COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 21.1.2004
COM(2004) 20 final

COMMUNICATION FROM THE COMMISSION

ON THE IMPLEMENTATION OF THE 2003-05 BROAD ECONOMIC POLICY GUIDELINES

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

{SEC(2004) 44}

PART I

General Assessment[1)]

1) Commission Communication

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EXECUTIVE SUMMARY

The BEPGs outline the medium-term economic policy strategy…

… on how to reach the Lisbon goal.

This Communication presents a first assessment of the follow-up given to the general guidelines in the 2003-05 Broad Economic Policy Guidelines (BEPGs). An assessment on the implementation of the country-specific recommendations is given in the accompanying working document of the Commission services. Together, they constitute the first Implementation Report (IR) following the move to multi-annual guidelines in 2003. The 2003-05 BEPGs laid down the EU's medium-term economic policy strategy with particular attention to the contribution economic policies can make to reach the Lisbon strategic goal. The three key elements of this strategy are:

- growth- and stability-oriented macroeconomic policies;
- economic reforms to raise Europe's growth potential; and
- strengthening sustainability.

Implementation assessment will be stepped up gradually.

Following the move to a better streamlined policy coordination cycle, this Implementation Report is presented as part of the "Implementation Package" together with the draft Joint Employment Report and the Implementation Report on the Internal Market Strategy. Furthermore, as a consequence of the clearer medium-term focus of the policy strategy, this first Implementation Report can only provide a preliminary assessment. It concentrates on policy measures taken and/or envisaged in 2003 in response to the 2003-05 BEPGs. Specific attention is given to the three priority areas highlighted by the Council. The implementation assessment will be stepped up the closer we get to the full review of the BEPGs planned for 2006.

Stagnation in the first half of 2003.

The economic background to this IR is that of a stagnation in the first half of 2003. Despite a clear improvement in economic activity in the third quarter, growth over the year as a whole is expected to have been a modest 0.8 per cent in the EU (and a mere 0.4 per cent in the euro area). The protracted period of low growth has started to take its toll on the labour market. Employment growth came to a halt and unemployment rose to 8.1 per cent in the Union. Headline inflation has been slow to come down, partly due to price increases for oil and fresh food, and rises in indirect taxes. A lack of response of wages to the cyclical slowdown in labour productivity also implied continued pressures on nominal unit labour costs.

On the basis of this first implementation assessment, the following key messages emerge.

Macroeconomic policies supported growth.

Macroeconomic policy was accommodative in 2003. Both the ECB and the national central banks in Denmark, Sweden, and the United Kingdom lowered further their key interest rates, thereby supporting domestic demand. Despite the appreciation of the euro, overall monetary conditions remained accommodative. The free play of automatic stabilisers helped to stabilise the economy. The EU's cyclically-adjusted primary balance remained broadly unchanged, indicating an overall neutral fiscal stance in 2003.

Budgets continued to deteriorate…

…but five Member States managed to maintain budget positions close to balance or in surplus in 2003…

The economic slowdown continued to weigh on public finances and progress seems mixed as regards reaching or maintaining a sound budgetary position. The average nominal budget deficit worsened further in 2003 to 2.7 per cent of GDP. However, differences are sizeable across Member States. Belgium, Denmark, Spain, Austria, Finland and Sweden had a cyclically-adjusted budgetary position close to balance or in surplus in 2002. With the exception of Austria, the other five Member States maintained such a budgetary position in 2003. Nominal deficits deteriorated sharply in several other Member States, with two countries (Germany and France) expected to have deficits exceeding the 3 per cent of GDP limit by a wide margin in 2003. While the economic slowdown is the main factor behind the recent deterioration in the public finances, part of the slippage in 2003 also stems from discretionary measures in some Member States (notably Greece, Austria, and the United Kingdom).

…and a further three markedly improved their CAB…

…while the excessive deficit situation seems likely to persist for three others.

In 2003, only Ireland, the Netherlands and Portugal showed a marked improvement (of more than 0.5 per cent of GDP) of their cyclically-adjusted budget balance (CAB). In the case of Portugal, this is due to substantial one-off measures, which also resulted in keeping the nominal deficit just below the 3 per cent limit in 2003. However, the deficit is expected to deteriorate in 2004 in the absence of further measures, thereby going above the ceiling again. The other two countries with an excessive deficit, Germany and France, made little, if any, progress. Notwithstanding the consolidation measures taken in Germany of about 1 per cent of GDP, the lower-than-expected-growth makes them inadequate to bring the excessive deficit situation to an end in 2004. France has not taken effective action to redress the budgetary imbalances to bring the excessive deficit situation to an end this year.

Wages put pressure on profitability.

Nominal wages continued to grow by about 3 per cent in 2003 in the EU (2 ¾ per cent in the euro area), despite the continued slowdown in economic activity. This has put further pressure on profitability and job-creating investment. However, seen in a medium-term perspective, wage trends appear still broadly compatible with price stability.

Labour market reforms have been stepped up in some areas, but appear insufficient to reach the Lisbon targets.

The labour market performed quite well in the beginning of this economic downturn, reaping the benefits of earlier reforms but also reflecting labour hoarding. The effect of the slowdown started to be felt more strongly in 2003 with employment growth stagnating and a continued rise in unemployment. The increase in the pace of labour market reforms in 2003 appears encouraging, but it needs to accelerate further. In particular, efforts have been made by most Member States to make work pay, even if reforms remain focused on the tax side. Some Member States have taken action to address incentive effects in the benefit systems (Denmark, Germany, France, the Netherlands, and the United Kingdom), which contribute most to the risk of unemployment- and inactivity traps. Several Member States have taken further measures to make the work organisation more adaptable (notably Denmark, Spain, France, Italy, the Netherlands and Sweden) and most Member States aim to foster occupational mobility through lifelong learning initiatives. Active labour market policies have also become better in responding to the individual needs of the unemployed. However and despite some improvements noted or planned in Denmark, Ireland, and the Netherlands, progress appears limited as regards improving the efficiency of ALMPs: e.g. evaluations are not systematically carried out or reported. Progress also appears limited in promoting wage differentiation or addressing the regulatory burden in the labour market. Despite the progress noted with some types of labour market reforms, the Lisbon- and Stockholm employment rate targets risk being missed, unless further and comprehensive reforms are undertaken without delay.

Disappointing labour productivity growth…

Labour productivity growth continued to disappoint and the gap with the USA widened. Lower labour productivity per hour worked now represents 40 per cent of the difference in GDP per capita between the EU and the USA. The gradual deterioration in labour productivity growth since the mid-1990s can be explained in equal parts by the slowdown in investment and in total factor productivity (which generally include effects from more efficient resource utilisation, technological progress and the natural catching-up process of lesser developed EU countries). ICT and their adoption are a key driver of productivity growth and the differentials between the EU and US productivity trends are strongly influenced by differences in the extent to which ICTs have penetrated the respective economies. This illustrates the need to stimulate market integration, business dynamism, and investment, particularly in knowledge.

...partly due to slow progress on the Internal Market.

Economic reforms are essential to enhance the EU's growth potential, which is necessary to achieve the 'Lisbon targets'. Progress in implementing the guidelines aimed at increasing productivity and business dynamism seems mixed. The functioning of the Internal Market is still hampered by the absence of proper regulation in the areas covered by proposals pending before the Council and the European Parliament (including directives on professional qualifications and on intellectual property rights). The average transposition rate by Member States also deteriorated somewhat in 2003.

Better progress on competition policies and the liberalisation of network industries.

Progress has been better in improving the effectiveness of competition policies, where e.g. Belgium, Austria, and the United Kingdom have acted to ensure the effective independence and capabilities of their competition authorities. Market opening in network industries also continues to progress both at EU level (with e.g. the directive laying down common rules for the electricity and gas market and an agreement on the trans-European networks) and at national level, even if the market share of the incumbent often remains very high after liberalisation.

Measures taken to improve the business environment…

The business environment continues to be hampered by some weaknesses, such as relatively high administrative burdens and the difficulties to find financing (notably venture capital). Nevertheless, several countries (e.g. Belgium, Germany, Greece, Spain, France, Luxembourg, and Austria) took measures to facilitate business start-ups in 2003.

…while investment in knowledge and innovation is still insufficient.

The transition to the knowledge based economy is progressing, albeit slowly, and differences between Member States remain important. The Commission put forward an Action Plan aimed at promoting R&D investments (to 3 per cent of GDP by 2010) where two-thirds are to be financed by the private sector. So far, evolutions remain far from satisfactory with declining R&D spending (as a share of GDP) in e.g. Ireland, the Netherlands, and the United Kingdom. It is also worrying that Member States failed so far to substantially raise investment in human resources, which was also addressed in a Communication from the Commission in November 2003. On the positive side, several Member States are trying to improve the quality and efficiency of their education systems, where e.g. Spain adopted a law on quality in education and Sweden introduced a new system of vocational training.

Good progress in implementing the RCAP and the FSAP,

As regards capital markets, the Risk Capital Action Plan is almost completely implemented. The Financial Services Action Plan is well on the way to full implementation and transposition of the adopted

but a final effort is needed.

legislative measures into national law has begun. However, a final effort is required to meet the 2005 deadline. Integration of clearing and settlement arrangements has become a clear priority for action at both the EU and the Member State level in 2003. Following corporate scandals in recent years, several Member States have strengthened corporate governance arrangements at the national level, while the Commission has adopted an Action Plan on company law and corporate governance in May 2003. Financial supervision arrangements are being streamlined, both at Member State- and EU level.

Long-term sustainability of public finances is not yet secured in about half of the Member States.

Long-term sustainability of public finances, particularly in view of the ageing population, is not yet secured in about half of the Member States, notably Belgium, Germany, Greece, Spain, France, Italy, and Portugal. While significant progress has been made through pension reform measures in some Member States in 2003, in particular in France and Austria, less progress was made in bringing the public debt down. Public debt remained above 60 per cent of GDP in 2003 in six Member States, including in Belgium, Greece, and Italy where it continued to exceed 100 per cent of GDP.

Limited progress on social sustainability, despite some measures taken.

The progress in improving social sustainability is hampered by the deteriorating labour market situation, since jobs play an important role in lifting people out of poverty and social exclusion. Some measures have been undertaken to tackle regional differences in unemployment, and above all, to enhance the efficiency of investments financed by the Structural Funds.

Environmental sustainability remains a major challenge

Some progress has been made towards improving environmental sustainability in 2003. At the EU level, the Council extended the coverage of Community legislation in energy taxation (on e.g. minimum taxation levels). Several Member States (e.g. Belgium, the Netherlands, and Sweden) took further measures to promote the use of renewable energy. Other Member States (notably Germany and Austria) took measures in the area of transport pricing. In the United Kingdom, congestion charges were introduced in London, causing a marked change in behaviour. In contrast, and despite the good progress made at the end of the 1990s, no progress was noted as regards reduction of greenhouse gas emissions.

Mixed progress so far in the euro area, where more action is needed on the budgetary side…

Progress in response to the guidelines for the euro area is mixed. The macroeconomic policy mix appeared broadly compatible with price stability and continued to be supportive to growth. However, the implementation of the budgetary guidelines is worrisome. Only three Member States maintained budgetary positions close to balance or in surplus in 2003 (namely Belgium, Spain and Finland), and three others recorded an improvement in the cyclically-adjusted budget

… and as regards the euro area's external representation.

balance of at least 0.5 per cent of GDP (Ireland, the Netherlands and Portugal). Half of the euro area Member States made insufficient progress towards sound public finances in 2003. Finally, progress appears very limited in improving the external representation of the euro area in international fora.

Despite important progress noted in some areas, the overall pace of reform has not been stepped up.

Recognising that this is only the first year in a multi-annual setting, the overall picture that emerges from this review is mixed. The pace of reform (incl. both measures taken and/or envisaged) appears to have improved somewhat as regards the labour market, policies affecting competition, the business environment and the use of new technologies, education, and pensions. Progress is more limited in market integration, investment in knowledge and research, social- and environmental sustainability. The rapid deterioration in budgetary positions in several Member States and the lack of resolve to address the (excessive deficit) situation is a source of great concern. Taken together, it does not appear as if the overall pace of reforms has been stepped up as requested by the Council. There is a clear risk that with the current reform pace, full implementation of the BEPGs can not be secured by 2006, thereby putting the fulfilment of the Lisbon targets by 2010 at risk. The slowdown and the need to consolidate public finances cannot be an excuse for postponing necessary reforms further. Indeed, both fiscal consolidation and structural reforms can be growth supportive even in the short run through positive effects on confidence. Their longer-term positive impact on growth is undisputed.

1. INTRODUCTION

This Communication aims to assess the action taken or envisaged in response to the EU's medium-term economic policy strategy as laid down in the 2003-05 Broad Economic Policy Guidelines (BEPGs)[1]. The BEPGs provide the overarching instrument for economic policy co-ordination in the European Union. Following streamlining of the Union's policy co-ordination processes, the BEPGs focus on key economic policy issues and the measures to be taken over the medium term to effectively address them. Other processes (such as the Internal Market Strategy and the European Employment Strategy) deal with their issues in greater detail. This Implementation Report is presented as a part of an "Implementation Package" with the draft Joint Employment Report and the Implementation Report on the Internal Market Strategy. Together they support the Commission's 2004 Spring Report. It has taken due account of the recent report of the European Employment Taskforce.

The EU's medium-term economic policy strategy is concentrated around:

- growth- and stability-oriented macroeconomic policies;
- economic reforms to raise Europe's growth potential; and
- strengthening sustainability.

The BEPGs concentrate on the contribution that economic policies can make in the medium term to the fulfilment of the strategic goal set in Lisbon in 2000: "*to become the most competitive and dynamic knowledge-based economy in the world capable of sustainable economic growth with more and better jobs and greater social cohesion*". An environmental dimension was added to the Lisbon Agenda in 2001.

The Implementation Report provides a key input for the multilateral surveillance of the economic policies of the Member States and the Union as envisaged by the Treaty Article 99 (3). This Implementation Report is the first one following the move to multi-annual guidelines. Recognising that Member States now have three years to address the general guidelines and country-specific recommendations in the BEPGs, an incremental approach will be followed where the implementation assessment becomes gradually more thorough the closer we get to the full review of the BEPGs planned for 2006. This implies that the implementation assessment of this first intermediate year is less detailed and conclusive, and concentrates on policy intentions to a greater extent than future assessments.

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1 See Council recommendation of 26 June 2003 on the BEPGs (2003/555/EC), published in the Offical Journal No. L 195/1 of 1 August 2003.

Box 1: Follow-up given to the Council's three main priorities

In a cover note to the 2003-05 Broad Economic Policy Guidelines (BEPGs) the Ecofin Council highlighted three main priorities for policy action in the coming year:

1. promoting growth;
2. increasing flexibility in our labour markets; and
3. ensuring sustainability of our public finances.

The Council also stated that the pace of reform must be stepped up and that a timely and effective implementation of the BEPGs is of crucial importance for confidence and growth. Moreover, it indicated that it had a vital role to play, together with the Eurogroup, to jointly monitor and encourage implementation by all policy actors.

Thereafter, the Italian Presidency indicated that the Council will start holding regular implementation discussions throughout the year. A working breakfast was devoted to the follow-up given to the 2003-05 BEPGs so far, notably with regard to the sustainability of public finances on 4 Nov. 2003. Adopting conclusions on this report will be the next opportunity for the Council to return to implementation discussions.

It is not easy to briefly summarise the actual follow-up given to the three priority areas highlighted by the Council, given their very broad nature. For instance, all general guidelines under "growth- and stability-oriented macroeconomic policies" and "economic reforms to raise Europe's growth potential" are more or less directly aimed at improving Europe's growth- performance and potential. The presentation below should therefore not be seen as replacing the more in-depth assessment carried out in the full report.

As regards "giving priority to growth in Europe" and the need to find an appropriate balance of macroeconomic policies, this Implementation Report concludes that such policies have been accommodative to growth. The monetary policy stance was loosened as the ECB cut interest rates by 75 basis points in total in 2003. The budgetary stance remained neutral given the broadly unchanged cyclically-adjusted budget deficit, although the play of automatic stabilisers helped to stabilise the economy.

In addition to sound macroeconomic policies, the Council highlighted the need to step up investments in human and physical capital and to complete the Internal Market. Progress appears mixed. Total investments are expected to have declined in 2003 (by 0.4 per cent in EU15 and 1 per cent in the euro area), albeit at a lower rate than in 2002, and in line with the adverse cyclical conditions. Investment in knowledge and innovation continues to lag behind that of the USA. Moreover, progress in creating a better functioning Internal Market has slowed down. However, the European initiative for growth, which was launched in October 2003, aims to encourage certain trans-European network infrastructure and R&D projects where funding can be provided from the EU budget. The contribution from the Community for trans-frontiers infrastructure investments is limited to 20 per cent of the project's cost. These projects will also benefit from an enhanced co-ordination in respect of planning, environmental impact assessment and financing.

As regards "increasing flexibility in our labour markets", it appears as if the pace of labour market reforms slightly improved in 2003, but needs to be stepped up further if the Lisbon targets are to be met. Efforts have been made in several Member States to make work pay, even if reforms remain focused on the tax side. Several Member States have also taken further measures to make the work organisation more adaptable and to foster occupational mobility. Active labour market policies (ALMPs) have also become better in responding to the individual needs of the unemployed. In contrast, few measures have been proposed to address incentive effects in benefit schemes, promote wage differentiation, enhance the efficiency of ALMPs in line with evaluations, or address the regulatory burden (e.g. the employment protection legislation).

As regards "ensuring sustainability of our public finances" progress seems to be mixed. Since 2000, the public debt level is increasing in both the EU and in the euro area, and remains well above the reference value of 60 per cent of GDP for the latter. Important pension reforms, on the other hand, were adopted in some Member States in 2003, notably in France and Austria. Several Member States have also tried to improve the interaction between the pension system and the labour market performance, but the employment rate of older workers amounted to only 40 per cent in 2002, with sizeable differences across Member States.

This Communication (Part I of the Implementation Report) is complemented by a working document of the Commission services that provides a first assessment of the implementation of the recommendations given to Member States to address their individual challenges on a country-by-country basis (Part II). As for the general guidelines, the implementation assessment will be stepped up gradually in the coming years.

