



**COUNCIL OF
THE EUROPEAN UNION**

Brussels, 4 June 2010

10731/10

**ECOFIN 345
COMPET 191
SOC 404**

NOTE

from: The General Secretariat of the Council
to: Delegations
Subject: Report on EU macro-structural bottlenecks to growth at the national level

Delegations will find attached a report on EU macro-structural bottlenecks to growth at the national level, as prepared by the Economic Policy Committee and by the Economic and Financial Committee.

Encl.:

EU MACRO-STRUCTURAL BOTTLENECKS TO GROWTH AT THE NATIONAL LEVELIntroduction

- While the recovery from the most severe economic crisis since the 1930s is underway in the EU, it is proving more tentative than in past upturns. In this context, it is imperative that exit strategies include structural reforms to boost potential growth.
- On 3 March 2010, the Commission outlined its proposal for a Europe 2020 strategy to help the Union emerge from the crisis and return to economic growth and public finances to sustainable trajectories. Building on this proposal, the ECOFIN Council recognised on 16 March "a need to start identifying areas that constitute the main bottlenecks, including infrastructure to growth at the EU and national level." The European Council on 25-26 March also highlighted the need to address bottlenecks constraining growth at national and at EU level, including those related infrastructure and to the working of the internal market.
- For each country, the bottlenecks have been identified on the basis of the following approach:
 - the focus is on identifying medium to long term challenges in line with the Europe 2020 time horizon and not on detailed policy suggestions;
 - as regards the scope/coverage, this exercise identified only macro-structural bottlenecks to growth. This encompasses both framework conditions for growth at macro level (budgetary, macro-financial, external imbalances) and growth drivers at macro level (labour utilisation, investment, productivity): thus, reflecting the more integrated approach to surveillance called for in European Council conclusions. These bottlenecks at the macro-structural level may over time be complemented by more detailed analysis arising under the thematic elements of the Europe 2020 strategy.

- bottlenecks have been identified on a country-specific basis reflecting the most important priorities of the country concerned according to the EPC and EFC. This means that a country may have a bottleneck identified in an area even if performance is above the EU average.
- the euro area dimension is taken into account with respect to competitiveness concerns and macroeconomic imbalances .
- Member States are invited to take these suggestions into account in setting out their bottlenecks in their National Reform Programmes.

Main messages

- Most Member States are experiencing significant fiscal deficits and rising debt ratios which together with the costs of ageing populations, pose a significant challenge for fiscal sustainability and thereby confidence and growth. The challenges outlined below draw upon and are consistent with recent Stability and Convergence Programme assessments.
- Many countries face the challenge of ensuring a stable and well-functioning financial sector that is capable of providing continuous financial intermediation without state support. A sound, well capitalised financial sector along with measures to avoid asset price bubbles and excessive private sector indebtedness would help to ensure the stability of the financial sector.
- Member States with large current account imbalances rooted in a persistent lack of competitiveness¹ or due to other reasons should address the underlying causes by acting for example on fiscal policy, on wage developments, on structural reforms relating to product and financial services markets (including the flow of productivity enhancing capital), on labour markets, in line with the employment guidelines, or on any other relevant policy area.

¹ In particular within the Euro area, see Eurogroup Terms of Reference, 15 March 2010.

- In this context, Member States should encourage the right framework conditions for wage bargaining systems and labour cost developments consistent with price stability, productivity trends over the medium-term and the need to reduce macroeconomic imbalances.
- Member States with large current account surpluses, especially within the Euro area², should pursue measures aimed at implementing structural reforms conducive to strengthening potential growth and underpinning domestic demand.
- Most Member States do not tap their full employment and productivity growth potential because of sectors with low competition, a weak business environment and obstacles to employment and labour reallocation. Appropriate labour market reforms are also needed in a number of countries so as to increase wage flexibility, reduce segmentation and improve incentives to work for all.
- Many Member States also face challenges regarding increasing productivity and facilitating transition towards higher value added production and exports, and in several cases a diversification of the industrial base. This can relate to increasing capital investment, ensuring an efficient regulatory business environment, administrative efficiency as well as promoting a higher degree of competition.
- Finally, most Member States face important challenges regarding the human capital endowment and upgrading of their economies. Together with the synergies from a favourable environment for research and development, a strong human capital base is essential for high growth and international competitiveness.

² See Eurogroup Terms of Reference, 15 March 2010.

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Austria

- *Combining fiscal consolidation with a reallocation of public expenditure towards growth-enhancing items while addressing fiscal relations between different layers of government*

Reducing inefficiencies flowing from the complexity of the inter-governmental fiscal relations would help bringing public finances back on a sustainable path and free up resources for investment in R&D and education.

- *Ensuring a well functioning and stable financial sector capable of meeting the financial intermediation needs of the real economy*

The need to repay the capital injected by the state in the wake of the financial crisis underlines the need to re-establish sound and sustainable financial sector framework conditions. In addition, cross-border activities of Austrian banks need to be monitored.

- *Strengthening of the sources of domestic demand*

A policy framework aimed at strengthening structural measures, encouraging private investment and consumption, will be key to raising the economy's growth potential over the longer term.

- *Further increasing labour market participation*

Further improving the employability of older workers remains an important challenge for Austria. Moreover, additional labour supply would come from the activation of workers facing disincentives to take up work.

- *Ensuring a stronger contribution of the educational system to human capital formation and promoting innovation capacity to support investment*

Reforming of the educational system at all levels and raising the number of science and engineering graduates would help Austria to translate its relatively high spending on R&D into upgrading of the production structure of the economy towards high-tech goods and services.

