COUNCIL OF
THE EUROPEAN UNION

Brussels, 8 January 2007

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COVER NOTE

from:	Secretary-General of the European Commission, signed by Mr Jordi AYET PUIGARNAU, Director
date of receipt:	22 December 2006
to:	Mr Javier SOLANA, Secretary-General/High Representative
Subject:	Annex to the Communication from the Commission to the Spring European Council Implementing the renewed Lisbon Strategy for growth and jobs - "A year of delivery" (PART IV/IV)

Delegations will find attached Commission document COM(2006) 816 final (Part IV).

Encl.: COM(2006) 816 final (Part IV)

COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 12.12.2006
COM(2006) 816 final
ANNEX

ANNEX TO THE

COMMUNICATION FROM THE COMMISSION TO THE SPRING EUROPEAN COUNCIL

IMPLEMENTING THE RENEWED LISBON STRATEGY FOR GROWTH AND JOBS

"A year of delivery"

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MACROECONOMIC PART

1. SUMMARY AND CONCLUSIONS

The macroeconomic outlook has considerably brightened, with economic growth in the EU25 increasing from 1.7% in 2005 to 2.8% in 2006. Recent Commission forecasts indicate that growth should continue in line with potential, estimated at slightly below 2½%, for at least the next two years. Resilient employment growth, coupled with a substantial drop in unemployment in 2006, suggest that the favourable trends are not due to cyclical developments alone, and that some structural improvements have taken place in the functioning of labour markets. Though caution must be exercised before drawing definitive conclusions on the source of the rebound, there are emerging signs that part of the observed rebound in labour utilisation and labour productivity is due to structural improvements and microeconomic reforms.

Stable macroeconomic conditions, including enhanced budgetary consolidation in line with the renewed Stability and Growth Pact, are underpinning the improved outlook for growth. Despite higher energy prices, inflation in the EU25 has hovered just above 2% in 2006. The EU25 current account deficit has grown, but this is likely to be a transitory consequence of high energy prices, stronger growth and an appreciation of the euro against major currencies. That being said, the external balance of several new Member States have reached levels that need careful monitoring, and for a number of euro-area Member States, they point to potential competitiveness challenges.

Income gaps exist between Member States due to differences in labour utilisation (i.e. hours worked by persons employed) and labour productivity. While many of the EU10 countries were able to narrow the income gap with the EU average as part of a catching-up process between 2000 and 2005, the general economic slowdown led to disappointing outcomes elsewhere, especially in some euro-area countries. A positive development, during this period, however, was the contribution of labour market participation (especially of women and older workers) to growth although these benefits were offset by a reduction in the average number of hours worked per person employed.

Ageing populations will significantly reduce the EU's economic growth potential in coming decades and lead to large increases in public spending on pensions and health care. More than half of all EU Member States, including many euro area countries, face medium to high risks to the sustainability of their public finances on the basis of current policies. During 2006, progress was made in addressing this key challenge. Many countries, including those with the highest deficits, pursued budgetary consolidation efforts, and consequently there was a halt in the increase of the debt/GDP ratio of the EU25 for the first time since 2002. Also, several countries adopted or announced reforms to pensions and health care systems, e.g. by increasing statutory retirement ages and strengthening incentives for older workers to remain in the labour market. These reforms, coupled with the implementation of measures already enacted in recent years, are starting to pay-off. Commission analysis suggests that they account for a sizeable proportion of the large observed increases in the employment rate of older workers. Notwithstanding these developments, sustainability risks remain in many countries, and the Commission has issued recommendations to several Member States to pursue an appropriate combination of reforms to reduce debt at a faster pace, to raise employment rates (especially of women and older workers) and to reform pension and health care systems (while respecting the goals of access, adequacy and financial sustainability of social protection systems).

Wage moderation has continued to support price stability in the EU25. Nominal unit labour costs have grown less than 2% in 2006, slightly more than in 2005. To make work pay, Member States have lowered levels of income taxation, either across the board or for specific groups such as the low paid. Some Member States have focused on boosting labour demand by cutting employers' social security contributions or reducing payroll taxes. Overall though, poverty, unemployment and inactivity traps remain to be tackled in many Member States.

A key feature of the relaunched Growth and Jobs Strategy (GJS) is to provide a framework in which macroeconomic policies and structural reforms are mutually reinforcing in pursuit of higher employment and growth potential. The comprehensive approach aims at ensuring that structural reforms, in both the microeconomic and employment pillars, form internally consistent packages where interlinkages are fully exploited. The objective is to yield an aggregate economic impact which is greater than the effect of individual reform measures and that possible negative effects on specific groups can be offset by reforms in other areas. The implementation reports prepared by Member States suggest that a more integrated and comprehensive approach to reforms is starting to take hold, and moreover that reform efforts at EU and national level are becoming better aligned. These findings are backed up by Commission analysis made using a variety of economic models. The results show that past reforms have delivered significant benefits, and that further reforms in key areas of the Strategy could generate important additional gains in terms of jobs and growth. The modelling results provide support for the existence of positive interactions between structural reforms in different areas, and the spillovers between reforms at EU and national level, the magnitude of which is being enhanced through the growing intensity of trade and investment between Member States.

2. MACROECONOMIC DEVELOPMENTS

2.1. Raising the growth and jobs potential of the EU

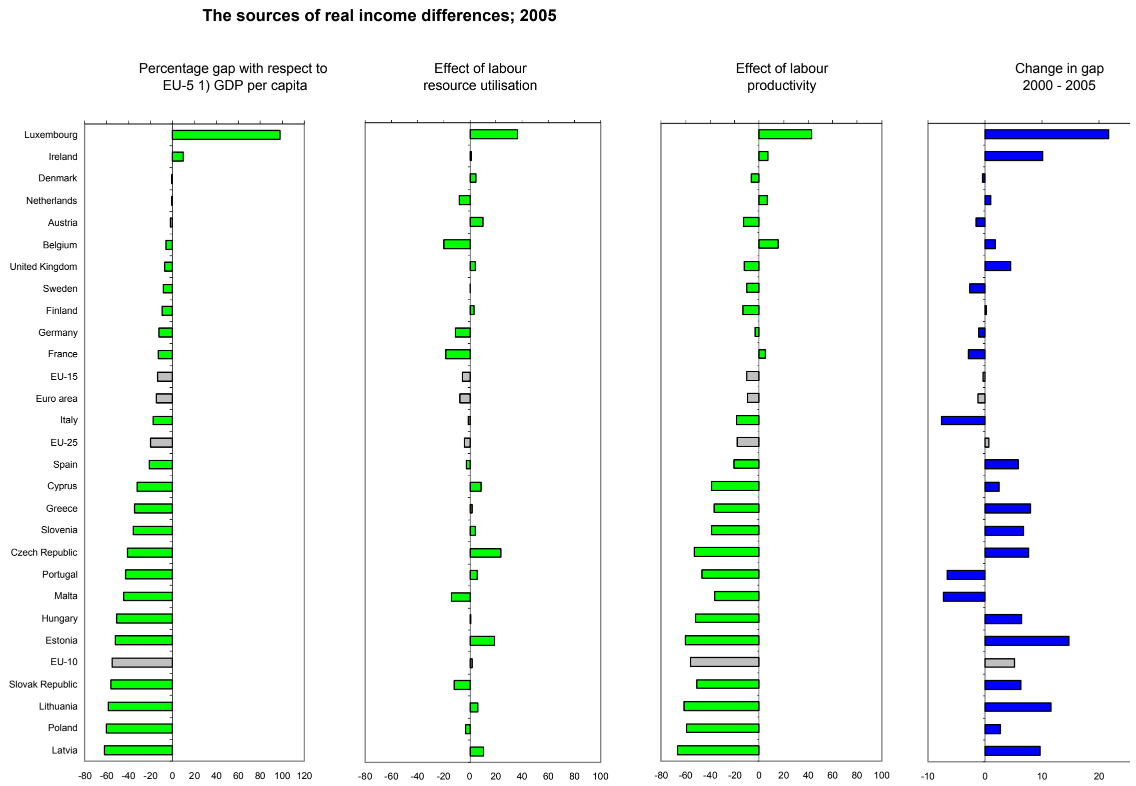
In March 2005, the Lisbon strategy was re-launched placing jobs and growth at the top of European political priorities. This focus stemmed from the recognition that economic growth in Europe has been disappointing relative to the most dynamic economies in the world, and that the Union faces major challenges in coping with globalisation and ageing populations. Euro area countries[1] face the additional challenge of improving the capacity of their economies to adjust to economic shocks in the absence of national monetary or exchange rate policies.

As illustrated in Graph 1, many EU-25 countries display a strong income gap vis-à-vis the best performing EU countries. In 2005, the average per capita GDP of the EU-25 was 20% below that of the five best performing EU countries (33% below that of the US). For EU-15 countries, the gap is mainly due to lower labour utilisation (i.e. the numbers of hours worked in the economy), whereas lower labour productivity (measured in terms of output per hour) is

1 Slovenia will enter the euro area in January 2007. The analysis in this text on the euro area focuses on the EUR-12, i.e. excluding Slovenia. A more thorough analysis of developments in the euro area can be found in the Annual Statement on the Euro Area - COM(2006) 392.

the main explanatory factor for EU-10 countries. The final column in Graph 1 indicates that EU-10 countries in particular have narrowed the income gap benefiting from the process of real convergence. However, progress has been mixed, with some euro area countries such as DE, FR, NL, AT and PT losing ground (also MT and SE outside the euro area).

Graph 1: Overview of the income gap in the EU-25 Member States



Note: The gap is measured relative to average of the five best performing countries in 2005 in terms of GDP per capita measured in 2000 purchasing power standards, i.e. LU, IE, DK, NL and AT

A closer breakdown on Graph 2 indicates that labour productivity gains accounted for two-thirds of the average economic growth recorded in EU-25 2000-2005, with labour inputs accounting for the remaining third. Labour inputs benefited from a growing working-age population: while demographic developments are largely beyond government influence, policy measures can influence migratory flows which are an increasingly important source of labour supply. The rise in participation rates, especially of women and older workers, was offset by the decline in average hours worked per person employed. Some of these changes are due to reforms to "make work pay" and to pension schemes, although cyclical effects and long-run societal change such as rising educational attainment levels also play a role. As regards labour productivity, technical progress appears to have been a stronger driving force than investment. However, there is an important cyclical component to productivity developments, although policy measures such as R&D and human capital formation may also have been contributory factors.

Graph 2: **Real GDP growth of EU25 in 2000-2005 and its components**

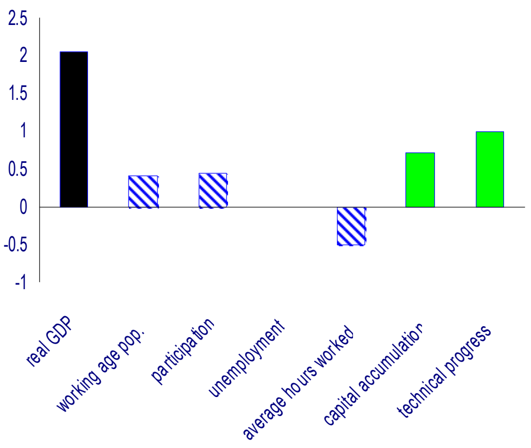


Table 1: Main features of the Commission forecast,
EU-25, % chg

	2005	2006	2007
GDP	1.7	2.8	2.4
Consumption	1.5	2.2	1.9
Investment	3	4.9	3.6
Employment	0.9	1.4	1.1
Unemployment (a)	8.8	8	7.6
Inflation (b)	2.2	2.3	2.3
Government balance (% GDP) (c)	-2.3	-2	-1.6
Government debt (% GDP)	63.3	62.5	61.4
Current account balance (% GDP)	-0.4	-0.5	-0.4

Note: * Technical progress is measured as a residual. It is often called Total Factor Productivity. (a) Percentage of labour force, (b) Harmonised index of consumer prices, (c) including proceeds relative to UMTS licenses.

Source: DG ECFIN

2.2. Macroeconomic developments in 2006

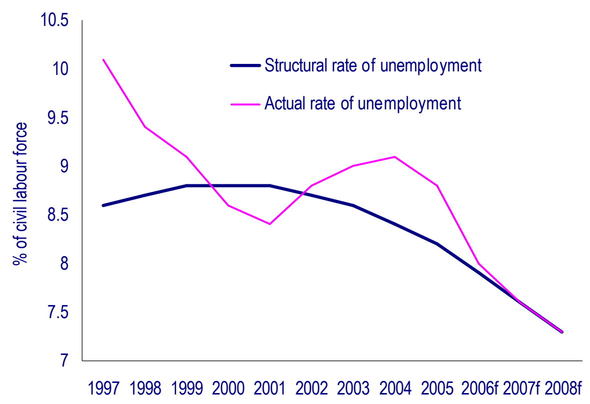
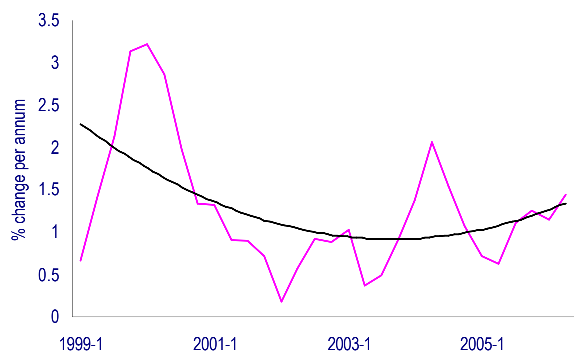
The macroeconomic outlook in the EU considerably brightened in 2006 after a protracted period of slow growth. GDP growth accelerated from 1.7% in 2005 to an above potential rate of 2.8% in 2006, and is forecast to grow in line with its potential of some 2½% in the next two years. The swift pace of economic growth in the first half of 2006 was well rooted in the larger euro-area Member States, with Spain posting an average annual growth rate of almost 4%, the Netherlands close to 3% and Germany at 2.3%. Outside the euro area, buoyant growth is projected for many of the EU-10 Member States. In line with the elevated level of business confidence and a strong turnaround in corporate profitability, there was surge in investment spending in the first half of 2006. A significant acceleration can also be observed for private consumption from apace of 1.5% in 2005 to 2.2% in 2006, which owes much to the improved performance of the labour market. Compared to a growth rate of just 0.9% in 2005, employment accelerated at an annual pace of 1.4% in 2006, the strongest pace since summer 2001, and the unemployment rate declined to 8.0%. Net trade also strongly improved in 2006, and although support from the global economy to the EU-25 GDP is likely to be more limited in the coming quarters, the outlook for a continuation of economic growth looks solid as it appears less dependent on external demand.

2.3. Are past reforms starting to pay dividends?

Caution must be exercised before drawing definitive conclusions on the source of the rebound. To a large extent, it has been driven by cyclical factors. However, the upturn has been supported by macroeconomic stability, and policies such as budgetary consolidation and a greater focus on ensuring sustainable public finances in the face o population ageing, a process that has been aided by a reformed Stability and Growth Pact[2]. The recent enlargement of Union may also have contributed to dynamism, and there are emerging signs that part of the observed rebound in labour utilisation and labour productivity is due to structural improvements and microeconomic reforms:

– some evidence is available that the observed gradual improvement in labour markets is more than a reflex of cyclical developments. The resilient employment performance during the years of sluggish growth already indicated that structural improvements have taken place[3]. Meanwhile, structural unemployment seems to have embarked on a clear downward trend, with a substantial drop in the estimated rate in 2006. The most evident link between reforms and labour market performance is apparent in the area of pension reforms and changes to early retirement rules, which were followed by a significant increase in the employment rate of older workers in many Member States over the last years.

– The picture is more mixed for productivity developments. On the one hand, a significant part of the labour productivity acceleration is of cyclical character and some of the investment has been driven by one-time factors. One the one hand, it is reassuring that both investment rebounded and productivity growth accelerated, although it would need to be sustained over a longer period before one could safely attribute positive changes to productivity and investment developments to structural improvements and microeconomic reforms.

<table>
<tr><th>Graph 3: Actual structural unemployment, EU-25</th><th>Graph 4: Labour productivity growth, actual and trend line, EU-25</th></tr>
<tr><td>
</td><td>
</td></tr>
<tr><td>Sources: Commission services
Notes: Structural rate of unemployment measures as NAWRU (Non-accelerating wage rate of unemployment), Commission Autumn 2006 forecast for 2006-2008.</td><td>Sources: Commission services</td></tr>
</table>

[2] Commission Communication 'Public finances in EMU-2006: the first year of the revised Stability and Growth Pact" - COM(2006) 304.

