiently addressed both employment and unemployment issues, given the still high barriers to entry and the strong rigidities in the Greek labour market. Nevertheless, many efforts have

Graph 6.1: **Single market directives — percentage implemented — November 2004**



Source: Commission services.

been made recently to improve services to the unemployed. In particular, as mentioned above, the public employment service (OAED) has been upgraded. In all, 71 job centres (KPAs) have been created employing 471 labour advisers, while the statistical surveillance system of OAED is being upgraded. A centralised information system of PAEP SA, a subsidiary firm of OAED, was created to monitor the personalised approach of the unemployed. Also, in conjunction with the job centres, private agencies of work advisers (IGSEs) have started operating. Temporary employment companies (EPAs) are expanding and at present 10 EPAs have been founded while 9 040 persons have already benefited from them.

Reduce the high rate of structural unemployment, and increase employment rates, particularly for women	**Assessment**
Under this challenge, Greece was requested to:	
8. improve work incentives, particularly by reducing non-wage costs and improving transferability of pension rights, in order to encourage increased employment in the formal sector, including part-time work (GLs 4 and 16);	Limited
9. promote changes to the wage bargaining process to ensure that wages reflect productivity differentials (GL 5);	Insufficient
10. implement the labour reform package to improve the balance between flexibility and security by ensuring effective implementation of reforms aiming to modernise work organisation and by reviewing unduly restrictive labour market regulations (GL 6).	Limited

Table 6.1

Economic indicators for Greece

	Greece				EU-25			
	2001	2002	2003	2004	2001	2002	2003	2004
General economic background								
Real GDP growth (1)	4.3	3.6	4.5	3.8	1.8	1.1	1.0	2.5
Inflation (2)	3.7	3.9	3.4	3.0	2.5	2.1	1.9	2.2
Labour productivity growth (3)	4.6	3.6	3.1	2.0	0.8	0.9	0.9	2.1
Employment growth (1)	– 0.3	0.1	1.4	1.8	1.0	0.3	0.3	0.4
Nominal wage growth (4)	5.2	9.2	4.0	6.5	4.0	3.2	3.1	3.0
Current account (5)	– 7.1	– 7.7	– 8.3	– 7.5	:	:	:	:
Unemployment (6)	10.4	10.0	9.3	8.5	8.5	8.9	9.1	9.1
Public finances								
General government balance (5)	– 3.7	– 3.7	– 4.6	– 5.5	– 1.2	– 2.3	– 2.8	– 2.8
Primary balance (5)	3.6	2.6	1.2	0.0	2.4	1.0	0.3	0.2
Cyclically adjusted balance (5)	– 4.3	– 3.8	– 5.1	– 6.1	:	:	:	:
Gross government debt (5)	114.7	112.5	109.9	112.2	62.1	61.6	63.2	63.5
Employment								
Employment rate (7)	55.4	56.7	57.8	:	62.8	62.9	63.0	:
Female employment rate (8)	40.9	42.5	43.8	:	54.3	54.7	55.1	:
Employment rate for older workers (9)	38.0	39.7	42.1	:	37.4	38.8	40.2	:
Long-term unemployment (10)	5.4	5.1	5.1	:	3.8	3.9	4.0	:
Tax rate on low wage earners (11)	34.3	34.3	34.3	:	37.2	37.1	37.4	:
Unemployment trap indicator (12)	69.0	70.0	76.7	:	78.8	78.5	78.3	:
Product market reforms								
Hourly labour productivity (13)	68.6	72.1	73.7	:	:	:	:	:
Total trade to GDP ratio (14)	30.3	26.5	25.0	:	:	58.8	57.2	:
Internal market directives (15)	97.0	96.7	96.9	94.5	:	:	:	96.3
Business investment (16)	19.9	20.2	21.8	:	17.9	17.2	16.8	:
Knowledge-based economy								
Total tertiary graduates (17)	:	:	:	:	46.8	:	:	:
Spending on human resources (18)	3.9	4.0	:	:	5.1	:	:	:
R & D expenditure (19)	0.6	:	:	:	1.9	1.9	:	:
Expenditure on IT (20)	1.4	1.3	1.2	1.2	3.1	2.9	2.9	2.9

(1) Growth rate in per cent.
(2) Annual average rate of change in harmonised index of consumer prices in per cent.
(3) Growth rate of real GDP per occupied person in per cent.
(4) Growth rate of compensation per employee.
(5) As a percentage of GDP.
(6) Number of unemployed as a percentage of the labour force.
(7) Employed persons aged 15–64 as a share of the total population of the same age group.
(8) Employed women aged 15–64 as a share of the total female population of the same age group.
(9) Employed persons aged 55–64 as a share of the total population of the same age group.
(10) Long-term unemployed (over 12 months) as a percentage of the total active population aged 15–64.
(11) Income tax plus employer/employee contributions as a percentage of labour costs of a single earner at 67 % of the average production worker wage, no children.
(12) Effective tax rate on labour income taking into account the combined effect of increased taxes and benefits withdrawal as an individual moves from unemployment back to work earning 67 % of the average production worker wage, measured at the first month of unemployment (after any 'waiting period' if applicable).
(13) GDP per hour worked in PPS, EU-15 = 100.
(14) Percentage, average value of imports and exports of goods and services divided by GDP, multiplied by 100; for DE, ES, FR, IT, PL and the UK, the value for the EU-25 is the total for the large Member States; for all the other States, the value for the EU-25 is the total for the small Member States.
(15) Percentage implemented in November 2004.
(16) Gross fixed capital formation by the private sector as a percentage of GDP.
(17) Total tertiary graduates (ISCED 5–6) per 1 000 of population aged 20–29.
(18) Public expenditure on education as a percentage of GDP.
(19) GERD — gross domestic expenditure on R & D as a percentage of GDP.
(20) Expenditure on information technology as a percentage of GDP.

Source: Commission services (including Eurostat, structural indicators). The data for 'general economic background' and 'public finance' are taken from the Commission's autumn 2004 economic forecasts.

7. Spain

Although still recording a positive growth differential with respect to the euro area, the gap narrowed significantly in 2004, mainly due to the recent recovery in the euro area, as the Spanish economy continues to register growth rates above 2.5 %. Growth continues to be mainly driven by relatively buoyant domestic demand, notably private consumption, investment in dwellings and, more recently, investment in equipment, whereas the external sector's drag on GDP growth widened. Behind the resilience of domestic demand are supportive monetary conditions coupled with a prudent fiscal stance and rapid employment growth, which has largely benefited from ongoing wage moderation as well as high net immigration. In spite of relatively moderated growth, Spain was successful in keeping fiscal consolidation on course and achieved an unprecedented surplus position in 2003. The budget for the general government sector in 2004 is now expected to turn to a deficit of 0.6 % of GDP. Rather than representing a deterioration in the budgetary situation, this deficit is more the result of some one-off measures and statistical reclassifications adopted by the new government that do not involve revisions for past years. Bearing in mind that the period covered by this assessment encompasses the end of a legislature and the subsequent change in government, no key additional measures to those implemented in 2003 have been adopted to address Spain's key challenges as regards the pension system and the labour market. The new government intends to maintain the main policy guidelines followed over the last few years and has continued to implement the initiatives that have already been introduced aiming at ensuring effective levels of competition in numerous sectors and enhancing the economy's capacity to innovate. Nevertheless, it is too premature to assess the impact of the ongoing and announced future measures on the performance of the hourly labour productivity. A unit to boost productivity was created by the government in 2004 to propose further actions to help the economy to meet this challenge. A detailed assessment of recent developments in addressing Spain's key policy challenges is presented in the following sections.

7.1. Labour market

Low employment rates are essentially due to lower female participation

Both the employment rate and labour participation are on an upward trend in Spain, but remain significantly below the EU average and the Lisbon target of 70 %. The unemployment rate, although on a downward trend, is, at 11.1 %, the highest in the euro area. In order to further promote employment growth, an amendment to the 2005 draft budget law has been introduced, according to which small companies, provided that average staff size increases, will enjoy tax relief for reinvested capital gains.

Whilst male employment rates are at around the EU average, female employment and participation rates, though rapidly increasing, remain at around 46 %, well below the EU average of 55.1 %. In this respect, no significant additional measures to those adopted up to 2003 in this area have been announced by the government appointed in April 2004.

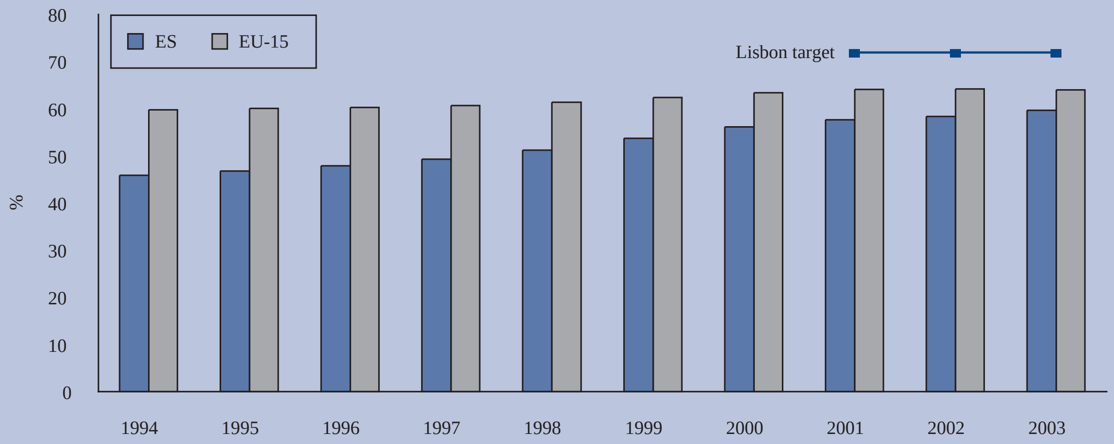
No significant changes in the wage bargaining system

Although no new measures have been adopted so far, the government has announced its intention to strengthen collective bargaining so as to better reflect local labour market conditions as well as specific circumstances at the firm level. Indexation clauses are still in force, although their use is not currently creating significant inflationary distortions. However, in general, backward-looking wage indexation introduces distortions in the functioning of the labour market and contributes to inflation persistence. In this respect, the substitution of indexation by other bargaining mechanisms including a closer link between wage increases and productivity growth would lead to more efficient results. A new agreement for civil servants' wage increases was reached for 2004. According to this, part of the increase would take place through contributions to pension funds as deferred wages and through non-consolidated one-off wage increases.

Raise the low employment rates, especially among women, and reduce wide regional labour market disparities	**Assessment**
Under this challenge, Spain was requested to:	
1. continue to encourage increased labour market participation, especially among women, including through higher provision of childcare facilities and the promotion of greater use of part-time contracts;	In progress
2. encourage a reform of wage setting in order to better reflect productivity taking into account productivity differences across skills, local labour market conditions and economic circumstances at the firm level, as well as phasing out indexation provisions in collective agreements (GL 5);	Limited
3. further reform employment protection legislation so as to reduce segmentation of the labour market across different types of contract (GL 6);	Insufficient
4. continue to facilitate the geographical mobility of workers by removing fiscal and other distortions, including by promoting the rental market for housing and removing rigidities in the availability of land for development (GL 7).	In progress

Bearing in mind the three-year period available for implementation, the degree of implementation since 2003 is indicated as: ‘Complete’ for (practically) complete; ‘In progress’ where progress is well advanced; ‘Limited’ where the recommendation is only partially addressed; and ‘Insufficient’ where no substantial measures going in the right direction have been taken.

Graph 7.1: **Employment rates (total)**



Source: Commission services.

Labour market remains heavily segmented

No new measures were implemented in 2004 as concerns the segmentation of the labour market and the share of fixed-term contracts in total employment remains at around 30 %, far above the EU level. Nevertheless, the government appears determined to closely monitor the disproportionate use of fixed-term contracts so as to prevent their use beyond their legal purpose of covering temporary needs of firms. However, the reform of the current employment protection legislation has not yet been addressed.

Geographical mobility and rigidities in the housing market are being addressed

The 2003 reform of the personal income tax introduced a higher tax relief for unemployed workers who accept a job requiring a change of residence. In addition to fiscal incentives on letting already introduced in 2003, the government allocated in 2004 an additional EUR 1 billion (0.1 % of GDP) to the current 2002–05 housing plan, aimed at enlarging the rental market and improving housing access for those who have been priced out. As a result, the plan reform includes measures to foster the development of price-controlled housing, transitory subsidies to low-income tenants and subsidies to landlords who rent their dwellings. Their effect might be, however, rather limited, if no additional measures are adopted. Finally, in order to dampen regional disparities by facilitating geographical mobility, the government interconnected regions' unemployment databases at the national employment agency level in 2004.

7.2. Productivity and business dynamism

Some initiatives have been launched to encourage the transition towards a knowledge-based economy

The level of educational attainment, as measured by the percentage of the population aged 20–24 having completed at least upper-secondary education, remains one of the lowest in the EU and the dropout rates from secondary school have not decreased in recent years.

In order to improve the situation, some measures were taken to develop the national system of qualifications and vocational training and the new government has announced changes to the legislative framework of the education sector. Spain also continues to be one of the worst performers in terms of R & D investment and ICT take-ups. The 2004–07 national R & D+I plan aims to raise R & D and innovation spending respectively to 1.2 and 2.1 % of GDP in 2005. This plan is currently under revision and, in the meantime, public expenditure in R & D and innovation will be increased by 25 % in the 2005 budget. More R & D tax breaks have been introduced. ICT diffusion is improving, albeit from a low level, as measured by the use of computers and Internet access by households and businesses and broadband diffusion. Prices for ADSL connections remain high, but the incumbent telecommunications company Telefónica, which is still the dominant firm in the market, has doubled the connection speed. The rest of the operators have followed suit in order to keep their increasing market share, which coincides with the EU average. The role of the public sector has been pivotal in the transition towards an information society by continuing to promote the use of IT in the public administration. A plan to foster e-government is currently being implemented. In addition, the government plans to encourage demand for the newly created services by launching a campaign to raise society's Internet awareness as well as a programme of digital alphabetisation.

Efforts to increase competition levels have proceeded at a slow pace …

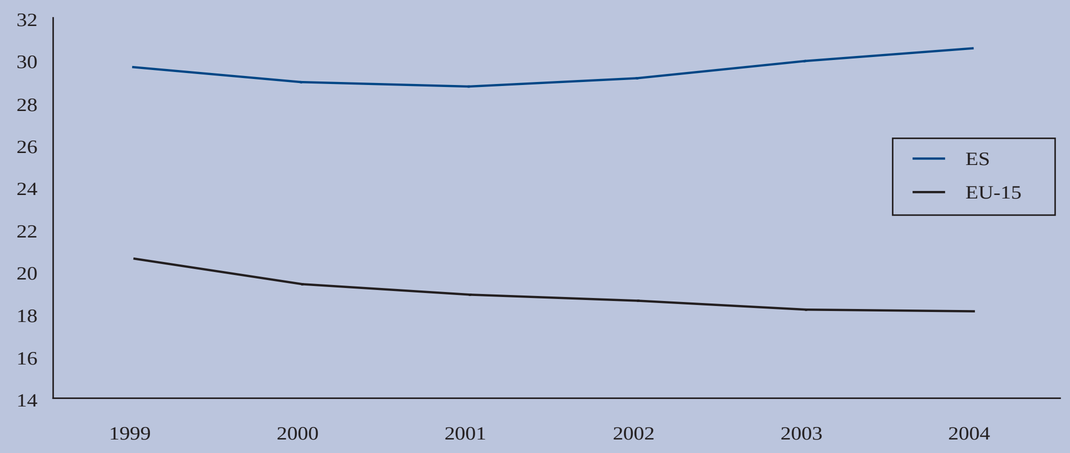
In 2004, efforts were made to achieve the complete transposition of EU competition regulations into Spanish law. In order to increase effective competition, the government aims to reinforce the role of the competition authorities and to ensure good coordination with the regional competition authorities that are currently being set up. A White Paper on the reform of the Spanish competition framework is currently in preparation. Conditions should be improved for regulators in liberalised network industries to be able to perform their duties in an independent and market-oriented fashion. In the retail sector, a draft law was approved establishing the minimum regulatory framework for shop opening hours across all Spanish regions, encouraging higher flexibility and longer opening hours. No progress was achieved this year with respect to the simplification of procedures and liberalisation of restrictions regarding the opening of large stores. This requires negotiations with the regional governments.

… but there is improvement in the environment for business creation

The opening of more one-stop shops and the extended availability of online facilities have continued to contribute to reducing the time and cost to set up a new business. Changes to the accounting regime for SMEs were adopted in 2004 to simplify compliance with tax and

Increase the low level of productivity, including by strengthening the knowledge-based economy in terms of educational attainment and skill levels, investment in IT, R & D and innovation performance	**Assessment**
Under this challenge, Spain was requested to:	
5. step up efforts to increase skilled human capital, investments in R & D and innovation, and ICT diffusion (GL 13);	In progress
6. continue to take measures to further enforce effective competition in certain sectors, such as retail distribution, and monitor closely the developments on the electricity market (GL 9), and pursue ongoing efforts to reduce the administrative burden on business (GL 11).	Limited

Graph 7.2: **Early school-leavers — percentage of the population aged 18–24 with, at most, lower-secondary education and not in further education or training**



Source: Eurostat.

accounting obligations. A new insolvency law was introduced to simplify procedures for winding-up companies while adopting a more preventive stance.

The liberalisation process of the electricity sector has moved forward gradually

Despite full market opening in 2003, the sector is still highly dominated by four vertically integrated firms. The fact that retail tariffs are still fixed while the wholesale market is liberalised hampers the entry of new suppliers. The integration of the Spanish market with neighbouring countries would contribute to increasing competition but progress has been limited in upgrading cross-border interconnection infrastructures. However, both the creation of the Iberian integrated electricity market (MIBEL) set for 30 June 2005 and the interconnection target of 10 % of domestic demand agreed at the Barcelona summit of the EU Council are expected to contribute to increasing the interconnection capacity in the near future. Nonetheless, a significant number of regulatory changes will be needed before the Spanish and the Portuguese market can be truly integrated.

7.3. Long-term sustainability of public finances

Progress in ensuring the long-term sustainability of public finances, but no major measures regarding reforms in the public pension system

In spite of the healthy financial situation of the public pension system in the short run, the sustainability of the Spanish public finances might be threatened in the longer term by the budgetary impact of an ageing population. Although the demographic scenario now appears more favourable due to recent net immigration flows, their effect might only be transitory and would only postpone the full budgetary impact. No further steps have been taken to reform the public pension system towards strengthening the relationship between the contributory effort and benefits. However, in the context of the three-pronged strategy, a number of measures aiming at enhancing the sustainability of the system should be mentioned. First, the pension reserve fund created in 2000, which received further endowments in the course of 2004 to amount to EUR 19.3 billion (2.6 % of GDP), is planned to reach EUR 24.7 billion (3.0 % of GDP) in 2005. Second, the healthy budgetary position has allowed for a steadily decreasing debt to GDP ratio, which is expected to be 47 % in 2005. Third, raising participation and employment rates, including through measures in force since 2003 to encourage workers to postpone retirement, would help attenuate the financial impact of ageing. Regarding the second and third pillars, some measures have also been introduced, in particular the implementation in 2004 of the 2003 agreement to constitute a pension fund by the general government to complement public servants' pensions.

Ensure the long-term sustainability of public finances in the face of population ageing	Assessment
Under this challenge, Spain was requested to:	
7. complement recent initiatives by taking the appropriate steps to implement a major reform of the pension system, so as to strengthen the link between contributions and benefits and control the long-term increases in pension expenditure linked to the foreseen demographic changes (GL 16).	Limited

Table 7.1

Economic indicators for Spain

	Spain				EU-25			
	2001	2002	2003	2004	2001	2002	2003	2004
General economic background								
Real GDP growth (1)	2.8	2.2	2.5	2.6	1.8	1.1	1.0	2.5
Inflation (2)	2.8	3.6	3.1	3.1	2.5	2.1	1.9	2.2
Labour productivity growth (3)	0.3	0.9	0.7	0.6	0.8	0.9	0.9	2.1
Employment growth (1)	2.5	1.7	1.8	1.9	1.0	0.3	0.3	0.4
Nominal wage growth (4)	3.8	4.3	4.3	3.7	4.0	3.2	3.1	3.0
Current account (5)	– 3.1	– 2.7	– 3.3	– 4.2	:	:	:	:
Unemployment (6)	10.6	11.3	11.3	11.1	8.5	8.9	9.1	9.1
Public finances								
General government balance (5)	– 0.4	– 0.1	0.4	– 0.6	– 1.2	– 2.3	– 2.8	– 2.8
Primary balance (5)	2.8	2.7	2.9	1.7	2.4	1.0	0.3	0.2
Cyclically adjusted balance (5)	– 1.0	– 0.5	0.2	– 0.7	:	:	:	:
Gross government debt (5)	57.5	54.4	50.7	48.2	62.1	61.6	63.2	63.5
Employment								
Employment rate (7)	57.7	58.4	59.7	:	62.8	62.9	63.0	:
Female employment rate (8)	43.0	44.1	46.0	:	54.3	54.7	55.1	:
Employment rate for older workers (9)	39.2	39.7	40.8	:	37.4	38.8	40.2	:
Long-term unemployment (10)	3.9	3.9	3.9	:	3.8	3.9	4.0	:
Tax rate on low wage earners (11)	33.4	34.0	32.8	:	37.2	37.1	37.4	:
Unemployment trap indicator (12)	78.8	79.2	78.3	:	78.8	78.5	78.3	:
Product market reforms								
Hourly labour productivity (13)	83.9	85.3	86.1	:	:	:	:	:
Total trade to GDP ratio (14)	30.8	29.6	28.8	:	:	58.8	57.2	:
Internal market directives (15)	98.7	98.4	99.1	98.7	:	:	:	96.3
Business investment (16)	22.1	21.7	22.1	:	17.9	17.2	16.8	:
Knowledge-based economy								
Total tertiary graduates (17)	42.1	44.7	:	:	46.8	:	:	:
Spending on human resources (18)	4.4	4.4	:	:	5.1	:	:	:
R & D expenditure (19)	1.0	1.0	1.1	:	1.9	1.9	:	:
Expenditure on IT (20)	1.8	1.6	1.6	1.5	3.1	2.9	2.9	2.9

(1) Growth rate in per cent.
(2) Annual average rate of change in harmonised index of consumer prices in per cent.
(3) Growth rate of real GDP per occupied person in per cent.
(4) Growth rate of compensation per employee.
(5) As a percentage of GDP.
(6) Number of unemployed as a percentage of the labour force.
(7) Employed persons aged 15–64 as a share of the total population of the same age group.
(8) Employed women aged 15–64 as a share of the total female population of the same age group.
(9) Employed persons aged 55–64 as a share of the total population of the same age group.
(10) Long-term unemployed (over 12 months) as a percentage of the total active population aged 15–64.
(11) Income tax plus employer/employee contributions as a percentage of labour costs of a single earner at 67 % of the average production worker wage, no children.
(12) Effective tax rate on labour income taking into account the combined effect of increased taxes and benefits withdrawal as an individual moves from unemployment back to work earning 67 % of the average production worker wage, measured at the first month of unemployment (after any 'waiting period' if applicable).
(13) GDP per hour worked in PPS, EU-15 = 100.
(14) Percentage, average value of imports and exports of goods and services divided by GDP, multiplied by 100; for DE, ES, FR, IT, PL and the UK, the value for the EU-25 is the total for the large Member States; for all the other States, the value for the EU-25 is the total for the small Member States.
(15) Percentage implemented in November 2004.
(16) Gross fixed capital formation by the private sector as a percentage of GDP.
(17) Total tertiary graduates (ISCED 5–6) per 1 000 of population aged 20–29.
(18) Public expenditure on education as a percentage of GDP.
(19) GERD — gross domestic expenditure on R & D as a percentage of GDP.
(20) Expenditure on information technology as a percentage of GDP.

Source: Commission services (including Eurostat, structural indicators). The data for 'general economic background' and 'public finance' are taken from the Commission's autumn 2004 economic forecasts.

8. France

Economic growth was higher in France than in the euro area in 2004. Real GDP growth is expected to have reached 2.4 %, as against 2.2 % in the euro area. The recovery was driven by the improvement in the global economy and, contrasting with developments in the euro area, a clear upswing in the domestic components of growth, notably private consumption. In view of the demographic shock that will start affecting the economy by the end of the current decade, the main economic policy challenge faced by France remains the need to foster potential growth through structural reforms both on the labour and on the product markets. Another major challenge is ensuring consolidation of government finances in the short run and their sustainability in the longer term. In 2004, some progress was made in bringing the deficit below 3 % of GDP: the general government deficit started to decline, to some extent thanks to the unexpectedly strong cyclical upswing and to limits on central government spending. In addition, a comprehensive reform of the health insurance system was introduced. This followed the implementation in 2003 of a major pension reform, which will also have clear positive effects on the labour market in the long run. Limited progress was made in the area of labour and product market reforms in 2004, and more has to be done in order to improve economic performance. On average, hourly productivity is one of the highest amongst EU Member States, but this is partly due to the exclusion from the labour market of the less productive workers and to a particularly low number of hours worked per employee. In the area of product markets, France continues to be among the worst performers in terms of both transposition and implementation of internal market directives and efforts have been slow to increase competition in energy markets. A detailed assessment of recent developments in addressing France's key policy challenges is presented in the following sections.

8.1. Public finances

The reduction in the cyclically adjusted deficit was lower than expected in 2004

In September 2004, the French government confirmed the deficit target for 2004 contained in the draft budget for 2004 (3.6 % of GDP), despite the clear improvement in macroeconomic conditions that had occurred in the meantime. While State expenditure was kept in line with plans (stabilisation in real terms), health and local expenditures were more dynamic than planned. The lack of improvement in the deficit compared with plans is also due to a number of adverse developments. Notably, the 2003 deficit estimate was revised slightly upwards (by 0.1 % of GDP) causing a negative base effect and the Conseil d'État partly cancelled a reform of the unemployment insurance system that had foreseen a substantial tightening of eligibility conditions to benefits (0.1 % of GDP). All in all, according to Commission services' calculations published in the autumn 2004 economic forecast, the improvement in the cyclically adjusted balance in 2004 did not exceed 0.3 % of GDP, as against the 0.8 % recommended.

As regards 2005, the draft budget assumes real GDP growth at 2.5 % and foresees a decline in the deficit from 3.6 % of GDP in 2004 to 2.9 % of GDP in 2005. The Commission services projected, in their autumn 2004 economic forecast, the 2005 deficit at 3.0 %. The same forecast foresees a decline in the cyclically adjusted balance by 0.7 percentage points of GDP in 2005. This reflects the effects of expenditure restraint and, to a larger extent, one-off revenues amounting to ½ % of GDP linked to the transfer of the responsibility to the social security sector for the payment of pensions to electricity and gas companies' employees.

Reduce rapidly the general government deficit to below 3 % of GDP and keep government finances on a steady consolidation path	Assessment
Under this challenge, France was requested to:	
1. achieve an annual reduction in the cyclically adjusted deficit of 0.8 % of GDP in 2004 and of at least 0.6 % of GDP or a larger amount in 2005 so as to ensure that the general government deficit is brought below 3 % of GDP in 2005 (GL 1);	Limited
2. should the recovery in economic activity be stronger than currently expected, allocate any higher-than-expected revenues to deficit reduction and accelerate the reduction in the cyclically adjusted deficit through the implementation of additional measures. In addition, any budgetary margin stemming from a slower-than-planned increase in expenditures should be allocated to deficit reduction;	Insufficient
3. ensure that the budgetary consolidation continues in the years after 2005, namely through a steady reduction in the cyclically adjusted budgetary deficit by at least 0.5 percentage points of GDP per year or more if necessary to achieve the medium-term position of government finances close to balance or in surplus and bring back the debt ratio to a declining path (GL 1).	Limited

Bearing in mind the three-year period available for implementation, the degree of implementation since 2003 is indicated as: ‘Complete’ for (practically) complete; ‘In progress’ where progress is well advanced; ‘Limited’ where the recommendation is only partially addressed; and ‘Insufficient’ where no substantial measures going in the right direction have been taken.

In 2004, higher-than-expected tax revenues did not lead to a lower deficit outcome, neither in actual nor in cyclically adjusted terms

The stronger-than-expected economic recovery in 2004, when real GDP growth reached 2.4 % instead of the 1.7 % projected in the 2004 budget law, triggered additional revenues of about 0.3 % of GDP, concentrated in the State sector. On the contrary, the weakness of payrolls triggered lower-than-expected social contributions of about 0.1 percentage point of GDP. As already mentioned, the additional revenues did not lead to an improvement in the 2004 deficit forecast compared with plans, due to adverse developments in other subsectors of general government. Therefore, the improvement in the cyclically adjusted deficit in 2004 was clearly lower than expected. This is also due to the fact that no additional measures were taken to accelerate the reduction in the cyclically adjusted balance in 2004 when it became clear that the economic recovery was stronger than expected.

Medium-term projections appear difficult to attain under current policies

The multiannual budgetary projection accompanying the draft budget for 2005 assumes real GDP growth at 2.5 % per year up to 2008 and projects a decline in the general government deficit of 0.6/0.7 percentage points of GDP per year from 2006 onwards. This is also valid for the year 2006, despite the fact that the implementation of significant tax cuts and the disappearance of the positive impact of the one-off EDF–GDF payment (½ % of GDP) will make the deficit reduction more difficult in that year.

Although consistent with a reduction in the cyclically adjusted deficit by 0.5 percentage points of GDP per year, the projected budgetary effort is not sufficient to bring government finances to a close to balance or in surplus situation in nominal terms within the projection period. In 2008, the end-year of the projection period, the general government deficit would still amount to 0.9 % of GDP. However, in structural terms, public finances would approach a close to balance or in surplus position, since the cyclically adjusted deficit is projected to be reduced to 0.7 percentage points of GDP in 2008. The general government debt ratio would start declining in 2006, but remain above 60 % of GDP up to 2008, when it would reach 62 % of GDP.

According to the multiannual projection attached to the budget, the reduction in the deficit in the years after 2005 would be achieved through ambitious expenditure restraint. General government expenditure is projected to increase by 1.2 % per year in real terms, a rate not observed since 1997. Even taking into account the medium-term savings generated by the reform of the health insurance system adopted in 2004, it appears difficult under current policies to keep expenditure in line with these plans, and also against the background of the past expenditure slippages compared with multiannual targets.

8.2. Labour market

Labour market performance remains weak, despite recent reforms

In 2001, France introduced a new unemployment insurance scheme. The scheme made it easier for the unemployed to qualify for unemployment benefits and removed the gradual reduction of benefits over time. As a counterpart, sanctions were foreseen in case a job-seeker refuses job proposals with no legitimate reason. In practice, the number of sanctions enforced for insufficient job search has remained very limited. This, combined with the absence of a decline in benefits over time, implied that the reform did not have the expected positive impact on job search. In 2003 and 2004, in reaction to the sharp deterioration in the budgetary situation of the unemployment insurance system, eligibility conditions for unemployment benefits were tightened and their duration was reduced, without, however, reforming requirements and incentives to search for a job. Nevertheless, these changes may have positive effects on job search. Furthermore, the law on social cohesion (LCS), which was adopted by Parliament in autumn 2004, foresees a reform of public employment services. The ANPE's (Agence nationale pour l'emploi — the public employment service) monopoly will be abolished and the sanction device will be changed in order to make it easier to implement and therefore improve the incentives to work.

France is one of the industrialised countries with the lowest level of number of hours worked per capita. This reflects both a low employment rate, particularly for young and older workers, and the low number of hours worked per person in employment, especially for full-time workers. As already underlined in the 2004 implementation report, important measures have already been taken in order to encourage labour market participation of older workers, notably in the context of the pension reform of 2003 (introduction of a system reducing the pension amount if the required contribution period is not reached and of a premium system that constitutes a genuine incentive for prolonging working life beyond the required contribution period). However, recent studies show that incentives to work remain relatively weak for people at and above the legal retirement age, which is at 60 among the lowest in the OECD. Apart from financial incentives, the negative perception by employers and employees of work after 50 or 55 needs to be changed. As regards other groups, and notably youngsters and people excluded from the labour market, the social cohesion law also foresees a significant increase in subsidised jobs, public employment, and training and apprenticeship. While it may have a positive impact on exclusion in the short run, at a relatively high cost for government finances, the long-term economic effects of the measures proposed in the plan are more uncertain.

Working time has continued to decline over the last decade in France, contrasting with developments elsewhere in the OECD. The 'Fillon law' adopted in 2003 introduced more flexibility into the legislation on working time by allowing a larger recourse to overtime hours and reducing their cost. The expected positive impact of this reform on working time is yet to come, mostly because it will take some time for firms to reorganise work and seize the possibilities offered by the law. However, in order to increase the growth potential of the French economy, a further loosening of the legislation on working time should be considered. Measures recently

Increase labour market participation and reduce structural unemployment	**Assessment**
Under this challenge, France was requested to:	
4. ensure that the new unemployment insurance system is fully implemented, including appropriate requirements and effective incentives to search for a job.	Limited

announced by the government (increase in the overtime limit, possibility for workers who wish to work longer to do so) are going in the right direction. Another major reform in order to improve labour market performance would be to reduce the stringency of employment protection legislation (EPL). According to several studies, overly tight EPL in France is a major burden on labour demand, and has constituted a barrier for some categories of workers (notably, young and unskilled workers) to access the labour market. In this regard, the social cohesion law lacks ambition but goes in the right direction: it loosens the criteria that trigger the complex and long procedure for collective dismissal and it allows social partners to negotiate the schedule of this procedure at the local level.

8.3. Long-term sustainability of government finances

Despite the clear improvement resulting from the implementation of the 2003 pension reform, long-term fiscal trends remain a cause for concern

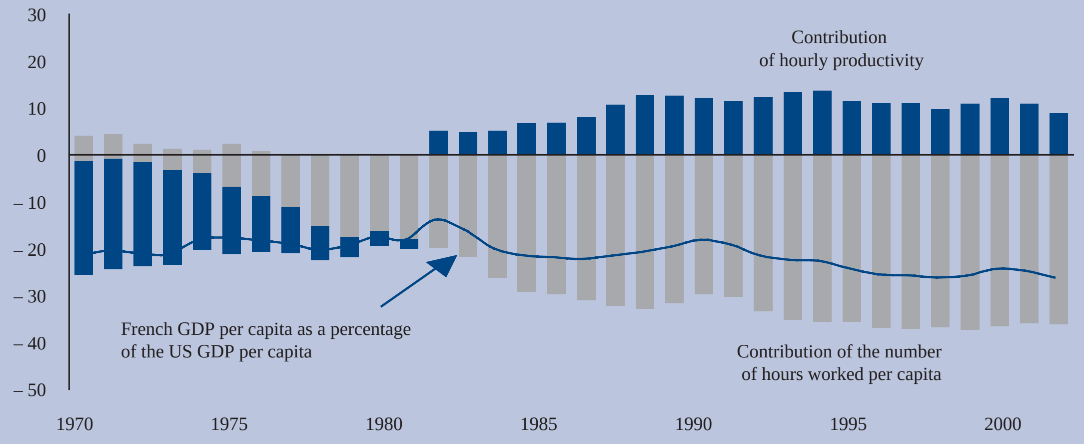
As reviewed in the 2004 implementation report, France implemented a major pension reform in summer 2003. This reform implies, notably, a gradual increase in the number of contribution years for entitlement to a full pension over the coming years. A positive aspect of the reform is that it foresees that after 2012 the contribution period should increase proportionally with life expectancy, through a rule meant to keep constant the ratio between the number of contribution years and the number of pension years. The reform also raises significantly the financial incentives to remain active until and after the legal retirement age, and changes the reference for the indexation of pensions in the public sector from wages to prices. According to the French authorities, this reform will cover around 40 % of the financing requirements of the pension system in 2020. Therefore, although the reform undeniably constitutes a large improvement compared with the previous situation, it is not sufficient to neutralise all the medium-term consequences of ageing on the pension system. In addition, the ageing population will continue to impact on the financial situation of the pension system after 2020 and until 2050; a new round of projections is currently being held by the European Commission and by the French Retirement Guidance Council in order to evaluate this impact more precisely. Further reforms will, in any case, be necessary in the next few decades to ensure the long-term sustainability of the pension system. The 2003 pension reform foresees a discussion on this issue between the government and social partners in 2008.

The reform of the health insurance system is a major step in the right direction

The deficit of the health insurance system has increased rapidly over the last few years to reach 0.8 % of GDP in 2004. This has reflected mostly the buoyancy of expenditure since 2000 despite several attempts by the government to curb its dynamics. It has led the French authorities to adopt in summer 2004 a major reform of the health system. The aim of the reform is to bring the health insurance system to budgetary balance in 2007, while preserving the quality of the health service. About one third of the effort is planned to be achieved through tax increases representing ¼ % of GDP, and the remainder through expenditure savings. These savings are supposed to stem notably from: (i) the introduction of a charge of EUR 1 payable by patients for every medical

Ensure the long-term sustainability of public finances in the face of population ageing	Assessment
Under this challenge, France was requested to:	
5. undertake with urgency a comprehensive reform of the pension system (GL 16), with the aim of ensuring its financial sustainability and increasing the effective retirement age, while adapting pension systems to more flexible employment and career patterns as well as to individual needs;	In progress
6. monitor closely the efficiency of the measures undertaken to curb the dynamics of spending in the health sector so as to reduce it to a sustainable level, and, if necessary, introduce new measures to achieve this objective in the context of the reforms envisaged (GL 14).	In progress

Graph 8.1: **Sources of the difference in GDP per capita — France/United States**



Source: Commission services.

consultation starting in January 2005; (ii) measures aimed at tackling fraudulent sick leave and at facilitating the development of generic drugs; and (iii) better medical cost control supposed to stem notably from the introduction of financial incentives for patients to use general practitioners rather than going straight to specialists. Although the reform is likely to trigger substantial savings over time, the precise budgetary impact of some expenditure-saving measures is highly uncertain. Notably, the large savings expected from the medical cost control — representing one third of the total expected savings — seems at risk, and highly dependent on the behaviour of the economic agents involved.

8.4. Product markets

Efforts have been made to increase competition in energy markets

As requested by the European directives on energy, 70 % of the French energy market was opened up to competition in July 2004. All non-household users are now eligible to freely choose their energy supplier. A law, adopted in August 2004, has also transposed the EU recommendations on the rules governing the transport and distribution of energy. Nevertheless, the incumbents still retain a strong dominant position. For instance, EDF and GDF still have market shares of 78 and 80 %, respectively, of the open market. The conditions imposed on new entrants remain restrictive and the unbundling of distribution activities in both sectors has not yet been fully carried out. In addition, according to the International Energy Agency (2004), the government still has the final authority on tariff setting. Finally, as requested by the directives, the energy market will only be opened up for all customers in 2007, although other European countries have already made that step.