Belgium

- *Ensuring the long-term sustainability of public finances in view of the high government debt level and population ageing*

Belgium's debt is high and rising and the long-term budgetary impact of aging is clearly higher than the EU average, prompting the need to consolidate public finances and reform the social security system.

- *Ensuring a well functioning and stable financial sector capable of meeting the financial intermediation needs of the real economy*

The financial situation of the banking sector remains fragile, which, given its size in the economy, underlines the importance of re-establishing a sound and sustainable financial sector framework.

- *Improving incentives to labour supply and demand by addressing the benefit system and the tax-wedge.*

Given structural problems stemming from large financial disincentives to take up work, a challenge will be to reduce further the tax wedge on labour and reform the unemployment benefit system.

- *Improving the functioning of the labour market notably by addressing the high differences in labour market performance across regions and age groups*

It will be a challenge to tackle the low employment rates of older workers, the coexistence of high and low employment areas in Belgium, a high number of job vacancies and low labour mobility (notably across regions). Addressing rigidities in the wage setting mechanism which depress labor demand especially for workers with a lower productivity would help in facilitating wage moderation.

- *Addressing the weaknesses in the business environment, notably by improving the regulatory framework and promoting competition notably in professional services and network industries but also further reforms in the retail sector.*

Belgium's competition and business environment is characterized by a high administrative burden at all levels of administrations and weaknesses in the competition framework making improvements of the regulatory framework a challenge.

Bulgaria

- *Improving the efficiency of public spending and ensuring a reallocation of public expenditure towards growth-enhancing items*

Bulgaria's challenge, given the current deficit is to proceed with a frontloaded fiscal consolidation while further deepening health care and pension systems reforms. The reallocation of public expenditure would positively contribute to its growth potential.

- *Ensuring a well functioning and stable financial sector as a precondition for a sustainable development of the economy*

Although the financial sector remained stable and profitable during the crisis, non-performing loans are still increasing and the losses will have to be absorbed by the build-up of capital buffers. In addition, the relatively low level of financial development highlights the scope for potential growth of the sector, which if sustainable, could be very important for enhancing the catching up-process of the country.

- *Ensuring better and more efficient utilisation of the economy's labour potential*

Raising participation rates would boost catching-up and potential growth. In the context of the current economic downturn, increasing unemployment risks becoming structural, which should be tackled by enhancing matching in the labour market and upgrading the skills of the labour force. Reducing labour supply resulting from massive emigration has a negative impact on potential growth.

- *Addressing the weaknesses in the business environment and enhancing administrative efficiency*

Increasing administrative efficiency, transparency of the regulatory framework and strengthening contract enforcement capacity would further improve the business environment. Improvements in this area and higher absorption of EU funds would support entrepreneurship, private investment and public infrastructure development needed to facilitate the transition to diversified and higher value added activities.

- *Improving the quality and efficiency of the education and training systems*

Completing the educational reform would help raising the skill levels in the work force, upgrading low-skilled workers and achieving better matching with the requirements and needs of the employers.

Cyprus

- *Reducing the high general government structural deficit and ensuring the long-term sustainability of public finances in view of population ageing*

Fiscal consolidation including expenditure control is crucial in stabilising the economy. To this end, accelerating pension and healthcare reform with a view of containing population-ageing related expenditure and the implementation of an effective multi-annual budgetary framework would ensure the adherence to the budgetary targets and contain expenditure over the medium-term.

- *Improving efficiency of public spending and ensuring a reallocation of public expenditure towards growth-enhancing items including weaknesses in energy and transport infrastructure.*

Improving quality of public finances could create the space for pursuing growth-friendly policies, while supporting social cohesion, and ensuring a smooth adjustment.

- *Ensuring wage and price adjustment to regain and sustain competitiveness*

Ensuring that wage developments are in line with productivity would support the country's competitiveness, particularly vis-à-vis its euro area partners, and be conducive in the adjustment of the external imbalance. More competitive price formation in product and service markets would also contribute to this objective. Cyprus' membership of the euro area reinforces the importance of this adjustment channel.

- *Promoting innovation and ICT capacity mainly of the private sector to support investment, diversification of the economy and orientation towards high value-added production and services*

With Cyprus being a mainly small, services-oriented economy with lack of industrial base, the main drivers of growth are its labour force and productivity. Investing in improving the country's innovation and ICT capacity, infrastructures, productivity and labour would facilitate Cyprus restructuring and transition to diversified and higher value added activities.

- *Restructuring the economy with emphasis on high-skilled jobs and the training of the low skilled and disadvantaged groups*

Restructuring the economy by shifting emphasis from low to high-skilled jobs and increasing labour productivity is an important challenge requiring investment in new technologies and a more efficient utilization of the highly qualified human capital thereby producing attractive jobs for university graduates.

Czech Republic

- *Reducing the high structural deficit and improving long-term sustainability of public finances*

The structural deficit was persistently high also during good times and it increased further during the crisis. Its reduction, together with healthcare and pension reforms, is important also in the long-term perspective as the country faces a big demographic challenge.

- *Improving the functioning of the labour market by addressing remaining structural weaknesses*

Despite considerable progress in recent years, several structural problems on the labour market persist, such as low employability of certain groups (low skilled workers, young people and women with children), skills mismatches and low regional mobility. Removing those weaknesses and increasing labour supply represents an important challenge as population ages and labour force turns negative.