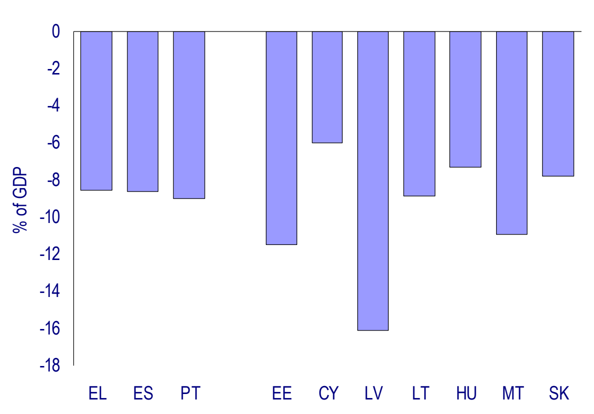
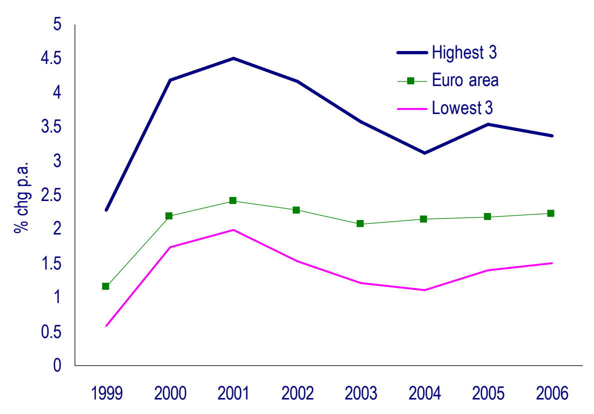
[3] European Commission (2006), 'Labour market and wage developments in 2005 with a special focus on adjustment in the euro area', European Economy Special report No 4, http://ec.europa.eu/economy_finance/publications/european_economy/2006/eespecialreport0406_en.htm

3. STABLE MACROECONOMIC CONDITIONS

Stable macroeconomic conditions are underpinning the improved outlook for growth. Despite higher energy prices, headline inflation in the EU-25 has hovered just above 2% in 2006. Core inflation, although edging up slightly in the course of the year 2006, has remained subdue at around 1½ %. Service inflation runs at a relatively high rate and appears to be persistent. However, second-round effects on wages have not materialised: indeed, wage moderation in 2006 has continued to support price stability in the EU-25. Annual growth in compensation per employee, which is the most prominent indicator, is forecast to have increased by just over 3% in 2006. Combined with labour productivity growth of 1.3%, this led to an increase in nominal unit labour costs by 1.8%, slightly more than in 2005.

The move of the EU-25 current account balance into negative territory is unlikely to signify the emergence of external imbalances, but is a transitory consequence of high energy prices, stronger growth and an appreciation of the euro against major currencies. It is normal for catching-up countries with high rates of growth to record current account deficits as investment demand often exceeds domestic savings. Notwithstanding the catching-up investment requirements, the current account deficits in several EU-10 Member States (EE, CY, LV, LT, HU, MT, SK) may warrant ongoing monitoring. Especially in the three Baltic States, the current account deficit widened significantly and signs of overheating emerged, most visibly in accelerating wage growth. In 2006, the trade deficit in LV is expected to reach almost 23% of GDP and the current account around 16% of GDP, which is the highest deficit recorded in any EU-25 Member State over the last 10 years.

Sustained and large current account deficits are indicative of deteriorating competitiveness. The restoration of competitiveness within the euro area may lead to painful adjustment because it is likely to involve a protracted slowdown of demand and increasing unemployment. In several euro area countries (EL, ES, PT), current account deficit is higher than 5% of GDP in both 2005 and 2006, and might be indicative of a lack of competitiveness.

Graph 5: Current deficits in selected EU Member States, 2004.	Graph 6: Inflation differences in the euro area, 1999-2006
	
Source: Commission services.	Source: Commission services.

4. ENSURING SUSTAINABLE PUBLIC FINANCES

4.1. The risks to the sustainability of public finances

The population of EU-25 is set to become slightly smaller, but much older, in coming decades dues to low fertility rates and continuous increases in life expectancy. With the baby-boom generation entering into retirement years after 2010, the EU will move from having four persons of working-age for every elderly citizen aged 65 or above to only two. Recent projections[4] indicate that due to the impact of ageing on the size of the working-age population, potential growth rates will fall sharply. Moreover, and as reported in the first column Table 2, it will lead to large increase in public spending, especially on pensions and health care. A recent detailed analysis by the European Commission[5] shows that on the basis of current policies including outstanding level of debt, there is a medium or high risk to the sustainability of public finances in a majority of EU and euro area countries

4 EPC and European Commission (2006): '*The impact of ageing populations on public expenditures: projections for the EU25 Member States on pensions, health care, long-term care, education and unemployment transfers'* European Economy Special Report No 1, http://ec.europa.eu/economy_finance/publications/european_economy/2006/eespecialreport0106_en.htm

5 European Commission (2006) 'Long-term sustainability of public finances in the EU', European Economy No 4, http://ec.europa.eu/economy_finance/publications/european_economy/2006/ee0406sustainability_en.htm

Table 2: Sustainability challenges and reform measures

	Diagnosis of challenge				Measures		
	Projected change in age-related expenditure*	Debt level 2006^{+}	Sustainability	Structural budget balance 2005^{+}	Change in structural balance 2005-07^{+}	Reference to reform in NRP	
						Pension	Health Care

	Diagnosis of challenge				Measures			Conclusions	
	Projected change in age-related expenditure*	*Debt level 2006^{+}*	*Structural budget balance 2005^{+}*	*Sustain-ability risk*	*Change in structural balance 2005-07^{+}*	Reference to reform in IR		*Watch-list[1]*	*CSR*
						Pension	*Health care*		
EL		105	-5.9	High	2.6	Yes	Yes	Yes	Yes
PT	10.1	67	-5.1	High	1.9	Yes	Yes	Yes	Yes
SI	9.7	28	-0.9	High	-0.6			Yes	Yes
CY	11.8	66	-2.7	High	1.5	Yes	Yes	Yes	Yes
CZ	7.2	31	-2.2	High	-1.9	Yes		Yes	Yes
HU	7.6	68	-8.5	High	1.9	Yes		Yes	Yes
BE	6.3	89	0.2	Medium	-0.5		Yes	Yes	
DE	2.7	68	-2.7	Medium	1.3	Yes	Yes	Yes	Yes
ES	8.5	40	1.5	Medium	0.1	Yes			
FR	3.2	65	-3.1	Medium	0.8	Yes	Yes	Yes	Yes
IE	7.8	26	1.0	Medium	0.7	Yes		Yes	
IT	1.7	107	-3.9	Medium	1.4	Yes		Yes	Yes
LU	8.2	7	0.0	Medium	-0.2	Yes		Yes	
MT	0.3	70	-4.0	Medium	1.5	Yes		Yes	
SK	2.9	33	-1.7	Medium	-1.7				
UK	4.0	44	-3.4	Medium	0.9	Yes		Yes	
AT	0.2	62	-0.9	Low	-0.3			Yes	
FI	5.2	39	3.4	Low	-0.6	Yes			
DK	4.8	29	5.1	Low	-0.8	Yes			
EE	-2.5	4	2.2	Low	-1.2	Yes			
LT	1.4	19	-0.8	Low	-0.6	Yes	Yes		
LV	-1.3	11	0.2	Low	-1.5				Yes[2]
NL	5.0	51	0.9	Low	-0.5	Yes	Yes		
PL	-6.7	43	-2.3	Low	0.2		Yes		Yes[2]
SE	2.2	47	2.9	Low	-0.8				
EU12	3.8	70	-2.0		0.9			Yes	

Note: CSR: country-specific recommendations. IR: Implementation Report[1] Sustainability either directly mentioned or an important reform area of importance for sustainability emphasised[2]. Recommendations to Latvia and Poland are not based on long-term fiscal sustainability concerns but, respectively, on securing macroeconomic stability and improving expenditure control institutions. (*) Projected change between 2004 and 2050, in % of GDP. Source: EPC and European Commission (2006). (+) in % of GDP. Source: Autumn Economic forecast, European Commission, 2006.

This confirms the approach adopted in the last year's National Reform Programmes, where nearly all Member States identified budgetary sustainability as a key macroeconomic challenge. In a recent Communication[6], the Commission concluded that the Strategy for Growth and Jobs, with its emphasis on raising employment of all groups, extending working lives and increasing investment in human capital throughout the life course, is an appropriate basis for responding to challenge of ageing populations. As a response to risks to the sustainability of public finances, the Commission has advocated that a three-pronged strategy be pursued, i.e. reduced debt at a fast pace, raising employment rates and productivity, and

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6 Commission Communication 'The demographic future of Europe – from challenge to opportunity' - COM(2006) 571, 12.10.2006.

reform pension, health care and long-term care systems. In assessing whether Member States have made progress in addressing the key challenge of the sustainability of public finances, the Commission has considered all three elements (this annex covers budgetary consolidations and pension/health care reform, whereas employment developments are addressed more fully in an accompanying annex).

4.2. Assessing progress with budgetary consolidation

Public finances have turned out better than expected. In 2006, the budgetary deficit for the EU-25 is projected to be at 2.0% of GDP, down from 2.3% in 2005. Based on a "no-policy-change" assumption, the Commission forecast the deficit to remain on a declining path in the next two years, reaching 1.6% in 2007, chiefly thanks to expenditure restraints, and 1.4% of GDP in 2008. Public debt is expected to embark on a downward trend after the increase witnessed over the past years. Following the peak of 63.3 % of GDP in 2005, the debt ratio for the EU-25 is expected to decline to around 60.5% in 2008.

When account is taken of cyclical factors, one-off and other temporary measures, the structural balance in the EU-25 is expected to improve by around 0.3 percentage points of GDP in 2006 and by 0.4 percentage point in 2007.This improvement is mainly coming from buoyancy of tax revenues, and although the structural improvement proved relatively sound in 2006, Member States do not seem to have taken full advantage of higher growth.

A positive development is that many countries with high deficits undertook above-average budgetary consolidation in 2006. Amongst the euro-area countries in excessive deficit only IT is expected to post a deterioration of the budgetary situation in 2006 (leading to a further increase the debt ratio to around 107% of GDP in 2007), whereas the deficit is predicted to decline to below 3% in DE, EL and FR, and to below 5% in PT (in part due to sizeable discretionary measures such as a hike in the VAT standard rate from 19 to 21%, enacted in 2005, increases in taxes on petrol and tobacco products and changes to health and pensions schemes for government employees). Outside the euro area, budgetary trends are more heterogeneous, with a rising deficit GDP ratio in HU and SK compared with a more marked improvement to just below 3% of GDP in MT and the UK. The most worrying deficit position materialised in HU where the deficit is expected to reach over 10% of GDP, although this would fall to 7.4% in 2007. No significant spending cuts have been introduced in the CZ in 2006, and increases in social spending approved before the 2006 parliamentary elections and worth an estimated 1.2% of GDP, will weigh on the 2007 deficit. Budgetary planning and control institutions have been strengthened in a number of countries, including CZ, FR, ES, PT, CY and with respect to measures boosting public sector efficiency AT and FI. The biggest deviation from the plans to improve planning and control institutions as a means to address short-to medium term challenges outlined in last year's NRP has occurred in Poland. Implementation of multi-annual task-oriented budgetary planning appears to be scheduled now only for 2011, rather than 2009 and the 4-year nominal state budget deficit anchor has not yet been formally adopted by law.

4.3. Assessing progress with the reform of pensions and health care systems

A number of countries progressed with the implementation of pension reforms, including some countries considered to face 'high' or medium' risks to the sustainability of their public finances. Rather comprehensive measures to reform the pension system have been conducted in DK, PT and MT. For example, DE and DK decided to raise the retirement age gradually to 67, while NL implemented a new surveillance scheme to help ensure the appropriate conduct of pension funds and the FI pension reform package was further supported by legislative changes related to the investment and management of employment pension funds, which is expected to increase the returns on investments. Although formal changes to pension schemes were not enacted in 2006, a number of other countries have made progress. The UK government proposed to reform the pension system (which *inter alia* would increase the pension age to 68 by 2050 and contribute to an increase in saving levels) and announced for 2007 a comprehensive spending review. . MT submitted legislation to reform the pension system to Parliament. ES announced a reform of the pensions system that aims mainly at a better alignment between contributions and benefits. HU aims at increasing the retirement age and decreasing early retirement, though reform plans remain to be spelled out. Various adjustments to the pension reform are being considered in SK but no changes have yet been adopted. In IE, the government's Pension Policy Green Paper will be important in furthering agreement on the way forward. Pension reforms are still in the consultation phase in the CZ, EL and IT, while there are risks for delays in PL. An innovative feature of pension reform in several Member States (SE, LV, IT, PL, FI, PT, DK, DE, FR, AT) in recent years are measures, which link pension benefits to life expectancy. Such reforms help ensure financial sustainability on a dynamic basis as they cater for increases in life expectancy, which are expected to continue in coming decades.

Health care measures were on the policy agenda in a number of countries, including, BE, DE, EL, FR, CY, LT, NL, PL and PT. Comprehensive measures have been introduced in PT and LT. CY envisages implementation in 2007. In BE, the 2006 reforms in the health sector appear to have been adequate in curbing the strong growth in health care expenditure. New health insurance and disability schemes have been implemented in the NL in 2006. PL has introduced additional forms of health insurance and the government will decide in 2007 on the final shape of reforms in the disability benefit system, with implementation scheduled for 2008. ES has introduced a major plan to increase coverage of all people in a situation of dependency. Though DE and FR advanced with reforms in the area of health care, in both countries it is uncertain whether the measures are sufficient to improve the long-term sustainability of finances.

5. PROMOTING AN EFFICIENT ALLOCATION OF RESOURCES THROUGH WELL DESIGNED TAX AND EXPENDITURE SYSTEMS

The integrated guidelines recognise the importance of having well designed tax and expenditure systems that promote an efficient allocation of resources. By this means, public finances can contribute to growth and employment while at the same time supporting economic stability and sustainability. One key area of reforms is to attract more people in the labour market and to make the underlying incentive structure in the tax and benefit systems more supportive to employment by ‘making work pay’. Modernisation of tax and benefit systems should be designed so that they provide effective incentives to participate in training, take up jobs and remain in work, thereby shifting the focus away from passive income support towards active measures designed to get people back to work. A central part of many recent tax and welfare reform strategies has been to reduce benefit dependency by making work an economically attractive and rewarding option relative to welfare, see Table 3 provides an overview of the reforms to tax and benefit systems in 2005 and 2006 based on the NRPs and the LABREF database[7].

As regards labour taxes, many Member States lowered the level of taxation on labour, either through reduction on general taxes (CZ, EE, FI, FR, LT, LV, MT, SI) or by targeting specific groups such as long term unemployed, low paid, young and older workers (AT, BE, FI, IE, FR). Some converges appears to be taking place, as countries with highest rates in 2001 are those that have reduced most over the last five years: nonetheless, tax wedges on low wages remain high at almost 40% in the EU25 and in twelve Member States even higher in 2005.

[7] LABREF is a factual database collecting information on enacted reforms to a variety of labour market institutions in the EU25 Member States - http://ec.europa.eu/economy_finance/indicators/labref_en.htm

Table 3: Overview of adopted reforms to labour tax and benefit systems in 2005 and 2006

	BENEFITS						LABOUR TAXATION					
	In work Benefits		Means-tested Benefits		Unemployment Benefits		Employees SSC		Employers SSC		Income tax	
BE												
DK											X	
DE		X		X								
GR											X	
ES						X			X	X		
FR												X
IE		X									X	X
IT	X		X		X				X			
LU											X	
NL				X		X	X	X	X	X		
AT	X			X							X	
PT							X		X			
FI									X		X	
SE			X		X				X			
UK		X			X							
CY												
CZ					X						X	
EE									X		X	
HU			X		X	X		X	X		X	
LT												X
LV											X	X
M											X	
PL												
SK			X						X			

SI												
Note: An "X" describes adopted measures in this area, which does not necessarily mean that the measure has been implemented.												
Source: LABREF and National Reforms Programmes.												

As regards benefit systems, only limited action was taken in the field of unemployment and welfare-related benefits. Many measures have addressed the easier parts of the tax-benefit system, such as reducing income tax rates or social security contributions on low-wages to make work pay, and risks remain of low-wage trap and unemployment/inactivity traps for the unskilled or low income earners in many Member States. In-work benefits are being increasing used to enhance the desirability of employment relative to non-employment, although often at the cost of introducing high effective marginal tax rates at the low end of the earnings scale. While many recent reforms do not appear to directly target financial incentives to work, they may be improving the overall incentive structure of the benefit system by strengthening enforcement of rules and by tightening up eligibility and work-availability requirements. The UK adopted a substantial reform programme, with the introduction of a new employment and support allowance replacing incapacity benefits. In NL, the maximum duration of unemployment benefits was reduced from 60 months to 38 months, and eligibility criteria were tightened. HU has replaced unemployment benefits by job-search assistance. In several other Member States, policy actions have been taken to promote labour market transition from non-employment to work through stricter work availability criteria, the use of sanctions for non-compliance with rules, strengthening of control mechanisms and a streamlining of the financing for labour market subsidies and income support (BE, CZ, CY, DE, DK, EE, ES, FI, LT, PT, SE, SI).

