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Second Implementation Report on the 2003-2005 BEPGs
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Second assessment of progress made in implementing the Broad Economic Policy Guidelines...

...providing input for the 2005 Spring Report

Shift of focus towards policy measures

Moderate economic recovery with subdued domestic demand

Macroeconomic policies remained accommodative

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 2004² 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 macro-economic 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.

Compared to the preliminary assessment made last year³, 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.

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 per cent in 2004 (and around 2 per cent 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 per cent in 2004 supported by moderate wage developments. Inflation is projected to have increased only slightly compared to 2003 to 2.2 per cent 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.

In a context of persistent uncertainties concerning the strength of the recovery and rising energy prices, macroeconomic policies remained accommodative in 2004. The 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.

¹ Council recommendation of 26 June 2003 on the broad guidelines of economic policies of the Member States and the Community (for the 2003-05 period), 2003/555/EC, published in the Official Journal (No. L 195/1 of 1 August 2003).

² Council recommendation of 5 July 2004 on the 2004 update of the Broad Economic Policy Guidelines for the period 2003-2005.

³ Commission Communication 'First report on the implementation of the 2003-2005 Broad Economic Policy Guidelines', COM(2004) 20 final, adopted on the 21 January 2004.

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 per cent 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 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 ten 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 per cent 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, 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 per cent of GDP in 2004, Germany, France and, above all, Greece (among the former EU-15 Member States) still struggle with high deficits. However, implementation of fiscal consolidation efforts in countries under the 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 2004-2005). In general, there is a tendency for many measures to remain focused on tax cuts, lifelong learning strategies or active labour market policies, while fewer initiatives (or less comprehensive proposals) 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 heighten 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 / 2010

Recent progress notwithstanding, it is increasing 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 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 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 2003-2005 BEPGs, the record is mixed. Several indicators (intra EU-trade, price convergence) show that the pace of Internal Market integration has slowed down, in part as a result of a 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 per cent. 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 per cent 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 have been 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 a 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 Ireland, the Netherlands, Spain 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 buy-out 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 were 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 US. 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 of 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 US in research and innovation (R&D). The last cyclical slowdown in business investment and FDI hampered knowledge and technology diffusion, which is particularly important for the new Member States. R&D-expenditures have increased only marginally to 2 percent of GDP in 2002, making the target for R&D-investments of 3 per cent of GDP by 2010 (of which

two-thirds to be financed by the private sector) virtually unattainable, without major initiatives. Some Member States (Sweden and Finland) 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 (FDI). 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 years old that have completed upper secondary level education. Summing 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 was on a downward path since the 1970s, stabilised at around 2½ per cent 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 TEN priorities approved by the Union in April 2004. In addition, the EU-budget is significantly financing investments in e.g. 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 per cent 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 budget 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 e.g. 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, Cyprus, the Czech Republic, Germany, Greece, Spain, France, Hungary, Italy, Malta, Poland, Portugal, Slovenia and Slovakia.

***Social sustainability
hampered by labour
market situation***

Progress in improving social sustainability continues to be limited in 2004. Above all, the relatively weak labour market performance, with a slow employment growth in 2003-2004, continues to hamper overall progress, as employment plays a major role in lifting people out of poverty and social exclusion. Recent measures taken by Slovakia, Hungary, the Czech Republic, Slovenia and Estonia 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 to 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, have not notified 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 gases are not 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 who 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 in increasing the efficiency of the whole energy supply and demand chain should be pursued in order to reduce European energy dependency, 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...***

Progress in response to the guidelines for the euro area remains mixed. While the macro-economic 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 to 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

...but where economic management will benefit from a 2-year presidency of the Eurogroup

in surplus' in 2003 is, also in this respect, a particular source of 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 will 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 2003-2005 BEPGs leaves much to be desired

Summing up, the overall conclusion from this second Implementation Report on the 2003-2005 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 goes 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 US. 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 remains unchanged in 2004. It is clear that with the current reform pace, full implementation of the 2003-2005 BEPGs will not be secured, making it difficult to fulfil the Lisbon ambitions.