- *Addressing the weaknesses in the business environment, including the regulatory environment and efficiency of public administration*

Businesses face a number of administrative and regulatory hurdles in several areas (tax administration, starting and closing business, access to finance for SMEs, enforceability of contracts, competition in network industries, transparency of public procurement), which hamper investment and growth.

- *Promoting innovation capacity and business R&D to support diversification of the economy and orientation towards high value-added production and services*

The country should be moving towards high-tech production and more developed services sector. The framework conditions for innovation could be strengthened in order to encourage R&D-intensive investment and increase the high-tech content of production and exports.

- *Continuing to upgrade the quality of human capital to improve labour productivity over the long term*

It will be important to strengthen the links between tertiary education, research and innovation systems. Upgrading the quality of labour force will also help further reducing skills mismatches.

Germany

- *Combining fiscal consolidation with ensuring a reallocation of public expenditure towards growth-enhancing items*

Shifting government expenditure towards growth-enhancing items (e.g. on education, R&D and gross fixed capital formation) and improving the overall efficiency of public spending, would help reconcile the necessary fiscal consolidation with strengthening potential growth.

- *Ensuring a well functioning and stable financial sector while addressing the structure of the banking sector*

Further stabilisation of the banking sector and securing access to finance, including adequate bank capitalisation, remains a precondition for a sustainable recovery. Successful restructuring of the *Landesbanken* and strengthening the regulatory and supervisory framework would not only help ensure a well functioning and competitive financial sector but also contribute to a more efficient allocation of domestic savings.

- *Strengthening domestic sources of demand*

Stronger domestic demand would also help to broaden the basis for economic growth. Sustaining high employment and real income growth, in particular through more buoyant domestic investment, and lowering regulatory barriers for the service and craft sectors could help the economy.

- *Ensuring full utilisation of the economy's labour potential*

Sustaining the recent trend of more dynamic employment growth and rising labour market participation would help counter the negative effects of demographic change on labour supply and strengthen domestic demand.

- *Improving the contribution of the education system to human capital formation*

Given the emerging shortages of high-skilled labour, further improvements of the quality and inclusiveness of the educational system remain central in supporting the employability of workers and maintaining the comparative advantage in technology-advanced products.

Denmark

- *Ensuring a well functioning and stable financial sector also in light of the high indebtedness in the household sector*

Dealing with risks stemming from high household indebtedness underlines the importance of a sound and sustainable financial sector.

- *Addressing the prolonged trend in decreasing labour productivity*

Danish labour productivity growth has lagged behind most OECD countries for a decade and a half. Reversing this trend is key to improving competitiveness.

- *Ensuring full utilisation of the economy's labour potential*

In the face of a decreasing population of working age, increasing labour force participation is a key challenge in order to secure fiscal sustainability and financing of the welfare state.

- *Addressing weak competition in parts of the Danish economy*

Weak competition, especially in the Danish services sector, is a factor causing relatively high prices and insufficient innovation capacity.

- *Improving the cost-effectiveness of education and increasing the completion rates in education*

Workers of higher qualification better absorb new technology and are less prone to unemployment and other losses of working time. Increasing the educational level of the work force would thus both increase productivity and increase labour supply.

Greece

- *Implementing the agreed frontloaded fiscal consolidation and thereafter sustaining a large primary surplus to reduce debt level and improving long-term sustainability of public finances.*

Greece's most pressing challenge is to ensure a swift reduction of its deficit and stabilise its debt dynamics in line with the EU and the IMF recommendations, while improving the management of its public finances in order to deliver pro-growth and cost effective services for businesses and citizens.

- *Strengthening the efficiency and effectiveness of the public administration, achieving a better control of public finances and improving the quality of public finances*

Improve administrative efficiency by modernising public administration and increasing transparency so as to achieve a better control of public finances and to deliver cost effective public services for businesses and citizens;

- *Ensuring a well functioning and stable financial sector including the safeguarding of banks' balance sheets*

Re-integration to global markets would flag the Greek government ability to refinance the public debt. Moreover, the safeguarding of banks' balance sheets and fostering sustainable credit growth would boost domestic demand.

- *Ensuring wage and price adjustments to regain and sustain competitiveness, through wage moderation and productivity- and competition- enhancing reforms*

The structural nature of external imbalances in Greece implies that, in the medium-to-long term, *restoring and sustaining competitiveness is a major challenge within the euro area.*

Competitiveness could be supported by tackling the rigidities in the product and labour markets and promoting innovation. Appropriate wage adjustment could be facilitated through changes to the wage bargaining system and the introduction of minimum entry level wages for groups at risk such as the young and long term unemployed...

- *Reducing the size of the informal economy by facilitating the full participation of all groups in the formal labour markets and, in tandem, improving tax administration.*

Reducing the size of the informal economy by facilitating the full participation of all groups in the formal labour markets is an important challenge that will require the implementation of a wide range of actions foreseen in the adjustment programme.

- *Overhauling the educational system in order to improve the quality of the country's human capital.*

An overhaul of Greece's educational and training system, aiming to improve performance and promote accountability will enhance the country's human capital formation.

- *Improving the business environment including by enhancing competition in services and regulated professions*

The improvement in the business environment, including the opening up of services and network industries, could make significant contribution to Greece's trend productivity and growth.

Estonia

- *Avoiding the recurrence of economic and financial imbalances, including by paying attention to credit flows, asset prices and balance sheets*

After the credit/real estate bubble of 2005-2007, policy measures are needed to ensure that economic actors deleverage in an orderly fashion and that similar imbalances do not recur once growth resumes.