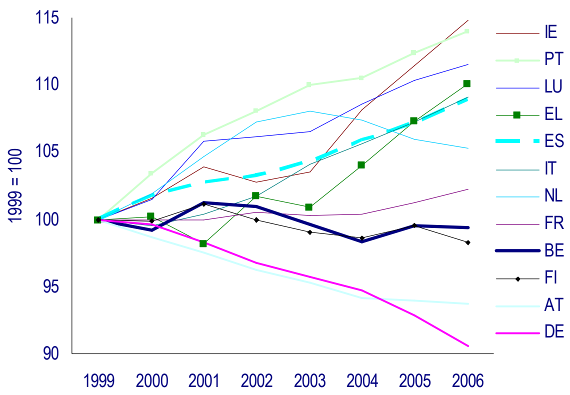
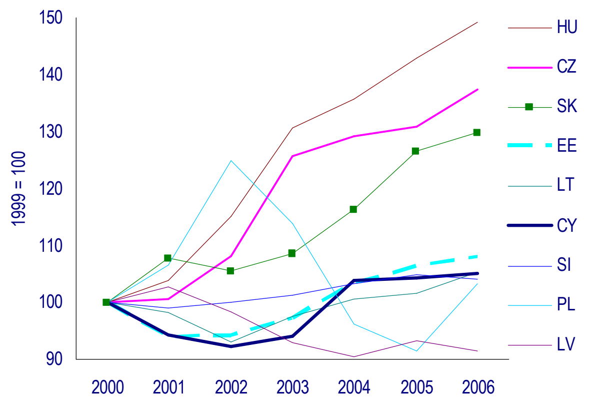
A focus of attention in many countries has been on older workers, where large variations and exensive gender gaps are observed in employment rates among Member States, underlying the need to strengthen financial incentives to take up and remain longer at work. In many countries (AT, ES, PT, SK, and in the reformed scheme of IT), early retirement has been made possible mainly on the conditions of (more or less) actuarial reductions to the pension level. Some countries (BE, DE, DK) have either taken measures to make reductions more actuarially fair or increased the requirement of contribution years regarding the eligibility to early retirement, hence effectively increasing the eligibility age to early retirement. Some Member States have taken actions to reduce the use of benefit schemes – either unemployment or disability schemes – as an alternative route for early retirement (DK, FI, NL, BE, DE). However, there is no reason for complacency, as progress has been uneven across countries, and even if the employment target for older workers is met, there would still be large unused labour capacity amongst older workers.

6. ENSURING WAGE DEVELOPMENTS CONTRIBUTE TO GROWTH AND STABILITY

The annual growth rate in compensation per employee is forecast to be 2.1% in the euro area and 3.1% in the EU-25 in 2006.With the increase in labour productivity being broadly similar in the euro area and the EU-25, a 1% gap in the growth rate of unit labour costs between both aggregates will emerge. Whereas the absence of wage pressure during the economic rebound has been a positive feature of the wage pressure in the EU as a whole, two aspects of wage developments warrant continued vigilance. First, nominal wage growth in excess of labour productivity increases led to deteriorating price competitiveness in a number of Member

States. Secondly, wages adjust slowly over time to changing cyclical conditions, especially in some countries of the euro area, which means a long-lasting impact of shocks on economic activity.

In the EU-10 Member States, the catch-up process is triggering higher-than-average wage growth, notably in EE, HU, LV and LT. This mirrors high productivity growth, though the situation appears worrisome in HU because it appears to have come at the expense of slower employment growth. As expected, many Member States with a cumulatively higher-than-average increase in nominal unit labour costs face a loss in price competitiveness, as evidenced by high current account deficits in most countries with high growth in unit labour costs.

Graph 7: Unit labour costs relative to the euro-area, 1999-2006	Graph 8: Real effective exchange rates in the new Member States, 1999-2006, deflated with unit labour cost
	
Source: Commission services.	Source: Commission services.

In the case of PT and IT, where GDP growth is below the euro-area average, wage developments are less benign; this may dampen cost competitiveness and thus further slow down economic activity.[8] The experience with adjustment to shocks in the early years of the euro area calls for greater downwards price flexibility. Prices and wages in some cases adjusted too slowly to changes in national cyclical conditions, especially at times of slowing activity. Rigid prices are accompanied by an increased resistance to adapt nominal wages, since that would result in larger real wage losses. Thus adjustment costs in terms of output and employment are higher. This lack of flexibility was present despite a general background of marked wage moderation. While wage moderation has been supportive of price stability, the continuously high-rates of long-term unemployment and the persistence of regional differences in employment performance suggest that there may be some lack of wage differentiation in some Member States.

National Reform programmes pay little attention to reforms of wage bargaining systems, possibly because it is more the competence of social partners and individual employers/employees rather than the competence of governments. This area warrants further exploration.

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8 For an in-depth analysis of adjustment patterns in the euro area, see EU Economy 2006 Review - COM(2006) 714 and SEC(2006) 1490.

7. ASSESSING THE COMPREHENSIVENESS OF REFORM PACKAGES AND THE INTERLINKAGES BETWEEN DIFFERENT REFORM MEASURES

The GJS provides a framework in which macroeconomic policies and structural reforms are mutually reinforcing in pursuit of higher employment and growth potential. Macroeconomic policies should provide the conditions of stability necessary to maximise the benefits of structural reform, while at the same time channelling public resources to productive uses. In turn, structural reforms can by creating appropriate incentive structures to work, save and invest and by ensuring effective framework conditions reinforce macroeconomic stability and the sustainability of public finances and improve resilience to economic shocks: this facilitates the task of monetary and fiscal policies in stabilising the economy, *inter alia* by mitigating sources of inflationary pressure and enabling interest rates to be kept low. The comprehensive approach of the GJS also helps ensure that structural reforms, in both the microeconomic and employment pillars, form internally consistent packages where interlinkages are fully exploited, this can yield an aggregate economic impact which is greater than the effect of individual reform measures.

Political economy considerations also favour comprehensive reform strategies. Reforms necessitate change, and usually result in some winners and losers. By pursuing an integrated set of reforms, policy debates take place amongst a wider group of stakeholders with heterogeneous interests, thus helping to generate constituencies which provide a counter-weight to vested interest groups who benefit disproportionately from the *status quo.* Moreover, integrated reform strategies can encompass compensatory measures so that stakeholders are supported through what can be a painful adjustment processes. In addition, they can cater for the fact that some reforms have an immediate impact, whereas in other cases the benefits only materialise after a long time lag.

The assessment of the National Reform Programmes confirms the mutually reinforcing dynamic of pursuing macroeconomic stability together with structural reforms, and equally the complementarities between reforms in the microeconomic and employment pillars. Four areas warrant a special focus.

– ***Budgetary consolidation and redirecting public spending towards growth enhancing items.*** Sound and sustainable public finances are a pre-condition for growth and viable social protection systems in the face of population ageing. Lower deficits and debt reduce the inter rate burden and allow more leeway for Member States to raise public spending on physical or human capital formation and/or reduce the tax burden. Several Member States are in the process of undertaking essential budgetary consolidation, and these efforts need to be reinforced given the favourable economic outlook. This inevitably requires difficult decisions to be made, and especially may affect public expenditures which contribute to physical and human capital formation, and thus growth potential over the long-run. There is no trade-off between the pursuit of sustainable public finances and the Lisbon goals of raising growth potential. Governments do, however, face hard budgetary choices as regards the composition of public spending. Inefficient expenditures need to be reduced, and thereafter expenditures should be redirected towards increasing the relative importance of capital accumulation (both physical and human) and supporting R&D, innovation and ICT. It may also be appropriate to review the sequencing of reform measures, concentrating initially on those with minimal budgetary impact.

– ***Raising the employment rates of older workers to increase growth potential and improve the sustainability of public finances.*** Member States continue to implement reforms to encourage older workers to stay longer in working life, e.g. reform incentives to stay in work, increase retirement ages. Reforms of early-retirement schemes and old-age pension regimes can generate multiple benefits in terms of labour markets, economic growth and public finance stability. The extension of working lives, resulting from measures which increase the financial incentives to work or increase statutory retirement ages, boosts labour supply and can help sustain potential growth economic. At the same time, it can help curtail the growth in pension expenditures, while also generating social benefits, and in particular help ensure the adequacy of pension income. However, financial incentives alone will not suffice, and a comprehensive strategy is needed to address the wide range of factors which lead to older workers losing their jobs and which decreases their prospects of finding a new job. This includes access to training, amending wage profile over time, life-long learning, measures to tackle age-discrimination, ensuring that work place conditions are appropriate for an older workforce, awareness raising and combating spurious perceptions and myths about older workers being less productive and crowding out younger workers. Likewise, to ensure the adequacy of retirement income, citizens need access to a variety of sources of retirement income, which requires appropriate access to and coverage of pension systems and well-integrated and stable financial market offering large choice of long-term saving and hedging instruments.

– ***Flexicurity approaches which combine reforms of labour market, social protection and tax systems.*** The implementation reports show the weakest policy implementation in this area despite the increasing need for adaptable labour markets. In today's labour markets, a high degree of flexibility is in the interest of both employers and employees. At the same time, security is not a matter of preserving a job for life: in a dynamic perspective, it is about building and preserving people's ability to enter, remain and progress in employment throughout the life-cycle. Flexicurity widens the focus from “security on-the-job” through rigid firing rules to the broader notion of security in the market. Strategies to promote flexicurity involve reforms to several aspects of employment and social policies, e.g. contractual and working arrangements (including wages), active labour market policies, lifelong learning systems and social protection. The focus is on the interplay and coherence of policies rather than on single policy measures. As argued in the Joint Employment Report[9], there is no one-size-fits approach to flexicurity for all Member States, and account has to be taken of existing institutions as well as the role of social partners. Flexicurity policies can have a significant budgetary cost as it encompasses changes to unemployment transfer schemes, ALMPs, training and Life-long learning policies. The feasibility and timing of flexicurity measures may be constrained for governments with weak underlying budget positions, and thus warrants careful analysis.

– ***Service market liberalisations –its contribution to labour market reforms and price stability.*** Liberalisation of services' market can facilitate labour markets reforms by increasing competitive pressures in large and fast growing sectors of the economy, which in turn can increase the productivity of workers and the demand for labour. More indirectly, better integration and higher liberalisation of services will cut service prices significantly, which is an important component of consumers' prices. This will then increase real wages and facilitates labour market reforms from a political point of view. As regards macroeconomic stability, price inertia appears to be very high, in particular in the service sector where inflation runs at a relatively high rate. Therefore, deep structural reforms in services are needed to boost the relatively low level of productivity, partly

[9] See also the chapter on the employment dimension.

responsible for the high inflation persistence. Reforms will consist in fostering competition by lowering cross-border barriers to the completion of the single Market, removing overly rigid national regulations and better integrating financial markets. This issue will be taken up in the forthcoming Internal Market Review[10].

Quantitative assessment of structural reforms

Using a variety of economic models[11], the Commission services have examined the impact of several reforms forming part of the Growth and Jobs Strategy. This exercise relies upon different methodologies and data sources, and as for all modelling exercises, caution must be exercised in interpreting the results as the have their strengths and weaknesses and do not take all factors into account. In particular they do not encompass all potentially important policy reform measures which contribute to growth and employment. Overall, the results show that past reforms have delivered significant benefits, and that further reforms in key areas could generate important additional gains. The modelling results provide support for the existence of positive interactions between structural reforms in different areas, and thus for having a comprehensive reform strategy. They also highlight spillovers between reforms at EU and national level, the magnitude of which is being enhanced through the growing intensity of trade and investment.

– *Labour and product markets* are at the core of the reform agenda. It is estimated that reforms in areas such as unemployment benefits, taxes and the ease of entry for new firms have reduced the structural unemployment rate by almost 1.4 p.p. and boosted GDP in the EU-15 by 2% since 1995. This positive outcome partly stems from the influence of product market reforms on job creation (i.e. by facilitating wage moderation and the entry of new firms to markets). Moreover, the results would have been even higher if the simulation took account of the positive impact of the reforms on the participation rate.

– Between 2000 and 2005, the *employment rate of older workers* (aged 55 to 64) in EU-15 increased by 6 p.p. to 44% and the *effective retirement age* rose by more than one year: this represents considerable progress towards the goal of a 50% employment rate for older workers by 2010. Analysis carried out at EU level on the economic and budgetary impact of ageing populations confirms that a considerable share of this increase is due to past reforms of pension and early retirement systems. It also projects that by 2025, the employment rate of older workers will rise to close to 60% and effective retirement ages will go up by one more year: approximately, one third of these gains will result from the lagged phasing-in of enacted pension reforms. An alternative set of simulations examines the economic gains from a one year increase in the effective retirement age: as a result of increased labour supply and a lower tax burden, this would bring about a rise of almost 1.5% in GDP by 2025 and 2.5% by 2050 in the EU-15.

– A central aim of the revised strategy for Growth and Jobs Strategy is to better align reform efforts at EU and national level, not least by giving full effect to the *internal market programme*. A recent analysis, carried out as part of the on-going review of the Internal Market, shows that past efforts to deepen the internal market, coupled with its extension to the EU-10 economies following enlargement, have been an important source of jobs and growth. Over the period 1992-2006, the achievement of an enlarged Internal Market is estimated to have resulted in a 2.2% increase in the EU-25 GDP and the creation of 2.75 million additional jobs (equivalent to a 1.4% increase in total employment). The analysis also confirms that these gains could be doubled with the removal of most remaining Internal Market barriers.

The need for continuing with ambitious reform efforts is demonstrated in simulations showing that *higher R&D expenditure* can lead to an enhanced economic performance. In the 2006 Spring European Council, Member States announced country-specific targets for R&D expenditure amounting to 2.7% of EU-25 GDP by 2010 from the current level of 1.9%. If Member States achieve their targets, R&D activities will rise by 50% in 2025 generating an increase of between 2.6% and 4.4% in GDP on the basis of conservative assumptions, with technological progress being the main growth channel. Moreover, as technological

[10] See also the chapter on the microeconomic dimension.

[11] These results summarise a set of simulations made using several versions of the QUEST model (a macroeconometric model developed by DG ECFIN) and WorldScan (a computable general equilibrium model developed at the CPB, Netherlands Bureau for Economic Policy Analysis, and used by DG ENTR). Detailed information on these simulations can be found in a forthcoming technical Staff Paper.

progress benefits from R&D activities elsewhere, there are large benefits from spillovers across countries and sectors. International spillovers account for some 25-30% of the overall effect on GDP for the EU25, with their scale depending upon the intensity of trade across countries. This points to potential synergies between R&D policy and internal market measures that increase market opening and therefore magnify R&D spillovers.

Efforts are underway to reduce costs for European businesses in complying with *administrative requirements laid out in national and European legislation. General a*dministrative compliance costs have been estimated at 3.5% of GDP for the EU-25. The effect of a gradual reduction by 25% between 2006 and 2010 of the administrative burdens for businesses related to these reporting requirements is estimated at 1.1% additional GDP for the EU-25 by 2010, which mainly results from boosting labour efficiency as workers undertaking such administrative tasks are freed up to carry out more productive activities. The full economic effect unfolds over time through subsequent capital accumulation reaching 1.3% by 2015. The impact of this cost reduction would be quite diverse across Member States, reflecting the level of the administrative burden in each country. A separate modelling exercise for the EU15 shows the competition enhancing effects induced by the potential entry of new firms: this channel could lead to a significant additional GDP increase over the long-run.

MICROECONOMIC PART

1. SUMMARY AND CONCLUSIONS

The microeconomic part of the Integrated Guidelines covers a large area of reform policies, ranging from competition policies to environmental sustainability and from ICT to transport and energy infrastructures. Most of the key challenges which the Member States identified in their 2005 National Reform Programmes fall into the area covered by the microeconomic guidelines. In particular, nearly all the Member States consider research and innovation as well as entrepreneurship and the business environment to belong to the key challenges on their reform agenda.

This part of the Annex assesses progress with the implementation of microeconomic policy reforms reported by Member States in their 2006 progress reports. It also looks at the way in which the Member States have addressed three of the four priority areas for action which were set out by the 2006 Spring European Council: knowledge and innovation, business environment and energy policy. The analysis is presented following the structure of the microeconomic integrated guidelines for 2005-2008.

Member States' 2006 Progress Reports show that implementation is generally moving ahead well across the area of microeconomic reforms. Member States are making considerable efforts in the areas of R&D and innovation and better regulation. One area where more action is still required is competition and market functioning. Member States' responses to the Spring European Council's call for more action to improve the business environment have for the most part been satisfactory. However, only a few Member States have so far set specific targets to respond to the SME policy specific Spring Summit requests.

Increasing overall EU spending on research and development to approach 3% by 2010 is one of the two quantitative targets under the Growth and Jobs Strategy to which all Member States committed themselves at the 2006 Spring European Council. If all Member States were to reach their announced spending targets for R&D, the European Union as a whole would likely reach a ratio of about 2.6% in terms of GDP for overall R&D spending by 2010. At present no statistics are available for 2006 that would allow an overall assessment of the impact of measures so far, but there are clear indications for a heterogeneous performance by individual Member States, with strong efforts on the part of a number of countries which look set to reach their national targets. The efforts in terms of increasing public spending and putting in place the necessary incentives private spending made by some others are insufficient. In a few cases, progress with implementation of the NRP with regard to R&D measures has been weak or absent. Some countries may face a difficult trade-off between the need for significant fiscal consolidation and strict prioritisation in optimising the structure of budgetary expenditures. However even in these countries other reforms are possible including in other policy areas that have a positive impact on R&D and innovation such as competition and better regulation.

Innovation is a key priority for Member States and progress with implementation in this area has been generally good. For a few countries the pace of reforms in the area of innovation is still insufficient or has slowed down. This concerns notably those with systemic deficiencies typical for economies in transition. In these countries, the innovation system is fragmented and not sufficiently developed. Clear progress was made in 2006 in the area of Information and Communications Technology (ICT). Actions in this area have been mainstreamed and new measures introduced. Implementation moves forward mainly in the areas of broadband, e-Government, and digital literacy. More should be done to strengthen the role of ICT in life-long learning and healthcare.

