COUNCIL OF THE EUROPEAN UNION

Brussels, 26 January 2004

5651/04 ADD 1

UEM 12
ECOFIN 23
SOC 29
MI 17
COMPET 8
EDUC 15
ENV 46
AG 4

COVER NOTE

from	:	Secretary-General of the European Commission, signed by Mrs Patricia BUGNOT, Director
date of receipt	:	22 January 2004
to	:	Mr Javier SOLANA, Secretary-General/High Representative
Subject:		Communication from the Commission on the implementation of the 2003-2005 Broad Economic Policy Guidelines - Commission Staff Working Paper[1]

Delegations will find attached Commission document SEC(2004) 44.

Encl.: SEC(2004) 44

[1] This document is only available in English.

COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 21.1.2004
SEC(2004) 44

COMMISSION STAFF WORKING PAPER

Annex to the

COMMUNICATION FROM THE COMMISSION ON THE IMPLEMENTATION OF THE 2003-05 BROAD ECONOMIC POLICY GUIDELINES

PART II

COUNTRY NOTES

{COM(2004) 20 final}

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1. BELGIUM

Like its neighbouring countries, Belgium has experienced a prolonged slowdown in economic activity, expected real GDP growth not exceeding 1% for a third consecutive year in 2003. Most demand components, have been weak during these years; in the first half of 2003, Belgium saw a significant drop in external demand but private consumption was relatively strong. Following the weak economic developments, labour market conditions have deteriorated. Initially, 2003 showed a further decrease in employment and a further increase in the unemployment rate, but there are indications of a strengthening in labour demand. Despite this unfavourable economic environment, Belgium has succeeded in attaining slight surpluses in the general government budget since 2000 and at continuously reducing the gross debt to GDP ratio, that still remains above 100% of GDP. Productivity in Belgium has remained high and tops EU-15 rankings in various sectors such as the industry, the construction and the financial sectors. In recent years, the business environment and the competitive framework have improved. Reforms aimed at simplifying corporate taxation and at cutting red tape for companies have been initiated. Together, these should consolidate high openness to trade in goods and services in Belgium and above-the-EU-average FDI inflows. Nevertheless, key network industries and the provision of local services still lack effective competition and the breadth and scope of the recent reforms aimed at liberalising further need to be sustained to deliver their full effects.

Key challenges in the light of recent developments

In Belgium the government has taken a number of measures, covering most challenges, notably as regards increasing labour demand and supply and improving the business environment. However, positive results are only partly visible in some cases, due largely to the cyclical downturn or because the effects of some measures have yet not materialised. Not all challenges have been properly tackled, for instance as regards the increase in real expenditures in Entity I (the Federal Government and the Social Security Sector) and as regards effective competition in local services. A more detailed assessment of recent developments in addressing key policy challenges in Belgium is presented in the following sections.

1. Long-term sustainability of public finances

Ensure the continuation of the budgetary adjustment in the forthcoming years, in particular in view of ensuring the long-term sustainability of public finances in the face of population ageing.

Under this challenge, Belgium was requested to:

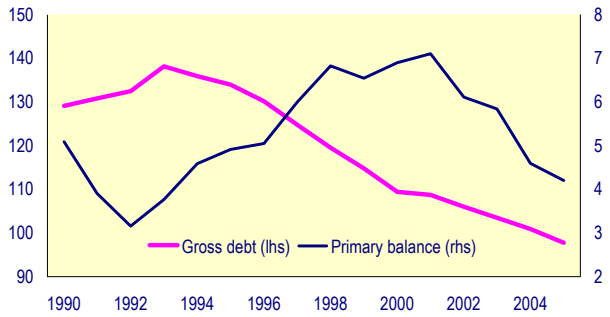
1. ensure that the government debt ratio is kept on a sustained declining trend at a satisfactory pace by maintaining high primary surpluses (GL 15);
2. limit the real expenditure increase in Entity I (Federal Government and social security) to 1,5 % and allocate proceeds stemming from higher than expected economic growth to improve the budgetary position as a matter of priority; and
3. strengthen the existing strategy in order to prepare for the budgetary implications of population ageing: in particular by reducing the debt level, better addressing the low effective retirement age, pursuing the reform of the pension systems, and strengthening efforts to finance the Ageing Fund (GL 16 and E-REC 2).

Debt ratio remains on a downward trend supported by lower interest payments.

Despite the unfavourable economic climate in the last few years, the general government balance has been in surplus and the government gross debt ratio has remained on a downward trend. Primary balances have been decreasing in the last two years, but this development seems to be largely related to the cycle, as the cyclically-adjusted primary balance has remained fairly stable. The impact of lower primary surpluses on the government balance has been balanced to a

large extent by favourable developments in interest payments, a budgetary structure which does not improve the sustainability of government finances. Furthermore, the levels of the budget balance and the debt in 2003 and in 2004 are influenced by a one-off measure, the transfer of the Belgacom pension fund for the government area and the respective payments which immediately accrue to the public finances. This measure is still under scrutiny by Eurostat. Without this one-off measure, Belgium would show a general government deficit of around 1% of GDP in 2003.

Graph 1.1: Primary balance and gross debt (in % of GDP)



Source : Commission services.

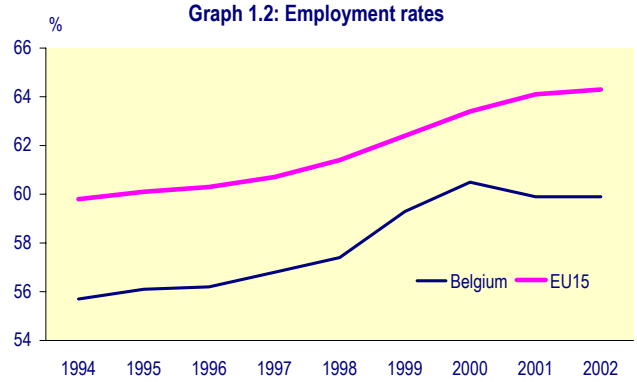
Still some difficulties in curbing real expenditures

The government seems to have been successful in limiting real expenditures in several areas. Real expenditures in the Federal Government are expected to increase by around 1½ % in 2003. However, deterioration in the economic environment and the increase in unemployment, has forced increases in social expenditures beyond the target. It is currently estimated that the growth of real expenditures of Entity I (Federal Government and social security) will exceed the 1.5% limit. In the 2004 budget, expenditures have been allowed to increase only in a few areas, including health, justice and investment. On the other hand, health expenditures are planned to increase by 4.5% annually in real terms for the next four following years. All in all, according to the 2004 budget, primary expenditures in Entity I will increase by close to 4% in nominal terms, which amounts to about 2.4% in real terms and is accordingly above the recommended maximum growth rate of 1.5%.

To meet the challenge of an ageing population, emphasis is put on increasing employment.

The employment rate is well below the EU average, particularly for older workers. In order to tackle this problem, employment promoting measures have been given highest priority. Social security contributions were reduced in 2003 and further reductions are announced in the 2004 budget for targeted groups. The size of the reductions is estimated to be around 0.2% of GDP in both 2004 and 2005. Several other measures have also been taken in order to increase demand and supply of labour. Some of these measures have a negative short term budgetary impact, making the objective of maintaining high primary surpluses harder. However, they are expected to have a positive impact on employment, productivity and the budget in the medium term.

Graph 1.2: Employment rates



Source : Commission services.

Further measures to meet the challenge of an ageing population include the reduction of the debt, the creation of the Ageing fund, as well as further reforms in the pension system. The Ageing Fund is meant to be used during the period 2010-2030 and is projected to raise about 10 billion euro in 2007. In order to strengthen the fund, the assets of the Belgacom pension fund have been allocated to finance the Fund. However, this transfer of the Belgacom pension fund to the public sector does not only imply assets but also government liabilities in a medium-long term perspective.

Some measures have been taken as regards the pension system. It has been decided to gradually extent the definition of a complete working career for women, from 40 to 45 years, and to gradually raise the minimum age within the GRAPA (garantie de revenues aux personnes agées) system. These measures should strengthen the sustainability of the pension system. In addition, steps have been taken in order to increase the number of participants within the second pillar in the pension system and the minimum pension levels for employees and employers and in the GRAPA system were raised as from April 2003.

2. Labour market and regional development

Increase the low participation and employment rates, especially for older workers and women, and improve incentives to work.

Under this challenge, Belgium was requested to:

4. take further steps to reinforce measures to postpone retirement from the labour force, in particular by combining a removal of incentives to early retirement (GL 16) with enhanced prevention and activation measures for older workers; and
5. continue progress in making work pay by eliminating the major distortions to work incentives arising from the interaction of the tax and benefit systems (GL 4 and E-REC 3).

Some measures have been taken to address the low employment rate.

The employment rate is relatively low in Belgium, 59.9% in 2002 as compared to 64.3% in the EU 15. Among older workers, 55-64 years, the rate was the lowest within the EU15, 26.7%, much lower than the 40.1% EU15 average. With employment falling, the situation has been worsening in 2003. This problem is widely recognised and measures have been taken in order to improve the situation. Besides those measures aimed at raising the overall employment rate, some others are directed towards older people. In January 2002, a system facilitating the access to part-time work for older workers was introduced; the aim being to prevent people from taking early retirement at the end of their careers by allowing them to work part-time while receiving full pension. In addition, the 2004 budget includes a reduction in social security contributions for workers above 58. It also includes an increase by 25% in the maximum amount of work allowed for pensioners who have reached pension age. These measures should have a positive influence on the employment rate among older workers.

Measures to encourage active job search have been adopted or are planned.

To encourage unemployed to look actively for work, the government has announced some measures. Firstly, the tax reform includes a reduction in the personal income tax, directed in particular towards lower wages. It is introduced gradually and is to be fully applied as from January 2004. Secondly, social security contributions paid by the employees have been reduced for lowest wages workers. Finally, co-operation between different social inspection services will be increased in order to prevent fraud and abuse of the system. These measures go in the right direction but results tend to take time to show up.

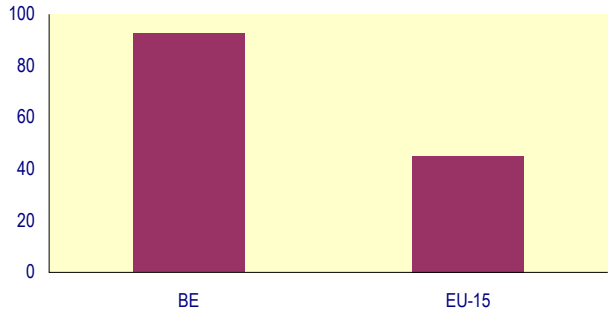
3. *Productivity and business dynamism*

Enhance competition in certain services sectors and continue to increase the efficiency of the public administration and to improve the business environment.

Under this challenge, Belgium was requested to:

6. take measures to enhance effective competition in network industries and in local services (in line with GL 9); and
7. improve public administration in the context of the ongoing reform and pursue the reduction of administrative burden for companies (GL 11).

Improvements made in the competitive and regulatory framework in network industries although effective competition has not yet appeared in some of these key sectors.



Graph 1.3: Market share of the incumbent in electricity generation (2001)

Source : Commission services.

Important steps have been taken to grant more independence to the regulator in the telecommunications and postal services sectors and to establish such a regulatory body in railways. In addition, the activities of the energy regulator for the non-eligible part of the market have been taken over by the regulator for the eligible part of the market, which is seen as more independent from operators. In full conformity with EU requirements, the reserved area in postal services was reduced and international rail freight services were opened to competition. Legal unbundling of transport and distribution systems operators in electricity and gas has been fully completed at the federal level and in Flanders but not yet in the two other regions. Likewise, full market opening of energy markets in Flanders has not been matched yet by the two other regions, which still officially stick to the timetable set in the EU directives. Despite these positive legal developments, effective competition in railways and in energy sectors remains low with high market shares for incumbents, low rates of consumer switching and high prices. No tangible progress has been made in clarifying the role of association of municipalities in the provision of local economic services and to solve the competition problems that could arise when private suppliers are competing for the provision of such services.

Reforms to encourage entrepreneurship and to ameliorate the business environment have been initiated….

The new government declared its commitment to reduce the administrative burden for citizens and businesses. Its top priority is to decrease the time and costs of administrative obligations for companies and to simplify the procedures to start a new company. It should translate into a single form to be filled at an accredited one-stop-shop that would provide the necessary accreditation within three days by 2005. These reforms should help to enhance the current position of Belgium as second-worst in terms of time and cost for starting-up a company and to improve its very poor performance in company's creation. Several initiatives have been achieved or initiated in 2003 at both federal and regional levels, among which the setting up of a crossroads bank for enterprises to simplify and centralise information on companies, the provision of guarantees to loans to SMEs, the extension of electronic interactive applications in the field of VAT returns and social security obligations, or the streamlining and acceleration of administrative procedures. However, most plans are in an early phase and have still to be fully completed within the deadline of 2005 set by the government.

...but the reform to modernise public administration has been suspended.

Although the new Federal government has declared its commitment to continue the modernisation of its administration, important aspects of the reform that started under the previous legislature (Copernicus) have so far been put to a halt. Specifically, the procedures to hire top managers for public administrations have been suspended and so is the modernisation of the status of civil servants with a university degree.

Table 1.1: Economic indicators for Belgium

	BELGIUM				EU 15			
	2000	2001	2002	2003	2000	2001	2002	2003
General economic background								
Real GDP[1]	3.8	0.6	0.7	0.8	3.6	1.7	1.1	0.8
Inflation[2]	2.7	2.4	1.6	1.5	1.9	2.2	2.1	2.0
Labour productivity[3]	1.9	-0.8	1.0	1.0	1.6	0.5	0.8	0.8
Employment growth[4]	1.9	1.5	-0.3	-0.2	2.0	1.2	0.4	0.0
Nominal wage growth[5]	2.1	3.6	4.3	2.2	3.5	3.3	3.1	3.1
Unemployment[6]	6.9	6.7	7.3	8.2	7.8	7.4	7.7	8.1
Employment								
Employment rate[7]	60.5	59.9	59.9	n.a.	63.4	64.1	64.3	n.a.
Female employment rate[8]	51.5	51.0	51.4	n.a.	54.1	55	55.6	n.a.
Employment rate for older workers[9]	26.3	25.1	26.6	n.a.	37.8	38.8	40.1	n.a.
Long-term unemployment[10]	3.7	3.2	3.5	n.a.	3.5	3.1	3.0	n.a.
Tax rate on low wage earners[11]	49.9	49.1	48.9	n.a.	38.6	37.7	37.8	n.a.
Unemployment trap indicator[12]	n.a.	88.8	91.3	n.a.	n.a.	79.4	79.1	n.a.
Product market reforms								
Relative price levels[13]	101.8	99.3	98.7	n.a.	100	100	100	100
Total trade to GDP ratio (%)[14]	92.7	93.3	97.7	n.a.	59.6	59.0	58.1	n.a.
Single Market Directives[15]	97.1	97.7	98.0	96.5	97.0	98.0	97.9	97.7
Business investment[16]	19.4	19.4	18.3	n.a.	18.3	17.9	17.2	n.a.
Knowledge based economy								
Tertiary graduates[17]	51.4	53.4	n.a.	n.a.	38.4	40.0	n.a.	n.a.
Spending on human resources[18]	n.a.	6.1	n.a.	n.a.	4.9	n.a.	n.a.	n.a.
R&D expenditure[19]	2.04	2.17	n.a.	n.a.	1.95	1.98	1.99	n.a.
Expenditures on IT[20]	4.5	4.5	n.a.	n.a.	4.2	4.2	n.a.	n.a.

[1] Growth rate in real GDP in % ;[2] Annual average rate of change in Harmonised index of consumer prices in %;[3] Growth rate of real GDP per occupied person in % ;[4] Growth rate in employment in %;[5] Growth rate of compensation of employees per head;[6] Number of unemployed as a percentage of the labour force;[7] Employed persons aged 15-64 as a share of the total population of the same age group;[8] Employed women aged 15-64 as a share of the total female population of the same age group.[9] Employed persons aged 55-64 as a share of the total population of the same age group;[10] Long-term unemployed (over 12 months) as a percentage of the total active population aged 15-64;

[11] Income tax plus employer and employee contributions as a % if labour costs of a single earner at 67% of the APW, no children;[12] Effective tax rate on labour income taking into account the combined effect of increased taxes and benefits withdrawal as an individual moves from unemployment back to work earning 67% of the APW wage, measured at the first month of unemployment (after any 'waiting period' if applicable) ;[13] Private final consumption, EU-15= 100;[14] %, average value of imports and exports of goods and services divided by GDP, multiplied by 100; For AT, BE, DK, FI, FI, EL, IE, LU, NL, PT and SE the value for EU 15 is the total for the small Member States; For DE, ES, FR, IT and the UK the value for the EU15 is the total of the large Member States;[15] % implemented;[16] Gross fixed capital formation by the private sector as a % of GDP;[17] Total tertiary graduates per 1000 of population aged 20-29;[18] Public expenditure on education as a percentage of GDP;[19] Gross domestic expenditure on R&D as a percentage of GDP;[20] Expenditure on information technology as a percentage of GDP.

Source: Commission services.

Table 1.2: Public finances in Belgium (% of GDP)

	BELGIUM					EU-15				
	2000	2001	2002	2003	2004	2000	2001	2002	2003	2004
Government balance	0.2	0.6	0.1	0.2	-0.4	1.0	-0.9	-1.9	-2.7	-2.6
Primary balance	6.9	7.1	6.1	5.8	4.6	4.8	2.7	1.4	0.6	0.5
Cyclically adjusted balance	-1.3	-0.4	0.0	0.8	0.1	-1.2	-1.6	-2.1	-2.2	-2.0
Cyclically adjusted primary balance	5.4	6.2	6.0	6.4	5.1	2.6	2.0	1.3	1.1	1.1
Government debt	109.5	108.7	106.1	103.5	101.0	64.1	62.8	62.5	64.1	64.4

Source: Commission services.

2. DENMARK

*After the robust GDP growth in 2002, economic activity was more subdued in 2003, mainly due to weak domestic demand. The slowdown has opened a negative output gap which has eased inflationary pressures but resulted in an increased unemployment, albeit from a relatively low level. Against this backdrop, a moderately expansionary fiscal policy stance is foreseen in the draft Budget Bill for 2004. Overall, economic policy remains focused on medium-term objectives. The challenge of securing longer-term sustainability of public finances is addressed through the target of reducing the public debt ratio substantially by 2010, by running general government surpluses of on average 1½-2½% of GDP until 2010. This will finance the expected future increase in net public expenditures due to ageing, without triggering a need for fiscal tightening at some later point . To this end, however, it is essential that the growth of public consumption expenditure is brought in line with targets and that further measures are taken to ensure the assumed increase in effective labour supply in addition to the measures already implemente*d. M*easures going in the right direction have been taken in the context of the 2004 tax reform, as well as in the 2002 labour market reform. Recent Danish productivity performance has been above the EU average, which could result from the advanced stage in the transition to a knowledge-based economy. However, competition is weak in a number of sectors, which contributes to Denmark having the highest price level in the EU, when including indirect taxes. Reform measures in 2003 included fully liberalising the electricity market and the launching of an action plan to increase public sector efficiency. However, further measures may be needed in order to increase public sector efficiency, which could contribute to increase competition and to reduce the price level relative to the EU15.*

Key challenges in the light of recent developments

Denmark's economic policy agenda keeps its medium-term focus on macroeconomic stability and debt reduction. The moderate fiscal expansion for 2004 reflects mostly the structurally motivated reductions of income taxes and a general government surplus in 2004 of 1.3% of GDP is envisaged for 2004. Reforms addressing the 2003-05 BEPG recommendations to enhance labour supply are being implemented, but it is still early to evaluate their effects. To underpin the medium-term fiscal strategy, targets for the growth of public consumption expenditure should be achieved through discipline at all levels of government. High prices and weak competition persist in many sectors, but measures have been taken to strengthen competition and increase efficiency in the public sector. The following sections present and assess in more detail recent developments in addressing the key economic policy challenges.

1. Long-term sustainability of public finances

Ensure an adequate labour supply in view of the ageing of the population

Under this challenge, Denmark was requested to:

1. continue efforts to increase labour supply notably by efforts to make work pay by increasing incentives to join and remain in the labour force and to postpone retirement, in particular by ensuring the implementation of the tax reform and by considering additional steps to tighten eligibility rules and reduce marginal taxes within a framework of sound public finances (GL 4 and ERECs 1 and 3); and
2. ensure expenditure control at all levels of government so that the multi-annual targets for public consumption growth are respected (GL 14).

Measures to enhance labour supply have been implemented…

Denmark ranks among the EU Member States with the best labour market performance and the Lisbon targets are fulfilled by a wide margin. Nevertheless, further increasing labour supply over the medium-term is essential to meet the future demographic challenge taking into account present and projected fiscal policies. In addressing this challenge, the employment rates will need to be raised, in particular among older persons and immigrants. Denmark's recent reform efforts include measures to increase labour supply and lower unemployment. The 1999 reform of the voluntary early retirement benefit is having some positive effects on the labour supply of persons aged 60-62 years. However, the scheme remains an obstacle to raising labour market participation for older persons overall. The 2002 "More people into employment" initiative includes a range of measures. In addition to simplifying the labour-market administration and introducing more results-oriented activation measures, the initiative addresses unemployment traps for specific groups benefiting from the social assistance system by strengthening economic incentives. The scope to keep earned income without losing means-tested benefits is increased and there is a reduction in the cash benefit after six months. Rules governing availability and willingness-to-work criteria have been tightened. The main objective of the 2004 tax reform is to stimulate effective labour supply through lower marginal rates by a rise in the threshold for the intermediate tax bracket and introducing an earned income tax credit in the form of an employment allowance.

… but it is early to assess their effects.

With already high employment rates as a starting point, Denmark is facing a challenging task financing its public sector commitments at the time of worsening demographic conditions. In addition, the present downturn is having a negative short-term effect on the labour market. The measures in the "More people into employment" and the lowering of tax rates on labour should have a positive effect on labour supply. However, as the effects of the measures take time to come through, it is still too early to evaluate their effects. Nevertheless, as recognised by the authorities, further efforts will be needed to reach Denmark's medium-term targets for increased labour supply.

Targets for public expenditure growth need to be achieved

In spite of some weakening of the general government surplus due to the economic slowdown, Denmark's public finances remain overall sound. Potential fiscal leeway for reducing taxes has been created by lowering the future growth of real public consumption expenditure. It is therefore essential that these lower growth rates are achieved. However, over the last decade, the average growth of public consumption expenditure in real terms has been 2-2½ %. In 2002, it was 2.1%, clearly above the target of 1%. Achieving the national target of ½% as from 2005 is therefore ambitious. As the largest share of public consumption is the responsibility of the counties and municipalities, fulfilling the targets for general government will require discipline in adhering to the agreements across all government levels. In addition to the budget agreements (between central and local governments), the tax freeze is key in this respect- as local governments are severely restricted in raising capital via loans- and it should prevent local governments from raising taxes to finance increased spending. The tax freeze did not fully constrain local government spending in 2002, which was the first year of its implementation. In 2003, compliance of local governments with the tax freeze and with the budgeted expenditure has been overall good. However, if a pattern of not living up to the budget agreements on expenditure persists, it should be considered to re-evaluate the instruments for assuring the necessary budgetary discipline.

2. *Productivity and business dynamism*

Enhance competition in certain sectors and improve the efficiency of the public sector

Under this challenge, Denmark was requested to:

3. step up efforts to enforce competition in sectors where competition is inadequate (GL 9); and
4. continue efforts to increase the efficiency of the public sector, inter alia by improving framework conditions for increased competition, promoting the benchmarking of public sector efficiency, and by increasing public tendering (GL 11).

Some measures have been taken to increase competition although high prices and weak competition persist in many sectors ….

Danish prices, including indirect taxes, remain the highest in the EU and weak competition in many sectors could be a contributing factor. There are so far no signs that prices measured relative to EU15 have decreased. The changes in the competition law in 2002 should enhance competition, but it is still too early to evaluate its effects. Some further measures have been taken in 2003 to increase competition. The electricity market was fully liberalised on 1 January 2003 and during the first six months 64.000 customers have changed suppliers, corresponding to a third of the total electricity consumption. Further changes made to the legal framework in some sectors such as payment services and regarding drinking cans may increase competition. However, there is no information on any recent measures taken to increase competition in the rental housing sector. The Competition Authority in co-operation with relevant Ministries has started a project to identify regulatory barriers to competition and will present the results in the first half of 2004.

… but some signs of increasing efficiency in the public sector.

The Danish public sector is among the largest in the EU and substantial efforts are made to improve its efficiency. During the last two years reforms in welfare services have increased competition and some measures have been taken to promote the benchmarking of public sector efficiency and increasing public tendering. The number of businesses for care for the elderly has increased after the opening of the market in 2003. Furthermore, the government has extended the free choice of hospital, in cases where patients have to wait more than two months, to include private hospitals and hospitals abroad, which is expected to increase the efficiency of (public) hospitals. The government launched a knowledge strategy in 2003 with inter alia the aim to increase the efficiency of the higher education system. A primary school reform, which came into effect in 2003, and a secondary school reform, which will come into effect in 2005, could increase the quality and efficiency in education. In August 2003 the government presented an action plan to increase the efficiency of the public sector by benchmarking it with the private sector, reducing administrative burdens and improving communication to the public. If the expected results of the reforms materialise, Denmark has prospects of increased efficiency in the public sector.

Table 2.1: Economic indicators for Denmark

	DENMARK				EU 15			
	2000	2001	2002	2003	2000	2001	2002	2003
General economic background								
Real GDP[1]	2.9	1.4	2.1	0.8	3.6	1.7	1.1	0.8
Inflation[2]	2.7	2.3	2.4	2.3	1.9	2.2	2.1	2.0
Labour productivity[3]	2.4	1.1	2.7	1.5	1.6	0.5	0.8	0.8
Employment growth[4]	0.5	0.4	-0.6	-0.6	2.0	1.2	0.4	0.0
Nominal wage growth[5]	3.8	4.8	3.8	3.7	3.5	3.3	3.1	3.1
Unemployment[6]	4.4	4.3	4.5	5.5	7.8	7.4	7.7	8.1
Employment								
Employment rate[7]	76.3	76.2	75.9	n.a.	63.4	64.1	64.3	n.a.
Female employment rate[8]	71.6	72	71.7	n.a.	54.1	55	55.6	n.a.
Employment rate for older workers[9]	55.7	58	57.9	n.a.	37.8	38.8	40.1	n.a.
Long-term unemployment[10]	1.0	0.8	0.9	n.a.	3.5	3.1	3.0	n.a.
Tax rate on low wage earners[11]	41.2	40.6	39.8	n.a.	38.6	37.7	37.8	n.a.
Unemployment trap indicator[12]	n.a.	91.2	90.7	n.a.	n.a.	79.4	79.1	n.a.
Product market reforms								
Relative price levels[13]	123.0	126.2	130.7	n.a.	100	100	100	100
Total trade to GDP ratio (%)[14]	44.1	45.0	44.7	n.a.	59.6	59.0	58.1	n.a.
Single Market Directives[15]	98.9	99.2	99.3	99.7	97.0	98.0	97.9	97.7
Business investment[16]	18.9	18.2	17.8	n.a.	18.3	17.9	17.2	n.a.
Knowledge based economy								
Tertiary graduates[17]	54.0	n.a.	n.a.	n.a.	38.4	40.0	n.a.	n.a.
Spending on human resources[18]	8.4	n.a.	n.a.	n.a.	4.9	n.a.	n.a.	n.a.
R&D expenditure[19]	2.26	2.4	n.a.	n.a.	1.95	1.98	1.99	n.a.
Expenditures on IT[20]	5.4	5.0	n.a.	n.a.	4.2	4.2	n.a.	n.a.

For footnotes and sources see Table 1.1 for Belgium.

Table 2.2: Public finances in Denmark (% of GDP)

	DENMARK					EU-15				
	2000	2001	2002	2003	2004	2000	2001	2002	2003	2004
Government balance	2.6	3.1	1.9	0.9	1.3	1.0	-0.9	-1.9	-2.7	-2.6
Primary balance	6.8	7.0	5.4	4.2	4.3	4.8	2.7	1.4	0.6	0.5
Cyclically adjusted balance	1.1	2.0	1.1	1.0	1.4	-1.2	-1.6	-2.1	-2.2	-2.0
Cyclically adjusted primary balance	5.4	6.0	4.6	4.3	4.4	2.6	2.0	1.3	1.1	1.2
Government debt	47.3	45.4	45.5	42.9	41.0	64.1	62.8	62.5	64.1	64.4

Source: Commission services.