2. STRENGTHENING THE EU'S ECONOMY

2.1 Growth- and stability-oriented macroeconomic policies

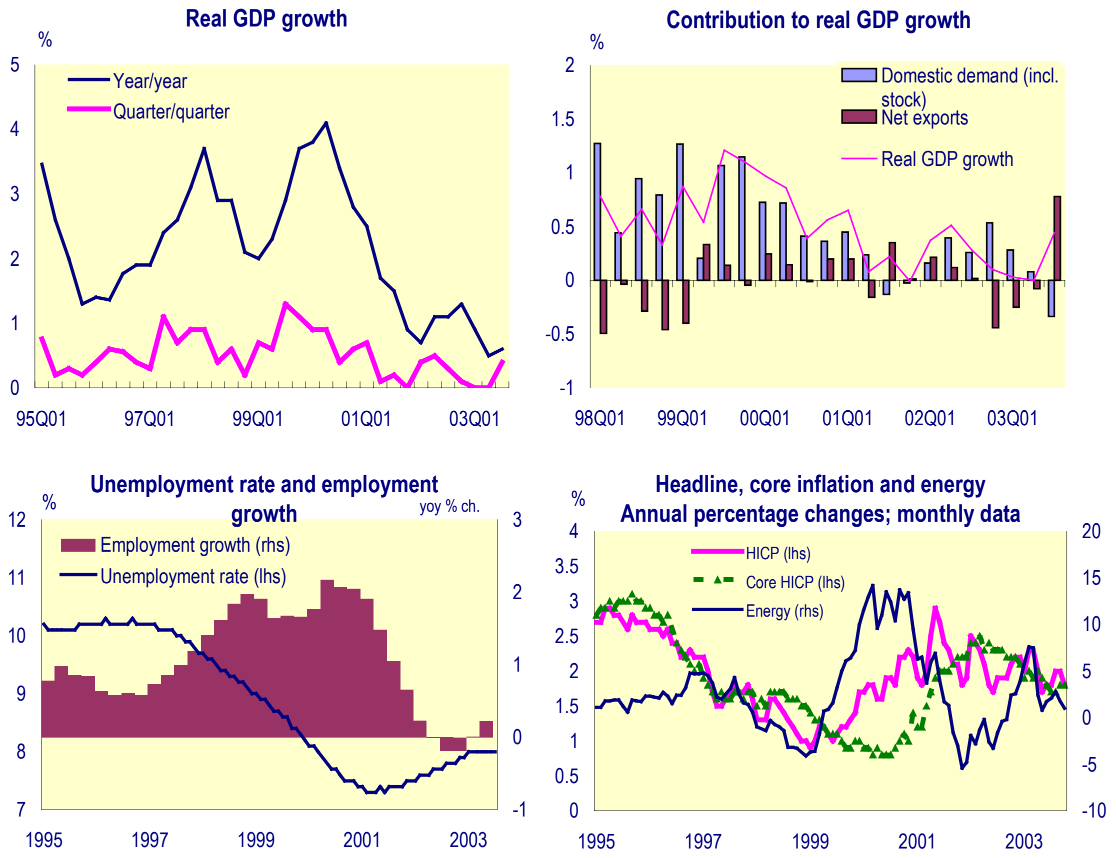
2.1.1 Economic background: lowest economic growth since 1993

Economic growth has turned out to be markedly weaker than anticipated. Following a poor performance at the end of 2002, the EU economy stagnated in the first half of 2003. Even if activity clearly improved in the third quarter, the average growth rate is expected to have been a modest 0.8 per cent in 2003 (0.4 per cent in the euro area), see Graph 1. This is the lowest growth rate since 1993. There are several factors behind the disappointing economic performance and the delay in the expected recovery. Firstly, confidence was generally undermined by the geopolitical tensions linked to the Iraq war. Secondly, uncertainties related to future labour and pension income and the adverse wealth effects of the prolonged stock market decline dampened consumers confidence in the euro area. Thirdly, weak profitability in the corporate sector following e.g. the on-going balance sheet adjustment and the increased costs for external funding is likely to have reduced or postponed investments. Finally, structural rigidities remain substantial. Market segmentation and inflexibility caused e.g. real unit labour costs and consumer price inflation to adjust only sluggishly to weak economic growth and deteriorating labour market conditions.

The protracted period of sluggish growth has started to take its toll on the performance of the labour market. In 2003, some 200.000 jobs are expected to have been lost in net terms in the euro area (thereby recording the first decline since 1994). The unemployment rate is forecasted to have increased to 8.1 per cent in the EU (8.9 per cent in the euro area).

Inflation, estimated at 2 per cent in the EU in 2003 (2.1 per cent in the euro area), has been relatively slow to come down despite weak growth. This is partly due to temporary factors such as the pass-through of oil price increases, weather-induced food prices hikes and rises in indirect taxes. But core inflation has also been sticky, because of upward pressures on unit labour costs from steady nominal wage growth in combination with a cyclically induced slowdown in productivity growth, and a slow pass-through of the euro appreciation into consumer prices.

Graph 1: Economic developments in the EU



Source : Commission services.

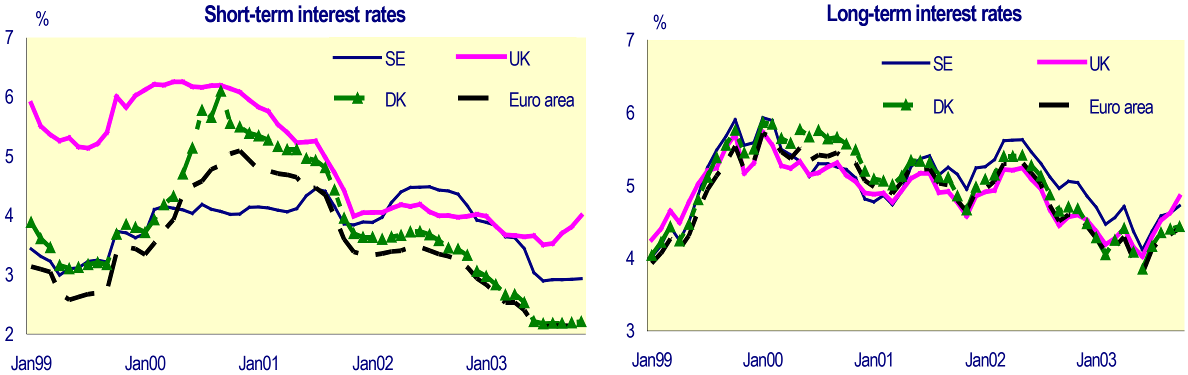
Macroeconomic policy conditions remained accommodative

Macroeconomic policies have been accommodative in view of the weak growth conditions.

The ECB cut interest rates two times in 2003, by a cumulative 75 basis points to 2 per cent for the minimum bid rate, in connection with decelerating cyclical conditions, see Graph 2. Its supportive effect on growth, and above all on domestic demand, was partly counteracted by the recent strengthening of the euro that hampered net export somewhat. Overall, the monetary policy stance continued to be accommodative. Even though inflation has remained above 2 per cent and monetary aggregates have grown strongly, inflation expectations remained low and stable.

Outside the euro area, central banks lowered policy rates in several steps in the first half of the year. The Bank of England cut the repo rate, the main policy rate, twice by 0.25 percentage points to 3.5 per cent by mid-July. Subsequently, amid signs of strengthening economic activity and strong credit growth, it raised the repo rate in November by 0.25 percentage points. In Sweden, the Riksbank cut the policy rate three times in the period between January and early July, by 1.0 percentage point in total. The repo rate has subsequently been kept unchanged and currently stands at 2.75 per cent, its lowest level ever.

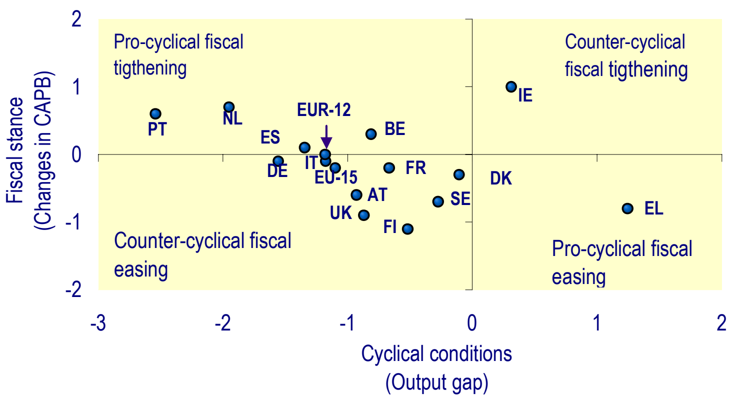
Graph 2: Short-term and long-term interest rates



Source : Commission services.

The overall fiscal policy stance remained neutral in the EU, where the primary cyclically-adjusted budget balance was broadly unchanged, see Graph 3. Nominal budgetary positions deteriorated, as automatic stabilisers acted to cushion the effects of the protracted slowdown. The lack of a budgetary consolidation in some Member States during the previous up-turn has limited the current room of manoeuvre. This has put the overall EU fiscal framework under pressure, see also Section 2.1.2 below.

Graph 3: Fiscal stance and cyclical conditions in EU Member States 2003



Source : Commission services.

Wage growth remained unchanged at around 3 per cent in EU-15 in 2003 (2 ¾ per cent in the euro area). The continued rise in nominal wages coupled with a slight decline in inflation has allowed real wage growth to edge higher, thereby benefiting households' purchasing power. Against a background of a cyclical reduction in labour productivity growth, unit labour cost growth remained above 2 per cent last year. Wage trends still appear broadly in line with price stability, provided that the expected cyclical recovery in labour productivity is not translated into higher wage growth.

2.1.2 Budgetary developments: fiscal policy framework under pressure

Further deterioration in budgetary positions

The impact of the economic slowdown on EU public finances became clearly visible after 2000. Both automatic stabilisers and discretionary policies exerted pressures on the budget balances, and the nominal surplus of 1.0 per cent of GDP in 2000[2] for EU-15 turned into a deficit of 1.9 per cent in 2002. The average nominal budget position worsened further in 2003 to -2.7 per cent of GDP in the EU, with sizeable differences across Member States. Despite the general worsening, four Member States managed to maintain a nominal budget position in balance or in surplus during the whole period 2000-2003 (BE, DK, FI and SE). A substantial deterioration can be noted for several other Member States, where two countries (DE and FR) are expected to have deficits exceeding the 3 per cent of GDP reference value by a large margin in 2003.

For the EU as a whole, the economic slowdown is the main factor responsible for the deterioration in public finances in recent years, through the working of the automatic stabilisers. An important part of the deterioration stems from discretionary deficit-increasing measures. The cyclically-adjusted budget deficit rose from -1.2 per cent of GDP in 2000 to -2.2 per cent in 2003. At Member State level, the development has been quite diverse (see also Graph 4). Of all the Member States that had a cyclically-adjusted budget deficit in 2000, the situation worsened in the case of Germany, Greece, France, and the Netherlands, while it improved in Belgium, Spain, Italy, Austria, and Portugal.

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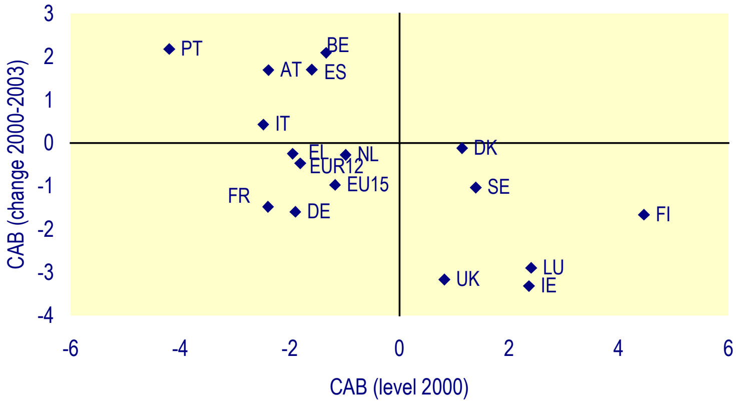
2 The EU-15 net lending figure included one-off proceeds for telephone licences (UMTS) of 1.2 per cent of GDP in 2000.

Graph 4: Cyclically-adjusted budget balance



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 pro-cyclical policies, in particular in economic upturns.

* Euro area Member States were recommended to improve their cyclically-adjusted balance by at least 0.5 per cent of GDP annually in case the medium-term objective had not yet been achieved.

Implementation of the guideline on fiscal policies is worrisome

According to the Commission's economic forecasts (autumn 2003) five Member States maintained a **budget position of close to balance or in surplus** in 2003 (in cyclically-adjusted terms), namely Belgium, Denmark Spain, Finland and Sweden (see Table 1). These Member States seem likely to maintain sound positions over the coming years. In the case of Austria and according to the recent Stability programme, the budgetary situation weakened in 2003 to a degree that it no longer complies with this guideline. On the assumption of unchanged polices, the autumn forecasts imply that two more Member States (IE and AT) could achieve a sound position by 2005. However as regards Austria, it now appears unlikely that the forthcoming tax cuts (amounting to 1 per cent of GDP) will be accompanied by corresponding expenditure restraint; thereby causing the cyclically-adjusted balance to deteriorate considerably in 2005.

Member States that had not reached the above mentioned objective are recommended to **improve their cyclically-adjusted budget balance** (and the adjustment should amount to at least 0.5 per cent of GDP per year for euro area countries with deficits below the 3 per cent of GDP ceiling whereas bigger improvements are expected from those with a deficit in excess of that limit, see also Section 3). In 2003, only Ireland, the Netherlands, and Portugal showed a more marked improvement (of more than 0.5 per cent of GDP) of their cyclically-adjusted budget balance. In 2004, an improvement is also expected in Germany and France, while the cyclically-adjusted budgetary deficits in Greece, Italy, Luxembourg, and Portugal could sharply deteriorate in 2004 and/or 2005 (but it should be noted that the forecasts for 2005 are based on a no-policy change scenario for all Member States).

Table 1 : Evaluation of changes in nominal and cyclically-adjusted balances

	Nominal balance		Cyclically-adjusted balance (CAB)[1]			Change in CAB[1]	
	2003	**2004**	**2003**	**2004**	**2005***	**2004**	**2005***
BE	0.2	-0.4	0.8	0.1	-0.2	-0.7	-0.3
DE	-4.2	-3.9	-3.5	-3.3	-3.0	0.2	0.3
EL	-1.7	-2.4	-2.2	-3.1	-3.2	-0.9	0.0
ES	0.0	0.1	0.1	0.3	0.3	0.2	0.1
FR	-4.2	-3.8	-3.9	-3.3	-3.2	0.6	0.1
IE**	-0.8	-1.1	-1.0	-0.6	-0.2	0.4	0.4
IT	-2.6	-2.8	-2.1	-2.3	-3.2	-0.2	-0.9
LU	-0.6	-2.1	-0.5	-1.3	-1.7	-0.9	-0.3
NL	-2.6	-2.7	-1.3	-0.7	-0.6	0.6	0.1
AT	-1.1	-0.7	-0.7	-0.3	-0.1	0.4	0.2
PT	-2.9	-3.3	-2.0	-2.1	-2.6	-0.1	-0.5
FI	2.4	1.7	2.8	2.1	2.0	-0.7	-0.1
Euro area	**-2.8**	**-2.7**	**-2.3**	**-2.1**	**-2.1**	**0.2**	**0.0**
DK	0.9	1.2	1.0	1.4	1.9	0.4	0.5
SE	0.2	0.5	0.4	0.9	1.5	0.5	0.6
UK**	-2.8	-2.7	-2.4	-2.3	-2.1	0.1	0.2
EU-15	**-2.7**	**-2.6**	**-2.2**	**-2.0**	**-1.9**	**0.2**	**0.1**

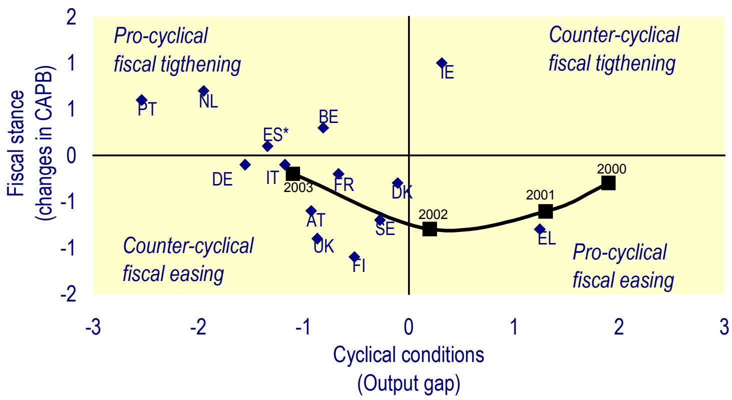
[1] On the basis of the PF method, except in the case of Germany, Spain, Luxembourg, and Austria were the HP filter method has been used.
* The forecast for 2005 is based on an 'unchanged policy' assumption for all Member States.
** The autumn forecast was prepared before Ireland presented its 2004 budget and before the United Kingdom presented its 2003 Pre-Budget Report.
Note : Differences are due to rounding.
Source : Autumn 2003 Commission forecasts.

In 2002, the Council identified an **excessive deficit** in Portugal, followed by Germany and France in 2003. Both Germany and Portugal have made considerable efforts in response to the recommendation to bring this situation to an end. According to the forecasts and following substantial one-off measures, the nominal deficit in Portugal is expected to stay below 3 per cent of GDP in 2003, but risks exceeding the limit again in 2004. In the German case, measures amounting to about 1 per cent of GDP have been taken in 2003, thereby fulfilling that part of the Council recommendation of January 2003. However, given the adverse cyclical conditions, the measures taken now appear inadequate in order to bring the excessive deficit situation to an end in 2004. France does not appear to have taken effective action to redress the budgetary imbalances, and given the current economic outlook, the excessive deficit situation is likely to persist with a continuation of a deficit well above 3 per cent of GDP in 2004.

In view of the developments outlined above, the Commission adopted recommendations to Germany and France in accordance with Treaty Articles 104 (8) and 104 (9) that no effective action has been taken (FR) or was inadequate (DE), and that both Member States should take measures to remedy the excessive deficit situation. However, in light of the weak economy, the Commission recommended to allow both Member States one additional year to bring down the deficit below 3 per cent of GDP, i.e. by 2005. On 25 November 2003, the Council rejected the Commission's recommendations and found an agreement outside the Treaty, de facto suspending its application for these articles. The Council took note of the commitments made by Germany and France to reduce their deficits to below 3 per cent of GDP by 2005.

Graph 5 examines the **fiscal stance** (approximated by the changes in the cyclically-adjusted primary balance (CAPB)) in relation to cyclical conditions which is approximated by the size of the output gap. The overall fiscal stance for the EU is expected to be broadly neutral in 2003. However, the aggregate fiscal stance results from quite diverse fiscal stances across Member States, despite fairly similar cyclical developments. Some Member States are expected to run somewhat pro-cyclical policies, reflecting consolidation efforts needed to abide by Guideline no. 1 on sound budgetary positions (e.g. NL and PT), which takes precedence over the Guideline on avoiding pro-cyclical policies. The pro-cyclical fiscal stance in Greece, however, can not be explained by a need to consolidate public finances.

Graph 5: Fiscal stance and cyclical conditions in the EU in 2003



Source : Commission services.

Box 2: Follow-up to country specific recommendations related to public finances

Country Specific Recommendations (as an extension of general Guidelines no. 1, 14-15)	**Significant Measures in 2003**	
	Adopted	**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 per cent of GDP annually in case the medium-term objective had not yet been achieved)		
DE: ensure a rigorous budget execution, including measures for 2003 of 1% of GDP; eliminate excessive deficit by 2004; lower the cyclically-adjusted deficit by at least 1pp of GDP between end-2003 and 2005	Measures of about 1% of GDP taken in 2003 but inadequate to eliminate excessive deficit by 2004	
FR: reduce the cyclically-adjusted deficit by more than planned in 2003 and by 0.5% of GDP or more in 2004 to ensure that the nominal deficit is brought down to below 3% in 2004 at the latest	Fiscal measures taken insufficient to ensure recommended correction in 2003-2004	
IT: reduce the cyclically-adjusted deficit by at least 0.5% of GDP per year until a close to balance or in surplus position is achieved; replace one-off measures by more permanent measures	Fiscal measures for 2004 insufficient to ensure planned correction; budgetary impact of one-offs in 2004 expected to be slightly lower than in 2003	
NL: continue to contain government expenditure within clearly defined ceilings set in real terms, consistent with a budgetary position close to balance or in surplus	Multi-annual real expenditure ceilings aimed at achieving close to balance position included in the 2004 budget	
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	Reform of public pensions system and of pension system for federal employees; income tax relief taking effect in 2004 but offset by indirect tax increase; reduction in number of federal employees and, at Länder level, of school teachers; but costly (third) economic stimulus package (with main impact in 2005)	Major income tax cuts envisaged for 2005; reform of health care system planned for 2005 at the earliest
PT: ensure the planned further reduction in the deficit for 2003; thereafter lower the cyclically adjusted deficit by at least 0,5 % of GDP a year to reach a close to balance position	No reduction in the nominal deficit ratio in 2003 due to adverse cyclical conditions; further disimprovement expected for 2004	

Box 2: Follow-up to country specific recommendations related to public finances (continued)		
Country Specific Recommendations (as an extension of general Guidelines no. 1, 14-15)	**Significant Measures in 2003**	
	Adopted	**Proposed**
GUIDELINE 14: Enhance the contribution of the public sector to growth		
DK: ensure expenditure control at all levels of government		
EL: ensure control of government current primary spending; use public resources more effectively		
FR: curb the dynamics of spending in the health sector	Some measures taken but insufficient to ensure lasting deceleration of health expenditure	Comprehensive reform of health insurance system to curb durably health expenditure growth
IE: enhance public expenditure efficiency; improve medium-term revenue and expenditure planning	Extension of multi-annual budgeting; reform of health care system; new capital appraisal procedures	
PO: obtain deficit reduction through expenditure side; increase health-care system efficiency	Expenditure outcome for 2003 expected to be broadly as planned; ambitious reform of health care system proceeding rapidly	Vast programme of structural reforms
FI: improve spending control; ensure compliance with expenditure rules	Introduction of improved multi-annual spending limits	Basic service programme between central government and municipalities to improve balance and predictability of municipalities' responsibilities, obligations and financing
UK: ensure efficient and cost-effective delivery of public services	Efficiency review of expenditure; web-based reporting against new PSA targets; new 'Green Book' on appraisal and evaluation guidelines	
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	Measures taken (incl. transfer of Belgacom's pensions fund)	
EL: ensure a sustained declining trend of the debt ratio by maintaining high primary surpluses	Privatisation proceeds ± 2 per cent of GDP	
FR: limit the increase in the general government gross debt to GDP ratio in 2003		
IT: ensure that the debt ratio is diminishing at a satisfactory pace towards the 60% of GDP threshold	Resumption of privatisations	Privatisation of 1 per cent of GDP per year on average

2.1.3 *Wage developments: wage growth too high to be conducive to employment creation*

Wage growth declined less than the drop in productivity growth…

Wages have responded only modestly to the worsened economic situation, partly reflecting a greater resilience initially shown in the labour market in the current slowdown. Nominal wage growth has fallen gradually from 3½ per cent in 2000 to around 3 per cent in 2003 in the EU, while it remained relatively stable around 2¾ per cent in the euro area during the same period. Unit labour costs increased, in contrast, as labour productivity growth declined sharply early in the slowdown reflecting labour hoarding in several Member States.