- *Enhancing competitiveness and productivity, primarily in tradable sectors, by assuring cost competitiveness and continued productive investment*

In the overheating period, competitiveness was eroded as wage growth outpaced productivity growth; however, current ongoing adjustment in costs is benefitting the competitiveness of the tradables sector. Ensuring more productive investment, in particular in export-oriented industries, could raise productivity and support trend growth while sustaining competitiveness.

- *Avoiding high unemployment from becoming structural and ensuring an adequate supply of skills as well as better matching in the labour market*

In the past, skill shortages and mismatches fuelled wage inflation, while overly buoyant non-tradable sectors lured labour resources. The challenge now is to facilitate reallocation of labour to expanding sectors, before structural unemployment develops and hampers potential growth.

- *Addressing weak aggregate fixed investment, notably in cross-border and internal infrastructure*

In view of Estonia's low level of capital-deepening, infrastructure investment oriented towards mobility of goods and factors would contribute to business environment and boosting growth.

- *Increasing business R&D to support diversification of the economy and orientation towards high value-added output*

Improving framework conditions and strengthening the links between tertiary education, research and innovation could contribute to a higher value-added production and services.

Spain

- *Reducing the high structural deficit and improving long-term sustainability of public finances*

The shift to a less tax rich tax-basis economy requires an adjustment of expenditure in all levels of government to this new situation. Dealing with impacts of ageing including higher health care costs and a significant increase in the ratio of retirees per worker is an important challenge.

- *Putting in place a policy framework to address imbalances in the real estate sector and ensuring a well functioning and stable financial sector in light of these imbalances and the high indebtedness in the household sector.*

The high concentration of loans on the real state sector is at present the main risk for the stability of financial sector, given also the high indebtedness of the private sector. Policy measures to avoid asset prices bubbles, household as well as non-financial sector indebtedness would ensure that similar imbalances do not recur in the future.

- *Facilitating wage and price adjustments and enhancing productivity to regain and sustain competitiveness*

This implies fostering a change in the economy's production structure towards higher-value added activities, as well as boosting competitiveness in the economy, notably in the non-tradables sector, and enhancing export-oriented activities and the spectrum of exporters. To this end, a challenge is to ensure wage and price adjustment in particular in non-export sectors.

- *Improving the functioning of the labour market in particular as regards labour market segmentation and wage bargaining*

The low activity rate, mainly among women, limits potential growth while the present high level of unemployment increases the risk of expanding structural unemployment, which would further reduce potential growth. Appropriate reform in the labour market, including inter alia a reduction of segmentation through changes in employment protection legislation, is essential to confront these risks.

- *Ensuring a stronger contribution of the educational system at all levels to human capital formation*

Low educational achievements and high rates of early school leaving undermine the quality of human capital. The challenge is to solve the educational problems of quality (at secondary and tertiary levels of education) and quantity (at the secondary level), as well as to improve the attractiveness of vocational training.

Finland

- *Ensuring the long-term sustainability of public finances particularly in view of population ageing, while boosting productivity in public services*

Productivity advances in the provision of public services, which to a large extent fall under the responsibility of local governments, have been lagging in recent years. Boosting productivity would become increasingly crucial as the imminent population ageing raises demand for related public services and could help ensure supply of labour for the private sector.

- *Addressing vulnerabilities arising from a concentrated industry structure*

A relatively concentrated industry structure and highly specialized exports renders the economy vulnerable to sector-specific shifts. Diversification could be promoted by enhancing the diffusion of technologies and incentives for resource reallocation, including a wage formation system that would better reflect productivity differentials between companies and industries.

- *Ensuring full utilisation of the economy's labour potential*

Some segments of the population have traditionally shown a weaker labour market attachment, notably youth, migrants and low-skilled workers. Furthermore, there is scope for extending the length of working careers and for decreasing regional, sectoral and skills mismatches' weight on structural unemployment.

- *Improving competition in services including retail and wholesale trade*

The lack of competitive pressure in the domestic market, with highly concentrated business structures, is reflected in a relatively high price level. This has adverse consequences for consumers' purchasing power, and crucially also for productivity in the sheltered sectors.

France

- *Reducing the high general government structural deficit and the high government debt level*

The sustained increase in the debt-to-GDP ratio following a prolonged period of insufficient consolidation and a significant deterioration in the context of the financial crisis brings about the need for fiscal consolidation. If addressed, a lower interest service could allow for more productive public and private investment, particularly necessary to support growth and boost confidence and allow a decline in the high current saving rate of households. ...

- *Enhancing external competitiveness and fostering export-oriented activities also by improving the technology positioning of French exports*

Since 2000, the current account balance is on a deteriorating trend and has implied that net exports have been hampering growth. Improving notably non-price competitiveness will be key to boosting growth so that the French economy relies less heavily on domestic sources.

- *Improving labour market functioning focusing on higher employment rates for different age groups*

The low employment rate, which reflects the weak activity rate and a persistently high unemployment rate, impacts negatively on potential growth. Improving labour market functioning and employment creation, especially at both ends of the age spectrum and for vulnerable groups and tackling segmentation is a major challenge.

- *Further addressing the weaknesses in the business environment, including the competition framework*

A regulatory framework removing barriers in potentially competitive sectors and being more business-friendly is crucial to raise the economy's growth potential over the longer term and will also reflect in a better external competitiveness.