3. GERMANY

Recent developments confirm the structural weakness of the German economy as identified in the country-specific challenges. Continued sluggish activity in 2003 was accompanied by a significant fall in employment, underlining the key importance of labour market reforms for stronger growth and job creation. There is a notable drive to reform: however, labour market rigidities remain a paramount problem. Public finances deteriorated, with the general government deficit exceeding 4% of GDP. Budget consolidation measures taken earlier this year were either undermined by unfavourable economic developments or proved inadequate. Prompted also by the ongoing excessive deficit procedure, the government has presented a package that would bring the deficit down by a significant amount, but not enough as to ensure that the deficit will be below the 3% of GDP by 2004 or even 2005. In order to raise the growth potential of the economy, the Government has launched the "Agenda 2010", which is a comprehensive project for restructuring Germany's expensive social security system and has major consequences for labour and product markets. On 14 December 2003, the governing coalition and the opposition reached a compromise deal, allowing large parts of "Agenda 2010"to come into effect. These measures should improve cost competitiveness by reducing non-wage labour costs and boosting productivity.

Key challenges in the light of recent developments

Germany's policy agenda has made some progress in the last year. The most remarkable aspect is a broad-based debate on structural reform, which has spawned already a number of promising legislative proposals and other policy initiatives, notably in the field of labour market reform, tax reform, education and health care. Most prominent here are the proposals under the heading of the Agenda 2010 and the "Hartz" labour market reforms. It is, however, at this stage too early to say whether these proposals will actually result in noticeable progress, because many proposals have only recently been passed into law and have not yet had the time to be fully effective. An agreement has been reached between the government coalition and the opposition on a health care reform. Furthermore, in order to contain the rise in retirement costs, pensions will be frozen next year and rise at a lower rate thereafter. Finally, a number of measures were taken to encourage enterprise creation and improve public service provision. A more detailed assessment of recent developments in addressing Germany's key policy challenges is presented in the following sections.

1. Labour market and regional development

Promote job creation and adaptability and mobilise the unutilised employment potential,

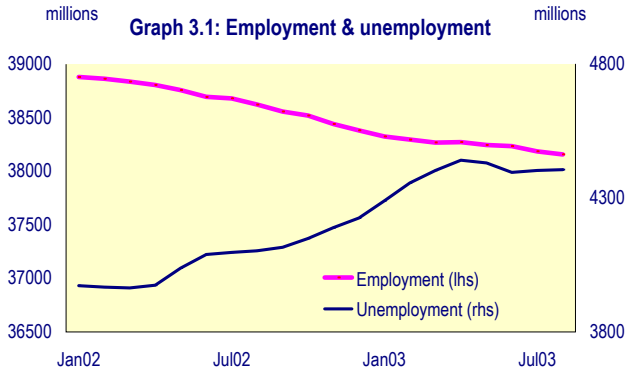
Under this challenge, Germany was requested to:

1. continue to reform the tax-benefit system (GL 4 and E-REC 6), in order to ensure sufficient incentives to take up work or to move into a higher income bracket, and firmly enforce the conditionality of benefits upon active job search;
2. take measures to ensure that wages reflect better productivity differences across skills and regions (GL 5), notably by reviewing the Günstigkeitsprinzip, allowing temporarily lower payments for job starters; and
3. carry forward the reforms to improve the efficiency of ALMPs, in particular of job search assistance. Further reform ALMPs according to cost-effectiveness criteria and target them better towards those persons most prone to the risk of long-term unemployment (GL 8, 13 iv and E-REC 1).

Efforts are under way to enhance work incentives provided by the tax-benefit-system…

Germany made noticeable progress in implementing the 2003 labour market recommendations. On 1 January 2003 and 1 April 2003, the first two of the four "Laws for modern services in the labour market" (Hartz I to IV) came into effect, while government and opposition agreed on the remaining "Hartz" proposals along with the bulk of Agenda 2010 on 14 December 2003.

The measures taken focus on improving the efficiency of job placement services and on the creation of new employment opportunities. Tighter eligibility criteria have caused unemployment to edge down even though overall employment has not increased (see chart). As of 2006, a general limitation of the entitlement to unemployment benefit to 12 months (older persons to 18 months) will come into effect. "Personal Service Agencies" (PSAs) have been created as public temporary work agencies, which effectively subsidise wages during a training period. Furthermore, self-employment and low-wage jobs are being promoted by offering favourable tax rates and social security contributions. While the promotion of self-employment has slightly increased employment, PSAs and the "Capital for Labour" scheme, which subsidises the recruitment of long-term unemployed, have met with only faint response so far. However, it is too early to judge the success of these measures.



Graph 3.1: Employment & unemployment

Source : Commission services.

Additional measures that were adopted in December 2003 include the reorganisation of Germany's Federal Employment Office into a more efficient service facility, the merger of social assistance with unemployment benefits and a tightening of rules for receiving unemployment benefits. Moreover, protection against dismissal will be eased for newly hired employees of small firms with up to 10 workers, and by lowering the threshold for which jobs are deemed acceptable, unemployed persons are expected to take employment more rapidly. However, the legal underpinnings of the wage bargaining systems remain as they were. In particular, no attempt has been made to alter the legal basis of the "Günstigkeitsprinzip", which allows for enterprise-level deviations from industry-wide tariff agreements only if the new contract is not unfavourable to employees on any aspect contained in the collective agreement.

The four Hartz laws and important parts of Agenda 2010 constitute significant progress in making the labour market more flexible. Considerable steps have therefore been undertaken or proposed by the German authorities to comply with GL 4. The framework conditions for job creation are also being improved through liberalisation of shop opening hours and reductions in the administrative burden on business. However, labour market participation of women is still negatively influenced by the continuing lack of care facilities.

…and some progress is being accomplished to make wages better reflect productivity differences.

Economic disparities have insufficiently narrowed since unification, with the East German unemployment rate still more than twice the national average. In dealing with these disparities, policy has to respect the autonomy of social partners. Some tentative progress can be observed, as collective wage agreements are more and more flexible by including opening clauses or are simply not applied, particularly in eastern Germany.

But active labour market measures still need to be improved

Active labour market measures (ALMPs) play an important role in the prevention of long-term unemployment, especially in eastern Germany. However, while being costly, public employment programs do not seem to have raised the probability of re-employment. On the contrary, ALMPs may have crowded out private sector activity. In order to improve the efficiency of ALMPs, German authorities thus called for more impact research and a comprehensive evaluation is currently being drawn up. The German vocational training system is also in the process of being modernised. Since August 2003, tests for on-the-job trainers are no longer obligatory, which facilitates training in new and small firms. Germany has thus made some progress in implementing the 2003 recommendations with respect to active labour market measures.

2. Productivity and business dynamism

Increase productivity through improvements in the business environment and the efficiency of the education system

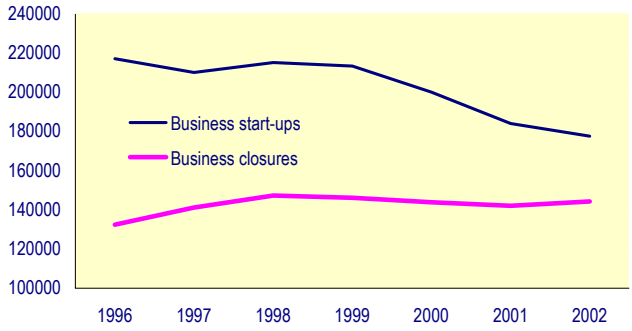
Under this challenge, Germany was requested to:

4. encourage businesses to invest and grow by creating a more competitive environment (GL 9) and by further reducing the regulatory and administrative burden (GL 11), inter alia, by lowering the effective degree of employment protection (GL 6); and
5. carry out further reforms contributing to improved educational achievements and the elimination of persistent skill shortages (GL 13).

The German government has taken a number of new initiatives.

The German Government has put forward proposals to bring German competition policies fully in line with EU competition law. In addition, the decision-making process in merger control will be speeded up. The new competition law should enter into force on 1 May 2004. The Government has also proposed to relax the law on unfair competition, lifting the prohibition of special sales. This reform should become effective at the beginning of 2004. Proposals to bring forward the third stage of the tax reform should contribute to a lowering of the tax burden on business in 2004. Sectoral and *ad hoc* State aids continued their slow decline, but the value of public procurement published in the Official Journal as a percentage of GDP remains the lowest of all Member states. The Government has included the simplification of public procurement rules as a priority in its initiative to reduce bureaucracy and over-regulation. This initiative, which was adopted on July 2003, aims to increase the attractiveness of Germany as a location for business and to improve public service provision through a series of measures in five domains: labour market and the self-employed; economy and 'Mittelstand'; research and technology; civil society and honorary posts; and services for the citizen. A number of measures were taken to encourage enterprise creation, which has recently been declining. These measures include the provision of low-interest loans, an easing of entry into the handicraft trades, and a lowering of the degree of employment protection in new and small firms.

Graph 3.2: Business start-ups and closures[1)]

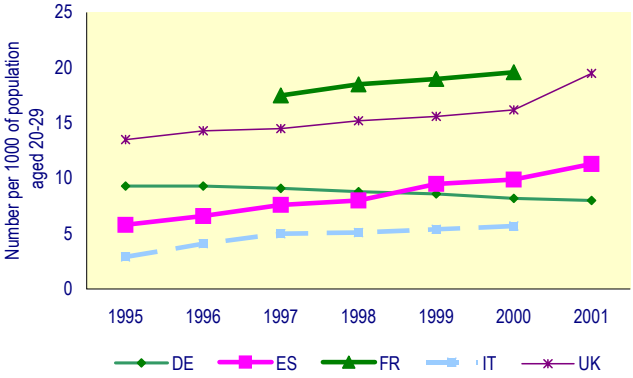


1) Excluding small-scale and secondary activities.
Source : Statistisches Bundesamt.

Success of federal education initiative depends on the follow-up by the Länder

In order to improve the achievements of its students in primary and secondary education, Germany intends to boost the supply of all-day schools (i.a. federal program of € 4 billion in the years 2004 to 2007); develop national standards (including the creation of an independent Agency for Standards and Evaluation); establish a committee of experts to report on development in the educational field; and take a number of measures aimed at improving the teaching quality. In spite of the continued decline in the number of tertiary graduates in science and technology, no new reforms at the university level are foreseen. Initiatives taken to improve the quality of vocational training are mentioned when discussing the follow-up to the recommendation on ALMPs.

Graph 3.3: Total tertiary graduates in science and technology



Source : Commission services.

3. Public finances

Reduce rapidly the general government deficit to below 3 % of GDP and keep government finances on a steady consolidation path

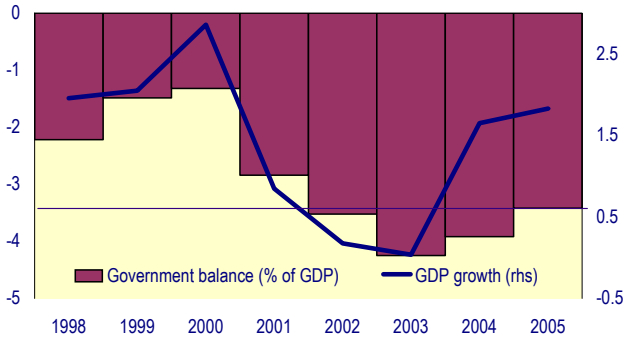
Under this challenge, Germany was requested to:

6. ensure a rigorous budget execution and implement the announced or compensatory measures for 2003 amounting to 1 % of GDP and put an end to the present excessive deficit situation by 2004 at the latest (GL 1); and
7. lower the cyclically-adjusted deficit by at least one percentage point of GDP between the end of 2003 and 2005.

Despite efforts, 2003 budget deficit deteriorates vis-à-vis 2002…

Following a recommendation of the Council for Germany, according to Article 104.7 of the Treaty, to carry out budget consolidation measures amounting to 1% of GDP in 2003, the German government implemented measures in the order of over € 20 billion. The actual budgetary outcome for 2003, however, turned out to be worse than expected, with the Commission forecasting a general government deficit of 4.2% of GDP in 2003, which marks a deterioration vis-à-vis the 2002 deficit by 0.7 percentage points in nominal terms and by 0.1% in

Graph 3.4: GDP growth and government balance



Note : figure for 2000 excluding UMTS-proceeds.
Source : Commission services.

cyclically adjusted terms. Although there is no evidence of significant budgetary slippage compared with plans, apart from expenditures related to the labour market, the consolidation results so far show that additional efforts are needed[2].

…requiring additional efforts in 2004 and 2005…

In the light of the unforeseen deterioration of the budget balance, the need for achieving substantial improvement in 2004 and 2005 has become more pressing. On the basis of a projected deficit of 4.2% of GDP in 2003 and the confirmation by German authorities that the 2004 deficit will exceed 3% of GDP, the Commission adopted on 18 November a Recommendation for the Council to decide that action taken by Germany is inadequate to bring the excessive deficit to an end, in accordance with Article 104.8 of the Treaty. At the same time, the Commission adopted a recommendation to the Council to take a decision pursuant Article 104.9. In light of the weak economy, the Commission recommended to the Council to allow Germany an additional year (i.e. until 2005) to bring the government deficit below 3% of GDP and to require Germany to reduce the cyclically-adjusted deficit by a total of 1.3% of GDP, of which 0.8% in 2004.

…to which Germany committed itself while the Council found an agreement outside the Treaty.

On 25 November, the Council rejected the two Commission recommendations. Germany committed itself to a reduction of the cyclically-adjusted deficit by 0.6% and at least 0.5% of GDP in 2004 and 2005, respectively. This commitment was repeated in the 2003 update of the Stability Programme. However, it is less than the consolidation effort recommended by the Commission. Any higher than expected revenue is to be used for additional deficit reduction. Based on the Commission Autumn 2003 forecast an achievement of this consolidation path would result in a deficit minimally below 3% of GDP in 2005, leaving a substantial risk that it might actually be above that threshold for a fourth year in a row.

4. Long-term sustainability of public finances

Secure the long-term viability of pension and health-care systems.

Under this challenge, Germany was requested to:

8. promote the take-up of supplementary pension schemes and strengthen incentives for later retirement, (GL 16); and
9. increase the efficiency in the health care sector by introducing economic incentives for health care providers and recipients.

Reforms to address short-term pension financing problems and proposals for long-term sustainability

In the so-called Pension Summit of 18/19 October, German cabinet ministers and government coalition leaders decided on a number of measures, which would improve to some extent the sustainability of public finances. The decision to gradually increase the mandatory retirement age from 65 to 67 years has been postponed until the end of the decade.

The decisions will also lead to some further progress in the take-up of supplementary pension schemes, by simplifying the supervision of private pension schemes. In addition, the take-up of

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[2] The fact that, despite the measures taken by the government, the cyclically-adjusted balance nevertheless deteriorated slightly can be attributed in particular to a downward revision of potential growth, as well as to a budgetary impact of the measures taken being lower than anticipated and a higher trend deficit due to the fact that growth turned out lower than expected in the Stability Programme on which expenditure plans were based.

private pension schemes will be promoted indirectly by the introduction of a "sustainability factor" into the pension formula, which effectively lowers future increases in pensions. While the proposals of the Pension summit will bring some short-term relief for pensions financing, it needs to be complemented with a more structured reform of the pension system.

Health care reforms shift costs to patients

The health care compromise, which has been passed by the Bundesrat and will be effective as from 1 January 2004 foresees savings of € 10 billion in 2004 (2007: € 23 billion) allowing for a reduction of the joint employer/employee health care contribution by 0.7 percentage points in 2004 (1.3 percentage points in 2007). In turn, patients will have to pay a higher share of the direct costs themselves, regarding for example items such as dental care and sickness benefit. Much of the reform does not actually provide cost-savings but consists in removing components from the regular health insurance. De facto, the burden of health insurance will not be reduced, apart from having a somewhat increased incentive for patients to save costs, for instance, in dental care and medication. There are further efforts needed to contain upward pressure on health insurance contribution rates in the long term. Particularly, reductions in the costs of medical treatment and better incentives for a rational use of health care services are warranted.

Table 3.1: Economic indicators for Germany

	GERMANY				EU 15			
	2000	2001	2002	2003	2000	2001	2002	2003
General economic background								
Real GDP[1]	2.9	0.8	0.2	0.0	3.6	1.7	1.1	0.8
Inflation[2]	1.4	1.9	1.3	1.1	1.9	2.2	2.1	2.0
Labour productivity[3]	1.1	0.4	0.8	1.6	1.6	0.5	0.8	0.8
Employment growth[4]	1.8	0.4	-0.6	-1.5	2.0	1.2	0.4	0.0
Nominal wage growth[5]	2.1	1.7	1.5	1.9	3.5	3.3	3.1	3.1
Unemployment[6]	7.8	7.8	8.6	9.4	7.8	7.4	7.7	8.1
Employment								
Employment rate[7]	65.6	65.8	65.3	n.a.	63.4	64.1	64.3	n.a.
Female employment rate[8]	58.1	58.7	58.8	n.a.	54.1	55	55.6	n.a.
Employment rate for older workers[9]	37.6	37.9	38.6	n.a.	37.8	38.8	40.1	n.a.
Long-term unemployment[10]	3.9	3.8	4.0	n.a.	3.5	3.1	3.0	n.a.
Tax rate on low wage earners[11]	46.5	45.5	45.9	n.a.	38.6	37.7	37.8	n.a.
Unemployment trap indicator[12]	n.a.	87.9	88.4	n.a.	n.a.	79.4	79.1	n.a.
Product market reforms								
Relative price levels[13]	101.6	103.3	104.0	n.a.	100	100	100	100
Total trade to GDP ratio (%)[14]	33.8	34.6	34.1	n.a.	30.2	29.9	29.1	n.a.
Single Market Directives[15]	96.9	97.4	97.3	96.5	97.0	98.0	97.9	97.7
Business investment[16]	19.9	18.6	16.9	n.a.	18.3	17.9	17.2	n.a.
Knowledge based economy								
Tertiary graduates[17]	31.0	31.0	n.a.	n.a.	38.4	40.0	n.a.	n.a.
Spending on human resources[18]	4.5	n.a.	n.a.	n.a.	4.9	n.a.	n.a.	n.a.
R&D expenditure[19]	2.49	2.5	2.51	n.a.	1.95	1.98	1.99	n.a.
Expenditures on IT[20]	4.3	4.2	n.a.	n.a.	4.2	4.2	n.a.	n.a.

For footnotes and sources see Table 1.1 for Belgium.

Table 3.2: Public finances in Germany (% of GDP)

	GERMANY					EU-15				
	2000	2001	2002	2003	2004	2000	2001	2002	2003	2004
Government balance	1.3	-2.8	-3.5	-4.2	-3.9	1.0	-0.9	-1.9	-2.7	-2.6
Primary balance	4.7	0.4	-0.4	-1.1	-0.7	4.8	2.7	1.4	0.6	0.5
Cyclically adjusted balance	-1.9	-3.3	-3.4	-3.5	-3.3	-1.2	-1.6	-2.1	-2.2	-2.0
Cyclically adjusted primary balance	1.5	0.0	-0.3	-0.3	-0.1	2.6	2.0	1.3	1.1	1.1
Government debt	60.2	59.4	60.8	63.8	65.0	64.1	62.8	62.5	64.1	64.4

Source : Commission services.

4. GREECE

Economic activity in Greece remains strong as the economy is benefiting from a series of factors which have boosted domestic demand. Specifically, high wage increases and tax reductions introduced by the tax reform of last year combined with low cost of borrowing, as a result of easy monetary conditions, have boosted private consumption. Moreover, public spending on projects linked to the Olympics and the financial flows from the EU Structural Funds have supported public investment. However, despite these favourable domestic conditions the Greek economy has not made sufficient progress to deal effectively with its two basic structural problems, namely weak international competitiveness and fiscal imbalances. The need to control on a more permanent basis fiscal imbalances is of primary importance all the more that Greece has made little progress in reducing the high government debt. The situation in the labour markets has lately been improving. Unemployment has been following a declining trend much supported by employment creation in the buoyant construction activity. However, despite some attempts made for implementing measures aiming to render employment conditions more flexible, the structural problems in the labour market are not being eliminated at a satisfactory pace. Nevertheless, some improvement with respect to the employment participation rate, the long run unemployment, and the unemployment rate of the youth has recently become clearer. Progress with respect to the employment participation and the unemployment rate of women remains limited. Although strongly rising in recent years, Greek labour productivity remains the second lowest in the EU. This is partly due to low levels of investment in R&D, the still low -albeit growing- level of ICT diffusion, and low levels of educational attainment of the population. But still limited competition in certain network industries and a lack of business dynamism, due to complex regulation and administrative systems, can also be part of the explanation.

Key challenges in the light of recent developments

Despite continued strong economic growth, the Greek government has not resolutely tackled all identified challenges notably in the area of the increasing budgetary imbalances. A series of unforeseen factors, the higher than initially projected costs for the Olympic Games, as well as new social measures aimed at supporting low incomes will further increase the pressures on the State budget. Nevertheless, the privatisation plans which are in progress are expected to provide some relief by reducing the high government debt. Several measures have been taken in order to encourage the transition towards a knowledge-based economy but effective competition in the electricity market needs to be strengthened. A more detailed account of recent developments in relation to key policy challenges in Greece is provided in the following sections.

1. Long-term sustainability

Ensure the long-term sustainability of public finances in the face of population ageing, in particular in view of the high government debt ratio,

Under this challenge, Greece was requested to:

1. ensure that the government debt ratio is kept on a sustained declining trend at a satisfactory pace by maintaining high primary surpluses (GL 15);
2. ensure effective control of government current primary spending by addressing resolutely the problem of the inelastic elements of expenditures (GL 14), e.g. the wage bill;
3. use public resources more effectively with the aim of improving labour productivity and enhancing working capacity of the unemployed (GL 14); and
4. continue reforms of the social security system, and in particular the pension system (GL 16), in order to avoid budgetary strains in the future due to the problem of the ageing population.

Slow decline in the government debt ratio

The government debt ratio in Greece is among the highest in the EU. So far progress made in its reduction has been limited in the face of the buoyant nominal GDP growth. In fact, in 2001 and 2002 when the rate of increase of nominal GDP was around 8%, the government consolidated gross debt rose, after the corrections in the treatment of some financial operations requested by Eurostat. In 2002, the government debt was reduced by only 2 percentage points while, according to the Greek authorities, in 2003 and 2004, the debt ratio is expected to decline by 3 percentage point each year. On the other hand, the general government primary surplus particularly in cyclically adjusted terms followed a declining trend over the last four years. As the reduction in the primary surplus is expected to continue further in 2004, the effort in reducing the government debt seems to be resting mostly on the success of the announced privatisation programme. The expected revenues from privatisation amounted to € 3 billion (or 2% of GDP) in 2003.

Lack of effective control of government primary spending

According to the estimates provided in the draft State budget for 2004, primary current expenditure in 2003 should record an overrun equal to € 475 million (or 0.3% of GDP). Preliminary data on the budgetary implementation suggest that primary spending increased by 6.2% from January to September over the same period in 2002, while the State budget projects an annual increase of 6%. Although this additional primary spending is expected to burden the 2003 budget, a more permanent effect on primary spending should not be excluded. Moreover, as the cost of the new social measures announced by the Greek government will fall mostly on the expenditure side, risks of an increasing trend in primary spending cannot be ruled out. With respect to both the estimated outcome of the 2003 budget and the projections of the 2004 budget, spending on wages in the public sector and on social protection continue to be quite inelastic and constantly overshooting budget projections. However, after the Olympic Games in 2004, the government can save up to 1% of GDP in expenditures which should be used for deficit reduction.

Some progress in productivity and working capacity of the unemployed

Labour productivity was on an increasing trend in the last years reaching almost 85% of the EU average. A series of measures aiming at increasing the incentives to work for specific categories of the working age population, as well as measures for improving the skills of the unemployed, are being implemented with the financial support of government agencies. The government wishes currently to replace unemployment subsidies with employment subsidies. The tax reform may also be considered as a means to promote job creation. Since this is an ongoing process, there is yet no clear evidence as to the effectiveness of these measures. It seems that some progress has been achieved in the front of the long-term unemployment and the unemployment of the youth. However, although the employment participation rate of women has been improving, the differences in the participation rate and the unemployment rate between men and women remain significant.

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

The reforms in the social security and pension systems introduced by the Greek government in 2002 emphasised the introduction of instruments that would add credibility and flexibility to the system. They may, nonetheless, be considered as not having sufficiently taken into account the current trends in public finances and especially the high level of the government debt. As the costs from the ageing population are expected to significantly rise in the future, the sustainability of the Greek public finances will be at high risk if no further measures are taken. However, no additional measures are foreseen for the moment in order to streamline and therefore reduce the future costs of the social security and pension systems.

2. *Business dynamism and labour market*

Increase the low level of productivity, which is associated with problems in the functioning of the labour and product markets, low investment in human capital, and the late development of the knowledge-based society.

Under this challenge, Greece was requested to:

5. step up efforts to increase the availability of skilled human capital, and continue to promote business involvement in R&D and innovation, and to improve ICT diffusion (GL 13 and E-REC 2);
6. enhance particularly competition in the energy sectors (GL 9);
7. continue to simplify the business and taxation environment and raise the transposition rate of internal market directives (GL 9 and 11).

Several initiatives have been launched to encourage the transition towards a knowledge based society

Several initiatives have been launched in 2003 to improve the availability of skilled human capital and to promote R&D and innovation and ICT diffusion. First, measures towards the development of information technology in schooling and professional training have been taken to upgrade human capital. Second, the links between universities and enterprises through initiatives supporting the establishment of spin-off-firms have been strengthened. Third, a programme which promotes technology cooperation among companies has been initiated. Fourth, a wide-range educational reform programme with various measures specifically targeted at tailoring education and training to the labour market needs has been implemented.

Despite steps in the right direction, effective competition in the electricity market still needs to be strengthened

On July 2003, the Greek Parliament amended the law transposing the EU directive on the liberalization of the electricity market. The amendments introduce a wholesale market and remove some administrative barriers to entry aiming at a more competitive market. Nevertheless as the incumbent is vertically integrated and its share of the generation market is 98%, entry of new firms is very difficult. The Commission has opened an infringement procedure relating to the unbundling of the incumbent company PPC.

Efforts have been made to simplify the business environment

Measures to reduce bureaucratic and legal obstacles to set up a new company have been implemented. As far as taxation is concerned, the Ministry of Finance has recently published one bill intended to further simplify the tax system and particularly the tax audit procedures. For example new practice for calculating taxable profits for businesses with inaccurate or inadequate accounting books should be implemented. Finally while Greece's transposition rate of internal market directives has increased from 96.7 to 96.9, it is still behind both the EU average and the target of 98.5% of Internal Market directives.

3. Labour market

Reduce the high rate of structural unemployment, and increase employment rates, particularly for women.

Under this challenge, Greece was requested to:

8. improve work incentives, particularly by reducing non-wage costs and improving transferability of pensions rights, in order to encourage increased employment in the formal sector, including parttime work (GL 4 and 16 and E-REC 4);
9. promote changes to the wage bargaining process to ensure that wages reflect productivity differentials (GL 5); and
10. implement the labour reform package to improve the balance between flexibility and security by ensuring effective implementation of reforms aiming to modernise work organisation and by reviewing unduly restrictive labour market regulations (GL 6 and E-REC 1).

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

Despite some improvement and efforts undertaken in the past to promote part-time work, its share has stagnated at low levels. Incentives, in the form of subsidising social security contributions, are being introduced for certain categories of the working force (unemployed, women) and for specific sectors but as yet the reaction of the private sector has not been very encouraging. Furthermore, there seems to be no focus on the reduction of non-wage costs. A new law aims at strengthening the incentives for part-time work, providing the recruitment of 25.000 part-time employees in the public sector in the area of services of social interest. Finally, the government intends to introduce changes to legislation in order to ensure social security rights when moving from one fund to another.

Social dialogue is put forward but wage bargaining is hardly modified

Enhancing the social dialogue has been among the priorities of the government in recent years, with wage bargaining being among the core issues. The private sector is bound by 2-year wage agreements setting the minimum wage on which several sectoral and regional agreements are decided; the benchmark wage in the private sector is linked rather to the announced incomes policy in the public sector and to inflation prospects than to productivity differentials. The last agreement, signed in 2002, managed to promote social peace until end of 2003 while limiting the impact of higher than expected inflation in wage formation. A new agreement should be signed in the first half of 2004 but in view of the forthcoming general elections, it is unlikely that the overall framework of wage bargaining will be substantially modified.

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

The restructuring of the institutional setting in the labour market has not yet enough maturity to tackle both employment and unemployment issues; the regulatory framework has not yet delivered fully satisfactory results. Under a new law "on the social dialogue for the promotion of employment and social protection" a National Employment Committee and a National Social Protection Committee was created and the role of the Temporary Employment Agencies in better matching demand and supply was strengthened. Emphasis is placed on offering personalised services to the unemployed through the creation of a Job Centres network and the restructuring of the Public Employment System. Nonetheless, barriers to entry in the labour market and supply side rigidities still constitute bold characteristics of the situation in the Greek labour market.