The implementation of NRP measures in the area of the sustainable use of resources is by and large promising, but still leaves significant room for improvement. The issues of resource pressures, climate change, and biodiversity loss are recognised by the Member States as both a challenge and an opportunity to foster growth and at the same time preserve a high quality of the environment. While the vast majority of Member States is reporting progress in the area of energy efficiency and the promotion of renewable energy sources, more than half of all Member States will need additional measures to fulfil their objectives on electricity from renewable energy sources. A number of Members States project that they will not reach their targets on climate change, and will have to identify further emission reduction policies and measures in order to comply. Progress, albeit slow, is being made in the internalisation of external environmental costs. All countries with NRP measures on environmental technologies report implementation progress in this area, especially where they have identified related export opportunities. While on biodiversity important progress is reported by many countries, additional integrated policy efforts are needed.

Both at Community and at national level progress has been made to contribute to a better functioning internal market. At Community level progress has been made with the services directive and in the area of financial services in particular. At Member State level, the average transposition rate has improved, however the number of infringements indicates that the quality of transposition needs more attention.

Some progress can be noted in the area of competition and market functioning. In the field of competition policy several countries are strengthening their enforcement regimes but there is room for improvement. While many Member States address competition in network industries, notably in gas and electricity and electronic communications, greater efforts are needed in many countries in respect of issues such as unbundling (notably in the gas, electricity and rail sectors) as well as the need for clearly mandated and independent regulatory authorities with adequate levels of resources. In the area of state aid, only a few Member States report on progress in reducing overall levels and shifting aid towards horizontal objectives. Most Member States are facing ongoing infringement procedures concerning the opening of electricity and gas markets.

On energy policies, there is insufficient market integration in the electricity markets of most Member States, with the exception of the Nordic countries, the Netherlands and the UK, where the situation is generally satisfactory. Market power, concentration and lack of transparency are observed in several Member States. Critical cross-border interconnections are also lacking. A general lack of market integration can also be observed in gas markets. Implementation of the current regulatory framework particularly regarding effective unbundling provisions, the removal of regulated tariffs distorting competition, and the role and independence as well as cooperation between national regulatory authorities are crucial to make progress toward fully functioning energy markets.

There has been significant progress across the European Union in launching and implementing Better Regulation initiatives, but there remains ample room for improvement. Progress was made mainly in designing Better Regulation strategies, impact assessment and consultation guidelines or in creating task forces and carrying out pilot projects to prepare the ground for the subsequent implementation of Better Regulation measures. The overall picture in the field of SME policy is mixed in terms of implementation. Most Member States are implementing the measures in the priority area "unlocking business potential" identified by the 2006 Spring European Council.

Under the new cohesion policy programmes for the period 2007-2013, Member States will use the major part of the resources available to support a short-list of actions directly relating to the Growth and Jobs Strategy and its microeconomic pillar. In the least developed regions a minimum of 60% of the resources available must be "earmarked" for Lisbon expenditures, 75% in the other regions, which translates into a Lisbon investment programme worth € 200 billion from the Structural Funds plus co-financing. The 25 draft and final National Strategic Reference Frameworks show that innovation is a priority in all Member States. It is also a top priority in most of the 'Regional competitiveness and employment' regions. The Commission expects approximately € 40 billion of the Structural Funds to be invested in the core sectors of R&D and innovation.

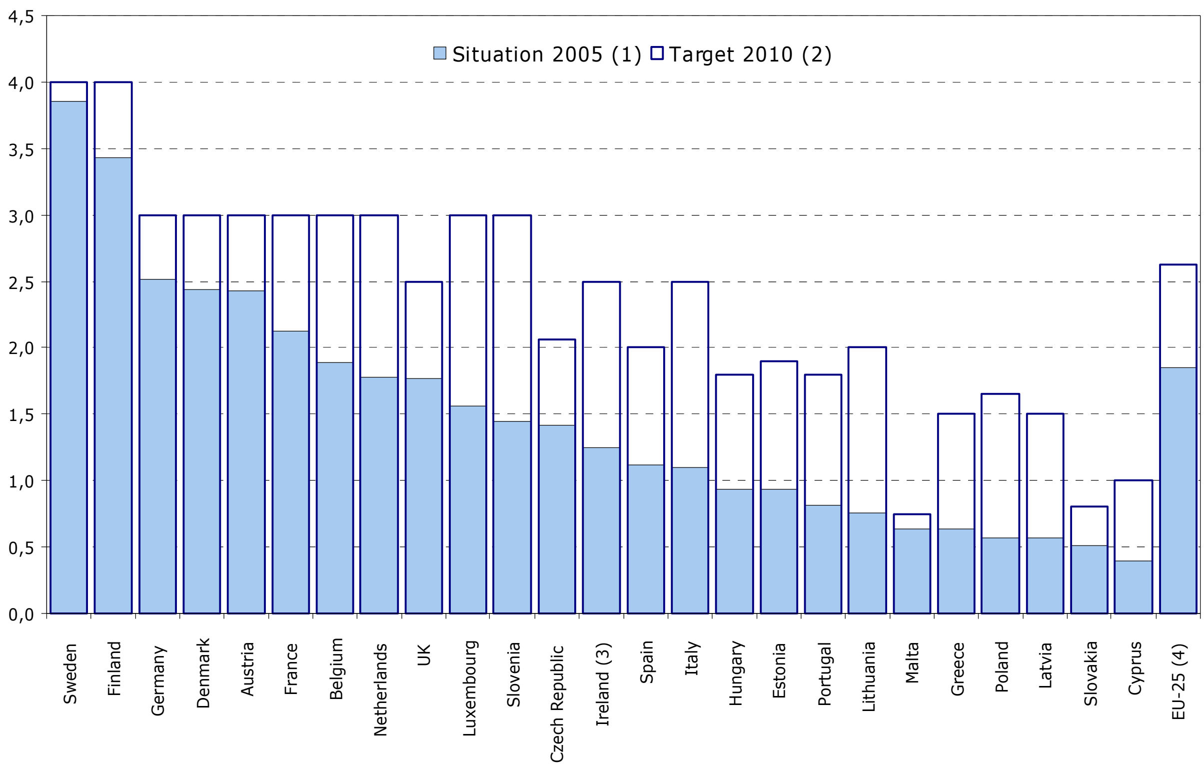
Nearly half of the Member States have decided to spend more than 50% of the European Agricultural Fund for Rural Development funds on competitiveness and diversification (this covers knowledge transfer and promoting innovation, human capital upgrading, as well as job creation and maintenance). Preliminary data suggest that about € 28 billion will be spent on improving the competitiveness of the agricultural and forestry sector, and about €13 billion on improving diversification of the rural economy and quality, where job creation is the overarching priority.

2. KNOWLEDGE AND INNOVATION

2.1. Research (Integrated Guideline 7)

Increasing investment in R&D and in particular in private R&D is crucial for long-term growth. All Member States have recognised this challenge and have set national R&D investment targets suited to their specific circumstances. Member States have in general used the national targets for R&D investment in a sound way as a tool to focus attention on ways to develop the input factors necessary to boost R&D for the purpose of developing more knowledge based economies (see Graph 1).

Graph 1: R&D Intensity (Gross domestic expenditure on R&D (GERD) as % of GDP)



Notes:
(1) EL: 2003; BE, IT, MT, NL, SI, UK: 2004.
(2) PL: 2008; IE: 2013; UK; 2014.
(3) IE: The target is 2.50% of GNP in 2013.
(4) EU-25: The EU-25 R&D intensity for 2005 was estimated by DG Research.
EU-25: The EU-25 R&D intensity for 2010 results from the aggregation of the set targets set by the Member States (including estimated targets for IE, PL and the UK).
(5) Member States have been ranked according to the current level of R&D intensity from left to the right.

Source: Eurostat, Member States

It is crucial to increase the leverage effect of public R&D policy in order to boost private investment in R&D. Developing and strengthening centres of excellence in educational and research institutions, promoting public-private partnerships and improving cooperation and transfer of knowledge between public research institutes and private enterprises are crucial to leverage private investment in research and to increase competitiveness. To achieve this, most Member States have embarked on reforms of their public research organisations. The main common elements of the reforms are greater autonomy for public research institutions, a higher proportion of project-based competitive funding, basing core funding decisions increasingly on excellence and the creation or strengthening of knowledge transfer mechanisms. In addition, some countries, in particular amongst the countries with a medium and low R&D intensity, emphasis has been put on leveraging private investment through fiscal incentives.

Several Member States have announced their intention, even in the presence of budgetary constraints (DE, EL, LV, PT) to prioritise public R&D expenditures, including in the structural funds programmes. However, several (BE, CZ, EL, IT, LT, PL, SL, SK) have not yet made the necessary budgetary commitments.

A sufficient supply of qualified researchers continues to be critical. This is particularly the case in Member States with a low R&D intensity, where this may be a barrier to boosting R&D (EE, EL, LV, LT, PT). While Member States are taking measures in this area, a shortage of qualified researchers cannot be overcome in the short term.

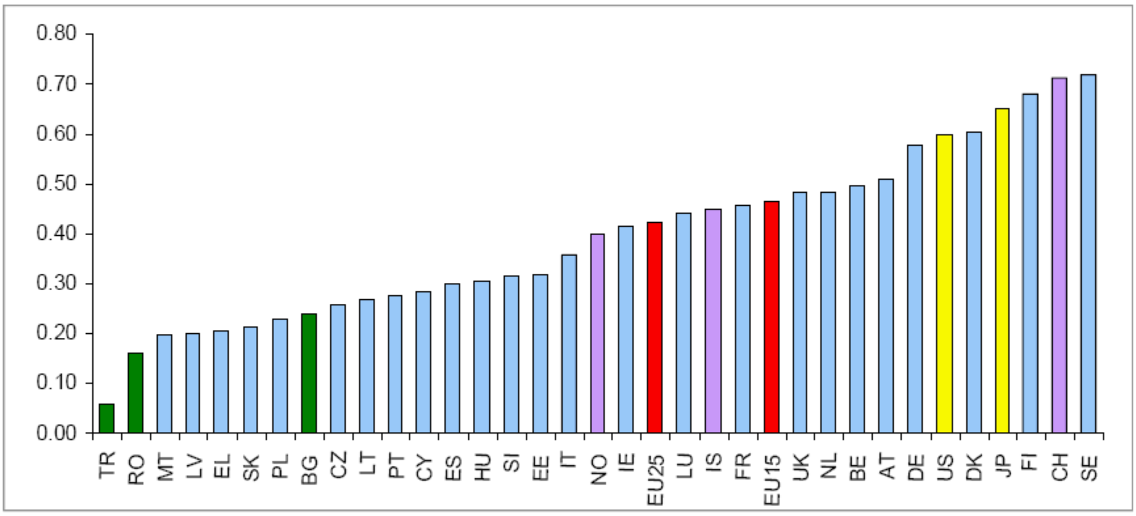
The majority of Member States have established coherent strategies for R&D. Most Member States have also taken concrete steps to strengthen the governance of R&D in order to ensure coherent research policy mixes and more integrated research policies. This is the case even for the most advanced countries in terms of R&D intensity. The new research policy governance measures range from establishing strategic councils chaired by the Prime Minister and with the involvement of important stakeholders to the creation of coordination committees between ministries with competencies relating to the research system.

In conclusion, most Member States have generally worked actively on developing and implementing the policies outlined in their NRP. There is progress in many areas, and most Member States show a strong commitment to increasing R&D spending. However, for some further policy initiatives will be needed to reach their R&D spending targets. There is a real opportunity for a breakthrough in this area, but to achieve this by 2010, it is necessary to show stronger commitment and speed-up policy development and implementation. In this regard it is also important for progress in R&D that progress are made in other areas such as innovation, better regulation and ensuring competitive markets.

2.2. Innovation (Integrated Guideline 8)

Innovation policies should contribute to enhancing the EU's capacity to produce and commercialise innovations and to create an adequate business environment for the diffusion and adoption of new technologies. This requires not only investment in knowledge but the right incentives. The 2006 implementation reports indicate good progress in the area of innovation, which is a key priority for Member States, but progress of reforms varies considerably, as the Summary Innovation Index (see Graph 2) illustrates.

Graph 2: The 2005 Summary Innovation Index



Source: European Innovation Scoreboard 2005 - DG Enterprise and Industry.

Improvements in innovation support services, in particular for dissemination and technology transfer are being pursued in most countries. Member States have set up or are developing innovation support services, including reinforced cooperation between universities and the business sector. More effective coordination between regional and national innovation policy and the stimulation of licensing and spin-offs by universities and technology transfer centres are being pursued. In order to support innovation and the growth and development of innovative enterprises at the European level, the Commission and the European Investment Fund are currently implementing the new financial instrument, "JEREMIE" (Joint European Resources for Micro to medium Enterprises). This provides a readymade system at the service of the programme managing authorities to help them in the complex task of designing and delivering financial engineering products such as venture capital, loans and guarantees and other forms of risk capital.

A majority of Member States is considering the development of innovation poles, networks and incubators bringing together universities, research institutions and enterprises, including at regional and local level, to help bridge the technology gap between regions. Many measures in this field are however on a small scale. Most European countries are making significant efforts to promote clusters. The focus in this area is generally in high-tech sectors.

The European Commission has set up a European Cluster Alliance under the PRO INNO Europe initiative, aimed at stimulating practical cooperation between regional governments and will present a roadmap supporting trans-national cooperation in the field of cluster policy. Furthermore, to encourage innovation in services, the Commission will prepare a policy document aimed at assessing whether existing innovation policies are service friendly and defining a strategy to foster innovation in services, in particular in knowledge intense services.

Cross-border knowledge transfer, including from foreign direct investment has received limited attention from Member States, but the innovation systems in several Member States are characterised by a highly productive and relatively technology-intensive FDI sector.

Relationships between local and foreign firms need strengthening (e.g. through clusters) to bring about spill-over of innovative practices. Some countries acknowledge the importance of cross-border knowledge transfer and are improving the framework for attracting FDI, notably through well qualified researchers. The UK has led work with European partners to facilitate cross-border collaborations and improving the framework of knowledge transfer training and a new R&D strategy has been approved with the aim of attracting more FDI. The analysis done for the innovation scoreboard demonstrates that Germany has a strongly integrated and coherent innovation strategy. The Danish Globalisation Strategy includes proposals to facilitate contacts with foreign research, innovation and business environments.

Few concrete measures are developed to drive the demand for innovation through public procurement. However, the Dutch government formulated an action plan setting out how it would foster innovation in the private sector by strengthening its role as 'launching customer'. In Lithuania, a new Law on public procurement entered into effect in 2006, which better promotes innovative solutions. Greece plans to establish a mechanism for the coordination of activities for the promotion of environmentally-friendly procurement. The European Commission is preparing a handbook with guidance on how to use public procurement rules to stimulate innovation. In addition, the Commission will propose a comprehensive "lead-markets"-strategy aiming at the removal of barriers in order to support the uptake of new products and services.

Most Member States are aware of the importance of better access to domestic and international financing and several have reinforced access to risk capital. This is a new and therefore particularly important issue for the EU10. More activity in this field is needed. The European Commission will launch a Risk Sharing Finance Facility which, in cooperation with the EIB, will approve loans and guarantees to support investments in high-risk research, technological development and demonstration projects. In addition, the Commission has adopted new State aid Guidelines for risk capital with the aim of facilitating access to finance.

The need for efficient and affordable means to enforce intellectual property rights is increasingly addressed by Member States. Finland adopted new legislation on university inventions and amended the law on employee inventions in May 2006. Both Belgium and the Netherlands have made it easier for companies, SMEs in particular, to access the patent system. Latvia has increased the protection of innovative processes. Italy has introduced a 'novelty assessment' and a government decree strengthening the patenting capacity of universities. To complement Member States' initiatives on intellectual property rights the European Commission will launch an initiative before the end of 2006 to improve the cost effectiveness and legal certainty of patents in Europe, and will work on a more comprehensive intellectual property rights strategy to foster the circulation of innovative ideas.

In some economies notably those whose innovation systems are fragmented and not sufficiently developed, the pace of reform is still insufficient or has slowed down. One challenge for these countries is the development of a strong national innovation strategy involving all major stakeholders, and identifying priorities while and building on existing industrial strengths.

A more comprehensive innovation strategy is needed in most Member States characterised by an evaluation and benchmarking culture and making reference to cross-border experiences.

The lack of competition in some markets, insufficiently balanced IPR regimes and demand-oriented policies must be addressed to improve the functioning of the innovation systems.

2.3. Information Society (Integrated Guideline 9)

Information and Communication Technologies (ICT) policy is crucial for the achievement of productivity gains. Compared to the 2005 NRPs Member States' Implementation Reports put more emphasis on mainstreaming ICT policies. ICTs are broadly reflected as (i) drivers and components of innovation and development; (ii) tools for transforming government and business models; and (iii) tools to improve the quality of life for citizens.

Overall progress in this area is good, in particular in the priority areas that were identified last year: eGovernment, broadband communications and digital literacy. However, progress is uneven among the Member States, and implementation of the policies is delayed in some areas.

Research and development activities in the area of ICT (BE, DE, DK, EE, ES, FI, FR, IT, NL, PT) and trust and security issues (BE, CY, DK, LU, NL, FI, FR) emerge as new priorities in a number of countries. Only few Member States report progress on strengthening the competitiveness of ICT industries (such measures are a priority for example in Malta where the ICT industry is heavily dependent on the existence of one semiconductor firm). As should be expected, progress mainly concerns the implementation of measures in the priority areas identified last year: eGovernment, broadband communications and digital literacy.