> Against this background, the 2003-05 BEPGs recommended to:
>
> 3. ensure that nominal wage increases are consistent with price stability and productivity gains; and foster the macroeconomic dialogue.

...but wages appear broadly compatible with price stability in the medium-term

Overall, the 2003 nominal wage increases of around 3 per cent in the EU and 2¾ per cent in the euro area are broadly in line with medium-term price stability. However, the cyclical slowdown in labour productivity growth has kept the rise in nominal unit labour costs above 2 per cent for the third year in a row. This still relatively high pace has contributed to the very gradual retreat in inflation. In addition, small advances in productivity have just been sufficient to keep real unit labour costs in check, see Table 2 below.

Wage increases appear relatively high, given the weak demand for labour. A number of institutional features contribute to explain a certain lack of nominal- and real wage flexibility (such as union power, co-ordination/centralisation of bargaining, bargaining coverage, the use of wage rules in collective bargaining, and not least various insider-outsider mechanisms). No major changes have been observed as regards the framework of wage formation in general in 2003, or the linking of wages to prices by means of indexation more specifically.

At a country level, nominal wage increases were comparatively high in Greece, Spain, Ireland, the Netherlands, and the United Kingdom[3], i.e. all countries with relatively tight labour markets and/or high inflation. Real unit labour costs rose particularly in Ireland, Luxembourg, and the Netherlands.

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[3] The increase in nominal compensation per employee in the United Kingdom in 2003 is partly explained by a raise in the employers' National Insurance Contribution (NIC), which contributed to the apparent wage increase by around 1.5 percentage points.

Table 2 : Wage developments in 2003

	Nominal compensation per employee	Real wages[1]	Labour Productivity	NULC[2]	RULC[3]
BE	2.2	0.8	1.0	1.1	-0.3
DE	1.9	0.7	1.6	0.3	-0.9
EL	6.5	2.4	3.0	3.4	-0.7
ES	4.1	0.1	0.6	3.5	-0.6
FR	2.7	1.0	0.3	2.4	0.7
IE	5.1	3.5	0.7	4.3	2.8
IT	3.0	0.0	-0.5	3.5	0.5
LU	2.7	0.8	-0.5	3.2	1.3
NL	4.1	1.3	0.2	3.9	1.1
AT	2.5	1.2	0.8	1.7	0.4
PT	2.7	-0.6	0.2	2.5	-0.9
FI	3.1	2.0	1.7	1.4	0.3
Euro area	**2.7**	**0.6**	**0.6**	**2.1**	**-0.1**
DK	3.7	1.4	1.5	2.2	0.0
SE	3.7	1.6	1.6	2.1	0.1
UK	4.3	1.9	1.4	2.9	0.5
EU-15	**3.1**	**0.9**	**0.8**	**2.3**	**0.1**

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

Source : Commission services.

The macroeconomic dialogue fosters a common understanding among policy actors

Over the last few years, the Macroeconomic Dialogue has developed into a useful forum at EU level for the regular exchange of views between all policy actors, including the social partners. It fosters a common understanding of the economic situation and can thereby help to prevent tensions that could lead to an unbalanced macroeconomic policy mix.

2.2 Economic reforms to raise Europe's growth potential

The EU needs higher and sustainable economic growth for the rest of this decade to achieve the Lisbon objectives. Structural reforms are necessary to increase Europe's growth potential. They are best implemented in a comprehensive and coordinated way. The 2003-05 BEPGs therefore focused on the need to both improve the functioning of the labour market, the quality of human resources, and to increase productivity and business dynamism.

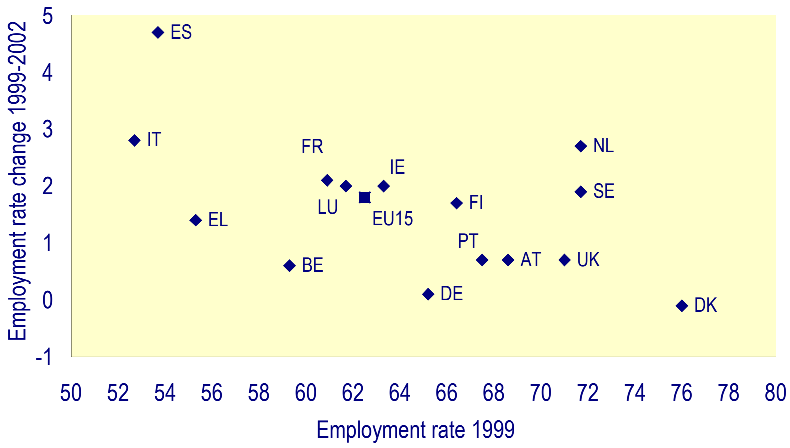
2.2.1 *The Lisbon employment targets are in serious jeopardy of being missed*

Progress towards the Lisbon and Stockholm employment targets is too slow

After several years of strong job creation, the impact of the economic slowdown on employment has started to be felt more strongly. Following a deceleration in 2002, job creation in the EU came to a standstill in 2003, and employment contracted slightly in the euro area. As firms accelerated labour cutbacks, unemployment started increasing more rapidly. From 7.3 per cent in early 2001, the (seasonally adjusted) unemployment rate increased to 8.0 per cent in October 2003. Differences across Member States are sizeable. Unemployment remains below 5 per cent in Luxembourg, the Netherlands, Austria, and Ireland, while it is above 9 per cent in Spain, Germany, and France.

The **total employment rate** stood at 64.3 per cent in the EU in 2002 (varying from 55.5 per cent in IT to 75.9 per cent in DK). Graph 6 illustrates the different starting points in 1999 and developments across Member States. Following a certain catching-up during the past three years, the difference between the highest and the lowest national employment rate was reduced from 23.3 to 20.4 percentage points.

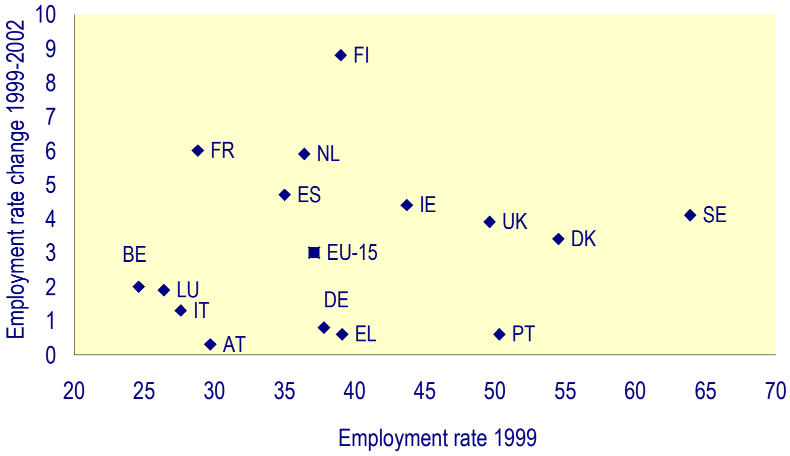
Graph 6: Total employment rate



Source : Commission services (structural indicator no. I.1.1).

The **employment rate for older workers** was only 40.1 per cent in 2002, leaving the greatest distance to cover towards the target for 2010 (of 50 per cent for the average EU employment rate). The differences across Member States are particularly large - only 26.7 per cent of those aged 55 to 64 work in Belgium, while it is 68.0 per cent in Sweden (see Graph 7). Moreover, progress in recent years is slowest in some of the Member States with the lowest starting levels. It is important that the errors of the past must not be repeated, i.e. the recourse to early retirement as a seemingly convenient solution for corporate restructuring has to be avoided.

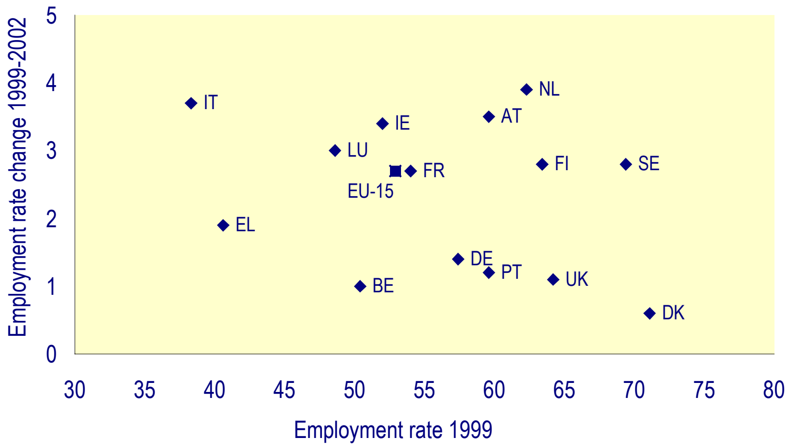
Graph 7: Older workers employment rate



Source : Commission services (structural indicator no. I.1.4).

Women benefited particularly from employment growth in the recent past. The **female employment rate** reached 55.6 per cent in 2002 (see Graph 8). Although cohort effects will continue to push the female employment rate up, since the propensity to work is higher among younger generations of women, specific barriers to female labour market participation (such as the lack of childcare and opportunities for part-time employment) remain a major impediment in some Member States.

Graph 8: Female employment rate



Source : Commission services (structural indicator no. I.1.2).

Kok report calls for wide-ranging reforms

Given the lack of employment growth in 2003 and a modest acceleration forecast for 2004 and 2005, the EU is likely to miss the intermediate employment rate target of 67 per cent by the end of 2005, and does not appear on course to meet 2010 targets. The risk of missing the Lisbon- and Stockholm employment targets should not be attributed to the cyclical slowdown. The problems are of a structural nature and to come anywhere close to meeting the employment targets, the swift implementation of comprehensive labour market reforms is urgently needed.

This was also highlighted in the recent report of the European Employment Taskforce (EETF), which was chaired by former Dutch Prime Minister Mr. Wim Kok, and released in November 2003. It makes an important contribution to the debate on how the EU can renew making progress towards the Lisbon employment targets. The policy recommendations are broad ranging, and underline the need for a consistent set of policy measures. The report outlined the following four key requirements to boost employment and productivity – increasing adaptability of workers and enterprises, attaching more people to the labour market, investing more and more effectively in human capital, and ensuring effective implementation of reforms through better governance. Overall, the policy recommendations are in line with the 2003-05 BEPGs. For example, the EETF report underlines the need for employees and employers to be able choose from a variety of contractual employment relations, and that business regulation needs to be simplified. It acknowledges the contribution that temporary work agencies can play in increasing the adaptability of the labor market, while providing employees with a well-defined framework. The EETF calls for a reconsideration of the concept of security for employees by simultaneously considering the contractual framework and adequate protection in the case of job loss through more dynamic forms of social protection "job-to-job insurance" and active measures. In addition, the EETF calls for renewed impetus in tax/benefit reform, and agrees that in-work benefits can be a powerful tool for alleviating unemployment traps, but that they need to be designed carefully in order to avoid poverty traps or excessive overall costs. It supports further reform of means-tested benefits and the individualisation of income taxation in order to remove inherent disincentives. Finally, the EETF recognises the importance for wage differentiation to reflect productivity and the sectoral and regional labour market situation.

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.

Overall, the pace of labour market reforms has become more encouraging, but it needs to accelerate further

In general, the pace of reforms on the labour market has slightly improved in 2003. Significant reforms have been adopted in several Member States, see Box 3. However, their impact is still to be seen as reforms are still in the process of being adopted and/or implemented in several Member States.

Tax/benefit reforms contribute to improving incentives, but so far they remain piecemeal and too much focused on the tax side

Improving incentives to work remains a serious challenge in most Member States. Indeed, all Member States but three (ES, IE and PT) received recommendations to address disincentives to work generated by the **combined effect of taxes and benefits.**

In general, measures implemented and announced in 2003 continue to be concentrated on the tax side, introducing or increasing work-related tax credits (BE, FR, IE and NL) and reducing the marginal tax rates at the lower end of the wage scale (in particular in DE, FR and IT). Others Member States, like Belgium, Austria, Denmark, and Finland, envisage further steps in this direction in the coming years. However, although the focus of measures on the tax side may be understandable from a political perspective, it is problematic as public finances are under pressure in several Member States, further limiting the room for manoeuvre.

Few steps have been taken (or announced) to reform benefit systems, which contribute most to the risk of unemployment- and inactivity traps. Eligibility criteria, duration of benefits, enforcement of job-search and availability-to-work requirements have changed only little. Nevertheless, Germany envisages important steps in this direction and is going to implement a reform of the unemployment benefit scheme in the coming months. A review of the unemployment insurance has been undertaken in the Netherlands in 2003, markedly tightening eligibility requirements. Some measures have also been undertaken in Denmark. Although Member States are increasingly developing activation measures related to the granting of welfare benefits, much more needs to be done in terms of closer interactions between passive and active labour market programmes.

Childcare provision has improved only slightly, even though it is recognised as a priority in most Member States. More efforts by Member States are needed to ensure adequate and affordable childcare for children in line with the Barcelona targets of childcare coverage.

Few concrete measures to foster wage differentiation can be noted so far

Unemployment differentials remain important across regions and skills levels. Seven Member States (DE, GR, ES, IE, IT, PT, FI) received a specific recommendation to allow for stronger wage differentiation, reflecting productivity ratios and local labour market conditions. Although discussions have started in some Member States, few concrete measures towards **wage differentiation** can be noted so far.

In 2003, concrete initiatives remained at early stages of discussion or were piecemeal. Wage differentiation in public sector collective agreements is being discussed in the UK. In Germany, public employers have been trying to reduce personnel costs, e.g. by negotiating working time reductions without compensating payments for overstaffed services or by cutting additional benefits for employees and officials. A relaxation of the "favourability principle" is under discussion in Germany and France, where lower-level agreements can only be more favourable than sectoral agreements. This notwithstanding, an informal trend towards more flexibility at the firm level continues while respecting the role of social partners according to national practices.

In most Member States, work organisation is becoming more adaptable, but there are only few recent initiatives to address employment protection legislation

A move towards full employment will require rapid net employment growth and high labour turnover. This needs to be supported by a **flexible regulatory framework and work organisation.** Excessively rigid labour market regulations discourage hiring and slow down adjustment. Country-specific recommendations were issued to Germany, Greece, Spain, and Italy to this end. Flexibility has been improved in most Member States, through e.g. enhanced rights to flexible working to improve reconciliation of work and family life. Security has also been strengthened, particularly the health and safety aspects in work organisation. However, not enough has been done to tackle employment protection legislation (EPL), or to render non standard contracts more attractive to employees.

Box 3: Follow up to country specific recommendations related to labour markets

Country specific recommendation (as an extension of general Guidelines no. 4-8)	**Significant Reform Measures in 2003** **Adopted**	**Proposed**
GUIDELINE 4: Improve the combined incentive effects of taxes and benefits and reduce high marginal effective tax rates		
BE: reduce distortions to work incentives in tax-benefit systems	Work-related tax credits reduce MTR at lower wages	Further steps envisaged.
DK: improve labour supply incentives, in particular tax reform and eligibility rules.	Some measures to tighten eligibility.	Some steps envisaged to reduce MTR
DE: continue tax-benefit reforms to work incentives, enforce job-search conditionality.	Reduced MTR at lower wages from Mini/Midi jobs & Mainz model.	Implementation of unemployment benefit reform
EL: improve formal work incentives, including part-time, through reduced non-wage costs and pension rights transferability.		
FR: implement new unemployment insurance system, including effective job-search incentives.	Work-related tax credits increased, reduced MTR at lower wages.	
IT: increase labour force participation of women and older workers; increase resources and efficiency of unemployment benefit and social insurance system.	Some decline of MTR at lower wages.	
NL: continue benefit reforms, particularly eligibility and conditionality & reform disability system.	Tighter eligibility requirements for UI; in-work tax credits increased.	
AT: improve pension contributions-benefits link and improve older worker participation.		Further steps to reduce MTR envisaged.
FI: improve tax-benefit incentives and eligibility criteria, particularly for older workers.		Further steps to reduce MTR envisaged.
UK: improve work incentives, particularly by reforming sickness and disability benefits.	In-work tax credits extended.	
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 Günstigkeitsprinzip.	Min pay reduced in East German construction sector.	Favourability principle under consideration.
EL: reform wage bargaining to reflect productivity differences.		
ES: reform wage setting to reflect productivity differences and phase-out indexation provisions in collective agreements.	Agreement on orientations for lower-level bargaining & increases to reflect productivity.	
IE: Social Partners to allow wages to adapt to productivity and skills differences.		
IT: encourage more decentralised wage setting to better reflect productivity and skills.		
PT: encourage wage moderation to allow increases to take into account productivity and skills.		Proposed 'social pact' on pay moderation and collective agreements.
FI: reform wage bargaining to reflect productivity differences.		

Box 3: Follow up to country specific recommendations related to labour markets (continued)		
Country specific recommendation (as an extension of general Guidelines no. 4-8)	**Significant Reform Measures in 2003** **Adopted**	**Proposed**
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, i.a. by lowering effective degree of employment protection. **EL:** improve flexibility & security balance; modernise work organisation; review labour market regulations. **ES:** further reform EPL to reduce labour market segmentation across types of contract. **IT:** further reform EPL and reduce labour market segmentation across different contract types and firm size	Reduced EPL for small firms; some flexibility introduced into social criteria used in lay-offs.	
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.		
ES: continue to facilitate geographical mobility, i.a. remove fiscal distortions and improve rental market conditions and availability of land for development.	Rental market & benefit reforms to encourage take-up of jobs requiring relocation; agricultural regional mobility promoted.	Measure to ease housing search & residence change. New co-ordination methods among PES.
GUIDELINE 8: Ensure efficient active labour market policies 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 jobsearch assistance. Improve cost-effectiveness and targeting.	Unemployment and social assistance merged under PES.	Hartz III to reduce ratio of unemployed : case worker from 410:1 to 75:1

The promotion of adaptable work organisation has mostly been taken up in social dialogues at the national level. In 2003, agreements were reached on flexibility of working time (DK, NL, and SE) and modernisation of public sector work organisation (ES). Legislative reviews are planned in France, Ireland, the Netherlands, and Portugal. The UK has introduced principles to improve the quality of future regulations. France has introduced legislation to make the 35-hour week more flexible. Several Member States (e.g. IE and NL) are also looking at how to adapt to future changes in working practices, such as how best to take advantage of e working opportunities. Many countries (e.g. IE, NL, and UK) have taken measures to improve reconciliation of work and family life through increased rights to parental- and/or care leave.