- *Promoting innovation capacity and business R&D investments as well as strengthening the links between tertiary education, research and innovation system.*

Evaluating and improving framework to increase business R&D and innovation, especially in small and mid-sized enterprises (SMEs) is a challenge, as well as strengthening the links between tertiary education, research and innovation system. Better targeted private R&D expenditure could stimulate total factor productivity, improve the competitive position of the country and strengthen the labour market.

Hungary

- *Reducing the deficit and the high level of government debt while continuing efforts to reallocate public expenditure towards growth-enhancing items.*

Further steps are needed to reduce the deficit and sustain declining public debt. Moreover, the successful efforts to contain the budget deficit are not fully the result of structural measures and therefore structural reform should be continued.

- *Ensuring a stable and well functioning financial sector by reducing the risk from over-exposure to foreign denominated credit*

The high level of household debt denominated in foreign currency imposes risks to the solvency of the bank sector, constrains the room for manoeuvre of monetary policy and thus may limit growth opportunities.

- *Ensuring full utilisation of the economy's labour potential, in particular through raising the participation and employment rates*

Addressing the obstacles that currently persist both on the demand and supply side of the labour market is important in order to boost potential growth and ensure economic convergence.

- *Improving business environment to facilitate the development of a more viable SME sector, and to promote favourable conditions for R&D and innovation activities*

SMEs have been hindered both by a high level of administrative burden and limited accountability and transparency in public administration and in business. Developing a dynamic business environment could enable Hungary to profit from the potential business opportunities and know-how transfer provided by the large international companies.

- *Improving the contribution of the education system to human capital formation.*

Improving the quality of the education system, including through better vocational and language training would support growth through a higher employment rate and inclusion of disadvantaged groups notably the Roma minority.

Ireland

- *Reducing the high general government structural deficit and improving long-term sustainability of public finances*

As the crisis brought about a double-digit deficit ratio and soaring public debt, continuing to pursue fiscal consolidation would help to boost market confidence, which is a prerequisite for a return to sustainable growth. Together with measures to address the increase in ageing-related expenditure, this would also create room for more productive public expenditure.

- *Ensuring a well functioning and stable financial sector in light of the high indebtedness in the household sector.*

The high exposure of the financial sector to the collapse of the property development segment and the relatively high share of Irish output accounted for by this sector underline the importance of re-establishing its soundness and well functioning so as to ensure an adequate supply of credit. Facilitating an orderly deleveraging also in the household and non-financial corporate sector in the aftermath of the property bubble would help to limit the dampening effect of deleveraging on domestic demand while avoiding negative feedback effects on credit supply.

- *Ensuring wage and price adjustment to restore and sustain competitiveness*

Promoting competitiveness will be important to support the return to and sustainability of export-led growth, also in view of the likely subdued domestic demand developments during the adjustment process. At the same time, Ireland's membership in the euro area reinforces the importance of this adjustment channel.

- *Ensuring full utilisation of the economy's labour potential*

While there is scope for female participation rates to increase, uncertainty about future migration flows following the downsizing of the construction sector means that insufficient labour supply could become an impediment to growth in the medium term.

- *Supporting the sectoral reallocation of resources towards higher value-added production and services*

Intensified re-skilling and up-skilling efforts should help to avoid the flow of the large pool of newly unemployed into long-term unemployment and inactivity. Investing for the knowledge-based economy, including in the areas of R&D, ICT and education, while further upgrading physical infrastructure, would support the sectoral shift towards higher value-added activities.

Italy

- *Consolidating public finances so as to reduce the high government debt*

The very high government debt highlights the importance of the committed fiscal consolidation. .. Even though the budgetary impact of ageing in Italy is lower than the EU average, pursuing a durable fiscal consolidation and firmly putting the government debt ratio on a steadily declining path remains nevertheless a key challenge.

- *Ensuring better alignment of wage and productivity developments while increasing productivity so as to restore and sustain competitiveness*

In order to allow wages to better reflect productivity developments, which has been very subdued since the end of the 1990s, there is scope for better balancing wage co-ordination at the national level with appropriate wage adjustment at the decentralized level, including in the public sector. This would also help to address regional imbalances in the labour market.

- *Ensuring full utilisation of the economy's labour potential, by continuing to increase the employment rates of the youth, women and older workers, also with a view to reducing regional disparities*

Despite considerable progress since the mid 1990s, employment and activity rates of women, youth and older workers remain significantly lower than the euro area average, with large regional disparities.

- *Addressing the weaknesses in the business environment, including the further opening up of services and network industries, and improving administrative efficiency*

Remaining weaknesses in Italy's business environment and competition policy framework may hamper business activity and entrepreneurship. The regulatory framework still entails lengthy and costly procedures for enforcing contracts, dealing with licences and starting a business; the overall administrative burden on firms is high and the degree of competition in services remains relatively low.

- *Enhancing human capital, also by improving the link between education and the labour market, and promoting innovation capacity to support investment and orientation towards high value-added production and services*

Encouraging a higher level of expenditure on R&D in the private sector would help to enhance the innovative capacity of firms and ensure the development of high-technology activities. At the same time, addressing the current weaknesses in the education system, including significant regional disparities in outcomes, would provide the skills and human capital that are needed for such move.

Lithuania

- *Reducing the high general government structural deficit and improving long-term sustainability of public finances*

The currently high general government deficit requires considerable consolidation efforts. Moreover, given the Lithuanian demographics and due to the projected increase in pension expenditure, ensuring the longer-term sustainability of public finances is also a challenge.