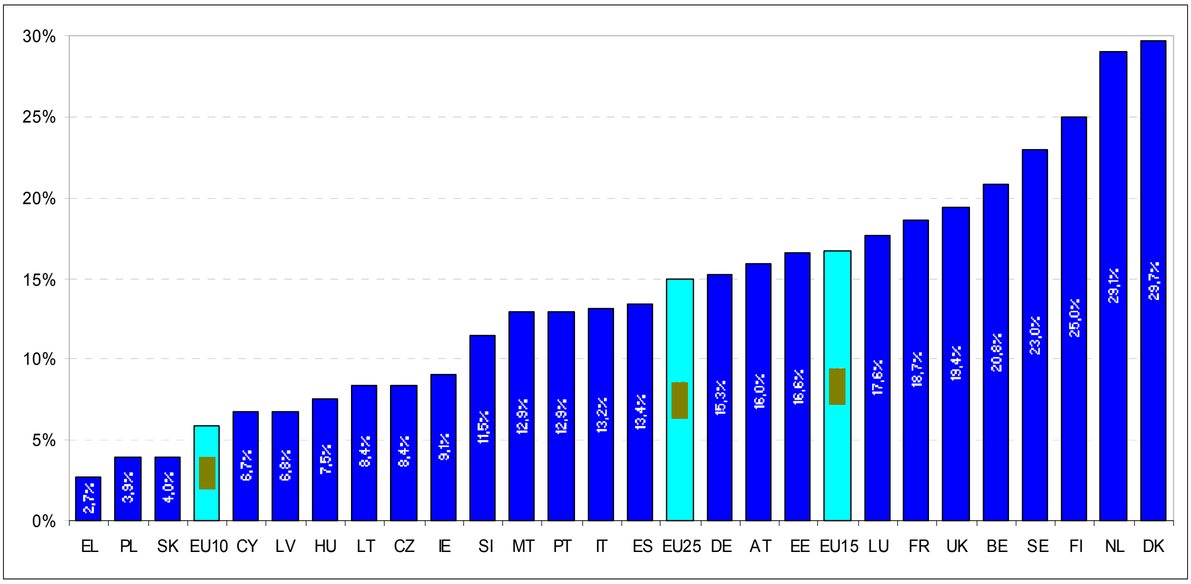
BE, CY, ES, EE, FI, FR, IE, LU, LV, NL, PT, SI focus their efforts on reducing administrative costs for the public administration as well as for businesses and are making progress. Several countries introduce internet portals for businesses to reduce the costs of company registration (EE, FR, IE, LU, NL, PT, SI). Other measures include the introduction of electronic ID cards (BE, ES), unified ICT platforms for back-office reorganisation (AT, EE, LV, PT), and the launch of portals for citizens (CY, LV, PT, SK, SI). On the other hand, electronic supply of healthcare services has not been widely addressed, with the notable exceptions of AT, CY, ES, IT.

The Commission supports Member States' efforts through the implementation of the *i2010 eGovernment Action Plan*. It supports research, the sharing of best practices and strengthens interoperability. Online access to basic public services is now mostly in place, and governments are moving to increase the interactivity of services. In 2006, nearly 50% of eGovernment services allow citizens to conduct all processes online, with interactivity rising by 6% in one year.

Nearly all countries have programmes aiming to enhance broadband infrastructure. Good regulatory practice in line with the EU framework for electronic communications, taking into account specific national conditions, provides a sound basis for competitive markets, investment, innovation, choice and consumers' protection. Publicly-funded broadband roll-out, following the EU initiative "Bridging the broadband gap", is taking place in areas where commercial deployment lags behind (AT, CY, CZ, EL, ES, FR, HU, IE, IT, LT, LV, PL, PT, SI). In remote and rural areas, support is mostly foreseen through Structural Funds. Action on a flexible approach to the use of spectrum for wireless technologies has been announced in NL and UK.

Broadband take-up has been increasing rapidly and the penetration rate reached 15% of EU-25 population in July 2006, up five percentage points within one year. The overall growth rate masks wide variations between Member States (see Graph 3). There remains a significant difference in broadband coverage between urban areas (more than 90% of EU-25 population) and the rural areas (about 65%).

Graph 3: Broadband penetration rate: Lines per 100 population



Source: Communications Committee.

Several Member States made a considerable effort last year to increase the digital literacy of workers and citizens was emphasised in a number of National Reform Programmes (CY, CZ, EE, ES, FI, FR, IE, LT, MT, NL, PT, SK, UK). The most important area for government policy is the promotion of education in ICT. This includes the improvement of ICT infrastructure at schools, updating school curricula to include digital skills, and training for teachers. A 2006 pan-European survey shows progress, as 96% of all schools in Europe have Internet access, 67% have broadband, and 90% of classroom teachers use computers to prepare lessons, while 74% use them as a teaching aid. However, broadband connectivity still varies, from about 90% of schools in Scandinavian countries, NL, EE, MT to under 35% in EL, PL, CY and LT. Initiatives for on-the-job training appear insufficient and the life-long learning dimension of ICT training is largely missing from the Progress Reports.

A broader use of ICT by citizens has been supported in many countries through the introduction of far-reaching action plans. Some of them announced in the 2005 NRP (PT, ES, EL, UK) and others announced this year (DE, FR, IE), recognising that successful information society policy entails collaboration among government organisations.

Finally, ICT is addressed as a tool to improve efficiency in various administrative sectors. Projects in PT, ES, IT and SI for example focus on the informatisation of departments like justice and police. Italy presents also a comprehensive programme to use ICT and preserve cultural heritage at lower costs.

2.4. Industrial Competitiveness (Integrated Guideline 10)

The majority of the Member States addressed industrial competitiveness in their NRP and proposed measures to enhance the technological content of industry, to support clusters, to promote sectoral competitiveness and to favour the internationalisation of companies by supporting exports or attracting foreign investments.

Most of Member States have started to implement the measures proposed in 2005 (AT, BE, CY, DE, EL, ES, FIN, F, IE, HU, LV, LU, MT, NL, PT, SL), with a view to enhancing the technological content of industry and to favouring the internationalisation of companies. In some cases, these measures are combined with an approach targeting specific sectors (CY, MT, NL, DE). In its 2006 implementation report, Italy proposes a new programme to reinforce its industrial competitiveness. Portugal is addressing the issue of structural change concretely with a programme aiming at accelerating the industrial transition and restructuring processes.

Industrial competitiveness is also addressed at Community level. In October 2005, the Commission published a Communication[12] on industrial policy which proposed a work programme to respond to identified challenges. This work programme is part of the Community Lisbon Programme.

2.5. Sustainable use of resources (Integrated Guideline 11)

The integrated guideline on the sustainable use of resources invites Member States to encourage the sustainable use of resources and to strengthen the synergies between environmental protection and growth.

All Member States address environmental sustainability and many identified it as a key challenge. While Member States generally report progress in implementation on green public procurement, environmental technologies and resource management (e.g. waste and water), progress has in some cases been slow with regard to the sustainable use of natural resources and note that environmental policy is still not sufficiently integrated into all policies.

The vast majority of Member States is reporting progress in the area of energy efficiency and the promotion of renewable energy sources. Eight countries (DE, DK, ES, FI, HU, IE, LU, NL) are on track to meet their national targets for renewable electricity, while most other Member States will have to take further action to reach them.

Progress in the implementation of measures against climate change is mixed. A number of Member States (AT, BE, DK, ES, IE, IT, PT,) will have to identify further emission reduction measures in order to comply with their burden sharing targets, while others are showing adequate progress (Graph 4). Some Member States consider the need to prepare for the consequences of climate change and to capture and store CO_2 without however presenting concrete measures.

Implementation of measures towards internalising external environmental costs appears to progress, albeit slowly and with a number of countries lagging behind expectations. Positive examples in this area include the Estonian tax reform, the Belgian adjustments to vehicle

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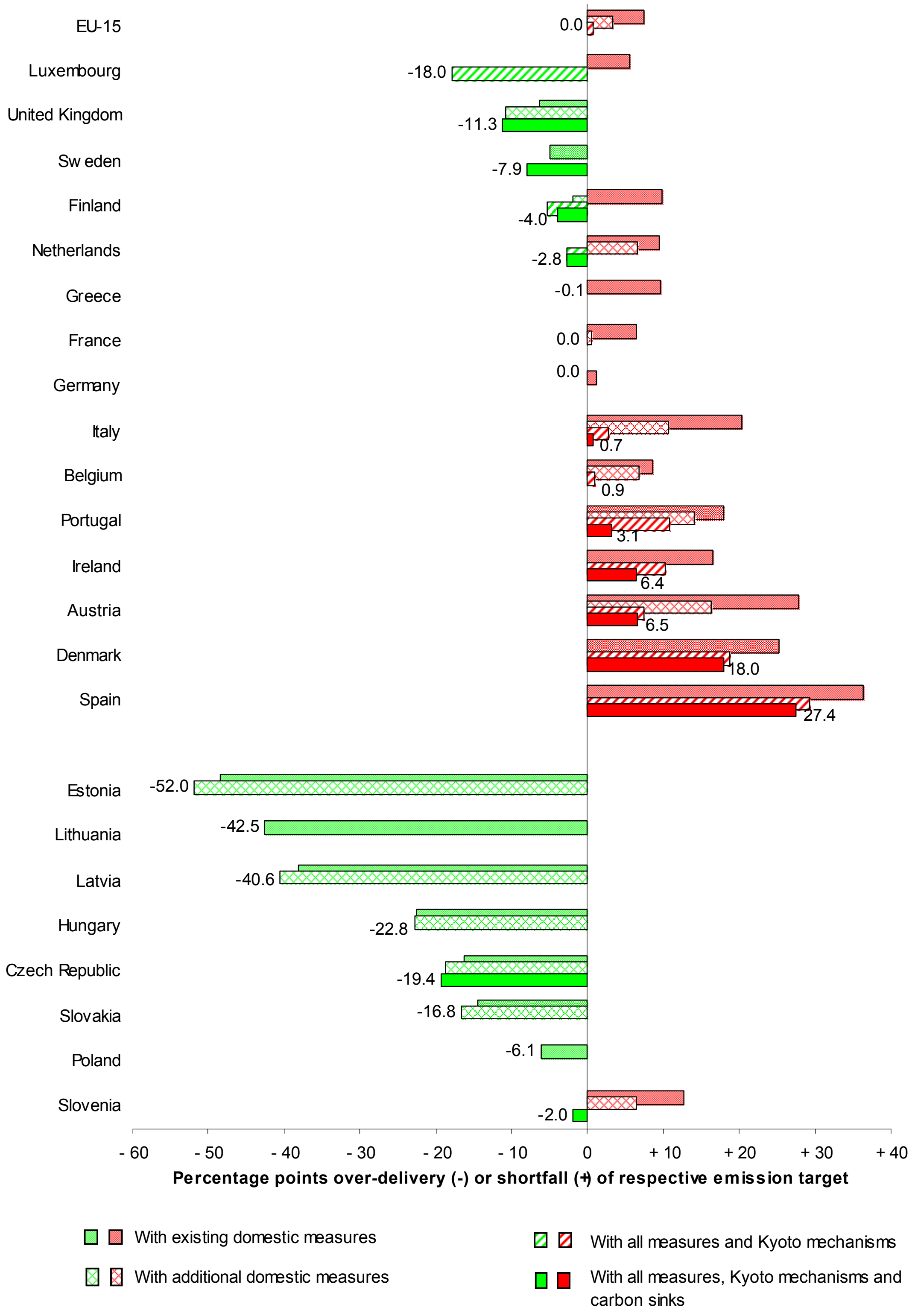
12 Implementing the Community Lisbon Programme: A policy framework to strengthen EU manufacturing - towards a more integrated approach for industrial policy - COM(2005) 474.

taxation, as well as the introduction of a toll system for heavy vehicles in Germany. Promotion of logistics, traffic management and shifts to more environmentally friendly modes of transport by several countries will help reduce external costs from the transport system.

Graph 4: Distance to Kyoto target indicating the relative gap (over-delivery or shortfall) between greenhouse gas projections for 2010 and the respective 2010 targets



<u>Source</u>: COM(2006) 658 - 'existing' and 'additional' domestic policies and measures, including the use of Kyoto mechanisms and carbon sinks.

In conclusion, the issues of resource pressures and global problems like climate change and biodiversity loss are recognised by the Member States both as a challenge and an opportunity to foster growth and preserve a high quality of the environment. Implementation is by and large promising, while leaving significant room for improvement. A number of EU level and national plans in the area of sustainable resource use seek to exploit synergies between economic growth and environmental protection.

3. MAKING EUROPE A MORE ATTRACTIVE PLACE TO INVEST AND WORK

3.1. Internal Market (Integrated Guideline 12)

Internal Market policy is by nature a Community responsibility. To reap the full benefits of these measures, they need to be properly transposed, implemented and enforced at Member State level. This is the responsibility of individual Member States.

A fundamental review of the Single Market has been launched with the Commission's Communication on "A Citizen's Agenda" (May 2006) to ensure that internal market policy responds best to the challenges of the 21st century. An interim statement will be presented to the 2007 Spring Council and the Review will be finalised before the end of 2007.

The final adoption of the Services Directive has been an important step forward. The modified proposal aims to enhance growth through removing legal and administrative barriers to the development of service activities, strengthening the rights of users of services and encouraging cross-border service provision. The European Parliament is likely to conclude its second reading in November. Final adoption is foreseen by the end of 2006.

The creation of a Community Patent System is a crucial building block toward the development of a European knowledge-based economy. The 2005 Spring European Council called for renewed efforts to reach an agreement on a Community patent. In order to regain momentum, the Commission organised a comprehensive stakeholder consultation in 2006. The Commission envisages adopting a Communication on the patent strategy for Europe by the end of 2006. This should prepare the ground for substantial progress on patent matters under the German presidency.

The Commission has adopted on 18 October a proposal to open EU postal markets fully to competition by 2009, in line with the agreed target date set out in the current Postal Directive. All Member States have transposed the present postal services acquis.

The Commission has actively supported Member States in the transposition of the Directive on the recognition of professional qualifications. The exercise carried out by the Commission during the transposition period forms part of a pilot project in the context of "Better Regulation". The directive will promote the development of the European skills labour market by easing the free movement of fully qualified professionals in the field of regulated professions, in particular with a view to their temporary provision of services. Better resource allocation of qualified professionals will also raise productivity and produce better economic performance in the medium term.

In 2006 the steady reduction of Member States’ transposition deficits continued across the board. While improving their performance, some Member States, in particular Portugal, Greece, Luxembourg and Italy, are still lagging behind. Attention also needs to be paid to the quality of transposition, as the number of infringements cases remains high.

Good progress has been made with the transposition and enforcement of the measures of the Financial Services Action Plan. The adoption of the Markets in Financial Instruments Directive (MiFID), of the Capital Requirements Directive (CRD), of the Industry's Code of Conduct on post-trading in the EU and of the White Paper on the next steps towards an efficient investment fund market (to be confirmed) have been important in this respect. The monitoring of transposition, implementation and enforcement is integral part of financial services policy, as laid down in its White Paper on Financial Services Policy (2005-2010). The performance of Member States in terms of transposition has improved noticeably in the past year (over 95% compared to only 87% at the beginning of the year). There is room for improvement in the performance of a few Member States (IT, FR, LU, NL, ES).

While the time limit for the transposition of the IPR enforcement expired on 29 April 2006, only 12 Member States, have so far notified the Commission of the full transposition of this directive into national law (AT, CY, CZ, DK, EE, ES, FI, HU, IE, IT, SI, UK). Similarly, there is still a large number of Member States who have not yet transposed the new legislative package on public procurement for which the deadline passed on 31 January 2006 (BE, EE, EL, ES, FI, IE, LU, PT, SE, SI).

The two Public Procurement Directives are set to further modernise and simplify award procedures. They will hence make it easier for enterprises, including SMEs, to access public procurement contracts which amount to 16% of the EU's GDP. Several Member States cite examples of non-legislatives measures which aim to facilitate SMEs' access to procurement, like a Best Practice Guide (CY), training and workshops on public procurement (CY), or Web Portals on public procurement (DE, FI, PL, PT, UK). Efforts are also made to promote e-procurement in CY, FI, HU and SK.

3.2. Competition (Integrated Guideline 13)

In the field of competition policy several countries are strengthening their enforcement regimes but there is room for improvement. Competition is in some cases treated more thoroughly in the implementation reports than in the original NRPs (e.g. IT, PL, AT, SI). Implementation reports focus mainly on competition in energy and electronic communications markets as well as competition law and enforcement. There is however a need for more concrete action by Member States in the area of competition. . At the same time, it is encouraging that many Member States are screening specific markets to identify problems with competition. As regards network industries, crucial competition issues remain to be tackled by most or many Member States in energy and rail. Moreover, only very few Member States address in concrete terms the issue of how to reduce their overall State aid level and how to redirect their aid towards horizontal objectives (such as R&D) as repeatedly called for by the European Council.

There is scope to promote external openness through competition reforms, for example, through removing restrictions on competition in Member States' bilateral air services agreements with third countries. Some measures being implemented with the aim to promote competition in retailing and distribution (ES, GR, FR, IT, IR) may benefit end consumers.

