
Overcoming the stigma of business failure – for a second chance policy

Implementing the Lisbon Partnership for Growth and Jobs

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1. **INTRODUCTION**

In February 2005, the Commission proposed a fresh start for the **Lisbon Strategy** focusing the EU’s efforts on delivering stronger, lasting growth and providing more and better jobs. This will only be achieved by creating a supportive environment for small and medium-sized enterprises (SMEs) and a more entrepreneurial culture¹.

**Entrepreneurship** is inherently risky and it requires self-confidence and autonomy as well as a certain readiness for risk-taking, as business creation, business success and business failure are inherent to the reality of the market economy. However, as part of the general lack of societal appreciation and understanding of entrepreneurship, business distress or even business failure is not yet sufficiently understood as a normal economic development and an opportunity for a new start.

The Commission considers that a more supportive environment for businesses at risk may prevent failure. Furthermore, addressing the negative consequences of business failure when it occurs and its negative image would help **make the best possible use of human creativity in Europe**, boost entrepreneurship and promote innovation and job creation. It would also help **foster a more favourable societal climate** in Europe towards entrepreneurship where only fraudulent and criminal behaviour is punished. Member States and the business community are therefore invited to further work on a supportive environment for entrepreneurs at risk and those who have experienced a business failure with a view to turning the EU into a more dynamic place for entrepreneurship and second chance.

2. **BUSINESSES AT RISK AND BUSINESS FAILURE ARE INHERENT TO OUR SOCIETIES**

2.1. **Business renewal is part of the market economy**

50% of enterprises do not survive the first five years of their life. The yearly average death rate of companies in the EU-25 is 7%². Economic literature see business closure as an element compatible with economic development in a global economy, something also recognised in the Charter for small enterprises³. A low survival rate is thus not necessarily a cause for concern – entry by new firms is part of the process whereby entrepreneurs react to market reality. A recent OECD study shows that survival rates of companies over a four-year period appear to be even lower in the US than in continental European countries⁴, illustrating that the death of companies can be compatible with **economic dynamism**. There is reason to believe that increasing global competition is forcing entrepreneurs to react more rapidly and more flexibly, even by closing their business and opening another one. The data confirm a high correlation between entry and exit rates in both the EU and the US, suggesting a continuous process of creative destruction by which low productivity firms exit the market and are replaced by new ones.

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2.2.  Bankruptcy is also an opportunity

Out of all company closures, bankruptcies account for some 15%\textsuperscript{5}, while 11 to 18% of all company creators have experienced some failure\textsuperscript{6}. Even though there is a natural correlation between the business cycle and the number of insolvencies\textsuperscript{7}, bankruptcies also happen in periods of high GDP growth. There is a strong case for believing that bankruptcy is in essence a direct consequence of entrepreneurial renewal: only \textbf{4-6% of bankruptcies are fraudulent}\textsuperscript{8}.

However, the role of business failure in economic life is not well understood in our society. Public opinion makes a strong link between business failure and personal incapacity or fraud. In the EU, stigma is present in the business environment, the legal framework and also in cultural and societal behaviour. This creates unnecessary hurdles to entrepreneurs who wish to restart. Despite existing knowledge of restarters’ performance, customers and financiers are reticent to place orders and invest. 79\%\textsuperscript{9} of EU citizens affirm that they would give a second chance\textsuperscript{9} to those who have previously failed. But attitudes change when it comes to “practice”: 47\%\textsuperscript{10} of Europeans would be reluctant to order from a previously failed business; 51\%\textsuperscript{11} of them would never invest in businesses in financial difficulties.

Available analysis also shows that only a small fraction of failed entrepreneurs make another attempt to start up\textsuperscript{12}, despite the fact that the majority of ex-entrepreneurs still have entrepreneurial preferences\textsuperscript{13} and young people hope for a second chance\textsuperscript{14}. This is first of all because insolvencies have a particularly great impact on entrepreneurs themselves. Around one third of bankrupts sell their house, while negative repercussions reach other family members in 25\% of cases. Business failure is a stressful situation leading to relationship breakdown in 15\% of cases\textsuperscript{15}.