The reduction and the simplification of business regulation should be pursued

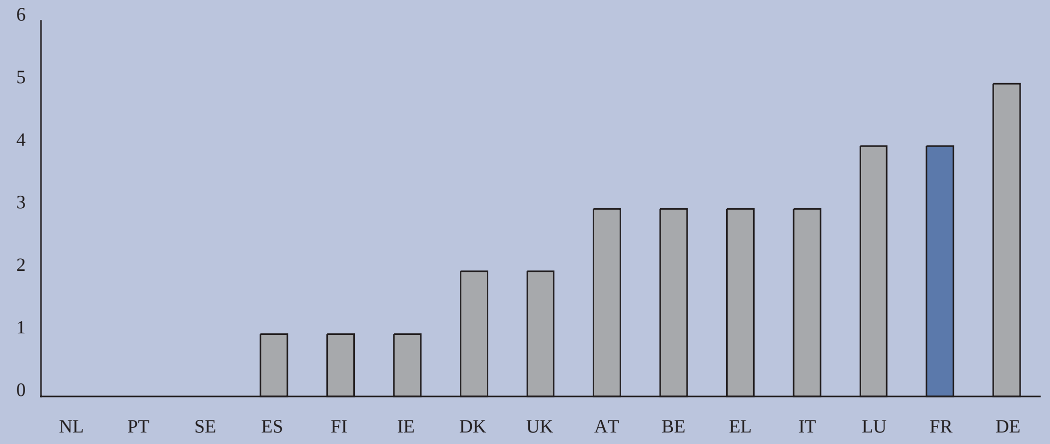
The economic initiative law adopted by the French Parliament in July 2003 sought to increase the birth and survival rates of enterprises and to promote entrepreneurship. It seems that it has begun to achieve results. After an important increase in the number of firms created in 2003, the results for the first nine months of 2004 show again a strong progression (+ 16.8 % compared with the same period in 2003). However, the number of new enterprises with more than one employee is stable and the survival rate of these newly created firms still has to be assessed. Besides, according to the last global entrepreneurship monitor report, France is still, in terms of level, amongst the countries with the lowest entrepreneurial activity. The complexity of fiscal and social regulations remains a business constraint, particularly for SMEs, which usually do not have sufficient financial capacity for detailed advice from tax experts. This complexity is one of the factors which explain why, in the last report of the World Bank on the best locations to do business, France does not appear as a top performer.

The transposition rate of internal market directives has slightly increased

Following an initiative from the government to transpose some European laws via an accelerated procedure, the transposition rate of internal market directives slightly increased at 96.8 % in 2004 against 96.5 % in 2003. However, this is still well below the EU target for transposition of 98.5 %. Regarding infringements, France's performance is still the second worst amongst the old EU Member States, even if the situation in that field has slightly improved recently. Finally, France has still the second-highest number of directives overdue for more than two years (four directives not transposed) but this number has been reduced significantly (in 2003, France had nine directives overdue for more than two years) (see Graph 8.2).

Ensure effective competition in the network industries and accelerate the adoption of internal market measures, in order to create a level playing field	**Assessment**
Under this challenge, France was requested to:	
7. pursue efforts to ensure competition in energy markets, namely in gas and electricity (GL 9);	Limited
8. sustain the efforts to reduce and simplify business regulations (GL 11);	In progress
9. raise the transposition rate of internal market directives and reduce the number of infringement proceedings (GL 9).	Limited

Graph 8.2: **Number of two years' overdue directives, 2004 (Lisbon target = no two years' overdue directives)**



Source: Commission services.

Table 8.1

Economic indicators for France

	France				EU-25			
	2001	2002	2003	2004	2001	2002	2003	2004
General economic background								
Real GDP growth (1)	2.1	1.2	0.5	2.4	1.8	1.1	1.0	2.5
Inflation (2)	1.8	1.9	2.2	2.3	2.5	2.1	1.9	2.2
Labour productivity growth (3)	0.2	0.2	0.4	2.7	0.8	0.9	0.9	2.1
Employment growth (1)	1.9	0.9	0.1	– 0.3	1.0	0.3	0.3	0.4
Nominal wage growth (4)	2.7	2.4	2.3	3.3	4.0	3.2	3.1	3.0
Current account (5)	1.5	1.5	0.4	– 0.2	:	:	:	:
Unemployment (6)	8.4	8.9	9.4	9.6	8.5	8.9	9.1	9.1
Public finances								
General government balance (5)	– 1.5	– 3.2	– 4.1	– 3.7	– 1.2	– 2.3	– 2.8	– 2.8
Primary balance (5)	1.6	– 0.2	– 1.2	– 0.7	2.4	1.0	0.3	0.2
Cyclically adjusted balance (5)	– 2.3	– 3.6	– 3.8	– 3.5	:	:	:	:
Gross government debt (5)	56.5	58.8	63.7	64.9	62.1	61.6	63.2	63.5
Employment								
Employment rate (7)	62.8	63.0	63.2	:	62.8	62.9	63.0	:
Female employment rate (8)	56.0	56.7	57.2	:	54.3	54.7	55.1	:
Employment rate for older workers (9)	31.9	34.7	36.8	:	37.4	38.8	40.2	:
Long-term unemployment (10)	3.0	3.0	3.5	:	3.8	3.9	4.0	:
Tax rate on low wage earners (11)	38.4	37.6	37.7	:	37.2	37.1	37.4	:
Unemployment trap indicator (12)	86.6	84.0	82.6	:	78.8	78.5	78.3	:
Product market reforms								
Hourly labour productivity (13)	120.6	120.0	122.5	:	:	:	:	:
Total trade to GDP ratio (14)	27.5	26.5	25.7	:	:	58.8	57.2	:
Internal market directives (15)	97.0	96.2	96.5	96.8	:	:	:	96.3
Business investment (16)	17.0	16.3	15.9	:	17.9	17.2	16.8	:
Knowledge-based economy								
Total tertiary graduates (17)	67.9	:	:	:	46.8	:	:	:
Spending on human resources (18)	5.8	5.8	:	:	5.1	:	:	:
R & D expenditure (19)	2.2	2.3	2.2	:	1.9	1.9	:	:
Expenditure on IT (20)	3.5	3.3	3.1	3.1	3.1	2.9	2.9	2.9

(1) Growth rate in per cent.
(2) Annual average rate of change in harmonised index of consumer prices in per cent.
(3) Growth rate of real GDP per occupied person in per cent.
(4) Growth rate of compensation per employee.
(5) As a percentage of GDP.
(6) Number of unemployed as a percentage of the labour force.
(7) Employed persons aged 15–64 as a share of the total population of the same age group.
(8) Employed women aged 15–64 as a share of the total female population of the same age group.
(9) Employed persons aged 55–64 as a share of the total population of the same age group.
(10) Long-term unemployed (over 12 months) as a percentage of the total active population aged 15–64.
(11) Income tax plus employer/employee contributions as a percentage of labour costs of a single earner at 67 % of the average production worker wage, no children.
(12) Effective tax rate on labour income taking into account the combined effect of increased taxes and benefits withdrawal as an individual moves from unemployment back to work earning 67 % of the average production worker wage, measured at the first month of unemployment (after any 'waiting period' if applicable).
(13) GDP per hour worked in PPS, EU-15 = 100.
(14) Percentage, average value of imports and exports of goods and services divided by GDP, multiplied by 100; for DE, ES, FR, IT, PL and the UK, the value for the EU-25 is the total for the large Member States; for all the other States, the value for the EU-25 is the total for the small Member States.
(15) Percentage implemented in November 2004.
(16) Gross fixed capital formation by the private sector as a percentage of GDP.
(17) Total tertiary graduates (ISCED 5–6) per 1 000 of population aged 20–29.
(18) Public expenditure on education as a percentage of GDP.
(19) GERD — gross domestic expenditure on R & D as a percentage of GDP.
(20) Expenditure on information technology as a percentage of GDP.

Source: Commission services (including Eurostat, structural indicators). The data for 'general economic background' and 'public finance' are taken from the Commission's autumn 2004 economic forecasts.

9. Ireland

The Irish economy is undergoing a significant adjustment to a pace of sustainable growth in the medium term of around 5 %. While still impressive, the extraordinary growth performance in the second half of the 1990s, then mainly due to a high inflow of foreign direct investment and a sizeable pool of available labour, is unlikely to be repeated. The economy's ability to sustain relatively high growth rates and a low unemployment rate in recent years constitutes evidence of its inherent flexibility. In 2004, Ireland's economic policy agenda built on both extending previous and introducing additional measures to promote stable macroeconomic conditions, strengthening the supply side and increasing the degree of competition. Concerns about the level and quality of public services and infrastructure have led to the government stepping up its efforts to secure value for money. As regards wage costs and competitiveness, some further easing of pressures can be expected over the medium term: fairly moderate pay provisions were agreed in summer 2004 for the second half-period of the 2003–05 national agreement 'Sustaining progress'. All in all, although some of the structural bottlenecks inherited from the high-growth period of the 1990s remain, measures undertaken in 2004 should facilitate a successful gradual transition towards a pace of sustainable growth. A detailed assessment of recent developments in addressing Ireland's key policy challenges is presented in the following sections.

9.1. Macroeconomic conditions and supply-side measures

Achieve a smooth transition from double-digit economic growth in the late 1990s to lower sustainable growth in the years ahead by ensuring stable macroeconomic conditions and by strengthening the supply side of the economy	**Assessment**
Under this challenge, Ireland was requested to:	
1. enhance the efficiency of public expenditure and improve revenue and expenditure planning in a stability-oriented medium-term framework building on the range of measures recently introduced to improve the planning, management and control of expenditure (GL 14);	In progress
2. encourage the social partners to adhere to a prudent and flexible wage norm to allow for adaptation to productivity and skill differentials and at the same time safeguard competitiveness (GLs 3 and 5);	In progress
3. prioritise the roll-out of the infrastructural elements of the national development plan, while preserving budgetary stability, and pursue policy measures to raise the level of R & D (GL 13);	In progress
4. increase competition in the network industries and in certain sectors of the economy, such as retail distribution (including the liquor trade), insurance and the professions (GL 9).	Limited

Bearing in mind the three-year period available for implementation, the degree of implementation since 2003 is indicated as: 'Complete' for (practically) complete; 'In progress' where progress is well advanced; 'Limited' where the recommendation is only partially addressed; and 'Insufficient' where no substantial measures going in the right direction have been taken.

Further measures to strengthen the budgetary framework are taken

As noted in the 2004 implementation report, deviations from revenue targets in recent years have led to tax forecasting procedures remaining under official review. A new provisional methodology for forecasting corporation tax revenues in the period 2004–06 was introduced in the 2004 budget. Developmental work is ongoing in the Department of Finance and by the revenue commissioners in examining the possibilities for refining the methodologies for forecasting tax revenues received under the major tax headings. As regards the management of expenditure, discretionary spending has been maintained closer to plans in recent years. From the 2004 budget, the medium-term framework has been strengthened by extending the system of rolling multiannual (five-year) spending envelopes from public transport to all areas of capital spending. In addition, a limited carry-over under the capital envelopes was made possible from one year to the next. These measures should encourage efficiency and increase the transparency of expenditure policy (see below).

Given constraints on the revenue side, including the desire to maintain a relatively low tax burden, the government has taken a number of initiatives to improve efficiency and control of expenditures, especially in high-priority areas such as health and infrastructure. As outlined in the 2004 implementation report, the government's health reform programme (announced in June 2003) will take several years to complete. Detailed planning on the health reform programme progressed during 2004 and further legislation is due in 2005. The Health Service Executive, a key new structure to manage services on a national basis, has replaced the regional health board structure as from 1 January 2005.

Wage agreement should tend to protect competitiveness

In recent years, higher inflation than in Ireland's main trading partners coupled with the strength of the euro have been at the centre of increasing competitiveness concerns. However, wage growth has eased markedly since the end of 2002, illustrating Ireland's capacity to respond flexibly to changing circumstances.

More recently, the annual growth in compensation has stabilised at around 5 %, with the latest data showing a gradual decline in the industry sector (see Graph 9.1). Overall, Irish economic conditions remain strong, with low unemployment, healthy employment growth and resilient exports.

Graph 9.1: **Compensation of employees per capita (year-on-year growth rates)**

Source: Central Statistics Office, Ireland.

In the medium term, wage moderation in the private sector should be fostered by the relatively moderate provisions of the new 18-month pay deal from June 2004 in the framework of the national agreement 'Sustaining progress'. The pay deal provides for a slightly higher wage increase for low-paid workers. In the public sector, 'Sustaining progress' provides, in addition to regular pay rises, for the gradual implementation by mid-2005 of an average 8.9 % rise under 'benchmarking', a process to align pay scales more closely with those for comparable jobs in the private sector. In line with the government's commitment to secure value for money, payment of three quarters of the awarded increase and of the general round increases under 'Sustaining progress' is conditional on verifiable progress in public sector modernisation and flexibility and the maintenance of industrial peace. In the course of 2004, the performance verification groups put into place in 2003 agreed the payment of the benchmarking and general round increases in 2004.

Measures to improve capital spending and to increase R & D have been implemented

The record growth rates of the 1990s have led to congestion and other infrastructure constraints in some areas, which the government has been trying to address primarily through the 2000–06 national development plan (NDP). The government has sustained efforts to increase investment in infrastructure. In October 2003, an independent mid-term review of the NDP, which was commissioned by the government and the European Commission, reported that progress has been made in investing in infrastructure such as roads, public transport and social housing. As outlined in the 2004 implementation report, the review also made several recommendations including the desirability of multiannual budgeting, further strengthening value for money and the timeliness of physical delivery (which, in some cases, has been behind schedule). In the budget for 2005, the capital envelopes contained a commitment to maintain public investment over the period 2005–09 at close to 4 % of GDP, well above the EU average for 2004 of around 2½ %. As regards management and cost control, the government has continued to encourage public–private partnerships. Work is also continuing on changes in the areas of public sector construction contracts by transferring appropriate risks to contractors, in order to improve the cost control of projects and facilitate budget planning in the years ahead. In 2004, a number of NDP projects were completed, in some cases ahead of schedule. For example, there were reported completions of broadband projects and road bypasses, but an example of where physical delivery has been behind schedule is the Dublin light rail system (LUAS), where there have been serious problems with delays and costs. Other developments in 2004 include the publication of a EUR 5 billion investment programme for 2004–06 in new water and sewerage infrastructure.

The government has stated its commitment to pursuing the objective of increasing investment in R & D and innovation. Under the NDP, EUR 2.5 billion was allocated to research, technological development and innovation across a range of sectors. Part of this funding has been directed towards major research centres. The 2004 budget included an incentive measure to increase private sector participation in R & D projects by the introduction of a 20 % tax credit for incremental R & D expenditure. Latest data show that measures taken in this field have helped to increase the level of R & D expenditure in Ireland, although it remains below the EU average.

Limited progress in increasing competition

Further measures have been taken to continue liberalising network industries. In 2004, postal services, electricity and gas were further liberalised to comply with European directives. In postal services, outbound cross-border mail services are now fully open to competition. In February 2004, market opening of the electricity sector increased from 40 % to 56 % by volume. All large customers and many SMEs are now eligible to source from licensed suppliers other than the State-owned Electricity Supply Board. For gas networks, an order came into effect in July 2004 which makes all non-household customers eligible to source from independent suppliers.

However, there was little progress in addressing competition issues in other sectors of the economy in 2004. The government is currently considering legislative proposals to remove a limited number of restrictions on the location and number of pharmacies. Following recommendations made in 2003 by the Commission on Liquor Licensing, the government is expected to publish shortly a comprehensive scheme of a bill to liberalise licensing. The government has also recently established a review group to examine the auctioneering and estate agency professions, which is expected to report in early 2005. Finally, no new measures have been taken to address the competition problems in the insurance sector.

Table 9.1

Economic indicators for Ireland

	Ireland				EU-25			
	2001	**2002**	**2003**	**2004**	**2001**	**2002**	**2003**	**2004**
General economic background								
Real GDP growth (1)	6.0	6.1	3.7	5.2	1.8	1.1	1.0	2.5
Inflation (2)	4.0	4.7	4.0	2.3	2.5	2.1	1.9	2.2
Labour productivity growth (3)	2.9	4.3	1.6	2.7	0.8	0.9	0.9	2.1
Employment growth (1)	3.0	1.8	2.0	2.4	1.0	0.3	0.3	0.4
Nominal wage growth (4)	7.7	5.0	4.7	5.4	4.0	3.2	3.1	3.0
Current account (5)	– 0.7	– 1.3	– 1.4	– 1.6	:	:	:	:
Unemployment (6)	3.9	4.3	4.6	4.4	8.5	8.9	9.1	9.1
Public finances								
General government balance (5)	0.9	– 0.2	0.1	– 0.2	– 1.2	– 2.3	– 2.8	– 2.8
Primary balance (5)	2.4	1.1	1.4	1.2	2.4	1.0	0.3	0.2
Cyclically adjusted balance (5)	– 0.3	– 1.3	0.1	0.1	:	:	:	:
Gross government debt (5)	35.9	32.7	32.1	30.7	62.1	61.6	63.2	63.5
Employment								
Employment rate (7)	65.8	65.6	65.4	:	62.8	62.9	63.0	:
Female employment rate (8)	55.0	55.6	55.8	:	54.3	54.7	55.1	:
Employment rate for older workers (9)	46.5	47.1	49.0	:	37.4	38.8	40.2	:
Long-term unemployment (10)	1.2	1.3	1.5	:	3.8	3.9	4.0	:
Tax rate on low wage earners (11)	17.3	16.7	16.7	:	37.2	37.1	37.4	:
Unemployment trap indicator (12)	72.6	73.4	73.3	:	78.8	78.5	78.3	:
Product market reforms								
Hourly labour productivity (13)	108.7	116.3	113.2	:	:	:	:	:
Total trade to GDP ratio (14)	91.0	84.4	76.0	:	:	58.8	57.2	:
Internal market directives (15)	97.2	98.6	98.6	97.5	:	:	:	96.3
Business investment (16)	19.3	18.2	19.7	:	17.9	17.2	16.8	:
Knowledge-based economy								
Total tertiary graduates (17)	70.9	70.9	:	:	46.8	:	:	:
Spending on human resources (18)	4.4	:	:	:	5.1	:	:	:
R & D expenditure (19)	1.2	1.1	1.1	:	1.9	1.9	:	:
Expenditure on IT (20)	2.1	1.8	1.7	1.6	3.1	2.9	2.9	2.9

(1) Growth rate in per cent.
(2) Annual average rate of change in harmonised index of consumer prices in per cent.
(3) Growth rate of real GDP per occupied person in per cent.
(4) Growth rate of compensation per employee.
(5) As a percentage of GDP.
(6) Number of unemployed as a percentage of the labour force.
(7) Employed persons aged 15–64 as a share of the total population of the same age group.
(8) Employed women aged 15–64 as a share of the total female population of the same age group.
(9) Employed persons aged 55–64 as a share of the total population of the same age group.
(10) Long-term unemployed (over 12 months) as a percentage of the total active population aged 15–64.
(11) Income tax plus employer/employee contributions as a percentage of labour costs of a single earner at 67 % of the average production worker wage, no children.
(12) Effective tax rate on labour income taking into account the combined effect of increased taxes and benefits withdrawal as an individual moves from unemployment back to work earning 67 % of the average production worker wage, measured at the first month of unemployment (after any ‘waiting period’ if applicable).
(13) GDP per hour worked in PPS, EU-15 = 100.
(14) Percentage, average value of imports and exports of goods and services divided by GDP, multiplied by 100; for DE, ES, FR, IT, PL and the UK, the value for the EU-25 is the total for the large Member States; for all the other States, the value for the EU-25 is the total for the small Member States.
(15) Percentage implemented in November 2004.
(16) Gross fixed capital formation by the private sector as a percentage of GDP.
(17) Total tertiary graduates (ISCED 5–6) per 1 000 of population aged 20–29.
(18) Public expenditure on education as a percentage of GDP.
(19) GERD — gross domestic expenditure on R & D as a percentage of GDP.
(20) Expenditure on information technology as a percentage of GDP.

Source: Commission services (including Eurostat, structural indicators). The data for ‘general economic background’ and ‘public finance’ are taken from the Commission’s autumn 2004 economic forecasts.

10. Italy

When compared with the euro-area average, the slow response of the Italian economy to the strong expansion of the global economy in 2004 bore witness to the structural challenges of the country's economic system. Highlighting the unresolved issue of competitiveness, the impact of reviving domestic demand on growth was dampened by a comparatively strong leakage to foreign markets which in turn was only partially offset by foreign sales. The loss of market shares continued. In terms of supply-side factors, the ongoing resilience of employment in the face of measured real GDP growth further underscored the issue of low productivity, which had affected Italy's growth potential in the recent past. Against this background, the economic reform effort proceeded at a variable pace. Following the pattern observed since 2001, fiscal policy largely relied on one-off measures adjourning a lasting consolidation of public finances warranted by the high debt to GDP ratio. The first part of the labour market reform aimed at reducing frictions and further increasing flexibility is being successively implemented, but little or no attention was focused on the revision of employment protection legislation and unemployment benefits. The pension reform was eventually adopted in 2004, yet will produce significant budgetary savings after 2008. The low level of investment in ICT and the low innovation capacity continue to be a drag on the productivity level and growth. In products and services markets, specific achievements were mitigated by the still high degree of regulation and a lack of competition, especially in the professional services sector. Overall, in 2004 the government's strategy was chiefly tilted towards securing recent reform steps while prioritising the reduction of taxes on the outstanding reform agenda. A detailed assessment of recent developments in addressing Italy's key policy challenges is presented in the following sections.

10.1. Public finances

Fiscal consolidation further postponed

Against the background of a mild economic recovery, the deficit to GDP ratio increased to 3.0 % in 2004, according to the Commission's autumn 2004 economic forecasts, up from 2.4 % in the year before. The worsening of the fiscal position essentially resulted from a gradual reduction in one-off measures coupled with a limited adjustment of the primary expenditure to GDP ratio. In cyclically adjusted terms, the primary surplus declined by 0.8 percentage points of GDP, more than the cyclically adjusted budget balance as a whole, which worsened by 0.5 percentage points of GDP, due to a lower interest expenditure. These figures contrast with the recommendation to ensure a reduction in the cyclically adjusted deficit of at least 0.5 percentage points of GDP per year until a medium-term budgetary position close to balance or in surplus is achieved. According to the Commission's autumn 2004 economic forecasts, the situation is not expected to improve in the short term, as the cyclically adjusted budget balance is projected to worsen in 2005 and the deficit to stay at 3 % of GDP even in the case where the planned budgetary correction is fully implemented. The deterioration in the cyclically adjusted balance also reflects the decrease in temporary measures, not yet compensated for by permanent ones. One-offs declined from over 2 % of GDP in 2003 to around 1½ % of GDP in 2004 and are planned to amount to ½ % of GDP in 2005.

The prospect of increased autonomy competes with efforts to curb regional spending

The domestic stability pact has proved effective in enforcing fiscal discipline on local governments in recent years. Moreover, concerning 2005, the budget includes a provision aimed at further improving the monitoring of the local government accounts, both in accrual and in cash terms. Conversely, attempts to control healthcare expenditure, which is under the authority of regional governments, have been much less successful. The draft 2005 budget fixed an ambitious target for healthcare expenditure, entailing a cut in nominal terms compared with 2004. Taking also into account the freeze of local and regional taxation until 2006, the achievement of the expected savings will crucially depend on an improvement in the monitoring and enforcement mech-

Rapidly consolidate public finances	Assessment
Under this challenge, Italy was requested to:	
1. take appropriate measures to avoid the occurrence of an excessive deficit; move towards achieving a medium-term close to balance or in surplus position by ensuring an improvement in the cyclically adjusted budget balance of at least 0.5 % of GDP per year, replacing one-off measures by measures of a more permanent character;	Limited
2. strengthen policy coordination between all levels of government, by ensuring adequate and transparent enforcement mechanisms for fiscal discipline, while providing for clear sources of financing regional spending;	Limited
3. finance further reductions in the tax burden through structural cuts in current primary expenditure within a comprehensive reform plan on both the expenditure and the revenue side.	Limited

Bearing in mind the three-year period available for implementation, the degree of implementation since 2003 is indicated as: 'Complete' for (practically) complete; 'In progress' where progress is well advanced; 'Limited' where the recommendation is only partially addressed; and 'Insufficient' where no substantial measures going in the right direction have been taken.

anisms. Parliament is currently working on a major constitutional reform which will devolve a broad range of responsibilities to the regions which are currently exercised by the central government. However, no final agreement has been reached so far on how to endow the regions with the resources needed to exercise the new powers.

Net of one-offs, revenues fall short of primary current expenditure

The declining reliance on temporary measures from over 2 % of GDP in 2003 to 1½ % of GDP in 2004 disclosed a gap between revenue and expenditure trends, which needs to be closed with structural measures in order to achieve fiscal adjustment. The draft 2005 budget introduced a new expenditure target for the 2005–07 period consisting of a 2 % ceiling on the annual nominal increase in primary expenditure, excluding pensions, with respect to the previous year. However, the new target was not accompanied by legislation defining its practical implementation, in particular for expenditure of regions. It relies on a strong political commitment and envisages a marked change in the behaviour of all levels of government. Any departure from the ambitious budgetary plan for 2005, involving a fiscal correction of 1.7 % of GDP, could lead to a deficit above the 3 % of GDP reference value. The tax cuts announced by the government for 2005 and beyond are not fully financed by structural measures on current expenditure.

10.2. Long-term sustainability of public finances

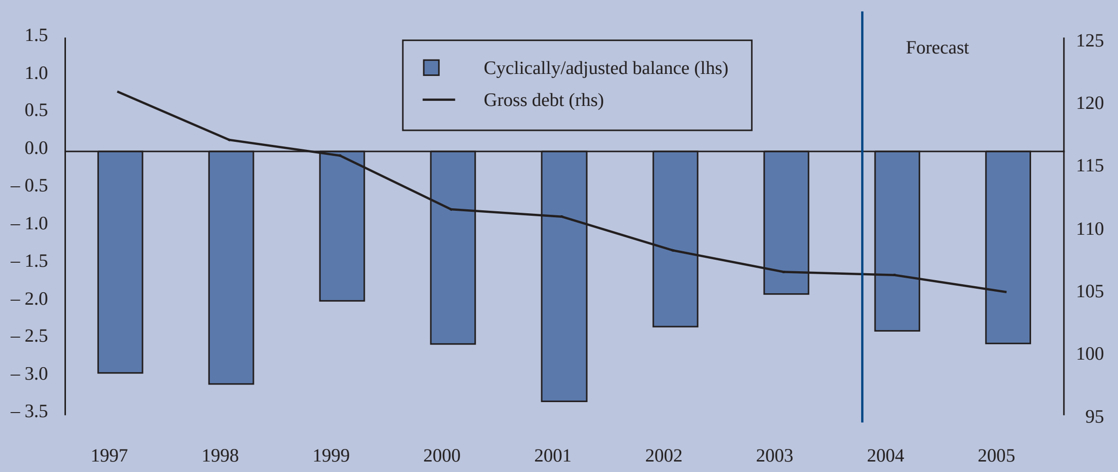
The pace of debt reduction remains slow

The assessment of public debt is essentially unaltered compared with the 2004 implementation report. The still very high debt to GDP ratio continues to decline at a very slow pace. In 2004, it was at 106.0 % of GDP, only 0.2 % lower than the year before in spite of significant privatisation proceeds totalling 0.7 % of GDP. Nominal GDP growth was essentially in line with official projections. Apart from the slippage in the primary surplus, the inertia of the debt is largely explained by the high levels of the cash borrowing requirement, which since 1999 has consistently exceeded the Maastricht definition of general government deficit. This difference has weighed over 9.5 percentage points of GDP on the reduction of the debt.

Moreover, the divergence between the cash borrowing requirement and the Maastricht deficit would seem to persist in future years according to the government's own medium-term projections presented in the 2004 update of the stability programme. As a consequence, the officially targeted decline in the debt to GDP ratio of around 2 percentage points on average per year in the 2005–08 period presumes significant fiscal corrections and large proceeds from disposals of financial assets.

Ensure the long-term sustainability of public finances in the face of population ageing	Assessment
Under this challenge, Italy was requested to:	
4. ensure that the debt ratio is diminishing at a satisfactory pace towards the 60 % of GDP threshold (GL 15);	Insufficient
5. adopt further measures to address the critical issue in the public pension system, in particular the long transition period to the new contributions-based system (GL 16). The new system has been designed just to deal with adverse demographic shocks and promote supplementary privately funded pension schemes.	Limited

Graph 10.1: **Debt and CAB developments (in % of GDP)**



Source: Commission services.

The primary surplus is planned to increase from 2½ % of GDP in 2004 to close to 5 % in 2008 and disposals of financial assets are expected to yield on average over 1.5 % of GDP year. Nevertheless, the privatisation plan appears particularly challenging by historical standards. Stepping up the reduction in the debt ratio with respect to both the past and plans remains one of the key challenges for Italy.

The pension reform sets stricter requirements for early retirement from 2008

In 2004, Parliament approved the pension reform originally presented by the government three years earlier. The tightening of the eligibility criteria to qualify for a seniority pension constitutes a positive step towards a shortening of the transition period to the new demographic shocks. However, the stricter provisions will apply only from 2008 onwards, when the reform foresees a sharp tightening of eligibility criteria, exacerbating the system's discontinuities. In addition, uncertainty characterises the ability of the adopted reform to promote the privately funded pension pillar. The new legislation also aims to kick-start privately funded schemes by diverting the annual flow of funds currently accounted by employers as *trattamento di fine rapporto* (a kind of severance payment that employers are obliged to accumulate each year and that is returned to workers at the end of the work relationship). As workers have the possibility to keep the money with the firm instead of transferring it to private pension funds, the development of the latter will also depend on the individual choices made.

10.3. Labour market and regional development

Implementation of first part of labour market reform advances …

In 2004, the government proceeded with the implementation of the first part of the government's labour market reform plan — the so-called 'Biagi law' — which had formally entered into force in October 2003. A series of ministerial decrees were adopted to make the reform law operational. In particular, the government successfully activated a number of new, more flexible labour contracts and effectively opened and liberalised the employment services sector to private firms. Both strands have the potential to increase labour force participation. The national online information and matching system (*borsa continua nazionale del lavoro*), which is also part of the Biagi law, is still under construction. Based on legislation adopted in 2002, in 2004 the Minister of Labour and Social Policies started selecting projects for childcare facilities at the firm level eligible for financial support. However, the initiative was blocked by the Constitutional Court as it falls within the remit of the regions. Because of its recent implementation, there are no clear-cut indications about the likely effects of the Biagi law. Employment growth slowed only slightly in 2004 exhibiting the traditional lag compared with economic activity. The rate of unemployment continued to follow the downward path of the past several years. As regards labour market data, it needs to be stressed that in 2004 the national statistical office carried out a major revision of the labour force survey in 2004 with a view to harmonising national statistics with EU legislation. The major implication of the revision is an upward shift in employment and a downward shift in the number of unemployed people. In 2003, the latest year for which 'new' and 'old' figures are available, the revision of the labour force survey led to an increase in the rate of employment from 56.0 % to 57.5 %. Despite the improvements observed over the recent past, the distance to the EU average of more than 64 % remains significant.

… increasing the need for further steps

While satisfying the need for more flexibility, there is the preoccupation that the increased variety of labour contracts may further increase the already visible segmentation of the Italian labour market. Employees in large manufacturing firms with a standard contract generally have better job protection and enjoy more generous benefits in the case of unemployment than workers with new non-standard contracts. The second and actually integral part of the reform plan, which was supposed to address the issue of segmentation, has made no progress. In particular, the draft law proposing a marginal loosening of the employment protection legislation (EPL) as well as the revision and broadening of the too segmented unem-

Raise the low employment rate, especially among women and older workers, and reduce the wide north–south economic disparities	**Assessment**
Under this challenge, Italy was requested to:	
6. further encourage increased labour force participation, especially among women, including by adequate provision of childcare facilities, and among older workers, stepping up and reinforcing measures targeted at postponing retirement from the labour force (GL 4);	In progress
7. further reform employment protection legislation, in order to facilitate job creation and adaptability and to reduce the segmentation of the labour market across types of contract and firm size (GL 6); and, at the same time, increase the resources and improve the efficiency of the unemployment benefit and social assistance system (GL 4);	Insufficient
8. encourage social partners to move towards more decentralised wage setting mechanisms that allow wages to better reflect different productivity conditions and individual skill levels (GL 5).	Limited

ployment benefit system is not making progress in Parliament. It has been put aside as priority was given to the reform of the pension system. The latter also includes a fiscal incentive for employees aimed at postponing their retirement decision which became effective in 2004. As the incentive became operational only in October, no definitive assessment can be made. From an economic point of view, the incentive would seem to merely change the distribution of income over time without increasing permanent income. However, preliminary indications on the number of applications point to a positive reception by potential beneficiaries.

Talks about a revision of the wage setting mechanism have eventually started

In clear contrast to past years, when trade unions had firmly refused to discuss a revision of the centralised wage setting mechanism, the social partners started talks in 2004 with a view to exploring possible changes. Two of the three leading trade unions explicitly signalled their willingness to discuss the option of regional negotiations and more generally to allow wages to better reflect different productivity conditions. However, the idea of regional wage agreements is strongly opposed by the largest trade union which has officially abandoned the talks. Progress in the field of wage differentiation would be instrumental for narrowing the large employment and ultimately the income gap between the north and the south of the country. This is recognised by the government, which encourages the social partners to continue their talks without interfering. The strong divergence of views across trade unions is likely to preclude a quick agreement on the issue.

10.4. Knowledge-based economy

A still weak innovation capacity

Despite some progress, the level of educational attainment, the skill levels and the number of researchers remain far below the EU average, which limits the availability of skilled human resources, reduces the capacity of absorption of new technologies and impinges on the overall innovative capacity. In 2003, steps were taken to implement a comprehensive reform of the school system. The past reforms of the universities have also started to show results (increase in the number of university graduates, international mobility of the students). The Italian Institute of Technology has been created with the mandate to stimulate research and scientific competition. Nevertheless, R & D expenditure and public and private sector expenditures remain among the lowest in the EU and demonstrate a relatively low average annual growth rate. Moreover, although increasing, the share of State aid redirected to the horizontal objective of steering investment towards R & D remains low. In this respect, the tax cut for firms hiring researchers is welcome. Little progress has been made regarding IT use and diffusion: IT expenditures have decreased as a percentage of GDP and Internet and broadband access, while increasing, also remain below the EU-15 average.

10.5. Business environment

High propensity towards entrepreneurship

Following the simplification law of 2003, efforts have continued to simplify the regulatory framework, in particular through the automatic cancellation from the register of firms that are no longer active. The cost, the number of procedures and time required for business start-up have decreased considerably. Relative progress has been made in e-government as measured by the number of services available online. A new corporate income tax system (IRES) became effective in January 2004 lowering the tax rate by 1 percentage point to 33 % and foreseeing some temporary tax deductions for investment in intangible assets (including items generally classified as R & D expenditure). The new corporate law also improves access to finance for businesses (private equity and venture capital).

Strengthen the knowledge-based economy in terms of educational attainment and skill levels, investment in IT, R & D and innovation performance	**Assessment**
Under this challenge, Italy was requested to:	
9. pursue efforts undertaken to raise the overall education and skill base of the population, to further increase investment in R & D and innovation, and to promote higher ICT take-up, in particular through measures targeted at small and medium-sized enterprises (GL 13).	Limited

The liberalisation of the energy sector proceeds but competition is not yet effective …

In the natural gas industry, the incumbent maintains a dominant position in the supply of both imported and domestically produced gas. As requested by the EU directives, some measures have been taken to address the competitiveness problems of the electricity sector. The creation of the electricity power exchange in April 2004 introduced a market-oriented price mechanism. In spite of ongoing reforms (e.g. the Marzano law and a change in the management of the transmission grid), the still imperfect competition in the energy sector contributes to high prices (especially for the larger users). The same conclusion holds for the prices of some telecommunication services, particularly for national calls.

… and limited progress has been made to increase competition in services and to improve the implementation of internal market directives

Italy was well below target in terms of transposition of internal market directives and recorded a very high number of infringement cases (95.3 % and 149, respectively, as of November 2004). A number of proposals to increase competition in the professional services sector have been discussed and examined by Parliament. Nevertheless, Italy remains the most regulated EU country for professional services ([1]).

([1]) Communication from the Commission 'Report on competition in professional services', COM(2004) 83, adopted 9 February 2004.

Continue to improve the business environment and to enhance competition in the energy and service sectors	**Assessment**
Under this challenge, Italy was requested to:	
10. improve the business environment by reducing the administrative burden on businesses (GL 11);	In progress
11. increase effective competition in the service sector, widen the opening of the energy markets, and improve the implementation of internal market directives (GL 9).	Limited

Table 10.1

Economic indicators for Italy

	Italy				EU-25			
	2001	2002	2003	2004	2001	2002	2003	2004
General economic background								
Real GDP growth ([1])	1.8	0.4	0.3	1.3	1.8	1.1	1.0	2.5
Inflation ([2])	2.3	2.6	2.8	2.3	2.5	2.1	1.9	2.2
Labour productivity growth ([3])	0.1	– 0.9	– 0.2	0.5	0.8	0.9	0.9	2.1
Employment growth ([1])	1.6	1.3	0.4	0.8	1.0	0.3	0.3	0.4
Nominal wage growth ([4])	3.2	2.5	3.8	3.4	4.0	3.2	3.1	3.0
Current account ([5])	0.3	– 0.3	– 1.2	– 1.0	:	:	:	:
Unemployment ([6])	9.4	9.0	8.6	8.3	8.5	8.9	9.1	9.1
Public finances								
General government balance ([5])	– 2.6	– 2.3	– 2.4	– 3.0	– 1.2	– 2.3	– 2.8	– 2.8
Primary balance ([5])	3.9	3.5	2.9	2.0	2.4	1.0	0.3	0.2
Cyclically adjusted balance ([5])	– 3.3	– 2.3	– 1.9	– 2.4	:	:	:	:
Gross government debt ([5])	110.6	107.9	106.2	106.0	62.1	61.6	63.2	63.5
Employment								
Employment rate ([7])	54.8	55.5	56.1	:	62.8	62.9	63.0	:
Female employment rate ([8])	41.1	42.0	42.7	:	54.3	54.7	55.1	:
Employment rate for older workers ([9])	28.0	28.9	30.3	:	37.4	38.8	40.2	:
Long-term unemployment ([10])	5.8	5.3	4.9	:	3.8	3.9	4.0	:
Tax rate on low wage earners ([11])	42.8	42.6	41.3	:	37.2	37.1	37.4	:
Unemployment trap indicator ([12])	59.6	59.9	58.2	:	78.8	78.5	78.3	:
Product market reforms								
Hourly labour productivity ([13])	106.3	102.7	101.1	:	:	:	:	:
Total trade to GDP ratio ([14])	27.0	25.9	24.5	:	:	58.8	57.2	:
Internal market directives ([15])	98.3	97.4	97.0	95.3	:	:	:	96.3
Business investment ([16])	17.3	17.9	16.5	:	17.9	17.2	16.8	:
Knowledge-based economy								
Total tertiary graduates ([17])	27.4	:	:	:	46.8	:	:	:
Spending on human resources ([18])	5.0	4.8	:	:	5.1	:	:	:
R & D expenditure ([19])	1.1	1.2	:	:	1.9	1.9	:	:
Expenditure on IT ([20])	2.1	2.0	1.9	1.8	3.1	2.9	2.9	2.9

([1]) Growth rate in per cent.
([2]) Annual average rate of change in harmonised index of consumer prices in per cent.
([3]) Growth rate of real GDP per occupied person in per cent.
([4]) Growth rate of compensation per employee.
([5]) As a percentage of GDP.
([6]) Number of unemployed as a percentage of the labour force.
([7]) Employed persons aged 15–64 as a share of the total population of the same age group.
([8]) Employed women aged 15–64 as a share of the total female population of the same age group.
([9]) Employed persons aged 55–64 as a share of the total population of the same age group.
([10]) Long-term unemployed (over 12 months) as a percentage of the total active population aged 15–64.
([11]) Income tax plus employer/employee contributions as a percentage of labour costs of a single earner at 67 % of the average production worker wage, no children.
([12]) Effective tax rate on labour income taking into account the combined effect of increased taxes and benefits withdrawal as an individual moves from unemployment back to work earning 67 % of the average production worker wage, measured at the first month of unemployment (after any 'waiting period' if applicable).
([13]) GDP per hour worked in PPS, EU-15 = 100.
([14]) Percentage, average value of imports and exports of goods and services divided by GDP, multiplied by 100; for DE, ES, FR, IT, PL and the UK, the value for the EU-25 is the total for the large Member States; for all the other States, the value for the EU-25 is the total for the small Member States.
([15]) Percentage implemented in November 2004.
([16]) Gross fixed capital formation by the private sector as a percentage of GDP.
([17]) Total tertiary graduates (ISCED 5–6) per 1 000 of population aged 20–29.
([18]) Public expenditure on education as a percentage of GDP.
([19]) GERD — gross domestic expenditure on R & D as a percentage of GDP.
([20]) Expenditure on information technology as a percentage of GDP.