Employment contracts and EPL were only addressed in a few countries in 2003. The new labour code in Portugal includes an increase in fixed-term contract duration, working hours flexibility, devices to control unjustified absenteeism and encouragement of occupational mobility. Portugal and Spain have continued efforts to reduce their high share of fixed-term contracts. In Italy, a decree on labour market reform has just entered into force. It includes new forms of 'flexible' contracts, but the EPL was not addressed. In Germany, a relaxation in the social criteria have been put forward determining which employees are laid off first in redundancies, including also a relaxation of the EPL for small firms.

Some Member States are encouraging geographical mobility, and a majority is addressing occupational mobility

Regional disparities, often with simultaneous unemployment and skills 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.

Some Member States have taken measures to encourage geographical mobility. The dissemination of information on vacancies is improving through the cooperation of Member States and the use of information technology. Some Member States have introduced changes in the tax/benefit system in 2003, in order to improve incentives to mobility (DE, EL, ES, FR, and SE). Belgium and Spain have started addressing rigidities in the housing market.

Most Member States continued to take initiatives to promote lifelong learning to foster occupational mobility. Some Member States have recently adopted, or are planning to adopt, measures to facilitate the recognition of informal skills. Denmark has introduced new training measures to address foreseen shortages of skilled labour. Belgium has stepped up efforts to overcome linguistic barriers.

Individualised approaches are spreading, but the redesign of ALMPs in the light of evaluations remains exceptional

Active labour market policies (ALMPs) are an important instrument to open a path back to employment and to prevent long-term unemployment. However, they need to focus on “the right measure to the right person at the right time”. Germany received a specific recommendation to increase the efficiency of ALMPs. While individualised approaches are becoming more widespread, evaluations are not systematically carried out, nor used to critically assess and redesign programmes.

Despite growing awareness of shortcomings in their efficiency following rigorous assessments, only a few Member States adapted ALMPs in 2003, or announced plans for doing so. For instance in Denmark, the former high activation target was abandoned in order to focus more strongly on job placement activities, and it is planned to streamline the tools available to the employment service. Sweden has looked at simplifying the structure of programmes. In Ireland, there has been a shift from employment schemes towards measures focusing on employability, while in the Netherlands “reintegration agencies” are paid depending on the integration results achieved.

More progress is made concerning the targeting of measures towards those hardest to place. The early identification of jobseekers’ needs and, where required, a tailor-made offer of an active programme are being implemented or on the agenda in a majority of Member States. In this context, the role of job placement activities is being strengthened. Unemployed with good employment prospects are increasingly channelled to self-service facilities. In Germany, the government proposed a simplification of benefit administration. It will free additional resources for placement activities. It is also likely to enhance efficiency e.g. by removing incentives for municipalities to provide an active measure with the main goal of re-qualifying a participant for unemployment benefits. Most Member States are planning to enhance the cooperation of different actors involved in job-placement, training, and benefit administration, in some cases by bringing the different providers together in a “one stop shop”.

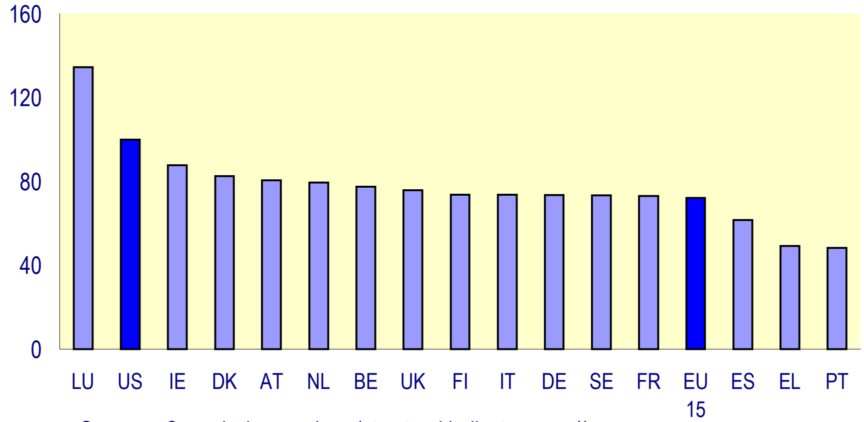
2.2.2 Economic reforms not reflected in productivity growth figures

The economic reform effort recommended by the 2003-05 BEPGs is aimed at increasing the long-term growth potential of the EU economy. This should be seen within the context of a divergence in EU employment and productivity growth patterns in recent years. Compared with the first half of the 1990s, the period 1996-2002 witnessed a significant increase in the contribution of labour to GDP growth in the EU, but this has been partly offset by a reduction in the contribution from labour productivity. By comparison, the USA has been able to combine a strong employment performance with accelerating labour productivity growth, resulting in GDP growth that was more than a full percentage point higher than in the EU over the period 1996-2003.

The labour productivity gap has widened between the EU and the USA...

The growth rate of labour productivity per person employed in the EU slowed down from 1.9 per cent in the first half of the 1990s to 1.3 per cent in the second half. Since then, annual labour productivity growth has fluctuated between 0.5 per cent and 1 per cent, reflecting initially a greater resilience in the labour market to the economic slowdown with continued (albeit modest) employment growth. The experience in the EU was quite different from that in the US, where labour productivity growth rates have recovered to levels of 2 per cent or more. As a consequence, the productivity gap with the USA has widened, with EU productivity per hour worked being 12 per cent below that in the US. This productivity gap is now responsible for 40 per cent of the difference in GDP per capita between the EU and the USA (where the European GDP per capita amounted to 72 per cent of the level in the USA in 2003), see Graph 9.

Graph 9: GDP per capita 2003 (US=100)

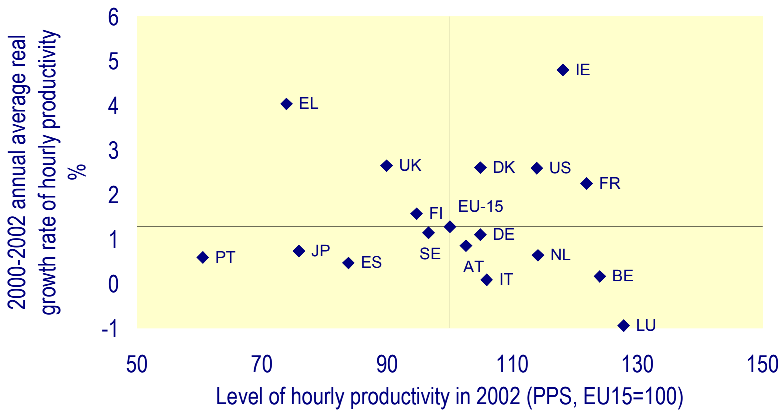


Source : Commission services (structural indicator no. a1).

…but the EU average hides significant differences between Member States

Differences are wide in hourly productivity levels and growth rates between Member States (see Graph 10). Starting from a good position, hourly labour productivity continued to increase relatively rapidly in Denmark, Ireland, and France. In France this may be associated with the introduction of the 35-hour working week as labour productivity growth per person employed was below the EU average. Productivity levels in Greece and the UK continued to catch-up with the EU average. In Spain and Portugal, on the other hand, productivity fell even further behind. Drops in relative productivity levels were observed as well in Italy and the Benelux countries.

Graph 10: Evolution of the hourly productivity (2000-2002)



Source : Commission services.

The deterioration in EU labour productivity growth may be explained in equal parts by slow-downs in investment and technological progress…

The productivity challenge is clear, with the EU's long-established superiority in terms of labour productivity growth having disappeared since the mid 1990s. Half of the decline in labour productivity growth since the first half of the 1990s can be attributed to a reduction in the contribution from capital deepening, while the other half emanates from a deterioration in total factor productivity. Whilst investment in ICT was contributing positively, its contribution to labour productivity growth was only half of that in the United States. The main reason for this was a lesser use and slower diffusion of these technologies in certain services sectors, including in particular the financial services and distribution sectors. This illustrates the need to raise business dynamism and investment, particularly in ICT. That can only be achieved through a reform strategy aimed at improving the regulatory environment, promoting market integration and efficiency, stimulating the diffusion of ICT, and boosting investments in human capital and R&D.

Table 3 : Spending on gross fixed capital formation, education and R&D in the EU (as a percentage of GDP)

	Average 1991-1995	1996	1997	1998	1999	2000	2001	2002	2003
Total investment	20.5	19.6	19.4	19.9	20.2	20.6	20.2	19.4	19.1
Private investment	17.6	17.1	17.2	17.6	17.9	18.3	17.9	17.2	16.7
Public investment	2.9	2.5	2.2	2.3	2.3	2.3	2.3	2.2	2.4
Education		5.2	5.0	5.0	5.0	4.9	5.1		
R&D	0.7	0.7	0.7	0.7	0.7	0.7			

Sources: For investments: AMECO DG ECFIN database; for public spending on education: Eurostat but 2001 is according to the COFOG classification; and for public spending on R&D: OECD.

…and recent developments in business investment and spending on IT, R&D, and education are not very promising.

Due to business cycle effects, business investment as a percentage of GDP in the EU declined from 18.3 per cent in 2000 to 17.2 per cent in 2002, see Table 3. This produced a reduction in total gross fixed capital formation (from 20.6 per cent in 2000 to 19.1 per cent in 2003) in spite of the fact that public investment has been quite stable (at 2.2-2.4 per cent of GDP) over recent years. Expenditure ratios on IT, R&D, and education showed little movement. According to the Commission's economic forecast (autumn 2003), business investment should recover in 2004 and 2005, provided that the economic framework conditions that encourage businesses to invest and grow have been put in place. Recent efforts to ease the regulatory burden on business should be helpful in that respect. Spending on IT should benefit as well from regulatory reform. A cross-country analysis of investment rates[4] reveals that countries with low levels of regulation have in general been more successful in adopting new technologies in the form of ICT investment.

Despite its many successes, the Internal Market is still not functioning as it should. After years of steady progress throughout the 1990s, some key indicators of Internal Market integration are now pointing in the wrong direction. Growth in trade amongst the EU Member States has almost stalled, growing by less than 3 per cent annually over the past three years, and the

[4] European Commission (2003), "Drivers of productivity growth: an economy-wide and sectoral perspective", Chapter 2 in the EU Economy 2003 Review.

dispersion of price levels between Member States in 2001 did not differ from that observed in 1998 or 1999.

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 and ensure consistent enforcement of EU rules and removing barriers to efficient cross border clearing and settlement;

11. generate a supportive environment for entrepreneurship and for 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 per cent of GDP objective of total R&D investment;

14. enhance the contribution of the public sector to growth.

Mixed progress in fostering competition in goods and services markets…

A **regulatory environment** that is conducive to investment is essential to make the EU economy more competitive and dynamic. Creating a well-functioning Internal Market with an effective competition policy is essential. Since the launch of the Lisbon Strategy more than 25 legislative measures have been adopted to extend the reforms in these areas (including the tax package aimed at curbing harmful tax competition), but a number of proposals (including directives on professional qualifications and intellectual property rights) remain pending before the Council and the European Parliament. The Commission issued new proposals for directives to eliminate further obstacles to the Internal Market found in the tax regimes applicable to associated companies located in different Member States; to further simplify and streamline VAT; and to update guidelines and financing rules for trans-European networks. It has adopted a proposal for the establishment of a legal framework for providing cross border services between Member States.

Box 4: Follow up to country specific recommendations related to product markets

Country Specific Recommendations (as an extension of general Guideline no. 9)	Significant Reform Measures in 2003 Adopted	Significant Reform Measures in 2003 Proposed
GUIDELINE 9: Foster competition in goods and services markets.		
BE: Enhance effective competition in network industries and in local services.	Improvements in the role of regulatory authorities. Further opening up to competition of network industries.	
DK: Enforce competition in sectors where it is inadequate.	Electricity market fully liberalised. Changes to legal framework for payment services and drinking cans. Project to identify regulatory barriers to competition started.	
DE: Create a more competitive environment.	Proposals to reform competition law. Proposal to relax the law on unfair competition.	Proposals should become law in 2004.
EL: Enhance competition in the energy sectors.	Introduction of a wholesale electricity market. Removal of administrative barriers to entry into electricity market.	
ES: Enforce effective competition in retailing and monitor developments on the electricity market.	As of January 2003, customers are free to choose electricity supplier. Legal basis to put in place a forward electricity market adopted.	The completion of the Spanish-Portuguese electricity market is planned for 2004.
FR: Ensure competition in energy markets. Raise the transposition rate of Internal Market directives and reduce number of infringements.	Transposition of the Gas directive. Opening up of energy market in line with EU directives. Emergency plan to speed up transposition.	Legal separation management gas pipeline network in 2004. In electricity, the operation of the transmission grid will be legally separated from power generation in 2004.
IE: Increase competition in network industries and certain other sectors.	Reform of motor vehicle insurance partially complete.	Competition Authority review of retail sector and rules of professional bodies.
IT: Increase effective competition in the service sector, widen the opening of the energy markets, and improve the implementation of Internal Market directives.	Gas sector fully liberalised.	Proposals to reform professional services in Parliament. Law reforming the electricity sector in Parliament
LU: Fully implement the reforms of the competition law and ensure that competition and regulatory authorities have sufficient independence, resources and power.	New legislation on public procurement.	Law to abolish present legislation on fixed and regulated prices and install an independent competition authority.
NL: Improve the regulatory framework as well as its implementation.	Increased power will be given to the Dutch Competition Authority.	
AT: Increase resources of the competition authority and enforce decisions of the telecom regulator.	Resources of the competition authority marginally increased.	Further increases planned.
PT: Enhance effective competition in liberalised utilities and increase the transposition rate of Internal Market directives.	Approval of a plan to restructure the gas sector. Elimination of long term purchase agreements between electricity generators and the electricity transmission company. Increase in transposition rate Internal Market directives.	The completion of the Spanish-Portuguese electricity market is planned for 2004. Opening up of the retail market for electricity by 2004.
FI: Enforce competition in network industries and non-tradable services.	Number portability in mobile telephony. Amendment of Electricity Act to make it easier to change suppliers.	Reform of the Competition Restrictions Act. Establishment of Competition Institute. Proposals on reform of energy network pricing and on enhancing competition in financial services reviewed.
SE: Enforce competition in sectors where it is inadequate.	Application of zoning and building legislation under investigation. Project to increase cross-border competition in construction sector.	New law on price information. Proposals to raise competition in services and construction.
UK: Improve competition in sectors like the professions, postal services and pharmacies.	Rules of some professional bodies amended to remove unnecessary restrictions of competition.	Slight relaxation of restrictions on pharmacies.

…particularly due to a lack of implementation of measures agreed

The average rate of transposition by Member States of **Internal Market directives** deteriorated from 97.9 per cent in 2002 to 97.7 per cent in November 2003, putting the target of 98.5 per cent (which is already overdue) further out of reach. Only five Member States, Denmark, Spain, Ireland, Finland, and the United Kingdom actually met the agreed target, while in five other Member States - Belgium, Germany, Greece, France, and Luxembourg - the transposition rate even dropped below 97 per cent. Moreover, the number of infringement cases related to the non-conformity or incorrect application of Internal Market law declined only slightly. France and Italy have particularly bad records in this respect. Finally, the amount of cross border public procurement remains very low, even if the share of call for tenders published in the Official Journal has been rising. Germany continued to lag behind the other Member States. Nevertheless, public procurement legislation appears to have a positive effect on cross border transactions.[5]

Measures have been taken to improve the effectiveness of **competition policies.** At the Community level, the most notable step has been the adoption by the Council of the new regulation on implementing the anti-trust rules. This regulation will streamline the procedures, improve the co-ordination between competition authorities and enhance the Commission's powers of investigation. Some Member States (incl. BE, AT, and the UK) have taken action to enhance the effective independence and capabilities of their competition or regulatory authorities. The level of sectoral and ad-hoc state aid in the EU appears to have stabilised at around 0.7 per cent of GDP.

Market opening in the **network industries** continues to progress, but does not necessarily guarantee effective competition. Even in liberalised markets, the market share of the incumbent often remains very high. In fixed **telephony**, for example, its market share was 81 per cent for local calls and 70 per cent for long distance and 62 per cent for international calls in 2002. In this latter market segment, the market shares of incumbents were relatively high in Greece, Luxembourg, and Portugal. Nevertheless, prices of long distance and international calls continued to decline slowly. The new regulatory framework for electronic communications, in force at the EU level since July 2003, aims at enhancing competition and improving legal certainty.

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5 European Commission services working paper, Internal Market DG (forthcoming): A report on the functioning of public procurement markets in the EU: benefits from the application of EU directives and challenges for the future. Almost half of firms seeking a public procurement contracts did so across borders, most of them via subsidiaries located in the Member State publishing the call for tender. Moreover, the probability, that a bid was successful was similar for domestic firms and foreign subsidiaries (30 per cent and 35 per cent respectively).

Contrary to telecommunications prices, **electricity and gas** prices show no clear downward trend. Electricity prices have experienced a general increase in 2003 due to low rainfall reducing hydro-electric output and extreme weather conditions. However, even in these circumstances, prices are still no higher than pre-liberalisation levels in nominal terms and much lower in real terms. Nevertheless, in Belgium, Greece, France, and Ireland, the market share of the largest electricity generator was still at 90 per cent or above in 2001. Meanwhile, gas prices are, on average, some 10 per cent lower than January 2001. The Council adopted a number of pieces of legislation in 2003 that should contribute to the completion of market opening in these sectors. The Barcelona European Council fixed in March 2002 the target of reaching by 2005 10 per cent electricity interconnection capacity for each member state compared to the domestic installed production capacity. The progress towards this target has been very slow, as there have been only minor capacity additions in the recent years.

There was progress at Community level in liberalising **rail transport**. The Transport Council reached an agreement in March on the "2nd railways package", opening the international freight market by January 2006, and the cabotage market by January 2008. A further opening of the international passenger market is still being debated between the Parliament and the Council.

The RCAP is almost, but not completely implemented as the deadline approached…

As the 2003 deadline for implementation of the **Risk Capital Action Plan** (RCAP) approached, considerable progress can be reported. Most of the RCAP measures have been completed. Member States have also taken steps in providing an environment – in terms of administrative/legal, regulatory, and fiscal aspects – which is more conducive to developing the risk capital industry.

Several Member States have undertaken reforms which facilitate institutional investment in risk capital. They include: (i) the creation of a new category of closed-end collective investment undertakings dedicated to investment in non-quoted SMEs (BE and LU); (ii) some facilitating of the setting up or functioning of venture capital companies (ES and PT); (iii) the easing of quantitative constraints on pension funds and insurance company investments (DK and PT). Some further types of distortions have been removed (e.g. minimum funding requirements in the UK), while others may still impede institutional investment in risk capital (e.g. liquidity requirements in BE, EL and AT).

Insolvency and bankruptcy rules are being adjusted in some of the Member States (e.g. BE, FI, and the UK), with a view to minimise the disincentives to entrepreneurial risk taking, but with a varying outcome regarding the remaining level of disincentives. In other Member States, however, it appears difficult to actually finalise reforms underway (e.g. DK, IT, and the NL). Most of the Member States are making further improvements in their fiscal frameworks for risk capital investment, whether by reducing corporate tax rates (e.g. BE and DE), by reducing VAT compliance costs for SMEs (e.g. the UK), or by introducing tax relief for venture capital investment (e.g. DE, ES, FR, IT, PT, SE, and the UK). However, further progress seems necessary, most notably in reducing the often substantial differences in national fiscal frameworks that are faced by pan-EU operators.