- *Avoiding the recurrence of economic and financial imbalances, paying attention to credit flows, asset prices and balance sheets*

After the credit/real estate bubble of 2005-2007, policy measures are needed to ensure that economic actors deleverage in an orderly fashion and that similar imbalances do not recur once the economic growth resumes.

- *Promoting rebalancing of the economy towards the tradable sector and high value-added activities including services, and raising productivity levels*

Rebalancing the economy towards the tradable sectors will require increases in productivity through higher levels of investment in physical and human capital.

- *Avoiding high unemployment from becoming structural and ensuring better matching in the labour market*

High unemployment as a consequence of the severe recession reinforces the risks of raising skill gaps vis-à-vis labour demand. The challenge now is to facilitate reallocation of labour to expanding sectors before structural unemployment develops and hampers potential growth.

- *Addressing the weaknesses in the business environment, ensuring adequate access to finance for companies with a view to favour productive investment and adequate inter-connected energy grids.*

Fostering a dynamic and competitive business environment could provide an important boost to trend growth including through adequate credit access for viable businesses, with the support of EU structural funds, underpinning the necessary rebalancing of the economy.

Luxembourg

- *Reforming the pension system in order to ensure the long-term sustainability of public finances in view of the population ageing*

The increase in age-related public expenditure in Luxembourg up to 2050 is projected to be the strongest in the EU and will essentially be the result of the generosity of the pension system.

Reforming the pension system is thus a major challenge for sustaining potential growth in the longer term.

- *Ensuring a well functioning and stable financial sector, in particular through enhanced European and international cooperation in regulation and monitoring*

The financial sector has played a very important role in sustaining high growth rates and it will be important to ensure its well functioning and stability while also identifying other sources of growth. One aspect that could be useful in this process is to enhance international cooperation in regulation and monitoring.

- § *Ensuring full utilisation of the economy's labour potential, in particular among the unemployed, the young and older workers*

The employment rate of residents is low at both ends of the age spectrum because youth unemployment is higher than the EU average and the pension system provides very high replacement rates and often allows workers to retire before the statutory pension age. Raising labour supply could have important contribution to potential growth and public finance sustainability in the medium term.

- *Improve the contribution of the education system to human capital formation*

Addressing weaknesses in the educational system will remove an important handicap for residents in the quest for jobs.

Latvia

- *Reducing the high general government structural deficit.*

As a condition for receiving Balance of Payments assistance, Latvia has committed itself to achieving the Maastricht budget deficit target by 2012. The authorities' commitment to reach this goal will be crucial for Latvia to regain and maintain access to international financing at reasonable rates and avoid a further accumulation of debt.

- *Ensuring a well functioning and stable financial sector in the light of the ongoing deleveraging of the private sector.*

After the very marked lending boom, the household and corporate sectors are indebted, which puts a drag on consumer spending and the investment needed to kick-start growth, while representing a risk to the banking sector. Moreover, avoiding a recurrence of asset price bubbles would ensure a sustainable price level convergence.

- *Promoting rebalancing the economy towards the tradable sectors and raising productivity levels*

In the boom years the tradable sector was largely neglected, losing much of its competitiveness. For Latvia to be able to gain new export markets and produce more innovative products, productivity and skill levels need to be raised significantly.

- *Avoiding high unemployment from becoming structural and ensuring better matching in the labour market*

Latvia has the highest unemployment rate in the EU. Long-term structural unemployment could damage the skills and motivation of the labour force resulting in further emigration.

- *Addressing the weaknesses in the business environment, ensuring efficient use of EU structural funds and adequate access to finance for companies with a view of favouring productive investment*

The banking system experienced severe losses and asset impairments in the downturn, and current lending practices are extremely cautious. Fostering dynamic business environment could provide an important boost to trend growth.

Malta

- *Ensuring the long-term sustainability of public finances in view of ageing of population*

The impact of demographic ageing in Malta on age-related expenditure is projected to be one of the most significant in the EU, both in health care and pensions. This challenge is amplified by low employment rate of older workers.

- *Ensuring the alignment of wages and productivity growth to sustain competitiveness*

Protecting competitiveness is important for a very small and very open economy like Malta's. A more efficient and flexible wage setting process could contribute to competitiveness allowing better alignment of wage and productivity developments including in the public sector. Malta's membership of the euro area reinforces the importance of this adjustment channel.

- *Support the diversification of the economy and a further move to higher value-added activities by raising investment in new areas of growth*

Encouraging further diversification of Malta's economic base towards the high value-added segment of production would help Malta reduce its reliance on tourism and manufacturing of electronics. Investing further in renewable energy sources as a new area of growth would offer the additional benefit of reducing Malta's high dependency on imported oil for energy.

- *Ensuring better utilisation of the economy's labour potential, in particular that of women and older workers, and improving the skills base of labour force*

Malta's low employment rate stems from very low female and older worker participation rates, which in turn may reflect a wide range of institutional features, such as childcare provision, education and training policies and retirement arrangements. Improving labour supply and the skills base of the labour force, particularly targeting the skills required to boost R&D and innovation and facilitate a further shift towards higher value-added sectors, is important for boosting potential growth.

- *Addressing the weaknesses in the business environment and enhancing competition*

The small size of Malta's economy lends itself to market imperfections, leading to high mark-ups in certain sectors and calling for an enhanced role of the competition authority. Lowering administrative and regulatory burdens could also make Malta a more attractive investment location.