Source: Commission services (including Eurostat, structural indicators). The data for 'general economic background' and 'public finance' are taken from the Commission's autumn 2004 economic forecasts.

11. Cyprus

As the unfavourable external environment continued to negatively affect tourism, a mainstay of the economy, real GDP growth in 2003 remained unchanged with respect to 2002, reaching 2 %. Economic activity was mainly driven by domestic demand, notably in investment and government expenditure. For 2004, the estimate is for a modest rebound in real GDP growth to 3.5 %, further projected to strengthen to about 4 % for 2005 and 2006 and thereby bringing growth closer to potential output growth. The recovery remains mostly led by domestic demand, although external demand is also projected to accelerate somewhat. As regards fiscal policy, the same factors that had led to an increase in the general government deficit in 2002 — an adverse external environment with lower GDP growth, and increased government spending to offset lower growth plus revenue shortfalls — entailed a widening of the deficit in 2003 to 6.4 % of GDP, which thereby became the main challenge for economic policy. Consequently, fiscal policy in 2004 mainly focused on reducing the government budget deficit in order to reach the convergence programme target of 5.2 % of GDP. Cyprus has the second-highest level of productivity per person employed among the new Member States but productivity growth has been relatively slow compared with them. The level of R & D expenditure and the share financed by industry are the lowest in the EU. In addition, although increasing, the use of ICT is quite limited. Finally, the Cypriot economy is dominated by small family enterprises and competition in network industries is still insufficient. A detailed assessment of recent developments in addressing Cyprus's key policy challenges is presented in the following sections.

11.1. Public finances

Fiscal consolidation efforts under way

On 5 July 2004, the Council decided that Cyprus was in excessive deficit and recommended that this be corrected by 2005 at the latest. Specifically, Cyprus was required to take effective action by 5 November 2004 in order to bring the deficit below 3 % of GDP in 2005. In addition, the Cypriot authorities are to ensure that the rise in the debt ratio, which, at 70.9 % of GDP in 2003, exceeds the 60 % of GDP reference value, is brought to a halt in 2004 and reversed thereafter.

For 2004, the convergence programme set a deficit target of 5.2 % of GDP. Government revenues in the period from January to September increased by 11.3 % and expenditure decreased by 1.6 % compared with the same period last year. However, a significant proportion of expenditures usually occurs at the end of the year, while there have also been delays in introducing some of the 2004 fiscal measures on the revenue side, and while there appear to be some uncertainties at present around the implementation of some of the measures for 2004 and 2005. Nevertheless, the developments in government finance and fiscal consolidation measures taken have on the whole been encouraging so far for 2004 and the Commission services' autumn 2004 economic fore-

Ensure a reduction of the general government deficit on a sustainable basis

Under this challenge, Cyprus was requested to:

1. reduce the general government deficit in a credible and sustainable way within a multiannual framework in line with the decisions to be taken by the Council in the context of the forthcoming budgetary surveillance exercise (GL 1).

cast expects that the 2004 deficit target will be met. The 2005 budget submitted to Parliament in September 2004 follows the outline and measures provided in the convergence programme with a budget deficit target of 2.9 % of GDP, which constitutes a challenging objective. The Commission services here project a somewhat higher deficit (3.0 % of GDP) due to the slightly lower GDP growth forecast, linked to higher oil prices and lower prediction on a tourism rebound, both vulnerable areas for Cyprus. At the same time, the debt is projected to inch lower from an estimated 72.6 % of GDP in 2004 to 72.4 % of GDP in 2005 ([1]).

11.2. Productivity and business dynamism

Several initiatives were launched to encourage the transition towards a knowledge-based society

Several initiatives were launched in 2004 to improve the adequacy of skilled human capital and to promote R & D, innovation and ICT diffusion. First, measures towards the development of information technology in schooling were taken to upgrade human capital. Both the number of computers and connections to the Internet in primary and secondary schools increased noticeably in 2004. Second, the funds allocated to R & D via the framework programme of the Research Promotion Foundation have, for example, been increased by around 30 %. Third, the preparation of a national strategy for the development of the information society which, in particular, included the implementation of e-government services and new legislation in the field of e-commerce was completed.

Efforts have been made to simplify the business and taxation environment

Measures to simplify the administrative burden for businesses were taken, notably through the implementation of e-government services. In July 2004, a scheme aiming at supporting youth entrepreneurship in the manufacturing sector and e-commerce as well as activities related to services in tourism was also initiated. As far as taxation was concerned, Cyprus complied with the VAT and excise duty rates prescribed by the *acquis communautaire*. It thereby shifted the tax burden from direct to indirect taxation with the aim of creating a better business climate. Finally, efforts were made to reduce entry barriers in the telecommunications, electricity and air transport sectors.

([1]) In November 2004, the Statistical Service produced a revision of national accounts for the period 1995–2003 in the context of adopting ESA 95. This brought small across-the-board upward revisions of nominal GDP of 1.5 to 3.9 % for the period 1995–2003. In addition, some further minor revisions in the expected debt ratio for 2004 were introduced. In total, this led to marginal downward corrections of the government deficit by an average of around 0.1 percentage point of GDP, and lower debt ratios by an average of nearly 2 percentage points.

Increase the diversification of the economy towards higher value added activities

Under this challenge, Cyprus was requested to:

2. step up efforts to increase the adequacy of skilled human capital, promote R & D and innovation, in particular in the business sector, and improve conditions to facilitate ICT diffusion (GLs 9 and 13);

3. continue to simplify the business and taxation environment (GL 11).

Table 11.1

Economic indicators for Cyprus

	Cyprus				EU-25			
	2001	2002	2003	2004	2001	2002	2003	2004
General economic background								
Real GDP growth (1)	4.0	2.0	2.0	3.5	1.8	1.1	1.0	2.5
Inflation (2)	2.0	2.8	4.0	2.4	2.5	2.1	1.9	2.2
Labour productivity growth (3)	1.9	0.8	1.1	2.4	0.8	0.9	0.9	2.1
Employment growth (1)	1.9	1.4	0.9	1.1	1.0	0.3	0.3	0.4
Nominal wage growth (4)	4.7	4.4	4.9	4.0	4.0	3.2	3.1	3.0
Current account (5)	– 4.0	:	– 3.5	– 4.5	:	:	:	:
Unemployment (6)	4.4	3.9	4.4	4.2	8.5	8.9	9.1	9.1
Public finances								
General government balance (5)	– 2.4	– 4.6	– 6.4	– 5.2	– 1.2	– 2.3	– 2.8	– 2.8
Primary balance (5)	1.2	– 1.3	– 2.9	– 1.8	2.4	1.0	0.3	0.2
Cyclically adjusted balance (5)	:	:	:	:	:	:	:	:
Gross government debt (5)	64.3	67.4	70.9	72.6	62.1	61.6	63.2	63.5
Employment								
Employment rate (7)	67.8	68.6	69.2	:	62.8	62.9	63.0	:
Female employment rate (8)	57.2	59.1	60.4	:	54.3	54.7	55.1	:
Employment rate for older workers (9)	49.1	49.4	50.4	:	37.4	38.8	40.2	:
Long-term unemployment (10)	0.9	0.8	1.1	:	3.8	3.9	4.0	:
Tax rate on low wage earners (11)	17.0	17.3	18.6	:	37.2	37.1	37.4	:
Unemployment trap indicator (12)	52.9	54.8	53.7	:	78.8	78.5	78.3	:
Product market reforms								
Hourly labour productivity (13)	:	:	:	:	:	:	:	:
Total trade to GDP ratio (14)	57.5	53.3	48.8	:	:	58.8	57.2	:
Internal market directives (15)	:	:	:	95.6	:	:	:	96.3
Business investment (16)	14.6	15.8	14.1	:	17.9	17.2	16.8	:
Knowledge-based economy								
Total tertiary graduates (17)	28.2	:	:	:	46.8	:	:	:
Spending on human resources (18)	6.3	6.8	:	:	5.1	:	:	:
R & D expenditure (19)	0.3	0.3	0.3	:	1.9	1.9	:	:
Expenditure on IT (20)	:	:	:	:	3.1	2.9	2.9	2.9

(1) Growth rate in per cent.
(2) Annual average rate of change in harmonised index of consumer prices in per cent.
(3) Growth rate of real GDP per occupied person in per cent.
(4) Growth rate of compensation per employee.
(5) As a percentage of GDP.
(6) Number of unemployed as a percentage of the labour force.
(7) Employed persons aged 15–64 as a share of the total population of the same age group.
(8) Employed women aged 15–64 as a share of the total female population of the same age group.
(9) Employed persons aged 55–64 as a share of the total population of the same age group.
(10) Long-term unemployed (over 12 months) as a percentage of the total active population aged 15–64.
(11) Income tax plus employer/employee contributions as a percentage of labour costs of a single earner at 67 % of the average production worker wage, no children.
(12) Effective tax rate on labour income taking into account the combined effect of increased taxes and benefits withdrawal as an individual moves from unemployment back to work earning 67 % of the average production worker wage, measured at the first month of unemployment (after any 'waiting period' if applicable).
(13) GDP per hour worked in PPS, EU-15 = 100.
(14) Percentage, average value of imports and exports of goods and services divided by GDP, multiplied by 100; for DE, ES, FR, IT, PL and the UK, the value for the EU-25 is the total for the large Member States; for all the other States, the value for the EU-25 is the total for the small Member States.
(15) Percentage implemented in November 2004.
(16) Gross fixed capital formation by the private sector as a percentage of GDP.
(17) Total tertiary graduates (ISCED 5–6) per 1 000 of population aged 20–29.
(18) Public expenditure on education as a percentage of GDP.
(19) GERD — gross domestic expenditure on R & D as a percentage of GDP.
(20) Expenditure on information technology as a percentage of GDP.

Source: Commission services (including Eurostat, structural indicators). The data for 'general economic background' and 'public finance' are taken from the Commission's autumn 2004 economic forecasts.

12. Latvia

After an impressive 7.5 % growth achieved in 2003, Latvia's real GDP growth is estimated to have expanded by a further 7.5 % in 2004. Private consumption and gross fixed capital formation have been the driving factors for growth. Strong private consumption has been supported by employment growth, rising real wages and increased bank lending. Gross fixed capital formation has remained buoyant as a result of favourable credit conditions and reinforced macroeconomic stability. Exports have grown strongly; however, imports have grown even more quickly, widening the already large external deficit. Inflation accelerated by almost 4 percentage points to 6.8 % year-on-year in 2004, but is expected to fall back to a little over 3½ % in 2006. Against this background, the apparently procyclical fiscal stance is of major concern. Despite significantly higher-than-expected growth in revenues in 2004, the estimated general government budget deficit remains at the originally targeted 2.0 % of GDP, since expenditure-increasing amendments to the budget of about 1 % of GDP were approved by the Latvian Parliament in August 2004. Another concern is that, in spite of a strong growth performance, and sizeable employment gains since 2001, the unemployment rate remains at around 10 % of the labour force and is expected to drop only slightly in the medium term. Moderate employment gains will contribute to the decline, although considerable regional development disparities will hold back a faster improvement in labour market conditions. Starting from very low levels, Latvia's growth rates of labour productivity per person employed and GDP per capita have been amongst the highest in the EU in the past few years. The economy is increasingly integrated into European markets and the level and growth of business investment are above the EU average. Despite accelerating reforms, however, Latvian network industries suffer from a lack of effective competition and international connections. In addition, the level of R & D and innovation activities is still low and the reforms in the education system still need to focus on key problems such as a lack of responsiveness to labour market needs. A detailed assessment of recent developments in addressing Latvia's key policy challenges is presented in the following sections.

12.1. Public finances

Following a period of uncertainty, the new 2005 draft budget is a step forward

On 5 July 2004, the Council recommended, in its examination of Latvia's first convergence programme, that, if the growth rates envisaged in the programme materialised, Latvia should make progress towards a budgetary position close to balance, particularly in view of the current account deficit and domestic demand pressures. The policy stance adopted by the Latvian authorities in the August 2004 budget amendments seems to have disregarded these guidelines. The deficit target for 2004 remained unchanged at 2.0 % of GDP, whereas growth of output and of revenues in 2004 was significantly higher than foreseen in the convergence programme (GDP growth is now estimated at 7.5 % instead of the 6.7 % assumed by the macroeconomic scenario of the convergence programme) which in the circumstances should have led to the target deficit being tightened.

Address the sizeable current account deficit, to which an appropriate fiscal policy should contribute

Under this challenge, Latvia was requested to:

1. reduce the general government deficit in a credible and sustainable way within a multiannual framework in line with decisions to be taken by the Council in the context of the forthcoming budgetary surveillance exercise (GLs 1 and 2).

However, on 11 December, the government approved new amendments to the 2004 budget setting the deficit target at 1.9 % of GDP. The December amendments foresee an increase in both expenditure and revenues. On the expenditure side, these include a number of one-off payments previously intended for the next year, such as direct payment to farmers, contributions to the EU 2005 budget and advancing of financing for some development and structural projects. At the same time, tax revenue forecasts have been raised in the light of much higher out-turns. The draft 2005 budget law adopted by the government in September marked a shift towards a more expansionary fiscal policy. The draft 2005 budget law foresaw consolidated budget revenues increasing by 23.5 % and expenditure by 21.5 %, both compared with the 2004 budget execution after taking into account the August 2004 amendments. At the same time, the authorities voiced their commitment to respect the 2.2 % of GDP deficit target set in the May convergence programme. However, this draft 2005 budget was rejected in Parliament during its first reading on 28 October. The rejection of the budget caused the government to resign. A new government was approved on 2 December and has submitted to Parliament a new draft 2005 budget which envisages the reduction of the deficit to 1.7 % of GDP. Although the new draft budget is not free of downside risks, mostly stemming from the rather optimistic forecasts of tax revenues, it marks some progress towards a close to balance budgetary position.

12.2. Productivity and business dynamism

Actions have been taken to improve the education system, albeit without focusing on the key problems …

Reforming the education system to transform Latvia into a knowledge-based economy is a priority for the authorities and this goal has been translated into a multiannual plan. The reform of basic education has been completed with increased decentralisation of decision-making and the reforms of secondary and tertiary education are ongoing. As a healthy sign, private universities are developing and new tax incentives should help families and companies to support the cost of education. The ratio of tertiary students to population is one of the highest in Europe. Nevertheless, the education system lacks financing to provide adequate remuneration of the teaching staff, to update programmes and teaching techniques and to maintain the infrastructure. In addition, there is a lack of responsiveness of the education system to labour market needs. In particular, the system of scholarships may put too much emphasis on studies for which student demand is high rather than on branches where there is a shortage of specialists in the labour market.

… whilst plans to promote R & D and innovation have been launched …

At around 0.4 %, the ratio of R & D expenditure to GDP is amongst the lowest of the EU-25. In addition, the share financed by industry is low, with approximately 80 % coming from public and foreign sources in 2002.

Latvia has taken action through its national innovation programme to promote R & D and innovation, to support the development of new technologies and to increase cooperation between research and business. Notably, the innovation system has been streamlined and financial support through risk capital and grants is increasingly available. Further actions are planned based on the additional possibilities offered by the EU Structural Funds.

… and measures have been taken to develop an entrepreneurial culture

Latvia has one of the lowest levels of business creation in the EU, despite an impressive level of business investment. The main barriers to entrepreneurship are admin-

Improve conditions for increasing productivity

Under this challenge, Latvia was requested to:

2. increase the efficiency, quality and accessibility of the education and training systems, and their responsiveness to the labour markets' needs (GLs 13 and 14);
3. encourage R & D and innovation, in particular in the business sector (GLs 13 and 14);
4. encourage an entrepreneurial culture (GL 11).

istrative, financial and cultural. The authorities have issued guidelines to promote the development of SMEs and have further reduced the corporate tax rate to 15 %. To promote access to capital by Latvian SMEs and to encourage commercial banks to offer loans to entrepreneurs, the authorities have issued State guarantees through various ad hoc financial and credit institutions. In addition, Latvia has established a so-called Business Environment Simplification Task Force, which *inter alia* evaluates policies towards entrepreneurship and identifies best practices in this field. Results have been achieved in reducing the administrative burden but the multiplicity of administrative requirements stemming from various levels of authorities remains a problem for businesses.

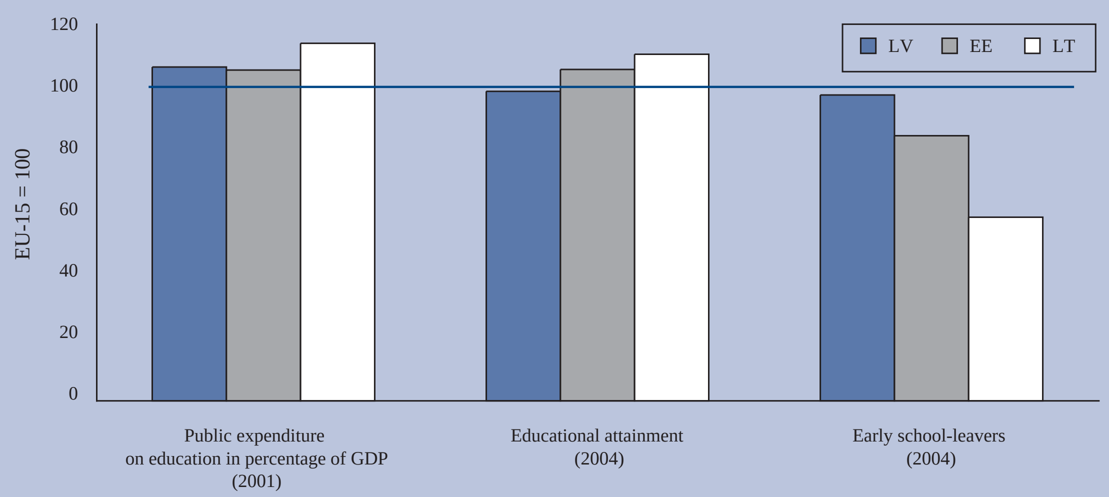
12.3. Labour market

Encouraging measures to make work pay

Even though the flat rate income tax of 25 % and the 33 % total rate of social security contributions can be considered average in comparison with the tax rates on labour in other EU countries, the labour tax wedge is very high in Latvia. This is due to low wages and very small provision for tax-free income. Thus, job creation is restricted and undeclared work, often taking the form of undeclared cash payments for part of an employee's work, is common. The government has prepared an action plan for 2005–09 to combat undeclared work, which foresees measures for increasing the administrative and regulatory capacity of the State Labour Inspectorate, improving cooperation of the regulatory institutions and the dissemination of information on the labour law. Furthermore, the State revenues service has developed its own action plan to combat undeclared work. This plan combines intensification of monitoring at the workplace and strengthening cooperation with other public and municipal institutions. A newly introduced contributions-based second pension pillar may increase incentives to report wages.

Recent changes in the tax and social security system with effect from 2005 may contribute to a higher motivation to enter the labour market. Most notably, the schedule adopted in 2003 by the Latvian government after lengthy discussions with the social partners provides for a gradual annual increase over a six-year period in the minimum wage from EUR 120 per month in 2004 to EUR 210 by 2010. The government has also approved a plan for raising the tax-free threshold over a six-year period, starting from 2005, to EUR 105, or half the minimum wage as it will then stand. The tax-free threshold currently stands at EUR 32 per month. The proposal also provides for setting income tax rebates for dependants at

Graph 12.1: **Education in the Baltic States**



Source: Commission services.

Address the structural problems in the labour market

Under this challenge, Latvia was requested to:

5. revise the tax and benefit system in order to make work pay, in particular by increasing the efficiency of social spending (GL 4);

6. strengthen labour supply by pursuing efforts to better adapt the qualifications of the workforce to the requirements of the labour market and by facilitating labour mobility, especially through improvements in transport infrastructure (GLs 7 and 13).

half the minimum tax-free threshold. However, despite these efforts, more needs to be done to ensure the efficiency of social spending.

Limited labour mobility with important elements of the reform still pending

Latvia has one of the highest unemployment rates in the EU (10.5 % in 2003). This is accompanied by a relatively low employment rate (61.8 % for the 15–64 age group for 2003). Despite a steady decline in unemployment and a sizeable increase in employment rates in recent years, the large share of underutilised resources and the lower level of labour productivity in the eastern regions of Latvia continue to be key challenges. In 2002, the latest year for which final regional data are available, GDP per capita in Riga was 182 % of the national average, while it reached only 37 % of the average in the eastern regions of the country. Low regional mobility is one factor, with transport and housing policy as the main obstacles. Commuting of the workforce is restricted by the deficiencies in the transport infrastructure at both intra- and interregional levels and difficulties in accessing the less developed regions. The development of the motorway network and public transport, which is a key priority of the Latvian authorities in the medium term ([1]), should improve the accessibility of the eastern regions of the country and thus might contribute towards job creation in these areas. However, there remains the risk that insufficient emphasis will be put on the construction, upgrading and capacity enhancement of smaller roads in regions with high unemployment. A strongly underdeveloped market for rented accommodation and significant regional differences in real estate prices limit the opportunities for domestic migration. In general, a lack of coordination among the public institutions concerned regarding mobility-improving measures is a concern. As a consequence, it seems uncertain whether the new measures will sufficiently take into account the characteristics of the targeted groups, and whether these will be sufficient to increase significantly the mobility of the workforce.

The Latvian authorities in consultation with social partners have prepared a national action plan for employment 2004, which builds on the experience of the four previous employment strategy declarations announced since 2000. Actions taken within the plan framework combine active labour market policies, including occupational training, retraining and raising of qualifications (similar actions in 2003 resulted in 51.9 % of 5 049 targeted unemployed persons finding a new job), measures of competitiveness and measures for specified groups such as the elderly, youth and the disabled unemployed. While progress is being made, strengthening labour supply by pursuing efforts to better adapt the qualifications of the workforce to the requirements of the labour market and by facilitating labour mobility remains a key challenge, as there is a limited capacity to respond to the demands for highly skilled labour and significant and persistent differences in employment across the regions.

12.4. Competition in network industries

Reforms to liberalise network industries have been of a different intensity across sectors …

Although all non-household users in practice have had access to the liberalised segment of the electricity market since July 2004, Latvia has not yet transposed EU electricity and gas directives. The current law states that the incumbent is indivisible. A draft law is being prepared

([1]) On 28 September 2004, the Cabinet of Ministers accepted the ‘Basic guidelines for development of public transport 2005–14’. This document outlines policy for domestic public transport for the next 10 years.

Develop effective competition in network industries

Under this challenge, Latvia was requested to:

7. take legal measures to enhance effective competition in network industries and to strengthen the role of the regulator (GL 9);

8. increase physical interconnections with other European networks (GL 9).

that should integrate universal service obligations and resolve the current lack of unbundling and third-party access. This new law should come into force by March 2005. The gas market depends largely on third-party access in Russia and effective competition in energy markets remains generally low. In telecommunications, postal services and railways, regulatory changes have been made to comply with the latest EU legislation. Competition is developing in telecommunications with a decreasing market share for the incumbent and the unbundling of the local loop. In terms of regulation, the fines that can be imposed by the Public Utility Commission appear too low to constitute a credible threat. Latvia is also considering moving to a one-tier State-level regulation for network industries instead of the current two-tier State- and local-level system.

… and projects are starting to improve interconnection capacities

As a legacy from the past, the Baltic countries’ railway interconnections with other EU neighbouring countries are not well developed. The creation of a modern and high-speed interconnection between the Baltic States and Poland has been set as a priority and approved in the list of projects adopted in the trans-European transport network guidelines. Efforts are also being made to create a common Baltic electricity market and projects to connect the electricity network with those of Poland and Finland have been studied. The interconnection with Finland is progressing as a consortium has been set up to finance the needed investment.

Table 12.1

Economic indicators for Latvia

	Latvia				EU-25			
	2001	2002	2003	2004	2001	2002	2003	2004
General economic background								
Real GDP growth (1)	8.0	6.4	7.5	7.5	1.8	1.1	1.0	2.5
Inflation (2)	2.5	2.0	2.9	6.8	2.5	2.1	1.9	2.2
Labour productivity growth (3)	5.7	4.8	5.6	6.7	0.8	0.9	0.9	2.1
Employment growth (1)	2.2	1.6	1.7	0.8	1.0	0.3	0.3	0.4
Nominal wage growth (4)	3.4	4.4	10.8	14.0	4.0	3.2	3.1	3.0
Current account (5)	– 8.9	– 7.0	– 8.6	– 9.9	:	:	:	:
Unemployment (6)	12.9	12.6	10.5	9.9	8.5	8.9	9.1	9.1
Public finances								
General government balance (5)	– 2.1	– 2.7	– 1.5	– 2.0	– 1.2	– 2.3	– 2.8	– 2.8
Primary balance (5)	– 1.1	– 1.9	– 0.7	– 1.2	2.4	1.0	0.3	0.2
Cyclically adjusted balance (5)	:	:	:	:	:	:	:	:
Gross government debt (5)	14.9	14.1	14.4	14.6	62.1	61.6	63.2	63.5
Employment								
Employment rate (7)	58.6	60.4	61.8	:	62.8	62.9	63.0	:
Female employment rate (8)	55.7	56.8	57.9	:	54.3	54.7	55.1	:
Employment rate for older workers (9)	36.9	41.7	44.1	:	37.4	38.8	40.2	:
Long-term unemployment (10)	7.2	5.7	4.3	:	3.8	3.9	4.0	:
Tax rate on low wage earners (11)	41.2	41.4	40.8	:	37.2	37.1	37.4	:
Unemployment trap indicator (12)	85.8	86.2	86.6	:	78.8	78.5	78.3	:
Product market reforms								
Hourly labour productivity (13)	:	:	:	:	:	:	:	:
Total trade to GDP ratio (14)	46.7	46.1	48.7	:	:	58.8	57.2	:
Internal market directives (15)	:	:	:	93.3	:	:	:	96.3
Business investment (16)	24.0	22.8	22.9	:	17.9	17.2	16.8	:
Knowledge-based economy								
Total tertiary graduates (17)	62.6	58.5	:	:	46.8	:	:	:
Spending on human resources (18)	5.8	5.8	:	:	5.1	:	:	:
R & D expenditure (19)	0.4	0.4	0.4	:	1.9	1.9	:	:
Expenditure on IT (20)	1.9	2.1	2.5	2.5	3.1	2.9	2.9	2.9

(1) Growth rate in per cent.
(2) Annual average rate of change in harmonised index of consumer prices in per cent.
(3) Growth rate of real GDP per occupied person in per cent.
(4) Growth rate of compensation per employee.
(5) As a percentage of GDP.
(6) Number of unemployed as a percentage of the labour force.
(7) Employed persons aged 15–64 as a share of the total population of the same age group.
(8) Employed women aged 15–64 as a share of the total female population of the same age group.
(9) Employed persons aged 55–64 as a share of the total population of the same age group.
(10) Long-term unemployed (over 12 months) as a percentage of the total active population aged 15–64.
(11) Income tax plus employer/employee contributions as a percentage of labour costs of a single earner at 67 % of the average production worker wage, no children.
(12) Effective tax rate on labour income taking into account the combined effect of increased taxes and benefits withdrawal as an individual moves from unemployment back to work earning 67 % of the average production worker wage, measured at the first month of unemployment (after any 'waiting period' if applicable).
(13) GDP per hour worked in PPS, EU-15 = 100.
(14) Percentage, average value of imports and exports of goods and services divided by GDP, multiplied by 100; for DE, ES, FR, IT, PL and the UK, the value for the EU-25 is the total for the large Member States; for all the other States, the value for the EU-25 is the total for the small Member States.
(15) Percentage implemented in November 2004.
(16) Gross fixed capital formation by the private sector as a percentage of GDP.
(17) Total tertiary graduates (ISCED 5–6) per 1 000 of population aged 20–29.
(18) Public expenditure on education as a percentage of GDP.
(19) GERD — gross domestic expenditure on R & D as a percentage of GDP.
(20) Expenditure on information technology as a percentage of GDP.

Source: Commission services (including Eurostat, structural indicators). The data for 'general economic background' and 'public finance' are taken from the Commission's autumn 2004 economic forecasts.

13. Lithuania

After growing rapidly at 9.7 % in 2003, real output is projected to expand by 6.5 % on average over the period 2004–06. Growth is foreseen to remain primarily sustained by strong investment and private consumption. Starting from very low levels, Lithuania's growth rates of labour productivity per person employed and GDP per capita have been amongst the highest in the EU in the past few years. The trend of falling prices initiated in 2002 reversed in 2004, when annual average inflation is estimated to have reached 1.2 %. Inflation is expected to accelerate further in 2005–06. The fiscal and external balances deteriorated significantly in 2004, and avoiding procyclical policies is a key challenge. Major reform efforts were concentrated on the promotion of active labour market policies, to attract more people to the labour market especially at a disadvantage, as well as on developing competition in network industries. The transposition rate of internal market directives is amongst the best in the EU and Lithuania has updated its competition and network industries legislation. Lithuania ranks among the economies with the best business climate. However, despite progress, reform efforts will have to be sustained to improve the conditions for increasing productivity and to develop effective competition in network industries. A detailed assessment of recent developments in addressing Lithuania's key policy challenges is presented in the following sections.

13.1. Labour market

Structural problems in the labour market are being addressed

Several measures under implementation should contribute to improving regional mobility in the medium term. Progress is being made as regards infrastructure development. In particular, new programmes are being implemented for the reconstruction of passenger terminals and access infrastructure, road paving and improving the quality of public transport, for which EU Cohesion and Structural Funds have been assigned. Those measures are expected to improve mobility, particularly in rural and remote areas. New measures aimed at reducing skill mismatches were taken in 2004 and should contribute to better meeting the rapidly growing demand for labour in the private sector. A new government resolution approved in May 2004 introduced measures aimed at promoting employers' investment in vocational training and the employees' qualifications, also allocating Structural Funds to co-finance these activities. The government is also preparing for the impact of the decommissioning of the Ignalina nuclear power plant, which is perceived as a major regional challenge. Actions taken consist of: strengthening of administrative structure for addressing the region's problems (development agency and business incubator, business competence centre); the preparation of active

Address the structural problems in the labour market

Under this challenge, Lithuania was requested to:

1. enhance regional mobility and reduce skill mismatches, whilst ensuring the efficiency of education, retraining measures and other active labour market policies (GLs 4, 7 and 8);
2. improve the combined incentive effects of taxes and benefits (GL 4).

labour market policies, including regional training offices in the area and improvement of secondary legislation (procedures of preparation of personalised action plans of employees, procedures of payment of additional severance payments, pre-retirement unemployment benefits, movement allowances) while preparing for the impact of potential sizeable lay-offs. While progress is being made, improving the quality of the labour force and increasing access to and the efficiency of the education system remain key challenges in Lithuania.

More emphasis will be devoted to the combined incentive effects of taxes and benefits

Discussions on labour taxation and work incentives involving the government, the central bank and different social partners took place in the course of 2004 but no major decisions have yet been taken. New measures to alleviate labour taxation and to improve incentives to work are expected to be adopted soon, as there was a general perception that decisions were delayed due to the parliamentary elections held in October 2004. Measures under preparation should improve incentives to work for several inactive groups of the population and contribute to increasing labour supply. Before the end of 2004, draft legislation on the conditions of paternity leave and new measures to improve incentives for elderly women to work are expected. Looking ahead, the unemployment insurance system will be overhauled in 2005. The new legislation links the unemployment benefits to earned income and establishes new criteria for receiving benefits. The financing system of unemployment benefits should become more transparent, using unemployment insurance funds to finance unemployment benefits only, while labour market institutions and active labour market policies will be financed by the State budget.

13.2. Public finances

The general government deficit in 2004 is likely to be better than planned

On 5 July 2004, the Council recommended, in its examination of Lithuania's first convergence programme, to make further progress towards a close to balance budgetary position if the growth rates envisaged in the programme materialise, particularly in view of current account deficit and domestic demand pressures. Lithuania was also encouraged to implement strictly the budget to reduce the risk of breaching the 3 % of GDP reference value in 2004, and to use better-than-projected revenues for deficit reduction. The general government deficit increased from 1.9 % of GDP in 2003 to 2.6 % in 2004 (compared with the 2.7 % target in the convergence programme). The government's deficit target for 2005 is 2.5 % of GDP. Avoiding a more procyclical stance in 2005 is regarded as a key challenge, particularly in view of the persisting pressures on domestic demand and the deterioration in the current account deficit, which reached 9.7 % in the first half of 2004. Furthermore, the target does not leave a sufficient safety margin against the 3 % reference value if automatic stabilisers were to play freely in a strong cyclical relapse. Based on recent revenue developments and the budget for 2005, the targets are likely to be met.

No sizeable budget amendments have been implemented after 5 July

Since the adoption of the Council recommendations on 5 July, no major budget amendments have been made. The Lithuanian authorities implemented two budget revisions in 2004. The first revision, approved in June, allocated significant additional expenditure on the back of higher-than-budgeted revenues and savings in debt service costs. The additional expenditure amounted to

Maintain low general government deficits

Under this challenge, Lithuania was requested to:

3. pursue low budget deficits in a credible and sustainable way within a multiannual framework in line with the decisions to be taken by the Council in the context of the forthcoming budgetary surveillance exercise (GL 1);

4. avoid procyclical fiscal policies that prevent a further reduction of the general government deficit, in particular by avoiding budget amendments that allocate additional expenditure in response to higher-than-expected revenues (GL 2).

some 0.3 % of GDP and was primarily allocated to social benefits, civil servant salaries, transfers to municipalities and savings restitutions. The second budget revision, approved by the government in August 2004, involved rather small amounts (about 0.03 % of GDP) and consisted of an increase in funds granted to political parties which was mostly financed by savings in public debt service costs. General government revenues increased more than expected in July to September 2004, and no further budget amendments were carried out.

13.3. Productivity and business dynamism

Actions have been taken to improve vocational training …

Over recent years, Lithuania has improved its youth educational attainment level from 77.9 % in 2000 to 82.1 % in 2003. However, the system of vocational training is still deficient with a low participation rate and an inadequate responsiveness to labour market needs. In 2003, only 2.3 % of the population aged 35–59 and 8.6 % of the population aged 25–34 participated in education and training. Lithuania has started a lifelong learning strategy to remedy this situation with policy actions in terms of education infrastructure, accessibility, coordination of programmes, and improvement and monitoring of quality. In particular, the accent is put on providing companies with incentives to invest in their human capital so as to match their specific needs. In addition, a new law on vocational education and training will be drafted in 2005.

… and to become a knowledge-based economy

At around 0.7 % of GDP, R & D expenditure is still far from the EU average (see Graph 13.1). In addition, the share financed by industry is low with over 60 % coming from public sources.

Albeit increasing over the most recent period, the number of IT users in Lithuania is still relatively limited because of financial reasons and because of a lack of adequate infrastructure and awareness. Lithuania has taken action to promote R & D and innovation, to support the development of new technologies and the use of IT, and to increase the cooperation between research and business, mainly through financial incentives and proactive coordination of programmes. Further actions are planned based on the additional possibilities offered by the EU Structural Funds, notably to help Lithuanian investors to face the costs of international patenting.

13.4. Competition in network industries

A set of reforms have been taken to further liberalise network industries …

In 2004, Lithuania embarked on a set of reforms to further liberalise and enforce competition in network industries. In line with EU legislation, the electricity and gas markets for non-household users have been liberalised. Following liberalisation in 2003, the telecommunications market has experienced a rapid growth and dramatic cuts in prices of local and international calls from fixed lines. The introduction of number portability and the digitalisation of lines are further determinants of increased competition. Finally, in the framework of the 2003–06 strategy to ensure the effective functioning of the railway sector and its integration into the EU network, Lithuania has passed a law to separate the management of the infrastructure from other operations. These reforms should help to promote effective competition in markets where incumbents still retain high market shares.

Improve conditions for increasing productivity

Under this challenge, Lithuania was requested to:

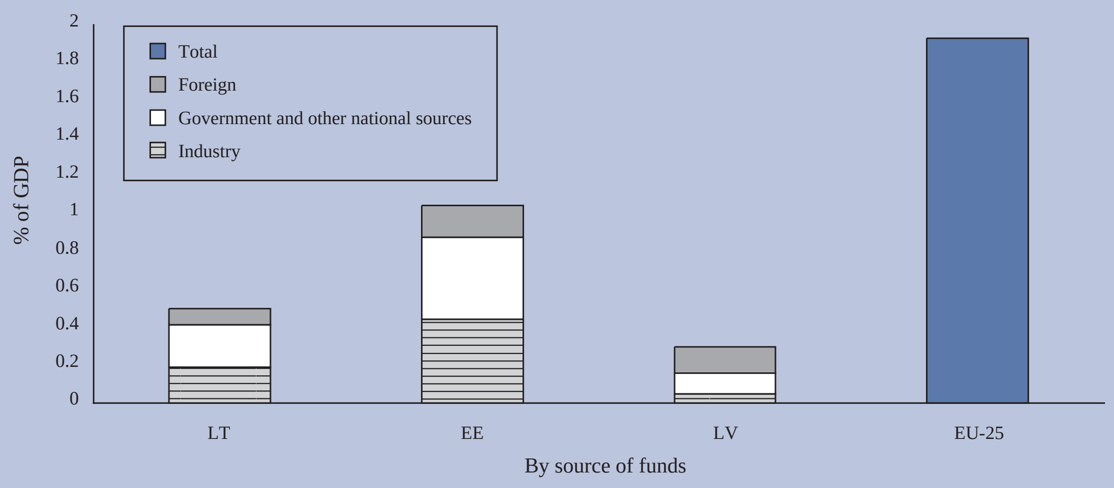
5. improve the efficiency and quality of the education and training systems and their responsiveness to labour market needs (GL 13);

6. promote R & D and innovation, strengthen the links between research institutes and the business sector and support knowledge transfer through FDI and higher IT penetration (GL 13).