Table 4.1: Economic indicators for Greece

	GREECE				EU 15			
	2000	2001	2002	2003	2000	2001	2002	2003
General economic background								
Real GDP[1]	4.4	4.0	3.8	4.1	3.6	1.7	1.1	0.8
Inflation[2]	2.9	3.7	3.9	3.6	1.9	2.2	2.1	2.0
Labour productivity[3]	4.2	4.4	3.7	3.0	1.6	0.5	0.8	0.8
Employment growth[4]	0.3	-0.3	0.1	1.0	2.0	1.2	0.4	0.0
Nominal wage growth[5]	5.8	5.3	8.4	6.5	3.5	3.3	3.1	3.1
Unemployment[6]	11.0	10.4	10.0	9.5	7.8	7.4	7.7	8.1
Employment								
Employment rate[7]	55.7	55.4	56.7	n.a.	63.4	64.1	64.3	n.a.
Female employment rate[8]	41.2	40.9	42.5	n.a.	54.1	55	55.6	n.a.
Employment rate for older workers[9]	38.6	38	39.7	n.a.	37.8	38.8	40.1	n.a.
Long-term unemployment[10]	6.0	5.4	5.1	n.a.	3.5	3.1	3.0	n.a.
Tax rate on low wage earners[11]	34.3	34.3	34.3	n.a.	38.6	37.7	37.8	n.a.
Unemployment trap indicator[12]	n.a.	79.4	80.8	n.a.	n.a.	79.4	79.1	n.a.
Product market reforms								
Relative price levels[13]	80.8	81.6	79.7	n.a.	100	100	100	100
Total trade to GDP ratio (%)[14]	31.5	30.6	26.6	n.a.	59.6	59.0	58.1	n.a.
Single Market Directives[15]	93.5	97.0	96.7	96.9	97.0	98.0	97.9	97.7
Business investment[16]	19.5	19.9	20.1	n.a.	18.3	17.9	17.2	n.a.
Knowledge based economy								
Tertiary graduates[17]	n.a.	n.a.	n.a.	n.a.	38.4	40.0	n.a.	n.a.
Spending on human resources[18]	3.8	3.5	n.a.	n.a.	4.9	n.a.	n.a.	n.a.
R&D expenditure[19]	n.a.	0.64	n.a.	n.a.	1.95	1.98	1.99	n.a.
Expenditures on IT[20]	1.2	1.2	n.a.	n.a.	4.2	4.2	n.a.	n.a.

For footnotes and sources see Table 1.1 for Belgium.

Table 4.2: Public finances in Greece (% of GDP)

	GREECE					EU-15				
	2000	2001	2002	2003	2004	2000	2001	2002	2003	2004
Government balance	-1.9	-1.5	-1.2	-1.7	-2.4	1.0	-0.9	-1.9	-2.7	-2.6
Primary balance	5.9	5.7	4.9	4.3	3.3	4.8	2.7	1.4	0.6	0.5
Cyclically adjusted balance	-1.9	-2.2	-1.5	-2.2	-3.1	-1.2	-1.6	-2.1	-2.2	-2.0
Cyclically adjusted primary balance	5.9	4.9	4.6	3.8	2.5	2.6	2.0	1.3	1.1	1.1
Government debt	106.2	106.9	104.7	100.6	97.1	64.1	62.8	62.5	64.1	64.4

Source: Commission services.

5. SPAIN

Spain's continuing positive and even increasing growth differential over most Member States (almost 2 percentage points in 2003 vis à vis the EU) stems from a relatively buoyant domestic demand, notably private consumption and investment in dwellings, whereas the external sector has been a drag on GDP growth. Behind the resilience of domestic demand are supportive monetary conditions coupled with the prudent fiscal stance and rapid employment growth. Impressive employment creation has largely benefited from ongoing wage moderation and the labour market reforms implemented in recent years, as well as high net immigration. While the differential has progressively been reduced in 2003, inflation has remained significantly above the EU average, raising concerns on the competitiveness of the Spanish economy in the medium term. In this connection, the insufficient competition in certain sectors such as retail distribution is also cause for concern. Despite GDP growth decelerating from 2001, Spain was successful in keeping fiscal consolidation on course by achieving a close-to-balance position for a third year in a row as a result of the reduction of interest payments, current spending control and positive evolution of tax revenues linked to fast employment growth. However, the government has taken no steps to reform the public pension system which is of key importance in order to guarantee the future viability of the system and ensure a gradual implementation avoiding disruptions of expectations. While allowing for a steady reduction in structural unemployment, the labour market remains segmented between permanent and temporary workers and the participation rate, though on the increase, remains among the lowest in the EU. Finally, poor labour productivity growth, also linked to the relatively low educational levels of the population and the slow transition to a knowledge-based economy, raises concerns about the long-term performance of the economy.

Key challenges in the light of recent developments

Reflecting the approaching of the general elections in March 2004, most important policy measures implemented in 2003 had been previously approved in 2002. Budgetary consolidation has remained on track. However, to face the budgetary impact of an ageing population, the current policy of public debt reduction and raising participation and employment rates, should be complemented by parametric reforms in the pension system where pending the result of political negotiation, no significant measures have been taken to reform the public pension system, which is key for coping with the budgetary consequences of ageing population. Conversely, in line with the Lisbon agenda, the new income tax and the reform of social benefits and employment protection legislation approved in 2002 entered in force in 2003. Additionally, measures specifically targeted at increasing female employability and facilitating geographical mobility were approved in April 2003. Further measures affecting the current wage bargaining system or the labour market segmentation remain to be taken. Actions have been engaged to further liberalise the electricity market, to strengthen the knowledge-based economy and to further improve the business environment, but little progress was made in the field of the development of effective competition in retail distribution. The following sections present a more detailed assessment of recent developments in addressing Spain's key policy challenges.

1. Labour market

Raise the low employment rates, especially among women, and reduce wide regional labour market disparities,

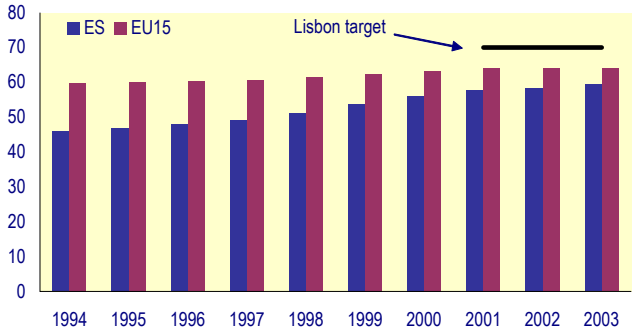
Under this challenge, Spain was requested to:

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

Employment rate differentials stem from significantly lower female participation

Both the employment rate and labour participation are on an upward trend in Spain, but remain significantly below the EU average and the Lisbon target of 70%. The unemployment rate, although on a downward trend, remains, at 11.3%, the highest in the EU.

Graph 5.1: Employment rates (Total)

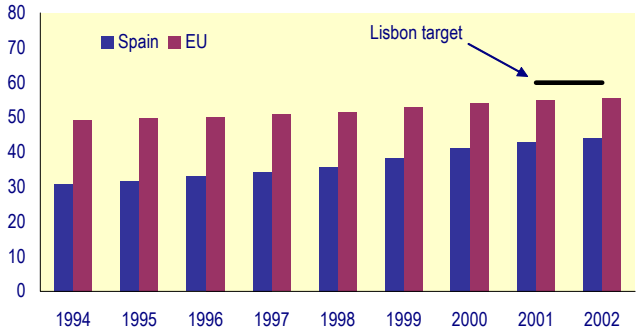


Source : Commission services.

Whilst male employment rates are at around the EU average, female employment and participation rates, though rapidly increasing, remain well below the European standards. In order to boost convergence of female employment rates some measures have been identified.

Firstly, increased female employability through tax incentives. The 2003 personal income tax reform has introduced a tax credit for women working with children under the age of 3. Furthermore, in April 2003 a set of new reductions of social contributions have been introduced for women joining the labour market within the 24 months after having given birth as well as for women with disabilities.

Graph 5.2: Employment rates (Female)



Source : Commission services.

Secondly, a higher provision of child-care facilities is likely to encourage women attachment to the labour market, thus complementing the above mentioned initiatives. Despite recent efforts, the share in GDP of total expenditure on social protection benefits to family and children is well below the EU average. From 2003 onwards, in addition to standard tax deductions for parents established by both central and regional governments, companies can

benefit from a 10% tax credit for creating new places in firms' nurseries. While in line with the specific recommendations in the BEPGs, these recent initiatives probably need to be complemented by further steps, mainly on child-care facilities.

Finally, the current limited use of part-time contracts in Spain contrasts sharply with that observed in other EU-countries: part-time employment in the EU is twice as high as in Spain. On the one hand, this type of contract is less attractive for workers in that the distribution of the working time is not clearly stipulated. In this respect, a new regulation might be desirable. On the other hand, the diffusion of the part-time contracts is hampered by the disproportionate use of fixed-term contracts.

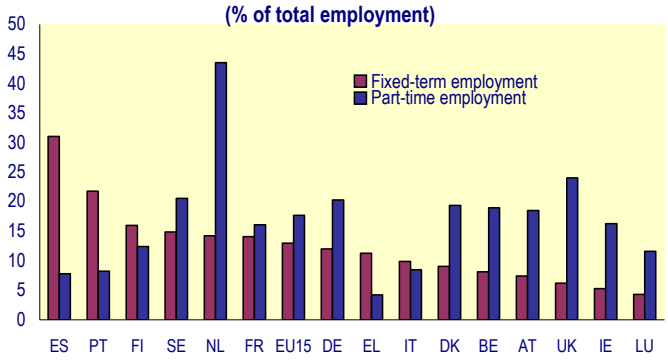
Wage bargaining system remains unchanged along with the use of indexation clauses

Most of the collective agreements are at a sectoral and provincial level. Given the fact that around 75% of Spanish firms have 10 workers or less, and thus do not have union elections, a fully decentralised system would be difficult to implement. Rather, it would seem desirable to increase coordination among the different levels of bargaining by more clearly delimiting the areas to be covered at each level. This should give room to better reflect local labour market conditions as well as specific circumstances at the firm level. So far no steps in this direction have been taken. In addition, indexation clauses allowing for recovery of the excess of actual inflation over the official forecast are still in force, although their use is not currently creating significant inflationary distortions. In particular, indexation clauses in collective agreements allow for lower wage claims than in sectors where they are not present. Their phasing-out would still appear desirable possibly in connection with the use of realistic inflation forecast in settling wage claims.

Labour market segmentation remains acute

No new significant labour regulatory measures have been adopted. In spite of the successful introduction in 1997 of a new permanent contract with lower dismissal costs and a number of fiscal incentives, the share of fixed-term contracts over total employment remains, at around 30%, far above the EU level (14%). Despite the introduction of some mechanism of control, fixed-term contracts are often used beyond their legal purpose of covering temporary needs of firms. While allowing for a quick allocation of labour in the face of changing economic conditions, excessive use of fixed-term contracts may deter investment in human capital and even reduce fertility rates while possibly hampering other elements of flexibility such as labour mobility. Further steps in the direction of the 1997 reform of permanent contracts, coupled with a closer monitoring of the use of fixed-term contracts, appear advisable.

Graph 5.3: Fixed-term and part-time employment in 2002
(% of total employment)



Source : Commission services.

Geographical mobility is deterred by rigidities in the housing market

The 2003 reform of the personal income tax introduced a higher tax relief for unemployed workers who accepted job implying change of residence. In addition, further fiscal incentives were set up for house owners putting their houses on the rental market along with fiscal advantages for firms operating in the rental sector. Although these are welcome, their effect

might be rather limited since the main factors preventing mobility is the narrow supply of rental housing. In this respect, while the authorities have taken measures to enhance the legal security of the rental market, no major initiative has been adopted in order to increase the availability of land for development.

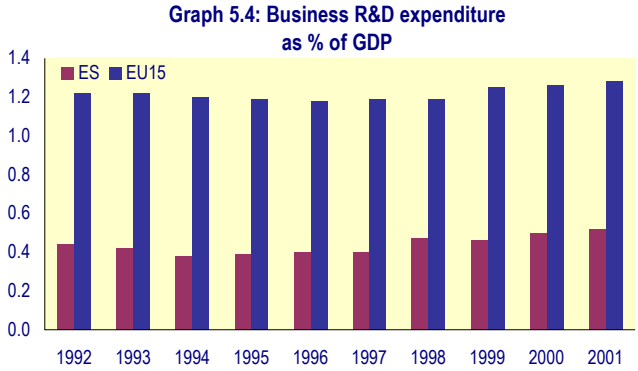
2. Productivity and business dynamism

Increase the low level of productivity, including by strengthening the knowledge-based economy in terms of educational attainment and skill levels, investment in IT, R&D and innovation performance,

Under this challenge, Spain was requested to:

5. step up efforts to increase skilled human capital, investments in R&D and innovation, and ICT diffusion (GL 13);
6. continue to take measures to further enforce effective competition in certain sectors, such as retail distribution (GL 9), pursue ongoing efforts to reduce the administrative burden on business and monitor closely the developments on the electricity market (GL 11).

Several initiatives have been launched to strengthen the knowledge-based economy



Graph 5.4: Business R&D expenditure as % of GDP

Source : Commission services.

The educational attainment of the population, as measured by the number of 18-24 years old with only lower education, is relatively low and spending in education as a percentage of GDP remains among the lowest in the EU. The development of the knowledge-based society still lags behind the EU average in terms of business R&D, patents and take-up of ICT. Several measures have been taken in 2003 with the view of promoting the development of human capital and life-long learning, such as several legislative measures to further adequate the educational system and the curriculum to labour market needs, the reform of continuous training which aims at making it available to all workers, especially SMEs and the promotion of vocational training. In addition, the plan "España.es 2004-2005" enacted in July 2003 contains a package of measures for the promotion and the development of the information society. It foresees the development of the e-government and a more intensive use of ICT in the education system. This plan is complemented by horizontal measures such as the promotion of internet access for all citizens and SMEs. Finally, a number of measures have been implemented to stimulate business R&D+i expenditure, and the new 2004-2007 R&D+i National Plan aims for expenditure on R&D to reach 1.4% of GDP in 2007, while business innovation will be promoted through tax rebates.

The business environment has improved and some progress has been made in terms of liberalisation of the electricity market, but effective competition in retail distribution remains insufficient.

In April 2003, the New Limited Company Act was adopted. It creates a new simplified legal framework for SMEs and cut the paperwork and procedures required to set up a small company. The necessary administrative formalities for registering a new company could be completed within 48 hours, mainly through the introduction of the Single Electronic Document (DUE), and a series of tax incentives aimed at encouraging new business creations have been implemented,

such as the postponement of the taxes to be paid on company establishment, on corporate profit and on personal income. In addition, Spain has extended the advantages of the law on inheritance and gift taxes in order to facilitate business transmission Moreover, 11 new "one-stop-shops" providing business support services have been established in the period July 2002-July 2003 and the setting up of 80 new "one-stop-shops" is planned over the two coming years.

As of January 2003, domestic customers are free to choose their electricity supplier, which should contribute to increase effective competition. However, the Spanish government has mandated that all utilities must charge the same price per Kwh to consumers which have not opted for a free provider, and that for these consumers prices can only rise by a maximum of 2% a year between 2003-2010. In addition, legal framework to put into place a forward market for electricity has been adopted in November. The completion of the integration of the Spanish and Portuguese electricity markets has been postponed to 2004, instead of 2003 as initially planned. Finally, the competitive situation in retail distribution remains unsatisfactory since market entry is still inhibited by the multiplicity of requirements to grant opening licences. It may be partly as a consequence of the low level of competitive pressures that prices in this sector, and particularly in food distribution, have substantially increased in 2003.

3. Long-term sustainability of public finances

Ensure the long-run sustainability of public finances in the face of population ageing.

Under this challenge, Spain was requested to:

7. complement recent initiatives by taking the appropriate steps to implement a major reform of the pension system, so as to strengthen the link between contributions and benefits and control the long-term increases in pension expenditure linked to the foreseen demographic changes (GL 16).

No new major measures regarding reforms in the public pension system

Major concerns for the sustainability of the Spanish public finances stem from the ageing population and its likely budgetary impact in the long-term. Despite a more favourable scenario than previously estimated in the light of recent net immigration flows, the older people dependency ratio should increase sharply between 2020 and 2030. Therefore, a large increase in the GDP share of age-related expenditure can be expected. Thus, the current policy of public debt reduction, including the pension reserve fund created in 2000 (1.6% of GDP in 2003) and raising participation and employment rates, comprising recent measures to encourage workers to postpone retirement, must be supplemented by a reform of the public pension system coupled with a strategy to promote the second and third pillars. Regarding the latter, some partial measures have been recently introduced, in particular, the setting up of a Pension Fund by the general government to complement public servants' pensions.

As to the reform of the public pension system, it is envisaged that it should affect the key parameters, such as the number of contributory years, the retirement age and the replacement ratio. Recently, the Parliament endorsed a new version of a politically broad-based agreement ("Pacto de Toledo", agreed first in 1995), which aims at ensuring the viability of the public pension system. The recommendations in the agreement, to be discussed in the coming months, are consistent with the 2003-05 BEPGs, in that they aim at prolonging working life and raising employment rates (especially that of women) while advocating strengthening the relationship between the contributory effort and benefits. The latter would in fact involve the implementation of a parametric reform of the system. However, no agenda has been provided so far and one is unlikely to be released before the general elections in March 2004.

Table 5.1: Economic indicators for Spain

	SPAIN				EU 15			
	2000	2001	2002	2003	2000	2001	2002	2003
General economic background								
Real GDP[1]	4.2	2.8	2.0	2.3	3.6	1.7	1.1	0.8
Inflation[2]	3.5	2.8	3.6	3.1	1.9	2.2	2.1	2.0
Labour productivity[3]	0.6	0.4	0.5	0.6	1.6	0.5	0.8	0.8
Employment growth[4]	3.6	2.4	1.5	1.7	2.0	1.2	0.4	0.0
Nominal wage growth[5]	3.7	3.8	3.9	4.1	3.5	3.3	3.1	3.1
Unemployment[6]	11.3	10.6	11.3	11.3	7.8	7.4	7.7	8.1
Employment								
Employment rate[7]	56.2	57.7	58.4	n.a.	63.4	64.1	64.3	n.a.
Female employment rate[8]	41.2	43.0	44.1	n.a.	54.1	55.0	55.6	n.a.
Employment rate for older workers[9]	37.0	39.2	39.7	n.a.	37.8	38.8	40.1	n.a.
Long-term unemployment[10]	4.7	3.9	3.9	n.a.	3.5	3.1	3.0	n.a.
Tax rate on low wage earners[11]	32.8	33.4	33.9	n.a.	38.6	37.7	37.8	n.a.
Unemployment trap indicator[12]	n.a.	81.3	81.7	n.a.	n.a.	79.4	79.1	n.a.
Product market reforms								
Relative price levels[13]	81.8	82.1	82.4	n.a.	100	100	100	100
Total trade to GDP ratio (%)[14]	31.4	30.8	29.3	n.a.	30.2	29.9	29.1	n.a.
Single Market Directives[15]	98.4	98.7	98.4	99.1	97.0	98.0	97.9	97.7
Business investment[16]	22.2	22.2	21.8	n.a.	18.3	17.9	17.2	n.a.
Knowledge based economy								
Tertiary graduates[17]	39.6	42.1	n.a.	n.a.	38.4	40.0	n.a.	n.a.
Spending on human resources[18]	4.4	4.4	n.a.	n.a.	4.9	n.a.	n.a.	n.a.
R&D expenditure[19]	0.94	0.96	n.a.	n.a.	1.95	1.98	1.99	n.a.
Expenditures on IT[20]	2.0	1.9	n.a.	n.a.	4.2	4.2	n.a.	n.a.

For footnotes and sources see Table 1.1 for Belgium.

Table 5.2: Public finances in Spain (% of GDP)

	SPAIN					EU-15				
	2000	2001	2002	2003	2004	2000	2001	2002	2003	2004
Government balance	-0.8	-0.3	0.1	0.0	0.1	1.0	-0.9	-1.9	-2.7	-2.6
Primary balance	2.5	2.8	2.8	2.6	2.5	4.8	2.7	1.4	0.6	0.5
Cyclically adjusted balance	-1.6	-0.9	-0.2	0.1	0.3	-1.2	-1.6	-2.1	-2.2	-2.0
Cyclically adjusted primary balance	1.7	2.2	2.6	2.6	2.7	2.6	2.0	1.3	1.1	1.1
Government debt	60.5	56.8	53.8	51.3	48.8	64.1	62.8	62.5	64.1	64.4

Source: Commission services.

6. FRANCE

The French economy has decelerated markedly in 2003 and real GDP growth is estimated to have been only 0.1%. The economy was strongly affected by the deceleration in global demand and the appreciation of the exchange rate of the euro. On the domestic side, private consumption remained relatively resilient but companies low profit margins and cash problems continued weighing on firms' investment. In the context of a cyclical slowdown, the absence of budgetary adjustment in 2003, following the large deterioration occurred in 2002, led to a general government deficit of more than 4% of GDP in 2003. While not respecting the nominal objectives in the area of government finances, the French authorities have taken relevant measures and implemented structural reforms. A major progress made is the implementation of a comprehensive reform of the pension system. The reform represents a major improvement of long-run fiscal sustainability, but does not address all the foreseeable financing challenges. Although reducing significantly the financial requirement of the system in the medium term, the reform is not yet sufficient to secure the long term sustainability of public finances. In order to foster the potential growth of the economy, further reforms will be necessary to address the structural problems of the labour market: despite recent progress, labour market participation is still relatively low and the structural unemployment rate remains at a relatively high level. Moreover, even if productivity per employee is relatively high, it has grown at a slower pace than the EU average over the recent years, probably as a result of the 35 hours work week. But hourly productivity has increased at a stronger pace in the period 1999-2002. In the same vein, reforms aimed at improving the functioning of the product market should be accelerated, even if the decrease of the relative price level below the EU average provides evidence of an increase in competitive pressure. Indeed, the liberalisation in the energy sector is implemented slowly and, despite recent progress, administrative burdens are still perceived as a major constraint by businesses.

Key challenges in the light of recent developments

Although the nominal objectives in the field of public finances were missed, clear progress was made to improve the long-term sustainability of public finances in the face of population ageing, through the implementation of a comprehensive reform of the pension system. As far as the two other challenges are concerned, any assessment remains at the current juncture very preliminary. Measures already taken and declared intentions go in the right direction, but it is still uncertain whether the reforms envisaged will allow compliance with the recommendations. A more detailed assessment of recent developments in addressing France's key policy challenges is presented in the following sections.

1. Public finances

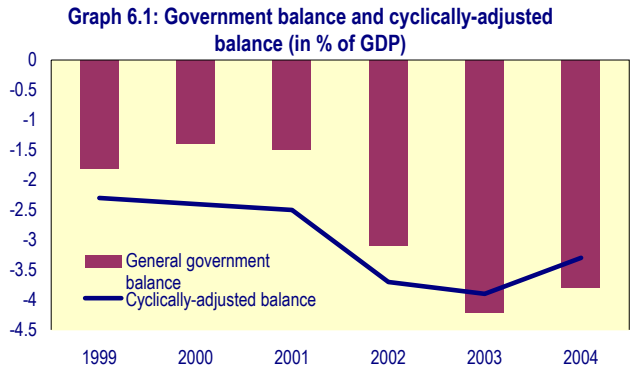
Reduce rapidly the general government deficit to below 3% of GDP and keep government finances on a steady consolidation path

Under this challenge, France was requested to:

1. achieve a significantly larger improvement in the cyclically-adjusted deficit in 2003 than that currently planned.
2. implement measures ensuring that the cyclically-adjusted deficit is reduced in 2004 by 0.5% of GDP, or by a larger amount, so as to ensure that the cumulative improvement in 2003-2004 is enough to bring the nominal deficit below 3% in 2004 at the latest.
3. limit the increase in the general government gross debt to GDP ratio in 2003.

France did not respect the recommendations issued in June by the Council

In the area of government finances, the country-specific recommendations addressed to France in June were very similar to those formulated three weeks earlier by the Council in the context of the excessive deficit procedure. Following the adoption of the 2003-05 BEPGs, the French authorities have taken a number of measures. However, these measures proved to be insufficient to respect the recommendations of the Council. According to the French authorities, the general government deficit will be reduced from 4.0% in 2003 to 3.55% of GDP in 2004; the Autumn 2003 Commission forecasts project a decline in the general government deficit from 4.2% of GDP in 2003 to 3.8% of GDP in 2004, under the assumption of real GDP-growth at 0.1% in 2003 and 1.7% in 2004. According to Commission calculations, no visible improvement in the cyclically-adjusted balance was achieved in 2003, both in absolute terms and compared to what was expected in June 2003. Moreover, even if the budgetary plans for 2004 include an improvement in the cyclically-adjusted balance larger than the minimum of 0.5 percentage point of GDP recommended by the Council in June, the cumulative improvement in the cyclically-adjusted balance in the years 2003 and 2004 will be insufficient to bring the nominal deficit below 3% of GDP in 2004. Finally, the French authorities did not take measures to limit the increase in the general government debt in 2003 as recommended by the Council in June. In view of these findings, it can be concluded that France did not respect the recommendations formulated.



While finding an agreement outside the Treaty, the Council decided to formulate new recommendations to France

On 8 October 2003, the Commission adopted a Recommendation to the Council to decide in accordance with Article 104.8 that no effective action has been taken by France in response to the Recommendation addressed under Article 104.7. The Commission also adopted on 21 October 2003 a Recommendation for a Council Decision giving notice to France, in accordance with Article 104.9 of the EC Treaty, to take measures for the deficit reduction judged necessary in order to remedy the situation of excessive deficit. In light of the severe economic slowdown, the Commission recommended the Council to allow France an additional year (i.e. until 2005) to bring the government deficit below 3% of GDP. The Commission also recommended the Council to request France to achieve a reduction in the cyclically-adjusted deficit by 1% of GDP in 2004. On 25 November 2003, the Council rejected the two Commission Recommendations finding an agreement outside the Treaty, de facto suspending its application. The Council recommended, in light of the commitments made by France, that France achieves a reduction in the cyclically-adjusted deficit by 0.8% of GDP in 2004 and by 0.6% or by a larger amount so as to ensure that the general government deficit is brought below 3% of GDP in 2005. This is less than the consolidation effort recommended by the Commission. In addition, should the recovery in economic activity be stronger than currently expected, the Council recommended France to allocate any higher-than-expected revenue to deficit reduction and to accelerate the reduction in the cyclically-adjusted deficit.

Ensure the long-term sustainability of public finances in the face of population ageing.

Under this challenge, France was requested to:

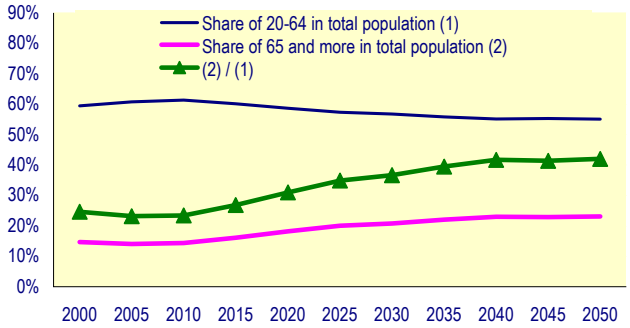
4. undertake with urgency a comprehensive reform of the pension system (GL 16), with the aim of ensuring its financial sustainability and increasing the effective retirement age, while adapting pension systems to more flexible employment and career patterns as well as to individual needs.

5. monitor closely the efficiency of the measures undertaken to curb the dynamics of spending in the health sector so as to reduce it to a sustainable level, and, if necessary, introduce new measures to achieve this objective in the context of the reforms envisaged.

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

The French Parliament adopted in the Summer 2003 a comprehensive reform of the pension system. The reform foresees an increase in the number of contribution years entitling to a full pension in two steps: until 2008, this number will increase only in the public sector from 37.5 years to the level of 40 years currently prevailing in the private sector; in a second step starting in 2008, the contribution period is foreseen to increase for all workers to the level of 41 years in 2012 and proportionally with life expectancy, through a rule meant to keep constant the ratio between the number of contribution years and the number of years in pension[3]. The reform also raises significantly the financial incentives to remain active until and after the legal retirement age, and changes the reference for the indexation of pensions in the public sector from wages to prices.

Graph 6.2: Demographic projections by age cohort



Source : Commission services.

According to the French authorities, this reform, which has been completed in 6 months, will on its own cover around 40% of the financial needs of the pension system in 2020 and will increase potential growth. *In the private sector,* to finance the remaining part, pension scheme contributions will be modestly increased by 0.2% on January 1st 2006. Thereafter, the financial equilibrium should be ensured, by 2020 through a reallocation of unemployment contributions to pension scheme contributions, as the unemployment rate will decrease. *In the public sector*, the remaining financial needs, representing 0.7 percentage point of GDP, will be funded by an increase in government expenditures. Although the reform undeniably constitutes a large improvement compared to the initial situation, it is not sufficient on its own to secure the sustainability of public finances in the long run. Indeed, ageing population will continue impacting on the financial situation of the pension system after 2020, and until 2050. In addition, the impact of ageing population on public finances will also materialise through a large increase in health expenditures in the coming decades. This is becoming a source of serious concern for the French government.