…and good progress is made so far with the FSAP…

The end of the legislative phase of the **Financial Services Action Plan** (FSAP) is in sight. 36 of the 42 original measures are now finalised. Progress continues to be made on the few remaining proposals. An agreement has been struck between Council and Parliament on the text of a new take-overs directive. Following Council agreement on the investment services directive, it now remains to forge consensus with the European Parliament on a handful of substantive issues. On the transparency directive, political settlement has been reached in the Council. The EP is working on the basis of the Council text so as to ensure final adoption in the first half of 2004. 3 FSAP measures must await the reformation of the EP before the legislative process can be brought to a conclusion. Amongst these is the proposal for a new directive on capital adequacy. This is linked to the finalisation of Basel II Accord, now scheduled for mid-2004.

Alongside conclusion of the FSAP agenda, the Commission will launch work on initiatives foreseen in the Communication on company law and corporate governance (including a proposal for the modernisation of EU legislation on statutory audit). Elsewhere, the Commission will take forward work on important prudential legislation relating to reinsurance and insurance solvency.

A key adjunct to the FSAP has been the creation of structured arrangements for national regulatory and supervisory authorities to participate in the formulation and consistent implementation of EU financial legislation ("Lamfalussy" approach). This approach has been successfully road-tested in the securities sector. The Commission has recently proposed to extend this approach to the banking, insurance and UCITS fields. The increased transparency and greater collective dimension in performance of supervision is the key to more consistent and effective enforcement of financial regulation in an enlarged EU financial marketplace.

As the legislative phase of the FSAP draws to a close, the Commission has launched a comprehensive assessment of the state of integration of EU financial markets. This is not a prelude to a comprehensive new legislative programme. It is an attempt to identify successes and failures of the evolving EU legislative framework and to draw lessons from the FSAP experience. As a first step, four expert groups in the fields of banking, insurance, asset management, and securities will assess the extent to which the EU legislative framework enables financial institutions to organise their business on a pan-European basis. The output from these groups will be submitted to public scrutiny and high-level public debate before being consolidated in late 2004.

Elsewhere, a sub-group of the newly created Financial Services Committee has been tasked with establishing a shared assessment of Member States of remaining priorities for financial integration. They will report to European Finance Ministers in mid-2004.

…while the cross-border clearing and settlement is still to become more integrated

The Commission is also anxious to take forward the policy debate on the value of / need for collective EU-level action in the areas of **clearing and settlement** – but also for cash transfers and payment systems (the Commission has recently launched a Consultation Communication on cross-boarders payments with an end-January 2004 deadline). Integration of clearing and settlement arrangements has become a clear priority for action at both the EU and national levels. Following up on the second report of the Giovannini Group of financial market experts from April 2003, the Commission will shortly come forward with a Communication formulating a strategy for removing barriers to an integrated EU clearing and settlement system.

Restructuring and consolidation in the EU clearing and settlement infrastructure has also continued in 2003 at the national level (DE, EL, and IT). The process of consolidation and restructuring within EU stock exchanges accelerated. An integrated Nordic-Baltic market for trading, clearing and settlement of securities was created by the merger of the Stockholm and Helsinki stock exchanges, with the merged entity maintaining a strategic co-operation with the Copenhagen, Oslo and Iceland stock exchanges within NOREX. Italy's MTS continued to expand internationally, providing a widely accepted infrastructure for bond trading. In 2003, Euronext (comprising the Belgian, French, Netherlands and Portuguese stock exchanges together with the UK-based Liffe derivatives market) expanded further via an agreement with the Warsaw stock exchange.

In spite of recent improvements, the business environment in the EU continues to be hampered by some weaknesses

Businesses' perceptions of the **administrative burden** in 2003 remained quite negative in many Member States and particularly so in Belgium, Germany, France and the Netherlands.[6] Also, the percentage of 18-64 year-olds involved

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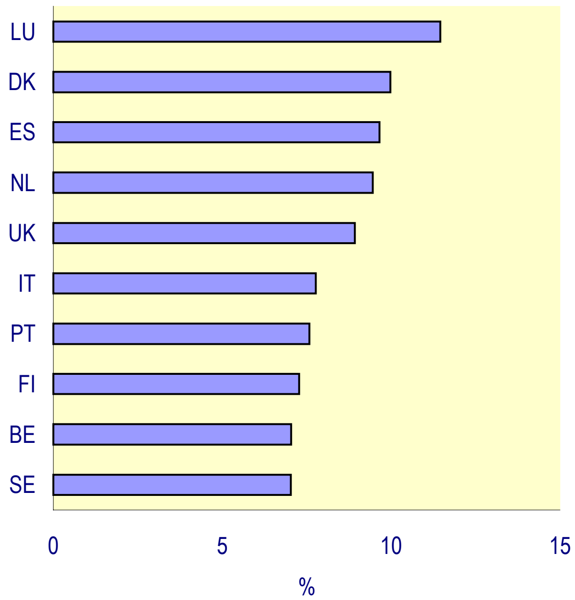
6 European Commission (2003): survey reported in the Enterprise Policy Scoreboard 2003, ENSR (European Network for SME Research).

in entrepreneurial activity remains below that in the United States. According to this measure, entrepreneurial activity is particularly weak in Belgium and France. The rate of enterprise creation is relatively low in Belgium, Finland, and Sweden (see Graph 11).

Graph 11: Gross birth rate of enterprises in % of enterprise population (2000)[1]



[1] Number of real enterprise births divided by the population of active enterprises.
Source : Commission services.

Differences in **entrepreneurship** between countries may be explained by many factors. An often-mentioned factor is ease of access to finance. The most commonly used indicators of access to finance – equity finance, venture capital and initial public offerings – tend to be strongly influenced by the business cycle. Venture capital, in particular, has suffered greatly from the slowdown in economic growth. In spite of the different measures taken to encourage investment in risk capital (see Section on the RCAP), early-stage venture capital investment levels in 2002 were only half or less of their 2000 levels in many Member States. Greece, Finland, and Sweden were exceptions. Moreover, investment shifted from the seed segment to more mature investments.

Box 5: Follow up to country specific recommendations related to product markets and knowledge based economy		
Country Specific Recommendations (as an extension of general Guidelines no. 11, 13 and 14)	**Significant Reform Measures in 2003**	
	Adopted	**Proposed**
GUIDELINE 11: Generate a supportive environment for entrepreneurship and for SMEs to start-up and grow.		
BE: Improve public administration and pursue the reduction of administrative burden for companies.	Simplification and centralisation of information on companies. Provision of loan guarantees to SMEs. Extension of electronic interactive applications in the field of VAT returns and social security obligations.	Further streamlining and acceleration of administrative procedures, including decrease of the time and costs of administrative obligations for companies and simplification of procedures to start a new company.
DE: Reduce the regulatory and administrative burden.	Government initiative to reduce bureaucracy and over-regulation. Various measures to encourage enterprise creation.	Proposal to bring forward third stage of tax reform.
EL: Simplify the business and taxation environment and raise the transposition rate of Internal Market directives	Measures to reduce bureaucratic and legal obstacles to start-ups. Simplification of tax system and particularly tax audit procedures.	
ES: Reduce the administrative burden on business.	Simplified legal framework for SMEs. 11 new 'One-Stop-Shops.	80 new 'One-Stop-Shops' over the coming two years.
FR: Reduce and simplify business regulations.	Economic initiative law has been adopted (reduction of administrative burden, reduction of time and costs required for company start-up, improved access to capital).	
IT: Reduce the administrative burden on business.	Simplified administrative procedures for company start-ups..	Reform of bankruptcy law.
LU: Encourage the creation of SMEs and help those to access venture capital.	Streamlining of data required to start up a business. Public-private joint venture to better SMEs' access to venture capital. Actions in schools to promote entrepreneurship.	

Box 5: Follow up to country specific recommendations related to product markets and knowledge based economy (continued)		
Country Specific Recommendations (as an extension of general Guidelines no. 11, 13 and 14)	**Significant Reform Measures in 2003**	
	Adopted	**Proposed**
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.		
DE: Reform education and training system.	Introduction of training vouchers. Tests for on-the-job trainers no longer obligatory.	Boost supply of all-day schools and develop education standards.
EL: Increase the availability of skilled human capital, promote business involvement in R&D and innovation, and improve ICT diffusion.	Development of IT in schooling and vocational training. Initiatives supporting the establishment of spin-off firms. Educational reform programme.	
ES: Increase skilled human capital, investments in R&D and innovation, and ICT diffusion.	Promotion of human capital development and support programmes for SMEs focused on R&D and technological investments	Plan to promote the development of the information society. Plan to stimulate business R&D expenditures.
IE: Prioritise roll-out of infrastructure and raise the level of R&D.		Government spending on R&D and innovation to be increased. New tax credit to promote business R&D.
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 primary and secondary education system. Creation of new fund for technological innovation projects. Actions to encourage a more intensive use of ICT among companies and households and schools.	
NL: Promote technology oriented education and strengthen science-industry links.	Innovation Council has been created to stimulate innovations by the private sector.	Measures to increase the intake into science and technology courses, bringing focus to scientific research, and improving co-operation between research organisations and business.
AT: Encourage business research and innovation, especially for SMEs.	Tax allowance for innovation expenditures. Strategic R&D partnership projects with Central and Eastern Europe.	Plan to streamline public support for R&D and innovation.
PT: Promote stronger involvement of the business sector in R&D, innovation and ICT. Improve the efficiency of spending in education.	Revision of legal framework for venture and risk capital investments. Tax deduction for investment in R&D Financial compensation for hiring technologically educated staff. Actions to promote the use of ICT in academia and the public sector. Educational reform programme.	
UK: Monitor closely existing measures to promote R&D. Review and strengthen policies aimed at improving basic skills in the work force.		A number of new training measures announced.
GUIDELINE 14: Enhance the contribution of the public sector to growth.		
DK: Increase the efficiency of the public sector.	Government Action Plan to increase the efficiency of public sector. Opening up of market for elderly care. Basic education reform	
FI: Increase the efficiency of the public sector.	Launch of Productivity Action Programme to reform public administration.	Reform of National Procurement Act. Set-up of advisory service point for public procurement. Introduction of vouchers for social and health care services.
SE: Increase the efficiency of the public sector.	Municipal benchmarking database publicly available.	

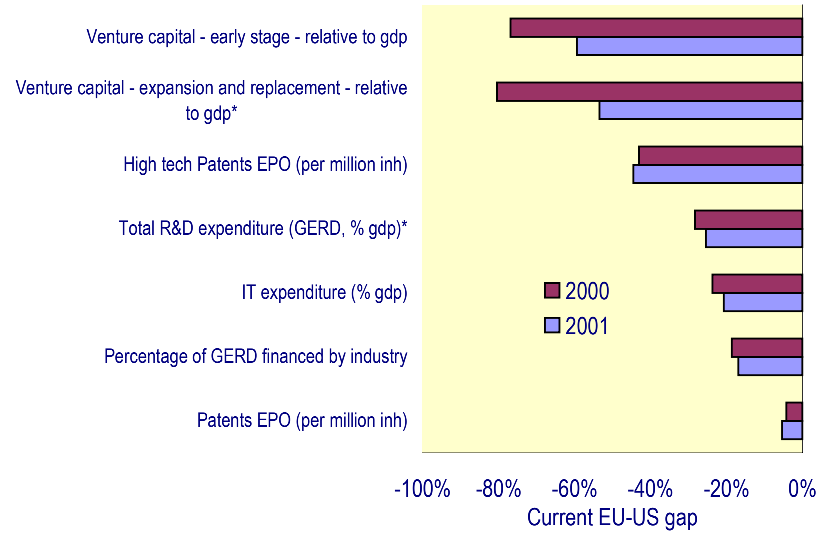
However, many other business framework conditions have shown a gradual improvement (time and costs of setting up a company, internet penetration, e-government, corporate tax system, etc.), and progress towards meeting the recommendations of the European Charter for Small Enterprises is encouraging. Several Member States have taken or implemented new measures aimed at reducing red tape and easing business start-ups (notably BE, DE, EL, ES, FR, LU, and AT). In addition, governments are increasingly turning their attention to shaping tomorrow's entrepreneurs and have stepped up efforts to develop entrepreneurial skills in education. Member States with programmes that support the teaching of entrepreneurial skills in primary schools now include Ireland, Luxembourg, Finland, Sweden, and the UK.

Investment in knowledge and innovation is lagging, even if…

There remains a substantial gap between the EU and the USA in terms of **innovative capacity** as measured by the availability of venture capital, R&D intensity, the number of patent applications and IT expenditures (see Graph 12). Nevertheless, the formation of the European Research Area will create an internal market for research which should contribute to achieving the Lisbon Strategy Goals. Moreover, Member States have unanimously endorsed the Barcelona target of increasing investment in R&D to approach 3 per cent of GDP by 2010, and a vast majority of them have defined national targets. In April 2003, the Commission put forward an Action Plan aimed at achieving the Barcelona target, taking into account that two thirds of the additional investment is supposed to be financed by the private sector; this in light of the fact that the bulk of the R&D gap, and most of its increase in recent years, is due to lower funding by the private sector. In Sweden and Finland, however, R&D expenditures as a percentage of GDP are above that in the USA and rising rapidly. Greece, Ireland, the Netherlands, and the UK, on the other hand, have witnessed a decline in R&D spending as a percentage of GDP in recent years. Even more worrying is the observation that companies in certain high-technology and research-intensive sectors such as pharmaceuticals or biotechnology are conducting a growing share of their research outside Europe, especially in the US, in order to take advantage of more favourable regulatory or other framework conditions. Still pending decisions on intellectual property rights, including a legally secure and affordable Community patent are just an example of what appears to be missing.

All Member States have decided to take an active part in applying the open method of coordination in support of the Barcelona targets. Various measures have been taken to stimulate R&D and innovation. For example, Belgium, Portugal, and the UK have extended tax credits for R&D and innovation expenditures and Ireland has introduced them in the budget for 2004; Belgium, Germany, Ireland, and Italy have opened up new sources of funding for R&D and innovation; Ireland and the Netherlands have taken measures to improve the cooperation between research and business; Greece is supporting university spin-offs; and Denmark and the Netherlands are making an effort to raise the number of university graduates in science and technology.

Graph 12: The EU/US gap in knowledge-based economy is large and persistent



* 2002 data.
Source : Commission services (incl. structural indicators on Research and Innovation).

…the development and use of key technologies in Europe is progressing

The fact that there are large differences between the research efforts of EU Member States may not be a problem as such, as long as the results of the R&D efforts are spread widely and knowledge is transferred into innovation across Europe. Knowledge diffusion is as important an element of the EU innovative capacity as is investment in research and development. Studies indicate that only 15 per cent of knowledge is gathered outside the region of origin and only 9 per cent outside the country of origin in North America and Western Europe. In its Action Plan “Investing in research” the Commission supported public-private partnerships and introduced the concept of European Technology Platforms, which are aimed at furthering the development and use of key technologies in Europe through improved science-industry links. In addition, the Commission intends to propose a directive permitting entry and stay of third country researchers, which should help facilitate researcher mobility.

Deployment of the Galileo satellite navigation system is now planned for 2006-2007 with a start of operations in 2008. The Galileo joint undertaking has started operation in June 2003 and international commercial interest has fully consolidated it as a global project. Moreover, the eEurope Action Plan has been instrumental in raising Internet access and use. The percentage of EU households with internet access at home rose to 50 per cent in 2003. In addition, 84 per cent of enterprises with more than 9 employees had internet access in 2003, which was a five percentage point increase over the previous year. In comparison with the year before, the broadband internet access rate per 100 EU inhabitants in October 2003 almost doubled to 5.2 per cent, but this was still less than the level reached by the US (8.1 per cent) in July 2003. The highest broadband access rates in the EU can be found in Denmark (11.2 per cent), Belgium (11.1 per cent), the Netherlands (10.1 per cent) and Sweden (9.0 per cent).

Corporate governance strengthened at national and at community level…

A series of high-profile corporate scandals in both the United States and Europe undermined investor confidence in the integrity of financial markets. It focused the attention of policymakers on the need to reinforce existing corporate governance arrangements. The Commission presented two Communications on company law and corporate governance in May 2003. These Communications provide an Action Plan, comprising a balanced mix of legislative and non-legislative initiatives and combining harmonisation of a few essential rules with closer co-ordination between national codes.

Several Member States have proceeded with strengthening **corporate governance** arrangements at the national level also, either by establishing a voluntary self-regulatory corporate governance code (e.g. AT and the UK), by introducing in company laws measures to improve corporate governance (e.g. EL, IE, IT, and NL), or by strengthening auditors' independence (e.g. FR).

…and financial supervision strengthened

In September 2003, the Ecofin Council reviewed the implementation on **financial supervision** and on financial crisis management. The Council concluded that further progress has been made in improving the institutional arrangements for cross-border supervision, notably through enhanced procedures for information exchange. A further review will be carried out in September 2004. Meanwhile, the extension of the Lamfalussy arrangements should further encourage cross-border co-operation in financial supervision and crisis management, as well as facilitating convergence in supervisory practices between the Member States.

At the national level, several Member States carried on the restructuring of supervisory structures in 2003. In France, supervisory authorities for securities have finally been regrouped, insurance and banking authorities have been streamlined, and the law on financial safety has been modernised. In other Member States, reforms of the national regulatory and supervisory authorities included various measures. They include the establishment of new supervisory boards for the integrated institutions (BE), the transfer of capital market regulatory authority from the exchanges and the Ministry of Economy and Finance to the supervisory authority: Hellenic Capital Market Commission

(EL), legislation affording the Government emergency powers to regulate the financial sector in exceptional circumstances (FI), regulatory measures to strengthen financial supervision of the insurance industry (PT), consolidating financial regulation into a uniform cross-sector law for financial services (DK), and adjusting the legislation to the new functional approach of supervision (NL).

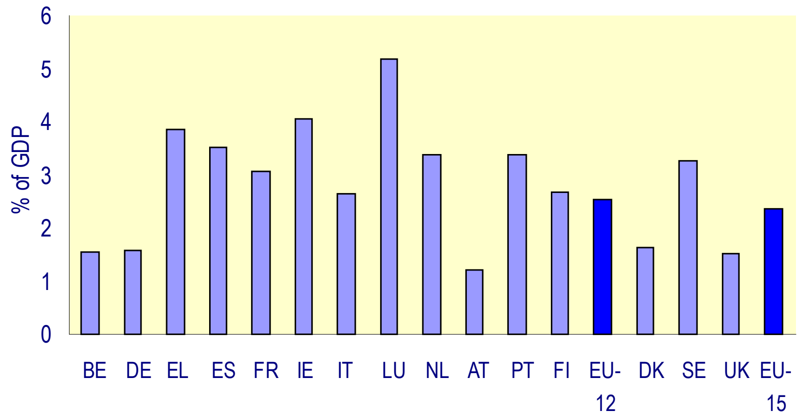
Member States are making an effort to improve the quality and efficiency of their education and training systems

There are clear signs of efforts to improve quality and efficiency in **education and training** in several countries (e.g. BE, DK, ES, IT, PT, FI and SE). In Spain, for example, a basic law on the quality of education has been adopted, while in Sweden a new vocational training system has been put into place. While some Member States are concentrating on in-company lifelong learning, others are more focused on improving basic skills and second chance schemes for adult education. Nevertheless, the lack of quality and attractiveness of vocational training remains a serious cause for concern. Moreover, there is a risk of a serious shortage of teachers and a need for an increase in the supply of scientists, technicians, engineers and business graduates. Finally, the level of private funding of higher education is only a small fraction of the level attained in the US. To address these problems, the Commission proposes a series of measures that are described in its November 2003 Communication entitled "Education and training 2010, the success of the Lisbon strategy hinges on urgent reforms".