… and projects are starting to improve interconnection capacities

As a legacy from the past, Lithuanian railway interconnections are not well developed with neighbouring EU countries. The creation of a modern high-speed interconnection called the 'Rail Baltica project' has been set as a priority and approved in the list of projects adopted in the trans-European transport network guidelines. Efforts are also being made to create a common Baltic electricity market and projects to connect the electricity network with those of Poland and Finland have been studied. Interconnections in air transport are developing as a result of liberalisation measures that increase the number of players and destinations, whilst several projects such as the 'Via Baltica' should improve the road connections between the Baltic States.

Graph 13.1: **Gross domestic expenditure on R & D, 2002**



Source: Commission services.

Develop effective competition in network industries

Under this challenge, Lithuania was requested to:

7. pursue liberalisation and enforce effective competition in energy, telecommunications and railway markets (GL 9);

8. create and improve interconnection capacities with neighbouring EU Member States (GL 9).

Table 13.1

Economic indicators for Lithuania

	Lithuania				EU-25			
	2001	2002	2003	2004	2001	2002	2003	2004
General economic background								
Real GDP growth (1)	6.4	6.8	9.7	7.1	1.8	1.1	1.0	2.5
Inflation (2)	1.3	0.4	– 1.1	1.2	2.5	2.1	1.9	2.2
Labour productivity growth (3)	10.0	2.7	7.2	5.5	0.8	0.9	0.9	2.1
Employment growth (1)	– 3.3	4.0	2.3	1.6	1.0	0.3	0.3	0.4
Nominal wage growth (4)	3.4	1.4	8.2	7.8	4.0	3.2	3.1	3.0
Current account (5)	– 4.7	– 5.2	– 6.9	– 8.7	:	:	:	:
Unemployment (6)	16.4	13.5	12.7	11.4	8.5	8.9	9.1	9.1
Public finances								
General government balance (5)	– 2.0	– 1.5	– 1.9	– 2.6	– 1.2	– 2.3	– 2.8	– 2.8
Primary balance (5)	– 0.4	– 0.1	– 0.6	– 1.4	2.4	1.0	0.3	0.2
Cyclically adjusted balance (5)	:	:	:	:	:	:	:	:
Gross government debt (5)	22.9	22.4	21.4	21.1	62.1	61.6	63.2	63.5
Employment								
Employment rate (7)	57.5	59.9	61.1	:	62.8	62.9	63.0	:
Female employment rate (8)	56.2	57.2	58.4	:	54.3	54.7	55.1	:
Employment rate for older workers (9)	38.9	41.6	44.7	:	37.4	38.8	40.2	:
Long-term unemployment (10)	9.1	7.3	6.1	:	3.8	3.9	4.0	:
Tax rate on low wage earners (11)	42.2	41.3	39.5	:	37.2	37.1	37.4	:
Unemployment trap indicator (12)	54.1	51.8	49.3	:	78.8	78.5	78.3	:
Product market reforms								
Hourly labour productivity (13)	:	37.6	39.2	:	:	:	:	:
Total trade to GDP ratio (14)	52.8	55.9	55.2	:	:	58.8	57.2	:
Internal market directives (15)	:	:	:	99.6	:	:	:	96.3
Business investment (16)	18.0	17.6	17.8	:	17.9	17.2	16.8	:
Knowledge-based economy								
Total tertiary graduates (17)	57.7	63.0	:	:	46.8	:	:	:
Spending on human resources (18)	5.9	5.9	:	:	5.1	:	:	:
R & D expenditure (19)	0.7	0.7	0.7	:	1.9	1.9	:	:
Expenditure on IT (20)	1.5	1.5	1.6	1.6	3.1	2.9	2.9	2.9

(1) Growth rate in per cent.
(2) Annual average rate of change in harmonised index of consumer prices in per cent.
(3) Growth rate of real GDP per occupied person in per cent.
(4) Growth rate of compensation per employee.
(5) As a percentage of GDP.
(6) Number of unemployed as a percentage of the labour force.
(7) Employed persons aged 15–64 as a share of the total population of the same age group.
(8) Employed women aged 15–64 as a share of the total female population of the same age group.
(9) Employed persons aged 55–64 as a share of the total population of the same age group.
(10) Long-term unemployed (over 12 months) as a percentage of the total active population aged 15–64.
(11) Income tax plus employer/employee contributions as a percentage of labour costs of a single earner at 67 % of the average production worker wage, no children.
(12) Effective tax rate on labour income taking into account the combined effect of increased taxes and benefits withdrawal as an individual moves from unemployment back to work earning 67 % of the average production worker wage, measured at the first month of unemployment (after any 'waiting period' if applicable).
(13) GDP per hour worked in PPS, EU-15 = 100.
(14) Percentage, average value of imports and exports of goods and services divided by GDP, multiplied by 100; for DE, ES, FR, IT, PL and the UK, the value for the EU-25 is the total for the large Member States; for all the other States, the value for the EU-25 is the total for the small Member States.
(15) Percentage implemented in November 2004.
(16) Gross fixed capital formation by the private sector as a percentage of GDP.
(17) Total tertiary graduates (ISCED 5–6) per 1 000 of population aged 20–29.
(18) Public expenditure on education as a percentage of GDP.
(19) GERD — gross domestic expenditure on R & D as a percentage of GDP.
(20) Expenditure on information technology as a percentage of GDP.

Source: Commission services (including Eurostat, structural indicators). The data for 'general economic background' and 'public finance' are taken from the Commission's autumn 2004 economic forecasts.

14. Luxembourg

The Luxembourg economy has performed rather well in recent years: real GDP growth has remained above the EU average in the past few years and is expected to have accelerated to around 4 % in 2004 slowing down only slightly. Even though these growth rates are significantly lower than the exceptional ones observed in the late 1990s (between 7 and 9 % a year), they are much higher than those recorded in neighbouring countries. Similarly, employment growth has kept posting positive growth rates albeit less impressive than in previous years. Faced with the possibility of weaker trend growth than in the past few decades, Luxembourg should attempt to increase the employment rate of its residents, which is low and even very low for workers above 55 years of age. The reforms under way aiming at improving the business environment, namely the modernisation of the competition law and the reduction in administrative burdens on businesses as well as the promotion of entrepreneurship, will contribute in the long term to reducing Luxembourg's excessive sectoral concentration of economic activity in banking services, business support and real estate services. The rate of transposition of internal market directives is still well below the target. A detailed assessment of recent developments in addressing Luxembourg's key policy challenges is presented in the following sections.

14.1. Labour market

Labour force participation remains low …

The massive job creation caused by fast output growth in the last two decades has chiefly been met by an increasing recourse to cross-border workers, who represent nowadays more than one third of total employment and have accounted for two thirds of its rise since 1995. However, while the country increasingly plays the role of a major employment pool for residents of neighbouring regions, national participation and employment rates remain low, especially for older workers: Luxembourg has the lowest participation rate in the EU-15 for workers aged between 55 and 64, for both men and women. Moreover, the impressive employment growth in the last two decades will inevitably translate into a similar increase in the number of retirees in the coming years. The ratio between contributors and pensioners will thus necessarily deteriorate, unless employment growth also accelerates in the same proportion, which seems unlikely.

Increase the low national participation and employment rates, especially for older workers	Assessment
Under this challenge, Luxembourg was requested to:	
1. review incentives for early and pre-retirement and ensure appropriate eligibility rules in the disability pension scheme (GL 16).	Limited

Bearing in mind the three-year period available for implementation, the degree of implementation since 2003 is indicated as: 'Complete' for (practically) complete; 'In progress' where progress is well advanced; 'Limited' where the recommendation is only partially addressed; and 'Insufficient' where no substantial measures going in the right direction have been taken.

… and only partial action has been taken to reduce incentives to use disability or early-retirement schemes and to encourage older workers to continue to work

As already stated in the 2004 implementation report, measures were decided in 2002 and 2003 to encourage older workers to continue in work (especially the removal in December 2003 of the obligation of prior approval by the administration when a pensioner starts a new activity) and some progress has been made in reducing the inflow into the disability scheme and raising the effective retirement age. However, no additional measure seems to have been taken in 2004.

14.2. Productivity and business dynamism

Reforms of the competition and regulatory framework have been finalised

The modernisation of the legislative framework for competition policy was finalised in 2004. The introduction of the new competition law in May 2004 will eliminate the shortcomings of the existing body of legislation such as the regulation on fixed and monitored prices. Pharmaceuticals, taxis and fuels are the only exceptions to the principle of market-based pricing. With this reform, an independent Competition Council has recently been set up whose duties include supervising the application of the new national legislation and the enforcement of EU law where applicable. However, the ability of the new competition authority and of the Institut luxembourgeois de régulation (ILR), the market regulator for electricity, gas, post, and telecommunications, to perform their tasks has still to be assessed. The resources of the latter have been gradually increasing: in December 2003, its total number of staff was 32 (up from 29 in December 2002).

Efforts to encourage entrepreneurship have continued

The implementation of initiatives to reduce the administrative burdens on businesses and on SMEs, in particular, has continued. New measures were announced such as the generalisation of audits of the effects of new legislation and regulation on the business environment, with particular emphasis on SMEs. However, Luxembourg is still one of the countries with the highest percentage of SMEs identifying administrative burdens as a major business constraint (8 %). In June 2004, a risk capital enterprise (SICAR) was launched to foster access to venture capital. It will contribute to improving business conditions for SMEs. The development of business entrepreneurship remains a concern of the government. In 2004, the action plan ‘Entrepreneurship au Luxembourg — Entreprendre pour reussir’ was launched to coordinate all initiatives in the area. Activities with the direct involvement of schools, businesses and chambers of commerce as well as awareness-raising campaigns are among the measures directed at the young that have continued to be implemented.

Improve the business environment and encourage entrepreneurship in order to achieve a more balanced economic structure	**Assessment**
Under this challenge, Luxembourg was requested to:	
2. fully implement the reforms of the competition law and ensure that competition and regulatory authorities have sufficient independence, resources and power to fulfil their tasks (GL 9);	In progress
3. take measures to encourage and facilitate the creation of SMEs and to help those to access venture capital (GL 11).	In progress

Table 14.1

Economic indicators for Luxembourg

	Luxembourg				EU-25			
	2001	2002	2003	2004	2001	2002	2003	2004
General economic background								
Real GDP growth (1)	1.5	2.5	2.9	4.0	1.8	1.1	1.0	2.5
Inflation (2)	2.4	2.1	2.5	3.0	2.5	2.1	1.9	2.2
Labour productivity growth (3)	– 3.9	– 0.5	1.1	1.9	0.8	0.9	0.9	2.1
Employment growth (1)	5.7	3.0	1.8	2.0	1.0	0.3	0.3	0.4
Nominal wage growth (4)	3.9	3.7	2.1	3.3	4.0	3.2	3.1	3.0
Current account (5)	5.5	5.9	5.3	4.4	:	:	:	:
Unemployment (6)	2.1	2.8	3.7	4.3	8.5	8.9	9.1	9.1
Public finances								
General government balance (5)	6.4	2.8	0.8	– 0.8	– 1.2	– 2.3	– 2.8	– 2.8
Primary balance (5)	6.7	3.0	1.0	– 0.6	2.4	1.0	0.3	0.2
Cyclically adjusted balance (5)	5.2	2.9	1.7	0.4	:	:	:	:
Gross government debt (5)	5.5	5.7	5.3	4.9	62.1	61.6	63.2	63.5
Employment								
Employment rate (7)	63.1	63.4	62.7	:	62.8	62.9	63.0	:
Female employment rate (8)	50.9	51.6	52.0	:	54.3	54.7	55.1	:
Employment rate for older workers (9)	25.6	28.1	30.0	:	37.4	38.8	40.2	:
Long-term unemployment (10)	0.6	0.8	0.9	:	3.8	3.9	4.0	:
Tax rate on low wage earners (11)	28.8	27.1	27.3	:	37.2	37.1	37.4	:
Unemployment trap indicator (12)	87.6	86.7	86.8	:	78.8	78.5	78.3	:
Product market reforms								
Hourly labour productivity (13)	131.1	126.7	127.1	:	:	:	:	:
Total trade to GDP ratio (14)	:	127.1	122.9	:	:	58.8	57.2	:
Internal market directives (15)	97.9	97.7	96.6	95.6	:	:	:	96.3
Business investment (16)	18.6	17.2	15.0	:	17.9	17.2	16.8	:
Knowledge-based economy								
Total tertiary graduates (17)	:	:	:	:	46.8	:	:	:
Spending on human resources (18)	3.8	4.0	:	:	5.1	:	:	:
R & D expenditure (19)	:	:	:	:	1.9	1.9	:	:
Expenditure on IT (20)	4.9	4.4	:	:	3.1	2.9	2.9	2.9

(1) Growth rate in per cent.
(2) Annual average rate of change in harmonised index of consumer prices in per cent.
(3) Growth rate of real GDP per occupied person in per cent.
(4) Growth rate of compensation per employee.
(5) As a percentage of GDP.
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(8) Employed women aged 15–64 as a share of the total female population of the same age group.
(9) Employed persons aged 55–64 as a share of the total population of the same age group.
(10) Long-term unemployed (over 12 months) as a percentage of the total active population aged 15–64.
(11) Income tax plus employer/employee contributions as a percentage of labour costs of a single earner at 67 % of the average production worker wage, no children.
(12) Effective tax rate on labour income taking into account the combined effect of increased taxes and benefits withdrawal as an individual moves from unemployment back to work earning 67 % of the average production worker wage, measured at the first month of unemployment (after any 'waiting period' if applicable).
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(17) Total tertiary graduates (ISCED 5–6) per 1 000 of population aged 20–29.
(18) Public expenditure on education as a percentage of GDP.
(19) GERD — gross domestic expenditure on R & D as a percentage of GDP.
(20) Expenditure on information technology as a percentage of GDP.

Source: Commission services (including Eurostat, structural indicators). The data for 'general economic background' and 'public finance' are taken from the Commission's autumn 2004 economic forecasts.

15. Hungary

After slowing down in 2003, Hungary's real GDP growth became stronger again in 2004 (3.9 %). This was accompanied by a shift in growth components, towards strong export and investment, and less consumption-based growth. The high real wage growth of the last three years also decelerated considerably. One of the major concerns regarding Hungarian economic policy is the high general government deficit, which reached 5.5 % ([1]) of GDP in 2004. While some consolidation was achieved in 2004, this was almost 1 percentage point less than originally envisaged by the authorities. Related to the fiscal performance is the high current account deficit of about 9 % of GDP in 2004. Against the background of the low employment and participation rates, a number of measures were carried out in order to promote employment and increase activity. Hungary was furthermore particularly successful in bringing down the previously high real wage growth to a moderate level below productivity growth. The level of labour productivity per person employed (at 63.4 % of the EU average) is relatively low but on average, for the period 1999–2003, the evolution was quite impressive with a real annual growth rate which was almost 2 percentage points higher than in the EU. Movement towards the knowledge-based economy is slow and inefficiencies in the education system still exist. Finally, effective competition in the network industries should be further encouraged. These are factors which should be tackled in order to improve the growth prospects and competitiveness of the Hungarian economy in the medium term. A detailed assessment of recent developments in addressing Hungary's key policy challenges is presented in the following sections.

([1]) This figure (and all the others in the text) does not yet take into account the recent decision of the Hungarian authorities to make use of the possibility granted by Eurostat to temporarily (until the March 2007 fiscal notification) subtract the burden of the pension reform from the general government deficit figures. The correction for this is 0.7, 0.8 and 0.9 percentage points in 2003, 2004 and 2005, respectively, and 1.0 percentage point in the following years.

15.1. Public finances

Short- and long-term fiscal trends continue to be a cause for concern

Based on a general government deficit well above 3 % of GDP in 2003, on 5 July 2004 the Council decided that Hungary was in excessive deficit and recommended that this was to be corrected by 2008 at the latest. Specifically, Hungary was required to stand ready to introduce additional measures, with a view to achieving the general government deficit target of 4.6 % of GDP for 2004, and to take effective action by 5 November 2004 regarding the measures envisaged to achieve the 2005 deficit target of 4.1 % of GDP. In addition, the Council invited the Hungarian authorities to seize every opportunity to accelerate the fiscal adjustment, and to undertake the envisaged reforms of the public administration, health and education systems in order to ensure the foreseen reduction of the expenditure ratio and to improve the long-term sustainability of the public finances. Moreover, the Council emphasised that planned tax cuts should be

Ensure a further reduction of the general government deficit on a sustainable basis

Under this challenge, Hungary was requested to:

1. reduce the general government deficit in a credible and sustainable way within a multiannual framework in line with the decisions to be taken by the Council in the context of the forthcoming budgetary surveillance exercise.

adequately financed and that their implementation should be conditional upon the achievement of the deficit targets.

The Hungarian authorities decided to take a number of corrective measures in the course of 2004. However, by mid-September, it became clear that these would not be sufficient, and the Hungarian authorities revised upwards the official general government target for 2004 from 4.6 % of GDP to 5.3 % of GDP. The slippage was mainly attributable to the upward revision of the 2003 deficit (by 0.3 percentage points of GDP), expenditure slippages and too optimistic revenue forecasts (mainly for VAT).

The budget for 2005 contains a higher deficit target of 4.7 % of GDP compared with the 4.1 % of GDP target contained in the May 2004 convergence programme. However, largely reflecting carry-over effects and doubts on the implementation of planned reforms, even the upward modified 2005 deficit target appeared to be subject to risk according to the Commission services' autumn 2004 economic forecasts which projected 5.2 % of GDP. While the measures of the 2005 budget include some reforms in the public administration, health and education sectors, these do not seem to be sufficient to achieve the path for deficit reduction specified in the May convergence programme and endorsed by the Council.

15.2. Labour market

Some measures but with an uncertain impact

Hungary has one of the lowest unemployment rates among the new Member States (5.8 % in 2004). However, this is accompanied by a low employment rate (57 % in 2003). Low regional mobility is one of the reasons behind this phenomenon, with transport and housing policy as the main obstacles. Commuting of the workforce is restricted by the deficiencies in the transport infrastructure and by high transportation costs on both the intra- and interregional levels. The development of the motorway network, which is a key priority of the Hungarian authorities in the medium term, should improve the accessibility of the eastern regions of the country and thus contribute towards job creation in these areas. However, sufficient emphasis should also be put on the construction, upgrading and capacity enhancement of smaller roads in regions with high unemployment in order to facilitate intra-community mobility. The high share of home ownership in the country — fostered by a generous housing loan scheme for several years — a strongly underdeveloped market for rental housing, high duties on purchasing and selling flats, and significant regional differences in real estate prices limit the opportunities for domestic migration. While the housing loan scheme has been substantially tightened since mid-2003 (partly with effect in 2004), the new government programme for 2005 plans again to broaden somewhat the eligibility for new house purchases, now mainly targeting young families with children. However, this step to more home ownership does not seem to be counterbalanced by the efforts envisaged to reduce the shortage of low-rent flats. In general, there seems to be a serious lack of coordination among the public institutions concerned with mobility-improving measures. As a consequence, it is questionable whether the new measures will sufficiently take into account the characteristics of the targeted groups, and whether they will be sufficient to increase significantly the mobility of the workforce.

Increase employment rates and address the structural problems in the labour market

Under this challenge, Hungary was requested to:

2. strengthen labour supply by removing obstacles to regional mobility through appropriate measures in the housing and transport policy (GL 7), and by encouraging disadvantaged groups (ethnic minorities, the disabled and homeless people) to (re-)enter the labour market (GL 8);

3. ensure that the tax and benefit systems support employment and provide incentives to enter or remain in the labour market (make work pay principle) — the high tax burden of the labour force should be further reduced (GL 4).

Several measures to encourage disadvantaged groups

The authorities have adopted several measures in order to integrate disadvantaged persons into the labour market. A medium-term action plan was initiated in 2004, aimed at the promotion of education and training of the Roma minority in order to reduce long-term unemployment and to promote their labour market integration. In order to stimulate the employment of persons with altered working capabilities, the amount of the rehabilitation contribution imposed on employers was tripled. Generally, against the background of the high number of disability beneficiaries, it is a positive development that emphasis is increasingly being put on rehabilitation. However, revision of the disability benefits is also necessary to ensure that these efforts are successful. Another positive development is a programme which started in December 2004, aiming at the employment of homeless people in the Budapest region during the winter months. However, despite these efforts, in order to further improve assistance to the disadvantaged groups, the formulation of clear priorities and basic principles concerning the development of employment policy measures would be beneficial, taking into account characteristics of the targeted groups in the planning process on the localisation, the content and the time schedule of the programmes.

Encouraging measures to make work pay

The Hungarian social system is characterised by the wide availability of different kinds of transfers (early-retirement, disability, generous maternity leave schemes, etc.). Besides their significant negative fiscal impact, these transfers constitute an important impediment to active engagement in the labour market. A constant tightening of this generous system has been carried out in recent years: the statutory retirement age has been steadily increased, old-age pensions have been fully excluded from taxable income, and the statutory minimum wage has been gradually increased (and exempted from income tax) in order to be perceptively higher than the social benefits. However, there is still room for tightening eligibility criteria and their application, and for further measures to encourage people with remaining capability to re-enter the labour market. Although revision of the social benefit system has started, no significant concrete measures were taken in 2004. Another problem is the comparatively high tax wedge on labour, restricting job creation and contributing to the widespread amount of undeclared work. In this respect, the recent changes in the tax and social security systems, which will take effect in 2005, seem to have contributed to a higher motivation to enter the labour market; whereas they have been implemented at a time of insufficient fiscal consolidation, they have been largely compensated for by other changes in the tax system. These are notably that: (i) low-income earners benefit from the elimination of the medium bracket of the personal income tax scheme; (ii) there was a 50 % reduction in social security contributions for those hiring job-starters, mothers returning from maternity leave and the long-term unemployed over the age of 50; and (iii) employers recruiting persons receiving childcare allowance or child-raising support as part-time employees or long-term unemployed persons over 50 are fully exempted from the flat-rate health contribution.

15.3. Wage policy

Significant slowdown in real wage growth

After three years of high real wage growth exceeding productivity growth owing to a doubling of minimum wages and a 50 % increase in public wages, real wage growth came down to more moderate levels, below productivity growth, in 2004. Besides a central recommendation made by the Tripartite National Reconciliation Council, demonstration effects on wages are deriving from public sector pay and minimum wage increases. Accordingly, the slowdown in wage growth in 2004 was induced by a moderate growth in the national min-

Enhance cost-competitiveness by pursuing policies that induce wage moderation

Under this challenge, Hungary was requested to:

4. encourage a reform of wage setting which allows wages to better reflect productivity (GL 5). Promote multiannual wage agreements with the social partners in order to keep real wage development in line with productivity growth.

imum wage in 2003–04 and significant public wage moderation. After three years of high public wage growth, the government committed itself to wage moderation in the public sector (coupled with ongoing downsizing of public sector employment). This was carried out in order to bring wage growth into line with productivity growth, but should also be seen against the background of fiscal constraints. Private sector wage developments also moderated significantly, and no significant changes were made in order to enforce central-level social dialogue. The government has an influential role in setting wages in the public sector, fixing mandatory minimum wages and issuing wage guidelines; for the private sector, bargaining takes place on an enterprise or individual level. In the longer run, the role of industry-level collective wage agreements might grow in the private sector due to the newly established sectoral dialogue committees.

15.4. Productivity and business dynamism

Movement towards the knowledge-based economy is slow

Since 1999, total R & D expenditures have increased at a higher rate in Hungary than in most of the other EU countries. However, the level of R & D expenditures (0.97 % of GDP in 2003) remains low and the number of researchers and scientific publications is well below the EU average, although it has recently started to improve significantly. In addition, the percentage of R & D expenditures financed by industry is amongst the lowest in the EU. It has declined even further over recent years despite several fiscal incentives and initiatives to strengthen the link between business and research institutions. The number of Hungarian patent applications to the European Patent Office has declined over recent years. Although, compared with the other new Member States, the number of patent applications is higher. Finally, in 2003, a decrease could be observed in the amount of total inward foreign investment, which could diminish the transfer of technology towards Hungary. Nevertheless, the level and share of reinvested earnings have increased showing some confidence in the strengths of the Hungarian economy on the part of investors.

The education system is improving but is not efficient enough

Even though the level of public expenditure on education is higher in Hungary than in other new Member States, its education performance is often worse, pointing to the need to improve the efficiency of the education system.

In this area, some measures have been taken to develop vocational training and the new Act on Higher Education also encourages positive developments in the educational field. As a result, the educational attainment of the population has already started to improve gradually. For instance, the percentage of Hungarians who have attained upper-secondary education increased from 50 % in 1998 to more than 57 % in 2002. The tertiary educational attainment level has also started to rise, but at a slow pace, and it is still amongst the lowest in the EU. The level of science and technology graduates is now the lowest amongst EU Member States.

Improve conditions for increasing productivity

Under this challenge, Hungary was requested to:

5. promote the stronger involvement of the private sector in R & D and innovation, strengthen the link between business and research institutions, ensure sufficient resources to improve the quality of research and support the transfer of knowledge through FDI (GL 13);

6. improve the efficiency of the education system, increase its flexibility in order to better adapt to the skill needs of the market and ensure adequate resources for vocational training and education (GL 13);

7. ensure stability of legislation and government policies to create a business environment more supportive to entrepreneurship (GL 11).

Some measures have been taken to create a business environment more supportive to entrepreneurship

Support is given to SMEs through grants for investment projects, improved access to finance and tax policy measures. Modernisation and technological development in SMEs are the two areas which have recently received most of the financial support. Furthermore, schemes allowing easier access to credit for SMEs have been extended. The corporate tax rate decreased from 18 % to 16 % in 2004 which by EU standards places Hungary amongst the countries with the lowest tax rate on corporate income. Finally, the simplified entrepreneurial tax available for small enterprises has been a positive development in the reduction of administrative burdens on Hungarian SMEs. However, business investment as a percentage of GDP remains low in Hungary compared with other new Member States. According to the World Bank (2004), Hungary is also not ranked in the top quartile of 145 countries on the ease of doing business whereas its closest neighbours are.

15.5. Network industries

Effective competition in network industries should be further encouraged

In the telecommunications sector, a new act which aims at increasing competition has been implemented from January 2004. Still, the incumbent dominates almost all segments of the market. The result of this low level of effective competition is that Hungarian telecommunication services remain relatively expensive compared with other EU countries. For instance, prices of national calls are the highest amongst the EU-25 Member States. These are serious barriers to a large diffusion of new communication technologies to the Hungarian consumers. As a result, the level of broadband subscribers is amongst the lowest in the EU.

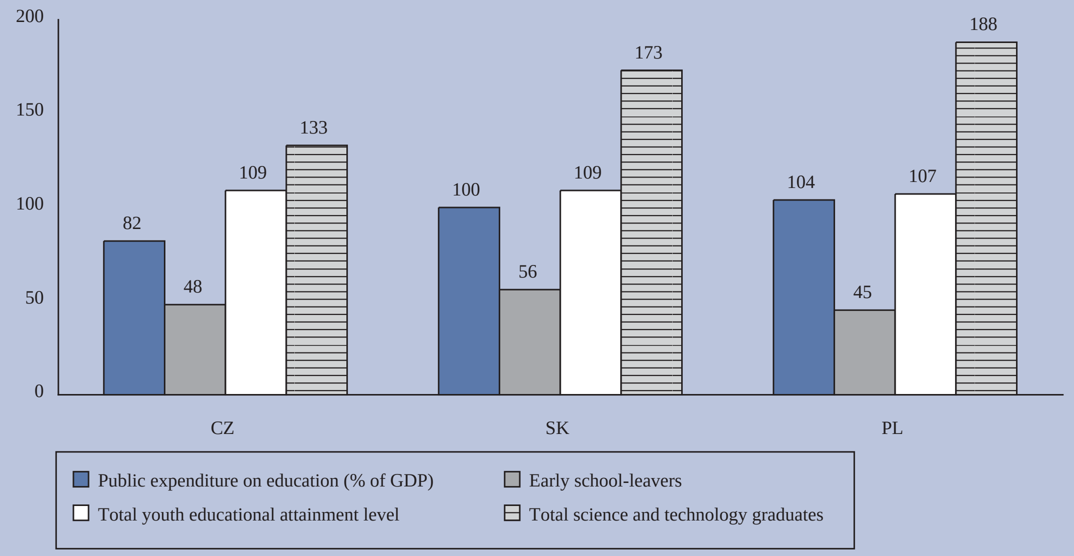
In the electricity market, all non-household users became eligible from July 2004. In the gas sector, liberalisation began on 1 January 2004 for big consumers, but from July 2004 all non-household users became eligible. Nevertheless, in electricity, more effective separation of transmission from the other activities is required and the conditions governing the entry of potential competitors should be made more favourable. Long-term purchasing agreements and the lack of interconnection capacities are two other issues where further progress is needed in order to increase effective competition. In the gas sector, better access to pipelines and storage facilities and improved interconnection capacities are necessary to facilitate new entries. Finally, according to the International Energy Agency and the OECD (2004), the independence of the network regulator in both sectors should be further guaranteed as the government has retained some influence and could interfere in the price setting agreements.

Develop effective competition in network industries

Under this challenge, Hungary was requested to:

8. proceed with the liberalisation of the network industries, increase the effectiveness of competition and the independence of the network regulators (GL 9).

Graph 15.1: **Education performance (HU = 100)**



Source: Commission services.

Table 15.1

Economic indicators for Hungary

	Hungary				EU-25			
	2001	2002	2003	2004	2001	2002	2003	2004
General economic background								
Real GDP growth (1)	3.8	3.5	3.0	3.9	1.8	1.1	1.0	2.5
Inflation (2)	9.1	5.2	4.7	6.9	2.5	2.1	1.9	2.2
Labour productivity growth (3)	3.2	2.9	2.2	3.4	0.8	0.9	0.9	2.1
Employment growth (1)	0.6	0.6	0.9	0.5	1.0	0.3	0.3	0.4
Nominal wage growth (4)	15.7	12.1	12.8	8.8	4.0	3.2	3.1	3.0
Current account (5)	:	– 7.1	– 9.0	– 8.7	:	:	:	:
Unemployment (6)	5.6	5.6	5.8	5.8	8.5	8.9	9.1	9.1
Public finances								
General government balance (5)	– 4.4	– 9.2	– 6.2	– 5.5	– 1.2	– 2.3	– 2.8	– 2.8
Primary balance (5)	0.4	– 5.1	– 2.1	– 1.1	2.4	1.0	0.3	0.2
Cyclically adjusted balance (5)	:	:	:	:	:	:	:	:
Gross government debt (5)	53.5	57.2	59.1	59.7	62.1	61.6	63.2	63.5
Employment								
Employment rate (7)	56.2	56.2	57.0	:	62.8	62.9	63.0	:
Female employment rate (8)	49.8	49.8	50.9	:	54.3	54.7	55.1	:
Employment rate for older workers (9)	23.5	25.6	28.9	:	37.4	38.8	40.2	:
Long-term unemployment (10)	2.5	2.4	2.4	:	3.8	3.9	4.0	:
Tax rate on low wage earners (11)	45.8	46.0	41.0	:	37.2	37.1	37.4	:
Unemployment trap indicator (12)	74.9	70.0	64.2	:	78.8	78.5	78.3	:
Product market reforms								
Hourly labour productivity (13)	:	:	:	:	:	:	:	:
Total trade to GDP ratio (14)	75.1	66.5	65.2	:	:	58.8	57.2	:
Internal market directives (15)	:	:	:	98.1	:	:	:	96.3
Business investment (16)	19.8	:	:	:	17.9	17.2	16.8	:
Knowledge-based economy								
Total tertiary graduates (17)	36.2	38.9	:	:	46.8	:	:	:
Spending on human resources (18)	5.2	5.4	:	:	5.1	:	:	:
R & D expenditure (19)	1.0	1.0	1.0	:	1.9	1.9	:	:
Expenditure on IT (20)	3.0	2.6	2.8	2.8	3.1	2.9	2.9	2.9

(1) Growth rate in per cent.
(2) Annual average rate of change in harmonised index of consumer prices in per cent.
(3) Growth rate of real GDP per occupied person in per cent.
(4) Growth rate of compensation per employee.
(5) As a percentage of GDP.
(6) Number of unemployed as a percentage of the labour force.
(7) Employed persons aged 15–64 as a share of the total population of the same age group.
(8) Employed women aged 15–64 as a share of the total female population of the same age group.
(9) Employed persons aged 55–64 as a share of the total population of the same age group.
(10) Long-term unemployed (over 12 months) as a percentage of the total active population aged 15–64.
(11) Income tax plus employer/employee contributions as a percentage of labour costs of a single earner at 67 % of the average production worker wage, no children.
(12) Effective tax rate on labour income taking into account the combined effect of increased taxes and benefits withdrawal as an individual moves from unemployment back to work earning 67 % of the average production worker wage, measured at the first month of unemployment (after any 'waiting period' if applicable).
(13) GDP per hour worked in PPS, EU-15 = 100.
(14) Percentage, average value of imports and exports of goods and services divided by GDP, multiplied by 100; for DE, ES, FR, IT, PL and the UK, the value for the EU-25 is the total for the large Member States; for all the other States, the value for the EU-25 is the total for the small Member States.
(15) Percentage implemented in November 2004.
(16) Gross fixed capital formation by the private sector as a percentage of GDP.
(17) Total tertiary graduates (ISCED 5–6) per 1 000 of population aged 20–29.
(18) Public expenditure on education as a percentage of GDP.
(19) GERD — gross domestic expenditure on R & D as a percentage of GDP.
(20) Expenditure on information technology as a percentage of GDP.

Source: Commission services (including Eurostat, structural indicators). The data for 'general economic background' and 'public finance' are taken from the Commission's autumn 2004 economic forecasts.

16. Malta

The Maltese economy is small and relies heavily on international business to sustain investment and economic growth. Tourism and the manufacturing sector make up a large proportion of GDP. The economy is also characterised by a high number of micro enterprises with 95 % of all companies having less than 10 workers. Under a more favourable international economic environment, Malta has continued with privatisation, industrial restructuring (the shipyard restructuring was accomplished in 2003) and liberalisation efforts, and has made progress in these areas. Real GDP grew by 1.5 % in 2004, recovering from negative growth rates in 2003. Growth in 2004, fuelled by both gross fixed capital formation and a substantial turnaround in external demand, stood below the potential growth rate, but is projected to gradually increase in 2005 and 2006. Higher unemployment caused by industrial restructuring and households' higher tax burden led to a fall in private consumption, while public expenditure remained sluggish due to fiscal stringency. The most important challenges faced by Malta continue to be the consolidation of public finances, the increase of employment rates and the enhancement of competitiveness. The 2004 budget laid the foundations of strengthened fiscal discipline, envisaging an increase in public revenues mainly from indirect taxation and other fiscal streamlining measures, on the revenue side, coupled with public expenditure tightening. The government has also pursued efforts to improve the efficiency of the public sector which could help reduce the government deficit. Nevertheless, other necessary improvements with a direct impact on fiscal consolidation, such as the reform of the healthcare and pension systems, remain to be tackled. Malta has also made progress in promoting ICT and in general improving the business environment. A detailed assessment of recent developments in addressing Malta's key policy challenges is presented in the following sections.

16.1. Public finances

Fiscal consolidation is on the way

On 5 July 2004, the Council decided that Malta was in excessive deficit and recommended that this be corrected by 2006 at the latest. Specifically, Malta was required to take action in a medium-term framework in order to bring the deficit below 3 % of GDP in 2006, implementing with vigour the measures envisaged in the May 2004 convergence programme, in particular those of a structural nature aimed at rationalising and reducing expenditures. The Maltese authorities were also required to ensure that the rise in the debt ratio, which exceeds the 60 % of GDP reference value, is brought to a halt in 2005 and reversed thereafter as specified in the 2004 convergence programme.

The general government deficit is expected to have narrowed from 9.6 % of GDP (9.7 % according to the budget presented in late November) in 2003 ([1]) to 5.1 % of GDP

([1]) Including a one-off measure in the public shipyards amounting to 3.2 % of GDP.

Ensure a reduction of the general government deficit on a sustainable basis and the long-term sustainability of public finances

Under this challenge, Malta was requested to:

1. reduce the government deficit in a credible and sustainable way within a multiannual framework in line with the decisions to be taken by the Council in the context of the forthcoming budgetary surveillance exercise (GL 1).

(5.2 % according to the budget) in 2004, thus achieving the target for 2004 set by the government in the May 2004 convergence programme (5.2 %). Total current revenues grew higher than projected in the budget while current expenditure grew much less than foreseen in the budget. Capital expenditure remained high due to the continuation of a major hospital construction project and to outlays related to the completion of works under the Italian financial protocol ([1]). The attainment of the fiscal target for 2004 also hinges on the estimate for a nominal GDP growth for 2004 of 4.4 % (according to the budget, the target would still be reached with a nominal growth of 3.0 %). On a no-policy-change basis, the Commission services' autumn 2004 economic forecast projected that the general government deficit for 2005 and 2006 would remain above the targets set in the May 2004 Maltese convergence programme. However, the 2005 budget added new measures to increase fiscal stringency, making the fiscal targets attainable.

16.2. Labour market

The streamlining of the tax–benefit system interaction remains to be accomplished

So far, the government has not carried out reforms to ensure that the tax–benefit system interaction has a favourable impact on those furthest from the labour market.

The short-term impact of recent measures in education and vocational training cannot yet be assessed …

The youth educational attainment level in Malta is the lowest in the EU and lags far behind the EU average (see Graph 16.1). However, the situation improved somewhat between 2000 and 2003 as the proportion of 20–24-year-olds who have completed at least upper-secondary education increased from 40 % to 46 %. Opportunities for lifelong learning have also increased in the public and private sectors alike. With regard to entrepreneurial training, the last few years have seen a number of initiatives initiated by different stakeholders, in a somewhat fragmented manner. The Business Promotion Act provides for grants to firms that train their workers, and these provisions will be reviewed and improved. Training in literacy and basic skills has increased as well. The outcomes of these measures are expected to become increasingly visible in the years to come.

... but gender equality appears closer

The government is currently designing a package of incentives to increase female labour market participation. It will also promulgate standards to regulate the provision of childcare, provide incentives to both providers and users of childcare, and will make best use of the European Social Fund to further childcare provision.