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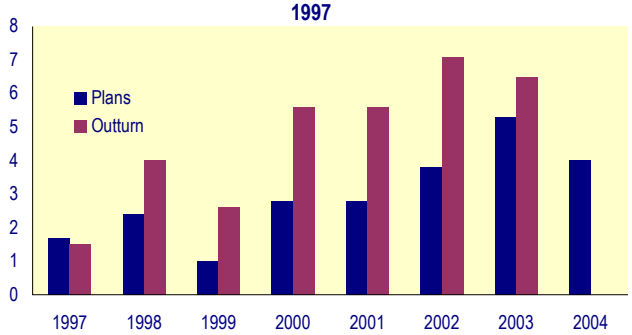
[3] The application of this rule will however not be fully automatic, any increase in the number of contribution years being conditional upon the agreement of an independent Commission.

The measures included in the budget for 2004 will only ensure a temporary deceleration in health expenditures

The deficit of the social security sector has increased continuously in the last few years, largely due to the rapid increase in health expenditures observed since 1998. Beyond its short term implications on the government deficit, the dynamism of health expenditures is a matter of concern for the long term sustainability of public finances. Particularly worrying is the systematic failure of the several attempts undertaken by the authorities to rein in expenditures in this sector. Indeed, on average since 1998, official targets for the yearly increase in health expenditures were overrun by roughly 2 percentage points.

Graph 6.3: Health expenditures: plans and outturn since 1997



Source : Official reports by the French authorities.

For 2004, the French authorities project a decrease in the deficit of the social security sector from 0.6 to 0.5% of GDP. Expenditure growth in the health sector is projected to decelerate to 4.0% in 2004, after 6.4% in 2003. Some measures were introduced to secure the deceleration, but, especially in the light of the past experience, their overall impact remains uncertain. Moreover, the measures taken so far will not - and are not intended to - ensure a lasting deceleration of health expenditures. This issue should be addressed in a comprehensive reform of the health insurance system that the government committed to implement in 2004. The aim of the reform will be to curb growth in health expenditures to a sustainable level, and to eliminate the deficit of the social security sector by 2007.

2. Labour market

Increase labour market participation and reduce structural unemployment.

Under this challenge, France was requested to:

6. ensure that the new unemployment insurance system is fully implemented, including appropriate requirements and effective incentives to search for a job.

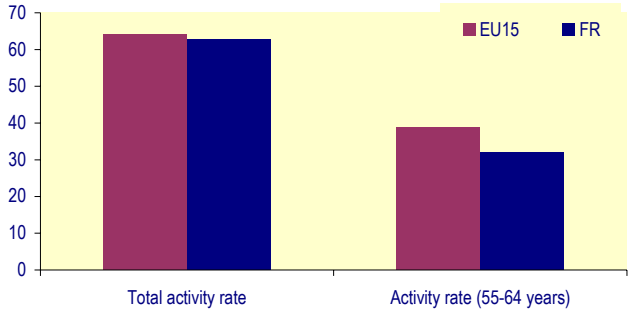
Despite recent progress, labour market participation remains relatively low

Labour market participation has continually increased in France in the last 5 years. Despite this progress, the utilisation of human resources is lower than the European average. In 2003, a number of decisions were taken in order to increase labour market participation through reductions in high marginal tax rates (income tax cuts, re-evaluation of the income tax credit). Specific measures were also taken to encourage labour market participation of older workers. This is particularly urgent because in the next few years large cohorts will move from high participation rate categories to low participation rate ones[4]; such an evolution, if not compensated

[4] For instance, between 2000 and 2010, the share of people aged between 55 and 59 years in the total population will increase from 4.5% to almost 7%. The average participation rate for this age group is one third lower than for people aged between 50 and 54.

by efficient structural measures, will weigh on the potential output growth of the economy. Some progresses were made in recent years, in particular through a significant decline in the flow of new entrants in existing early retirement schemes. The reduction in the duration of unemployment benefits for older workers decided in early 2003, and the implementation of the reform of the pension system, which increases significantly financial incentives to remain in work until and after the legal retirement age, should also produce positive effects in the next few years. Most of these measures go in the right direction, but it is too early to assess their efficiency.

Graph 6.4: Participation rate to the labour market by age cohort



Source : Commission services.

Bolder labour market reforms will be necessary to achieve a significant reduction in the NAIRU

According to Commission estimates, the NAIRU has declined continuously in the last 5 years, to reach about 10% of the labour force in 2003. This indicator remains however well above the level projected for 2010 in the macroeconomic scenario underlying the reform of the pension system. While efforts should be strengthened to accelerate the decline in structural unemployment, it is a source of concern that the declining trend followed by labour cost of low paid workers for several years will probably come to an end in the next few years. Further cuts in social contributions will indeed continue to be implemented, as was the case in 2003, but these new cuts are designed to compensate for the labour cost impact of the increase in the minimum wage stemming from the phasing out of the multiple minimum wage system inherited from the implementation of the 35-hour working week. In order to achieve the large decline in the NAIRU projected by the French government, bolder labour market reforms will have to be implemented. As recommended in June, the authorities have in particular to ensure that the new unemployment insurance system is fully implemented, including appropriate requirements and effective incentives for job search. Moreover, the authorities should continue reducing the regulatory and administrative burden, particularly the effective degree of employment protection which is higher than in most EU countries.

3. Productivity and business dynamism

Ensure competition in the network industries and accelerate the adoption of internal-market measures, in order to create a level playing field.

Under this challenge, France was requested to:

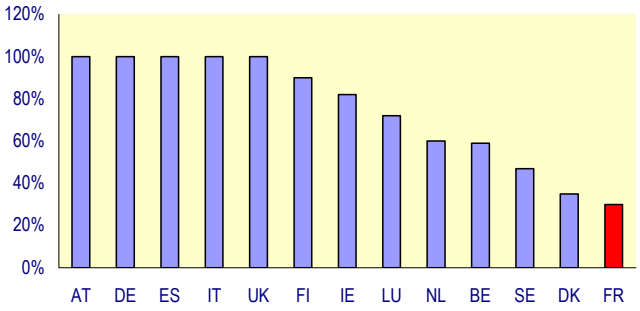
7. pursue efforts to ensure competition in energy markets, namely in gas and electricity sectors (GL 9);
8. sustain the efforts to reduce and simplify business regulations (GL 11); and
9. raise the transposition rate of internal market directives and bring down the number of infringement proceedings (GL 9).

Slow opening to competition in the energy sector.

With a delay of two years, the gas directive has finally been transposed. As to electricity, the eligibility threshold has been reduced to 7 GWh allowing more eligible customers to choose their energy supplier. Both markets now fulfil the legal openness requirements of the EU directives. However, incumbents still retain a strong dominant position. Besides, the declared percentage

market opening in gas and electricity remain, with values of respectively 30% and 37%, amongst the lowest of the EU. Moreover, in electricity the total network access cost is still high in comparison to the other Member States. Nevertheless, respectively 25% and 21% of electricity and gas customers have switched suppliers, whereas the electricity prices are low, and the gas prices on the European average. Finally, the unbundling of distribution activities in both sectors is still unachieved, but should be completed when the markets are fully opened (at the latest in 2007).

Graph 6.5: Declared market opening in the gas sector (2003)

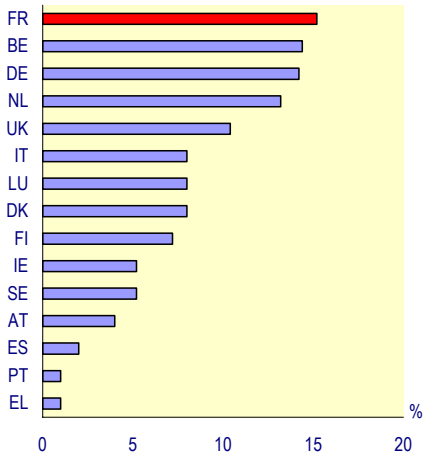


Source : Commission services.

Measures have been taken to reduce and simplify business regulations.

According to a 2003 survey conducted by the European Network for SME Research, the complexity of administrative rules was identified by 15% of the French SMEs as a major business constraint. However, an OECD study shows that France has made major progress between 1996 and 2002 in the reduction of administrative burdens faced by enterprises. Entrepreneurial activity, as measured by the percentage of 18-64 years old involved in entrepreneurship activity, was still one of the lowest in Europe in 2002. To improve this situation, an economic initiative law has been adopted by the French Parliament in July 2003. The law seeks to increase the birth and survival rates of enterprises and promotes entrepreneurship. It includes measures to reduce administrative burdens, to lower the time and cost necessary to start a new business and improve the access to capital. For instance, the minimal capital requirement to start a new business is freely chosen by the entrepreneur (it can even be fixed to one symbolic Euro) and one stop internet offices make it easier to register a new business. The law also includes the creation of local investment funds. Supposedly as a consequence of the 2003 reforms announcements, the number of created firms has increased during the first semester of 2003, but the survival rate of these newly borne firms still has to be assessed.

Graph 6.6: Percentage of SMEs identifying administrative burden as a major business constraint (2003)

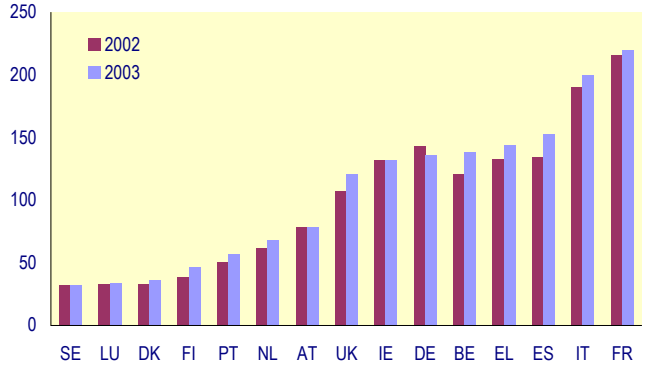


Source : Commission services.

Although the transposition rate of internal market directives increased, no progress made in bringing down the number of infringement proceedings

The transposition rate of internal market directives has increased from 96.2% in 2002 to 96.5% in November 2003. This is still one of the poorest records amongst EU Member States. However the trend is positive whereas, at the same time, the transposition rate has stagnated at EU level. Concerning infringements, France performance is still the worst amongst the EU Member States and the situation is deteriorating. The number of infringements cases open has slightly climbed again in 2003 to reach 220.

Graph 6.7: Number of infringements cases open



Source : Commission services.

Table 6.1: Economic indicators for France

	FRANCE				EU 15			
	2000	2001	2002	2003	2000	2001	2002	2003
General economic background								
Real GDP[1]	3.8	2.1	1.2	0.1	3.6	1.7	1.1	0.8
Inflation[2]	1.8	1.8	1.9	2.1	1.9	2.2	2.1	2.0
Labour productivity[3]	1.1	0.3	0.5	0.3	1.6	0.5	0.8	0.8
Employment growth[4]	2.7	1.8	0.7	-0.2	2.0	1.2	0.4	0.0
Nominal wage growth[5]	2.3	2.6	2.8	2.7	3.5	3.3	3.1	3.1
Unemployment[6]	9.3	8.5	8.8	9.4	7.8	7.4	7.7	8.1
Employment								
Employment rate[7]	62.1	62.8	63.0	n.a.	63.4	64.1	64.3	n.a.
Female employment rate[8]	55.2	56.0	56.7	n.a.	54.1	55	55.6	n.a.
Employment rate for older workers[9]	29.9	31.9	34.8	n.a.	37.8	38.8	40.1	n.a.
Long-term unemployment[10]	3.6	3.0	2.8	n.a.	3.5	3.1	3.0	n.a.
Tax rate on low wage earners[11]	39.6	38.4	37.8	n.a.	38.6	37.7	37.8	n.a.
Unemployment trap indicator[12]	n.a.	86.8	84.0	n.a.	n.a.	79.4	79.1	n.a.
Product market reforms								
Relative price levels[13]	102.9	101.8	99.7	n.a.	100	100	100	100
Total trade to GDP ratio (%)[14]	28.3	27.4	26.3	n.a.	30.2	29.9	29.1	n.a.
Single Market Directives[15]	95.5	97.0	96.2	96.5	97.0	98.0	97.9	97.7
Business investment[16]	17.0	17.0	16.4	n.a.	18.3	17.9	17.2	n.a.
Knowledge based economy								
Tertiary graduates[17]	64.5	n.a.	n.a.	n.a.	38.4	40.0	n.a.	n.a.
Spending on human resources[18]	5.8	5.8	n.a.	n.a.	4.9	n.a.	n.a.	n.a.
R&D expenditure[19]	2.18	2.23	2.20	n.a.	1.95	1.98	1.99	n.a.
Expenditures on IT[20]	4.7	4.8	n.a.	n.a.	4.2	4.2	n.a.	n.a.

For footnotes and sources see Table 1.1 for Belgium..

Table 6.2: Public finances in France (% of GDP)

	FRANCE					EU-15				
	2000	2001	2002	2003	2004	2000	2001	2002	2003	2004
Government balance	-1.4	-1.5	-3.1	-4.2	-3.8	1.0	-0.9	-1.9	-2.7	-2.6
Primary balance	1.8	1.7	0.1	-0.9	-0.6	4.8	2.7	1.4	0.6	0.5
Cyclically adjusted balance	-2.4	-2.5	-3.7	-3.9	-3.3	-1.2	-1.6	-2.1	-2.2	-2.0
Cyclically adjusted primary balance	0.8	0.7	-0.5	-0.7	-0.2	2.6	2.0	1.3	1.1	1.1
Government debt	57.2	56.8	59.0	62.6	64.3	64.1	62.8	62.5	64.1	64.4

Source : Commission services.

7. IRELAND

The Irish economy is undergoing a significant adjustment from double-digit growth in the second half of the previous decade to a lower pace of sustainable growth in the medium term of up to 5%. On account of its high degree of openness to trade and investment flows, Ireland's capacity to respond flexibly to economic shocks is fairly well-developed and the fact that a low unemployment rate has been preserved so far constitutes further evidence of its inherent flexibility. Additional measures to promote stable macroeconomic conditions, strengthen the supply-side and increase the degree of competition should facilitate a successful completion of Ireland's gradual transition towards its new pace of sustainable growth.

Key challenge in the light of recent developments

In the recent past, Ireland's economic policy agenda has built on and extended previous measures. Further, the government's response to the recommendations in several independent reviews published through 2003, in particular regarding the health care system and the National Development Plan for investment, is starting to take shape. The following sections present a more detailed assessment of recent developments in addressing Ireland's key policy challenge.

1. Macroeconomic conditions and supply-side measures

Achieve a smooth transition from double-digit economic growth in the late 1990s to lower, sustainable growth in the years ahead by ensuring stable macroeconomic conditions and by strengthening the supply-side of the economy.

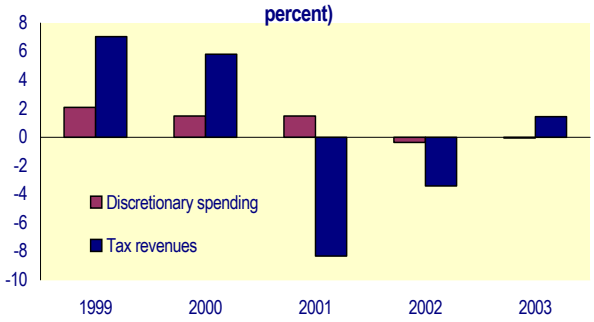
Under this challenge, Ireland was requested to:

1. enhance the efficiency of public expenditure and improve revenue and expenditure planning in a stability-oriented medium-term framework building on the range of measures recently introduced to improve the planning, management and control of expenditure (GL 14);
2. encourage the social partners to adhere to a prudent and flexible wage norm to allow for adaptation to productivity and skill differentials and at the same time safeguard competitiveness (GL 3 and 5);
3. prioritise the roll-out of the infrastructural elements of the National Development Plan, while preserving budgetary stability, and pursue policy measures to raise the level of R&D (GL 13); and
4. increase competition in the network industries and in certain sectors of the economy, such as retail distribution (including the liquor trade), insurance and the professions (GL 9).

Some further measures to strengthen the budgetary framework are taken

In view of the deviations from revenue and expenditure targets in recent years, tax forecasting procedures are being kept under review by the Department of Finance and the Revenue Commissioners. Two areas receiving particular attention are the full incorporation of structural changes in the tax system and the availability of more timely data. Work of this nature is expected to be ongoing for several years, potentially leading to modifications in forecasting procedures from 2004 onwards. As regards the development of the medium-term

Graph 7.1: Outturn vs target for discretionary spending and taxes (Exchequer cash accounts; deviation in percent)



Source : Department of Finance.

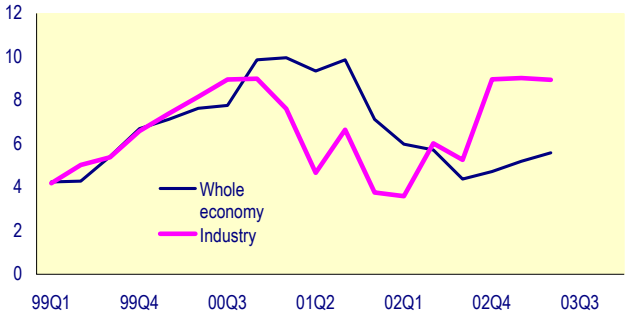
framework, an extension of multi-annual budgeting (rolling five-year envelopes) public transport capital projects to all areas of capital spending was announced with effect from 2004 (see also below).

Given the tighter budgetary situation, the government is stepping up its efforts to secure value for money, especially in high-priority areas which have received ample additional funds in recent years, such as health and infrastructure. As a follow-up to its Health Strategy 2001, the government commissioned more detailed reports on reform of the institutional structure of the health care system and of financial and accountability procedures. This led to the government's health reform programme announced in June 2003. Its main elements are: a rationalisation of the existing health service agencies, the establishment of a national health service executive, the decentralisation of budgetary responsibility and the modernisation of planning and reporting processes. Implementation is currently underway but will take several years to complete. Progress on value for money as part of the benchmarking process and the review of the National Development Plan are dealt with below.

Wage moderation required to protect competitiveness

Higher inflation than in the main trading partners coupled with the recent appreciation of the euro have heightened competitiveness concerns. In response, wage growth eased markedly between early 2001 and end-2002, illustrating Ireland's capacity to respond flexibly to changing circumstances. However, the latest data show a gradual pick-up in compensation growth, especially in industry. This implies that competitiveness concerns, which resulted in relatively modest pay provisions for the private sector in the wage clause of the March 2003 national agreement, *Sustaining Progress*, are likely to feature prominently in the negotiations on a new pay deal, which are to start in Spring 2004.

Graph 7.2: Compensation of employees per capita (year-on-year growth rates)



Source : Central Statistics Office.

In the public sector, *Sustaining Progress* provides for the gradual implementation by mid-2005 of an average 8.9% rise under "benchmarking", an exercise to better align pay scales with those in the private sector for comparable jobs. Payment of three-quarters of the increase is conditional on verifiable progress on modernisation and flexibility and maintenance of the industrial peace, in line with the government's drive to secure value for money. In the course of 2003, the necessary arrangements (action plans, performance verification groups) were put in place to monitor such progress and the first verification evaluations took place.

Various measures are planned to improve capital spending and to increase the level of R&D

The National Development Plan (NDP) 2000-2006 came up for a detailed mid-term evaluation in 2003. An independent review published in October 2003 concluded that the overall strategy underlying the NDP is as valid as in 1999, when it was drawn up. Regarding the infrastructural part of the NDP, the review argued that substantial progress has been made and that the returns to investment in physical infrastructure, especially roads, are very substantial. Hence, it advocated an increase in funding for the infrastructure programme of the NDP over the rest of the NDP period, primarily for the National Roads priority. In addition, the review made several recommendations to strengthen value for money and to address management weaknesses as manifested in cost overruns and delayed project delivery. For instance, it underlined the need to

improve project selection, the desirability of multi-annual budgeting and the need to strengthen the capacity of implementing departments to manage large-scale projects.

The government agreed with the independent review's evaluation that infrastructure should be the key priority for investment over the remainder of the NDP period and the 2004 allocations for infrastructure are deemed to be broadly in line with the review's recommendations. In December 2003, the government published its first five-year envelopes for capital spending by department for the period 2004-2008, which aim at keeping public investment close to 4% of GDP, well above the EU average of around 2½% in 2003. The practice of multi-annual envelopes provides greater certainty for government departments and public bodies, which should enhance the efficiency of capital expenditure planning and management. In addition, the government intends to publish legislation to speed up the planning and environment impact assessment process and address issues arising from compulsory purchase orders and their cost. Finally, revised capital appraisal procedures to be introduced in 2004 should also help achieve better value for money.

In comparison with other EU countries, both business and total R&D spending are quite low in Ireland as a percentage of GDP. Although expenditure on R&D continued to increase in absolute terms between 1999 and 2001, the ratio of R&D expenditure to GDP levelled off at 1.2% because of the rapid growth in GDP. The number of Irish patents applied for at the EPO (per million inhabitants) is also below the EU average, although it has increased quite strongly in recent years. Funding for science, technology and innovation under the current NDP is on a larger scale than under the previous NDP. New research centres have been created and partnerships have been developed between Irish universities and companies. Naturally, the results of these efforts by the Irish authorities to improve the overall level of R&D will only be seen in the medium term. In addition, in the budget for 2004, it is proposed to introduce a tax credit for incremental R&D spending by companies.

Competition is increasing but at a variable speed depending on the sector

In the telecommunications sector, more competition has been introduced. In mobile telephony, three operators are currently operating on the market. In fixed telephony, the local loop is now unbundled and the market share of the incumbent is now 80% against 95% in 2000. Significant improvements have also been made in the telecommunications infrastructure and in broadband services, mainly for enterprises. In the gas and electricity markets, new competition rules have been introduced. 56 % of the electricity market and 85% of the gas market are now open. Additional measures are being introduced which will achieve full liberalisation in both sectors by early to mid-2005. In transport, new proposals have been made for reforming the aviation and bus sectors.

The Competition Authority is currently reviewing the medical and legal professions as well as engineers and architects and this work will be concluded by end-2004. As regards insurance, reform of motor insurance advances slowly with only 48% of the measures proposed by the Motor Insurance Advisory Board currently implemented. In the other insurance sectors, the authorities are analysing the degree of competition and barriers to entry. This work will be completed by end-2003 and a report on possible regulatory changes is expected for 2004. Finally, the retail sector, including retail in pharmacies, is also under review.

Table 7.1: Economic indicators for Ireland

	IRELAND				EU 15			
	2000	2001	2002	2003	2000	2001	2002	2003
General economic background								
Real GDP[1]	10.1	6.2	6.9	1.6	3.6	1.7	1.1	0.8
Inflation[2]	5.3	4.0	4.7	4.1	1.9	2.2	2.1	2.0
Labour productivity[3]	5.2	3.1	5.5	0.7	1.6	0.5	0.8	0.8
Employment growth[4]	4.7	3.0	1.3	0.8	2.0	1.2	0.3	0.0
Nominal wage growth[5]	8.1	9.0	5.2	5.1	3.5	3.3	3.1	3.1
Unemployment[6]	4.3	3.9	4.4	4.8	7.8	7.4	7.7	8.1
Employment								
Employment rate[7]	65.1	65.7	65.3	n.a.	63.4	64.1	64.3	n.a.
Female employment rate[8]	54.0	54.9	55.4	n.a.	54.1	55.0	55.6	n.a.
Employment rate for older workers[9]	45.3	46.8	48.1	n.a.	37.8	38.8	40.1	n.a.
Long-term unemployment[10]	1.6	1.2	1.3	n.a.	3.5	3.1	3.0	n.a.
Tax rate on low wage earners[11]	18.1	17.3	16.6	n.a.	38.6	37.7	37.8	n.a.
Unemployment trap indicator[12]	n.a.	72.6	73.4	n.a.	n.a.	79.4	79.1	n.a.
Product market reforms								
Relative price levels[13]	107.4	112.0	118.3	n.a.	100	100	100	100
Total trade to GDP ratio (%)[14]	87.8	87.9	84.3	n.a.	59.6	59.0	58.1	n.a.
Single Market Directives[15]	96.4	97.6	97.4	98.6	97.0	98.0	97.9	97.7
Business investment[16]	20.6	19.0	17.7	n.a.	18.3	17.9	17.2	n.a.
Knowledge based economy								
Tertiary graduates[17]	67.4	n.a.	n.a.	n.a.	38.4	40.0	n.a.	n.a.
Spending on human resources[18]	4.4	n.a.	n.a.	n.a.	4.9	n.a.	n.a.	n.a.
R&D expenditure[19]	1.2	1.2	n.a.	n.a.	1.95	1.98	1.99	n.a.
Expenditures on IT[20]	2.4	2.3	n.a.	n.a.	4.2	4.2	n.a.	n.a.

For footnotes and sources see Table 1.1 for Belgium.

Table 7.2: Public finances in Ireland (% of GDP)

	IRELAND					EU-15				
	2000	2001	2002	2003	2004	2000	2001	2002	2003	2004
Government balance	4.4	0.9	-0.2	-0.9	-1.2	1.0	-0.9	-1.9	-2.7	-2.6
Primary balance	6.5	2.5	1.2	0.7	0.3	4.8	2.7	1.4	0.6	0.5
Cyclically adjusted balance	2.4	-0.7	-1.9	-1.0	-0.6	-1.2	-1.6	-2.1	-2.2	-2.0
Cyclically adjusted primary balance	4.5	0.9	-0.4	0.6	0.9	2.6	2.0	1.3	1.1	1.1
Government debt	38.4	36.1	32.4	33.5	33.8	64.1	62.8	62.5	64.1	64.4

Source : Commission services.

8. ITALY

In the context of a cyclical slowdown, Italy's recent economic performance has underlined some of the emblematic aspects of the country's economy. In 2003, the economy went into a slight recession in the first half of the year, recovering somewhat in the second. Inflation remained relatively high and sticky in the face of a negative output gap inter alia due to insufficient competition in services. On the external side, the economy continued to suffer from foreign sales concentrated towards markets growing less than world demand and from the comparatively high price sensitivity of its exports. Defying stagnant economic growth, the labour market continued to create new jobs, which, however, were not fully reflected in higher consumption expenditure. In this difficult context, authorities have chosen to rely on temporary measures to stave off the risk of breaching the 3% of GDP deficit threshold and avoid a restrictive fiscal stance, postponing the lasting consolidation of public finances warranted by the high debt ratio. As to the overall reform agenda, some progress has been made in the labour market and in education, while a proposal for pension reform to be implemented in the medium-term was presented in the Autumn. While the cycle is expected to have improved in the second half of 2003, no rapid improvement can be expected in the slow pace of underlying growth observed since the early 1990s. A series of structural weaknesses such as the slow transition to a knowledge-based economy, comparatively low expenditure on R&D and a relatively unfriendly business environment also weigh on economic growth. As a result, the government faces a difficult trade-off between improving the long-term growth perspective and obeying to short-term political constraints.

Key challenges in the light of recent developments

Last year, Italy's economic policy agenda largely reflected issues stemming from unfavourable short-term developments. In this context, the government has nonetheless progressed, albeit in a piecemeal way, in some areas of its more long-term reform agenda, most importantly labour market and education, while significant reform plans were put forward for pensions. Progress was made to accelerate the transition to the knowledge-based economy and to reduce the administrative burden for businesses, but measures undertaken to stimulate effective competition in services and energy markets are at this stage insufficient. In other areas, notably in the case of lasting adjustments in public finances, reforms were deferred. A more detailed assessment of recent developments in addressing Italy's key policy challenges is presented in the following sections.

1. Public finances

Rapidly consolidate public finances

Under this challenge, Italy was requested to:

1. until a medium-term budget position close to balance or in surplus is achieved, ensure a reduction in the cyclically-adjusted deficit of at least 0.5% of GDP per year, replacing one-off measures by measures of a more permanent character;
2. strengthen policy co-ordination between all levels of government, by ensuring adequate and transparent enforcement mechanisms for fiscal discipline, while providing for clear sources of financing regional spending; and
3. finance further reductions in the tax burden through structural cuts in current primary expenditure within a comprehensive reform plan on both the expenditure and the revenue side.