Complementarity and interaction between the Community and national level is particularly relevant and intense in the area of enforcement of EC competition rules. Most countries are strengthening their competition enforcement regimes in line with the modernised Community competition rules (e.g. BE, DK, ES, SV, FI, NL). The European Competition Network (ECN) is characterised by close cooperation between the Commission and the 25 national competition authorities. While enforcement procedures have not been formally harmonised by EC law, there is, in many instances, convergence of national laws beyond legal obligations towards the Community standard. Such convergence entails considerable benefits for undertakings in the EU in terms greater predictability. Programmes foreseeing immunity from or reduction in fines for undertakings revealing cartels (leniency) is an area where such convergence is of key importance.

Some Member States (e.g. UK, LV, FI, IR) are undertaking or plan to launch studies into the functioning of specific markets and sectors (so-called competition screening) or even across a very wide segment of the economy (DK).

Many Member States address as a key challenge competition issues in certain network industries. Network industries such as telecoms, air transport, energy, postal services and rail are not only economically significant sectors in their own right. They also provide inputs which are indispensable for the competitiveness of Europe. While the coverage of network industries (in particular energy but also electronic communications) by most Member States in their progress reports is welcomed, more concrete measures to open up markets to competition are urgently needed in particular in the electricity, gas and rail sectors. A general priority across all network sectors is to ensure that the sector regulator is sufficiently resourced and independent. Cooperation between sectoral regulators and national competition authorities should be encouraged.

Promoting competition in *gas and electricity markets* remains a key challenge and concern for most Member States. Issues that Member State should in particular address include making unbundling effective (e.g. FR, PL, DE) and ensuring sufficient resources and independence of the regulators. Progress under the latter point has been made in DE. Some progress in opening up gas and electricity markets can be discerned in certain countries. In other countries systems of regulated prices favour incumbents and discourage competitive entry (ES, FR). Only a few Member States (e.g. NL, UK) have achieved a satisfactory situation as regards unbundling. High levels of market concentration, vertical foreclosure and lack of transparency characterise gas and electricity markets in most Member States.

Competition in *financial services* could also be strengthened throughout the EU. Member State authorities, including financial supervisors and central banks, should attach a high priority to promoting competition and work closely with competition authorities. Retail financial services markets remain fragmented, notably in retail banking. Removing unnecessary barriers to merger and acquisitions and providing open and non-discriminatory access to upstream services such as payment systems and credit registers will support market integration and enhance competition in the banking sector.

Competition in *electronic communications markets* is governed by the regulatory framework adopted in 2002. This is an innovative construction involving internal market harmonisation legislation based on competition policy principles. The review of the regulatory framework for electronic communications is ongoing and legislative proposals will be made in 2007. The experience with the regulatory framework during its first three years of operation is positive. More competition has led to innovation and investment by both new entrants and incumbent operators as well as to significant retail price declines.

Ex ante regulatory intervention under this sector-specific framework can however only be imposed where there is no effective competition. While some national regulators are lagging behind in notifying the market analyses establishing whether there is effective condition on particular markets (e.g. EE, LV) it is encouraging that several others are catching up in this respect (e.g. CY, EL, LU, LT, PL). In Germany the intention to exempt certain markets from regulation and the absence of regulation in other respects which may hamper further broadband penetration raise particular concerns.

While competition in the *rail sector* is addressed in some progress reports (FR, BE, PL), few measures are envisaged to tackle key problems limiting competition such as the need for effective separation between the infrastructure manager and the incumbent rail operator and ensure that the rail regulators are sufficiently resourced and independent.

Within the area of competition in services some Member States are taking positive steps towards reform by rooting out disproportionate restrictions on competition in the key area of professional services (in particular IT but also the UK, DK, NL, and CZ). It must however be underlined that significant reforms are still needed on the part of certain Member States (DE, EL, ES, MT, SI) starting with the most severe restrictions (e.g. price regulation and unjustified barriers to entry). Reform efforts in this sector should also be stepped up by other countries (e.g. AT, BE, CY, FR, HU, LT, LU, PL, PT).

There are few signs of new measures to enhance competition in the services sector with notable exceptions, in particular IT. There is an increasing tendency on the part of Member States to screen markets for competition. More needs to be done to enhance competition in financial services over and above the implementation of agreed Community legislation, taking into account the findings of the Commission's inquiry into financial services focusing on payment cards, core retail banking and business insurance.

Only a few Member States report on progress in reducing overall State aid levels (CY, SI), or reorientation or plans to reorient aid towards horizontal objectives (CY, IT, SI). Additional efforts are needed by certain Member States to increase the share of horizontal aid (CY, ES, HU, MT, PL, PT SK) and/or to reduce the overall aid level (CY, DE, HU, MT, PT, SE, SK). Only a few Member States set out concrete objectives and measures in the area of state aid. A few countries apply or intend to apply in the near future measures to assess the effectiveness of existing and planned State aids (CY, FI, SK, UK) in order to ensure that state aid targets genuine market failures. The Community State aid rules are undergoing a radical overhaul in line with the State Aid Action Plan (2005-2009) to further meet the Lisbon objectives by promoting less and better targeted aid.

3.3. Business environment and better regulation (Integrated Guideline 14)

Better Regulation was identified as one of the prime contributors to achieving the goals of the Lisbon agenda for growth and jobs and became thus an integral part of the National Reform Programmes and Community Lisbon Programme. A need for a joint effort at EU and Member States level has been widely recognised and Member States have speeded up designing and implementing the key elements of a Better Regulation strategy to maximise benefits whilst minimising costs from the regulatory environment in Europe. At EU level, a strategic review of Better Regulation in the European Union, approved by the Commission in November 14th identified further steps to be taken. It also put forward a proposal for an EU-wide strategy to reduce the administrative burden for businesses[13].

All Member States addressed in their Progress Reports several elements of Better Regulation as a part of their efforts to improve the business environment, reflecting their national political priorities and legal and administrative cultures. However, Better Regulation was not always seen as a key factor in the overall policy and law making processes.

Significant progress is underway in the area of measuring and reducing administrative burdens, which can be a serious issue and impede on EU competitiveness, particularly of SMEs, so essential for meeting the jobs and growth goals of the Lisbon Strategy. Sixteen Member states, up from eleven last year, have decided to measure and reduce administrative burdens. All of them have opted for the standard cost model (AT, BE, CZ, DK, EE, FI, FR, DE, HU, IT, LT, NL, PL, PT, SE and UK), while Latvia is planning to do so. A further two Member States are testing or developing the measurement methodology (IE, LU). Six Member States have announced concrete reduction targets (AT, CZ, DK, NL, SE, UK) while Germany is planning to do so. Substantial benefits of reducing administrative burden for businesses have been reported by Belgium, Denmark and Netherlands.

However, the reduction of administrative burden is only one element of regulatory simplification efforts that are targeted at existing legislation. Systematic simplification programmes have been designed and implemented by 13 Member States (BE, DK, DE, FR, IE, IT, MT, NL, PT, SI, SE, UK) and its introduction is foreseen by Poland and Estonia. Even though the coverage of these programmes varies and their implementation has been in most cases only recently launched, the number of Member States has about tripled since last year. Other Member States simplify the stock of existing legislation on an ad-hoc basis.

Less progress has been achieved in carrying out Impact Assessments. There are still only six Member States that systematically assess all relevant impacts of their legislative proposals (AT, DK, DE, IE, NL, UK). Some regulatory impacts are being assessed by four Member States (BE, FR, PT, SE) and another nine Member States are striving to enforce obligatory provisions related to impact assessments (EE, EL, FI, HU, IT, LV, LT, PL, SK). . The implementation of impact assessment systems, combining sectoral effort in analysing economic, social and environmental impacts of a legislative proposal and considering alternatives to regulation, has been slowed down by a need to induce cultural change, sustained commitments to impact assessments enforcement, monitoring and dedication of adequate resources.

The least recognised Better Regulation tool among Member States remains the consultation of stakeholders. Although consultation of stakeholders has recently improved in many Member States and is becoming more and more an integral part of their impact assessment procedures, there is still significant room for improvement when it comes to ensuring that consultation of stakeholders is based on clear, consistent and transparent consultation rules and that minimum consultation standards are applied across the board and these consultation results are made public. Five Member States have made particularly good progress towards this direction (AT, DK, DE, IE,UK).

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13 COM(2006) 689.

Most importantly, progress has been achieved in developing explicit Better Regulation strategies or programmes that ideally encompass the main Better Regulation tools. 13 Member States have developed an explicit Better Regulation strategy (BE, DK, FI, FR, DE, IE, IT, MT, NL, PL, PT, ES, UK), nearly twice as many Member States as last year, notwithstanding differences in focus of these strategies. However, it is important that BR strategies are translated into tangible policies such as simplification programmes and the systematic use of impact assessments in practice.

Overall, there has been significant progress across the European Union, which however mainly concerns conceptual work in designing Better Regulation strategies, impact assessment and consultation guidelines, creating task forces or carrying out pilot projects. With regard to the three stages of Better regulation development that were identified last year, many Member States, which last year were identified as being in the first stage, have now progressed to the next one. As a consequence, most Member States find themselves in the second stage now.

There are serious challenges in the implementation of the announced measures. Establishing a fully fledged Better Regulation system is a long-term goal because its implementation requires a cultural change. This cannot be, however, achieved without strong, sustained and continuous political support, development of adequate institutional structures and dedication of sufficient financial and human resources. Specific targets, compliance incentives and monitoring and enforcement mechanisms are still missing in majority of Progress Reports.

3.4. Entrepreneurship and SMEs (Integrated Guideline 15)

All Member States have addressed SME policy issues in their implementation reports and show determination to create a more favourable environment for SMEs. Most Member States are developing or introducing initiatives to reduce the time to set up a business and efforts are producing results. However, progress has not been uniform. While PT has made particularly good progress, in LT and PL progress seems to have stalled. Regarding cost reduction, EL, ES, HU and PL need to make bigger efforts to bring their costs more in line with the rest of the Member States. While most Member States already have operational one-stop-shops for start-ups, these are currently being developed in CY, DE, EE, HU, MT, PL and SK (see table 1). Only two Member States explicitly addressed the recruitment procedures for small companies (AT, FR) despite the Spring Council conclusion on only one mandatory administrative contact. In only few Member States (especially EE, IE) this is the consequence of an already satisfactory regulatory arrangement.

Europe needs more entrepreneurs to provide more growth and jobs. 21 Member States report on measures to foster entrepreneurial mindsets among young people through education, but only four have introduced entrepreneurship education in the school curricula (FI, IE, PL, UK). ES is starting to implement and EE and SE are planning reforms in this direction. In some Member States there is a national strategy for entrepreneurship education at all levels (CY, ES, FI, SI, UK). While the implementation of appropriate reforms is a pre-condition for success, more support to schools, teachers are needed. Some initiatives are reported to reinforce the teaching of entrepreneurship in higher education (DK, ES, EL, LU). Much remains to be done in most Member States to enhance the role of education in creating a more entrepreneurial culture.

By promoting women's entrepreneurship, Member States would have a chance to integrate a large number of unemployed women into the labour market. However, only six Member

States mentioned specific policies in this area (CY, DE, EL, ES, SE, UK). Good examples are the measures taken by ES (micro-credits, mentoring, coaching and grants) and the UK action plan which aims to reach the target of 20% female business ownership in 2006. Furthermore, only two Member States (NL, UK) report on specific measures to promote entrepreneurship among ethnic minorities.

Access to finance will remain crucial for fostering entrepreneurship, innovation and. Microcredit is an important tool to address the needs of smaller companies. Several Member States are continuing their efforts to increase the share of risk financing (AT, DE, DK, EL, FR, IE, LV, MT, NL, UK), mainly by introducing venture capital instruments. A good example of such continuity is the new round of venture capital funding in Ireland which wants to attract €1bn for start-up, early stage and development stage business by investing €175m. Several Member States are planning to launch initiatives for venture capital (EE, LV, PL, SI, SK). A number of Member States are also setting up loan guarantee schemes (AT, EE, EL, ES, HU, NL, UK). Taking a comprehensive approach, the Austrian SME package consisting of measures for microcredit, equity and working capital can be highlighted as a good example.

In 2005, some 140,000 corporate insolvencies in EU15 potentially affected the jobs of 1.5 million employees. In the recent past, several Member States improved their bankruptcy legislation to promote the continuity of viable enterprises rather than their liquidation, along with faster proceedings. While many NRPs announced measures in this area (CY, EL, HU, IT, LT, LU, LV, PL, SI, SK) some implementation reports remain silent about those reforms. In some Member States (CZ, CY, EL, HU and IT) reviews of bankruptcy procedures are ongoing. DK proposes faster proceedings to help entrepreneurs that failed start afresh, as well as a pilot scheme with an “Early Warning System” to prevent bankruptcy.

Roughly one third of Member States report tax measures to improve the business environment. The scope of the measures is rather broad covering e.g. income taxes, payroll taxes, VAT and inheritance taxes. In several cases, tax measures are directly targeted at small companies (e.g. AT, IE, MT, SI).

Six Member States provide information on business support measures for SMEs (ES, LT, NL, PT, SK, UK). ES and UK are reforming their business support provision. NL has set up a one-stop-shop information portal for businesses and PT is in the process of setting up an interactive online one-stop-shop. No country explicitly addressed the issue of business transfers. Substantial variation exists across Member States in terms of the level of support for the internationalisation of SMEs, but only 12 Member States (AT, CY, DA, DE, EE, ES, FR, LT, LV, PL, PT, SI) report on initiatives related to the promotion of internationalisation of SMEs.

3.5. Transport, Energy and European Infrastructure (Integrated Guideline 16)

Infrastructure is important for competitiveness; in particular trans-European infrastructure is instrumental to the internal market and to territorial cohesion.

The EU10 need to upgrade and improve their infrastructure, not least to improve safety conditions. For all the Member States, infrastructure has to be adapted to the continental dimension, linking the different countries with one another and upgrading the networks to make better use of the opportunities offered by current technologies.

Member States finance or promote the establishment of cross-border links and trans-European corridors, whether for transport, energy or telecommunications. Most Member States addressed infrastructure in their National Reform Programmes and nine (CZ, EL, ES, IE, IT, CY, LT, HU, AT) ranked it as a priority. With regard to the trans-European networks aims to implement the 30 transport priority projects identified by the Council and Parliament and to carry out the cross-border links for the gas and electricity priority projects.

There seems to be an increase in some Member States' infrastructure expenditure (DE, FI, IE). Spain has provided a good example of the links between NRP and the National Strategic Frameworks for its infrastructure investments 2007-2013.

Major efforts are already being carried out for the modernisation of roads, railways (CZ, HU) and airports (CY) and the construction of motorways (PL). Reinforcement of main roads to allow standard EU 11.5 MT axle trucks is important (HU, PO).

It is important to complete the missing links in their high performance networks such as the High Speed Train in order to collect the benefits in increased destinations that the new links open (BE). Major projects cross-border corridors are the biggest challenge of trans-European transport infrastructures. Some of them are reaching completion such the access to the Channel Tunnel Rail Link (UK) some are on a construction stage, such as the international tunnel for rail Figueres-Perpignan – while others, such as the Brenner tunnel (AT), are in an advanced stage of preparation, or being discussed, like the Fehmarn fixed link (DK). Efforts are being made also for the gradual deployment of European Rail Traffic Management System (ERTMS) (CZ) and in road traffic management and multimodal logistic centres (CZ, PT). The Commission has recently highlighted the importance of logistics and intelligent transport systems to improve efficiency in the use of infrastructure[14]. Investments in inland waterways and rail freight (B) will alleviate congestion in the heavily used road infrastructure of the economic centre of the Union and improve the accessibility from peripheral countries and regions. Motorways of the Sea, currently being defined by all Member States – like those in the eastern Mediterranean (EL, IT, CY, SI) will also fight congestion and improve sustainability, while involving a limited amount of infrastructure investment. A growing reliance on sea transport will put pressure on existing port capacities which will have to be used in an better and optimal way; to facilitate this the Commission will put forward proposals for an European ports policy during the second part of 2007.

Urban areas are the engines of competitiveness, urban transport systems have to tackle the congestion that goes together with agglomeration economies. Some Member States, like Ireland, the UK and Estonia are taking good action in this direction.

[14] Keep Europe Moving. Sustainable Mobility for our Continent. Mid-term review of the European Commission's 2001 transport White Paper - COM(2006) 314.

Table 1: State of Play – Functioning of Electricity Markets				
	Quality of active generators and suppliers	**Medium/Large consumers switching supplier**	**Industrial price level**	**Degree of Interconnection**
Austria	Medium	Medium	Medium	High
Belgium	Low	Medium	Medium	High
Denmark	High	High	Medium	High
Finland	High	High	Low	Medium
France	Low	Medium	Low	Medium
Germany	Medium	Medium	High	Medium
Greece	Low	Zero	Medium	Medium
Ireland	Low	Medium	High	Low
Italy	Medium	Medium	High	Low
Luxembourg	Low	Low	Low	High
Netherlands	Medium	Medium	Medium	Medium
Portugal	Low	Low	**Medium**	Low
Spain	Medium	**Low**	Medium	Low
Sweden	High	High	Low	High
United Kingdom	High	High	Medium	Low
Estonia	Low	Zero	Low	High
Latvia	Low	Zero	Low	High
Lithuania	Low	Medium	Low	High
Poland	Medium	Low	Low	Low
Czech Republic	Medium	Low	**Medium**	High
Slovakia	Medium	Low	**Medium**	High
Hungary	Medium	Medium	Medium	High
Slovenia	**Low**	Low	Medium	High
Cyprus	Low	Zero	High	
Malta	Low	Zero	Medium	

Notes	Low < 3 Medium 3-6 High > 6 Lowest figure for generation/supplier taken as e.g. small suppliers often very dependent on large generators (e.g. Germany). Alternatively small generators may be in long term PPAs with dominant supplier (e.g. Poland, Hungary).	Low < 10% Medium 10-50% High > 50% Estimated figures since market opening. Comment: medium to large companies worried about their electricity bill and would be expected to aim to test the market regularly if not annually.	Low < 55€/MWh Medium 55-75€/MWh High > 75€/MWh Prices reported to Eurostat for consumer using 24GWh/year. This is a quite large business customer. The Berlayamont uses about 10-15GWh/year I think. Eurostat may overstate prices for some MS where only the standard tariff "i.e. before negociation" is quoted. Some MS, including most new MS have strict end-user price controls. Although this is nice for large users, it is an unsustainable policy and will stifle competition.	Low < 10% Medium 10-20% High > 20% Of installed generation capacity.
Source: European Commission Report to the Economic Policy Committee, October 2006.				