Moreover, entrepreneurs who have failed are still confronted with an environment which underestimates the new opportunities created by business failure. Evidence suggests that failed entrepreneurs learn from their mistakes and are generally more successful second time around\textsuperscript{16}. Restarters usually experience faster growth than newly established companies\textsuperscript{17} and after five years their start-ups have good survival rates. Research on the

\textsuperscript{5} A.C.P. de Koning, \textit{Business failure and entrepreneurship in international perspective}, EIM Small Business Research and Consultancy, 1999.


\textsuperscript{7} The concept of business insolvency varies from one country to another, making it hard to compare data.

\textsuperscript{8} The percentage would be 3-4\% in Italy and the UK and 7\% in Austria (2003-2006 national data).

\textsuperscript{9} Flash Eurobarometer No 192 (2007).

\textsuperscript{10} Flash Eurobarometer No 146 (2004).

\textsuperscript{11} See footnote 9.

\textsuperscript{12} G. Metzger, \textit{After life – who takes heart for restart?} ZEW Discussion Paper No 06-038, 2006.


\textsuperscript{14} In a 2005 youth survey by Junior Achievement-Young Enterprise, involving respondents from 18 EU Member States and 7 countries from Eastern Europe and the Balkans, 58\% of young Europeans felt that if they failed at starting a business they would have a second chance.


profile of successful entrepreneurs shows that 18% had already run one enterprise. 6% had run two or more.\textsuperscript{18}

Finally, while being part of economic life, insolvency has a negative impact on jobs, consumers and public and private creditors. In 2006, some 135 000 company insolvencies in the EU-15 threatened the jobs of 1.4 million employees (1.5 million in 2005) and the number of personal insolvencies amounted to more than 237 000 in Germany and the UK alone.\textsuperscript{19} The same year in Austria outstanding debts to employees represented 243 million euros. As regards other unpaid debts, in Germany 50% of debtors were active enterprises and self-employed. In France, where the yearly estimated costs of insolvency proceedings are 13.7 billion euros, some 55-60% of unpaid debts are due to tax and social security authorities and banks, this percentage being 70-80% in the case of bankrupt services companies.\textsuperscript{20} Unpaid debts in Germany amounted to 31.1 billion euros in 2006 (37.5 in 2005; 39.4 in 2004), in Italy 9.6 billion in 2004, in Finland 1.37 billion in 2003. The wide range of costs that bankruptcies entail would be reduced if businesses at risk were better assisted and, in case of bankruptcy, a fresh start was facilitated.

3. \textbf{TOWARDS A SECOND CHANCE POLICY}

The Commission has started addressing the need for a new policy to tackle the issue of business at risk and the negative effects of business failure since 2001 and, subsequently, as part of the Entrepreneurship Action Plan.\textsuperscript{21} It renewed its commitment to such a policy in the Modern SME policy,\textsuperscript{22} launched in 2005. In particular, the Commission has flagged the need to improve bankruptcy procedures. Given its limited competencies in the area the Commission has limited itself to collecting data on the legal and social consequences of business failure,\textsuperscript{23} facilitating the identification and dissemination of good practices\textsuperscript{24} and recently to working on early warning tools as a means of reducing the stigma of failure. This has helped trigger reform across the EU and many Member States have already drawn some inspiration from the good practices and policy conclusions collected at European level.

There is in many EU countries – although to varying degrees – a policy commitment at the level of national and regional authorities to address the issue of business failure and promote fresh starts. In the context of the renewed Lisbon Strategy, around one third of the Member States have put forward plans to reform the national insolvency legislation in their National Reform Programmes.\textsuperscript{25} As a result, progress has been made in improving insolvency law: half of the Member States have taken measures to reduce the discharge periods, remove restrictions or streamline bankruptcy proceedings (see Annex). The UK addressed most issues

\textsuperscript{18} The profile of the successful entrepreneur. Results of the survey “Factors of Business Success”, Eurostat, Statistics in focus 29/2006.

\textsuperscript{19} Insolvencies in Europe 2005/6, Creditreform Economic Research Unit.


\textsuperscript{22} See footnote 1.

\textsuperscript{23} Activities carried out within the Multiannual Programme for Enterprise and Entrepreneurship 2001-2006 (“Best Procedure”, “European Charter for Small Enterprises”).