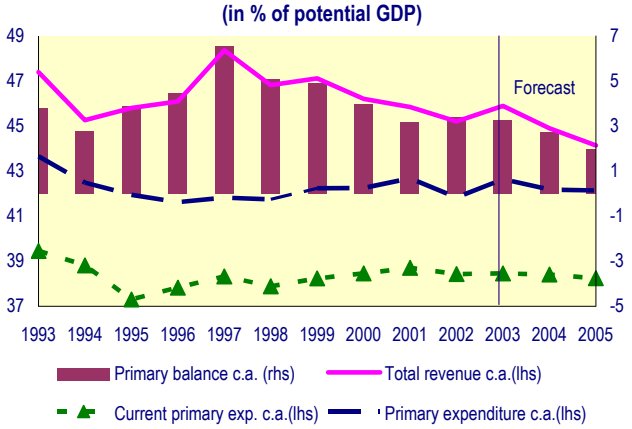
Budgetary consolidation slackens

In line with the experience of recent years, budgetary consolidation did not advance significantly in 2003. With a deficit in the region of 2.6 percentage points of GDP, the cyclically-adjusted primary surplus is estimated to have contracted, albeit slightly, and the cyclically-adjusted budget balance to have improved marginally compared to 2002. Also taking into account lower growth than had generally been expected, this contrasts with the recommendation to ensure a reduction in the cyclically-adjusted deficit of at least 0.5 percentage point of GDP per year until a medium-term budget position close to balance or in surplus is achieved. Moreover, the government continues to rely on one-off measures (sales of real assets and a series of tax amnesties), whose impact on the budget balance was in excess of 1 percentage point of GDP in 2002 and could be around 1.5 percentage points in 2003. The draft budget and fiscal measures adopted for 2004 do not foreshadow a significant turnaround in the fiscal stance. Temporary measures (including disposals of real assets and a fiscal amnesty for building regulation violations) once again feature prominently in the fiscal package. Taking into account receipts from sales of real assets already decided in the past, the full weight of the one-off measures may well be over 1 percentage point of GDP. On the whole, despite the perspective of an improving economic environment, the government's determination to implement a sizeable structural correction appears weakened, and there is a risk, after half the parliamentary term has elapsed, of further postponement in the coming years.

Sluggish current primary expenditure reduction constrains tax reform implementation…

In 2003, the government implemented the first phase of the tax reform, hinging chiefly on a reduction in the personal income tax, which is to be followed in 2004 by a modification of corporate taxation. Given the goal of reducing the overall tax burden, fiscal consolidation implies lowering current primary expenditure in percentage of GDP, which has displayed a strong degree of downward rigidity in past years. Steps taken in late 2002 to tighten controls, implement more transparent spending procedures and set in place a system to collect timely information on the disbursements of public entities, all represent welcome progress. However, major difficulties persist in implementing structural expenditure cuts, and in perspective the process of decentralisation will continue to represent a key challenge, requiring a clear definition of means, instruments, competencies and objectives at all levels of government.

Graph 8.1: Cyclically adjusted primary balance (in % of potential GDP)



Source : Commission services.

… and generates initiatives to promote public-private partnerships in infrastructure investment

The rigidity of current primary expenditure limits the possibility to expand capital expenditure, which so far has borne the major brunt of consolidation efforts. To overcome this constraint, in 2002 the government set up *Infrastrutture S.p.A*, a public company designed to finance infrastructure programmes by operating as a borrowing institution of the private sector and promoting public-private partnerships. It is expected to shortly embark on a first operation involving high-speed trains. The operations of *Infrastrutture S.p.A*. and their impact on the public debt will have to be closely monitored.

Ensure the long-term sustainability of public finances in the face of population ageing.

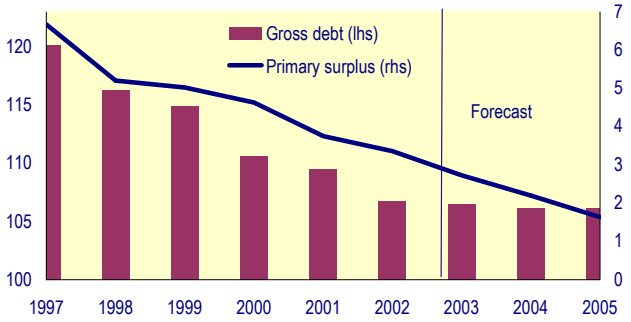
Under this challenge, Italy was requested to:

4. ensure that the debt ratio is diminishing at a satisfactory pace towards the 60% of GDP threshold; and
5. adopt further measures to address the critical issue in the public pension system, in particular the long transition period to the new contribution-based system. The new system has been designed just to deal with adverse demographic shocks and promote supplementary privately funded pension schemes.

Long-term fiscal trends continue to be a cause for concern…

Italy's debt to GDP ratio remains very high. A marked slowdown in the process of disposal of financial assets and persisting high levels of the cash government borrowing requirement, which since 1999 has tended to exceed the Maastricht definition of general government deficit by about 1.5% of GDP on average, have weighed on the path of reduction of the debt ratio in recent years, while the dampening effect of low real GDP growth has been counterbalanced by a strong dynamics of the GDP deflator. In 2002 the reduction in the debt ratio of around 3 percentage points of GDP was achieved chiefly through an extraordinary debt conversion operation. In 2003, in a context of continued subdued real GDP growth, the debt ratio will decrease largely thanks to a resumption of privatisations (subject to Eurostat clearing the privatisation of the *Casa Depositi e Prestiti*, the formerly public deposits and loans fund), a sizeable reduction in cash assets held by the government with the Bank of Italy and a favourable exchange rate effect. The debt targets for the coming years are conditional upon achieving a progressive recovery in primary surpluses (increasing from the current expected 2.7% of GDP to above 5% in 2007) and on an estimate of privatisation operations of 1% of GDP per year on average, which appears ambitious even in comparison with the experience of 1995-2000. An acceleration of the reduction in the debt ratio compared to plans would be warranted in the light of the looming pressures from population ageing.

Graph 8.2: Debt developments (in % of GDP)



Source : Commission services.

…despite plans to pursue reform in the pension system in the medium term.

The current draft framework law on the reform of the pension system appreciably dampens the projected increase in the ratio of pension expenditure to GDP over the next twenty years and advances on the implementation of the fully-funded second pillar. The government's plans envisage tightening conditions required to benefit from seniority pensions from 2008, in practice inducing the deferral of the age for retirement. Savings in pension expenditure, estimated by the Treasury at up to 0.7% of GDP per year compared to the present system, would gradually taper off after around 2030, as a longer contribution period will entail a higher average pension for workers falling under the full-contribution system. Yet the enabling legislation draft, subjects the proposal to non-negligible political risks, *inter alia* by deferring steps to curb pension expenditure trends to 2008. Moreover the proposal leaves open a number of critical issues such as the long interval between scheduled reviews of the parameters of the system.

2. *Labour market and regional development*

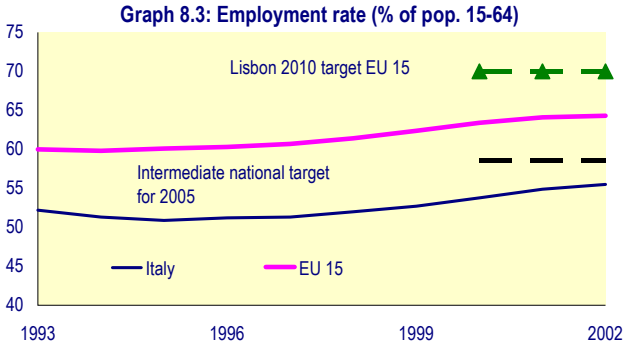
Raise the low employment rate, especially among women and older workers, and reduce the wide North-South economic disparities.

Under this challenge, Italy was requested to:

6. Further encourage increased labour force participation, especially among women, including by adequate provision of child-care facilities; and among older workers, stepping up and reinforcing measures targeted at postponing retirement from the labour force;
7. Further reform employment protection legislation, in order to facilitate job creation and adaptability and to reduce the segmentation of the labour market across type of contracts and firm size; and, at the same time, increase the resources and improve the efficiency of the unemployment benefit and social assistance system; and
8. Encourage social partners to move towards more decentralised wage setting mechanisms that allow wages to better reflect different productivity conditions and individual skill levels.

Employment rate rises as job creation continues in the face of anaemic growth

The Italian labour market has continued to perform relatively well throughout the recent economic slowdown. Employment was still up, despite a slight contraction of real GDP in the first half of 2003. Thanks to this and a pro-cyclical labour force, the rate of unemployment in 2003 fell below the current estimate of the non-accelerating inflation rate of unemployment (NAIRU) of 9.1%, possibly reflecting the increasingly tight labour market conditions in the North of Italy. Italy's employment rate remained on an upward trend in 2003. Following the pattern of the recent past, including the demographic effect, i.e. the effect from an increasing share of age cohorts with high employment rates, the increase was mainly due to women. Older workers also posted a further rise in their very low rate of employment. However, despite the ongoing progress Italy's employment rate remains the lowest in the EU. Apart from marginal steps included in the 2004 draft budget, no significant measures have been taken to improve childcare facilities.



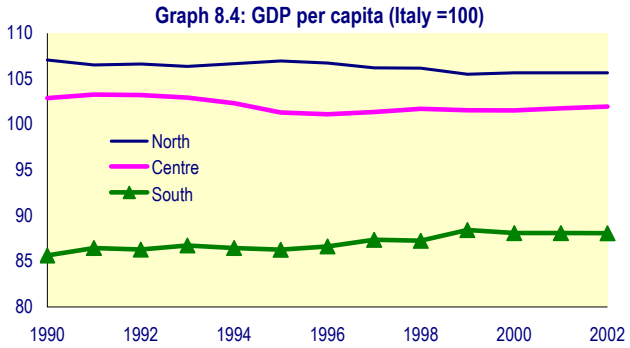
Source : Commission services.

Labour market reform proceeds at variable pace…

Besides wage moderation and fiscal incentives, the positive performance of the Italian labour market is believed to reflect the impact of the successive stages of reform since the mid 1990s, chiefly by introducing new more flexible labour contracts. The most recent reform, the so called 'Biagi law', was approved by Parliament in February and entered effectively into force in October 2003. In the main, the new law further extends the range of existing, flexible labour contracts, attempts to tackle the issue of precarious work and sets out a reform of private and public employment services. While this may further increase the degree of flexibility of the labour market at the margin and improve its matching capacity, the issue of segmentation of the labour market across types of contract and firms remains to be addressed.

.....with important elements of the reform still pending.

The original version of the draft 'Biagi law' also aimed at loosening employment protection legislation (EPL) and reforming the unemployment benefit system so as to mitigate the risk of a dual labour market. However, the proposals were removed from the law in the light of fierce trade union protest and wrapped in a separate draft law still pending in Parliament. While parts of the still outstanding reform agenda may currently be difficult to implement from a political point of view, the overall progress and impact of the labour market reform will crucially depend on the government's readiness to tackle the issue of tight EPL and the atypical structure of unemployment benefits system favouring mainly 'insiders' in the manufacturing sector. As regards the low participation of older workers, the government plans to offer a fiscal incentive to employees postponing their retirement decision. The effectiveness of that incentive remains subject of debate.



Source : Commission services.

North-South economic disparity narrowing, although slowly

The regional income gap between the North and South of the county linked to large differences in the employment ratio and labour productivity remains high. The relative income level in the South has slowly improved in the second half of the 1990s returning to the levels observed in the late 1980s. In 2001, the latest year for which final regional data is available, GDP per capita in the South was at 68% of the country's average. Based on preliminary data the slow convergence is estimated to have continued in 2002. The relative improvement of the South since the mid-1990s chiefly resulted from somewhat higher productivity growth. However, the regional productivity differential remains high compared to a low regional wage dispersion. While the government acknowledges that a greater wage differentiation is needed to reduce the employment gap in the South it believes the issue should be dealt with by social partners.

The government's strategy for the South aims at increasing productivity

In view of the fact that the regional income gap intersects with regional employment disparities, progress in the labour market reform is clearly instrumental. More generally, the government's strategy for the South is to reduce the reliance on market-distorting subsidies and to improve the competitiveness of local firms by increasing the quantity and quality of local public goods and, therefore, productivity. The medium-term economic and financial plan (DPEF) for the period 2004-2007 released in July 2003 outlines the key points of that strategy, notably to accelerate public infrastructure programmes (*inter alia* by resorting to public-private-partnerships) and to strengthen local public administration. In terms of budgetary resources, the government aims at increasing the share of total public capital expenditure designated to the South to 45% in 2007, up from somewhat below 40% in 2002. It is also pursuing a plan of thorough institution building, especially in the Regional administrations. Moreover, the 2003 budget law introduced a single fund for lagging areas providing for more flexibility in the allocation of resources so as to faster react to changing requirements. While these elements clearly go into the right direction, their impact will depend on the improvement in the administrative capacity in Southern regions and the availability of funding for the implementation of infrastructure projects.

3. Knowledge-based economy

Strengthen the knowledge-based economy in terms of educational attainment and skill levels, investment in IT, R&D and innovation performance.

Under this challenge, Italy was requested to:

9. Pursue efforts undertaken to raise the overall education and skill base of the population, to further increase investment in R&D and innovation and to promote higher ICT take up, in particular through measures targeted at small and medium enterprises.

Efforts have been undertaken to accelerate the transition to a knowledge-based economy

Despite recent progress, Italy lags behind most of the other Member States in the field of the development of the knowledge-based economy. This is reflected by lower performances than the EU 15 average in the fields of IT expenditures as a percentage of GDP, of internet penetration and of e-commerce use. This slow transition to a knowledge-based economy can be explained by below EU average business R&D expenditure and patent applications and by a weak educational achievement of the population, as measured by the proportion of tertiary graduates. In March 2003, the Parliament approved a reform of the primary and secondary level education system which notably aims at reducing the still high drop out rates and at facilitating the school-to-work transition. In this respect, the compulsory schooling years have been increased from 10 to 12 years and a vocational education and training stream is proposed. Several measures have also been taken with the view of stimulating R&D and innovation. Actions have been engaged to simplify the public procedures aiming at supporting innovation in the private sector and to make the public aids system for innovation more efficient. Moreover, a new fund for technological innovation projects has been created. Specific actions have also been launched by the government to favour a more intensive use of ICT among companies and households and schools.

4. Productivity and business dynamism

Continue to improve the business environment and to enhance competition in the energy and service sectors.

Under this challenge, Italy was requested to:

10. Improve the business environment by reducing the administrative burden on businesses; and
11. Increase effective competition in the service sector, widen the opening of the energy markets, and improve the implementation of internal market directives.

Better environment for business creation…

Regarding the time and costs necessary to set up a new company, Italy still needs to improve its performance, also in terms of enterprise creation. Administrative procedures for the setting up of new businesses have been lightened and all the relevant documents necessary for companies' registration can henceforth be send via electronic means. A wide reform of Italian bankruptcy law is currently under discussion. One of its major objectives is to make bankruptcy procedures less harsh towards debtors so to ensure that the consequences of business failures are not so severe as to discourage risk taking. However, administrative burden and red-tape associated with running a business in Italy are still high by international standards.

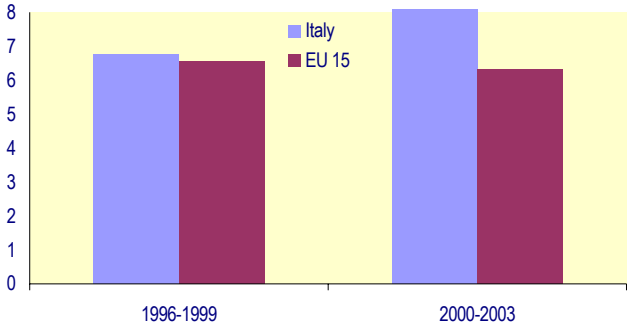
…but the liberalisation of the service sector and of the energy markets proceeds at a slow pace.

Professional services (such as liberal professions and services to households) are still highly regulated and characterised by measures restricting market entry. A number of proposals to reform professional services are being discussed before the Parliament. These proposals assign to

the Professional Associations the task of establishing and enforcing appropriate quality standards. However, these proposals do not contain substantial changes in the regulation of entry and Italy still remains among the worst performers in term of strict regulation of professional services.

As regards the energy sector, the gas market for final consumers has been fully liberalised but in many instances there is still one firm in the market. In electricity, recent developments are mixed. On the one hand, the Parliament is currently discussing a comprehensive energy sector reform, part of which has already been enacted. Some of the new measures could result in enhancing competition in the electricity sector, by accelerating investments in new capacity and by privatising the firms and allowing the Transmission System operator to own the facilities. Moreover, the law under discussion foresees the acceleration of the liberalisation of the market as requested by the EU Directive (full market liberalisation in 2004 for non-households users and 2007 for households). On the other hand, the measures designed to develop interconnections capacities also contain provisions that would allow the company investing in such capacities to be exempted from the "third party access" requirement for a limited period of time and only for a limited extent. In addition, in order to control inflation, the government has intervened recently by asking the energy regulator to modify the criteria for updating the part of the tariff linked to the fuel prices. A new proposal under discussion reorganises some aspects of the regulatory Authorities, assigning new regulatory competencies to the Ministries is being discussed. The introduction of a wholesale electricity pool has been postponed to 2004 and in the meantime a provisional system of exchanges, limited to captive market, has been set up.

Graph 8.5: Average electricity prices - Industrial users in euro per 100 KW/h



Source : Commission services.

Finally, the transposition rate of internal market directives (97.0%) has continued to decrease in 2003 and remains below the 98.5% target.

Table 8.1: Economic indicators for Italy

	ITALY				EU 15			
	2000	2001	2002	2003	2000	2001	2002	2003
General economic background								
Real GDP[1]	3.1	1.8	0.4	0.3	3.6	1.7	1.1	0.8
Inflation[2]	2.6	2.3	2.6	2.8	1.9	2.2	2.1	2.0
Labour productivity[3]	1.4	0.1	-0.7	-0.5	1.6	0.5	0.8	0.8
Employment growth[4]	1.7	1.7	1.1	0.8	2.0	1.2	0.4	0.0
Nominal wage growth[5]	3.1	3.0	2.4	3.0	3.5	3.3	3.1	3.1
Unemployment[6]	10.4	9.4	9.0	8.8	7.8	7.4	7.7	8.1
Employment								
Employment rate[7]	53.7	54.8	55.5	n.a.	63.4	64.1	64.3	n.a.
Female employment rate[8]	39.6	41.1	42.0	n.a.	54.1	55	55.6	n.a.
Employment rate for older workers[9]	27.7	28.0	28.9	n.a.	37.8	38.8	40.1	n.a.
Long-term unemployment[10]	6.4	5.8	5.3	n.a.	3.5	3.1	3.0	n.a.
Tax rate on low wage earners[11]	43.3	42.8	42.7	n.a.	38.6	37.7	37.8	n.a.
Unemployment trap indicator[12]	n.a.	59.6	59.9	n.a.	n.a.	79.4	79.1	n.a.
Product market reforms								
Relative price levels[13]	90.4	92.2	94.5	n.a.	100	100	100	100
Total trade to GDP ratio (%)[14]	27.2	26.8	25.8	n.a.	30.2	29.9	29.1	n.a.
Single Market Directives[15]	96.8	98.3	97.4	97.0	97.0	98.0	97.9	97.7
Business investment[16]	17.4	17.3	17.8	n.a.	18.3	17.9	17.2	n.a.
Knowledge based economy								
Tertiary graduates[17]	24.8	n.a.	n.a.	n.a.	38.4	40.0	n.a.	n.a.
Spending on human resources[18]	4.6	5.0	n.a.	n.a.	4.9	n.a.	n.a.	n.a.
R&D expenditure[19]	1.1	n.a.	n.a.	n.a.	1.95	1.98	1.99	n.a.
Expenditures on IT[20]	2.4	2.5	n.a.	n.a.	4.2	4.2	n.a.	n.a.

For footnotes and sources see Table 1.1 for Belgium.

Table 8.2 : Public finances in Italy (% of GDP)

	ITALY					EU-15				
	2000	2001	2002	2003	2004	2000	2001	2002	2003	2004
Government balance	-0.6	-2.6	-2.3	-2.6	-2.8	1.0	-0.9	-1.9	-2.7	-2.6
Primary balance	5.8	3.8	3.4	2.7	2.2	4.8	2.7	1.4	0.6	0.5
Cyclically adjusted balance	-2.5	-3.2	-2.3	-2.1	-2.3	-1.2	-1.6	-2.1	-2.2	-2.0
Cyclically adjusted primary balance	4.0	3.2	3.4	3.2	2.7	2.6	2.0	1.3	1.1	1.1
Government debt	110.6	109.5	106.7	106.4	106.1	64.1	62.8	62.5	64.1	64.4

Source: Commission services.

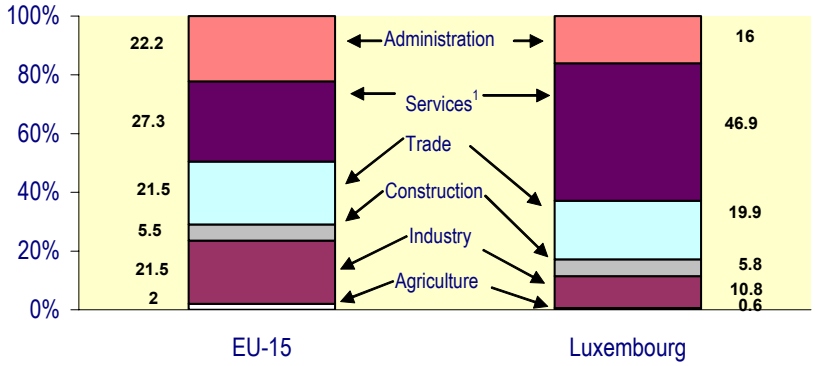
9. LUXEMBOURG

Following many years of real GDP growth well above the EU average, economic growth in Luxembourg slowed down sharply. Over the last decades, the sectors of financial intermediation, real estate and services to businesses have seen their share in gross value added increasing at the expense of the industry to reach about 47%, compared to an average of 27% in the EU-15 (see chart). Because of the importance of the financial sector to the economy of the Grand Duchy, the negative impact of the turmoil on financial markets on economic growth was more profound than in most other EU Member States. The resulting drag on activity and productivity growth continued into 2003, as firms adjusted to the shock. Weak profits and balance sheet restructuring held back investment. As the slowdown in economic activity spread to more sheltered sectors of the economy, the negative impact on employment was increasingly felt. Against the backdrop of weak economic growth, the labour market has weakened markedly in the course of 2002 and 2003. While economic growth is expected to pick up in 2004, there would be no improvement in the labour market in the near term. Its high openness and receptiveness to FDI inflows allows Luxembourg to benefit from competition from abroad whilst the reform of its own competition framework is dragging.

Key challenges in the light of recent developments

The weakened situation of the labour market makes the challenge to increase the domestic employment rates, especially for older workers, which is currently among the lowest in the EU, even more important. Strengthening competition and improving the business climate remain fundamental to boost the growth potential of the economy. In addition, the reform of the competition law is a long-awaited measure, which has not yet been implemented. The following sections present a more detailed assessment of recent developments in addressing key policy challenges identified for the Grand Duchy.

Graph 9.1: Composition of Gross Value Added (2002)



[1] Fin. Int., real estate & services to businessess.
Source : Commission services.

1. *Labour market*

Increase the low national participation and employment rates, especially for older workers,

Under this challenge, Luxembourg was requested to:

1. review incentives for early and pre-retirement and ensure appropriate eligibility rules in the disability pension scheme (GL 16 and E-REC 2).

Continued weak growth takes its toll on employment

The substantial slowdown in employment growth in the course of 2003 (in response to sluggish real GDP growth) has led to a progressive increase in the domestic registered unemployment rate, which is forecast to increase from a low of 2.1% in 2001 to 4.2% in 2004. While in 2002 the overall employment rate in terms of full time equivalents still increased, the expected further deceleration in employment would lead to a decrease in the participation rate, even though this is likely to be cushioned somewhat by the specific employment schemes. In the public sector, employment would increase only slightly in 2004, in order to limit the increase in public expenditure.

In the limited time that elapsed since the adoption of the 2003-2005 BEPGs, to date, no concrete policy measures have been implemented to reduce incentives for early retirement. However, the government is considering abandoning legislation that prohibits people receiving pension benefits to take up salaried employment. In the public sector, a new measure allows officials to continue working beyond the age they are eligible for retirement. Some progress has been made to reduce the inflow in disability pension schemes by tightening eligibility. A specific measure aimed to promote the participation rate concerns the introduction of more flexible working schedules for workers in the public sector. An agreement has been reached on the right to vocational education. Because of the recent introduction of all these measures, it is too early to assess their impact on the participation rate.

2. Productivity and business dynamism

Improve the business environment and encourage entrepreneurship in order to achieve a more balanced economic structure.

Under this challenge, Luxembourg was requested to:

2. fully implement the reforms of competition law and to ensure that competition and regulatory authorities have sufficient independence, resources and power to fulfil their tasks (GL 9); and
3. take measures to encourage and facilitate the creation of SMEs and to help those to access venture capital (GL 11).

The reform of the competition law is slowly within sight…

The recommendation to reform the competition legislation dates from 2000. Original and amended draft legislations have been approved by the government respectively in September 2002 and in November 2003. The latter text should now go to the Parliament to be adopted, possibly before the end of the present legislature in mid-2004. It will abolish the present outdated legislation on fixed and monitored prices and install an independent Competition Council. New legislation has been adopted to set up a single legislative framework for public procurement, in order to align the national legislation with EU directives. No progress has been reported on the financial and human resources of the competition and regulatory authorities.

… and some measures have been taken to encourage entrepreneurship.

Luxembourg has traditionally been among Member States where a high share of SMEs identified the administrative burden as a major constraint for business performance. Typically, the thirty days necessary in 2002 to register a start-up and the associated cost of the procedure placed Luxembourg at the 11th position of the EU ranking. Legal initiatives have been taken in 2002 and 2003 to streamline the set of data requested to start up a business. A joint venture between the Public Company for Credit and Investment and some private banks has been created to help SMEs to access venture capital. In addition, actions to make pupils aware of entrepreneurship have been launched in schools with the help of Chambers of Commerce. These targeted schemes

aim at removing cultural barriers to entrepreneurship, which Luxembourg claims to be the main problem in this field. It is too early to assess the effectiveness of the various programmes.

Table 9.1: Economic indicators for Luxembourg

	LUXEMBOURG				EU 15			
	2000	2001	2002	2003	2000	2001	2002	2003
General economic background								
Real GDP[1]	9.1	1.2	1.3	1.2	3.6	1.7	1.1	0.8
Inflation[2]	3.8	2.4	2.1	2.2	1.9	2.2	2.1	2.0
Labour productivity[3]	3.3	-4.2	-1.8	-0.5	1.6	0.5	0.8	0.8
Employment growth[4]	5.6	5.6	3.2	1.7	2.0	1.2	0.4	0.0
Nominal wage growth[5]	4.7	3.7	3.1	2.7	3.5	3.3	3.1	3.1
Unemployment[6]	2.3	2.1	2.8	3.7	7.8	7.4	7.7	8.1
Employment								
Employment rate[7]	62.7	63.1	63.7	n.a.	63.4	64.1	64.3	n.a.
Female employment rate[8]	50.1	50.9	51.6	n.a.	54.1	55	55.6	n.a.
Employment rate for older workers[9]	26.7	25.6	28.3	n.a.	37.8	38.8	40.1	n.a.
Long-term unemployment[10]	0.6	0.6	0.8	n.a.	3.5	3.1	3.0	n.a.
Tax rate on low wage earners[11]	30.4	28.8	27.3	n.a.	38.6	37.7	37.8	n.a.
Unemployment trap indicator[12]	n.a.	87.6	86.7	n.a.	n.a.	79.4	79.1	n.a.
Product market reforms								
Relative price levels[13]	97.2	99.5	99.7	n.a.	100	100	100	100
Total trade to GDP ratio (%)[14]	92.7	93.3	131.3	n.a.	59.6	59.0	58.1	n.a.
Single Market Directives[15]	96.8	97.9	97.7	96.6	97.0	98.0	97.9	97.7
Business investment[16]	17.0	18.7	17.9	n.a.	18.3	17.9	17.2	n.a.
Knowledge based economy								
Tertiary graduates[17]	12.0	n.a.	n.a.	n.a.	38.4	40.0	n.a.	n.a.
Spending on human resources[18]	n.a.	n.a.	n.a.	n.a.	4.9	n.a.	n.a.	n.a.
R&D expenditure[19]	1.71	n.a.	n.a.	n.a.	1.95	1.98	1.99	n.a.
Expenditures on IT[20]	5.5	5.4	n.a.	n.a.	4.2	4.2	n.a.	n.a.

For footnotes and sources see Table 1.1 for Belgium.

Table 9.2: Public finances in Luxembourg (% of GDP)

	LUXEMBOURG					EU-15				
	2000	2001	2002	2003	2004	2000	2001	2002	2003	2004
Government balance	6.4	6.2	2.4	-0.6	-2.1	1.0	-0.9	-1.9	-2.7	-2.6
Primary balance	6.6	6.4	2.7	-0.4	-2.0	4.8	2.7	1.4	0.6	0.5
Cyclically adjusted balance	n.a.	n.a.	n.a.	n.a.	n.a.	-1.2	-1.6	-2.1	-2.2	-2.0
Cyclically adjusted primary balance	n.a.	n.a.	n.a.	n.a.	n.a.	2.6	2.0	1.3	1.1	1.1
Government debt	5.5	5.5	5.7	4.9	4.7	64.1	62.8	62.5	64.1	64.4

Source: Commission services.