A key actor in the promotion of gender equality in the labour market will be the National Commission on the Promotion of Equality between Women and Men. Its strategic priorities for the years 2004–06 are to raise awareness of equality and of the commission itself, to develop guidelines and procedures for handling complaints of discrimination, to network with other entities to strengthen women's labour market position, to study the issue of gender targets, and to monitor laws and collective agreements from a gender perspective. These initiatives constitute a positive step but at this stage it is too early to make a proper appraisal of their effects. Measures to facilitate the return to work of middle-aged women are to be implemented.

([1]) Cooperation agreement between Malta and Italy which expires in 2005.

Increase employment rates, especially among women

Under this challenge, Malta was requested to:

2. streamline the tax–benefit system interaction to strengthen the incentives to work, within the context of the government's fiscal consolidation process (GL 4);
3. improve the quality of secondary education and vocational training (GL 8);
4. strengthen retraining of labour to make it more adaptable in the case of labour shedding and facilitate the return to work of middle-aged women (GL 8).

16.3. Productivity and business dynamism

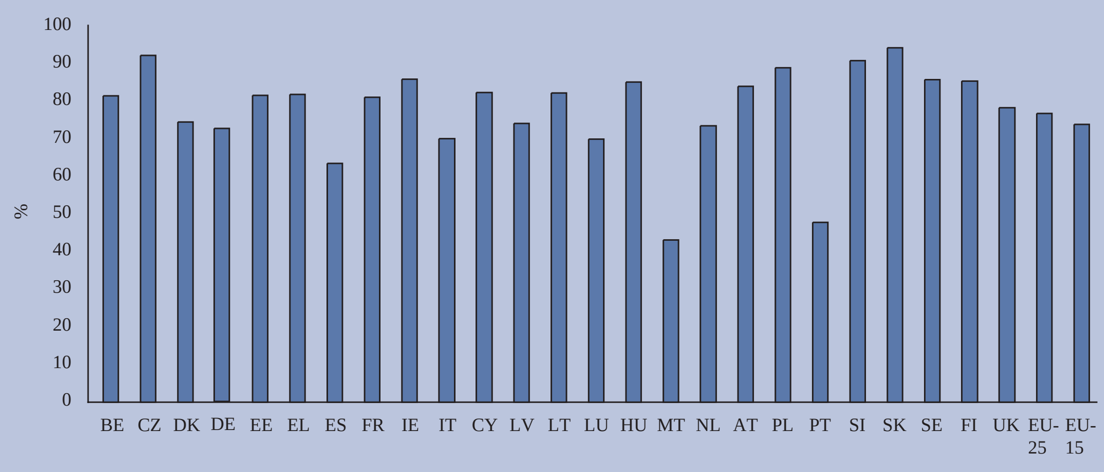
Continued efforts to improve competition

The government has continued to pursue efforts to provide the right environment for competition to develop. In the first quarter of 2004, regulations establishing rules for the licensing of activities in the electricity sector and relating to electricity tariffs, among other things, came into force. Also in 2004, one of the routes of transport operated by a monopoly ferry service was liberalised and the government published a White Paper on a new framework for the electronic communications market.

Legislation to restructure the ship repair and shipbuilding industry came into force on 7 November 2003. This industry is currently a major beneficiary of State aid but the restructuring programme aims to phase out these subsidies by 2008 in line with the transition period agreed during the accession negotiations. In the food industry, the dismantling of levies on agriculture and agro-food products was finalised by Malta's accession to the EU on 1 May 2004.

The government has continued with its privatisation programme as part of efforts to increase competition and efficiency. The privatisation of the national lottery licence was accomplished in February 2004. The privatisation unit completed evaluation of the expressions of interest from various companies for the privatisation of Sea Malta, the commercial national shipping line. The government has announced its intention to carry out the privatisation process for a number of its holdings, notably Bank of Valletta plc, a leading financial services provider, and Maltacom plc, the main telecommunications provider.

Graph 16.1: **Youth educational attainment level (20–24-year-olds), 2003**



Source: Commission services.

Encourage effective competition taking into account the specific characteristics of the small domestic economy

Under this challenge, Malta was requested to:

5. pursue the efforts to increase competition in certain sectors such as network industries, food industries, and shipbuilding (GL 9).

Table 16.1

Economic indicators for Malta

	Malta				EU-25			
	2001	2002	2003	2004	2001	2002	2003	2004
General economic background								
Real GDP growth (1)	– 2.2	2.2	– 1.8	1.5	1.8	1.1	1.0	2.5
Inflation (2)	2.5	2.6	1.9	3.7	2.5	2.1	1.9	2.2
Labour productivity growth (3)	– 4.1	2.5	1.2	0.4	0.8	0.9	0.9	2.1
Employment growth (1)	2.1	– 0.7	– 1.0	0.6	1.0	0.3	0.3	0.4
Nominal wage growth (4)	5.9	1.5	1.5	0.6	4.0	3.2	3.1	3.0
Current account (5)	:	:	:	– 4.0	:	:	:	:
Unemployment (6)	6.7	7.5	8.2	8.6	8.5	8.9	9.1	9.1
Public finances								
General government balance (5)	– 6.4	– 5.8	– 9.6	– 5.1	– 1.2	– 2.3	– 2.8	– 2.8
Primary balance (5)	– 2.8	– 1.9	– 5.9	– 1.3	2.4	1.0	0.3	0.2
Cyclically adjusted balance (5)	:	:	:	:	:	:	:	:
Gross government debt (5)	62.0	62.3	70.4	72.4	62.1	61.6	63.2	63.5
Employment								
Employment rate (7)	54.3	54.4	54.2	:	62.8	62.9	63.0	:
Female employment rate (8)	32.1	33.9	33.6	:	54.3	54.7	55.1	:
Employment rate for older workers (9)	29.4	30.1	32.5	:	37.4	38.8	40.2	:
Long-term unemployment (10)	3.2	3.3	3.5	:	3.8	3.9	4.0	:
Tax rate on low wage earners (11)	17.4	18.1	15.8	:	37.2	37.1	37.4	:
Unemployment trap indicator (12)	64.4	64.4	64.2	:	78.8	78.5	78.3	:
Product market reforms								
Hourly labour productivity (13)	:	:	:	:	:	:	:	:
Total trade to GDP ratio (14)	83.4	82.5	79.5	:	:	58.8	57.2	:
Internal market directives (15)	:	:	:	94.7	:	:	:	96.3
Business investment (16)	17.0	14.3	16.1	:	17.9	17.2	16.8	:
Knowledge-based economy								
Total tertiary graduates (17)	32.7	:	:	:	46.8	:	:	:
Spending on human resources (18)	4.5	4.5	:	:	5.1	:	:	:
R & D expenditure (19)	:	:	:	:	1.9	1.9	:	:
Expenditure on IT (20)	:	:	:	:	3.1	2.9	2.9	2.9

(1) Growth rate in per cent.
(2) Annual average rate of change in harmonised index of consumer prices in per cent.
(3) Growth rate of real GDP per occupied person in per cent.
(4) Growth rate of compensation per employee.
(5) As a percentage of GDP.
(6) Number of unemployed as a percentage of the labour force.
(7) Employed persons aged 15–64 as a share of the total population of the same age group.
(8) Employed women aged 15–64 as a share of the total female population of the same age group.
(9) Employed persons aged 55–64 as a share of the total population of the same age group.
(10) Long-term unemployed (over 12 months) as a percentage of the total active population aged 15–64.
(11) Income tax plus employer/employee contributions as a percentage of labour costs of a single earner at 67 % of the average production worker wage, no children.
(12) Effective tax rate on labour income taking into account the combined effect of increased taxes and benefits withdrawal as an individual moves from unemployment back to work earning 67 % of the average production worker wage, measured at the first month of unemployment (after any 'waiting period' if applicable).
(13) GDP per hour worked in PPS, EU-15 = 100.
(14) Percentage, average value of imports and exports of goods and services divided by GDP, multiplied by 100; for DE, ES, FR, IT, PL and the UK, the value for the EU-25 is the total for the large Member States; for all the other States, the value for the EU-25 is the total for the small Member States.
(15) Percentage implemented in November 2004.
(16) Gross fixed capital formation by the private sector as a percentage of GDP.
(17) Total tertiary graduates (ISCED 5–6) per 1 000 of population aged 20–29.
(18) Public expenditure on education as a percentage of GDP.
(19) GERD — gross domestic expenditure on R & D as a percentage of GDP.
(20) Expenditure on information technology as a percentage of GDP.

Source: Commission services (including Eurostat, structural indicators). The data for 'general economic background' and 'public finance' are taken from the Commission's autumn 2004 economic forecasts.

17. The Netherlands

In 2004, budgetary policy was determined by the sharp deterioration in the fiscal position in 2002 and 2003, which mainly resulted from the protracted economic slump, and the government's determined efforts to reduce the deficit to below the threshold of 3 % of GDP. The subdued labour productivity growth in 2002 and 2003 stems from the combination of cyclical factors and from remaining product market imperfections in some sectors and relatively low innovative capacity. Despite the efforts, structural reforms have not yet resulted in higher trend productivity and productivity growth. A detailed assessment of recent developments in addressing the Netherlands' key policy challenges is presented in the following sections.

17.1. Public finances

Deficit exceeded the 3 % of GDP limit in 2003, leading to the launch of the excessive deficit procedure

Based on a general government deficit of 3.2 % of GDP in 2003, the Council decided on 2 June 2004 that the Netherlands was in excessive deficit and recommended that this be corrected by 2005 at the latest. To this end, the Netherlands was required to take effective action by 2 October 2004 regarding corrective measures in 2005, mainly of a structural nature. In addition, the Council urged the Dutch authorities to ensure that budgetary consolidation towards a position close to balance or in surplus is sustained.

A substantial consolidation effort is estimated to bring the deficit below 3 % of GDP from 2004

The 1.3 % of GDP increase in the general government deficit to 3.2 % of GDP in 2003 occurred despite substantial fiscal tightening. It has shown, among other things, the sensitivity of Dutch public finances to the deep and protracted economic slowdown. In order to stem the worsening of the public accounts, the authorities promptly implemented a supplementary package of savings equivalent to 0.6 % of GDP in April 2004; around half of these measures were of a one-off nature. As a consequence, the general government deficit is expected to have fallen to 2.9 % of GDP in 2004.

The 2005 budget contains consolidation measures equivalent to around 0.5 percentage points of GDP. The deficit-reducing measures in the 2005 budget comprise cuts in health expenditures, increases in income tax rates,

Pursue budgetary adjustment in the coming years in the face of weaker potential growth, and the budgetary costs of ageing	**Assessment**
Under this challenge, the Netherlands was requested to:	
1. stand ready to take the necessary measures in response to the existence of an excessive deficit, while continuing to contain government expenditure within clearly defined ceilings set in real terms, consistent with a medium-term budgetary position close to balance or in surplus (GLs 1 and 14).	In progress

Bearing in mind the three-year period available for implementation, the degree of implementation since 2003 is indicated as: 'Complete' for (practically) complete; 'In progress' where progress is well advanced; 'Limited' where the recommendation is only partially addressed; and 'Insufficient' where no substantial measures going in the right direction have been taken.

reduced access to unemployment benefits, higher disability premiums, and the phasing-out of subsidies on low-paid labour. For a large part, the savings in 2005 reflect the structural impact of measures that were part of the April 2004 adjustment package. The main additional savings in the 2005 budget are an increase in the rate for the first two income tax brackets and further cuts in the net spending of ministries. In 2006, an end to fiscal facilities for early retirement would also help to improve the general government balance. In the wake of fiscal tightening and a recovery in revenues in line with the expected economic upturn, the deficit is expected to fall to 2.4 % of GDP in 2005 and, on a no-policy-change basis, to 2.1 % of GDP in 2006 according to the Commission's autumn 2004 economic forecast. According to the Commission's forecast, the cyclically adjusted deficit would remain at around 1 % of GDP in 2005 and 2006, so further adjustments might be needed to achieve a fiscal position close to balance.

17.2. Labour market

Profound reforms of the social security and pension systems …

Against the background of the deterioration in public finances and the ensuing corrective budgetary measures, the government is pursuing a deep-rooted overhaul of the social security and pension systems. The rationale for these reforms is to boost labour participation and to secure the ensuing budgetary savings. Following up on action already taken in 2003 (discussed in the 2004 implementation report) and encompassing several measures taken in spring 2004, the 2005 budget (as amended by Parliament) specifies a series of far-reaching measures.

Measures include a limitation of the maximum duration of unemployment benefits to improve incentives to take up work. Some proposals have been put on hold awaiting advice by the Social Economic Council. These concern, in particular, the proposals to abolish the special unemployment benefit for persons with short work records and to limit lump-sum payments which employees may receive after lay-offs without unemployment benefits being reduced (which actually risks hindering matching in the labour market, thus offsetting budgetary gains).

Progress has been made in the integrated approach of job search and benefit determination. As a consequence, full financial and administrative responsibility for those on welfare benefits lies with the municipalities as of 2004. Moreover, the streamlining of various income-dependent subsidies should enhance efficiency in the implementation, with a larger role for the tax administration.

Subsidies on low-paid labour will be phased out by 2006. These subsidies implied a large deadweight loss, limiting the efficiency of the subsidies in enhancing employment. However, the increase in the two lowest income tax brackets in 2005 will partly reverse the reductions in marginal tax rates for low to medium incomes in recent years (which promoted employment growth), while progress in the removal of poverty traps has been slow.

A reform of the disability scheme will be implemented with effect from 2006. The restructuring implies stricter eligibility, aimed at reducing both the inflow and the stock of current recipients and at an adjustment of the incentive structure. The period of illness before being eligible for a disability benefit will be lengthened to two years. During this two-year period, the employer will have to pay sickness benefits. The reform will be reviewed after its implementation. A positive assessment would lead to an increase in the benefit level for those

Draw currently inactive people into the labour market	Assessment
Under this challenge, the Netherlands was requested to:	
2. push forward with reforms of benefit systems in order to make work pay (GL 4); concentrate, in particular, on benefit eligibility and conditionality; legislate and implement the planned reform of the disability scheme, thereby paying attention to both the inflow and to the activation of those who already receive benefits.	In progress

deemed fully and permanently disabled ([1]), while the current (successful) differentiation in disability premium payments on the part of employers would be abolished. As regards childcare, new rules of financing will apply as of 2005, with the aim of splitting costs among parents, employers and the government. To the extent that the employer indeed pays, the impact for low to medium wage earners appears to be positive. A major drawback, however, is that disincentives remain to take up work when only one of the two spouses is employed.

As regards pensions, the government will end fiscal facilitation of pre-pension and early-retirement schemes in 2006. While this should help to enhance fiscal sustainability, the long transition period granted for those who are 55 years or older at the start of the new system risks leading to the early retirement of persons who are still eligible. Moreover, social partners might (partly) offset the intended impact through a faster accumulation of tax-exempt ordinary pension rights. Even though the introduction of an element of choice adds flexibility compared with existing pre-pension arrangements, this could leave in place a high implicit tax on working until the statutory pension age, thereby not fully addressing the problem of low labour participation among the over-55s.

Finally, the government launched an initiative for a fiscal savings scheme (*levensloopregeling*) to facilitate career breaks. Its modalities do not imply a sizeable improvement over existing fiscal arrangements. It risks being used primarily as an alternative route to early retirement for certain older employees, while not appreciably alleviating the burden on people in the age group combining a career and raising children.

On balance, several measures are aimed at limiting eligibility for social security and disability benefits, therefore promoting labour participation. The new measures imply a substantial overhaul of social security and pension regulations. Due to this encompassing approach, substantial progress in implementing the recommendations has been made in the past year or will be made in 2005 and 2006. However, in some areas, notably pension reform, doubts exist about the actual effectiveness in terms of influencing the actual behaviour of economic agents, and thus achieving their intended aim.

([1]) In the social agreement reached on 5 November 2004, the definition of 'permanently disabled' was mitigated to include persons with a 'small chance' of recovery.

… mitigated in the wake of social agreement

Dissatisfaction among the social partners with key elements of the government plans in the areas of pensions and social security led to calls for modification of those plans. On 5 November 2004, the government reached an agreement with the social partners and modified the plans in certain respects. The Social Economic Council should come up with budget-neutral alternative proposals for the elements of the reform of the unemployment and disability schemes that have been put on hold awaiting its advice. In addition, an agreement was reached to moderate contractual wage increases, while collective labour agreements would remain binding. The budgetary costs of the adjustments are estimated to be limited, at less than 0.1 % of GDP in 2006.

17.3. Productivity and business dynamism

Some measures were taken to improve the regulatory framework …

The bill strengthening the Dutch competition authority (NMa) and broadening its competences came into force on 1 August 2004. In 2003, the NMa addressed competition problems in the construction industry, healthcare, the financial sector and the energy sector. In the last sector, markets have been fully liberalised since July 2004 and network unbundling should take effect by 1 January 2007 at the latest. Quantified targets for a reduction in the administrative burden will be set up for each ministry in 2005. A more intensive use of ICT should also help to reduce administrative costs. One example is the national electronic one-stop shop for businesses that is currently under construction.

… and to strengthen the innovative capacity of the Dutch economy

The Innovation Platform, created in 2003, has organised consultation groups and issued policy recommendations, but few concrete measures have been taken as a follow-up ([2]). Nevertheless, measures, mainly targeted at universities, were taken to stimulate industry–university links (university patent policy, start-ups, spin-offs, 'TechnoPartner' action programme). The 'Deltaplan béta en techniek' aims at increasing the inflow of science and technology students by, for example, bringing school pupils into contact with sci-

([2]) Relaxation of regulations for qualified migrant workers, innovation vouchers for SMEs, 'smart mix' for university funding, and increased mobility of researchers.

ence and technology. Finally, initiatives have been taken to boost the entrepreneurial orientation of students ('Action entrepreneurship in the education system'). Despite the reforms undertaken, the share of R & D financed by industry is below the EU-15 average and shows a negative trend. Similarly, the number of students in science and technical courses remains below the EU average.

Tackle the relatively slow productivity growth, stemming, *inter alia*, from the low level of competition in some sectors, and insufficient business investment, particularly in R & D	**Assessment**
Under this challenge, the Netherlands was requested to:	
3. improve the regulatory framework as well as its implementation (GL 11), especially in sectors where competition has been found to be inadequate, such as construction and professional services;	In progress
4. promote more technology-oriented education and strengthen science–industry links with the aim of increasing business investment in R & D (GL 13).	Limited

Table 17.1

Economic indicators for the Netherlands

	Netherlands				EU-25			
	2001	2002	2003	2004	2001	2002	2003	2004
General economic background								
Real GDP growth (1)	1.4	0.6	– 0.9	1.4	1.8	1.1	1.0	2.5
Inflation (2)	5.1	3.9	2.2	1.2	2.5	2.1	1.9	2.2
Labour productivity growth (3)	0.1	0.7	0.1	3.2	0.8	0.9	0.9	2.1
Employment growth (1)	1.3	– 0.1	– 1.0	– 1.7	1.0	0.3	0.3	0.4
Nominal wage growth (4)	5.5	6.2	3.9	2.4	4.0	3.2	3.1	3.0
Current account (5)	3.8	2.8	2.7	3.7	:	:	:	:
Unemployment (6)	2.5	2.7	3.8	4.6	8.5	8.9	9.1	9.1
Public finances								
General government balance (5)	– 0.1	– 1.9	– 3.2	– 2.9	– 1.2	– 2.3	– 2.8	– 2.8
Primary balance (5)	3.3	1.1	– 0.3	0.0	2.4	1.0	0.3	0.2
Cyclically adjusted balance (5)	– 1.3	– 2.0	– 1.8	– 1.4	:	:	:	:
Gross government debt (5)	52.9	52.6	54.1	55.7	62.1	61.6	63.2	63.5
Employment								
Employment rate (7)	74.1	74.4	73.5	:	62.8	62.9	63.0	:
Female employment rate (8)	65.2	66.2	65.8	:	54.3	54.7	55.1	:
Employment rate for older workers (9)	39.6	42.3	44.8	:	37.4	38.8	40.2	:
Long-term unemployment (10)	0.7	0.7	1.0	:	3.8	3.9	4.0	:
Tax rate on low wage earners (11)	36.8	37.0	37.6	:	37.2	37.1	37.4	:
Unemployment trap indicator (12)	85.2	84.8	85.7	:	78.8	78.5	78.3	:
Product market reforms								
Hourly labour productivity (13)	115.9	112.9	112.3	:	:	:	:	:
Total trade to GDP ratio (14)	68.4	67.3	66.1	:	:	58.8	57.2	:
Internal market directives (15)	98.7	98.7	97.4	98.0	:	:	:	96.3
Business investment (16)	18.3	17.1	16.5	:	17.9	17.2	16.8	:
Knowledge-based economy								
Total tertiary graduates (17)	39.2	42.0	:	:	46.8	:	:	:
Spending on human resources (18)	5.0	5.1	:	:	5.1	:	:	:
R & D expenditure (19)	1.9	:	:	:	1.9	1.9	:	:
Expenditure on IT (20)	3.9	3.6	3.5	3.5	3.1	2.9	2.9	2.9

(1) Growth rate in per cent.
(2) Annual average rate of change in harmonised index of consumer prices in per cent.
(3) Growth rate of real GDP per occupied person in per cent.
(4) Growth rate of compensation per employee.
(5) As a percentage of GDP.
(6) Number of unemployed as a percentage of the labour force.
(7) Employed persons aged 15–64 as a share of the total population of the same age group.
(8) Employed women aged 15–64 as a share of the total female population of the same age group.
(9) Employed persons aged 55–64 as a share of the total population of the same age group.
(10) Long-term unemployed (over 12 months) as a percentage of the total active population aged 15–64.
(11) Income tax plus employer/employee contributions as a percentage of labour costs of a single earner at 67 % of the average production worker wage, no children.
(12) Effective tax rate on labour income taking into account the combined effect of increased taxes and benefits withdrawal as an individual moves from unemployment back to work earning 67 % of the average production worker wage, measured at the first month of unemployment (after any ‘waiting period’ if applicable).
(13) GDP per hour worked in PPS, EU-15 = 100.
(14) Percentage, average value of imports and exports of goods and services divided by GDP, multiplied by 100; for DE, ES, FR, IT, PL and the UK, the value for the EU-25 is the total for the large Member States; for all the other States, the value for the EU-25 is the total for the small Member States.
(15) Percentage implemented in November 2004.
(16) Gross fixed capital formation by the private sector as a percentage of GDP.
(17) Total tertiary graduates (ISCED 5–6) per 1 000 of population aged 20–29.
(18) Public expenditure on education as a percentage of GDP.
(19) GERD — gross domestic expenditure on R & D as a percentage of GDP.
(20) Expenditure on information technology as a percentage of GDP.

Source: Commission services (including Eurostat, structural indicators). The data for ‘general economic background’ and ‘public finance’ are taken from the Commission’s autumn 2004 economic forecasts.

18. Austria

Benefiting from a booming world economy, in 2004 GDP growth in Austria gathered momentum after the slowdown of 2003. This brought about an improvement in the labour market, with a slight reduction in the number of unemployed. The general government deficit, however, remained practically unchanged at 1¼ % of GDP as both revenue and expenditure ratios fell. A tax reduction in 2005 is expected to raise the deficit to around 2 % of GDP in spite of economic activity expected to remain firmly upward bound. Following a fairly high pace of reforms in 2003 with the implementation of a substantial and welcome overhaul of the pension system, 2004 brought further developments with the 'pension harmonisation law' that will introduce a new system of individual pension accounts. The 2004 law is achieving its goals to a large degree. However, this is also leading to individual pension accounts that are non-transparent to the insured and the law contains some concessions that temporarily undo a part of the exonerating budgetary effects of the 2003 law, while resulting in additional expenditure savings in the long run. Austria continues to rationalise and streamline its R & D and innovation support. Increased R & D spending and the recent educational reform should speed up the transition towards the knowledge-based economy. Moreover, the current reform of higher education might help increase the very low levels of graduates. The business environment is improving due to the measures taken to support entrepreneurship and SMEs, and to the reduction in the corporate tax rate from 34 % to 25 %. However, effective competition particularly in the liberal professions remains low. Efforts to increase competition in network industries have suffered a setback, as the only foreign electricity retailer has left the market. A detailed assessment of recent developments in addressing Austria's key policy challenges is presented in the following sections.

18.1. Long-term sustainability of public finances

2004 deficit almost double the planned size …

In 2004, the general government deficit edged up from 1.1 % of GDP in 2003 to 1.3 % of GDP, whereas the

Draw currently inactive people into the labour market	**Assessment**
Under this challenge, Austria was requested to:	
1. implement measures leading to structural expenditure savings, also at lower levels of government, so as to lower the high tax burden, while securing a cyclically adjusted budgetary position close to balance (GL 1);	Limited
2. reform the public pension system to ensure the sustainability of public finances (GL 16); in particular, link more closely the level of pension benefits to lifelong contributions; increase the low average effective retirement age and ensure in this context that incentives to work are enhanced (GL 4), with a view to raising the labour market participation of older workers.	In progress

Bearing in mind the three-year period available for implementation, the degree of implementation since 2003 is indicated as: 'Complete' for (practically) complete; 'In progress' where progress is well advanced; 'Limited' where the recommendation is only partially addressed; and 'Insufficient' where no substantial measures going in the right direction have been taken.

2003 update of the stability programme had projected a deficit reduction to 0.7 % of GDP. According to the 2004 update of the stability programme, all levels of government performed below the stability programme target, the federal level fell short of its target by 0.3 % of GDP as did the *Land* and local level. The social security accounts did not reach the projected surplus of 0.1 % of GDP, but remained in balance.

… due to overspending

The 2003 update of the stability programme had projected a reduction in the expenditure share in GDP by 1.2 percentage points in 2004, while the 2004 update estimates that the ratio was reduced by only 0.6 % of GDP. The general government revenue share in GDP fell in 2004 by only a little more than expected in the 2003 stability programme. This implies that the first stage of the income tax reform, amounting to tax relief worth 0.1 % of GDP in 2004 (including some measures of the 2005 tax reform brought forward to 2004), was accompanied by much less expenditure restraint than planned. Much of the expenditure slippage (in the national accounts definition) resulted from the incremental investment premium (*Investitionszuwachsprämie*), which was taken up by companies to a much larger extent than expected by the government. Expenditure on unemployment benefits was also slightly higher than expected.

In 2005, the second stage of the income tax reform will take effect, amounting to tax relief worth 1 % of GDP. The tax reform is deliberately not contemporaneously counter-financed, thus the general government deficit will widen to 2.0 % of GDP according to the Commission's autumn 2004 economic forecast. As a result, the Commission estimates the cyclically adjusted balance to have widened by 0.2 percentage points to – 1.0 % of GDP in 2004, to rise further to – 1.9 % in 2005 and, on a no-policy-change basis, to fall slightly to – 1.7 % of GDP in 2006. Hence, despite lowering the tax burden, Austrian budgetary policy has failed to implement structural savings and is moving further away from a cyclically adjusted position close to balance. For the period 2005–08, the different levels of government have concluded a new fiscal revenue-sharing act and a new national stability pact, which outline the adjustment path for each level of government to arrive at a balanced budget for general government by 2008, thereby postponing the consolidation promised in earlier stability programmes. Although the national stability pact provides some incentives to follow the planned path, its achievement is unlikely under a no-policy-change scenario, and the 2004 update of the stability programme explains only partly the specific measures needed to achieve this.

Ambitious pension reform implemented in 2004 …

As reviewed in the 2004 implementation report, Austria passed a substantial pension reform law in 2003, taking effect in 2004. In the long term, the actuarial fairness of the public pension system will be enhanced by extending the assessment period for the individual benefit entitlements and by gradually raising the statutory retirement age, expected to lead to higher labour market participation of the elderly.

… but partly undone in 2005

With the aim of bringing all groups of private and public sector employees into a harmonised pension system, a further pension reform law was passed in 2004 (*Pensionsharmonisierung*). The significant contribution of the 2004 law to long-term financial sustainability is now being backloaded to take effect only after 2030, while partly reducing the medium-term savings from the 2003 law. More specifically, this entails the following.

- Pension levels will be adjusted annually for consumer price inflation only, which is the main driver of future expenditure savings. An automatic adjustment for demographic change is not foreseen, but the government is obliged to report every three years on demographic change and to propose measures on how to cope with its financial implications.

- The expenditure savings will take effect only from 2030 onwards, while the medium-term savings from the 2003 reform are partly undone. For entitlements, two so-called 'parallel calculations' are carried out. The first accounts for a weighted average of the entitlements before and after the 2003 law, and the second accounts for the entitlements under the 2004 law. In total, the loss from the 2003 reform (the first calculation) is partly undone. Moreover, the method of calculating individual benefit levels is not transparent to the insured. It will thus not facilitate rational choices on working time, the timing of retirement or childcare.

- The goal of harmonisation remains incomplete; in particular, civil servants older than 50 years are not subject to the new regulation and the *Länder* will yet have to apply the rules to their civil servants.

Furthermore, employees, farmers and the self-employed continue to pay different contribution rates that do not fully reflect differences in entitlements (e.g. for periods of unemployment or childcare).

- Although the statutory retirement age remains at 65 years, the draft law introduces a 'corridor' for early retirement, beginning at 62 years of age and aiming at actuarially fair discount rates. Employees within this age corridor who are made redundant by their employer would be entitled to one further year of unemployment benefits before they must take up the 'corridor' pension. As the statutory retirement age of 62 will apply to women as from 2027, they would be entitled to the corridor pension from 2028 onwards.

The law further contains an early-retirement clause for workers having done heavy-duty manual labour, with the aim of restricting it to 5 % of new retirees. While such workers may indeed have a lower life expectancy, the eligibility criteria are still to be elaborated by an ad hoc working group.

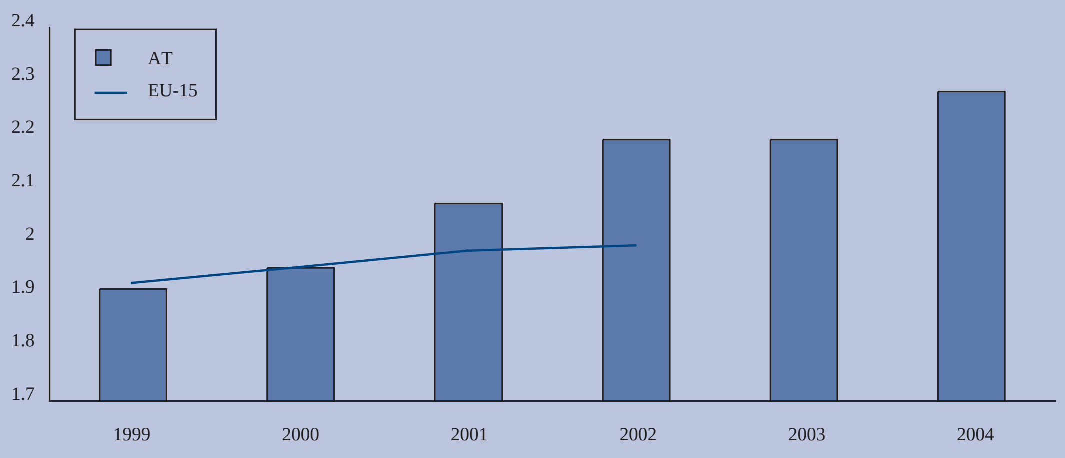
18.2. Productivity and business dynamism

Spending on R & D has been steadily increasing …

The sustained effort of Austria to boost R & D and innovation is producing results. The 2003 European innovation scoreboard shows that Austria is closing the innovation gap vis-à-vis the EU average. The steadily increasing overall R & D expenditure reached 2.2 % of GDP in 2003 and is expected to have risen to 2.3 % in 2004.

Continue to improve the weak technology base, and encourage business R & D and innovation	**Assessment**
Under this challenge, Austria was requested to:	
3. take measures to encourage business research and innovation, especially for SMEs (GL 13).	In progress

Graph 18.1: **Overall R & D expenditure (as % of GDP)**



Source: Commission services.

As regards public spending, Austria has approved additional resources for R & D for the period 2004–06. The share of R & D expenditure financed by industry (42.6 % in 2004) is considerably lower than the EU average.

… and the institutional set-up for R & D promotion is being restructured

The government has continued to streamline and rationalise the complicated system of R & D and innovation support. First, the Austrian research promotion company (Forschungsförderungsgesellschaft) was founded by merging four independent sectoral institutions. Second, the fund providing resources for scientific research (FWF) was reformed in order to modernise the organisational structure and increase transparency. Third, the independence of the Council for Research and Technological Development, which decides on the distribution of the funds for R & D, was increased. Finally, the National Foundation for RTD was created which will annually distribute grants amounting to around EUR 125 million. The numerous programmes for support of R & D and innovation and technology transfer in companies and particularly SMEs (e.g. Protec 2002+, Kplus and RegPlus) continued operating. As regards other measures to boost R & D, as part of the ongoing tax reform, the adjustment of the taxation of groups, in order to attract headquarters and R & D facilities to the country, will be implemented by 1 January 2005.

18.3. Competition

Effective competition in some sectors increased …

As elaborated in the 2004 implementation report, measures to increase effective competition were implemented (partial liberalisation of the regulation on opening hours in the retail sector, decrease in start-up costs and easier access to several professions). The number of newly founded enterprises increased considerably by over 9 % in 2003. While the business environment had improved, part of this rise was the result of the investment premium subsidy, which also gave incentives for existing companies to undertake new investment in newly founded companies. Limited competition in some sectors remains a problem. In particular, liberal professions remain heavily regulated, while Austria has launched consultations on streamlining the rules and aligning them with European competition law.

Overall, the liberalisation of the network industries has proceeded and has led to a drop in mark-ups. In the energy sector, the electricity retail prices net of taxes stayed below the European average, despite a relative increase in 2004. However, the network access costs for electricity retailers ranked among the highest in Europe. This is an indication for low retail margins, and in October 2004 the only foreign electricity retailer active in Austria announced that it was to shut down its operations.

… and the resources of the federal competition authority increased slightly

In the second year of its existence, the federal competition authority (FCA) has continued successfully to build up a public record of its activities. The staff of the competition authority increased slightly. However, the staffing problem seems to persist. Nevertheless, the Austrian competition system foresees a distribution of tasks between the FCA and the Cartel and the Supreme Cartel Courts, which are the two decision-making bodies in cartel affairs. The law on telecommunications adopted in August 2003 strengthened the position of the telecommunications authority.

Strengthen the development of effective competition in some sectors	**Assessment**
Under this challenge, Austria was requested to:	
4. increase the resources of the competition authority and to take measures to enhance effective enforcement of regulators' decisions in telecommunications (GL 9).	Limited

Table 18.1

Economic indicators for Austria

	Austria				EU-25			
	2001	2002	2003	2004	2001	2002	2003	2004
General economic background								
Real GDP growth (1)	0.7	1.2	0.8	1.9	1.8	1.1	1.0	2.5
Inflation (2)	2.3	1.7	1.3	2.1	2.5	2.1	1.9	2.2
Labour productivity growth (3)	0.3	1.1	0.7	1.4	0.8	0.9	0.9	2.1
Employment growth (1)	0.4	0.1	0.0	0.5	1.0	0.3	0.3	0.4
Nominal wage growth (4)	1.4	1.7	2.1	2.5	4.0	3.2	3.1	3.0
Current account (5)	– 0.4	2.5	1.5	1.9	:	:	:	:
Unemployment (6)	3.6	4.2	4.3	4.2	8.5	8.9	9.1	9.1
Public finances								
General government balance (5)	0.3	– 0.2	– 1.1	– 1.3	– 1.2	– 2.3	– 2.8	– 2.8
Primary balance (5)	3.7	3.0	1.9	1.7	2.4	1.0	0.3	0.2
Cyclically adjusted balance (5)	0.0	– 0.2	– 0.8	– 1.0	:	:	:	:
Gross government debt (5)	66.1	65.7	64.5	64.0	62.1	61.6	63.2	63.5
Employment								
Employment rate (7)	68.5	68.7	69.0	:	62.8	62.9	63.0	:
Female employment rate (8)	60.7	61.3	61.7	:	54.3	54.7	55.1	:
Employment rate for older workers (9)	28.9	29.1	30.1	:	37.4	38.8	40.2	:
Long-term unemployment (10)	0.9	1.1	1.2	:	3.8	3.9	4.0	:
Tax rate on low wage earners (11)	39.7	39.9	40.2	:	37.2	37.1	37.4	:
Unemployment trap indicator (12)	74.8	72.0	75.1	:	78.8	78.5	78.3	:
Product market reforms								
Hourly labour productivity (13)	101.1	100.0	99.8	:	:	:	:	:
Total trade to GDP ratio (14)	51.8	51.3	51.3	:	:	58.8	57.2	:
Internal market directives (15)	97.1	97.1	97.5	97.8	:	:	:	96.3
Business investment (16)	20.8	19.5	20.3	:	17.9	17.2	16.8	:
Knowledge-based economy								
Total tertiary graduates (17)	26.6	:	:	:	46.8	:	:	:
Spending on human resources (18)	5.7	:	:	:	5.1	:	:	:
R & D expenditure (19)	2.1	2.2	2.2	2.3	1.9	1.9	:	:
Expenditure on IT (20)	3.1	2.9	2.9	2.9	3.1	2.9	2.9	2.9

(1) Growth rate in per cent.
(2) Annual average rate of change in harmonised index of consumer prices in per cent.
(3) Growth rate of real GDP per occupied person in per cent.
(4) Growth rate of compensation per employee.
(5) As a percentage of GDP.
(6) Number of unemployed as a percentage of the labour force.
(7) Employed persons aged 15–64 as a share of the total population of the same age group.
(8) Employed women aged 15–64 as a share of the total female population of the same age group.
(9) Employed persons aged 55–64 as a share of the total population of the same age group.
(10) Long-term unemployed (over 12 months) as a percentage of the total active population aged 15–64.
(11) Income tax plus employer/employee contributions as a percentage of labour costs of a single earner at 67 % of the average production worker wage, no children.
(12) Effective tax rate on labour income taking into account the combined effect of increased taxes and benefits withdrawal as an individual moves from unemployment back to work earning 67 % of the average production worker wage, measured at the first month of unemployment (after any 'waiting period' if applicable).
(13) GDP per hour worked in PPS, EU-15 = 100.
(14) Percentage, average value of imports and exports of goods and services divided by GDP, multiplied by 100; for DE, ES, FR, IT, PL and the UK, the value for the EU-25 is the total for the large Member States; for all the other States, the value for the EU-25 is the total for the small Member States.
(15) Percentage implemented in November 2004.
(16) Gross fixed capital formation by the private sector as a percentage of GDP.
(17) Total tertiary graduates (ISCED 5–6) per 1 000 of population aged 20–29.
(18) Public expenditure on education as a percentage of GDP.
(19) GERD — gross domestic expenditure on R & D as a percentage of GDP.
(20) Expenditure on information technology as a percentage of GDP.

Source: Commission services (including Eurostat, structural indicators). The data for 'general economic background' and 'public finance' are taken from the Commission's autumn 2004 economic forecasts.