The Netherlands

- *Ensuring the long-term sustainability of public finances in view of population ageing*

The impact of the ageing population is significantly above the EU average, due to relatively high increases in both pension and long-term care expenditure, leading to high risks to the sustainability of public finances.

- *Ensure a well functioning and stable financial sector capable of meeting the financial intermediation needs of the real economy*

The relatively large and open Dutch financial sector was hit hard by the crisis, triggering a wide range of government interventions. The risks to the stability of the financial sector have not fully disappeared and require close monitoring of cross border activities and the supply of credit.

- *Strengthen the sources of domestic demand*

Structural reforms promoting private investment and consumption would help raising the economy's growth potential over the longer term.

- *Ensuring full utilisation of the economy's labour potential*

The total amount of hours worked in the Netherlands is one of the lowest in the EU, partly resulting from financial disincentives to work more hours.

- *Promoting innovation capacity to support investment and orientation towards high value-added production and services*

Private Dutch R&D and innovation expenditures are relatively low. The underperformance of the Netherlands in this area may negatively affect future economic growth and the competitiveness of the Dutch economy. Addressing this challenge will trigger positive spillovers throughout the economy.

Poland

- *Reducing the high general government structural deficit and ensuring a reallocation of public expenditure towards growth-enhancing items including infrastructure*

The structural deficit was high also during good times and it increased during the crisis. Reducing it, including through reforms to enhance the quality of government spending, is a major challenge for the short and medium run.

- *Addressing weak aggregate fixed investment, including in the transport and energy infrastructure*

The underdeveloped transport infrastructure is a key obstacle to investment. Invigoration of physical infrastructure would help reducing regional disparities ensuring territorial cohesion and boost potential growth. The existing energy network is outdated and inefficient.

- *Addressing high regulatory and administrative burden and accelerating financial deepening in order to further improve the business environment*

The inefficient and burdensome public administration, including procedures for starting businesses, and underdeveloped financial sector, in particular corporate debt market, undermine growth and competitiveness.

- *Further improving the functioning of the labour market notably by addressing the low participation rate*

Labour force participation is low, especially on both ends of the working age distribution. In view of unfavourable demographic developments, improving labour market participation and performance is a priority for the coming decade. It will also be important to improve mobility of labour across regions and sectors.

- *Promoting innovation capacity to support investment, diversification of the economy and orientation towards higher value-added production and services by strengthening the links between tertiary education, research and innovation system*

Insufficient links between businesses and public research institutes and skill mismatches hamper the innovation capacity of the economy. Strengthening the knowledge triangle is therefore an important challenge.

Portugal

- *Reducing the high government structural deficit in line with fiscal commitments in the context of the Stability and Growth Pact while ensuring a reallocation of public expenditure towards growth-enhancing items*

Following the rapid decline in tax revenues and increase in public spending as a share of GDP brought about by the current crisis, rebalancing the government budget is a challenge both for the immediate and longer term. Expenditure developments call for particular attention in order to ensure their sustainability in a context of low GDP growth over the medium term and of high and rising government debt.

- *Dealing with the risks stemming from the high levels of indebtedness of the non-financial sector and ensuring a stable and well functioning financial sector*

The negative feedback loop from real economy to the financial sector is another main type of risk to financial stability, which is heightened in the case of Portugal by higher-than-average debt levels and subsequent pressure for deleveraging. Household sector deleveraging is needed and will be an important challenge, especially as interest rates begin to rise.

- *Ensuring wage and price adjustment to regain and sustain competitiveness*

Promoting competitiveness will be important to support the return to and sustainability of export-led growth, also in view of the likely subdued domestic demand developments during the adjustment process. Cost competitiveness as well as promoting wage moderation and flexibility have an important role to play in this respect.

- *Improving labour market functioning by tackling in particular labour market segmentation and fostering flexibility*

Labour market functioning can be improved by reducing the duality of the labour market and by allowing for more flexibility in working arrangements to accommodate heterogeneity of production and work specificities.

- *Improving the contribution of the education and training systems to human capital formation with a view to support the restructuring of the economy towards higher value-added production and services*

To raise productivity growth allowing the catching-up of the Portuguese economy, it is necessary to address weaknesses of a more structural nature, including the relatively low levels of formal education of the labour force and the low educational achievements of current students. This makes the enhancement of the human capital factor by means of improving the efficacy and effectiveness of education and training systems an important challenge.

Romania

- *Reducing the high general government structural deficit while generating a reallocation of public expenditure towards growth-enhancing items including infrastructure and ensuring long-term sustainability of public finances in view of the population ageing*

The structural deficit was persistently high during good times and increased further during the crisis. Its reduction is important also in a long-term perspective and could be supported by reforms of pension and healthcare systems as the country faces a major demographic challenge. Within the context of the BoP assistance program, Romania has agreed to take further consolidation measures aimed at further sizeable reduction in the structural deficit.

- *Strengthening the efficiency, effectiveness and independence of the public administration, including the absorption capacity of EU structural funds*

Important reforms are needed in public administration to limit tax evasion, improve absorption of EU structural funds, strengthen the regulatory environment, and increase efficiency of the public sector

- *Ensuring a well functioning and stable financial sector, in particular by continuing to ensuring sufficient buffers in the banking system to face direct and indirect credit risks*

The Romanian banking sector faced stress at the beginning of 2009, reflecting negative balance sheets effects from the depreciation of the RON given the high share of foreign-denominated loans.

- *Further improving the functioning of the labour market especially as regards wage bargaining*

The system of collective bargaining at national level, which is regulated by law and sets national minimum pay and conditions applicable to all employees, has been a drag on competitiveness and growth, affecting particularly young and long-term unemployed.