10. NETHERLANDS

In 2003 real GDP is expected to decline by 0.9% in the year as a whole, compared to a meagre positive growth rate of 0.2% in 2002, the weakest growth performance in the EU. In response, social partners agreed to freeze contractual wage increases in 2004 and 2005. Against the background of stronger and more protracted economic slowdown than in most other EU countries, the situation of public finances deteriorated markedly as surpluses turned into deficit. To reverse these adverse budgetary developments, the government adopted substantial fiscal consolidation measures in 2003 and 2004, in total equivalent to 2.5% of GDP. This substantial consolidation effort is an important step to meet the short-term objective in the field of public finances. Nevertheless, the weak economic prospects imply that the deficit would increase to 2.7% of GDP in 2004. Planned expenditure reductions are mostly of a structural nature and stem, inter alia, from reforms in social security, wage restraint in the public sector, measures to control health care spending, and a reduction of subsidies. The reforms of benefit systems should help to promote labour force participation in the medium term and thus go some way to meet the key challenges formulated for the labour market. Productivity growth has been relatively slow in the Netherlands over the recent years. Although this may be partly attributed to rapid employment growth, the low level of competition in some sectors as well as the declining specialisation in high-tech manufacturing sectors also contributed to this slowdown. Thus, reforms aimed at improving the functioning of product markets should be stepped up.

Key challenges in the light of recent developments

Shortly after adoption of the 2003-2005 BEPGs, the new Dutch government decided to pursue even more rigorous fiscal consolidation than previously envisaged in order to ensure that the deficit would not pass the 3% of GDP threshold. Some of the measures taken in order to meet the budgetary challenge posed by the severe economic slowdown are also aimed at increasing labour force participation. This constitutes progress with respect to labour market reforms, to the extent that these measures will be successful in promoting labour force participation in the medium term, even though the adverse economic situation hinders progress in the near term. However, some fundamental issues, specifically with respect to pensions, are still undecided. Productivity and innovation should be enhanced to boost potential growth, but while declared intentions go in the right direction recent progress in these areas has been slow. The following sections present a more detailed assessment of recent developments in addressing key policy challenges identified for the Dutch economy.

1. Long-term sustainability of public finances

Pursue budgetary adjustment in the coming years in the face of weaker potential growth, and the budgetary costs of ageing.

Under this challenge, The Netherlands was requested to:

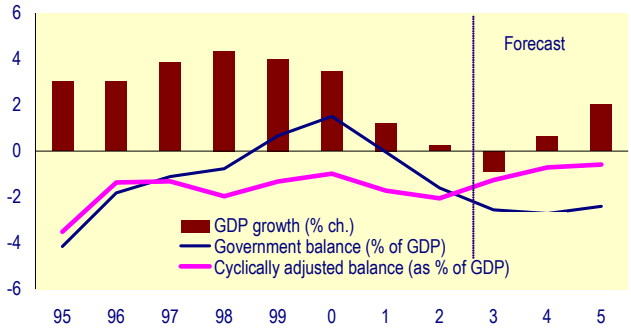
1. continue to contain government expenditure within clearly defined ceilings set in real terms, consistent with a budgetary position close to balance or in surplus (GL 1 and 14).

Substantial budgetary consolidation despite economic headwind

Despite the strong and commendable fiscal consolidation effort, Dutch public finances have deteriorated very quickly and the deficit is expected to peak in 2004 just below 3% of GDP. Both the 2003 and 2004 budgets are very restrictive and contain ex-ante consolidation packages

equivalent to 1.2% and 1.3% of GDP respectively[5]. In fact, over the summer the new government decided a package of additional measures in order to prevent the deficit from exceeding the 3% of GDP mark. For the whole cabinet period from 2003 to 2007, the budget contains ex-ante consolidation measures equivalent to a cumulative 3.9% of GDP. The consolidation effort relies to a large extent on expenditure reductions of a structural nature. As a consequence of tight budgetary policy, the cyclically adjusted deficit is forecast to improve markedly between 2002 and 2005. The budgetary consolidation effort is appropriate in view of the rather moderate growth rate of potential real GDP, which requires expenditure to move in line with the relatively modest increase in the revenue base in years ahead. In line with the recommendation in the 2003-05 BEPGs, the new government has decided to maintain the key elements of the budgetary strategy already used by previous governments. This encompasses limiting the growth of real government expenditure under ceilings defined in real terms and set in advance for the whole cabinet period up to 2007. The challenge for the Dutch authorities in the current adverse macro-economic environment is to ensure that actual expenditure remains consistent with achieving and maintaining a budgetary position close to balance or in surplus in the medium term. This may require additional consolidation efforts, should budgetary prospects worsen significantly compared to the targets set.

Graph 10.1: GDP growth and government balance



Source: Commission services.

2. *Labour market*

Draw currently inactive people into the labour market.

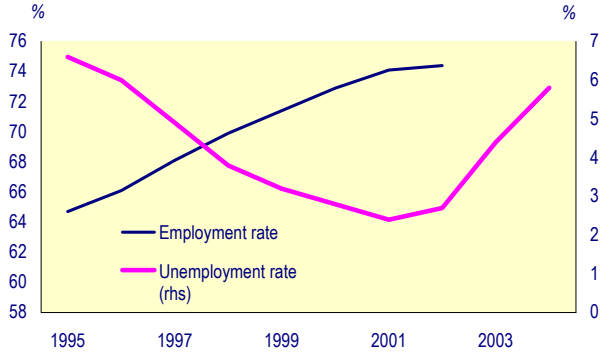
Under this challenge, The Netherlands was requested to:

2. push forward with reforms of benefit systems in order to make work pay (GL 4 and E-REC 3). Concentrate, in particular, on benefit eligibility and conditionality. Legislate and implement the planned reform of the disability scheme, thereby paying attention to both the inflow and to the activation of those who already receive benefits.

Several measures aim to enhance incentives to work and discourage early retirement…

The 2004 budget contains several measures to reform benefit systems with the aim of enhancing incentives to work. In addition, the government intends to promote the labour force participation of the elderly by removing fiscal incentives for private early retirement schemes. Measures decided upon include a limitation of the duration of unemployment benefits. In order to encourage the participation of older employees (of 57½ years and over), the

Graph 10.2: Employment & Unemployment rates



Source: Commission services.

[5] Because of second-round effects on economic activity, the actual (ex-post) improvement of the government balance is less.

obligation for unemployed elderly people on benefits to actively search for a job will be reintroduced. The municipalities will have full financial and administrative responsibility for those on welfare benefits (including both the payment of benefits and reintegration efforts) as of 2004. This decentralisation should save costs and enhance the efficiency of reintegration efforts. Measures taken to limit income-dependent subsidies would help to diminish the adverse cumulated effects of different benefit schemes. With respect to disability benefits, a reformed system will come into force in 2006. The period during which employers have to pay the sickness benefits of employees is extended from one to two years. Furthermore, criteria for the partly disabled to receive an income-related wage supplement will be limited. These measures are in line with the recommendation to reform benefit systems as they limit eligibility and enhance conditionality. The reforms of social security and pensions decided upon aim to reduce public expenditure and strengthen supply side conditions. At this juncture it is too early to assess to what extent they will actually affect the behaviour of economic agents.

...but some issues still pending in the aftermath of the wage moderation agreement.

However, some of the reforms of social security and pensions announced in the 2004 budget as presented to Parliament have been dropped or are still pending. This mainly reflects the outcome of a dialogue with social partners, which resulted in an agreement to freeze contractual wage increases new collective labour agreements in 2004 and to have these increases approach zero in 2005. Social benefits will be frozen in 2004 and 2005. The wage agreement is an important step marking efforts to improve external competitiveness, which had suffered substantially in recent years due to high wage and price increases. It is clear that the central wage agreement will have a beneficial impact on labour costs and external competitiveness in the near term. However, in the longer term more wage differentiation across sectors is called for, to promote innovation, competition, and an efficient distribution of production factors.

In response to the wage agreement, the government agreed to delay or modify some intended measures, especially concerning pre-pensions and early retirement and the disability benefit scheme. The planned measures to abolish tax-facilitation of early retirement and pre-pension schemes are put on hold. The cabinet and the Labour foundation have agreed to jointly propose a new arrangement to be introduced in 2006, including possible transitory arrangements. For the time being, the cabinet will put on hold some additional initiatives to tighten conditions to become eligible for unemployment benefits. As regards the disability scheme, proposed limitations on benefit payments related to family income and income suppletion of sickness benefits in the second year of illness have been dropped under the condition that social partners agree not to provide supplementary income. This has significant implications both for the recipients and for the costs of the system if the intended savings from this measure will occur. The new criteria for determining disability will be determined taking into account advice from the Social Economic Council. However, it is important not only to stem the inflow in disability schemes, but also to add further measures aimed at activating those currently on benefits to the extent possible. Apart from the introduction of medical re-examinations, this issue has not been sufficiently addressed so far.

3. Productivity and business dynamism

Tackle the relatively slow productivity growth, stemming, inter alia, from the low level of competition in some sectors, and insufficient business investment, particularly in R&D.

Under this challenge, The Netherlands was requested to:

3. improve the regulatory framework as well as its implementation (GL 11), especially in sectors where competition has been found to be inadequate, such as construction and professional services; and
4. promote a more technology oriented education and strengthen science-industry links with the aim of increasing business investment in R&D (GL 13).

Effective competition in a number of sectors remains limited

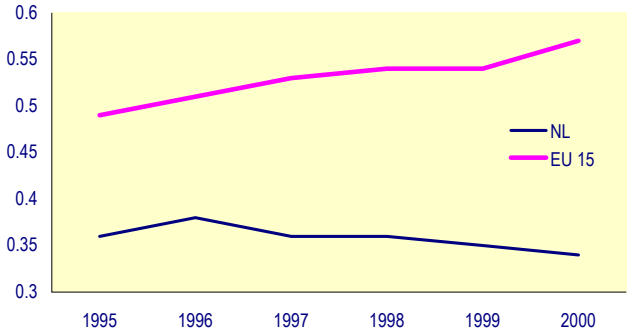
Until recently, the process of liberalisation in the network industries in the Netherlands was proceeding quite rapidly. However, as competition in the already liberalised markets remained rather limited, consumers benefited only little from the reform effort. This has negatively affected the public perception of liberalisation, which led the Dutch Government to delay further reforms (while opening up the electricity market for residential private customers was initially planned for January 2004, the government recently postponed the date to July 2004). In order to regain support for liberalisation, the government announced that further liberalisation will be accompanied with measures allowing to safeguard consumers' interests. This would imply a reinforcement of the regulatory regimes in the network industries.

The Dutch government intends to increase the powers of the Dutch Competition Authority, in order to better handle competition problems in sectors such as construction and professional services, where competition was found to be inadequate. In particular, the Competition Authority will have the power to enter the homes of suspected private individuals; to seal off business premises and objects (which would facilitate investigation procedures in the construction industry, for example); to give increased fines for failing to co-operate with an investigation; and to allow for penalties for directors as well as organisations.

Objectives have been set to promote a more technology oriented education.

The Netherlands has an advanced R&D sector. However business R&D expenditure has been below the EU average during the last years. In order to stimulate private innovations an Innovation Council has been created recently which is headed by the Prime Minister. One specific problem is the low level of new science and technology graduates, which may create an obstacle for future innovation. The difference in the number of new Science and Technology PhDs between the Netherlands and the EU average has been growing over the recent period. There is a shortage in the labour market for highly qualified specialists and scientists. Therefore, the Ministry of Education, Culture and Science defined as a key objective increasing the intake into science and technology courses, bringing focus to scientific research, making vocational training more innovative and to improving the co-operation between research and educational institutions and business. In order to strengthen the Science-Industry links the Netherlands is currently reviewing all policy measures for innovative start-ups with the view of bringing all instruments under one initiative called "TechnoPartner".

Graph 10.3: Total new Science and Technology PhDs per 1000 population aged 25 to 34 years



Source : Commission services.

Table 10.1: Economic indicators for Netherlands

	NETHERLANDS				EU 15			
	2000	2001	2002	2003	2000	2001	2002	2003
General economic background								
Real GDP[1]	3.5	1.2	0.2	-0.9	3.6	1.7	1.1	0.8
Inflation[2]	2.3	5.1	3.9	2.4	1.9	2.2	2.1	2.0
Labour productivity[3]	1.6	-0.1	0.0	0.2	1.6	0.5	0.8	0.8
Employment growth[4]	1.8	1.3	0.6	1.3	2.0	1.2	0.4	0.0
Nominal wage growth[5]	4.7	5.5	4.9	4.1	3.5	3.3	3.1	3.1
Unemployment[6]	2.9	2.5	2.7	4.4	7.8	7.4	7.7	8.1
Employment								
Employment rate[7]	72.9	74.1	74.4	n.a.	63.4	64.1	64.3	n.a.
Female employment rate[8]	63.5	65.2	66.2	n.a.	54.1	55	55.6	n.a.
Employment rate for older workers[9]	38.2	39.6	42.3	n.a.	37.8	38.8	40.1	n.a.
Long-term unemployment[10]	0.7	0.6	0.7	n.a.	3.5	3.1	3.0	n.a.
Tax rate on low wage earners[11]	40.6	36.8	37.2	n.a.	38.6	37.7	37.8	n.a.
Unemployment trap indicator[12]	n.a.	85.2	84.8	n.a.	n.a.	79.4	79.1	n.a.
Product market reforms								
Relative price levels[13]	100.2	100.3	101.8	n.a.	100	100	100	100
Total trade to GDP ratio (%)[14]	73.1	69.1	66.9	n.a.	59.6	59.0	58.1	n.a.
Single Market Directives[15]	97.5	98.7	98.7	97.4	97.0	98.0	97.9	97.7
Business investment[16]	19.0	18.4	17.4	n.a.	18.3	17.9	17.2	n.a.
Knowledge based economy								
Tertiary graduates[17]	37.2	39.2	n.a.	n.a.	38.4	40.0	n.a.	n.a.
Spending on human resources[18]	4.9	5.0	n.a.	n.a.	4.9	n.a.	n.a.	n.a.
R&D expenditure[19]	1.90	1.89	n.a.	n.a.	1.95	1.98	1.99	n.a.
Expenditures on IT[20]	5.3	5.2	n.a.	n.a.	4.2	4.2	n.a.	n.a.

For footnotes and sources see Table 1.1 for Belgium.

Table 10.2 : Public finances in Netherlands (% of GDP)

	NETHERLANDS					EU-15				
	2000	2001	2002	2003	2004	2000	2001	2002	2003	2004
Government balance	2.2	0.0	-1.6	-2.6	-2.7	1.0	-0.9	-1.9	-2.7	-2.6
Primary balance	6.0	3.4	1.5	0.4	0.0	4.8	2.7	1.4	0.6	0.5
Cyclically adjusted balance	-1.0	-1.7	-2.1	-1.3	-0.7	-1.2	-1.6	-2.1	-2.2	-2.0
Cyclically adjusted primary balance	2.9	1.7	1.0	1.7	2.0	2.6	2.0	1.3	1.1	1.1
Government debt	55.9	52.9	52.4	54.6	55.5	64.1	62.8	62.5	64.1	64.4

Source: Commission services.

11. AUSTRIA

Against the background of subdued growth in a weak external environment, the Austrian government pressed forward with an extensive reform agenda, featuring most prominently a comprehensive reform of the public pension system and a sizeable tax relief. Budgetary negotiations and the simultaneous debate on the complete overhaul of the pension system accompanied by multi-sectoral strikes were at the centre stage in spring 2003. Against this background and despite increased uncertainty linked to the pension debate, consumer demand proved surprisingly resilient, although household disposable income was squeezed by weak employment growth and a further increase in unemployment. Notwithstanding a short-term economic outlook in line with international developments, potential growth in the medium term is projected to decrease. Measures aiming at raising participation rates are particularly welcome and represent the path to be followed with a view to reversing the projected trend in potential output growth. In this respect, however, the government's current policies send contrasting signals. Austria has benefited from reasonably high growth rates of labour productivity over the recent years. Increasing competition in product markets and intensive trade relations with the accession countries have been instrumental in this respect. However, some sectors still suffer from a lack of effective competition and the implementation deficit of the Internal Market directives should be further reduced. Due to a number of measures adopted, the conditions for a transition to the knowledge-based economy have improved but R&D expenditures remain slightly below the EU average.

Key challenges in the light of recent developments

In less than a year since having taken office, the Austrian government has implemented important economic reforms. Most importantly, it has enacted a comprehensive overhaul of the Austrian pension system. Moreover, a sizeable tax reform, to be implemented in two steps, is in the offing. The blueprint for the second, more substantial step of the tax reform 2005 is currently being drafted. Its implementation would require additional savings to return to a cyclically-adjusted budgetary position close to balance. Austria has continued building and streamlining the framework for support of R&D. Effective competition in some sectors has been promoted but significant weaknesses remain. A more detailed assessment of recent developments in addressing Austria's key policy challenges is presented in the following sections.

1. Long-term sustainability of public finances

Ensure the sustainability of public finances in the face of population ageing,

Under this challenge, Austria was requested to:

1. implement measures leading to structural expenditure savings, also at lower levels of government, so as to lower the high tax burden, while securing a cyclically-adjusted budgetary position close to balance (GL 1); and
2. reform the public pension system to ensure the sustainability of public finances (GL 16); in particular link more closely the level of pension benefits to life-long contributions; increase the low average effective retirement age and ensure in this context that incentives to work are enhanced (GL 4 and E-RECs 2 and 3), with a view to raising the labour market participation of older workers.

In 2003, deficit increase mainly induced by discretionary measures …

The general government deficit in 2003, has widened to 1% of GDP according to preliminary official data. Apart from automatic stabilisers working fully, the deterioration of the budgetary balance vis-à-vis 2002 is mainly explained by discretionary measures. On the revenue side, the full impact of two economic stimulus packages is being felt, resulting in considerable permanent income shortfalls while on the expenditure side an increase in the family allowances and

deferred, if small, one-off spending related to the flood disaster in summer 2002 led to rising discretionary expenditures. Structural savings have been implemented in the area of the ongoing administrative reform, consisting of staff reductions and cuts in current expenditure. As a result, the cyclically-adjusted deficit in 2003 is estimated to have widened by half of a percentage point to 0.7% of GDP.

In 2004, structural savings are expected to outpace additional increases in discretionary spending. Above all, spending should be curbed by beginning effects of the pension reform and related measures. Combined with a streamlining of health insurance funds and the administrative reform, the total impact of structural expenditure savings are estimated at some 0.6% of GDP in 2004. On the other hand, higher spending for R&D, universities, and family allowances is estimated to burden the budget by ¼% of GDP.

At the state level (Länder), structural savings measures have not been implemented (apart from a reduction in the number of school teachers).

Overall, noticeable progress with regard to structural savings is clearly being made, providing room for lowering the tax burden. However, due to an increase in discretionary spending and a sizeable tax relief planned for 2005, after a smaller one having become effective as of 2004, a cyclically-adjusted budgetary position close to balance is projected not to be maintained after 2004. Although planned to be of a temporary nature, this departure from the medium-term target may turn out to be persistent, if the expenditure savings announced in the stability programme update of November 2003 were only partly implemented or did not materialize as intended.

... but comprehensive overhaul of the Austrian pension system should rein in long-term spending increase with positive effects already in the short term.

The substantial modification of the pension system was for a long time the politically most sensitive and from a budgetary perspective most important issue. After long negotiations, the Austrian parliament on 11 June 2003 adopted a pension reform law, concerning both the public and the private sector pension regimes. The measures address the key problem areas and are fully in line with the respective recommendation:

- The actuarial fairness of the pay-as-you-go scheme should be enhanced. Starting from 2004, the reference period for calculating pension benefits will be extended by one additional year annually from currently 15/18 years with the highest income to ultimately – by as late as 2028 - a full 40-year earnings career. The same will apply to federal government officials, whose pension benefits have so far been based on their last salary.

- The effective retirement age as well as the labour force participation of older workers should be raised by a series of measures, mostly starting in 2004: (1) Early retirement will be abolished, but the effective retirement age should correspond to the statutory age only by 2017. In the private sector, unequal treatment of genders is planned to persist, as the early retirement age will be raised to 65 years for men and to only 60 years for women (from at present 61½/56½ years). As of 2019, however, due to the reform in 1997, the gender harmonisation of retirement ages will be phased in until 2033. For federal government officials, the retirement age will be raised likewise, with the same age limit of 65 years applying equally to men and women. (2) The retirement age for persons with particularly long contribution periods (men 45, women 40 years) will also be raised as of 2007. (3) Moreover, the gradual retirement scheme for older workers ("Altersteilzeit") is modified. Front-loading is prohibited, i.e. employees must actually work part-time for a period of 6½ years, instead of effectively retiring early. (4) In addition, incentives to stay in employment are strengthened. To this end, the so-called bonus/malus system is modified, increasing gains from remaining active or losses from retiring early. As a consequence, the Austrian authorities expect the overall participation rate to increase from 67% in 2000 to 76% by 2040 and the participation for workers aged 60-64 from 10% to 42% respectively.

- Upward pressure on budgetary spending shall be contained by lowering the annual accruals rate for pension benefits from 2 percentage points to 1.78 percentage points per contribution year, in five steps between 2004 and 2008. As a result, the maximum replacement ratio, remaining at 80%, will be attained after 45 instead of 40 contribution years.

Notwithstanding the overall merits of the reform, a few shortcomings remain: (1) A uniform 10 percent cap on benefit "losses" compromises guiding principles of this reform. New parameters become ineffective with benefits determined essentially by the old formula, reduced by 10%. Moreover, the notion of benefit "losses" is an artefact, misleadingly suggesting that benefit levels based on the old formula could have been maintained in the long run. (2) Long transition periods will delay the exonerating effect on public finances. In particular, the phasing-in period for early retirement, rather generous from the outset, should have been abolished by 2013, but was extended until 2017. (3) Early contribution years are not sufficiently re-valued in the framework of extending the reference period for calculating pension benefits. In practice, this implies that individuals with a flat earnings profile will receive lower benefits than persons with a steeper profile, even if in absolute terms their accumulated pension contributions are equivalent.

While the initial proposal was somewhat diluted in the parliamentary process, the pension reform should, nevertheless, be considered a major political success. Some measures are expected to have budgetary effects already in the short term, and further sizeable expenditure savings should materialise far beyond the current legislation period.

The Austrian authorities project the long-run upsurge in public pension spending to abate noticeably thanks to the recent reform. Expenditure for private sector pension schemes is forecast to be up by less than 2 instead of some 3 percentage points in 2050, rising from currently 10.5% of GDP to 12.3% in the year 2050, with a peak at 13.1% of GDP in 2035. In addition, savings in the civil servants' pension schemes are estimated at some 0.1 percentage point of GDP by 2010, rising to 0.3-0.4 percentage point by 2030. Clearly, even if these projections were subject to change, the pension reform 2003 represents a substantial, albeit not the last, step towards ensuring the long-term sustainability of public finances.

2. Productivity and business dynamism

Continue to improve the weak technology base, and encourage business R&D and innovation,

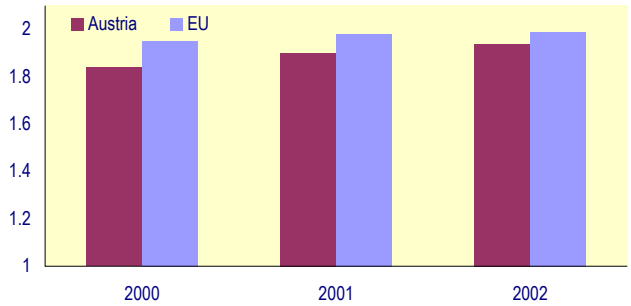
Under this challenge, Austria was requested to:

3. take measures to encourage business research and innovation, especially for SMEs, (GL 13).

Strengthening of weak technology base should continue to be a priority …

While an increasing trend of some indicators on innovation and research (e.g. number of patents, scientific publications) provide evidence of improvements, a strengthening of the weak technology base should continue to be a priority, especially given the slow increase in R&D expenditures which have kept Austria below the EU average. Moreover, the low participation of domestic companies in the financing and carrying-out of research activities has not significantly improved as the share of business

Graph 11.1: Gross domestic expenditure on R&D (% of GDP)



Source : Commission services.

financed R&D has stagnated at around 40%, as compared with around 55% at the EU level.

... but measures adopted promise future improvement.

Over the last year, Austria has taken several measures to increase and rationalise R&D and innovation support. On the one hand, the government adopted measures to stimulate R&D and innovation in the business sector. In this respect, the government has recently announced further extension for the next year of the tax allowance for innovation expenditures and pledged additional funds for R&D. In April 2003, a pilot project was launched with aim to step up the creation of technological axes between Austrian technology parks, research skills centres, technology-oriented clusters and cooperative research institutes, and their counterparts in Central and Eastern Europe. On the other hand, the government proceeded with rationalising the R&D support framework as a means of ensuring its efficiency. After creating the Austrian Business Service with focus on SMEs and start-ups by merging different promotion and financing bodies, a streamlining of the institutional framework for the administration of State aids to R&D is currently under examination. Since the recently adopted measures, coupled with sustained future efforts, might have the potential of generating benefits in the medium term, heightened attention should now be paid to introducing systematic monitoring and assessment of the programmes.

Strengthen the development of effective competition in some sectors.

Under this challenge, Austria was requested to:

4. increase the resources of the competition authority and to take measures to enhance effective enforcement of regulators' decisions in telecommunications (GL 9).

Effective competition increased in some sectors ...

Austria has made a step towards enhancing effective competition in the retail sector by partially liberalising the regulation on opening hours. Furthermore, a simplification of the regulatory framework has resulted in the decrease of start up costs and allowed for easier access to several professions. As a result, the share of SMEs considering administrative burdens as a major constraint has declined significantly in 2003. However, no measures to address high concentration in some other sectors (e.g. print media, health insurance, network industries, drugstores and furniture) have been reported.

... but resources of the Federal Competition Authority remain inadequate and the power of the telecom regulator continues to be insufficient.

During the first year of its existence the Federal Competition Authority started to build up the public record of its activities. Notwithstanding a slight increase in the number of the Authority's staff, insufficient resources remain a problem. The Authority has fewer resources than competition authorities in any of the other EU countries. The ability of the Authority to carry out thorough investigations, produce studies or get involved in competition advocacy is thus severely limited. No measures to enhance effective enforcement of the regulator's decisions in telecommunications were reported over the period under examination.

Table 11.1: Economic indicators for Austria

	AUSTRIA				EU 15			
	2000	2001	2002	2003	2000	2001	2002	2003
General economic background								
Real GDP[1]	3.4	0.8	1.4	0.9	3.6	1.7	1.1	0.8
Inflation[2]	2.0	2.3	1.7	1.3	1.9	2.2	2.1	2.0
Labour productivity[3]	2.4	0.1	1.4	0.8	1.6	0.5	0.8	0.8
Employment growth[4]	1.0	0.6	0.0	0.1	2.0	1.2	0.4	0.0
Nominal wage growth[5]	2.2	1.4	2.2	2.5	3.5	3.3	3.1	3.1
Unemployment[6]	3.7	3.6	4.3	4.5	7.8	7.4	7.7	8.1
Employment								
Employment rate[7]	68.5	68.5	69.3	n.a.	63.4	64.1	64.3	n.a.
Female employment rate[8]	59.6	60.7	63.1	n.a.	54.1	55	55.6	n.a.
Employment rate for older workers[9]	28.8	28.9	30.0	n.a.	37.8	38.8	40.1	n.a.
Long-term unemployment[10]	1.0	0.9	0.8	n.a.	3.5	3.1	3.0	n.a.
Tax rate on low wage earners[11]	40.1	39.7	39.9	n.a.	38.6	37.7	37.8	n.a.
Unemployment trap indicator[12]	n.a.	74.8	72.0	n.a.	n.a.	79.4	79.1	n.a.
Product market reforms								
Relative price levels[13]	98.2	99.0	101.5	n.a.	100	100	100	100
Total trade to GDP ratio (%)[14]	51.2	52.9	51.8	n.a.	59.6	59.0	58.1	n.a.
Single Market Directives[15]	97.1	97.1	97.1	97.5	97.0	98.0	97.9	97.7
Business investment[16]	22.5	22.0	20.9	n.a.	18.3	17.9	17.2	n.a.
Knowledge based economy								
Tertiary graduates[17]	23.6	26.2	n.a.	n.a.	38.4	40.0	n.a.	n.a.
Spending on human resources[18]	5.8	n.a.	n.a.	n.a.	4.9	n.a.	n.a.	n.a.
R&D expenditure[19]	1.84	1.90	1.94	n.a.	1.95	1.98	1.99	n.a.
Expenditures on IT[20]	3.8	3.8	n.a.	n.a.	4.2	4.2	n.a.	n.a.

For footnotes and sources see Table 1.1 for Belgium.