\textsuperscript{24} Final report of the expert group of the Best project on Restructuring, Bankruptcy and a Fresh Start, European Commission, 2003.

already in 2002. Spain and Italy introduced similar measures in their laws more recently. However, almost half of the EU countries still need to take the first steps in this direction. Also, no Member State has yet set up a comprehensive strategy for a second chance policy – only Austria has announced new plans for 2008. Indeed, there is still room to go further to foster a more positive attitude towards entrepreneurship, to encourage more people to start up and to reduce risks and the stigma of failure.

3.1. Public image, education and the media

The first step to tackle the negative effects of business failure is to publicly discuss it, address the entrepreneurs of the future and raise awareness of the benefits of renewed entrepreneurship. Research indicates that cultural support (e.g. through promotional campaigns) is positively linked to the amount of entrepreneurial activity in the EU.\textsuperscript{26}

Many young people never become entrepreneurs in the end. Entrepreneurship education is a fundamental means to materialise their entrepreneurial spirit and make them aware that business failure is the starting point of a new beginning. Nowadays Europeans are reluctant to take up opportunities for self-employment and entrepreneurial activities and are clearly afraid of bankruptcy.\textsuperscript{27} National lifelong learning strategies can play a key role in developing and updating entrepreneurial and business skills.

A Dutch booklet\textsuperscript{28} presents seven cases where entrepreneurs share their own experience about bankruptcy and explain how they became successful restarters. It can be downloaded from the website of the Dutch Ministry of Economic Affairs.

In the EU the general public often perceives bankruptcy as a criminal affair, no matter the cause. The media have a positive role to play in tackling this misperception and in disseminating information on the benefits our society can derive from the experiences of failed entrepreneurs. So do relevant awards.

In the last two years in Germany there has been a START AWARD with a category called RESTART. Sponsored by the two public support banks and a regional start-up support agency, it was given to honest entrepreneurs who learned from business failure and succeeded with their second start-up. Mainstream media were eager to report more on the topic.

Lessons to be learnt

- The benefits of a fresh start should be put forward in information campaigns and education programmes, showing that making several attempts goes hand in hand with a normal learning process, research and discovery.

- The media can play a role in dissociating bankruptcy and fraud and disseminating the benefits of renewed entrepreneurship, thus improving the image of business restarters among the public at large and valuing their experience.

- Further discussing the issue with all relevant actors should help uncover the many facets of stigma surrounding business failure.

\textsuperscript{26} Global Entrepreneurship Monitor 2004.

\textsuperscript{27} See footnote 9.

\textsuperscript{28} Tweede kans – failliet gaan betekent niet mislukken/lessen in vallen en opstaan, http://www.minez.nl/.
3.2. The role of insolvency law

Making a fresh start after bankruptcy can be challenging from a legal standpoint. Still in many countries bankruptcy law treats everyone in the same way irrespective of whether the bankrupt was fraudulent or irresponsible or whether the failure was through no obvious fault of the owner or the manager, i.e. honest and above-board. Also, numerous rules impose restrictions, prohibitions and disqualifications on bankrupts solely on the basis of the existence of bankruptcy proceedings. This automaticity of approach takes no account of the risks that are an everyday fact of business life and implies a belief that the bankrupt is someone in whom society can have no trust or confidence. A radical shift in the rationale of insolvency laws is needed in the EU.

Recent research sought to test whether relaxing the severity of personal bankruptcy law would stimulate entrepreneurship across 15 countries. 13 EU countries were analysed, along with Canada and the US, where the federal Bankruptcy Code permits debtors an immediate discharge. The study used discharge as a measure of “severity” and data on self-employment over 13 years. It concluded that bankruptcy law has a strong effect on business start-ups and that its economic significance was greater than GDP growth and stock market returns.

**Greece** has introduced a new bankruptcy code aimed at differentiating between plain and fraudulent bankruptcy. In the future, non-fraudulent bankrupts will not be liable to personal arrest and their rights to vote and stand for election will remain intact.

Entrepreneurs can find it difficult to free themselves from overwhelming debts and then again starting up. Often the remaining debts will not automatically cease to exist once insolvency proceedings are closed: if the debtor is a natural person he will remain answerable for them. In the event of personal liability, the creditors will be free to recover the remaining debts by attachment of the debtor’s personal assets. Nonetheless, when the entrepreneur’s personal assets do not suffice, debt relief is sometimes possible. For honest bankrupts a plan for repayment of the debts is possible in countries like Portugal, Hungary or Finland. They are automatically granted a discharge in Belgium, Ireland or the UK.