19. Poland

After two years of slow growth in 2001 and 2002, the Polish economy is experiencing a strong recovery. The upswing gradually gained strength, and real GDP growth accelerated to close to 6 % in 2004. Despite robust growth, the labour market situation has little improved so far, underscoring the structural nature of Polish unemployment. With almost 50 % of the working-age population out of work and an unemployment rate close to 19 % of the labour force, improving the functioning of the labour market remains of paramount importance. In spite of favourable cyclical conditions, no progress towards fiscal consolidation was made last year. However, a large number of measures outlined in the authorities' public finance reform package (Hausner plan) were adopted in the course of 2004 and will start to be implemented in 2005. In particular, the reform of the tax and benefit system should pave the way for reducing the inactivity traps that hamper labour market adjustment. Important risks remain stemming from the rising stock of contingent liabilities. Despite a steady productivity growth, productivity levels per person employed are still relatively low. Moreover, the Polish economy shows a relatively weak innovation and absorption capacity for capital, technological and organisational progress, although many initiatives have been taken to adapt the education and training system accordingly. Also, considerable efforts have been made to reduce the administrative burden and to improve the business environment. However, the State continues to hold an important share of the economy and the privatisation process lacks public support. A detailed assessment of recent developments in addressing Poland's key policy challenges is presented in the following sections.

19.1. Labour market

The lack of wage flexibility remains an acute problem …

Poland has a fairly decentralised wage bargaining system which should in principle be conducive to a flexible adjustment of wages to productivity developments, at least in the private sector. Nevertheless, there is evidence that greater wage differentiation is needed to better reflect differences in productivity across skills, firms and regions.

Urgently address the deep-seated structural problems in the labour market

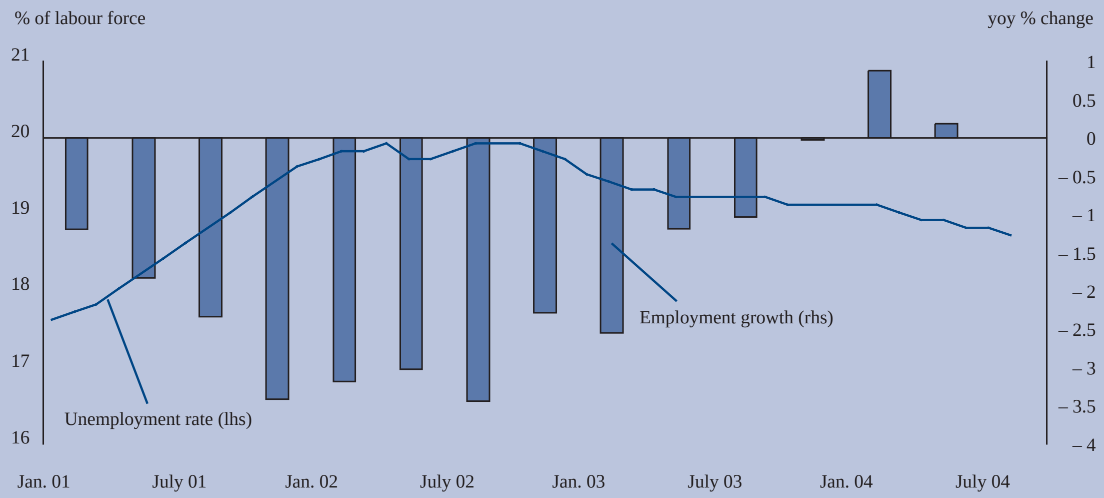
Under this challenge, Poland was requested to:

1. increase the flexibility of the wage setting process to ensure that wages better reflect differences in productivity across skills, firms and regions (GL 5);

2. lower the tax burden on labour, together with efforts to widen the tax base on labour and to improve the efficiency of the tax collection and enforcement system, and reform the tax and benefit system to eliminate financial disincentives to work, in particular high inactivity traps for married couples, and to increase the efficiency of social spending (GL 4);

3. strengthen labour supply by pursuing efforts to better adapt the qualifications of the workforce to the requirements of the labour market and by removing obstacles to regional mobility, especially through reform of the housing market and improvements in transport infrastructure (GLs 7 and 13).

Graph 19.1: **Labour market developments**



Source: Commission services.

The lack of wage flexibility in Poland is mainly linked to the existence of a nationally set minimum wage. Indeed, the minimum wage is high relative to average wages in many regions, especially regions with large proportions of low-skilled workers, and, as a result, it is a strong impediment to the wage flexibility at the lower end of the wage distribution. In order to improve employment prospects for young and low-skilled workers, it would be desirable to make the minimum wage less binding. A first step in this direction was taken with the introduction of a time-limited scheme allowing firms to pay job-starters or workers who did not work in the past two years 80 % of the minimum wage in the first year of a new job and 90 % during the second year. However, the scope of this measure remains limited and more needs to be done to allow the minimum wage to decline relative to average wages so as to reduce the cost to firms of hiring unskilled workers.

… but efforts are under way to reduce the disincentives to work associated with the current tax and benefit system

The authorities adopted last year, or are at present considering, a number of initiatives outlined in the Hausner plan (programme of rationalisation and reduction of public spending approved by the government in January 2004), and designed to reduce the inactivity traps associated with the current benefit systems. However, compared with initial plans, some of the proposals have been watered down or abandoned, such as the reform of the disability pension system and the phasing-out of the early-retirement pension scheme. The measures incorporated into the draft budget for 2005 include steps to limit inflows into the pre-retirement programmes and reduce their disincentive effects (via the reduction of benefits), and new rules for sickness benefits and family allowances, as well as changes in the farmers' special social security system (increase in contributions). While these measures will contribute to increasing work incentives, they need to be complemented by more substantial reforms. By contrast, no progress has been made in lowering the high tax burden on labour, and some of the measures envisaged, such as the increase in social security contributions for the self-employed, go in the wrong direction.

While several initiatives have been taken to improve the education and training system, little progress has been made in removing barriers to labour mobility

Regional differences in employment and unemployment could be reduced by increasing labour mobility. Low geographical mobility in Poland results mainly from a shortage of accommodation, high housing costs, and a lack of transport infrastructure, as well as cultural factors. In order to facilitate the purchase of housing, the authorities intend to give access to preferential mortgage loans through a State-owned bank, BGK. Plans to improve the regional passenger transport network should contribute to reducing the unwillingness of workers to take up jobs outside their area of residence. In addition, the law on employment promotion adopted in April 2004 provides for mobility grants for certain groups of people. While these measures are welcome, they would need to be supplemented by additional steps to improve the functioning of the housing market and remove transport barriers to mobility.

A comprehensive reform of the education system was launched in September 1999 in order to increase overall education levels and better adapt the skills of the workforce to the requirements of the labour market. The authorities are pursuing the implementation of the reform which is spread over a period of eight years. Moreover, a series of measures was adopted last year to encourage participation in continuing training (see below). The government has also announced its intention to introduce a law imposing compulsory training cycles within firms.

19.2. Public finances

Fiscal consolidation helped by stronger growth ...

On 5 July 2004, the Council decided that Poland was in excessive deficit and recommended that this be corrected by 2007 at the latest. Specifically, Poland was required to implement with vigour the measures envisaged in the May 2004 convergence programme, in particular those contained in the Hausner plan, and to take effective action by 5 November 2004 regarding the measures envisaged to achieve the 2005 deficit target. In addition, the Council requested the Polish authorities to allocate possible extra revenues to decrease the general government deficit and to ensure that the rise in the debt ratio is brought to a halt.

The request to use extra revenues for deficit reduction was followed in 2004. The deficit target was revised downwards to 5.4 % of GDP from 5.7 % in the May 2004 convergence programme, while the growth forecast for 2004 was revised upwards from 5 % to 5.7 %. The draft budget for 2005, adopted by the government at the end of September, incorporates an important number of measures contained in the Hausner plan. These measures will rationalise and retrench public expenditure and increase revenue in 2005 in the following domains: (i) the State and its administration; (ii) some inefficient sectors in the economy; (iii) social policy. They will continue to have a positive budgetary impact in 2006. Overall, the authorities expect the general government deficit to decline to 3.9 % of GDP in 2005 and 3.1 % in 2006 compared with respectively 4.2 and 3.3 % of GDP in the convergence programme. Based on no-policy-change assumptions, the Commission services' forecasts are closer to the initial targets for 2005. In both years, fiscal adjustment is expected to be helped by the favourable cyclical conditions.

The strong debt dynamics came to a halt. The foreseen privatisation revenues for 2004 materialised due to the privatisation of the biggest Polish State-owned bank. The debt to GDP ratio forecasts for 2004 and 2005 were revised downwards also as a result of the decreasing borrowing needs of the public sector.

Ensure a reduction of the general government deficit on a sustainable basis and the long-term sustainability of public finances

Under this challenge, Poland was requested to:

4. reduce the general government deficit in a credible and sustainable way within a multiannual framework in line with the decisions to be taken by the Council in the context of the forthcoming budgetary surveillance exercise (GLs 1 and 2);

5. monitor the implementation of the reform of the pension system to counter the expected increase in the old-age dependency ratio, and take measures to reduce the fiscal risk stemming from the rising stock of contingent liabilities (GLs 15 and 16).

… but there are still important risks stemming from the rising stock of contingent liabilities

Contingent liabilities still constitute a risk to the sustainability of public finances. The outstanding debt of the healthcare system continues to grow and expectations for a bail-out by the government are rising. The law on the reform of the healthcare units (ZOZ) that would allow the issue of their indebtedness to be tackled was sent to Parliament at the beginning of 2004 with no follow-up. The profitability of the mining sector improved in 2004 due to higher coal prices on international markets and progress in restructuring, thus limiting potential recourse to State financing. Railways are being decentralised and regional firms are taking over some activity segments thus decreasing the pressure on the general government budget.

As the financial capacity of the central government budget is limited, there is a tendency to decentralise education, healthcare and transport but also innovation and R & D expenditure towards the local governments without, however, putting in place a thorough monitoring system ([1]).

The pension reform was implemented in 1999. The system is stable and under constant monitoring. While the plan to equalise the retirement age of men and women has been abandoned, new steps are envisaged to encourage those who want to work longer and accumulate more pension rights.

19.3. Productivity and knowledge-based economy

Many initiatives have been taken to adapt the education and training system to labour market requirements …

The law of 20 April 2004 foresees instruments to promote investment in training for employees and lifelong learning, such as the creation of a training fund devoted to the financing and co-financing of training. Changes in the general education programme have been introduced to develop the entrepreneurial potential at different levels of education including in secondary schools. The strategy ‘*e*Poland’ for the years 2004–06 (including, among other things, a broadband access strategy and the Internet in schools) was adopted in January 2004.

… but the still weak innovative capacity impairs the competitiveness of the Polish economy

In December 2003, the pilot programme of SME productivity and quality improvement by using IT was launched. The aim of this programme is to improve the transfer of knowledge by using IT in a chosen sample of pilot enterprises. The Ministry of Science and Information Technology also developed a system of targeted projects in order to spur the implementation of R & D results in the economy (7 % of the budget is dedicated to the implementation of this aim). Nevertheless, the share of innovative companies with respect to the total number of companies was halved during the period from 1994–96 to 1998–2000. In 2003, Poland’s expenditure in IT as a percentage of GDP was 2.5 %, compared with the EU-15 average of 2.9 %. Total R & D expenditure amounted to 0.6 % of GDP with only one third financed by industry. As far as FDI is concerned, compared with 2002, it has shown a general downward trend over the recent period, with an increase in greenfield FDI and a decrease in FDI associated with privatisation. There is also evidence that companies with foreign capital increased their share in Polish exports, indicating their international competitiveness compared with companies with Polish capital only.

([1]) Data about the budgetary situation of the local governments are published very late in the process of fiscal reporting.

Improve conditions for increasing productivity

Under this challenge, Poland was requested to:

6. pursue and reinforce efforts to improve the efficiency and quality of the education and training system and its responsiveness to changing skills requirements (GL 13);

7. promote R & D and innovation, in particular in the business sector, and support the transfer of knowledge through FDI (GL 13).

19.4. Restructuring of the economy

No substantial reorientation of State aid is hampering the economic restructuring …

In order to comply with the EU *acquis*, many changes in the procedure for use and scope of State aid have been implemented. Improvements in data transparency and the monitoring of granted aid have been introduced. However, the amount of aid granted has increased as a result of the government's anti-crisis activity package of 2003. No reorientation towards horizontal aid was observed with 92 % of aid being sectoral (80.5 % for coal mining).

… and the privatisation process is resuming but much still needs to be done to develop effective competition in a number of sectors of the economy

After a slowdown in 2002–03 due to unfavourable world economic conditions and to the lesser attractiveness of the remaining assets, the Polish Treasury has resumed with a more active privatisation policy. Plans have been announced to accelerate the pace of privatisation in 2005 (*inter alia*, in the electricity, oil and gas sectors), although the strategy of restructuring, i.e. merging State-owned firms and consolidating the sectors (steel, mining and energy sectors) before sale, slows down the process. Energy prices are still regulated by the State. As regards telecommunications and in accordance with the EU regulations, the telecommunications law amendment continued the process of increasing competition, which should result in a fall in prices. Similarly, Poland has taken the necessary steps to comply with the EU *acquis* as regards postal services and competition is increasing in the courier service market.

19.5. Business dynamism

The legislative steps are taken … but the implementation is considerably delayed

The law on freedom of economic activity was adopted on 2 July 2004. The law should, among other things, reduce the administrative burden for business (simplified registration, reducing the number of licences, decreasing controls) and introduce the provision on binding interpretation of the law (from January 2005). The amendment of the law on the national criminal register should also quicken the registration process. However, registration at the one-stop shop will only be possible in 2007. The level of business investment in 2003 was 14.9 %, which was below the EU average. Venture capital is also relatively low. Some remaining barriers still hinder entrepreneurship: *inter alia*, lack of infrastructure, high prices of telecommunications, weak incentive packages in comparison with other EU countries, a relatively high administrative burden, and lack of transparency of the tax system.

Speed up the restructuring of the economy and accelerate privatisation in industry

Under this challenge, Poland was requested to:

8. reduce the overall level of State aids, whilst reorienting aid towards horizontal objectives (GLs 9 and 14);

9. encourage market entry and effective competition in network industries while pursuing a greater connectivity of national markets (GL 9).

Strengthen the development of effective competition in some sectors

Under this challenge, Poland was requested to:

10. continue to reduce administrative burden, simplify regulation and support the growth of SMEs, in particular, by improving access to finance (GL 11).

Table 19.1

Economic indicators for Poland

	Poland				EU-25			
	2001	2002	2003	2004	2001	2002	2003	2004
General economic background								
Real GDP growth (1)	1.0	1.4	3.8	5.8	1.8	1.1	1.0	2.5
Inflation (2)	5.3	1.9	0.7	3.5	2.5	2.1	1.9	2.2
Labour productivity growth (3)	1.7	3.7	5.0	6.0	0.8	0.9	0.9	2.1
Employment growth (1)	– 0.6	– 2.2	– 1.2	– 0.2	1.0	0.3	0.3	0.4
Nominal wage growth (4)	13.3	2.0	5.0	4.7	4.0	3.2	3.1	3.0
Current account (5)	– 2.9	– 2.6	– 2.2	– 2.6	:	:	:	:
Unemployment (6)	18.5	19.8	19.2	19.0	8.5	8.9	9.1	9.1
Public finances								
General government balance (5)	– 3.1	– 3.6	– 3.9	– 5.6	– 1.2	– 2.3	– 2.8	– 2.8
Primary balance (5)	– 0.8	– 0.7	– 0.8	– 2.5	2.4	1.0	0.3	0.2
Cyclically adjusted balance (5)	:	:	:	:	:	:	:	:
Gross government debt (5)	36.7	41.1	45.4	47.7	62.1	61.6	63.2	63.5
Employment								
Employment rate (7)	53.4	51.5	51.2	:	62.8	62.9	63.0	:
Female employment rate (8)	47.7	46.2	46.0	:	54.3	54.7	55.1	:
Employment rate for older workers (9)	27.4	26.1	26.9	:	37.4	38.8	40.2	:
Long-term unemployment (10)	9.3	10.8	10.7	:	3.8	3.9	4.0	:
Tax rate on low wage earners (11)	41.4	41.6	41.6	:	37.2	37.1	37.4	:
Unemployment trap indicator (12)	77.4	75.1	73.8	:	78.8	78.5	78.3	:
Product market reforms								
Hourly labour productivity (13)	:	:	:	:	:	:	:	:
Total trade to GDP ratio (14)	29.5	31.3	35.6	:	:	58.8	57.2	:
Internal market directives (15)	:	:	:	96.8	:	:	:	96.3
Business investment (16)	17.2	15.4	14.9	:	17.9	17.2	16.8	:
Knowledge-based economy								
Total tertiary graduates (17)	71.1	74.5	:	:	46.8	:	:	:
Spending on human resources (18)	5.6	5.4	:	:	5.1	:	:	:
R & D expenditure (19)	0.6	0.6	0.6	:	1.9	1.9	:	:
Expenditure on IT (20)	1.6	1.8	2.5	2.8	3.1	2.9	2.9	2.9

(1) Growth rate in per cent.
(2) Annual average rate of change in harmonised index of consumer prices in per cent.
(3) Growth rate of real GDP per occupied person in per cent.
(4) Growth rate of compensation per employee.
(5) As a percentage of GDP.
(6) Number of unemployed as a percentage of the labour force.
(7) Employed persons aged 15–64 as a share of the total population of the same age group.
(8) Employed women aged 15–64 as a share of the total female population of the same age group.
(9) Employed persons aged 55–64 as a share of the total population of the same age group.
(10) Long-term unemployed (over 12 months) as a percentage of the total active population aged 15–64.
(11) Income tax plus employer/employee contributions as a percentage of labour costs of a single earner at 67 % of the average production worker wage, no children.
(12) Effective tax rate on labour income taking into account the combined effect of increased taxes and benefits withdrawal as an individual moves from unemployment back to work earning 67 % of the average production worker wage, measured at the first month of unemployment (after any 'waiting period' if applicable).
(13) GDP per hour worked in PPS, EU-15 = 100.
(14) Percentage, average value of imports and exports of goods and services divided by GDP, multiplied by 100; for DE, ES, FR, IT, PL and the UK, the value for the EU-25 is the total for the large Member States; for all the other States, the value for the EU-25 is the total for the small Member States.
(15) Percentage implemented in November 2004.
(16) Gross fixed capital formation by the private sector as a percentage of GDP.
(17) Total tertiary graduates (ISCED 5–6) per 1 000 of population aged 20–29.
(18) Public expenditure on education as a percentage of GDP.
(19) GERD — gross domestic expenditure on R & D as a percentage of GDP.
(20) Expenditure on information technology as a percentage of GDP.

Source: Commission services (including Eurostat, structural indicators). The data for 'general economic background' and 'public finance' are taken from the Commission's autumn 2004 economic forecasts.

20. Portugal

The economic downturn in Portugal bottomed out in 2003, when real GDP fell by 1.2 %. In 2004, the economy picked up, growing by close to 1 %. In 2005, growth is set to come closer to the euro-area average, after having lagged behind for three years. The turnaround in both private consumption and investment was the main driver of the recovery in 2004, although export growth was also surprisingly on the positive side. Budgetary consolidation has been the core concern of Portuguese economic policy since 2002. In order to avoid an overly restrictive stance during the recession, the government relied strongly on revenues from one-off measures to keep the general government deficit below the 3 % of GDP ceiling. These measures, which in 2004 amounted to 2.2 % of GDP, are to be gradually phased out as soon as the structural reforms that are currently being implemented start yielding the expected expenditure savings. Portugal has been reforming its health system and the pension scheme for government workers in order to ensure the long-term sustainability of public finances in the face of the expected population ageing. The 2004 productivity and business dynamism policy developments in Portugal were to a large extent the continuation of initiatives of previous years, reflecting the fact that the electoral mandate was entering its second half. Efforts have continued, particularly in terms of network industries' liberalisation and promotion of education. The deep-rooted nature of the problems Portugal has to overcome, particularly in terms of low human capital endowments and low labour productivity per hour, have to be taken into account when assessing policy results. Nevertheless, worries remain about the general efficiency of the education system. A detailed assessment of recent developments in addressing Portugal's key policy challenges is presented in the following sections.

20.1. Public finances

One-off measures have once again kept the general government deficit below 3 % of GDP

After a general government deficit of 2.8 % of GDP in 2003, Portugal benefited in May 2004 from an abrogation of the excessive deficit procedure that had been launched in November 2002. The general government deficit amounted to 2.9 % of GDP in 2004. In both 2003 and 2004, deficit figures below 3 % of GDP were achieved through the raising of sizeable revenues from one-off operations, worth 2.5 and 2.2 % of GDP, respectively. Therefore, the underlying deficits were 5.3 % of GDP in 2003 and 5.1 % in 2004. In 2003, the recession caused a massive shortfall in tax revenue. In 2004, fiscal revenues were above expectations amid a stronger-than-expected internal demand recovery; however, a slippage on public expenditures hindered a stronger budgetary improvement. Since without further measures the deficit would have clearly exceeded 3 % of GDP, the Portuguese government introduced one-off operations in the course of 2004: the transfer to the general government sector of pension liabilities for four State-owned enterprises, which raised proceeds equal to 2.2 % of GDP.

The cyclically adjusted headline deficit remained unchanged at 1.9 % of (actual) GDP in 2004. However, taking into account the lower revenues from one-off measures, the 'underlying' cyclically adjusted deficit is estimated to have fallen from 4.4 % of GDP in 2003 to 4.1 % in 2004. Despite this improvement, Portugal has made only limited progress with regard to the recommendation that called for a further improvement in the cyclically adjusted budget balance towards a position close to balance. The replacement of one-off operations by measures of a more permanent character is not proceeding as fast as desirable for consolidation of public finances in the medium term. In the light of the Portuguese authorities' 2005 budget and the Commission's autumn 2004 economic forecasts, continued strong reliance on revenues from one-off measures will be needed in order to keep the deficit below 3 % of GDP in 2005.

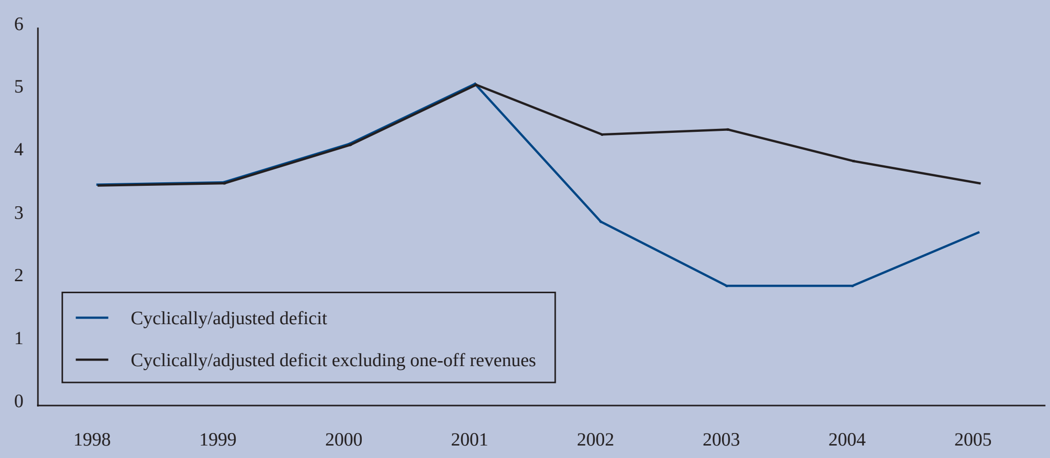
Current primary expenditure growing more strongly than expected …

After a deceleration in the annual growth rate of current primary expenditure from 7.3 % in 2002 to 4.2 % in 2003, no further improvement was achieved in 2004.

Accelerate the consolidation of public finances and address the strong dynamics of government expenditure	**Assessment**
Under this challenge, Portugal was requested to:	
1. take appropriate measures to avoid that the deficit breaches the 3 % of GDP reference value again; move towards achieving a medium-term close to balance or in surplus position by ensuring an improvement in the cyclically adjusted budget balance of at least 0.5 % of GDP per year, replacing one-off measures by measures of a more permanent character (GL 1);	Limited
2. ensure that the deficit reduction is obtained mainly through the expenditure side by firmly executing budgetary plans for all subsectors of general government (GL 14);	Insufficient
3. undertake structural reforms in areas with a more direct impact on budgetary consolidation, notably in public administration, education, healthcare, and social security.	In progress

Bearing in mind the three-year period available for implementation, the degree of implementation since 2003 is indicated as: ‘Complete’ for (practically) complete; ‘In progress’ where progress is well advanced; ‘Limited’ where the recommendation is only partially addressed; and ‘Insufficient’ where no substantial measures going in the right direction have been taken.

Graph 20.1: **Cyclically adjusted balance and one-off revenues (in % of GDP)**



Source: Commission services.

Against a targeted increase of 3.1 % in the budget for 2004, current primary expenditure is estimated to have gone up by around 5 %, largely due to slippages on health and old-age pension expenditures.

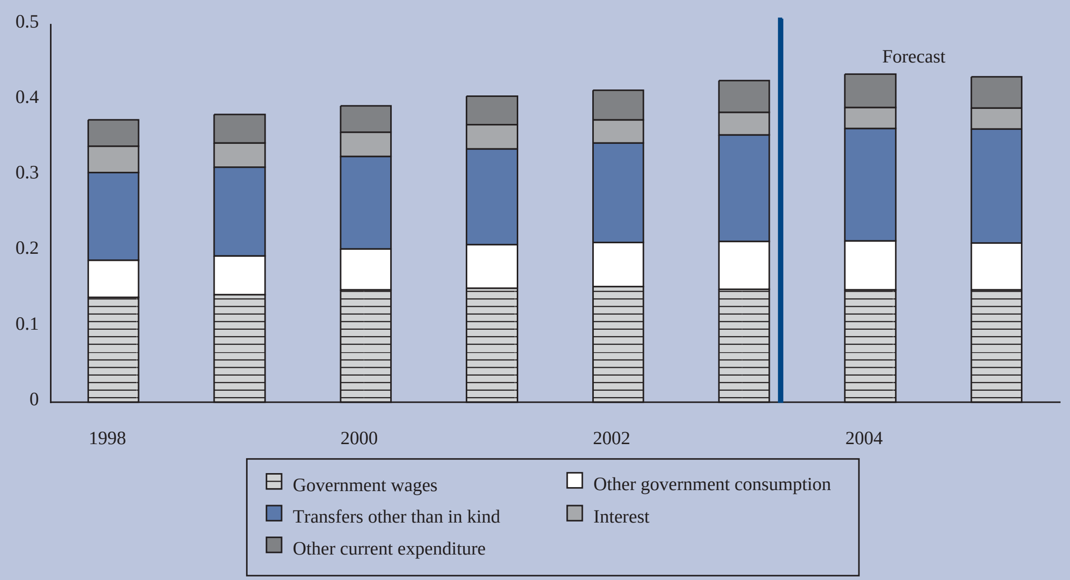
For 2005, the Portuguese authorities envisage some moderation in current expenditure growth. However, such expectation may turn out to be too optimistic, in particular with regard to direct transfers to families, of which expenditure on old-age pensions represents nearly half. The forces behind the expansion of pension expenditure remain strong: first, the phased convergence of pensions to the minimum wage; second, the ongoing population ageing; and, third, the maturing of pension schemes, which is reflected in higher average replacement ratios for new pensioners due to longer working careers. All in all, expenditure on pensions is projected to grow above nominal GDP and unless a strong decrease in unemployment benefits occurs, due to a stronger-than-expected recovery of the labour market, so will social transfers overall.

In 2004, the budgetary execution revealed expenditure levels in excess of the budgetary targets in the various subsectors of general government. The expenditure slippage was particularly notorious in the 'State' subsector, which has thus jeopardised a further deficit reduction. The situation of the 'social security' subsector was characterised by a significant reduction in the surplus, while, despite the slippages, the subsectors 'local and regional government' and 'autonomous funds and services' likely moved from deficits to, respectively, situations of close to balance or in surplus.

… and the effects of structural reforms still to materialise

The programme of structural reforms extends over several important policy areas, including all those with significant budgetary impact, such as public administration, education, healthcare, and old-age pension schemes. These reforms aim at supporting the process of budgetary consolidation by moderating public expenditure growth to a sustainable path, and enhancing the growth potential of the economy. The major steps had already been launched in late 2002 and 2003, and 2004 was mainly a year of fine-tuning the implementation of some measures or extending the coverage of others, such as the restructuring of the primary-school network. Building also on the review of the 2004 implementation report, there is evidence that the implementation of reforms has proceeded broadly in line with plans. Since most of the measures concerned have lagged effects, the evidence of their effects on public sector efficiency and on the budget is still somewhat limited for a comprehensive assessment. Moreover, the Portuguese authorities have recently restated their commitment to proceed as planned with the ongoing reforms for the year 2005.

Graph 20.2: **Current expenditure developments (in % of GDP)**



Source: Commission services.

20.2. Productivity and business dynamism

The strategy initiated last year to encourage the transition towards a knowledge-based society has continued to be implemented …

Portugal is below the EU average in terms of business R & D, patents and the take-up of ICT. Therefore, fostering innovation and technological diffusion has continued to be a priority for the government. A new science and innovation action plan is due to be implemented soon. Its main guidelines are to continue to foster public investment in R & D, increase training investment in science and technology while promoting scientific employment, and reinforce the fiscal incentives for private R & D and support for start-ups of innovative enterprises. Further support will be given for cooperation projects between the business sector and R & D institutions aiming to disseminate innovation throughout the corporate sector.

The promotion of IT use through the Portuguese information society strategy is starting to show visible results. Access to the Internet has been consistently rising and the broadband penetration rate almost doubled between 2003 and 2004 (but from a low level). Additional public administration initiatives have contributed to the diffusion of IT such as the citizen's portal launched in 2004 to provide electronic access to various public services. The adoption of IT-based practices by the business community has been promoted by the transposition into national law of the EU directive that regulates electronic commerce. Legislative reforms have also been implemented to allow and regulate the use of electronic documents.

… but human capital endowment remains very low

While there has been substantial progress in terms of increasing the number of graduate and postgraduate students, important human capital insufficiencies remain, hindering the transition to a knowledge-based society. Educational attainment levels are still the lowest amongst the EU Member States with the exception of Malta. The efficiency of the education policy remains a concern. While Portugal has consistently spent higher shares of GDP on education than the EU average, the percentage of early school-leavers was still the second highest in the EU. Reforms to the education system have continued to be implemented to modernise curricula and promote the use of IT and vocational education. A new plan for the prevention of school dropout has been launched to cut early school-leaving by half by 2010. The strategy includes the adoption of innovative education training projects as well as initiatives such as the setting-up of social support centres at schools to address the needs of disadvantaged students. In order to increase the fraction of the population involved in lifelong learning (still among the lowest in the EU), a new Vocational

Increase overall competitiveness, which is at risk from the low efficiency of the education system, low R & D spending, a low degree of competition in certain sectors, and high nominal wage growth	**Assessment**
Under this challenge, Portugal was requested to:	
4. promote the stronger involvement of the business sector in R & D spending and innovation (GL 13), together with higher ICT take-up;	In progress
5. improve the efficiency of spending in education with a view to, *inter alia*, raising the qualification of human resources (GL 13), and reducing substantially the number of early school-leavers with insufficient levels of schooling or training;	Limited
6. enhance effective competition in liberalised utilities, especially in the energy sector, and create a better competitive environment by increasing the transposition rate of internal market directives (GL 9);	Limited
7. encourage the social partners to secure wage moderation, while allowing wage increases to take into account productivity and skill differentials, with a view to improving competitiveness (GLs 3 and 5).	Limited

Training Bill was proposed by the Council of Ministers in 2004 to establish the legal framework for vocational training and set up the national vocational training system. This structure would create a national inventory of skills to better adjust the training supply to the needs of the population and employers.

Some competition-enhancing reforms have been taken in liberalised utilities but effective competition is not yet secured

In telecommunications, where the incumbent firm still largely dominates, further competition-enhancing reforms have been enforced by the regulator, such as facilitating number portability. In the energy sector, fuel prices were liberalised in January 2004. The competition authority has recently advised the government to reduce barriers to entry in the sector, particularly by facilitating hypermarket firms' expansion of their networks of petrol distribution outlets. In the electricity sector, eligibility to freely choose the electricity supplier has been extended to all consumers from August 2004. However, prices of electricity and gas remain higher than the EU average. This could be offset with the creation of the Iberian electricity market (MIBEL) that the Portuguese and the Spanish governments announced for June 2005. The two governments are committed to tackling the issues that are holding back this process, namely the harmonisation of regulation and tariffs and the improvement of network connections between the two countries.

Efforts have continued to improve the business environment

The time necessary to set up a new business was shortened as the expansion of business formalities centres continued, while the formalities for winding up companies were simplified and made more efficient with the reform of the bankruptcy law. In March 2004, a new commercial licensing regime was adopted to liberalise and simplify the requirements for granting licences for opening new shops. The basic rate for corporate income tax was reduced and a tax deduction for investment in equipment and R & D was introduced in January 2004. However, the rate of transposition of internal market directives remains far from the objective and has decreased to 96.6 %.

Wages growing at a slower pace

Portugal has not changed its wage bargaining mechanisms towards ensuring that wages better reflect productivity and skill differentials. Wage developments over the last two years have been strongly influenced by the economic recession and the ensuing jump in unemployment. Government sector wages were nearly frozen in 2003 and 2004, while private sector wage increases slowed substantially from 2002 to 2003. The lagged effects of the downturn in 2003 helped to keep wage growth low throughout 2004. The end of the quasi-freeze of wages in the government sector in 2005, with nominal wage gains set to exceed 2 %, is likely to exert upward pressure in the private sector as well. However, the sizeable negative output gap should help to contain such pressure.

The implementation of a new labour code was finalised in mid-2004, replacing the previous different pieces of labour legislation by a single text. It is expected to enhance labour market adaptability, in particular by allowing for greater flexibility for some work arrangements. Changes in the sickness benefit scheme eliminated inconsistencies in the earlier provisions that provided disincentives for taking up work.

20.3. Long-term sustainability of public finances

The reform in the health sector is proceeding as planned

As reviewed in the 2004 implementation report, Portugal launched in late 2002 the first steps of a major reform of its health sector. The main elements of the ongoing reform are: (i) the incorporation of public hospitals into State-owned enterprises — the units incorporated so far represent about a quarter of the Portuguese health system; (ii) a clear separation between financing and provision of healthcare; (iii) changes in the compensation to hospitals for medical services, with a move from coverage of operational losses to payments according to the services provided; (iv) changes of policy on medication, involving the promotion of generic drugs and the setting of ceilings for the reimbursement of drugs aligned with reference prices; and (v) higher fees for medical treatment.

In 2004, the implementation of the reform continued broadly in line with plans. An increase in services rendered by the incorporated hospitals was noticeable in 2004. However, at this stage, a comprehensive assessment of the efficiency and budgetary impact of these measures faces two constraints: changes in accounting procedures from a cash to an accruals basis; and the short

Ensure the long-term sustainability of public finances in the face of population ageing	Assessment
Under this challenge, Portugal was requested to:	
8. increase the efficiency of the healthcare system by introducing a wide range of measures that strengthen market mechanisms and rationalise demand (GL 14);	In progress
9. adopt further reforms to the pension system for workers in the general government sector to secure its long-term sustainability and in order to progressively align it with the pension regime for private sector workers (GL 16).	In progress

period of observation and hence the difficulty of disentangling the effects of the ongoing reform process from changes in demand directed to the incorporated units, or changes in waiting time for surgery. In 2005, a holding-type company will be set up to centralise the management of all incorporated hospitals, a measure that is expected to allow for better coordination between units and dissemination of best practices, and, consequently, to enhance efficiency and cost savings. It is also intended to reinforce the policy on the use of generic drugs.

The effects of the reform of pension schemes will be lagged

In January 2004, changes to the rules governing the retirement and the assessment of pension rights of civil servants came into force. Withdrawal from active service before the official retirement age of 60 years has become more costly, even for those individuals with a 'complete' working career (36 years). New pensioners' benefits have been lowered by basing the assessment of the reference pension on wages net of social contributions rather than on gross wages. As already mentioned in the 2004 implementation report, the pension system for workers in the government sector is closed for those joining the civil service as from September 1993, who will be covered by the general pension scheme, which is less generous when compared with the government workers' pension arrangement.

The measures introduced will ease the upward pressure on pension expenditure, although this effect on the long-term sustainability of public finances may to some extent be offset by the trend increase in life expectancy and the implicit extension of average benefit periods.

Table 20.1

Economic indicators for Portugal

	Portugal				EU-25			
	2001	2002	2003	2004	2001	2002	2003	2004
General economic background								
Real GDP growth (1)	1.6	0.4	– 1.2	1.3	1.8	1.1	1.0	2.5
Inflation (2)	4.4	3.7	3.3	2.4	2.5	2.1	1.9	2.2
Labour productivity growth (3)	0.3	0.1	– 0.8	0.9	0.8	0.9	0.9	2.1
Employment growth (1)	1.3	0.3	– 0.4	0.4	1.0	0.3	0.3	0.4
Nominal wage growth (4)	5.7	4.4	4.1	3.1	4.0	3.2	3.1	3.0
Current account (5)	– 10.1	– 7.8	– 5.7		:	:	:	:
Unemployment (6)	4.0	5.0	6.3	6.3	8.5	8.9	9.1	9.1
Public finances								
General government balance (5)	– 4.4	– 2.7	– 2.8	– 2.9	– 1.2	– 2.3	– 2.8	– 2.8
Primary balance (5)	– 1.2	0.3	0.1	– 0.2	2.4	1.0	0.3	0.2
Cyclically adjusted balance (5)	– 5.1	– 2.9	– 1.9	– 1.9	:	:	:	:
Gross government debt (5)	55.8	58.4	60.3	60.8	62.1	61.6	63.2	63.5
Employment								
Employment rate (7)	69.0	68.8	68.1	:	62.8	62.9	63.0	:
Female employment rate (8)	61.3	61.4	61.4	:	54.3	54.7	55.1	:
Employment rate for older workers (9)	50.2	51.4	51.6	:	37.4	38.8	40.2	:
Long-term unemployment (10)	1.5	1.7	2.2	:	3.8	3.9	4.0	:
Tax rate on low wage earners (11)	29.5	29.6	29.6	:	37.2	37.1	37.4	:
Unemployment trap indicator (12)	87.7	87.0	86.6	:	78.8	78.5	78.3	:
Product market reforms								
Hourly labour productivity (13)	59.0	59.0	58.1	:	:	:	:	:
Total trade to GDP ratio (14)	35.8	34.0	33.5	:	:	58.8	57.2	:
Internal market directives (15)	97.5	96.9	97.8	96.6	:	:	:	96.3
Business investment (16)	23.2	21.7	19.1	:	17.9	17.2	16.8	:
Knowledge-based economy								
Total tertiary graduates (17)	37.9	40.3	:	:	46.8	:	:	:
Spending on human resources (18)	5.9	5.8	:	:	5.1	:	:	:
R & D expenditure (19)	0.9	0.8	0.8	:	1.9	1.9	:	:
Expenditure on IT (20)	2.2	1.9	2.0	2.0	3.1	2.9	2.9	2.9

(1) Growth rate in per cent.
(2) Annual average rate of change in harmonised index of consumer prices in per cent.
(3) Growth rate of real GDP per occupied person in per cent.
(4) Growth rate of compensation per employee.
(5) As a percentage of GDP.
(6) Number of unemployed as a percentage of the labour force.
(7) Employed persons aged 15–64 as a share of the total population of the same age group.
(8) Employed women aged 15–64 as a share of the total female population of the same age group.
(9) Employed persons aged 55–64 as a share of the total population of the same age group.
(10) Long-term unemployed (over 12 months) as a percentage of the total active population aged 15–64.
(11) Income tax plus employer/employee contributions as a percentage of labour costs of a single earner at 67 % of the average production worker wage, no children.
(12) Effective tax rate on labour income taking into account the combined effect of increased taxes and benefits withdrawal as an individual moves from unemployment back to work earning 67 % of the average production worker wage, measured at the first month of unemployment (after any ‘waiting period’ if applicable).
(13) GDP per hour worked in PPS, EU-15 = 100.
(14) Percentage, average value of imports and exports of goods and services divided by GDP, multiplied by 100; for DE, ES, FR, IT, PL and the UK, the value for the EU-25 is the total for the large Member States; for all the other States, the value for the EU-25 is the total for the small Member States.
(15) Percentage implemented in November 2004.
(16) Gross fixed capital formation by the private sector as a percentage of GDP.
(17) Total tertiary graduates (ISCED 5–6) per 1 000 of population aged 20–29.
(18) Public expenditure on education as a percentage of GDP.
(19) GERD — gross domestic expenditure on R & D as a percentage of GDP.
(20) Expenditure on information technology as a percentage of GDP.