Table 11.2: Public finances in Austria (% of GDP)

	AUSTRIA					EU-15				
	2000	2001	2002	2003	2004	2000	2001	2002	2003	2004
Government balance	-1.5	0.3	-0.2	-1.0	-0.6	1.0	-0.9	-1.9	-2.7	-2.6
Primary balance	2.2	3.8	3.2	2.4	2.7	4.8	2.7	1.4	0.6	0.5
Cyclically adjusted balance	-2.4	0.1	-0.2	-0.7	-0.3	-1.2	-1.6	-2.1	-2.2	-2.0
Cyclically adjusted primary balance	1.2	3.6	3.2	2.6	3.0	2.6	2.0	1.3	1.1	1.1
Government debt	67.0	67.1	66.7	66.4	65.2	64.1	62.8	62.5	64.1	64.4

Source: Commission services.

12. PORTUGAL

The impact of the economic slowdown in Europe is being accentuated by the ongoing adjustment of domestic demand such that economic growth is projected to stay below the EU average during the period 2002-05. Since the end of 2001, domestic demand has been receding on account of the continuous efforts of private sector agents to restore the sustainability of their balance sheets and of the tightening of fiscal policy. After the significant losses in price-competitiveness accumulated in recent years, cyclical conditions, together with the near-freeze in wages in the general government sector in 2003, are having a favourable impact on wage settlements for the private sector. As regards fiscal policy, in order to avoid having to adopt an overly restrictive stance, and to give extra-time for a broad-based programme of structural reform that is currently being carried through in order to yield the expected benefits in terms of expenditure savings, the Portuguese authorities have had to rely, for a second year running, on sizeable one-off measures in order to keep the budgetary deficit below the 3% of GDP ceiling. In order to strengthen the catching up process, the Portuguese authorities have taken a number of initiatives (or are planning to), notably to stimulate innovation and R&D activities, improve the education system, foster life-long learning, and enhance competitiveness, particularly in network industries.

Key challenges in the light of recent developments

In the present difficult circumstances, the Portuguese government has started to address the key challenges identified in the 2003-05 BEPGs. However, the budgetary plan for a further reduction of the general government deficit was severely hampered by the large (negative) output gap that induced a large revenue shortfall. However, considerable progress was made in slowing down the pace of total current primary expenditure on account basically of the rapid deceleration of public consumption, although this was partly offset by a strong dynamism of social benefits that is unsustainable over the medium-term. Progress was also made in the implementation of a number of reforms as recommended in the BEPGs, especially in the health-care sector and as regards incomes policy. Nevertheless, further efforts are needed to accelerate the transition towards a knowledge-based economy in order to increase productivity. A more detailed assessment of recent developments in addressing Portugal's key policy challenges is presented in the following sections.

1. Public finances

Accelerate the consolidation of public finances and address the strong dynamics of Government expenditure,

Under this challenge, Portugal was requested to:

5. ensure that the Government deficit is further reduced in 2003 as planned, and that the cyclically adjusted deficit is thereafter lowered by at least 0,5 % of GDP a year in order to reach a budget position that is close to balance (GL 1);
6. ensure that the deficit reduction is obtained mainly through the expenditure side by firmly executing budgetary plans for all sub-sectors of the general government (GL 14); and
7. undertake structural reforms in areas with a more direct impact on budgetary consolidation, notably in public administration, education, health-care, and social security.

The general government deficit in 2003 is expected to be below the 3% of GDP ceiling due to sizeable one-off measures.

As the general government deficit is estimated to amount to 2.9% of GDP in 2003 compared with 2.7% in 2002, Portugal did not meet the recommendation that called for a further reduction of the deficit, which was planned to be achieved against a much more favourable growth background.

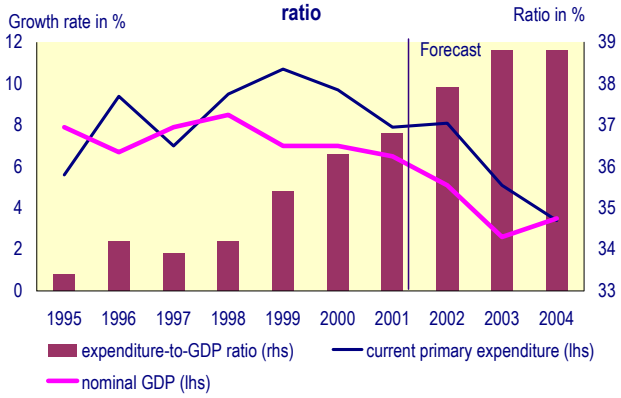
The strong deterioration of the cyclical position that has emerged together with the high sensitivity of the tax system to cyclical movements caused a massive shortfall in tax revenue. Government expenditure is expected to grow broadly in line with targeted values for 2003. These revenue and expenditure developments would lead to a government deficit above 3% of GDP in 2003. In order to prevent this, the Portuguese authorities have introduced two one-off measures, together worth more than 2% of GDP: (i) a lump-sum payment by the Post Office (CTT) to the government in exchange of the transfer to the government of CTT's unfunded pension obligations; (ii) the sale to a financial corporation of non-performing tax claims (i.e. tax arrears). Both operations have been cleared by Eurostat.

The cyclically adjusted deficit is expected to fall by more than ½ percentage point of GDP in 2003. This, however, is largely due to the impact of one-off measures.

Current primary expenditure is developing broadly in line with planned values.

Total current primary expenditure is growing broadly in line with targeted values. This corresponds to a significant deceleration in the annual growth rate from 8.1% in 2002 to 5.1% in 2003. Despite the concerted efforts by the Portuguese authorities to rein in expenditure growth, the expenditure-to-GDP ratio increased further in 2003, basically because growth in nominal GDP decelerated by about 2½ percentage points. The progress made on curbing current primary expenditure growth in 2003 reflects basically the strong deceleration in public consumption growth from 6.9% in 2002 to an estimated 2.9% in 2003, to a large extent on account of a significant slowdown in the compensation of employees. Further moderation in current expenditure growth is expected for 2004, brought about both by budgetary measures and the efficiency gains associated with the ongoing implementation of a number of structural reforms.

Graph 12.1: The current primary expenditure-to-GDP ratio



Source : Commission services.

The reforms programme is proceeding broadly as planned

The programme of structural reforms encompasses nearly all major policy areas, including those with a more direct impact on budgetary consolidation, notably public administration, the labour code, competition policy, the provision of education and health-care, and the reform of pension schemes. The main aims of the reforms are twofold: first to pursue the process of budgetary consolidation on a sustainable basis, therefore eventually dispensing with one-off operations, and second, to enhance the growth potential of the economy.

2. *Productivity and business dynamism*

Increase overall competitiveness which is at risk from the low efficiency of the education system, low R&D spending, a low degree of competition in certain sectors, and high nominal wage growth,

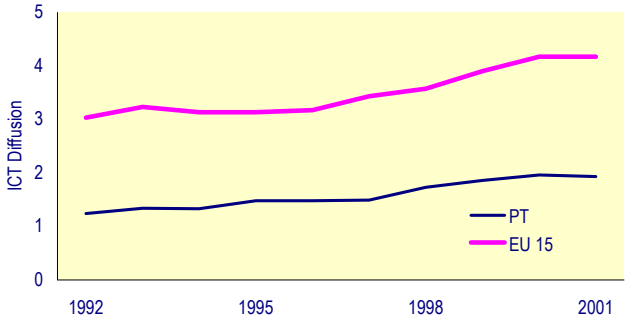
Under this challenge, Portugal was requested to:

8. promote the stronger involvement of the business sector in R&D spending and innovation (GL 13), together with higher ICT take-up;
9. improve the efficiency of spending in education with a view to, *inter alia*, raising the qualification of human resources (GL 13 and E-REC 1), and reducing substantially the number of early school leavers with insufficient levels of schooling or training;
10. enhance effective competition in liberalised utilities, especially in the energy sector, and create a better competitive environment by increasing the transposition rate of internal market directives (GL 9); and
11. encourage the social partners to secure wage moderation, while allowing wage increases to take into account productivity and skill differentials, with a view to improving competitiveness (GL 3 and 5).

Several initiatives have been launched to encourage the transition towards a knowledge based society

The levels of R&D expenditure (as a percentage of GDP) particularly in the business sector are among the lowest in the EU. In addition, overall ICT diffusion remains below the EU level, while showing an improvement over the last decade. However, measures have recently been taken to spur innovation in enterprises and R&D activities. For example, in order to develop venture capital and risk capital funds, their legal framework is being revised. Tax deduction for investment in R&D is granted to firms that produce tradables. The "Quadros Programme" gives financial compensation to small and micro enterprises for hiring staff with university degree in technological areas. Moreover, within the framework of the Operational programme for information society, actions to promote the use of ICT within academic communities (the e-U programme) and by the public sector have been implemented. For example, the e-procurement Program is currently being developed in order to offer a unified platform for public tendering. Public access points have also been opened in municipalities and a tax incentive has been given to households for the acquisition of IT equipment.

Graph 12.2: Expenditure on Information Technology as % of GDP

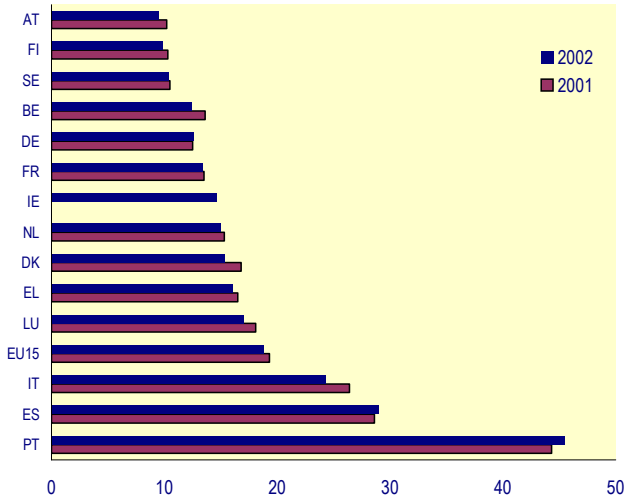


Source : Commission services.

Initiatives have been taken to improve the quality of education and to promote life-long learning

Despite spending on education (as percentage of GDP) above the EU average, the level of educational attainment of the population remains comparatively low. For example, in 2002 the percentage of early school-leavers in the population aged 18-24, with at most lower secondary education and not in further education training, was the highest in the EU. In addition, the fraction of the active population involved in life-long learning is one of the lowest in the EU. In order to increase the quality of education, a law has been recently approved, setting a comprehensive system of evaluation for all non-tertiary schools. In secondary education, the range of courses offered has also been broadened and modernised with the objective of reducing dropout rates. The creation of a general and independent system of evaluation and certification of university courses has been announced by the Portuguese government. Finally a law which aims to promote life-long learning is currently being discussed between the government and social partners.

Graph 12.3 : Early school-leavers



Source : Commission services.

In the gas sector, steps in the right direction are being taken, but effective competition in the electricity market is not yet secured

Portuguese electricity and gas prices for households and, albeit to a lesser extent, for large users rank amongst the highest in the EU. In 2001 the market share of the largest generator in the electricity market was higher than the EU average. Despite a derogation on the gas market, the Portuguese government approved a plan to restructure this sector. The severing between the oil and gas businesses and the unbundling between the generation and the transporter should contribute to more competition in this sector. On the electricity market, the elimination of long term purchase agreements between generators and the transmitter may lead to more competitive prices. The implementation of the Iberian Electricity market will improve capacity and efficiency in this sector. In addition, Portugal plans to open its retail market by 2004. However, the government intends to merge the ownership of the gas and electricity transmission networks. This new structure added to the common ownership of transmission and generation of electricity are likely to raise competitive concerns at the generation level.

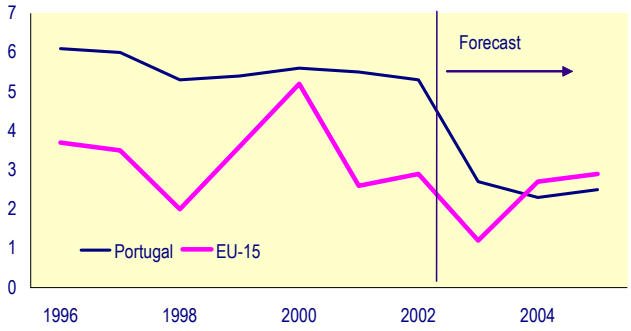
The transposition rate of internal market directives has improved but remains insufficient.

Although the transposition rate of internal market directives in Portugal has increased from 96.9% to 97.8%, it is still lower than the target set in Internal Market directives of 98.5%.

Major steps towards improving competitiveness and enhancing the flexibility of the labour market

In 2003, wage settlements in the private sector decelerated significantly compared with 2002 on the back of the cyclical weakness and the leadership role played by the general government sector that adopted a quasi-wage-freeze, following a number of years of both buoyant wage and employment growth. According to the Commission Autumn 2003 forecast, the slowdown in the growth rate of wages (per employee) is projected to bring to a halt the trend decline of price-competitiveness registered in recent years. In 2003, a new labour code (Código do Trabalho) was approved, replacing most current individual and collective labour legislation with a unified text. Some of the areas that were amended in the new code, notably the introduction of expiry clauses in collective agreements and the possibility of compulsory arbitration being determined by the Ministry of Social Security and Labour if a collective agreement expires without being replaced by another are likely to enhance the responsiveness of wage settlements to productivity and skill differentials across economic sectors.

Graph 12.4: Nominal compensation per employee; total economy (% growth rates)



Source : Commission services.

3. Long-term sustainability of public finances

Ensure the long-term sustainability of public finances in the face of population ageing.

Under this challenge, Portugal was requested to:

12. increase the efficiency of the health-care system by introducing a wide range of measures that strengthen market mechanisms and rationalise demand (GL 14); and
13. adopt further reforms to the pension system for workers in the general government sector to secure its long-term sustainability and in order to progressively align it with the pension regime for private sector workers (GL 16).

A comprehensive reform of the health-care system is proceeding at a rapid pace.

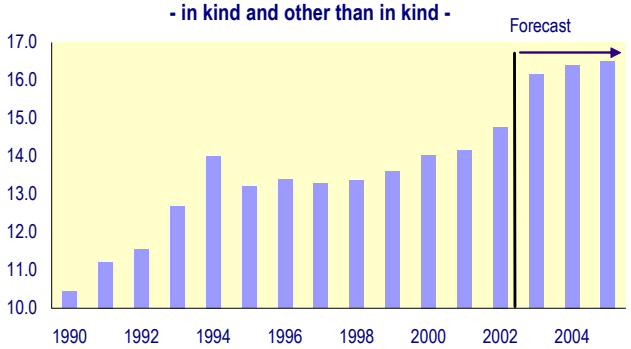
A thorough reform in health-care is underway of which the major elements are: (i) a significant number of public hospitals have been transformed into publicly owned corporations, with an enhanced degree of entrepreneurial autonomy; (ii) medical services will be charged for in future according to a price list established for services/techniques and not as in the past as part of an overall budgetary envelope based on historical data; (iii) the setting-up of a regulatory agency for the health-care sector that will address, among other things, the problem of adverse selection, (iv) the implementation of a comprehensive policy for the consumption of medicines, involving the promotion of generic drugs and the setting of ceilings for the reimbursement of drugs according to reference prices; and (v) an increase in user fees for medical treatment.

At this stage, it is too early to assess of the impact of these ambitious reforms on either efficiency or equity grounds.

The reforms of the pension scheme for the general government sector have not yet been fully implemented

Since 2001, the pension schemes (both the general social security and the public employee scheme to be gradually phased out) are being reformed in order to strengthen their long-term sustainability. As regards the former, the formula used to calculate pension benefits was modified in 2001: benefits will eventually be based on the entire working career and no longer on the best 10 out of the last 15 contribution years. However, given the long transition period to the new formula, it is projected that only pensioners retiring after 2016 will have a lower pension compared with the pension that would have resulted from using the previous formula. In 2004, the government projects to introduce legislation allowing for contributions in excess of a relatively high threshold to be channelled into individual pension funds. As regards the public employee scheme, the government introduced a number of reforms in 2003, which are expected to come fully into force at the beginning of 2004, in order to reduce the generosity of this scheme when compared with the general pension scheme[6].

Graph 12.5: Total Social Transfers (as % of GDP)
- in kind and other than in kind -



Source : Commission services.

However, on account of a constitutional court ruling, these reforms were only partly carried through in 2003. Both pension schemes have not yet reached their maturity. In the coming years, new pensioners are going to retire with longer contribution records, thereby increasing the average replacement ratio even after consideration of the reform of 2001 to the pension formula and the measures introduced or planned to be for the public sector scheme. In addition, the government has decided to secure, by 2006 at the latest, the convergence of minimum pensions to certain pre-determined fractions of the statutory minimum wage net of the worker's social contributions. Combined with the imminent demographic shock, the planned convergence of minimum pensions, as well as the envisaged setting of ceilings for the contributions to the general social security scheme will put additional pressure on pension expenditure, requiring offsetting measures in order to secure the long-term sustainability of the social security system.

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6 Entry to this regime was closed in 1 September 1993. After that date, the pension rights of new general government employees follow the same rules of the general social security pension scheme. The changes to be implemented in January 2004 include: the calculation of new pensions based of the last net wage (instead of the last gross wage) and penalties for retirement before 60 years of age even for pensioners that have the full contributory career of 35 years.

Table 12.1: Economic indicators for Portugal

	PORTUGAL				EU 15			
	2000	2001	2002	2003	2000	2001	2002	2003
General economic background								
Real GDP[1]	3.7	1.6	0.4	-0.8	3.6	1.7	1.1	0.8
Inflation[2]	2.8	4.4	3.7	3.4	1.9	2.2	2.1	2.0
Labour productivity[3]	1.5	0.3	0.2	0.2	1.6	0.5	0.8	0.8
Employment growth[4]	2.1	1.3	0.3	-1.0	2.0	1.2	0.4	0.0
Nominal wage growth[5]	5.6	5.5	5.3	2.7	3.5	3.3	3.1	3.1
Unemployment[6]	4.1	4.1	5.1	6.6	7.8	7.4	7.7	8.1
Employment								
Employment rate[7]	68.4	68.7	68.2	n.a.	63.4	64.1	64.3	n.a.
Female employment rate[8]	60.5	61.0	60.8	n.a.	54.1	55	55.6	n.a.
Employment rate for older workers[9]	50.7	50.1	50.9	n.a.	37.8	38.8	40.1	n.a.
Long-term unemployment[10]	1.7	1.5	1.8	n.a.	3.5	3.1	3.0	n.a.
Tax rate on low wage earners[11]	30.4	29.5	29.5	n.a.	38.6	37.7	37.8	n.a.
Unemployment trap indicator[12]	n.a.	87.7	87.0	n.a.	n.a.	79.4	79.1	n.a.
Product market reforms								
Relative price levels[13]	70.6	72.0	73.5	n.a.	100	100	100	100
Total trade to GDP ratio (%)[14]	37.4	36.2	34.0	n.a.	59.6	59.0	58.1	n.a.
Single Market Directives[15]	95.6	97.5	96.9	97.8	97.0	98.0	97.9	97.7
Business investment[16]	24.2	23.1	21.6	n.a.	18.3	17.9	17.2	n.a.
Knowledge based economy								
Tertiary graduates[17]	35.9	37.9	n.a.	n.a.	38.4	40.0	n.a.	n.a.
Spending on human resources[18]	5.7	5.9	n.a.	n.a.	4.9	n.a.	n.a.	n.a.
R&D expenditure[19]	n.a.	0.84	n.a.	n.a.	1.95	1.98	1.99	n.a.
Expenditures on IT[20]	2.0	1.9	n.a.	n.a.	4.2	4.2	n.a.	n.a.

For footnotes and sources see Table 1.1 for Belgium.

Table 12.2: Public finances in Portugal (% of GDP)

	PORTUGAL					EU-15				
	2000	2001	2002	2003	2004	2000	2001	2002	2003	2004
Government balance	-2.8	-4.2	-2.7	-2.9	-3.3	1.0	-0.9	-1.9	-2.7	-2.6
Primary balance	0.4	-1.1	0.3	0.0	-0.6	4.8	2.7	1.4	0.6	0.5
Cyclically adjusted balance	-4.2	-4.9	-2.7	-2.0	-2.1	-1.2	-1.6	-2.1	-2.2	-2.0
Cyclically adjusted primary balance	-1.0	-1.8	0.3	0.8	0.6	2.6	2.0	1.3	1.1	1.1
Government debt	53.3	55.5	58.1	57.7	58.8	64.1	62.8	62.5	64.1	64.4

Source : Commission services.

13. FINLAND

Although Finland was also affected by the cyclical slowdown, economic performance in 2003 remained clearly above the euro area average. While sluggish external demand and further declining business investment weighed on activity, private consumption, fuelled by rising real disposable income, provided firm support. The new government, appointed in June, responded to the slowdown by easing the fiscal stance and introduced measures to stimulate growth. Employment has been surprisingly resilient, falling only marginally. The situation of public finances is expected to remain favourable, even though the general government surplus is projected to moderate in 2004. The new government has put forward measures that respond to the recommendations of the 2003-05 BEPGs, inter alia, by introducing multi-annual spending limits for the entire election period and tax cuts on labour. Regarding productivity and business dynamism, Finland has maintained its leading position in the transition to the knowledge-based economy, even though the benefits have not yet been fully materialised into higher hourly productivity, which remains around the EU average. Contributing factors could be weak competition in some sectors of the economy and inefficiencies in the large public sector. Enhancing competition could also help to lower the price level, which is one of the highest in the EU. Some initiatives have been taken to improve competition and to enhance the efficiency of the large public sector.

Key challenges in the light of recent developments

In 2003, Finland's economic policy has addressed concerns arising from the unfavourable short-term development and medium-term challenges facing the economy. The new government decided as one of its first steps to lower taxes on earned income and step up measures to support employment growth. Further tax cuts could be envisaged, as lowering the tax burden on labour is one the key priorities in the Government Programme. While fostering job creation, the government also seeks to ensure the sustainability of public finances. Furthermore, important adjustments have been made to improve the efficiency of the public sector, notably the introduction of multi-year spending limits and the envisaged reform of local government finances. Measures have also been taken to increase competition in network industries. A more detailed assessment of recent developments in addressing Finland's key policy challenges is presented in the following sections.

1. Labour market

Reduce the high level of structural unemployment and increase the employment rate of older workers,

Under this challenge, Finland was requested to:

1. improve incentives in tax and benefit systems further to make work pay, in particular by addressing their combined effects on older workers, continue to reform the eligibility criteria, improve the administration of benefit systems and target the tax measures on low-paid labour (GL 4 and EREC 2); and
2. seek possibilities to ensure that wage bargaining systems allow wages to better reflect productivity differences across skills in order to improve the job prospects of low-skilled unemployed (GL 5).

The new government is proposing steps to reduce structural unemployment and promote labour supply

The government has decided to cut taxes on labour by at least € 1.12 billion i.e. 0.8% of GDP over the electoral period 2003-07. In the first 2003 supplementary budget, taxes on labour were reduced by € 295 million. Taking earlier decisions into account, including an increase in tax deductions for household service work, tax cuts in 2003 will total € 792 million. These tax cuts

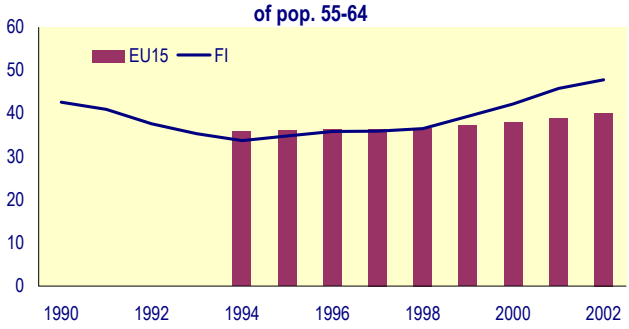
have been distributed fairly evenly among all income levels. For 2004, the government has put forward the following proposals: cuts in earned income taxation worth of € 775 million, by lowering marginal tax rates in state income tax schedules, increasing work-related deductions and earned income deductions in municipal taxation. Even though the tax cuts on income will apply to all income levels fairly evenly, the increase in deductions of work-related expenses and an earned income is targeted towards low and medium-income wage-earners. Furthermore, the government decided to reform the capital and corporate income taxation as from 2005. The corporate income tax rate will be reduced by 3 percentage points to 26 per cent and the capital tax rate will also be reduced by one percentage point to 28 per cent, yielding a decline in tax receipts from business and capital taxation by € 500 million i.e. 0.3% of GDP.

These tax reliefs will narrow the tax wedge (i.e. the ratio between take-home pay and total labour costs to the employer) for a low-income wage earner by about one percentage point to 50% in 2004. The tax wedge on labour has narrowed by 5.5 percentage points since the mid-1990s. The government is also planning to improve incentives for offering and accepting work, particularly in low-productivity sectors.

The government has introduced an intersectoral employment programme to raise the employment rate and prevent social exclusion. The emphasis of the programme is to reduce the high level of structural unemployment and boost labour supply. Some of the key measures to achieve these targets include reforming public employment services, raising the participation of job-seekers in active labour market policy measures to 30%, shifting the emphasis from passive to active labour market support and improving the effectiveness of active labour market programmes. While these measures represent a step in the right direction, it remains to be seen how effective they will be. The previous government had launched similar programmes to combat the high level of structural unemployment, but their effects have been marginal with the NAIRU estimated being around 8-9%. Admittedly, the proposed measures appear to be on a larger scale and may potentially be more effective than the previous ones. The present government is also setting up rather ambitious employment targets; creating 100 000 new jobs by the end of election term in 2007 and raising the employment rate to 75% by 2011.

The employment rate of older workers has been rising markedly over the last few years and this is expected to continue when the 2002 pension reform is implemented in 2005. Consequently, the Lisbon target of 50% employment rate for older workers is achievable. Concerning the further tightening of the eligibility criteria and improvement of the administration of benefit systems, no progress has been made so far.

Graph 13.1: Employment rate for older people (55-64) % of pop. 55-64



Source : Commission services.

Some progress in allowing wages to better reflect productivity differences

In previous wage agreements, pay rises have been based on the average productivity increase with the result that in low-productivity sectors unit labour costs have risen significantly. In the current two-year collective bargaining agreement that was settled in December 2002, this factor was taken into account and the cost effect of the pay rises is now somewhat less biased against the low-wage sectors than previously. Still, progress on this issue is small and tangible outcomes will likely be limited in 2003-04 as multi-annual centralised wage agreement is binding until January 2005.

2. *Productivity and business dynamism*

Enhance competition in certain sectors and improve the efficiency of the public sector.

Under this challenge, Finland was requested to:

3. step up efforts to enforce competition in network industries and non-tradable services (GL 9);
4. make further efforts to increase the efficiency of the public sector, inter alia by improving the framework conditions for increased competition, promoting the benchmarking of public sector efficiency and by increasing public tendering (GL 11); and
5. improve mechanisms to help control spending and ensuring compliance with rules on expenditure (GL 14).

Steps towards improved competition …

Prices remain among the highest in the EU, including indirect taxes, and competition in sectors such as network industries and non-tradable services is still weak. However, there are some planned measures to strengthen competition in general. The Competition Restrictions Act is currently subject to a reform aligning it with EU competition rules and introducing a leniency programme in the case of revealing cartel agreements. In order to get better information on competition and market efficiency, the Competition Institute will be established. Some measures have been taken to enhance competition in network industries such as mobile number portability and amending the Electricity Market Act to make it easier to change suppliers. However, the government is concerned about excessive market concentration in the electricity sector and a government working group has presented proposals in November 2003 on how to reform the network pricing in the energy markets. In 2003 a government working group presented proposals to enhance competition in the financial sector and some steps have been taken to strengthen competition in the real estate sector and construction.

… and initiatives have been launched and pursued to improve the efficiency of the public sector.

Some encouraging measures have been taken to improve the efficiency of the large public sector. In 2003, the Ministry of Finance has launched a Productivity Action Programme to enforce reforms in the public administration with the aim to increase public sector productivity. Other government programmes pursued during 2003 aim at increasing the public sector efficiency through more advanced use of information technology. Work is continuing on reforming the National Procurements Act and special attention will be devoted to procurement below the EU threshold value. There are plans to set up an advisory service point for public procurement to promote the use of the private sector in the provision of public services. In September 2003, the government submitted a bill to parliament regarding service vouchers. The objective is to open up the possibility to use service vouchers for social and health care services.

Multi-annual spending limits introduced to improve spending control

After repeated overruns of spending targets during the previous government, the new government has redesigned politically binding spending ceilings, first introduced in 1991. In the new type of ceilings about ¾ of budget appropriations are designed to fall within the spending limits. Excluded from the ceilings are expenditures like housing subsidies and unemployment benefits, which are typically vehicles for automatic stabilisers. Furthermore, interest expenditures and financial investment expenditures are excluded as well as compensations of tax losses of other levels of government due to tax reforms. A further change to previous spending limits is that supplementary budgets are included in the ceilings. In its new budget rules the government aims at balance in central government finances at the end of its term and introduces a central government deficit ceiling of 2.75% of GDP in national account terms, even in times of weak economic development. Furthermore, the government has made a commitment to take

expenditure-reducing measures and other remedial action if the deficit limit on central government finances threatens to be breached. However, the update of the 2003 stability programme envisages that the government will fall short of target of balancing central government finances, as the deficit in central government finances is expected to widen from 0.1% of GDP in 2003 to 0.9% in 2007.