Initiatives have been taken to enhance the contribution of the public sector to growth

The European **initiative for growth**, which was launched in October 2003 and endorsed by the European Council in December, aims to mobilise public and private funds to finance certain infrastructure and R&D projects that have a truly European scale. The Council reached a political agreement that up to 20 per cent of the trans-frontier infrastructure projects' costs could come from the EU budget. Despite the economic slowdown, public investment expenditures have been stable around 2.3 per cent of GDP. However, differences are noticeable across Member States, where the investment ratios vary from around 1½ per cent of GDP (in BE, DK, DE, AT and the UK) to 3 per cent or more (in EL, ES, FR, IE, LU, NL, PT, and SE). In general, public expenditures on education as a share of GDP declined slightly in recent years, in part due to demographic factors, while public spending on R&D has been stable around 0.7 per cent of GDP. Member States have taken various measures to encourage the development of public-private partnerships, the adoption of new technologies in government and competition in public procurement, particularly through an increased use of ICT tools. In addition, statutory corporate tax rates have been sharply reduced in many Member States over the past couple of years, accompanied by measures that broadened the tax base leading to less dispersion in the tax burden on corporations between Member States.

Graph 13: Public investments in EU Member States in 2003



Source : Commission services.

Another way of strengthening the contribution of the public sector to growth is through **redirecting spending** towards growth-enhancing cost-effective investments in physical and human capital. As a share of total public expenditure, public investment is expected to increase modestly by 0.3 percentage points in the EU in 2003. More marked increases can be noted for Spain, Italy[7] and the UK, while the share is expected to decline by 0.6 percentage points or more in Ireland[8] and Finland. The expected increase in the share of the EU's public spending on investments is a positive step towards improving its growth capacity and securing "value for tax payers' money". Not least, since interest payments are expected to increase in some Member States as a consequence of the deterioration of budgetary positions (in e.g. DE and FR) thereby crowding out other expenditures.

Social transfers will continue to represent by far the largest share of public expenditure in the EU (see Table 4). However, levels and developments differ across Member States (where they are likely to increase by more than 1 percentage point in BE, NL, PT and SE, while they will decline in the UK by almost as much).

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7 The increase in public investments in Italy is mostly an accounting effect, resulting from the marked decrease in sales of public-owned real assets compared to the previous year.

8 Despite the recent reduction, Irish public investment still corresponded to around 4 per cent of GDP in 2003, thereby remaining one of the highest investment ratios in the EU.

Table 4 : Composition of public expenditure in 2003 (as a percentage of total public expenditure)

	Social transfers other than in kind	Purchases of goods and services[1]	Compensation of employees	Subsidies	Interest	Investment[2]	Others	Total spending as a share of GDP
BE	32.7	20.8	23.2	3.1	11.0	3.0	6.2	51.2
DK	32.8	16.2	32.5	3.9	6.2	3.0	5.4	55.5
DE	40.7	23.3	16.2	2.9	6.5	3.2	7.2	49.1
EL	36.2	8.5	26.0	0.3	13.3	8.6	7.0	46.3
ES	30.7	19.0	25.5	2.8	6.3	8.8	7.0	39.8
FR	34.7	20.1	26.0	2.4	6.0	5.8	5.0	54.7
IE	25.5	20.5	25.9	2.3	4.3	11.8	9.7	34.8
IT	35.9	16.8	22.5	2.1	11.0	5.5	6.3	48.5
LU	34.8	20.3	18.8	3.8	0.3	10.7	11.4	48.0
NL	26.3	30.2	22.6	3.0	6.2	7.1	4.5	48.5
AT	37.3	17.7	18.9	6.0	6.9	2.4	10.8	51.4
PT	29.5	13.1	32.4	3.2	6.2	7.2	8.4	47.1
FI	35.4	17.5	28.5	2.9	4.4	5.5	5.7	50.9
SE	31.2	20.1	27.9	2.6	4.5	5.5	8.2	59.0
UK	31.9	30.0	19.1	1.6	4.8	3.5	9.0	42.8
Euro area	35.7	20.5	22.0	2.7	7.4	5.3	6.4	49.0
EU-15	34.9	21.9	22.0	2.5	6.9	4.9	6.9	48.4

[1] Government consumption expenditure net of compensation of employees.
[2] Gross fixed capital formation, concerns physical capital.

Source : Commission services.

Although additional steps have been taken, enforcement of budgetary rules and procedures could be enhanced at the national level

In 2003 Member States continued to apply national **budgetary rules and procedures** in order to improve efficiency and control. However, as shown by the Commission Report "Public Finances in EMU - 2003" there are large variations in the kind of fiscal rules adopted and implemented across EU Member States. All countries have targets for the upcoming and subsequent years in so-called multi-annual budget plans. Some Member States target the budget balance, while others set expenditure limits. Nevertheless, the deterioration of budgetary positions in respect to targets indicates that the enforcement of the rules in many cases is weak. The mechanism to control public spending at sub-national level also remains a key issue for some Member States.

A number of Member States have recently improved the **budgetary process** somewhat. In Spain the General Law on Budgetary Stability, which came into force in 2003, requires that all the general government sub-sectors should show a surplus or balanced budget in nominal terms every year. In Portugal the Budgetary Stability Law, which is effective from 2003, sets more stringent, although temporary limits to net borrowing across all levels of general government. Austria adopted this year a budget law which implies a cut in the ministries' budgetary envelops by 5 per cent across-the board compared with the budget 2002. Also, Finland has reformed its spending limits. A multi-annual budget plan covering the election period has been introduced. The spending limits cover ¾ of the central government's budget expenditure, including supplementary budgets. Budgetary items sensitive to the business cycle and interest payments on the general government debt are, however, excluded.

Full assessment of efficiency in public sector not yet possible

The composition of public expenditure does not change much from one year to another. In particular, it takes time for public consumption to adapt to new legislation, changes in the demographic structure of the population, or changes in welfare functions. For this reason, it is difficult to assess progress in the composition of public spending. In addition, the lack of timely and comprehensive data hampers a thorough assessment of the quality of public expenditure. Moreover, the impact of public expenditure on economic and social goals is difficult to assess. Expenditure efficiency relates to the links between inputs (mainly money, but not solely) and output. A proper assessment would require better information, notably on measures of the input (policies and expenditure) and output (objectives met), and a detailed microeconomic assessment of specific policies.

National fiscal rules can also contribute to enhance the quality of public spending and to the compliance with the EU fiscal framework. Again, a proper evaluation requires a longer observations period. Nevertheless, in many cases it would be useful to strengthen the enforcement mechanisms: experiences with fiscal policy rules in different countries indicate that, without an effective enforcement and sanction system, rules often turn out to be ineffective in term of ex-post outcome.

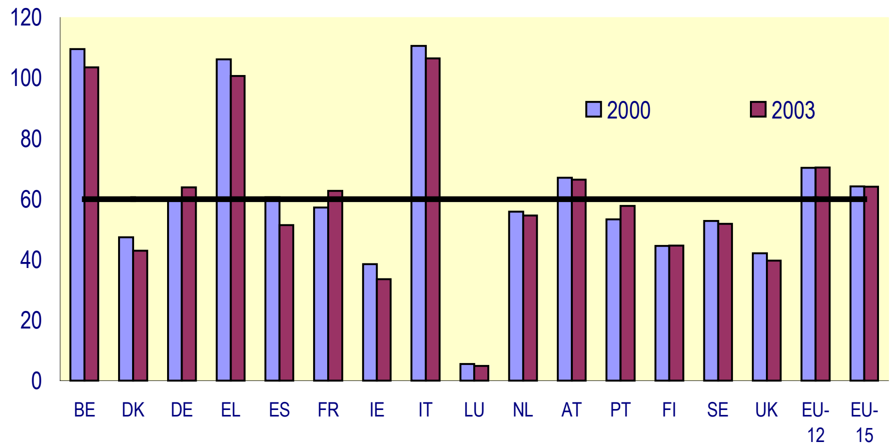
2.3 Strengthening sustainability

2.3.1 Economic sustainability: ensuring the long-run sustainability of public finances

Since 2000, the average public debt ratio in the EU has not declined

The sustainability of public finances in view of the ageing population is far from secured in about half of the Member States (notably BE, DE, EL, ES, FR, IT, and PT)[9]. As a whole, the average government debt to GDP ratio in the EU has not declined between 2000 and 2003 and thus remains at 64.1 per cent of GDP (70.4 per cent of GDP in the euro area). However, the situation differs substantially across Member States (see Graph 14). The debt ratio declined in most Member States during the period 2000-2003, in particular in Belgium, Greece, and Spain, while it rose in Germany, France, and Portugal. Despite recent improvements, the debt ratios continue to be above 60 per cent in six Member States (BE, DE, EL, FR, IT and AT), where it is very high or above 100 per cent of GDP in Belgium, Greece, and Italy.

Graph 14: Debt ratio



Source : Commission services (structural indicator no. g).

Both the size and age structure of the EU's population will undergo dramatic changes over the coming decades. Its working-age population is projected to decline very significantly, from 243 million in 2000 to 203 million in 2050, a drop of 40 million persons or 18 per cent. At the same time, the population of older persons above 65 years will increase by 40 million persons to 103 million in 2050, an increase of over 60 per cent.

The demographic developments have a significant impact on two important elements. First, most Member States project the long-term rate of economic growth to be lower than 2 per cent, also due to the contraction of the number of active people. Second, there will be a pressure for higher public expenditure due to ageing population over the next 15 to 20 years.

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

9 This is based on the sustainability assessment of the 2003 updated programmes, except for Germany and Spain where the assessments should be considered as provisional since they are still ongoing.

15.	ensure a further decline in government debt ratios;
16.	design, introduce and effectively implement reforms of pension systems.

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

The Commission's economic forecast (autumn 2003) show that the **debt ratio** declined in most Member States in 2003. Six Member States, namely Belgium, Germany, Greece, France, Italy and Austria, are expected to have a debt ratio above 60 per cent of GDP in 2003 and 2004. The debt ratio is expected to continue to decline in Belgium, Greece, and Austria, to stabilise in Italy, while it continues to increase in Germany and France in the coming two years.

There would appear to be a need for stronger commitment to reduce debt ratios in several Member States, not least those with very high government debt ratios. The current trends do not show a satisfactory rate of reduction that could bring debt ratios below the 60 per cent of GDP reference value before the full impact of ageing takes place in 15 to 20 years. In addition, the unfavourable development noted in some Member States where debt ratios are raising in recent years is a source of concern.

The pace of pension reform has accelerated in the EU and important pension reform measures have been adopted in some Member States

Eight Member States received country specific recommendations concerning the reform of their **pension systems** (BE, DE, EL, ES, FR, IT, AT, and PT). Significant progress has been made in several Member States. France and Austria adopted major reforms in 2003 that are an important step towards securing more sustainable pension systems. Germany and Portugal introduced some changes aiming at improving the financial balance of their public pension schemes and facilitating the development of supplementary private pension schemes. Greece put in place the operational reorganisation of social security funds enacted in 2002. In Germany the public debate has continued on the basis of a report of the 'Commission for Sustainability in Financing the German Social Insurance System', and the Italian government tabled a reform proposal.

Some progress towards tackling the budgetary consequences of ageing populations on public pension schemes

France enacted a gradual increase in the number of contribution years entitling to a full pension and modified the indexation mechanism from wages to consumer prices to tackle **budgetary consequences**. Moreover, private sector employees will have to pay higher social contributions, compensated by a symmetric decrease in unemployment contributions. Austria has enacted the gradual extension of the reference period for calculating pension benefits and will also gradually lower the yearly accumulation rate for pension rights. Portugal extended the contribution period, increased the basic pension calculation period, and linked the benefits growth to the rate of growth of wages net of contributions. According to the Italian government's proposal, eligibility conditions are to be tightened and the minimum retirement age is to be increased.

Both France and Germany have initiated reforms that address demographic risks. France has implemented a rule linking the contribution period required for entitlement to a full pension to the increase in life expectancy. In Germany , the gradual raising of the retirement age and the link between benefits and the system dependency ratio through an indexation rule have been proposed.

Reforms address interaction of pension systems with labour market performance

More transparency and better incentives to take up work have been sought in several Member States to improve the interaction between the **pension system and labour market performance** in several respects. As part of efforts to strengthen the link between contributions and entitlements, the Austrian government intends to harmonise all pension insurance systems and establish an integrated uniform pension system: it is also considering establishing individual retirement accounts. In Italy, the government plans to reduce the contribution rate to the public pension scheme for newly hired employees. Greece proceeds with moves towards a uniform social security system with the single managing body, where uniform terms, conditions of entitlement and method of pension calculation for all wage-earners is going to be introduced.

Raising the employment rates of older workers will require removing incentives to withdraw early from the labour market and providing incentives to prolong working lives. In Austria, early retirement schemes will be gradually abolished. Both French and Austrian reforms have strengthened financial incentives for the employees to remain active after having obtained the right to retire. In France, incentives have been offered to the employers to hire elderly workers as well as to discourage employers from dismissing them or obliging them to retire. The French reform made it easier to receive both a pension and a supplementary income from employment. An increase in the statutory retirement age has been proposed in Germany, while the Italian and Portuguese governments have proposed methods to calculate seniority pensions which penalise early retirees.

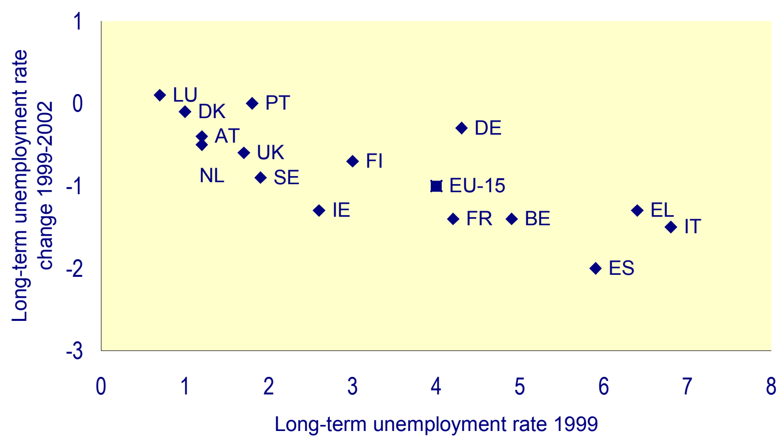
But more analysis required on long-term impact of the reforms

The long-term impact of reforms, including the financial impact, depends notably on the length of the transition periods, which are necessary in order to ensure a smooth adjustment process and in view of the legitimate expectations of people planning for their own retirement. The downside of this is that, as in the case of the Austrian and French reforms, a long time will be needed before they produce a full positive impact on public finances and labour market performance. Lower benefits from public pension schemes imply a rebalancing between different pillars of the pension system. A key consideration in this context is whether an appropriate fiscal and regulatory regime has been put in place to develop supplementary retirement schemes through occupational pension schemes and/or third pillar schemes so that citizens have alternative means to save for retirement income. Italy, Germany, and Austria have proposed to establish or further develop private, fully funded schemes. The proposed changes deserve a more thorough analysis.

2.3.2 Social sustainability: Contributing to economic and social cohesion

The lack of up-to-date data continues to hamper the assessment of progress in improving social sustainability. The weakened labour market situation lately is a source of concern as regards social sustainability, since jobs play an important role in lifting people out of poverty and social exclusion. While the long-term unemployment rate continued to decline in 2002 (to 3.0 per cent down from 3.5 per cent in 2000), more recent developments are likely to have been less promising as e.g. the overall unemployment rate started to increase. For instance, the share of jobless households has not declined in 2002 (unchanged at 12.2 per cent).

Graph 15: Long-term unemployment



Source : Commission services (structural indicator no. IV.6.1).

Box 6: Follow up to country specific recommendations related to pension systems		
Country specific recommendation (as an extension of general GL no 16)	**Measures**	
	Adopted	**Proposed**
BE: reinforce measures to postpone retirement from the labour force.		
DE: promote supplementary pension schemes, strengthen incentives for later retirement.	Contribution rate increased from 19.1% to 19.5%. Raised monthly income ceiling for the contributions payments.	Increase statutory retirement age. Indexation formula linking benefits to the system dependency ratio. Establish fully-funded, individual accounts.
EL: pursue reforms of the social security system, and in particular the pension system.	Incorporation of the uniform social security funds. Creation of occupational funds. A uniform method of pension calculation. Single framework of rules for pension entitlement for all wage earners.	
ES: strengthen link between contributions and benefits and control the long-term increases in pension expenditure.		
FR: undertake comprehensive reform of the pension system	Gradual increase in the number of contribution years entitling to a full pension. Financial incentives to remain active until and after the statutory retirement age. Public pensions indexed in line with consumer prices, instead of wages. Increase in social contributions in the private sector	
IT: address long transition period to the new contributions-based system and promote supplementary privately funded pension schemes.		Incentives to raise retirement age through seniority pension calculated on the basis of notional defined contributions, rather than earnings-based system. Tightened eligibility conditions and incentives to remain in employment. Support for private, fully-funded schemes through harmonising legislation on collective and individual pension funds, to eliminate distortions and increase competition amongst them.
AT: reform public pension system; increase low average effective retirement age and ensure incentives to work are enhanced.	Gradual abolition of early retirement. Strengthened incentives to stay in employment. Extended reference period for calculating the pension benefits. Lower accumulation rate for pension rights	Harmonisation of the pension systems and establishment of an integrated system
PT: adopt further reforms to the pension system for workers in the general government.	Extended reference period for calculating the pension benefits. Extended contribution period. Benefits indexed to the net wage.	Financial disincentive for early retirement. Measures to reduce the pension system generosity.

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.

Increased efforts needed in modernising the social protection system

Efforts concentrate more on the tax side than on benefit reforms. In 2003, only Denmark, Germany, France, the Netherlands, and the United Kingdom appear to have taken further steps to reform benefit systems (see also the follow-up to Guideline 4). Several Member States introduced measures to facilitate the access to the labour market of those at a disadvantage. Promoting their employment opportunities is key to social inclusion. Thus, recruitment incentives targeting disabled persons are being introduced in Belgium and increased in Austria, while Denmark targets newly qualified disabled. New financial incentives to encourage people with disabilities to seek and take up work and to make work attractive are also implemented in Ireland and the UK. Newly introduced employment subsidies target the long-term unemployed (in the NL, FR and the eastern Länder in DE), the disabled (FR and the eastern Länder) or the unskilled youth (the eastern Länder).

With no major initiative to enhance wage differentiation, regional differences in unemployment remain wide

In spite of significant employment growth in the second half of the 1990s, in particular in lagging regions, **regional differences** in both employment and unemployment rates remain substantial. High unemployment is generally concentrated in poorer regions, with a low GDP per capita. While unemployment rates were below 3 per cent in 27 regions in 2002 mostly in the Netherlands and the UK, they exceeded 20 per cent in ten regions in the south of Spain and Italy and the French overseas territories. Regional differences remain wide within some Member States, e.g. in Italy where the difference between the highest unemployment rate (in Calabria) and the lowest (in Trentino-Alto Adige) exceeds 21 percentage points.

Such differences in unemployment point to the need for additional policy steps, in particular with a view to enhancing human capital investments in disadvantaged regions and wage differentiation. In 2003, no major comprehensive initiative has been taken in the Member States most concerned to allow wages to reflect differences in skills and in local labour market conditions (see also the follow up to Guideline 5 on wage differentiation). Nevertheless, wage differentiation under the form of performance-related pay is gaining ground. Elements of flexibility based on company/sector situation are either possible in e.g. Spain (in the interconfederal agreement for 2003) or due for discussion in Germany and France where a relaxation of the "favourability principle" (by which lower level agreements can only be more favourable than sectoral ones) is being considered.