Source: Commission services (including Eurostat, structural indicators). The data for ‘general economic background’ and ‘public finance’ are taken from the Commission’s autumn 2004 economic forecasts.

21. Slovenia

In 2004, the Slovenian economy rebounded as exports expanded vigorously due to the recovery in the EU, the main trade area for Slovenia. The prospects for good performance to endure over the medium term are solid. However, should the international environment fail to buoy adequate demand, economic activity might become strained due to the structural weaknesses as spelled out in the country-specific challenges. Structural adjustments are deemed essential to assure the long-term sustainability of the disinflation process, which has been identified as a policy priority, mobilising the government's principal efforts in 2004. It appears as though inflation remains well above the EU average due to structural imperfections, particularly in the non-tradable sector. Furthermore, structural rigidities generate labour market shortcomings, confirmed by slow progress in creating jobs despite some measures taken to facilitate the participation of groups furthest from the labour market, such as older workers and the long-term unemployed. The implementation of the reform programme, involving privatisation, liberalisation and production capacity restructuring, is limited. Slovenia has completed a number of reforms to promote entrepreneurship. Significant liberalisation has occurred in the network industries; however, State-owned incumbents continue to dominate. The latest figures show that in 2003 FDI inflows were equal to 0.6 % of GDP, one of the lowest rates in the EU. A detailed assessment of recent developments in addressing Slovenia's key policy challenges is presented in the following sections.

21.1. Inflation

Inflation has declined impressively but the sustainability of the disinflation process should be closely monitored

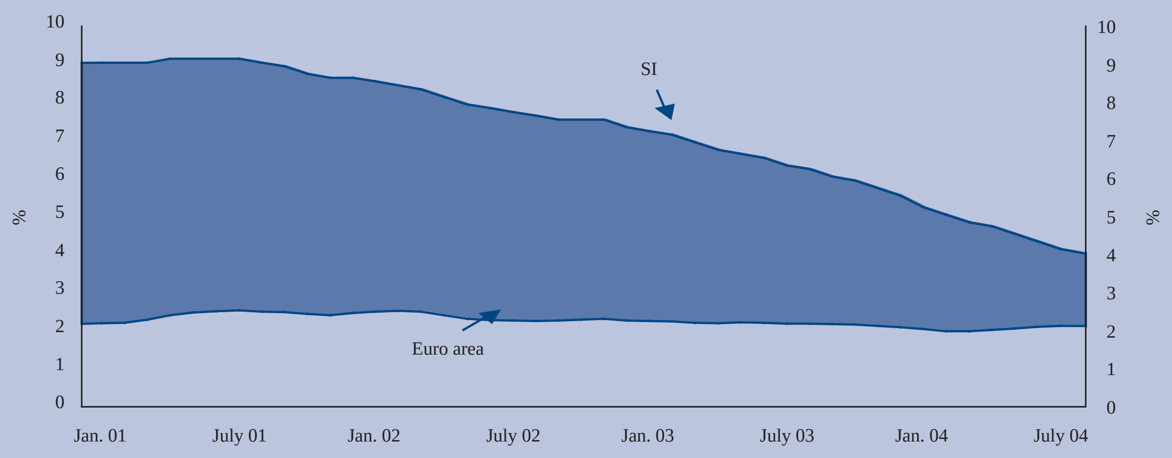
Helped mostly by the concerted policy action of the government and the national central bank, inflation continued to decrease rapidly in 2004. While the annual increase in consumer prices averaged 5.7 % in 2003, in November, the 12-month moving average of consumer price inflation stood at 3.8 %. The government regulated administered price rises and indirect tax changes in such a way as not to exceed the targeted inflation rate. Moreover, it applied frequent adjustments of excise duties on oil to temper the impact of world market price fluctuations. In pursuing the objective of dispensing with backward-looking wage indexation schemes, further progress was made in May 2004, when a new wage agreement was concluded in the private sector. Based on expected rather than actual inflation, it mirrors the adjustment method for public sector wages, negotiated in July 2003, to take effect in 2004–05. The Bank of Slovenia contributed to the disinflation through monetary policy geared to slowing the depreciation of the currency. On 28 June, upon entering ERM II, the central parity rate was fixed at SIT 239.64 per EUR 1 within a +/– 15 % fluctuation band. A coordination of anti-inflationary policy measures has led to the sustained lowering of inflation, nevertheless, it remains substantially above the euro-area levels.

Strengthen the sustainability of the disinflation process

Under this challenge, Slovenia was requested to:

1. step up structural reforms aimed at liberalising administered prices and advance further with de-indexation, in particular of the wage setting mechanism (GL 5).

Graph 21.1: **Twelve-month average HICP inflation**



Source: Commission services.

Admittedly, it is not unacceptable that inflation in Slovenia would stay somewhat higher than the EU average in the next few years as long as Slovenia's productivity growth on average outstrips productivity gains in the EU (the so-called Balassa–Samuelson effect). However, inflationary pressures persist due to structural rigidities. Liberalisation of the network industries is ongoing but some utilities still operate in ineffective competition conditions, wherein prices stay under different regimes of regulation. While containing price increases resulting from monopolistic behaviour in utilities such as electricity and gas would make sense, the extension of the list of regulated prices as of March 2004 could be perceived as a reduction in the commitment towards price liberalisation and competitiveness. Furthermore, part of the disinflation came about due to the lowering of indirect taxes, which affect headline inflation but have a limited impact on underlying inflation. Only if disinflation is accompanied by a removal of structural rigidities can it be sustainable in the long run.

21.2. Labour market

Labour market reform proceeds in 2004 with important elements of the reform pending

With a recent economic slowdown impinging on Slovenia's labour market, employment fell while unemployment increased. The authorities aimed to reduce labour costs by adapting the tax system. In September, the amended Act on the Payroll Tax entered into force, raising the minimum threshold for payment of tax. Furthermore, certain provisions with respect to structural shortcomings, such as the low employment levels of older workers and the large share of long-term unemployment

Increase employment rates, especially for older workers

Under this challenge, Slovenia was requested to:

2. review the tax and benefit systems, with a focus on labour market participation of older workers, and reassess the measures promoting active ageing by means of lifelong learning activities, as well as address the imbalance between temporary and permanent work conditions (GLs 4 and 8).

have been adopted. The measures are channelled through the tax system in such a way as to give employers the incentive to hire people furthest from the labour market. Employers have been awarded an exemption from paying social contributions for employing a worker aged over 55 years and are now granted a lump-sum subsidy when a long-term unemployed person is taken on. While some activities have been launched to facilitate access to lifelong learning, they would need to be embedded in a comprehensive active ageing strategy, including financial incentives and flexible working arrangements, to assure that the retirement age will increase notably. As regards the invitation to address the imbalance between temporary and permanent work conditions to avoid segmentation of the labour market, threatening also young workers, especially first-time job-seekers, no measures were taken in 2004.

21.3. Productivity and business dynamism

Some progress has been made to facilitate the creation of new businesses

During 2004 Slovenia took positive steps to reduce the administrative barriers facing new businesses. These included passing two acts of Parliament (the Act on the Support Environment for Entrepreneurship, and the Act on Revisions and Amendments to the Small Business Act) and the partial completion of the one-stop shop service for small businesses. The effect of the Act on the Support Environment for Entrepreneurship will be to strengthen the support network that exists to provide help and advice for entrepreneurs. The Act on Revisions and Amendments to the Small Business Act is designed to simplify the procedure for small businesses wishing to get the necessary licence to enter a particular market. The information and business support elements of the one-stop shop system, which are already in place, allow small businesses to exchange information and to receive support and advice via a subsidised advisory system. Implementation has begun on the third element of the one-stop shop system, which will allow the registration of a business to be carried out within 14 days. Other regulatory decrees, designed to eliminate unnecessary administrative barriers for small businesses are being drafted but have not yet been implemented. On a less positive note, many small and medium-sized enterprises face problems getting access to capital from banks.

Positive steps have been taken to encourage businesses to invest in R & D

At 1.5 % of GDP in 2003, Slovenia already has the highest R & D spending of the new Member States; 60 % of this comes from industry. In order to further encourage business R & D spending, the Slovenian government passed in 2004 an act of Parliament which grants tax incentives to companies investing in new equipment, with stronger incentives for those investing in equipment for research and technological development. The act also gives substantial tax relief to companies who hire Ph.D. graduates. This measure directly incentivises companies to hire highly qualified staff with backgrounds in research and may also indirectly incentivise more people to study for Ph.D.s. Furthermore, 2004 saw the adoption of a decision to finance the establishment of eight or nine centres of excellence, co-financed by EU Structural Funds, which are intended to provide links between research institutions and industry. These links, combined with a focus on applied research, are important if returns on R & D expenditure are to be realised in terms of new products and services. In order to improve the quality of tertiary education, two new laws were adopted in 2004, one on higher education and one on post-secondary education. These form part of Slovenia's efforts within the framework of the Bologna and Bruges–Copenhagen processes on tertiary education and training.

Improve conditions for sustained productivity growth

Under this challenge, Slovenia was requested to:

3. further reduce the time and costs necessary to set up a new company and simplify the administrative procedures affecting businesses (GL 11);

4. promote R & D and innovation in the business sector and improve the quality of the tertiary-level education system (GL 13).

21.4. Competition

The Competition Protection Office is still understaffed

The Competition Protection Office (CPO) currently has 18 employees. There are plans to increase the staff to at least 37 but there is no clear timescale for the planned increases. Fines for anticompetitive behaviour are currently set by the courts, on the basis of a written proposal by the CPO. A new act, which has yet to be enacted, will confer direct responsibility for issuing fines on the CPO. The level of fines will increase under the new act but they will remain well below the deterrent-level fines that can be set in some other Member States.

Liberalisation of the network industries continues but at a different intensity across sectors

Progress is being made in liberalising all the main network industries, although some are far more advanced than others. In the telecommunications sector, only the fixed-line segment continues to lack competition, and even there a number of competitors to the incumbent have acquired operator licences although they have not yet entered the market. The proposed privatisation of the incumbent telecommunications operator has been delayed due to unfavourable market conditions. The legal unbundling of the transport system operators in electricity and gas represents a significant step towards increased competition although the distribution system operators are still currently unbundled only through separate accounting. Also, the May 2004 amendment to the Energy Act, which allows non-household users to choose their electricity supplier, should increase competition and may lead to lower prices.

Limited progress is being made on facilitating the purchase of land for industrial use

In 2004, Slovenia started to use the EU Structural Fund co-financed subsidies for the renovation, modernisation and development of public and utility infrastructure. The aim is that redeveloped land and infrastructure will increase the supply of land for industrial use. Public tendering of real estate is the first stage in a long process and the benefits in terms of greater inward FDI are likely to still be some way off.

Promote the development of effective competition in all segments of the economy, notably in network industries

Under this challenge, Slovenia was requested to:

5. strengthen the administrative capacity of the Competition Protection Office, ease the entry of new competitors in network industries, and facilitate the purchase of land for industrial use (GL 9).

Table 21.1

Economic indicators for Slovenia

	Slovenia				EU-25			
	2001	2002	2003	2004	2001	2002	2003	2004
General economic background								
Real GDP growth (1)	2.7	3.3	2.5	4.0	1.8	1.1	1.0	2.5
Inflation (2)	8.6	7.5	5.7	3.9	2.5	2.1	1.9	2.2
Labour productivity growth (3)	2.2	3.7	2.8	3.8	0.8	0.9	0.9	2.1
Employment growth (1)	0.5	– 0.4	– 0.3	0.2	1.0	0.3	0.3	0.4
Nominal wage growth (4)	11.6	10.0	7.8	6.0	4.0	3.2	3.1	3.0
Current account (5)	0.2	1.4	– 0.4	– 0.2	:	:	:	:
Unemployment (6)	5.8	6.1	6.5	6.3	8.5	8.9	9.1	9.1
Public finances								
General government balance (5)	– 2.8	– 2.4	– 2.0	– 2.3	– 1.2	– 2.3	– 2.8	– 2.8
Primary balance (5)	– 0.4	0.0	0.1	– 0.3	2.4	1.0	0.3	0.2
Cyclically adjusted balance (5)	:	:	:	:	:	:	:	:
Gross government debt (5)	28.1	29.5	29.4	30.9	62.1	61.6	63.2	63.5
Employment								
Employment rate (7)	63.8	63.4	62.6	:	62.8	62.9	63.0	:
Female employment rate (8)	58.8	58.6	57.6	:	54.3	54.7	55.1	:
Employment rate for older workers (9)	25.5	24.5	23.5	:	37.4	38.8	40.2	:
Long-term unemployment (10)	3.5	3.4	3.4	:	3.8	3.9	4.0	:
Tax rate on low wage earners (11)	40.3	39.8	40.2	:	37.2	37.1	37.4	:
Unemployment trap indicator (12)	80.5	80.5	80.5	:	78.8	78.5	78.3	:
Product market reforms								
Hourly labour productivity (13)	:	:	:	:	:	:	:	:
Total trade to GDP ratio (14)	58.0	56.9	56.4	:	:	58.8	57.2	:
Internal market directives (15)	:	:	:	96.3	:	:	:	96.3
Business investment (16)	21.5	20.5	21.1	:	17.9	17.2	16.8	:
Knowledge-based economy								
Total tertiary graduates (17)	40.2	47.6	:	:	46.8	:	:	:
Spending on human resources (18)	6.2	6.0	:	:	5.1	:	:	:
R & D expenditure (19)	1.6	1.5	1.5	:	1.9	1.9	:	:
Expenditure on IT (20)	1.8	2.0	2.1	2.2	3.1	2.9	2.9	2.9

(1) Growth rate in per cent.
(2) Annual average rate of change in harmonised index of consumer prices in per cent.
(3) Growth rate of real GDP per occupied person in per cent.
(4) Growth rate of compensation per employee.
(5) As a percentage of GDP.
(6) Number of unemployed as a percentage of the labour force.
(7) Employed persons aged 15–64 as a share of the total population of the same age group.
(8) Employed women aged 15–64 as a share of the total female population of the same age group.
(9) Employed persons aged 55–64 as a share of the total population of the same age group.
(10) Long-term unemployed (over 12 months) as a percentage of the total active population aged 15–64.
(11) Income tax plus employer/employee contributions as a percentage of labour costs of a single earner at 67 % of the average production worker wage, no children.
(12) Effective tax rate on labour income taking into account the combined effect of increased taxes and benefits withdrawal as an individual moves from unemployment back to work earning 67 % of the average production worker wage, measured at the first month of unemployment (after any 'waiting period' if applicable).
(13) GDP per hour worked in PPS, EU-15 = 100.
(14) Percentage, average value of imports and exports of goods and services divided by GDP, multiplied by 100; for DE, ES, FR, IT, PL and the UK, the value for the EU-25 is the total for the large Member States; for all the other States, the value for the EU-25 is the total for the small Member States.
(15) Percentage implemented in November 2004.
(16) Gross fixed capital formation by the private sector as a percentage of GDP.
(17) Total tertiary graduates (ISCED 5–6) per 1 000 of population aged 20–29.
(18) Public expenditure on education as a percentage of GDP.
(19) GERD — gross domestic expenditure on R & D as a percentage of GDP.
(20) Expenditure on information technology as a percentage of GDP.

Source: Commission services (including Eurostat, structural indicators). The data for 'general economic background' and 'public finance' are taken from the Commission's autumn 2004 economic forecasts.

22. Slovakia

Slovakia's real GDP growth has increased over recent years and is expected to average close to 5 % over the period 2004–06. Provided that second-round effects are kept in check, rapid disinflation from almost 8 % in 2004 should be possible, as the period of major adjustments in administered prices and indirect taxes basically came to a close. After a remarkable improvement in 2003, Slovakia's current account deficit is anticipated to stay close to 3 % of GDP. Against this favourable macroeconomic background, the government has intensified its actions to address the main economic policy challenges. Public finance reforms have been accelerated since 2003 and contribute to the sustainable reduction of the general government deficit, although the latter remains above the 3 % of GDP Treaty reference value. Efforts to tackle the structural shortcomings in the labour market have been stepped up, but these reforms seem to bear fruit only gradually: according to labour force survey data, the unemployment rate still amounts to around 18 % as economic restructuring, which has been underpinning Slovakia's growth performance, continues. Slovakian labour productivity per person employed stood at 54.1 % of the EU-15 level. In terms of productivity growth, Slovakia has enjoyed rather high rates of around 3.5 % over the last five years which has enabled the country to close the gap somewhat vis-à-vis the EU average. Slovakia has proceeded vigorously with structural reforms and has won the title of 'top reformer' from the World Bank. Despite these efforts, weaknesses in the business environment persist, particularly in terms of law enforcement. Much still remains to be done to speed up the transition to the knowledge-based society. Education reform is only in its first stages and progress on R & D and innovation and transfer of knowledge, despite significant FDI inflows, has been limited. However, to address all these issues, the government has prepared a 'competitiveness strategy for Slovakia until 2010: national Lisbon strategy' for approval in January 2005. Its main objective is to achieve a transition to the knowledge-based society by focusing government policies on four main areas: human resources and education; the information society; the business environment and science; R & D and innovation. A detailed assessment of recent developments in addressing Slovakia's key policy challenges is presented in the following sections.

22.1. Public finances

The deficit reduction path in the convergence programme is adhered to

On 5 July 2004, the Council decided that Slovakia was in excessive deficit and recommended that this be corrected by 2007 at the latest. Specifically, Slovakia was required to implement with vigour the measures envisaged in the May 2004 convergence programme, in particular those related to the proposed further healthcare reforms and public sector rationalisation. Slovakia was also required to accelerate the fiscal adjustment if the implemented structural reforms result in higher growth than expected.

Ensure a further reduction of the general government deficit on a sustainable basis

Under this challenge, Slovakia was requested to:

1. reduce the general government deficit in a credible and sustainable way within a multiannual framework in line with the decisions to be taken by the Council in the context of the forthcoming budgetary surveillance exercise (GL 1).

The general government deficit target for 2004 of 4 % of GDP, as communicated in the May 2004 convergence programme, seems to have been reached with a comfortable margin. On the basis of current information, the budget outcome is estimated at 3.9 % of GDP. The budget for 2005 adopted by Parliament in December last year and the associated detailed multiannual budgetary framework for 2005–07 are in line with the deficit reduction path as presented in the May 2004 convergence programme. The deficit target for 2005 is 3.8 % of GDP, which is marginally better than the 3.9 % of GDP in the convergence programme. It is 3.4 % of GDP without the revenue loss stemming from the introduction of a funded pension pillar. For 2006, the deficit target in the budget as well as in the convergence programme is 3.9 % of GDP (including 1 % of GDP resulting from the pension reform).

The 2005 budget incorporates the measures which underpinned the deficit target in the convergence programme, in particular: (i) a systemic pension reform, leading to a redirection of social security contributions to a newly introduced funded pension pillar; (ii) the last tranches of the current government’s healthcare reform agenda; and (iii) further public sector rationalisation. The Commission services’ autumn 2004 economic forecasts confirm that the macroeconomic projections underlying the 2005 budget are broadly plausible. They also confirm that the measures presented in the budget are broadly sufficient to achieve the 2005 deficit target set in the May 2004 convergence programme, although some uncertainties remain on the revenue side, including with respect to VAT revenues, social contributions and the revenue effect of the pension reform.

As regards the recommended acceleration of the fiscal adjustment if the implemented structural reforms result in higher growth than expected in the convergence programme, it seems that the authorities would have had some additional opportunities.

22.2. Labour market

The government has been stepping up its efforts to strengthen labour supply …

After a tightening of unemployment benefit rules in 2003, further reforms in the social area, in particular regarding social assistance, became effective at the beginning of 2004 with a view to enhancing incentives to work and to leave the informal sector. In addition, the public employment services were reformed and joint offices for social and employment services were created to ensure more coherence in the administration of related categories of social benefits and assistance. Specific measures to dismantle obstacles to regional mobility and to reduce skill mismatches are being implemented: regional mobility is strengthened by financial support for commuters, by continued improvements in the transport infrastructure (including public transport) and by housing benefits and measures to improve the functioning of the housing market, which remains the core deficiency in this area. Skill mismatches are being tackled by active labour market policy measures, which were intensified in 2004 and for which an evaluation methodology is under preparation. A reform of the education system is ongoing and encourages a more efficient and effective use of resources, for example through per capita financing of schools.

Continue to address the deep-seated structural problems in the labour market

Under this challenge, Slovakia was requested to:

2. strengthen labour supply by removing obstacles to regional mobility and by reducing skill mismatches, whilst ensuring the efficiency of retraining measures and other active labour market policies (GLs 4, 7 and 8);

3. generate additional labour demand by allowing for more flexibility in the wage setting mechanism (GLs 5 and 18);

4. lower the very high combined health and social contribution rates, while observing the overall budgetary consolidation constraints, in particular by additional health system reform measures and more effort to effective and functioning implementation of the new pension system combined with appropriate control (GLs 4 and 16).

… to generate additional labour demand …

Improvements in the legal environment and the general business climate assist in strengthening incentives for job creation. They comprehend notably the enhanced implementation of a more flexible labour code effective since 2003, and efforts to further facilitate business start-ups and to further improve the judicial system. The government continues to be successful in the acquisition of sizeable foreign investments. Moreover, complementary to the efforts to foster regional mobility among the active population, the government is trying to strengthen the incentives for job creation in particular in regions affected by high unemployment. The direct influence of the government on wage setting is limited to minimum wages, which amounted to about 45 % of the average wage in 2003. Aware of potential disincentive effects, the government does not seem to have any intention of decreasing the gap to the average wage. Furthermore, the government has continued to refrain from using the possibility of extending collective wage agreements to enterprises that have not participated in the negotiations. The government is actively advocating increased flexibility in work and wage arrangements. This and stronger incentives for outsiders to get a job should assist in mobilising pressure in this direction and help to promote greater room for flexibility, notably in collective wage agreements. Altogether, these developments are likely to cater for a more enterprise-specific differentiation in wage setting, although there remains further room for improvement.

… and to create the conditions for an affordable reduction in contribution rates

The introduction of a flat corporate and individual income tax rate of 19 % at the beginning of 2004 is set to motivate both job creation and willingness to work. A similar effect was achieved when social contribution rates payable by employers were reduced by 3 percentage points from 38.2 % of gross wages. Nevertheless, the total health and social contribution rate remains at a very high level of 48 % of gross wages and it remains challenging to make a further reduction affordable. A substantial step in this direction was taken at the beginning of 2005 when a sizeable funded pension pillar (with contributions of 9 % of gross wages) was introduced — a reform that increases the sustainability of the pension system and could, in the medium and long run, make reductions in contributions possible. This systemic pension reform complemented earlier parametric reforms of the pay-as-you-go pillar that were adopted in 2003. They included a rise in the retirement age to 62 for both men and women, which is now successively implemented at a pace of an increase of nine months per year. A further increase to 65 is contemplated, but only for the time after the current BEPG horizon. In the healthcare area, Parliament has passed the last tranches of the government's comprehensive reform package. They became effective at the beginning of 2005 and add to earlier introduced reforms (e.g. co-payments for health services). The more recent reforms strengthen competitive elements, for instance through the reconfiguration of the health insurance system, and provide the basis for a streamlining of the benefit package. The reform measures should help to rein in healthcare costs, thereby strengthening the basis for an eventual, fiscally sound, reduction in health insurance contribution rates. The overarching constraint for reductions in both health and social insurance contributions remains the necessity of a strict adherence to and, if possible, acceleration of the deficit reduction currently envisaged by the authorities.

22.3. Business environment and entrepreneurship

Several measures have been taken to improve the business environment …

There has been significant progress in improving the business environment in Slovakia. In order to do this, the government aimed at enhancing both the legislative framework and its enforceability. As regards the former,

Improve the business environment and support entrepreneurship

Under this challenge, Slovakia was requested to:

5. strengthen the legislative framework supportive to entrepreneurship and improve its enforceability by, in particular, adopting the new bankruptcy legislation and increasing the capacity and transparency of the judicial system (GLs 11 and 12).

the improved operation of the commercial register together with strict time limits for the other procedures required to set up a company have considerably reduced the overall time needed for the whole process.

Further improvements (e.g. online communication with the register, unified forms, one-stop shops for entrepreneurs, online submission of tax declarations, and better transmission of information within the administration) are foreseen. The new bankruptcy legislation, speeding up the bankruptcy procedures and allowing for more effective restructuring of troubled companies, is being discussed in Parliament. The reform of the tax system has led to a decrease in the corporate tax rate. As regards the latter, the government aims at improving the working of the judicial system. In order to speed up the proceedings and reduce the workload for the judges, an institute of court administrators who are responsible for acts of an administrative nature has been established.

… but weaknesses persist and, in particular, weak enforcement remains a problem

However, changes are taking root only slowly. The business sector still considers the efficiency of the judiciary, law enforcement, the level of corruption and bureaucracy as major weaknesses.

22.4. Productivity

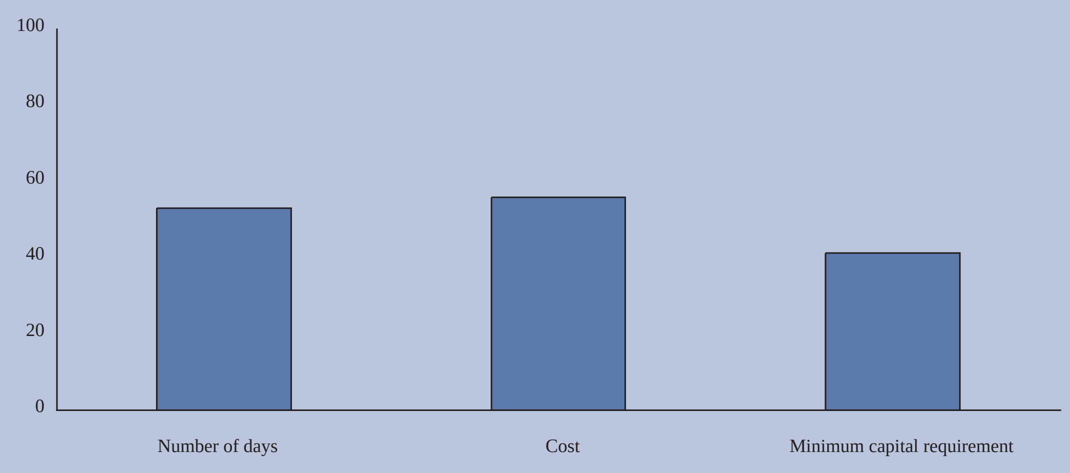
The education reform is in its initial stages …

In order to reform the education system, the measures taken so far aim at increasing the efficiency of the system and improving its financing. However, no significant measures to enhance the quality and increase the responsiveness of the education system to market needs have yet been taken. The government has implemented the first stage of the reform of primary and secondary schooling intended to decentralise, restructure and rationalise the system through changes in financing. However, a major reform including the changes in curricula is only now being prepared. Also, a major reform of tertiary education is outstanding. The Education Bill was rejected by Parliament and will be resubmitted for discussion soon. The major change in the bill is the introduction of tuition fees, which are expected to provide the universities with greater resources and, at the same time, exert pressure to improve the quality of education. The Slovakian authorities expect that this would also induce students to choose specialisations demanded by the market.

… the progress on R & D is slow …

The progress in encouraging R & D activities has so far been limited. The government is planning a reform of

Graph 22.1: **Ease to start a business in Slovakia, 2004 (2003 = 100)**



Source: Commission services.

R & D financing which should create a system based on excellence. Measures to encourage R & D are included in the 'national Lisbon strategy'. Public spending on R & D is very low, but the government foresees some increases in the forthcoming period.

Slovakia has attracted significant inflows of FDI which are expected to contribute to know-how and technology transfer. The major investments target the automotive industry. Technology transfer might be somewhat inhibited by the limited links between the foreign-owned companies and domestic enterprises.

… but information technologies are spreading

The number of households and companies connected to the Internet is increasing quickly and, by the end of 2004, all schools should be connected to the Internet. However, the successful development of information technologies has been hampered by the low level of competition in the telecommunications sector.

Improve conditions for increasing productivity

Under this challenge, Slovakia was requested to:

6. improve the efficiency and quality of the education and training system and its responsiveness to changing skills requirements (GL 13);

7. encourage R & D and innovation and support the transfer of knowledge through FDI (GL 13).

Table 22.1

Economic indicators for Slovakia

	Slovakia				EU-25			
	2001	2002	2003	2004	2001	2002	2003	2004
General economic background								
Real GDP growth (1)	3.8	4.6	4.0	4.9	1.8	1.1	1.0	2.5
Inflation (2)	7.2	3.5	8.5	7.7	2.5	2.1	1.9	2.2
Labour productivity growth (3)	3.2	5.2	2.2	5.0	0.8	0.9	0.9	2.1
Employment growth (1)	0.6	– 0.5	1.7	– 0.1	1.0	0.3	0.3	0.4
Nominal wage growth (4)	6.3	9.3	9.9	9.9	4.0	3.2	3.1	3.0
Current account (5)	– 7.4	– 8.2	– 1.1	– 2.9	:	:	:	:
Unemployment (6)	19.4	18.7	17.5	18.4	8.5	8.9	9.1	9.1
Public finances								
General government balance (5)	– 6.0	– 5.7	– 3.7	– 3.9	– 1.2	– 2.3	– 2.8	– 2.8
Primary balance (5)	– 2.0	– 2.1	– 1.2	– 1.6	2.4	1.0	0.3	0.2
Cyclically adjusted balance (5)	:	:	:	:	:	:	:	:
Gross government debt (5)	48.7	43.3	42.6	44.2	62.1	61.6	63.2	63.5
Employment								
Employment rate (7)	56.8	56.8	57.7	:	62.8	62.9	63.0	:
Female employment rate (8)	51.8	51.4	52.2	:	54.3	54.7	55.1	:
Employment rate for older workers (9)	22.4	22.8	24.6	:	37.4	38.8	40.2	:
Long-term unemployment (10)	11.4	12.2	11.1	:	3.8	3.9	4.0	:
Tax rate on low wage earners (11)	40.4	40.1	40.3	:	37.2	37.1	37.4	:
Unemployment trap indicator (12)	81.0	76.0	73.2	:	78.8	78.5	78.3	:
Product market reforms								
Hourly labour productivity (13)	46.1	50.0	43.7	:	:	:	:	:
Total trade to GDP ratio (14)	77.8	74.3	78.1	:	:	58.8	57.2	:
Internal market directives (15)	:	:	:	93.5	:	:	:	96.3
Business investment (16)	25.7	24.3	23.2	:	17.9	17.2	16.8	:
Knowledge-based economy								
Total tertiary graduates (17)	29.2	30.7	:	:	46.8	:	:	:
Spending on human resources (18)	4.0	:	:	:	5.1	:	:	:
R & D expenditure (19)	0.6	0.6	0.6	:	1.9	1.9	:	:
Expenditure on IT (20)	2.7	2.7	2.5	2.4	3.1	2.9	2.9	2.9

(1) Growth rate in per cent.
(2) Annual average rate of change in harmonised index of consumer prices in per cent.
(3) Growth rate of real GDP per occupied person in per cent.
(4) Growth rate of compensation per employee.
(5) As a percentage of GDP.
(6) Number of unemployed as a percentage of the labour force.
(7) Employed persons aged 15–64 as a share of the total population of the same age group.
(8) Employed women aged 15–64 as a share of the total female population of the same age group.
(9) Employed persons aged 55–64 as a share of the total population of the same age group.
(10) Long-term unemployed (over 12 months) as a percentage of the total active population aged 15–64.
(11) Income tax plus employer/employee contributions as a percentage of labour costs of a single earner at 67 % of the average production worker wage, no children.
(12) Effective tax rate on labour income taking into account the combined effect of increased taxes and benefits withdrawal as an individual moves from unemployment back to work earning 67 % of the average production worker wage, measured at the first month of unemployment (after any 'waiting period' if applicable).
(13) GDP per hour worked in PPS, EU-15 = 100.
(14) Percentage, average value of imports and exports of goods and services divided by GDP, multiplied by 100; for DE, ES, FR, IT, PL and the UK, the value for the EU-25 is the total for the large Member States; for all the other States, the value for the EU-25 is the total for the small Member States.
(15) Percentage implemented in November 2004.
(16) Gross fixed capital formation by the private sector as a percentage of GDP.
(17) Total tertiary graduates (ISCED 5–6) per 1 000 of population aged 20–29.
(18) Public expenditure on education as a percentage of GDP.
(19) GERD — gross domestic expenditure on R & D as a percentage of GDP.
(20) Expenditure on information technology as a percentage of GDP.

Source: Commission services (including Eurostat, structural indicators). The data for 'general economic background' and 'public finance' are taken from the Commission's autumn 2004 economic forecasts.

23. Finland

Real GDP growth accelerated from 2 % in 2003 to an estimated 3 % in 2004, remaining well above the euro-area average. Activity was firmly supported by domestic demand as private consumption stayed lively while the sharp fall in business equipment investment of the last two years turned around. The revival of exports was held back by weaknesses in the electronics industry in the early part of 2004. The recovery has begun to be felt in the labour market, with employment increasing and unemployment falling. Public finances remain solid, with the general government surplus set to remain over 2 % of GDP in 2004–06. In 2004, the government followed up on earlier commitments, such as by adhering to the multiannual spending limits set for the entire election period. By way of new measures, it introduced further tax cuts on labour. Despite these tax cuts, structural unemployment remains high, although the new wage agreement allows wages to better reflect productivity differences. Regarding productivity and business dynamism, Finland has maintained its leading position by being one of the most competitive economies in the world. R & D spending is high (3.4 % of GDP) and is two thirds financed by industry. Labour productivity per hour worked is below the EU-15 average, but is growing at a slightly faster rate than the average. The competition law has recently been updated and efforts have been made to bring competition policy into the heart of economic policy, but problems continue in some of the network industries. Moreover, prices remain high compared with the EU average. A detailed assessment of recent developments in addressing Finland's key policy challenges is presented in the following sections.

23.1. Labour market

Although the Lisbon target for employment of older workers was reached, structural unemployment remains high

In 2004, the government cut income taxes by a total of EUR 775 million, i.e. 0.5 % of GDP, by lowering marginal tax rates in State income tax schedules, and increasing work-related deductions and earned income deductions in municipal taxation. Combined with the tax cut worth EUR 295 million in 2003, this almost fulfils

Reduce the high level of structural unemployment and increase the employment rate of older workers	Assessment
Under this challenge, Finland was requested to:	
1. improve incentives in tax and benefit systems further to make work pay, in particular by addressing their combined effects on older workers, continue to reform the eligibility criteria, improve the administration of benefit systems and target the tax measures on low-paid labour (GL 4)	In progress
2. seek possibilities to ensure that wage bargaining systems allow wages to better reflect productivity differences across skills in order to improve the job prospects of the low-skilled unemployed (GL 5).	Limited

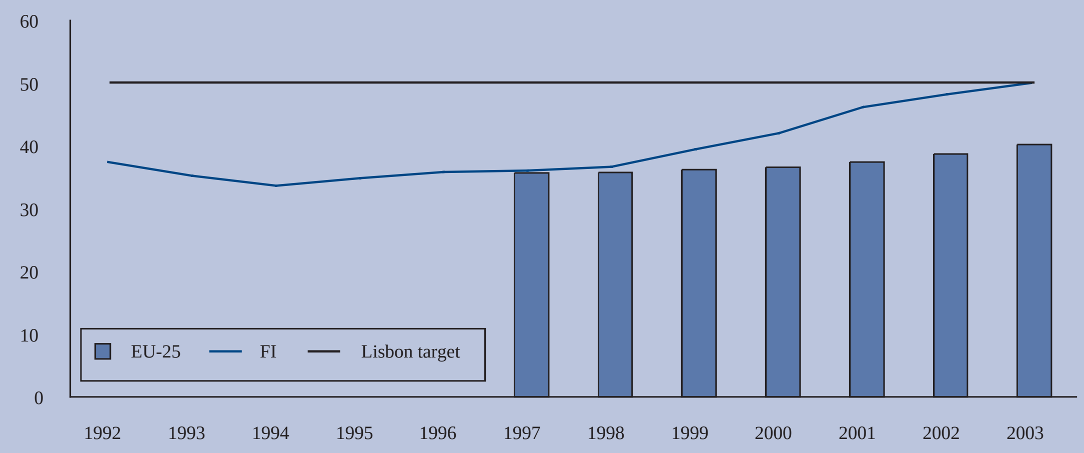
Bearing in mind the three-year period available for implementation, the degree of implementation since 2003 is indicated as: 'Complete' for (practically) complete; 'In progress' where progress is well advanced; 'Limited' where the recommendation is only partially addressed; and 'Insufficient' where no substantial measures going in the right direction have been taken.

the minimum target of EUR 1.12 billion in tax cuts, i.e. 0.8 % of GDP, over the electoral period 2003–07 set in the government programme.