The internal energy market relies on the availability of cross-border interconnections for electricity and gas to become a reality. In the energy sector new electricity links like Estlink the undersea cable between Estonia and Finland allow an increase in the security of supply and the efficiency of the energy systems involved. However, progress is slow in the case of crucial links such as the electricity transmission project Spain-France.

The sector inquiries into the gas, electricity and financial services markets launched in the summer of 2005 under the EC competition rules (and which are about to be completed) strongly complement and add value to Member States action in these fields by identifying – from a European perspective - obstacles to competition and market access (e.g. need for cross-border interconnection capacity and regulatory cooperation) and by examining the scope for applying competition law and other remedies. Table 1 gives an overview of the state of play in electricity markets.

The introduction of natural gas produces improvements in energy efficiency (in particular via cogeneration), and in energy emission of CO2. Only Malta and Cyprus are not supplied with natural gas. Several Member States, like Portugal, Ireland and Greece have been connected recently to the European grid and they are developing construction of urban networks. With the increase of imports (more than 80 % of the EU consumption in 2020), the main concern today is the security of supply. Diversification of the import routes and the timely implementation of the projects are the core objectives of the Priority Interconnection Plan which will be submitted to the Parliament and the Council in January 2007.

The lead times for major infrastructure to go from inception to operation phases are extremely long for technical, regulatory and financial reasons. These delays hamper the contribution of infrastructure policies to competitiveness. Some Member States are improving their regulatory framework to reduce the costs in time and money incurred by promoters. An "Infrastructure Planning Acceleration Act" is being discussed in Germany which will shorten planning times (by up to 2.5 years) for key infrastructure projects (similar rules had been applied in the Eastern Länder. A streamlined consent procedure is equally being applied in Ireland for energy infrastructure. Efforts in this direction must be encouraged in all Member States.

In conclusion, the progress reports show that most Member States give high priority to transport and energy infrastructure modernisation, even beyond what the National Reform Programmes would lead to expect. These efforts should be kept, clearing the way of regulatory and financial obstacles through better regulatory practices and pricing schemes and by facilitating public-private-partnerships while making the best use of EU and national funds.

EMPLOYMENT PART

1. SUMMARY AND CONCLUSIONS: A BETTER IMPLEMENTATION OF EMPLOYMENT POLICIES

Employment is increasing and unemployment falling. However, productivity growth and quality of jobs remain below Europe's needs. The responsiveness of European labour markets to the challenges of globalisation and ageing remain critical issues. The implementation reports indicate that of the three European Employment Strategy priorities, attracting and retaining more people in employment sees most policy implementation. Implementation of policies to increase investment in human capital through better education and skills is also progressing. Policy implementation to improve the adaptability of workers and enterprises is lagging behind.

1.1. Attracting and retaining more people in employment, increasing labour supply and modernising social protection

Efforts have been intensified to reach out to groups and individuals at the margins of the labour market, and society[15]. Member States are devoting more attention to labour market reforms that have an impact on poverty and exclusion and which encourage longer working lives. They are converging in efforts to offer active support to the most disadvantaged through a balanced approach combining personalised labour market support, high quality social services and adequate level of minimum income.

In response to the 2006 Spring European Council's request, more attention has been paid to an integrated lifecycle approach to work. Despite this, policies for young people, women and older workers are still mostly treated separately.

Youth unemployment is a severe problem in many Member States and labour market segmentation to the disadvantage of the young is increasing. A number of measures are being implemented both to increase employability and provide incentives for employers to hire young people. Many Member States are still far away from the target of a "new start" for young unemployed within 6 months by 2007 and 4 months by 2010.

Through the European Pact for Gender Equality, Member States were asked to include a perspective of gender equality when reporting on implementation. In spite of this, the promotion of female employment and systematic gender mainstreaming of policies are rarely emphasised. There is some progress in many Member States to develop childcare facilities and encourage employers to be more family friendly. Affordable and accessible quality childcare provision must be expanded to allow both parents to work, to better reconcile work and family life for both and to reduce high levels of child poverty.

An increasing number of old Member States are opening their labour markets to citizens of the new Member States. Some are implementing measures targeted at immigrants or minorities. The unemployment gaps between EU and non EU nationals are increasing,

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15 This is also shown in the National Reports on strategies for social protection and social inclusion.

especially where large gaps already existed. Labour market integration of legal migrants should become a more explicit dimension of employment policies.

Member States continue to implement reforms to encourage older workers to stay longer in working life. There is a shared will to progress on adequacy and sustainability within pension reform. It is crucial to create real job opportunities for older workers. This would complement the strengthening of incentives to work longer as a condition for ensuring future adequacy of retirement provisions and to avoid additional pressures on system sustainability. Equally, Member States increasingly recognise that improving health and the access to medical and preventive care and rehabilitation are key dimensions of a strategy to increase labour supply in a sustainable manner.

1.2. Improve adaptability of workers and enterprises

The implementation reports show the weakest policy implementation in this area despite the increasing need for adaptable labour markets. Rapid technological progress and increased competition stemming from globalisation require increased flexibility. Governments have tended to focus on easing labour market regulation for new entrants to facilitate more contractual diversity, without reforming legislation for existing contracts and ensuring transitions between types of contracts and opportunities to progress. Labour market segmentation and undeclared work remain important problems in many Member States.

A more comprehensive approach is necessary to combine flexibility and security in a more integrated approach. Flexicurity policies should attempt at going beyond the old trade-off where more flexibility meant less security. The aim is for workers to exchange traditional security in the job for security in the market, brought about by efficient and cost-effective active labour market policies (ALMPs), and adequate levels of social protection to tide them over between jobs. Flexicurity policies should aim at raising productivity and quality of jobs.

There is recognition that modernising social protection systems, covering all major social risks independent of the nature of employment and labour contract, and removing disincentives to work, is crucial for improving flexicurity. Progress is in some respects slow.

Member States could pursue a range of policy pathways towards greater flexicurity with packages of measures reflecting different starting points. Such packages would help promote a climate of trust with all actors accepting responsibility for relevant action. Flexicurity pathways would see Member States combining policies covering contractual arrangements, ALMPs, lifelong learning and social security systems that promote mobility and provide adequate income support.

1.3. Increase investment in human capital through better education and skills

Many Member States are developing policies to increase investment in education and skills. Implementation is progressing, but often in a piecemeal way. Only a minority of Member States have a comprehensive strategy to invest in human capital throughout the life cycle.

Almost all Member States report on measures addressing the low skilled, in particular the prevention of early school-leaving and compensatory measures within adult learning. Progress is however slow in reducing early school leaving; in 2005, 6 million young people left education prematurely. Many Member States need to increase their efforts if the EU is to reach its 2010 target of 85% of 22 year olds in the EU having completed at least upper secondary education. Since 2000 the figure has moved little from around 77%.

The situation is also worrying in terms of adult participation in lifelong learning. In 20 of the 25 Member States the participation rates remained virtually stable or actually fell! Participation is particularly low in Southern European countries and most of the new Member States. Older workers continue to see very low rates throughout the EU.

Much of the focus is on structural reforms to education and on improving the link with the labour market. There is little information provided on an explicit commitment to increase investment in human capital. A breakthrough in the level of this investment is essential if we are to generate sufficiently adaptable economies with high productivity growth. Member States need, therefore, to develop the appropriate incentives and cost sharing mechanisms for enterprises, public authorities and individuals.

2. Progress in achieving the objectives of the European Employment Strategy

Member States' policies should foster full employment, quality and productivity at work and social and territorial cohesion. These objectives, together with good governance, frame the European Employment Strategy.

2.1. Full Employment

Employment growth picked up in 2005 to 0.8%, the largest increase since 2001. As a result, the employment rate increased to 63.8%. The rise in the employment rate was driven by increases within both gender groups. Employment grew by 1.1% for women and by 0.6% for men (after three years of virtual stagnation). The employment gender gap further narrowed to 15 percentage points, but remains too large. Progress has been slower in full-time equivalents (21.4 pp in 2005 compared to 21.7 pp in 2004).

Unemployment fell from 9.1% in 2004 to 8.8% in 2005, with long-term unemployment falling for the first time since 2002, and standing at 3.9%, compared with 4.1% in the previous year. Both women and men experienced the decrease; the unemployment rate fell to 9.9% for women and 7.9% for men.

There were further increases in employment for older workers, with the employment rate increasing from 41% in 2004 to 42.5% in 2005. In contrast, many Member States have seen the labour market situation for the young stagnate. At 18.3%, youth unemployment is about twice the overall rate.

Despite some progress over the years, (overall employment rate has increased by 15.3 million since 1997) the employment rate remains 6.7 pp or around 20 million jobs below the 2010 target. Even if employment increases, as currently projected, by 7 million by 2008, there will still be a gap of some 13 million jobs to bridge. Whilst older people's employment rates have risen more rapidly, they still remain 8.5 pp below their respective 2010 targets, Female employment rates have also risen fast and are on track to reach the target (3.7 pp below 60%).

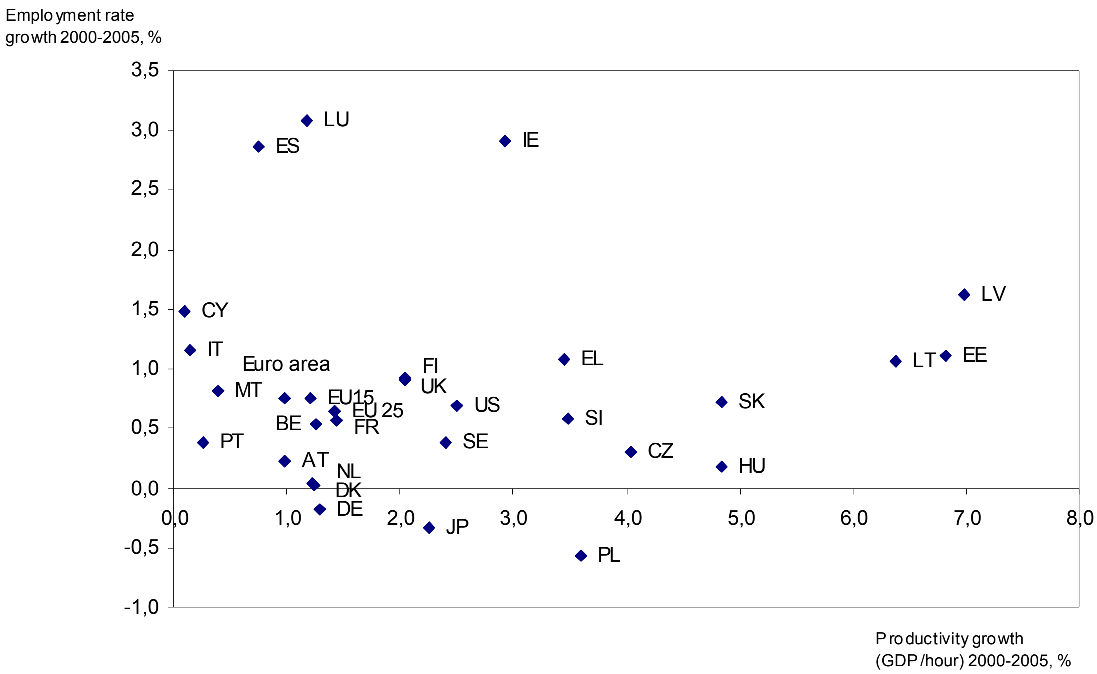
2.2. Quality and productivity at work

Productivity

Globalisation has seen a massive increase in the effective labour supply shifting capital/labour ratios considerably. Technological advances have become more prominent. To be competitive and ensure sustainable growth productivity must increase. However, labour productivity growth has been decreasing in the EU as a whole since the eighties. Average productivity growth (average annual change in GDP per hour) fell from around 2% a year in the 1980s and the second half of the 1990s, to 1% in the 1996-2001 period and to below 1% between 2001 and 2003. The situation improved in 2004 (1.9%) but has again slipped below 1% (0.9%) in 2005. This compares unfavourably with the US (1.8%) and Japan (2.2%).

Addressing this productivity slowdown will be a key challenge in ensuring further growth and jobs. While in the short term trade-offs between employment and productivity can occur there is a clear positive link in the long term between the two. Thus, a high level of productivity appears to be a necessary condition for sustainable employment growth. Table 1 reports the clustering of EU countries according to their relative position in terms of average growth in labour productivity growth per hour and growth in employment for the 2000-2005 period.

Graph 1: Employment and Productivity Developments across the Member States



Source: DG ECFIN, 2006.

In the CZ, HU, SK, LT, EE, LV and PL high growth rates in productivity growth between 2000 and 2005 were accompanied by low growth rates in employment (or negative in the case of PL). Industrial restructuring that took place in these countries had the effect of both increasing productivity and shedding jobs. By contrast, in ES and CY, increasing employment was combined with below-average productivity growth. The position in PT, AT and MT is characterised by low productivity growth combined with low employment growth. Only IE, has succeeded in achieving high growth rates in both employment and productivity.

Quality at work

Progress in the quest to increase quality at work again remains mixed[16] and the implementation of policies to further this aim limited. 2005 saw further improvements in youth education levels. Nevertheless, there is again limited progress in other elements of quality at work, especially the transitions from temporary to permanent jobs and out of low-paid jobs, and in reducing labour market segmentation. A worry is that many Member States saw adult participation in lifelong learning fall.

2.3. Social and territorial cohesion

The Lisbon strategy calls for economic and labour market reforms to contribute to strengthening social cohesion and for social policies to help economic and employment growth. The *National Reports on strategies for social protection and social inclusion* and the Implementation Reports both show that Member States are converging in their efforts to reduce child poverty and to strengthen the active inclusion of the most disadvantaged groups through a balanced approach.

Social protection reforms are needed to improve the sustainability of public finances. Reforms in pension systems can contribute to save financial resources for modernising social policies, and shift resources towards new needs. With the improved economic outlook, the challenge is to ensure that growth and job creation translate into greater social cohesion. Spending on social policies is likely to increase in the coming years to meet growing needs. But looking together at the EU objectives of accessibility, adequacy, quality and sustainability when implementing reforms will help Member States improve the quality of their policies and of the spending which supports them.

Regional employment disparities slightly narrowed in 2005. However regional disparities remain widespread, with very high rates of unemployment in many regions. Regions with low levels of employment also tend to be the ones with lower productivity levels. Rises in labour productivity in regions with low overall levels of productivity have not yet been followed by substantial increases in employment.

3. IMPLEMENTING THE PRIORITIES FOR ACTION

To achieve EU employment objectives and targets, the Employment Guidelines are built around three priorities for action: attract and retain more people in employment, increase labour supply and modernise social protection systems; improve the adaptability of workers and enterprises; and increase investment in human capital through better education and skills.

16 For details of the 10 dimensions of quality at work see: Improving quality in work: a review of recent progress - COM(2003) 728, 26.11.2003.

3.1. Attract and retain more people in employment, increase labour supply and modernise social protection systems

Promote a lifecycle approach to work

Demographic change requires an increase in hours worked, longer working lives and later retirement. More work over the life-cycle is key for sustainable social systems and increased standards of living. Member States have continued their focus on reforms to attract and retain more people in employment, increase labour supply and modernise social protection systems in this year's implementation reports. Limited attention is however again devoted to the development of an integrated life cycle approach. Policies targeted at youth, women and older people are treated separately.

Member States report on reforms to allow older workers to stay longer in working life, to facilitate the return of unemployed older people back to the labour market, and/or to fight discrimination. Financial incentives have been increased for workers over 65 years of age in IE through increased exemption limits from income tax, and in SE through lower social security contributions. In a number of Member States more wide-ranging actions are crucial to cope with increasing longevity and extending working lives. Reforms must press ahead to discourage early retirement. Stronger efforts are also needed to ensure that real job opportunities for older workers are created. To meet the demographic challenges requires more rapid progress towards both the employment rate target of 50 percent set for 2010 and the target to increase the average exit age by 5 years. The employment rate of older workers has increased in most Member States, and now stands at 42.5%. However this varies significantly with rates below 35% in BE, IT, LU, HU, AT, PL, SI, SK and in MT. This rate has increased for both women, and men, to 33.7% and 51.8% respectively, but a significant gender divide remains. The average exit age increased in 2005 to 60.9 years, 60.4 for women and 61.4 for men, an increase of only 1.5 years since 2001, and clearly below the target of raising it by 5 years.