Measures taken to ensure efficiency of investments made

The lack of timely and sufficiently disaggregated data hampers a thorough assessment of the types of investments that are the focus of public support. In three cohesion countries (ES, IE, and PT) data on national public structural support in lagging regions are available from the ex-post and mid-term additionality assessments for 1994/1999 and 2000/2002. There is some evidence of an increased emphasis on human resources, in particular on qualifications related to RTD, where their shares in national public spending have increased in 2000/2002. The importance of infrastructure has declined somewhat, but still represents a major share of structural public spending.

The Commission has recently taken steps to increase the **efficiency of investment programmes** supported by the EU. The management of the 2000-2006 structural funds programmes will be simplified and made more flexible. As a result of the mid-term evaluation which is due to take place in 2004, the Commission and the Member States will decide to reallocate resources from ineffective measures to more effective measures, with a view to increasing their contribution to Lisbon objectives, notably investment into knowledge and innovation. The achievement of the targets on effectiveness, management, and financial implementation, which are set out in each programme, will also be assessed before 31 March 2004. The results will be decisive for the allocation of the performance reserve (that was introduced in 2000). Cooperation with the EIB has also been enhanced, notably to strike an adequate balance between loans and grants co-financing. The Bank has stepped up its advisory work on the appraisal of the technical and economic soundness of a number of ERDF, Cohesion fund and Ispa projects. From 2000, a hundred projects have been reviewed.

2.3.3 Environmental sustainability: promoting efficient management of natural resources

Maintaining a high level of environmental quality is not only an end in itself but may have wider benefits

Reforms such as removing subsidies and introducing taxes and charges that internalise external costs of pollution not only yield environmental benefits, they also enhance the effects of structural reforms in other areas by helping to "get prices right". This is particularly so if revenue from environmentally-motivated reforms is used to reduce other, distortionary taxes. Alternatively, although revenue raising is not the primary purpose of these measures, they can contribute towards fiscal consolidation, or the provision of other public goods.

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 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 in transport modes;

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 bio fuels.

Progress towards environmental sustainability in 2003 was disappointing

Given the economic slowdown, more attention was paid to boosting growth in the short-term rather than to securing medium- and **longer-term sustainability.** However, some events served as reminders of the need for action in this area. Whether or not it can be attributed to human-induced climate change, the long hot summer of 2003 stretched electricity supplies to capacity. This, together with (unrelated) power cuts in some Member States, stresses the importance of removing distortions in energy prices and ensuring that all actors – generators, suppliers and consumers – face appropriate incentives.

The Council adopted a number of pieces of legislation in 2003 that should contribute to this: directives concerning common rules for the **electricity and gas markets** aimed at making these markets competitive, secure, and environmentally sustainable, and a regulation setting fair rules for cross-border electricity exchanges. The latter has been complemented by a decision of EU electricity regulators to make no additional charges for cross-border electricity transactions in the internal market. The Council also adopted the directive restructuring the Community framework for taxing energy products. Although this will have little effect on energy prices in the short run, the directive will have a more substantial impact over time, in particular in the new Member States. It extends the Community framework to include the use of coal and natural gas as heating fuels, so that the Community is moving towards a framework that could enable appropriate differentiation of energy taxation.

At Member State level, there have been a number of changes relating to support for different energy sources. 2003 has been the year for the implementation of the directive on electricity from renewable energy sources. Results in terms of generation of green electricity are far from impressive except for wind energy mainly in three Member States: Germany, Spain and Denmark (23 GW were installed in Europe at the end of 2002). Although it is premature to make a detailed analysis, it is already clear that the Community target of 22 per cent electricity share from renewable energies in 2010 will not be achieved unless Member States take additional action. The Commission will report to the Council and to the European Parliament in May 2004 assessing to what extent Member States have made progress towards their national indicative targets and consistency with the 22 per cent Community target of renewable electricity contribution to the European gross electricity consumption in 2010.

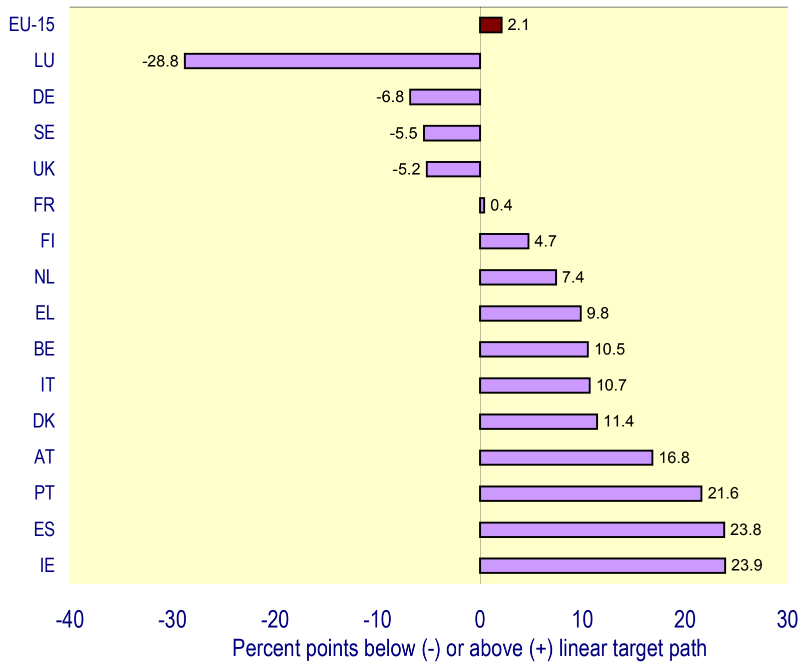
Belgium (Wallonia) and Sweden introduced “green certificates”, requiring electricity suppliers to source a minimum percentage of their output from **renewable energy** sources. Sweden also continued its policy of switching taxation from labour to pollution. The Netherlands now uses its tax on electricity from renewable sources to fund differentiated feed-in tariffs for these energies. While Germany reduced the overall level of state aid to the coal industry, operating aid was increased.

Congestion charges in London led to marked changes in behaviour

In the area of **transport pricing**, Austria plans to introduce a kilometre-based charge for commercial vehicles from 2004; delays in the start of a similar scheme in Germany highlight the importance of ensuring that transport charging schemes will work in practice and do not entail excessive transaction costs. In the United Kingdom, London launched a congestion charge in February 2003. This scheme has been highly successful in terms of its objective of reducing traffic congestion, without giving rise to significant negative side-effects, while it has yielded significantly less revenue than expected. Other cities, such as Rome, Bristol or Edinburgh, have been experimenting with road pricing in order to reduce car traffic in city centres. Some of these schemes are still at a preliminary stage; however, the automated control system in place in Rome since 2001 has already restricted access to the historic city centre. One may tentatively conclude that changes in urban transport prices can lead to greater changes in behaviour than is generally believed, which has as a consequence that one should not necessarily look to transport charging schemes as major revenue sources.

There was progress at Community level in liberalising rail transport. The Transport Council reached an agreement in March on the "2nd railways package", opening the international freight market by January 2006, and the cabotage market by January 2008. A further opening of the international passenger market is still being debated between the Parliament and the Council. At Member State level, the existing legislation (the first rail legislative "package" introducing competition to the market for international freight services) has been implemented slowly and/or ineffectively, discouraging private investment in the sector.

Graph 16: Distance to target indicators for the Kyoto Protocal and burden sharing targets of the EU MSs



Note: The Danish distance-to-target indicator is +2.6 points if Danish greenhouse gas emissions are adjusted for electricity trade in 1990.
Explanatory note: The distance-to-target indicator is a measure of how close the current emissions are to a – hypothetical – linear path of emissions reductions (or allowed increases) from 1990 to the Kyoto target of 2008-12 (for total greenhouse gas emissions) assuming that only domestic measures will be used.
Source : EEA, 2003.

Greenhouse gas emissions are rising – not falling in the EU

As regards **climate change**, the European Environment Agency reported that EU greenhouse gas emissions rose in 2001 for the second year in succession, moving the Union away from its target under the Kyoto Protocol, despite the slowdown in economic growth. Indeed, only five Member States (DE, FR, LU, SE and the UK) are currently on track or close to their specific targets, while ten Member States are well above their target paths (ES, IE, AT and PT are 15 percentage points or more off track), see Graph 16.

All Member States are preparing to implement the EU emissions trading scheme, which became law in October. However, projections by Member States show that even with this and other existing and planned policies and measures, most will not reach their targets unless they aim higher. This points to the need for additional action on their part, for example by setting more ambitious objectives for the sectors covered by the emissions trading scheme in their forthcoming national allocation plans, or by introducing cost-effective measures to tackle emissions in sectors outside the scheme. Several Member States have already decided or declared their intention to use the flexible mechanism of the Kyoto protocol in addition to domestic and European policies and measure to achieve their targets. Still only a few have explicitly foreseen the budgetary resources to be used to this end.

As regards compliance with legal reporting requirements and the evaluation of actual and projected progress, some Member States were several months late with the submission of inventory data, others did not deliver all the data required or the required level of detail (by gas and by sector) for their inventories as well as for their projections (in particular Germany, Greece, Italy, Luxembourg, the Netherlands, Portugal and Spain). Additional efforts will be required by all Member States to improve the situation.

3. EURO AREA SPECIFIC CHALLENGES.

In 2003 the euro area recorded subdued growth for the third year in a row.

For a third consecutive year, economic performance disappointed. Average GDP growth declined gradually to a mere 0.4 per cent in 2003, the rate of unemployment increased by about half a percentage point to 8.9 per cent, while public finances deteriorated further. At the same time, inflation came down only sluggishly, fluctuating around 2 per cent in the course of 2003. However, survey indicators paint an increasingly optimistic picture and the recovery is likely to gain pace in 2004.

Against this background, the 2003-05 BEPGs recommended policy actors at national level to:

24. Contribute to a policy-mix that is compatible with price stability;

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 per cent 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 co-ordination procedures in the area of structural reforms.

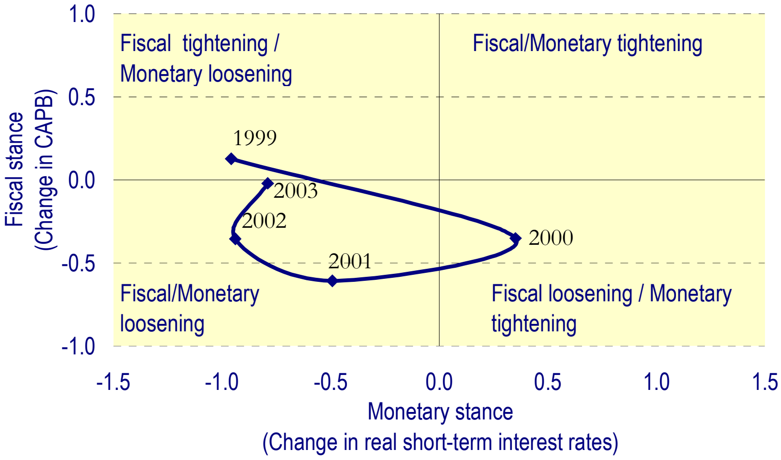
Policy mix appears supportive to growth

Macroeconomic policy was accommodative in 2003. The ECB cut interest rates two times in 2003, by a cumulative 75 basis points to a level of 2 per cent for the minimum bid rate. When assessed against the so-called Taylor rule[10], short-term interest rates have been accommodative to economic activity during the slowdown. The fiscal policy in the euro area was broadly neutral as the cyclically-adjusted primary balance remained unchanged. However, it can not be excluded that the public debate on the sustainability of public finances and an apparent reduced resolve to abide by the SGP has weighed on consumer

10 According to the so-called Taylor rule, the appropriate short-term interest rate is conditional on two variables, the actual rate of inflation and the size of the output gap. Any deviation of both variables from their target value should lead to adjustments of the short-term interest rate according to the weights of both variables in the Taylor rule.

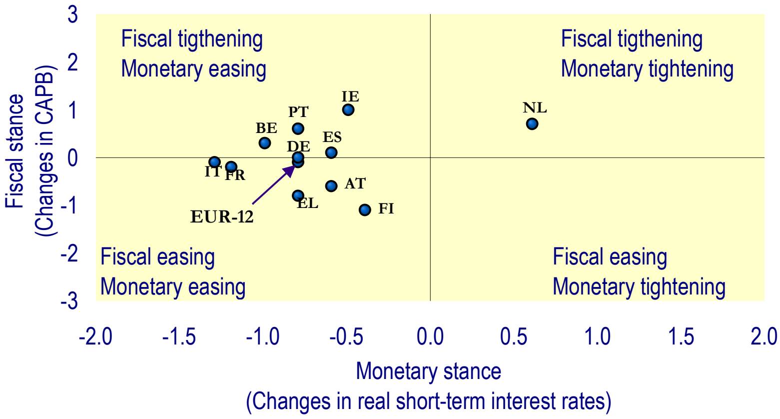
confidence. The strong co-movement of the households' savings ratio with the budget deficit would appear to be a clear indication of that, and rising public consumption in the euro area went alongside weaker private spending. During 2003, the euro exchange rate appreciated by 8 per cent in nominal effective terms. This contributed to some losses in market shares of euro-area exporters on the world market, while the positive disinflationary impulse has not yet visibly fed through to consumer price inflation.

Graph 17: Policy-mix in the euro area



Source : Commission services.

Graph 18: Policy-mix in euro area Member States in 2003



Source : Commission services.

Implementation of the guideline on fiscal policies is worrisome

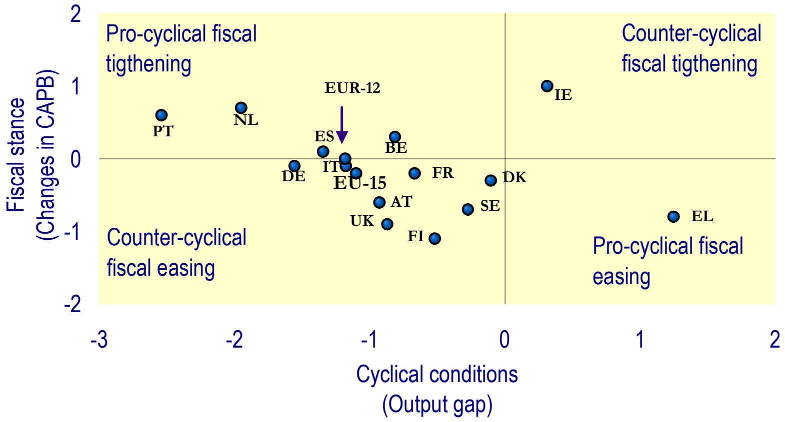
In recent years the fiscal position in the euro area has deteriorated. The annual nominal budget deficit has increased by 3 percentage points of GDP since 2000[11] to a deficit of –2.8 per cent of GDP in 2003. The working of the automatic stabilisers explains most of this development. Another part of the slippage results from discretionary deficit-increasing measures. Overall, the cyclically-adjusted budget balance worsened by 0.4 percentage points between 2000 and 2003.

According to the Commission's economic forecast (autumn 2003) three of the four euro area Member States that had a cyclically-adjusted budget position of **close to balance or in surplus** in 2002, namely Belgium, Spain, and Finland, managed to maintain those in 2003 and will continue to do so in 2004. In view of the national budgets and on the assumption of unchanged polices in 2005, Ireland and Austria could achieve a sound position by 2005. However as regards Austria, it now appears unlikely that the forthcoming tax cuts (amounting to 1 per cent of GDP) will be accompanied by corresponding expenditure restraints, thereby causing the cyclically-adjusted balance to deteriorate considerably in 2005.

Among those euro area Member States that had not reached the above mentioned objective, only Ireland, the Netherlands, and Portugal are expected to have **improved their cyclically-adjusted budget balance by at least 0.5 per cent of GDP** in 2003. In 2004, France and the Netherlands would, according to the forecast, be able to comply with this Guideline. Although a certain improvement in the cyclically-adjusted deficit is expected for Germany, it would, just as the remaining Member States (EL, IT, LU, and PT), not achieve the required improvement in 2004. However, on the basis of the no-policy-change assumption, the cyclically-adjusted budgetary positions in Greece, Italy, Luxembourg and Portugal would seem to sharply deteriorate in 2004 and/or 2005. This clearly indicates the need for further policy measures in 2004.

11 The euro area net lending figure included one-off proceeds for telephone licences (UMTS) of 1.1 per cent of GDP in 2000.

Graph 19: Euro area fiscal stance and cyclical conditions, 1999-2003



Source : Commission services.

The three countries in an **excessive deficit** situation are having difficulties correcting it. Both Germany and Portugal have made considerable efforts in response to the recommendation to bring this situation to an end. According to the forecasts and following substantial one-off measures, the nominal deficit in Portugal is expected to stay below 3 per cent of GDP in 2003, but risks exceeding the limit again in 2004. In the German case, measures amounting to about 1 per cent of GDP have been taken in 2003, thereby fulfilling that part of the Council recommendation of January 2003. However, given the adverse cyclical conditions the measures taken appear inadequate in order to bring the excessive deficit situation to an end in 2004. France does not appear to have taken effective action to redress the budgetary imbalances, and given the current economic outlook, the excessive deficit situation is likely to persist with a continuation of a deficit well above 3 per cent of GDP in 2004.

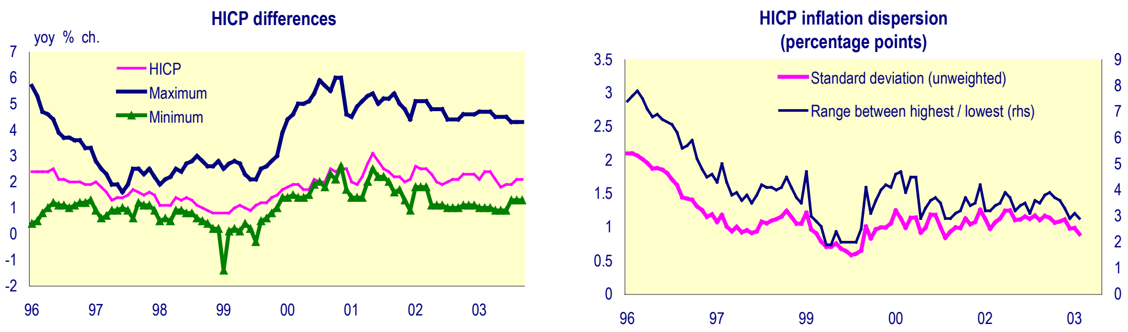
In view of the developments outlined above, the Commission adopted recommendations to Germany and France in accordance with Treaty Articles 104 (8) and 104 (9) that no effective action has been taken (FR) or was inadequate (DE), and that both Member States should take measures to remedy the excessive deficit situation. However, in light of the weak economy, the Commission recommended to allow both Member States one additional year to bring down the deficit below 3 per cent of GDP, i.e. by 2005. On 25 November 2003, the Council rejected the Commission's recommendations and found an agreement outside the Treaty, de facto suspending its application for these articles. The Council took note of the commitments made by Germany and France to reduce their deficits to below 3 per cent of GDP by 2005.

Inflation differences remain wide

Over the first three quarters of 2003, **inflation differences** in the euro area, as measured by the difference between the Member State with the highest and the one with the lowest HICP inflation rates or by the unweighted standard deviation, have narrowed slightly compared to the situation last year, but they remain wider compared to the first year of EMU.

At the euro area level, the extent of inflation dispersion observed since the introduction of the euro does not appear to be significantly higher than that of other monetary unions. It is roughly comparable to that of cities in the USA, while it is somewhat above that of regions in the USA or that within some Member States. From a historical perspective, the inflation dispersion in the euro area seems low. The sui generis (or special) character of the euro area and the relatively short experience with it, however, call for a degree of caution in interpreting results from such comparisons.

Graph 20: Inflation differences and dispersion, euro area



Source : Commission services.