However, as a comprehensive, moderate and long-term wage agreement was achieved between the social partners in late November 2004, the government supplemented the outcome with a proposal to reduce taxation in 2005 by a further EUR 350 million, i.e. 0.2 % of GDP, through an increase in earned income deductions in municipal taxation and lowering the State income tax scale. In addition, the government is proposing to cut income taxes by EUR 1.36 billion, i.e. 0.8 % of GDP, between 2006 and 2007. This more than doubles the government's initial plan for reducing income taxation. In the 2005 budget proposal, the tax burden on employment is reduced by extending further the tax deduction granted for household service work in order to increase the incentive for private households to employ service workers. Also, the government proposed a 2 % inflation adjustment to the State income tax scale, reducing tax revenues by EUR 160 million or 0.1 % of GDP. Moreover, to support growth in the smallest companies, the sliding maximum limit on value added tax relief was raised to EUR 22 500. Furthermore, a reform of capital and corporate income taxation entered into force at the beginning of 2005. The corporate income tax rate was reduced by 3 percentage points to 26 % and the capital tax rate by 1 percentage point to 28 %, yielding an initial decline in tax receipts from business and capital taxation by EUR 555 million, i.e. 0.4 % of GDP. However, in the long run, the tax reform is expected to increase tax receipts via stimulating effects on investment and growth.

In 2003, the government introduced an intersectoral employment programme, to raise the employment rate and prevent social exclusion. The emphasis of the programme is to reduce the high level of structural unemployment and boost labour supply. Key measures to achieve these targets include reforming public employment services, raising the participation of job-seekers in active labour market policy measures (activation rate) to 30 %, shifting the emphasis from passive to active labour market support and improving the effectiveness of active labour market programmes. These measures have already produced some early results: 29 new labour force service centres have been opened, which provide services for the most difficult-to-place job-seekers, and the activation rate of unemployed job-seekers rose by 1 percentage point to 24 % in 2004. Nevertheless, the government's target of creating 100 000 new jobs by the

Graph 23.1: **Employment rate for older people (55–64 years) as a percentage of population aged 55–64 years**



Source: Commission services.

end of the electoral term in 2007 will be difficult to meet under current growth conditions. Also, the objective of raising the employment rate to 75 % by 2011 appears difficult to attain. However, the momentum towards reaching these targets should be kept up in view of the serious challenges Finland will be facing as a consequence of population ageing over the next decade.

On the positive side, the employment rate of older workers has been rising markedly over the last few years and this development is expected to continue when the 2002 pension reform is implemented in 2005. According to data on the first half of 2004, the Lisbon target of a 50 % employment rate for older workers has already been achieved. Regarding the tightening of the eligibility criteria, there has been some progress, relating to measures already implemented in 2003 in the context of pension reform, such as raising the minimum age of eligibility for a part-time pension by two years. Improvement of the administration of benefit systems is linked to the founding of labour force service centres. These centres operate on the one-stop shop principle, making the services of different authorities such as the employment office, the municipality and the social insurance institution available at the same location, thereby increasing the effectiveness of the administration benefit systems. Progress in improving incentives in benefit systems has been made with the aim of dismantling income traps as the Act on Unemployment Benefit was amended from the beginning of 2004 to alleviate means tests for labour market support with regard to spouses' income. Moreover, the government is looking into ways to improve work incentives for people with disabilities. Thus, the introduction of long-term or even permanent employment subsidies for employers who employ disabled job-seekers will be considered, which will be tailored to the reduction in the work ability of the individual employee.

The new wage agreement allows wages to better reflect productivity differences

Traditionally, in the collective wage agreements, pay rises have been based on average increases in productivity across sectors, implying that low-productivity sectors have received higher wage rises than warranted by their productivity growth. The previous collective wage agreement that was settled in December 2002 paid more heed to this problem, and the cost effect of the pay rises was somewhat less biased against the low-wage sectors than previously. The new two-and-half-year collective wage agreement, settled on 29 November 2004, will bring further progress in this regard. The first 15 months of the wage contract is more a traditional wage agreement, where pay rises are mainly based on a fixed predetermined euro amount per month, while during the latter part of the contract, starting from June 2006, the wage increases are based on percentage increases across the board. This, combined with a new emphasis on local bargaining, will introduce greater flexibility to wage formation, albeit to a limited extent.

23.2. Productivity and business dynamism

Some progress towards improving the competitive environment …

In May 2004, the Finnish Parliament passed the Act on Competition Restrictions, which harmonises the Finnish competition law with the modernised EU competition law. The Finnish competition authority (FCA) has also been given powers to offer leniency in cartel cases, which will enhance its ability to uncover and prosecute

Enhance competition in certain sectors and improve the efficiency of the public sector	**Assessment**
Under this challenge, Finland was requested to:	
3. step up efforts to enforce competition in network industries and non-tradable services (GL 9);	Limited
4. make further efforts to increase the efficiency of the public sector, *inter alia* by improving the framework conditions for increased competition, promoting the benchmarking of public sector efficiency and increasing public tendering (GL 11);	In progress
5. improve mechanisms to help control spending and ensuring compliance with rules on expenditure (GL 14).	In progress

illegal agreements. The budget of the FCA is to be increased in 2005. The Competition Institute was set up in 2004 to carry out research into competition and to educate businesses and consumers about the benefits of competition. In the telecommunications sector, barriers to entry will be reduced by the EC directive on the regulation of access to communications networks, currently being implemented into Finnish legislation, and a recent judgment by the Supreme Administrative Court relating to mobile telephone call termination charges may result in lower prices. No progress appears to have been made regarding the government's concerns about excessive market concentration in the electricity sector; the reforms suggested by a working group of Nordic competition authorities in 2003 have not yet been acted upon.

… but high prices and a lack of competition persist in some sectors of the economy

Prices in Finland are some of the highest in the EU. An investigation into price levels in different sectors of the economy by the Finnish Ministry of Finance found that prices in some sectors were up to 70 % higher than the EU average. Prices for consumer expenditure were particularly high. Prices in the housing sector demand further investigation, in particular, due to their high level (30 % higher than the EU-15 average) and the fact that they account for a significant share of consumer spending (26 %). These results should not be considered definitive as a more in-depth analysis has yet to be completed. It has been suggested that the problem may be due in part to zoning restrictions at the local level and national standards. The government is aware of problems with zoning restrictions and there are plans to examine national standards which, the government believes, raise costs and impede competitive imports.

Efforts to improve the efficiency of public services are continuing …

The government is implementing the action plan that was launched in 2003 to improve the efficiency of the public sector both at the national and municipal levels. At the national level, this involves greater use of IT and the exploitation of scale efficiencies in accounting and personnel administration by moving to a service-centre-based approach rather than individual ministries carrying out these functions. The government has estimated that this change will lead to a 40 % increase in productivity when the new centres become operational in 2006. At the municipal level, efforts have been made to remove disincentives and introduce productivity incentives into the financing system for municipalities, although so far success here has been limited. The government also plans to introduce efficiency conditions into the discretionary grants that it makes to municipalities.

The government is continuing to implement strategies designed to increase the efficiency of the public procurement process. In 2004, an advisory board was founded jointly by the central government and the association of local municipalities to increase understanding and expand the use of public procurement. Legislative reform aimed at improving competition in public procurement, particularly in cases that fall below the EU threshold value, is currently being drafted.

… and mechanisms to help control public spending are being implemented

The basic service programme that was set up between the central government and the municipalities in 2003 to improve the balance and predictability of the municipalities' responsibilities, obligations and financing came into force in 2004. According to the government, early results of the programme have been encouraging. The government believes that in education and healthcare, areas both administered at the municipal level, the scope for increased productivity is between 10 and 20 %. As mentioned above, the government has attempted to inject productivity incentives into local government financing. One example is that budget underspends may be kept by the municipalities and the money carried forward to the next year's budget.

Multiannual spending limits have helped to keep central government expenditure under control

As reviewed in the 2004 implementation report, the government after taking office in June 2003 redesigned spending ceilings and made them politically binding. Under the new type of ceilings, about three quarters of budget appropriations are designed to fall within the spending limits. Excluded from the ceilings are expenditures such as housing subsidies and unemployment benefits, which typically function as automatic stabilisers. Furthermore, interest expenditures and financial investment expenditures are excluded, as well as compensation for tax losses to other levels of government due to tax reforms. A further change to the previous spending limits is that supplementary budgets are included in the ceilings. Under its new budget rules, the government has also introduced, as a safety margin, a central government deficit ceiling of 2.75 % of GDP in national account terms, even in times of weak economic activity. The government has committed itself to taking expenditure-reducing measures and other remedial action if the deficit limit on central government finances threatens to be breached.

The spending ceiling worked well in its first year in operation, namely 2004, when final expenditure remained below the spending limit by EUR 84 million or 0.1 % of GDP. Also, the 2005 budget proposal is within the ceiling, with expenditures of EUR 377 million or 0.2 % of GDP below the ceiling. This leeway will be used to cover any supplementary budgets and pay rises following from the new wage agreement.

Table 23.1

Economic indicators for Finland

	Finland				EU-25			
	2001	2002	2003	2004	2001	2002	2003	2004
General economic background								
Real GDP growth (1)	1.1	2.3	2.0	3.0	1.8	1.1	1.0	2.5
Inflation (2)	2.7	2.0	1.3	0.2	2.5	2.1	1.9	2.2
Labour productivity growth (3)	– 0.4	1.3	1.9	3.5	0.8	0.9	0.9	2.1
Employment growth (1)	1.5	0.9	0.0	– 0.4	1.0	0.3	0.3	0.4
Nominal wage growth (4)	4.7	1.9	3.3	4.1	4.0	3.2	3.1	3.0
Current account (5)	6.9	7.4	5.2	4.9	:	:	:	:
Unemployment (6)	9.1	9.1	9.0	8.8	8.5	8.9	9.1	9.1
Public finances								
General government balance (5)	5.2	4.3	2.3	2.3	– 1.2	– 2.3	– 2.8	– 2.8
Primary balance (5)	7.9	6.5	4.1	4.1	2.4	1.0	0.3	0.2
Cyclically adjusted balance (5)	4.5	4.1	2.8	2.8	:	:	:	:
Gross government debt (5)	43.8	42.6	45.6	44.8	62.1	61.6	63.2	63.5
Employment								
Employment rate (7)	68.1	68.1	67.7	:	62.8	62.9	63.0	:
Female employment rate (8)	65.4	66.2	65.7	:	54.3	54.7	55.1	:
Employment rate for older workers (9)	45.7	47.8	49.6	:	37.4	38.8	40.2	:
Long-term unemployment (10)	2.5	2.3	2.3	:	3.8	3.9	4.0	:
Tax rate on low wage earners (11)	41.0	40.2	39.5	:	37.2	37.1	37.4	:
Unemployment trap indicator (12)	80.6	83.4	81.5	:	78.8	78.5	78.3	:
Product market reforms								
Hourly labour productivity (13)	95.5	93.0	91.5	:	:	:	:	:
Total trade to GDP ratio (14)	35.9	34.6	34.4	:	:	58.8	57.2	:
Internal market directives (15)	99.3	99.4	98.6	97.5	:	:	:	96.3
Business investment (16)	17.7	16.1	15.3	:	17.9	17.2	16.8	:
Knowledge-based economy								
Total tertiary graduates (17)	58.3	:	:	:	46.8	:	:	:
Spending on human resources (18)	6.2	6.4	:	:	5.1	:	:	:
R & D expenditure (19)	3.4	3.5	3.4	:	1.9	1.9	:	:
Expenditure on IT (20)	3.5	3.4	3.4	3.4	3.1	2.9	2.9	2.9

(1) Growth rate in per cent.
(2) Annual average rate of change in harmonised index of consumer prices in per cent.
(3) Growth rate of real GDP per occupied person in per cent.
(4) Growth rate of compensation per employee.
(5) As a percentage of GDP.
(6) Number of unemployed as a percentage of the labour force.
(7) Employed persons aged 15–64 as a share of the total population of the same age group.
(8) Employed women aged 15–64 as a share of the total female population of the same age group.
(9) Employed persons aged 55–64 as a share of the total population of the same age group.
(10) Long-term unemployed (over 12 months) as a percentage of the total active population aged 15–64.
(11) Income tax plus employer/employee contributions as a percentage of labour costs of a single earner at 67 % of the average production worker wage, no children.
(12) Effective tax rate on labour income taking into account the combined effect of increased taxes and benefits withdrawal as an individual moves from unemployment back to work earning 67 % of the average production worker wage, measured at the first month of unemployment (after any 'waiting period' if applicable).
(13) GDP per hour worked in PPS, EU-15 = 100.
(14) Percentage, average value of imports and exports of goods and services divided by GDP, multiplied by 100; for DE, ES, FR, IT, PL and the UK, the value for the EU-25 is the total for the large Member States; for all the other States, the value for the EU-25 is the total for the small Member States.
(15) Percentage implemented in November 2004.
(16) Gross fixed capital formation by the private sector as a percentage of GDP.
(17) Total tertiary graduates (ISCED 5–6) per 1 000 of population aged 20–29.
(18) Public expenditure on education as a percentage of GDP.
(19) GERD — gross domestic expenditure on R & D as a percentage of GDP.
(20) Expenditure on information technology as a percentage of GDP.

Source: Commission services (including Eurostat, structural indicators). The data for 'general economic background' and 'public finance' are taken from the Commission's autumn 2004 economic forecasts.

24. Sweden

Swedish economic growth was strong in 2004 and is forecast to remain above potential rates also in the medium term. In 2004, net exports, in particular, private consumption and investment expansion contributed to the growth performance. In the coming years, domestic demand will be the main driver. Wage developments have been contained and inflationary pressures are low. In response to weak labour market developments, in 2004 the government implemented measures to strengthen employment and to reduce unemployment. With the income tax cuts introduced in the budget for 2005, the government has nearly completed its income tax reform. However, incentives to work, contributing to higher labour force participation and a better labour market performance, remain to be strengthened. The fiscal policy framework and plans, focusing on sound public finances, suggest the continuation of a sound budgetary position. The hourly productivity trend growth in 1999–2003 was above the EU-15 average. The ICT sector and increased use of ICT in the production of other goods and services contributed to this strong productivity growth. However, weak competition in several sectors of the economy and inefficiencies in the public sector were still limiting factors, and the price level remains one of the highest in the EU. A detailed assessment of recent developments in addressing Sweden's key policy challenges is presented in the following sections.

24.1. Labour market

Employment rates remain very high, though falling also in 2004

Employment rates, while remaining very high and well beyond the Lisbon targets, fell further in 2004 in spite of very strong economic activity, reflecting in part a normal phase of a lagged labour market response to the cycle. The Swedish authorities implemented measures in 2004 to reduce unemployment through an expansion of places in labour market programmes. Additional financial support to local government also contributed. However, some initiatives may have an adverse impact on labour supply. Since the review in the 2004 implementation report, the extension throughout the country of the 'free-year' initiative (under which an employee can, while paid a salary-linked benefit, take up to one year off work under certain conditions) has been confirmed and will take effect in 2005. On the tax side, there has been some further easing of labour taxation in the framework of the 'green tax swap' strategy. With the Budget Bill for 2005, the Swedish government has made further progress in implementing its income tax reform, with half of the fourth and final step of tax cuts taking effect in 2005 (the first three steps were taken in 2000–02). However, these tax cuts mainly consist of a higher basic allowance and

Ensure an adequate labour supply in view of the ageing of the population	Assessment
Under this challenge, Sweden was requested to:	
1. pursue further the reforms of tax and benefit systems to improve work incentives, in particular for those groups with high marginal effective taxes (GL 4), and complete the tax reform on labour income while maintaining sound public finances.	Limited

Bearing in mind the three-year period available for implementation, the degree of implementation since 2003 is indicated as: 'Complete' for (practically) complete; 'In progress' where progress is well advanced; 'Limited' where the recommendation is only partially addressed; and 'Insufficient' where no substantial measures going in the right direction have been taken.

therefore have limited impact on marginal tax rates and thus work incentives. Moreover, local government tax rates were increased further in 2004. According to the Swedish government, the intention is to finalise the income tax reform in 2006 should the budgetary position allow it. On the benefit side, a mixed picture emerges. On the one hand, the authorities announced plans in the 2005 budget to raise certain social insurance benefit levels. Moreover, the cut in the sickness insurance benefit level introduced in 2003 was reversed as from 1 January 2005. On the other hand, in order to achieve the nationally set target of halving the number of sick days by 2008 (compared with 2002), additional measures, including enforcement of the rules for receiving sickness insurance, were implemented in 2004. All in all, further efforts to increase labour market participation and employment appear important; not least as according to the budget for 2005 the Swedish authorities do not expect to have reached their nationally set target of raising employment by 2004. Despite downward revisions of the budgetary targets in the latest budget, broadly consistent with the Commission services' autumn 2004 economic forecast, Sweden is expected to continue to show a sound fiscal position in the coming years ([1]).

24.2. Productivity and business dynamism

Some steps towards increased competition taken …

Prices in Sweden remain among the highest in the EU, with very high prices in sectors such as retailing, construction, housing, and non-tradable sectors, and so far there are few signs of increased competition. In September 2004, the government started an investigation in order to improve the implementation of competition policy. In October 2004, a law intended to increase price transparency for all goods and services marketed to consumers took effect. At the sectoral level, the application of the planning and building legislation may constitute an obstacle to competition in the construction and food retailing sector. A commission has therefore been appointed by the government to review the legislation and analyse how competition aspects can be better taken into account in the actual planning process, and thereby provide better conditions for increased competition within these sectors. Some suspected cartels in the construction sector are currently being investigated by the competition authorities. A project to increase competition and trade in the construction sector involving the Nordic and Baltic countries and Poland is also still under way. However, no further measures have been taken in order to open up the non-tradable sectors.

… and further efforts to increase public sector efficiency have been made

There is still little evidence of increased efficiency in the public sector. However, the Swedish government has acknowledged the importance of reviewing and improving the functioning of the public sector. No later than February 2005, a commission will present proposals on how the new EC directives on public procurement should be implemented in Swedish law. In September 2005, a report to be presented by the Council for Municipal Analysis on the development of key national indicators could contribute to the benchmarking of public sector efficiency.

([1]) Eurostat's decision of 2 March 2004 on the classification of pension schemes, to be implemented by March 2007 at the latest according to their press release of deficit and debt data for 2003 of 23 September, would in all likelihood reduce the general government balance in Sweden by about 1 % of GDP per annum.

Enhance competition in certain sectors and improve the efficiency of the public sector	**Assessment**
Under this challenge, Sweden was requested to:	
2. step up efforts to enforce competition in sectors where competition is inadequate (GL 9);	Limited
3. make further efforts to increase the efficiency of the public sector, *inter alia* by improving framework conditions for increased competition, promoting the benchmarking of public sector efficiency, and increasing public tendering (GL 11).	Limited

Table 24.1

Economic indicators for Sweden

	Sweden				EU-25			
	2001	2002	2003	2004	2001	2002	2003	2004
General economic background								
Real GDP growth (1)	0.9	2.1	1.6	3.7	1.8	1.1	1.0	2.5
Inflation (2)	2.7	2.0	2.3	1.1	2.5	2.1	1.9	2.2
Labour productivity growth (3)	– 1.0	1.9	1.8	4.3	0.8	0.9	0.9	2.1
Employment growth (1)	1.9	0.2	– 0.2	– 0.5	1.0	0.3	0.3	0.4
Nominal wage growth (4)	4.5	2.7	2.4	3.4	4.0	3.2	3.1	3.0
Current account (5)	4.4	5.1	5.7	7.3	:	:	:	:
Unemployment (6)	4.9	4.9	5.6	6.3	8.5	8.9	9.1	9.1
Public finances								
General government balance (5)	2.8	0.0	0.3	0.6	– 1.2	– 2.3	– 2.8	– 2.8
Primary balance (5)	6.0	2.9	2.3	2.7	2.4	1.0	0.3	0.2
Cyclically adjusted balance (5)	3.1	0.6	1.4	0.7	:	:	:	:
Gross government debt (5)	54.4	52.6	52.0	51.6	62.1	61.6	63.2	63.5
Employment								
Employment rate (7)	74.0	73.6	72.9	:	62.8	62.9	63.0	:
Female employment rate (8)	72.3	72.2	71.5	:	54.3	54.7	55.1	:
Employment rate for older workers (9)	66.7	68.0	68.6	:	37.4	38.8	40.2	:
Long-term unemployment (10)	1.0	1.0	1.0	:	3.8	3.9	4.0	:
Tax rate on low wage earners (11)	46.8	45.8	44.8	:	37.2	37.1	37.4	:
Unemployment trap indicator (12)	87.3	87.1	87.1	:	78.8	78.5	78.3	:
Product market reforms								
Hourly labour productivity (13)	95.2	95.3	97.4	:	:	:	:	:
Total trade to GDP ratio (14)	42.6	41.3	40.5	:	:	58.8	57.2	:
Internal market directives (15)	99.1	99.6	98.4	97.9	:	:	:	96.3
Business investment (16)	14.4	13.4	12.6	12.5	17.9	17.2	16.8	:
Knowledge-based economy								
Total tertiary graduates (17)	38.5	41.5	:	:	46.8	:	:	:
Spending on human resources (18)	7.3	7.7	:	:	5.1	:	:	:
R & D expenditure (19)	4.3	:	:	:	1.9	1.9	:	:
Expenditure on IT (20)	4.7	4.3	4.0	3.9	3.1	2.9	2.9	2.9

(1) Growth rate in per cent.
(2) Annual average rate of change in harmonised index of consumer prices in per cent.
(3) Growth rate of real GDP per occupied person in per cent.
(4) Growth rate of compensation per employee.
(5) As a percentage of GDP.
(6) Number of unemployed as a percentage of the labour force.
(7) Employed persons aged 15–64 as a share of the total population of the same age group.
(8) Employed women aged 15–64 as a share of the total female population of the same age group.
(9) Employed persons aged 55–64 as a share of the total population of the same age group.
(10) Long-term unemployed (over 12 months) as a percentage of the total active population aged 15–64.
(11) Income tax plus employer/employee contributions as a percentage of labour costs of a single earner at 67 % of the average production worker wage, no children.
(12) Effective tax rate on labour income taking into account the combined effect of increased taxes and benefits withdrawal as an individual moves from unemployment back to work earning 67 % of the average production worker wage, measured at the first month of unemployment (after any 'waiting period' if applicable).
(13) GDP per hour worked in PPS, EU-15 = 100.
(14) Percentage, average value of imports and exports of goods and services divided by GDP, multiplied by 100; for DE, ES, FR, IT, PL and the UK, the value for the EU-25 is the total for the large Member States; for all the other States, the value for the EU-25 is the total for the small Member States.
(15) Percentage implemented in November 2004.
(16) Gross fixed capital formation by the private sector as a percentage of GDP.
(17) Total tertiary graduates (ISCED 5–6) per 1 000 of population aged 20–29.
(18) Public expenditure on education as a percentage of GDP.
(19) GERD — gross domestic expenditure on R & D as a percentage of GDP.
(20) Expenditure on information technology as a percentage of GDP.

Source: Commission services (including Eurostat, structural indicators). The data for 'general economic background' and 'public finance' are taken from the Commission's autumn 2004 economic forecasts.

25. United Kingdom

Recent economic performance in the UK has been strong by international standards. Output growth in 2004 is estimated to have been relatively robust, well above Commission estimates of the trend rate of growth, though some moderation is expected for the years ahead as household and general government consumption growth softens. Labour market performance is good: unemployment is at near-record lows, remaining below 5 % in 2004, while employment rates are amongst the highest in the EU. Despite the strength of economic performance, and the apparent tightness of the labour market, inflationary pressures generally remain subdued, with HICP inflation well below the Bank of England's new 2 % inflation target set in December 2003. Notwithstanding this sound performance, the UK faces several challenges. Increasing the level of productivity is a key objective. The UK has been making progress on boosting hourly labour productivity growth, and the gap in productivity levels relative to the EU-15 average has been closing over a number of years. The government's approach to raising productivity has centred on maintaining macroeconomic stability and implementing microeconomic reforms to remove hindrances to efficiently functioning markets. Reforms have focused on taking measures to improve competition, enterprise, innovation, skills, investment and public services' productivity, with varying degrees of progress, but more needs to be done to close the productivity gap with the EU-15 average. The government projects an improvement in the public finances over the medium term, though evidence of significant progress has yet to be confirmed in out-turn data. A detailed assessment of recent developments in addressing the United Kingdom's key policy challenges is presented in the following sections.

25.1. Productivity

Some progress in improving competition in protected sectors

The government has set a target to have a competition regime that is amongst the best in the world by 2006. Evidence that this target is achievable is provided by a number of studies giving a positive assessment of the current regime. The government has continued its efforts to promote competition but progress has varied across

Improve the relatively low level of productivity	**Assessment**
Under this challenge, the United Kingdom was requested to:	
1. continue to improve competition in sectors like the professions, postal services and pharmacies (GL 9);	Limited
2. monitor closely existing measures to promote R & D (GL 13);	Limited
3. review and strengthen, where appropriate, policies aimed at improving basic skills in the workforce (GL 13).	In progress

Bearing in mind the three-year period available for implementation, the degree of implementation since 2003 is indicated as: 'Complete' for (practically) complete; 'In progress' where progress is well advanced; 'Limited' where the recommendation is only partially addressed; and 'Insufficient' where no substantial measures going in the right direction have been taken.

sectors. Since 2003, a number of restrictions on competition in professions such as accountancy have been removed but others still need to be addressed. The government has consulted on and subsequently commissioned an independent review of proposals to reform the regulatory framework for legal services in England and Wales to improve competition in this sector. Recommendations of the review are expected shortly.

More limited progress has been made on improving competition in pharmacies and postal services. The government rejected an Office of Fair Trading (OFT) proposal to remove many of the restrictions on entry in the pharmacy sector as it considered that this conflicted with its objectives for increasing the role of pharmacies within the National Health Service. In postal services, about 30 % of the total letters market has been open to competition for bulk mail services since 2003. However, in practice, it has been difficult to achieve a significant amount of competition and the State-owned monopoly, Royal Mail, retains more than 99 % of the entire market. The postal regulator has, meanwhile, continued efforts to further liberalise postal services, and is proposing to bring forward full liberalisation, abolishing all restrictions on market entry, to January 2006.

Finally, the OFT has investigated the effect on competition of public sector procurement (which accounts for between 11 and 18 % of UK GDP). The results of a study were published in September 2004, and identified a number of sectors for further investigation.

Limited monitoring and evaluation of the measures taken to promote R & D

The UK has made a number of efforts to promote R & D. Although records are kept of public and private sector spending on R & D, and the Department of Trade and Industry has a mechanism for evaluating a very small number of R & D initiatives, there has so far been little overall evaluation of the success of government R & D policy and, in particular, measures to boost both public and private R & D and innovation. The government's strategy to promote R & D and innovation emphasises the need for conducive macroeconomic fiscal competition and trade policies, and improved education and skills. The government has also been using a wide range of other measures to boost R & D expenditure and innovation, such as the use of R & D tax credits and project-specific grants. The government launched a science and innovation investment framework in July 2004, setting out the target for R & D expenditure to reach 2.5 % of GDP by 2014 as well as the policy framework needed to achieve this. The framework sets out a comprehensive set of targets and performance indicators to track progress. The 2004 pre-budget report announced further steps to support implementation and monitoring of the framework, including a biennial assessment of progress against targets, and a commitment to publish a detailed sectoral assessment of UK business R & D alongside the 2005 budget. Other steps announced include the establishment of a business-led strategy board, which will advise the government on technologies which have commercial potential, and a regular high-level forum of key government ministers, business leaders and scientists.

Ongoing initiatives to boost training and basic skills

The UK authorities consider improving skills among young people and the adult workforce to be one of the key drivers of improved productivity performance. In direct response to low productivity levels, the April 2003 budget included a number of measures to boost training and basic skills. The March 2004 budget and the December 2004 pre-budget report build on these. Following successful pilot schemes, the government has announced the full implementation (by 2007–08) of a subsidised workforce-level training scheme to provide all employed people in England with the opportunity to secure Level 2 skills training, such skills being considered as the foundation for employability and lifelong learning. The target for the number of adults involved in programmes to raise basic literacy, ICT and numeracy skills has been extended from 1.5 million by 2007 to 2.25 million by 2010. The government has reformed and relaunched apprenticeship schemes, including apprenticeships for 14–16-year-olds, and is introducing trials of apprenticeship programmes for adults. Long-term reform of the qualifications and curriculum for 14–19-year-olds is also under review, with a policy response expected in 2005.

Although a number of these measures take the form of pilot schemes, the authorities report that since 2001 over 2.3 million adults have started basic skills courses, and almost 750 000 adults have achieved literacy, numeracy and ICT qualifications. Furthermore, while 29 % of adults in the workforce lack Level 2 skills, the number without a Level 2 qualification has fallen by 434 000. This should help the authorities achieve their stated aim of decreasing, by 40 % by 2010, the number of adults in the workforce who do not have a Level 2 qualification.

The government's initiatives are set in a medium- to long-term perspective based on July 2003 proposals to develop workforce skills. While the initiatives to strengthen apprenticeships and facilitate adult learning represent welcome steps, it appears too early to judge whether the many different initiatives will work together, as a set, to raise productivity by boosting basic skills.

25.2. Labour market

New initiatives for sickness and disability benefit claimants

While unemployment has fallen to around 4.7 %, the number of people claiming incapacity and severe disability benefits was 2.7 million (roughly 7 % of the workforce) in May 2004. There are strong regional and local variations in the scale of the problem. Importantly, however, there are signs that growth in the number of claimants has slowed in recent years, with the total number of working-age claimants stabilising over the last year or so.

Operation began in October 2003 of the 'Pathways to work' pilot schemes, the purpose of which was to test an intervention regime aimed at actively supporting incapacity benefit claimants' return to work. In its March 2004 budget, the government announced it would extend provision in the existing pilot areas. The December pre-budget report announced a major expansion of these pilot schemes to cover 900 000 incapacity benefit claimants in areas with the highest concentrations of claimants.

The authorities will also pilot a scheme for a mandatory work-focused interview regime for some existing incapacity benefit claimants and a new job preparation premium for people pursuing an activity that supports their return to work. The latter will be piloted from February 2005. The pre-budget report also announced an additional pilot scheme that will place employment advisers in doctors' surgeries, and, to ease the transition into employment, simplified rules on the work claimants are allowed to undertake while still claiming benefits.

25.3. Quality and efficiency of public services

A new strategy for increasing public sector efficiency

Recent years have witnessed a large increase in expenditure on public services in the UK, aimed at addressing a perceived legacy of underinvestment and underprovision. The authorities have recognised the need for efforts to ensure the efficiency of public spending, which will become increasingly important as the rate of growth in total expenditure is expected to slow, if efforts to improve public services are to be maintained at the current pace.

Address the high numbers of working-age people claiming sickness and disability benefits and sustain labour supply in the longer term	**Assessment**
Under this challenge, the United Kingdom was requested to:	
4. ensure that all those who are able to work have the opportunities and incentives to do so, in particular by examining and reforming as necessary sickness and disability benefit schemes (GL 4).	In progress

Improve the quality and efficiency of public services	**Assessment**
Under this challenge, the United Kingdom was requested to:	
5. ensure that the public services associated with the announced increases in public expenditure (including investment in the transport infrastructure) are delivered efficiently and with a view to ensuring cost-effectiveness (GLs 11 and 14).	In progress

The key development in 2004 was the publication of a major review of public sector efficiency. Building on this, government departments have submitted plans to achieve significant annual efficiency savings that are expected to reach GBP 21.5 billion (roughly 0.2 % of GDP) over the medium term (by 2007–08). Key points include:

- a reduction in administrative costs of at least 5 % in real terms over the period 2006/07 to 2007/08 for each department; and
- a net reduction in civil service employment of 70 600 posts (roughly 13.5 % relative to an April 2004 complement of 524 580) in central government by 2008.

In order to ensure the successful implementation of the drive for greater efficiency, a formal process of assessing departmental progress is being implemented. Government departments will be required to report publicly on progress against targets, while reports setting out how performance will be measured have been scrutinised by the National Audit Office (NAO) and the Audit Commission. In addition, all departments will be required to have, by December 2006, a professional finance director reporting to the head of department (the Permanent Secretary), with a seat on the departmental board.

This input-oriented approach should complement the existing focus on outputs/results underpinned by public service agreements (PSAs), target outcomes, agreed as part of each department's budget. Assessing the ultimate success of the initiative will, however, require longer-term analysis, not least because some of the potential savings identified are difficult to assess *ex ante*. In addition, transparency will be key to ensuring a successful outcome that is easily demonstrable to the wider public — indicating a premium on ensuring that the departmental reviews of measurement and assessment are clear, rigorous and accessible.

In parallel, significant efforts are being made to improve the measurement of public sector output, with an interim independent review of these issues having been published in July 2004, and a final report due in January 2005. More accurate measurement would complement the broader efforts to improve efficiency; in this regard, improved measures of health sector output have already been adopted.

25.4. Public finances

Signs of budgetary improvement, but uncertainties exist

The UK's general government deficit is now estimated to have reached 3.4 % of GDP in 2003, and is estimated to have been 3.2 % of GDP for the financial year 2003/04 ([1]). A Commission report of April 2004 ([2]) assessed UK budgetary developments. After considering the report, the Economic and Financial Committee (EFC) concluded that an excessive deficit, in the sense of the Treaty, did not exist and therefore that the UK's budgetary position did not warrant further steps under the excessive deficit procedure ([3]).

The government did not adopt any specific measures in 2004 to improve the budgetary position, though the authorities' March projections foresaw an improvement in the general government deficit on the basis of existing policy measures. This was also the view taken in the

([1]) Commission services' estimate, based on public finance data released on 20 October 2004.
([2]) http://europa.eu.int/comm/economy_finance/about/activities/sgp/country/edp/edprep2004_uk.pdf.
([3]) According to the relevant Treaty protocol, UK deficits are assessed on a financial year basis.

Strengthen the budgetary position so as to avoid emerging budgetary imbalances	Assessment
Under this challenge, the United Kingdom was requested to:	
6. in endeavouring to avoid the occurrence of an excessive deficit, to improve the cyclically adjusted position to consolidate the public finances, consistent with a budgetary position of close to balance or in surplus in the medium term (GL 1).	Limited

Commission services' autumn 2004 economic forecast, where the deficit is expected to narrow and be under 3 % of GDP for each calendar year of the 2004–06 forecast period. A clear improvement is also foreseen in cyclically adjusted terms, and with growth in general government consumption projected to slow relative to 2004, and revenues to recover relative to nominal income. Revenues should increase as a result of strong GDP growth, albeit at a slower pace than was forecast by the authorities in the March 2004 budget. However, evidence of significant progress has yet to be confirmed in out-turn data and there remains a high degree of uncertainty over both revenues and expenditures. In particular, it will be important to ensure that government departments adjust to the period of tighter budgets and slowing expenditure, if budgetary consolidation is to be fully implemented.

Even if the deficit improves in line with forecasts — and the risk of a worse outcome cannot be excluded — the budgetary position would remain some way from being close to balance in the medium term, with insufficient margin against future deficits in excess of 3 % of GDP. Nonetheless, the ratio of gross debt to GDP, though increasing slightly, is expected to remain close to 40 % and also to remain amongst the lowest in the EU.

Table 25.1

Economic indicators for the United Kingdom

	United Kingdom				EU-25			
	2001	2002	2003	2004	2001	2002	2003	2004
General economic background								
Real GDP growth (1)	2.3	1.8	2.2	3.3	1.8	1.1	1.0	2.5
Inflation (2)	1.2	1.3	1.4	1.4	2.5	2.1	1.9	2.2
Labour productivity growth (3)	1.6	1.6	1.3	2.6	0.8	0.9	0.9	2.1
Employment growth (1)	0.7	0.2	0.9	0.7	1.0	0.3	0.3	0.4
Nominal wage growth (4)	5.4	4.5	4.1	5.2	4.0	3.2	3.1	3.0
Current account (5)	– 2.3	– 1.7	– 1.9	– 2.0	:	:	:	:
Unemployment (6)	5.0	5.1	5.0	4.9	8.5	8.9	9.1	9.1
Public finances								
General government balance (5)	0.7	– 1.7	– 3.3	– 2.8	– 1.2	– 2.3	– 2.8	– 2.8
Primary balance (5)	3.0	0.3	– 1.3	– 0.9	2.4	1.0	0.3	0.2
Cyclically adjusted balance (5)	0.3	– 1.7	– 2.9	– 2.7	:	:	:	:
Gross government debt (5)	38.8	38.3	39.8	40.4	62.1	61.6	63.2	63.5
Employment								
Employment rate (7)	71.7	71.7	71.8	:	62.8	62.9	63.0	:
Female employment rate (8)	65.0	65.3	65.3	:	54.3	54.7	55.1	:
Employment rate for older workers (9)	52.3	53.5	55.5	:	37.4	38.8	40.2	:
Long-term unemployment (10)	1.3	1.1	1.1	:	3.8	3.9	4.0	:
Tax rate on low wage earners (11)	24.5	24.5	26.2	:	37.2	37.1	37.4	:
Unemployment trap indicator (12)	70.4	70.3	70.8	:	78.8	78.5	78.3	:
Product market reforms								
Hourly labour productivity (13)	91.9	93.5	94.3	:	:	:	:	:
Total trade to GDP ratio (14)	28.8	27.7	26.7	:	:	58.8	57.2	:
Internal market directives (15)	97.6	97.4	98.6	97.5	:	:	:	96.3
Business investment (16)	15.2	15.0	14.6	:	17.9	17.2	16.8	:
Knowledge-based economy								
Total tertiary graduates (17)	71.4	72.7	:	:	46.8	:	:	:
Spending on human resources (18)	4.7	:	:	:	5.1	:	:	:
R & D expenditure (19)	1.9	1.9	:	:	1.9	1.9	:	:
Expenditure on IT (20)	4.0	3.8	4.4	4.0	3.1	2.9	2.9	2.9

(1) Growth rate in per cent.
(2) Annual average rate of change in harmonised index of consumer prices in per cent.
(3) Growth rate of real GDP per occupied person in per cent.
(4) Growth rate of compensation per employee.
(5) As a percentage of GDP.
(6) Number of unemployed as a percentage of the labour force.
(7) Employed persons aged 15–64 as a share of the total population of the same age group.
(8) Employed women aged 15–64 as a share of the total female population of the same age group.
(9) Employed persons aged 55–64 as a share of the total population of the same age group.
(10) Long-term unemployed (over 12 months) as a percentage of the total active population aged 15–64.
(11) Income tax plus employer/employee contributions as a percentage of labour costs of a single earner at 67 % of the average production worker wage, no children.
(12) Effective tax rate on labour income taking into account the combined effect of increased taxes and benefits withdrawal as an individual moves from unemployment back to work earning 67 % of the average production worker wage, measured at the first month of unemployment (after any 'waiting period' if applicable).
(13) GDP per hour worked in PPS, EU-15 = 100.
(14) Percentage, average value of imports and exports of goods and services divided by GDP, multiplied by 100; for DE, ES, FR, IT, PL and the UK, the value for the EU-25 is the total for the large Member States; for all the other States, the value for the EU-25 is the total for the small Member States.
(15) Percentage implemented in November 2004.
(16) Gross fixed capital formation by the private sector as a percentage of GDP.
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(18) Public expenditure on education as a percentage of GDP.
(19) GERD — gross domestic expenditure on R & D as a percentage of GDP.
(20) Expenditure on information technology as a percentage of GDP.

Source: Commission services (including Eurostat, structural indicators). The data for 'general economic background' and 'public finance' are taken from the Commission's autumn 2004 economic forecasts.

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