The 2004 budget proposal provides for expenditure of € 316 million or 0.2% of GDP below the spending limit. This leeway will be used to cover the supplementary budgets. In the light of the experience with the supplementary budgets over the recent years, the proposed leeway is somewhat small.

On intra-government financial relations, a basic service programme between the central government and municipalities will improve the balance and predictability of municipalities' responsibilities, obligations and financing. A working group, assessing the local government financing and the central government transfer systems to municipalities, has been set up with the objective of reforming the transfer system. The reform is aiming to improve the stability of local government finances and provide incentives to carry out reforms with a view to improve service efficiency. This is envisaged to take effect from the beginning of 2005.

Table 13.1: Economic indicators for Finland

	FINLAND				EU 15			
	2000	2001	2002	2003	2000	2001	2002	2003
General economic background								
Real GDP[1]	5.1	1.2	2.2	1.5	3.6	1.7	1.1	0.8
Inflation[2]	3.0	2.7	2.0	1.4	1.9	2.2	2.1	2.0
Labour productivity[3]	2.8	-0.3	1.8	1.7	1.6	0.5	0.8	0.8
Employment growth[4]	2.3	1.5	0.4	-0.2	2.0	1.2	0.4	0.0
Nominal wage growth[5]	3.7	4.7	2.3	3.1	3.5	3.3	3.1	3.1
Unemployment[6]	9.8	9.1	9.1	9.3	7.8	7.4	7.7	8.1
Employment								
Employment rate[7]	67.2	68.1	68.1	n.a.	63.4	64.1	64.3	n.a.
Female employment rate[8]	64.2	65.4	66.2	n.a.	54.1	55	55.6	n.a.
Employment rate for older workers[9]	41.6	45.7	47.8	n.a.	37.8	38.8	40.1	n.a.
Long-term unemployment[10]	2.8	2.5	2.3	n.a.	3.5	3.1	3.0	n.a.
Tax rate on low wage earners[11]	42.4	41.0	40.4	n.a.	38.6	37.7	37.8	n.a.
Unemployment trap indicator[12]	n.a.	80.6	83.4	n.a.	n.a.	79.4	79.1	n.a.
Product market reforms								
Relative price levels[13]	118.3	118.6	122.7	n.a.	100	100	100	100
Total trade to GDP ratio (%)[14]	38.2	36.1	34.6	n.a.	59.6	59.0	58.1	n.a.
Single Market Directives[15]	98.7	99.3	99.4	98.6	97.0	98.0	97.9	97.7
Business investment[16]	17.2	17.8	16.0	n.a.	18.3	17.9	17.2	n.a.
Knowledge based economy								
Tertiary graduates[17]	57.1	n.a.	n.a.	n.a.	38.4	40.0	n.a.	n.a.
Spending on human resources[18]	6.0	6.3	n.a.	n.a.	4.9	n.a.	n.a.	n.a.
R&D expenditure[19]	3.4	3.4	3.49	n.a.	1.95	1.98	1.99	n.a.
Expenditures on IT[20]	4.5	4.4	n.a.	n.a.	4.2	4.2	n.a.	n.a.

For footnotes and sources see Table 1.1 for Belgium.

Table 13.2: Public finances in Finland (% of GDP)

	FINLAND					EU-15				
	2000	2001	2002	2003	2004	2000	2001	2002	2003	2004
Government balance	7.1	5.2	4.2	2.4	1.7	1.0	-0.9	-1.9	-2.7	-2.6
Primary balance	10.0	8.0	6.4	4.6	3.7	4.8	2.7	1.4	0.6	0.5
Cyclically adjusted balance	4.5	4.2	3.8	2.8	2.1	-1.2	-1.6	-2.1	-2.2	-2.0
Cyclically adjusted primary balance	7.3	7.0	6.0	4.9	4.0	2.6	2.0	1.3	1.1	1.1
Government debt	44.6	44.0	42.7	44.6	44.5	64.1	62.8	62.5	64.1	64.4

Source: Commission services.

14. SWEDEN

While Sweden's economic performance has been affected by the global downturn, the economy has held up relatively well supported by a stability-oriented macro-economic framework. Steady private consumption growth contributed to growth in 2003 and a recovery is expected in 2004 and beyond, benefiting from a revival in export markets and business activity. Inflation should remain in line with the Riksbank's 2% inflation target, underpinned by a negative output gap and moderate wage increases. In 2003, the situation on the labour market deteriorated with negative employment growth and a significant rise in unemployment. While addressed by the Swedish authorities, a strengthening of the incentives to work by means of further reducing negative effects on labour supply and employment stemming from the interaction of tax and benefit systems and by completing the tax reform, should result in higher labour force participation and a better labour market performance. The government surplus is expected to be low in 2003, in response to relatively weak economic growth. The Swedish fiscal policy framework and plans – with a strong emphasis on sound public finances - suggests that fiscal stance will be tight in 2004-05. Whereas Sweden had maintained its lead in R&D and innovation, the effects of the advanced stage of the transition to the knowledge-based economy does not yet seem to have fully materialised into higher productivity. Both the hourly productivity trend growth 2000-2002 and the hourly productivity level in 2002 are below the EU average. Contributing factors could be weak competition in several sectors of the economy and possible inefficiencies in the large public sector. Enhancing competition could also help to lower the Swedish price level, being one of the highest in the EU.

Key challenges in the light of recent developments

Sweden has made some progress in several key areas in implementing the 2003-05 BEPGs. However, the relatively weak cyclical position of the economy has impacted negatively on the room for fiscal manoeuvre and has been a constraint on some reforms, e.g. to complete the tax reform. Nonetheless, some steps towards strengthening the work incentives have been taken and additional measures are expected in 2004. Some initiatives have been taken with a view to strengthen competition and to increase efficiency in the public sector. The following sections present a more detailed assessment of recent developments in addressing Sweden's key policy challenges.

1. Labour market

Ensure an adequate labour supply in view of the ageing of the population,

Under this challenge, Sweden was requested to:

1. pursue further the reforms of tax and benefit systems to improve work incentives, in particular for those groups with high marginal effective taxes (GL 4 and E-REC 3), and complete the tax reform on labour income while maintaining sound public finances.

Some progress has been made, but several important issues are pending

Employment rates, while remaining very high and well beyond the Lisbon targets, have fallen during 2003, as economic activity has been subdued. The Swedish authorities have undertaken several steps with a view to improve work incentives. Efforts have been made to retain older workers in the labour force, to integrate immigrants into the labour market and to strengthen prospects for the young to find employment. However, there are also some elements that may have an adverse impact on labour supply. Preparations are underway to extend the 'free-year' initiative (an employee can, while paid a salary-linked benefit, take up to one year off under certain conditions) throughout the country, aimed at taking effect in 2005. Another measure having that could have a negative impact on supply are the plans tp reduce working time, for

which a pilot is starting in 2004. On the tax side, there has been some easing of labour taxation in the framework of the 'green tax swap' strategy. However, local government tax rates were increased in 2003 and further increases have been announced for 2004. The Swedish government intends to complete the tax reform – the fourth and final step – during the present term in office (until 2006). However, this hinges upon the government finances being 'sufficiently sound'. There would appear to be little room for going through with the reform unless it is offset in the Budget, keeping in mind the Swedish surplus target for the public finances of 2% of GDP on average over the cycle. There are no detailed plans as to when this reform will be implemented. On the benefit side, the authorities introduced a cut in the sickness insurance with the 2003 Spring Fiscal Policy Bill, which should strengthen the financial incentives to work. Other measures for this insurance have also been introduced, intended to curb the rising costs in this area e.g. the employers' financial responsibility for the sickness leave period has been extended from two to three weeks and the sickness benefit for unemployed persons can no longer exceed the highest unemployment benefit. In order to achieve the nationally set target of halving the number of sick days until 2008, additional measures are foreseen in 2004. Increasing labour market participation and employment further remains crucial, not least as the Swedish authorities do not expect to reach the nationally set target of raising employment by 2004, according to the latest Budget Bill. As noted above, Sweden has an ambitious surplus target, intended to ensure the long-term sustainability of the public finances with regard to the ageing of the population. While according to the Commission services estimates in the years to 2005 this target is not fully reached, Sweden is nevertheless expected to continue to show a sound fiscal position during this period, therefore continuing to respect the Stability and Growth Pact's requirement of a fiscal position 'close to balance or in surplus'.

2. Productivity and business dynamism

Enhance competition in certain sectors and improve the efficiency of the public sector.

Under this challenge, Sweden was requested to:

2. step up efforts to enforce competition in sectors where competition is inadequate (GL 9); and
3. make further efforts to increase the efficiency of the public sector, inter alia by improving framework conditions for increased competition, promoting the benchmarking of public sector efficiency, and by increasing public tendering (GL 11).

Some steps towards increased competition taken….

Prices in Sweden, including indirect taxes, remain among the highest in the EU, with very high price levels in sectors such as retailing, housing, construction and non-tradable services, and there are so far few signs of increased competition. Laws which came into effect in August 2002 have increased the effectiveness of competition policy, enabling the discovery and prosecution of several cartels during 2003. In September 2003 the government presented a proposal for a new law on price information, which is expected to increase price transparency in general and especially for the energy market and financial services. At the sectoral level the government has acknowledged that competition is weak in the food industry and construction. The establishment of a foreign food discount chain in 2003 may put pressure on food prices. A parliamentary committee will further investigate whether the local application of zoning and building legislation constitutes an entry barrier for competitors. Regarding the construction sector, proposals from a committee with the aim to increase competition are currently reviewed by the government. A project to increase competition and trade in the construction sector involving the Nordic and Baltic countries and Poland has started during 2003. The National Board of Trade will present a report on how to tackle and solve problems common to a number of service sectors. Regarding the rental housing sector no further measures have been taken to open-up the market, but there is evidence of greater influence of location factors as well as of production costs for new rental housing. Sweden is a pioneering country as regards efforts to simplify rules and reduce

administrative burdens to enterprises. However, according to representatives of the private sector there is still a lot to be done.

... but further room to increase public sector efficiency.

There is little evidence of increased efficiency in the public sector. Competition for public sector welfare services remains limited with private operators having less than ten percent of the market for schools and care for the elderly. There has been a long-term trend towards a slightly larger share of privately provided welfare services, but no further measures to increase the share of private operators in welfare services have been reported. In 2003 the Council for Municipal Analyses made publicly accessible a municipal benchmarking database containing more than 100 indicators covering mainly public services.

Table 14.1: Economic indicators for Sweden

	SWEDEN				EU 15			
	2000	2001	2002	2003	2000	2001	2002	2003
General economic background								
Real GDP[1]	4.4	1.1	1.9	1.4	3.6	1.7	1.1	0.8
Inflation[2]	1.3	2.7	2.0	2.3	1.9	2.2	2.1	2.0
Labour productivity[3]	1.9	-0.8	1.7	1.6	1.6	0.5	0.8	0.8
Employment growth[4]	2.4	1.9	0.2	-0.2	2.0	1.2	0.4	0.0
Nominal wage growth[5]	7.0	5.0	3.9	3.7	3.5	3.3	3.1	3.1
Unemployment[6]	5.6	4.9	4.9	5.7	7.8	7.4	7.7	8.1
Employment								
Employment rate[7]	73.0	74.0	73.6	n.a.	63.4	64.1	64.3	n.a.
Female employment rate[8]	70.9	72.3	72.2	n.a.	54.1	55	55.6	n.a.
Employment rate for older workers[9]	64.9	66.7	68	n.a.	37.8	38.8	40.1	n.a.
Long-term unemployment[10]	1.4	1.0	1.0	n.a.	3.5	3.1	3.0	n.a.
Tax rate on low wage earners[11]	47.9	46.8	45.9	n.a.	38.6	37.7	37.8	n.a.
Unemployment trap indicator[12]	n.a.	87.3	87.1	n.a.	n.a.	79.4	79.1	n.a.
Product market reforms								
Relative price levels[13]	121.9	113.0	117.3	n.a.	100	100	100	100
Total trade to GDP ratio (%)[14]	44.3	43.7	40.5	n.a.	59.6	59.0	58.1	n.a.
Single Market Directives[15]	98.8	99.1	99.6	98.4	97.0	98.0	97.9	97.7
Business investment[16]	14.8	14.4	13.5	n.a.	18.3	17.9	17.2	n.a.
Knowledge based economy								
Tertiary graduates[17]	38.0	38.5	n.a.	n.a.	38.4	40.0	n.a.	n.a.
Spending on human resources[18]	7.4	7.3	n.a.	n.a.	4.9	n.a.	n.a.	n.a.
R&D expenditure[19]	n.a.	4.3	n.a.	n.a.	1.95	1.98	1.99	n.a.
Expenditures on IT[20]	6.9	6.8	n.a.	n.a.	4.2	4.2	n.a.	n.a.

For footnotes and sources see Table 1.1 for Belgium.

Table 14.2: Public finances in Sweden (% of GDP)

	SWEDEN*					EU-15				
	2000	2001	2002	2003	2004	2000	2001	2002	2003	2004
Government balance	3.4	4.5	1.3	0.2	0.5	1.0	-0.9	-1.9	-2.7	-2.6
Primary balance	7.5	7.7	4.2	2.8	3.1	4.8	2.7	1.4	0.6	0.5
Cyclically adjusted balance	1.4	3.5	0.8	0.4	0.9	-1.2	-1.6	-2.1	-2.2	-2.0
Cyclically adjusted primary balance	5.4	6.8	3.7	3.0	3.5	2.6	2.0	1.3	1.1	1.1
Government debt	52.8	54.4	52.7	51.7	51.4	64.1	62.8	62.5	64.1	64.4

* Statistics Sweden published revised historical figures, including methodological changes, up to 2002 on 17 November 2003. Real GDP growth was revised to 4.3% in 2000 and to 0.9% in 2001. The general government balance was revised to 5.1% of GDP in 2000, to 2.9% of GDP in 2001 and to 0.1% of GDP in 2002. The primary balances were adjusted by similar magnitudes. The cyclically adjusted (and primary) balances were additionally affected by the impact of the GDP revisions on the cyclical component of the balances.

Source: Commission services.

15. UNITED KINGDOM

The UK's macro-economic performance continues to combine low inflation, low unemployment and steady growth, and is now recovering from the relatively slow growth rate as the global economy situation improves in a framework of supportive, stability-oriented macro-economic policy. For 2003 as a whole, growth is expected to be some way below trend growth as a result of a less strong private consumption, but a recovery in fixed investment and export growth. Actual and prospective inflation is subdued, as an output gap persists, although it is narrowing. The easy monetary stance of the recent past, together with large rises in government expenditure, has helped maintain domestic demand growth in 2003. Employment growth remained healthy and unemployment stabilised on a low level. To sustain labour supply in the longer term, as well as address social concerns, the UK authorities have announced some new initiatives for the disabled, but the number helped by such policies is small. Recent revisions of national accounts data give an improved picture of UK productivity growth. Nevertheless, the level of productivity remains well below the EU average. The reforms undertaken to tackle this problem will take some time to produce their effects. Among these reforms are many initiatives to boost training and basic skills. The UK authorities have also made some progress in opening up certain protected sectors, such as professional bodies, pharmacies and postal services. While the UK is below the EU average in terms of R&D expenditure as a percentage of GDP, a mechanism has now been put in place for evaluating the science and technology strategy. To help ensure that the large rises in public expenditure are as effective as possible, the government launched a consultation process for an efficiency review.

Key challenges in the light of recent developments

The key challenges for the United Kingdom as identified in the 2003-05 BEPGs include the need to improve the relatively low level of productivity, to address the high numbers of working-age people claiming sickness and disability benefits and sustain labour supply in the longer term, and to improve the quality and efficiency of public services. This is particularly important given that there is a widening general government deficit. This was 1.4% of GDP in 2002, and is expected to widen further. The Commission is projecting deficits of around 2¾% of GDP in 2003 and 2004. A more detailed assessment of recent developments in addressing the UK's key policy challenges is presented in the following sections.

1. Productivity and business dynamism

Improve the relatively low level of productivity,

Under this challenge, United Kingdom was requested to:

1. continue to improve competition in sectors like the professions, postal services and pharmacies (GL 9);
2. monitor closely existing measures to promote R&D (GL 13); and
3. review and strengthen, where appropriate, policies aimed at improving basic skills in the work force (GL 13).

Although a revision of the national accounts has improved the picture of UK productivity growth, the relatively low level of productivity remains a key challenge for the UK. Productivity per person employed was still well below the EU average in 2002 although the gap has been declining in recent years. While the UK did embark on reforms, their effect will take time to feed through into increases in productivity. The government itself has identified five priority areas for further action to improve productivity: strengthening competition to promote greater business efficiency and consumer choice, promoting enterprise by removing market barriers to entrepreneurship, improving the skills base, encouraging investment through stronger local and

national capital markets, and supporting science and innovation to harness the potential of new technologies.

Some progress in opening up protected sectors

The Enterprise Act 2002 increased the powers of the competition authorities. Amongst other things, it is no longer possible for the government to exclude the rules of professional associations from control by the competition authorities. The Office of Fair Trading has made some progress in persuading professional bodies, particularly in accountancy, to amend anti-competitive rules. The government has announced a slight relaxation of the restrictions on the location of pharmacies. On the other hand, full opening of the postal markets is not foreseen until 2007, although this deadline is to be reviewed in 2005.

A mechanism is in place for evaluating the science and technology strategy

A wide range of measures for promoting research and innovation is in place. Nevertheless, the U.K. is below the EU average in terms of the percentage of GDP spent on R&D, both by businesses and by government. The Department of Trade and Industry has a long-established mechanism for evaluating initiatives in this field but the published reports are limited in scope. The most important recent initiative in this field was the extension of tax credit for R&D to large companies. Since this measure only applies to expenditure incurred since April 2002, it is clearly too early to assess its impact.

Many initiatives to boost training and basic skills

As was mentioned above, the UK government has identified five priority areas for increasing productivity. One of these concerns improving the skills base. The UK authorities thus consider improving skills among young people and the adult workforce to be one of the key drivers of productivity performance.

The 2003 Budget included a number of measures to boost training and basic skills as a direct policy response to improving productivity. Further, in July 2003, the authorities presented a White Paper on Skills Strategy in which additional initiatives have been announced. It outlines an agenda for sustained effort over the long term, through to 2010 and beyond. As for basic skills, the government's target is to raising the literacy and numeracy skills of 750,000 adults by 2004 and those of 1.5 million adults by 2007. It is as yet too early to assess the impact of these measures, especially since a number of them take the form of pilot schemes.

The 2003 Budget announced measures including pilots for improving access to training such as extending the Employer Training Pilots which were launched in September 2002, and introducing a new form of adult learning grant. The government also announced the creation of a Sector Skills Council network. Sector Skills Councils are independent, UK-wide organisations who are licensed to tackle the skills and productivity needs of their sector throughout the UK. The first full five year licences were issued in April 2003. The UK authorities claim to be on track to establish 23 Sector Skills Councils by summer 2004. In their approach to apprenticeships, the UK authorities intend to meet a target that, by 2004, 28% of 22 year-olds will have entered an apprenticeship. The plan is to have 320,000 young people will be participating in an MA by 2006. The Budget also enhanced MAs by lifting the current age cap, so adults can benefit.

Although the medium-to-long term perspective encouraged by the White Paper on Skills Strategy, and the initiatives to strengthen apprenticeships and facilitate adult learning are steps in the right direction, it is premature to judge whether the many different initiatives will work together, as a set, to raise productivity by boosting basic skills in the UK.

2. *Labour market*

Address the high numbers of working-age people claiming sickness and disability benefits and sustain labour supply in the longer term,

Under this challenge, United Kingdom was requested to:

4. ensure that all those who are able to work have the opportunities and incentives to do so, in particular by examining and reforming as necessary sickness and disability benefit schemes (GL 4 and E-REC 3).

New initiatives for the sick and disabled

While unemployment has fallen to around 5%, the number of people claiming incapacity benefit and severe disability allowance was 2.7 million in 2003Q2, slightly more than the trough value at the beginning of 2000. Survey evidence suggests that many of these people – the Labour Force Survey suggests over a quarter – would like to work if they could find suitable employment and obstacles to accessing work could be overcome. Finding ways to encourage all these people to find work will sustain labour supply in the longer term and address social concerns.

In its 2003 Budget, the government announced further pilot projects to provide claimants with better advice (the extension to the New Deal for Disabled People), new programmes which aim to provide recipients of incapacity-related benefits with greater support and improved financial incentives (such as the Pathways to work programme, launched in October 2003, and the newWorking Tax Credit). Also mentioned in the Budget in this context was the National Minimum Wage. In March 2003, the Fourth Report from the Low Pay Commission (LPC) found that the National Minimum Wage had also benefited disabled workers. In particular, the LPC found that when the National Minimum Wage was increased in October 2001, it specially benefited working disabled people and women. It is estimated that 70% of employees benefiting from the increase were women, 13% were disabled, and two-thirds worked part-time. As a result of these findings, the government has announced an increase to the National Minimum Wage as of October 2003 and, subject to consideration of the LPC's review early next year, again as of October 2004. However, any beneficial effects on the supply of disabled workers may be counteracted by the impact on employers' demand for labour of the increased National Insurance Contributions (NICs) which came into effect in April 2003. It is as yet premature to assess the impact, if any, of the NICs changes on labour demand. More analysis by the authorities on the combined impact of changes in the National Minimum Wage and in the the tax and social insurance regime would give a more complete picture of the work opportunities facing the disabled.

In 2003 the Government introduced regulations, which implement the disability provisions of the EU Article 13 Employment Directive and come into force in October 2004. Existing anti-discrimination legislation is affected, such as the Disability Discrimination Act (DDA). In this context, a draft Disability Discrimination Bill was proposed on 3 December 2003. The current DDA exemption of small employers (i.e. those with fewer than 15 employees) will be ended together with a wide range of occupational exclusions, bringing within the scope of the DDA occupations like the police, fire-fighters, barristers in chambers and partners in business partnerships. The authorities estimate that these changes will extend the DDA's coverage to over 1 million additional employers, 7 million further jobs and 600,000 disabled people already working in those jobs.

The number helped by policies specifically targeted at the disabled so far was relatively small compared to the 2.7 million claiming incapacity benefit and severe disability allowances. The new policy initiatives would appear to be addressing this weakness.

Improve the quality and efficiency of public services.

Under this challenge, United Kingdom was requested to:

5. ensure that the public services associated with the announced increases in public expenditure (including investment in the transport infrastructure) are delivered efficiently and with a view to ensuring cost-effectiveness (GL 11 and 14).

Consultation process for an efficiency review underway

The government has budgeted for a large increase in expenditure on public services. As a result of decisions taken in the 2002 Spending Review, public sector net investment is projected to rise steadily to 2¼% of GDP in 2007-08 from around 1.0% of GDP in 2002-03. Current expenditure is set to rise by 2.6% a year in real terms in 2004-05 and 3.7% in 2005-06. NHS healthcare spending is planned to grow by 7.2% per year in real terms over the same period. Planned spending on education is set to grow by 6.0% a year and on transport by 8.3%. These increases are affecting the public finances. There was a general government deficit of 1.4% of GDP in 2002, and it is expected to widen further in 2003 as some tax revenues, notably income and corporation tax, are weak, while discretionary expenditure growth is forecast to rise strongly as planned. The Commission Autumn 2003 forecast projects deficits of around 2¾% of GDP in 2003 and 2004. The ratio of gross debt to GDP, though increasing slightly, is forecast to be close to 40% by the end of 2005.

The UK government has recognised the need to accompany the increases in expenditure with reforms designed to ensure that these resources are used and allocated efficiently and effectively, that consumers receive high quality public services and that both consumers and taxpayers receive best value for money. Some may argue that the significant increases in general government consumption and investment expenditures in real terms (at 2.4% and 10.8% respectively in 2002) are a testimony to the beneficial impact of this efficiency drive. However, a note of caution is sounded by the noticeable rise in the value of the public expenditure deflators in recent years. For example, the general government consumption deflator was a robust 6.8% in 2002.

To further address this issue, the Chancellor announced an Efficiency Review in his Budget speech in the Spring. The Review seeks to maximise the effectiveness of investment going into public services by assessing measures to strengthen the transfer of best practice and support the devolution of funds to local bodies. A consultation process was launched in October 2003, with views sought by 21st November 2003. No conclusions on the effectiveness of this measure can therefore be drawn yet.

A well-established policy cornerstone for public expenditure reform is the use of Public Service Agreements (PSAs). These were first introduced in the 1998 Comprehensive Spending Review and are central to the Government's strategy for public service reform and improved delivery. PSAs set targets for the outcomes that each department is committed to achieving, so they form an integral part of the Government's public spending framework. Government departments now publish details of progress against their targets twice a year, in their Autumn and Spring departmental reports. As of April 2003, the government introduced an innovation in this area in the form of regular web-based reporting against all the new PSA targets, making all the latest performance information accessible to the public in a single place, the website of HM Treasury. Alongside these developments in public accountability, HM Treasury and the Cabinet Office have worked closely with departments to improve departmental capacity to manage performance to deliver the public service improvements outlined in PSAs. This includes improving work on active performance management and use of the evidence base in developing policies. The 2003 Budget specifically stated that "targets set out in PSAs have contributed to a genuine shift in departmental culture away from inputs and processes and towards the delivery of outputs and

results." In addition, following a public consultation, in January 2003 the Treasury issued a new edition of its long-standing guide to appraisal and evaluation – the 'Green Book'. This guidance is binding on all government departments, their agencies and Non-Departmental Public Bodies. Departments are required to follow the principles and practice set out in the Green Book, requiring them to justify departures from the guidance when circumstances dictate. The principles of appraisal and evaluation in the Green Book help ensure that lessons from the delivery of outputs and results are widely learned, communicated and applied when assessing new proposals.

Table 15.1: Economic indicators for United Kingdom

	UNITED KINGDOM				EU-15			
	2000	2001	2002	2003	2000	2001	2002	2003
General economic background								
Real GDP[1]	3.8	2.1	1.7	2.0	3.6	1.7	1.1	0.8
Inflation[2]	0.8	1.2	1.3	1.4	1.9	2.2	2.1	2.0
Labour productivity[3]	2.7	1.5	1.6	1.4	1.6	0.5	0.8	0.8
Employment growth[4]	1.1	0.6	0.1	0.7	2.0	1.2	0.4	0.0
Nominal wage growth[5]	6.0	4.7	4.3	4.3	3.5	3.3	3.1	3.1
Unemployment[6]	5.4	5.0	5.1	4.9	7.8	7.4	7.7	8.1
Employment								
Employment rate[7]	71.5	71.7	71.7	n.a.	63.4	64.1	64.3	n.a.
Female employment rate[8]	64.8	65.0	65.3	n.a.	54.1	55	55.6	n.a.
Employment rate for older workers[9]	50.8	52.3	53.5	n.a.	37.8	38.8	40.1	n.a.
Long-term unemployment[10]	1.5	1.3	1.1	n.a.	3.5	3.1	3	n.a.
Tax rate on low wage earners[11]	25.3	24.5	24.7	n.a.	38.6	37.7	37.8	n.a.
Unemployment trap indicator[12]	n.a.	70.4	70.3	n.a.	n.a.	79.4	79.1	n.a.
Product market reforms								
Relative price levels[13]	112.8	110.3	107.5	n.a.	100	100	100	100
Total trade to GDP ratio (%)[14]	28.9	28.3	27.6	n.a.	30.2	29.9	29.1	n.a.
Single Market Directives[15]	97.3	97.2	98.6	98.6	97.0	98.0	97.9	97.7
Business investment[16]	15.8	15.6	15.0	n.a.	18.3	17.9	17.2	n.a.
Knowledge based economy								
Tertiary graduates[17]	30.2	35.4	n.a.	n.a.	38.4	40.0	n.a.	n.a.
Spending on human resources[18]	4.4	4.5	n.a.	n.a.	4.9	n.a.	n.a.	n.a.
R&D expenditure[19]	1.85	1.89	1.84	n.a.	1.95	1.98	1.99	n.a.
Expenditures on IT[20]	5.6	5.6	n.a.	n.a.	4.2	4.2	n.a.	n.a.

For footnotes and sources see Table 1.1 for Belgium.

Table 15.2: Public finances in United Kingdom (% of GDP)

	UNITED KINGDOM					EU-15				
	2000	2001	2002	2003	2004	2000	2001	2002	2003	2004
Government balance	3.9	0.7	-1.5	-2.8	-2.7	1.0	-0.9	-1.9	-2.7	-2.6
Primary balance	6.6	3.1	0.5	-0.7	-0.7	4.8	2.7	1.4	0.6	0.5
Cyclically adjusted balance	0.8	0.4	-1.4	-2.4	-2.3	-1.2	-1.6	-2.1	-2.2	-2.0
Cyclically adjusted primary balance	3.5	2.7	0.6	-0.3	-0.3	2.6	2.0	1.3	1.1	1.1
Government debt	42.1	38.9	38.5	39.6	40.5	64.1	62.8	62.5	64.1	64.4

Source: Commission services.