At the national level, it should be noted that since the start of Stage Three of EMU, some countries have registered persistent differentials relative to the euro area average, particularly in the main sectors that make up core inflation (HICP excluding energy and unprocessed food). On the one hand, inflation differences can 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. On the other hand, the persistence of inflation differentials could indicate that structural rigidities are impeding a smooth adjustment, requiring policy action at the national level to prevent an unwarranted deterioration in competitiveness. The fact that the single monetary policy is geared to safeguarding price stability for the euro area as a whole, and hence cannot address country specific inflation differentials, underscores the importance of continuing with structural reforms. They raise growth potential, safeguard long-term competitiveness at the national level, and will also increase the flexibility of national economies thereby easing the adjustment process to common or country specific shocks and reducing the scope for protracted inflation differentials. However, 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.

The external representation of the euro area needs to be strengthened

Economic policy co-ordination has proven increasingly beneficial in e.g. the spring 2003 when the increased economic uncertainty related to the Iraq conflict demanded for a coherent policy approach. In contrast to the oil price hike in 2000, Member States abstained from isolated national measures and agreed on a common line in international fora. Also the discussions on the impact of the sizeable euro appreciation witnessed in 2003 took place in a more orderly form than when the euro depreciated, which has supported the credibility of EMU's policy framework.

Although the start of EMU constituted a major change for the international monetary system, this has, however, yet to result in a complementary upgrade of the international role of the euro area. The need to strengthen the **external representation** of the euro area in the relevant international institutions and fora was fully recognised by the Convention, in order to ensure that the area's political importance becomes commensurate to its economic weight. While the issue was discussed in several working groups, no clear conclusion has been reached and the text of the draft Constitution basically leaves the matter unchanged. Apart from the debate in the Convention, no actual and tangible improvements can be reported in respect of the euro area's representation on the international scene. Nevertheless, the preparations of euro area positions in e.g. the IMF has improved somewhat, at least as regards issues where a consensus can be reached and 'common understandings' adopted.

The Lisbon Strategy has reinforced the awareness of and interest in structural reforms

The Lisbon Strategy, which is at the centre of the structural reform process, has increased the awareness of, and interest in, medium term policies that simultaneously promote potential growth; full employment; improvements in the European social model; and a sustainable development. That has called for a 'streamlining' of the **policy co-ordination processes**, with a view to increase the coherence and complementarity between the various processes. The Broad Economic Policy Guidelines were thus adopted as a part of a "Guidelines Package" together with the Employment Guidelines and the Internal Market Strategy for the first time in 2003. A greater emphasis has also been given to the follow-up in terms of implementation, when the Council adopted conclusions on the 2003 Implementation Report for the first time, stating *inter alia* that it was a useful tool to monitor progress and give guidance for areas where further progress is particularly needed. The Italian Presidency has indicated that the Council will start holding regular implementation discussions throughout the year. A first working breakfast in November 2003 was devoted to the follow-up given to the 2003-05 BEPGs so far, notably with regard to the sustainability of public finances. While it appears too early for any firm conclusions on the efficiency of the existing co-ordination processes, the streamlining ought to have improved the consistency between the different sets of guidelines and should limit the reporting burden for Member States.

Looking ahead, the Lisbon Strategy will be subject to a mid-term review in 2005 with an eye to making it a more effective tool for achieving the objectives set out at the Lisbon and Gothenburg European Councils. In addition, decisions on the financial perspectives post-2006 will be taken on the basis of policy priorities and objectives identified within the context of the Lisbon strategy. The Open Method of Co-ordination (OMC), which was conceived with the launch of the Lisbon strategy, is increasingly being used to co-ordinate Member States' and Community policies in a number of areas, including R&D, education and social protection policies.

4. IMPLEMENTATION BY THE MEMBER STATES: A PRELIMINARY ASSESSMENT.

In the accompanying working document of the Commission Services more detailed information can be found on how economic policies in the Member States so far have responded to the identified challenges and the country-specific recommendations in the 2003-05 BEPGs. As this Communication provides a first, intermediate, look at the progress made and Member States have two more years to complete their follow up on the challenge and recommendations, a full assessment can only be made in two years time i.e. in the Implementation Report 2006. Nevertheless, a preliminary assessment of the degree of implementation at this moment can give a useful overview of which Member States have taken steps in the right direction towards adequately addressing the policy challenges. In a number of cases reforms undertaken or envisaged allow already a more in-depth assessment.

Since the number and the nature of challenges differ among Member States, a comparison of the follow-up between Member States is difficult. Some challenges are more demanding and often more difficult to fulfil than others. In the following summary of the progress made in the individual Member States, the indication 'fully addressed' is used when policy actions in response to a challenge going in the right direction have been adopted or proposed. The indication 'largely addressed' is used when actions have been taken but do not yet cover the whole challenge and all specific recommendations. The indication 'partially addressed' is used when policy actions have been adopted or proposed only relating to a small part of the challenge and the recommendations. When no follow-up has yet been given to the challenge and recommendations, the indication 'not yet started' is used.

It must be stressed that from the assessments on how well Member States responded to these recommendations, it cannot be inferred how Member States compare in terms of absolute performance and improvements therein. From this follows that a Member State can be performing relatively well compared to other Member States, but nevertheless has not implemented or planned measures to tackle the policy challenges and the country-specific recommendations. An indication of the absolute performance (both in terms of progress and in terms of level) of Member States on the basis of the shortlist of structural indicators can be found in the Commission's Spring Report 2004, see Annex 1 therein.

On the basis of the detailed information of the individual countries it appears that all Member States have started to address their challenges. While Belgium, Denmark, Germany, Ireland, the Netherlands, Austria, Portugal, Finland and the UK seem to be addressing, overall, the identified challenges in a satisfactory way, there seems, however, to be scope for improvement in the other Member States.

4.1 Belgium

Overall, Belgium seems to be addressing the three identified policy challenges. The challenge and the recommendations regarding public finance in the 2003-05 BEPGs appear largely addressed. The high debt ratio continues to decline steadily and primary surpluses, although decreasing, remain sizeable. Measures have been taken to limit the growth of real expenditure but the increase is still higher than recommended. Preparations for the budgetary implications of ageing continued in 2003, notably via stimulating employment, but more needs to be done to ensure long term sustainability.

Also the challenge and the recommendations on the labour market seem to be largely addressed. Some action has been taken to address the low employment rate among older workers. Progress is made on reducing distortions to work incentives in tax-benefit systems with a strong focus on the tax-side.

Finally, the challenge and recommendations on competition, public administration and the business environment appear partially addressed. Improvements were made in the regulatory framework in telecommunications, postal services and railways, and energy markets have been opened to competition in Flanders. However, no progress has been registered in stimulating competition in local services and the reform of the public administration has been suspended.

4.2 Denmark

Overall, Denmark seems to be addressing the two identified policy challenges. The challenge and recommendations regarding long term fiscal sustainability appear fully addressed. The tax reform, aimed at increasing labour supply, will be implemented in 2004. Regarding labour market reform some measures have been adopted to tighten eligibility rules. Achieving the targets for the growth of public consumption will require discipline in adhering to the budget agreements across all government levels, including the tax freeze.

The challenge and recommendations on enhancing competition and improving efficiency in the public sector seem largely addressed. Some measures have been taken in 2003 to increase competition and the regulatory barriers to competition are being identified, but weak competition persists in many sectors. Reforms in welfare services have increased competition and the government has presented plans to make further use of benchmarking and reduce administrative burdens.

4.3 Germany

Overall, Germany seems to be addressing the four identified policy challenges. Based on the measures adopted in parliament, the challenge and recommendations regarding the labour market appear largely addressed. Measures have been implemented and proposed to reform the tax-benefit system including a reduced eligibility of unemployment benefits and promotion of low-wage jobs. Some progress has been made in a more flexible system of wage formation but the authorities should go further to promote wage flexibility across skills and regions. Efforts to enhance the efficiency of active labour market policies have started, but there remains room for improvement.

Also the challenge and recommendations on increasing productivity and the efficiency of the education system appear largely addressed. An initiative to improve the business environment, through the reduction of red tape and overregulation was launched. In addition, the competition law will be brought in line with EU-rules and the law on unfair competition will be relaxed. Measures also have been proposed to improve primary and secondary education, but success hinges upon effective follow-up by the Länder.

The challenge and recommendations on public finances in the 2003-05 BEPGs seem only partially addressed. Despite the implementation of compensatory measures amounting to about 1 per cent of GDP, the government deficit is expected to have exceeded 4 per cent of GDP in 2003. Following the confirmation of the German authorities that the 2004 deficit will exceed the 3 per cent ceiling, the Commission made recommendations to decide that inadequate action has been taken and to allow, in light of the weak economy, to bring the government deficit below 3 per cent of GDP in 2005, which were rejected by the Council. The Council took note of the commitments made by Germany on 25 November 2003 to reduce the cyclically-adjusted deficit by 0.6 per cent in 2004 and at least 0.5 per cent of GDP in 2005 to ensure that the general government deficit is brought below 3 per cent of GDP in 2005.

Finally, the challenge and recommendations on long term sustainability appear being largely addressed. Measures have been proposed to address the ageing challenge notably the introduction of a sustainability factor in order to contain the increase in pension payments. Changes in the supervision of private pension schemes and adjustments to increases in pensions need however to be complemented with a structural reform of the pension system.

4.4 Greece

Overall, Greece does not yet seem to be addressing sufficiently all three identified policy challenges. The challenge and recommendations regarding public finance in the 2003-05 BEPGs appear partially addressed. As primary surpluses are decreasing, the reduction of the high debt ratio as requested depends to a great extent on the success of the announced privatisation programme. So far no sufficient measures have been implemented to effectively control government spending and no follow-up has been made or planned to continue reforms in the social security system.

The challenge and recommendations on increasing productivity seem largely addressed. The government has launched several initiatives to accelerate the transition towards the knowledge-based economy, to improve the business environment and to simplify the tax system. In the area of competition in the energy sectors, steps were taken in the right direction but still need to be strengthened in order to ensure effective competition.

Finally, the challenge and the recommendations on the labour market appear partially addressed. Some measures to improve work incentives have been implemented, in particular for women and low wage workers, but no progress is made in reducing non-wage costs as requested. No action has yet been taken to changing the wage bargaining process.

4.5 Spain

Overall, Spain does not yet seem to be addressing sufficiently all three identified policy challenges. The challenge and recommendations regarding the labour market appear being partially addressed. Measures have been implemented to increase female participation through tax incentives and a higher provision of care facilities. In addition, some progress has so far been made in the removal of fiscal distortions hampering the geographical mobility of workers. Nevertheless, no changes were made to the wage bargaining system including the use of indexation clauses whereas the requested reform of employment protection legislation to reduce the labour market segmentation is still pending.

The challenge and recommendations on raising the low level of productivity seem largely addressed. Several initiatives have been launched to strengthen the knowledge-based economy. Progress was also made in improving the business environment by tax incentives and a reduction of red tape. As regards competition, some progress has been made in the electricity market while effective competition in retail distribution has not been addressed.

Finally, the challenge and recommendation on the long term sustainability of public finances seem partially addressed. Some measures have been implemented so as to tackle the budgetary impact of ageing, namely actions to increase the employment rate while continuing to reduce public debt. In addition the Pension Reserve fund is planned to be further increased to 1.6 per cent of GDP. However, no measures strengthening the link between contributory effort and pension benefits have been adopted, which appears indispensable to ensure the long term sustainability.

4.6 France

Overall, France does not yet seem to be addressing sufficiently the four identified policy challenges. The challenge and recommendations regarding public finance in the 2003-05 BEPGs seem only partially addressed. Insufficient measures were taken to respect the recommendation issued by the Council in June in the context of the Excessive Deficit Procedure. Therefore the Commission made recommendations to decide that no effective action has been taken and to allow, in light of the weak economy, to bring the government deficit below 3 per cent of GDP in 2005, which were rejected by the Council. The Council took note of the commitments made by France on 25 November 2003 to reduce the cyclically-adjusted deficit by 0.8 per cent of GDP in 2004, and by 0.6 per cent of GDP or a larger amount in 2005 so as to ensure that the general government deficit is brought below 3 per cent of GDP in 2005.

By contrast, the challenge and recommendations on the long term sustainability of public finances appear largely addressed. A comprehensive reform of the pension system has been adopted increasing the contribution period entitling to a full pension and strengthening the financial incentives to remain active. The reform represents a major improvement of long run fiscal sustainability. Some measures have been introduced to control health spending, but a more comprehensive reform of the health insurance system is to be implemented in 2004.

The challenge and recommendations on the labour market appear partially addressed. In particular, specific measures were taken to encourage participation of older workers and to make work pay.

Finally, the challenge and recommendations on the business environment and competition seem partially addressed. Measures have been taken to reduce and simplify business regulations. Competition in energy markets has improved but the market is still dominated by incumbents. While the transposition rate of internal market directives (one of the lowest in the EU) has increased, the number of infringement increased too.

4.7 Ireland

Ireland seems to be addressing the single identified policy challenge. The challenge and recommendations regarding the management of the transition to lower, sustainable growth appear largely addressed. Efforts are being made to enhance the efficiency of public expenditure, notably by extending multi-annual budgeting and reorganising the health sector. Various measures are taken to improve capital spending and to increase the level of R&D. As regards competition, measures for several sectors are under review including full liberalisation of gas and electricity markets.

4.8 Italy

Overall, Italy does not yet seem to be addressing sufficiently all five identified policy challenges. The challenge and recommendations regarding public finance in the 2003-05 BEPGs appear partially addressed. Little progress has been made in achieving lasting budgetary consolidation and the Italian government has continued to rely on one-off measures. Primary expenditures continue to show a strong downward rigidity constraining the room for implementation of the tax reform.

The challenge and recommendations regarding the long term sustainability of public finance seem only partially addressed. An acceleration of the planned reduction of the high debt ratio would be warranted in the light of ageing. Proposals to reduce pension expenditures as of 2008 were presented to parliament.

Also the challenge and recommendations regarding the labour market seem partially addressed. Reform measures have been taken but important elements of labour market reform are either still pending in parliament (employment protection legislation) or were not tackled (wage differentiation).

The challenge and recommendations regarding the knowledge-based economy are being fully addressed. In particular, the primary and secondary education level system has been reformed and several measures have been taken to stimulate R&D and innovation.

The challenge and recommendations regarding the business environment and competition seem largely addressed. Administrative burdens on start ups and red tape affecting businesses have become less onerous. However, the liberalisation of the service and energy sector proceeds at a slow pace and the rate of transposition of internal market directives has further decreased.

4.9 Luxembourg

Overall, Luxembourg does not yet seem to be addressing sufficiently both identified policy challenges. The challenge and recommendations on the labour market seem partially addressed. No action has so far been taken to reduce incentives for early retirement. Some progress has been made to reduce the inflow in disability pension schemes by tightening eligibility.

Also the challenge and recommendations concerning the business environment and entrepreneurship seem partially addressed. Little progress has been made regarding the reform of the competition law but some measures have been taken to encourage entrepreneurship.

4.10 Netherlands

Overall, the Netherlands seem to be addressing the three identified policy challenges. The challenge and recommendation regarding public finance in the 2003-05 BEPGs appear fully addressed. The new government continued to limit expenditure growth under multi-annual ceilings defined in real terms. Additional efforts may be required to ensure that expenditure plans remain consistent with a budgetary position of close to balance or in surplus.

The challenge and recommendation on the labour market seem largely addressed. Whereas the envisaged reform to reduce the flow into the disability scheme seems adequate, additional efforts are needed to activate people that are already in this scheme. Progress has been made in reforming other benefit systems with the aim of enhancing incentives to work.

Finally, the challenge and recommendations on productivity growth seem fully addressed. The government plans to make improvements in the regulatory framework for competition by increasing the powers of the competition authority. Also progress is made in promoting a stronger technology oriented education and in improving the co-operation between research institutions and business.

4.11 Austria

Overall, Austria seems to be addressing the three identified policy challenges. The challenge and recommendations regarding public finance in the 2003-05 BEPGs appear largely addressed. Action to achieve structural expenditure savings has been taken but was partly offset by increases in discretionary expenditure. Most notable in Austria is the comprehensive overhaul of the pension system which leads to significant savings in the long run and should raise the participation rate of older workers.

The challenge and recommendation regarding the weak technology base appear largely addressed. Several measures have been implemented to increase and rationalise R&D and innovation support.

Finally, the challenges and recommendation regarding competition appear partially addressed. Although steps have been made to enhance effective competition in the retail sector, no measures have been made to address high concentration in some other sectors. The resources of the competition authority remain inadequate and the power of the telecom regulator continues to be insufficient.

4.12 Portugal

Overall, Portugal seems to be addressing the three identified policy challenges. The challenge and recommendations regarding public finance in the 2003-05

BEPGs seem largely addressed. Although the general government deficit rose in 2003 but stayed just below 3 per cent due to the effect of sizeable one-off measures, progress was made in curbing expenditure growth notably through a strong deceleration of public consumption outlays. Portugal has continued to implement reforms in several areas such as health-care and education with a direct impact on budgetary consolidation as requested.

The challenge and recommendations on productivity and business dynamism seem largely addressed. Measures have been taken to stimulate innovation and R&D, to improve the quality of education and to reduce the number of early school leavers. Steps in the right direction have been taken to enhance competition in the gas sector, but in the electricity sector effective competition is not yet secured. Finally, the transposition rate of internal market directives improved in 2003 but stays below the set target of 98.5 per cent. A quasi-wage freeze in the government sector has contributed strongly to overall wage moderation, possibly bringing to a halt the deterioration in price-competitiveness registered in recent years.

Finally, the challenge and recommendations on long term sustainability appear fully addressed. A comprehensive reform of the health-sector is proceeding at a rapid pace but it is yet too early to assess its impact. Reforms of the pension system for workers in the general government sector have so far only partly been implemented, but the government plans to introduce additional measures.

4.13 Finland

Overall, Finland seems to be addressing the two identified policy challenges. The challenge and recommendations regarding the labour market seem partially addressed. Tax reductions implemented and intended will lead to a reduction of the tax wedge for a low wage earner by 1 percentage point. Reform of eligibility criteria to improve work incentives are however lacking. There is little progress in allowing wages to reflect productivity differences.

The challenge and recommendations on competition and public sector efficiency appear largely addressed. Some steps toward improved competition in network industries and non-tradable services have been launched. Further efforts have been made to improve the efficiency of the public sector. The new government has introduced multi-annual spending limits for the period 2003-2007 in order to improve spending control, in line with the request in the recommendation.

4.14 Sweden

Overall, Sweden does not yet seem to be addressing sufficiently the two identified policy challenges. The challenge and recommendations regarding labour supply appear partially addressed. On the one hand, measures have been undertaken to retain older workers and to promote the participation of immigrants and young in the labour force. On the other hand, some planned measures could have a negative impact on labour supply. Furthermore, there are no detailed plans as to when the last step of the income tax reform will be implemented.

The challenge and recommendations on competition and public sector efficiency appear partially addressed. Efforts have been made to improve competition in some sectors, such as construction and food retail, but no further measures have been taken to open up the rental housing market. Steps have been taken to increase the efficiency of the public sector by increasing the use of benchmarking, but no major initiatives have been taken to improve framework conditions for increased competition for public services.

4.15 United Kingdom

Overall, the United Kingdom seems to be addressing the three identified policy challenges. The challenge and recommendations regarding productivity seem fully addressed. The competition authority is progressing in further improving competition in specific sectors such as professional bodies, although the government is taking a cautious line on the deregulation of pharmacies and the liberalisation of postal services. Furthermore a long term strategy has been set out to improve the basic skills in the work force containing clear quantitative targets.

The challenge and recommendation on the labour market also seem fully addressed. Pilot projects have been launched to address the issue of high sickness and disability benefits (Pathways to Work) and financial incentives (Working Tax Credit) have been improved. A growing number of workers is being targeted by the above policies.

Finally, the challenge and recommendation on quality and efficiency of public services appear fully addressed. Reforms have been made to ensure that increased public spending is allocated efficiently and effectively. The authorities plan to make an Efficiency Review and further improvements are made in the use of Public Service Agreements, which are considered central in the strategy for public sector reform and improved delivery.