The employment rate for women has increased in almost all Member States. However, the potential contribution of women to raising the aggregate employment rate is still not fully exploited. Further policies to promote child and elderly care, and the reconciliation of work and family life would continue to improve the labour market position of women. The average female employment rate rose to 56.3% in 2005, but is still under 50% in EL, IT, MT and PL. In the majority of Member States there remains no reference in the Implementation Reports to specific measures aimed at promoting female employment or reducing gender gaps, with the exception of measures to increase access to childcare facilities. Some Member States (AT, BE, DK, DE, ES, IE, IT, LU, UK) have set national childcare places targets but few report on progress towards the European childcare target. Overall progress towards this target remains slow. Actions to make childcare more affordable through a maximum fee or reduced costs are stressed in just AT, DK, FI, IE, MT, and NL. The need to strengthen the role of men in the reconciliation of work and family life is lacking. SI has launched a campaign to make men more active in family life and CZ, DE and EL will extend the possibility for fathers to take parental leave.

Responding to the commitments made at the 2006 Spring European Council

Young people tend to profit less from employment growth. In most countries the labour market integration of young people is not improving significantly. The youth employment rate remained unchanged at 36.8% in 2005, with rates of 39.7% for men and 33.8% for women. There was a slight increase in the youth unemployment ratio with the overall ratio moving up to 8.4%. The ratio is now above 10 percent in PL, SE, SK and FI. The decrease in youth unemployment in some Member States is linked to emigration of the young.

Both the European Pact for Youth and the commitments made at the 2006 Spring European Council, identified young people as a priority group. All countries now pay increased attention to the issue, but with varying levels of commitment. Measures are being implemented, but a more comprehensive approach is needed. Few Member States implement measures to both increase employability and incentives for employers to hire young people. In some countries the new start for youth is enshrined in legislation or operative targets of public employment services (AT, DE, CZ, DK, FI, NL, UK) or this is envisaged (LU, IE). Less than half of the Member States actually meet the target of a new start within six months by 2007 (AT, CZ, DK, FI, DE, UK. LV, NL, SE).

Member States use a range of measures to provide for a new start. Typically these are training measures, but also include financial incentives for employers to hire the young or apprentices (AT, FR, HU), the obligatory return to education for early school leavers (CZ, UK), and reform of the public employment services (PES) to provide a better quality service. A few countries point out the need to activate young people through reduced social benefits for young unemployed (LU). In many Member States youth unemployment is the result of deficiencies in other areas (education and training systems) and due to the poor functioning of labour markets (high barriers for new entrants; labour market segmentation pushing young people into precarious work). Attention needs to ensure that measures targeted at the young do not have the adverse effect of segmenting labour markets even more.

Ensure inclusive labour markets, enhance work attractiveness, and make work pay for job-seekers, including disadvantaged people, and the inactive

Policies to encourage the inclusion of people on the margins of the labour market need to be stepped up in order to fully exploit potential labour supply. Member States are converging in efforts to strengthen the active inclusion of the most disadvantaged through a balanced approach combining individual labour market support, high quality social services and an adequate level of minimum income. Increased conditionality for benefit receipt is an important part of this, but must not push the weakest members of society further into social exclusion. AT, BE, FI and FR are, and SE will, subsidise household work which will increase employment opportunities for the low skilled and low paid. Few Member States report on progress towards the target that a quarter of the long-term unemployed should be receiving active support. A number of Member States are implementing measures to raise employability, encourage the start up of a business, or provide subsidised jobs. However, the overall level of support is insufficient. The employment Strategy target that all people should receive a new start within 12 months for adults is poorly reported and where it is, the outcome varies considerably.

Most Member States devote attention to people with disabilities, and in some cases people on sick leave, through a combination of legislative measures and reforms focused on rehabilitation, activation and the provision of employment incentives. A number of Member States are implementing measures targeted at immigrants or ethnic minorities, but the unemployment rate gap between EU and non- EU-nationals is still more than 10 pp in many countries (BE, DE, FR, NL, FI, SE). The most worrying concern is that this gap actually increased in all these Member States except FR.

Measures to make work more attractive through financial incentives, including lower social security contributions (BE, FR, NL, SE), lower taxes (BE, FR, IE, MT, NL, SE, SI, SK), the use of in-work benefits (BE, FR) and an increased minimum wage (LT, LV and UK) are now widely used. These measures are mostly targeted at low and middle income earners, but an increasing number are being targeted towards specific groups. Financial, and non financial, incentives are directed towards women who have been away from the labour market in MT, and a return to work bonus for long term unemployed will be further developed in FR. Some Member States are strengthening the obligations and activation requirements for unemployment benefit (DK, HU, FI, LT, NL, MT, SI, SK). In SE the level and duration of unemployment benefit will be reduced in order to stimulate the work first principle. The effects of such policies on the most disadvantaged needs to be carefully monitored.

Improve the matching of labour market needs

Reforms of the public employment services (PES) are now either put in place or continue in many Member States. An increasing number of PES' are focusing on unemployment prevention and on ensuring an individualised approach to support. FR, for example, sets an objective to increase assistance and to shorten the time between inscription at the employment service and the first interview. Some Member States provide detail on an increased spending on labour market policies. The importance of increased efficiency in labour market policies is increasingly highlighted (CZ, EE, UK, PL, FI, DK, FR, HU, NL, SE).

Little attention is given to the role that measures to increase geographical mobility and occupational mobility can play in improving the functioning of the labour market. FI, FR, SK, IT and CZ support the take up of jobs in other parts of the country and AT, CY, EE, FI, LT, SK, and SI have increased or improved labour market training and/or vocational training to promote occupational mobility.

The decision to open up labour markets for the citizens of new Member States in 2006 is rarely mentioned in the reports. Actions to review and revise the management of economic migration from third countries are in place in CY, CR, DK, HU, MT, NL, and PT. IE will take steps to work with Social Partners to assure the good treatment of migrant workers. Steps to better anticipate future skill needs, and manage immigration accordingly, is not mentioned in the reports with exception of CY, FI, IE and MT.

3.2. Improve the adaptability of workers and enterprises

Promote flexibility combined with employment security and reduce labour market segmentation, having due regard to the role of social partners

In line with the conclusions of the APR 2006, which clearly illustrated a lack of policy emphasis in the adaptability priority, implementation under this priority has been slow. At the 2006 Spring Council, Member States committed themselves to a more comprehensive strategy to improve the adaptability of workers and enterprises, directing special attention to the challenge of **flexicurity**. Although not every country explicitly cites flexicurity, it is clear that the attention given to this concept has had a positive effect on the policy debate. Most countries are testing its value for national policy making. As yet, few go beyond clustering separate measures under this new heading. Member States have not yet integrated the concept to focus on the interaction of measures rather than on measures individually. Nonetheless, a small number of them have already taken serious steps towards such an approach. In IE a new 10-year social partnership agreement was signed in 2006, covering many items related to flexicurity.

Labour code reviews are by far the most widespread type of measure. Member States are increasing contractual diversity but generally do not focus on transitions between types of contracts. There are few examples of measures aimed at redesigning Employment Protection Legislation for regular contracts to promote more flexibility and transitions (including LV, PT). Some countries, such as EE and SI, announce new reviews of their labour codes with a view to making them more flexible. In other cases political sensitivity causes delays in policy making (CZ, PL) or abandonment of previous plans, such as the announcement by DE to extend probation periods in exchange for the abolition of fixed term contracts. Policies to introduce flexibility 'on the margins' are still pursued (FR, PL). Countries having operated such policies for some time increasingly realise these encourage labour market segmentation which needs to be addressed. In IT temporary workers will benefit from increasingly harmonised social rights and improved pension rights via higher social security contributions In ES, a package of measures was agreed with the social partners.

A majority of countries pay attention to tackling undeclared work, often through strengthening the labour inspectorate or other control or surveillance measures (AT, EE, DK, EL, HU, LV, LT, SI). A few countries have designed measures to improve their capacity to anticipate and manage economic restructuring and to forecast future labour market needs. LU is introducing transition plans for those who lose their jobs due to restructuring. IE is announcing a review of future challenges facing the manufacturing sector. The introduction of innovative and adaptable forms of work organisation has been promoted in several countries by initiatives at national level (LV, SI, SK, UK) and by the social partners (DE, LU).

Some countries are implementing new forms of support for transitions in occupational status (transition security) allowing workers to be better prepared for transitions between jobs. FI is implementing 'change security', providing dismissed workers with greater financial security during the stage of transition between jobs and fostering more efficient cooperation between employers, employees and labour authorities. Other initiatives focus on incentives for unemployed people to start businesses (BE, DE).

Policies presently implemented or designed will not suffice to meet the flexicurity challenge. Effective combinations of flexibility and security result from comprehensive policies impacting on labour markets as a whole. Redesigned EPL to promote more flexible contractual arrangements, active labour market policies, lifelong learning and modern social protection systems should interact with each other, supporting transitions between jobs and contract types, and offering opportunities for workers to progress.

Promoting a Flexicurity Response

The extent to which flexicurity conditions are in place and interacting positively differs widely across Europe. North European countries generally provide the right conditions for flexicurity. Northwest European countries represent dynamic labour markets and good activation performance, but may need to invest more in benefit systems and human resources. In West Central European countries, policies tend to introduce flexibility at the margins, which, in spite of some employment success aggravates the risk of segmentation. Active labour market policies are being developed but effectiveness should be increased, combining 'carrots' with 'sticks'. South European countries often represent strongly segmented labour markets, resulting from previous policies to introduce flexibility at the margins without addressing the very static mainstream labour markets and rising undeclared work. Active labour market policies and lifelong learning systems are weak. Central and Eastern European countries are facing segmentation between rigid work arrangements in traditional sections of the economy and strongly liberalised contractual arrangements in the new economy as well as high incidence of undeclared work. Lifelong learning systems and active labour market policies are very weak.

Common principles of flexicurity should take account of this diversity of starting points. They will centre on policy pathways towards greater flexicurity. Policy pathways are packages of measures reflecting, in particular the different starting points in Member States. The starting point reflects the institutional set-up, economic situation of the country, available financial resources and the precise challenges that need to be addressed. The policy pathway would help to promote a climate of trust in which all the actors concerned actively accept responsibility for relevant action. Flexicurity pathways mean countries will combine policies covering labour laws, active labour market measures, lifelong learning and social security reforms. In the course of 2007, the Commission will come forward with a Communication providing key input to the development of common principles of flexicurity.

Ensure employment-friendly labour cost developments and wage setting mechanisms

The implementation reports show that wage bargaining developments are generally in line with macroeconomic stability and productivity developments, although the continuously high rates of long-term unemployment and persistent regional differences in employment performance suggest a lack of wage differentiation. High gender pay gaps show no significant signs of being closed. Targets are set only by two countries (EE, FI), and most Member States do not address the issue. Several countries (FI, DE, LV, IT, SI) are implementing plans to reduce non-wage labour costs across the board, and some of these are quite ambitious. Some countries are targeting non-wage labour cost reductions on specific groups, such as long-term unemployed, low paid, young and older workers (AT, BE, FI, IE, FR, SE). In-work benefits are increasingly used, but despite this risks of low-wage and unemployment traps remain. However, there are also cases in which plans made previously had to be abandoned or postponed because of budgetary reasons (HU, PL, CZ).

3.3. Increase investment in human capital through better education and skills

There is a good level of overall implementation of measures announced in the 2005-2008 NRP, with a wide variety of measures. Much of the focus of action is in the areas of: new framework legislation for education and training systems or for lifelong learning, the introduction of new curricula, improving educational offers and enhancing the flexibility of educational pathways. However, many measures are still in their initial phase, and approaches continue to be often rather piecemeal. More comprehensive reforms including long-term policy planning and the development of a culture of evaluation are needed to address some deep-rooted challenges. Member States should also focus on improving the efficiency and equity of education and training systems, in order to ensure a good return on investment by reducing the indirect costs, and to ensure that every citizen, especially the disadvantaged, migrants, and ethnic minorities, can play their full part in society and the economy. It is too often the case that systems reproduce or even compound existing inequities.

Expand and improve investment in human capital

The 2004 Spring European Council committed Member States to put in place coherent and comprehensive lifelong learning policies by the end of 2006. Only a small number of countries (AT, CY, SK, SI) report on the process of designing their strategy and announce that this work will be completed by the end of 2006. Such strategies should include a strategic overview and priority setting, with a targeted allocation of resources; should cover all forms of education and training (formal and non-formal) and all levels (from pre-school to adult learning); should foresee flexible learning pathways and effective transition points between levels and systems; and they should involve stakeholders at all stages of implementation.

The 2006 Spring European Council identified an increase in education levels as key to improving employment opportunities for priority categories, but there is very little progress in achieving the targets set for 2010. In 2006 about 6 million young people aged 18 to 24 were early school-leavers. At EU level, the rate decreased slightly from 15.6% to 15.1% between 2004 and 2006. The rate remains significantly higher for boys (17.3) than girls (13.1). In this period, school drop-outs rate decreased at least one percentage point in six countries (CY, ES, FR, IT, NL, UK). However, numbers actually increased by more than one percentage point in seven countries (DE, DK, EL, LV, SI, SE, SF). Increased efforts are required in coming years to help reach the EU target, through comprehensive approaches combining preventive and remedial measures. This need is particularly pressing in countries with highest rates of school drop-out (CY, IT, MT, PT, ES, EL, LV).

The upper-secondary education completion rate of 20-24 year-olds has hovered around 77% since 2000 (74% for men, 79% for women), against the target of at least 85%. This target is met by only eight Member States. While the situation is improving in some of the poorly performing countries (MT, PT), it is particularly worrying in ES, which combines a low starting point with a decreasing trend. Decreasing trends also merit attention in DE, FI, and LU. Stronger efforts to increase the completion rate are needed in most Member States. Since upper secondary education is the phase when the majority of young people prepare for transition into the labour market, it is particularly important to improve and diversify educational offered. Strengthening vocational training is crucial for many Member States. Partnership with business also needs to be strengthened to increase the quality and relevance of training. More attention must also be paid to ensuring access to upper secondary education for all young people, including migrant and minority youth. Some countries (AT, DE) have recognised this as a priority, given they face difficulties in youth access to vocational training for migrants.

Europe is not advancing sufficiently towards the target of 12.5% participation rate for adults in lifelong learning. Although participation increased slightly from 9.9% in 2004 to 10.2% in 2005[17], only five Member States saw participation increased significantly. The situation is most concerning in Southern European countries (EL, IT, PT) and in most new Member States where the average rate is less than half of the EU-15 average (5.5%). Of particular concern is the low participation of older workers in lifelong learning in all Member States. In view of the ageing of the workforce in Europe, it is urgent to develop lifelong learning of people over 40. Only a few countries have concrete measures for this.

Despite a commitment by Member States to improve investment in human capital, there is little evidence of actual or planned increases in public and private investment. Very few Member States set national targets for increase of the public education budget (EL does). Only CY and UK have substantially increased public investment in human capital in recent years. The role of private investment from individuals and companies is still not given enough attention. The European Social Fund 2007-2013 will have to play an important role in increasing investment in human capital in many countries, particularly the cohesion countries.

[17] Mainly due to doubling of the figure for ES measurement changes at national level.

Education and Growth

One major cause of the relatively slow economic growth in Europe compared with the US is low investment in research and development and human capital. Currently the EU invests approximately 1.2% of GDP in tertiary education compared with nearly 2.9% in the US.

There is a consensus that education, and more generally human capital, are key determinants of productivity, and that its role is crucial in a knowledge-based economy. Recent studies acknowledge that an educated workforce is better at creating, adopting and implementing new technologies; human capital influences technological progress. Thus economies endowed with a high-skilled and adaptable workforce are better able to create and make effective use of new technologies and to embrace change. Moreover, the empirical results suggest that the impact of a high skilled workforce on technological progress through technology creation is greater in countries where the working environment encourages adaptability – the capacity of high-skilled workers to trigger, absorb and adapt to changes in economic conditions. They also suggest that although the EU should invest more in higher education, this solution is not the panacea. Indeed, the whole lifelong learning continuum should be considered. Member States should also invest more in pre-primary education as an effective means to establish the basis for further learning and preventing school drop-out. The results also suggest that investing more in higher education, though necessary, is unlikely on its own to be sufficient for the EU to move to the world technology frontier – the adaptability of workers and enterprises matters too. Therefore, the promotion and dissemination of innovative and adaptable forms of work organisation, such as "discretionary learning" are essential.

Adapt education and training systems in response to new competence requirements

Member States pay increasing attention to the relevance of education to labour market requirements. This is particularly important for countries where high educational attainment levels are accompanied by high youth unemployment. There are positive signs of upgraded vocational training systems in a number of countries. Measures are being taken to improve the attractiveness of vocational training, to modernise curricula and to improve the infrastructure. The involvement of employers is recognised as crucial for ensuring sufficient numbers of training places; some countries therefore introduce financial bonuses to increase places (AT). However, in a number of countries progress in vocational training reforms remains slow (CY) or reform strategies are lacking (PL).

While the employment rates of graduates are high in most Member States, unemployment is increasing among tertiary education graduates. Policy responses require a stronger focus on the transition between higher education and the labour market. A few countries report measures to reduce gender segregation of studies and to attract more women to studies in engineering and natural sciences. Speeding up graduation is a measure actively pursued in countries with labour supply problems (DK, FI), but may also become an issue for other countries. Implementation of measures for improving the transparency of qualifications and the validation of prior learning, including non-formal and informal learning, is reported by some Member States. These aspects will need more attention in the future.