**In the UK** all bankrupts are subject to some restrictions during the period of their bankruptcy but honest bankrupts are discharged within a maximum of 12 months. Bankrupts whose conduct was dishonest, reckless or culpable may have severe restrictions imposed upon them for up to 15 years.

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Moreover, there seems to be a clear correlation between the relative quality of a country’s insolvency legislation and the relative effectiveness of its insolvency regime\textsuperscript{31}, the rule of law being key to our society\textsuperscript{32}. In particular, lengthy proceedings are generally too time- and money-consuming and deter a fresh start through capital destruction. In the EU, the average time to complete a bankruptcy procedure and close a business varies between 4 months (Ireland) and 9.2 years (Czech Republic), the cost ranging from 1% (the Netherlands) to 22% of the estate (Poland)\textsuperscript{33}. Streamlined bankruptcy proceedings would mean an easier exit for loss-making enterprises, better re-allocation of resources and a fairer distribution of remaining assets among creditors.

In Latvia a new Insolvency Law will come into force on 1 January 2008. One of the goals being to reduce the length of procedures, it will substantially change the objectives and principles of insolvency proceedings.

**Lessons to be learnt**

- It is vital to create the right framework which, while protecting all parties’ interests appropriately, recognises the possibility for an entrepreneur to fail and start again. Bankruptcy law should include a clear distinction between the legal treatment for non-fraudulent and fraudulent bankrupts.

- Entrepreneurs who go bankrupt through no fault of their own should be entitled to receive a formal Court decision declaring them non-fraudulent and excusable. The decision should be publicly accessible.

- An early discharge from remaining debts subject to certain criteria should be provided for in insolvency law.

- Legal restrictions, disqualifications or prohibitions should be reduced.

- Legal proceedings should be made simpler and faster, thus maximising the value of the assets in a bankruptcy estate when reallocating resources. Typically, proceedings should last a maximum of one year.

### 3.3. Actively supporting businesses at risk

The stigma of business failure is one reason why many SMEs in financial trouble conceal their problems until it is too late. Timely action is crucial to avoid bankruptcy and a rescue is in many cases preferable to liquidation. This is why the legal systems of countries like France, Estonia, Spain, Malta or Italy now opt rather for restructuring and business continuity.

Many entrepreneurs often lack the necessary resources and experience for successful crisis management. If mistakes occur at this stage, or if there is no proper advice available in time, bankruptcy can become inevitable.

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\textsuperscript{32} Closer judicial cooperation should help ensure that some bankrupts do not cross borders in order to avoid disqualifications and restrictions imposed by their home country but unknown in the country of the next establishment. The E-justice Group of the Council is studying the possibility of setting up a register of company law-related Court judgments at EU level, allowing direct interconnection of national registers and Courts.

\textsuperscript{33} Doing Business in 2007, World Bank.
**Denmark** is introducing a pilot “early warning system” modelled on the Dutch Ondernemersklankbord. With 4-year funding, this system will help viable enterprises that are headed for insolvency owing to temporary problems by giving them practical know-how and advice.

**Early warning** tools can be of many kinds, ranging from on-line resources, through relevant publications to more direct involvement of those actors who are better equipped to follow the financial situation of businesses. Additional **funding** to overcome an unstable period can also be crucial. To help entrepreneurs assess their financial health at an early stage, the Commission has put a self-assessment tool on-line\(^{34}\).

In the reminders for VAT non-payment, **France** includes information on where entrepreneurs who are facing financial problems can seek advice\(^ {35}\). Also, entrepreneurs can take out an insurance policy covering expenses (legal advice and mediator fees) for settling debts at an early stage.

**Lessons to be learnt**

- The number of insolvencies cannot be reduced to zero, but early support for viable enterprises will help keep insolvencies to a minimum. Support measures should focus on bankruptcy prevention, expert advice and timely intervention.

- Attention needs to be paid to the accessibility of support, as businesses at risk cannot afford expensive advice.

- The networking opportunities offered by the EU\(^ {36}\) and European business organisations should be fully exploited.