- *Ensuring a stronger contribution of the education system at all levels to human capital formation*

Romania's performance in terms of primary and secondary education is poor relative to other EU countries, which is slowing the transition of the economy and, more generally, the real convergence process.

Sweden

- *Ensuring a well functioning and stable financial sector, facilitating deleveraging of the household sector*

Strengthening the financial and supervisory framework and dealing with the risks stemming from a high and rising level of household sector indebtedness, which is contributing to rising house prices, are important challenges.

- *Avoiding high unemployment from becoming structural and improving labour market inclusiveness*

It is important to promote a quick absorption of unemployment in the wake of the recession, which could lead to weakening of human capital and hysteresis effects. In the longer run it is crucial to make use of the full potential of the labour supply by raising the inclusiveness of groups with a currently loose connection to the labour market, such as young persons and immigrants.

- *Addressing weaknesses in the business environment, including by increasing competition*

Challenges stemming from shortcomings in the level of competition in some areas, such as markets where private and public companies compete with each other and in public procurement, are important and could be addressed by effectively making use of the new powers granted the Competition Authority.

- *Promoting innovation capacity by strengthening the links between tertiary education, research and the corporate sector*

Addressing the issues concerning converting large investments in R&D into growth-enhancing productive innovations, including by improving the attitude towards entrepreneurship, could help boost potential growth in the long run.

Slovenia

- *Reducing the general government structural deficit and ensuring the long-term sustainability of public finances, particularly given population ageing in particular through reforming the pension system.*

The old-age dependency ratio and consequently pension expenditure are projected to increase significantly over the coming decades, posing a risk for the long-term sustainability of public finances, especially given the currently low employment rate of older workers. The high general government deficit in 2009 compounds the budgetary impact of population ageing on the long-term sustainability challenge.

- *Enhancing flexibility while tackling segmentation in order to improve labour market functioning and ensuring a better alignment of wages and productivity.*

Employment protection for workers with permanent contracts is higher than for workers with fixed-term contracts. In addition, "student work" constitutes a largely unregulated labour market.

- *Increasing competition in the service sector and addressing other weaknesses in the business environment*

A range of difficulties in the business environment gives rise to inefficiencies and elevated business costs, particularly for SMEs. This includes high mark-ups and high concentration in certain services sectors, impediments to getting credit and registering property and gaps in transport infrastructure.

- *Promoting innovation capacity and increasing overall R&D investments*

R&D expenditure in Slovenia still lags behind the EU level and is relatively inefficient while employment in high-tech sectors and the share of innovative SMEs remain low.

- *Refocusing human capital investment, especially in tertiary education, on higher value-added activities*

Tertiary education is insufficiently oriented towards emerging labour market needs and the restructuring of the economy. Furthermore, it operates with relatively low staff/student ratios.

Slovakia

- *Reducing the high general government structural deficit and ensuring long-term sustainability of public finances in view of the population ageing*

The significant structural deficit persisted during good times and increased further during the crisis, also taking into account some uncertainty regarding potential output. Expected growth of age-related expenditure, especially in the health sector, poses an additional challenge in the longer term.

- *Ensuring reallocation of public spending towards growth-enhancing items, including education, R&D and infrastructure*

The share of spending in growth enhancing items, in particular R&D, education and capital expenditure is low in Slovakia compared to its peers. Increasing their share would support real convergence of the economy, given diminishing scope for technological catch-up.

- *Implementing the necessary reforms to ensure better quality of public spending and in particular that the additional expenditure for education and R&D are used efficiently*

There are inefficiencies in Slovakia's education and R&D systems. Addressing them, in particular by strengthening links between research and business sectors, and refocusing education towards labour market needs would support potential output.

- *Ensuring wage and price adjustment to sustain competitiveness, while improving the business environment*

The rapid appreciation of the Slovak REER over the recent years points to a need for careful monitoring of relative prices and costs vis-à-vis Slovakia's competitors. Improvements in the business environment would help maintain competitiveness.

- *Ensuring full utilisation of the economy's labour potential, by tackling the long-term unemployed and marginalised groups*

Unemployment, including long-term unemployment, remained high even during the economic boom. Structural problems on the labour market need to be addressed.

United Kingdom

- *Reducing significantly the high general government deficit*

Following the rapid decline in tax revenues and increase in public spending as a share of GDP brought about by the financial crisis, rebalancing the general government budget is a challenge both for the immediate and longer term.

- *Ensuring a well functioning and stable financial sector capable of meeting the financial intermediation needs of the real economy*

Both the relatively high share of UK output accounted for by the financial sector and the large capital flows required to fund a rebound in private investment underline the importance of re-establishing a sound and sustainable financial sector framework.

- *Ensuring that constraints on growth posed by household and government sector indebtedness are countered by a rebalancing towards net exports*

Household sector deleveraging and fiscal consolidation are likely to limit growth in the short to medium term, but sterling's depreciation since 2007 should be conducive to minimising the resulting output loss by both reducing import growth and boosting UK exports.

- *Facilitating an increase in aggregate fixed private investment*

In view of the UK's typically low rates of capital deepening, a lasting reinvigoration of fixed capital accumulation could provide an important boost to trend growth.

- *Improving the contribution of the education system to human capital formation including through a broader skills base*

Weaknesses in the lower and intermediate skilled segment of the labour force make the broadening of access to opportunities to develop such skills an important challenge.