- Insolvency laws should provide an option to restructure and rescue rather than focus solely on liquidation.

**3.4. Actively supporting restarters**

The main constraints entrepreneurs face when setting up a second venture – resources, relevant skills and psychological support – are not sufficiently addressed by public support. Being **alone** as an entrepreneur is among the top four difficulties when starting up\(^ {37}\).

In general, fresh starts are deterred because of the lack of resources to set up a new business, notably of **financial means**\(^ {38}\). Often restarters plan to start with less capital than other new starters, plan businesses with relatively few employees and choose a limited company as legal form. During the early months of their start-up their main problems are finding clients and customers, liquidity and obtaining public financial support.

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\(^{36}\) The INTERREG IVC programme under the European Regional Fund is a strong tool to foster the exchange of good practices in the area of business support, [http://www.interreg3c.net/web/fic_en](http://www.interreg3c.net/web/fic_en).

\(^{37}\) See footnote 18. The other three difficulties are contacts with customers, administration and financing.

\(^{38}\) See footnote 12.
In Saxony (Germany), SMEs that, in the context of insolvency proceedings, prove their ability to reorganise can obtain funding from the Public Development Bank of Saxony with a view to drawing up an insolvency plan, continuing in business and starting afresh once the insolvency proceedings are closed.

It is vital to ensure that bankrupts take stock of their experience and are then well trained for their new business. The existence of entrepreneurial role models, being mobile and having a higher education would increase the probability of starting anew. Also younger ex-entrepreneurs are much more likely to be renascent entrepreneurs than are older ones. These are some common trends, but the needs of restarters are rather singular and require a flexible approach when designing support measures.

Since 2004, Luxembourg has offered some 40 non-fraudulent bankrupts a tailor-made training course on management issues to better equip them for their fresh start.

Bankrupts can lose confidence in their own capabilities and be emotionally affected. Specific professional and psychological advice on how to overcome bankruptcy is then crucial. Re-entry into the business community would also be facilitated by matching restarters with market niches, new partners and potential investors.

The French association Re-créer, created in 1999 with the backing of the French Chamber of Commerce and Industry and the French Association of Bankers, works on boosting the confidence of restarters who underwent business failure.

Lessons to be learnt

- Relevant authorities should devote sufficient financial means to fresh starts by removing barriers to public finance schemes for start-ups.
- Banks and financial institutions should revisit their very cautious attitude towards restarters, often based on negative credit ratings. The Commission plans to put this issue on the agenda of the Round Table of Bankers and SMEs.
- EU countries should ensure that the names of non-fraudulent bankrupts do not appear on lists restricting access to loans in the banking sector.
- Public procurers should be aware that public procurement directives do not allow for former non-fraudulent bankrupts to be disadvantaged.
- Adequate psychological and technical support and specific training and coaching should be available for restarters.
- Relevant authorities should facilitate getting support from customers, business partners and investors by fuelling links between them and potential restarters with the objective of meeting restarters’ needs.

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39 See footnote 13.
4. **Conclusion**

Good national **framework conditions** for entrepreneurship are crucial to the full exploitation of the EU’s entrepreneurial potential and to the creation of dynamic companies. The **societal appreciation** of successful entrepreneurship, vital to this end, should go hand in hand with a policy of **promoting a second chance** for entrepreneurs who are at risk or have failed. Consequently, the Commission invites EU countries to engage more vigorously in reducing the stigma of business failure as part of their commitment to promote entrepreneurship under the Growth and Jobs Strategy and within the context of a comprehensive entrepreneurship policy. The Commission will continue to support the Member States’ efforts by raising the visibility of national good practices. To speed up the pace of reforms, the Commission will also provide communication material to be used for campaigns in order to promote a better image of business failure.
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<td>Y</td>
<td>Y</td>
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<tr>
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<td>(Y)</td>
<td>Y</td>
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<tr>
<td>Total Y+(Y)</td>
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<td>1</td>
<td>3</td>
<td>12</td>
<td>15</td>
<td>17</td>
<td>17</td>
<td>3</td>
<td>2</td>
<td>1</td>
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</tbody>
</table>

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This table does not reflect an assessment of measures. It shows whether or not measures exist, according to Member States’ reports and available data.